The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Flood Levy Initial Advice

Date:	3 March 2023	**Report No:**	T2023/277
		File Number:	4767492: 1

Action sought

	Action sought	Deadline
Hon Grant Robertson **Minister of Finance** Hon David Parker **Minister of Revenue**	**Discuss** this report with officials at the Weekly Agency Meeting on 6 March **Refer** this report to the Minister of Revenue	6 March 2023

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Rebecca Hardy	Senior Analyst	[39]	N/A (mob)	✓
Stephen Bond	Manager, Tax Strategy		[35]	

Minister’s Office actions (if required)

Return the signed report to Treasury.

Refer the report to the Minister of Revenue.

Note any feedback on the quality of the report	

Enclosure: No

Executive Summary

This report responds to your request for advice on implementing a levy to help fund the response to Cyclone Gabrielle.

This advice covers the fiscal, macroeconomic, and tax considerations as well as the design issues associated with a levy on wages and profits. You have also indicated that you are interested in considering whether a levy on the supernormal profits of banks (T2023/53), on which you are receiving further advice next week.

Your revenue and fiscal strategies provide a sound framework for considering any response. As a general principle, we would not recommend that a temporary levy to manage a near-term fiscal shock is consistent with your revenue or fiscal strategies. This is because while the economic costs of a temporary levy would be small, the overall wellbeing cost of adjusting taxes to manage near-term fiscal shocks is likely to be higher than aiming for fiscal sustainability over time (provided there is sufficient fiscal headroom to manage the shock).

However, in the context of a highly constrained economy a temporary levy may support your macro-economic objectives, by reducing the net fiscal impulse of Government response and recovery-related spending. It could reduce overall aggregate demand in the economy and reduce inflationary pressures, although the impact is uncertain given that capacity constraints are most acute in the construction sector compared to the general economy.

This impact would also depend on a design that raised revenue in a way that reduced aggregate demand effectively. A progressive levy on higher incomes or on company profits is less likely to achieve that objective.

The case for a temporary levy has these trade-offs between tax, fiscal, and economic considerations. While this advice does not consider it in detail, there may be a case for considering whether a permanent levy would provide an ongoing source of revenue to fund expected additional spending on the response and adaptation to more frequent adverse events.

This advice also covers some initial policy and administrative considerations around introducing a levy:

1. What tax lever(s) to use
2. What thresholds and rates to set
3. Design questions around exempting those affected by floods
4. Some initial implementation considerations

Any levy will have significant administrative impacts on Inland Revenue, and these would be critical if it were not integrated with the existing income tax system or included exemptions.

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. Further consideration of a levy should be considered in the context of your wider strategy for funding the response to the cyclone.

Recommended Action

We recommend that you:

a **discuss** this report with officials at the Weekly Agency Meeting on 6 March;

b **indicate** whether you want further advice on a levy as described in this advice;

Yes / No

c **refer** a copy of this report to the Minister of Revenue;

Refer / Do Not Refer

Stephen Bond
Manager, Tax Strategy
The Treasury

Hon Grant Robertson
Minister of Finance
/ / 2023

Purpose of Report

1. This report responds to your request for advice on funding part of the response to Cyclone Gabrielle through a temporary levy. This advice covers the macroeconomic, fiscal and tax considerations of such a levy.

2. You have also indicated you would be interested in considering whether revenue from a levy on the supernormal profits of banks (covered in T2023/53) could be used to fund cyclone related costs. You will receive further advice on this next week, and it is not covered in this advice. However, the broader macroeconomic, fiscal, and tax considerations are relevant in considering that option.

3. You have given the initial steers that any levy would have to be:

   a Paid by both individuals and companies

   b Progressive

   c Not paid by those directly affected by the damage

4. This report focuses on the policy and administrative considerations of introducing a levy. Based on your steers, this report does not consider options for raising taxes that are not linked to income, such as general rates, GST or excise duties.

5. 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.

Fiscal and economic implications of a levy

6. The overall costs of the recovery and rebuild following Cyclone Gabrielle and the January Auckland floods are still unknown. You have received separate advice related to near-term fiscal management in the context of the Cyclone Gabrielle response (T2023/251 refers), as well as advice on further savings options to offset new spending (T2023/141). This advice recommends a phased approach to cost management whereby:

   a The first phase, prior to the Budget moratorium, focuses solely on urgent funding required in the current financial year (2022/23).

   b Phase two then would occur following Budget Day, and cover costs in the 2023/24 fiscal year and beyond.

   c We will provide further advice on this expenditure, and we recognise that providing funding solely from allowances and savings is unlikely to be sufficient to meet the total costs of the Government's ongoing response – although these costs are still unquantified.

