

The Treasury

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.



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Briefing note

Reference: BN2015/173

Date: Wednesday 8 April 2015

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From: Chris Gillion, Policy Manager, Policy & Strategy

Subject: **Paper on child support legacy debt**

Further to our meeting with the Minister of Revenue on Wednesday 1 April, please find attached a revised paper on the proposals to address child support legacy debt.

Consultation with Treasury

Treasury was informed about this briefing note.

Chris Gillion
Policy Manager
890 6056

Addressing Child Support Legacy Debt

Purpose

The purpose of this paper is to outline additional measures to address child support legacy debt and strengthen the child support reforms. The recommended measures focus on incentivising parents with child support debt (assessment and penalties) to pay their assessment amounts, improving negotiation levers between the Commissioner of Inland Revenue and liable parents and enabling the Commissioner to pragmatically manage the debt book.

Prior to the child support reforms the high, compounding penalty rates for child support debt combined with the low incomes of many liable parents has resulted in penalties that are disproportionate to the originally assessed debt. These measures aim to permit a fairer treatment of the accumulated penalties faced by liable parents so as to encourage them to focus on repayment of the original assessment and meet their obligations to pay financial support for their children. The proposals aim to promote the welfare of children by recognising that children are disadvantaged when child support is not paid, or not paid on time.

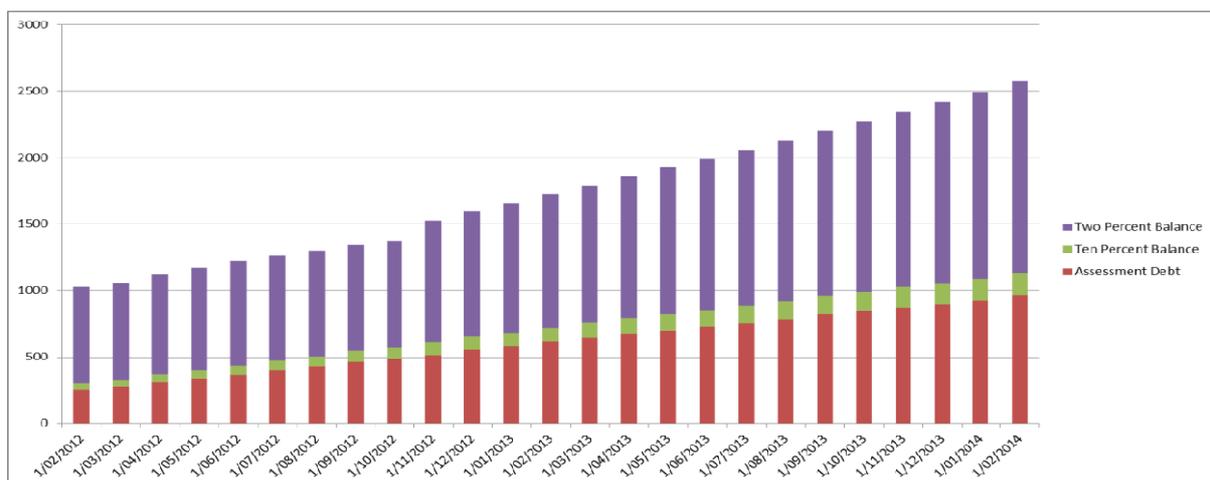
The proposals have been incorporated into the Budget 2015 process but can be scaled up or down depending on Ministers' decisions on the final Budget 2015 package.

Background

The object of the Child Support Act 1991 is to ensure that parents, who live apart, financially provide for their children. For parents who are unable to make private child support arrangements, Inland Revenue has an important role in collecting and passing on child support payments. Where these payments are not made, or are not made on time, penalties are charged. The aim of these penalties is to encourage liable parents to pay in full and on time. Penalties, when paid, are not passed on to custodial parents.

