The Treasury

Budget 2024 Information Release

September 2024

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[1] 6(a) - to avoid prejudice to the security or defence of New Zealand or the international relations of the government

[23] 9(2)(a) - to protect the privacy of natural persons, including deceased people

[25] 9(2)(b)(ii) - to protect the commercial position of the person who supplied the information or who is the subject of the information

[27] 9(2)(ba)(ii) - to protect information which is subject to an obligation of confidence or which any person has been or could be compelled to provide under the authority of any enactment, where the making available of the information would be likely otherwise to damage the public interest

[31] 9(2)(f)(ii) - to maintain the current constitutional conventions protecting collective and individual ministerial responsibility

[33] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

[34] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions

[35] 9(2)(g)(ii) - to maintain the effective conduct of public affairs through protecting ministers, members of government organisations, officers and employees from improper pressure or harassment;

[36] 9(2)(h) - to maintain legal professional privilege

[37] 9(2)(i) - to enable the Crown to carry out commercial activities without disadvantage or prejudice

[38] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice

[39] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage

[40] 18(c)(i) - that the making available of the information requested would be contrary to the provisions of a specified enactment

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Further information on Inland Revenue's Budget 2024 investment in compliance bid and related matters

Date:	22 March 2024	**Report No:**	T2024/724
		File Number:	SH-13-5-8-M103324

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**Note** the contents of this report **Agree** to the recommendations	28 March 2024

Contact for telephone discussion (if required)

Name	Position	Telephone		1st Contact
Paul Quirke	Senior Analyst, Tax Strategy	[39]	N/A (mob)	✓
Jean Le Roux	Manager, Tax Strategy, Tax Strategy		N/A (mob)	

Minister's Office actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Treasury Report: Further information on Inland Revenue's Budget 2024 investment in compliance bid and related matters

Executive Summary

Following the bilateral meeting with the Minister of Revenue on 11 March 2024, you requested further information on Inland Revenue's Budget 2024 compliance bid (the compliance bid). The purpose of this report is to provide the information you requested.

You directed that the compliance bid's investment should be scaled from [33] operating per annum to $29 million operating per annum (total operating funding of $116 million). You also directed Inland Revenue officials to report back on the associated return of this scaled funding amount, and how Inland Revenue would use that funding effectively.

Accordingly, Inland Revenue has revised its submission and confirmed that the $29 million per annum would be split into the following activities:

Breakdown of Compliance activities	**Operating ($million per annum)**
Audit	11
Electronic Sales suppression tools (ESST)	5
Unfiled returns	3
Debt collection	6
Tax Compliance activities	**25**
Student Loan Overseas-based borrower compliance activities	**4**
Total operating per annum	**29**

The original investment was [33] over the forecast period, with an expected net positive impact on OBEGAL of [33] over forecast. The scaled investment of $116 million over forecast is estimated to have a net positive impact of $658 million over the forecast period[1]. Whilst the investment has reduced by [33] (from the original submission), the net impact on OBEGAL over the forecast period has only reduced by [33] due to the increased speed in scaling-up this initiative. However, the increased speed in scaling-up this initiative only benefits the first two years of returns. From 2026/27 and thereafter the per annum impact on OBEGAL is [33] of the original submission in line with the [33] reduction in investment.

Inland Revenue's plan to scale-up their capability (including retraining existing staff), use of intelligence information (including analytics tools and third-party data) and their compliance targeting approach, means they can increase the speed of the return on investment to 4:1 in 2024/25 and 8:1 in 2025/26 and thereafter. This compares to the original return on investment of [33] in 2024/25, [33] in 2025/26, and [33] in 2026/27 and thereafter.

[1] The $658 million net positive impact over the forecast period is due to the increased tax revenue of $514 million as well as $260 million of second-order impacts minus the departmental cost of $116 million. The second-order impacts are comprised of $60 million increase in other revenue, $188 million of reduced expenditure on Impairment of Debt and Debt Write-Offs, and $12 million of reduced expenditure on the initial fair value write-down of student loans.

The compliance bid will lead to an expected increase in tax revenue of $514 million over the forecast period. The bid will also have a second-order positive impact of $260 million over the forecast period. While historically, second-order impacts have not been charged against the Budget allowance, it is ultimately a decision for Ministers. Officials consider that the decision of whether to positively charge this impact against the Budget allowance should be considered in the wider context of the fiscal management approach (e.g. ensuring a consistent treatment of all Budget decisions).

