THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Financial Statements of the Government of New Zealand for the Seven Months Ended 31 January 2008

Date:	28 February 2008	**Report No:**	T2008/287

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	**Note** the contents of this report and **sign** and **return** the attached Gazette Notice to Treasury.	Thursday, 6 March 2008
Associate Minister of Finance (Hon Phil Goff)	**Note**	None
Associate Minister of Finance (Hon Trevor Mallard)	**Note**	None
Associate Minister of Finance (Hon Clayton Cosgrove)	**Note**	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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David Galt	Manager, Macroeconomic and Tax Forecasting	917 6023 (wk)	934 4422 (res)	
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Minister of Finance's Office Actions (if required)

None

Enclosure: **No**

Treasury Report: Financial Statements of the Government of New Zealand for the Seven Months Ended 31 January 2008

Executive Summary

The Financial Statements of the Government of New Zealand for the seven months ended 31 January 2008 are due for public release on 6 March 2008.

The key issue for the January outturn is that the operating balance was in deficit by $0.4 billion, or $4.2 billion lower than forecast. The three main contributors to this lower than expected outturn were:

- Mark-to-market losses of $2.5 billion recorded by the NZS Fund ($1.5 billion), ACC ($0.7 billion) and EQC ($0.3 billion);
- The revaluation of the ACC claims liability ($1 billion); and
- Lower than forecast tax revenue ($0.7 billion).

The mark-to-market losses and revaluation of the ACC claims liability were highlighted in the November and December outturns and, to that extent, the January outturn was expected.

The first part of this report explains the lower than forecast tax revenue. The second part of this report shows how the January outturn will be published in the Financial Statements.

Tax revenue

Core Crown tax revenue to January was below forecast by $746 million (–2.3%). Core Crown tax receipts were, however, just $164 million (–0.5%) below forecast.

The largest tax revenue variances were in other individuals tax (–$415 million), corporate tax (–$215 million), GST (–$152 million) and source deductions (+$79 million). Table 1 outlines the principal causes of these variances.

Table 1 – Key factors in tax revenue variances

	$millions
Unallocated	–520
[redacted]	–[redacted]
Portfolio Investment Entity (PIE) regime	–170
Terminal tax	–160
Provisional tax	–200
GST	–150
[redacted]	+[redacted]
Other taxes (PAYE etc)	+100
Total tax revenue variance	–750

Explanations

There is considerable uncertainty around most of the numbers in Table 1, so they should all be considered as indicative rather than definitive.

- ***Unallocated, –$520 million***

This is the largest negative variance in Table 1. This figure demonstrates that tax revenue numbers and, in particular, income tax revenue numbers, can fluctuate greatly from one month to the next without an immediately obvious cause.

To a large extent, income tax revenue outturns rely on taxpayers own estimates of their income tax liability. Inland Revenue relies on receiving those estimates from the taxpayers to be able to produce a tax revenue outturn. For various reasons, these estimates can arrive at Inland Revenue at any time and the same taxpayers do not always file their assessments at the same time every year. This leads to volatility in the tax revenue outturns.

Included in the $520 million of ‘unallocated’ is about $300 million of tax revenue that would normally have been recognised in respect of certain taxpayers by this time of the year, but this year the assessments have yet to be filed. There is considerable uncertainty around when these assessments might be filed and how much they will contribute to tax revenue.

The remainder of the $520 million is likely to be a mixture of the other reasons mentioned in Table 1, i.e. some of it will be genuinely lower-than-forecast income tax assessments, but some will also be revenue temporarily lost to PIEs and/or tax pooling that will be recovered later in the current fiscal year.

- ***Increase in tax pooling, [redacted]***

To reduce their use-of-money interest exposure, taxpayers may pay their tax to Inland Revenue through a third party, i.e. a tax pool. When a taxpayer pays tax into a tax pool but does not lodge an assessment with Inland Revenue, no tax revenue is booked for that taxpayer. The increase in deposits into the tax pool has contributed about [redacted] to the tax revenue variance as at January. This variance will reverse once the assessments are lodged with Inland Revenue, and can therefore be recognised as revenue, later in the current fiscal year.

