Inland Revenue
Te Tari Taake

Vote Revenue: Budget 2010: A world-class tax system

Date:	27 November 2009	**Priority:**	High
Security Level:		**Report No:**	IRD 2009/092

Action sought

	Action Sought	Deadline
Minister of Revenue	**Sign** and **refer** attached paper to Minister of Finance	1pm, 30 November 2009

Contact for telephone discussion (if required)

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IRD 2009/092

26 November 2009

Minister of Finance

IRD report: Vote Revenue: Budget 2010 – A world-class tax administration

Executive Summary

1. As part of the budget 2010 process Inland Revenue has assessed the implications of its baseline funding and the impacts of implementing the Government's legislative programme. Inland Revenue considers it will be unable to deliver priorities and cater for cost pressures from within its 2010 baseline.

2. Our role has expanded over recent years with the addition of some significant new Government programmes including Working for Families tax credits, interest-free student loans and KiwiSaver. While we received funding for implementation and delivery of these, substantial volume increases have also occurred over time in a number of core tax areas. Significant proportions of these have been unfunded and have been largely supported through year-on-year productivity gains.

3. Inland Revenue has delivered significant value for money to the Government in the past five years; however, the rapid pace of change has left the organisation in a very challenging financial position with a funding pressure of around $37 million:
   - Inland Revenue's agreed baseline funding has decreased by $18 million for 2009-10 and will decrease by a further $17 million in 2010-11. This is primarily as a result of the expiry of time-limited funding for revenue protection including property audits, complex litigation, and other Government initiatives.
   - Inland Revenue committed to value-for-money savings resulting in a reduction of $11 million in the 2009-10 baseline.
   - Inland Revenue has reprioritised to manage $20 million of cost pressures in 2009-10, and expects an additional pressure for 2010-11 of $20 million.
   - Inland Revenue is considering opportunities to transform its administration to meet the Government's expectations of a world-class tax system. A key initiative is a redesign of the PAYE system for individuals and the associated PTS process. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

4. Inland Revenue seeks investment funding of $16 million in 2010-11 ($76 million over four years) for priority compliance areas. This investment will provide additional revenue of $113 million in 2010-11, and $736 million over four years.
   [*Note: Actual funding for, and estimated returns from, priority compliance areas is greater in Budget 2010 than the amounts detailed in this report. Information on further funding decisions can be found in the document entitled "Consideration of extension of bi-lateral funding requests - supplementary information to Budget 2010 paper" which forms part of the proactive release of documents relating to the tax package.*]

5. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

6. Inland Revenue considers that all these investments provide a worthwhile return to the Government, but due to the financial pressures outlined above Inland Revenue cannot self-fund these investments.

Recommendations

It is recommended that you:

- **Note** the baseline funding pressure of $37 million that Inland Revenue will manage in 2010-11
- *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*
- **Note** the four year return on investment opportunities of:
  - Tax debt collection $450 million
  - Property speculation $180 million
  - Hidden economy $106 million
- **Note** that Inland Revenue has delivered value-for-money in the form of:
  - 15% volume growth in the last five years absorbed through productivity increases, which equates to a growth in workload equivalent to over 500 staff
  - $11 million returned for value-for-money savings last year
  - a $35m reduced baseline over a two year period
- **Note** that if all investments were endorsed this would result in an $82-87 million return to Crown in the 2010-11 year for re-investment.

Robert Russell	Peter Dunne
Commissioner	**Minister of Revenue**

1. Context: A world-class tax system

1. The Government has an economic vision focusing on six strategic policy drivers, one of which is a world-class tax system.

2. As indicated in our policy report on achieving a world-class tax system [PAD 2009/210 refers], we have assessed ourselves against the four criteria which typically describe a world-class tax system and conclude that our current tax administration system falls short of what the Government demands in terms of:

- **Certainty:** We cannot currently provide certainty for many individual taxpayers, nor can taxpayers directly manage or control straightforward tax interactions.
- **Speed of interaction:** Additional customer contacts are generated because we cannot currently respond to taxpayers within timeframes that should be reasonably expected. In addition the overall volume and diversity of customer contacts contributes to reducing the timeliness of our responses.
- **Value for money:** While our cost of collection as a percentage of revenue collected has been improving over recent years and we are in line with other similar tax administrations, we are facing increasing costs to maintain a complex, aging system and our ability to respond to policy changes efficiently and effectively is declining.
- **Compliance, trust and integrity:** Compliance levels in New Zealand are slowly declining and the level of filing and payment compliance is lower than in similar tax administrations.

3. Over recent years we have faced growing volume and complexity in our work. In response we have begun a transformation programme to fundamentally change the way we do business. This transformation programme aims to position us to meet taxpayers' expectations and deliver better value for money.

4. Electronic means will be the channel of choice for the vast majority of our customers and we aim to increase the ability for customers to interact with us electronically. We will also focus on delivering more proactive interventions to assist those who have difficulty in meeting obligations and accessing entitlements. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

5. In relation to the criteria for a world-class tax system we aim to:

- Improve **certainty** by:
  - providing customers with the tools to manage their accounts on-line and receive rapid confirmation that they are doing the right thing;
  - receiving authenticated information straight into our systems; and
  - ensuring our legislation, policies and processes provide clear guidance for customers.

- Improve **speed of interaction** by:
  - providing greater accuracy in deductions and entitlements through pay period-based calculations removing the need for end-of-year square-ups for salary and wage earners;
  - building electronic services with real time processing allowing customers to see updated accounts straight away reducing customer contacts to find out what is happening; and
  - requiring less manual interventions within our processes and systems and reducing cycle times.

- Improve **value for money** by:
  - utilising a range of trusted third parties to transact Inland Revenue business with customers;
  - identifying smarter and more cost-effective ways to deliver outcomes thereby reducing our internal costs; and
  - enhancing processes and tools to manage debt and realise additional revenue.

- Improve **compliance**, **trust and integrity** by:
  - improving our information collection to enable us to more effectively target increasingly sophisticated non-compliance;
  - developing more proactive compliance interventions to assist those at risk of non-compliance, using a range of tools including industry information, targeted campaigns, audit, and leveraging compliance through proactive relationships; and
  - applying the law to enhance compliance results.

6. The other element of a world class tax system is, of course, a world's best tax policy. This matter is being progressed by the Victoria University Tax Working Group with Government consideration of their recommendations for Budget 2010.

7. The scale of change we are seeking to make is large and will take time to achieve. For example by 2014:

- our inbound service contacts will reduce by 20%, and 40% of our service contacts (e.g. inbound phone, correspondence) will be shifted to e-channels;
- 95% of returns and payments will be processed electronically with no manual intervention (at the end of 2008-09 only 37% of returns were received electronically); and
- 50% of our non-investigative interventions will be proactive and based on risk assessment.

8. We have started work on four immediate priorities:

- the redesign of the student loans system;
- redesign of the PAYE system for individuals (including the PTS);
- strengthening and renewing our information technology infrastructure; and
- *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

2. Inland Revenue's financial situation

Evidence for value for money to date

9. Over the past ten years, Inland Revenue's role has expanded from solely tax administration to also include implementation and delivery of some very significant new social policies, including Working for Families tax credits, interest-free student loans, and KiwiSaver.

10. The combination of the impacts of new business, with the growth in demand for existing services, has resulted in a rapid growth in the total volume of outputs Inland Revenue has had to deliver each year. The scale of growth in Inland Revenue's business activities is shown in the following table:

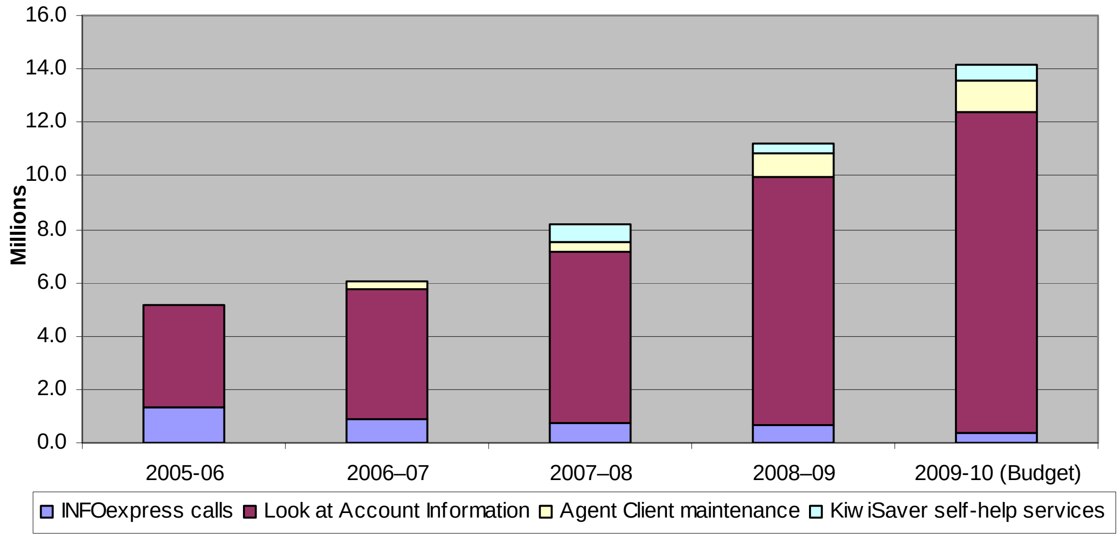
	2005-06	2008-09 (excl KiwiSaver)	Change	2008-09 (incl KiwiSaver	Change
Customer base	6.2 million	6.8 million	+10%	6.8 million	+10%
Phone calls answered	3.7 million	4.2 million	+14%	4.4 million	+19%
Correspondence answered	1.7 million	2.2 million	+29%	3.1 million	+82%
Tax returns processed	7.7 million	8.7 million	+13%	8.7 million	+13%
Total tax revenue	$46.8 billion	$49.0 billion	+4%	$49.0 billion	+4%
Total tax debt	$3.5 billion	$5.1 billion	+44%	$5.1 billion	+44%
Revenue assessed via audit	$1.0 billion	$1.3 billion	+29%	$1.3 billion	+29%
Cash collected via debt activities	$1.8 billion	$2.4 billion	+36%	$2.4 billion	+36%

11. Inland Revenue has worked hard to manage the pressure created by the growing demand for services. While Inland Revenue has been funded for delivery of new policy initiatives, there has also been substantive growth in core operating volumes as evidenced above. Even with KiwiSaver impacts excluded, overall volume growth has been around 15% — a growth in workload equivalent to over 500 FTEs. This growth has been managed through year-upon-year, self-funded productivity increases.

