The Treasury

Budget 2023 Tax Initiatives Information Release

July 2023

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TE TAI ŌHANGA
THE TREASURY

Inland Revenue
Te Tari Taake

Windfall taxes

IR and Treasury – for discussion at WAM on 22 August

A number of EU countries have recently announced or implemented windfall taxes, mainly linked to the energy crisis from the war in Ukraine.

Purpose of windfall taxes

Windfall taxes are **temporary or one-off taxes on an economic rent** earned by a select group of businesses due to factors outside their control.

They are often introduced in order to redistribute the windfall gain, particularly as windfall gains for one group are usually matched with windfall losses to another.

There are generally two key factors that create a case for a windfall tax:

1. **Excess profits** being earned in a particular sector or business
2. The excess profits are a **'windfall'.** They are caused by an **extraordinary external event that businesses are not responsible for**, such as an increase in extractive prices rather than from productivity gains

Windfall taxes are usually **retrospective**, but more recently in Europe levies on the current profits of specific sectors (such as energy) are being described as "windfall taxes".

Box 1. What are the proposed windfall taxes in Europe?

<u>Who is taxed?</u>

- In response to the energy crisis in Ukraine, mainly providers or producers of energy or petroleum.
- The UK has a temporary 25% levy on profits from North Sea oil and gas extraction.
- Some countries have also looked at windfall taxes on banks (e.g. Spain, Hungary)

<u>What is the base for the tax?</u>

There have been a range of approaches including basing on profit margins, gross or net income of the business.

<u>When it is taxed?</u>

The current EU proposals appear to be based on revenues or profits between 2019 and up till 2025. This is unusual given the general concept is to apply windfall taxes retrospectively. For example in 1997 the UK introduced a retrospective windfall tax on privatised utilities.

<u>Implementation and impact</u>

Some of the proposals have not yet been implemented and design issues are still being worked through. It is too early to see what the impacts of these proposals are.

Question:

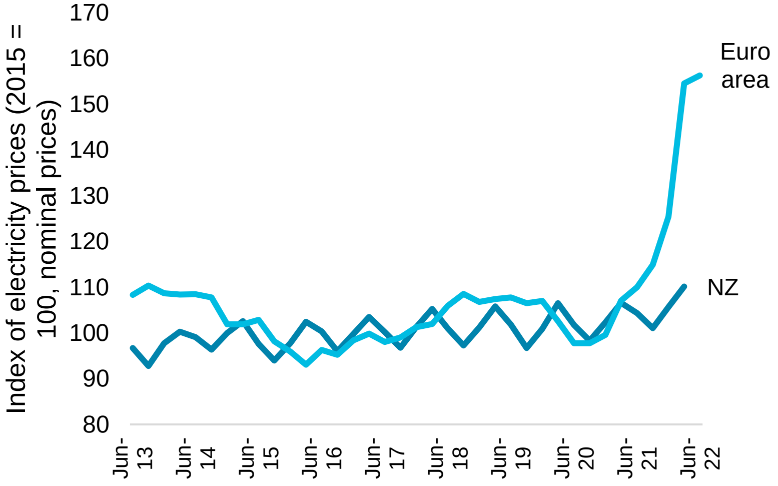
- *Is your interest in a windfall tax similar to those being introduced in Europe?*
- *Or are you more concerned about whether there are systemic excess profits across the economy, or in particular other sectors?*

Our initial review does not provide a strong case that any particular NZ sectors are making windfall profits

This interim analysis suggests that the New Zealand situation is different from the EU

We have not found a clear case that there are sudden ‘windfall’ profits being earned by NZ companies due to the Ukraine war or other external events; and energy in particular is not facing the same windfall gain (fig. 1).

Figure 1. New Zealand is not facing the same electricity crisis as Europe



Source: Treasury analysis of MBIE and Federal Reserve Economic data. Note indexation method differs slightly between series.

