Vote Revenue

Baseline Alignment Proposal

Version 1

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Section 1: Alignment to Government Priorities

Minister's Priorities and fit with the Government's strategic direction

The Government's economic vision includes ensuring we have a growth-enhancing tax system which creates incentives for people to work hard, improve their skills and get ahead. The aims for tax reform are also to encourage savings and boost productivity and to be fair to all New Zealanders. More efficent and effective services for New Zealanders are also a priority for Government through driving better performance across the public sector.

The two overarching prorities for Vote Revenue over 2010/2011 and the next two financial years are consistent with these objectives. [2]

The first priority is to streamline the administration of the tax system through an initiative to **transform Inland Revenue** from the current paper based system to a more electronic and smarter approach to provide customers greater certainty and speedier interactions with Inland Revenue. This will also produce the benefit of reduced operating costs and provide better value for money to Government.

The initiative seeks to address the following issues:

- **Providing greater certainty:** Inland Revenue cannot currently provide certainty for many individual taxpayers, nor can taxpayers directly manage or control straightforward tax interactions without assistance or other intervention.

- **Speed of interaction:** Additional customer contacts are generated because Inland Revenue cannot currently respond to taxpayers within timeframes that should be reasonably expected. In addition the overall volume and diversity of customer contacts contribute 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, there are increasing costs to maintain a complex aging system and our ability to respond to policy changes efficiently and effectively is declining.

- **Compliance levels and integrity of the tax system:** Compliance levels in New Zealand are slowly declining over time and the level of filing and payment compliance is lower than in similar tax administrations.

The second overarching priority is implementing the Government's response to the **Tax Working Group** recommendations following their review of the tax system. Budget 2010 will include a number of decisions which will require a focussed and speedy response from Inland Revenue to set these changes in place.

In addition, three other significant specific policy priorities have been identified for 2010:

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[2] *[Deleted – free and frank]*

International Tax Review Phase 2: The first priority for this review is to extend the active income exemption for controlled foreign companies, to substantial but non-controlling interests in foreign companies (non-portfolio FIFs). It is important that legislation to implement the exemption be introduced in 2010. Other priorities to be progressed later in the review are extensions of the active income exemption to offshore branches and to offshore financial institutions.

Income splitting: Consistent with provisions of the confidence and supply agreement, an official's paper was released in December for consultation on the design of a voluntary income splitting scheme for parents with dependant children.

Child Support: A review of the child support formula is ongoing, focussing on the areas of shared care, the costs of children in New Zealand, and the incomes of both parents.

Critical elements and phasing

Implementation of any tax changes arising from Budget 2010 is the main priority for Government and Inland Revenue.

The component parts of work to transform Inland Revenue are also essential to deliver an administration which supports Government objectives. This work represents a fundamental change to the way that Inland Revenue operates and the scale of change to be made is large and will take time to achieve. (More detail is provided in Section 2).

Work has commenced on four immediate priorities:

- The redesign of the student loans system (funding received in the 2009 Budget)
- Simplifying customer interactions including redesign of the PAYE system for individuals (potential Budget 2011 proposal)
- Strengthening and renewing the information technology structure (potential Budget 2011 proposal)
- Developing the skills and capability of our future workforce.

Pressures and risks

Inland Revenue has managed some significant impacts from substantial new business and growth in demand for existing services over recent years. The nature of Inland Revenue's core business means that there is very limited potential to reduce or cease activities without negatively impacting on the revenue base and/or people's access to entitlements.

Driving through the fundamental changes envisaged while still maintaining business as usual will pose challenges which will be closely monitored. There are however substantial potential benefits for both customers and Government from this change programme. Future design and costing work on a) IR's transformation initiatives and b) Government proposals from the VUW Tax Working group will assist in clarifying impacts and timing.

Section 2: Reprioritisation

Introduction

Inland Revenue is not in a position to stop or decrease any of its current programmes. The nature of Inland Revenue's core business means that there is very limited potential to reduce or cease activities without negatively impacting on compliance, the revenue base and/or people's access to entitlements. This means that our focus for freeing up funding for the activities described above will be to ensure that current programmes are delivered more efficiently. This improvement in efficiency will also be utilised to manage Inland Revenue's continuing contracting baseline, which further reduces by $6 million next year, and external cost pressures.

