



Sleeping through a revolution



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There have been many interpretations and adaptations of Washington Irvin's story of Rip Van Winkle, who slept for 20 years – all the way through the American Civil War and the changes that followed. Martin Luther King Junior eloquently adapted the story in the context of America sleeping through the rise of the black consciousness movement.

In 2014 we celebrate 20 years of the new South Africa. There could be many analogies with Rip Van Winkle. Here is an analogy of sleeping through the revolution in personal financial planning in South Africa over 20 years.

Twenty years ago many privileged South Africans were offered early retirement packages by their employers. Early retirement or *Die Paket* (The Package) was the in thing as it seemed like a very sweet deal. Retire to a modern golf estate for a 20-year holiday before confronting the stark reality of the shady pines retirement home. But many who took a package are struggling today. What went so horribly wrong?

Life expectancy

Some say that the predicament of today's pensioners is principally due to increased life expectancy. Yes, there are many cases of pensioners who are living far longer than expected.

But recent statistics released by the World Health Organisation (WHO) reveal that life expectancy is increasing by about one and a half years per decade. In short, those retiring today (the Baby Boomers) will, on average, live three to five years longer than their parents (Generation Jones).

If increased life expectancy was the sole problem, the solution would be to increase retirement age to 68 or slightly increase retirement fund contributions. Some have achieved this; many have not.

South Africa's current average national life expectancy of 53 years is a very misleading statistic in the context of financial planning and takes into account the tragedy that is the HIV/Aids pandemic. It is critical to note that

the privileged have far greater life expectancy. Simply put, the privileged have enjoyed access to food, housing, sanitation facilities and medical services during their lifetime without being subject to the physical risks created by menial work. These factors alone increase life expectancy by 20 to 25 years above the national average.

The WHO has also developed a model indicating worldwide life expectancy as 60 years. South Africans will live for 16 to 18 years post 60. This can also be a misleading statistic in the context of financial planning as most should consider the combined life expectancy of both husband and wife. Due to increased longevity in women – and most women being younger than their spouses – it is unusual to create a retirement plan with a combined life expectancy of less than 20 years post retirement.

But so many of those who retired 20 years ago ran into financial problems within 10 to 15 years of retirement. Conclusion: there is a lot more to a retirement plan than a life expectancy prediction!



Taxation

There is little merit to the popular argument that the South African pensioner has been taxed into poverty.

SARS statistics reflect that the average rate of taxation for all South Africans has reduced from 34% in 1994 to 18% today. This claim is clouded when it comes to employed taxpayers who today are taxed on a far wider range of fringe benefits. But there can be no doubt that the widening of the tax brackets since 2000 has substantially reduced the taxation liability of the pensioner.

Some pensioners remain steadfast in the pursuit of tax-free income offered by insurance policies and preference shares that were very much in vogue prior to 2000. These instruments are by no means as tax-efficient as they were and many pensioners should have exited these arrangements years ago.

The increased exposure of pensioners to indirect taxation is a factor. The 14% VAT rate may have remained constant across 20 years. But there have been substantial increases in sin taxes and fuel and electricity levies that have contributed to the increased cost of living. Few pensioners have factored in the effect of stealth taxes. But it is highly unlikely that the increased levels of indirect stealth taxes have outweighed the reduction in direct taxation enjoyed by most pensioners over the past 15 years.

Residential property

Few of those who elected to take early retirement 20 years ago downsized their accommodation requirements. On the contrary, many increased their property portfolios in the euphoria that was the housing boom between 2000 and 2008.

When developing a financial plan one must consider the substantial increase in utility charges associated with South African property ownership since the promulgation of the Municipal Property Rates Act, 2004. This must be coupled with a 550% increase in electricity charges between 2000 and 2014 caused by the Eskom debacle and the introduction of an electricity levy in 2008. In most instances insurance and security costs have also increased at well above the official inflation rate.

Associated with the residential property debate is also the decline of empty-nest syndrome. Internationally there has been a substantial lifestyle change as Generation Y reached adulthood and the temptation to leave home has evaporated. No pension plan can be expected to accommodate the associated costs of an indefinite visit from children and grandchildren, let alone grandparents.

All of the above are factors in the unhappy predicament of today's pensioner. But the biggest change is rarely recognised.

Call back the past

The standard investment advice dispensed to pensioners 20 years ago was simple: Liquidate all investments to cash. And if interest receipts create a tax problem, run for the cover offered by insurance policies and preference shares. Essentially these were savings plans, not investment plans. To appreciate the difference requires a short history lesson.

The 1974 oil crisis, coupled with vastly increased levels of consumerism, led to rampant worldwide inflation. Internationally politicians sought answers. And they found them in the Monetarist ideals of Nobel laureate economist and philosopher Milton Friedman.

Friedman will not be remembered for liberal thought. On the business front he was hailed during the 1970s and 1980s for his ideal of 'the social responsibility of business is to make a profit ...'. But that is another story.

Friedman's ideal to contain world inflation was to reduce demand by substantially increasing interest rates. These ideals were accepted by world leaders of the time, primarily Ronald Reagan and Margaret Thatcher, and were implemented regardless of collateral damage.

