

IRD Report: Value for money – line-by-line review of expenditure

Date:	3 February 2009	Priority:	High
Security Level:	Budget: sensitive	Report No:	IRD2009/005

Action sought

	Action Sought	Deadline
Minister of Revenue	Sign and refer attached paper to Minister of Finance	Thursday 5 February 2009

Contact for telephone discussion (if required)

Name	Position	Telephone
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3 February 2009

Minister of Revenue

IRD Report: Value for money – line-by-line review of expenditure

Executive summary

1. On 17 December 2008 the Cabinet Business Committee, as part of a suite of value-for-money initiatives, directed chief executives to report by 5 February 2009 on line-by-line reviews of expenditure [CBC Min (08) 32/6 refers].
2. This report contains comment on a range of possible areas for review. I have organised the report in sections that reflect Inland Revenue's operating structure, finances and priorities for reform, rather than under the 7 Cabinet questions. This is because the emphasis in the Cabinet minute on discretionary programmes does not perfectly reflect the way Inland Revenue operates and the issues I have to consider in seeking opportunities to realise efficiencies.
3. Over the years, funding increases have tended to favour new projects over growth in existing operations. Generally Inland Revenue is efficient and comes out well in international measures of collecting \$100 of revenue. However, like all organisations, greater efficiencies can be obtained. For this exercise, savings of \$50 million have been identified over three years, with \$15.4 million identified for the 2009/10 year. In addition a further \$100 million of additional revenue could be realised through specific audit targeting.
4. However, Inland Revenue faces real funding pressures in the 2009/10 year, amounting to an additional \$18.6m. Inland Revenue proposes that the identified savings be retained in Vote Revenue and used to offset against acute funding pressures arising from unavoidable cost increases. The net result of this is that Inland Revenue will self-fund most current pressures and will only bid for critical pressures that cannot be self-funded due to their capital requirements.

5. In the medium term, further savings are possible if Inland Revenue is permitted to investigate solutions that could deliver deeper and sustainable benefits by improving business processes and simplifying delivery, particularly in the areas of Student Loans and the EMS return. These options are part of a separate bilateral Budget bid.
6. In the longer term, Inland Revenue is embarking on a wider organisation review (called *Transform IR*) to leverage opportunities for greater alignment of policy and administration, improving business processes and mitigate risks to delivery of our services. Inland Revenue is to fund \$8 million over the next two years to further this programme.
7. Other possibilities for savings could arise by re-examining some non-tax processes Inland Revenue administers, such as paid parental leave, gift duty and the payroll subsidy.
8. In order to show how Inland Revenue has responded to each of the 7 Cabinet questions, I have summarised the line-by-line results for Vote Revenue in a table at the end of the report.
9. Much of the substantive discussion relates to issues that you will already be aware of – current performance pressures, infrastructure risks and Inland Revenue’s transformation programme. I see this value-for-money process as an opportunity to keep you and other interested ministers informed on Inland Revenue’s approach to addressing these issues and to seek your input and support. I am committed to ensuring Inland Revenue provides genuine value for money to the government and will actively work with you towards this goal.

