The Treasury

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Inland Revenue
Te Tari Taake
Policy Advice Division

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Funding the Earthquake Recovery: Levies and Other Potential Funding Options

Date:	4 March 2011	**Report No:**	T2011/334 PAD 2011/036

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	**Discuss** with officials: • Design of a temporary earthquake levy • Other potential tax changes **[2]**	None.
Minister of Revenue (Hon Peter Dunne)	**Discuss** with officials: • Design of a temporary earthquake levy • Other potential tax changes **[2]**	None.

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Peter Martin	Director, Tax Strategy Team, The Treasury	**[1]**	
Steve Cantwell	Principal Advisor, Tax Strategy Team, The Treasury		✓
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Minister of Finance's Office Actions (if required)

None.

Enclosure: **No**

Joint Report: Funding the Earthquake Recovery: Levies and Other Potential Funding Options

Executive Summary

This report responds to your request for advice on options for funding the earthquake recovery, including a dedicated earthquake levy. This report focuses on tax issues, (including both temporary tax and levy revenue raisers), and reprioritisation or reconsideration of more enduring tax initiatives, (including student loan reform).

This report does not consider whether there *should* be a temporary levy. Any tax initiative, including a temporary levy, should be consistent with the Government's revenue strategy, which in turn is a subset of the Government's fiscal strategy. Therefore any temporary levy requires a compelling rationale situated in the Government's fiscal strategy. The Treasury aide memoire of 2 March *Fiscal Policy Scenarios Based on Preliminary Numbers Released in the Monthly Economic Indicators* notes that fiscal modelling, based on very early information, suggests that an earlier return to surplus before 2015/16 is possible with the savings proposals already on the table. These savings will also cap the increase in level at which net debt peaks compared to HYEFU to 2% (30.7% of GDP). This increase is clawed back by 2016/17 as a result of stronger growth through the projection period.

This report does not seek decisions. We would like to discuss with you what, if any, extra reporting you would like on the issues raised.

Temporary Levies

We analyse four options for a temporary levy. They are:

1. Introduce a levy based on all taxpayers' taxable income;

2. Introduce a labour income tax on all employees. This could be done via a payroll tax, similar to the ACC employer premium, or levied on employees in a similar manner to the current ACC earners' levy;

3. Use the existing local government rating system to impose a central government earthquake levy on ratepayers (potentially excluding Christchurch ratepayers); and

4. Increase the EQC levy (separately from any levy increase as a result of the review of the NDF), and use special dividends to transfer the resulting revenues from EQC to central Government.

If the wider analysis supports the introduction of a temporary levy we would recommend the first option – a flat-rate levy on all taxpayer's income.

A flat 1% levy on all income would raise about $1.2 billion per annum of levy revenue. However as the levy reduces household income, and hence spending, GST and excise revenues reduce. This reduces the net revenue gain to about $1 billion per annum. Limiting the levy to high income earners costs a great deal of revenue. A levy structured similarly to the Queensland flood levy; say a 0.5% levy from $48,000 and 1% from $70,000, would raise about $250 million of revenue per annum, reducing to about $210 million after clawback.

Applying the levy to entities other than people, such as companies, introduces a range of complexities that we can provide more advice on if required.

More Permanent Tax Changes

If options other than than temporary levies are considered, the only potentially attractive sources of significant tax new revenue were considered and not proceeded with as part of the development of Budget 2010 (e.g. land tax, loss ring-fencing).

[2]

Over and above the current Budget 2011 proposals regarding student loans, officials have also considered options to raise additional revenue through changes to the student loans system.

[2]

Recommended Action

We recommend that you:

a **note** that initial work reported in the Treasury aide memoire of 2 March *Fiscal Policy Scenarios Based on Preliminary Numbers Released in the Monthly Economic Indicators* suggests that Budget savings proposals already on the table would enable the government can return to surplus before 2015/16 without introducing a temporary earthquake levy;

b **note** that, should a temporary earthquake levy be considered necessary, officials would recommend the levy be implemented by increasing income tax rates on all taxpayers;

Agree/disagree.

c **note** that, should the fiscal situation require it, there are a range of non-temporary tax and student loan initiatives that could also be considered; and

Agree/disagree.

d **discuss** this report with tax officials.