We do not intend to stop or reduce delivery of core functions as a result of these efficiency measures. We will aim to maintain performance against external standards at current levels, or better.

Inland Revenue's Senior Management Team has identified specific targeted savings to make funding available for the increased activities described below and to meet the reduction in appropriated baseline. These include:

- Reducing funding for change initiatives that are not being administered directly through the Transform IR Programme and not undertaking any new change initiatives if they are not part of the Programme.
- Putting on hold ongoing substantial policy and service design work that is not related to the priorities outlined in Section 1.
- Negotiating reduced contractual costs with large suppliers
- Reducing property costs
- Efficiencies from different areas working together better and improved coordination of workflows between business units
- More cost effective management structures
- More cost effective administrative services
- Other productivity gains

It should be noted that a further $8.8 million from savings in 2009/10 has also been returned to Government in Inland Revenue's February Baseline update. These savings reflect 2009/10 initiatives no longer required due to current Government priorities, the constrained fiscal position, and efficient delivery of policy initiatives. Expenditure for the first six months of the current year is $23.6 million lower than the same period last year. The department is operating with over 300 less staff, whilst achieving 89% of performance targets to date. Inland Revenue will continue to attempt to deliver additional 'value for money' savings where possible.

Savings from specific initiatives include:

- a second phase of the Tax Relief for Redundancy payments as the solution implemented in phase one is providing adequate service;
- operating funding not needed due to repeal of KiwiSaver Employer Tax Credits;
- costs for implementation of the Taxation (Consequential Rate Changes Alignment and Remedial Matters) Bill, being less than estimated.

We will continue to monitor value for money and it's possible that further savings may be returned due to year end under-spend.

What would be new or different?

Increased Activity on Transforming Inland Revenue

Over the next three years Inland Revenue will increase activity under the Transform Inland Revenue programme of work. Inland Revenue's transformation to its future business model is designed both to meet contemporary customers' expectations for service and to deliver on Government's expectation for better value for money. The objectives are to:

Improve certainty by:
- providing customers with the tools to manage their own accounts on-line and receive rapid confirmation they are doing the right thing
- ensuring legislation, policies and processes provide clear guidance for customers

Improve speed by:
- building electronic services with real time processing
- requiring less manual interventions within processes and systems and reducing cycle times

Improve value 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 internal costs
- Enhancing processes and tools to manage debt and realise additional revenue

Improve compliance, integrity of the system by:
- Improving information collection to enable us to more effectively targeting of 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
- Applying the law to enhance compliance results

Transform IR Programme resources are currently concentrated in a programme office that connects and supports work across Inland Revenue. This work by the programme office will continue over the next two to five years. However, considerable additional resources will also be needed to complete the large, centrally managed initiatives that will be the major components of the transformation programme.

Work is yet to be completed on details and sequencing of the complete programme but we anticipate that the major elements of the programme will be Simplifying Customer Interactions, Strengthening and Renewing IT Infrastructure and Product Transition.

1. Simplifying Customer Interactions

This initiative will be a mix of policy and administrative solutions that will reduce the compliance costs of employers, particularly small and medium–sized businesses, in meeting their tax obligations by simplifying the Pay As You Earn (PAYE) system; and provide greater certainty to individuals by simplifying end-of-year income tax requirements.

It will also provide opportunities to enhance information-sharing across the public service and enable a significant shift from paper-based processes to electronic services for both employers and individuals.

2. Strengthening and Renewing our IT Infrastructure

Investment is required in Inland Revenue's core information technology and communications infrastructure to maintain existing service levels and to protect this critical investment in the tax system for the Crown.

This initiative is an essential part of Inland Revenue's Transformation Programme, providing the core platforms that will enable long term improvements in customer interactions and efficiency gains.

It is comprised of a number of interrelated parts that together will ensure that Inland Revenue's IT infrastructure supports both essential business activity and the long term transformational programme.