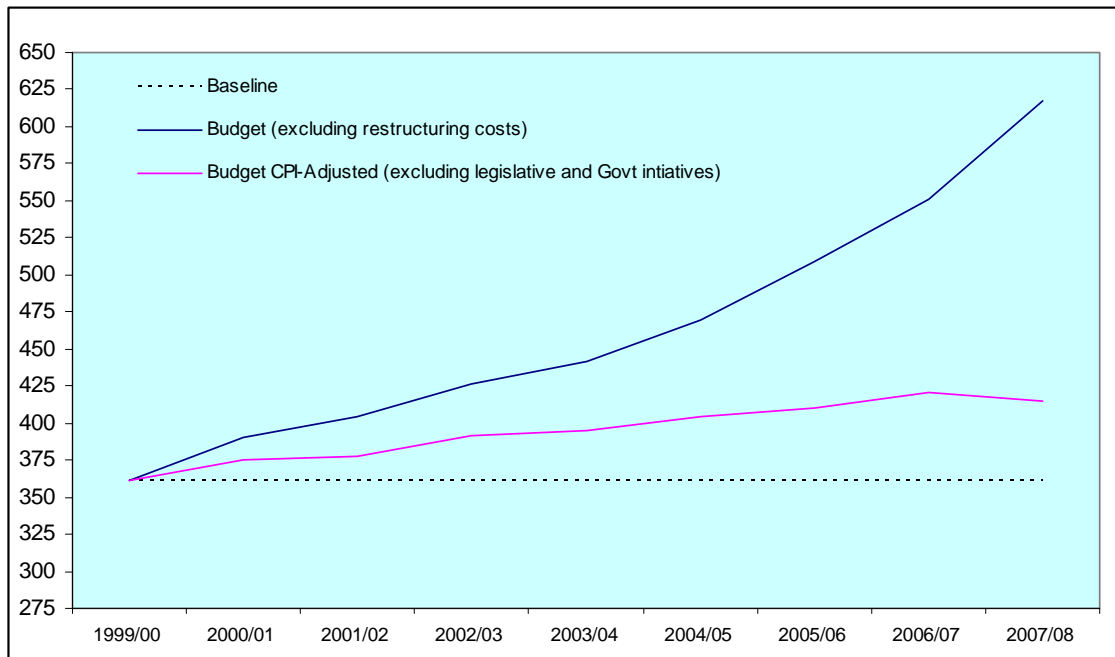
Efficiencies identified for 2009/10

Historical trend in Inland Revenue's funding

10. Inland Revenue strives to be an efficient and effective organisation. Inland Revenue's cost of collecting \$100 tax has steadily fallen over the past 10 years from 96c in 97-98 to 76c in 07/08. This compares favourably to other tax administrations:

	2001	2002	2003	2004	Trend	2008
Australia	1.06	1.07	1.05	1.05	-	0.84
Canada	1.08	1.20	1.33	1.17	↑	
Ireland	0.90	0.95	0.91	0.86	↓	
New Zealand	0.90	0.87	0.83	0.81	↓	0.76
Singapore	0.90	0.99	1.01	1.02	↑	
United Kingdom	1.06	1.11	1.04	0.97	↓	
United States of America	0.46	0.52	0.57	0.56	↑	

11. At the same time Inland Revenue's customer base has grown and new and expanded business functions have been added. The following graph compares nominal and CPI-adjusted Inland Revenue funding since 1999/2000.



12. Inland Revenue has managed its responses to volume growth largely within baselines and has limited requests for additional baseline funding to critical cost increases.

13. While this approach has contained the historical growth in Inland Revenue's baseline funding, in many instances the full costs of adding new policies have not been funded and only immediate and critical cost pressures have been funded through the budget cycle.

Efficiencies identified for Budget 2009

14. As indicated above Inland Revenue is experiencing a widening gap between its funding and the true cost of maintaining an effective tax administration. However, given the current fiscal pressures, for Budget 2009 Inland Revenue is aiming to continue its past approach of managing pressures within baselines by finding efficiencies where possible, and bidding only for critical pressures that cannot be self-funded.

15. Inland Revenue is aiming to manage forecast 2009/10 volume increases within baselines using efficiencies generated from the Budget 2008 investment in upgraded call centre infrastructure and associated service enhancements (such as virtual hold).

16. Inland Revenue is aiming to self-fund contractual increases through efficiencies.

17. The cost increases (which are largely unavoidable) are as follows:

Source of increased cost	Value (\$million)
[deleted – to enable negotiations without prejudice or disadvantage]	
[deleted – prejudice commercial position]	
Replenishment of overdrawn capital reserves	2.000
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
Contribution to cross-government Identity Verification Service	0.750
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
Total	18.635

18. Inland Revenue has done substantive work over the last few weeks, assessing all available opportunities to identify efficiency savings that can be achieved over the course of 2009/10 with as small an impact as possible on revenue and on core business delivery.