Corporate tax revenues appear to have been increasing faster than GDP but this does not appear to be due to ‘windfall gains’

Annex A contains our initial analysis on recent profitability. The key messages from this are:

A. *Early data indicates that corporate profits have risen faster than GDP in the last year, but this is not unusual*
   - Corporate profits are volatile and often grow faster than GDP, particularly after a downturn
   - We advise caution with this data. It is interim, some of it based on modelling, and is likely to be revised.

B. *Some industries have had particularly large profit growth*
   - However it isn’t clear that these will be sustained or whether this is standard volatility for many industries. Many of these industries are commodity based or have strong international connections which make volatile profits more likely on both the upside and the downside.

Annex A contains more of our analysis.

There are limitations to this analysis, caused by data quality and lags in the data. We intend to continue exploring data for this to support further reporting.

Question:
- *Were you interested in the (excess) profitability of any particular industries or sectors?*

Windfall taxes can be efficient in the right circumstances and with careful design. At this point, it is not clear those circumstances exist in NZ.

In the right circumstances, windfall taxes can be an effective means of taxing an excess economic rent.

They can provide temporary revenue-raising in response to a specific external event (such as the Ukraine energy crisis). This can enable windfall gains to be redistributed to those groups disadvantaged by the external event and mitigate any unintended distributional consequences.

A windfall tax is not well suited to addressing medium-term fiscal pressures

This is because the revenue from a windfall tax is temporary while fiscal pressures are primarily due to permanent expenditure.

The main risk with windfall taxes is that they can create uncertainty for investors, and distort investment behaviour.

Businesses may be less willing to invest in NZ if they perceive a risk of sudden or retrospective tax policy changes.

The impact on investor confidence will depend on design and context.

Internationally, windfall taxes have tried to minimise the risks by being 'one-off', retrospective and highly targeted towards businesses that have benefited from an extra-ordinary event.

This helps to ensure that the tax is not perceived as likely to be repeated, or at least that the tax would only be repeated when there are extraordinary external events.

There may be other options depending on your objectives

For example, high on-going profits may suggest that deeper structural issues require attention. For example you have already agreed to implement measures to improve competition in the retail fuel, and groceries sector and will be receiving further advice from the Commerce Commission on residential building supplies.

If the focus is to explore tax options to address any long run fiscal challenges or distributional goals, permanent tax options may be better suited.

Annex: Initial data on profits in NZ

Context

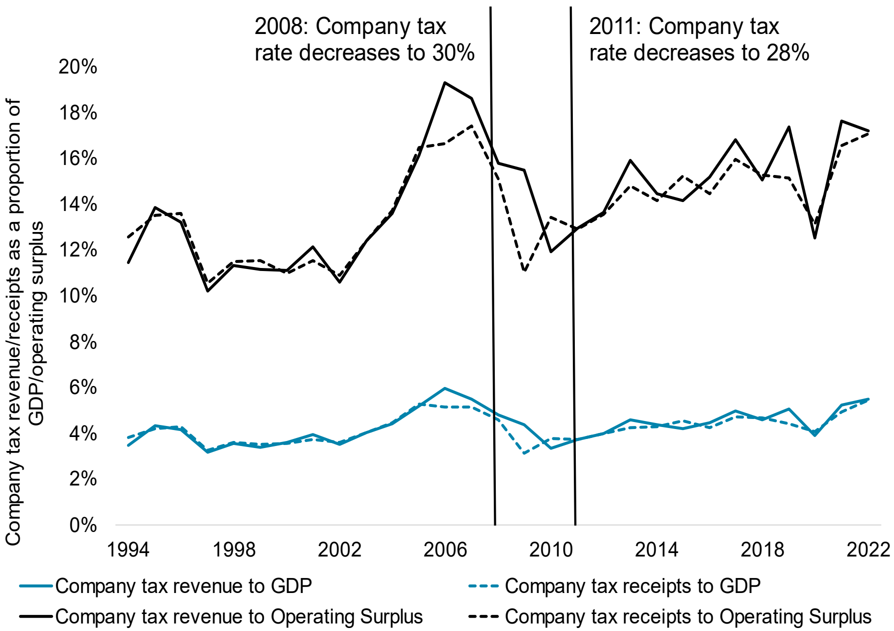
- This annex provides our initial analysis on the recent profitability of New Zealand companies
- We have focused on whether there is evidence of sudden windfall profits being earned by NZ companies similar to European energy companies
- This analysis has been done under time pressure. It is indicative only and has not gone through a full quality assurance process.

