3

Fiscal Outlook

Introduction

This chapter discusses the trends, influences and assumptions behind the outlook for the Crown's finances. The discussion covers:

- key components of the operating balance including tax revenue, expenses, and state-owned enterprises' and Crown entities' surpluses
- net worth and net debt, including the relation between the operating balance and net worth and net debt, and details of revisions to the 2001/02 bond programme.

Following these sections are technical tables and information including fiscal indicators, OBERAC methodology, a reconciliation of the operating balance since the 2001 Budget, the Government's operating and capital provisions, the relationship between the operating balance and net debt, the Air New Zealand recapitalisation package and the NZS Fund assumptions.

Page 70 outlines the impending change to how the Crown will prepare its fiscal forecasts and Crown financial statements through the introduction of line-by-line consolidation of SOEs and Crown entities

Influences on the Operating Balance

Operating surpluses will continue to rise over the forecast period.

In 2001/02, the OBERAC is $1.2 billion once the operating balance is adjusted for ACC and GSF revaluations of around $250 million. Thereafter, both the OBERAC (see page 61) and operating balance grow from $1.8 billion in 2002/03 (1.5% of GDP) to $3.9 billion in 2005/06 (2.7% of GDP).

The following sections discuss the trends in the three main operating balance components (revenue, expenses and SOE/CE surpluses) and any significant changes in these components since the 2001 Budget.

For a detailed comparison of key fiscal indicators with the 2001 Budget, see Table 3.4 on pages 58 and 59.

Tax Revenue

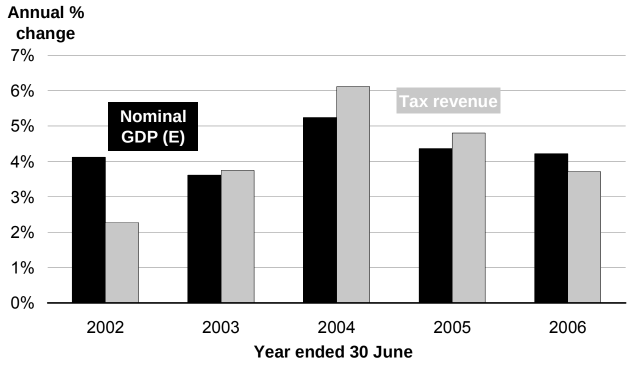
The main driver of tax revenue is nominal economic growth

Tax revenue is expected to grow broadly in line with growth in nominal GDP, apart from in 2001/02.

An expected drop in corporate tax in 2001/02 is the major factor behind total tax revenue growth of 2.3% in 2001/02.

Tax forecasts across all years are lower compared with the 2001 Budget, with by far the biggest reduction ($840 million) occurring in 2002/03.

Figure 3.1 – Tax revenue and GDP



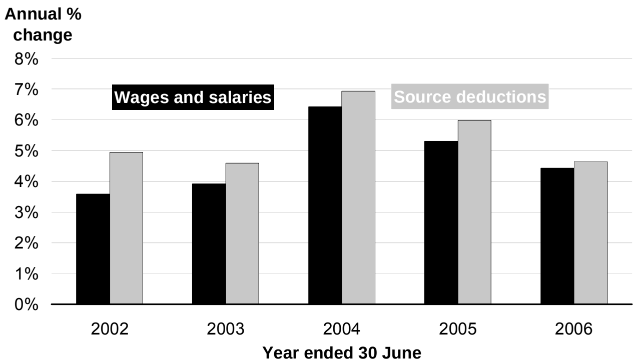
Source: The Treasury

PAYE forecasts largely track wages and salaries, but…

Source deductions (PAYE) is tax paid on wages and salary income and is the largest single component of tax revenue.

Source deductions' growth is usually slightly above growth in wages and salaries owing to the "fiscal drag" effect, where income growth over time moves more people into higher tax brackets.

Figure 3.2 – Source deductions and wage bill



Source: The Treasury

However, in 2001/02, the gap between the two growth rates is larger than usual. This is because PAYE is also paid on social welfare benefits and NZ Superannuation and, in 2001/02, growth in benefits is expected to be slightly ahead of growth in wages and salaries.

…GST growth is well in excess of growth in domestic consumption

A substantial shift in GST revenue from the latter part of 2000/01 into the early part of 2001/02 has boosted growth in GST above growth in underlying domestic consumption.

This revenue shift prompted an increase to the GST forecast for 2001/02.

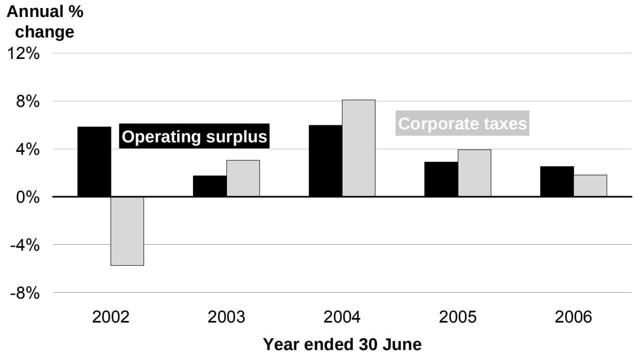
This increase in the forecast continues through later years as GST grows in line with domestic consumption.

Corporate tax dips, but recovers

There is some downward pressure on the corporate tax forecast for 2001/02, with tax from the savings and investment sector expected to be lower than 2000/01 as a result of poor investment returns.

It is also expected that many large companies will reduce their estimates of tax liability, which is likely to have a negative effect on tax revenue in terms of both provisional tax and terminal tax.

Figure 3.3 – Corporate taxes and corporate operating surplus



Source: The Treasury

On the other hand, the tax revenue of small companies to date is higher than last year's level, which puts upward pressure on the forecast.

On balance, corporate tax revenue is expected to decline by nearly 6% in 2001/02.

With profits expected to stagnate in 2003, corporate tax growth in the 2002/03 year is expected to be slight. However, tax growth recovers again in 2003/04 on the back of strong profit growth.

Other persons' tax is affected by fluctuations in terminal tax and refund payments

Net other persons' tax is tax paid mainly by the self-employed, farmers and investors, less refunds paid to all individuals.

The increased level of other persons' refunds to date in 2001/02 has a flow on to the level of terminal tax. This is likely to be down compared to last year, particularly since terminal tax was unusually high in 2000/01 when there was a great deal of terminal tax paid by individuals who had shifted income into the 2000 tax year to minimise the effects of the tax rate rise.