12. At the same time as managing growth, Inland Revenue has continued to increase the overall level of performance delivered — of our approximately 70 performance standards, 91% were met in 2008-09, compared to 81% in 2004-05. In 2009-10, while staffing levels will reduce by approximately 7%, or 350 people, by the end of the year, Inland Revenue expects to maintain the level of performance achieved in 2008-09.

13. In the past few years, as part of its efforts to improve productivity and manage growth, Inland Revenue has sought to invest in technology that allows it to respond effectively and efficiently to growth in demand for services. The use of automated self-help services, especially web-based services, has grown significantly. These and more recent technological developments, virtual hold and SPK2IR voice recognition technology, are expected to relieve some of the pressure from high demand for telephone services.

14. The increasing significance of self-help services can be seen in the following graph:



15. Inland Revenue's continued productivity improvement is reflected in New Zealand's comparatively strong performance on the OECD indicator of the cost of collecting 100 units of revenue, as shown in the table below:

	Administrative cost/net revenue collection (cost per 100 units of revenue)						
	2001	2002	2003	2004	2005	2006	2007
Canada	1.08	1.20	1.33	1.17	1.31	1.35	1.22
United Kingdom	1.06	1.11	1.04	0.97	1.10	1.12	1.10
Australia	1.06	1.07	1.05	1.05	1.03	0.99	0.93
New Zealand	**0.90**	**0.87**	**0.83**	**0.81**	**0.76**	**0.71**	**0.75**
United States	0.46	0.52	0.57	0.56	0.52	0.47	0.45

16. Due to economic conditions the cost is expected to increase to 0.89 for 2009/10, then decrease again in subsequent years, passing below 0.80 by 2012-13.

17. Overall, Inland Revenue has:

- successfully integrated major new social policy business;
- managed volume growth pressures largely within baseline funding;
- generally improved performance standards; and
- delivered technologically enhanced services that have been well received by customers.

18. These achievements point to significant value for money delivered to the Government over the past five years.

Current financial position

19. While Inland Revenue has delivered significant value for money to the government in the past five years, the rapid pace of change has left the organisation in a very challenging financial position:

- Inland Revenue's agreed baseline funding has decreased by $18 million for 2009-10 and will decrease by a further $17 million in 2010-11. This is primarily as a result of the expiry of time-limited funding for revenue protection including property audits, complex litigation, and other government initiatives.
- Inland Revenue committed to value-for-money savings resulting in a reduction of $11 million in the 2009-10 baseline.
- Inland Revenue drove savings last year in the way it operates to meet these challenges, and will continue to do this in the year ahead.
- *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

20. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*

[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]	

21. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

22. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

23. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

24. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

Capital position for 2010-11

25. Inland Revenue expects to have a modest amount of capital available over the next five years. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*.

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

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

28. Inland Revenue's overall capital intentions are set out in the following graph:

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

3. Investment opportunities for the Government

29. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials].* As the corresponding rates of returns are high, we request that you consider providing additional funding in order to invest in the areas set out below.

Priority investments

30. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*. Out of a number of significant priority compliance areas, we consider that investing additional resources in the following areas would provide the highest return in terms of revenue, and strengthening the integrity of the tax system:

- enhanced debt collection activity, to improve the carrying value of the tax debt book currently valued at $0.8bn, compared to a possible collectable value of $5.0bn;
- property speculation; and
- the hidden (cash) economy
- *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials].*

31. Inland Revenue, as part of its new business model, is placing increasing emphasis on proactive compliance interventions through education, increasing awareness, and influencing community perceptions. Our overall focus however remains on maintaining and improving compliance while also addressing threats and risks to both the revenue base, and the integrity of the tax and social policy systems.

32. The initiatives proposed are aligned to our longer-term transformational goals including:

- using sophisticated intelligence to target increasingly sophisticated non-compliance;
- interventions at all levels based on risk; and
- customers perceive a higher probability of detection and sanctions and there is more voluntary disclosure, higher compliance and lower levels of debt.

33. Details of these proposals are set out in Appendix 2 but are summarised below.

34. The **debt** initiative aims to improve cash collections, reduce the outstanding dollar value of debt and the number of debtors through early intervention. The carrying value of the outstanding tax debt book is $0.8bn, compared to a possible gross collectable value of $5.0 billion. There is an opportunity to lift the value of a significant Government asset, and improve the financial position of the Crown Accounts. This will be achieved through investment in additional technology comprising campaign management software, and outbound dialler and base debt collection resources.

35. The growth of our debt portfolio is affected by historical factors such as the effects of rising revenue coupled with consistent increases in our customer base. With the economic recession, there are a number of new factors impacting debt levels. These are:

- financial pressure on customers' available funds which force them to prioritise payment obligations; and
- increases in bankruptcy, liquidation and receivership cases.

36. Funding to continue work on non-compliance related to **property transactions** would enable Inland Revenue to address the higher than expected level of non-compliance detected as a result of the existing Property Compliance Programme. Our approach would include a continuing emphasis on education and awareness as well as using a range of other compliance interventions for those who do not voluntarily comply.

37. We have demonstrated a positive return on the Property Compliance Programme to date with a return on investment of 5.75:1. Further work on the speculator market would allow us to look at [deleted – free and frank] speculators who have been identified as buying or selling [deleted – free and frank] properties [deleted – free and frank] and who appear to have not reported this in their tax returns. This group has an estimated $150-200 million potential tax associated with it. Continuing work in this area aligns well with the current discussion/focus of the Tax Working Group and the attention being given to how property investment issues should be addressed.

38. The **hidden economy**[1] undermines the integrity of Inland Revenue's tax and social policy systems. International evidence indicates that in times of recession the level of hidden economy activity increases and taxpayers may opt out of the system. This is supported by a recent IMF report that indicated the hidden economy is likely to increase by 0.5% of GDP during 2009 for all OECD countries.

39. Additional funding will enable new and innovative compliance approaches to be developed and implemented. Inland Revenue will use a proactive approach to address the hidden economy and reflect best practice approaches that are modelled off the OECD, The Australian Tax Office and from the successes of the property compliance programme. This aims to influence social norms including reinforcing the public perception that there is a high likelihood of being caught for non-compliant tax behaviour.

[deleted – free and frank]

40. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

[1] The hidden economy is defined as individuals and business that operate outside the tax and social policy systems.

41. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

Summary of priority investments

42. The operating investment, return, and associated rate of return over a four-year period (2010-11 to 2013-14) are outlined in the table below:

Priority compliance area	2010-11 investment	2010-11 return	Total four-year investment	Total four-year return	Rate of return
Tax debt[2]	$3.5 million	$45 million	$26.8 million	$450 million	17 : 1
Property speculation	$6.6 million	$45 million	$26.6 million	$180 million	7 : 1
Hidden economy	$5.8 million	$23 million	$22.4 million	$106 million	5 : 1
[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]					

43. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

[2] Excludes $3m capital component.

Appendix 1: Required baseline examination of Vote Revenue

As a part of the Budget 2010 process Inland Revenue has assessed the implications of its baseline funding and the impacts of implementing the Government's legislative programme. We consider we will principally be able to deliver priorities and cater for cost pressures from within our 2010 baseline, *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*. In addition, Inland Revenue has identified investment opportunities for the Government that would deliver $736 million of revenue through increased compliance over the next 4 years.

Inland Revenue's baseline review follows, specifically:

- Response 1: How all increases to our baseline since 2005 have been applied and what value has been obtained from that additional expenditure;
- Response 2: Review of all areas of expenditure within our baseline and identification of any that are not consistent with Government's priorities;
- Response 3: Demonstrate that we are unable to handle the pressures facing Inland Revenue from within the funding available;
- Response 4: Review of the number of policy advisors and the cost of policy advice provided by Inland Revenue; and
- Response 5: Consideration of any fiscal savings expected as a result of implementing performance improvement actions.

