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Budget 2011
Are we keeping pace?
Deloitte's perspective

19 May 2011

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Contents

The events of the past year have been a recipe for red ink as far as the Government accounts are concerned.

Introduction
Steady as she goes, for now

What a difference a year makes! Last year's budget was full of optimism with the most significant tax changes in 25 years targeted to provide a platform for productivity and economic growth. A year and two Christchurch earthquakes later and the Government's accounts are less rosy in the near term. The earthquakes and a slower recovery coming out of the GFC enhanced long recession have exposed prior assumptions.

Last year's Budget Overview commented...."and this [2010 Budget] 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."

Well the economy hasn't grown and won't grow much for the rest of this year. Beyond that there are hopes for a rapid growth by past standards – but that is not certain.

So in 2011 we see the first tentative steps to tackling entitlements.

- Working for Families faces a trim for the higher earners with fewer kids.
- Student Loans are no longer as "interest-free" for some and others face curbs.
- KiwiSaver subsidies are trimmed and employers and workers pick up the slack with minimum contributions lifted to 3%.

Of these most rhetoric will flow around KiwiSaver. The problem, however, is that a scheme that relies for its success on the Government contributing a dollar for every dollar saved makes no sense. The quirkiness of this is even more exposed when 45% of the funds in KiwiSaver are invested off-shore. We can fiddle with KiwiSaver as much as we like but as long as we have a relatively generous universal pension, health care free at the point of delivery, and a largely free education system backed at the tertiary level by interest-free loans we will have to continue to pay people to save. More serious reform is needed.

But the entitlement changes are hardly frontal assaults on middle-class welfare. Bill English's austerity budget cannot be remotely compared with Ruth Richardson's mother of all budgets. This is because most of the expenditure restraint is forecast to come from public sector administration efficiencies and "reprioritisation". This is appropriate. The noughties saw a relentless rise in the number of public servants and hence cost with hard to find evidence of productivity gains. To date the private sector has borne by far the greatest burden of adjustment during the long recession, both in terms of employment and wages. The predicted restraint in the Budget is sensible.

However, this comes with its risks. The risks don't relate to cessation of services but to the capabilities within the public sector to drive out costs and reprioritise expenditure and the speed with which they can do so. The lower spending path of the last two years has helped condition attitudes but this Budget sees a quantum shift in scale and urgency of action.

As a consequence of this strategy there remains a reliance on rebounding economic growth to pull the country out of deficit (forecast to be in 2014/15 - just). The earthquakes complicate prediction here. Some commentators believe Treasury has significantly underestimated growth and no doubt a positive surprise would be a boost. But there are risks and many of these are on the downside – the global economy is not yet firing on all cylinders, Australia's two-speed economy is becoming more apparent, and business investment in New Zealand is still anaemic and will remain so until consumer demand recovers.

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More positively the Government has mainly held its nerve on infrastructure spending. While there are many views on the suitability and priorities of some of the spending there is no argument that overdue investments must be made and that productivity gains for business will follow. A commitment to partial asset sales is also encouraging. Forget the ideological battles here. Sales are a pragmatic way of improving the Government's balance sheet, driving better performance, and relieving the taxpayer of the risks of business ownership. They are also critical to re-energising our capital markets and providing an investment destination for the growing private savings pool. Getting them away in the timeframe envisaged is not a simple matter.

However, the state of the balance sheet and unwillingness to tackle entitlements in more a material way has meant that the Budget has not materially addressed two key areas – savings and investment and welfare reform. Working Groups have reported out on both these and both have received little attention. These remain a work in progress and something to perhaps look forward to in 2012. A wish list for business here could include lower taxes on investment income, reintroduction of youth rates and improved incentives to train and work. Our youth unemployment rates are a disgrace. It was baffling to see that we need to spend (another) $55m in schemes to get young people into work while we merrily abolished youth rates and raised the minimum wage. The latter two are beguiling arguments (at least to those who have jobs) that have adverse consequences for our youth and yet we continue to support them.

Two these two arguably research, development and innovation could be added. There is little here that might help arrest the decline in New Zealand's competitiveness most recently observed by IMD's World Competitiveness Centre. We are now 21st on a ladder where we used to be in the top three.

Overall Bill English has produced a steady-as-she-goes budget. It is sufficiently austere to deal with the fiscal position we are in and will keep the rating agencies at bay - so long as economic growth returns. We will never know if this budget would have been more reforming in nature. That debate now shifts to the up-coming election.

Overall Bill English has produced a steady-as-she-goes Budget. It is sufficiently austere to deal with the fiscal position we are in and will keep the rating agencies at bay – so long as economic growth returns.

Budget at a glance

Budget 2011 has disaster recovery, savings and investment, and managing the fiscal deficit as its key themes.

Here are the highlights for business:

Savings and investment

As has been signalled, Budget 2011 contained some material policy changes designed to encourage savings and investment:

- Substantive changes to Kiwisaver including the tax free employer contributions, the Government subsidy and the level of compulsory contributions
- The partial privatisation of certain SOEs as a home for those investment dollars
- Two new savings products being an Inflation Indexed bond and an Earthquake Kiwi Bond
- The establishment of a new local government funding agency to provide cheaper funding for local body projects and more liquid assets for investors.

KiwiSaver

- For the year ended 30 June 2012 a halving of the Member Tax Credit
- Removing the tax free status of employer contributions from 1 April 2012.
- From 1 April 2013 the minimum employee and employer contribution rate will rise from 2% to 3%

Earthquake recovery

The Budget also contained further earthquake recovery measures, including:

- $5.5 billion over six years to the new Canterbury Earthquake Recovery Fund.
- $25.5million to the new Canterbury Earthquake Recovery Authority.
- $10m to support Cantabrians rebuilding their lives

Infrastructure

- Treasury is to undertake preliminary work to prepare to extend the mixed ownership model to Mighty River Power, Meridian, Genesis and Solid Energy. Shares would be offered via initial public offerings.
- The Government's majority stake in Air New Zealand will be reduced.
- Any divestments will be undertaken as part of a three to five year programme starting in 2012 – assuming the Government is re-elected in November.
- No decisions have been taken on precisely how much of each company will be sold, or when – other than the Government will retain a majority shareholding.
- These changes are expected to free up $5 to $7 billion of capital.
- Broadband, rail and schools are top priorities for about $1.6 billion of further infrastructure spending, including $500 million reprioritised from other areas.

Fiscal outlook

The government announced a fiscal deficit of $16.7 billion for 2011 – the largest deficit in New Zealand's history.

The fiscal outlook remains negative, with deficits forecast for the next 3 years.

However, the deficit forecast has improved from Budget 2010 with the operating balance forecast to return to surplus in 2015, as opposed to 2016 as was forecast in 2010. This is 3 years after Australia is proposed to return to surplus.

Importantly however the last big deficit is anticipated to be in 2013, one year later than the Australian equivalent.

Budget 2011 frees up $5.2 billion until 2015 to invest in improving frontline public services and reducing debt.

Savings and investments
Initiatives aimed at getting Kiwis saving

The Government had been signalling for some time that a major theme of the Budget would be savings and investment reform.

This followed the establishment of the Savings Working Group last year and the release of the Working Group's report earlier this year.

So what are the key announcements and did they live up to Budget 2011 being about savings and investment?

Budget announcement

The Government announced that it intends to consider the ideas of the Savings Working Group and won't be rushed into making decisions on these measures but in the meantime, Budget 2011 introduces the following initiatives:

- Changes to KiwiSaver (see page 9 for further details)
- Extending the mixed ownership model to four state-owned energy companies and reducing the Governments stake in Air New Zealand (actual decisions on how much and when are still to be made)
- Creating an earthquake "Kiwi Bond" to generate funds to meet the cost of earthquake rebuilding
- Issuing a new inflation-indexed bond

Deloitte comment

Fostering saving in New Zealand's productive assets is critical. The KiwiSaver changes start to move the burden of that saving to employees and employers as opposed to the Government. The potential partial privatisation of state assets provides a home for those investment dollars as part of a cultural step-change to what we invest in.