When the scheme was introduced in 1992, the number of penalties and the rate at which they would increase was not anticipated. Rather than encouraging liable parents to pay, in some cases, these penalties have reached a level where they have become a barrier to compliance. The following graph illustrates the inflationary nature of child support penalties on debt:

Figure 1: Growth in \$1,000 of unpaid child support debt over 2 years



In many cases, the amount of penalties charged far outweighs the actual child support due. Liable parents feel the debt cannot be repaid, and therefore disengage from the scheme. The result is increased debt, increased collection costs for Inland Revenue, and most importantly, child support not being passed on to financially support children.

Improving the rate of child support collected means more money going to low income New Zealand families who are reliant on it to help cover the cost of raising children. This better focuses the child support scheme on meeting the needs of children, and helping the financial wellbeing of both liable parent and receiving carer families.

The child support reforms include changes aimed at slowing the rate of penalty debt growth, reducing the penalty rates and improving the Commissioner of Inland Revenue's ability to write off debt. In June 2014, Cabinet agreed to review, re-scope and re-focus the child support reforms on reducing the size and growth in child support debt. At that time, Cabinet noted that officials would further analyse the debt book to develop strategies targeting the older legacy debt.

Further analysis shows that the penalty regime — post-reform — will continue to constrain positive compliance outcomes and the Commissioner's ability to work with liable parents to achieve more manageable legacy debt levels and repayment plans.

Child Support Debt Book

As at 31 December 2014, child support debt was \$3.2 billion and is depicted in the map below.

Figure 2: Child support debt book map

Residing outside of NZ and Australia

- 4,859 debtors (\$778m)
- 84% penalties



Domestic

A key issue underlying the domestic debt book of \$1,458 million (76% of which is penalties) is the excessive, ineffective and inflexible penalty regime. In addition, the incomes of many liable parents are low with around two-thirds earning less than \$30,000. The Appendix contains details of debt by region as at 28 February 2015. Changes to the penalty rules could be used to support liable parents to control and manage their child support debt and meet financial obligations for their children.

International – Australia

A total of \$801 million (\$278 million + \$523 million) relates to liable parents thought to be residing in Australia. For known debtors, Inland Revenue's collection efforts are underpinned by a reciprocal agreement with the Australian Department of Human Services (DHS), engagement with private debt collectors to track and trace debtors, legal action, and data-match arrangements with the New Zealand Customs Service (NZCS) and the Department of Internal Affairs (DIA). An incentive, by way of change to the penalty rules, for liable parents to contact Inland Revenue and enter into a payment arrangement would support collection efforts across this component of the debt book.

International – beyond Australia

\$778 million (84% of which is penalties) of the total debt book relates to debtors residing outside of New Zealand and Australia. Although collection efforts are underpinned by track-and-trace activity by private debt collection agencies, data match arrangements with NZCS and DIA and proactive calling by Inland Revenue, contact details for around 85% of debtors are unknown. An incentive, by way of change to the penalty rules, for liable parents to contact Inland Revenue and enter into a payment arrangement would support collection efforts across this component of the debt book.

The breadth of collection tools is similar to those available for collection of student loan debt (except for the reciprocal arrangement with Australia's Department of Human Services) which provides a sound platform for compliance going forward. However, it is the legacy debt that is the problem.

Addressing Child Support Legacy Debt

Child support debt, whether it be domestic or international, is typically old, mostly penalties and continuing to accrue because of the current penalty regime. The annualised rate of penalties for child support is around 25% compared to student loans around 11%.

A range of provisions are being introduced through the child support reforms to address debt by encouraging compliance and relaxing the circumstances where penalties, and in some cases assessment debt, can be written off. But these changes don't go far enough. Further changes are needed to address the older, legacy debt by incentivising parents to re-engage with their child support obligations and strengthening Inland Revenue's ability to work with parents to control and manage their child support debts and pragmatically manage the debt book.

Proposals

Proposals have now been developed to address child support legacy debt and are summarised as follows:

- Proposal 1: Extend the mandatory write-off of monthly incremental penalties for payment arrangements subject to 26 week review to payment arrangements where a liable person has not explicitly agreed to the arrangement. If approved, this proposal would operate to reduce the domestic debt book.
- Proposal 2: Amend the discretionary penalty write-off tests to adopt a more pragmatic test based on "fair and reasonable". If approved, this proposal would apply to all components of the debt book.