7. In the current context, a levy could support the following objectives:

   a **Minimising the fiscal impact of the recovery**, preventing increases in net debt that may be paid by future generations. Revenue from a levy would start to materialise in 2023/24 at the earliest.

   b **Macroeconomic stability**, minimising the impact of the recovery on inflation.

Minimising the fiscal impact of the recovery

8. Your revenue and fiscal strategies provide a sound framework for the response to spending shocks such as the recent floods and cyclone Gabrielle.

9. As a general principle, we would not advise temporary tax changes in response to temporary fiscal costs. Temporary levies impose economic costs (which increase as taxes rise) and weaken the simplicity and stability of the tax system. While those costs are likely to be relatively small, the overall wellbeing costs are probably greater than a revenue strategy that targets fiscal sustainability over time, rather than seeking to offset fiscal shocks year-on-year.

10. A temporary levy to manage a near-term fiscal shock may also not be consistent with your fiscal strategy, which is to run a prudent fiscal position so that shocks (e.g. natural disasters, financial crises or pandemics) can be accommodated by borrowing or dissaving. While there is an argument that the frequency and severity of weather events could increase and a levy at the margin might provide more headroom, our initial assessment is that we have significant headroom under the fiscal rules to respond to multiple events. When calibrating the fiscal rules, the Treasury considered stress scenarios where net debt increased by 40 percentage points of GDP above the debt ceiling following a shock (i.e. to around 70% of GDP). The Treasury concluded that while this kind of scenario would be challenging, it would still be manageable.

11. On the other hand, additional headroom from a levy may also allow us to remain within our allowances for longer which supports the overall FMA. Allowances incentivize prioritization of new spending, provide transparency around Government spending, and help ensure Government decisions are supportive of its fiscal strategy.

Macroeconomic Stability

12. This fiscal strategy recognises that such shocks are often accompanied by economic downturns, where seeking to fund a response through tax rises/spending cuts could dampen the impact of automatic stabilisers and exacerbate the impact of the economic shock.

13. In the current context the macroeconomic considerations could mean that there is a stronger case for a levy than there would otherwise be. This is because there remains limited capacity in the economy and inflationary pressures remain strong. The largest risk of higher near-term inflation to the medium-term outlook comes from inflation expectations remaining elevated for longer – which will in part be informed by your decisions on the fiscal response, including the timeframe over which the rebuild occurs and how it is funded. In this environment meeting some of the rebuild and recovery costs from a levy may make sense due to the dampening effect on aggregate demand thereby limiting additional inflationary pressure.

14. On the other hand, the costs of the recovery and rebuild following the cyclone are likely to take place over a couple of years and the current capacity constraints are expected to ease over time. As such running a relatively more expansionary fiscal policy to accommodate rebuild and recovery costs without a levy offset is an option.

15. There are alternative approaches to limit the fiscal impulse of the cyclone recovery which we would recommend you consider in advance of a temporary levy:

    a Reprioritisation within the capital investment programme: Capacity constraints, particularly in the construction sector, continue to limit the deliverability of new spending for the cyclone recovery, regardless of whether it is debt or levy funded. As such, we recommend you consider your relative priorities for public investment and identify projects that could be delayed allowing construction sector resources to be redirected towards the cyclone recovery and rebuild. Reallocation of like-for-like resources towards recovery-related activity would support the cyclone rebuild, and could lessen the fiscal impulse of the rebuild.

b Spreading the rebuild over time: Sequencing the rebuild over several years, where possible, limits the fiscal impulse that results from rebuild activity, as was following the Canterbury earthquakes. Reallocating work through time could allow more scope for a supply response (firms bringing in overseas skills, scaling up, etc.), again reducing the inflationary impact.

Implications

16. The purpose of a levy matters for its design.

a If the primary purpose is fiscal sustainability, then (if you decided to proceed with a levy), we would recommend you consider tax bases that best meet your general revenue objectives.

b If the primary purpose is macroeconomic stability, then you would want a levy to maximise its impact on aggregate demand. Levies that are primarily levied on higher earners, or on company profits, would have less of an impact on aggregate demand per dollar raised than a broader based levy – and would be less effective than reprioritising other spending commitments.

c There is also a much broader policy question about the intergenerational balance of who pays for the response to these types of events, especially in the context of climate change. If a goal is to shift the incidence of who pays for responding to significant events, then that should be the subject of a more deliberate piece of work looking at wider issues such as debt targets.

17. A progressive levy would temporarily contribute towards Government's objectives of making the tax system more progressive and reducing inequality, but these would only be temporary changes.

18. Overall, the key judgement is whether you consider that the macroeconomic case for a levy outweigh impacts on your broader tax and fiscal strategy.

A permanent adverse events levy

19. While a temporary levy has these trade-offs between tax, fiscal, and economic trade-offs, a permanent levy is a more structural policy option to respond to more adverse events in the future.

