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The tax barrier to retirement prosperity in New Zealand

September 2013

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FinancialServicesCouncil.
growing and protecting the wealth of New Zealanders

The tax barrier to retirement prosperity in New Zealand

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EXECUTIVE SUMMARY

The Financial Services Council of New Zealand commissioned this paper on how our current tax rules affect savings, retirement provision and New Zealand's overall economy[1]. The conclusion reached is that tax changes are necessary. The issues are not easy but the do nothing option accepts that:

- Our economy will continue to have lower productivity growth.
- We will continue to have higher overseas debt and thus be more vulnerable to international events.
- Housing will increasingly be unaffordable for the average New Zealand household.
- Increasingly people will have inadequate savings available to fund a comfortable retirement.

New Zealand Superannuation ("NZ Super") provides the first pillar of our retirement income policy. By itself it is not sufficient. In general, most New Zealanders consider about twice the current level of NZ Super is needed for a comfortable retirement. This requires New Zealand Superannuation to be supplemented by private savings – a retirement fund of $300,000 to $450,000. For most people their first priority is likely to be paying off the home mortgage and then meeting their retirement savings target by building up investments. Internationally, a normal way of doing this is by saving throughout one's working life in a retirement fund investing mainly in financial instruments. In New Zealand this is likely to be a KiwiSaver scheme. New Zealanders are not, however, saving enough in this way. Our current tax rules are a major reason for this.

KiwiSaver and PIEs

KiwiSaver is a voluntary savings scheme designed to encourage New Zealanders to save for their retirement. The government provides members with a one-off (kick-start) payment of $1,000 to everyone who joins the scheme. The government also provides an annual member tax credit (MTC) of 50 cents for every dollar of member contributions up to a maximum of $1,042 contributions per annum (so that the maximum annual MTC is $521). Contributions to the scheme are made by members and their employers. Employees can contribute 3%, 4% or *8% of their salary or wages to KiwiSaver. People can also make other extra payments into their accounts. The employer contribution is a compulsory 3% of salary and wages. Savings in KiwiSaver accounts cannot in most circumstances be withdrawn until the member reaches the age of 65 years.

Contributions (employer and member) into the scheme remain taxable as income. Scheme earnings are taxable on an annual basis as they arise. This is either as a widely held superannuation scheme with the rate being a flat 28%, or as a Portfolio Investment Entity (PIE) where the rate is 10.5%, 17.5% or a maximum of 28% depending on the overall income of the member. A KiwiSaver PIE pays tax on the scheme income based on the individual rates of members as notified to the provider. Provided those rates reflect the members actual income under rules set out in the legislation, members face no further tax on the income attributed to their accounts. Withdrawals from KiwiSaver are not taxed.

The tax treatment of KiwiSaver compares unfavourably with that of home ownership or an investment in rental property. Home ownership is outside the tax net and not taxed. Income from rental property (the rent) is taxable and expenses deductible but a large part of any return is normally in the form of gain in the value of the property. This is most likely to be a tax free capital gain but even if this is taxable the tax is levied only when the house is sold which can be 20 or more years after the gain first arises.

[1] This Paper has been produced with the assistance of Paul Mersi (a former tax partner of PricewaterhouseCoopers and a member of the Savings Working Group), and Robin Oliver MNZM (a former Deputy Commissioner of Inland Revenue in charge of tax policy). The Technical Annex is based on modelling work done for FSC by EY, with the particular input of Peter Goss (Director, Transaction Advisory Services) and Aaron Quintal (Director, Tax) both of whom were previously in Treasury tax policy and Blair Tomblin (Senior Consultant, Tax) who was with IRD Policy Advice Division. The Paper has been reviewed by Professor John Piggott of the University of New South Wales and a member of the Henry Review in Australia and the modelling work has been reviewed by John Savage a former NZIER Senior Economist.

Our Income Tax is Skewed Against Savings in Financial Instruments

The problem is that our income tax is heavily skewed against such a savings programme. Internationally, New Zealand stands out. No other country has our combination of comprehensive taxation of the return on debt instruments as they accrue, no superannuation tax concessions, no tax on capital gains on rental properties, and the unconstrained deductibility of the nominal value of interest against other income on debt used to purchase rental property. As a result New Zealand stands out compared to comparable economies by having one of the highest tax biases in favour of investing in real estate and against investing in financial assets (such as KiwiSaver and bank term deposits).

It is difficult to make clear international comparisons of effective tax rates given various assumptions that need to be made and different tax laws. The following table is drawn from work undertaken by tax reviews in the United Kingdom and Australia and work commissioned by the Financial Services Council in New Zealand. Despite the difficulties of international comparisons it demonstrates how much New Zealand stands out in its adverse tax treatment of investments in financial assets (bank accounts and superannuation). In the United Kingdom and Australia superannuation is tax subsidised (it faces a negative tax rate) whereas in New Zealand the equivalent KiwiSaver investment is taxed over its life at much higher than the statutory rate. Rental property by contrast is more lowly taxed in New Zealand because of the absence of a tax on the capital gains and the deductibility of the nominal value of interest against other income on debt used to fund the purchase of rental property. Details of how these rates are calculated are set out in the Technical Annex. [2]

INTERNATIONAL COMPARISONS OF EFFECTIVE TAX RATES (ETRs)

	Bank Account [3]	Rental Property	Super-annuation
United Kingdom	67	48 (0% leverage)	(40) [4]
Australia	Not calculated – above the statutory rate of 46.5	46 (0% leverage)	(30) [5]
New Zealand	49	24 [6] (0% leverage	38 [7]

The tax rates for UK and Australian superannuation shown in (brackets) are negative tax rates. They are tax subsidies so that in effect people are paid by the tax system to hold these investments.

Home ownership stands at one extreme as being the most highly tax favoured form of investment. For a home owner every dollar used to repay the mortgage reduces mortgage interest costs that are non-deductible and have to be paid out of after-tax wages. The return on an investment in mortgage repayments is thus totally tax-free. Being a tax-free investment the tax benefit or subsidy is equal to the total equity investment in the home times the income a person would get from investing this money in, for example a bank account, times the person's marginal tax rate. So if a person has $200,000 equity in a home which they would have otherwise received 6% interest on, and they are on the top 33% marginal tax rate, then the benefit is $3960 per annum ($200,000 at 6% at a 33% tax rate). This is the tax the person would have paid had he or she put the funds into a bank account instead of buying a house.

As the Savings Working Group noted, ownership of rental accommodation is also tax favoured to a lesser extent. This is largely due to the non-taxation of capital gains and the ability to deduct the inflation component of interest costs against other income. By contrast, an investment in debt instruments is tax penalised with an effective tax rate up to almost 50%.

The tax penalty on savings is made up of a number of components.

- Income tax inherently penalises savings whereas GST does not. If future and present consumption are treated as two goods, income tax, by taxing interest income, taxes future consumption more than present consumption.
- This penalty on saving is especially harsh on long-term or accumulating savings since it is higher the more years over which the saving takes place. As the Savings Working Group noted, this by itself means that, compared with GST, income tax over a person's working life, halves the sum available for retirement.

The uneven income tax law compounds the problem. Whereas it is estimated that debt instruments face an effective tax rate of 50% or more, home ownership faces a 0% rate, with other investments in between these extremes. This is caused by the fact that debt instruments are taxed on:

[2] In all cases a saving period of 25 years is assumed. In the rest of this Paper the base period used for analysing effective tax rates is 20 years. The differences are, however, marginal. If 20 years is used for New Zealand the real ETR for superannuation reduces from 38.24% (after 25 years) to 38.05% (after 20 years). For rental property the real ETR (0% leverage) reduces from 23.78% to 23.42%. In all cases the effective tax rates are for those on the top marginal tax rate. [3] Tax rates are higher than the statutory rate because of the taxation of the inflation component of interest. [4] Employer contribution pension scheme. [5] Australian superannuation guarantee scheme. [6] In the rest of this Paper the more realistic 80% gearing assumption is used as a base case. This produces an effective tax rate of 1.47% for rental property held for 20 years. [7] KiwiSaver scheme.

- A comprehensive basis (taxing any change in capital value as income). There is no tax-free capital gain as opposed to, for example, an investment in rental accommodation.
- An accrual rather than realisation basis (taxing interest annually as it arises). Tax is levied each year on interest whereas, even if another investment is taxed on capital gains, tax is deferred until that gain is realised on being sold. With accumulating savings, compounding investment income is reinvested each year as fund capital. When tax is levied on an accrual basis, these annual additions reinvested in the fund are only the after-tax amount. When tax is levied only upon realisation, the savings are built up much more rapidly out of pre-tax returns as there is no tax deduction from the amount of earnings that is re-invested each year.
- The part of interest which is not really income but simply compensation for inflation over the term of the investment. This is why the tax rate on financial instruments, such as bonds, can exceed the statutory rate of say 33%.

Rental property (after home ownership) is probably the most tax preferred investment alternative to saving via financial instruments such as KiwiSaver. The tax preferences for rental property increase the longer it is held until sold and the more highly it is geared (financed by debt). This is demonstrated in the following table.

HOW LEVERAGE AND THE PERIOD OVER WHICH PROPERTY IS OWNED IMPACTS ON EFFECTIVE TAX RATES

Years before rental property is sold	Leverage ratio			
	0%	50%	80%	100%
10 years	22.68%	10.22%	(4.55%)	(6.05%)
20 years	23.42%	12.83%	1.47%	(2.83%)
30 years	24.13%	14.79%	5.20%	(1.02%)
40 years	24.80%	16.37%	7.90%	0.37%
50 years	25.45%	17.71%	10.02%	1.55%

The table assumes a 33% marginal tax rate (the top rate) for a person holding property as an investment. The table uses 100% gearing as one example. This means that the rental property is fully funded by debt and there is no equity investment. Such gearing is possible if an investor uses equity in their own home as security to purchase rental properties. A professional couple who have $400,000 equity in their $500,000 home can borrow $1 million to purchase two $500,000 houses to rent out. The couple have then used $200,000 of equity in their own home so that the bank is prepared to lend the full $1 million to purchase the rental properties. For tax purposes the two rental properties are 100% geared (funded by debt). The couple can then deduct the full interest cost, to the extent it exceeds rental income, from their other professional, income.

The above table is expressed in terms of real effective tax rates.

Real Effective Tax Rates and Required Marginal Tax Rates to Level the Playing Field

The Real Effective Tax Rate (Real ETR) is the tax wedge between the post-tax return and the pre-tax real return. The required marginal tax rate is the statutory rate required to produce the same return from different investments assuming both have the same pre-tax nominal return. When considering what rate is required to, for example, make an investment in KiwiSaver as attractive from a tax viewpoint as an investment in rental housing, the appropriate rate to consider is the required marginal tax rate. These terms are explained in more detail in the Technical Annex.

"New Zealand stands out compared to comparable economies by having one of the highest tax biases in favour of investing in real estate and against investing in financial assets (such as KiwiSaver and bank term deposits)."

The Tax Bias has Important Consequences

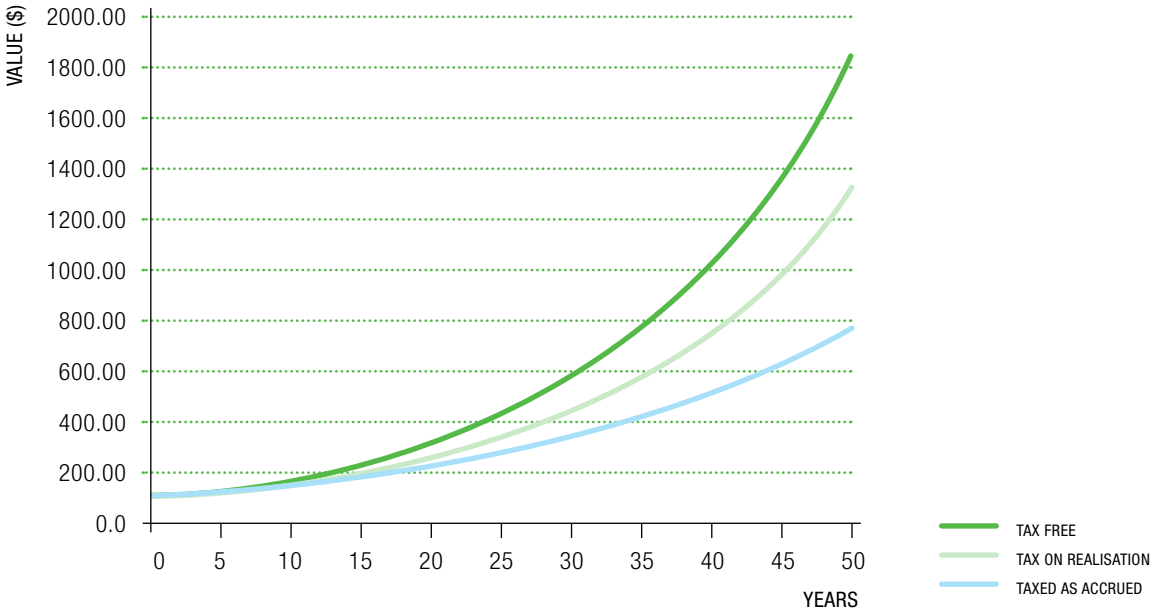
This tax bias against financial instruments used to build up a retirement fund matters. It penalises such savings and makes it hard for people to save to meet their retirement objective. The Savings Working Group estimated that on reasonable assumptions up to 90% of a person's retirement income comes from the tax penalised compounding investment income and only 10% from the initial annual contributions out of salaries and wages made over a person's working life.

When it comes to accumulating savings whether tax is levied each year as income accrues (the tax treatment of KiwiSaver and bank term deposits) versus taxing only when the savings are withdrawn (the tax treatment of a property taxed on gains when it is sold) makes a big difference to the eventual post-tax saving fund, the longer the savings accumulate.

The retirement income that a person can expect to be generated from KiwiSaver or similar savings is therefore largely going to be from the compounding income the scheme generates. Taxing this compounding income substantially reduces the source of 90% of expected retirement income.

This simply reflects the importance of compounding interest in building up a substantial fund of savings over time. This is demonstrated in the following graph. This shows how an initial $100 deposit grows over 50 years to $1,842 if untaxed, $1,319 if taxed only when withdrawn and only $782 if taxed annually on an accrual basis. In other words, in this example taxing the deposit earnings reduces its value to the saver by about one third but taxing those earnings as they accrue year by year reduces the savings by 57%.

THE IMPACT ON VALUE OF TAXATION ON A REALISATION BASIS



Assumptions: nominal return of 6%, marginal tax rate of 30%. $100 is invested for up to 50 years.

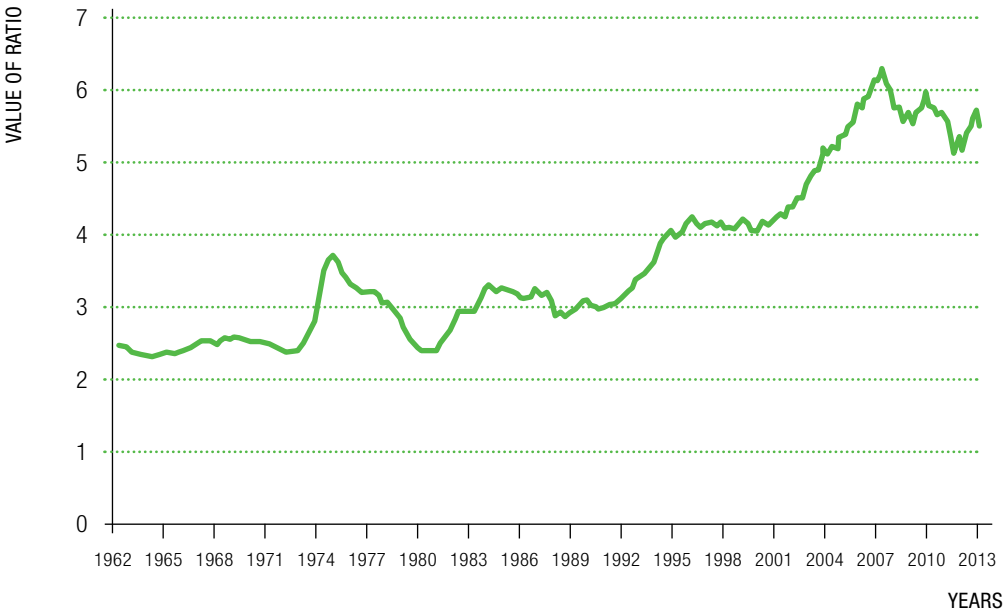
This tax bias also encourages people to invest in housing not financial instruments. Whereas financial investments are likely to be used to increase the productive potential of the economy, more jobs and higher future incomes, tax induced housing investment is likely to flow through to higher land prices. This does little if anything to increase the real wealth of New Zealand nor our ability to earn higher incomes. Moreover, much of our housing investment is likely to be funded ultimately by offshore borrowing. The tax system encourages offshore borrowing so that New Zealanders can bid against each other to increase land prices.

As a result housing becomes increasingly less affordable for lower income earners as demonstrated by the following graph.

Numerous government reports have concluded that this flows through to a low performing economy, lower incomes and less jobs, an economy that is vulnerable to offshore financial crises, unaffordable housing costs, and a higher exchange rate that makes it difficult for exporters to compete on world markets.

This is the result of tax rules that penalise saving in financial instruments and provide subsidies to housing and alternative investments. The level of subsidy for housing is very high. The tax subsidy on owner occupied housing is estimated to be $4 billion per annum. This is about twice the level of assistance the Crown spends each year to meet the housing needs of lower income New Zealanders through rent subsidies for state home tenants and in the accommodation supplement. It is no wonder that an estimated 60% of household wealth is in the form of housing. It is not a surprise that most New Zealanders do not think they are saving enough to fund the sort of retirement they want.

RATIO OF AVERAGE HOUSE PRICE TO AVERAGE HOUSEOLD DISPOSABLE INCOME



Source: Reserve Bank of New Zealand (Briggs and Ng, 2013).

"The level of subsidy for housing is very high. The tax subsidy on owner occupied housing is estimated to be $4 billion per annum. This is about twice the level of assistance the Crown spends each year to meet the housing needs of lower income New Zealanders through rent subsidies for state home tenants and in the accommodation supplement."

Options for Change

Common sense calls out for change. But the options for change are not easy.

This paper canvasses numerous tax reform options. These range from replacing income tax with GST, to taxing capital gains, to changes in the manner in which housing or financial instruments are taxed. History demonstrates that any realistic reform needs not only to have economic merit, but it also needs to be feasible and politically palatable. On that basis, reform involving a substantial tax on currently tax exempt owner occupied housing does not seem viable.

A more modest and realistic objective is to recognise that home ownership will remain the priority for most people. We should, however, ensure that the tax system provides a level playing field with respect to how people invest their discretionary savings over and above their home ownership needs. This requires a more even tax treatment of savings for retirement in financial assets and investments in rental accommodation. To get a more even tax treatment, the tax on savings in financial instruments needs to be lowered closer to the effective rate applying to rental property. The effective tax rate on rental property varies according to the assumptions made as to, for example, the length of time the rental property is held and the degree to which an investment in such property is geared (the level of debt used to buy a rental property). The higher the level of mortgage debt held in the rental property and the longer the time it is owned the lower is the effective tax rate.

