

Budget 2010 What's in the mix for business? Deloitte's perspective



Contents

4	Introduction
6	Budget at a glance
7	Tax reform
9	Personal tax rates
13	Taxation of property
15	GST increase confirmed
17	Company taxes
19	Superannuation
21	SME sector
23	Taxation of resources
25	Tax Working Group
28	Public sector
29	Infrastructure
31	Snippets

Budget 2010 was about materially repositioning the tax system to achieve some basic economic goals and chart a new strategic direction for the economy.

Introduction

Time to place some stakes in the ground

This was a very important budget. Last year's budget was dominated by the need to deal with the consequences of the Global Financial Crisis and our home-grown recession, and election promises made. The Government was in no position to chart a strategic direction for the economy. As it happened New Zealand had a very good recession by global standards, largely because our Australasian banks remained sound and there was enough fiscal stimulus in the pipeline in the form of tax cuts and inherited expenditure commitments. And the strength of the Australian economy helped. Already it is clear that the deficit and borrowing paths will not be as bad as first thought. All this meant that this budget represented the Government's opportunity to put stakes in the ground in pursuit of its strategy for the economy.

And this strategy focuses on raising New Zealand's productivity and growth rate. This is the only way the Government can deal with the "dead rats" it swallowed in the lead up to its election – interest-free student loans, working for families, and not raising the entitlement age for superannuation. Let's be clear – if the economy does not reach sustainable growth levels there will be no choice but to peel back entitlements if the country is to remain within prudent levels of debt. So what are the key stakes in the ground that the Government is relying on to generate greater growth?

Stake One: Tax changes.

The switch to higher GST and lower marginal tax rates is targeted to tilt the tax base to provide incentives to work and save in favour of consumption. Eliminating depreciation claims on property recognises the special nature of property returns and brings them properly into the tax net to help fund cuts to marginal tax rates. Applying the same treatment to commercial property is perhaps a step too far. The lowering of the Corporate Tax rate is welcome and deals effectively with Australia.

The question is does this go far enough, especially at the lower end? The answer for now is probably yes absent a reform of Working for Families.

The incentive effects are uncertain and will take time to play out. If the experience of the cuts to marginal tax rates in the mid 1980s is repeated the tax take will ultimately rise.

Importantly the Government will be hoping that extra economic growth will provide a fiscal dividend. The odds are that they will – the new tax direction signalled is pro growth.

Stake Two: Research & Development funding.

Having culled the Labour Government's R&D tax break scheme in last year's budget there is a new commitment to multiyear funding for R&D grants. But only to larger entities currently undertaking R&D. This is hailed as more efficient than a tax break largely as it avoids the compliance industry (mainly Accountants it seems!). But it does assume that large companies are good at or best placed to undertake R&D and get the rocket-fuel the grants provide. That seems counterfactual when confronted with the dominance of technology entities in the Deloitte Fast 50, many of which have highly innovative R&D activities. These kinds of entities arguably need more help as they are mostly start-ups.

There is also a question as to whether the amount committed is enough to make a material difference to our long term growth rates – it seems small compared with Australia's commitment to R&D funding in the cleantech space for example. There is not yet a "NZ Inc" type commitment to building world-class R&D environments in our areas of competitive advantage – agriculture and food production. This will take much more money than is currently on the table.



Murray Jack

Chief executive

mjack@deloitte.co.nz

Ph: +64 (0) 9 303 0942

Stake Three: Constraining Government expenditure.

The evidence for fast-growing economies with Government spending over 40% of GDP is extremely thin on the ground. The Government recognises this and the strategy is to constrain increases to below the rate of inflation for a sustained period, while at the same time diverting spending from low value areas to higher priorities. The budget delivers on this although arguably it could have been more aggressive. Staff numbers in the core public sector are coming down, but not by the rate of adjustment we saw in the private sector during the recession. Unfortunately adjusting to a lower spending path actually requires investment up front in new technology and systems, and restructuring. More importantly this strategy is hard to sustain for a prolonged period.

The judgement may well be that the recovery is still too fragile to make large cuts but that time will come and the open question is – will the Government be up for it?

There were some missed opportunities, particularly in the SME sector, even when it is noted that the cuts to marginal tax rates do provide meaningful assistance to SMEs not in corporate form and the corporate tax rate reduction will benefit those in profits. Notably here the Australians are more ambitious. It is interesting to

see their raised threshold for writing off small assets (A\$5,000 as against our paltry \$500), and the Henry proposal to allow loss carry-backs – two initiatives that offer real help to small businesses in managing risk and cash flow. We are after all a nation of small businesses and this is a sector still under extreme pressure. But this is at the margin given the lowering of the tax rates.

This is by the measure of the past 10 years a radical pro growth budget. It sets the scene for a step change in productivity and economic growth provided succeeding budgets up the ante in R&D and innovation. As always there are risks but these are now largely confined to the expenditure side of the National Accounts – it could be argued by moving first and further on taxes the Government is upping the ante on the public sector to drive efficiencies and productivity gains. In other words play their part in our efforts to close the gap with Australia. That is different.

Let's be clear: if the economy does not reach sustainable growth levels there will be no choice but to peel back entitlements if the country is to remain within prudent levels of debt.

Budget at a glance

Budget 2010 has tax at its centrepiece. The tax policy reform should be welcomed by the majority and has largely been foreshadowed, albeit there are a few extra surprises.

Here are the highlights for business:

Tax

As had been signalled, Budget 2010 contained a raft of material changes to the tax system which represent the most thorough overhaul of the tax system in 25 years:

- Personal tax cuts effective from 1 October 2010 for all taxpayers, but most notably a decrease in the top personal income tax rate from 38% to 33%.
- GST will increase from 12.5% to 15%, from 1 October 2010. This increase in GST will raise an additional \$2.46 billion in government revenue by 2013/14, without factoring in increasing spending arising from income tax relief. Benefits will be increased by 2.02% on 1 October to compensate for the GST rise.
- The company tax rate will fall from 30% to 28% from the 2011/12 income year. There will be a two year transitional period for imputing dividends at the existing 30% rate.
- The top tax rate for most portfolio investment entities (PIEs) will be reduced from 30% to 28% from 1 October 2010. Other PIE rates will also be reduced to align with the new personal income tax rates. The tax rate for other savings vehicles will also reduce to 28%, from the 2011/12 income year.
- Depreciation deductions will be removed for buildings that have an estimated useful life of 50 years or more from the 2011/12 income year.
- Depreciation loading will be removed for the purchase of all new assets on or after 21 May 2010.
- The thin capitalisation threshold for non-resident investors will be reduced from 75% to 60% from the 2011/12 income year.
- Loss attributing qualifying companies and qualifying companies will become flow-through entities for tax purposes for income years starting on or after 1 April 2011.
- GST rules will be changed to prevent the use of "phoenix" arrangements, by zero-rating transactions involving the transfer of land between registered persons.
- Inland Revenue will receive a funding boost of \$119.3 million funding over four years to increase its audit and compliance activity.

Infrastructure

The government has reiterated its commitment to infrastructure investment, with an allocation of \$1.45 billion in capital spending in 2010/11.

Research, science and technology

\$321 million will be allocated over four years for new science, research and technology initiatives, including \$234 million for supporting business R&D.

Fiscal outlook

Again, the Government announced a deficit of \$8.6 billion for 2010 and the fiscal outlook remains negative, with deficits forecast for the next 6 years.

It's not all doom and gloom though – the deficit forecast has improved from Budget 2009 with the operating balance forecast to return to surplus in 2016, as opposed to 2018/19 as was forecast in 2009. This clearly provides the Government with headroom to continue to shape the economy.

The taxation package announced is broadly fiscally neutral. The tax package is conservatively forecast to add about 1 percent to the size of the economy by 2017.

Tax reform

A series of real steps in the right direction

Budget 2009 was about battenning down the hatches as New Zealand attempted to weather an economic storm. Budget 2010 was about trying to hit a home run now that the initial storm seems to have largely passed.