In the absence of a ministerial decision and consistent with previous practice, officials will not charge the second-order impacts against the Budget allowance.

There are other matters relating to increases in appropriation buffers and a technical issue relating to tax pooling and its impact on debt impairment which we would like to further inform you of:

- **Increase in appropriation buffers for 2023/24:** the Minister of Revenue's 2024 March Baseline Update (MBU) letter to you indicated he would be seeking approval in the upcoming BEFU 2024 submission for increased appropriation buffers, provisionally estimated at $400 million for 2023/24 for some of the Vote Revenue non-departmental annual appropriations (mainly for impairments).

- **Tax Pooling debt in 2023/24**: there is a further reporting issue involving a technical setting (related to tax pooling[2]) on Inland Revenue's IT system that may negatively impact on the Impairment of Debt and Debt Write-Offs appropriation for 2023/24. Inland Revenue are waiting on the results of the 2024 interim debt valuation to determine if this amount can be absorbed within current appropriation levels. Agreement will be sought at a later date as to the fiscal treatment of the impacts of the tax pooling debt issue if necessary.

Recommended Action

We recommend that you:

a **note** the contents of this report.

Noted.

b **note** the revised Inland Revenue Budget 2024 investment in compliance bid has a cost of $116 million, with a net positive fiscal impact of $658 million over the forecast period.

Noted.

[2] Tax pooling groups provisional tax payments by several taxpayers into the account of a registered intermediary. Provisional tax underpayments by members of the pool can then be offset by amounts in this pooling account. Tax pooling allows taxpayer to pool provisional tax payments, allowing offsetting of underpayments within the same pool, reducing the amount of use of money interest (UOMI) charged.

c agree in principle, subject to approval by Budget Ministers, either to;

charge the positive second-order impacts of the compliance bid (totalling $260 million over the forecast period) against the Budget allowance.

Agree/not agree.

OR

allow the positive second-order impact of the compliance bid (totalling $260 million over the forecast period) to flow-through to OBEGAL with no impact on the Budget allowance. (Officials' recommended approach).

Agree/not agree.

d **note** that agreement will be sought at a later date as to the fiscal treatment of the impacts of the tax pooling debt issue if necessary.

Noted.

e **refer** to the Minister of Revenue.

Refer/not referred.

Jean Le Roux
Manager, Tax Strategy

Hon Nicola Willis
Minister of Finance

_____/_____/_______

Treasury Report: Further information on Inland Revenue's Budget 2024 investment in compliance bid and related matters

Purpose of Report

1. Following the bilateral with the Minister of Revenue on 11 March 2024, you requested further information on Inland Revenue's Budget 2024 investment in compliance bid (the compliance bid). This report provides the information you requested.

Context

2. You raised several questions during the Revenue Bilateral meeting on 11 March 2024, including:

   - What would the compliance activity funded by the bid focus on?
   - What would the impacts of a scaled compliance funding bid be on revenue and savings?
   - [33]

3. The compliance bid seeks to provide additional funding to Inland Revenue to increase activities in relation to tax compliance and Student Loan Scheme Overseas-Based Borrowers (SLS OBB). The funding is a permanent increase in the compliance funding for Inland Revenue.

4. The initial proposal sought an extra [33] per annum in departmental funding. It was initially expected that the bid would ultimately generate a return of 8:1, primarily through a combination of increased tax revenue and decreased debt impairment and debt write-offs expenditure3.

5. As compliance with tax obligations (and student loan repayment obligations) improves, there is a lower level of tax (and student loan repayment) debt. This in turn results in lower debt impairment. The bid includes specific debt activities that reduce the level of debt, and subsequent impairment.

6. The expected additional tax revenue from the initial proposal was [33] over the forecast period. There was also [33] increase in other revenue over the forecast period.4 The reduced expenditure on debt impairment and debt write-offs was [33] over the forecast period; and the reduced expenditure on the initial fair value write-down of new student loans was [33] over the forecast period.

[3] The decrease in debt impairment and debt write-offs arises as a second-order impact of improving compliance.
[4] The other revenue consisted of interest unwind.