Agree/disagree.

Mike Nutsford
Principal Advisor, Tax Strategy
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David Carrigan
Policy Manager
Inland Revenue Department

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Joint Report: Funding the Earthquake Recovery: Levies and Other Potential Funding Options

Purpose of Report

1. This report responds to your request for advice on options for funding the earthquake recovery, including a dedicated earthquake levy. This report focuses on tax issues, including both temporary tax and levy revenue raisers, and reprioritisation or reconsideration of more enduring tax initiatives, including student loan reform.

1. Reporting on whether a levy or other tax change is required in order to meet your fiscal objectives, on other spending reprioritisation options, and on the EQC-specific issue of the appropriate rate for EQC levy, will be provided separately.

Analysis

2. Any tax initiative, including a temporary levy, should be consistent with the government's revenue strategy. In summary:

”The Government's revenue strategy is to raise revenue in ways that:

- maintains revenue flows to pay for valued public services and reduce debt;
- responds to New Zealand's medium-term needs in a planned and coherent way;
- biases economic decisions as little as possible - which allows people to work, save, spend or invest in ways that they believe are best for them;
- rewards effort and individuals' investment in their own skills;
- has low compliance costs and low administrative costs;
- minimises opportunities for tax avoidance and evasion; and
- shares the tax burden as fairly as possible.

The revenue strategy supports the Government's economic and fiscal strategy. In particular, it is consistent with returning to fiscal surplus as quickly as practical in order to maintain prudent levels of government debt, while providing the right incentives to achieve stronger and more sustainable economic growth.”

4. This strongly situates the revenue strategy as part of the fiscal strategy. It balances the government's revenue, growth and fiscal demands.

5. Tests provided by the revenue strategy that are particularly relevant to any temporary levy are:

- there must be a compelling fiscal rationale for its introduction;
- it should be able to be legislated through simple legislation or under the emergency earthquake regulatory powers.
- it must be relatively simple and quick to implement and unwind for both levy payers and the collection agency; and
- it should meet perceptions of fairness and burden-sharing appropriate to a levy to fund recovery from a national disaster.

6. Lastly, fiscal modelling, based on very early information, suggests that a levy may not be necessary (refer to the Treasury aide memoire *Fiscal Policy Scenarios Based on Preliminary Numbers Released in the Monthly Economic Indicators* of 2 March). An earlier return to surplus before 2015/16 is possible with the savings proposals already on the table. These savings will also cap the increase in level at which net debt peaks

compared to HYEFU to 2% (30.7% of GDP). This increase is clawed back by 2016/17 as a result of stronger growth through the projection period.

Options for a Temporary Levy

7. We have identified four options that best meet these tests. They are:

   i Introduce a levy based on all taxpayers' taxable income;

   ii Introduce a labour income tax on all employees. This could be done via a payroll tax, similar to the ACC employer premium, or levied on employees in a similar manner to the current ACC earners' levy;

   iii Use the existing local government rating system to impose a central government earthquake levy on ratepayers (potentially excluding Christchurch ratepayers); and

   iv Increase the EQC levy (separately from any levy increase as a result of the review of the NDF), and use special dividends to transfer the resulting revenues from EQC to central Government.

8. The pros and cons of these options are examined in the following table.

Temporary Earthquake Levy Options

Option	Advantages	Disadvantages
Levy on all Taxable income (i.e. increasing income tax rates for all taxpayers)	Potential to raise significant revenue – a 1% levy on all personal taxable income would raise levy revenue of about $1.2 billion per annum, “negative clawback” on other taxes would reduce the net revenue gain to about $1 billion. Existing statutory and legislative frameworks exist, could be implemented relatively easily by increasing the relevant income tax rates and administratively assigning the tagged income to earthquake recovery. Design choices are available. Could apply to personal taxable income, or be extended to non-natural persons, including companies, trusts, PIEs. Subsequent reversal of levy relatively easy to implement. Could be implemented as soon as 1 July this year.	Reduced work and saving incentives would partially undo the benefits of the 2008-2010 income tax cuts. Difficult to exclude earthquake survivors or affected businesses from the levy. As the levy would have no legal status separate from income tax, it may be hard to position it as a temporary tax. Legislative pre-commitment to the removal of the levy would be essential, but may have only a limited effect on taxpayer perceptions as in recent years several NZ governments have made legislative pre-commitments to reduce taxes that have subsequently been reversed.
Temporary Labour Income Tax (Paid by Employer or Employee)	*Shared Advantages* Potential to raise significant revenue – a 1% payroll levy capped at $110,000 (per the ACC arrangements) would raise levy revenue of about $950m per annum. “Negative clawback” on other taxes would reduce the net revenue gain to about $800m. Does less harm to investment and savings than an increase in income tax. A payroll tax is consistent with	*Shared Disadvantages* No current legislative basis, although existing ACC legislation provides a good template. Increase in gap between tax rates applicable to employees and tax rates on capital, and potential for self-employed to plan around the levy, raises equity and integrity concerns.