The past 12 months have been a period of uncertainty for the tax system, largely driven by the deliberations of the Tax Working Group and signals from the Government that the status quo was probably not sustainable in the medium term.

Budget 2010 draws this period of uncertainty to a close, pulling together a number of material tax reforms drawn from the recommendations of the Tax Working Group designed to refocus the tax system and correct some historic imbalances.

When the layers of analysis are pulled back, Budget 2010 was about repositioning the tax system to achieve some basic economic goals:

- Encouraging productivity of labour
- Encouraging savings
- Improving the integrity of the tax system
- Removing the tax bias toward housing investment

The Government has sought to implement these goals via the following measures.

Personal tax rate reductions across the board to encourage labour market productivity

The Government had always signalled its intention to cut personal tax rates at all income levels, to ensure that adequate compensation was provided for an increase in GST.

Time will tell whether taxpayers deem it has provided adequate compensation (see our separate table of weekly tax savings). No doubt the Government will eagerly await the next political poll, but clearly it's a material step in the right direction.

The decision to reduce personal tax rates for a second time in only 18 months is about more than compensation for increasing GST – it is a clear signal of a change in direction between this Government and the last.

Tax rate alignment to improve the integrity of the tax system

The need to align tax rates was identified by the Tax Working Group as being critical to improving the integrity of the tax system.

The Government has not fulfilled its own goal of tax rate alignment at 30:30:30 – and probably never will as globally savings and corporate rates have greater gravitational forces pulling them down than other rates.

But we have taken a major step in that direction by aligning the top personal income tax rate and trust rate at 33%.

With the corporate and savings tax rates dropping to 28%, we are left with a 5% wedge – maybe just a fact of life evidencing that the theoretical nirvana is best left to theory.

Corporate and savings tax rate reductions to encourage savings and investment in the productive sectors

The Government never signalled its intention to cut these rates so soon. A clear “bravo”.

In terms of the corporate rate a jump start on Australia that would be a first, given the Australian decision earlier this month to reduce their rate to 28%, but three years later in 2014-15.

Increasing GST to change the tax mix and encourage savings

Without doubt the decision to increase GST to 15% will be the most unpopular decision in this Budget for the masses. Also New Zealand's worst kept tax secret. The increase in GST will raise over \$2 billion in government revenue which is being used to fund the package of tax relief measures.



Thomas Pippos
Managing Tax Partner
tpippos@deloitte.co.nz
+ 64 (0) 4 495 3921

Given the Government wished to align tax rates and offer tax reductions across the board, it had little choice but to increase GST given it had ruled out introducing a capital gains tax or a land tax. But more importantly, increasing GST coupled with the tax rate reduction package has the substantial merit of reducing the taxation bias against saving and investment – therefore effectively satisfying two thorny issues for the Government in one hit.

The immediate concern with an increase in GST will be how businesses handle the change, in terms of business systems, compliance and customer relations. Watch this space, but with a reduction in the corporate tax rate of 2% I am sure many impacted business taxpayers will weather the storm!

Removing depreciation deductions for buildings to eliminate investment bias

Changes to the taxation of residential rental properties were inevitable from the moment the Tax Working Group identified that \$200 billion dollars of wealth was invested in rental properties, but that the sector had a negative taxable return of approximately \$500 million in 2008.

While the fiscal projections have not stood the test of time, nonetheless they are correct in terms of a trend line.

What will be of interest in the short to medium term is whether removing depreciation deductions is enough to ensure that the Government gets a fair return from the rental property sector. There was no signalling that any further review will be undertaken.

More importantly, no massive sigh of relief from commercial property owners as changes to depreciation on commercial buildings were also announced. A slight reprieve in that commercial fit out will continue to be depreciable. Likewise the ability to take a deduction for repairs and maintenance remains intact.

Depreciation loading will also now be a thing of the past but in the context of the total package - barely registerable.

Changing the thin capitalisation threshold for certain non resident investors is a sigh however.

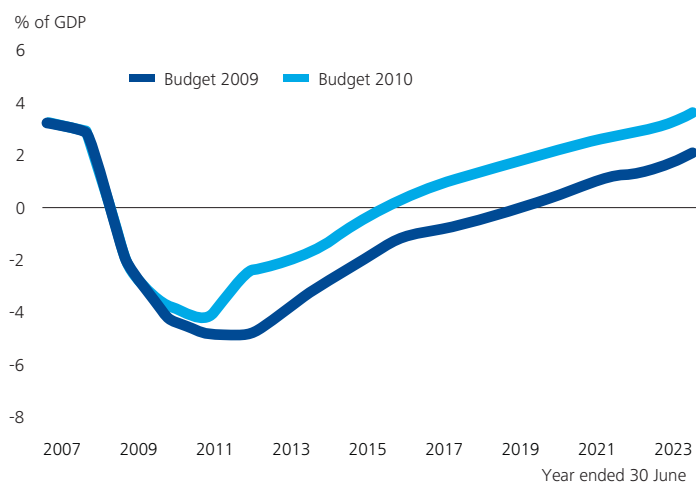
This is much more complicated than it appears and fails to really address the initial issue and whether the regime is actually hitting the real target.

But ... we're not out of the woods yet

The mark of the global financial crisis is still etched across the Government's accounts. Budget 2010 announced a deficit of \$8.6 billion for 2010/11, and anticipated future deficits till 2016.

In this context the proposed tax changes are much braver than anyone really anticipated albeit the financial position has materially improved from what was expected even a year ago. An investment in tax reform that is likely to pay material dividends to the economy going forward.

Operating balance before gains and losses 2001/11: -\$8.6b (-4.2% of GDP)



On the positive side, the trend line is an improvement on the projections in 2009, which had the operating balance in deficit until 2018/19.

Personal tax rates

Reductions across the board welcomed

The Government had signalled in the lead-up to the Budget that any tax cuts it delivered would be across the board. Budget 2010 confirmed this.

Budget announcement:

Tax rates will be reduced from 1 October 2010, taking effect at the same time as the increase in GST.

New Zealand			
Current tax thresholds income range		New tax thresholds from 1 October 2010	
0 – 14,000	12.5%	0 – 14,000	10.5%
14,001 – 48,000	21%	14,000 – 48,000	17.5%
48,001 – 70,000	33%	48,001 – 70,000	30%
70,001+	38%	70,000 +	33%

Minor changes are also being made to Working for Families (WfF) so that families will no longer be able to use investment losses to reduce their income for WfF purposes from 1 April 2011.

An issues paper will be released later this year looking at other reforms to WfF.

Deloitte comment:

With the tax cuts announced in Budget 2010, taxpayers will be receiving their third tax cut since October 2008 – a trend that goes against the international norm in recent times.

A worker on an average wage of approximately \$50,000 will receive an extra \$29.42 a week (\$1,529.84 a year), while a taxpayer on \$100,000 will receive an extra \$69.81 a week (\$3,630.12 a year).

One major issue that the Government faced in formulating the Budget was how to provide tax relief across the board, particularly when a large number of taxpayers effectively do not pay any income tax when their WfF rebates are taken into account.



Thomas Pippos
Managing Tax Partner
tpippos@deloitte.co.nz
+ 64 (0) 4 495 3921



Robyn Walker
Associate Director
robwalker@deloitte.co.nz
+64 (0) 4 470 3615

Annual income	Weekly tax (current)	Weekly tax (1 Oct 2010)	Weekly saving	Annual saving
20,000	57.88	48.46	9.42	489.84
30,000	98.27	82.11	16.16	840.32
40,000	138.65	115.77	22.88	1,189.76
50,000	183.64	154.22	29.42	1,529.84
60,000	247.11	211.91	35.20	1,830.40
70,000	310.57	269.61	40.96	2,129.92
100,000	529.79	459.98	69.81	3,630.12
150,000	895.17	777.29	117.88	6,129.76
200,000	1,260.56	1,094.60	165.96	8,629.92

* ignores impact of Working for Families and independent earner rebate

To conceptualise this problem, consider that the aggregate percentage of personal tax paid by taxpayers earning over \$70,000 is 49% of personal income tax revenue. Clearly, a disproportionately small number of taxpayers (12%) pay a disproportionately large amount of personal tax, noting that personal income tax comprises \$23.5 billion or 43.6% of all tax revenues.