Proposal 1: Extension of mandatory write-off of monthly incremental penalties subject to 26 week review

Currently, when a repayment arrangement for debt is negotiated and agreed between the Commissioner of Inland Revenue and a liable parent an automatic write-off of monthly incremental late payment penalties is considered at each 26-week period (or at the completion of an arrangement). Liable parents who remain fully compliant with their negotiated repayment arrangement receive an automatic write-off (mandated in child support legislation) of monthly incremental late payment penalties.

Repayment arrangements where explicit agreement with the liable parent has *not* been received do not currently qualify for write-off of monthly incremental late payment penalties as above. These types of arrangement can occur where the Commissioner has statutory authority to collect payment by automatic deduction from a liable parent's source deduction income (such as salary and wages, contract payments, student allowances) and income from benefits (such as Social Security and NZ Superannuation and Retirement benefits).

The manner in which the repayment is being made, and the rate of repayment, can be the same as an arrangement negotiated with a liable parent, the only difference being no explicit agreement.

Example: A liable parent with income from a benefit has child support debt of \$52,139 (\$17,577 unpaid core assessments, \$1,775 initial late payment penalties and \$32,787 monthly incremental penalties). As the main source of income is a benefit, the legislation requires Inland Revenue to impose automatic deductions from the benefit income to repay current obligations and debt amounts. The beneficiary is not asked whether they agree with child support being paid in this manner. The automatic deductions continue to be made as expected, and at the conclusion of each 26-week period until full repayment, monthly incremental penalties are automatically written off. If the liable parent does not comply with the arrangement, Inland Revenue ceases the arrangement and the monthly incremental penalties will begin to accumulate from that point on. Inland Revenue also has the discretion to decline any future payment agreements if the liable parent is non-compliant. Without the proposed extension of the mandatory write-off, the liable parent would be required to pay the monthly incremental penalties of \$32,787 even while on a benefit.

Currently, there are 27,500 liable parents with child support debt amounts totalling \$423 million under payment arrangements that do not qualify for monthly incremental penalty write-off. If this proposal is approved, the debt to be collected under these plans could reduce by \$123 million. In addition, aligning treatment across arrangements regardless of the liable parent's agreement would increase equity across liable parents.

Proposal 2: A pragmatic test for discretionary penalty relief

Child support legislation (both current and anticipated reform) contains penalty relief discretions designed to increase flexibility to manage the debt book effectively. The discretions cover both initial late payment and monthly incremental penalties across a range of circumstances where penalty write-off would be appropriate, such as incentivising arrangements and promoting and rewarding positive compliance behaviour.

To qualify for penalty relief, some discretions (the upfront monthly penalty write-off and residual penalties write-off) require a liable parent to be in serious hardship or for continued collection to represent an inefficient use of the Commissioner's resources. In both of these circumstances, write-off is subject to further tests resulting in less discretion than originally envisaged.

As a consequence, the debt book is inflated with penalties that are unlikely to be collected and unable to be written off. In many cases, the high value of penalty debt (often a result of the inflationary penalty rates over time) implies that the debt value is sufficient to warrant collection.

To incentivise parents to re-engage with their child support debt, enable the Commissioner to negotiate payment arrangements with parents and better manage the debt book, I recommend a more pragmatic approach to the discretionary penalty relief tests. Such an approach would amend the existing write-off tests to adopt a "fair and reasonable" test in place of an "inefficient use of resources" and related further test. The current test for penalty relief based on "serious hardship" would remain.

Adopting a "fair and reasonable" test would enable penalty relief to be applied in circumstances where it makes sense to do so but where the "inefficient use of resources" based test would not allow relief.

Example: A liable parent receiving NZ Superannuation from the Ministry of Social Development owes \$136,958 in penalties for child support. He has paid all his core assessment debt, all his late payment penalties and \$943 towards his incremental late payment penalty debt. He is repaying his penalty debt at \$25 per week. He will be 89 years old at the conclusion of the arrangement in 2037. As his debt is currently under arrangement, he does not qualify for any penalty write-off (i.e. the debt is not inefficient to collect). A more pragmatic test would allow for the write-off of some or all of the incremental late payment penalty debt.