Figure 3.4 – Other persons' tax and entrepreneurial income

Source: The Treasury

Consequently, growth in net other persons' tax is well below growth in entrepreneurial income for 2001/02.

Terminal tax, mostly from farmers, is expected to boost other persons' tax growth in 2002/03, aided by a fall in refunds.

For the remainder of the forecast horizon, net other persons' tax is expected to grow broadly in line with growth in entrepreneurial income.

Risks around the tax forecasts from judgements made

As always, the main risks around the tax forecasts are economic. The macroeconomic forecasts are the primary input into the tax forecasts, which means that the accuracy of the tax forecasts depends, to a large extent, on the accuracy of the economic forecasts.

However, when formulating tax forecasts, many judgements need to be made. Having to make these judgements introduces further risks to the accuracy of the tax forecasts.

Particular risks in these forecasts stem from:

- reconciling tensions between recent tax data and economic data, particularly for PAYE and GST
- determining the incidence of revenue recognition, particularly in self-assessed tax types such as other persons and companies, where terminal tax and refunds can shift tax revenue between years
- deciding how much of an effect tax losses will have on tax revenue over the next few years in corporate and other persons' tax.

Inland Revenue's Forecasts

In line with established practice, the Inland Revenue Department has prepared an independent set of tax forecasts, based in the short term on more detailed analysis of taxpayer information, and in the longer term reflecting the same underlying macroeconomic trends.

Aggregate differences between the two sets of forecasts in the 2001/02 and 2002/03 fiscal years are negligible. Over subsequent years, Inland Revenue projects total tax revenue to be somewhat lower than the Treasury's estimates. However, the differences between the total tax forecasts are less than 1%.

The two sets of forecasts are compared in Table A.1 on pages 146 and 147.

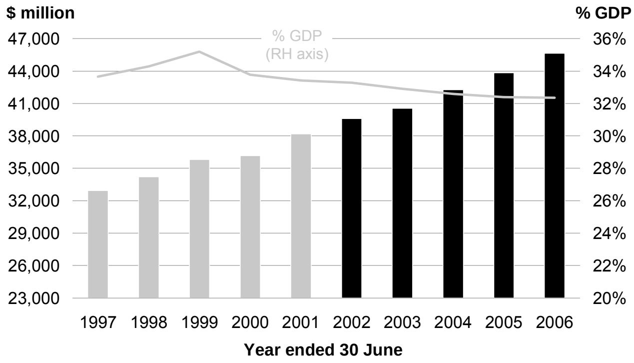
Expenses

Expenses as a percentage of GDP continue to trend down

Expenses fall as a percentage of GDP from 33.4% in 2000/01 to 32.4% in 2005/06.

Over the same period, nominal expenses grow by around 4% each year, owing to both policy spending and demand-driven factors. This represents an increase of around $7.4 billion from $38.2 billion in 2000/01 to $45.6 billion in 2005/06.

Figure 3.5 – Expenses ($ and % of GDP)



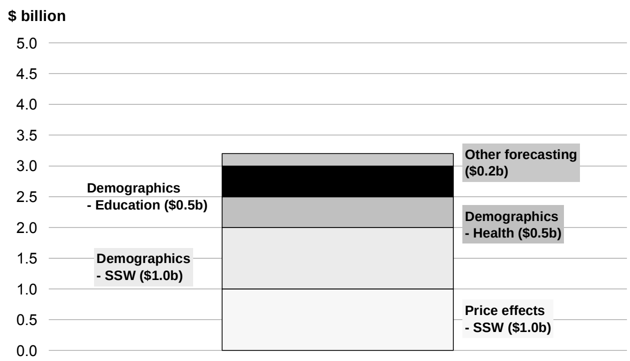
Source: The Treasury

Demand-driven factors outlined in Figure 3.6 account for around 40% ($3.2 billion) of the expense increase. These factors include demographic impacts and CPI indexation of benefits. They are not met from the fiscal provisions, as the Government has little direct influence over their movement.

Over the five year forecast period:

- CPI indexation averages 1.6%, increasing benefits expenses by around $1 billion
- population growth increases the number of invalids and superannuitants by 47,500, this being the main demographic drivers for Social Security and Welfare (SSW) expenses
- population ageing is the main driver for health demographics
- school and tertiary rolls increase by around 25,000.

Figure 3.6 – Expense increases owing to demand-driven and other factors 2001/02 to 2005/06



Source: The Treasury

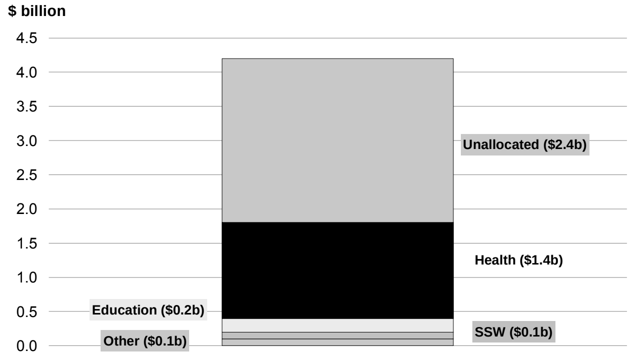
Other expense categories remain relatively static, except finance costs which increase slightly reflecting higher nominal debt levels.

Around 60% ($4.2 billion) of increases in expenses is policy driven, comprising the Government's operating provisions (see Figure 3.7).

The bulk of the expenses allocated to date from the provisions has been directed towards Education, Health and Social Security and Welfare ($1.8 billion[1]). Around $2.4 billion remains unallocated. These amounts are intended to fund new initiatives, while managing cost pressures the Government can directly influence.

Table 3.8 outlines the policy decisions affecting expenses since Budget 2001.

Figure 3.7 – Expense increases owing to policy spending 2001/02 to 2005/06



Source: The Treasury

Health spending the key feature of expense growth since the 2001 Budget

The Government has announced an increase in cumulative health spending of $2.4 billion over the next three financial years, over and above funding for existing demographic and other forecasting items. The announcement represents a health package of $400 million growth in each year of 2002/03, 2003/04 and 2004/05.

Table 3.1 shows the growth of health spending year on year.