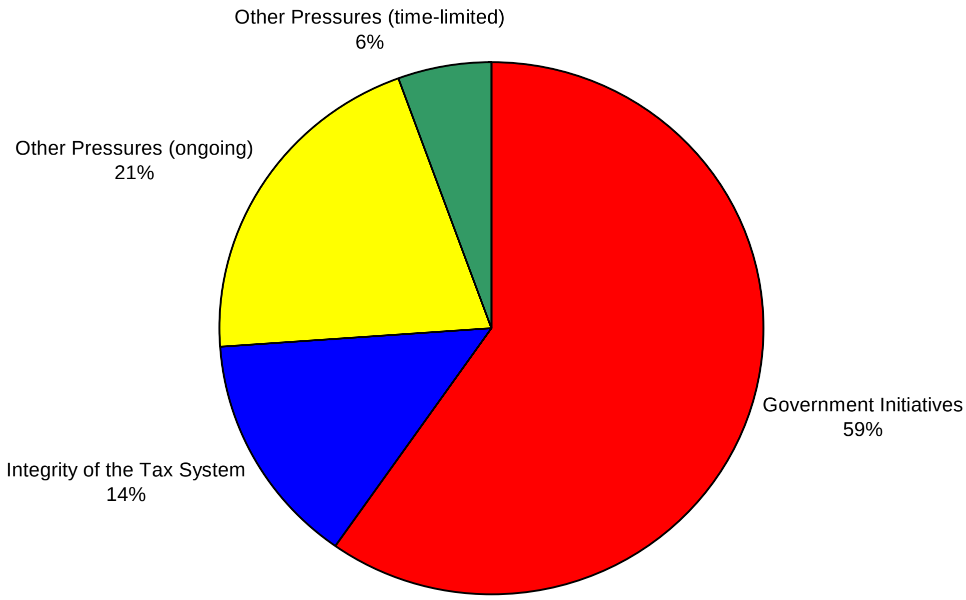
Response 1:
Baseline increases since 2005

Detail how all increases to the Vote since 2005 have been applied and what value has been obtained from that additional expenditure.

Inland Revenue's baseline has increased by $148 million from $488 million in 2005-06 to $636 million in 2009-10.

Almost three-quarters of this increase is due to implementing the Government's legislative programme and specific investments made to protect the integrity of the tax system. The remaining increase has been to meet other business operating pressures such as remuneration and accommodation costs[3]. This is illustrated below:

Substance of Inland Revenue Baseline Changes since 2005



[3] Note: 'pressures' indicated have not been reattributed to government initiatives but arguably a portion of these increased costs result from increased staff due to implementing new government initiatives.

Further details of the composition of the baseline increases are per the table below:

Funding item	Cost ($ million)
Baseline 2005/06	488.1
Integrity of the Tax System	20.9
Student Loans	3.9
Working for Families	(6.6)
KiwiSaver	67.6
Business Tax Review	7.2
Evidence of Identity	3.0
Other Government initiatives	11.9
Capital Charge	1.6
Subtotal Government Initiatives	88.6
Accommodation	10.0
Capability and Remuneration	28.2
Value for Money	(10.9)
IRD as employer (SSRSS + KiwiSaver contributions)	3.3
Subtotal Other Pressures (ongoing)	30.5
Redundancy funding	2.8
Other	5.5
Subtotal Other Pressures (time-limited)	8.3
Baseline 2009/10	636.5

These baseline increases have enabled Inland Revenue to deliver value to the Government in a number of ways including:

- Successful implementation and ongoing delivery of social policy programmes such as KiwiSaver;[4]
- Enhanced compliance outcomes and corresponding increase in Crown revenue; and
- Retention of skilled staff enabling successful implementation of complex social policies while delivering improved performance (as evidenced by performance standard achievement) in an environment of volume growth and increasing complexity.

[4] Note: In the interests of brevity and political neutrality, Inland Revenue has not (re)articulated the value proposition of the social policy to the New Zealand public.

It is important to note that there has been minimal funding received for base volume pressures. These cumulative pressures have been substantial over time and highlight the year-on-year productivity gains Inland Revenue has achieved:

	2005-06	2008-09 (excl KiwiSaver)	Change	2008-09 (incl KiwiSaver	Change
Customer base	6.2 million	6.8 million	+10%	6.8 million	+10%
Phone calls answered	3.7 million	4.2 million	+14%	4.4 million	+19%
Correspondence answered	1.7 million	2.2 million	+29%	3.1 million	+82%
Tax returns processed	7.7 million	8.7 million	+13%	8.7 million	+13%
Total tax revenue	$46.8 billion	$49.0 billion	+4%	$49.0 billion	+4%
Total tax debt	$3.5 billion	$5.1 billion	+44%	$5.1 billion	+44%
Revenue assessed via audit	$1.0 billion	$1.3 billion	+29%	$1.3 billion	+29%
Cash collected via debt activities	$1.8 billion	$2.4 billion	+36%	$2.4 billion	+36%

Details of the value obtained from key funding increases are set out in the following sections.

Integrity of the tax system

Inland Revenue received several injections of funding that allowed it to respond to emerging compliance risk areas. The value proposition for this funding was strong, not only because it brought direct revenue benefits but because addressing risk areas mitigated risks to the ongoing integrity of the tax system by showing that non-compliant activity is detected and is addressed.

Baseline funding for revenue and cash protection

In 2005-06 and 2006-07 baseline funding was increased in order to increase Inland Revenue's general capacity to support compliance through all phases — policy, risk identification, investigations, litigation, and debt management. This funding also enabled some specific initiatives to support compliance, such as an improved process for issuing IRD numbers, a programme for providing proactive and tailored support to new SMEs, audit and debt collection activities for child support, and a programme for responding to an increase in complex and difficult debt cases.

The value of these increases to baseline funding was that they enhanced Inland Revenue's capacity to identify and manage compliance risk areas at the policy and enforcement levels. The most direct return on investment for the government was in the form of increased collections of audit-assessed debt worth approximately $8 million each year.

For 2009-10 baseline funding for audit activities was further increased. This is partially allowing Inland Revenue to respond to the growth in income non-disclosure and sheltering resulting from the decline in economic conditions. This activity has an expected revenue gain of $18 million in 2009-10.

The increases to baseline funding for compliance enforcement activities have had a direct return on investment for the government in the form of increased revenue assessed and increased cash collected. They have also helped Inland Revenue to maintain the integrity of the tax system by allowing the department to address known compliance risks and maintain a degree of general coverage in its enforcement activities.

Time-limited funding for structured finance

Inland Revenue's initial work on structured finance transactions was funded from within baselines. However, as the disputes progressed to the litigation phase from 2007-08 additional funding was required. A three-year block of additional funding was allocated to cover the costs of the litigation, including the cost of retaining experts. Due to both timing uncertainty and unexpectedly high costs of experts, the litigation cost more than was allowed for in 2008-09, and Inland Revenue self-funded the difference.

The litigation has cost some $39 million in total to date. The tax at issue is $2.2 billion and Inland Revenue is confident of a win. Hence the expense is justified and the value to the government is significant.

Initial wins have already been achieved in relation to BNZ ($685 million) and Westpac ($961 million). The litigation funding allocated to Inland Revenue expires after 2009-10. Both BNZ and Westpac have now lodged appeals which will add to the cost, but the timing and extent of the cost impact is currently uncertain.

Time-limited funding for property compliance

In 2007-08 real property was recognised as an emerging compliance risk area and three-year funding was provided for a programme of audits targeted at property-related issues such as property transactions on revenue account and treatment of losses.

The activities have exceeded revenue targets. The revenue assessed to date is $62 million and based on current forecasts the anticipated 3-year revenue gain is around $68 million. This represents a 5.75:1 return on investment.

In addition to the revenue benefit, assessment of additional tax on property transactions may help to reduce the incentive towards property speculation and damp the associated inflationary impacts.

Student loans

In order to deliver policy changes to make student loans interest-free for resident borrowers and to offer an amnesty for overseas borrowers, Inland Revenue received:

- one-off project funding in 2005-06 and 2006-07 to make necessary changes to systems, processes, customer information and contact channels, and to establish data matching with the New Zealand Customs Service in order to verify residency;
- additional one-off funding in 2007-08 to extend the amnesty and to implement a suite of changes to repayment obligations for overseas borrowers; and
- ongoing baseline funding from 2006-07 to ensure Inland Revenue could handle additional customer contacts and could enforce the compliance requirements associated with the amnesty.

The value of the funding allowed Inland Revenue to take the necessary steps to ensure that the student loans policy changes were successfully delivered. Take-up of the amnesty was good and borrowers responded well to the web-based services Inland Revenue provided to help them understand how the policy changes would affect them.

Most of the funding for interest-free student loans and the amnesty was one-off and has now expired, with remaining funding being ongoing baseline funding for service delivery.

However, Inland Revenue currently has additional largely one-off funding to implement the voluntary repayment bonus policy and to design and implement a new and more effective student loans system.

Working for Families

In order to deliver the Working for Families policy, including changes to the policy that extended Working for Families entitlements to a broader base of customers, Inland Revenue received:

- one-off project funding in 2005-06 to make necessary changes to systems, processes, customer information and contact channels; and
- ongoing baseline funding from 2005-06 to provide capacity to handle over 200,000 forecast additional contacts in the first year, reducing to 100,000 annual contacts in subsequent years.

The value of the one-off funding was that it allowed Inland Revenue to make system and process changes in order to implement the policy. The value of the ongoing funding was that it allowed Inland Revenue to deliver a high quality of service to customers in order to support the ongoing success of the policy. Continuing high levels of customer awareness of the policy and high levels of take-up of entitlements indicate that Inland Revenue's delivery of the policy has been successful overall.

The $6.6 million decline in total funding from 2006-07 reflects the expiry of the one-off project funding over several years as the various phases of the implementation project were completed, and the reduction in the level of ongoing baseline funding after the first year.

The remaining component is ongoing baseline funding for service delivery activities. Early indications when the policy package first went live were that customer contacts were at a level that could be managed within the ongoing baseline funding. Since then Working for Families activities have grown continuously, and they are now more around twice the level which the ongoing funding was intended to cover.