The lack of any clear signalling on what, if any, Savings Working Group reforms are to see the light of day is disappointing, but perhaps not that surprising given the other priorities facing the Government leading up to Budget 2011.

A related area warranting leadership and policy reform are the introduction of tax rules that facilitate, as opposed to discourage, direct investors to invest alongside the New Zealand public in New Zealand assets – the NZ Inc story. Again, a multitude of micro tax issues discourage that from occurring.

There is a lot of work still to be done in this space!

Savings Working Group – tax recommendations.... and results

The Savings Working Group made nearly 50 recommendations to the Government back in January, very few of which have been acted on with the justification that the Government can't be rushed in making decisions on complex issues.

Eleven of those recommendations involved tax reform – let's see what has happened to them.
(table overleaf)

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Recommendation / comment	Government response	Comment
Interest income and expenses should be indexed.	No specific announcement.	A definitive decision not to proceed with this complex initiative would have been welcomed. A more targeted approach is to aim for lower tax rates over time.
Portfolio investment entity (PIE) tax rates should be reduced.	No specific announcement.	The fiscal position makes a lack of movement here unsurprising.
PIE tax rates should be applied to interest and dividends subject to resident withholding tax (RWT).	No specific announcement.	The fiscal position makes a lack of movement here unsurprising.
Interest deductions related to PIE and RWT income should be reduced consistent with the above lower tax rates on income.	No specific announcement.	The fiscal position makes a lack of movement here unsurprising.
Imputation credits should be refundable to the extent that an investor's RWT rate is below 28%.	No specific announcement.	The lack of action on this recommendation is hardly surprising given it would have a fiscal cost. Many impacted taxpayers can effectively access refunds if they have income from other sources as other forms of tax are refundable.
Supports a continuing switch from income tax to consumption tax, and consideration of an increase in GST from 15% to 17.5%.	Announced that the government would not be considering a further increase in GST.	While economic theory suggests that taxing consumption is less damaging to growth, politically the government could not have increased GST for the second time in 12 months.
A further reduction in the safe harbour ratio for thin capitalisation should be considered.	No specific announcement. – other than to change the rules as they apply to the banking sector	Given the last changes to the thin capitalisation rules are only just kicking in, it is premature to take any further action in this space at this stage. If anything, we'd like to see a wider review of who thin capitalisation applies to and what it applies to rather than any further mivements in the thresholds.
The tax base should continue to be broadened and tax rates kept low.	No specific announcement.	In the current economic climate further tax rate reductions are current off the table.
Does not recommend implementing a full Nordic/Dual approach to taxation.	No specific announcement.	The SWG decision not to recommend this reform was the right one – a dual income tax system would have taxed labour at high rates.
Supports mutual recognition of imputation/ franking credits between Australia and New Zealand.	No specific announcement.	As Australia does not seem to want to progress with mutual recognition the government should look at other unilateral reforms to address issues from a NZ perspective.
Notes investor frustration in relation to the regime (fair dividend rate or FDR) that applies to the taxation of non-Australian-listed off-shore portfolio holdings.	No specific announcement.	The FDR regime effectively taxes fictional (or deemed) income, and can therefore lead to perverse outcomes – a review of FDR should be undertaken to see how the regime has been working for Kiwi investors.

KiwiSaver
The changes keep coming

The Government was very careful, in the lead up to the Budget, to ensure that the electorate was softened up for yet another round of changes to KiwiSaver.

Budget announcement

- From 1 April 2012 the tax free status of employer contributions will be removed. All employer contributions will now be subject to Employer Superannuation Contribution Tax (ESCT) at the employee's marginal tax rate
- The Member Tax Credit (previously up to $1,040 per annum) will be halved from $1 to 50c for every $1 contributed by members, up to $521 per annum
- From 1 April 2013 the minimum employee and employer contributions will rise from 2 percent to 3 percent
- In addition, after the Budget the Government is to assess whether there should be a one-off enrolment exercise with employers
- Budget Day legislation is expected to be introduced to give effect to these changes

Deloitte comment

KiwiSaver, like its older relative, National Superannuation, is at risk of becoming the political football that sees changes every election year Budget. There are clear danger signs that the continual tinkering of KiwiSaver will make it more and more confusing and therefore less and less used. As illustrated below, there will soon effectively have been five different versions of KiwiSaver since the scheme was originally put in place.

However we all must accept reality.

Earlier this month the Prime Minister noted that KiwiSaver was "affordable in the sunshine", but signalled that with the heavy rain that we are currently experiencing, changes would need to be made to ensure KiwiSaver has a sustainable future.

The changes announced in the Budget will save the Government $2,6 billion over the next four years. Importantly for employers and employees, the changes announced today will not kick in immediately, and this will give people and businesses time to adjust. This will be particularly important for businesses which have to bear the compliance costs of yet another change to KiwiSaver.

From an economic perspective, the changes are unavoidable. Currently over $1 billion a year of what goes into KiwiSaver accounts comes from the Government, through subsidies and tax breaks. This represents nearly half of all KiwiSaver funds.

The Government's predicament is that by borrowing to fund KiwiSaver, there is no real increase in national savings – the Government's debt acquired as a result of borrowing the funds cancels out the impact of savings through KiwiSaver.

Year	Government kick start	Government tax credit	Employee contribution	Employer contribution
2006	$1000	$0	4% or 8%	Voluntary
2007	$1000	$20 p/w maximum	4% or 8%	1% moving to 4% over 4 years (compulsory)
2008	$1000	$20 p/w maximum	2%, 4%, or 8%	2% compulsory (exempt from tax)
2012*	$1000	$10 p/w maximum	2%, 4%, or 8%	2% compulsory (less tax)
2013	$1000	$10 p/w maximum	3%, 4% or 8%	3% compulsory (less tax)

*Member Tax Credit reducing from the year ended 30 June 2012 and beyond

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What's happening to Kiwisaver:
How it has changed

Exacerbating matters somewhat from a Government perspective is that about 44% of these funds are invested outside of New Zealand.