Analysis

7. This report considers the following issues:

- Further information on the scaled investment in tax compliance activities, including:
  - What would the compliance activity funding be focussed on?
  - What would the impacts of a scaled compliance funding bid be on revenue and savings?
  - [33]
  - What impacts can be managed against the Budget allowance (including second-order impacts of the compliance bid)?
- Other Matters relating to increases in debt impairment appropriation buffers in 2023/24 and a technical issue relating to tax pooling and its impact on debt impairment, and therefore OBEGAL in the 2023/24 year. Further detail on these aspects is provided below.

What would the scaled compliance activity funded be focussed on?

8. Inland Revenue has provided further information following the bilateral meeting. The key points are discussed below. We note that the increased compliance work is already underway, as Inland Revenue is increasing its compliance activity following the COVID period (where the focus had been on COVID related customer demand and delivering COVID related and other Government initiatives).

9. Inland Revenue has scaled down and reprioritised the areas for investment and recalculated the associated returns to the suggested $29 million per annum investment. The revised submission includes $25 million per annum for tax compliance activities and $4 million per annum for student loan compliance activity. More specifically the submission is divided as per the below:

Breakdown of Compliance activities	**Operating ($million per annum)**
Audit	11
Electronic Sales suppression tools[5]	5
Unfiled returns	3
Debt collection	6
Tax Compliance activities	**25**
Student Loan Overseas-based borrower compliance activities	**4**
Total operating per annum	**29**

[5] Electronic Sales Suppression Tools are used to systematically alter point-of-sale data collected by a business in order to understate or completely conceal revenues for the purpose of evading tax.

10. We note that the first year of funding is not all FTE-related and includes increased advertisements on compliance activities, targeted engagement, and enhancements to system-based intelligence tools and third-party data sources.

11. Additionally, some previous time-limited funding is expiring in 2023/24 and 2024/25 and so a portion of this funding would be used to retain, re-deploy and re-train existing FTE to undertake these activities. This approach mitigates the risk of an inability to hire due to market capacity constraints, and acknowledges that re-training new staff would take some time. In addition, Inland Revenue will use international resources and third parties to increase track and trace of overseas-based student loan borrowers and the use of contingent labour around debt management.

12. The $658 million net positive impact over the forecast period is due to the increased tax revenue of $514 million as well as $260 million of second-order impacts minus the departmental cost of $116 million. The second-order impacts are comprised of $60 million increase in other revenue, $188 million of reduced expenditure on Impairment of Debt and Debt Write-Offs, and $12 million of reduced expenditure on the initial fair value write-down of student loans.

13. Inland Revenue has advised that the primary target areas of the additional compliance activity will initially be:

- hidden economy (encompassing individuals and/or businesses that attempt to operate outside of the tax system and intentionally not report some or all of their income)
- organised crime
- high wealth individuals
- trusts compliance
- property compliance
- corporate entity restructuring for tax avoidance
- online risks such as crypto assets
- income suppression, for example electronic sales suppression tools
- overseas-based student loan borrowers
- increased prosecutions and other legal remedies,
- unfiled returns (NZ and overseas), and
- customers who have the ability to pay outstanding debt in full (NZ and overseas).

What are the impacts of a scaled compliance funding bid on revenue and savings?

14. The original submission had a net positive OBEGAL impact of [33] over the forecast period. This revised submission has a net positive impact of $658 million over the forecast period. Whilst the investment has reduced by [33] the net impact on OBEGAL over the forecast period has only reduced by [33] based on planned 2024/25 activities and the increased speed in scaling-up this initiative noted above. However, the increased speed in scaling-up this initiative only benefits the first two years of returns. From 2026/27 and thereafter the per annum impact on OBEGAL is [33] of the original submission in line with the [33] reduction in investment.

15. The initial proposal was broadly for a return of [33] in 2024/25, [33] in 2025/26, and [33] in 2026/27 and thereafter. Based on the reduced scale of this initiative, Inland Revenue's plan to scale-up its capability (including retraining existing staff), use of intelligence information (including analytics tools and third-party data) and its compliance targeting approach, it would be able to increase the speed of the return on investment to 4:1 in 2024/25 and 8:1 in 2025/26 and thereafter. This reflects the fact that a smaller investment will mean it is easier to mobilise resources and get to full resource capacity. Additionally, it reflects that the smaller investment will be focussed on those areas generating the highest return.