<table>
<tr><th>Option</th><th colspan="2">Advantages</th><th colspan="2">Disadvantages</th></tr>
<tr><td rowspan="2"></td><td colspan="2">Savings Working Group.

Equity concerns could be partially addressed by a progressive levy; e.g. 1% on the first $70,000 and 2% thereafter.</td><td colspan="2">For a given revenue target would need to apply to at a higher rate than a levy applied to all taxable income.

Difficult to exclude earthquake survivors or affected businesses from the levy.

May be seen as unfair as people earning capital income would not be subject to the levy.</td></tr>
<tr><td>Employer Payroll Tax

As employee remuneration does not change equity concerns may be minimal.</td><td>Employee Levy

Aligns short-run and long-run incidence (in the long run the incidence would largely be borne by employees).</td><td>Employer Payroll Tax

As the short-run incidence falls on the employer employer’s labour unit costs increase, negatively affecting hiring decisions. Would not be able to be delivered by 1 July 2011.</td><td>Employee Levy

Would reduce take-home pay, reducing work incentives. Unclear at this stage whether it could be delivered by 1 July 2011.</td></tr>
<tr><td>Surcharge using local government rating base and collection systems</td><td colspan="2">Local government rating machinery is in place.

Potential to exclude earthquake-affected areas from the levy.

Property taxes score relatively well on efficiency grounds, growth consequences will be less than for the income tax-based options.

Matches the tax base to the big cost drivers. The costs to the central government of the earthquake recovery will be dominated by property repairs (including local infrastructure and remediation).</td><td colspan="2">Would require significant legislative change, and time, as the Local Government (Rating) Act 2002 has no provision for rates to be used for central government purposes.

Flat-rate property taxes are regressive (as people earn more their house typically forms a declining fraction of their wealth). Compensating for this with progressive levies or exempting properties under a certain value adds complexity.

Property values are not always a good indicator of income or ability to pay. About 100,000 ratepayers nationwide currently seek rates relief under the rates</td></tr>
</table>

Option	Advantages	Disadvantages
		rebate scheme. Also, retired people are often identified as those with valuable land but low incomes. Burden is borne by those who hold land and property, and a greater proportion by those who hold more land (e.g. farmers, foresters, property investors). Delivers a large rates hike. Forecast 2010/11 total rates revenues are $4.6 billion (incl. GST) so a $1 billion earthquake rates levy would increase average rating burdens by about 22%. Keeping the $1 billion revenue target and exempting Christchurch ratepayers would push this to about 23% and exempting all Canterbury ratepayers would push this to 24%. Given the need for legislative change and recognised efficiency of this tax base it may be hard to credibly position any levy as temporary. Likely to be strongly opposed by local government.
Temporarily increase EQC levy, transfer funds to Crown by matching special dividend	All necessary machinery is in place, simply need to legislate a higher EQC levy. Property taxes score relatively well on efficiency grounds, growth consequences will be less than for the two income tax-based options. Special dividends have been paid by EQC in the past to meet Crown costs of compensating land damage. In 2002. EQC paid a $1.3m special dividend to the Crown to fund ex gratia payments by the Crown to 12 Waihi homeowners whose houses were damaged or	The revenues are too small for the task. EQC levy revenue was $86 million in 2009/10; generating enough new levy revenue to fund the recovery requires implausibly large levy increases. Would clutter policy and communications around standalone review of the NDF and the appropriate rate for EQC levies.