- ***PIE regime, –$170 million***

Most PIEs are opting to be annual taxpayers rather than quarterly or provisional taxpayers. Many companies that we know have converted to PIEs had already lodged an income tax assessment by this time last year, but have not done so this year. This means that their income tax revenue will be recognised later in the fiscal year than was previously expected.

The $170 million includes only those entities that we know have converted to PIEs. There are also a large number of investment entities that have not filed income tax assessments with Inland Revenue this year that may have converted to PIEs, but we do not know the extent to which this may be occurring at this stage, as we do not have any reliable information on them. This means that some of the –$520 million of 'unallocated' may also be attributable to the PIE regime and may be recovered in tax revenue later in the fiscal year.

- ***Terminal tax, –$160 million***

Net income tax assessments for the 2007 tax year (and earlier) that have been lodged since June 2007 are about $160 million below what we expected.

- ***Provisional tax, –$200 million***

Provisional, i.e. current-year, assessments of income tax, where a taxpayer has lodged an income tax assessment both this year and last year, are about $200 million below what we expected.

We are restricted in the amount of detail we can supply on these taxpayers. Neither do we have definitive economic data for January. However, the following point to reasons for some businesses to re-estimate their provisional tax downward:

- Retail activity in the December quarter was weak. Excluding automotive sales, seasonally-adjusted sales volumes were unchanged. January data for electronic cards show that the value of transactions, excluding automotive, fell 0.6% from December to January. These factors also point to weaker GST;

- REINZ sales numbers fell 0.2% in January and the median price fell 1.4% in the month;

- Sheep and beef farm profits are falling, despite overseas prices rising. The Meat and Wool New Zealand Economic Service suggested in February that average sheep and beef farm profits would be $21,400, compared with $23,400 in July 2007 estimates;

- Dry conditions throughout much of the country were becoming apparent in January;
  Bank funding costs have risen sharply (since the 2007 Half-Year Update); and

- The February NBNZ Business Outlook showed a sharp fall in repondents' outlook for their own businesses to only a net 2.4% expecting an improvement, compared to 18.2% in the December Outlook.

- ***GST, –$150 million***

The housing downturn is likely to be a factor in weak retail sales, and this will be having a negative effect on GST.

■■■

- ***Other taxes, +$100 million***

PAYE was $100 million (0.6%) above forecast owing to continued strength in the labour market.

- ***Tax revenue vs tax receipts***

Usually, as the fiscal year progresses, tax revenue is higher than tax receipts until they come back to more-or-less in line with each other by year-end. This happens chiefly because terminal tax revenue accrues as the returns are filed during the year but the tax payments are not due until the following February or April.

Unusually, tax revenue for the seven months to January is lower than tax receipts. This situation should resolve itself by:

- Terminal tax payments due in February and April, and later provisional tax payments through the remainder of the year, will be lower than previously expected, bringing tax receipts down to the same level as revenue; or

- Further income tax assessments and re-assessments will be lodged with Inland Revenue, bringing tax revenue back up into line with tax receipts.

The extent to which tax receipts will come down to match tax revenue, or tax revenue will come up to match tax receipts, is far from clear at this time.

Implications

At this stage, there is insufficient information to be clear about what the likely implications are for year-end and for the next year.

We will be preparing initial economic and tax revenue forecasts by 7 March, which will be able to take account of further economic information but no further tax information beyond that available up to January.

At this point, information available does not suggest a major decline occurred in overall economic activity up to January. Increased exports in the December quarter point to quarterly GDP growth being at or slightly above the HYEFU forecast of 0.5%. We would expect an easing in our growth and tax forecasts because of drought (a temporary effect), higher interest rates to businesses and households, higher petrol prices and a modest effect from reduced international growth rates. So far there has not been a major impact on GDP from international financial conditions, although they will probably have more effect on tax revenue through their effect on the domestic financial sector.

From a medium-term perspective, which is the focus of your fiscal strategy, the size of the nominal economy at the end of the forecast period is likely to dominate any short-term softness in GDP and revenue.