The Financial Services Council commissioned work from independent experts on the various effective tax rates on different types of investments under current New Zealand tax rules. It shows how effective tax rates vary greatly and how much housing is tax preferred relative to, say KiwiSaver. The results are summarised in the table below.

REAL EFFECTIVE TAX RATES ON DIFFERENT TYPES OF INVESTMENTS

	Tax rate					
	0%	10.5%	17.5%	28%	30%	33%
Owner-occupied home, debt-free		0%	0%	0%	0%	0%
General rental property (100% leverage)	0%	(1.13%)	(1.75%)	(2.52%)	(2.65%)	(2.83%)
General rental property (80% leverage)	0%	0.38%	0.68%	1.20%	1.31%	1.47%
General rental property (50% leverage)	0%	4.27%	7.01%	10.99%	11.73%	12.83%
General rental property (no leverage)	0%	7.70%	12.70%	20.02%	21.38%	23.42%
PIE / KiwiSaver with no subsidies[8]	0%	14.27%	23.78%	38.05%	38.05%	38.05%
Foreign shares	0%	13.13%	21.88%	35.00%	37.50%	41.25%
Bank account term deposit	0%	15.60%	26.10%	41.70%	44.70%	49.20%

Where the tax rate is in (brackets) it represents a subsidy to the investor.

[8] The KiwiSaver government incentives encourage people to join a scheme but do not increase returns at the margin and so do not change those results. The rental properties are assumed to be held for 20 years in these examples.

The tax rates necessary to even the playing field between rental property (with different levels of leverage) and KiwiSaver at the different marginal tax rates are as illustrated below:

REQUIRED MARGINAL PIE TAX RATES TO EVEN THE PLAYING FIELD

Tax rate	Rental property – no leverage		Rental property – 50% leverage		Rental property – 80% leverage		Rental property – 100% leverage	
	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate
10.5%	7.70%	5.70%	4.27%	3.30%	0.38%	0.30%	(1.13%)	(1.10%)
17.5%	12.70%	9.30%	7.01%	5.40%	0.68%	0.60%	(1.75%)	(1.70%)
28.0%	20.02%	14.70%	10.99%	8.40%	1.20%	1.00%	(2.52%)	(2.40%)
30.0%	21.38%	15.70%	11.73%	9.00%	1.31%	1.10%	(2.65%)	(2.60%)
33.0%	23.42%	17.20%	12.83%	9.80%	1.47%	1.20%	(2.83%)	(2.70%)

Assumes the property is sold after 20 years

The most reasonable assumption seems to be rental property leveraged to 80% and a tax rate of 28% (the top PIE tax rate). This shows that the required tax rate on KiwiSaver to level the playing field with an investment in rental property is 1%.

Details on these rates and assumptions used are provided in the Technical Annex.

This work estimates that, on reasonable assumptions, the highest tax rate on savings in a KiwiSaver scheme needs to be lowered from the current 28% to 1% assuming that the alternative investment to KiwiSaver is an investment in rental property that is 80% geared and is held for twenty years until sold. In other words, only if investment returns in KiwiSaver are taxed at a rate of about 1% would that investment offer a comparable after-tax return to investing in rental property geared to 80% (assuming the same nominal pre-tax return). This paper concludes that such a reduction in the tax on saving in financial instruments could be achieved by either lowering the tax on all financial instruments (by, for example excluding the inflationary compensation embedded in interest from the tax base) or by providing lower tax rates on locked in savings such as KiwiSaver schemes. Ideally a lower scheme tax rate would be based on a proportion of the appropriate marginal tax rate of each individual scheme member but, if this is not practical, a single lower rate seems justified. The options here have advantages and disadvantages and these are canvassed in the paper.

In effect we are saying if we cannot fix the comprehensive income tax base we should fix the tax rates on locked-in savings like KiwiSaver to ensure there is no barrier to sensible saving behaviour.

Clearly any reduction to the tax rate on financial instruments or KiwiSaver-type schemes would have a fiscal cost. However, if necessary, work commissioned by the Financial Services Council demonstrates that most of any fiscal cost could be met by removing the current government funded incentives for KiwiSaver (the $1,000 kick-start payment and the member tax credit) currently estimated to cost some $740 million per annum. While the KiwiSaver incentives act as a strong incentive to enrol in KiwiSaver, they do not offset the tax bias that exists for investment in rental property over investments in KiwiSaver. Over time it is estimated that the KiwiSaver incentives could be used to fully pay for (in net present value terms) a flat KiwiSaver tax rate of 6.38% if the incentives were removed from 2015. If the $1000 upfront incentive was retained and only the $521 annual tax credit was removed from 2015 that would fund a 7.96% KiwiSaver PIE flat rate. (This assumes the $521 annual tax credit is indexed to the future growth in wages and that no behaviour change occurs). It is thus possible, at no fiscal cost, to go a long way towards removing the current bias against saving by way of financial instruments like KiwiSaver.

FISCALLY NEUTRAL KIWISAVER PIE TAX RATES

Reform Option	NPV 0 Tax Rate – $521pa MTC only removed	NPV 0 Tax Rate – $521pa MTC and $1000 kick-start removed
Phase out incentives from 2015	9.92%	8.63%
Remove incentives from 2015	7.96%	6.38%

The above demonstrates that if necessary a significant reduction in the KiwiSaver tax rate could be achieved at no fiscal cost. We also explored the options of a fiscally neutral reduction in KiwiSaver tax rates while retaining the progressivity of rates so that a greater benefit would be able to be delivered to lower income savers. This produced the results in the following table:

EXAMPLES OF FISCALLY NEUTRAL PROGRESSIVE PIE TAX RATES

Progressive PIE tax rates	Low rate	Middle rate	Top rate
Current PIE tax rates	10.5	17.5	28.0
Fiscally neutral if only $521pa MTC removed	4.3	8.0	15.0
Fiscally neutral if $521pa MTC and $1000 kick-start removed	3.5	6.4	12.0

Details of the tax rate numbers required to equate saving through KiwiSaver with investing in a rental property, a comparison of current effective tax rates on different types of investments and fiscal implications of reform options are included in Chapter III and in the Technical Annex to this paper.

A high tax rate on KiwiSaver investments has consequences for the level of retirement savings in New Zealand. A marginal tax rate on KiwiSaver above that applying to rental property investments (such as the prevailing 28% rate for many savers) means that the rental property provides much better after-tax returns. The earlier a person starts saving for their retirement in KiwiSaver, the higher the real effective tax rate impact becomes due to, in large part, the taxation of the inflation component of investment returns. This is illustrated in the following Table:

"Saving a little for a long time is therefore not a tax effective retirement savings strategy for New Zealanders but saving over a shorter time period is unaffordable."

EFFECTIVE TAX RATE IMPACTS INCREASE THE LONGER THE TERM OF SAVINGS

Years of saving	Annual savings required		Impact of tax on cumulative return
	No tax	With Tax	
10	$37,481	$40,479	44.3%
20	$15,112	$17,918	47.7%
30	$8,024	$10,529	51.2%
40	$4,736	$6,930	54.7%
50	$2,948	$4,845	58.2%

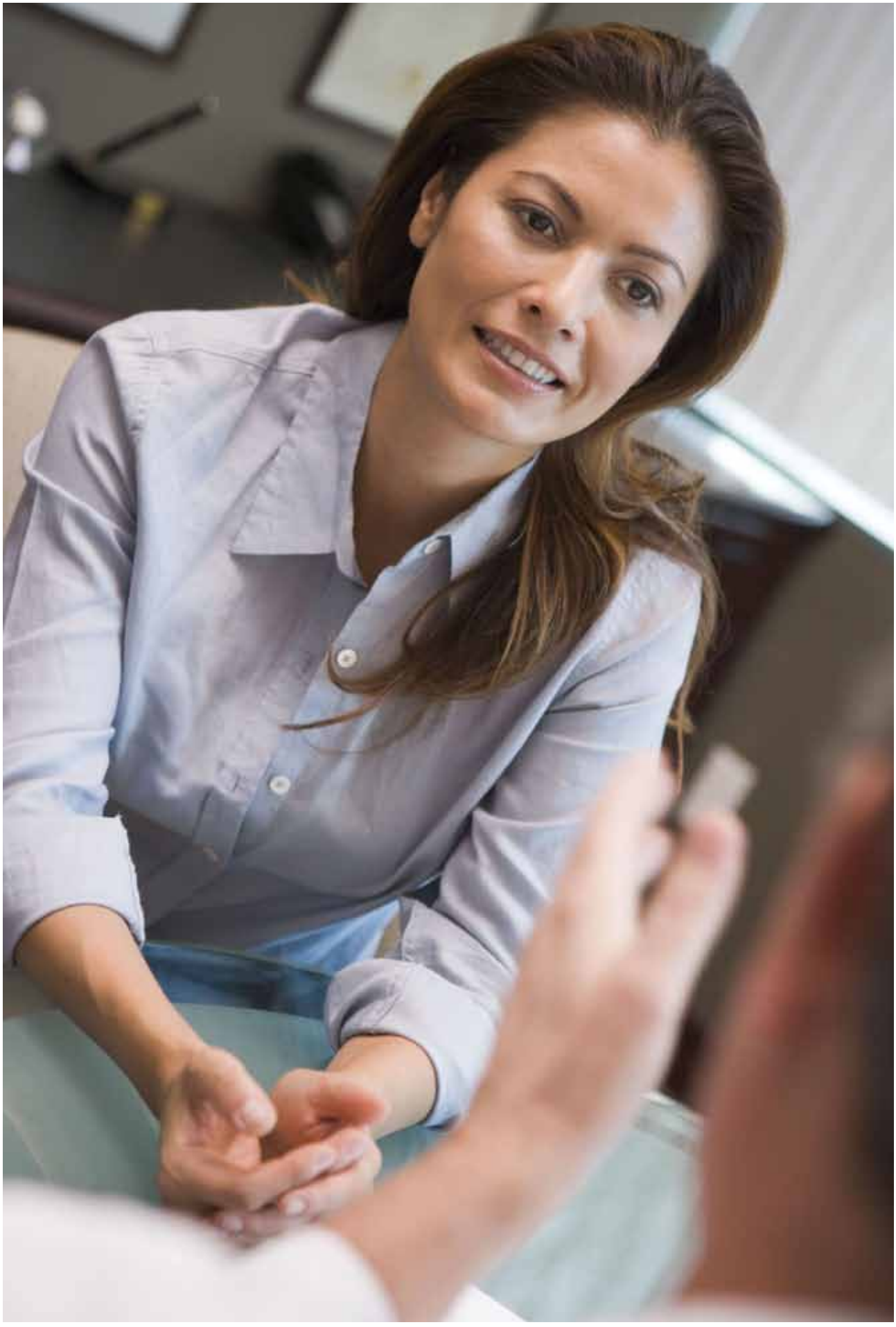
Assumptions: 4% real rate of return, 2% inflation, 28% PIR (Prescribed Investor Rate). Required annual savings shown is in 2013 dollars, and is assumed to increase with inflation.

As a consequence, a person would effectively be incentivised to delay saving for their retirement until a later time, thereby reducing the real effective tax rate impact on their KiwiSaver investment but greatly increasing the amount of contributions needing to be made annually in order to have enough savings for a comfortable retirement. Saving a little for a long time is therefore not a tax effective retirement savings strategy for New Zealanders but saving over a shorter time period is unaffordable.

As noted above, most New Zealanders consider that private savings of $300,000 to $450,000 (i.e. in addition to NZ Super) are needed to be enough to live comfortably in retirement. To accumulate $450,000 of savings in KiwiSaver, a person would need to save approximately $7,000 annually over 40 years. In doing so, however, the person's cumulative investment returns would be reduced by 54.7%. That is, their after-tax return at the end of 40 years would be 54.7% lower than it would be in the absence of tax, a reduction of more than half. The impact of tax on the cumulative return for a 10-year savings horizon falls to 44.3% but the required annual savings increase to more than $40,000 per year, a prohibitive amount for the average New Zealander.

It is also noted that the current high taxation of compound returns in financial instruments is another reason why New Zealand financial institutions are reluctant to provide annuity type products so that lump sums can be turned into pensions for retirement and New Zealanders are reluctant to buy such products.

A much lower tax rate for investments in financial instruments or KiwiSaver-type schemes, as proposed in this paper, would reduce the disincentive effect and encourage more people to save for their retirement from an earlier stage of life. This is critical to ensure that New Zealand builds a more solid economy for the future and that people have a comfortable standard of living in their retirement years.



1 The tax barrier to retirement prosperity in New Zealand

Introduction

The cost of government-provided "NZ Super" is a significant fiscal burden on our government (and taxpayers) and that cost is forecast to increase over time as the population ages and longevity increases. There have been a number of proposals to reduce this expected cost, such as raising the age of entitlement. Despite the high fiscal cost of NZ Super, it does not provide what most New Zealanders consider to be a comfortable retirement income. In general, most New Zealanders consider about twice the current level of NZ Super is needed for a comfortable retirement[9]. In other words, for most people, their NZ Super will need to be supplemented by income from investments of about $17,000 a year (the after tax level of superannuation for a single person living alone).

Building up such a level of private retirement income requires substantial savings, a lump sum on retirement at age 65 years of between $300,000[10] and $450,000[11] would be needed. It would be consistent with government policy for most New Zealanders to aim to build up such a retirement fund mainly via their KiwiSaver scheme. However, under current policy settings this is not happening. One major reason is because there is a major tax impediment to doing so. Tax rules heavily discriminate against savings in financial assets (whether directly or via KiwiSaver or other types of funds) relative to investing in home ownership. Home ownership is outside the income tax net. An investment in a home faces a zero tax rate. This tax-free status of home ownership is in effect a tax subsidy for this form of investment. The tax benefit or subsidy is equal to the total equity investment in the home times the income a person would get from investing this money in, for example a bank account, times the person's marginal tax rate. So if a person has $200,000 equity in a home which they would have otherwise received 6% interest on, and they are on the top 33% marginal tax rate, then the benefit is $3960 per annum ($200,000 at 6% at a 33% tax rate). This is the tax the person would have paid had he or she put the funds into a bank account instead of buying a house.

The option to rent or buy a house is strongly influenced by this tax difference. By owning your own home you do not have to pay rent from your after-tax income. So another way of looking at the tax benefit is that by owning your own home you get the benefit of the rental value of your home grossed up by your marginal tax rate.

By contrast, the Savings Working Group estimated that the marginal effective tax rate on debt instruments (in which a large percentage of KiwiSaver funds can be expected to be invested) is about 50%.[12] This estimate has been confirmed by work undertaken by independent experts for the Financial Services Council (summarised in the Technical Annex to this paper). What this means is that people need to save almost twice as much when investing savings in financial products (such as KiwiSaver) in order to generate the same income as investing in home ownership.

We estimate later in this paper that the government effectively provides something like over $4 billion per annum in tax subsidies to owner-occupied housing. This housing tax subsidy is of the same order as the total income of managed funds (including KiwiSaver funds) and is about twice the $2 billion the government spends directly each year on housing assistance.[13] It is difficult to persuade people to invest in financial assets and products when government tax policy is now so heavily skewed towards encouraging people to invest in home ownership instead.

It is appreciated that the bias in favour of home ownership is unlikely to be removed entirely. Nor is home ownership the only form of investment favoured by our current tax system over saving in financial instruments or products. Investment in rental housing is also tax favoured albeit to a lesser extent. In looking at comparable overseas tax jurisdictions, New Zealand stands out. No other comparable country has the combination of comprehensive taxation of the return on debt instruments as they accrue, no superannuation tax concessions and no tax on capital gains on rental properties. As a result New Zealand stands out by having one of the highest tax wedges between investment in real estate and financial assets.

It is difficult to make clear international comparisons of effective tax rates given various assumptions that need to be made and different tax laws. The following table is drawn from work undertaken by tax reviews in the United Kingdom and Australia and work commissioned by the Financial Services Council in New Zealand. Despite the difficulties of international comparisons it demonstrates how much New Zealand stands out in its adverse tax treatment of investments in financial assets (bank accounts and superannuation). In the United Kingdom and Australia superannuation is tax subsidised (it faces a negative tax rate) whereas in New Zealand the equivalent KiwiSaver investment is taxed higher than the saver's statutory marginal tax rate. Rental property by contrast is more lowly taxed in New Zealand because of the absence of a tax on the capital gains. Details of how these rates are calculated are set out in the Technical Annex. [14]

[9] Horizon Research poll conducted for the Financial Services Council, December 2011. [10] Based on the Retirement Planning calculator on www.sorted.org.nz for a person retiring at 65 years of age requiring an indexed pension of $17,000 post-tax. [11] ANZ Media Release 15 August 2012. [12] Saving New Zealand: reducing Vulnerabilities and Barriers for Growth and Prosperity, Savings Working Group Final Report to the Minister of Finance, January 2011, "Savings Working Group Report 2011", page 83. Final report and other material available on-line: http://www.treasury.govt.nz/publications/reviews-consultation/savingsworkinggroup [13] About $620 million on Income Related Rents, $1,240 million on the Accommodation Supplement and $170 million on Temporary Additional Support per annum. [14] In all cases a saving period of 25 years is assumed. In all cases the tax rates are for those on the top marginal tax rate.

INTERNATIONAL COMPARISONS OF EFFECTIVE TAX RATES (ETRS)

	Bank Account[15]	Rental Property	Superannuation
United Kingdom	67	48 (0% leverage)	(40)[18]
Australia	Not calculated – above the statutory rate of 46.5	46 (0% leverage)	(30)[19]
New Zealand	49	24[20] (0% leverage	38[21]

To correct the tax system's current bias against saving via financial instruments, it may be more realistic to aim for a more even treatment of savings in financial assets and investment in rental accommodation rather than trying to offset the heavier bias in favour of home ownership. This would recognise that retirement saving and home ownership are the two main channels of long term life cycle saving with, in New Zealand, investment in rental accommodation (after home ownership) being the main alternative to saving via financial assets as a form of retirement savings.

The Savings Working Group estimated that rental accommodation investment faces a tax rate in the order of 15% to 20%. The Savings Working Group took into account only the non-taxation of capital gains on rental property. When other factors, such as the deductibility of nominal interest costs, are also taken into account, the tax bias in favour of rental property increases. The Technical Annex to this paper calculates that rental property generally has an effective tax rate of 1.2 % (if the property is 80% geared and is held for twenty years until sold). Even with 50% gearing, the effective tax rate is around 10% for many taxpayers. These highly concessionary rates arise in large part from the deductibility of interest costs on mortgages and the absence of tax on the capital gains, thereby clearly demonstrating the preferential tax treatment of rental property.

The impact of these policy settings is felt well beyond retirement policy. Government spending, private saving, housing, the exchange rate, our vulnerability to international financial crises are all inter-related issues and as various government reports have noted the tax treatment of savings is a critical factor in all these areas. This is the subject of this paper. What is the impact of the current tax treatment of savings and what are the options to produce a less distorted outcome so that: the New Zealand economy invests its savings more productively than it does now, we reduce our vulnerability to overseas developments, we increase overall welfare, and secure better retirement outcomes?

[15] Tax rates are higher than the statutory rate because of the taxation of the inflation component of interest. [16] Employer contribution pension scheme. [17] Australian superannuation scheme.
[18] In the rest of this Paper the more realistic 80% gearing assumption is used as a base case. This produces an effective tax rate of 1.47% for 20 years. [19] KiwSaver scheme.

