REPORT OF THE CONSULTATIVE COMMITTEE ON SUPERANNUATION TO THE MINISTER OF FINANCE

CHAPTER 1 - INTRODUCTION AND SUMMARY

1.1 Announcement of Government Policy and Formation of Consultative Committee

On 17 December 1987, the Government announced a series of far reaching economic policy changes, one of which related to the tax treatment of superannuation. The 17 December statement was further amplified by a ministerial statement on 10 February 1988, and at that point most of the features of the proposed treatment of superannuation were outlined. Essentially, the Government proposed to ensure that contributions to superannuation schemes would henceforth be from tax-paid income, and that the income generated within such schemes would be taxed at a rate approximating the marginal rate of contributors, while on the other hand providing that all benefits paid out by superannuation schemes would be exempt from taxation.

Early in March 1988, the Government issued the "Consultative Document on Superannuation and Life Insurance: Volume 1", setting out the proposed changes in detail. The Consultative Document was critical of the previous tax regime as it applied to superannuation, and noted that under that regime savings channelled into superannuation received a markedly more concessionary tax treatment than savings channelled into other areas, such as banks.

Section 5.1 of the Consultative Document argued that past tax concessions provided to superannuation have "been expensive in terms of tax revenue lost, created distortions in investment patterns and in employment behaviour, created the need for tight regulatory control of superannuation funds, led to tax planning, and have made the tax system unfair by favouring the high over the low income earner. Arguments for retaining tax preferences - the desirability of encouraging savings and the desirability of encouraging private, as opposed to public, provision for retirement - do not, in the end, stand up to close analysis".

Following a pattern adopted on several previous occasions, the Government invited public submissions "on matters concerning the implementation and operation of the measures proposed" in the Consultative Document, and established a Consultative Committee to receive those submissions. The Committee was charged with reporting to the Minister of Finance on matters raised in the submissions concerning "the implementation and administration" of the proposed changes, as well as to suggest possible amendments to the detailed changes set out in the document "consistent with the Government's policy announcements and policy objectives".

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1.2 Submissions Received

In response to that invitation, a total of 225 submissions were received:

Employers and employer-related superannuation schemes	72
Private individuals	88
Superannuation professionals (actuaries, life insurance companies, fund managers, etc)	33
Trade and professional associations, accountants, trade unions, and other	32
Total	225

Of the submissions from private individuals, 46 took the form of two or three essentially standard letters, obviously reflecting an organised lobbying campaign in some areas.

It was not possible to meet personally with most of the parties who had made submissions. But we were able to meet with the following:

AMP Society
Association of Consulting Actuaries of New Zealand
Association of Superannuation Funds of New Zealand
Government Life
Life Offices' Association
National Mutual
National Provident Fund
New Zealand Council of Trade Unions
New Zealand Society of Actuaries

In comparison to the 1067 written submissions made to the Advisory Panel on the Goods and Services Tax, and the 1084 submissions made to the Consultative Committee on Primary Sector Taxation, the 225 submissions made on the proposed changes to superannuation taxation seem modest in number, particularly in the light of the number of form letters. On the other hand, the submissions on superannuation frequently argued on behalf of many hundreds, indeed sometimes many thousands, of superannuation scheme members, and were reflective of a very widespread public interest in the Government's proposals.

As noted above, the Government charged us with the responsibility of receiving public submissions, and reporting to the Minister of Finance, on matters concerning "the implementation and administration" of the proposed changes. Our terms of reference did not, therefore, extend to a comprehensive analysis of the merits or demerits of the Government's proposals.

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We would be failing in our duty, however, if we did not report to the Minister that the overwhelming majority of submissions received were very strongly opposed to the policy which Government has announced in this area. In a few cases, the anger was directed at the Committee itself, in the mistaken belief that the Committee had initiated the policy proposals.

1.3 <u>The Criticisms Summarised</u>

There were seven major areas of concern mentioned frequently:

A. <u>Lack of consultation</u> - Many of those professionally involved in providing superannuation services recalled frequent Government promises of "consultation" with the industry before any major changes were announced. Those parties resented Government's policy announcements as a <u>fait accompli</u>. Two submissions actually called upon the Committee to resign immediately, on the grounds that the whole consultation process was a farce, particularly in view of the fact that several of the key features of the proposal had already been enacted into legislation.

B. <u>Retrospectivity</u> - A number of submissions expressed concern that the proposals would effectively abrogate existing contractual rights, and give little or no time to adjust financial plans. Several submissions described the proposals as having retrospective effect, and argued that the existing tax treatment should apply to all superannuation schemes, or at least all existing members of existing schemes, as at 17 December 1987.