Option	Advantages	Disadvantages
	endangered by the 13 December 2001 gold mine collapse. The Waihi damage wasn't covered by the EQC Act as it was subsidence. The Crown agreed to pay for the Waihi damage as if it was covered by the EQC, and to fund that by directing a special dividend from the NDF. It wasn't possible to direct EQC to pay the Waihi homeowners directly.	

Preferred Temporary Option

9. The pros and cons of each of these four options is explored further in the attached table. If an earthquake levy were to be introduced, officials recommend option 1 - a simple levy on all taxable income (i.e. increase income tax rates for all entities). An income tax-based levy is the only option that does not require significant new legislation that has the prospect of raising the amount of revenue required. In addition, this approach has the advantage of using an existing revenue collection mechanism (the income tax) to generate the additional revenue. The simpler a temporary levy is to introduce and repeal the easier it is to position the levy as genuinely temporary, which in turn helps mitigate the negative economic effects of the levy, as taxpayers anticipate the impost will only be in place for a relatively short period of time.

10. The biggest drawback of this option is that it increases income tax rates, albeit temporarily, which is inconsistent with the revenue strategy and the Budget 2010 tax package.

11. Ministers face the same design decisions with this levy that they face with income tax – whether to have a flat rate or a progressive scale, and what the appropriate tax base should be, for instance whether to subject trusts, companies and PIEs to the levy.

12. Officials' initial judgement is that, reflecting standard broad-base-low-rate tax precepts, any levy should be applied to as many taxpayers as possible, and at a standard flat rate.

13. This approach would preserve existing relativities in the tax rates paid by different entities and people. Perhaps counter-intuitively, a flat rate levy would slightly improve aggregate measures of equity such as the Gini co-efficient. This is because a given flat tax increase reduces a high income earner's after-tax income by more, in percentage terms, than a low income earner's. For instance, if a 1% levy is introduced a person currently facing the 17.5% tax rate will now face an 18.5% rate. Their after-tax income on a marginal dollar reduces from 82.5c to 81.5c, a 1.2% reduction. For someone facing a 33% marginal rate, their after-tax income on a marginal dollar has reduces from 67c to 66c, a 1.5% reduction.

14. A flat 1% levy on all income would raise about $1.2 billion per annum of levy revenue. However as the levy reduces household income, and hence spending, GST and excise revenues reduce. This reduces the net revenue gain to about $1 billion per annum. The Queensland flood levy applies at a rate of 0.5% on all taxable income between A$50,000 and A$100,000, and at a rate of 1% on taxable income over A$100,000 for the 11/12 year only. A similarly structured earthquake levy, using our current tax thresholds to apply a 0.5% levy from $48,000 and 1% from $70,000, would raise about $250 million of revenue per annum, reducing to about $210 million after clawback.

15. As people and businesses are mobile, it would be difficult to reliably exclude earthquake-affected people and businesses from any levy without creating gaming opportunities. Excluding affected people from the increased income tax administratively – through reduced PAYE deductions - would be virtually impossible. The only way of achieving this would be for affected people to file a tax return at the end of the year and claim the additional levy as a tax refund. This is fraught with difficulties. For example, processes would have to be designed to identify who has been affected and who has not.

16. The earliest an income-based levy could be implemented for individuals is 1 July 2011. This timeframe is still tight but should provide payroll software providers and Inland Revenue with sufficient time to implement the change. To meet this timeframe it would

be necessary that decisions were made soon so that the necessary consultation could take place with payroll software providers.

17. An associated issue that we could provide more detailed advice on later would be whether other withholding-type tax rates in the system that are based on income tax rates (e.g. RWT rates, Maori Authority rates, and secondary tax codes) should be adjusted to reflect the levy.

Companies

18. If the levy is extended to entities such as companies, and officials recommend that it do, the question arises of when the levy should start applying. The company tax rate is reducing from 30% to 28% for the 2011/12 income year. One approach would be to delay the application of the reduced rate, or apply a levy-inclusive intermediate transitional rate for a temporary period.