Taxation and Savings

The largest cost by far borne by those saving for retirement is the taxation of the return on savings. As this paper explains, the effect of taxation can be to reduce a person's private retirement income on a given level of savings by almost half. This is because the New Zealand government, like governments of other developed economies, relies heavily on income tax to meet its revenue demands. Income tax, by reducing the return an individual receives on his or her savings, significantly adversely impacts savings. That is especially the case with long term or accumulating savings where savings are made over time and the return is reinvested each year in the instrument or savings fund. This type of saving is the basis for successful retirement savings plans. The tension between the need to raise government revenue via an income tax and the adverse impact this has on accumulating savings is managed in most other countries by generous tax concessions for retirement savings. New Zealand moved away from retirement saving tax concessions in 1987-89. This makes it all the more important that our tax policy settings reach an appropriate balance between revenue and other objectives.

This paper considers these issues largely in the context of New Zealand's existing and traditional tax policy settings of a comprehensive income tax and goods and services tax. In recent years other models for taxation have been advanced that differ significantly from this by, in particular, recommending that labour and capital income and the income of residents and non-residents be taxed, not on the same basis as under a comprehensive income tax, but at different rates or bases. A notable example of this line of thinking has been the Mirrlees Review in the United Kingdom.[20]

The thinking behind this is that labour income and capital income should be thought of as two economically distinct bases. The underlying assets that generate these forms of income are quite different, and their tax treatment should reflect their particular features.

The comprehensive income tax treats income from capital and labour in the same way. The ideal of a comprehensive income tax is most often associated with three mid-twentieth century economists – Robert Haig and Henry Simons in the United States of America and Sir John Hicks in the United Kingdom. The idea of such a tax as some kind of ideal persisted for several decades, coming under challenge only in the 1970s and 1980s where the analysis demonstrated that a zero capital income tax would be optimal under certain assumptions concerning market completeness and liquidity [21]. The underpinning economic analysis is essentially that which leads this report to assert that heavy capital taxation impedes productive investment. More recent academic analysis is more nuanced, but there is still no economic justification for taxing labour and capital at the same rate, and much to be said for taxing capital income at a lower rate.

An income tax which exempts the taxation of saving is really an expenditure tax (the equivalent under certain assumptions of relying solely on GST for revenue). This is closer to what economists might think of as a tax structure supporting efficiency and growth. In most developed countries this is achieved through two provisions in the income tax code: the owner-occupier housing exemption, and the non-taxation of pension fund earnings. Most life cycle saving takes place through these two channels. Assuming that much private saving in an economy is undertaken for life cycle purposes, these two provisions serve to remove the double taxation of saving, and reduce the inter-temporal price distortion inherent in the comprehensive income tax.

Further, if it is accepted that the income taxation (imputed rent and capital gain) of the owner-occupied home is not currently a feasible policy option, then the pension fund earning-exemption removes a major inter-asset price distortion as well. It has been demonstrated that the efficiency costs of adverse asset allocation can be very serious.[22] Again, this economic analysis underpins the report's concerns about the differential taxation of real estate and financial assets.

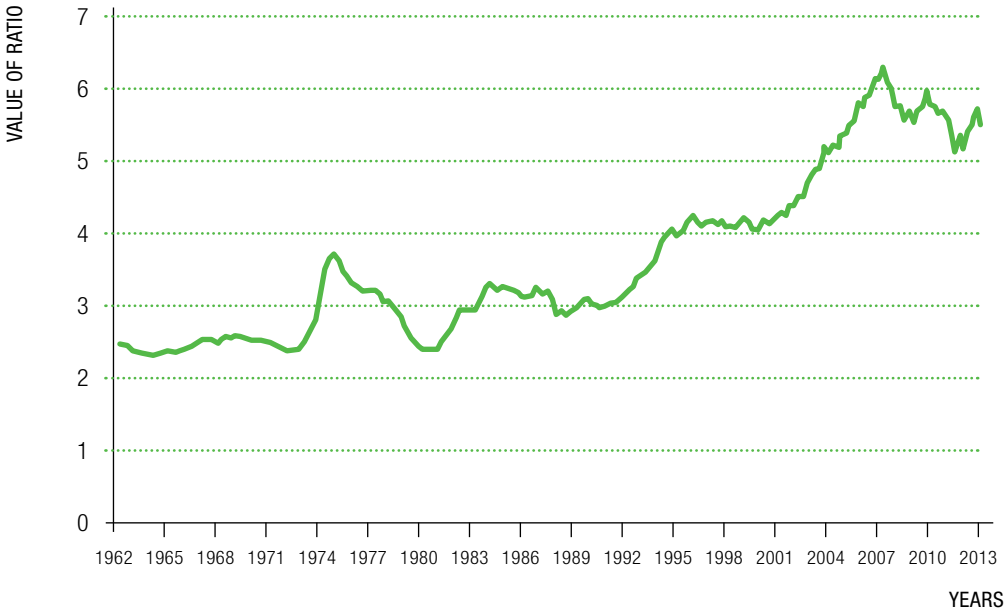
A fundamental shift in our tax policy away from the traditional comprehensive taxation of all forms of income has been considered in New Zealand by a number of reports, most recently by the Treasury and Inland Revenue paper on the Taxation of Savings and Investment Income [23]. That report rejected such an approach for New Zealand, at least in the meantime. Critically, successive governments have also consistently resisted such changes. Given this state of affairs, we have chosen in this paper not to pursue such arguments further (although options such as moving to a Nordic type tax system are briefly canvassed later in this paper) and proceed with our analysis and recommendations on the basis that any future policy changes only have a chance of proceeding if they can be justified in the context of a comprehensive income tax. In other words, if we cannot fix the tax base we should look to fix the tax rates on locked-in savings like KiwiSaver to ensure these are not a barrier to sensible savings behaviour.

[20] Tax By Design, The Mirrlees Review, Institute of Fiscal Studies, Oxford University Press, 2011. [21] See, for example, Chamley, C "Optimal Taxation of Capital Income in General Equilibrium with Infinite Livrs", Econometrica, volume 54 (3) May 1986, pages 607-622. [22] See Hamilton, R and Whalley, "The Tax treatment of housing in a dynamic sequenced general equilibrium model", Journal of Public Economics, volume 27 (2) July 1985 pages 157 – 175. [23] Treasury Report T2012/2470 of 27 September 2012.

The issue of the appropriate tax policy settings for savings is critical for the ability of people to provide a comfortable retirement income by saving a relatively small proportion of their income throughout their working years (saving a little for a long time). However, the issue of how best to tax savings reaches well beyond retirement income policy. Numerous government publications over the last decade have emphasised how this is also critical to New Zealand's economic performance – productivity growth, international vulnerability and our competitiveness and exchange rate. It has also been emphasised that tax and savings policy impacts on New Zealand's ability to provide affordable housing.

Our generous tax treatment of housing relative to other investments flows through into higher land and house prices. As a result, over time there has been a steady increase in the multiple of house prices to incomes which is continuing. This is demonstrated in the following graph.

RATIO OF AVERAGE HOUSE PRICE TO AVERAGE HOUSEHOLD DISPOSABLE INCOME



Source: Reserve Bank of New Zealand. (Briggs and Ng 2013)

Examples of recent reports in this area are:

- McLeod 2001 Tax Review – "the McLeod Review 2001".[24]
- Report of the House Prices Unit, Department of the Prime Minister and Cabinet 2008 .[25]
- Report of the Capital Market Development Taskforce, 2009 – "the Capital Market Report 2009".[26]
- Report of the Victoria University of Wellington Tax Working Group, 2010 – "the TWG Report 2010".[27]
- Budget 2010.
- Report of the Savings Working Group, 2011- "the SWG Report 2011".[28]
- Productivity Commission, Housing Affordability inquiry 2012 – "the Productivity Commission Report 2012".[29]
- A Treasury/Inland Revenue Report on the Taxation of Savings and Investment Income of September 2012 – "the Officials' 2012 Report".[30]
- Business Growth Agenda Progress Report, February 2013.[31]

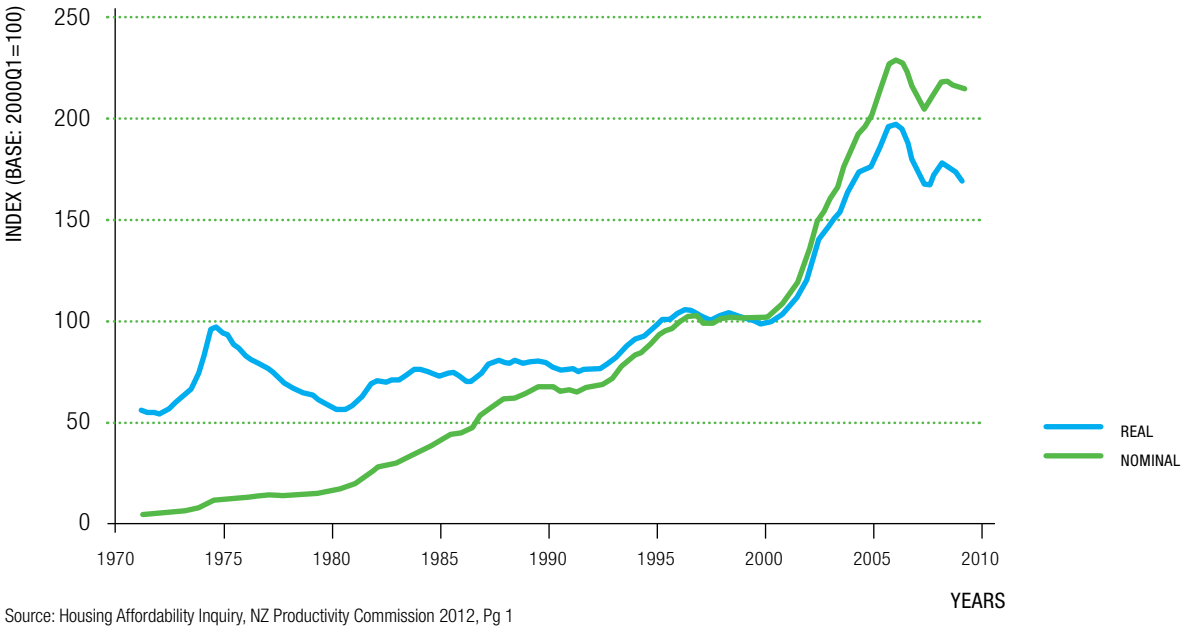
All these reports agree that tax has a major impact on savings. Higher savings better employed would lead to capital deepening (more capital per worker) and greater productivity, less overseas borrowing and lower vulnerability, more affordable housing and less pressure on the exchange rate. These reports also point to the tax preferences for housing especially owner-occupied housing. There is general agreement that, to the extent to which it is equity funded, owner occupied housing is an untaxed investment whereas the effective tax rate on bonds and similar financial instruments used to fund retirement savings is higher than the statutory tax rates. This distorts investment decisions by favouring investment in housing rather than savings in financial instruments (the latter likely to contribute to growth in jobs and productivity). Much of this housing over-investment appears to be reflected in excessive urban land prices. There is general agreement in the reports that while our tax rules discourage saving in general, their most adverse impact is to misallocate what savings New Zealanders are able to accumulate by directing them into real estate with consequentially high land and housing prices. This can be seen in the steep rise in New Zealand house and land prices over recent years as shown in the graph below which measures land and house prices over time. [32]

House and land prices are also influenced by other factors such as the impact of monetary policy on interest rates, levels of immigration, growth in incomes, the number of homes being built and restrictions on access to land suitable for housing.

[24] McLeod Tax Review, Tax Review 2001- Final Report, The Treasury, New Zealand, 2001. [25] Final Report of the House Prices Unit: House Price Increases and Housing in New Zealand, department of the Prime Minister and Cabinet, 2008. [26] Capital Markets Matter – Report of the Capital Market Development Taskforce, December 2009. [27] A Tax System for New Zealand's Future – Report of the Victoria University of Wellington Tax Working Group, January 2010. [28] Saving New Zealand: Reducing Vulnerabilities and Barriers for Growth and Prosperity, Savings Working Group Final Report to the Minister of Finance, January 2011. [29] New Zealand Productivity Commission, The Housing Affordability Inquiry, 2012. [30] Treasury/ Inland Revenue, Taxation of Savings and Investment Income", T2012/2470 of 27 September 2012. [31] Business Growth Agenda Progress Report, February 2013. [32] New Zealand Productivity Commission, Housing Affordability Inquiry, page 29.

HOUSE PRICES REAL AND NOMINAL

Note: Real house prices are measured as the ratio of actual house prices to the CPI



Source: Housing Affordability Inquiry, NZ Productivity Commission 2012, Pg 1

We save too little and invest those savings badly.

We need to move away from tax rules that encourage overseas debt, low levels of productive assets and inadequate savings in financial instruments. This paper surveys the economic costs of the current tax system. The next two chapters consider in more detail the impact on retirement savings and housing. The choices are difficult. The effective tax rate on equity funded owner-occupied housing is zero so, to equalise the tax impact on savings, the tax rate on savings in financial assets would need also to be zero. Unless there is political support for increasing tax on housing (in particular on owner-occupied housing, which has been politically unpalatable to date) then things will stay the same. Options to at least reduce the distortions created by current policy must be explored as the do-nothing option accepts that:

- Our economy will continue to have lower productivity growth.
- We will have higher overseas debt and thus are vulnerable to international events.
- Housing will increasingly be unaffordable for the average New Zealand household.
- Increasingly people will have inadequate savings available to fund a comfortable retirement.

New Zealand tax rules give rise to two problems in the savings area: they discourage savings, and they distort the way what saving we do is allocated. Ideally both should be addressed. Chapter II focuses on the misallocation of saving away from savings in financial assets that can be available to fund retirement incomes. This is generally conceded to be the more significant problem. The Chapter canvasses options to reduce the tax preference for housing. This would be the better way to reduce incentives the current tax rules provide for housing and land investment as opposed to accumulating savings in financial assets. It is stressed that these options, to be effective, need to target owner-occupied housing (where the tax incentives are highest) as well as rental housing. If policies along these lines are not possible, consideration needs to be given to reducing the tax bias favouring housing by reducing tax on accumulating savings in financial assets. Chapter III canvasses options in this area. The conclusion reached is that the more viable options that can be seen as best fitting within current tax policy settings would be to provide tax relief to all savings by, for example, not taxing a component of the return on savings simply attributable to the effects of inflation or providing lower tax rates on (potentially restricted locked-in) savings in KiwiSaver and similar locked-in schemes.

Measures along these lines would obviously need to take into account the government's fiscal position. As this paper later demonstrates, measures along these lines could be funded by removing or reducing the up-front KiwiSaver incentives costing $740 million per annum[33] the government now provides. That would clearly have a lower impact on participation in KiwiSaver if it were accompanied by measures that would make participation less voluntary. In any case the critical need is to establish a pathway for reform and to implement that as fiscal circumstances allow.

[33] Budget 2013 Kick-start $165 million and KiwiSaver Tax Credit $575 million.

The Impact on the Level of Savings

The need to address the tax treatment of savings is often seen as an issue relevant to our level of retirement provision. In part that is the case, but it is only part of the story. The issues raised in this paper need to be addressed not only as part of sensible retirement income policy but also if New Zealand is to meet our economic expectations.

As the February 2013 Business Growth Progress Report noted:[34]

"New Zealand's level of national savings has tended to be lower than our level of investment. For several decades, we have supplemented national savings with foreign savings, which has led to growing offshore debt. Increasing national savings and reducing offshore debt will help make New Zealand more resilient to external shocks and will put downward pressure on interest rates and the exchange rate."

"It is important that government policy settings provide New Zealanders with the right incentives to save. This means appropriate tax settings that do not discourage saving or distort how people save, as well as good information about investment performance."

In short, current policy does not provide New Zealanders with the right incentives to save but discourages and distorts saving decisions. As noted above, this impacts not only on retirement policy, but also macro-economic performance. This is true even under the assumption that our tax system will continue to be based on a comprehensive income tax as the norm.

A higher level of New Zealand savings, other things being equal, can reasonably be expected to increase New Zealand's economic performance over time. It would have broad positive economic effects. These were canvassed in the Report of the Savings Working Group 2011. Fundamentally if we save more today we have more tomorrow but less today.

The Savings Working Group Report noted that available economic literature came to two tentative conclusions with respect to the effect of reducing tax on savings to increase savings:

"The first is that tax incentives increase retirement saving mostly by reallocating existing savings. Secondly, while there is some evidence that tax incentives for retirement savings may produce a small amount of new savings, the increase is lower than supporters of tax incentives often advocate. However, tax incentives may reduce the relative tax advantage of other classes of investments (such as owner-occupied housing or investment [in rental accommodation] made for capital gain) and thus improve the overall allocation of savings".[35]

"For anything other than a revenue-neutral shift away from income tax, there is a high degree of uncertainty over whether or not cutting the tax rate on private saving alone will increase or decrease national saving. Thus decisions on whether or not to cut taxes on capital income should not be made primarily in terms of their effects on the quantity of national savings." [36]

In a joint Treasury/Inland Revenue Report of 27 September 2012[37] officials considered whether changing tax settings could lead to a material improvement in economic performance by improving efficiency, incentives to save and invest, and reduce macroeconomic vulnerabilities. That Report considered a number of tax reforms and recommended further work be undertaken on reducing personal income tax rates and on reforming the tax rules for Portfolio Investment Entities. This is in line with options canvassed in Chapter III.

[34] Business Growth Agenda Progress Report, February 2013, page 22. [35] Page 78. [36] Page 79. [37] Taxation of Savings and Investment Income T2012/2470 of 27 September 2012.

Savings and Retirement Income Provision

New Zealand's retirement income provision rests on two pillars. First, NZ Super which is a moderate taxpayer funded pension paid to everyone reaching a certain age (presently 65 years) and meeting certain residency tests. The pension is modest ($20,802 per annum gross for a single person living alone and $31,449.60 gross for a married couple). This finances a modest retirement lifestyle lower than the expectations that most people have for their retirement and the pressure on future government finances means that this is unlikely to significantly increase in real terms. For New Zealanders to have more than this minimum retirement lifestyle they need to provide for themselves by saving to build up capital that can be invested to produce a supplementary retirement income. This is the second pillar of our retirement income provision.

While people can build up a retirement fund in a number of ways (such as building up a business or buying and paying off a house) for the great majority of New Zealanders, the expectation is that this will be by way of saving directly in financial assets (such as shares or bank deposits) or using one of the products provided by the financial services industry, and in particular a KiwiSaver fund. In most other countries with a developed income tax, retirement savings funds receive very generous income tax concessions. Generally, contributions into retirement savings can be paid from pre-tax income, the fund earnings can accumulate tax-free, and tax is deferred until savings are paid out in retirement as a pension (an EET regime). That is not the case in New Zealand. Since 1989 our general rule has been that contributions to retirement savings should be made out of after-tax income, the fund should be taxable as and when income is received or accrues, and payments out of the fund, as a lump sum or pension, should be tax-free. This is a non-concessionary income tax regime – a TTE system.