16. Specifically, Inland Revenue considers that by initially focussing on customers with unfiled returns that have an income activity and/or own assets of value (such as property), it will be able to generate a return of 4:1 in the 2024/25 fiscal year compared to [33] in the 2024/25 fiscal year with the initial larger investment. Inland Revenue will leverage its data and analytics capability to identify where they can gain the highest return.

17. The return from other activities such as audit will take time to ramp up and build momentum. Building broader capability to enable Inland Revenue to address more complex compliance work will also take time. Effectively, the initial proposal would have targeted areas with a lower initial return but that would generate 8:1 returns over time. This reflects the reducing marginal return from additional compliance activity.

[33]

What impacts can be managed against the Budget operating allowance (including second-order impacts of the compliance bid)?

21. You wanted the second-order impacts of the compliance bid to be reflected in the Budget operating allowance (the Allowance), where possible. A significant part of those second-order impacts is the positive impact on Inland Revenue's debt impairment ($188 million over the forecast period) and student loan initial fair value write down ($12 million over the forecast period). There is also a $60 million increase in other revenue over the forecast period.[6]

22. The Allowance forms a self-imposed cap by Ministers on expenditure growth (less any revenue changes). It is a means of prioritising spending by making Ministers trade-off spending decisions against other decisions through the Budget process.

23. The Allowance is a fiscal management tool to help the Government achieve its fiscal strategy. Generally, all new spending and savings/revenue is managed against the Allowance. This allows Ministers to make trade off decisions through the Budget process. However, based on past practices and principles, officials will usually recommend that the impact be looked-through for fiscal management purposes (directly impact indicators) when:

- It is an indirect result of a policy decision; or
- The impact is mainly due to economic factors; or
- There is little discretion for Ministers in making the decision as to whether the revenue or expenditure arises (for example, the impact is beyond the control of the relevant agency); or

[6] The other revenue consists of interest unwind.

- There are changes to impairments or other revaluation changes due to large assets and liabilities (these items are highly volatile, and are often non-cash related) that are outside of the control of Ministers; or

- There are changes to the cost of debt servicing.

24. These factors can be seen as reflecting areas where trading off the impacts would be difficult. For example, while it is possible to trade off the first order impacts, it is difficult to trade off the second-order impacts in themselves (as they flow as a natural consequence of the first order impacts). Likewise, where an impact flows mainly from economic factors, it becomes difficult to trade off against other impacts.

25. Sometimes different factors may indicate different outcomes, and so officials will balance those factors when providing you with recommendations. Officials also consider the different types of appropriations in considering whether to advise that an impact should be managed against the Allowance or flow-through. For example, officials may recommend different approaches to impacts on permanent legislative authorities (PLAs) or other forecast appropriations as opposed to other types of appropriations.

26. We have considered the above factors when developing our recommendations in response to your request that the positive impacts of the compliance bid should be managed against the Allowance, where possible.

27. Our recommendation, consistent with the principles outlined above (and past practice) would be to not charge the second-order impacts of the compliance bid against the Allowance because:

    - They are indirect impacts of the decision to increase the compliance funding for Inland Revenue; and

    - This treatment is consistent with the approach taken with other Budget 2024 initiatives submitted.

28. As noted above, these are reflections of past practice and principles, and the decision ultimately lies with Ministers.

Other Matters

29. There are other matters relating to increases in debt impairment appropriation buffers and a technical issue relating to tax pooling and its impact on debt impairment which we would like to further inform you of.

Debt impairment – increase in appropriation buffers for 2023/24

30. We note the Minister of Revenue's 2024 MBU letter to you indicated he would be seeking approval to include appropriation buffers on top of the revised forecast expenditure in the upcoming BEFU 2024 submission[7]. These buffers may increase total Vote Revenue non-departmental annual appropriations by up to $400 million for 2023/24. The request for buffers is consistent with the approach taken in previous years. The buffers are not necessarily indicative of additional spend but are intended to prevent any breach of annual non-permanent legislative appropriations.

[7] The buffer would increase the appropriation amount to avoid the risk that any relevant unexpected expenditure was not appropriated.