The Committee recognises that this is a very difficult area. If it is accepted that the present multiplicity of tax regimes applying to different superannuation schemes is undesirable, and that the present situation is both open to manipulation for tax planning purposes and inefficient as a means of providing retirement income to the majority of the population, as many submissions did, then it follows that some fundamental change is required. It also follows that, unless arrangements existing at 17 December 1987 are to be preserved until the death of those concerned, in perhaps 50-60 years' time, some element of "retrospectivity" is inevitably involved in that change. It was for this reason that the Consultative Document proposed concessionary arrangements to smooth the transition from the previous regime to the proposed one.

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The Committee believes that it would be quite unreasonable to expect any Government to tie its hands for a period of up to 50 or 60 years. This is particularly true in a situation where many other parts of the New Zealand economy are being forced to face up to radical change, with tariffs, import controls, and export incentives, for example, being reduced or phased out "retrospectively" after investments have been made.

Moreover, no submissions complained that the proposals would "retrospectively" provide benefits to many people, by making tax-free benefits which under the previous regime would have been taxable. (In at least some cases, it seems virtually certain that the benefit of receiving payments from superannuation schemes in a tax-exempt form would more than offset any possible reduction in the size of those payments.) In complaining about the "retrospectivity" of the proposals, however, a small number of submissions did acknowledge the very important point that the proposed changes to the taxation of superannuation were only one aspect of a larger tax reform programme, some parts of which involved significant reductions in both corporate and personal tax rates.

C. Distribution of benefits - Section 5.7 of the Consultative Document argued that the previous superannuation tax regime provided substantially greater benefits to high income earners than low income earners. A great many submissions questioned this argument, most simply noting that most of the members of employee superannuation schemes were low or middle income earners.

There is no doubt that a large number of New Zealanders earning quite modest levels of income are members of superannuation schemes. The Committee was not persuaded, however, that the benefits of the previous tax regime were distributed on the same basis as the membership of schemes. High income earners typically save more in tax (because of their higher marginal tax rates) for any given level of superannuation exemption than do low income earners; high income earners are able to save a higher proportion of their income, and shelter the income on that savings through superannuation schemes, than can low income earners; and, particularly in defined benefit superannuation schemes, it is the high income earners who receive overwhelmingly the largest part of the employer subsidies. (This last point is frequently overlooked. The reality, however, is that a great many of the contributors to defined benefit superannuation schemes receive little or nothing of the employer subsidies notionally made on their behalf, with these subsidies effectively appropriated for the benefit of long-term, and therefore frequently higher income earning, employees.)

D. <u>Lack of neutrality</u> - One of the main arguments advanced by the Consultative Document for the proposed changes is that the changes would make the tax system more neutral, in that savings in the form of contributions to superannuation schemes would be treated in the same way as savings in all other forms. Most submissions questioned the desirability of neutrality as a goal, but even those submissions that accepted neutrality as a desirable objective argued that the proposed system fell well short of that objective. It was noted, for example, that in proposing to tax the income of superannuation schemes at 33% the Government's policy would act as a significant deterrent to those low income earners paying a marginal tax rate of less than 33%. The Committee recognises that this particular aspect of neutrality will be very difficult to avoid with anything other than a single personal tax rate.

Another point raised by a large number of submissions was the proposal to tax capital gains in superannuation schemes. Interestingly, a great many submissions accepted the desirability of having a comprehensive capital gains tax, and the Committee addresses this question later. But there was a virtually unanimous view on the part of the many submissions which raised the subject that, as long as capital gains are not subject to tax in the hands of private individuals, they should not be subject to tax within a superannuation scheme if neutrality is an important objective.

E. <u>Security of private retirement plans</u> - In large measure because the personal tax rate is now above the corporate tax rate, there was a widespread recognition on the part of many of those who made submissions that the proposed policy would create a quite considerable financial incentive for companies not to fund superannuation schemes, but rather simply to promise to provide retirement income to long serving employees on retirement. Such a move to unfunded "superannuation" could have a most undesirable effect on the security of the provision for retirement in the private sector because employees would be entirely dependent upon the long-term financial viability of their employers for retirement security.

F. <u>Effect of proposals on level of savings</u> - The great majority of those who made submissions expressed serious concern about the effect which the proposals would have on the level of savings for retirement. This concern was expressed in many different ways, but the common thread was that many employers would cease providing superannuation schemes to their employees, that employees would cease to provide for their own retirement, and that as a consequence dependence on state-provided income would increase markedly over the next 10 to 20 years. A number of submissions pointed out that, because this would be the result of the Government's proposals, it was imperative that the whole issue of the provision of retirement income, both state and private, should be addressed at the same time.