This is a long-standing New Zealand tax policy position and the merits or demerits of our unique approach to the taxation of retirement savings are not argued here. However, this does place considerable importance on ensuring that the tax system, while not providing concessions for retirement savings, does not go beyond that and penalise retirement savings or distort decisions between different forms of savings. If such savings are penalised, this is likely to:

- Create a disincentive to save for retirement since people could then gain a greater benefit from doing something else that is not so tax-penalised (including spending more and saving less).
- Reduce the funds most people have for their retirement on the basis that, except for very high income earners, people save for retirement out of money not needed for day to day living costs. They may not be in a position to increase savings to compensate for a lower after-tax return from those savings.
- Reduce overall household savings in the economy on the basis that retirement savings makes up a large part of household savings (aside from home ownership).
- Place increased fiscal pressure on the government to provide a more generous retirement income through NZ Super.

The strategic issue is therefore to have all savings taxed to an equal extent but, if this is not possible, to remove or at least reduce tax penalties on accumulating savings so that savings are not directed by the tax system away from financial instruments. Accumulating savings are long term savings that are re-invested within the instrument or the savings product so that savings grow through a combination of contributions and the return on the capital saved. Accumulating savings also manifest themselves in the form of directly held bonds, government stock, bank term deposits and bank accounts. While people can have various objectives for their long term savings (purchase an expensive asset such as a house, start a business, precautionary savings and so forth) a normal purpose of long term savings is to fund retirement.

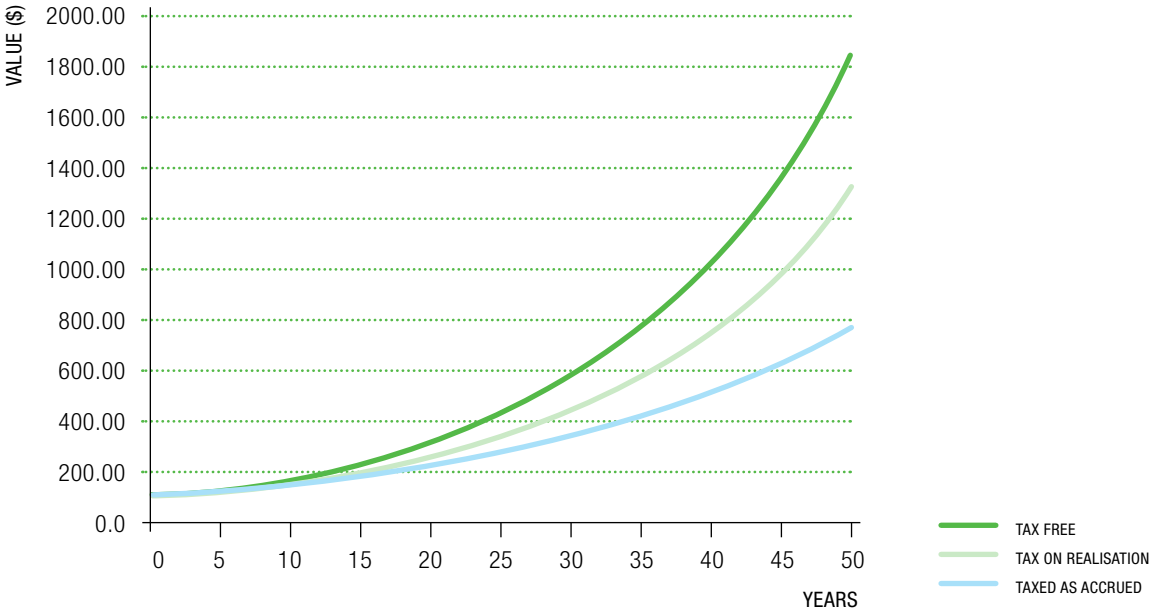
An individual's retirement savings needs to replace working income and therefore is, of necessity, a large sum relative to annual working income. Thus, a successful retirement savings scheme involves saving over a large part of a person's working life gradually building up savings out of contributions and investment returns over a lifetime. In this scenario the ultimate level of a person's retirement savings will be determined predominantly by the fund's investment returns rather than the actual contributions made. The Savings Working Group in its Final Report[38] quoted the example of a 35 year old worker who saves a fixed percentage of an increasing payroll stream until retirement at age 65, and then draws down an inflation-indexed pension until age 90. Using reasonable assumptions with no tax on investment income it is calculated that 90% of retirement income is generated by compounding investment income and only 10% from actual contributions made.[39]

The retirement income that a person can expect to be generated from KiwiSaver or similar savings is therefore largely going to be from the compounding income the scheme generates. Taxing this compounding income substantially reduces the source of 90% of expected retirement income.

This simply reflects the importance of compounding interest in building up a substantial fund of savings over time. This is demonstrated in the following graph. This shows how an initial $100 deposit grows over 50 years to $1,842 if untaxed, $1,319 if taxed only when withdrawn and only $782 if taxed annually on an accrual basis. In other words, in this example taxing the deposit earnings reduces its value to the saver by about one third if taxed only at the end of the 50 years but taxing those earnings as they accrue year by year reduces the savings by 57%.

[38] Savings Working Group, reported in January 2011; [39] Savings Working Group Report 2011, page 79.

THE IMPACT ON VALUE OF TAXATION ON A REALISATION BASIS



Assumptions: nominal return of 6%, marginal tax rate of 30% after an initial investment of $100.

How our tax system impacts on the accumulated investment income of retirement savings is therefore critical for determining the level of retirement income New Zealanders can expect in the future.

The Impact on the Allocation of Savings

Retirement savings and housing are the two main purposes for which New Zealand households save. Getting the balance right is critical not only to ensuring New Zealanders are reasonably housed and can afford a comfortable retirement, but also to how our economy performs in the future. The overall future welfare of New Zealanders will ultimately be determined by our future economic performance.

Our economic performance will be determined by a number of factors many of which are beyond the control of governments – the terms of trade, climatic conditions, the choices of individuals etc. A number of government reports have, however, highlighted the importance of increasing national savings (which would increase the amount of capital available per worker if those savings are invested productively in New Zealand) and the need for the efficient allocation of those savings. Both are heavily influenced by government policy. As noted above, New Zealand's tax rules heavily favour investment in housing, including rental housing, over other investments that could be used to fund retirement incomes and thus put upward pressure on the price of land and houses.

New Zealanders invest heavily in home ownership. The current make-up of New Zealand household assets is estimated to be:[40]

- Value of housing $615 billion
- Equity in unincorporated enterprises and unlisted companies $167 billion
- Bank and other deposits $114 billion
- Managed funds, life insurance, superannuation and bonds $ 89 billion
- Direct public equities $22 billion

In other words, over 60% of household assets are in housing. Much of this is borrowed ultimately from offshore. This increases our foreign indebtedness, puts upward pressure on interest rates which in turn puts upward pressure on the exchange rate.

This strong preference for personal home ownership reflects the substantial tax concessions this form of investment enjoys. These can be illustrated in a number of different ways:

First, if a person places $100,000 in a bank on deposit, the return is fully taxed at that person's marginal rate. If instead the person uses the $100,000 to help pay for a house, the return in terms of not having to pay rent on accommodation is totally tax-free. The benefit to the homeowner is the rental that would be paid

[40] Business Growth Agenda Progress Report, February 2013, page 8.

for the house (if it were owned by someone else) grossed up by the person's marginal tax rate so as to get the gross income they would have to earn to have been able to pay the rent out of after-tax income.

Secondly, assume a person on a 33% tax rate deposits $100,000 in a bank earning 4% per annum for five years. After 5 years they will have earned $14,138 after tax in interest. If instead they used the $100,000 to pay off their home mortgage on which they are charged 4% interest, after 5 years they have saved $21,665 in interest costs. They are better off by $7,527 by repaying the mortgage. If the mortgage interest rate is more than the deposit rate, as is likely, they will be even better off repaying the mortgage than putting the money into the bank.

Thirdly, the expected capital gain on the house is also tax-free. Hence the Savings Working Group calculated that for a person on a 33% marginal income tax rate with inflation at 2% and nominal interest rates of 6%, the marginal effective tax rate on debt instruments is about 50% whereas for housing it is 0%.[41] Work specifically commissioned by the Financial Services Council from independent experts reached a similar conclusion and is set out in the Technical Annex. The high 50% tax rate (when our top personal income tax rate is 33%) is the result of the fact that part of a taxable interest return is merely compensation for inflation over the term of the loan. Our income tax taxes this non-real income component as well as the remainder of the interest return increasing the tax rate on the real income above the statutory tax rate. Since home ownership is tax-free there is no tax on the inflation return in that area. As a result, about half the return on a bank deposit goes in tax whereas housing is tax-free. It is this strong tax incentive to invest in housing over other, mainly retirement, savings that needs to be dealt with if New Zealand is to perform to our expectations economically.

[41] Savings Working Group Report 2011, page 83.

An estimate of the tax benefits of home ownership

Using Auckland city data for 2012/2013 assuming a $500,000 mortgage free owner occupied home with the owner being in the 33% marginal tax bracket

If the $500,000 was invested in a bank term deposit earning 4% = $20,000 ÷ 0.67 = $29,851	$29,851
Or,	
alternatively the value of the rental cost avoided Avoiding rent at a 4% gross yield on the $500,000 Gross rental yield 4% = $20,000 ÷ 0.67 =	$29,851
Plus an 8% untaxed capital gain 8% on $500,000 = $40,000 ÷ 0.67 = $59,701	$59,701
Total equivalent tax free income in 2012/2013	$89,552

As the 2013 Business Growth Agenda Report notes: "house prices more than doubled in real terms from 2001 to 2007 and this helps to explain the attractiveness of housing as an investment for many people. However, high housing debt diverts money from more productive investments, contributes to New Zealand's significant overall level of indebtedness and exposes taxpayers to growing demands for State assistance with housing costs." [42]

Moreover, the Savings Working Group argued that 50% of house price increases in the last decade are attributable to the tax advantages housing enjoys over saving alternatives.[43]

The McLeod Review 2001 estimated that the level of tax concession for owner-occupied housing was at that stage $750 million per annum – in 2001 about 12% of company net tax collections. This was based on an estimated owner-occupied housing valuation of $125 billion, with housing loans of $50 billion giving $75 billion of net investment. Assuming this stock produced a rate of return of 4% this gives implicit income from housing of $3 billion which if taxed at an average personal income tax rate of 25% would produce about $750 million of tax revenue.[44] Since 2001 house prices have risen dramatically while company tax collected has changed much less markedly. The value of housing stock is now estimated at $615 billion funded in part by loans of $175 billion giving net housing investment of $430 billion.

Using the McLeod formula of this producing a 4% untaxed return that should be taxed at an average of a 25% rate, the tax subsidy for housing would now be $4.3 billion per annum. To put this figure in context, it is equal to about 50% of current company tax collections, and is more than twice the government's annual expenditure on housing assistance.[45] The total estimated savings that have been placed in managed funds, life insurance, superannuation and bonds is only $89 billion suggesting an average investment return over time of somewhere between $4 billion to $6 billion. In other words the tax subsidy for owner-occupied housing is estimated to be of the same order of magnitude as the total income from managed funds, life insurance, superannuation and bonds.

Those trying to encourage people to save for retirement, including the government, are therefore facing the uphill battle of competing against a tax subsidy for housing as an alternative use of savings that is of the same magnitude as the entire income from investment in financial instruments.

The options to address this subsidy, attracting people away from accumulating savings, are not easy but the real choice is between continuing with the status quo with a low saving, unproductive, highly indebted vulnerable economy with expensive housing or moving to a more equal tax treatment of housing and retirement saving with higher savings more productively employed, a lower debt burden and less vulnerable economy with more affordable housing.

[42] Business Growth Agenda Progress Report, February 2013, page 24. [43] Savings Working Group Report, February 2011, page 47. [44] McLeod Tax Review – issues Paper, June 2001, page 37. [45] About $620 million on Income Related Rents , $1,240 million on the Accommodation Supplement and $170 million on Temporary Additional Support per annum.

Housing and Retirement Savings

New Zealand has approximately 1.7 million households. Broadly, 1.1 million are housed in owner occupied private accommodation (65% of all households), 500,000 are renting a private dwelling (29% of households) and about 100,000 are housed otherwise (e.g. state housing).[46] Over the last twenty years, the proportion of home owners to renters has fallen significantly.

As the New Zealand Productivity Commission has noted, "home ownership peaked in the late 1980s/early 1990s when around 75% of private dwellings were owned by their occupants. The decrease in home ownership since the end of the 1990s has been particularly marked in Auckland, where around 40% of households now rent." [47]

Whether owner occupied or rented, most of these houses are owned by households. This is a significant investment. The supply of urban land is restricted and demand has therefore put upward pressure on land and, as a consequence, house prices. New Zealanders have developed the habit of borrowing effectively from offshore (via the intermediary of our trading banks), in order to buy increasingly expensive urban land. The amount of urban land does not increase as a result, so New Zealand as a whole ends up with higher household debt and increased land prices but no increase in real and productive investment. This is evidenced by the high ratio of land to total house (home plus land) prices in New Zealand. This stands at about 40% on average in New Zealand, while in Auckland it is closer to 60%. In other words, in Auckland, on average, about 60% of the price of a home is the cost of buying the land on which it is situated (and there will be many homes where the ratio will be even higher). It is understood that the normal ratio in similar overseas economies is closer to 20%. The desire to access tax concessions has driven up the price of land in our major cities to international highs, and all on borrowed money placing home ownership increasingly beyond the reach of many low and middle income households.

The biggest choice facing most New Zealand households is:

- How much of the limited resources of a household, after living costs are met should be used for home purchase (i.e. servicing the mortgage repayment and interest costs) and how much for retirement savings in other forms?
- Should retirement savings be in the form of buying a rental property or investments in financial assets via, or including, KiwiSaver?

The choice to invest in a house or rental property or financial assets for retirement should not be influenced by biases in the tax rules. As the tax system heavily favours home ownership and rental housing investment , this diverts savings into non-productive assets (and stimulates higher land prices) and away from financial assets that can in turn be invested in assets that add to the country's productive potential (and thus enhance its ability to sustain aged healthcare and other support in the longer term). The performance of the New Zealand economy and also the future retirement incomes of New Zealanders depend (at least in part) on the tax system not biasing savings into home ownership and rental properties more than the market would normally determine.

It is noted that tax is only one of the biases that favour investment in property. Others include:

- The ability to easily borrow on an extremely long term basis for land investment which makes such investment able to be highly geared – it is simply not possible to borrow for a 25 year term at anything near mortgage rates in order, for example, to purchase a share portfolio. Real estate is a relatively easy asset to borrow against and is also available as security to borrow for a number of purposes such as buying or expanding a business in which case the interest costs are also deductible against other income.
- The lack of financial literacy and skills that make it difficult for most people to own and manage a portfolio of financial assets directly (without intermediary fees and risks).
- The folklore of relentless material nominal capital appreciation for generations of owners of homes and baches. Behind this lies the fact that to date house prices have been less volatile than other investments. At least in part this is because when demand for housing falls people can continue to live in their property with no adverse impact on their lifestyle. Thus houses are withdrawn from the market until prices improve. With shares, on the other hand, a fall in demand immediately translates to a fall in measureable wealth.
- The cost and effort of exiting a home (real estate and other fees, moving costs, and personal and family disruption) is very high relative to the low costs of, say, selling shares. This seems to reduce the volatility of house prices reducing the downside risk of this form of investment.
- The possibility that people do not take fully into account the costs associated with home or property ownership such as rates, insurance, repairs and maintenance, rental and management fees and personal time and effort.

The heavy tax bias in favour of housing simply increases an inherent bias that most people are likely to have for this form of investment.

[46] Home and Housed – A Vision for Social Housing in New Zealand, Housing Shareholders Advisory Group, April 2010, page14. [47] New Zealand Productivity Commission, The Housing Affordability Inquiry, 2012 page 11.

2 Real Estate and a Level Playing Field for Savings in Financial Assets

Introduction

This Chapter considers further the policy relationship between retirement saving and housing. The conclusion reached in the first Chapter is that current policy settings encourage the over-investment in land and under-saving by way of financial instruments. This has adverse impacts on retirement and housing policy but also results in our relatively low level of savings being put to relatively unproductive use. Options to address this are set out in this Chapter. It is appreciated that these options are not easy to adopt. However, failure to take action will condemn New Zealand to a future of low economic performance and will inevitably mean that our aspirations, as for example set out in the government's Business Growth Agenda, may not be met. It is also noted that these options are not necessarily mutually exclusive. It would be possible to adopt more than one option.

The Issue

Current tax rules unambiguously favour home ownership, and favour rental property investment over savings in financial assets. The Savings Working Group noted that different investments face different marginal effective tax rates. To some extent that is inherent in an income tax given measurement and other practical considerations. The issue, from a retirement perspective, becomes critical if there is a form of saving or investment that is highly substitutable for retirement savings and such an investment faces much lower effective tax rates. As the Savings Working Group notes, that seems to be the case with housing.[48] Retirement savings through, say a KiwiSaver scheme, is likely to be weighted towards debt instruments that have high effective tax rates. As the Savings Working Group points out, housing, on the other hand, has very low effective tax rates.

The return from a fully equity-funded owner-occupied house faces an effective tax rate of zero. That is because the return to the owner is in the form of rent that does not have to be paid for the benefits of the house and any capital gain on the house is usually tax-free. If an owner-occupied house is partially debt funded by way of a mortgage, interest on the mortgage will be non-deductible. The non-deductibility of interest means that the investment is now effectively taxed at the individual's marginal rate but only to the extent to which the house is debt funded. If the person then uses money that would otherwise be saved to repay the mortgage, that also earns a tax-free return since the person does then not have to pay non-deductible interest. Repaying a mortgage is equivalent in economic terms to investing in a tax-exempt bank account. For high wealth individuals with fungible capital, they can always gear up their business investments with interest deductible against business income and use surplus capital freed from the business to purchase a house. Such individuals can, in effect, always effectively deduct the interest cost on a house purchase and enjoy the tax benefits of effectively fully equity funded home ownership.

[48] Savings Working Group Report, 2011, page 83.

For a rental property, expenses should be deductible and rental income taxable. The concern has been that rental property owners can gear up the rental property, receive interest deductions for those borrowed funds, also receive depreciation deductions for the house[49] and contents and then sell the house for a tax-free capital gain (albeit being taxed on the depreciation recovery). The result is often that deductions exceed taxable income and the loss can be used to reduce tax on other income, and the return is in the non-taxable form of a capital gain.

There are probably many reasons why New Zealanders invest relatively heavily in land. The tax advantage over financial assets is almost certainly one. A particular feature of land is that the supply is for all intents and purposes fixed. Overall, the supply in New Zealand is fixed by geography. The supply of urban land is fixed by planning laws etc. In relation to the former, the supply cannot respond to price signals, and in relation to the latter, it generally does not respond to price signals. An increase in the demand for land (driven by tax advantages) is thus not responded to by an increase in supply but by an increase in price.

This has a number of adverse macro-economic implications as outlined in the Savings Working Group Report:

- Poor economic performance. It does not add to New Zealand's productive capacity; all that happens is that the price of land increases.
- Vulnerability to economic cycles because of high levels of foreign debt.
- Fiscal pressure because of low level of financial assets available to fund retirement expenses.

A number of factors peculiar it seems to New Zealand have combined to increase the problems this poses for macro-economic policy. The New Zealand foreign borrowing model in its most simplistic form is that trading banks borrow from overseas (increasing foreign debt) to lend to New Zealand households that then use these funds to bid up the price of land. We end up with high levels of household (ultimately foreign) debt but no increase in productive assets to offset or service that debt. Total household debt by way of home loans now totals $175 billion, which is about the same as the total liabilities of central government (including commercial and social liabilities). [50]

In Budget 2010, depreciation deductions for rental property were removed on the basis that in most cases such a property is in fact an appreciating and not a depreciating asset. Nevertheless, depreciation was generally only a timing advantage and the ability to deduct interest costs and benefit from a tax-free capital gain remains (thus still materially reducing the tax rate on such an investment).