19. Inland Revenue has identified the following operating efficiencies that it can realise within 2009/10:

Source of efficiency	Value (\$million)
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
[deleted – prejudice commercial position]	
<i>KiwiSaver</i> employer tax credit square up	2.682
[deleted – prejudice commercial position]	

20. These baseline efficiencies will continue into subsequent years: over 3 years they provide \$50 million that can be reprioritised.

21. In addition to the savings noted earlier, Inland Revenue intends to self fund \$8 million over two years of operating costs associated with standardising current business processes in advance of core systems replacement and the scoping of several components of *Transform IR*.

22. No capital efficiencies are available as Inland Revenue's capital base is under significant pressure and its reserves are already overdrawn.

23. For 2009/10 I propose that the [deleted – prejudice commercial position] million operating efficiencies identified above be retained in Vote Revenue and offset against the \$18.635 million funding pressures arising from contractual cost increases. This will largely close the funding gap and address the pressures created by the contractual cost increases. The remaining [deleted – prejudice commercial position].

24. The net result for 2009/10 is that Inland Revenue will self-fund all volume increases and cost increases, and its Budget 2009 emergency pressures bid will be limited to critical infrastructure pressures which Inland Revenue cannot self-fund due to their capital requirements.

25. As I have indicated, the level of efficiencies identified and the proposed use of them will minimise the impact on service delivery. With many performance standards already under significant pressure, the efficiencies will inevitably place further pressure on performance in some areas. The main areas that will be affected are:

- **Call management:** Existing performance pressure will continue, and further pressure will be evident relating to less general services personnel being available to assist our call centres staff during peak periods;
- **Debt:** Inland Revenue's outstanding debt has grown by 53% over the last 3 years but Inland Revenue has only been able to increase resourcing by 9%, and this gap may widen further with more debt issues arising out of the current economic climate;
- **Operations:** Turnaround times for most processing activities – including processing of returns, rebate claims and refunds, and responding to correspondence – will remain under substantial pressure;

26. There is however a possible source of further small savings in *KiwiSaver* advertising. A *KiwiSaver* evaluation is about to be done and once that work is complete you may form a view as to whether further *KiwiSaver* advertising is desirable, or whether you would prefer to realise a small saving by scaling back or stopping the advertising.

Additional value-for-money opportunity for Budget 2009: additional revenue

27. Inland Revenue has identified an opportunity to gain in excess of \$100 million of additional revenue through a range of compliance activities over the next 3 years in emerging international compliance risk areas, at a cost of \$4.8 million each year. Inland Revenue has been unable to reprioritise within its compliance resourcing because the department does not have enough investigators with the required skills to conduct this investigation work at the same time as continuing the structured finance work currently underway.

28. The focus of the investigation work is on larger enterprises that are in a position to undertake aggressive tax planning; small and medium enterprises and individuals will not be targeted for additional audit in this work.

29. The proposed approach includes:

- Providing additional resources to target aggressive tax planning schemes that have been identified via collaboration with international agencies and access to intelligence data;
- Addressing Inland Revenue's increasing concern over multi-national taxpayer hybrid financing instruments;
- Developing more effective information gathering techniques to obtain key data on assets, enhancing Inland Revenue's ability to identify potential GST fraud.

30. The costs and the performance benefits are as follows:

		Revenue Opportunity Impacts				
		2008/09	2009/10	2010/11	2011/12	2012/13
Quantity		Target	Additional			
Investigation hours		975K – 1,078K hrs	32K hrs (\$4.8m)	32K hrs (\$4.8m)	32K hrs (\$4.8m)	-
Quality		Target	Additional			
Assessed Revenue	Aggressive tax planning		\$18.2m	\$18.2m	\$18.2m	
	Hybrid financing	\$877.1m	Identified \$700m revenue potentially at risk, final discrepancies dependant on investigation outcome			
	Asset details (GST claims)		\$ -	\$26.0m	\$26.0m	\$10.0m

31. The proposed activities will promote future compliance, while also providing an excellent return in terms of additional revenue.