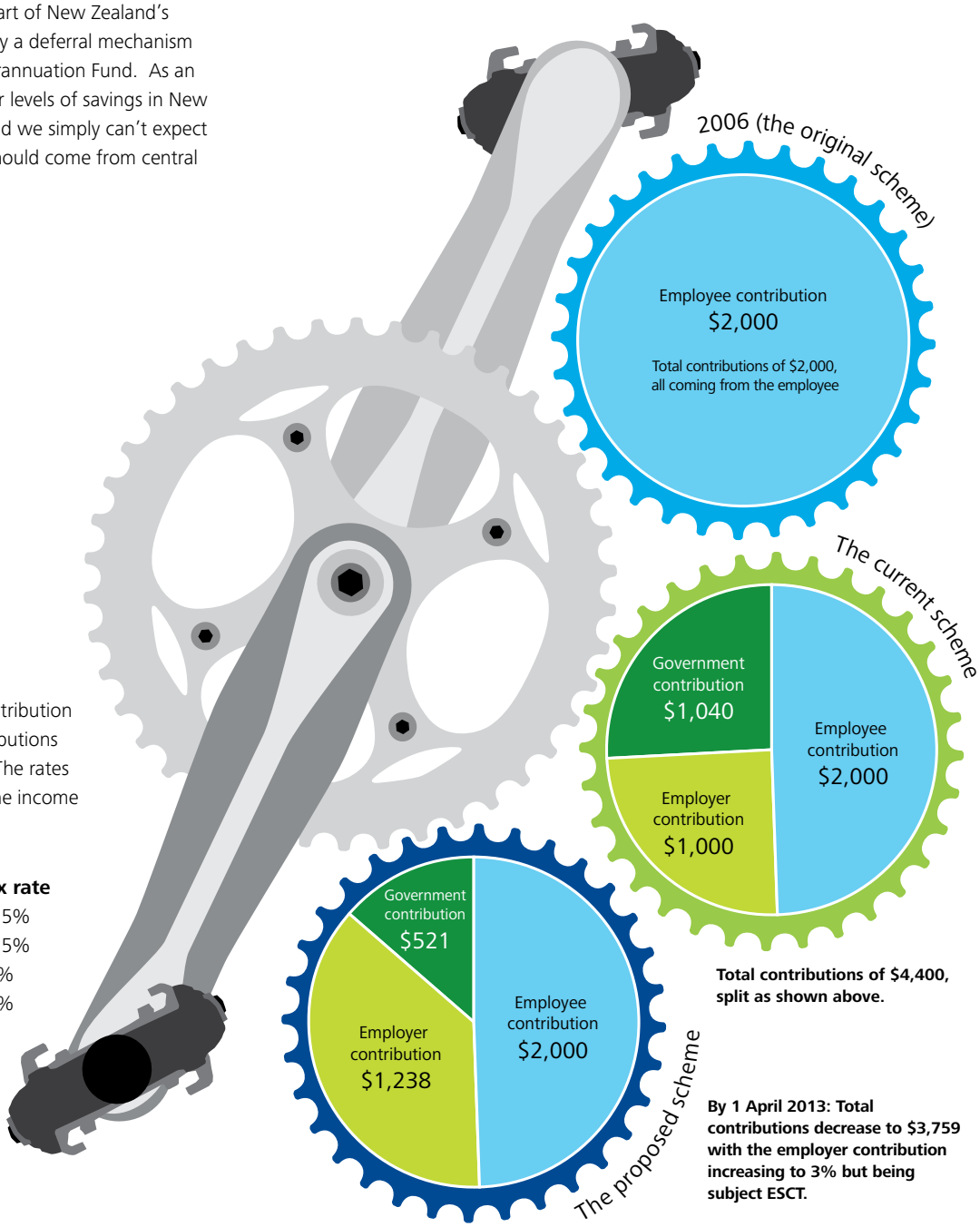
While some will react negatively to the Government reduction in contributions, it was left with little choice in the current fiscal environment. The Government simply cannot continue to be the material funder of KiwiSaver savings.

KiwiSaver was always at risk of being targeted for fiscal savings – in part due to its wild success. KiwiSaver now has 1.68 million members, and is gaining about 20,000 new members a month – far more than what was expected when the scheme was introduced.

Behind the sound bites though, KiwiSaver needs to evolve to becoming a key part of New Zealand's personal savings and not simply a deferral mechanism akin to the New Zealand Superannuation Fund. As an economy we must increase our levels of savings in New Zealand's productive sector, and we simply can't expect that the vast majority of this should come from central Government.

So long live KiwiSaver. Perhaps we might see some bold politics in the future that will see it as a compulsory part of New Zealanders lives; the Budget fine print has signalled this is moving closer to a reality with work to be undertaken on upping enrolment rates amongst employees.

The diagrams below illustrate how KiwiSaver contributions have changed over time for an employee earning $50,000 a year and contributing at 4%. We have assumed that the employer contributes no more than the compulsory amount, and they ignore the impact of the $1000 kickstart contribution from the Government. As can be seen, annual contributions will take a fall with the tax exemption going and the member tax credit halving despite an increase in the employer contribution.



What is ESCT?

Employer Superannuation Contribution Tax applies to employer contributions to superannuation schemes. The rates applying vary depending on the income of the employee as follows:

Income range $	Tax rate
0 – 16,800	10.5%
16,801 – 57,600	17.5%
57,601 – 84,000	30%
84,001 and over	33%

Infrastructure investment

State assets sales on the agenda, but only just

Last year's Budget set out a clear agenda to shift the economy from consumption towards savings and investment. This year's Budget provided the opportunity to continue this work by providing Kiwis with some new opportunities to invest in, and to some extent the Government has delivered.

Budget announcement

Treasury is to undertake preliminary work to prepare to extend the mixed ownership model to Mighty River Power, Meridian, Genesis and Solid Energy. Shares would be offered via initial public offerings

The Government's majority stake in Air New Zealand will be reduced.

Any divestments will be undertaken as part of a three to five year programme starting in 2012 – assuming the Government is re-elected in November. No decisions have been taken on precisely how much of each company will be sold, or when – other than the Government will retain a majority shareholding

These changes are expected to free up $5 to $7 billion of capital.

Broadband, rail and schools are top priorities for about $1.6 billion of further infrastructure spending, including $500 million reprioritised from other areas

Deloitte comment

These Budget 2011 announcements have provided some clarity in relation to the Government's economic priorities and its stated desire to create an environment which results a lift in the performance of the assets it owns but there is still a lot of blue sky here.

Of course, the partial privatisation of the electricity and mining SOEs had been telegraphed, to the extent that the expectation was "when, not if" they will go to the market. The more interesting questions are "why?" and "why now?"

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The first and most obvious point is to reduce the burgeoning debt that has been built up in response to the global financial crisis, not to mention that which is likely to be needed for the Christchurch earthquake recovery which is to be partly funded through a Government bond issue, ie more debt.

Secondly, privately owned companies generally perform better than Government-owned ones. They are subject to pressure from shareholders demanding market rates of return and to deliver this they need to give their customers what they want. Air New Zealand is a shining example of what can be achieved when a company part-owned by Government is subject to market disciplines.

The third point is that it provides an investment destination for the savings funds which the Government has tried hard to encourage to wean Mom and Dad investors into New Zealand's capital markets. The disappointing aspect of the budget is that "now" seems to be some time in the next three years. Our current situation demands rather more urgent and authoritative action.

The mixed ownership model proposed for Mighty River Power, Meridian, Genesis and Solid Energy deals with questions of control and is likely to be targeted at smaller investors. But the question still remains as to whether this is right for all of the companies. Why, for example, does Government want or need to own 51% or more of a coal mining company or electricity generator and can it really afford to have that amount of capital tied up in an asset which could clearly be 100% investor owned? The need for capital elsewhere is pressing and whatever is left tied up in SOEs reduces the amount available for investment in

much-needed infrastructure projects. The response to this is that unquestionably New Zealand needs to retain head office activity here.

Infrastructure investment has been used by Governments around the world to try to spend their way out of the aftermath of the global financial crisis. Much of this spending has gone into infrastructure which is an enabler of broader economic activity such as roads, where the pay-off to the country as a whole is at best indirect and often in the distant future.

The announcements for irrigation are a refreshing change from this approach. The funding announcements – $35 million over five years for the Irrigation Acceleration Fund – target investment in an area of infrastructure which is of direct benefit to a core part of our economy: the agriculture sector. The proposals target meaningful sums of money at determining the commercial viability of schemes with the aim of maximising private sector participation. There is also the promise of the Government enabling investment where a need is proven to get schemes off the ground.

Private sector participation in infrastructure and the disciplines and benefits it can bring has been a recurring theme of this Government, with PPPs identified and promoted as the primary vehicle for achieving this. The PPP label has been bandied around for a number of projects, some of which are clearly not suitable, and what is lacking is any sense of a programme of candidate projects. (Sadly the Budget once again missed the opportunity to provide this and with it the confidence needed by project sponsors to invest in the bidding processes for New Zealand projects.) Again PPPs can play a material role in deepening our capital markets.

New Zealand is well behind the play in its infrastructure development and needs to step up several gears and pedal hard to make up the ground we have lost to other developed economies over the past 10 or 20 years. The Budget has done little more than release the brakes and put our feet on the pedals. We have a long way to go and a tough ride ahead.