Table 3.1 – Growth in health expenses

$ million	**2000/01 Actual[1]**	**2001/02 Forecast**	**2002/03 Forecast**	**2003/04 Forecast**	**2004/05 Forecast**	**2005/06 Forecast**
Health spending	**7,342**	**7,797**	**8,225**	**8,744**	**9,264**	**9,385**
Sources of growth						
Demographic adjustment		92	94	96	98	100
Budget 2000 initiatives profile difference		8	30	20	-	-
2000 contingency (DEFU 2000)		(22)	1	-	-	-
Previous Budget decisions		(14)	31	20	-	-
Health payments to ACC		173	(17)	9	22	22
Expense transfers between years[2]		62	(62)			
Budget 2001 initiatives		246	(7)	-	-	-
Health package announcement		-	400	400	400	-
Other (includes forecasting)[1]		(104)	(11)	(6)	-	(1)
Total growth		**455**	**428**	**519**	**520**	**121**

Source: The Treasury

NOTES:
1 Included in 2000/01 is unappropriated expenditure on pharmaceuticals and laboratory services which does not flow through to future outyears.
2 Expense transfers of $30 million were made from 2000/01 to 2001/02 which do not flow through to future outyears.

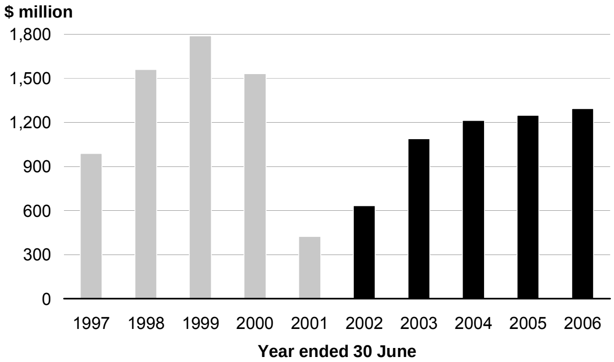
1 Comprises $0.6 billion allocated in the 2001 Budget package, and $1.2 billion for the health package announced in December 2001.

SOE and Crown Entity Surpluses

SOE and Crown entity surpluses have generally decreased from prior years (excluding 2000/01). In 2000/01 and 2001/02, the surplus is affected by increases in the ACC outstanding claims liability ($420 million and $205 million respectively).

Abstracting from the ACC liability valuation impacts, gross SOE and Crown entity surpluses are around $850 million in 2001/02, rising over the forecast period to $1.3 billion in 2005/06.

Figure 3.8 – SOEs' and Crown entities' gross surpluses



Source: The Treasury

SOE and Crown entity surpluses are lower than the 2001 Budget forecasts for 2001/02. This is primarily due to two factors:

- forecast revisions to the deficits for the DHBs. The current forecasts include a combined net deficit of $220 million. DHB deficits are forecast to be around zero by 2003/04
- ACC valuation changes have resulted in an increase in the outstanding claims liability of around $205 million.

Surpluses are higher than those forecast in the 2001 Budget for the remainder of the forecast period owing to additional deficits in the DHBs being more than offset by improved surpluses from SOEs.

Influences on Net Worth and Debt

Operating surpluses increase net worth and generate cash…

Net worth increases by $13.2 billion from $11.5 billion to $24.7 billion between 2000/01 and 2005/06. This increase reflects the level of operating balances over the forecast period of around $13.2 billion.

Table 3.2 shows how the forecast operating surpluses flow through to the Statement of Financial Position over the five-year forecast period.

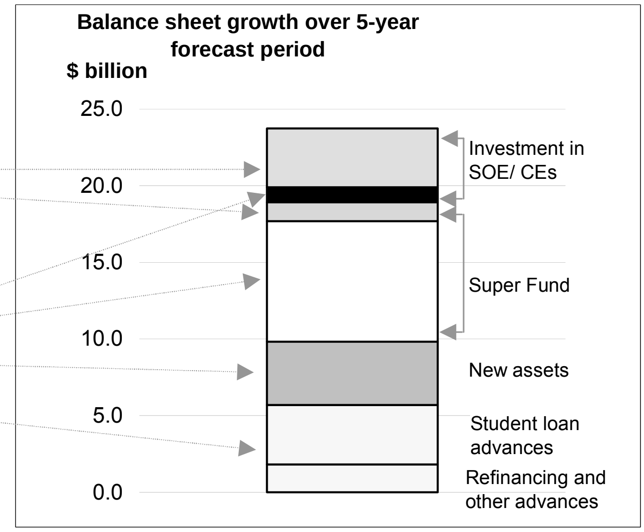
Some portions of the operating surplus are non-cash in nature, including:

- depreciation of $5.0 billion, for which a broadly equivalent amount of cash is earmarked for maintaining existing physical asset levels; offset by
- SOE and Crown entity net surpluses of $3.8 billion, which are retained by the SOEs and Crown entities and increase the Crown's investment in these entities
- NZS Fund returns (after tax) of $1.2 billion, which are retained by the NZS Fund, and increase the Crown's investment in this asset.

Adjusting for these items, the rising operating surplus profile generates a similar level of operating cash flows ($13.0 billion). The Crown can use this cash to either invest in assets or repay debt.

Table 3.2 – Impact of operating surpluses on the balance sheet from 2001/02 to 2005/06

	$ billion
Total Operating Balances	13.2
Add	
Depreciation	5.0
Less	
Retained net SOE/CE surplus	(3.8)
Retained NZS Fund returns	(1.2)
Other	(0.2)
Operating cash flows	13.0
Invested in	
SOE/CE net capital injections	(1.0)
NZS Fund contributions	(7.9)
Increase asset base	(4.1)
Maintain existing asset base	(5.0)
Advances	(5.7)
Other	-
Requiring Finance	(10.6)



Source: The Treasury

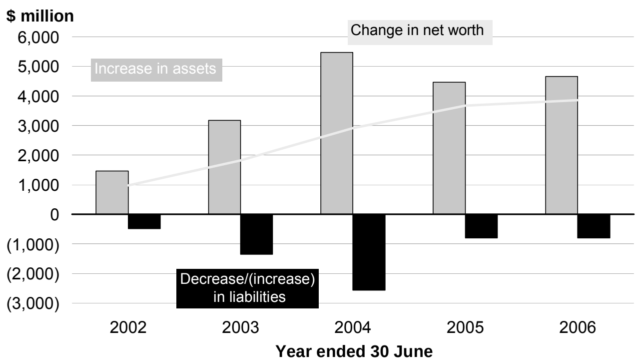
In the 2001 Budget, the forecast financing requirement for the years 2000/01 to 2004/05 was $7.6 billion. The updated financing requirement for the comparative period is now around $1.5 billion higher. This primarily reflects the Air New Zealand recapitalisation package (around $1 billion), higher student loan advances and refinancing of DHB debt (around $0.7 billion combined), partially offset by a higher than expected surplus cash position of $0.5 billion in 2000/01.