The proposal to introduce a "fair and reasonable" test for penalties would encourage liable parents across the debt book to change their behaviour towards compliance, to contact Inland Revenue and tailor payment arrangements to control and manage child support debt. In addition, the proposal would provide a pragmatic approach to support Inland Revenue's debt collection and reduction efforts across the debt book.

With regard to the reciprocal arrangement with DHS, the proposal would begin to address the difference in how penalties are dealt with under the arrangement relative to Australian-based debt cases dealt with by Inland Revenue directly.

Expected outcomes and benefits

The proposals are designed to permit a fairer treatment of the accumulated penalties faced by liable parents to encourage behaviour change and re-engage with Inland Revenue to make arrangements to pay financial support for their children (or repay the Crown to the extent of benefit components). They aim to promote the welfare of children by recognising that children are disadvantaged when child support is not paid, or not paid on time.

Currently, the liable parent target group (around 40,000) for the proposals have average debt of \$33,912, of which 80% are penalties. The average amount of core assessment debt is \$6,553. 86% of this group do not have a current debt arrangement. The proposals could operate to significantly reduce the debt burden and time to repay debt across this group.

For example, assume a liable parent has \$30,000 child support debt, of which \$5,000 is core assessment and \$25,000 is penalties. Contacting Inland Revenue, negotiating a payment arrangement for \$10 per week and sticking with that arrangement, could result in total penalty relief (using the proposed “fair and reasonable” approach together with child support reforms) and repayment of the debt in 12 years rather than 58 years (\$30,000/\$520).

Key proposal outcomes from Inland Revenue’s perspective include strengthened negotiation levers when establishing payment arrangements with liable parents, greater flexibility to relieve penalty burden on liable parents, increased ability to reward positive compliance behaviour, and ability to focus resources more on collecting assessment amounts to financially support children (or increase Crown revenue if benefit related).

Status quo

When considering the Budget Initiative it may be useful to consider some key outcomes if the status quo continues — overwhelming debts for liable parents resulting in continued disengagement and lack of payment of financial support for children; the child support debt book continues to grow as penalties continue to compound, remain largely uncollectible and can’t be written off given their high value and legislative constraints; and Inland Revenue resources diverted from the more important task of collecting financial support for children and repaying debt to the Crown.

Legislative implications

In terms of legislation required to give effect to the proposals, this has already been drafted and could be integrated into the Taxation (Annual Rates for 2015-2016, research and Development and Remedial Matters) Bill by way of Supplementary Order Paper at the Select Committee stage (May/June) or at the Committee of the Whole House (September/October) stage. Either way, it would be enacted by the end of 2015.

Financial implications

The financial implications of additional measures to address child support legacy debt would depend on debt repayment levels by liable parents and the timing of any penalty relief granted.

Inland Revenue has modelled some scenarios (low/medium/high) to reflect three options giving effect to the proposals and their impact on the Crown Operating Balance and core assessment receipts. Scalability from the low scenario to the medium or high is underpinned by resources that Inland Revenue would apply to each option. Inland Revenue would strictly adhere to the limit of any appropriation provided for in relation to these proposals.

Appropriate resourcing would be established using Budget 2014 funding allocated to improve child support collection. Through additional resources, Inland Revenue would be able to increase the number of debt campaigns for the target group. Existing resources could be used more effectively to apply new negotiation levers across all other liable parent interactions.

Option 1: Low scenario

Assuming a conservative response to debt repayment incentives and approach to penalty write-off (based on a 1 April 2016 effective date for the proposals) the impacts on the Crown Operating Balance are summarised in the table below. The table has been incorporated into a Budget Initiative submitted to The Treasury as part of the Budget 2015 process.