The following table illustrates the impact on Inland Revenue over and above funded levels:

Working for Families activities	Government-funded		Actual requirements		Variance
	FTE	Funding	FTE	Cost	Cost
Pre-WFFTC families levels	**74**	**$3.05 million**	**74**	**$3.05 million**	**-**
Debt management	8	$0.43 million	23	$1.27 million	($0.84 million)
Community seminars and advisories	15	$0.92 million	14	$0.98 million	($0.06 million)
Customer contacts	88	$5.17 million	188	$7.49 million	($2.32 million)
Other	4	$0.30 million	4	$0.30 million	-
Total additional activities	**115**	**$6.82 million**	**229**	**$10.03 million**	**($3.21 million)**
Total families activities	**189**	**$9.87 million**	**303**	**$13.09 million**	**($3.21 million)**

KiwiSaver

Inland Revenue received funding for implementation and administration of KiwiSaver, the Tax on Investment Income regime and subsequent changes to the KiwiSaver legislation. Not only were these substantial legislative programmes delivered on time and with minimal problems for providers and customers but unexpected and therefore unfunded consequences have also been met.

1.1 million New Zealanders have joined the KiwiSaver scheme compared to the anticipated 423,000. Inland Revenue has managed these without additional funding.

KiwiSaver has also caused other unanticipated pressures on Inland Revenue's administrative systems. The Employer Monthly Schedule is the fundamental method of collection of information for the majority of tax and social policy programmes Inland Revenue administers. KiwiSaver has caused a high number of schedules to fall into error which has added to pressures on administrative resources across Inland Revenue. These have been managed without substantive impact on performance.

Long-term accommodation solution in Wellington

Inland Revenue's 2006-07 proposal for a long-term accommodation solution in Wellington was based on two main factors:

- Inland Revenue's comparatively low accommodation cost in Wellington was expected to end with exposure to market rentals from 2012. Options were sought for mitigating potential rental cost increases.
- Inland Revenue's Wellington presence had grown in several short bursts over time, resulting in an inefficient portfolio of 10 buildings. Options were sought for consolidating the portfolio.

Inland Revenue's accommodation solution is to retain one service delivery building and lease one new building (1 Featherston St) to replace all the others. The Featherston St building's efficient design allows Inland Revenue to reduce its total space requirements by 25%, offsetting the building's higher rental. This means the overall operating cost is about the same as the current portfolio, but Inland Revenue will be paying for quality instead of quantity.

Inland Revenue is contractually committed to 1 Featherston St and is due to occupy the building from 2011. From that time on, the higher quality of accommodation will support higher staff productivity, and consolidation of the portfolio will reduce the need for travel and site support — annual benefits of up to $2 million. Savings reflecting these benefits have been incorporated into Inland Revenue's agreed baseline allocations.

The operating funding provided by the government relates mainly to project costs and depreciation on capital fit-out costs. Much of this expenditure would have been required regardless of the specific accommodation option chosen.

Remuneration

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Value for money savings

In 2009/10 Inland Revenue returned baseline funding of $10.9 million to the Government as a result of savings identified through a line-by-line review of spending. The funding returned came from:

- $5.7 million savings from operating efficiencies, targeted productivity gains, personnel reductions, KiwiSaver employer tax credit square up and other savings (totalling $20.6 million) netted against increased cost pressures from remuneration increases, additional depreciation from capitalising legislative change projects, fixed cost increases and the costs of the Government Identify Verification Service (totalling $14.9 million).

- $1.7 million no longer needed for KiwiSaver advertising.
- Reduced remuneration update expectations of $3.5 million.

This will reduce to $8.3 million returned to the Government in 2010/11 and ongoing due to the employer tax credit square-up savings being one off.

Other additional funding

A number of other small initiatives have received funding over the last five years. The funding has mostly been one off in nature and has funded; specific unavoidable costs, risk mitigation, long term efficiency gains and some of the work that has laid foundations for Inland Revenue’s transformational programme. This funding has been used to:

- Implement Standard Business Reporting tools that will enable future improvements in cross-government services and efficiency.
- Implement changes necessary to meet future demand for IRD numbers, avoiding costly administrative problems and a loss of confidence in the tax system.
- Undertake work that has contributed to Inland Revenue’s roadmap for future transformation and the design of the PTS/PAYE initiative that will deliver the foundations of a world class tax system.
- Improve compliance and customer experience through implementation of technology that has improved call centre service.
- Deliver urgently needed upgrades to our IT infrastructure to mitigate serious risks to our ability to deliver service to customers and administer tax and social policy programmes. These risks had developed because implementation of large Government initiatives reduced capacity and capital available for ongoing maintenance.
- Deliver policy changes associated with the Business Tax Review (some funding was handed back to the Government to reflect a policy decision to discontinue the research and development tax credit).
- Meet Inland Revenue’s KiwiSaver employer contribution obligations.

Conclusion

The Government has invested significantly in Inland Revenue over the past five years.

The majority of the additional funding received was for the implementation and delivery of new Government policies and increases in outputs (especially audit and compliance capability) with a direct return on investment for the Government in the form of increased revenue.

Where funding was sought for organisational costs, value for money was a foremost consideration. The funding allowed Inland Revenue to cost-effectively manage its capability, its ability to respond to growth pressures and its overhead costs, thereby continuing to provide value for money to the Government.

Response 2:
Consistency with Government priorities

Demonstrate that they have reviewed all areas of expenditure within the Vote and identified any that are not consistent with the Government's priorities.

Inland Revenue has not identified any activities that are inconsistent with Government priorities. We make the following observations in relation to Inland Revenue's ability to deliver outcomes that best align with the Government's priorities:

- In Inland Revenue's 2009 line-by-line review we highlighted a small number of policy areas that could be amenable to review, either on the basis of policy alignment with this Government's priorities or on the basis of administrative simplification. Any changes would require policy work and legislative amendments. Some of the areas highlighted could be affected by the recommendations of the Tax Working Group or by policy considerations arising from the outcome of the Henry Review in Australia. Any areas where a review or change is desirable are best identified and prioritised as part of the ongoing development of the tax policy work programme.
- Inland Revenue has identified a number of areas where its current administration is not well placed to meet the Government's expectation of a world-class tax system. The most acute areas are the student loans system (currently being redesigned) and the PTS/PAYE system (*[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*).
- Inland Revenue's key outcome of collecting revenue through voluntary compliance is being adversely affected by the current economic situation, with a direct adverse impact on the Government's fiscal position. Inland Revenue needs to develop and expand its activities in key compliance areas, including debt management. For this reason Inland Revenue is proposing to seek additional operating funding in these areas, and anticipates that there will be a significant return on Government investment in these areas.

Response 3:
Pressures facing Inland Revenue

If relevant, demonstrate that they are unable to handle the pressures facing the Vote from within the funding available to the Vote.

Inland Revenue's role has expanded over recent years with the addition of some significant new Government programmes including Working for Families tax credits and KiwiSaver. While we received funding for implementation and delivery of these, substantial volume increases have also occurred over time in a number of core tax areas. Significant proportions of these have been unfunded and have been largely supported through year-on-year productivity gains.

While Inland Revenue has delivered significant value for money to the government in the past five years, the rapid pace of change that Inland Revenue has managed has left the organisation currently in a very challenging financial position:

- Inland Revenue's agreed baseline funding has decreased by $18 million for 2009-10 and will decrease by a further $17 million in 2010-11. This is primarily as a result of the expiry of time-limited funding for revenue protection including property audits, complex litigation, and other government initiatives.
- Inland Revenue committed to value-for-money savings resulting in a reduction of $11 million in the 2009-10 baseline.
- Inland Revenue drove savings last year in the way it operates to meet these challenges, and will continue to do this in the years ahead.
- *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*.

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The baseline funding reductions from 2009-10 to 2010-11 are:

Government Initiatives	($7.3m)
Property Audit strategy	($5.8m)
Structured Finance	($3.0m)
Other compliance initiatives	($1.4m)
Transform IR (Time limited funding)	($2.0m)
IT/Infrastructure (Time limited funding)	($1.2m)
Operating pressure contingency	($2.8m)
Authentication + Identity Verification	$1.2m
Wellington property	$5.5m
Total	($17.0m)

[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions].

The targeted cost savings are:

Productivity gains	($10.5m)
Benefits delivered from initiatives	($8.0m)
Fixed cost savings	($5.0m)
Reducing property footprint	($1.0m)
Travel	($1.0m)
Initiatives’ cost reduction	($1.0m)
Structural streamlining	($1.5m)
Total	($28.0m)

[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions].

Response 4:
Cost of policy advice

Demonstrate that they have reviewed the number of policy advisors in, and cost of policy advice provided by, their department and whether some reduction in that number or cost can be made.

Currently, Inland Revenue has 48 policy advisors. This has been fairly constant over the five-year baseline review period. These include staff required to support Ministers' offices.

Direct cost for policy advisors (plus some element of overheads) is currently $5.7 million per annum.

Inland Revenue staffs its policy function in order to deliver the tax policy work programme as set by Ministers. The current work programme is very demanding including an extensive workload associated with policy and bill development work. The policy function's responsibilities also include co-ordinating the implementation of legislative changes within Inland Revenue e.g. system changes, publication updates, communication and staff education.

With the current work programme and need to deliver quality policy advice to the Government (utilising processes as detailed in the generic tax policy process), the only opportunity for reducing policy advisors is to reduce the quantity of advice provided. This would be possible only through a change to the tax policy work programme, for example, reducing or ceasing involvement in negotiating Double Tax Agreements (DTAs) and Tax Information Exchange Agreements (TIEAs). Any such changes would require the agreement of Ministers.

Five key priorities have been agreed as the focal points for Inland Revenue's current tax policy work programme:

- Transform IR;
- the Victoria University Tax Working Group / the Brash review / the Capital Market Development Taskforce;
- international tax (including Double Tax Agreements);
- income splitting; and
- child support.

These priorities are reflected in a number of projects on the current tax policy work programme.