…though investment claims outweigh available cash surpluses

The Crown invests $23.6 billion cash – $10.6 billion more than its operating cash flows over the forecast period, including[2]:

- maintaining and improving the existing asset base ($9.1 billion) and providing injections of $1 billion to DHBs and for establishing Kiwibank
- investing in the NZS Fund ($7.9 billion)
- funding advances ($5.7 billion). The advances comprise student loans of $3.9 billion with the remaining

Figure 3.9 – Assets and liabilities



Source: The Treasury

2 The capital provisions are allocated across purchases of assets, SOE/Crown entity capital injections, and advances (see Tables 3.9 and 3.10 on pages 65 and 66).

$1.8 billion relating to refinancing Crown entity private sector debt (DHBs and Housing New Zealand Corporation) and other miscellaneous advance activity.

To fund the difference of $10.6 billion between operating cash flows and investment programme requirements, existing levels of marketable securities and deposits (MSDs) will be run down and new debt will be required.

Gross debt increases by around $6.6 billion and MSDs decrease by around $3.9 billion over the forecast horizon. The change in these financial assets and liabilities, together with other working capital movements (for example, movements in accounts payable), funds the $10.6 billion additional investment in the balance sheet.

The increase in net debt over the forecast period is $4.9 billion, lower than the total funding requirement of $10.6 billion mentioned above. Net debt is not influenced by movements in advances (mainly student loans and refinancing Crown entity debt) or foreign exchange revaluations of overseas debt (which is fully hedged by movements in foreign currency denominated financial assets)[3].

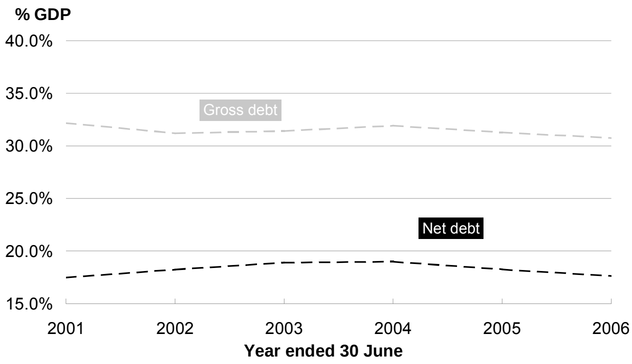
Debt as a percentage of GDP rises slightly in the middle of the forecast period before falling again

While both gross and net debt increase in nominal terms over the forecast period, of more relevance is how debt tracks with growth in the economy.

The Government's debt objective is established at a gross debt constraint of 30% of GDP. The associated net debt indicator is 20% of GDP.

Gross debt falls as a percentage of GDP from around 32% at the start of the forecast period to slightly below 31% by 2005/06.

Figure 3.10 – Gross and net debt as % of GDP



Source: The Treasury

Net debt increases from 17.5% in 2001 to 19% in 2003/04, before dropping back to 17.6% at the end of the forecast period.

Net debt and gross debt as a percentage of GDP rise in the middle of the forecast period mainly owing to lower economic growth in earlier years and the bringing forward of capital spending. Stronger economic growth towards the end of the period sees the trends moving downwards again.

3 Table 3.11 on page 66 outlines the relationship between the operating balance and net debt in detail.

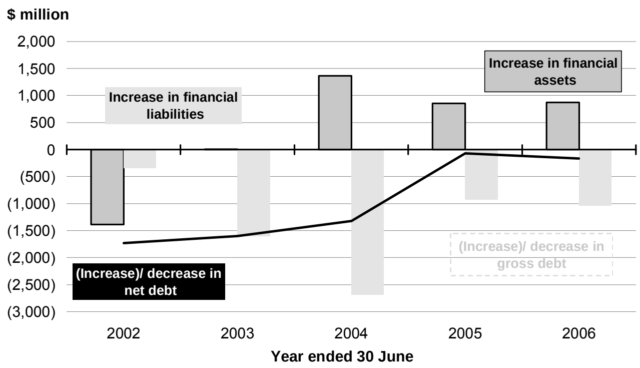
Influences on gross and net debt

Generally, nominal gross debt increases relatively faster than net debt due to net student loan[4] capital requirements, which average around $775 million per year.

Additional factors causing the tracks to diverge over the forecast horizon include:

- the bulk of the existing Housing and Health sector[5] private sector debt refinancing, which takes place in 2001/02 ($700 million), $300 million in 2002.03 and 2003/04 ($770 million), which only impacts on gross debt
- in 2001/02 and 2002/03, funding requirements are partially met through a decrease in holdings of MSDs, which only impact on net debt.

Figure 3.11 – Financial assets and financial liabilities



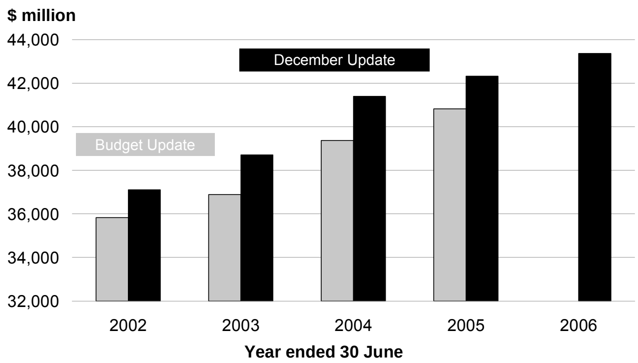
Source: The Treasury

Changes in debt relative to the 2001 Budget

Both gross and net debt increase relative to the 2001 Budget. The key changes in funding requirements for the comparable period of 2000/01 to 2004/05 are:

- lower forecast cash generated from operating balances from 2001/02 ($0.4 billion), offset by an improved surplus cash position in 2000/01 from forecast of around $0.5 billion
- higher forecast demand for student loans, in tandem with revised forecast requirements to fund DHB debt refinancing ($0.7 billion combined)
- increases in the capital provisions ($1 billion) for the Air New Zealand recapitalisation package.

Figure 3.12 – Gross debt comparison



Source: The Treasury

Net debt (in nominal terms and as a percentage of GDP) is, on average, slightly higher across the forecast horizon than the 2001 Budget.

4 These are neutral from a net debt perspective as advances are included in the definition of “financial assets”.

5 The Crown has undertaken to refinance DHB and Housing New Zealand Corporation private sector debt with Crown-issued debt as it results in overall lower interest costs. This is a technical change that increases gross Crown-issued debt. Because it brings a financial asset onto the Crown’s balance sheet, however, there is no impact on net debt. Since the 2001 Budget, revised forecasts from DHBs have increased the refinancing requirement by around $330 million.