3. Product Transition (Modernising FIRST)

This work will complete the replacement of our aging IT system. Details of what will be involved will be determined as the business cases for the first two elements are developed. Possibilities may include, a) the transition of remaining products and functions off the FIRST platform (e.g. Child Support, Working for Families tax credits, Non-individual tax, KiwiSaver, compliance management, etc), and b) service improvements for other customer groups (e.g. Child support custodians and paying parents, families, companies, GST taxpayers, etc).

Implementation of New Tax Policy

The Tax Working Group identified that New Zealand relies heavily on the taxes most harmful to growth and that tinkering over recent years has made the tax system more complicated, led to poor incentives in the economy, and created a raft of different ways for people to minimise their tax payments. The Government will therefore be introducing measures to reform the tax system.

The Government is still determining what tax changes will be implemented so the costs involved are uncertain. However, it is likely that implementing the necessary system and administrative changes on time will be a significant undertaking. It will require a major focus of Inland Revenue resources.

If implemented, the recommendations from the review of Child Support, the International Tax initiative (phase two) and Income Splitting, will also add to resource requirements.

Putting existing substantial ongoing legislation change work on hold will free up some resources for implementation of tax changes as a result of the VUW Tax Working group. However, the scale of change is likely to be greater than current levels of activity and more resources will be required.

As we do not yet know the extent of pressures on Inland Revenue resources, we cannot provide a view as to whether implementation of the changes will be possible within existing baselines. Inland Revenue will need to provide a separate view of our ability to self fund these changes once more detail is known.

Increased Activity in Targeted Compliance Areas and Debt

Ensuring that people pay their fair share is an essential part of an effective tax administration. It enables people to have confidence in the tax system and makes sure revenue is available to fund Government programmes. For this reason Inland Revenue will increase compliance and debt activities in the next three years[3].

This activity will contribute directly to ensuring revenue is available to fund government priorities. It will help reduce the level of government indebtedness by:

- generating additional revenue of $113 million in 2010-11, and $736 million over four years;
- improving the value of the Government's debt asset, which is currently valued at $0.8 billion compared to a possible collection value of $5.0 billion.

[*Note: Actual funding received in Budget 2010 for priority compliance areas was greater 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.*]

This will support the Government in maintaining its credit rating and borrowing ability, and enable economic growth.

The increased compliance and debt activity will be targeted to three specific areas.

1. Property Speculation

This will continue work in relation to non-compliance associated with property transactions. We have found high levels of non-compliance greater and increased resources will 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.

2. Addressing the Hidden Economy

The hidden economy[4] undermines the integrity of 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. We will develop and implement new and innovative compliance approaches such as industry benchmarking initially focussed on hospitality and services. This will increase compliance beyond the primary enforcement treatment approach.

[3] Based on Inland Revenue receiving funding from recent budget proposals

[4] Hidden economy is defined as individuals and businesses that operate outside the tax and social policy systems.

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).

3. Debt

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.

Structured Finance Litigation

During Budget 2009 Cabinet approved a tagged contingency for structured finance litigation for the 2009/10 and 2010/11 financial years (Cab Min (09) 13/8 (52) refers). The tagged contingency expired on 1 February 2010.

Inland Revenue experienced favourable outcomes in four major structured finance litigation cases in 2009. The cost of pursuing these cases between 2003 and 2009 totals $34 million net of court costs recovered. *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*.

Work is continuing on the remaining two active structured finance cases that were not settled in 2009. These outstanding cases have revenue at risk of approximately $40 million.

The cost of pursuing the outstanding transactions is unknown due to a number of variables such as the use of experts and the length of legal proceedings. *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*.

Baseline Alignment Proposal - Financial Summary Report

Vote: **Revenue**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
	($000)	**($000)**	**($000)**	**($000)**	**($000)**
Baseline (2009/10 FBU)	**627,720**	**621,702**	**625,574**	**615,822**	**612,054**
Share Allocation	15,000	15,981	21,198	20,958	17,665
Centralised Saving	0	0	0	0	0
Reprioritisation					
Total Reprioritisation	0	0	0	0	0
Transfers Outside Vote					
Total Transfers Outside Vote	0	0	0	0	0
Total Changes	**15,000**	**15,981**	**21,198**	**20,958**	**17,665**
Total Proposed Baseline	**642,720**	**637,683**	**646,772**	**636,780**	**629,719**