Inland Revenue's current tax policy work programme includes:

Priority projects
- Tax rate alignment at 30%
- Income splitting

- Completion of post-election action plan (completed)
- Taxation (Business Tax Measures) Bill (completed)
- Taxation (International Taxation, Life Insurance and Remedial Matters Bill)
- Approved Issuer Levy (AIL) and Non-resident Withholding Tax (NRWT)
- Base maintenance and broadening
- Capital Market Development Task Force, Job Summit and other forums
- Charitable giving
- Child support — shared care
- Double taxation agreements
- Imputation
- International tax review
- Mutual recognition and the Australian tax review
- Transforming Inland Revenue

Other projects

- Annuities and home equity
- Anti-money laundering (AML) and Countering the Financing of Terrorism (CFT)
- Bank liquidity
- Banks — regulatory changes
- Binding rulings
- Cross-agency projects
- Capital loss deductions
- Disputes
- Emissions trading scheme (EMS)
- Finance leases
- Further issues arising from the recent tax cuts
- Gift duty
- GST — business to business transactions
- Hybrid financial arrangements
- International Financial Reporting Standards (IFRS) tax consequences
- Key remedial matters e.g. KiwiSaver
- Mutuality and non-profit bodies
- Parental tax credit
- Personal tax summaries
- R&D tax credit
- Review of secrecy provisions
- Review of UOMI and provisional tax rules
- Rewrite advisory panel
- Small and Medium Enterprises (SMEs) Phase 2
- Trans-Tasman retirement savings portability with Australia
- Social policy integrity

New projects

Significant new projects added since the work programme was agreed in March 2009 include:

- Employee share options
- Non-resident investors in PIEs
- Profit distribution plans (PDPs)
- Local authorities — Auckland super city

- Victoria University Tax Working Group
- 2025 Taskforce

Substantive reductions to Inland Revenue's tax policy work programme would be required in order to release savings in the policy advice function. This decision would need to be led by Ministers.

Response 5:
Fiscal savings expected as a result of Performance Improvement Actions

Demonstrate that any fiscal savings expected as a result of the department implementing its performance improvement actions have been taken into account.

Inland Revenue is undertaking a multi-year programme of initiatives consistent with the Government's priorities, to deliver greater efficiency, along with more certainty and lower compliance costs for taxpayers ('Transform IR'). The benefits that this programme is delivering have not been formalised as Performance Improvement Actions at this point. However, the expected costs of, and savings from, the Transform IR programme have been taken into account throughout our baseline review process. The key priorities are:

Student loans redesign
The redesign of the student loan system was funded at Budget 2009 and is now underway. This initiative will allow improvements in the user experience for borrowers as well as better integrity of information Inland Revenue holds about borrowers and a more flexible system for supporting future policy settings.

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

Strengthen and renew information technology
This is a programme of upgrading or replacing technology platforms to ensure our information technology is stable, supported and fit for purpose. Some upgrades are already under way, and Inland Revenue has scoped the need for further changes to core systems such as FIRST. We are seeking to leverage off the Student Loans re-design and the PTS/PAYE proposal as far as possible to provide Enterprise capability for a new technology platform to replace FIRST.

e-business
This programme aims to increase customer use of e-channels to reduce compliance costs and increase customer certainty. Current initiatives to improve electronic GST and PAYE filing, provide better online information and tools for families and reduce paper-based information are achieving small savings. There is scope for greater savings in the future as take-up increases and more sophisticated electronic services are offered, reducing the need for manual interventions.

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

Appendix 2: Detailed information on the investment opportunities for which Inland Revenue proposes to seek funding in Budget 2010

Title: Debt compliance[5]

Brief Description: This initiative is designed to improve the impairment level of the Inland Revenue's debt book (a key Government asset), as well as improving cash collections and compliance through increased early intervention. This will be achieved through investment in additional technology (campaign management software and an outbound dialler) and people resources. Enhanced debt collection activity will assist with improving the carrying value of the tax debt book which is currently valued at $0.8 billion, compared to a possible collection value of $5.0 billon. There is a large opportunity to lift the value of a significant government asset and improve the financial position of the Crown accounts.

This investment will also assist Inland Revenue in responding to a number of the recommendations in the June 2009 performance audit report by the Office of the Auditor General, *Inland Revenue — Managing Tax Debt* and the resulting September 2009 Finance & Expenditure Committee report.

Funding sought:

Table 1

$000	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15 & outyears**
Gross operating impact	3,519	8,736	8,496	6,078	3,109
Offsetting savings/revenue	45,000	150,000	150,000	105,000	45,000
Net operating impact	**41,481**	**141,264**	**141,504**	**98,922**	**41,891**
Gross capital impact	3,000				
Offsetting capital saving					
Net capital impact	**3,000**				

Performance Specification

In alignment with Inland Revenue's debt management strategy, we have commenced outbound calling campaigns targeted at a number of key areas of specific customer and compliance risk. This is with the purpose of:

- strengthening the value of the debt asset to Government by reducing existing impairment levels; and
- supporting the New Zealand Government in maintaining its credit rating & borrowing ability.

As a result of this increased collection activity there will be an improvement in the carrying value of the debt book in the Crown accounts.

[5] Note: Actual funding for, and estimated returns from, priority compliance areas is greater in Budget 2010 than the amounts detailed in this report. Information on further funding decisions can be found in the document entitled "Consideration of extension of bi-lateral funding requests - supplementary information to Budget 2010 paper" which forms part of the proactive release of documents relating to the tax package.

Additional benefits include:

- sustainable improvements to cash collection rates, reducing the outstanding dollar value of debt and the number of taxpayers in debt;
- contacting greater volumes of customers (improved coverage) displaying specific debt risk; and
- encouraging ongoing voluntary compliance.

Based on public and private sector experience, the ability to contact large volumes of customers early in the debt management cycle through a campaign approach is critical to the success of proactive debt management. This would involve a range of both customer segments and product types (PAYE, GST, Income Tax etc).

Early intervention makes it easier for Inland Revenue to assist taxpayers to manage their tax obligations and improves the prospects of businesses with short term cash flow difficulties remaining viable. This success is best underpinned by both the deployment of appropriate technology and human resources.

Inland Revenue's current debt campaigns are manually resource intensive. They are not supported by best practice technology capabilities, which are recognised and widely used across the collection industry — both in the NZ private sector and other international revenue jurisdictions.

These technology capabilities — campaign management and an outbound dialler — would enable Inland Revenue to:

- improve its overall ability to manage and control the growth in the debt book, with a particular focus on pursuing recently overdue debt;
- minimise manual effort and intervention;
- take full advantage of our analytical capabilities; and
- utilise these tools across the wider organisation for other work streams.

These tools enable much higher levels of engagement with customers (high volume, low cost) through a variety of different forms of contact than Inland Revenue is currently able to achieve. Estimates from the public and private sector indicate a potential 25-35% efficiency gain following deployment of this technology. This efficiency gain will lead to greater volumes of debtor contact and improved cash collections.

Combining this technology bid with an investment in additional people over a five-year period would enable us to fully utilise these tools and to obtain the greatest productivity uplift.

Campaign management software functions enable us to:

- target groups formed from the debt management customer base according to selected risk criteria using a variety of channels (e.g. e-mail, telephone, SMS, post); and
- track, store, and analyse campaign statistics, including tracking responses, evaluating and analysing trends.

An outbound **dialler** is a computerised system that automatically dials large numbers of telephone numbers for connection to officers assigned to debt management campaigns.

Whilst this proposal focuses specifically on the collection of outstanding tax debt, these tools could, over time, be configured for the collection of child support debt and other organisational campaigns.

Additionally, this proposal would enable (over the extended period of this funding request) existing resources to be re-deployed to debt management activities requiring a greater degree of intensive case management.

Problem Definition

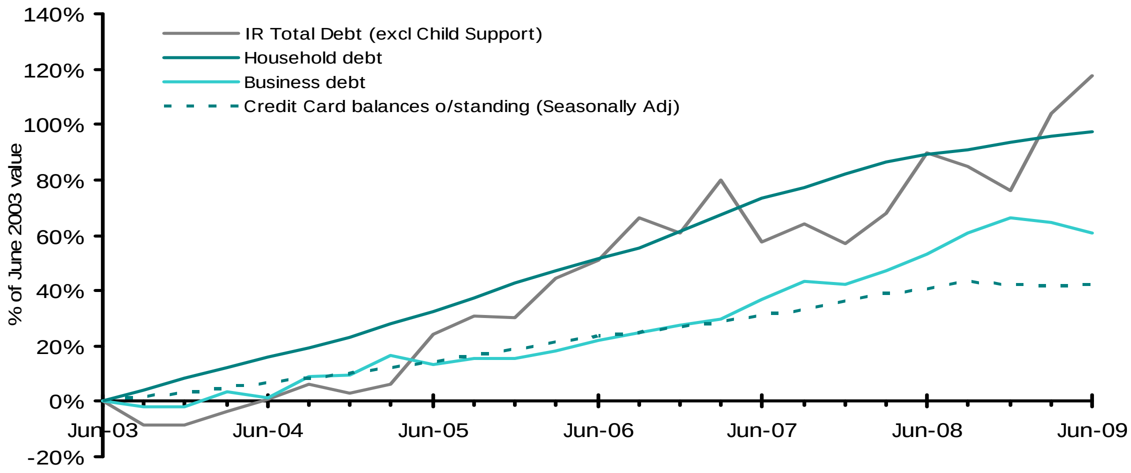
As noted in the Auditor General's June 2009 performance audit report, *Inland Revenue — Managing Tax Debt*, and the Finance and Expenditure Committee's review in September 2009, Inland Revenue acknowledges that tax debt is growing at a rate that is outpacing its capacity to manage it. As at 30 June 2009, there were 353,300 cases of tax debt, totalling $5.060 billion.