This issue is of such fundamental importance to the matter under consideration that it is discussed further in Chapter 2.

G. Need for long-term stability - Many submissions expressed grave concern at the number of changes which had afflicted superannuation arrangements over the years since 1975. More than one submission claimed that there had been five major changes in the policy framework relevant to superannuation during that 13 year period. It was noted that the introduction of National Superannuation was itself a distinct discouragement to undertaking long-term retirement-orientated savings. The introduction of the National Superannuation surcharge increased that disincentive, by sharply reducing the return from private provision for retirement. Many submissions suggested that the December 1987 package, as it related to superannuation, was the final nail in the coffin of private provision for retirement.

Yet at the same time there was also widespread recognition that there is little prospect of National Superannuation surviving in its present form, given the demographic trends which we face. A considerable number of submissions argued in favour of there being some form of compulsion to belong to a funded superannuation scheme, rather along the lines proposed by the Hon. Mr Trevor de Cleene. And there was a widespread feeling that a bipartisan approach was crucially important in order to provide some form of certainty to those planning for their retirement. One individual submission wrote that "if ever there was a case for a common approach by the two major political parties then it must be over superannuation. If the Committee can give a lead to some consensus on this, if nothing else, then the effort will be totally worthwhile." The sentiment was expressed by many others, and the Committee comments further on this issue in Chapter 2.

Despite the criticism of Government's proposals, there was also, in many submissions, a recognition that the previous regime had some serious deficiencies as a way of encouraging provision of retirement income. It was recognised, for example, that much of the money that goes into superannuation schemes is withdrawn well before retirement. It was pointed out that, as a consequence, savings in this form is both enormously concessional from a tax point of view and quite ineffective as a means of providing for retirement income. Some submissions recognised also that most of the employer contributions in some defined benefit schemes went to high income participants only. It was pointed out, however, that these difficulties could in large measure be dealt with by appropriate legislative change relating to vesting, portability, and "preservation."

Commenting on the fairly wide range of tax treatments of superannuation schemes under the previous regime, several submissions favoured standardising on the exempt/exempt/taxed approach, ie. allowing contributions into superannuation schemes to be deducted from taxable income, allowing income to accrue within superannuation schemes on an exempt basis, but taxing the payments out of superannuation schemes. It was suggested that this was the internationally typical arrangement, and that it would retain a substantial incentive for the private provision of retirement income while avoiding the worst abuses possible under the present situation.

A very small number of submissions fully accepted Government's desire to move to a tax neutral situation, but argued that this objective would be much better achieved by moving to an exempt/taxed/taxed (E/T/T) regime, ie. allowing deductibility of contributions into superannuation schemes, while taxing both the income in those schemes and the payments from those schemes. It was claimed that, whereas no other country in the world had moved to the taxed/taxed/exempt (T/T/E) regime proposed in the Consultative Document, four countries had moved to an E/T/T regime, namely Denmark, Finland, Norway, and Spain.

1.4 Brief Summary of Key Recommendations

Much of this report is devoted to a commentary on the implementation and administration of the proposals contained in the Government's Consultative Document, as requested in our terms of reference. But the Committee was sufficiently impressed by the arguments of those who claimed that the Government's proposals would lead to both a significant reduction in aggregate savings, and a substantial disruption of capital markets in the short-term, to recommend to the Government that the proposals themselves should be fully reviewed in a wider context.

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We recognise that, at this stage, with some of the proposed tax changes already in place, there is little prospect of any fundamental change in the proposed regime for 1988/89. In any event, the Committee recommends that this regime (subject to modifications outlined in Chapter 4) should be adopted for lump sum superannuation schemes. But it was also the unanimous view of the Committee that -

a) Every effort should be made to ensure a bipartisan approach to the whole question of the provision of retirement income in New Zealand.

b) The Government should urgently review the feasibility of continuing National Superannuation on the present basis and, if found appropriate, make it clear at the earliest opportunity that present levels of state-provided retirement income will not be available in future. (The Committee's reason for this recommendation is that the proposed non-concessional tax regime to apply to the private provision of retirement income provides a substantial disincentive for such private provision, when there remains access to a generous, but income-tested, state-provided retirement income.)

c) In this context, the Government should give serious consideration to the adoption of a "modified E/T/T" regime for pension schemes (Retirement Income Funds, or RIFs).