Corporate tax revenues appear to have risen in the past year

Table 2. Total corporate tax: 11 months to May 2022

	Forecast	'Actual'
Corporate tax ($m)	16,221	17,904

Figure 3. Company tax revenue as a proportion of GDP and operating surplus



Source. Treasury. Note. Tax revenue is a measure of tax due at a particular period. As there are delays to when companies file returns this involves estimation.
Tax receipts is a measure of cash received

The Government's financial accounts suggest strong corporate profit growth in the 2022 financial year. Corporate tax revenue for 11 months to May 2022 was $1.6 billion (10.4%) higher than forecast.

However, this does not necessarily reflect actual profit growth in 2022. We advise caution in interpreting these figures.

Most company tax returns for 2022 have not been received so these corporate tax revenue figures are based on uplift factors that are subject to revision. Company revenue measured in 2022 also partially reflects revisions to 2021 revenue as lagged information arrives.

In addition, 2021 was a highly unusual year and comparisons between 2022 and 2021 may be misleading.

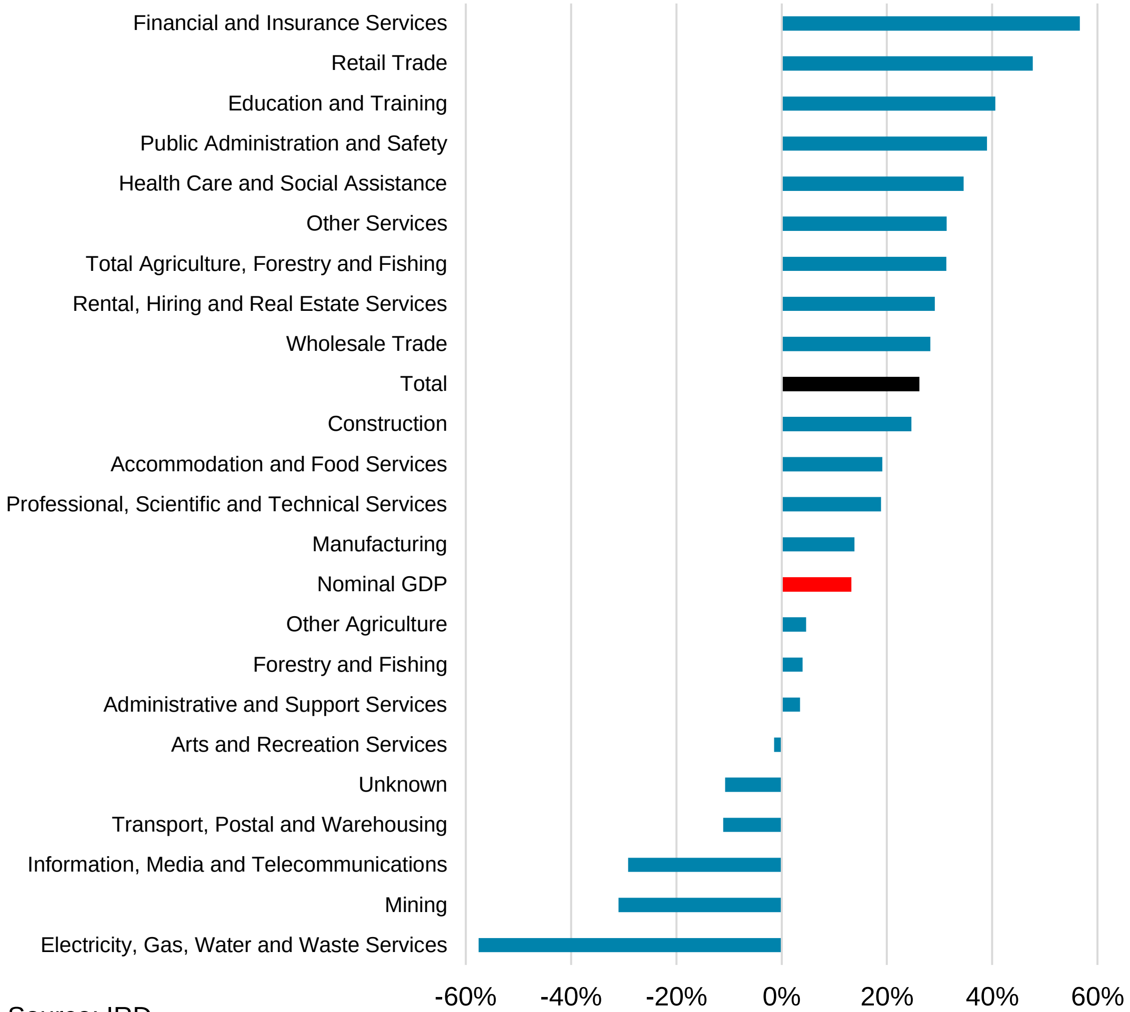
Company taxes are naturally volatile and COVID/lockdowns has exacerbated this.