Net debt and the domestic bond programme

The domestic bond programme for 2001/02 is now $4.1 billion, a $600 million increase over the programme announced at the time of the 2001 Budget. The bond programme finances the Crown's operating, investing and financing cash flows.

Table 3.3 outlines the reconciliation of the change in the 2001/02 programme.

Table 3.3 – Change in domestic bond programme

Change from the 2001 Budget	$ million	Explanation
Additional 2001/02 funding requirement	(1,100)	Additional operating and investing activity requiring finance[6] – mainly to allow for the recapitalisation of Air New Zealand.
Funded from:		
• Outturn from 2000/01 fiscal year	500	Additional cash available from the better than expected 2000/01 financial year.
• New Zealand Dollar swap programme provision	500	The original 2001/02 bond programme made some allowance for issuing domestic bonds to fund foreign currency reserves, via the swap market. Foreign currency reserves will now be funded entirely by borrowing directly in foreign currencies during 2001/02. This creates capacity in the domestic bond programme to fund the additional cash requirement.[7]
Residual 2001/02 funding requirement	**(100)**	
Partial pre-funding of 2002/03 debt programme	(500)	A decision has been taken to partially pre-fund the 2002/03 borrowing requirement. This reduces the forecast 2002/03 bond programme to around the $5.1 billion shown in the fiscal forecasts (it would otherwise be $5.6 billion).
Increase in 2001/02 domestic debt programme	**(600)**	

6 The operating and investing cash flows incorporate cash flows from operations, net purchase of physical assets, net increase in advances, net purchase of investments (essentially capital injections/(withdrawals) to SOEs and Crown entities) and the capital provision.

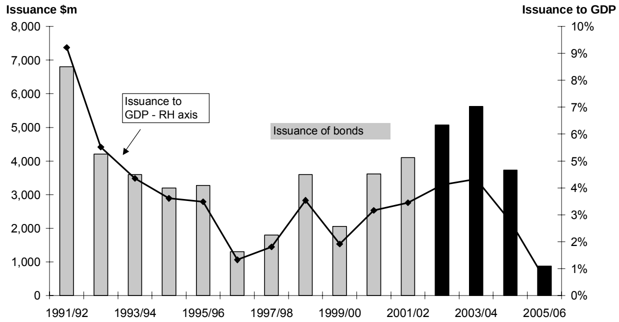
7 While this strategy alleviates the need to increase domestic borrowing, there will be an increase in foreign currency borrowing, therefore total Government debt increases.

Forecast increases in the level of the domestic bond programme

The forecasts indicate that the domestic bond programme is to increase in nominal terms over the next two years, at $5.1 billion and $5.6 billion for 2002/03 and 2003/04 respectively – which is somewhat larger than was experienced during the late 1990s.

However, the nominal increases should be viewed in context with the relative size of the economy. Growth in the New Zealand economy means that the $5.1 billion debt programme is forecast (in 2002/03) to be much smaller relative to GDP (4.1%) than was the case in 1991/92 (9.2%) when the domestic debt programme amounted to $6.8 billion.

Figure 3.13 – Domestic Bond Programme 1992 to 2006



Source: The Treasury

Fiscal Indicators – Comparison with 2001 Budget

Table 3.4 – Fiscal indicators – compares key fiscal information with the 2001 Budget

($ million, year ended 30 June)	2001 Actual	2002 Budget	2002 DEFU	2003 Budget	2003 DEFU
Statement of Financial Performance					
Revenue					
Taxation revenue	36,738	37,685	37,571	39,818	38,978
Other revenue	2,754	2,311	2,719	2,469	2,553
Total Revenue	**39,492**	**39,996**	**40,290**	**42,287**	**41,531**
Ratio to GDP (%)	**34.6%**	**34.1%**	**33.9%**	**34.2%**	**33.7%**
Tax ratio to GDP (%)	**32.1%**	**32.1%**	**31.6%**	**32.2%**	**31.6%**
Expenses					
Functional expenses	35,750	36,810	37,186	37,385	37,775
Finance costs	2,483	2,395	2,345	2,334	2,322
Net foreign exchange gains	(47)	-	(18)	-	-
Provision for future initiatives	-	160	90	955	450
Total Expenses	**38,186**	**39,365**	**39,603**	**40,674**	**40,547**
Ratio to GDP (%)	**33.4%**	**33.6%**	**33.3%**	**32.9%**	**32.9%**
Contribution of SOEs and CEs					
Surplus attributable to SOEs and CEs	424	953	634	1,050	1,089
Dividends and other distributions	(321)	(208)	(336)	(222)	(250)
Net Contribution of SOEs and CEs	**103**	**745**	**298**	**828**	**839**
Operating Balance	**1,409**	**1,376**	**985**	**2,441**	**1,823**
Ratio to GDP (%)	**1.2%**	**1.2%**	**0.8%**	**2.0%**	**1.5%**
Statement of Financial Position					
Assets (excluding NZS Fund assets)	65,081	63,233	65,934	65,351	67,817
NZS Fund assets	-	617	614	1,888	1,904
Liabilities	(53,618)	(51,893)	(54,106)	(52,841)	(55,456)
Crown Balance (net worth)	**11,463**	**11,957**	**12,442**	**14,398**	**14,265**
Ratio to GDP (%)	**10.0%**	**10.2%**	**10.5%**	**11.7%**	**11.6%**
Statement of Borrowings					
Crown Debt					
Gross debt	36,761	35,831	37,105	36,887	38,708
less financial assets	(16,790)	(14,368)	(15,402)	(14,846)	(15,406)
Net Crown Debt	**19,971**	**21,463**	**21,703**	**22,041**	**23,302**
Net Crown debt to GDP (%)	**17.5%**	**18.3%**	**18.2%**	**17.8%**	**18.9%**
Gross debt to GDP (%)	**32.2%**	**30.5%**	**31.2%**	**29.9%**	**31.4%**
Net debt repayment/(increase)	1,425	(1,031)	(1,732)	(578)	(1,599)
Nominal GDP	114,275	117,323	118,980	123,573	123,271

Source: The Treasury

Table 3.4 – Fiscal indicators (continued)