32. Inland Revenue has not included additional compliance activity as a component of its Budget 2009 bid, but because it does represent value for money and an opportunity to help to ease overall funding pressures for the government I wanted to highlight it to you. If you wish to pursue this revenue opportunity Inland Revenue will add a compliance activity item to the ministerial pre-commitment bid for Budget 2009.

Longer-term prospects for achieving the best value for money

Opportunities at a process and infrastructure level

33. Inland Revenue is committed to providing long-term value for money to the government. Inland Revenue has begun a programme of work called *Transform IR*, which is aimed at identifying and implementing changes necessary to ensure Inland Revenue's administration of the tax system remains reliable, effective and sustainable into the future, and that it delivers excellent value for money.

34. The scale of the changes required means that government support for this programme will be critical to its success. In particular:

- Investment over the medium-to-long term will be required in order for Inland Revenue to implement major changes.
- Inland Revenue is seeking to take innovative approaches to many activities, and as proposals are developed the department will seek agreement from ministers that it is on the right path and that the risks associated with new approaches are acceptable.

35. A key driver for Inland Revenue needing to undertake a programme of transformation is the scale and pace of the policy changes Inland Revenue has delivered in the past few years. The rapid addition of complex social policy delivery to tax policy and administration activities has had the following impacts on the delivery of tax and social policy:

- Customer contact volumes and complexity have exceeded forecasts, stretching Inland Revenue's capacity to deliver existing services. This is particularly critical for *Working for Families*, where annual call volumes are 350,000 over the level for which Inland Revenue is funded.
- Funding and work effort have been prioritised towards policy delivery over maintenance of underlying systems. Inland Revenue has not requested any material funding for IT infrastructure investment over the last four years and critical maintenance of Inland Revenue's systems and process has been deferred, with the result that system reliability will reduce below prudent levels.
- Legislative requirements for business processes and interventions have increased delivery cost disproportionately to their contribution to policy objectives.
- Inland Revenue's capability to implement new government tax or social policy initiatives has been eroded.

36. The twin factors of increasing demands on core systems and under-investment in maintenance of those systems has created an unacceptable risk to Inland Revenue's ability to maintain performance and manage costs in a sustainable manner. On the basis of projections of future growth in the volume of customer contacts, known policy changes, and ageing of systems, Inland Revenue's capacity to deliver services reliably and in a cost-effective way will deteriorate if Inland Revenue does not invest in both addressing immediate infrastructure risks and longer-term re-engineering of systems and processes.

Initiatives already being actively considered by Inland Revenue

37. The most urgent responses to infrastructure and process risk are those included in the proposed emergency pressures bid for Budget 2009. These consist of unavoidable software and hardware upgrades plus those initiatives from within the *Transform IR* programme that are ready for implementation or for detailed design. The current overall suite of initiatives, including those currently at a preliminary stage, is as follows:

Transformational initiatives already under way and requiring investment	
Modernising the company income tax return (IR4/IR10)	This is a revised income tax return and filing process resulting from a review of Inland Revenue's data requirements from companies. This is ready for implementation. Funding is sought in Budget 2009.
Student loans redesign	Student loans as a policy area has suffered from the limitations of the current IT system. Redesign options were put forward in a stage 2 business case and the option chosen is now ready for implementation. Funding is sought in Budget 2009.
Transforming employer information	As more policies have sought to leverage the efficiency of the PAYE system, the system itself has begun to be undermined. The addition of <i>KiwiSaver</i> to the monthly information requirements from employers has placed a burden on the core forms and processes that is not sustainable. Optimisation initiatives are under way to keep the current process running as smoothly as possible, but a longer-term redesign of the process is required. Inland Revenue has considered the nature of the problem and possible responses at a high level, and is now ready to commence more concrete proposals culminating in a stage 2 business case. Funding is sought in Budget 2009.