Figure 3 shows that company tax revenue historically rises after a downturn. Revenue appears to have risen faster for 2022, however this is still broadly in line with past trends.

This analysis however should be taken with caution as it is based on interim data. We expect this to be revised when updated tax and GDP data is released.

Profit growth has been uneven across industries in 2021

Figure 4. Income tax: Year ended March 2021 vs 2017-19 average



Source: IRD

Figure 4 shows the change in income tax by broad industry categories.

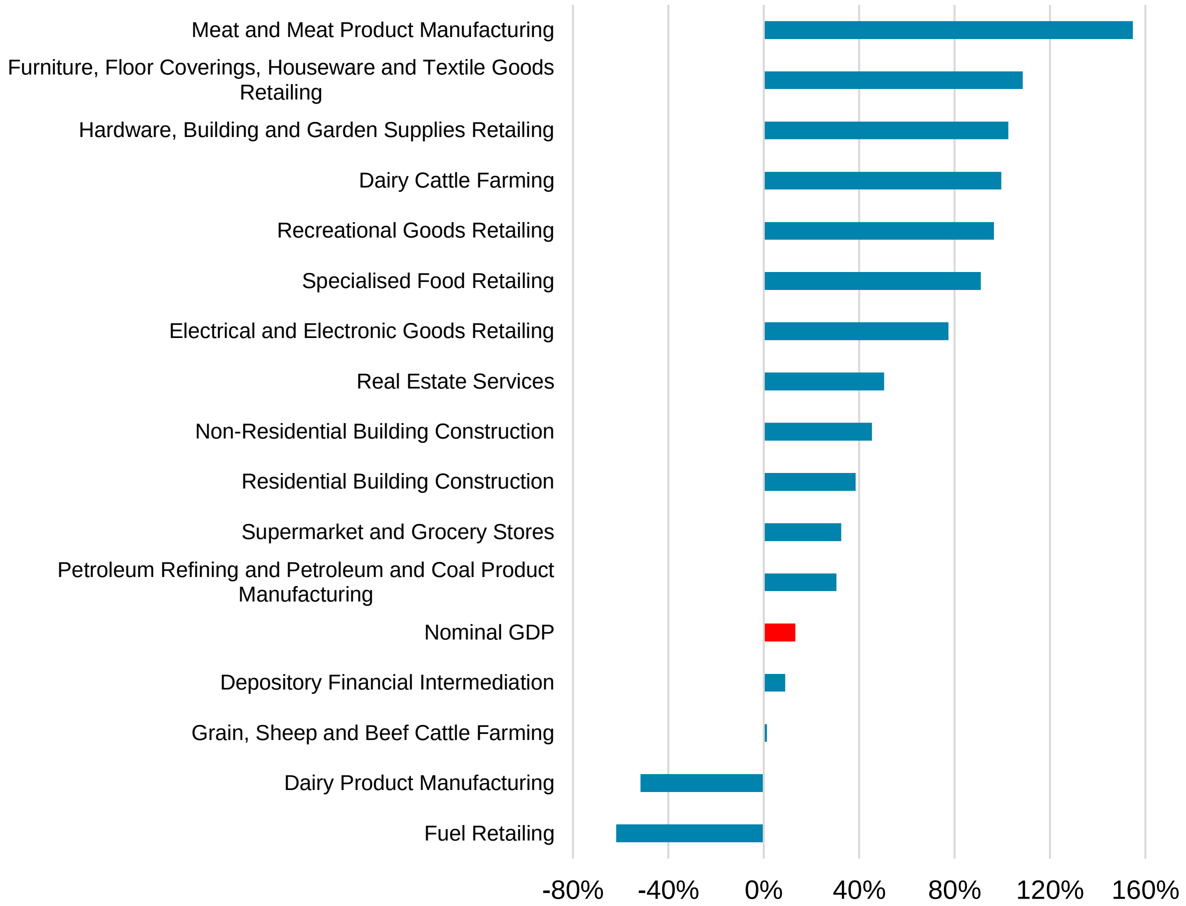
This reveals that some industries have grown more than others and there is significant variability.

