Excess Profits Tax

A Green Party discussion document
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GREEN PARTY DISCUSSION DOCUMENT

A fair tax system supports strong public services

In Aotearoa, there is enough to go around.

Our tax system, alongside income support, should support a fair distribution of resources so everyone can live with dignity.

Successive governments have failed to ensure we have a fair tax system, which in turn means there is not enough revenue to provide the standard of public services New Zealanders deserve.

The Green Party has led the debate in Aotearoa on a fairer tax system. This discussion document continues that commitment to pushing for a progressive, fair taxation by exploring the potential of an "excess profits" tax. These types of taxes have historically been used in New Zealand and are currently used overseas as part of the response to aspects of global inflation, particularly the high fossil fuel prices caused by the war in Ukraine.

The aim of excess profits taxes is to level the playing field, so that big businesses are not able to profit to excess when so many people are struggling. They also generate revenue which can be used, to support those on low incomes with the rising cost of essentials like food and rent.

We need to address an unprecedented transfer of wealth

The economic response to COVID-19 has affected the distribution of wealth, and the Government needs to take steps in response.

Since the start of COVID-19 we have seen two significant economic phenomena:

1. A significant transfer of wealth to the richest New Zealanders during 2020 and 2021 as asset prices exploded.
2. A rise in inflation from late 2021, particularly in fuel, housing and food costs, that has hit those on lowest incomes the hardest.

These two factors have created a small group of lucky economic winners and many more who are missing out, and struggling to make ends meet.

At the last election the Green Party campaigned for a progressive tax system, including a net wealth tax to ensure that millionaires pay their fair share. Subsequently, the last two years has shown up another potential hole in our tax system.

While some businesses have struggled through COVID-19 (mainly smaller businesses), others have brought in huge profits due to external factors like global inflation, and the Government's COVID-19 response including significant direct corporate subsidies.

In the 2021 financial year the most comprehensive survey of businesses operating in New Zealand showed that there was corporate profit of $103.3 billion, up $24.5 billion (31.1 percent) on the previous year.[i]

The Green Party considers that record profits during a time of economic hardship for many New Zealanders are immoral and unsustainable. The Government therefore needs to closely examine tax settings and Government investment in social services and income support.

With this discussion document the Green Party is exploring how to strengthen our system of corporate taxation to better spread the impact of inflation and the Government's economic response to COVID on our community. We believe large corporates (many based overseas) should contribute a fair share of their profit when conditions mean they are able to unfairly make supernormal or excess profits. We want to hear New Zealanders' views on whether excess profits should be taxed at a higher rate than normal profits and what any extra Government revenue should be used for.

This discussion document looks at the key decisions to be made in designing a tax on excess profits. It also looks at the alternative of raising company tax rates so that all profits are taxed more. Finally it suggests some considerations for how to spend the revenue from greater corporate taxation.

The Green Party sees this as part of an important conversation about the Government's economic response to COVID-19. We hope the Government's economic response will be comprehensively reviewed in time. We are proud to get that conversation started with this discussion document.

Excess profits taxes are an established tool in other countries

Excess profit taxes (also called "windfall taxes") have been recently implemented in many European countries and around the world.[ii]

An excess profits tax is usually a one-off levy imposed on a company or a group of companies by the government. They target businesses that have made unreasonably high profits, normally due to unusually favourable markets. In Europe, the EU is now implementing an excess profit tax on the energy sector.[iii] Spain has its own excess profit tax on both the energy sector and on banks.[iv]

> In these times of crisis, more and more people are being pushed into poverty while big business is raking in unexpected profits. The EU's proposal to apply a windfall tax will raise much needed funds to fight the climate crisis and shield consumers from high energy bills. But this tax should not be limited only to energy companies, but all companies profiting off the pandemic, like big pharma and tech giants.
>
> - Chiara Putaturo, Oxfam EU's tax expert[v]

Excess profits often come at the expense of wider society and as a result of factors unrelated to improved business performance. When something like the war in Ukraine, or fiscal and monetary stimulus, has contributed to higher than normal profits in some businesses, it is fair that a higher than normal tax contribution could be expected. The excess profits tax is a way of redistributing these gains so Government can support those who are facing the brunt of cost of living increases.

Historically, excess profit taxes have often been used at times of war, including in New Zealand during World War I and World War II. They have also been used for a range of other situations where it was seen that companies were inappropriately profiting from particular market conditions.

Case study: Windfall Tax on Banks, UK, 1981

The windfall tax on energy profits by the Conservative Government in 2022 is one of many examples of windfall taxes in the United Kingdom.