($ million, year ended 30 June)	**2004 Budget**	**2004 DEFU**	**2005 Budget**	**2005 DEFU**	**2006 DEFU**
Statement of Financial Performance					
Revenue					
Taxation revenue	41,661	41,359	43,468	43,344	44,952
Other revenue	2,770	2,924	3,085	3,286	3,630
Total Revenue	**44,431**	**44,283**	**46,553**	**46,630**	**48,582**
Ratio to GDP (%)	**34.4%**	**34.1%**	**34.6%**	**34.4%**	**34.4%**
Tax ratio to GDP (%)	**32.3%**	**31.9%**	**32.3%**	**32.0%**	**31.9%**
Expenses					
Functional expenses	38,026	38,793	38,633	39,774	40,622
Finance costs	2,409	2,508	2,431	2,594	2,641
Net foreign exchange gains	-	-	-	-	-
Provision for future initiatives	1,855	975	2,755	1,475	2,376
Total Expenses	**42,290**	**42,276**	**43,819**	**43,843**	**45,639**
Ratio to GDP (%)	**32.7%**	**32.6%**	**32.6%**	**32.4%**	**32.4%**
Contribution of SOEs and CEs					
Surplus attributable to SOEs and CEs	1,163	1,214	1,185	1,248	1,295
Dividends and other distributions	(247)	(313)	(267)	(365)	(384)
Net Contribution of SOEs and CEs	**916**	**901**	**918**	**883**	**911**
Operating Balance	**3,057**	**2,908**	**3,652**	**3,670**	**3,854**
Ratio to GDP (%)	**2.4%**	**2.2%**	**2.7%**	**2.7%**	**2.7%**
Statement of Financial Position					
Assets (excluding NZS Fund assets)	68,753	71,276	70,844	73,277	75,223
NZS Fund assets	3,852	3,914	6,665	6,379	9,091
Liabilities	(55,150)	(58,017)	(56,402)	(58,813)	(59,617)
Crown Balance (net worth)	**17,455**	**17,173**	**21,107**	**20,843**	**24,697**
Ratio to GDP (%)	**13.5%**	**13.2%**	**15.7%**	**15.4%**	**17.5%**
Statement of Borrowings					
Crown Debt					
Gross debt	39,368	41,400	40,815	42,326	43,368
less financial assets	(16,138)	(16,773)	(16,555)	(17,628)	(18,502)
Net Crown Debt	**23,230**	**24,627**	**24,260**	**24,698**	**24,866**
Net Crown debt to GDP (%)	**18.0%**	**19.0%**	**18.0%**	**18.2%**	**17.6%**
Gross debt to GDP (%)	**30.5%**	**31.9%**	**30.3%**	**31.3%**	**30.7%**
Net debt repayment/(increase)	(1,189)	(1,325)	(1,030)	(71)	(168)
Nominal GDP	129,179	129,725	134,563	135,373	141,076

Source: The Treasury

Operating Balance Excluding Revaluations and Accounting Policy Changes (OBERAC)

The OBERAC is an additional fiscal indicator that strips out revaluation movements and accounting policy changes to provide a measure of underlying financial stewardship. The OBERAC is not a measure of the controllable portion of the operating balance. As such, it does not isolate aspects of the operating balance (such as tax revenue and unemployment benefits) that arise from cyclical factors.

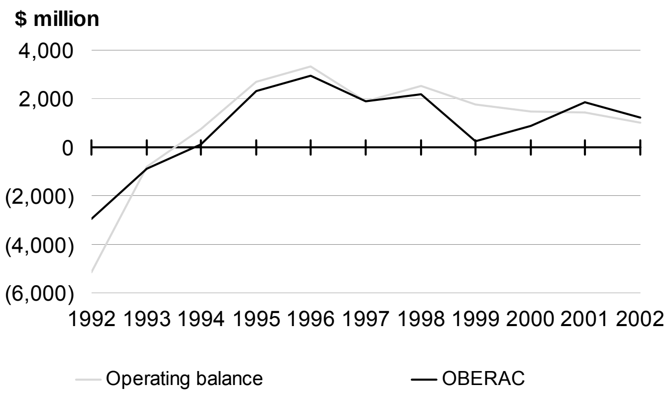
Revaluations have significantly affected the operating balance as it is a relatively small balancing item between two large numbers: total revenue and total expenses. Revaluation effects are not forecast beyond the current year as a matter of policy given their inherent uncertainty.

The OBERAC is calculated by adjusting for the following revaluation effects (unless the revaluation is a result of a policy decision):

- Net Present Valued assets and liabilities such as the GSF pension liability, ACC outstanding claims liability and NZS Fund assets
- market-valued financial assets and liabilities, such as tradeable MSDs
- gains or losses on sale. Selling an asset for greater (or less) than its book value is a terminal revaluation
- changes in accounting policy around the recognition of assets and liabilities. For example the recognition of the Public Trust reserves in 1999/2000 would be adjusted for had they met the materiality limit outlined below

The materiality limit for adjustments is $100 million. Materiality is from a Crown-wide, rather than an individual department perspective and applies for any one year.

The graph below indicates the extent to which the OBERAC has differed from the operating balance reported in the accounts over the past ten years.



Source: The Treasury

Table 3.5 – Detail of OBERAC calculation

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Operating Balance	**(5,149)**	**(819)**	**755**	**2,695**	**3,314**	**1,908**	**2,534**	**1,777**	**1,449**	**1,409**	**985**
Adjustments											
GSF pension liability movements	420	664	111	155	226	(4)	(233)	429	(201)	164	38
ACC revaluation	-	-	-	-	-	-	-	-	(519)	420	205
NPF liability movement	-	-	-	-	-	-	-	-	-	253	-
Gain on sale of assets											
Contact	-	-	-	-	-	-	-	(1,421)	-	-	-
Airport companies	-	-	-	-	-	-	-	(204)	-	-	-
Hydro stations	-	-	-	-	-	-	-	(195)	-	-	-
Spectrum licences	-	-	-	-	-	-	-	-	-	(140)	-
Other sales (BNZ, TVNZ shares, etc)	-	(283)	(129)	-	-	-	-	(140)	-	-	-
Write-downs (Police and Defence)	-	-	-	-	-	-	-	-	155	103	-
(Gains)/losses on marketable securities and deposits	-	-	-	-	-	-	(110)	-	-	(102)	-
Unrealised forest revaluations	-	(766)	292	-	-	-	-	-	-	-	-
Exchange rate movements	1,764	296	(898)	(551)	(603)	-	-	-	-	-	-
Total adjustments	2,184	(89)	(624)	(396)	(377)	(4)	(343)	(1,531)	(565)	698	243
OBERAC	**(2,965)**	**(908)**	**131**	**2,299**	**2,937**	**1,904**	**2,191**	**246**	**884**	**2,107**	**1,228**