Between 2004 and 2008, the total tax base grew by 35%, but total tax debt increased by 91% ($1.92 billion). This indicates that Inland Revenue's collection practices are not keeping pace with tax debt. Without the investment in additional resources detailed in this proposal, Inland Revenue will not be able to manage nor contain this growth. As a proportion of the overall tax debt book, the penalties and interest component has remained static. For the 2007-08 year, Inland Revenue had 428 staff working on tax debt and tax returns (and similar numbers for the two years before that).

Table 2

	2005	**2006**	**2007**	**2008**	**2009**
Total Debt Book	$2,883	$3,515	$3,663	$4,412	$5,060
Penalty & interest charges	$1,192	$1,504	$1,604	$1,836	$2,040
Penalty & Interest % of debt book	41%	43%	44%	42%	40%

Inland Revenue notes that society's general attitude towards debt appears to have led to a growth of both household debt and personal debt in New Zealand. Growth across these debt streams has placed additional pressure in securing payment from customers, in particular individuals and businesses, as they prioritise their payment obligations and manage their cash flows and financial situations accordingly. The growth in tax debt versus external debt is detailed below:



Inland Revenue recognises the need to take a different approach to managing debt. Inland Revenue is aware of the challenges it faces, and is updating its tax debt strategy to respond to these challenges.

The growth of our debt portfolio is affected by historical factors such as the effects of rising revenue coupled with consistent increases in the customer base. Additionally, with the economic recession, there are a number of new influences impacting the growth in debt, including:

- financial pressure on customers' available funds which force them to prioritise payment obligations; and
- increases in bankruptcy, liquidation and receivership cases.

The deployment of the campaign management tool (which has high end analytical and evaluative capabilities) will improve Inland Revenue's ability to collect, monitor and analyse effectiveness of our inventions in a timely and responsive manner. Additionally, these tools support our desired approach of identifying specific non-compliant taxpayer behaviour and applying appropriate interventions.

This would assist Inland Revenue in progressing two of the five recommendations from the recent Office of the Auditor Generals' performance audit report *Inland Revenue — Managing Tax Debt*, which are also complimented by a number of findings recently highlighted by Parliament's Finance & Expenditure Committee report of September 2009:

Recommendation 1
Inland Revenue to collect and analyse information about how many cases debt officers are managing, how much is inbound contact and how much is outbound contact.

Recommendation 4
Inland Revenue to improve the information used to monitor the effectiveness and efficiency of its tax debt collection work, and to prepare its debt management strategy.

How do we know this initiative will deliver the outcomes?

These tools are used extensively and effectively by both:

- overseas revenue jurisdictions including the;
    - Australian Taxation Office (Early Collections business stream);
    - Canada Revenue Agency (Debt Management Call Centre - DMCC); and
    - Her Majesty's Revenue & Customs (HMRC) (Debt Management business stream).
- and the external New Zealand private sector debt collection industry

Private sector debt collection agencies focus on using tools to analyse debtor profiles and determine the most appropriate method for collecting customer debts to maximise cash collections.

Evaluation of Initiative's contribution to Outcome

The benefits of focusing on the debt book (both now and in the future) will include a positive impact for the Crown in terms of protecting a key Government asset driven by a sustainable improvement in cash collections. This would also support improvements in compliance behaviour through:

- earlier intervention in the debt cycle for customers displaying specific debt risk — particularly a focus on the high volumes of customers with recently overdue debt;
- reducing the need for more costly interventions for aged debt for both customers and Inland Revenue; and
- maximising coverage and community presence.

Funding for five years would enable Inland Revenue to make sustainable improvements to the debt book and improve the value of a significant government asset. This will better position Inland Revenue to manage future debt volumes brought about by wider environmental factors in the future.

Policy work is also being undertaken to ensure that the current requirements for tax secrecy do not hinder the efficient operation of the tax system. If these policy proposals go ahead, it would be clear that Inland Revenue can release information for the purposes of administering the tax system, where the integrity of the tax system is maintained. These changes could potentially allow Inland Revenue to develop new initiatives that were previously unable to be used because of the secrecy rules.

How could the initiative be scaled?

The campaign management and outbound dialler tools are unable to be scaled from an implementation perspective. Once deployed, the use of the outbound dialler can be scaled up or down to accommodate campaign activities as required. In terms of people, this option could be scaled up or down with cash collection proportional to the level of funding secured.

However, in order to fully utilise the deployment of the campaign management software and the outbound dialler, the securing of additional people resources is imperative to maximise the return on investment. Options to scale the people component of this initiative are detailed below, with consideration to this occurring over a five year investment window:

Option 1
Assumptions

- The funding detailed below would enable Inland Revenue to “ramp up” outbound calling activity and human resources as the campaign management and outbound dialler technology is implemented in 2010-11.
- Significant investment in customer facing staff (with specific skill set) supported by personnel experienced in customer analytics and campaign design, delivery and evaluation

Table 2

$000	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15 & outyears**
Gross operating impact	3,519	8,736	8,496	6,078	3,109
Offsetting savings/revenue	45,000	150,000	150,000	105,000	45,000
Net operating impact	**41,481**	**141,264**	**141,504**	**98,922**	**41,891**
Gross capital impact	3,000				
Offsetting capital saving					
Net capital impact	**3,000**				

Option 2
Assumptions

- Reduction in front line personnel by 30 FTEs in years 2, 3 and 4.
- Reduction of supporting FTEs by 4 in years 2, 3 and 4.

Table 3

$000	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15 & outyears**
Gross operating impact	3,519	6,471	6,230	3,637	2,879
Offsetting savings/revenue	45,000	105,000	105,000	60,000	32,000
Net operating impact	**41,481**	**98,529**	**98,770**	**56,363**	**29,121**
Gross capital impact	3,000				
Offsetting capital saving					
Net capital impact	**3,000**				

Funding Options

Although initial debt campaigns are being implemented within Inland Revenue, there remains a significant opportunity to implement this intervention activity more broadly across our taxpayer debt base. While this would remain a focus for the organisation, the current level of work without the deployment of, and investment in, additional technology (industry standard tools) will only continue to bring limited improvements in the value of Inland Revenue's debt book.

Detailed costings

[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]

Title: Property Compliance

Brief Description: This request is for funding to continue work in relation to non-compliance associated with property transactions. We have found the level of non-compliance greater than expected and will require ongoing investment and resources to address this. Our approach would include a continuing emphasis on awareness and education as well as using a range of compliance interventions, depending on the situation, for those who do not voluntarily comply.

Funding sought:

$000	2009/10	2010/11	2011/12	2012/13	2013/14 and outyears
Gross operating impact	-	6,644	6,644	6,644	6,644
Offsetting savings/revenue	-	45,000	45,000	45,000	45,000
Net operating impact	**-**	**38,356**	**38,356**	**38,356**	**38,356**

Performance Specification

In response to the high level of activity in the property market between 2002 and 2007 Inland Revenue received funding to address a range of revenue related risks, in particular property speculation. This funding ($14.605 million) was for a three-year period due to conclude as at 30 June 2010. This funding will generate more than a $68 million return at 30 June 2010.

The funding has addressed revenue risks relating to property transactions through a new and innovative approach for Inland Revenue. Using the OECD Compliance model, Inland Revenue identified several key areas of risk, including property speculation and the misuse of Loss Attributing Qualifying Companies (LAQCs).

Funding is sought for resources for the continuation of this work.

Inland Revenue has implemented a range of initiatives with an emphasis on raising awareness and education in relation to property transactions entered with the intention of making a profit. These initiatives have included:

- a strong component of working together with tax agents and legal advisors;
- producing a variety of publications about tax and property transactions; and
- using direct mailing and calling where there are historical patterns of activity such as buying and selling property.

These initiatives have encouraged people who may have a tax liability to consider their positions and seek advice where necessary. As a result, 143 voluntary disclosures were received in 2008-09 with respect to property transactions returning an additional $8.7 million in revenue.

There has been concern about the misuse of LAQCs where company directors/shareholders transfer their private homes to their LAQC and then claim expenditure, usually of a private nature, as a tax deduction. Inland Revenue has undertaken a programme of contacting just over 41,000 directors to advise that LAQCs may be subject to an audit.

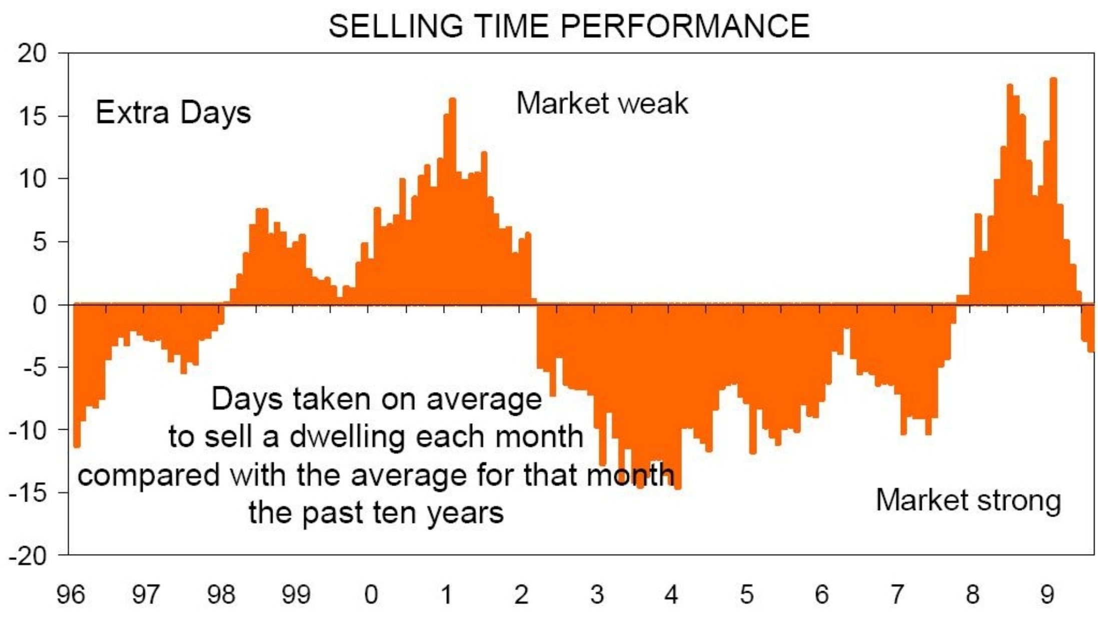
Within this population we have monitored the level of LAQC de-registrations and also new registrations (when compared to previous years) and have seen a substantial change to the extent that just over 7,800 LAQCs have either not been registered or have de-registered. These LAQCs typically claim an average annual loss of $15,000 to $25,000. Accordingly, we estimate that this change in the registration/de-registration pattern will translate into an annual reduction in loss claims of between $118 and $197 million. There has been a significant change to speculator behaviour — that should flow on to positively impact the revenue base — following Inland Revenue's intervention to suggest an audit may follow.