In 1981, Conservative Chancellor Geoffrey Howe, under Prime Minister Margaret Thatcher, introduced a one-off levy on banks, charged at 2.5 per cent of their non-interest bearing current account deposits. Howe imposed the levy after accusing high street banks of escaping the recession. The tax recouped about £400m in revenue (equivalent to around £3bn in today's terms). This represented about a fifth of the profits banks were pocketing.

At the time, this was seen as a move that risked leaving banks undercapitalised and weakening their ability to lend. However, Howe persevered and saw the tax as reasonable due to interest rates being raised by 17 per cent in 1979. The banks were unsurprisingly furious, as were some of Howe's Conservative colleagues, but not Thatcher. In her memoir, the 'Downing Street Years' she fully grasps the moral argument supporting windfall taxes:

"Naturally, the banks strongly opposed this, but the fact remained that they had made their large profits as a result of our policy of high interest rates rather than because of increased efficiency or better service to the customer."

How would this tax work in New Zealand?

Who should an excess profits tax apply to?

Excess profit taxes were applied by a number of countries during World War I and World War II and were largely applied across all businesses that were making excess profits, whereas recent European taxes have targeted the energy industry. UK windfall taxes over the last few decades have also been specific to certain industries like banks or privatised utility companies.

Applying the tax to specific sectors can help with administrative simplicity. Options for sectors in Aotearoa include those that have been making record profits during recent times and/or have significant issues with competitiveness. This could include:

- Banks
- Fuel companies
- Supermarkets
- Building products suppliers
- Energy generators/retailers ('gentailers').

These sectors have had the highest contribution to CPI inflation in New Zealand and have varying degrees of issues with market competitiveness. This means they are the greatest cause of the rising cost of living, with the least innovation gains justifying the high profits. All of these industries provide essential goods and services to people and so there is a public interest in ensuring excess profits are not being made.

Questions

1. Do you support applying an excess profits tax to certain sectors like banks, fuel companies, supermarkets, large construction companies, and/or energy retailers?
2. Which sectors do you consider should be subject to an excess profits tax?
3. Alternatively, do you support applying an excess profits tax to all businesses that made excess profits?

How to define “excess” profits

Economists have a concept of “normal” profit of firms and “excess” profits.[vi] Excess profits often can’t be justified by the nature of that business and their operation, and instead are the result of factors outside their control. When there are times of collective struggle – such as we’ve all faced over the pandemic – it is particularly concerning to see some businesses making excess profits, and particularly important that the benefits are shared.

Methods used to calculate excess profit in other places where taxes have been applied include:

1. **Average earnings method:** this involves a comparison of a company’s normal profit from the period immediately before the change of economic conditions that led to the excess profits, and their profit after the change in conditions. For example, this could be applied in New Zealand by looking at 2017-2019, before COVID-19, and then comparing that with profits made once COVID-19 hit in 2020-2022.
2. **Invested capital method:** this involves looking at the return on equity or total assets and determining that any return above a certain percentage are excess profits. Different sectors historically have different levels of return, so there may need to be adjustments across different industries.

The excess profits tax implemented in the United States in World War I and World War II allowed businesses to choose which method they wanted to apply. This is a potential option to ensure that businesses with different structures and lifespans are treated fairly – for example, to avoid penalising a business that has recently been established. It would also be possible to apply the tax only to businesses with revenue above a threshold amount.

What level of tax should be paid?

Excess profit taxes would apply as an additional tax above the standard company tax rate of 28%. Excess profit taxes can be set at different levels, which in turn generate different amounts of revenue.

During war times, excess profit taxes have been set as high as 80% on the excess profit made by businesses.[vii] As this is a new tool for New Zealand in recent years, a lower level may be seen as more appropriate.

For example, this could be set at 11% to bridge the gap between the company tax rate and the top income tax rate. Alternatively, it could be set closer to 50%, recognising the effectively unearned nature of excess profits.

Administrative implications

While excess profits taxes have made significant revenue in the past, there are administrative challenges in identifying excess profits accurately, and this can increase avoidance and reduce revenue.

A more straightforward option would be to apply a temporary industry-wide increase in company tax for companies over a threshold size, in sectors of the economy that can clearly be shown to be making profits due to external factors. This is the approach that Thatcher took in 1981 with the windfall tax on banks.

Questions

1. Which method do you support to calculate excess profits?
2. What additional rate of tax would you support either on excess profits or as a temporary levy across an industry?

Retrospective tax or only on future profits?

In general, taxation rates are always known in advance. However, there is a case for making excess profit taxes retrospective.