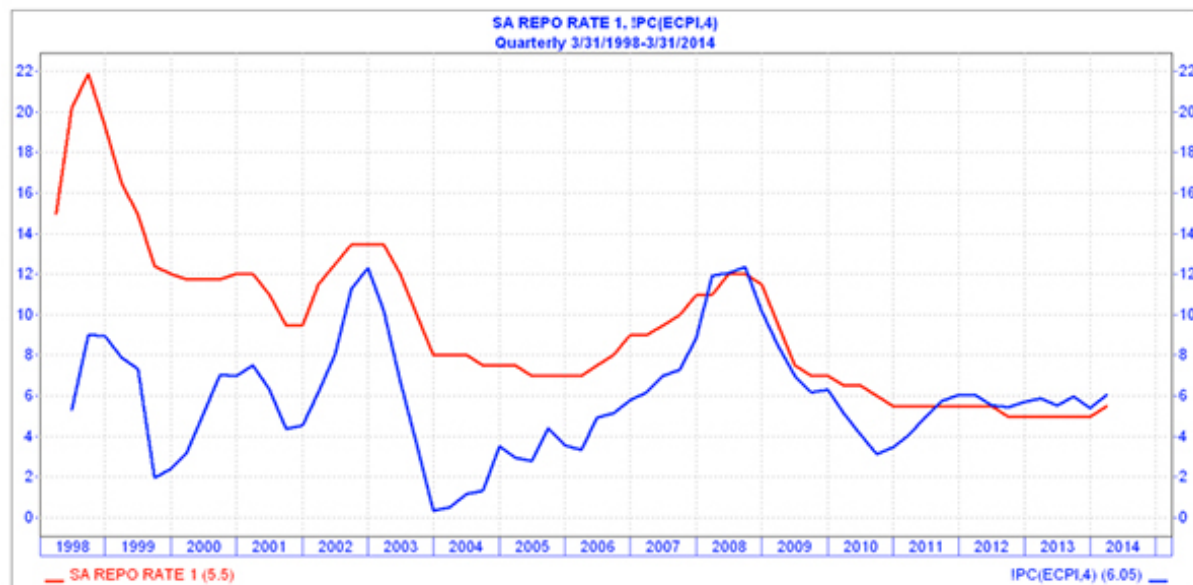
Back in South Africa the Reserve Bank had no option but to increase interest rates. And given the 'state of siege' that existed at the time, interest rates were increased above the international norm. At times pre-tax interest rates exceeded the official inflation rate by more than 10%.

The fundamental flaw in Friedman's ideal of increasing interest rates is the inevitable concomitance of the slowing down of economic growth. The result is an increase in unemployment levels and a decline in tax collections. In short, the staunch ideals of Friedman are not sustainable.

Thus by the late 1990s the ideals of US Federal Reserve Governor Alan Greenspan ('let the people borrow') had replaced Friedman's ideals and interest rates declined internationally.

Chris Stals, South Africa's Reserve Bank Governor from 1989 to 1999 was a Monetarist. Furthermore, he sought to support the ailing rand by attracting speculative international investment to South Africa using massive real interest rates. This created the ideal climate for savings.

Real interest rates: Repo rate versus consumer price index, 1998 – today



By 1999 when Tito Mboweni succeeded Chris Stals as Reserve Bank Governor, interest rates exceeded the official inflation rate by 10%, strangling the economy, wrecking tax collections, but benefitting pensioners.

Between 1999 and 2010 Mboweni managed the Reserve Bank lending rate downwards to approximate the official inflation rate. The economy thrived and tax collections increased. But the principle casualty was pensioner savings.

This policy was extended further when Gill Marcus succeeded Mboweni as Governor of the Reserve Bank in 2010. In the aftermath of the 2008 financial crisis, South African interest rates declined below the official inflation rate.

The result:

Twenty years ago it was reasonable to devise a retirement plan based on the following:

- Cash in all retirement funds, thereby substantially reducing taxation by applying exemptions and the average rate of tax or rating formula available at the time.
- Invest the after-tax proceeds in interest-bearing risk-free instruments.
- If a tax problem arose, investments would then be placed within insurance policies and preference shares.

Applying the above, it was reasonable to base the retirement plan on a risk-free return of 8–10% above the inflation rate.

In round numbers, applying a return rate of 10% above the inflation rate, retirement capital of R4 million can yield an inflation-linked after-tax income of R30 000 per month for 20

years without exhausting capital.

Today the after-tax interest rate can be as much as 3% below the inflation rate. This would lead to a R30 000 per month after-tax inflation-linked pension eroding R4 million retirement capital in just eight years.

In order to sustain a R30 000 per month after-tax inflation-linked pension for 20 years on a 3% below-inflation return, retirement capital of R11 million would be needed.

The moral of the story

South Africans have slept through a revolution in Reserve Bank strategy. Most have failed to recognise the staggering effect of the decline in real interest rates on their financial planning.

Today it is simply impossible to base a financial plan on a savings plan yielding risk-free fully taxable interest.

Even using an equity investment strategy, it is hard to justify a return assumption of more than 6% above inflation. Thus the financial planning has to incorporate other strategies to supplement lower anticipated growth rates. These strategies can include:

- Downward adjustment of income expectations on retirement.
- Postponement of retirement date.
- Reinvestment of tax savings achieved on contributions to retirement funds.
- Maximising tax-free growth of retirement investments within retirement funds.
- Management of tax-profile of withdrawal benefits from retirement funds.
- Containing exposure to dividend tax and capital gains tax via retirement funds.

A sustainable financial plan is still achievable in South Africa. But while South Africans slept for 20 years, the challenge of a financial plan has escalated from a simple savings strategy to the integrated science that is financial planning today.

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