Individual taxable income (NZ\$)	Who pays tax... and how much?							
	2007		2008		2009		2010	
	People	Tax	People	Tax	People	Tax	People	Tax
Zero	7%	0%	7%	0%	7%	0%	7%	0%
1-10,000	14%	1%	14%	1%	14%	1%	13%	1%
10-20,000	26%	8%	26%	8%	25%	7%	25%	7%
20-30,000	12%	7%	11%	6%	12%	7%	12%	6%
30-40,000	11%	9%	10%	8%	11%	10%	10%	8%
40-50,000	10%	12%	10%	11%	10%	11%	9%	10%
50-60,000	6%	10%	7%	11%	7%	11%	7%	10%
60-70,000	9%	9%	4%	9%	5%	11%	5%	9%
70-100,000	6%	17%	6%	17%	6%	16%	7%	20%
100,000+	3%	27%	5%	29%	3%	26%	5%	29%
Above \$70,000	9%	44%	11%	46%	9%	42%	12%	49%

Effective marginal tax rates compound this problem

But the table above doesn't portray the real position. As the Tax Working Group pointed out, when you add in superannuation, benefits, and the tax credits received by those claiming Wff, 10% of individual taxpayers pay 76% of all personal income tax and 40% of households pay no net tax – hardly evidence of a healthy tax system.

But in formulating the tax cuts in Budget 2010, the Government has effectively ignored net tax statistics, and cut rates at all levels. On the face of it such an across-the-board tax cut should be sufficient compensation for the increase in GST, for the large majority of taxpayers.

With the tax rate differential and the adverse incentives it provided removed, hopefully for good, the tax system should be left to settle back to some semblance of normality.

Tax rate alignment is a particularly important aspect of the tax rate reductions.

By tax rate alignment, we mean the decision to align the top personal tax rate with the trust rate at 33%. Clearly there is still a differential, albeit manageable, between these rates and the new 28% company rate and the rate applying to savings.

As the Tax Working Group identified, without tax rate alignment taxpayers are faced with an incentive to restructure their affairs using trusts and companies (currently paying tax at 33% and 30% respectively) rather than paying income tax at 38%.

The layer of complexity this rate differential has created throughout the tax system has been remarkable.

Compounding matters are debates as to whether different structures that are not subject to the 38% rate nonetheless fall foul of the avoidance boundary, including the imposition of material penalties and interest. Hopefully they are now more a thing of the past but the aftertaste is likely to linger for a while yet.

In saying that, with the most significant tax rate differential and the adverse incentives it provided being removed, hopefully for good, the tax system should be left to settle back to some semblance of normality.

Australia is still our closet neighbour and stiffest competitor

From an international perspective “competition” for labour with Australia continues, albeit the personal tax rate reductions announced in Budget 2010 mean that New Zealand is well and truly back in the game.

The Australian Budget on 11 May included a continued commitment to reducing personal tax rates across the Tasman, reaffirming previously announced personal tax cuts and application dates.

Australia			
Current tax thresholds income range (AUD)		Tax thresholds from 1 July 2010 income range (AUD)	
0 – 6000	0%	0 – 6000	0%
6,001 – 35,000	15%	6,001 – 37,000	15%
35,001 – 80,000	30%	37,001 – 80,000	30%
80,000 – 180,000	38%	80,001 – 180,000	37%
180,001+	45%	180,001 +	45%

There is still a tax advantage in Australia for some – but from 1 October 2010 an individual taxpayer would only have to earn over \$43,760 before they paid more tax in Australia than in New Zealand (but of course this doesn’t take account of rebates, additional taxes and levies, and makes a number of other simplistic assumptions).

The tax wedge (the difference between tax paid in Australia and New Zealand) therefore isn’t generally the chasm that perceptions might imply, and as illustrated below the upcoming personal tax reductions will close it even further. In fact, many higher income earners will be substantially better off in New Zealand.

Income	NZ Tax Current	Australia Tax Current	NZ Tax From 1 October 2010	Australia Tax From 1 July 2010	Tax Wedge Current	Tax Wedge From October 2010
20,000	3,010	2,100	2,519	2,100	910	1,190
40,000	7,210	5,850	6,019	5,550	1,360	469
60,000	12,849	11,850	11,019	11,550	999	(531)
80,000	19,948	17,850	17,319	17,550	2,098	(231)
100,000	27,549	25,449	23,919	24,949	2,100	(1,030)
140,000	42,749	40,649	37,119	39,749	2,100	(2,630)
180,000	57,949	55,849	50,319	54,549	2,100	(4,230)
200,000	65,549	64,849	56,919	63,549	700	(6,630)
240,000	80,749	82,849	70,119	81,549	(2,100)	(11,430)

Of particular note is the reduction in the tax wedge when the income tax cuts take effect in October. This is largely brought about by the reduction in the top personal income tax rate, from 38% to 33%.

With the tax wedge closing, it is perhaps more important to focus on the real difference with Australia: the real wages upon which these rates are applied, the opportunities to continue to grow that wage, and the compulsory savings that also flow to employees.

The key statistic is of course the average wage. On the latest Australian data available, an adult working full time would earn on average approximately A\$66,040. The most recent New Zealand data puts our average wage significantly lower at approximately NZ\$49,874.

If New Zealand wants to catch Australia it will need to step up to the mark in terms of competing for capital and talent, and more importantly retain and if possible attract highly paid jobs to New Zealand.

To the Government's credit it does at least recognise this, as illustrated by the Prime Minister's desire to transform New Zealand into a back office financial hub. But these measures are not straightforward and will take more than just talk – it remains to be seen whether the Government is up to the task. Certainly there are more than a few sceptics, and it will take more than targeted tax relief to make New Zealand competitive globally.

A personal tax calculator is available online at
www.deloitte.com/nz/2010governmentbudget

Taxation of property

Depreciation going for most buildings not just residential rentals

The government had signalled in the lead-up to the Budget that there would be changes to the taxation of property investment. The only question was how far the changes would go.

Budget announcement:

Depreciation deductions will no longer be available for any buildings with an estimated useful life of 50 years or more. This will include residential rental properties and most commercial buildings. The change will take effect from the start of the 2011/12 income year and will raise \$690 million per year.

Building owners will be able to apply to Inland Revenue for a provisional depreciation rate if they consider a class of buildings as an estimated useful life of less than 50 years.

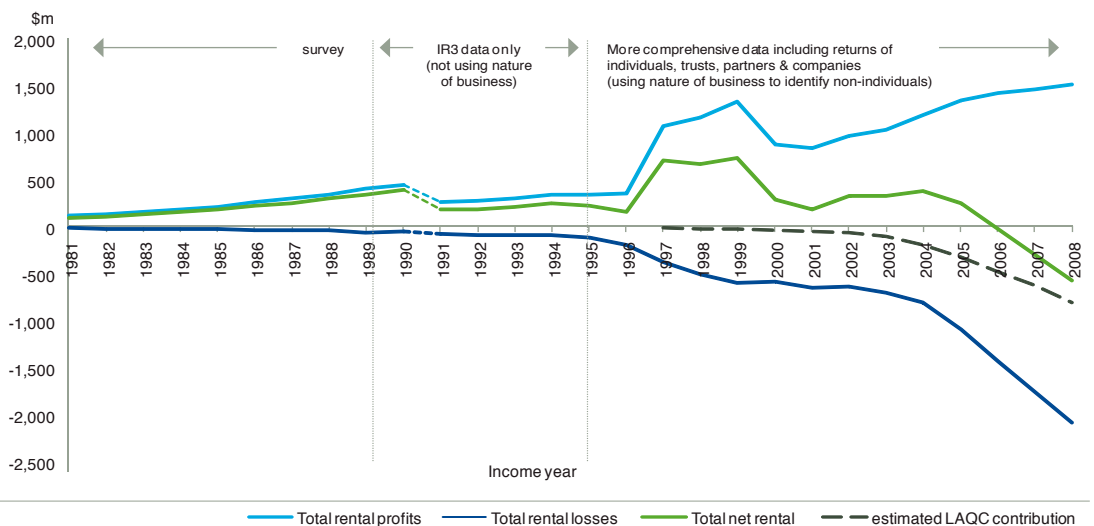
Building owners will still be able to claim deductions for repairs and maintenance. Depreciation deductions will still be able to be claimed for "fit outs" not considered part of the building. The Government intends to review the treatment of commercial "fit out" and, if necessary, amend the rules prior to 1 April 2011 to address any uncertainty in this area.