38. The three initiatives currently in the scoping phase are not explained in the Budget 2009 bid, as funding is not currently being sought for them. Broadly they involve the following goals:

Transformational initiatives being scoped for next phase of investment	
Customer relationship management	With an increasingly diverse range of customer relationships Inland Revenue is finding that a one-size-fits-all approach to service delivery is no longer appropriate or effective. This initiative seeks to develop functionality allowing a clearer view of customer history, preferences and account status, and better links between different tax types, supporting a more satisfactory customer experience and more efficient delivery of services through targeting and tailoring.
FIRST modernisation	Like the policy framework, the FIRST system has grown unwieldy because of misalignment between its original tax-oriented design and the requirements of the various social policies it now has to cater for. The system is nearly 20 years old and is built in a programming code and architecture that makes structural changes within the system to suit changing policy requirements extremely difficult to achieve. The result is that the system is now laden with workarounds that are affecting its performance, reliability and capacity to accommodate future policy requirements. A review of the business requirements for Inland Revenue's core IT system is required. This will identify opportunities to decouple components, simplify and align processes and create a new architecture that will provide adequate flexibility to meet changing policy requirements. It is likely that as a result of this review some or all of the current components of FIRST will need to be replaced. This is a large undertaking involving significant investment, but it is a process that Inland Revenue considers will be critical to maintaining an effective tax administration.

Possible further areas for further investment in development with a view to longer-term efficiency gains

39. Two further activity areas with opportunities for efficiency enhancements through investment in system and process redevelopment are debt management and returns processing. The details are as follows:

Areas for future investment in development	
Debt	<p>Inland Revenue has done considerable work over the last year reviewing its debt practices and opportunities for enhancements. Best practice for effective debt management centres on taking a dual approach, stopping or preventing the debt before it happens, and responding quickly when default occurs. Opportunities exist to:</p> <ul style="list-style-type: none">▪ Deliver an improved debt management system that allows a more targeted customer debt management approach, including the development of portal and digital work management systems;▪ Provide a service allowing customers to set up repayment arrangements online; and▪ Ensure more pro-active interventions, reducing overall cost of collection. <p>In addition the Office of the Auditor-General is due to review and make recommendations on Inland Revenue's debt practices in June 2009.</p>
Returns	<p>Inland Revenue processes millions of returns of varying content and complexity. There is an opportunity to reconsider the whole returns process – triggers and thresholds for return filing obligations, information requested on returns, the need for special returns and returns with no financial information on them, processing errors and ways to reduce them, storage and retrieval of returns.</p>

Possible areas for review at a policy / legislation level

40. This section covers programmes and activities that ministers may wish to discontinue either on policy grounds or because of the administrative expense.

41. It is important to emphasise that almost all of Inland Revenue's activity consists of core functions to meet the requirements of the tax and social policy legislation. Inland Revenue's administration is not structured around programmes of discretionary expenditure and Inland Revenue does not hold pools of funds disbursed to customers or to third-party providers.

42. This means that there are very few activities that could simply be stopped with the cash handed back.

Programmes / policies

43. As I noted above, Inland Revenue’s business does not involve discretionary programmes. The closest Inland Revenue has to the kinds of programmes envisaged in the line-by-line review questions are social policy programmes, a small number of subsidised or concessionary schemes, and some small non-core responsibilities. Ministers may wish to make policy changes (or unwind policy entirely) in some of these areas to align with government priorities.

44. In some areas there is imperfect alignment of the current policy with the structures required for the core tax system and opportunities to reduce administrative expense for Inland Revenue could be taken into account as part of any review of the policies.