New Zealand is well behind the play in its infrastructure development and needs to step up several gears and pedal hard to make up the ground we have lost to other developed economies over the past 10 or 20 years.

The Nation's bank account

A hole in our pocket – but it can be mended

The Government took the opportunity to hit a home run in terms of tax reform in Budget 2010, as the world looked to slowly shake off the effects of the global financial crisis and return to a period of growth.

How the outlook can change over the course of 12 months. Not only has the economy underperformed, this has been exacerbated by New Zealand being hit by a series of emotional and economic shocks in the form of the two Christchurch earthquakes, the receivership of South Canterbury Finance, the Government's liability under the Retail Deposit Guarantee Scheme, and the bail-out of AMI Insurance.

The events of the past year have been a recipe for red ink as far as the Government accounts are concerned.

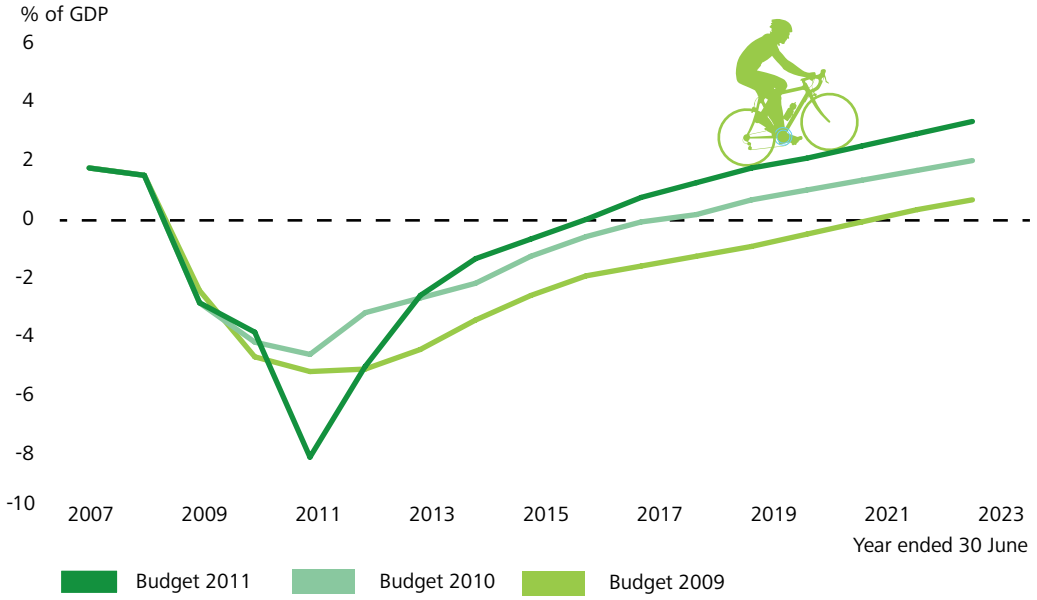
Budget 2011 announced a deficit of $16.7 billion for 2011 (8.4% of GDP), and anticipated future deficits until 2015.

On the positive side, the trend line is an improvement on the projections in 2009 and 2010, which had the operating balance in deficit until 2019 and 2016 respectively.

So despite the current circumstances, the resilience of the economy coupled with the Budget measures announced today means that the Government proposes to rein in the deficit projection by another 4 years, albeit 2 years after Australia has been able to do the same.

How has it achieved this? Simply put, the Government is putting the break on spending, delivering a zero Budget and implementing a series of reforms designed to save $5.2 billion over the next five years.

Operating balance before gains and losses



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Key areas of reform that are delivering fiscal savings include:

KiwiSaver

Savings of $2.6 billion over the next four years from reducing the Member Tax Credit and removing the tax exemption for employer contributions

Working for Families

Changing abatement thresholds at the same time family tax credits are adjusted for inflation will save $448 million over four years

Student loans

The exodus of funds through student loans will be curtailed by tightening up on who can borrow, what they can borrow for and shortening the repayment holiday for oversees based borrowers.

Other belt tightening

The Government has set a clear expectation for the state service to find $980 million in savings over three years.

While the move to curb spending may seem material, the Government's financial position and the fiscal savings it is seeking are comparatively minor when you look at some of our traditional competitors.

Australia has just announced a Government deficit of $49.4 billion (3.6% of GDP) for the 2011-11 year, and while smaller than the New Zealand position as a proportion of GDP, this is still a big number. Luckily for Australia, their deficit is forecast to reduce to $22.6 billion (1.5% of GDP) in 2011-12, driven by $22 billion in savings over the next five years, and returning to surplus in the following year.

In a worse state is the United Kingdom, which has a deficit of nearly £150 billion (just over 10% of GDP).

What really matters:

Income and expenditure

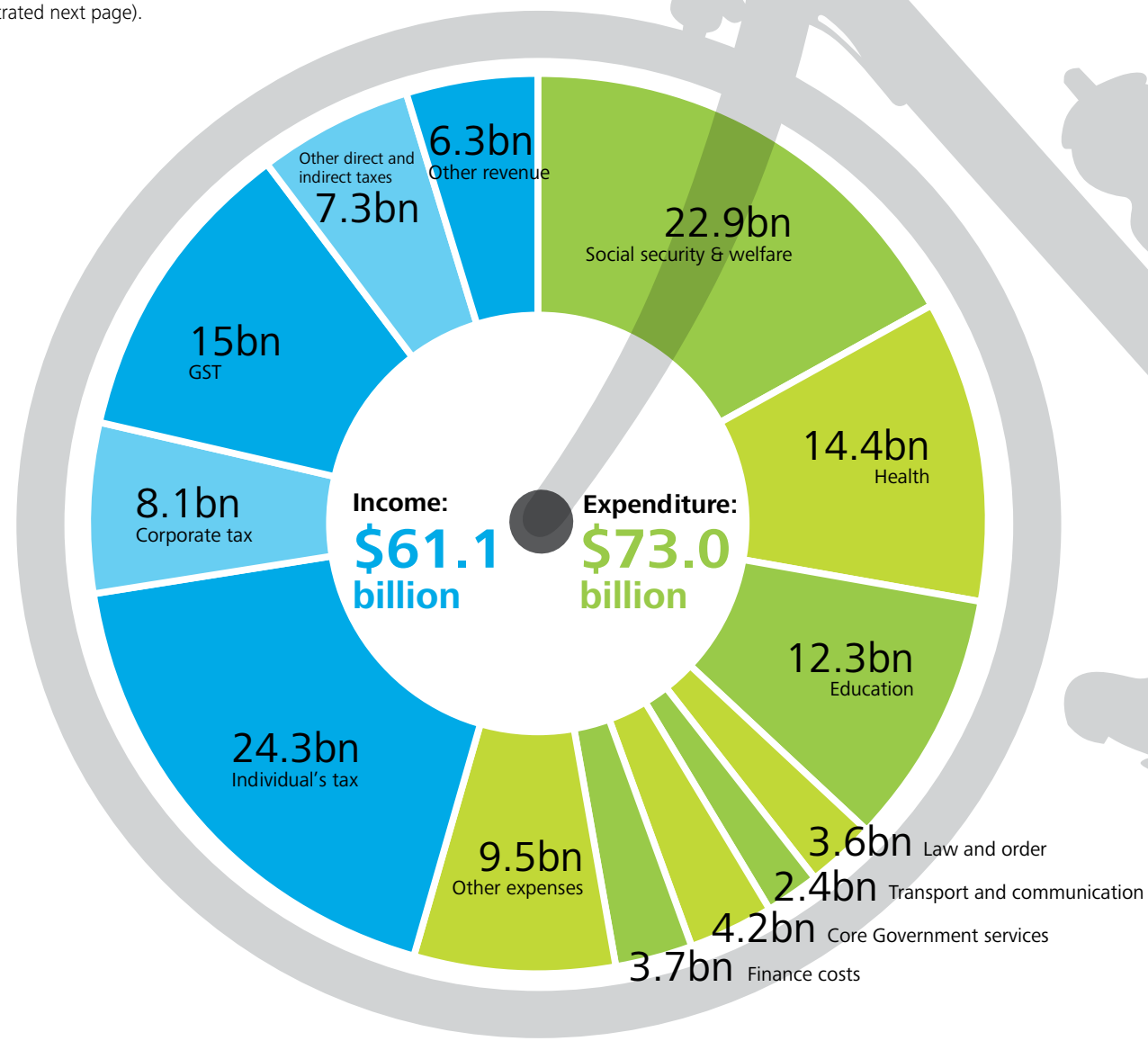
The state of Government's bank account is ultimately determined in the same manner as our personal bank account balances – the balance is a result of what we earn and what we spend.