20. This advice does not consider this option in detail, but we could provide more advice if requested. A permanent levy would provide an ongoing source of revenue to fund the expected additional spending on the response and adaptation to more frequent adverse events .

Designing a levy

21. If you were inclined to take forward a levy, there are several things you would need to think through, including design of any levy and operationalising any exemptions.

International precedents

22. There are international precedents for raising taxation to fund the response to a natural disaster.

a The closest parallel is the temporary flood levy introduced in Australia following the 2010/11 Queensland floods to fund part of the reconstruction. This resembles some of your initial preferences in that it applied only to higher earners and excluded those affected by the floods. This funded c$1.8bn of a $5.6bn total recovery cost, with the rest funded by spending cuts.

b Other countries have also used taxes to partially fund recovery efforts, such as Ecuador following an earthquake in 2016, Japan following the 2011 Great East Japanese Earthquake, and Turkey following the 1999 İzmit earthquake.

c Australia have previously added a surcharge to their medicare levy to fund policy initiatives, such as a gun buy-back follow Port Arthur massacre.

Taxing individuals

23. Working within the existing income tax system (rather than creating a new tax) is the easiest and fairest way of taxing individuals. It is possible to do within existing statutory and legislative frameworks (although any exemptions would require legislation), and the existing system taxes all income equally regardless of source. It is also the only approach that could be implemented in the near term given other pressures on IR's work programme.

24. Ministers face the same design decisions with this levy that they face with income tax – at what income thresholds the levy should apply, and whether to have a flat rate or a progressive scale.

25. 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. This would also support your macroeconomic stability objectives.

26. Based on your stated preferences for a levy, you may want any levy to only apply to those above a certain income threshold. These thresholds could be those already within the system (such as applying to all earners above $48,000) but could also be bespoke thresholds that apply only to the levy (which was the approach taken in Australia – these did not correspond to existing income tax thresholds). The latter would add administrative complexity, including because new tax thresholds mean that additional secondary tax codes are required to manage secondary earnings that fall between thresholds.

27. The choice about where to set the threshold would significantly affect the amount of revenue raised by the levy. Illustrative amounts raised by a 1% levy at different thresholds is set out below. These are not costings and are the static impact of tax changes based on last year's distribution of taxpayers:

Indicative Annual Revenue from a temporary 1% levy*

Threshold above which a levy could apply	Estimated Revenue ($m) **
$0 (i.e. applies to all taxpayers)	1,800
$48,000 (beginning of second tax band)	650
$50,000 (first threshold applied in Australia)	600
$70,000 (beginning of third tax band)	400
$100,000 (second threshold applied in Australia)	250
$180,000 (top rate threshold)	100

** As you begin taxing higher earners these numbers likely overstate the revenue gained, as we would expect more behaviour change*

***This does not include the cost of excluding those affected by the floods. Excluding some taxpayers would reduce the estimated revenue. It also does not consider any tax changes made at Budget 2023.*

28. There are also design choices around what rate a levy should be – with potential to apply different rates at different income levels. For instance, Australia introduced a 0.5% levy on income between $50,000 and $100,000, and a 1% levy on income above $100,000.

29. 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) should be adjusted to reflect the levy, and whether there would be any flow-on impacts for Fringe Benefit Tax.

Corporate Income Tax

30. Companies in New Zealand pay tax at a flat rate of 28% on their taxable income (revenue minus expenses). You have signalled that you would want to ensure that any levy would be paid by companies as well as individuals.

31. If the key objective of a levy is to prevent recovery costs from further fuelling inflation, then company income is unlikely to be the most effective tool to do that. Furthermore, there are additional complications with changes to the company rate, namely:

    a Companies tend to have more flexibility to move taxable income between years, and so will be able to more easily adjust the timing of their earnings to avoid paying it;

    b How imputation credits are treated and whether any future dividend payments could benefit from a higher imputation credit amount;

32. Company tax is unlikely to have a significant impact on aggregate demand. This limited macro effect is because a large proportion of company tax is paid by foreign investors.

33. A 1ppt levy in the form of a temporarily higher company tax rate could raise around $400 million, not accounting for any behavioural response. As with the numbers above, this is an indicative figure based on ready-reckoners, not a costing, and any policy designed would have a materially different fiscal impact.

Exclusions

34. You have suggested that you are interested in exempting people who have been affected by flooding from the levy. However, there are design questions about if and how far this should be applied. Any exclusion will significantly increase the complexity of design and compromise Inland Revenue’s ability to deliver with high levels of integrity.

35. There is a spectrum of what counts as ‘affected’ by the flood, ranging from very narrow (such as only severe impacts on health/life) to a very broad definition (short term lack of utilities).