Deloitte comment:

The decision to remove depreciation deductions for residential rental properties had been widely signalled, and is no doubt the easiest first step in ensuring the taxation of rental properties is fairer, particularly given it is such a comparatively simple measure.

It was the Tax Working Group process that identified that the residential rental property sector had a negative taxable return of approximately \$500 million in 2008. A negative return from a \$200 billion sector was never sustainable.

Figure 7: Rental housing income, 1981 to 2008



Source: Inland Revenue Department



Mike Shaw
 Tax Partner
 mishaw@deloitte.co.nz
 + 64 (0) 4 495 3932

The previous graph illustrates the problem facing the Government. Despite increasing profits over time, total residential rental losses have been increasing dramatically. The result is that total net rentals (the green line) have fallen below breakeven.

An ingredient in that negative outturn is the ability to depreciate rental properties, as is consistent with most other capital assets. Depreciation is designed to reflect that capital items reduce in value over time – and so a portion of this reduction in value can be recognised as an expense every year, over the useful life of the asset.

The problem with residential rental properties, as pointed out by the Tax Working Group, is that by and large they increase in value over time – it is therefore counter-intuitive that they should qualify for depreciation deductions.

What will be of interest in the short to medium term is whether removing depreciation deductions is enough to ensure that the net residential rental line in the graph (see previous page) starts to track upwards.

If removing depreciation deductions is not enough then the Government is likely to consider other options – including ring-fencing losses. While ring-fencing of losses raises a number of real challenges, it probably would address 80% of the taxpayers the Government is concerned about.

The Government has gone a step further, and it is a big step

It has also targeted commercial buildings. From the 2011/12 income year depreciation deductions on buildings will cease where the building has an economic life of 50 years or more. This will include all office buildings, shopping malls, industrial buildings. Certain buildings with an estimated life of less than 50 years escape the changes; they include fowl houses, pig houses, chemical and fertiliser works and the all important dairy sheds.

This will be of real concern to business who have single purpose buildings whether it be meat processing plants, coolstores etc. Where these buildings are not depreciating in value, the principled position is correct and the Government has removed a tax subsidy from this sector. However where these buildings reduce in value, this sector can be rightly concerned as it will be paying greater than its fair share of tax.

However, where it can be shown that a specific class of building reduces in value, there will be the ability to seek a provisional depreciation rate and continue to claim tax depreciation. This may be the lifeline for those specific purpose buildings that truly do reduce in value.

On the bright side for what can be declared a very gloomy day for all property investors, the Government will clarify that fit out costs can be treated separately and continue to have depreciation deductions.

The decision to remove depreciation deductions for residential rental properties had been widely signalled, and is no doubt the most appropriate approach to take to ensure the taxation of rental properties is fair, particularly given it is such a comparatively simple measure.

GST increase confirmed

The consequences for business are significant

The government has been pretty transparent over the past few months in preparing taxpayers for an increase in GST, with the increase to 15% confirmed.

Budget announcement:

The rate of GST will increase from 12.5% to 15% from 1 October 2010.

In 2010/11 this measure will raise a net \$1.62 billion in additional government revenue after allowing for \$420 million compensation to superannuitants and beneficiaries. In 2011/12 the estimated net gains are \$2.255 billion.

As anticipated, no new exemptions have been introduced around necessities such as food.

GST rules will be changed to stop the use of "phoenix" GST fraud schemes.

Deloitte comment:

Increasing GST is an effective way to change the tax mix, simply because everyone pays GST in one form or another, and from an economic perspective it is one of the least distortionary and most efficient ways to raise revenue.

GST is already an important source of government revenue, raising \$14.4 billion in 2010 (24% of government revenue). This is significantly more than what the Government collects from corporate income tax (being \$8.9 billion).

A consequence of the rate change and the heightened importance of GST, we can expect to see a much greater audit focus from Inland Revenue on GST as a result of the change, particularly around the date the rate changes. Whether the GST increase leads to consumers saving, rather than spending, will take some time to determine.

The immediate issue, however, is not how an increase in GST will affect behaviour, but how businesses will cope with the change.

While increasing GST is easy from a tax legislative perspective, there are many practical implications which businesses will have to work through. We have commented on just some of these issues below.

Pricing points will need to be considered carefully

Pricing points will be a major headache for businesses selling directly to end consumers on a GST inclusive basis. For example, if a product sells for \$9.95 under the 12.5% rate and stays at \$9.95 under the 15% rate, the business will suffer a decrease in after GST revenue of 2.2%.

To maintain the same gross profit under the new 15% GST rate, the product would need to be sold for \$10.17 – which hardly has the same ring as \$9.95, and may dampen consumer spending.

Thought will clearly need to be given to the price elasticity of end-consumer products in this regard.

If a decision is made to increase prices, the shelf price of thousands of products will most likely need to be manually changed and marketing material such as brochures will need to be updated.

Businesses will not be looking forward to the prospect of potentially having to re-price thousands of items overnight. So in practice we could expect to see price movements well in advance of 1 October 2010.

Business systems will need to be updated

The new rate will have far-reaching consequences for business systems – ERP, billing, purchasing, expenses, and accounting systems will all be affected by the change.

The real challenge for taxpayers will be updating their systems in time for the application date of the change on 1 October 2010. For many businesses, particularly large corporates, updating GST systems will be very complex – it is not simply a matter of substituting one rate for the other. There will be a period of some months during which businesses will have to deal with both the old and the new rate.



Allan Bullôt
Tax Partner
abulloc@deloitte.co.nz
Ph: +64 (0) 9 303 0732

Accentuating this is that just over four months is not a particularly long time for such a major systems overhaul. Many businesses have already commenced GST rate change systems update projects and in general it is a significantly larger project than many would have thought.

Taxpayers will be looking to Inland Revenue for guidance on what will happen if some systems cannot be updated in time for the change.

One would hope Inland Revenue will exercise discretion and pragmatism in the event that some systems cannot immediately cope with the change and technical breaches of the law result, particularly for errors between businesses with no real cash cost to the Government. It would not be the right outcome if businesses were to suffer penalties simply because of the short timeframe they were given to update their systems for the GST increase.

However, don't expect Inland Revenue to show much tolerance to businesses that fail to correctly collect GST from end consumers at the new 15% rate after 1 October, as indications are that a hard line will be taken. After all, the income tax cuts have to be paid for somehow.

The Financial Services Industry will suffer a 20% rise in GST cost

A further consequence of the GST rate increase will be that GST exempt entities will need to factor in a 20% rise in GST cost, as they cannot recover all input tax credits.

This will largely impact financial institutions, the most immediate example being financial intermediaries such as banks and life insurance companies. The Budget was silent on any measures to compensate them for this additional cost.

GST fraud will be targeted

The Government has been concerned about a number of opportunities that exist to commit GST frauds. The most common example involves "phoenix" companies that enter into high value transactions with a mismatch between the claiming of input tax and the returning of output tax – with the output tax invariably never being returned to the Government. The Government consulted on these issues in 2009 and this announcement is entirely sensible and appropriate. Stamping down on these fraud opportunities is expected to save the Government \$60 million annually.

If a decision is made to increase prices, the shelf price of thousands of products will most likely need to be manually changed, and marketing material such as brochures will need to be updated.