19. For most companies the 28% rate will not apply until 1 April 2011. However, for companies with early balance dates the 28% rate is already in place. Delaying the application of the reduced rate to these companies (which would in effect be the same as removing the 28% rate that currently applies), therefore, would have retrospective effect and could, in very limited circumstances, result in adjustments to provisional tax. However, it should be noted that the first provisional tax payment date for most early balance date taxpayers is not until 28 May 2011. Therefore, if the deferral is announced this month this would give plenty of notice for taxpayers to plan for the increased provisional tax payment.

20. If Ministers wanted to avoid any retrospectivity a 2012/13 application date could be considered for any earthquake levy payable by companies. This would result in the 30% rate being reduced to 28% for 1 year, increased the year after and then reduced again when the temporary period elapses. This is clearly messy.

21. Inland Revenue advises that it would be possible from an administrative perspective to temporarily delay the scheduled application of the reduced company tax rate.

22. In the time available we have not been able to fully estimate the fiscal savings from deferral. The Cabinet paper that approved the Budget 2010 tax package (CAB Min (10) 12/10 refers) included the information in this table on the fiscal cost of the company and PIE tax reductions. If the cuts were deferred a year the schedule of costs would essentially move one year to the right, saving around $350 million across the forecast period (with some changes due to forecasting changes and some initial costs already have been incurred, such as PIEs, and companies with early balance dates, which are already paying tax based on the 28% rate).

	Decrease in operating balance, $m				
Note is Budget 2010 costing	2010/11	2011/12	2012/13	2013/14	4 yr total
Company tax cut to 28%	-20	-340	-450	-305	-1,115
PIES & savings vehicles capped at 28%	-15	-40	-55	-60	-170

23. If you would like a temporary earthquake levy to be developed further we can provide more advice on the revenue, administrative, and distributional impact of different design options, including options for dealing with companies.

Other temporary options not favoured

24. Other options we identified and rejected after preliminary examination include:

- *A temporary increase in GST*
  Rejected due to the high compliance costs and the perverse behavioural effects created when the increase is temporary (for example, home owners would be incentivised to defer rebuilding or replacing breakages until after the GST rate returned to 15%).

- *A temporary increase in alcohol, tobacco or fuel excises*
  Rejected as these excises have narrow bases and all have their own rationales and processes for determining their level (there is a programme of tobacco excise increases already in place, the level of alcohol excise was recently considered as part of the larger review of alcohol policy, and fuel excise policy is primarily shaped by transport and climate change policy).

- *A temporary increase in tariffs*
  Rejected as highly disruptive, poor signalling, inconsistent with economic strategy.

25. If you wish any of these options to be explored more carefully we can do so.

Other Tax Options Beyond an Earthquake Levy

26. Aside from a new temporary earthquake levy there are other tax options:

Prioritise fiscal considerations when making decisions on base-maintenance measures

For instance, raising the minimum equity requirements for banks to 8% rather than 6 percent would raise an extra $50 million per annum. However, this is likely to have significant impacts on the banking sector, the cost of capital in New Zealand and will be inconsistent with the intent of the minimum equity rules. It may also undermine the integrity of the banking tax base, leading to a smaller increase in revenues than expected.

Reconsider options rejected for Budget 2010

In developing the Budget 2010 tax package Ministers considered and rejected several structural changes to the tax system, including a land tax and loss ring fencing, that have the potential to raise significant revenues.

27. As with the temporary levy, in order to properly inform decisions regarding tax options we need a firmer idea of the nature and scale of the revenue challenge, namely how big is the mismatch between the fiscal strategy and forecast and projected fiscal tracks, before seriously considering what, if any, contribution these options can make.

Student loans

28. The Minister for Tertiary Education is currently considering options for student loan reforms for Budget 2011, as outlined in his Four-Year Budget Plan. These are aimed at improving the financial sustainability of the student loan scheme asset and include:

- Broadening the definition of assessable income for student loan repayment purposes.
- Restricting the eligibility for further student loans for those borrowers who are currently in default of their repayment obligations.

- Making the overseas repayment holiday policy application-based, rather than automatically applied.
- **[2]**
- Measures looking at eligibility in relation to age.

29. Ministers will have an opportunity to decide whether this increased revenue/savings should be reallocated within Vote Tertiary Education or returned to the centre. If Ministers decided that they wished to return these savings to centre, then these funds could be used to offset some of the costs of the earthquake. Over and above these measures, officials have also considered options to raise additional revenue through changes to the student loans system.

[2]