Source: The Treasury

Operating Balance Changes Since the 2001 Budget

Table 3.6 – Operating balance reconciliation (explains changes to the operating balance since the 2001 Budget)

($ million)	2001/02 Forecast	2002/03 Forecast	2003/04 Forecast	2004/05 Forecast	2005/06 Forecast
Operating Balance 2001 Budget	1,376	2,441	3,057	3,652	-
Policy changes					
Revenue initiatives	15	25	15	15	
Net expense initiatives	(66)	(150)	(93)	(97)	
Drawdown from Government's operating provisions	51	125	78	82	
Total Policy Changes	-	-	-	-	
Forecasting changes					
Tax revenue forecasting changes	(129)	(850)	(302)	(124)	
Other revenue changes	255	42	71	88	
Welfare benefit indexation increases	-	10	44	54	
Welfare benefit forecasting increases	188	276	281	287	
Valuation changes (GSF and ACC liability movements)	(294)	-	-	-	
Finance expenses	50	12	(99)	(163)	
Higher Transport expenses	(76)	(93)	(90)	(78)	
Change to SOEs and Crown entities (excluding ACC valuation change)	(114)	39	51	63	
Other forecast changes	(271)	(54)	(105)	(109)	
Total Forecasting Changes	**(391)**	**(618)**	**(149)**	**18**	
Operating Balance - 2001 *December Update*	985	1,823	2,908	3,670	3,854

Source: The Treasury

Explanations for key changes not covered elsewhere within this chapter include:

- The increase in other revenue in 2001/02 is partially due to gains on MSDs of around $60 million. In addition, part of the increase in other revenue ($90 million) for 2001/02 is offset by increased expenses in Courts (previously Courts was recording net revenues, which should have been gross revenues with provisions in expenses).
- The valuation impacts consist of increases in the ACC outstanding claims liability and GSF unfunded liability of around $200 million and $90 million respectively.
- Higher transport costs are due to a change in the forecast split between operating and capital spending on roading improvements (no overall cash impact as capital spending reduces).
- Other expense movements include provisions for the Māori Trustee Office debt and Māori Lessee court settlement.

Budget Policy Decisions

This section explains changes to the Government's operating and capital provisions.

Fiscal and indicative provisions

In addition to the health package mentioned earlier, the Government has allocated a further $176 million of the $6.126 billion three-year fiscal provision since the 2001 Budget. The table below provides a breakdown of the Government's three-year fiscal provision since 1999/2000 to 2002/03:

Table 3.7 – The Government's fiscal provisions

Fiscal provisions ($ million, GST inclusive)	Actual 1999/2000	Actual 2000/01	2001/02	2002/03	Total
Budget 2000 decisions	420	1,050	1,060	1,120	3,650
2000 contingency decisions	-	99	74	78	251
Budget 2001 decisions	-	52	532	526	1,110
2001 contingency decisions	-	-	51	125	176
December 2001 Health package	-	-	-	400	400
Budget 2002 provision [1]	-	-	89	450	539
Total	420	1,201	1,806	2,699	6,126

[1] $20 million of the Budget 2002 provision has been rephased from 2001/02 to 2002/03.

Source: The Treasury

Beyond 2002/03 the forecasts use indicative operating spending allocations of $900 million for each year from 2003/04 to 2005/06, less the amounts already allocated as part of the health package. Therefore, the forecasts include operating provisions for each year of $500 million for 2003/04; $500 million for 2004/05; and $900 million for 2005/06.

Note 5 of the forecasts contained in the GAAP tables (page 141) outlines the cumulative provisions included in the forecasts.

The $176 million allocated as part of 2001/02 Contingency from the fiscal provisions listed in Table 3.7 is summarised in Table 3.8:

Table 3.8 – Allocation of 2001/02 contingency

2001 Contingency decisions ($ million, GST inclusive)	**2001/02**	**2002/03**	**Total [1]**	**2003/04**	**2004/05**	**2005/06**
Revenue initiatives						
GST: Non-registered offshore warrantors	(15)	(10)	**(25)**	-	-	-
Introduction of an Import Transaction Fee	-	(15)	**(15)**	(15)	(15)	(15)
Total revenue initiatives	(15)	(25)	**(40)**	(15)	(15)	(15)
Savings initiatives						
Partial moratorium on funding to private training providers	(8)	(11)	**(19)**	(14)	(15)	(15)
Other education savings	(30)	(30)	**(60)**	(30)	(30)	(30)
Total savings initiatives	(38)	(41)	**(79)**	(44)	(45)	(45)
Expenditure initiatives						
Primary teachers' and primary principals' collective agreements	32	59	**92**	59	58	58
School staffing improvements	9	23	**32**	25	25	25
Police 2001 wage bargaining round	-	30	**30**	-	-	-
Administration of the Australian Social Security Agreement	16	9	**24**	4	4	4
Tertiary Education Strategic Change Fund	-	19	**19**	-	-	-
Incursion of the Painted Apple Moth	5	5	**10**	1	-	-
"More Time for Business" tax package	2	8	**9**	9	9	9
Promotion of NZ associated with the America's Cup and Lord of the Rings	6	3	**9**	-	-	-
Maori Television	-	7	**7**	15	22	22
Funding for Customs Service capability needs	-	6	**6**	7	8	8
E-government programme	1	5	**6**	5	5	5
Injury Prevention and Rehabilitation Bill	1	3	**4**	3	3	3
Managing the implications of the forecast prison population	1	3	**3**	3	3	3
Other expenditure	31	11	**42**	7	6	6
Total expense initiatives	104	191	**295**	137	143	143
Net Impact on the 2001 Contingency	**51**	**125**	**176**	**78**	**82**	**82**

1: The "Total" column relates to the contingency settings as shown in Table 3.7

Source: The Treasury

Capital Provisions

As part of the 2001 Budget, the Government set capital provisions of $850 million for 2003/04 and 2004/05 (and $550 million has been set for the new 2005/06 financial year).

Table 3.9 outlines the full extent of capital spending over the current term of Government (1999/2000 to 2002/03), and the movements in the provisions beyond 2002/03, including the rephasing over the entire forecast period.