For example, several industries have had reductions in their profitability and many have grown slower than GDP.

Note – data is not yet available for 2022 and so we have focused on 2021.

We took a look at a more detailed look at some sectors and found that some particular industries have had strong growth

Figure 5. Income tax: Year ended March 2021 vs 2017-19 average



Source: IRD

Figure 5 shows the change in income tax for a select group of sub-industries (this is a more detailed industry classification than Figure 4).

We have selected subindustries based on where there are public concerns about their profitability or prices or where identified as high profit growth in Figure 4

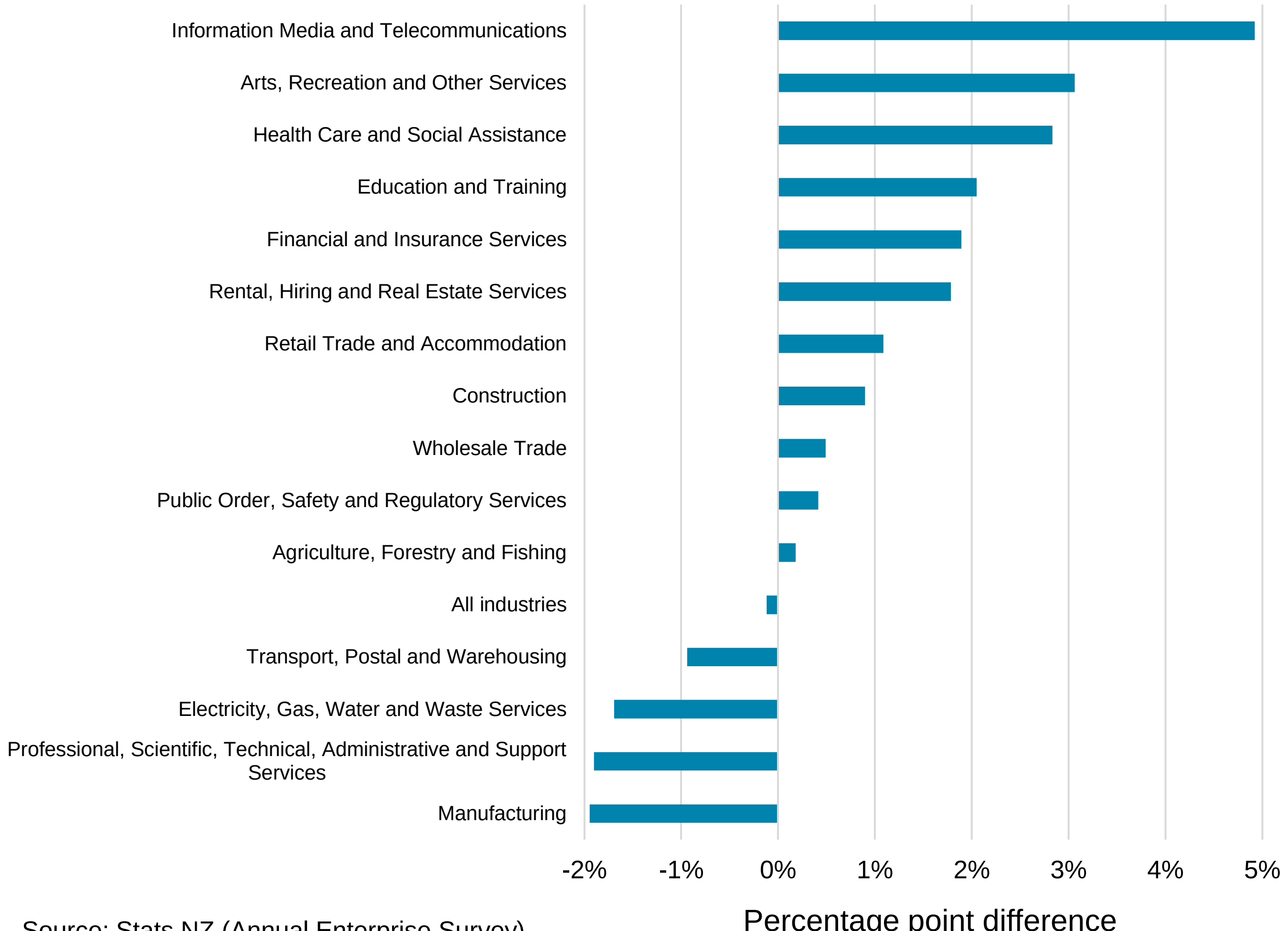
This shows that some sectors have had significant profit growth since 2017-19