There are two different approaches:

1. Apply excess profit taxes retrospectively, to ensure that the tax is covering the period that excess profits were made.
2. Only apply excess profit taxes to profits made following the introduction of the tax, which gives better certainty to businesses.

Excess profit taxes that are future focussed can help to discourage any price gouging in non-competitive markets, as companies know profits generated through artificially high prices will need to be paid back through taxation. Retrospective taxes are less likely to change behaviour. However, if the purpose of the tax is to address existing excess profits, retrospective application would be necessary.

Question

1. Do you consider that retrospective excess profit taxes are less distortionary and better reflect excess profits? Or do you support only taxes on future earnings to give businesses more security and confidence?

Incentivising businesses through exemptions

An excess profits tax is an opportunity to provide incentives on companies to be part of a just transition to a low emission economy.

One of the theoretical criticisms of an excess profit tax is that they reduce profits reinvested in the growth of a company. This theoretical concern is questionable, as rational businesses should only invest for the normal risk return in that particular industry.

To address concerns around reduced business investment, a potential option would be to carve out investment in important emissions reducing infrastructure or public benefit research and technology. Businesses, when deciding what to do with their profits, will have extra incentive to invest in a new electric truck, or retrofit their buildings, or remove coal boilers.

Question

1. Would you support an exemption to an excess profits tax where the company has used profit to invest in reducing their carbon emissions?

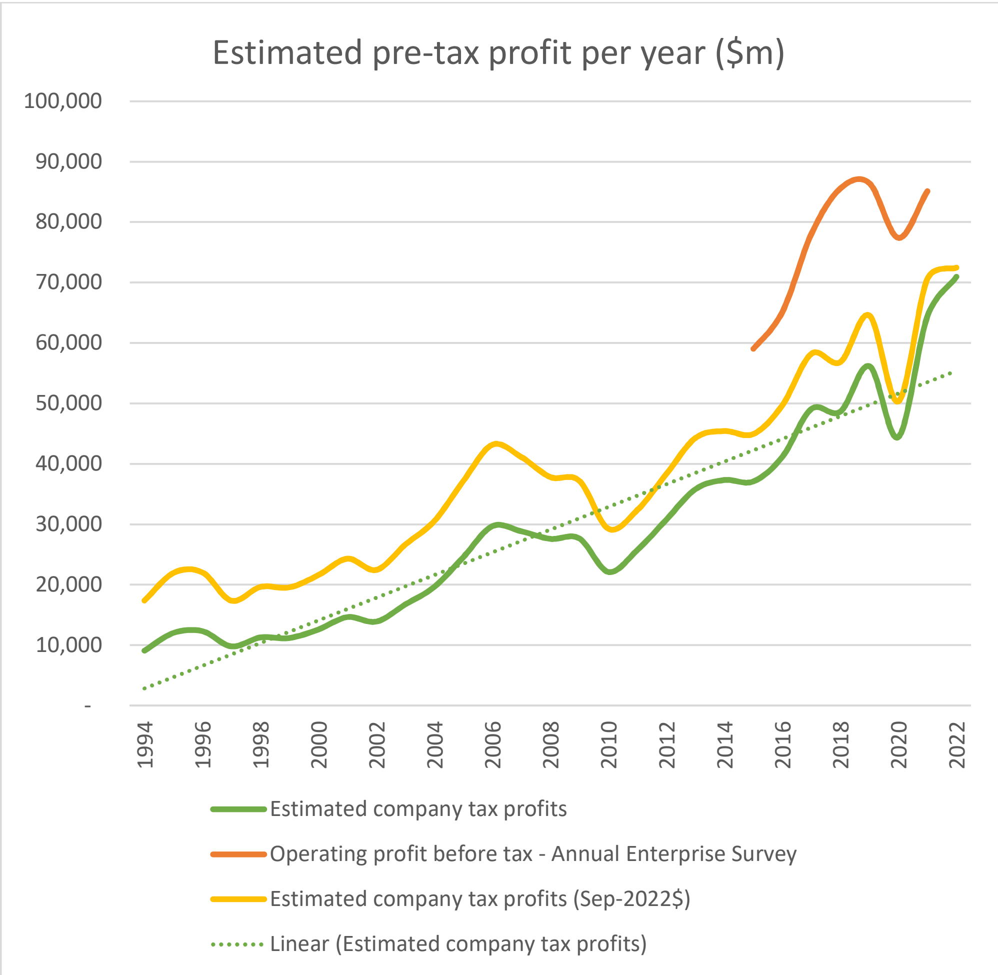
Alternative or additional option: increase in company tax rate

A low company tax rate exacerbates excess profits, and may indicate that the tax rate needs to be increased as a permanent measure, as well as addressing excess profits in the immediate term. It would be less administratively challenging to simply raise the corporate tax rate for future years, rather than trying to isolate particular industries that had received windfall gains or calculate excess profit taxes across the economy. However, this does not address the immediate issue of excess profits being generated by a few companies in particular sectors.