Company taxes

A reduction in the corporate tax rate – yes

Budget announcement:

The corporate tax rate will drop to 28% next financial year – generally from 1 April 2011.

Deloitte comment:

In 1989 New Zealand's 33% corporate tax rate was one of the lowest in the world. More than 20 years later, our corporate tax rate was only 3% lower, at 30%, now it will be a further 2% down to 28%.

During those two decades, the international trend has been overwhelmingly downwards – but now New Zealand has a comparable corporate tax rate relative to the OECD average of 26% (see below):

Almost unbelievably New Zealand has overtaken Australia in terms of timing given that Australia has announced that it will reduce its corporate rate to 28% but only by 2014.

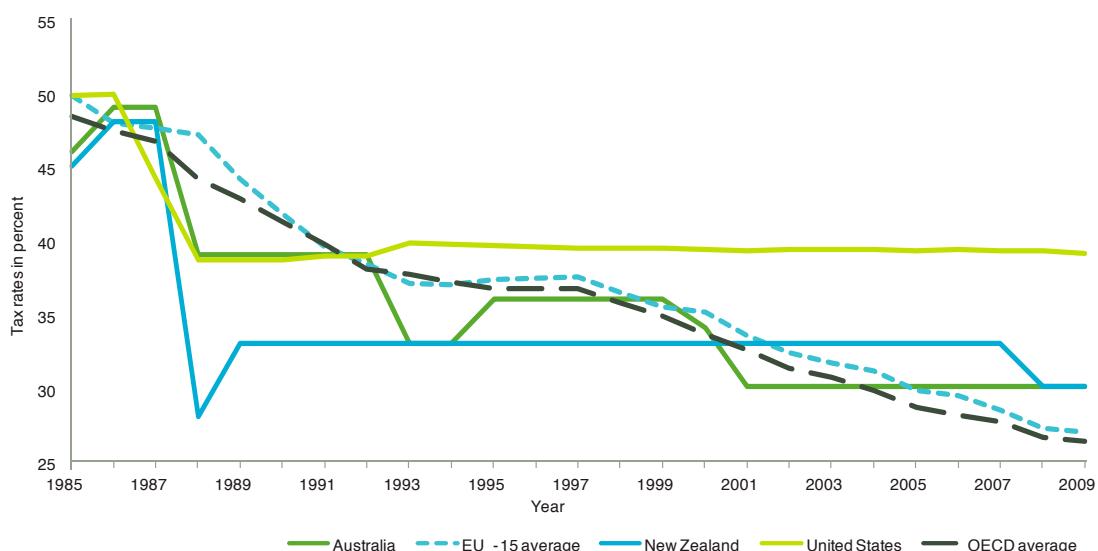
Offsetting measures...

Budget announcements:

The safe harbour threshold for inbound thin capitalisation purposes will decrease from 75% to 60% from the 2011/12 income year.

Depreciation deductions will no longer be allowed for buildings with an estimated useful life of 50 years or more. This change will apply from the 2011/12 income year.

Figure 8: Trends in statutory company tax rates in OECD countries, 1985-2009



Source: OECD



Thomas Pippas
 Managing Tax Partner
 tpippas@deloitte.co.nz
 + 64 (0) 4 495 3921

Businesses will no longer be able to claim 20 per cent accelerated depreciation on new plant and equipment. This will apply to assets purchased after Budget day.

Deloitte comment:

While there will be some collateral damage around depreciation, more material is the blunt change to the safe harbour threshold that assumes the initial target was the right one.

In the scheme of things it's relevant but not overpowering in terms of the overall benefit that the rate reduction will provide.

From a technical perspective removing depreciation loading has merit to the extent that having the 20% uplift was resulting in depreciation being claimed more quickly than the estimated decline in the value of that asset.

It is helpful that the removal of depreciation loading will only apply to the purchase of new assets. What will need to be considered is whether some depreciation rates need to be increased, in the absence of the loading, to reflect their actual useful economic life – particularly in the technology area.

Matters unaddressed - Mutual Recognition

Budget announcement:

Not that it was unexpected, but the vexed question of mutual recognition of imputation and franking credits didn't shine through in this year's Budget.

Deloitte comment:

We think that it is time to move on and the reality is that mutual recognition is unlikely to see the light of day in our generation, if ever.

This nut needs to be cracked in a manner that enables continued New Zealand portfolio equity participation and does not incentivise head offices to relocate to Australia.

Mutual recognition would have gone some way to addressing these issues but such a bilateral option is effectively off the table with the lukewarm support set out in the Australian Henry Review.

In the scheme of things this is a micro policy reform but with potentially material ramifications that need to be addressed – not for today though.



Superannuation

Surprise tax rate reduction for savings vehicles

Budget announcement:

From 1 October 2010, the top tax rate for most portfolio investment entities (PIEs), including KiwiSaver accounts, will be reduced from 30% to 28%, while other PIE rates drop to align with the new personal tax rates.

The tax rate for savings vehicles like unit trusts and widely-held superannuation funds will also be reduced from 30% to 28% from the 2011/12 income year.

Deloitte comment:

The surprise drop in the highest PIE rate should be warmly welcomed by the savings industry as savings vehicles will still enjoy a significant tax reduction for high income earners. Post the personal tax reductions, high income earners would ordinarily pay tax at 33% on investment income, however if they invest through PIEs they will only pay tax at 28%.

This 5% differential should be a real bonus for this group of investors. Some may have argued that the principled approach would be that the top PIE rate should have been increased to 33%, and not reduced to 28%. However such a view would overlook the importance of savings which Australia has embraced.

Others will argue that long term savings should have a significantly lower tax rate if New Zealand is serious about saving. They will point to Australia where long term savings are taxed at 15%.

While these changes are a significant step that surpasses expectations, the big untouchable political hot potato of compulsory savings did not get a mention.

Does Australia have us beat?

Australia's decision to pursue compulsory superannuation has built up a trillion dollar industry that's several times larger than our GDP.

It is difficult to compare the superannuation industries in Australia and New Zealand. Essentially they are two entirely different beasts – and Australia's industry could have ours for lunch.

Australia's superannuation industry is worth approximately \$1.1 trillion – about six times the size of New Zealand's gross domestic product and apparently the fourth largest geographic savings pool in the world.

And it is set to grow larger. Last month the Australian Government announced significant changes to superannuation, including increasing the compulsory employer superannuation contribution rate to 12% by 2019 (it is currently at 9%).

It is estimated that the package of superannuation changes will provide an additional increase in the value of Australian superannuation schemes of \$80 billion over the next decade – this additional increase is greater than the market capitalisation of our stock exchange.

Effectively this pool of wealth sitting in the Australian superannuation industry will ensure that Australians retire wealthier than would otherwise be the case, and provides an investment pool to help stimulate further growth and investment into the Australian economy.

Meanwhile, on our side of the Tasman, while KiwiSaver continues to grow – reaching 1.3 million members and a total value of approximately \$4.8 billion – it is dwarfed by comparison.

KiwiSaver in its current form only pays lip service to the Australian industry – not only is it voluntary, but compulsory employer contributions are capped at 2% (compared to the current 9% in Australia).



Donald Wong

Tax Partner
dwong@deloitte.co.nz
+ 64 (0) 4 495 3923



Charles Hett

Actuarial Services
charleshett@deloitte.co.nz
+ 64 (0) 4 470 3866

The surprise drop in the highest PIE rate should be warmly welcomed by the savings industry as savings vehicles will still enjoy a significant tax reduction for high income earners.

Australia also only taxes superannuation funds at a flat rate of 15%. KiwiSaver funds will be taxed at rates as low as 10.5%, although most savings will be taxed at either 17.5% or 28% therefore ensuring a higher tax burden for New Zealand savers.

In the wider context, some New Zealanders also have additional investments in private superannuation schemes and New Zealand does have the Cullen Fund, which has recovered somewhat after being hit by the global financial crisis and is currently worth \$15.49 billion up from \$12.88 billion last year.

