Date: 26 March 2010 SH-13-5-2-1

To: Minister of Finance

AIDE MEMOIRE: ADDITIONAL FUNDING OPTIONS FOR BUDGET 2010 TAX PACKAGE

Existing Scenario

The preliminary BEFU cost of the tax package including macroeconomic impacts is $535m over the forecast period ($175m in 2013/14) as shown in the table below:

$ million	***2010/11***	***2011/12***	***2012/13***	***2013/14***	***total***
Personal Tax (10.5, 17.5, 30, 33)	-2,365	-3,720	-4,000	-4,250	-14,335
Net NZS	-255	-360	-385	-390	-1,390
Net main benefits	-75	-100	-100	-105	-380
WFF Compensation	-45	-65	-65	-65	-240
Other compensation	-40	-70	-70	-70	-250
GST (excluding clawback)	1,590	2,235	2,345	2,460	8,630
WFF de-indexation	0	15	50	40	105
WFF Integrity Measures	5	15	15	15	50
Company tax cut to 28%	-20	-340	-450	-305	-1,115
Building Depreciation (all buildings)	0	685	685	690	2,060
Depreciation Loading (grandfathering)	135	245	310	345	1,035
LAQCs (incl. remission loophole)	0	70	65	55	190
Thin Cap 60%	0	200	200	200	600
Depreciation - capital contributions	5	5	5	10	25
GST maintenance	15	60	60	60	195
5-year brightline	10	35	70	70	185
Tobacco excise	60	105	140	145	450
Audit activity (incl. admin)	85	170	170	130	555
Inland revenue admin costs	-10	0	0	0	-10
First round effects on revenue (prelim BEFU)	***-905***	***-815***	***-955***	***-965***	***-3,640***
Static clawback estimate	450	625	655	705	2,435
Initial estimate of impact	**-455**	**-190**	**-300**	**-260**	**-1,205**
adjustment for macroeconomic effects	*5*	*25*	*205*	*435*	*670*
Operating balance before gains and losses	**-450**	**-165**	**-95**	**175**	**-535**

*figures rounded to nearest $5m

The adjustment for macroeconomic effects is explained in the A3 note “Budget 2010 tax package and the preliminary economic and fiscal outlook”.

Risks to the Existing Scenario

While the scenario outlined above is broadly fiscally neutral, there are risks remaining to forecasts.

In particular, the scenario includes revenue from introducing a 5 year brightline test and a phased introduction of a 33 percent increase in the tobacco excise. It also includes an estimate of revenue gains from additional audit activity. Budget Ministers have already agreed time-limited funding of roughly $20m per annum to undertake this additional audit activity. We are recommending that this funding become permanent and the revenue benefits are included in the tax package.

Any decision to not proceed with either of these policy changes or additional audit activity, or any other revenue positive policy change, would undermine the broad fiscal neutrality of the overall package. Similarly, slower than expected revenue increases from agreed base-broadening measures would also threaten the fiscal neutrality of the package.

For this reason, Treasury recommends that you consider further principled base-broadening options beyond those that have so far been agreed. These measures are listed below.

Working for Families Integrity Measures

The existing scenario includes revenue from excluding investment losses from the definition of income for Working for Families (WFF) purposes from Budget night. However, this measure will only address a small portion of the concerns regarding the integrity of the scheme.

In order to address more WFF integrity issues, there is potential to indicate a policy intention that would include trust distributions within the definition of income for WFF purposes. This change is expected to result in savings of $10m per annum (minimum).

As part of the 2010 Budget tax package we also recommend announcing a future review that would look at other issues such as addressing integrity concerns relating to social assistance programmes (covering WfF tax credits, student allowances and health entitlement cards).

Additional Audit Activity

In December 2009, Cabinet made an in-principle decision to provide funding to Inland Revenue to undertake increased audit activity as part of Budget 2010. Confirming this decision is expected to lead to a net increase in revenue and reduction in expenses of $170m in 2011/12. This audit activity has been included in the main scenario.

More audit activity could be pursued, over and above that already agreed in-principle by Cabinet, which would further offset the cost of the tax package. Extending the existing time-limited funding to permanent funding is expected to increase revenue in outyears by roughly $120m per annum. Additional funding for further audit activity could raise a further $30m per annum in revenue across the forecast period.

You will receive a joint report on Monday detailing the expected revenue increases from additional audit activity.

[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]

Tobacco Excise

The scenario includes an increase in the tobacco excise of 14 percent for loose tobacco before May 20, with further steps of 10 percent over and above the CPI on 1 January 2011, 1 January 2012 and 1 January 2013.

Due to the expected impacts on the CPI of such a dramatic increase in the tobacco excise, there are significant flow-on costs to Government from indexation of benefits and New Zealand Super to compensate for the excise increase.

There is no reason to increase benefits, super and tax credits to compensate for a rise in tobacco excise. Non-smokers will be compensated for a price increase they won't face, while smokers will be partly compensated for a price increase resulting from an intentional policy decisions intended to discourage smoking. If the tobacco excise is increased, we recommend removing the price impact of these step changes in the tobacco excise from benefit and super indexation. This results in a further saving of $45m per annum in outyears.

Total Additional Funding Options

The following table shows the additional revenue that each initiative is expected to generate.

	$m increase/(decrease)			
	2010/11	2011/12	2012/13	2014/15
Working for Families Integrity	10	10	10	10
Additional Audit Activity	30	30	30	30
[deleted – confidentiality of advice]				
Tobacco Excise - No Indexation	5	20	45	45
Total	**95**	**110**	**135**	**135**

[information deleted in order to maintain the constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]

More detailed advice on all of the options above, [deleted – confidentiality of advice], is being provided to you in separate reports.

Not Achieving Fiscal Neutrality

If significant base broadening measures are removed from the package without being replaced by additional fiscally comparable measures, it is possible that the tax package would not achieve fiscal neutrality. In this case, the additional cost of the package would need to be matched by reductions in existing Government expenditure. Otherwise, any deficit from the tax package would count against the $1.1 billion operating allowance.

If this situation does occur any one-off deficit over the forecast horizon is expected to be small, particularly when compared to the overall package. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*

Bill Moran, Manager, Tax Strategy, [deleted - privacy]