31. The Impairment of Debt and Debt Write-offs appropriation is an annual appropriation which covers general tax, KiwiSaver and Working for Families debt. Debt remissions for COVID-19, floods and cyclones are included in this appropriation. Inland Revenue officials advise that the level of overdue debt at financial year end is difficult to accurately forecast for the Supplementary Estimates. This is because debt temporarily increases in the April to May period, based on the timing of income tax returns, and only begins to fall in June as tax pooling transfers are completed.

32. Additionally, large debt write-offs can fall either side of the financial year-end depending on the conclusion of debt and legal activities. The accounting level of impairment is also difficult to accurately forecast as it is based on a provisional independent valuation that is finalised after year-end, based on updated customer debt and repayment data, as well as the latest macroeconomic data.

33. As an example, the level of the 2022/23 appropriation was initially set at $841 million. The appropriation was revised up to $1,185 million in the subsequent Budget Economic and Fiscal Update. The $1,185 million appropriation included a $200 million buffer to cover for any unexpected write-offs, significant movements in the forecast level of overdue debt between March and June 2023, and any changes in the accounting level of impairment. The final amount spent under the appropriation was significantly higher than the increased threshold and totalled $1,467.6 million, resulting in a breach of appropriation $282.6 million in excess of the appropriation amount. There were three reasons for the increased expenditure:

- Higher than forecast write-offs and COVID-19 remissions; and
- An increase from the forecast level of overdue debt, and
- A small increase in the accounting impairment rate.

34. Inland Revenue are currently working with their independent valuer, PricewaterhouseCoopers (PwC) to forecast the level of impairment for each tax type as at 30 June 2024. Inland Revenue teams are also working to forecast the outstanding debt as at 30 June 2024. Updated forecasts for the impairment appropriations will be included in the Budget and Economic Fiscal Update. While any inclusion of appropriation buffers does not automatically mean increased spending, it does suggest a risk that spending could increase.

35. The need to increase buffers arises from general economic factors impacting the value of the debt book, so therefore the increase would flow through to OBEGAL for 2023/24 with no corresponding allowances impact.

36. An increase to appropriation would require Joint Minister approval. While Ministers could choose not to approve these buffers, it would heighten the risk of unappropriated expenditure. More broadly, officials recommend that thorough scrutiny of the impairment forecasts and buffers is undertaken before they are submitted for your approval in the 2024 Budget and Economic Fiscal Update.

Debt impairment – tax pooling issue

37. We also note that there is a further issue that may impact on the Impairment of Debt and Debt Write-offs appropriation for the current year. This matter will be included in your MBU response letter to the Minister of Revenue.

38. The issue involves a technical setting within Inland Revenue's IT system (related to tax pooling debt) that may negatively impact on the Impairment of Debt and Debt Write-offs appropriation for 2023/24. Specifically, the system has applied a blanket exclusion of taxpayers who have a tax pooling[8] indicator on their account from the overdue debt reporting which understates overdue debt and impairment.

39. Inland Revenue is working with Audit New Zealand to confirm the correct accounting treatment which will determine whether it needs to restate the prior years or whether it is more appropriate to account for all the increased debt and impairment in the current financial year.

40. If the change in debt is recognised in the current year, then initial estimates indicate this could be an increase of around $250 million to the current debt impairment forecasts. Agreement will be sought at a later date as to the fiscal treatment of the impacts of the tax pooling debt issue if necessary. As the nature of this change reflects a revaluation on an asset, any operating impacts would generally flow-through to impact OBEGAL rather than be charged against the Budget allowance.

41. There is a risk that the increase in debt impairment relating to the tax pooling correction will push the forecasts above the current appropriation limit, in which case an increase to the appropriation will have to be sought.

42. Inland Revenue is currently working with PwC to confirm the forecast impairment rate which will determine the impairment expense. Inland Revenue will report back with further information as part of the 2024 Budget and Economic Fiscal Update, including whether or not they will be seeking an increase to the Impairment of Debt and Debt Write-offs appropriation.

[8] Tax pooling clients pay their provisional tax to registered intermediaries (tax poolers). The tax poolers then deposit payments into an account with Inland Revenue. Inland Revenue hold the payments until the tax poolers tell Inland Revenue where to transfer them. Inland Revenue treat transfers to a client account as a tax payment from the date it was paid into the tax pool.