Vote Revenue	2015/16 \$m	2016/17 \$m	2017/18 \$m	2018/19 \$m
Reduction in Revenue from child support penalty write-off provisions	(35.7)	(158.4)	(219.6)	(284.5)
Non-Departmental Other Expenses: Impairment of Debt Relating to Child Support	34.6	153.6	213.0	276.0
Increase in Revenue from child support core assessment receipts	<u>0.6</u>	<u>0.9</u>	<u>1.1</u>	<u>1.1</u>
Net impact on Crown Operating Balance	(0.5)	(3.9)	(5.5)	(7.4)

In addition, there is an expected increase of \$2.3 million (also conservative) in core assessment receipts payable to receiving carers across the 2015/2016 to 2018/2019 period as follows:

Increase in core assessment receipts payable to receiving carers	0.3	0.6	0.7	0.7
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Option 2: Medium scenario

Vote Revenue	2015/16 \$m	2016/17 \$m	2017/18 \$m	2018/19 \$m
Reduction in Revenue from child support penalty write-off provisions	(51.7)	(242.3)	(386.8)	(550.8)
Non-Departmental Other Expenses: Impairment of Debt Relating to Child Support	50.1	235.0	375.2	534.3
Increase in Revenue from child support core assessment receipts to the Crown	<u>0.7</u>	<u>1.2</u>	<u>1.5</u>	<u>1.5</u>
Net impact on Crown Operating Balance	(0.9)	(6.1)	(10.1)	(15.0)

In addition, there is an expected increase of \$2.9 million in core assessment receipts payable to receiving carers as a across the 2015/2016 to 2018/2019 period as follows:

Increase in core assessment receipts payable to receiving carers	0.4	0.7	0.9	0.9
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Option 3: High scenario

Vote Revenue	2015/16 \$m	2016/17 \$m	2017/18 \$m	2018/19 \$m
Reduction in Revenue from child support penalty write-off provisions	(67.7)	(326.0)	(553.8)	(816.8)
Non-Departmental Other Expenses: Impairment of Debt Relating to Child Support	65.6	316.2	537.1	792.3
Increase in Revenue from child support core assessment receipts to the Crown	<u>0.9</u>	<u>1.5</u>	<u>1.8</u>	<u>1.8</u>
Net impact on Crown Operating Balance	(1.2)	(8.3)	(14.9)	(22.7)

In addition, there is an expected increase of \$3.7 million in core assessment receipts payable to receiving carers as a across the 2015/2016 to 2018/2019 period as follows:

Increase in core assessment receipts payable to receiving carers	0.6	0.9	1.1	1.1
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Appendix

Child Support Domestic Debt by Region As at 28 February 2015

Region	Debt Cases	Total Debt (\$000)	Assess Debt (\$000)	Ten Percent Penalties (\$000)	Two Percent Penalties (\$000)	Owed to Custodian (\$000)	Owed to Crown (\$000)
Auckland	26,996	546,026	120,549	17,974	407,502	30,675	89,806
Waikato	10,078	129,424	34,552	5,523	89,348	9,263	25,184
Canterbury	9,799	136,826	38,857	6,181	91,787	11,664	27,150
Bay Of Plenty	7,847	89,884	24,545	3,984	61,354	6,437	18,105
Wellington	7,493	119,902	28,310	4,404	87,187	7,993	19,722
Manawatu-Wanganui	5,701	70,246	17,460	2,857	49,929	4,470	12,752
Northland	4,789	78,284	16,863	2,650	58,770	3,837	12,942
Hawkes Bay	4,515	56,363	13,485	2,250	40,627	3,318	10,014
Otago	2,882	34,546	9,441	1,567	23,540	2,762	6,283
Taranaki	2,445	25,359	7,453	1,260	16,645	2,108	5,315
Southland	2,073	32,865	7,712	1,302	23,860	2,545	5,114
Gisborne	1,844	29,921	6,443	1,023	22,454	1,290	5,150
Nelson	1,133	12,204	3,640	610	7,954	1,074	2,520
Marlborough	864	11,003	3,082	490	7,431	857	2,168
West Coast	662	11,345	2,381	416	8,548	688	1,664
Tasman	542	11,753	2,464	371	8,917	756	1,709
Unknown	384	11,237	1,575	229	9,432	493	1,054
Other	358	11,959	2,297	245	9,416	873	1,320
Chatham Islands	[4	1,108	266	38	804	74	182
Grand Total	90,420	1,420,267	341,385	53,382	1,025,515	91,185	248,161