Still, the combined value of all New Zealand superannuation barely scratches the surface of Australia's, partly because New Zealand was such a late starter.

Sooner or later the issue of compulsory superannuation will be raised again – the problem is that successive New Zealand governments have viewed compulsory super as political suicide.

Time will tell where this issue washes up, but one thing is certain: while the course of superannuation in New Zealand is debated, our Australian counter-parts are growing from strength to strength.



SME sector

This budget delivers tax rate reductions for the small business owner

Budget announcement:

There are no Budget announcements specifically aimed at the SME sector. However SMEs will be impacted by the wider tax changes including:

- The company tax rate reduces from 30% to 28% from the 2011/12 income year
- Personal tax rates reduce from 1 October 2010
- Qualifying companies and loss attributing qualifying companies will become flow-through entities for tax purposes – similar to limited partnerships
- GST is being increased to 15% from 1 October 2010
- Depreciation on buildings will be denied from the 2011/12 income year
- The 20% depreciation loading on new plant and equipment is removed for assets purchased from 21 May 2010.

Deloitte comment:

We are largely a nation of small businesses, yet this fact seems to have gone unrecognised by successive governments. While there has been considerable “noise” on assisting small and medium sized businesses (SMEs), the delivery of practical assistance has been thin on the ground beyond the corporate and personal tax cuts. Alignment of the top individual tax rate and the trust tax rate should greatly simplify tax compliance.

With a relatively new government and understandably last year’s budget aimed at managing the impacts of the global recession, the SME sector would have been hoping for some well considered specific incentives and compliance-cost saving reforms. However, they are once again likely to be disappointed on these fronts.

There is a very real and pressing need to provide assistance with developing export markets, removing unnecessary compliance costs and mitigating the impacts of a very difficult funding environment.

On the brighter side, the reduction of the corporate tax rate will provide a material saving especially for those corporate SMEs that reinvest profits back into their business. Further, the reduction in the top marginal personal tax rate will provide welcome relief for some unincorporated business owners, or those individuals whose current accounts have run out and are faced with the need for increased salary or dividend payments.

A hidden benefit that will address some compliance cost concerns will result from the personal tax rate reductions. They will likely simplify aspects of the tax system, including:

- Simplifying compliance with fringe benefit tax – lower personal tax rates mean lower FBT bills and less incentive to undertake complicated FBT attribution calculations;
- Personal attribution rules should become simpler;
- Arguably the growing tension within Inland Revenue around the tax motivations behind the choice of business vehicle and the salaries paid to owners should start to dissipate.



Ross Milne
Tax Partner
romilne@deloitte.co.nz
+ 64 (0) 9 303 0950



Keith McArley
Accounting & Advisory partner
kemcarley@deloitte.co.nz
+ 64 (0) 3 474 8634

How much SME business owners will truly benefit will be a function of their personal spending habits given the increase in GST to 15%. The impact of the GST increase on SMEs' operating margins also needs to be taken into account. There is a very real prospect that in the current economic climate pressure will be applied to suppliers to absorb the impact of the GST rate increase rather than the cost being passed on to end consumers.

On a technical front, officials released an issues paper seeking consultation on requiring qualifying companies to be treated as flow through vehicles. Qualifying companies are not uncommon amongst SMEs. Currently only losses of loss attributing qualifying companies are allocated to shareholders. The proposal is intended to require both profits and losses to flow through to shareholders. This is to address the concerns about shareholders claiming losses at the highest individual tax rate however taxing profits at the company tax rate (moving to 28%). While it is too early to tell what will ultimately transpire from this consultation, there is a real likelihood that loss attributing companies will lose their ability to allocate losses to shareholders. The alternative options appear very complex and possibly unworkable.

Tax rate reductions aside, the overall benefit aimed directly at SMEs from this Budget is in stark contrast to Australia, which is actively trying to make life considerably easier for SMEs. The pragmatism being shown in Australia in relation to small businesses and the ability to adopt different policy solutions for that group of taxpayers is something that New Zealand is sadly lacking in any material way.

Another area where we believe our trans-Tasman cousins have it right and we don't is in the support for research and development. Australia specifically provides tax breaks for SMEs in the area of research and development via a 45% refundable tax credit for firms with an annual turnover of less than \$20 million. Again, this translates in to real cash in the hands of SME business owners.

The Budget 2010 announcement of an additional \$321m for research, science and technology is on the face of it pleasing. Although how much of the new money will find its way to the SME sector is debatable given the funds will only be available to businesses with a turnover of more than \$3 million. This seems counter intuitive to us when aligned to the predominance of technology entities in the Deloitte Fast 50. Experience shows these entities typically have highly innovative R&D activities that arguably need more help as they are mostly start-ups.

It remains to be seen if Budget 2010 delivers on its major objectives of helping the economy through the recession, lifting productivity and controlling government spending. The tax reductions will assist SMEs, however there is clearly still room for greater assistance to be offered to SMEs.

How much SME business owners will truly benefit will be a function of their personal spending habits given the increase in GST to 15%. The impact of the GST increase on SMEs' operating margins also needs to be taken into account.

Taxation of resources

Is it the gate to a golden age?

Budget announcement:

The Government released a plan to unlock New Zealand's petroleum and mineral potential in November 2009 and has begun implementing it. Budget 2010 allocates funds to implement that plan.

Deloitte comment:

Whether New Zealand should be seeking to tap into our natural resources isn't a tax consideration, but taxes do impact on whether anyone wants to tap into them in the first place. Australia's tax initiatives in this area are of direct relevance to New Zealand given the noise about growing this sector of the New Zealand economy.

Australia is proposing to increase taxes on its non-renewable resource sector to fund various taxpayer friendly initiatives with the introduction of a new resource super profits tax (RSPT).

The RSPT – effectively an explicit tax on economic rents – taxes the so-called "super" profits made from the exploitation of Australia's non-renewable resources at a rate of 40% (in actual fact it is seeking to levy an additional tax on what many would consider ordinary profits, and it should also be noted that income tax will also continue to apply).

Taxing economic rents in this way flows from the concept that taxing something that is so physically intertwined with a geography, i.e. its natural resources, has merit since those resources cannot be extracted anywhere else.

It is estimated that the RSPT will generate Australia an additional \$3 billion in government revenue in 2012/2013 and \$9 billion by 2013/2014. Needless to say there has been the anticipated outcry from the mining sector in Australia and concern from other taxpayers as to who or what may be next.

In terms of the anticipated revenue, it would be enough to single-handedly put New Zealand back into surplus. Can we ever hope to generate similar revenue figures from the taxation of our resources? Let's consider the current position.

Companies that are involved in mining or any other exploration in the resources sector are subject to income tax like other businesses (noting that there are specific tax rules for this sector). Like other jurisdictions, the petroleum, mineral and coal industries are also subject to royalty regimes which collect tax on the basis of a percentage of net revenues or accounting profits (whichever is greater).

In the 2008-09 year, the petroleum industry paid \$511 million in royalties to the Government, largely due to increased oil production worth \$2.8 billion, New Zealand's third largest export earner. The mineral and coal industries accounted for only \$7.5 million in royalties between them, despite the recent boom in gold prices.

Combined with an energy resources levy the annual benefit to the Government from the resource sector (excluding company tax) is somewhere in the region of \$557 million.

Could the Government abolish or amend the current royalties and introduce a resource super profits tax? Theoretically yes, but while the resources sector is not a revenue stream to be laughed at, it's not currently our economic saviour either.



Robyn Walker

Associate Director
robwalker@deloitte.co.nz
+64 (0) 4 470 3615

The annual benefit to the Government from the resource sector (excluding company tax) is somewhere in the region of \$557million.



Given the risks involved, particularly in greenfields exploration, the tax and royalty regimes still need to leave enough rewards with the private sector for locating and extracting resources as otherwise no one will.

A positive development in Australia is the proposed introduction of a Resource Exploration Rebate. This rebate recognises the inherent risk of digging an expensive hole in the ground and essentially provides cash back for tax losses. This is the economic equivalent of allowing "flow through shares" and is something which should also be considered here to foster investment in this sector, particularly if residential rental properties are no longer flavour of the month.