[49] The option to receive deductions for the depreciation on the house and contents was removed following the 2010 Budget.
[50] Business Growth Agenda Progress Report, February 2013, page 8.

Possible Responses

Taxing imputed rental income of owner occupied homes

While the tax system is biased towards investment in residential property in general, the largest and most unambiguous tax preference is for owner occupied housing with the main form of preference being the non-taxation of imputed rental income. While the economic rationale for taxing such income is clear, the difficulty in getting the concept across to people means that the political obstacles to doing so seem insurmountable. The McLeod Business Tax Review in its 2001 Interim Report recommended taxing such income. However, this was met with such popular and political resistance that it was never pursued by the Review itself, nor by any subsequent government nor any political party. This simply does not seem to be a politically feasible reform option.

Taxing the capital gains on owner occupied homes

This also does not seem to be a politically palatable option. The norm for OECD countries that have a capital gains tax is to exempt the principal home from such a tax. This also seems to be the position of those New Zealand political parties that have advocated a capital gains tax.

In fact, recognising the lack of political traction (at least in the past) around taxing capital gains saw the Tax Working Group avoid adding to a long history of recommendations along that path, and instead it used its imagination to suggest alternatives that might (at least arguably) go some way towards achieving a similar result (see RFRM below) – with as yet no uptake from politicians. It is relevant too to note that a capital gains tax was specifically off limits to the Savings Working Group, despite it being an obvious potential solution to a distortion that was very relevant to its deliberations on national savings issues.

A land tax

The Tax Working Group also explored the possibility of an across the board tax on the unimproved value of land in New Zealand as a revenue raising measure that could be used to fund lower income tax rates. Whatever the merits of such a tax, it would not, however, reduce any tax preference for owner occupied or rental housing. As the Group explained, a land tax on unimproved value is a one-off cost on land owners at the time it is introduced (penalising savers who are heavily reliant on the value of their homes as a retirement asset). Land prices can be expected to fall after a land tax is introduced so that new owners still receive the same return and benefits as before. A land tax on the improved value of land (i.e. a tax that taxed not only the value of the land itself but also improvements such as housing or other buildings), could be expected to partially offset the income tax advantages enjoyed by home owners. However, such a tax inevitably faces the problem that landowners may be asset rich but can be income poor. There would thus be pressure to defer the tax payment until the land is sold or the owner dies, reducing the revenue flow to the Crown.[51]

General comments on removing tax preferences only for rental housing

The first point to note here is that if it is not feasible to reduce or remove the tax preferences for owner occupied housing, then 66% to 60% of the housing market is unaffected by any reforms of the tax treatment of housing. If effective, it simply reduces the preferences available to some extent. A second point is that any reduction in the tax preferences only for rental housing will be likely, given the restrictions in supply of affordable housing (especially in Auckland and Christchurch), to increase rents. That will impact adversely on tenants already struggling with high rents and flow through to increases in government benefits such as the accommodation supplement. The increased rents are likely to restore, to some extent, the attractiveness of rental housing as a means of saving for retirement over financial assets.

Restricting or denying interest deductions for rental housing

Since it is argued that rental housing benefits from interest deductions and non-taxable capital gains, one option is to deny interest deductions for money borrowed to fund ownership of rental housing. One difficulty is the practical one of tracing particular lending to rental housing ownership. That is likely to be especially so where the rental house is owned in a separate entity such as a company. Tracing rules can be developed but they are likely to be ineffective or harsh and ad hoc. An example is the latest tax legislation – the Taxation (Livestock Valuation, Assets Expenditure and Remedial Matters) Act 2013 – which deems borrowings by a member of a company group or a major shareholder to be fully used to fund a mixed use private/business asset and thus have interest deductions denied even in circumstances when the asset was owned prior to any borrowings. These proposed rules are extremely complex and in some situations would be very harsh.

Economists also point out that if interest deductions are denied for a tax preferred asset (rental housing), the tax preference (capital gains) still remains for those who equity fund the property. It is plausible to assume that if rental housing offers a good return there are sufficient people in New Zealand with sufficient capital to hold those assets debt-free. All such a reform would achieve is to effect a change in who owns the tax preferred asset. The issue is similar to the limited effectiveness of denying interest

[51] Ibid. Pages 50 to 51.

deductions for owner occupied housing. For example if a person retains a debt financed rental house, that person receives a tax-free return by paying off the debt.

Restricting interest deductions to the real interest rate

Instead of restricting all interest deductions, one option is to allow interest deductions only for the real interest rate. When people borrow money, they pay for that by way of interest. In a world without inflation interest reflects the benefit of the borrower being able to spend money now rather than later. In the presence of inflation, interest also includes compensation to the lender for the future reduced value of money. For a borrower, the inflation component is compensated for by the fact that he or she need only repay the loan at a future date with money that has a lower real value than when it was borrowed. That being the case, there is an argument for denying an interest deduction for the inflation component of interest – say 2% a year non-deductible. The argument seems stronger still when the borrowed funds are invested in an asset, such as rental property, that itself can be expected to rise in value in line with inflation and that gain is tax-free as a capital gain. Under current rules the borrower has the benefit of repaying the loan at a reduced value and a tax-free gain in line with inflation and a full deduction for the inflationary component of the interest cost.

The inflation advantage provided to the borrower is to some extent a disadvantage to the lender or saver of the funds. That person is under current laws taxed on the inflationary interest component that is merely compensating him or her for the loss in the real value of the funds lent. It would thus seem more coherent to remove the inflationary component of the interest from tax for both the borrower and the lender. This would require a move towards indexation of the tax base, an issue considered in the next Chapter.

Restricting losses on rental housing

This is simply an alternative way of restricting interest deductions and the same arguments apply.

Taxing the capital gains on rental housing

This has the merit of removing the tax preference from rental housing rather than targeting peripheral deductions leaving the preference intact. Any such tax would have to be extended on practical grounds to all non-principal dwelling residential housing (e.g. including second and holiday homes) on the practical grounds that it can be hard to distinguish rented versus non-rented housing. For example, a second home may be rented out intermittently.

Taxing capital gains on a realisation basis would only partially remove any tax preference since although the gains accrue across the holding period for practical reasons any gains would be likely to be taxed only on realisation. This would encourage people not to realise their rental house investment. It is sometimes argued that a tax on gains could be restricted to when the rental house is sold within a particular period of time – such as 3 years. This would provide a strong incentive to hold the house for the required minimum period.

Rules would also need to be developed where rental property is held in another entity such as a company and that entity is sold rather than the house. Undoubtedly such rules could be developed but equally undoubtedly schemes will be devised to try to skirt around them.

Overall, the arguments for taxing capital gains on rental housing seem the same as the wider capital gains debate.

It should be noted that even if the capital gains on rental accommodation were taxed under, for example, a general capital gains tax, this would not in itself eliminate the lower effective tax rates enjoyed by investors in rental accommodation. This is partly because, as noted above, for practical reasons any tax on gains would likely be on the realisation of those gains whereas financial instruments are taxed on accrual. Secondly, for highly geared properties the inflation component of interest would remain deductible. Work commissioned by the Financial Services Council suggests that 33% taxpayers with geared residential accommodation investment held over a medium term (20 years or more) would still face effective tax rates significantly lower than the effective rates on KiwiSaver investments. For example, at a 28% marginal tax rate the real effective tax rate on KiwiSaver is 38.05% whereas the effective rate on a 50% geared rental property in a world with a capital gains tax on realisation is still only 24.28%. Therefore, a realisation-based capital gains tax reduces but does not eliminate the large discrepancy in real effective tax rates between KiwiSaver and rental property. Moreover, especially if the principal residence was exempt from capital gains taxation, it is likely that rental yields would increase if rental accommodation were taxed on capital gain, thereby restoring some savings in financial instruments.

A risk free rate of return tax on rental properties

This would deem rental properties to get a deemed rate of return along similar lines to the existing "fair dividend rate" regime applying to portfolio-type shareholdings in offshore companies and trusts (i.e. foreign investment funds). For example, a rental property would be deemed each year to derive income of, say 5% of its valuation. If part of the return of the house owner were capital gains then this would implicitly be taxed under this approach. The Victoria University of Wellington Tax Working Group explored this option but concluded that it would be difficult to design rules that were robust enough to make this work. [52]

An alternative

Provide a similar tilting of the playing field by expressly not taxing capital gains on land in a PIE just as PIEs are not taxed on equity capital gains. The impact of this approach would see KiwiSaver fund managers joining other investors to further bid up the price of urban land.

The policymaker's dilemma

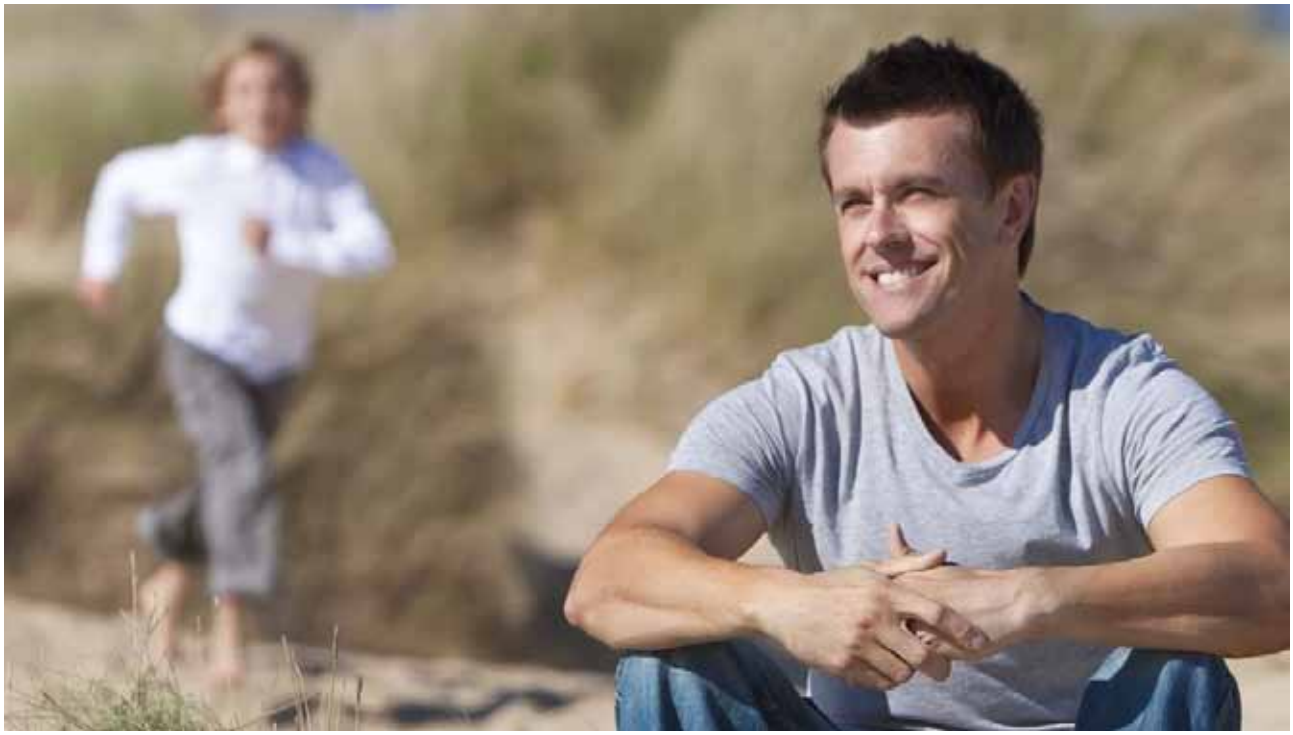
Land, specifically residential housing, happens to be one of the major (and in many cases, the only) asset that New Zealanders have when they retire. Given that this is an asset class that has been tax-preferred for generations; any successful policy change to remove or significantly mitigate such preferences (and create a more level playing field with other asset classes) may have a negative impact on land prices.

This creates a dilemma for policymakers and politicians: making the "right" change to taxes should improve future asset allocation, investment returns and national income, but at the same time potentially wiping value off a significant portion of assets that thousands of New Zealanders are relying on for and in their retirement.

The timing and transition into such change is therefore fraught, both politically and economically.

[52] A Tax System for New Zealand's Future, Report of the Victoria University of Wellington Tax Working Group, 2010, page 54.

3 The Over-taxation of Accumulating Savings



Introduction

This Chapter considers the issue of the tax treatment of accumulating saving in New Zealand – savings where the principal is reinvested and the earnings are added to that principal to build up a pool of savings over time. The Chapter considers the consequences of current rules and the problems they give rise to and options for reform. The conclusion reached is that accumulating savings are penalised relative to other forms of savings or investment. That is especially so when compared to the case of housing which was considered earlier in this paper. Again options for reform are not necessarily mutually exclusive but instead a portfolio of options could be pursued.

The Issue

The New Zealand tax system penalises savings and in particular savings accumulating over time, and thus retirement savings. The penalty falls most harshly on compounding investment income that is relied upon to create the bulk of retirement income.

New Zealand's tax revenue relies on two main tax bases – GST and income tax. Broadly, one third comes from GST and two thirds from income tax.

These two tax bases differ significantly in how they tax savings or capital/investment income. GST does not tax savings or investment income. Under GST neither interest nor business income is taxed. GST does not change a person's preference for consuming goods now or at some time in the future (such as in retirement). Normally, a person will prefer buying goods now over waiting and buying them in the future since they then get to enjoy the goods immediately. However, this is compensated for by the interest or investment return they receive on the savings and under GST this is not taxed. They are fully compensated for their restraint in spending. Barring rate changes over time, the GST is in substance the same whether money is spent now or deferred and spent later.

Unlike GST, income tax does penalise savings. It does so in two ways. First, it taxes the component of interest or an investment return that merely compensates for inflation. This is not income in the true sense of adding to a person's wealth but because our income tax ignores inflation it is treated as such. Secondly, under an income tax the compensation a person gets by way of interest or an investment return for deferring consumption is taxed. A person is therefore not fully compensated for their restraint in not spending their wages immediately – some of this compensation goes to the government as tax. If we regard future and present consumption as two goods, the situation under an income tax is as if GST were levied at a higher rate on one good – future consumption - than another – present consumption. The New Zealand GST has been carefully designed (and successive governments have gone to great pains) to ensure that it does not discriminate between consumption on different goods or services, but our income tax does not have such a neutral impact.

The penalty is especially harsh on long term savings and retirement funds that need to be built up over time through accumulating investment income. Income tax imposes this penalty on savings each year. If you save for one year, there is a penalty for that year. But if you save for two years, an additional penalty

is imposed and so forth. These penalties compound over time just as interest does. The Savings Working Group provides the example where a tax rate of 33% imposes a tax on consumption of 33% in the first year rising to 40% after 10 years and 45% after 20 years[53]. The compounding penalty an income tax imposes on accumulating savings means that the tax penalty increases year by year.

As a result, a 33% tax rate on accumulated savings reduces the amount saved for retirement after 20 years by 40%. Retirement savings that could have amounted to $500,000 in the absence of tax on the interest income as it accrues would after such a tax amount to only $300,000. The Technical Annex shows that the effective tax rate on savings in a financial instrument increases from 44.3% after 10 years saving to almost 55% after 40 years. In a similar vein, a paper by Don Erza concludes that for someone with a pension scheme over a working lifetime starting at age 25 years and retiring at 65 years and dying at 90 years, a 35% tax rate on the scheme earnings as they accrue reduces the pension by 42%.[54] In a world with taxation on accumulating savings at about a 30% rate, retirement income is almost halved.

Investments of different types and in different forms incur different levels of this tax penalty. Home ownership that is fully equity funded is fully exempt income tax and faces no such tax penalty. A forestry investment receives upfront deductions for planting and is not taxed until harvested so also faces no such income tax penalty. Geared investments are less highly taxed than other forms of investment since an interest deduction is available effectively for the inflation component of the interest. The most highly taxed form of investment would generally be debt instruments (such as bonds, government stock, and bank term deposits) which are fully taxed on the inflation component and fully taxed on an accrual basis.

This leaves retirement savings facing the highest tax penalties. Increasingly, for most people, retirement savings are held in the form of a KiwiSaver fund or its equivalent. While a KiwiSaver fund can invest in a wide variety of assets, prudent management will generally mean that a significant proportion of the fund will be invested in debt instruments. That tends especially to be the case for those investments held on behalf investors nearing or in retirement; as the Savings Working Group noted, a high proportion of retirement income can be expected to be derived from accumulating investment earnings in retirement.

Most other countries also favour home ownership under their income taxes. However, no other country has the combination of comprehensive taxation of the return on debt instruments as they accrue, no superannuation tax concessions and no tax on capital gains on rental properties. A brief explanation of the findings of two recent international studies, the Henry Review in Australia and the Mirrlees Review in the United Kingdom, is in the Technical Annex to this paper. These studies show that debt instruments specifically used for retirement savings are accorded concessionary tax treatment and are, on that basis, tax preferred when compared to both rental and owner-occupied property. There is a large tax bias in favour of retirement savings.

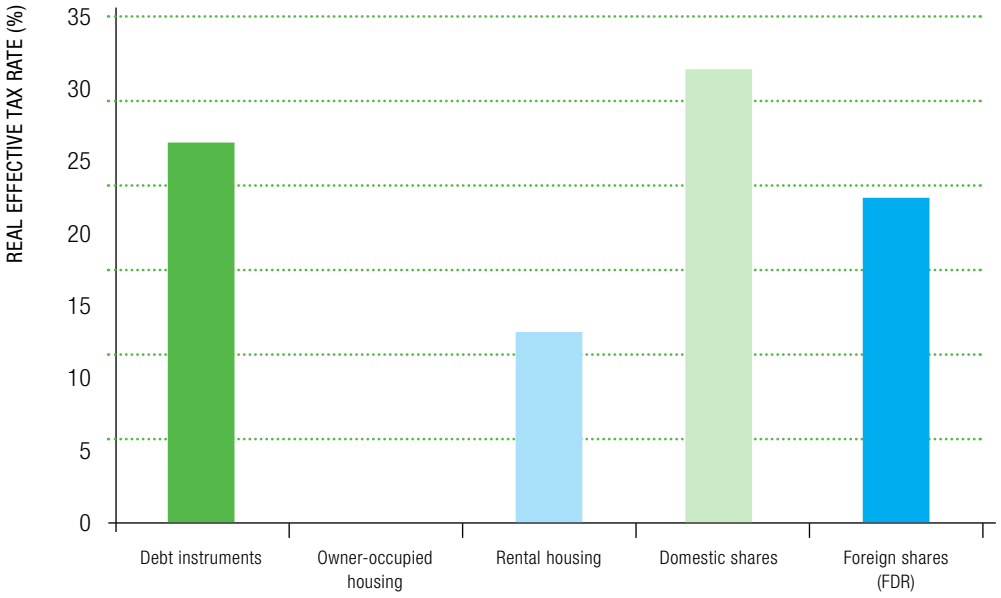
In contrast, New Zealand stands out by having one of the highest tax biases in favour of investment in real estate over investment in financial assets. This is illustrated in the following Savings Working Group graphs showing different after-tax returns from different forms of investment.