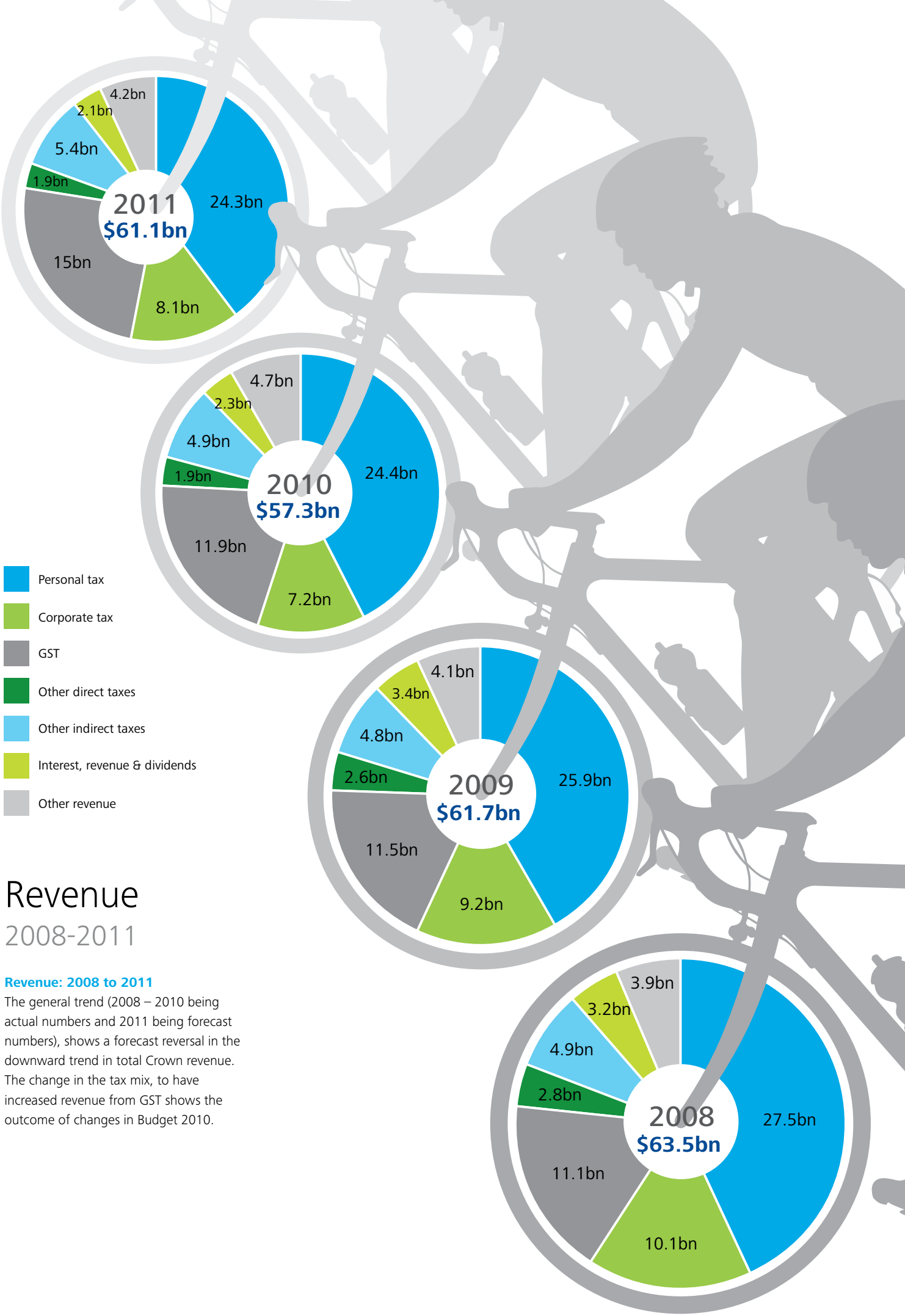
Set out below is the Government's forecast "transaction statement" for 2011/12 – where government revenue is forecast to come from, and where it is budgeted to be spent.

Despite delivering a fiscally neutral Budget in terms of new reforms, the Government is still forecasting to spend $12 billion more than the revenue it will receive in the 2011/12 year.

In order to rein back the deficit and return to surplus faster than expected (currently forecast to be 2015) the Government needs to make further cuts to expenditure, or grow revenue.

Certainly from a revenue perspective, the Government has had a hard time over the past few years, with the global financial crisis shrinking the tax revenue base (as illustrated next page).





Revenue

2008-2011

Revenue: 2008 to 2011

The general trend (2008 – 2010 being actual numbers and 2011 being forecast numbers), shows a forecast reversal in the downward trend in total Crown revenue. The change in the tax mix, to have increased revenue from GST shows the outcome of changes in Budget 2010.

Where to from here

What about the following as overt areas of additional focus in terms of the future:

- Continuing with the series of reforms that have been championed by the Prime Minister around developing a financial services hub. The "I don't need the Magna Carta of documents - just get on and do something" approach is likely to have to be rolled out a few more times to actually implement anything outside of the norm.
- A related area of reform could be around encouraging head office/regional head office activity to either come here or stay here, and reforms to attract and retain high net wealth individuals to base their operations here. From a tax perspective at least, there are a plethora of micro-measures that could be undertaken which would collectively provide a step in the right direction in the pursuit of these goals.
- A further related area warranting leadership and policy reform is around tax rules that facilitate, as opposed to discourage, direct investors investing alongside the New Zealand public in New Zealand assets – the NZ Inc story. Again, a multitude of micro tax issues currently discourage that from occurring.
- Tapping into more of our mineral wealth also seems inevitable. Clearly this is a sensitive political issue, but it's hard to ignore the economic potential that could be reaped in this area; just look across the Tasman for the evidence. Unfortunately, unlike our neighbour, the environmental implications are more severe in New Zealand, but it's about striking a balance between the pros and cons. Recent experience with oil exploration on the East Coast suggests that the Government is willing to move in this space.
- Finally, fostering savings and investment in New Zealand's productive assets is critical. The KiwiSaver changes move the burden of that saving to employees and employers as opposed to the Government. The potential partial privatisation of state assets provides a home for KiwiSaver investment dollars as part of a cultural step-change to what we invest in.