This is mainly commodity producers (meat and dairy) and those who have significant increase in domestic demand (construction, goods retailing)

We have taken a look at some of the drivers of price growth further on slides 13 and 14.

Profit margins increased in some industries in 2021, but within the normal range of volatility

Figure 6. Profit margin: Year ended March 2021 vs 2017-19 average



Source: Stats NZ (Annual Enterprise Survey)

Between 2013 and 2019 the standard deviation of annual profit margins was 2% for all industries

For individual industries the standard deviation ranged between 0 to 8%. As a result, the changes in profit margins for Figure 6 are within the expected range.

Because profits data has significant lags, we looked at more recent data on prices.

From this we took an initial look at the three sectors experiencing largest price growth – transport, housing and food.

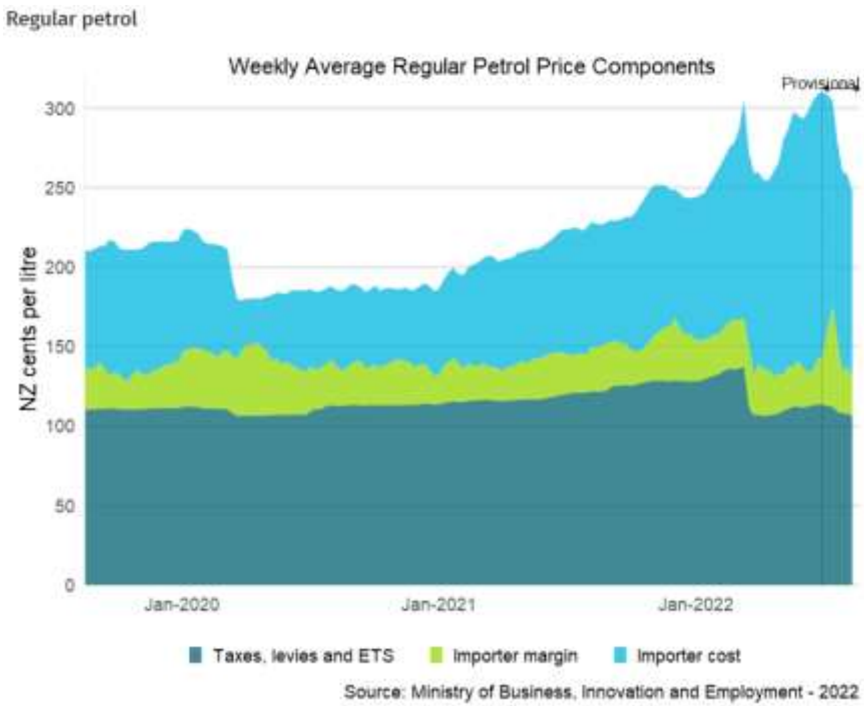
Table 7. Annual inflation – 2022 Q2 – top 5

