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SUPERANNUATION - 1990 AND BEYOND

As it plays host to the 12th Conference of the International Association of Consulting Actuaries, New Zealand enters the last decade of the 20th century by also hosting the Commonwealth Games and by celebrating the 150th anniversary of the signing of the Treaty of Waitangi. This should be an auspicious occasion for the superannuation industry in New Zealand and yet the 1990's may foreshadow a crisis in retirement planning that cannot be averted.

Amid the chaos created by a Government which has had the courage to bring a nation kicking and screaming into the realities of an international economy, we are faced with the need to completely overhaul a system that may be working directly against the fundamental needs of a nation to ensure that today's working generation can retire and live in dignity tomorrow.

Life has changed dramatically for New Zealanders over the past 20 years. Current circumstances are in many respects a product of forces beyond the control of most New Zealanders. That comment must be balanced by the fact that the nation may have allowed valuable opportunities to slip through its grasp at critical points in the past.

The Institute of Policy Studies at Victoria University has published an excellent study on superannuation in New Zealand. This study identifies with an uncertain future and the need to develop a comprehensive retirement incomes policy that will meet the needs and objectives of retired New Zealanders both today and in the decades ahead. This study is commended to all who wish to better understand the background to the current situation and the increasing need

to take action before a potential crisis becomes reality.

To come to grips with superannuation in New Zealand today it's necessary to review events of the past 20 years, albeit very quickly. The current environment for superannuation planning is a creation of the Labour Government that came to office in 1984. However the current generation of politicians are not entirely to blame for the upheaval that rocked the industry on December 17 1987.

New Zealand is a welfare state originally set up in the 1930's that expanded rapidly in the decades thereafter. As an agricultural country, dependent on exports, the economy has been weakening since the 1950's. There are two main political parties, essentially a right of centre National Party and a left of centre Labour Party.

National has been in Government for most of the last 40 years and has, some would say, led the country from riches to rags. Past policies and a high standard of living by international levels were not supported by basic economics. An increasing amount of social legislation evolved to protect an eroding standard of living. A high degree of protection for major industrial products and import tariffs were set in place to protect local manufacturers.

Badly hit by the oil shocks of the 1970's, New Zealand owed a large amount overseas to finance its oil purchases and other major projects of that decade. The national debt was recently in the region of $39 billion, or about $33,000 per household. This is high by international standards - about sixth highest among OECD countries.

Inflation has ravaged the New Zealand economy. Between 1971 and 1988 the Consumer Price Index rose at an average annual rate of 12.2%. While this may be mild in comparison to the rate of inflation in some third world countries, New Zealanders like to think of themselves as being members of the western world who enjoy a decent standard of living.

By the early 1980's, an over-regulated economy was burdened with further regulations at an alarming rate. Wage, price and rent controls were instituted in 1982 creating an artificially stable and controlled economy for a short period of time.

The current Labour Government was elected following a snap election in 1984. Since that time, the buzz words have been deregulation, free market economy and a level playing field. The current Labour Government introduced a series of new tax measures which drastically overhauled and broadened the tax base. From 1985, fringe benefits tax applies to employer provided benefits that previously enjoyed preferential status. From 1986 a consumption tax was introduced such that all goods and services now attract GST at 12.5%. Personal and company tax rates have fallen dramatically with most loopholes and avenues of tax exemption being eliminated. On 17 December 1987, the Minister of Finance dropped a bombshell with a Government economic statement about changes in the basis of taxation for superannuation schemes and life insurance.

The changes announced were:

1. Employee contributions would not be eligible for income tax deduction;

2. Company contributions would be deductible for income tax purposes but would attract fringe benefit tax, which was later replaced with a final withholding tax at source;

3. The investment income of superannuation trust funds would be liable to tax;

4. All benefits paid out of superannuation schemes would in future be tax exempt.

In recognition of these radical changes and the impact that they would have on the financing of existing superannuation obligations, Trustees would be permitted to renegotiate the level of benefits payable in recognition of the complete reversal from the taxation policies of the past. The stated rationale for introducing these taxation changes was to put superannuation savings on the same basis as all other forms. That is, the savings would be made out of after tax income, the investment income roll-up would be taxable and any withdrawal of savings would be tax exempt. The Government indicated that a consultative document would be released in short order but many questions remained. The most fundamental question related to whether or not people would save for their own retirement, even though personal rates of taxation were being reduced to much lower levels. The Government was firm in its resolve to carry through its reform policies but many people had misgivings about the wisdom of those policies.

As time passed subsequent to the announcements of December 17 1987, a public row erupted in the Labour Party, and as we now know, the internal wrangling continued for nearly a full year culminating in the firing of the Minister of

Finance prior to Christmas 1988. His proposal for a flat rate of personal income tax was shelved and replaced with a two-tier system, with marginal rates of taxation of 24% up to $30,875 and 33% thereafter. The departure from the proposed flat rate of tax threw a giant wrench into the Government's economic policy of taxing the capital contributions and the investment earnings of superannuation schemes as a proxy for taxing the individuals directly.