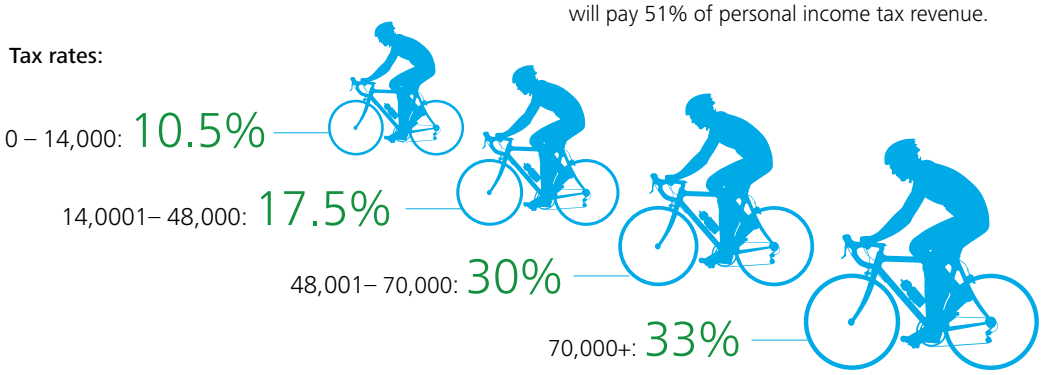
The Budget and you
How your money is raised and spent

Following the comprehensive tax reform package included in Budget 2010, it comes as no surprise that general tax reforms are few and far between in Budget 2011.

As expected, no further tax reductions are on the table. Personal income tax rates are likely to sit where they are for the foreseeable future:

Budget 2011 shows the beginnings of a slight adjustment to these statistics, seemingly driven by the reduction in the top personal income tax rate. The trend line is still concerning in that a small proportion of the population still pay a disproportate amount of the personal income tax; for the year ended March 2012 it is expected that 13% of the population will pay 51% of personal income tax revenue.

Tax rates:



One of the most signifcant changes in Budget 2010 was a reduction in the top personal income tax rate from 38% to 33% which now kicks in from every dollar of income earned over $70,000.

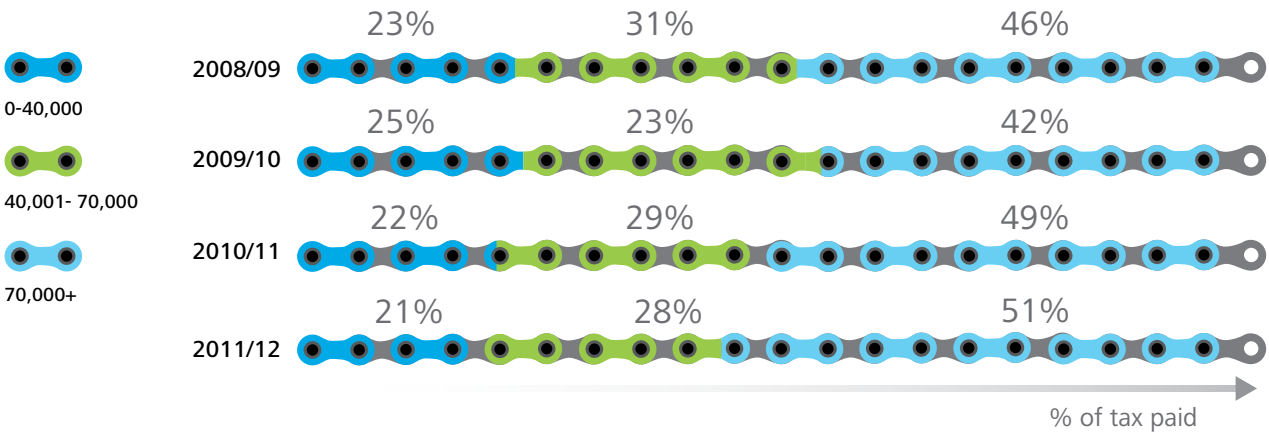
In Budget 2010 12% of the population earned over $70,000 and paid tax at the then top tax rate of 38%. This 12% of the population paid 49% of personal income tax revenue – a significant number when you consider that personal income tax in 2010 comprised $23.5 billion (43.6%) of all tax revenues. While this proportion of the population isn't quite so low that those taxpayers should be included on the "endangered species list", certainly those in that bracket are doing more than their fair share of heavy lifting.

These statistics highlight the critical nature of growing the number of highly paid jobs in New Zealand through the type of measures required to attract and retain corporate activity, and attract high net wealth individuals to be based here.

The diagram below illustrates the amount of tax paid by taxpayers within three different salary bands:

- earning up to $40,000 - 66% of the population
- earning between $40,000 and $70,000 - 21% of the population
- earning over $70,000 - 13% of the population

Proportion of personal tax paid by different salary bands



Where does your money go?

Low, medium and high income earners

In terms of total Government revenue, the 2011/12 forecast is for $61.1 billion. The large majority of this ($47.4 billion) will come from GST, corporate tax and individual income tax.

As is to be expected given the 2010 tax reforms, the tax mix is forecast to change slightly from previous years, with GST making up 24.5% of the total revenue forecast, and individual income tax making up 39.8%.

The change in tax mix is best illustrated by casting our eyes back to 2008, when in percentage terms GST and personal tax made up 18% and 43% of government revenue respectively – a subtle but significant difference from today.

Again, individual taxpayers are forecast to pay $24.3 billion in personal income tax to the government in 2011/12.

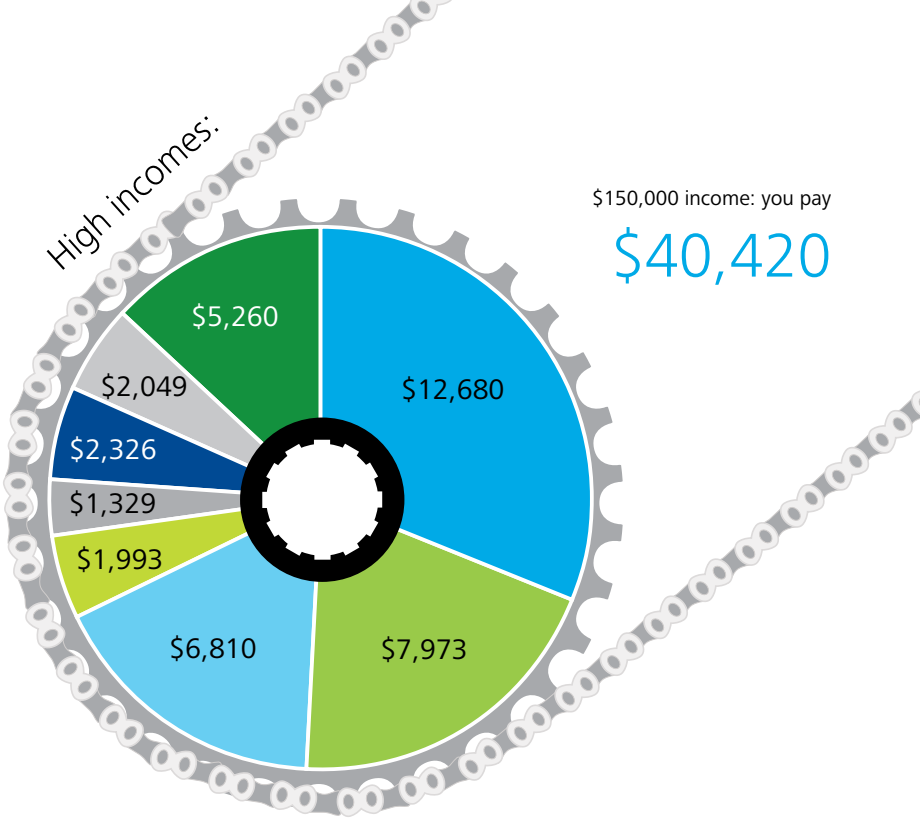
So how is that money spent when considered on an individual-by-individual basis?