CPI groups	Annual inflation
Transport	14.5%
Housing and household utilities	9.1%
Household contents and services	6.8%
Food	6.5%
Miscellaneous goods and services	5.5%

Source: Stats NZ

Transport prices have been increasing due to the rising cost of imported fuel

Retail margins have been equally volatile in response to volatile prices. However, margins appear to have returned to a relatively stable level.



Source: MBIE

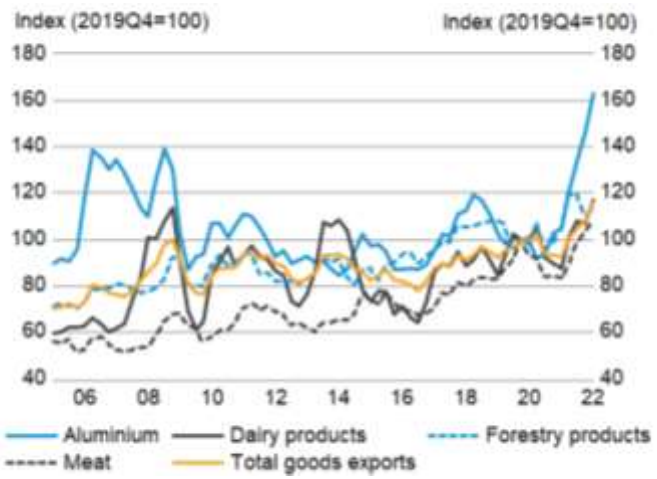
Rising dairy, meat, and housing prices are being driven by rising international prices and interest rates

Meat and dairy prices are high.

It is unclear whether this will be sustained. Commodity prices are volatile and sudden increases and decreases in profits are expected.

For example in 2016/17 meat and dairy prices were relatively low and so profits were low. (This is one of the comparator year in Figure 5 which is part of the reason why the profit growth is high for meat and dairy in these earlier charts)

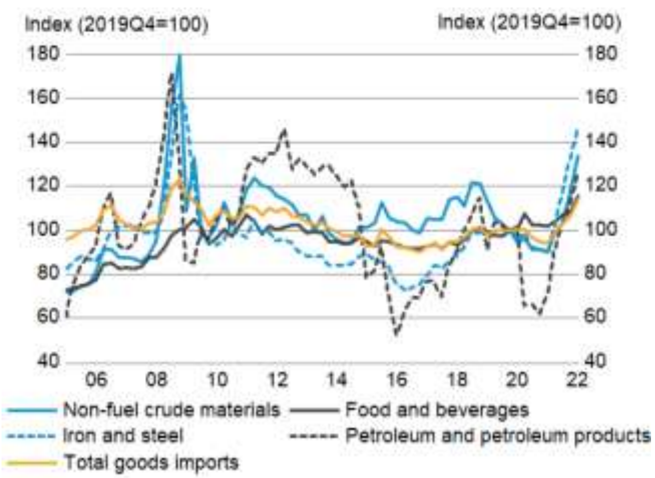
Figure 8. Merchandise export price indexes



Higher import costs and interest rates are putting pressure on housing costs

This is likely to be the main factor in rising housing costs.

Figure 9. Merchandise import price indexes



Source: Stats NZ