The remainder of this report is essentially what will be published in the January Financial Statements.

Key January Outturns

- The operating balance was in deficit by $0.4 billion, or $4.2 billion lower than forecast. The three main contributors to this lower than expected outturn were:
    - o Mark-to-market losses of $2.5 billion recorded by the NZS Fund ($1.5 billion), ACC ($0.7 billion) and EQC ($0.3 billion);
    - o The revaluation of the ACC claims liability ($1 billion); and
    - o Lower than forecast tax revenue ($0.7 billion).
- Adjusting for the non-cash valuation changes, the OBEGAL was $0.6 billion lower than forecast at a surplus of $3.1 billion, with the lower than forecast tax revenue of

- $0.7 billion being the main contributor, offset by departmental operating expenditure being marginally behind forecast ($0.2 billion);

- The largest tax revenue variances were in other individuals tax (-$415 million), corporate tax (-$215 million), GST (-$152 million) and source deductions including deductions from salary and wages (+$79 million);

- A portion of these tax revenue variances was due to timing effects associated with tax pooling and the PIE regime, and tax revenues from month to month can be inherently variable. Tax receipts were only $0.2 billion lower than forecast. A clearer picture of the likely impact of this month's outturn on the full year position will be developed for the Economic and Fiscal Update incorporated in Budget 2008; and

- Residual cash and consequently the debt indicators were largely on target.

Table 2 – Key Fiscal Indicators

	Year to date				**Full Year**
$ million	**January 2008 Actual**	**January 2008 Forecast**	***Variance $m***	***Variance %***	**HYEFU June 2008 Forecast**
Core Crown					
Core Crown revenue (excl. NZS Fund)[1]	**34,045**	35,143	*(1,098)*	*(3.1)*	62,130
Core Crown expenses	**32,126**	32,525	*399*	*1.2*	57,137
NZS Fund operating balance	**(911)**	539	*(1,450)*	*(269.0)*	917
Core Crown residual cash	**478**	588	*(110)*	*(18.7)*	759
GSID (excl. settlement cash)	**31,605**	31,595	*(10)*	*(0.0)*	33,303
as a percentage of GDP[2]	***18.5%***	*18.5%*			*18.7%*
Net Core Crown debt	**2,647**	2,634	*(13)*	*(0.5)*	1,983
as a percentage of GDP[2]	***1.5%***	*1.5%*			*1.1%*
Net Core Crown debt (incl. NZS Fund)	**(9,257)**	(10,708)	*(1,451)*	*13.6*	(13,102)
as a percentage of GDP[2]	***(5.4)%***	*(6.3)%*			*(7.4)%*
Total Crown					
OBEGAL	**3,057**	3,690	*(633)*	*(17.2)*	6,574
Net gains / (losses)	**(3,536)**	15	*(3,551)*		636
Operating Balance	**(394)**	3,793	*(4,187)*	*(110.4)*	7,388

1 NZS Fund revenue is the sum of its revenue (ie, interest and dividends) adjusted to add back tax revenue received by Inland Revenue from the Fund.

2 GDP for the year ended 30 September 2007 (Source: Statistics New Zealand).

Table 3 – The following table outlines the key **highlights** for the seven months ended 31 January 2008:

Item/indicator	Variance	Key drivers
Core Crown		
Core Crown revenue (excl. NZS Fund revenue)	- $1,098 million (lower than forecast)	• Core Crown tax revenue (excluding the NZS Fund) was $746 million (2.3%) lower than forecast. The largest variances were in: o other individuals tax ($415 million below forecast) o corporate tax ($215 million below forecast) o GST ($152 million below forecast), and o source deductions ($79 million above forecast). o The reasons for these variances were: o Timing effects associated with tax pooling and the PIE regime have resulted in at least [redacted] of tax revenue, that was expected to have been recognised in this period, not now being able to be recognised as revenue until later in the fiscal year. o Terminal tax assessments for the 2007 tax year were below expectations. o Provisional tax assessments for the 2008 tax year are also below expectations. o Weakening domestic demand has contributed to the shortfall in GST. o Continued strength in the labour market has contributed to the positive variance in source deductions. • Other core Crown revenue was $352 million lower than forecast. Interest revenue was lower than forecast by $293 million primarily due to timing issues with the phasing of interest earned on the Crown settlement account. The impact was offset by a related variance in interest expense.
Core Crown expenses	+ $399 million (lower than forecast)	• Interest expense was $246 million lower than forecast which was related to the lower than expected level of settlement cash. • Core Crown operating expenses were $153 million lower than forecast. The main contributors to this were: o Health expenses $52 million – mainly due to national contracted services and public health programmes lower than forecast. o KiwiSaver $10 million – largely due to fluctuations in the start dates at which kickstart payments are applicable. o MED $59 million – includes incorrect forecast timing of the Americas Cup promotion expenses (around $10 million). The rest of the variance was mainly due to timing delays across a number of appropriations. o Foreign Affairs and Trade $40 million – continued delays across the Pacific development assistance programs. o Other core Crown operating expenses were $59 million lower than the forecast across a number of departments.

		o Lower than forecast expenditure was offset by the write off of tax receivables which was $67 million higher than forecast.

Item/indicator	Variance	Key drivers
Core Crown		
NZS Fund operating balance	- $1,450 million (lower than forecast)	• The NZS Fund's operating balance was a deficit of $911 million compared to a forecast surplus of $539 million. The decline in investment returns continues to be driven by the recent slowing in United States' economic activity, and future growth uncertainty generated by the recent fall out in the sub-prime lending market. While the NZS Fund is reporting a deficit in the current financial year its annualised return since inception (September 2003) is 11.03%, compared to 6.63% for the risk-free rate of return (Treasury bills).
Core Crown residual cash	- $110 million (lower than forecast)	• Core Crown tax receipts were $164 million lower than forecast. This was made up of a number of small variances across a number of tax types. The largest of these variances was in other individuals tax, which was $88 million (4.4%) below forecast, where, although well up on last year, tax payments from the agricultural sector were below forecast. • Core Crown operating payments (excluding finance costs) were $151 million higher than forecast due to differences in the phasing of cash payments. • Core Crown capital expenditure was $171 million lower than forecast. The main contributors were: o Defence ($72 million lower than forecast) due to delays in acquisition projects; and o Education ($48 million lower than forecast) due to forecast phasing issues. At this stage it is too early to determine the impact of these capital delays on the year end outturn. • Core Crown advances and capital injections were largely on target at $34 million lower than forecast.
GSID (excluding settlement cash)	- $10 million (higher than forecast)	• GSID (excluding settlement cash) is in line with forecast.
Net core Crown debt	- $13 million (higher than forecast)	• Net core Crown debt is in line with forecast.
Net core Crown debt (incl. NZSF)	- $1,451 million (lower than forecast)	• NZS Fund financial assets were lower than forecast due to declines in investment returns.

Item/indicator	Variance	Key drivers
Total Crown		
OBEGAL	- $633 million (lower than forecast)	• Tax revenue was lower than forecast as discussed above
Operating balance	- $4,187 million (lower than forecast)	• OBEGAL was $633 million lower than forecast (as noted above). • Gains and losses were $3,554 million lower than forecast as a result of: o A $2,479 million decline in investment returns by the CFIs (NZS Fund $1,500 million, ACC $704 million and EQC $275 million) due to the recent market downturn resulting from the US economic slowdown. o An actuarial loss in the ACC claims liability of $1,020 million. This was primarily driven by changes to economic assumptions used in the valuation of the liability eg. the discount rate has decreased from 6.10% at 30 Sept to 5.86% as at 31 January and the long-term inflation rate has increased from 2.58% to 2.70%. Previously valuations took place at 31 March and 30 June, however the 31 March 08 valuation was moved forward to 31 December 07 in order to provide ACC with more timely information on emerging claims experience. This most recent valuation will not impact on levy rates at MBU, but is likely to result in changes when the annual update to levies occurs later in the year. From January onwards the ACC claims liability will be updated monthly to reflect any changes in the discount rate; and o Other gains and losses were $55 million lower than forecast.