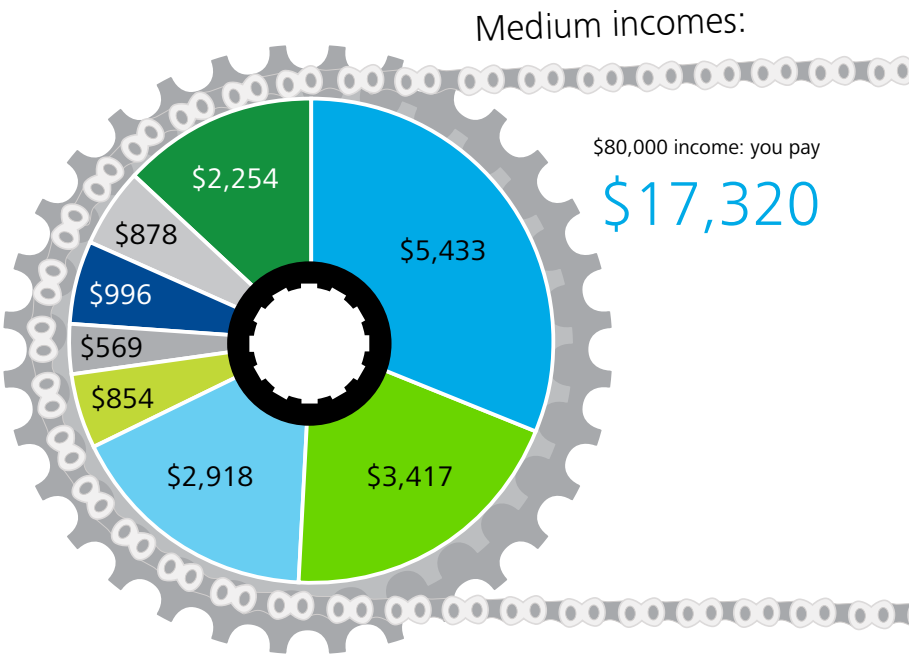
Consider three taxpayers, earning $30,000, $80,000 and $150,000 respectively. Under current tax rates the personal tax they pay will be as follows (ignoring any tax credits such as Working for Families):

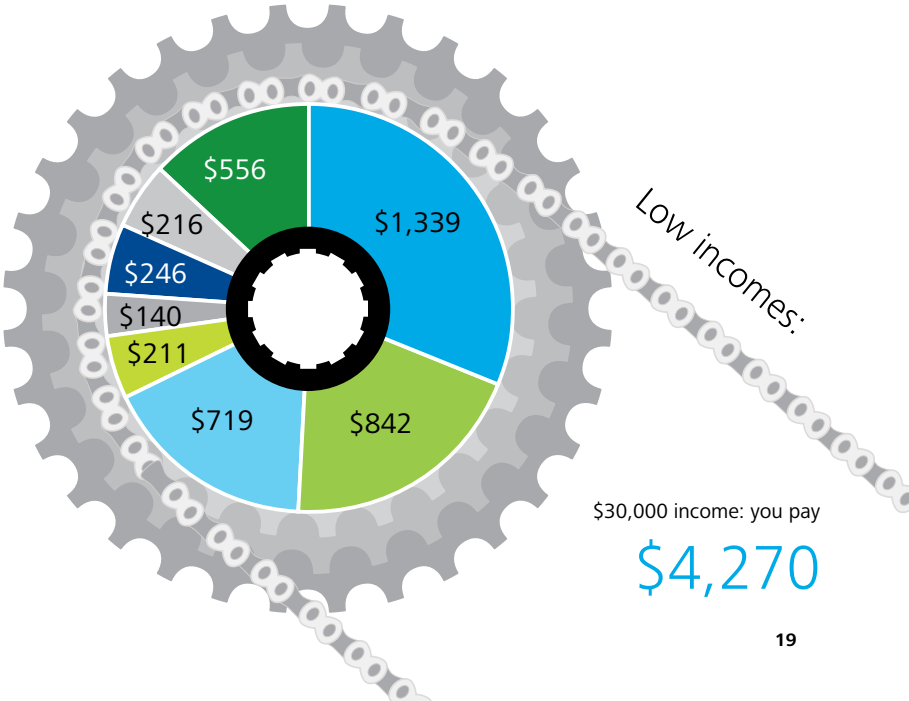
- A taxpayer earning $30,000 will pay $4,270 in tax
- A taxpayer earning $80,000 will pay $17,320 in tax
- A taxpayer earning $150,000 will pay $40,420 in tax

How the Government plans to spend these tax dollars is illustrated below using the breakdown of overall Government expenditure.

So, do taxpayers feel that they are getting value for money?







Where does your money go

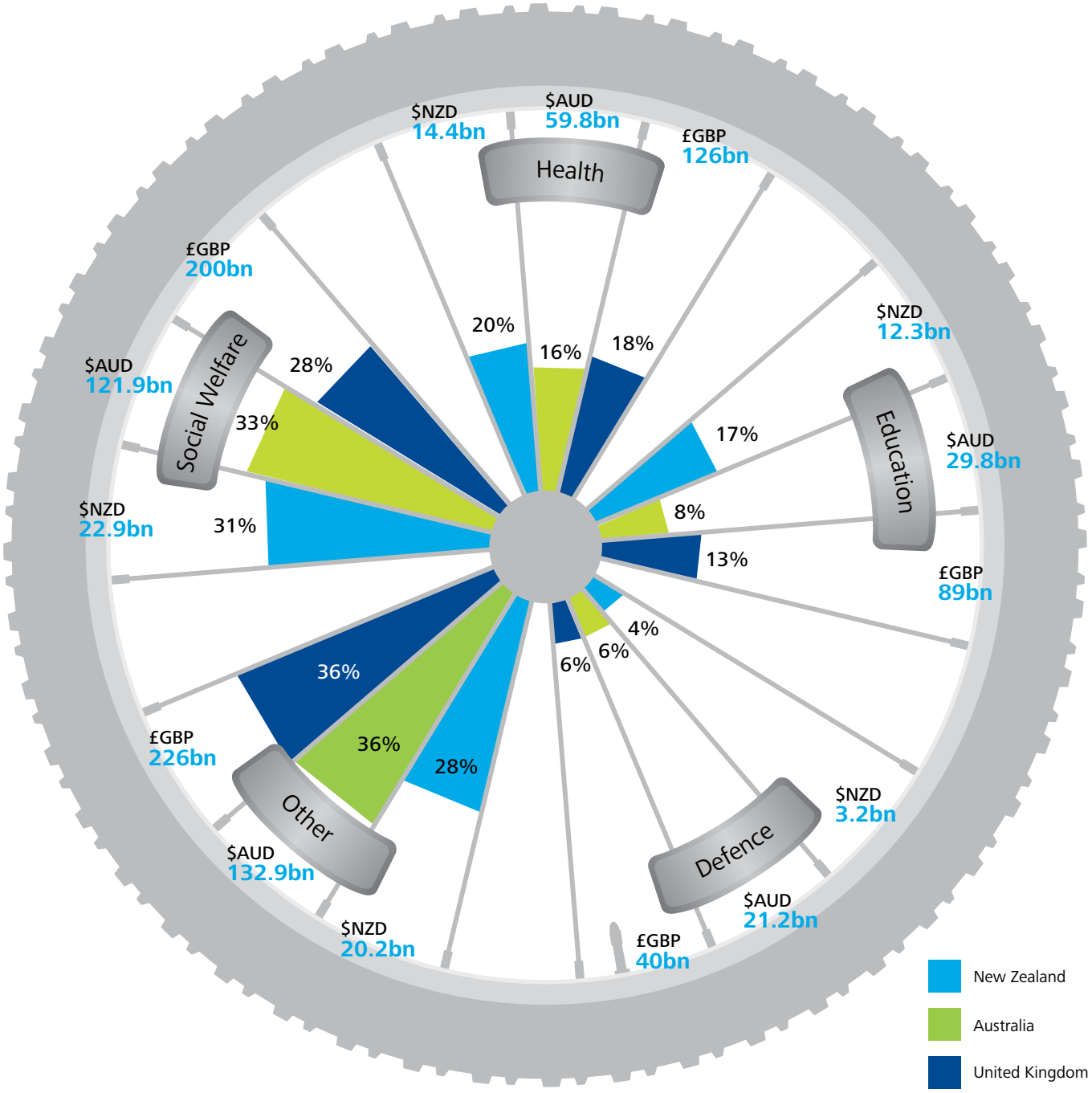
compared to Australia and the UK?