45. The major policy areas where changes could be made are:

Longer-term opportunities to review – major programmes	
<i>KiwiSaver</i>	The changes to the employer tax credit mean that removal of the legislative square-up requirements is a possibility, and removal of the square-up could generate some administrative savings. There is also an evaluation about to begin which may highlight further areas for review at an administrative or policy level.
Student loans	This programme has a number of ongoing administrative difficulties for Inland Revenue, some of which arise from misalignment between the structure and capability of Inland Revenue’s systems and the needs of a loan administration programme. Inland Revenue has developed a proposal for a redesigned system to better meet the needs of the programme, but there is an opportunity to reconsider how the programme is administered in broader terms.
<i>Working for Families</i>	A formal post-implementation review of the 2005 changes to family assistance is about to begin. It is becoming evident that while the programme is effective, it is not efficient from an administrative perspective and has resulted in a sustained increase in the level of contacts. Inland Revenue now receives 350,000 more <i>Working for Families</i> contacts each year than it is funded for. The difficulty of ensuring that payments are accurate and of managing any debt is a major driver of contacts. Inland Revenue is considering policy and process changes that may address this issue.
Paid parental leave	Ministers may wish to review this scheme and its interaction with the <i>Working for Families</i> tax credits. The scheme does not have high administrative cost for Inland Revenue but reimbursement of employers means there is a revenue cost. Extension of the scheme to self-employed people has been considered but not implemented – this would increase the revenue cost.

46. The more minor policy areas where changes could be made (with correspondingly smaller savings potential) are:

Longer-term opportunities to review – minor programmes	
Gift duty	This is an older tax which has not been reviewed for some time. It brings in little revenue but helps to combat income tax leakage. The thresholds for liability are arbitrary and easy to cross inadvertently, with often punitive results. There may be opportunities to simplify administration (e.g. integrating with income tax assessment systems), or to reconsider whether the tax is necessary at all.
Unclaimed monies	This is a non-core activity for Inland Revenue. It is not expensive to administer but the approach to delivery and the necessity of publishing a list at all could be reviewed.
Payroll subsidy	This subsidy was designed to incentivise use of intermediaries for payroll processing, but with only around 3,000 claimants the use may not be high enough to justify administration of the subsidy.
Adverse events income equalisation	This is a scheme for smoothing income volatility due to adverse events such as drought. Use of the adverse events scheme is very low – it appears the primary sector is using the general income equalisation scheme to manage volatility of income whether it is due to adverse events or not. The general income equalisation scheme should be retained, but the adverse events scheme could be discontinued.
Provisional tax pooling	This scheme is designed to provide a hedge against interest where taxpayers under-pay or over-pay their tax. It provides concessionary interest rates to taxpayers, meaning that the Crown is not fully compensated for the use of money. It causes accounting difficulties for Inland Revenue as some funds in the pool may be hedging against uncertainty over the outcome of litigation and given this uncertainty the Crown must be wary of recognising those funds as revenue.

47. In addition to these policy areas, Inland Revenue has identified a number of administrative activities that relates to meeting its obligations as an organisation. Some of those obligations are imposed on Inland Revenue by other government agencies or by their empowering legislation, and while some are important for ensuring good practices, many are of little value to Inland Revenue in terms of supporting effective administration of the tax system.

48. Whether these obligations change may depend on ministers' decisions about policies administered by other agencies that create these obligations. A table of the main obligations imposed on Inland Revenue by other government organisations is appended at the end of the report.

Summary of line-by-line results

49. These results need to be read in the light of my comments about Inland Revenue's historical under-funding, current performance pressures and infrastructure risk, and the transformation work programme which Inland Revenue has underway in order to address these issues and provide long-term value for money through a more efficient and flexible set of business processes and systems.