The phrase "watch this space" applies to this industry as there are certainly a few officials that see it as furtive ground for "remedial" (and fiscally positive for the Government) policy intervention.

Tax Working Group

Final results revealed

The Tax Working Group made 13 recommendations to the Government back in January, sparking much debate and public interest. While the Government immediately ruled out some of the more controversial recommendations, decisions on the majority were left for the Budget. Let's see what happened ...

Recommendation / comment	Government response	Comment
1. The company, top personal, and trust rates should be aligned.	Announced in Budget 2010 that the top personal rate and trust rate will be aligned at 33%. The company rate has been reduced to 28%.	The alignment of the top personal and trust rate will improve the integrity of the tax system by removing the current bias of using trusts to avoid the top marginal tax rate. The gap between these rates and the corporate tax rate will be 5%.
2. The company tax rate needs to be competitive.	Announced in Budget 2010 that the company tax rate will be reduced to 28% for 2011/12 income year.	The reduction in the corporate tax rate is welcomed. The Government has effectively trumped the recent Australian moves of moving their rate to 29% in 2013-14 and 28% in 2014-15.
3. The imputation regime should be retained.	Announced in February that imputation would be retained.	Imputation has many benefits, primarily to prevent double taxation when New Zealand tax paid profits are distributed to New Zealand shareholders. Consideration needs to be given to how imputation can be improved where corporates have significant foreign investments and foreign shareholders. Australia has also confirmed that it will retain its imputation regime. And following recent announcements in Australia, mutual recognition seems to be no more than a remote possibility – at best.



Mike Shaw
Tax Partner
mishaw@deloitte.co.nz
+ 64 (0) 4 495 3932

Recommendation / comment	Government response	Comment
4. Personal tax rates should be reduced.	Personal tax cuts announced in Budget 2010.	The move towards lower personal income tax rates is positive; where high marginal tax rates exist there is disincentive to increase income, productivity and efficiency. International evidence suggests that taxing income is harmful to economic growth.
5. The tax base should be broadened.	Budget 2010 does not tax any new sectors, albeit as outlined below changes are being made to depreciation.	When considering the direction of the tax system, we agree that "broad base-low rate" is utopia. Removing the tax bias for residential rental investment and the reduction in avoidance opportunities around Working for Families is a step in the right direction.
6. A comprehensive capital gains tax would broaden the tax base.	Ruled out in the Prime Minister's statement to Parliament on 9 February.	There are many issues with a comprehensive capital gains tax, the political dimension probably the most daunting. For the time being New Zealand will have pockets of taxing capital gains through the application of specific tax regimes but no general capital gains tax – a relief no doubt to many.
7. Consideration should be given to an RFRM model for residential rentals.	Ruled out in the Prime Minister's statement to Parliament on 9 February.	We support the minority view of the TWG, and the Government was right to rule this out. Taxing deemed notional returns has real practical issues and because of these it seems unworkable.
8. A low-rate land tax should be introduced.	Ruled out in the Prime Minister's statement to Parliament on 9 February.	The Government was right to rule this out as it would not only be politically difficult without exemptions, but it would also have been largely incurred by current property owners through an immediate drop in value which would have been inequitable.
9a. Depreciation loading should be removed on new plant and equipment.	Announced in Budget 2010 that depreciation loading will be removed.	The decision to remove the 20% depreciation loading is understandable given the standard depreciation rates are meant to reflect economic usage of an asset. With the additional loading to be removed, it is important that all business taxpayers review the depreciation rates applicable to their business to ensure the standard depreciation rates do actually reflect the useful life of assets. If not, consideration should be given to applying for special determination rates for material assets.

Recommendation / comment	Government response	Comment
9b. Depreciation should be removed for buildings that do not depreciate.	Announced in Budget 2010 that depreciation will be removed for buildings that have an estimated useful life of 50 years or more, this applies to residential rental homes and commercial buildings.	It is a big step for depreciation deductions to be removed for most buildings. The TWG identified that depreciation of residential rental homes is questionable as this asset class generally appreciates in value. Therefore tax depreciation provides a tax subsidy to this sector that other forms of investment do not obtain – it was therefore expected that depreciation changes would target this sector.
9c. The thin capitalisation safe harbour should be reduced to 60%.	Announced in Budget 2010 that the thin capitalisation threshold will be reduced to 60% from 2011/12 income year.	New Zealand's existing thin capitalisation debt to asset percentage of 75% is not out of alignment with other countries and as such did not warrant any immediate change. This change will cause some foreign investors real concern.
10. GST should continue to apply broadly with no exceptions.	The Government does not support moves to exempt GST on food.	We agree with the TWG and the Government – New Zealand has a very stable GST system; exempting certain items would only lead to complexity.
11. Increasing GST to 15% would have merit on efficiency grounds.	Announced in Budget 2010 that GST will be increased to 15%.	The Government has been careful to compensate taxpayers via personal tax cuts and selected changes to benefits. We agree that there should be a shift away from taxing personal exertion income and savings towards taxing consumption. Evidence suggests that taxing consumption is less harmful to economic growth than other taxes.
12. There should be a review of welfare policy and how it interacts with the tax system.	No comment in the Budget.	This has been identified for a longer term project with the Government rightly tackling the current avoidance areas to improve the integrity of these regimes. The whole issue of effective marginal tax rates largely as a consequence of the Working for Families initiatives remains a fundamental unresolved tax issue.
13. Institutional arrangements should be introduced for when changes to the tax system are considered.	No comment in the Budget.	This is a technical issue around consultation and more consideration of the macro settings. This is something that was not expected to be covered in the Budget.

Public sector

Time to change the spending cuts game

This Budget has affirmed the Finance Minister's mantra of "no more money" for government agencies, which have to cope with less or the same amount of funding in the foreseeable future. While the plan is to redirect some \$1.8 billion of "lower quality spend" to other higher priority areas and new operational spending will be capped to 2 percent per annum, some fundamental questions still need to be tackled.

Some ground work has identified scope for agencies to provide better public services by improving processes, removing duplication and reallocating poorly used resources to improve frontline public services. However, responses to the Finance Minister's repeated challenge for government agencies to "shock him with new ideas" to do things better and smarter have been underwhelming.

Strategies to lower costs permanently remain elusive in this Budget and so far the new reality has not yet sunk in deep enough in the modus operandi of agencies. The focus on procurement, reducing the number of agencies and consolidating back offices will provide one-off gains but require material upfront investment to implement and sustain lower operational costs.

Public sector leaders will find it increasingly hard to achieve large sustainable cost reductions in successive years unless there is a fundamental rethink of current operating frameworks, structures and capability. Budget-holders have no choice but to rethink their strategy to embed permanent cost reductions while improving public service. Some areas for attention include:

Tackling the front-line: Much of the spending cuts here and overseas focus on procurement and administrative and support functions. But given the relative magnitude of frontline costs, agencies need to properly engage with their frontlines to improve service quality and reduce costs. Continuous improvement driven from the frontline is more effective, sustainable and comparably less expensive.

Governance and management of whole-of-government ICT investment: Current ICT planning, budgets and investment decisions are very much "stoke-pipe", remaining with individual agencies. A whole-of-government ICT governance and management regime can deliver better productivity and long-term efficiency that is key to higher quality spending across government.

Improve leadership and commercial talent: Stepped change requires investment in knowledge, skills and experience that are crucial in judging priorities, managing change, dealing with poor performance, intelligent purchasing and assessing value for money (not just short-term savings). Public sector leaders must be allowed to take risks, and politicians must accept that some failures will happen if innovation within the public service is to become a reality not just rhetoric.

Address cross organisation boundary spending: Much of the Government's spending is by agencies outside core departments – in Crown entities, NGOs, not for profits, etc. Finding efficiencies across organisation boundaries is more likely to yield better return and applying a systems-wide view that enables re-consideration of how services are provided through the delivery network rather than their sum parts.