So how does New Zealand allocate its expenditure compared to our competitors?

What is the difference in how one dollar of tax revenue is spent depending if you are in the UK, Australia or New Zealand?

The diagrams below compare New Zealand's spending priorities in health, education, welfare, defence, and other areas with those of the Australia and the UK – perhaps not surprisingly there are some similarities, but also some interesting areas of distinction. Some particular points of note include:

- Australia spends more on social welfare (as a proportion of GDP) than New Zealand.
- New Zealand and the United Kingdom spend 2-4% more on health than Australia.
- As a percentage of GDP, New Zealand spends significantly more on education than Australia and the United Kingdom – particularly Australia.
- The United Kingdom will spend a massive £40 billion on defence in 2011/12 (approximately NZ$80 billion) – more than the New Zealand Government's entire expenditure and over 25 times more than New Zealand's defence spending in dollar to dollar terms.



Earthquake response

Country remains on shaky ground but stability on the horizon

In the months following the devasting Christchurch earthquakes, the focus has turned towards the infrastructral and economic challenges facing Christchurch. However, while the economic impact of the earthquakes have been severe for the city, it has also had a material impact on the Government's accounts – this is plain for all to see in the Budget.

While the decision not to proceed with some form of earthquake levy is sure to be criticised by some political parties, the cost is a national one to be shared across the whole economy not just those individuals earning over a certain amount.

From a tax perspective, the Government had already announced a number of reforms designed to lighten the burden on earthquake-impacted individuals and businesses, including:

- Tax exemptions for welfare contributions by employers to Christchurch employees
- Tax relief for donating trading stock
- Extensions of time for tax compliance obligations
- Specific changes to the aspects of the depreciation rules

However Budget 2011 contained some further reforms to help with the earthquake recovery.

Budget announcement

Budget 2011 delivers $5.5 billion over six years for the Governments new Canterbury Earthquake Recovery Fund. Of this $4.8 billion comes from new funding while the balance comes from reprioritising spending in other areas. The CERF will fund:

- Repairing essential infrastructure
- Repairing state owned assets
- Welfare support
- Financial support package for AMI insurance

Combined with the costs of the Earthquake Commission and ACC costs, the Government's total investment in rebuilding Canterbury is estimated at $8.8 billion

The Government has also today launched a new Earthquake Kiwi Bond to help fund the recovery. Kiwi investors will be able to invest in the four-year bond with an initial 4 per cent interest rate from today.

Deloitte comment

The commitment of the Government of substantial funds to the recovery in Canterbury continues to be welcomed by all those in the region.

In terms of the tax-specific reforms, the Government has sought to strike a balance between providing much-needed relief from the strict tax rules, around, for example, ex-gratia payments to employees and the donation of trading stock, and ensuring that the integrity of the tax system is not undermined in the process.

The Government's response in providing tax relief has also been consistent with the response of other jurisdictions to their own natural disasters – other than the use of a levy.

For example, only a short time before the February earthquake Queensland was suffering from its own natural disaster in the form of severe flooding. The Australian Government announced a series of measures that effectively allowed employers to provide assistance to employees affected by the natural disasters without incurring additional tax.

The Japanese Government is also progressing reforms to ease tax burdens on those affected by the devastating March 11 earthquake and tsunami, which caused unprecedented property damage in northeastern Japan.

In taking the same path as Australia and Japan, the New Zealand Government has not veered far from the norm in these situations. It is still a work in progress as to whether more needs to be done as the rebuild starts to get more traction.

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Public Sector
More of the same for less "a wasted opportunity"

Budget announcements

The Government expects that wider state service to find $980 million in savings over three years to go towards improving frontline public services and reducing debt

Savings are to be found from 1 July 2012, including finding $650 million to fund state sector agencies contributions to KiwiSaver

New budget funding of $27.6 million has been provided over the next two years for igovt services to help public services be delivered more efficiently

Statistics New Zealand receives $58 million in new operating funding over four years to ensure the ongoing supply of important economic and social data

Deloitte comment

Cuts to public sector budgets have been far from radical in Budget 2011, and while they may squeeze out some savings they won't materially improve the value that citizens or businesses get from Government services.

In general, the focus over the past two years has been on saving money through reducing services and increasing back office efficiency.

Reducing services may force spending to be better prioritised, but choosing services to cut is inevitably a political issue. In general this does nothing to deliver core services better.

Increasing back office efficiency has focused on collective procurement, shared services and mergers. While these can produce savings, they are more likely to result in higher quality back office functions for the same overall cost. That assumes the initiatives are implemented successfully, which is certainly not guaranteed when funding is scarce.

If the public sector is really going to save money sustainably and improve the quality of services, the front office must be tackled with a genuine commitment to doing things differently.

An attitude of simply doing more with less leads to standardisation, centralisation and automation of existing processes – this is easier than rethinking the way services are delivered.

This approach will entrench processes that are not currently delivering good results. Even worse, it will reduce the accessibility and quality of services for citizens with the greatest need, who generally require flexible, face-to-face attention.

It also reduces the ability to redesign future services, as capacity and capability within agencies is absorbed in day-to-day operations. The reduced cost baseline will make genuine improvement initiatives harder to justify, due to lower savings on offer.

Despite one or two promising initiatives, including increased funding for igovt services, the funding signals being sent to public sector agencies are not forcing them to rethink service delivery. The Government may claim some immediate savings, but this won't deliver us better value for money.

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Snippets
What else did the Budget hold for business?

Negative Neutral Positive

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

Other Budget Announcements		
Banking thin capitalisation	Neutral	Foreign owned banks will faced increased tax bills as the minimum required equity for tax purposes is increased to keep pace with the enhanced levels of capital reported in a post-GFC world. The changes will see the minimum tax required capital threshold for banks increase from 4% of risk weighted exposures to 6% of risk weighted exposures, with the increased capital requirements taking effect from 1 April 2012. The fiscal impact of this is forecast as $31m per annum. While the change can be justified in light of the increased capital being reported by banks, it's a fine balance between tax reflecting the existing minimum capital reality and imposing an additional capital cost to doing business in New Zealand. At 6% that balance looks to have been struck.
Savings Working Group recommendations	Positive	Still WIP with the Government signalling a continued work on considering these issues including considering creating broadly diversified, share market listed passive debt and equity vehicles.
Mixed use assets	Positive	The Government is looking to review the tax treatment of mixed use assets (examples given are yachts and holiday homes – expect aircraft to also make the cut) used for private and business purposes. Consultation on this matter will be undertaken later this year.
Employee definitions of income for working for families	Neutral	Proposed to be widened to also include more fringe benefits. Consultation on this matter will be undertaken later this year.
Livestock valuation elections	Positive	The Government is looking to address concerns around flip flopping as between the herd and national standard cost scheme. Consultation on this matter will be undertaken later this year.
Additional IR audit activity	Neutral	No new funding but the historic funding is paying material dividends – more of the same focus anticipated.
R&D	Positive	No R&D tax credit regime. An additional $36m over four years targeted to business R&D and commercialisation, and earthquake research. The funding is not being new but a reprioritisation from within Vote Science and Innovation.
IR focus in 2011	Neutral	In 2011the Inland Revenue spent $3m more than anticipated managing debt and outstanding returns, nearly $4m less informing the public about tax matters and $7.4m less on audit activity.

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