1. Savings that can be freed up for Budget 2009	\$50 million over 3 years
	<i>For 2009/10:</i> [deleted – prejudice commercial position] [deleted – prejudice commercial position] [deleted – to enable negotiations without prejudice or disadvantage] of 09/10 cost increases
	Opportunity to invest \$4.8 million per year for three years for additional revenue of \$100 million
2. Programmes that are inconsistent with this government's priorities and should be discontinued	R&D tax credit Tax implications of ETS Possibly some elements of lapsed tax bill
3. Programmes that may be inconsistent with this government's priorities and should be looked into	<i>Major programmes:</i> Student loans Working for Families Paid parental leave
	<i>Minor programmes:</i> Gift duty Unclaimed monies Payroll subsidy Adverse events income equalisation Provisional tax pooling
4. Programmes and expenditure that are not efficient or effective	<i>Known functional areas requiring investment under Transform IR in order to achieve long-term efficiency:</i> IR4/IR10 review Student loans redesign Transforming employer information Customer relationship management Policy framework review FIRST system modernisation
	<i>Additional functional areas where efficiency might be improved through investment:</i> Debt management Returns processing

4. Programmes and expenditure that are not efficient or effective (cont.)	<i>Low-value activities (as detailed in appendix):</i> Archives Act compliance Project governance Government Shared Network Identity Verification Service Government Log-on Service Compliance and penalties annual report Regulatory Impact Statements Business Compliance Cost Statements Statements of Intent / Annual reports
5. Areas where performance information is insufficient to make a judgement about efficiency or effectiveness	KiwiSaver – an evaluation is about to be done, which will provide an indication of effectiveness and efficiency in this area
6. The actions agencies should take to make improvements by the next review period	1. Take steps to achieve efficiencies 2. Engage with Treasury and ministers on transformation work programme
7. Initiatives of the previous government that are not funded	Nil

Next steps

50. If you agree to the proposal to retain efficiencies and offset them against the contractual cost increases for 2009/10, Inland Revenue will continue to take steps to implement these efficiencies.

51. Inland Revenue is currently due to report to ECC (formerly EXG) in March 2009 with an update on its research programme on effectiveness and cost-effectiveness. I expect that the value-for-money processes currently being set up will supersede this work, and I anticipate ongoing conversations with you as Minister of Revenue, with other responsible ministers and with Treasury to ensure that Inland Revenue is on the path to delivering the value for money that the government is looking for.

52. With this in mind, my focus will be on keeping you informed of progress on Inland Revenue's transformation work programme, and on pursuing any work that you direct on reviewing or altering particular policies within the revenue portfolio.

Recommendation

I recommend that you sign this report and refer it to the Office of the Minister of Finance by Thursday 5 February 2009.

Robert Russell

Commissioner of Inland Revenue

Hon Peter Dunne

Minister of Revenue

Appendix: low-value activities imposed on Inland Revenue by other government agencies

Low-value activities	
Archives Act	If the forthcoming archiving requirement on Inland Revenue is maintained in its current form, Inland Revenue will need to run an implementation project to ensure compliance. Given the volume of material Inland Revenue holds this will be expensive – current expectations are that the operating and capital cost of the project will be around \$14 million over 4-5 years.
Project governance	Between Gateway, project quality assurance and the two-stage business case process there seems to be a significant amount of quality review for projects, some of which may be redundant. Given that these processes are expensive to run, a more streamlined approach may be desirable.
Government Shared Network	Inland Revenue pays an annual fee for access to this service but its current utilisation of the service is not high.
Identity Verification Service and Government Log-on Service	SSC cost recovery per customer is triggered by the first registration with public sector agency – because of Inland Revenue’s large customer base the cost will fall disproportionately on us and the trigger system creates a perverse incentive for other agencies to wait till Inland Revenue has registered customers before using it. This may be leading to sub-optimal use of the services.
Compliance and penalties annual report	A summary of shortfall penalties charged must be tabled in parliament each year. This is an old post-implementation monitoring requirement that is not so relevant now as the rules have been in place for some time.
Regulatory Impact Statements and Business Compliance Cost Statements	All policy changes require an assessment of regulatory and compliance cost impacts. It is unclear whether these documents actually result in practical advice on minimising impacts, or are just a form of reporting with little potential to improve policymaking.
Statements of Intent and Annual Reports	Central agencies have asked for accountability documents to be briefer and more focused, but at the same time additional content requirements such as outcome reporting and efficiency reporting have been added.