Recommended Action

We recommend that you:

a **note** the financial results for the seven months ended 31 January 2008; and

b **sign** the attached gazette notice and **return** it to Treasury to arrange the publication in the gazette.

Hugh Packer
Manager, Fiscal Reporting
for Secretary to the Treasury

David Galt
Manager, Macroeconomic and
Tax Forecasting for Secretary to
the Treasury

Hon Dr Michael Cullen
Minister of Finance

Table 4 – Reconciliation to Core Crown Residual Cash

	Year to date			Full Year
	January 2008 Actual YTD	**January 2008 Fcast YTD**	***Variance $m***	**HYEFU June 2008 Forecast**
$ million				
Operating balance	**(394)**	3,793	*(4,187)*	7,388
Total (gains) and losses and other items	**3,451**	(103)	*3,554*	(814)
OBEGAL	**3,057**	3,690	*(633)*	6,574
Net NZS Fund after-tax revenue	**(46)**	(27)	*(19)*	(169)
Net retained surpluses of SOEs and Crown entities	**(1,082)**	(1,043)	*(39)*	(1,305)
Non-cash items and working capital movements	**1,082**	706	*376*	1,396
Net cash flows from core Crown operations	**3,011**	3,326	(315)	6,496
Contribution to NZS Fund	**(1,211)**	(1,211)	-	(2,103)
Core Crown purchases of physical assets	**(725)**	(896)	*171*	(1,773)
Core Crown advances and capital injections	**(597)**	(631)	*34*	(1,861)
Core Crown Residual Cash	**478**	588	*(110)*	759

Table 5 – The following table outlines the **core Crown tax revenue** by major tax type:

Tax type	January YTD Actual ($m)	January YTD Variance to forecast ($m)	January YTD Variance to forecast (%)	Growth from same period last year (%)
Source deductions	13,309	79	0.6	10.6
Other individuals tax	2,151	(415)	(16.2)	(4.7)
Corporate tax	5,354	(215)	(3.9)	(3.5)
Other direct taxes	1,497	(18)	(1.2)	14.7
GST	6,264	(152)	(2.4)	5.0
Customs and Excise duties	2,057	(1)	(0.0)	(0.8)
Other indirect taxes	853	(24)	(2.7)	5.3
Core Crown tax revenue	31,485	(746)	(2.3)	5.0
NZS Fund tax revenue	149	(78)	(34.5)	(60.5)
Core Crown tax revenue plus NZS Fund [i]	31,634	(824)		

Table 6 – The following table outlines the **core Crown tax receipts** by major tax type:

Tax type	January YTD Actual ($m)	January YTD Variance to forecast ($m)	January YTD Variance to forecast (%)	Growth from same period last year (%)
Source deductions	13,084	(6)	(0.0)	8.4
Other individuals tax	1,900	(88)	(4.4)	5.4
Corporate tax	5,852	(20)	(0.3)	10.5
Other direct taxes	1,500	(24)	(1.6)	13.5
GST	6,244	11	0.2	4.7
Customs and Excise duties	2,119	(37)	(1.7)	1.4
Other indirect taxes	878	-	-	8.0
Core Crown tax receipts	31,577	(164)	(0.5)	7.6
NZS Fund tax receipts	241	1	0.4	109.6
Core Crown tax receipts plus NZS Fund [i]	31,818	(163)		

i Core Crown tax plus NZS Fund represents revenue and cash available to the Crown.

GAZETTE NOTICE

PUBLIC FINANCE ACT 1989

Notice of Publication of Financial Statements of the Crown

Pursuant to section 31B of the Public Finance Act 1989 the Minister of Finance gives notice of the publication of the financial statements of the Crown for:

- The seven months ended **31 January 2008**, on 6 March 2008.

Copies of these financial statements are available:

- For inspection free of charge at the National Library of New Zealand, Auckland City Library, Wellington Public Library, and Canterbury Public Library;
- For purchase at branches of Bennetts bookshops; and
- Through the Internet (address: http://www.treasury.govt.nz).

Dated at Wellington this 6th day of March 2008.

Hon Dr Michael Cullen
Minister of Finance