36. There are several things to consider when thinking through whether and how far to exempt individuals and businesses that are affected:

    a **Rationale for exemption: I**f a broad definition of impact is used, then people who are minimally affected and financially able to bear the burden may be exempted. In addition, any income threshold could already exempt many of those most affected.

b **Revenue impact:** The broader the criteria for exemption, the more people are exempted from paying the tax and therefore the larger the loss of revenue. This would be particularly important if a broad exclusion meant that many Aucklanders were exempt from paying the levy.

c **Fraud risk:** A system with no checks could open opportunities for gaming. However, adding a process to assess claims or require evidence would represent a significant additional administrative burden and could outweigh the costs saved through assessing claims.

37. Further considerations apply to exempting businesses if you choose to do so:

a **Multi-site businesses:** For businesses with multiple locations, there is a choice around whether to exempt the business from paying the levy at all, or proportionally to how many stores were affected. If it is proportional, then there is a further question about how to calculate this split (for example, according to number of stores vs proportion of revenue generated), as well as significant additional administrative complexity.

b **Business disruption:** some businesses may not be directly affected by the floods, but will face significant market or supplier disruptions, for instance horticultural supply chain operators.

38. Australia used several criteria to determine which individuals were exempt, including eligibility for Disaster Recovery Payments. The full list of potential reasons for exemption was relatively broad list in what was considered an impact. It is possible that eligibility for (or successfully claiming) Civil Defence Payments could be used analogously in New Zealand, although further work would be needed. However, you should note that these do not require any evidence to claim.

39. Any model would have to be relatively high-trust for both businesses and individuals, much like the COVID business supports. Even with a high-trust model there will be large contact volumes for Inland Revenue to manage and substantial follow up work to deal with integrity concerns. Experience with previous supports indicates that eligibility criteria is often confusing and difficult for Inland Revenue staff, businesses and individuals to apply, driving contacts, errors, debt and integrity risk.

Implementing a levy

40. Any work on a levy would add to pressure on Inland Revenue's work programme and depending on timing could compromise the delivery of other Budget measures.

41. The simplest form of a levy to deliver administratively would:

a Make changes at the same time as any other changes to the personal income tax scale (or otherwise at the beginning of the tax year);

b Make changes to existing rates and thresholds (as at the point that the levy is introduced) only, rather than introduce new rates at new thresholds;

c Not make any other adjustments or exclusions

42. An exclusion was designed in Australia in the aftermath of the Queensland flooding. There, people could tell their employers they were exempt via a declaration.

43. However, excluding affected people based on some form of declaration would be complex and generate significant administrative impacts for IR. This is because:

a Any design would come with boundary issues where the rules include individuals who believe they should be excluded, while at the same time being “high trust” given the lack of objective data on what “affected by the cyclone” would mean;

b Having some earners subject to a levy and some exempt means there is a need to essentially run two withholding systems impacting employers and payroll systems;

c Based on the experience during COVID-19 and the delivery of the Cost of Living payment, IR would expect a very high number of customer contacts to clarify the rules and eligibility for any exclusion.

d IR is also likely to experience significant pressure at year-end verifying the application of exclusions and carrying out integrity and debt work. This will apply to both auto-calc customers and those who must file an IR3 but also have salary and wage income, meaning these impacts will extend right through the full filing period for returns.

44. While in isolation, these administrative impacts would be significant, they are critical in light of other potential administrative demands on IR that are likely to consume both change and system delivery resource as well as customer contact resources for the next year.

45. Even a simpler form a levy will have these impacts to a lesser extent, and put IR delivery of Budget work and related customer service interface at risk.

46. You are receiving advice on these administrative issues and how they relate to the Budget package as a whole on 14 March.

Consultation

47. Inland Revenue has been consulted on the contents of this report.

Inland Revenue comment

48. Inland Revenue recommends against altering tax rates for short periods to cover unexpected fiscal costs, at least in current circumstances where the cost of doing so is likely to be lower than the cost of tax changes. Tax smoothing literature generally concludes that where possible, the government should maintain a stable path for taxes over time, and issue debt or maintain surpluses to meet year to year fluctuations.

49. If the government wants to proceed with a levy, aside from administrative issues, Inland Revenue recommends against basing it on region or another method of testing whether people are “affected” by the cyclone. Taxpayers’ taxable income is one of our best measures of ability to pay and Inland Revenue recommends using taxable income to determine the levy. Introducing a regional or other measure of whether a taxpayer has been affected would produce seemingly anomalous results where taxpayers who have very high incomes but are “affected” do not pay a levy, while taxpayers with low incomes who live outside of the area are being required to pay for the rebuild, despite their (sometimes material) lower ability to pay.

Next Steps

50. We recommend that you discuss this report with officials at the Weekly Agency Meeting on 6 March**.**