"New Zealand stands out by having one of the highest tax biases in favour of investment in real estate over investment in financial assets."

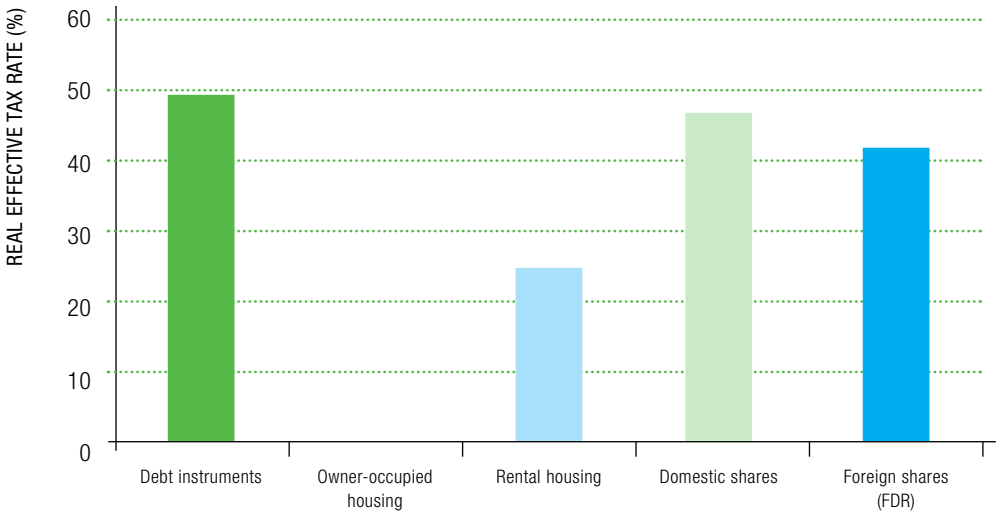
[53] Savings Working Group Report, 2011, pages 76 – 77). [54] Erza, Don "The 10/30/60 Rule" Russell Investments July 2012.

DIFFERENCES IN THE TAX TREATMENT OF DIFFERENT ASSET CLASSES, AS WELL AS INFLATION, LEADS TO VASTLY DIFFERENT REAL EFFECTIVE TAX RATES FOR DIFFERENT CLASSES OF ASSETS. THE LARGE DIFFERENCES DISTORT THE WAY PEOPLE HOLD THEIR SAVINGS.

MARGINAL RATE 17.5%



MARGINAL RATE 33%



Source: Savings Working Group Report 2011

The findings of the Savings Working Group echoed earlier conclusions reached by the 2008 Report of the House Prices Unit of the Department of the Prime Minister and Cabinet that the tax system strongly favours home ownership and investment in rental property. For example, the Report highlighted the advantages that high gearing provides the rental property owner. The Report estimated that the effective interest rate faced by rental property investors was reduced by between 1.5 and 2.5 percentage points depending on the level of gearing. [55]

The Financial Services Council commissioned its own study on the effective tax rates facing different types of investment in New Zealand. The results are elaborated upon in the Technical Annex to this paper. In summary the estimated different tax rates are as follows:

This shows that in order to remove the tax incentive for people to invest in geared rental property in preference to financial instruments such as a KiwiSaver fund, the tax rates on financial instruments would need to be considerably reduced, given in particular that most rental property held by those still in the workforce is significantly geared. The work commissioned by the Financial Services Council estimates that the tax rates required to level the playing field between savings in rental accommodation[57] and savings in financial instruments would be as follows:

EFFECTIVE TAX RATES ON DIFFERENT TYPES OF INVESTMENT[56]

	Tax rate					
	0%	**10.5%**	**17.5%**	**28%**	**30%**	**33%**
Owner-occupied home, debt-free	0%	0%	0%	0%	0%	0%
General rental property (100% leverage)	0%	(1.13%)*	(1.75%)	(2.52%)	(2.65%)	(2.83%)
General rental property (80% leverage)	0%	0.38%	0.68%	1.20%	1.31%	1.47%
General rental property (50% leverage)	0%	4.27%	7.01%	10.99%	11.73%	12.83%
General rental property (no leverage)	0%	7.70%	12.70%	20.02%	21.38%	23.42%
PIE / KiwiSaver with no subsidies	0%	14.27%	23.78%	38.05%	38.05%	38.05%
Foreign shares	0%	13.13%	21.88%	35.00%	37.50%	41.25%
Bank account term deposit	0%	15.60%	26.10%	41.70%	44.70%	49.20%

**The tax rates in (brackets) are negative, which in effect means a person receives a tax subsidy for holding this type of asset with this level of leverage.*

[55] Final Report of the House Prices Unit: House Price Increases and Housing in New Zealand, 2008, page 34. [56] For rental property it is assumed that the property is sold after 20 years.
[57] Again it is assumed that the property is sold after 20 years. Estimates are provided in the Technical Annex for different holding periods.

REQUIRED TAX RATES TO LEVEL THE PLAYING FIELD

Tax rate	Rental property – no leverage		Rental property – 50% leverage		Rental property – 80% leverage		Rental property – 100% leverage	
	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate
10.5%	7.70%	5.70%	4.27%	3.30%	0.38%	0.30%	(1.13%)	(1.10%)
17.5%	12.70%	9.30%	7.01%	5.40%	0.68%	0.60%	(1.75%)	(1.70%)
28.0%	20.02%	14.70%	10.99%	8.40%	1.20%	1.00%	(2.52%)	(2.40%)
30.0%	21.38%	15.70%	11.73%	9.00%	1.31%	1.10%	(2.65%)	(2.60%)
33.0%	23.42%	17.20%	12.83%	9.80%	1.47%	1.20%	(2.83%)	(2.70%)

The Real Effective Tax Rate (Real ETR) is the tax wedge between the post-tax return and the pre-tax real return. The required marginal tax rate is the statutory rate required to produce the same return from different investments assuming both have the same pre-tax nominal return. When considering what rate is required to, for example, make an investment in KiwiSaver as attractive from a tax viewpoint as an investment in rental housing, the appropriate rate to consider is the required marginal tax rate. These terms are explained in more detail in the Technical Annex.

For example, at a 28% marginal tax rate a person with rental property geared to 50% faces a real effective tax rate of 10.99%. In order to face the same real effective tax rate for savings in a KiwiSaver scheme, the person's statutory marginal tax rate would need to fall from 28% to 8.40%. The disparity grows greater with higher gearing levels. It is not uncommon for rental properties to be geared at 80% or more. With 80% gearing on rental property, for example, the real effective tax rate for a 28% taxpayer is a mere 1.20% (arising, in large part, due to the deductibility of the interest costs). To match this effective tax rate, a person with savings in KiwiSaver would need their statutory marginal tax rate reduced from 28% to only 1%.

The issue therefore is that New Zealanders who are (and who are encouraged to be) dependent on accumulated income from savings for their retirement income are highly penalised under current tax policy settings. A response might be that, despite the tax penalty on KiwiSaver-type investments, nevertheless many New Zealanders have joined KiwiSaver and are not investing in tax-preferred rental housing. It should be noted, however, that first, most New Zealanders will not save enough at current KiwiSaver contribution rates to fund a comfortable retirement. Secondly, there are many reasons why a person may not invest in rental housing despite its tax concessions. Lower income investors are likely, for example, to face difficulties in raising the capital necessary to make an initial deposit on a rental property. Less sophisticated investors are likely to find the management of a rental property investment more difficult than simply contributing to a KiwiSaver fund. For such people the current tax preference for rental housing may not divert investment but it is patently unfair that tax preferences are directed at richer and more sophisticated savers.

Possible Responses

This section considers possible tax policy responses to the tax penalty currently imposed on long term and especially retirement savings. It looks at various options and the pros and cons of each. The options are considered in terms of the breadth of the reform involved, the broader to the narrower.

This section also assumes the quantum of government expenditure is not reduced. If government expenditure were reduced, then tax rates (either generally or specifically on savings) could also be reduced.

Replacing income tax with GST

As discussed above, the tax penalty imposed on accumulating savings is inherent in an income tax but avoided under GST. One option therefore would be to move from reliance on the dual tax bases of income and GST to reliance on a single base – GST. Given current government expenditure levels this would require a very high GST rate (about 40%) and even then, as with past GST reforms, compensatory government expenditure increases would be likely to be seen as necessary to protect the retired and lower income families. Since GST when imposed or increased imposes a one-off tax on all existing savers and wealth holders (since the higher GST is then incurred when those savings are spent) any transition to sole reliance on GST would be both long and difficult to manage. A very high GST rate would in any case seem to pose insurmountable compliance and political problems. For example, a 40% GST rate would seem to provide excessively high incentives for New Zealanders to buy goods and services outside New Zealand. That could be expected to severely erode the GST tax base over time.

This does not rule out gradually changing the balance of revenue raised from income tax to GST as circumstances permit. That of itself would reduce the tax penalty on savings but would not remove it.

An alternative to removing income tax and raising tax revenue from GST would be to raise revenue by way of expenditure or a cash flow tax. This is a direct form of taxation (like income tax and unlike GST) but has the same characteristics as GST of not taxing capital income or savings. Broadly, interest income would not be taxed (and interest expense non-deductible) and an immediate tax-write off given for all investments (ie income tax not payable on income to the extent that it is invested). Such a tax system has been considered in many countries (UK, USA and even New Zealand in the 1990s) but not implemented for political and administrative reasons (for example it would remove interest deductions, and this would adversely impact on highly geared companies). These issues have not been resolved and this reform also seems to be unlikely to be adopted in New Zealand in the foreseeable future.

Broaden the Income Tax Base Further and Reduce Rates

If the income tax base can be broadened, the same level of revenue can be raised with lower rates. Lower rates would reduce the penalty on savings. However, the opportunities to broaden the base (other than by taxing capital gains) are limited. Relative to other countries, our income tax base is already broad with few concessions. Those that still exist largely do so for administrative or political reasons. The main candidate for base broadening is capital gains. The desirability of taxing capital gains or not is a matter of debate and the issue should be considered on its own merits. However, overseas precedents suggest that in the short term at least the revenue from a capital gains tax would not be sufficient to significantly and quickly reduce income tax rates and therefore the penalty on savings. In general, for example, countries exempt from their capital gains taxes the principal home, and there is usually concessionary treatment of assets owned at the date the tax is introduced. It is also noted that this would seem to result in PIEs losing their existing tax exemption on capital gains on shares thereby, in this respect, increasing the savings' tax penalty.

We note that successive New Zealand governments have consistently resisted the introduction of capital gains tax on real property (or even one that would tax it comprehensively with no exemption for the principal place of residence). Given this, we do not pursue this objective further in this paper despite its potential merits.

It is, however, noted that the Treasury/IRD Report of September 2012 notes that work undertaken for officials by Andrew Coleman concludes that taxing housing more heavily (by taxing capital gains, even when the tax is limited to investment housing only) does tend to:

- Reduce the total amount invested in housing.
- Increase the amount invested in interest-bearing assets.
- Reduce the price of housing and increase affordability of owner-occupied housing.
- Increase rents and reduce the affordability of rental housing.
- Increase economic welfare; and
- Reduce the level of foreign borrowing compared to the status quo.[58]

[58] Treasury/IRD Report Taxation of Savings and Investment income, 27 September 2012, page 10.

Dual income tax system

This option retains the income tax but distinguishes between income from labour and income from capital, and taxes capital income at a lower rate with an offsetting increase in tax on labour income to make up the fiscal balance. Since savings produce capital income this would reduce the penalty on savings. However, determining whether income is capital or labour can be complex. For example rules need to determine whether the income of a small (especially owner-operated) company is attributed to labour or capital. Such rules have been developed in the Nordic countries but it seems unlikely that New Zealand would adopt this approach unless and until it has been adopted by countries like Australia. Moreover, New Zealand has a relatively high level of self-employed making resolution of this issue especially important in the context of our economy. The Savings Working Group concluded that "the effort and complexity of a full-blown Nordic/Dual approach does not justify its adoption."[59] This is a conclusion that recognises successive governments' adherence to the concept of a comprehensive income tax, an adherence that shows no sign of changing.

Indexation of the income tax base – Taxing only the real component of interest

As noted above, one of the tax penalties faced by savers is that they are taxed on the inflation component of their return, and especially so in the case of interest. The obvious answer to this issue is to exclude inflationary gains from the income tax base by indexing it for inflation[60]. The downside is the complexity involved and the obverse of not taxing the inflation component of interest income is that the inflation component of interest expense is non-deductible. On the other hand, if interest deductions on overseas debt were more restricted, this could be expected to encourage multi-national enterprises to allocate more of their debt to countries other than New Zealand. Notably no country in a similar position to New Zealand has indexed its income tax. Indexation was, however, supported by the Savings Working Group.[61] Ideally, the issue of indexation should be considered on its own merits outside the context of relieving the over-taxation of accumulating savings but it is one orthodox method for relieving the over-taxation of accumulating savings and if it were to be implemented the current low inflation, low real interest rate environment seems a perfect time to do so.

Reduce tax rates on certain types of income

This option would simply reduce the rate of tax on income from certain types of investment assets that form the bulk of the investment returns (and that in turn form the bulk of most retirement income). The most obvious candidate for such treatment would be interest income that is, as noted earlier, the most penalised under current tax rules. The Henry Review in Australia raised a proposal along these lines – taxing only 60% of interest and net rental income[62]. A tax rate reduction for interest

[59] Savings Working Group Report, 2011, page 81. [60] This would involve excluding from taxable income all gains or income that is merely compensation for the impact of inflation. Thus, if inflation is 2% per annum and the interest rate is 4%, only half (2%) of the interest would be taxable under an indexed income tax. Adjustments for inflation would need to be made to interest, trading stock, revenue account assets and depreciable assets. Indexation as used here is not the same as indexing the income thresholds at which different marginal income tax rates apply.
[61] Ibid, page 85. [62] Australia's Future Tax System, December 2009, Part 2, volume 1, pages 70 – 76). The Henry Review, reported in May 2010: final report and associated material available on-line: http://www.taxreview.treasury.gov.au/Content/Content.aspx?doc=html/home.htm

could be achieved by having special rates of tax for such income – (say half or two thirds etc. of normal marginal tax rates) – or, probably administratively more convenient, by including only a proportion of such income in taxable income subject to normal rates (as proposed by the Henry Review). The Savings Working Group seemed to support an approach along these lines[63].

Such a change might be seen as inconsistent with the tax neutrality objectives of our tax system, favouring one form of income over another. However, as already noted, first, the body of economic literature does not generally support taxing all income at the same rate and, secondly, our income tax already treats different forms of income very differently. Such a measure would simply relieve the disadvantaged position that these rules impose, in particular on interest income. An attraction is that it can be seen as a means of providing at least some relief from the over-taxation, relieving tax of the inflation component of interest as well as the tax on deferred consumption.

A more compelling concern is the arbitrage opportunities it would seem to create. If interest is fully deductible and only part of the interest is taxable then a person can make an after tax profit by borrowing and lending even at the same interest rate. It is doubtful whether sufficiently robust anti-avoidance provisions could be designed to overcome this flaw. If instead only the same proportion of interest costs were deductible this would raise some of the concerns that have hindered the application of indexation and dual income tax systems. For example, New Zealand companies will often borrow from non-residents. The non-resident interest recipient receives no value from New Zealand tax relief (since they will usually be taxable in their home country with a credit only for New Zealand withholding tax), but the New Zealand company will receive less than full deductions for interest, a legitimate business cost.

The Savings Working Group suggested that this option could be extended to dividend income.[64] It seems difficult to justify this. Dividend income is simply the income of the ultimate shareholders in the company. Dividend income can represent any form of income, including labour income (especially in small companies), and thus is only viable if all capital income of whatever form is taxed at a lower rate. In other words it requires a full dual income tax system. It is noted that the Henry Review in Australia did not include dividends in its proposed reduced tax on savings income.

Reduce the tax rates on certain entities – PIEs

Instead of providing tax relief for a certain type of income, an alternative is to provide relief for income derived by certain entities. With a focus on accumulating savings, the obvious candidate would be PIEs since almost all new retirement savings schemes are now run through these tax entities. The Savings Working Group favoured this approach arguing for reduced tax rates 5 to 10 percentage points below the individual investor's normal tax rate[65]. The Savings Working Group noted that highest income earners already have a PIE tax rate capped at 28% - 5 percentage points below their normal marginal tax rate of 33%. Moreover the Savings Working Group noted that because PIE

[63] Savings Working Group Report 2011, page 82. [64] Idem. [65] Ibid, pages 81 - 82.

income needs to be attributed to individual investors and taxed at their individual rates without the PIE knowing the details of their other income, the PIE rules apply tax rates at higher than the lowest rate only when income exceeds a higher threshold than the normal tax scale. This is to prevent over-taxation of income for taxpayers whose PIE income crosses a personal tax threshold. For many investors, this means PIE rates are already 12.5 to 5 percentage points lower than the tax rate they would pay if they received the income directly.

The current ordinary personal income tax rate scale contrasted with possible rates applying to a PIE investor are shown in the following table[66]:

PIE AND ORDINARY TAX RATES

	Ordinary Tax Rate %	PIE Tax Rate	PIE Tax Rate Advantage
Up to $14,000	10.5	10.5	0
$14,000 to $48,000	17.5	10.5	7.0
$48,001 to $70,000	30	17.5	12.5
Over $70,000	33	28	5.0

Further reduced PIE rates would mitigate the tax penalty on a reasonable proportion of retirement savings given that most new retirement savings schemes operate through the PIE vehicle. There are no significant barriers preventing older retirement savings schemes from transforming themselves into the PIE vehicle should they so wish. The flexibility of the PIE vehicle, means it can be used for what is in effect a normal bank account, and this means in turn that those who wish to undertake long-term savings for retirement or other purposes would be able to access this savings vehicle at low cost.

However, this very flexibility of the PIE entity creates a problem in that many forms of income can be transformed into PIE income by interposing a PIE. The requirements to be a PIE are broadly as follows:

- 90% or more of investments by value must be in land, debt instruments or equity.
- 90% or more of income must be from these sources.
- Must not exceed a 20% voting interest in the shares of any company.
- Must have 20 or more investors; and
- No investor can hold 20% or more of the Fund.

In effect, therefore having PIE rates lower than normal individual rates would be similar to having lower rates for interest, dividend and specified forms of income with the problems inherent in that option. The only difference is that a PIE would need to be interposed between the individual and the income source and the minimum PIE requirements would need to be met.

Reduce Tax Rates only for KiwiSaver and Similar Entities

Under this option the reduced tax rates would be limited to KiwiSaver schemes and similar entities[67] where savings are predominantly statutorily locked in until retirement age. In other respects this is similar to the prior option.

The main disadvantage of this option is that it limits relief only to KiwiSaver and similar schemes and thus provides a tax advantage to one type of saving vehicle (an advantage over all other vehicles, and over direct investment). However, if the focus is on long term accumulating savings and most of such savings are for retirement and most new schemes for such savings are now KiwiSaver or equivalents, this is arguably relatively well-targeted relief for a targeted tax bias – the penalty income tax imposes on accumulating savings. Importantly, the KiwiSaver requirement that savings for the most part be locked in until retirement age deals with the arbitrage problem of borrowing at a cheaper after-tax cost than the after-tax return on the same KiwiSaver investment noted with the prior two options. A KiwiSaver investment, because it is largely locked in, is not the same as a loan to fund contributions.