A Consultative Document heralded a new regulatory regime for previously "approved" superannuation schemes. The terms and conditions of existing schemes could be renegotiated if approved by the Government Actuary before a certain date. All existing schemes would become "registered" at a certain date not far into the future. As we now know, 1 January 1990 and 1 April 1990 are particularly significant dates for superannuation schemes in New Zealand.

Transitional arrangements were offered to existing schemes on a concessional basis. Many believe these concessions will evaporate on 1 April 1990 with a single rate of taxation applying to the investment income of all superannuation schemes. The Brash Committee reported to the Minister in mid-1988 with a series of proposals and recommendations to assist the Government in implementing the new regime. These proposals included:

- a 33% withholding tax applies to employer contributions and replaces the previous fringe benefit tax;

- a 33% income tax on the earnings of the scheme, payable by the trustees on behalf of the members;

- pension benefits and annuities to be paid free of tax from 1 April 1990;

- all existing "approved" superannuation schemes would automatically become "registered" on 31 March 1990;

- approved schemes would have until 31 December 1989 to renegotiate their terms and conditions in recognition of the taxation changes that have been brought about.

The final two months of 1988 saw a great flurry of activity on the legislative front. The Government passed a Bill establishing the framework for the taxation of trusts, introduced a Bill governing the taxation issues of superannuation that remained outstanding, and introduced a Bill which deals with the new regulatory regime for "registered" superannuation schemes. This last Bill established the legislative authority under which existing benefits may be renegotiated - which is a polite way of saying reduced.

There really were few surprises in the rush to legislate before the end of the year - perhaps the item of some disappointment was the proposal to incorporate all income in the calculation of the surcharge assessed against National Superannuation payments. However, in the July 1989 budget, the Government reversed their position so that only 50% of pension and annuity income would be taken into account in the calculation of this much reviled surcharge. At the date this paper has been written, the superannuation industry is struggling with the renegotiation process that was given legislative authority in the Superannuation

Schemes Act 1989. The industry is awaiting a judicial decision in a landmark case involving the perplexing question of who owns the actuarial surplus in a defined benefit scheme.

As practitioners in the superannuation industry, we look to the future and wonder what it may hold. General reaction to the changes that have been brought about has ranged from philosophic acknowledgement to passioned disagreement. An initial knee-jerk reaction to the proposed taxation changes was: "Well, we will wind-up our scheme and give the members a salary increase". Many schemes were closed to new entrants until the dust settled and the situation clarified as to the new regulatory regime. Many sponsors of defined benefit schemes chose to take a contribution holiday, notwithstanding the damage inflicted by the October 1987 sharemarket crash. Sponsors who were able to enjoy a contribution holiday were able to mitigate the effect of fringe benefits tax and the introduction of the withholding tax, for the time being at least. Most employers resolved themselves to the position that the extra costs had to be passed on to the members in some fashion. Most plan sponsors wanted to know what other companies were doing, with the frequent response being: "Well, we're waiting to see what other companies are doing!".

One reaction is to do nothing as the change in the rate of corporate tax is such that a company may be able to enjoy enhanced profitability notwithstanding the increased costs of providing superannuation. Another, and often voiced reaction, is to wait for the next election - the stated position of the opposition National Party is to restore, in some fashion, incentives to defer current consumption for

future needs.

The side of human nature overlooked by the Government is that most people are not sufficiently far-sighted to save for their own retirement and any additional savings gained by current cuts in taxation will be translated into immediate consumption. This will be especially true of those in lower income groups. Even those people on middle incomes may have little appreciation of the amounts that are required to be saved to provide for their own retirement.

National Superannuation in its present form has been paid for the past 14 years. Many New Zealanders have become comfortably conditioned to expect that the state will look after them in their old age. One of the hard realities of life in New Zealand is that the state cannot continue, as it has admitted in its 1989 Budget, to support previous levels of benefits provided through this vehicle. Starting early in the 21st century, the age of entitlement to National Superannuation will be raised from the present age of 60 to 65. Means testing by way of a surcharge will continue and the relative level of the benefit will be reduced in relation to the national average wage. Ironically, at a time when the Government is coming to grips with the fact that it cannot sustain the level of benefits that it provides directly, it has removed the taxation based incentives for individuals to save themselves.

The sponsors of superannuation schemes are still uncertain of what the future may hold. Many are not convinced that the current regime will stand the test of time. Some sponsors have taken a serious look at unfunded or book

reserve arrangements. Personal savings plans which are fully portable may become more popular than corporately sponsored arrangements. There appears to be a trend towards defined contribution planning in New Zealand today with hybrid schemes also being favourably considered. For a country that has enjoyed a love affair with lump sum benefits, there is now no distinction between schemes that provide benefits in lump sum or pension form. Many existing schemes are looking at cashing up the existing pensioner obligations and handing the assets over to the individuals.

New Zealand, in conjunction with the rest of the world, is facing an aging population and a deteriorating ratio of retired to working people. When the current generation retires, we may find that our children are unwilling to accept the promise that we have made that they can be taxed to pay for our retirement incomes. There is a feeling of discontent and uncertainty in New Zealand, not just in the superannuation industry. The rest of the world is looking into the test tube called New Zealand and waiting to see what happens. The Government marches on.