Less focus on dollars, more on value: While there's no denying the need to watch the pennies, agencies need to become more knowledgeable about what they are paying for, otherwise they cannot make informed choices nor measure the efficiencies gained. Properly applying value for money and cost tradeoffs is essential to "living within their means". The Government and agencies also need to pay more than lip service to the need to properly account for the cost effectiveness of their spending in public reporting than they have done in the past.

Cost reduction is not about being able to point to headcount reductions or one-off operational savings from structural changes. Ministers and public sector leaders should be insisting on programmes that embed permanent core savings founded on having the best leadership, long-term capability and the right incentives in place.

Aloysius Teh
Public Sector Leader
ateh@deloitte.co.nz
+ 64 (0) 4 495 3934



Infrastructure

Where will the money come from?

During the past 18 months the National-led Government has done much to move the infrastructure agenda forward, and used last year's Budget to announce significant investment programmes. So it's been no surprise then that this year's Budget hasn't featured another round of major new infrastructure announcements beyond those already underway, particularly given the focus on taxation and the return to growth.

Budget announcement:

Budget 2010 allocates another \$1.45 billion in capital spending in 2010/11 – the second year of a five-year \$7.5 billion infrastructure funding plan.

Capital spending over the next four years includes:

- Broadband - \$200 million for the roll out of ultra-fast broadband
- Prisons - \$337.4 million to lift prison capacity and manage justice sector pressures
- Schools - \$177.4 million for new schools and school property
- Rail - \$500 million is allocated to the electrification of Auckland rail lines. \$250 million is committed to support the \$4.6 billion KiwiRail Turnaround Plan with \$750 million committed in principle over the next three years

Deloitte comment:

Rail has suffered from substantial under investment and is likely to require even greater injection of capital to improve its competitiveness and enable it to remain relevant in the 21st century. The Budget allocation of \$250 million now and \$500 million in principle provides both certainty and some limited breathing space for KiwiRail. One suspects that the availability of the "in principle" funding is also likely to be heavily dependent

on what is achieved with the first \$250 million. In the longer term it will have to stand on its own two feet commercially and generating the balance of the \$4.6 billion of turnaround funding from earnings will be a substantial task. Clearly the Government wants to see the benefits of its investment realised quickly.

The bulk of the rest of the infrastructure spending is essentially the latest instalment of commitments already made. The roll out of broadband is already underway and the fact that the Government will actually front up with some cash in the next 12 months, is welcome but not exactly surprising. The latest \$1.45 billion funding for the \$7.5 billion infrastructure plan falls into the same category.

New capital for prisons and schools is welcome, particularly when Government is already looking at new procurement models, and in particular PPP's in both those sectors. A clear message that the right answer to funding capital in core public sectors is a mix of both public and private funding.

What about everything else?

We have already seen the establishment of the Roads of National Significance, and investment is underway on some of the projects identified in 2009. The continued commitment to funding this programme is a clear signal of the Government's intention to continuing its progress in this area. The National Infrastructure Unit has also been established and has produced a plan for investment in the nation's infrastructure, from new roads to electricity and water. New Zealand's first major PPP is also under development for a new prison facility together with contracting out of custodial management at Mt Eden.



Paul Callow

Energy and Infrastructure Leader

pcallow@deloitte.co.nz

+ 64 (0) 4 470 3635

Infrastructure spending needs are staggering

While this could be viewed as “so far so good” given the current economic climate, the infrastructure plan nevertheless makes for sobering reading and the current budget does little more to deliver it than has already been committed in previous years. The capital requirements to bring our national infrastructure up to scratch are staggering. Ownership is scattered across central government, local government, SOEs and other quasi commercial organisations and coordination of investment is poor.

With these enormous demands on its available capital, the Government needs to ask itself whether its capital is deployed in the right places and what other sources of capital it can access to fund the investment needed.

It has over \$50 billion tied up in commercial assets comprising mainly SOEs which do everything from electricity generation and farming to property valuation. A partial listing of some or all of the larger SOEs would achieve a number of goals: it would free up capital badly needed for infrastructure elsewhere, provide an attractive destination for New Zealand investment capital and savings building up in KiwiSaver funds and elsewhere, and it would also subject key infrastructure operators to market disciplines and free investment decisions from any opportunity for political interference. There were no signals in this Budget, but clearly it needs to be on the Government’s agenda for the future.

PPP model offers procurement alternative

One encouraging sign has been the Government’s willingness to consider PPPs as a procurement model. This, essentially, deals with the second point: providing access to new sources of capital. Much has been made of a PPP’s improved service delivery and reduced costs and when done well, they will deliver this. More importantly for New Zealand is that they provide access to private capital for critical public infrastructure projects which have traditionally been restricted because they depended upon limited public sector funding.

While capital remains very tight, demands for infrastructure investment have never been higher. The Government appears to be taking the opportunity to adopt smarter ways of using public and private capital to achieve its goals. Let’s hope they maintain this momentum.

With these enormous demands on its available capital, the Government needs to ask itself whether its capital is deployed in the right places and what other sources of capital it can access to fund the investment needed.



Snippets

Other points of significance

We summarise below what else was in the Budget that may be of interest to business.

- Negative
- Neutral
- Positive

Other Budget announcements												
Tourism	●	The Budget allocates an extra \$30 million to the tourism industry, \$25 million of which will be used to increase the marketing of New Zealand as a tourism destination internationally with the further \$5 million to be allocated to joint venture initiatives. Tourism is a vital part of the economy with potential for growth, and it is positive to see the government supporting the industry.										
Budget deficits	●	<p>Operating deficits are forecast to reduce faster than expected in 2009, with the government returning to surplus in 2016. Forecast deficits are:</p> <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: right;">2010</td> <td style="text-align: right;">\$3.1b</td> </tr> <tr> <td style="text-align: right;">2011</td> <td style="text-align: right;">\$7.1b</td> </tr> <tr> <td style="text-align: right;">2012</td> <td style="text-align: right;">\$3.6b</td> </tr> <tr> <td style="text-align: right;">2013</td> <td style="text-align: right;">\$2.4b</td> </tr> <tr> <td style="text-align: right;">2014</td> <td style="text-align: right;">\$0.8b</td> </tr> </table>	2010	\$3.1b	2011	\$7.1b	2012	\$3.6b	2013	\$2.4b	2014	\$0.8b
2010	\$3.1b											
2011	\$7.1b											
2012	\$3.6b											
2013	\$2.4b											
2014	\$0.8b											
Crown retail deposit guarantee	●	The Crown has provided \$881m as at 31 March for future payments under the retail deposit guarantee scheme, less expected recoveries.										
Kyoto Protocol	●	The Crown contingent liability for Kyoto obligations has reduced from \$1.8B to \$1.7B.										
Productivity Commission	●	Funding for the Productivity Commission will be \$2.4m, rising to \$5m by 2012/13										
Maori business	●	There will be \$4.5m of new spending to grow Maori productivity and export growth, and to support Maori innovation. In addition a further \$4.5m has been set aside to support Maori Tourism.										

Deloitte New Zealand brings together more than 900 specialists providing audit, tax, technology and systems, strategy and performance improvement, risk management, corporate finance, business recovery, forensic and accounting services. Our people are based in Auckland, Hamilton, Wellington, Christchurch and Dunedin, serving clients that range from New Zealand's largest companies and public sector organisations to smaller businesses with ambition to grow.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 140 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's more than 168,000 professionals are committed to becoming the standard of excellence.

Deloitte's professionals are unified by a collaborative culture that fosters integrity, outstanding value to markets and clients, commitment to each other, and strength from cultural diversity. They enjoy an environment of continuous learning, challenging experiences, and enriching career opportunities. Deloitte's professionals are dedicated to strengthening corporate responsibility, building public trust, and making a positive impact in their communities.

This publication contains general information only, and none of Deloitte Touche Tohmatsu, its member firms, or its and their affiliates are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

None of Deloitte Touche Tohmatsu, its member firms, or its and their respective affiliates shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/nz/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its Member Firms.