The Savings Working Group recommendation that PIE tax rates should be 5 to 10 percentage points below individual marginal tax rates[68] is a useful starting point for considering lower KiwiSaver tax rates. The basis for the Savings Working Group's view was that high income earners already receive a 5 percentage point reduction in the tax rate (a PIE rate of 28% versus the marginal tax rate of 33%). It seems reasonable to apply the same concession across the income scale. Moreover, as noted above, many PIE investors on lower incomes already receive a reduced PIE tax rate because of how the PIE rate scale works. Thus, a PIE investor with income of between $14,000 and $48,000 per annum has a PIE tax rate of 10.5% whereas the ordinary tax rate for this level of income is 17.5%. There seem to be alternative methods of implementing a reduced tax scale along these lines:

[66] For a PIE investor this is:
- Non-PIE income of $14,000 or less and PIE plus other income of $48,000 or less – 10.5%.
- Non-PIE income of $14,001 and up to $48,000 and PIE plus other income of $70,000 or less - 17.5%.
- Over these thresholds – 28%.

[67] Similar entities would include superannuation funds and other products that have similar lock in rules to KiwiSaver.
[68] Ibid, page 82.

- Retaining a progressive tax scale and applying lower rates at each threshold. This is what the Savings Working Group recommended.
- Having a single comparable low rate for all KiwiSaver and similar investment.

Retaining a progressive tax scale with a 5 percentage point reduction would produce a tax scale along the following lines:

- Non-PIE income of $14,000 or less and PIE plus other income of $48,000 or less – 5.5% instead of the current 10.5%.
- Non-PIE income of $14,001 and up to $48,000 and PIE plus other income of $70,000 or less – 12.5% instead of the current 17.5%.
- Over these thresholds – 28% as is already the case.

This retains the equity of progressivity and provides lower income earners with similar tax benefits now available to the highest income earners.

However, the Savings Working Group lower but progressive Kiwisaver tax rate scale would not level the tax playing field between KiwiSaver and rental income investment and would provide no reduction in the existing tax savings penalty on the highest income earners. It would also retain the complexity of having to allocate income out to individual savers and apply different tax rates to them. Even then, the PIE tax scale does not closely align with the actual personal income tax scale in terms of thresholds. This is inherent in the PIE tax regime that applies final withholding rates at the PIE level without knowing the individual savers non-PIE income for the year. It could be overcome by requiring Kiwisaver investors to file annual returns of KiwiSaver and non-KiwiSaver income and pay any excess tax over and above that withheld at the KiwiSaver level. Requiring investors to file tax returns would be likely to be resisted by Inland Revenue since it would place pressure on its system and would discourage saving via KiwiSaver since people would have to pay any additional tax without being able to access the KiwiSaver income giving rise to that tax. Alternatively more accurate withholding taxes could be levied at the PIE level but this would require IT system changes for financial institutions and the IRD. This is required to link the marginal tax rate assumed by the employer to calculate the tax on employer KiwiSaver contributions to the rate applied by the PIE provider so that the KiwiSaver member is taxed at the right PIE rate.

The alternative is to apply a single tax rate to all KiwiSaver schemes. Taking the Savings Working Group proposal of a 5 percentage point reduction in KiwiSaver tax rates, a comparable flat tax rate might be in the order of 15%. A 15% rate would align New Zealand and Australian superannuation tax rates which would remove a current barrier to the trans-Tasman transfer of superannuation savings. A 15% single rate would provide significant tax savings for higher income earners on a 30% or 33% normal marginal rate. The reduction in tax for those on a 17.5% normal marginal rate would be modest. For those earning $14,000 or less of taxable income a 15% KiwiSaver rate would be higher than their normal rate. Most importantly, a 15% rate would not seem to come close to equalising the tax treatment of KiwiSaver and rental property investment assuming capital gains remain untaxed and the property is significantly geared. It would approximately level the playing field with respect to the top KiwiSaver tax rate (now 28%) assuming a rental property is 100% equity funded i.e. no gearing. However, that is not a realistic assumption. Most property investors of working age highly gear rental properties. The norm is for available surplus funds over time to be used to buy a further rental property, not to reduce the level of debt. Since the tax preference for rental property increases to the extent it is geared, this means KiwiSaver, to be an attractive investment, needs a much lower tax rate than 15%. Using the reasonable assumption of 80% gearing, the rate needs to be close to 1% and with 50% gearing close to 10%.

As this paper demonstrates, a flat KiwiSaver rate of close to 1% is justified and indeed required if the tax bias in favour of investing in rental property is to be removed. If this is not considered to be fiscally sustainable, at least in the short term, then as the next section demonstrates the KiwiSaver incentives (the $1000 up front and the $521 ongoing annual tax credit), could be used to fiscally neutrally fund either a single PIE tax rate in the order of 6.4% or a progressive KiwiSaver tax scale with a top rate of 12%. If just the $521 tax credit was removed a single PIE tax rate of 8% could be funded or a progressive KiwiSaver PIE tax scale with a top tax rate of 15%. (These estimates assume that the $521 tax credit is indexed to the future growth of wages and that no change in behaviour occurs.)

There are some technical issues involved with moving KiwiSaver to lower tax rates (flat rate or progressive). First it would require imputation credits on dividends received from New Zealand companies to be refundable. Otherwise equity investments by

KiwiSaver schemes would be taxed at 28% (the company tax rate) but debt at a much lower rate. Australia refunds their equivalent franking credits for superannuation so this is not seen as more than a technical issue. Secondly, it would probably be necessary to ensure that those over retirement age who are not restricted to withdrawals from KiwiSaver could not use a KiwiSaver as a bank account. One way to do this would be to bar those over retirement age from being able to make new contributions to the KiwiSaver scheme. This is similar to restrictions already applying to kick-start payments.

Finally, it is to be noted that a low flat rate KiwiSaver tax rate would enable New Zealand to adopt simple and appropriate rules for the taxation of life annuities. An annuity could be provided via a KiwiSaver scheme and taxed at the KiwiSaver rate. This would enable KiwiSaver to be used as a draw down facility in retirement to help fund a comfortable level of income.

- Retaining a progressive tax scale and applying lower rates at each threshold. This is what the Savings Working Group recommended.
- Having a single comparable low rate for all KiwiSaver and similar investment.

Retaining a progressive tax scale with a 5 percentage point reduction would produce a tax scale along the following lines:

- Non-PIE income of $14,000 or less and PIE plus other income of $48,000 or less – 5.5% instead of the current 10.5%.
- Non-PIE income of $14,001 and up to $48,000 and PIE plus other income of $70,000 or less – 12.5% instead of the current 17.5%.
- Over these thresholds – 28% as is already the case.

This retains the equity of progressivity and provides lower income earners with similar tax benefits now available to the highest income earners.

However, the Savings Working Group lower but progressive Kiwisaver tax rate scale would not level the tax playing field between KiwiSaver and rental income investment and would provide no reduction in the existing tax savings penalty on the highest income earners. It would also retain the complexity of having to allocate income out to individual savers and apply different tax rates to them. Even then, the PIE tax scale does not closely align with the actual personal income tax scale in terms of thresholds. This is inherent in the PIE tax regime that applies final withholding rates at the PIE level without knowing the individual savers non-PIE income for the year. It could be overcome by requiring Kiwisaver investors to file annual returns of KiwiSaver and non-KiwiSaver income and pay any excess tax over and above that withheld at the KiwiSaver level. Requiring investors to file tax returns would be likely to be resisted by Inland Revenue since it would place pressure on its system and would discourage saving via KiwiSaver since people would have to pay any additional tax without being able to access the KiwiSaver income giving rise to that tax. Alternatively more accurate withholding

taxes could be levied at the PIE level but this would require IT system changes for financial institutions and the IRD. This is required to link the marginal tax rate assumed by the employer to calculate the tax on employer KiwiSaver contributions to the rate applied by the PIE provider so that the KiwiSaver member is taxed at the right PIE rate.

The alternative is to apply a single tax rate to all KiwiSaver schemes. Taking the Savings Working Group proposal of a 5 percentage point reduction in KiwiSaver tax rates, a comparable flat tax rate might be in the order of 15%. A 15% rate would align New Zealand and Australian superannuation tax rates which would remove a current barrier to the trans-Tasman transfer of superannuation savings. A 15% single rate would provide significant tax savings for higher income earners on a 30% or 33% normal marginal rate. The reduction in tax for those on a 17.5% normal marginal rate would be modest. For those earning $14,000 or less of taxable income a 15% KiwiSaver rate would be higher than their normal rate. Most importantly, a 15% rate would not seem to come close to equalising the tax treatment of KiwiSaver and rental property investment assuming capital gains remain untaxed and the property is significantly geared. It would approximately level the playing field with respect to the top KiwiSaver tax rate (now 28%) assuming a rental property is 100% equity funded i.e. no gearing. However, that is not a realistic assumption. Most property investors of working age highly gear rental properties. The norm is for available surplus funds over time to be used to buy a further rental property, not to reduce the level of debt. Since the tax preference for rental property increases to the extent it is geared, this means KiwiSaver, to be an attractive investment, needs a much lower tax rate than 15%. Using the reasonable assumption of 80% gearing, the rate needs to be close to 1% and with 50% gearing close to 10%.

As this paper demonstrates, a flat KiwiSaver rate of close to 1% is justified and indeed required if the tax bias in favour of investing in rental property is to be removed. If this is not considered to be fiscally sustainable, at least in the short term, then as the next section demonstrates the KiwiSaver incentives (the $1000 up front and the $521 ongoing annual tax credit), could be used to fiscally neutrally fund either a single PIE tax rate in the order of 6.4% or a progressive KiwiSaver tax scale with a top rate of 12%. If just the $521 tax credit was removed a single PIE tax rate of 8% could be funded or a progressive KiwiSaver PIE tax scale with a top tax rate of 15%. (These estimates assume that the $521 tax credit is indexed to the future growth of wages and that no change in behaviour occurs.)

There are some technical issues involved with moving KiwiSaver to lower tax rates (flat rate or progressive). First it would require imputation credits on dividends received from New Zealand companies to be refundable. Otherwise equity investments by KiwiSaver schemes would be taxed at 28% (the company tax rate) but debt at a much lower rate.Australia refunds their equivalent franking credits for superannuation so this is not seen as more than a technical issue. Secondly, it would probably be necessary to ensure that those over retirement age who are not restricted to withdrawals from KiwiSaver could not use a KiwiSaver as a bank account. One way to do this would be to bar those over retirement age from being able to make new contributions to the KiwiSaver scheme. This is similar to restrictions already applying to kick-start payments.

Finally, it is to be noted that a low flat rate KiwiSaver tax rate would enable New Zealand to adopt simple and appropriate rules for the taxation of life annuities. An annuity could be provided via a KiwiSaver scheme and taxed at the KiwiSaver rate. This would enable KiwiSaver to be used as a draw down facility in retirement to help fund a comfortable level of income.

Fiscal Issues

No reform is likely to be undertaken if it comes at too high a price. It is therefore necessary to gauge the fiscal viability of reducing the tax rate applying to KiwiSaver.

Prima facie, lowering the statutory tax rate would clearly come at a fiscal cost. However, if necessary, this cost could be offset by removing or reducing the existing KiwiSaver incentives, being the one-off $1,000 kick-start payment and the annual $521 member tax credit. These subsidies could either be cancelled or reduced from a certain year or phased out over a number of years.

The current cost of KiwiSaver tax incentives is $740 million per annum which is forecast by Treasury to increase to $780 million in 2017. If this cost grew by 2.5% per annum the costs would reach about $1.1 billion in 2031. KiwiSaver funds under management in 2013 are estimated to be $14.5 billion.[69] In Budget 2011, Treasury estimated such funds under management would total $25 billion in 2015 and $60 billion in 2020 (an annual growth rate of 16.3%). Assuming thereafter a lower, more conservative growth rate of 10.8%, by 2031 KiwiSaver funds under management would be $186 billion.

The estimated tax revenue from KiwiSaver funds in 2013 was $220 million. Based on the above estimated growth in fund size, tax revenue from KiwiSaver is estimated to grow to $580 million in 2017 and $2.8 billion in 2031.

The Financial Services Council commissioned work to estimate what KiwiSaver tax rate could, if necessary, be funded out of the existing incentives over a twenty year time horizon at no fiscal cost in net present value terms. This was based on either phasing out KiwiSaver incentives over 5 years from 2015 or, alternatively cancelling the incentives from 2015. The tax rate was calculated assuming the member tax credit is increased by 1.1% per annum so that it retains value proportional to income growth from labour productivity growth. The results are shown in the following table:

FISCALLY NEUTRAL KIWISAVER PIE TAX RATES

Reform Option	NPV 0 Tax Rate – $521pa MTC only removed	NPV 0 Tax Rate – $521pa MTC and $1000 kick-start removed
Phase out incentives from 2015	9.92%	8.63%
Remove incentives from 2015	7.96%	6.38%

The above demonstrates that if necessary a significant reduction in the KiwiSaver tax rate could be achieved at no fiscal cost. We also explored the options of a fiscally neutral reduction in KiwiSaver tax rates while retaining the progressivity of rates so that a greater benefit would be able to be delivered to lower income savers. This produced the results in the following table:

EXAMPLES OF FISCALLY NEUTRAL PROGRESSIVE PIE TAX RATES

Progressive PIE tax rates	Low rate	Middle rate	Top rate
Current PIE tax rates	10.5	17.5	28.0
Fiscally neutral if only $521pa MTC removed	4.3	8.0	15.0
Fiscally neutral if $521pa MTC and $1000 kick-start removed	3.5	6.4	12.0

[69] Source: Morningstar, KiwiSaver performance survey, March 2013, available at: http://www.morningstar.co.nz/s/documents/kiwisaver_survey130430_Combined.pdf

Technical Annex

This technical annex sets out findings of work commissioned by the Financial Services Council on effective tax rates in New Zealand undertaken by Ernst and Young (EY). Details of this work will be available on the Financial Services Council website.

Tax bias between investment in real property and retirement savings

Analysis on the tax bias between investment in rental property and saving for retirement has been undertaken by at least two prominent international studies. Australia's Henry Review and the United Kingdom's Mirrlees Review both compared the tax return on different asset classes and independently concluded that real effective tax rates were generally higher for rental property than for superannuation savings, at times significantly so. In other words, it is more tax advantageous to save using retirement savings schemes than in buying and holding rental properties. As has been shown, in New Zealand the converse is true: rental property is tax-preferred compared to KiwiSaver and other financial assets.

Based on these studies, we can conclude that New Zealand has a significantly larger tax bias between rental property and retirement savings than either Australia or the UK, being two of our key trading partners. New Zealand effectively operates a concessionary tax regime for rental properties through not taxing the capital gains, while at the same time taxing investment returns through KiwiSaver at up to 28%. Australia and the UK, on the other hand, operate a capital gains tax – including on rental property – whilst also offering concessionary tax treatment for superannuation schemes.

In the UK, the Mirrlees Review found that the effective tax rate on retirement savings, assuming a 5% nominal rate of return and 2% inflation, was negative for persons on both a low and a high basic tax rate. As shown in Table 1,[70] the rates differed between employer and employee contributions but ranged from -8% to -40% over a 25-year savings horizon. The concessions are even greater when the savings are invested for ten years, with the real effective tax rate reaching less than -100%. A negative real effective tax rate means, in short, that the Government is paying the person in order to save. Inflation does not affect the effective tax rates for retirement savings as the returns are tax-exempt. In contrast, rental housing invested for 25 years had an effective tax rate of 28% for a low-income person and 48% for a high-income person.

Similarly, in Australia the Henry Review concluded that the real effective tax rates for retirement savings are lower than for rental property for persons on higher tax rates. The analysis provided in the report assumes a 6% nominal return, 2.5% inflation and with investment horizons of 7 years for rental property and 25 years for retirement savings. It is further assumed that half of the rental return is due to the capital gain and half due to rental income, which are the same assumptions made in this paper. The Henry Review asserts that the real effective tax rate on rental property is close to a person's marginal tax rate – such as 15%, 31.5% or 46.5%.

In comparison, the effective tax rate on superannuation for a person on a low marginal rate is above 20%, which is greater than the effective tax rate on rental housing. However, for individuals with a higher marginal tax rate the effective tax rate on superannuation is negative – approximately -30% for a person with a 46.5% marginal tax rate. Thus, for a high wealth person in Australia the tax wedge between rental property and superannuation is approaching 70% in favour of the latter. There is a significant tax advantage to investing in a superannuation scheme.

TABLE 1 – EFFECTIVE TAX RATES IN THE UNITED KINGDOM (MIRRLEES REVIEW)

Asset	Effective tax rate for:	
	Basic-rate taxpayer	Higher-rate taxpayer
Individual savings account (ISA)	0%	0%
Interest-bearing account	33%	67%
Pension – employee contribution – invested 10 years	(21%)*	(53%)
– invested 25 years	(8%)	(21%)
Pension – employer contribution – invested 10 years	(115%)	(102%)
– invested 25 years	(45%)	(40%)
Housing – main or only house	0%	0%
Rental housing – invested 10 years	30%	50%
– invested 25 years	28%	48%
Direct equity holdings – invested 10 years	10%	35%
– invested 25 years	7%	33%

Source: The Mirrlees Review, United Kingdom, chapter 14, p.322.
Assumptions: 3% annual real rate of return and 2% inflation. Rental housing assumes no mortgage (i.e. 0% gearing).
**A tax rate in (brackets) is negative which means holding this asset is being tax subsidised.*

[70] Mirrlees Review, chapter 14, p.322

Saving $450,000 for retirement

As previously noted, surveys demonstrate that a person would need about $450,000 as a lump sum on retirement in order to provide what most New Zealanders consider to be a comfortable retirement income.

The longer that a person takes to save $450,000 in today's dollars by the time they reach the age of retirement, the greater the impact of tax on their cumulative investment return. Maintaining the assumptions used in this report of a 4% real rate of return and 2% inflation, it is also assumed that the nominal returns are taxed at the top personal tax rate applying to KiwiSaver funds of 28%.

As Table 2 illustrates, in order to save $450,000 in today's dollars over a ten year period, a person would need to contribute more than $40,000 annually to their KiwiSaver fund. The value of the contributions in today's dollars would be approximately $405,000, with the remaining $45,000 or so (in today's dollars) constituting cumulative investment returns.

In a world without tax, however, a person who continued to contribute $40,479 per year (in today's dollars) would have cumulative investment returns of around $81,000 in today's dollars. The total investment over 10 years would, in the absence of tax, exceed $450,000. The after-tax return of $45,000 is 44% less than $81,000, and we describe this difference in the table above as the impact of tax on the person's cumulative investment return.

The impact of tax on a person's return increases with longer savings horizons due to the higher weighting of returns to contributions. Consider instead a person who begins saving for their retirement in a KiwiSaver scheme at the age of 20 with fifty years until they retire at age 70. Over this fifty year period, the person would need to save almost $5,000 annually in today's dollars to reach $450,000 by the time they retire. Of this $450,000, approximately $242,000 would comprise contributions and $208,000 investment returns. In the absence of taxes, the investment returns would instead be valued at almost $500,000. The impact of tax is to therefore reduce the person's cumulative return by more than 58%.