An audit response is being reserved for those who do not take the step to comply voluntarily. As a result of the audit intervention a number of cases are being progressed to the prosecution phase.

Problem Definition

The original Property Compliance Programme was initially set up based on the high level of activity in the property market and while the property market has changed significantly in the past three years this continues to be a revenue risk.

Based on current economic indicators the property market is showing signs of recovery. Using selling performance as one indicator of activity within this market, see the chart below[6], shows that property market activity was strong from 2002 through to May 2007. This was followed by a weak period. However in the past few months the days taken on average to sell is again indicating that the market is gaining strength.



[6] BNZ Weekly Overview – Week of 17/09/09

Net sales (based on the median house price) increased 200% from the four year low in January 2009 to September 2009. There is a greater degree of optimism in the housing market with expectations of house price increases over the next twelve months[7].

Recent economic impacts within the property market has resulted in a group being identified as "accidental" or "reluctant" landlords, homeowners renting out their properties because they can't sell for an acceptable price. With the market showing signs of recovery, motivation to sell within this group is high and they may look to re-enter the market. In addition to the focus on buying and selling, there is further evidence showing high levels of activity in section speculation[8].

Funding resources to continue this programme will ensure that the compliance message in relation to property is sustained.

Victoria University Tax Working Group

A continuation of this property compliance work would also support the objectives of the current review of the tax system via the Tax Working Group as it relates to property investment. It is noted that the Tax Working Group is currently reviewing the tax system as a whole and that a key part of this review is ensuring that the tax system can continue to deliver sufficient revenue in the medium term.

Accordingly, as part of its consideration of various base broadening and revenue raising options, the Tax Working Group considered the possibility of increasing the funding available to Inland Revenue to enforce the current tax system. The final recommendations are yet to be released.

During its session on base broadening and revenue raising options, the Tax Working Group expressed concern over the significant overall tax losses that are being generated by the rental property sector. While changes to tax rules would be required to fully address this issue, investment in the continuation of the programme would ensure Inland Revenue can maintain its current strong focus in this area.

Investment in the programme would enable Inland Revenue to continue its work with respect to property transactions which is well aligned with the current discussion/focus of the Tax Working Group review process and the attention being given to how property investment issues should be addressed.

The high public profile and interest in issues around property transactions continues and the need to reinforce compliance messages given to date is critical to a longer term level of compliance. Any change in the current focus would give mixed messages to the public and commentators about the relative level of importance this issue is being given by Inland Revenue and the Government.

[7] QV Housing Survey September 2009.
[8] Research from Strategic Risk Analysis Limited, "The Role of Speculators in the Section Market" 11 September 2009.

A further reality is that any potential changes to the current tax regime for property investment that may arise from the Tax Working Group's recommendations, once delivered, could take a number of years to implement. The continuation of Inland Revenue's focus under the current regime for taxing property investment would provide an appropriate transition and ensure that there is no exploitation of any loss in focus during the transition period.

How do we know this initiative will deliver the outcomes?

Inland Revenue has demonstrated a positive return through the programme to date with a return on investment of 5.75:1. The table below provides a summary of the Performance Specification progress to date.

	Unit of Measurement	**Performance Specification 2007/08**	**2008/09**	**2009/10**
Quantity	Audit output hours			
Target		*18,000*	*36,000*	*36,000*
Results		26,170	38,465	
Quality	Assessed revenue			
Target		*$7–8m*	*$29-30m*	*$29-30m*
Results		$15m	$36.275m	

In relation to the current year, at the end of the first quarter $10.55m had been assessed against the annual target of $29-30m. The target is likely to be exceeded for 2009/10.

There is, therefore, a high expectation that the additional revenue generated by Inland Revenue's work with respect to property transactions will exceed the three-year target of $68 million.

Evaluation of Initiative's contribution to Outcome

The benefits of continued focus on the property market include the positive return to the Crown on this investment, ensuring the strong compliance message is re-enforced, and continued work on understanding the level of speculation.

For example, further work on the speculator market would allow [deleted – free and frank] speculators who have been identified as buying or selling [deleted – free and frank] properties [deleted – free and frank] and who appear not to have reported this in their tax returns to be looked at. This group has an estimated $150-200 million potential tax associated with it. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]*.

Funding for a further period would allow Inland Revenue to continue addressing these historical transactions and to also monitor these speculators for future transactions as the property market improves.

Funding Options

The property compliance programme has increased awareness of tax obligations in relation to property transactions, as shown by the increased number of voluntary disclosures and Inland Revenue's current knowledge of the speculator market. While this would remain a focus for the organisation, the current level of work could not be sustained without reducing our efforts on other equally important and valuable risk areas.

How could the initiative be scaled?

Options to scale this programme are outlined below:

Option 1 – Address property transaction compliance (2,000 identified speculators) over a 2 to 4 year period

Assumptions:
[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions]. This is estimated to take a 2 to 4-year period. In addition to the group identified above, over this period attention would also be given to sellers who have been caught by the down turn but will over the next 4 years be re-entering the market to on sell. This is particularly so for section sales.

	Unit of Measurement	**Performance Specification** 2010/11	**2011/12**	**2012/13**	**2013/14**
Quantity	Compliance output hours				
Target		*40,000*	*40,000*	*40,000*	*40,000*
Quality	Assessed revenue				
Target		*$40-45m*	*$40-45m*	*$40-45m*	*$40-$45m*

Financial impact:

$000	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Gross operating impact	-	6,644	6,644	6,644	6,644
Offsetting savings/revenue	-	45,000	45,000	45,000	45,000
Net operating impact	**-**	**38,356**	**38,356**	**38,356**	**38,356**

Option 2 – Address property transaction compliance up to a 2 year period

Assumptions:

[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions].

Performance Specification			
	Unit of Measurement	**2010/11**	**2011/12**
Quantity	Compliance output hours		
Target		*40,000*	*40,000*
Quality	Assessed revenue		
Target		*$40-45m*	*$40-45m*

Financial impact:

$000	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Gross operating impact	-	6,644	6,644	-	-
Offsetting savings/revenue	-	45,000	45,000	-	-
Net operating impact	**-**	**38,356**	**38,356**	**-**	**-**

Detailed Costings

[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]

Title: Addressing the hidden economy[9]

Brief Description: This initiative is designed to address the hidden economy[10] which undermines the integrity of Inland Revenue's tax and social policy systems. International evidence indicates that in times of recession the level of hidden economy activity increases and taxpayers opt-out of the tax system. Inland Revenue's approach to address this risk is aligned to responses being applied by international tax authorities and research carried out by both the International Monetary Fund and Organisation for Economic Co-operation and Development (OECD).

The additional funding will enable new and innovative compliance approaches to be developed and implemented such as industry benchmarking initially focussed on hospitality and services. This will increase compliance beyond the primary enforcement treatment approach.

Funding sought:

$000	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Gross operating impact	-	5,818	5,818	5,818	4,943
Offsetting savings/revenue	-	23,000	31,000	31,000	20,500
Net operating impact	**-**	**17,182**	**25,182**	**25,182**	**15,557**

Performance Specification

Inland Revenue will use a proactive compliance response to address the hidden economy and reflect best practice approaches that are modelled off the OECD, the Australian Tax Office (ATO) and from the property compliance programme (PCP). This compliance response is designed to influence social norms (including reinforcing the public perception that there is a high likelihood of being caught for non-compliant behaviour), increase community presence and provide more preventative assistance to those who are generally compliant but may be tempted by the current economic climate to non-comply. There are three components of the response; campaign interventions and audit, leveraged compliance activity and industry tools.

Campaign interventions and audit

The campaign intervention mentioned below is modelled on the PCP, the industry partnership and the ATO cash economy initiative. While this initiative will generate a rate of return approximately of 5:1, it is likely that other streams of revenue may occur through; businesses electing to self-correct with no direct contact with Inland Revenue, reduced cash jobs, and potentially a large proportion of voluntary compliance as a result of targeted activity.

[9] Note: Actual funding for, and estimated returns from, priority compliance areas is greater in Budget 2010 than the amounts detailed in this report. Information on further funding decisions can be found in the document entitled "Consideration of extension of bi-lateral funding requests - supplementary information to Budget 2010 paper" which forms part of the proactive release of documents relating to the tax package.
[10] Hidden economy is defined as individuals and businesses that operate outside the tax and social policy systems.