New Zealand's corporate tax rate is currently 28%. In contrast, before 1987 it was above 40%. It has been steadily reduced – first to 33% in the

1990s and 2000s, then to 30% in 2008 and down to 28% in 2010. In Australia the main company tax rate is 30%.

Corporate profits have increased significantly over the past twenty years, with rapid bounce backs from periods of economic downturn. The graph below demonstrates that profits are already exceeding pre-pandemic levels; and are several times higher in real terms than in the 1990s.[viii]



Based on a 28% company tax rate producing around $20 Billion in revenue in the year to June 2022,[ix] increasing the company tax rate to 33% could generate over $3 billion dollars in annual revenue (though exact modelling would need to take into account imputation adjustments and allowances for avoidance, which is beyond the scope of this discussion document).

By cutting corporate tax rates Aotearoa is part of a global race to the bottom of trying to subsidise and encourage foreign investment. Corporate profits continue to grow, but most people are not seeing the benefit. And foreign direct investment as a percentage of GDP actually went down following lowering the company tax rate change in 2008.[x] Empirical evidence suggests that modest increases in corporate tax rates do not negatively affect wages or productivity.[xi]

Because of the way imputation tax credits work, most small New Zealand businesses and their shareholders would not have to pay significantly more tax if the company tax rate was lifted to 30% or 33%. This is because any company tax paid counts towards any tax that shareholders need to pay on dividends, shareholders who will likely be paying a marginal rate of tax above 28%. A lift in company tax rates will more substantially hit large multinational corporations.

Example

Susan owns and operates a small restaurant, trading through a company of which she is the sole shareholder. She pays herself a salary of $80,000 a year and in years where her company makes a large enough profit she gets a dividend.

If the company tax rate is at 28%, Susan claims the 28% imputation tax credit but then needs to pay a top-up on her income tax to take it to her 33% marginal income tax rate. If the company tax rate is at 33%, Susan claims the 33% imputation tax credit and does not need to pay any more tax. Susan has paid the same tax on the dividend when the company rate is at either 28% or 33%.

Questions

1. Do you support raising company tax rates in Aotearoa? If so, to what level?
2. Would raising company tax rates be a better option than introducing an excess profits tax? Or do you support both?

Extra revenue: how to help people with money raised

It's crucial to spend any new revenue on addressing the hardship regular people are facing and, where possible, helping to create a fairer, lower emission economy.

The infrastructure deficit, housing crisis, and persistent inequality in New Zealand mean that there are many areas where additional investment by the Government could help improve people's lives, now and into the future. Government spending is always constrained by revenue – there are many worthwhile areas of spending not prioritised in each budget due to revenue constraints. Some of these are ongoing expenditure, and some are one-off.

If the excess profits tax was a one-off tax, it would restrict what the revenue could be spent on. It would be appropriate to ensure that revenue was directed at one-off spending, avoiding any liabilities for ongoing spending that could not be met in future.

Other potential considerations include supply shortages and associated inflationary pressures, which mean that spending the money in some areas may not be either practical or as beneficial as it would normally be.

Within those restrictions, we consider that revenue could be used for a range of areas to ease the inflationary pressures on people and help transition to a more equitable, lower emissions economy:

- A cost of living payment extension, with eligibility expanded to include beneficiaries.
- Cancelling MSD debt accrued to pay for essentials (noting ongoing funding would be needed to ensure incomes are adequate to prevent future debt).
- Partially cancelling student debt.
- Increasing funding to Kainga Ora to build public housing, or providing this to iwi, local government, and community housing providers to use for housing.
- Establishing a sovereign wealth fund that could provide ongoing smaller grants for both environmentally and socially beneficial programmes.

- One-off subsidies for measures that improve energy efficiency and environmental performance of housing.
- One-off capital grants to public institutions, for example to enable repairs or upgrades of hospitals and schools.
- Easy to implement capital works that reduce carbon emissions, such as creating new cycleways and installing solar panels on public housing.

The level of revenue raised from strengthening corporate taxation would depend on a large range of policy decisions, including the ones highlighted above.

Questions

1. What do you think any revenue should be spent on, when this would likely be a one-off tax?

Tell us what you think

We'd love to hear your responses to the questions in the document.

Answer online at www.greens.org.nz/excess-profits-tax

Sources and notes

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