TABLE 2 – EFFECTIVE TAX RATE IMPACTS INCREASE THE LONGER THE TERM OF SAVINGS

Years of saving	Annual savings required		Impact of tax on cumulative return
	No tax	With Tax	
10	$37,481	$40,479	44.3%
20	$15,112	$17,918	47.7%
30	$8,024	$10,529	51.2%
40	$4,736	$6,930	54.7%
50	$2,948	$4,845	58.2%

Assumptions: 4% real rate of return, 2% inflation, 28% PIR[71]. Required annual savings shown is in 2013 dollars, and is assumed to increase with inflation.

[71] The PIE Investor Tax Rate – the rate of tax on which a PIE investor is taxed on PIE earnings.

Effective tax rates on different types of investments, compound interest and inflation

Illustration of compound interest and accrual taxation

As illustrated, even where two different investments are both subject to tax at the same tax rate, the timing of when that tax is paid can make a significant difference to the return the investor actually receives. Imagine a simple world where there are only two investment choices. The first is an investment where all of the income is taxed every year (regardless of whether or not that income is distributed) and the net (i.e. after tax) amount is reinvested each year. In simple terms, this is how a bank term deposit works. The second investment pays tax on the total return at the end of the investment; in much the same way as property purchased by a speculator is treated in New Zealand where the gains are taxable when the property is sold. Assume both investments earn 10% per annum before tax and the tax rate payable by the investor is 30% regardless of which investment they choose.

If the investor is only thinking about the first year, the two investments look the same. If he invests $100 at the start of the year, he will have an additional $7 to spend or invest at the end of the year (i.e. $10 pre-tax return less $3 tax payable to the government). However, it is a very different story if the investor is thinking about long-term saving and plans to leave the income in the investment to compound.

In the case of the term-deposit, the investor has $107 to invest at the start of year 2 (because the $3 tax is payable regardless of whether or not the money is withdrawn or reinvested). In the case of the property investment, however, the investor has $110 to invest in year 2 (as no tax is payable until the end of the investment). In the second year, the holder of the term deposit will earn $10.70 before tax (i.e. 10% of $107), while the holder of the property investment will earn $11 before tax (i.e. 10% of $110). The longer the investment is held (and the longer the tax cost is deferred for the holder of the property investment), the greater the impact this accrual-based taxation has.

After 25 years, the holder of the property investment will have turned his $100 into $788.43, after paying all of the tax at the end. If he or she had put the money into a term deposit that earned the same 10% return every year (but paid tax along the way), he or she would have just $542.74.

Understanding the impact of inflation on effective tax rates

When you invest money, the return you receive (such as interest in the case of a bank deposit) is intended to compensate you for two things. First, what is often called the time value of money, which is simply how much you need to receive for deferring your consumption and still be no worse off. It is, in effect, the reward for waiting. The second part of the return is to ensure that inflation does not erode the value of your savings. The New Zealand tax system (like most systems around the world) taxes the nominal return; that is, the tax system does not take inflation into account in determining your tax liability. This failure to take the effects of inflation into account increases the real effective tax rate over and above whatever the nominal tax rate might be.

This is best illustrated through an example. Consider the case where you have $100 today which would buy you 100 chocolate fish (which each cost $1). You would only save the money (and buy chocolate fish in the future) if you could get more than 100 chocolate fish, otherwise you are better off buying the chocolate fish now.

Imagine a world without inflation where a bank deposit earns 10% per annum and the income is taxed at 30%. Your $100 is worth $107 at the end of the year, meaning you can buy 107 chocolate fish. Your effective tax rate, the difference between the number of extra chocolate fish you can buy before you pay your tax and the number after tax, is 30% (i.e. 3 over 10). It is up to each individual to decide whether the extra 7 chocolate fish makes the wait worthwhile (and whether or not they will consume the chocolate fish in year 1 or save and consume more in year 2).

The situation is complicated once inflation is taken into account. If we assume a 2% rate of inflation (so that each chocolate fish costs $1.02 after a year), at the end of the year you can only buy 107.8 chocolate fish ($110/$1.02) even in a tax-free world. Despite the fact your spending power has gone down, your tax is calculated without reference to inflation, so you pay tax on the $10 nominal interest received at 30% (i.e. $3). So, you only have $107 after-tax to buy chocolate fish that now cost $1.02 each, so you can only afford 104.9 chocolate fish. Your real effective tax rate is now 37% (being (7.8 – 4.9)/7.8). For someone who previously needed an additional seven chocolate fish to make the wait worthwhile (that is, someone who was the marginal saver before inflation), the effect of being taxed on the nominal return means that it is no longer worth their while saving for the future as the reduced rewards (in terms of the bundle of goods they can consume) make current consumption the preferred choice.

EFFECTIVE TAX RATES ON DIFFERENT TYPES OF INVESTMENTS

	Tax rate					
	0%	10.5%	17.5%	28%	30%	33%
Owner-occupied home, debt-free		0%	0%	0%	0%	0%
General rental property * – (100% leverage)	0%	(1.13%)	(1.75%)	(2.52%)	(2.65%)	(2.83%)
General rental property * – (80% leverage)	0%	0.38%	0.68%	1.20%	1.31%	1.47%
General rental property * – (50% leverage)	0%	4.27%	7.01%	10.99%	11.73%	12.83%
General rental property * – (no leverage)	0%	7.70%	12.70%	20.02%	21.38%	23.42%
PIE / KiwiSaver with no subsidies	0%	14.27%	23.78%	38.05%	38.05%	38.05%
Foreign shares	0%	13.13%	21.88%	35.00%	37.50%	41.25%
Bank account term deposit	0%	15.60%	26.10%	41.70%	44.70%	49.20%

**In these examples the rental properties are assumed to be held for 20 years.*

The assumptions underlying these figures are similar to those used by the Savings Working Group in its calculation of real effective tax rates across different asset classes. The Savings Working Group assumed a nominal return of 6% with inflation of 2%, leading to a real return of 4%. For real estate, it also assumed that 50% of the nominal return arose from rental yield and the remaining 50% from (non-taxable) capital gains. The real effective tax rate was calculated as the tax rate on the nominal return as a percentage of the real return. For example, regarding interest income on a bank term deposit a person pays tax on the 6% nominal return at 33%. The tax liability of 1.98% (being 33% times 6%) is calculated as a proportion of the real return of 4%. Thus, the real effective tax rate on a bank account term deposit is simply 49.50% (being 1.98% / 4%).

The calculations in the above table of real effective tax rates for foreign shares give the same results as those attained by the Savings Working Group. Both calculations assume tax is imposed on a deemed 5% return using the fair dividend rate (FDR) method. For example, on the 5% deemed investment return, tax at a marginal tax rate of 17.5% equals 0.875 percentage points (being 17.5% times 5%). Thus, of the 6% nominal return derived from the foreign shares, 0.875 percentage points go to Inland Revenue as tax. 0.875% as a percentage of the 4% real return is 21.88%.

However, the methodology used to calculate the other real effective tax rates in the above table differs slightly. This does not change the results significantly – for example, the above table shows a real effective tax rate on a term deposit of 49.20% compared to the Savings Working Group's 49.50% – but may be a more robust approach. The above calculations use the internal rate of return (IRR) method to calculate the real returns before and after tax for each asset class. The real effective tax rate is calculated as the proportionate difference in the pre- and post-tax real returns. In other words, the reduction in the person's real return from imposing tax compared to what they would have received in the absence of any tax.

Assume, for example, a 4% real return, 2% inflation and a 50/50 split between rental yield and (non-taxable) capital gains. These are consistent with the Savings Working Group's assumptions. Further assume that the rental property is geared to 50%, is held for 20 years before being sold and that the person is on a 33% marginal tax rate. The pre-tax real return calculated using the IRR method is 6.42%, whereas the post-tax real return (also using the IRR method) is 5.60%. Ignoring rounding, the proportionate change in these numbers is the real effective tax rate of 12.83% (being 1 – (5.60%/6.42%)). That is, the cost of imposing tax at a marginal rate of 33% is to reduce the person's after-tax real return on rental property by 12.83%.

The real effective tax rates for rental properties vary according to the gearing ratio assumed. As the interest expenditure incurred on mortgages over rental properties is deductible, a larger mortgage implies higher (deductible) interest costs and therefore lower taxable income. This leads to a lower real effective tax rate.

The assumed nominal interest rate applying to the mortgage is 6.6% whereas the nominal return from the rental property is 6%. This has been assumed because borrowing rates are typically higher than lending rates. Furthermore, it is assumed that mortgage interest is payable at a constant amount per annum – i.e. the person does not repay the mortgage principal over time.

Say a person purchases a house for $500,000 with $100,000 of their own savings and a $400,000 mortgage. The gearing ratio is 80% (i.e. debt of $400,000 / $500,000 = 80%). Consistent with the Savings Working Group's report, it is assumed that half of the return arises from rental yield and the other half from a tax-free capital gain. At a high enough gearing ratio, the interest payable on the mortgage exceeds the nominal rental yield derived from the property in the early years. However, as the rental yield is calculated as a percentage of the property's value (which increases over time) the rental yield increases year-on-year while the interest cost remains constant.

With 80% gearing, interest costs exceed the rental yield until about year eight. That is, the person is paying more in interest than they are receiving in rental income. (This assumes that the person has other income against which the excess interest deductions can be offset.) Until that time, the person's real effective tax rate is negative as the interest deductions exceed the rental income. From year eight to year 20 (when it is assumed the property is sold), the rental income exceeds the interest costs and the real effective tax rate in any particular year is therefore positive. This duration is sufficiently long enough to ensure the overall real effective tax rate from the investment is positive.

Consequently, if the property is instead held for longer than 20 years, the real effective tax rate would increase. This is on the basis that the rental yield exceeds the interest costs for a longer period of time, and so taxable income (i.e. after deductions) from the rental property increases over time.

With 100% leverage,[72] in contrast, under the same set of assumptions the rental income does not catch up to the interest costs until about year 13. Until that point, the person has negative taxable income from the rental property as their interest deductions outweigh their rental income. Although there is taxable income after year 13 and so a positive real effective tax rate for individual years, there is not sufficient time (before the property is sold in year 20) to ensure the real effective tax rate over the life of the investment is positive. Only if the property is held for at least 37 years would rental property with 100% leverage face a positive real effective tax rate over its lifetime.[73]

The following table shows how effective tax rates on rental property vary according to how long the rental property is held before being sold and what the leverage ratio is. This table is based on a 33% marginal statutory tax rate (the top rate) for a person holding a rental property as an investment.

HOW THE EFFECT OF LEVERAGE AND THE PERIOD OVER WHICH RENTAL PROPERTY IS OWNED IMPACTS ON THE EFFECTIVE TAX RATE

Years before rental property is sold	Leverage ratio			
	0%	50%	80%	100%
10 years	22.68%	10.22%	(4.55%)	(6.05%)
20 years	23.42%	12.83%	1.47%	(2.83%)
30 years	24.13%	14.79%	5.20%	(1.02%)
40 years	24.80%	16.37%	7.90%	0.37%
50 years	25.45%	17.71%	10.02%	1.55%

This table assumes the owner is on a 33% marginal tax rate.

The table illustrates that a rental property with a 50% mortgage held for 10 years and then sold faces a real effective tax rate of 10.22%. The longer that property is held for, the higher the real ETR becomes as, over time, the rental yield (based on the property's value) will increasingly outweigh the interest costs.

Real effective tax rates also obviously vary according to the statutory marginal tax rate of the property investor. This is illustrated in the following tables.

[72] This is determined in the model using 99.99% leverage (rather than 100%) for practical reasons, as with 100% leverage there is no initial investment and therefore no basis on which a real effective tax rate can be calculated. [73] It is noted that 100% gearing for tax purposes is feasible for a rental property if the rental investor is able to use his or her home as security. To the bank that lends the loan, it is not lending at 100% of security but for tax purposes it is.

REAL EFFECTIVE TAX RATES ON RENTAL PROPERTIES OVER 10 YEARS AT VARYING MARGINAL TAX RATES

Leverage ratio	Marginal tax rate					
	0%	10.5%	17.5%	28%	30%	33%
0% leverage (no mortgage)	0%	7.34%	12.17%	19.32%	20.66%	22.68%
50% leverage	0%	3.34%	5.52%	8.73%	9.33%	10.22%
80% leverage	0%	(1.60%)	(2.58%)	(3.94%)	(4.19%)	(4.55%)
100% leverage	0%	(2.26%)	(3.57%)	(5.31%)	(5.61%)	(6.05%)

REAL EFFECTIVE TAX RATES ON RENTAL PROPERTIES OVER 20 YEARS AT VARYING MARGINAL TAX RATES

Leverage ratio	**Marginal tax rate**					
	0%	**10.5%**	**17.5%**	**28%**	**30%**	**33%**
0% leverage (no mortgage)	0%	7.70%	12.70%	20.02%	21.38%	23.42%
50% leverage	0%	4.27%	7.01%	10.99%	11.73%	12.83%
80% leverage	0%	0.38%	0.68%	1.20%	1.31%	1.47%
100% leverage	0%	(1.13%)	(1.75%)	(2.52%)	(2.65%)	(2.83%)

REAL EFFECTIVE TAX RATES ON RENTAL PROPERTIES OVER 30 YEARS AT VARYING MARGINAL TAX RATES

Leverage ratio	**Marginal tax rate**					
	0%	**10.5%**	**17.5%**	**28%**	**30%**	**33%**
0% leverage (no mortgage)	0%	8.03%	13.21%	20.69%	22.07%	24.13%
50% leverage	0%	4.98%	8.15%	12.71%	13.55%	14.79%
80% leverage	0%	1.65%	2.76	4.42%	4.73%	5.20%
100% leverage	0%	(0.50%)	(0.73%)	(0.95%)	(0.98%)	(1.02%)

REAL EFFECTIVE TAX RATES ON RENTAL PROPERTIES OVER 40 YEARS AT VARYING MARGINAL TAX RATES

Leverage ratio	**Marginal tax rate**					
	0%	**10.5%**	**17.5%**	**28%**	**30%**	**33%**
0% leverage (no mortgage)	0%	8.35%	13.68%	21.33%	22.73%	24.80%
50% leverage	0%	5.56%	9.09%	14.10%	15.02%	16.37%
80% leverage	0%	2.59%	4.29%	6.75%	7.22%	7.90%
100% leverage	0%	(0.01%)	0.06%	0.25%	0.29%	0.37%

REAL EFFECTIVE TAX RATES ON RENTAL PROPERTIES OVER 50 YEARS AT VARYING MARGINAL TAX RATES

Leverage ratio	**Marginal tax rate**					
	0%	**10.5%**	**17.5%**	**28%**	**30%**	**33%**
0% leverage (no mortgage)	0%	8.65%	14.13%	21.93%	23.35%	25.45%
50% leverage	0%	6.07%	9.90%	15.29%	16.27%	17.71%
80% leverage	0%	3.35%	5.50%	8.60%	9.17%	10.02%
100% leverage	0%	0.40%	0.73%	1.27%	1.38%	1.55%

It might be thought that the government KiwiSaver subsidies might offset to some extent the high relative effective tax rates facing KiwiSaver. However, the $1,000 kick-start subsidy is a one off payment to encourage people to join a scheme. It provides a financial incentive for that but after a person has joined a scheme it offers no further benefit. The high effective tax rates remain. The member tax credit is paid at a rate of 50 cents per dollar of contributions up to a maximum of $521.43 per annum (i.e. on contributions of $1,042.86 or greater). After a person has made contributions of $1,042 per annum, insufficient by itself to fund a comfortable retirement, remaining investments (and all past investments) still face the high effective tax rates noted above.

Required statutory rate for long-term savings to even the playing field

The tax rates necessary to even the playing field between rental property (different levels of leverage) and KiwiSaver at the different marginal tax rates are as illustrated below:

REQUIRED TAX RATES TO EVEN THE PLAYING FIELD FOR LONG TERM SAVINGS

Tax rate	Rental property – no leverage		Rental property – 50% leverage		Rental property – 80% leverage		Rental property – 100% leverage	
	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate	Real ETR	Required marginal tax rate
10.5%	7.70%	5.70%	4.27%	3.30%	0.38%	0.30%	(1.13%)	(1.10%)
17.5%	12.70%	9.30%	7.01%	5.40%	0.68%	0.60%	(1.75%)	(1.70%)
28.0%	20.02%	14.70%	10.99%	8.40%	1.20%	1.00%	(2.52%)	(2.40%)
30.0%	21.38%	15.70%	11.73%	9.00%	1.31%	1.10%	(2.65%)	(2.60%)
33.0%	23.42%	17.20%	12.83%	9.80%	1.47%	1.20%	(2.83%)	(2.70%)

The most reasonable assumption seems to be rental property leveraged to 80% and a tax rate of 28% (the top PIE tax rate). This shows that the required tax rate on KiwiSaver to level the playing field with an investment in rental property is 1%.

Fiscal costs

The current cost of the KiwiSaver upfront and tax incentives is $740 million per annum which is forecast by Treasury to increase to $780 million in 2017. If this cost grew by 2.5% per annum the costs would reach about $1.1 billion in 2031. KiwiSaver funds under management in 2013 are estimated to be $14.5 billion.[74] In Budget 2011, Treasury estimated such funds under management would total $25 billion in 2015 and $60 billion in 2020 (an annual growth rate of 16.3%). Assuming thereafter a lower, more conservative growth rate of 10.8%, by 2031 KiwiSaver funds under management would be $186 billion.

The estimated tax revenue from KiwiSaver funds in 2013 was $220 million. Based on the above estimated growth in fund size, tax revenue from KiwiSaver is estimated to grow to $580 million in 2017 and $2.8 billion in 2031.

The KiwiSaver PIE tax rate that could, if necessary, be funded out of the existing incentives over a twenty year time horizon at no fiscal cost in net present value terms has been calculated. This is based on either phasing out KiwiSaver incentives over 5 years from 2015 or, alternatively cancelling the incentives from 2015. The tax rate is calculated assuming the member tax credit is increased by 1.1% per annum so that it retains value proportional to income growth. The results shown in the table below assume either the $521 annual member tax credit only is removed or the member tax credit and the $1000 kick-start payment is removed:

FISCALLY NEUTRAL KIWISAVER PIE TAX RATES

Reform Option	NPV 0 Tax Rate – $521pa MTC only removed	NPV 0 Tax Rate – $521pa MTC and $1000 kick-start removed
Phase out incentives from 2015	9.92%	8.63%
Remove incentives from 2015	7.96%	6.38%

The above demonstrates that if necessary a significant reduction in the KiwiSaver PIE tax rate to 6.4% could be achieved at no fiscal cost. We have also calculated how the current progressivity of the KiwiSaver rate scale (a low rate of 10.5%, a middle rate of 17.5% and a top rate of 28%) could be preserved if a fiscally neutral reduction in KiwiSaver rates were implemented.

PIE Progressive tax rates	Low rate	Middle rate	Top rate
Current PIE Tax Rates	10.5	17.5	28.0
Fiscally neutral if only $521pa MTC removed	4.3	8.0	15.0
Fiscally neutral if $521pa MTC and $1,000 kick-start removed	3.5	6.4	12.0

Measures along these lines could deliver greater benefits to lower income savers while still enabling the top KiwiSaver tax rate to be reduced from its current 28% to 12% or 15%.

[74] Source: Morningstar, KiwiSaver performance survey, March 2013, available at: http://www.morningstar.co.nz/s/documents/kiwisaver_survey130430_Combined.pdf

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