Campaign interventions include a mix of desk reviews, outbound calling and letter campaigns using risk based selection. There will also be targeted audits and increased prosecution and litigation for groups who are identified as showing potential fraudulent and evasive behaviour, such as taxpayers:

- outside the tax system;
- inside the tax system with no source of income; or
- who appear to be omitting income from specific third party sources.

Leveraged compliance activity

This component is designed to create a level playing field for businesses and for Inland Revenue to be more transparent and open about what behaviour is expected. Key approaches include:

- Building and leveraging compliance through partnerships with industry and tax agents or other government departments (including expanding industry partnership work);
- Extending fraud prevention, detection and reviews in relation to areas such as Working for Families, Donation Tax Credit and Goods and Services (GST) tax claims;
- Initiatives designed to enable easier re-entry into the system;
- Initiatives designed to improve Inland Revenue's understanding of compliance behaviour; and
- Initiatives designed to increase community presence and drive a strong perception that that the likelihood of non-compliant activity being detected is high.

Policy work is also being undertaken to ensure that the current requirements for tax secrecy do not hinder the efficient operation of the tax system. If these policy proposals go ahead, it would be clear that Inland Revenue can release information for the purposes of administering the tax system, where the integrity of the tax system is maintained. These changes could potentially allow Inland Revenue to develop new initiatives that were previously unable to be used because of the secrecy rules.

Industry tools

Industry benchmarking tools have been developed and used successfully by other tax authorities to address the hidden economy by setting compliance expectations and influencing behaviour through the use of outlier data. These tools would allow businesses and tax agents to check and assess themselves and provide Inland Revenue with an additional means of identifying possible tax evasion and fraudulent activities. The focus would be developing industry benchmarks for cash based industries. This should build on the existing industry partnership approach and the compliance focus. The initial focus would be the hospitality and services industries, which benchmarks for some 25 different business types could be developed.

By developing targeted education and industry tools Inland Revenue will influence social norms and increase community presence.

These three components are important to reinforce our compliance message that tax evasion and fraudulent behaviour is unacceptable and likely to be detected as well as ensuring that Inland Revenue continues to be open and transparent by setting clear compliance expectations.

Problem Definition

Hidden economy is a significant risk that undermines the integrity of Inland Revenue's tax and social policy systems and our goal of having a world class tax system. Inland Revenue's current response to the hidden economy has been primarily enforcement activity combined with industry partnership[11]. While effort in the enforcement area has increased, the rate of return from investigations has not declined, indicating that the current level of compliance activity is not keeping pace with the growth of revenue at risk in this area. This is supported by evidence of an increase in non-compliant behaviour for filing returns and risks associated with donation and working for families' fraudulent behaviour.

In times of economic difficulty, tax evasion and fraudulent activities increase in the hidden economy[12]. This is supported by a recent IMF report[13] that indicated the hidden economy is likely to increase by 0.5% of GDP during 2009 for all OECD countries. These activities deeply affect a compliant business's ability to compete in a tight market place. Once a business is outside the tax system or has suppressed income, it is difficult for them to re-enter or retain the life style they may have become accustomed to.

With an increased emphasis in the hidden economy we need more innovative compliance approaches to address the widening gap between compliant business and non-compliant business as well as the expected increase in fraudulent activity due to the current economic environment.

Inland Revenue's proposed approach is supported by other tax authorities where they have increased effort[14] applied to the hidden economy and are using innovative compliance approaches to tackle the hidden economy. Tools such as industry benchmarking, targeted audit activity and campaigns are being used to promote compliance and voluntary disclosures. This is supported by both the success to date from the property compliance programme and the external release of "Helping you get it right: Inland Revenue's compliance focus 2009-10" document. This document has been well received by agents, who have been actively using it with clients.

For example, currently the ATO has set small business benchmarks for more than fifty industry types[15]. This makes it harder for dishonest operators to get away with not reporting cash income by setting an expected range that a typical business would fall in. Falling outside of that benchmark range is one way the ATO identifies businesses for audit or review.

A combined campaign enforcement and education compliance approach to the hidden economy would enable targeted activity that detects and deters active non compliance

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[11] A recent OAG report (08) supported the work carried our in Industry Partnerships as a good approach.
[12] This is supported by anecdotal evidence through OECD, ATO and CRA.
[13] IMF (July 2009) Collecting taxes during an economic crisis: challenges and policy options.
[14] This includes investment through government funding – ATO received $700m for Hidden economy.
[15] Understanding and using small business benchmarks; htp://atogovau/print.asp?.doc=content/00214689.htm.

particularly as a result of the economic environment and also influence social norms to increase ongoing income returned.

While the initial funding bid is for a three year period, the scope of this project has a longer term view. Based on the success within the initial three years, further funding requests may follow in order to build on the compliance outcomes achieved and to enable additional risk based targeting of other cash based industries.

How do we know this initiative will deliver the outcomes?

Addressing the hidden economy has been a focus of other tax authorities who have reported success with initiatives similar to those proposed by Inland Revenue. The hidden economy is a high priority for many tax authorities such as HM Revenue and Customs, Canadian Revenue Authority and Irish Revenue who are focussed on industry tools, data matching and leveraged compliance to address non-compliant behaviour. The ATO has implemented several successful hidden economy initiatives including:

- Engagement with Small Medium Enterprises and their advisors to discuss trends in tax and economic performance;
- Leveraged media campaigns, such as media articles by industry partners and their recent online magazine ("targeting tax crime" — a whole of government approach, July 09);
- Educational letters to tax agents and clients identified as at risk of participation;
- Phone calls and letters to identified participants based on data matching providing opportunity for voluntary adjustment;
- Data-matching exercises to compare business income with either "life-style" (Canadian Revenue Authority) or "conspicuous consumption" (ATO) such as motor vehicles/marine vessels suggesting cash income not declared; or
- Active enforcement including pursuing returns, audits and prosecution action.

An example of success is shown in an outbound "letter" campaign to 40,000 taxpayers by the ATO which generated $235 million in revenue. While many voluntary disclosures are made as a result, resources are assigned to resolve the non-respondents and complex cases. Overall the ATO's hidden economy initiative has generated approximately $500 million and has positively influenced compliance behaviour.

Based on the positive return from PCP campaigns and the expected return from the development of education and industry tools (which have an important role in increasing the compliance awareness among New Zealanders) the expected return is outlined in the table below:

	Unit of Measurement	**Performance Specification**		
		2010/11	**2011/12**	**2012/13**
Quantity	Compliance output hours			
Target		52,000	52,000	52,000
Quality	Assessed revenue	23,000	31,000	31,000
Target		$20 - 25m	$30 - 35m	$30 - 35m

Other key outcomes expected from this initiative for Inland Revenue include:

- Increased community presence resulting in a popular belief that non-compliant behaviour will not go undetected.
- Positive influence on social norms such as compliance behaviour and attitude towards paying tax (social responsibility).
- Decreased compliance costs for business through education on what they need to do.
- Clear understanding of expectations through industry benchmarking.
- Reduction of individuals registered for tax with no source of income.
- Increased re-entry of individuals and businesses back into the system through voluntary disclosures.
- Improved understanding on drivers of non-compliance.

Evaluation of Initiative's contribution to Outcome

The benefits of addressing the hidden economy include the strong compliance message to groups who may be tempted in the economic climate and seek an unfair advantage by not recording and paying tax on all their transactions and supporting honest businesses to remain competitive. It is important that the integrity of the tax system maintained through Inland Revenue having the capability and willingness to take action, and being seen to be taking action especially in this economic climate.

Another benefit is ensuring that those who are generally compliant stay inside the tax system at a time when there is temptation to become non-compliant. There is also a positive return to the Crown on investment.

Funding these initiatives would allow Inland Revenue to focus not only on taxpayers that deliberately non-comply and also develop new and innovative compliance approaches to the hidden economy addressing revenue risk in line with overseas tax administrations.

Funding Options

There is currently enforcement activity being undertaken by Inland Revenue to address Hidden economy activities. This level of activity would not be increased without additional funding due to other revenue risks that are being addressed. This funding would allow Inland Revenue to take the opportunity to align with international practises, increase cash collection through increased voluntary compliance and send a strong compliance message to non-compliers and those on the verge of non-compliance.

How could the initiative be scaled?

Options to scale this programme are outlined below.

Option 1 – Optimal funding to address the hidden economy

Assumptions:

This level of funding would allow Inland Revenue to start the initiative immediately as outlined above. The lag in benefits in 2010-11 is due to the time needed to identify and process cases (typically six to nine months).

Financial Impact:

$000	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Gross operating impact	-	5,818	5,818	5,818	4,943
Offsetting savings/revenue	-	23,000	31,000	31,000	20,500
Net operating impact	**-**	**17,182**	**25,182**	**25,182**	**15,557**

Option 2 – Build intelligence on hidden economy

Assumptions:

A lower level of funding in the first year would result in some action being delayed while data matching is undertaken allowing Inland Revenue to increase intelligence.

Risk:

The current economic outlook appears to be more optimistic than first predicted; a delayed response could result in an increased risk of slower re-entry for those who became non-compliant as a result on economic pressures as they become accustomed to the level of cash income they are not declaring.

Financial Impact:

$000	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14 and outyears**
Gross operating impact	-	3,105	6,831	6,831	4,347
Offsetting savings/revenue	-	10,940	36,400	36,400	18,000
Net operating impact	**-**	**7,832**	**29,569**	**29,569**	**13,653**

Detailed Costings

[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]

Dependencies

Campaign Intervention & audit — There is a capital component to this initiative that is linked to the Debt compliance bid. This dependency centres on the campaign management tool and the outbound dialler. Without the capital component a manual approach will still deliver the outlined result but will result in inefficiencies.

Industry tools — There is a capital component to this initiative that allows for automated third party data matching and does not impact the benchmarking work. Without the capital component this data matching will be completed manually.