Table 3.9 – The Government's capital provisions[8]

Capital provisions ($ million, GST inclusive)	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**Total**
Capital provision - *Budget Update*	(69)	639	1,256	1,172	850	850	-	4,698
Establish 2005/06 provision							550	550
Budget 2000 decisions	(54)	827	576	568	-	-	-	1,917
December Update 2000 decisions	(15)	(58)	(4)	40	-	-	-	(37)
Receipts from spectrum sale	-	(135)			-	-	-	(135)
Budget 2001 decisions	-	5	369	204	-	-	-	578
December Update 2001 decisions	-	-	76	27	1	-	5	109
Total decisions to date	(69)	639	1,017	839	1	-	5	2,432
Remaining provision	-	-	239	333	849	850	545	2,816
November 2001 increase to provision	-	-	1,035	-	-	-	-	1,035
December Update 2001 rephasing of provision	-	-		413	89	(387)	(115)	-
Remaining provision	-	-	1,274	746	938	463	430	3,851
Total Provision	**(69)**	**639**	**2,291**	**1,585**	**939**	**463**	**435**	**6,133**
Total Capital Provisions for the Current Term				**4,446**				

Source: The Treasury

The capital provisions have increased since the 2001 Budget from $3 billion to $4.45 billion. This is due to the $1 billion for the Air New Zealand recapitalisation package and the bringing forward of around $500 million from 2004/05 and 2005/06 to 2002/03 and 2003/04 to better reflect planned commitments. The key capital pressures are in the social sector (hospitals and schools), prisons, developing a transport strategy, and re-equipping the Defence Force.

The capital provisions from 2003/04 onwards are the provisions established in the 2001 Budget, less the rephased amount.

8 Note that the remaining capital provision numbers do not exactly equal those contained in the fiscal forecasts owing to rounding.

Capital spending since Budget 2001 (across the forecast horizon) is detailed in Table 3.10:

Table 3.10 – Capital spending since Budget 2001

2001 Post-Budget capital decisions ($ million, GST inclusive)	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Partial moratorium on funding to private training providers	(7)	(9)	(11)	(12)	-	(40)
School staffing initiatives	22	-	-	-	-	22
Tertiary Education Strategic Change Fund	-	17	-	-	-	17
Managing the implications of the forecast prison population	11	11	2	-	-	24
Te Wananga O Aotearoa	29	9	10	12	5	65
Meridian Energy dividend	(50)	-	-	-	-	(50)
		-	-	-	-	-
Capital injections to public hospitals	60	-	-	-	-	60
Other decisions	11	-	-	-	-	11
Net Impact on the Capital Provisions	**76**	**27**	**1**	**-**	**5**	**109**

Source: The Treasury

Table 3.11 – Relationship between the operating balance and net debt

($ million)	2001 Actual	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast	2006 Forecast
Operating balance	1,409	985	1,823	2,908	3,670	3,854
Less/(plus) valuation items	698	243	-	-	-	-
OBERAC	2,107	1,228	1,823	2,908	3,670	3,854
Less NZS Fund contributions	-	(600)	(1,200)	(1,800)	(2,100)	(2,150)
Less after-tax income of the NZS Fund	-	(14)	(91)	(210)	(372)	(559)
Available after NZS Fund requirements	2,107	614	532	898	1,198	1,145
Decrease/(increase in net debt)	1,425	(1,732)	(1,599)	(1,325)	(71)	(168)
Difference	**(682)**	**(2,346)**	**(2,131)**	**(2,223)**	**(1,269)**	**(1,313)**
This difference comprises:						
Non-cash elements of the OBERAC						
SOE/CE retained surplus net of dividends (excluding valuation issues)	(523)	(503)	(839)	(901)	(883)	(911)
Depreciation	925	965	1,000	1,002	1,033	1,034
(Gain)/loss on sale of assets	8	1	-	-	-	-
Commercial forests and net FX movements	(40)	(18)	-	-	-	-
Student loan influences	(61)	(7)	(53)	(47)	(39)	(45)
Cash elements not in the OBERAC						
Circulating currency	303	126	-	-	-	-
Net purchase of physical assets including capital contingency provision	(1,130)	(2,631)	(1,921)	(2,039)	(1,287)	(1,277)
Asset sale receipts	140	-	-	-	-	-
Net capital injections	34	(440)	(233)	(220)	(44)	(44)
Other working capital movements	(338)	161	(85)	(18)	(49)	(70)
	(682)	**(2,346)**	**(2,131)**	**(2,223)**	**(1,269)**	**(1,313)**

Source: The Treasury

Air New Zealand: Impact on the *December Update* Forecasts

The Government has announced a recapitalisation package for Air New Zealand that has been agreed with the Air New Zealand Board.

The terms of the equity investment involve the Crown paying 27 cents a share for the $585 million second tranche of the $885 million Air New Zealand recapitalisation package, giving the Crown an 82% stake in the airline.

The first tranche – for $300 million – was paid over as a loan in October 2001 and will be converted, with accrued interest, into new convertible preference shares at 24 cents a share.

The Crown has also committed to provide up to $150 million in further funding before June 2003.

The necessary approvals for the second tranche will be sought from Air New Zealand shareholders at the Annual General Meeting scheduled for 19 December 2001.

How Air New Zealand is represented in the December forecasts

A specific investment in Air New Zealand is not shown in the December Update forecasts, as shareholder approval of the offer has yet to be obtained. Instead the capital provisions for 2001/02 have been increased by the full value of the package – $1.035 billion. This results in:

- no immediate change to net worth as the increase in the capital provisions (the asset) are financed by movements in the borrowing statement (either reduced MSDs or increases in borrowings)
- an increase in net debt
- additional finance costs included in the operating statement.

If the proposal is accepted

If Air New Zealand shareholders agree to the package, Air New Zealand's operating results will be incorporated into future forecasts and Crown Financial Statements from the date of effective ownership. Including Air New Zealand into the Crown Financial Statements requires valuation issues to be considered.

Accounting issues around the fair value of assets and liabilities to be brought onto the Crown's Balance Sheet on acquisition are being considered at present. There is a risk that if there is a differential in the purchase price and the value of Air New Zealand's assets and liabilities, a write-down in the Crown Financial Statements would be required. It is likely to take some time to work through this issue and assess the probability of the risk crystallising.

New Zealand Superannuation Fund Contributions

Section 42 (2) of the New Zealand Superannuation Act 2001 requires that the Treasury must include in the Budget Economic and Fiscal Update:

- the amount of the required annual capital contribution for the financial year
- a statement of the assumptions and judgments on which the calculations are based.

The contribution to the Fund is calculated over a 40-year rolling horizon to ensure Superannuation entitlements over the next 40 years could be met, if the contribution rate were to be held constant at that level for 40 years.

In the first three years of the Fund's operation the Government plans to build towards making the full capital contribution as calculated by the formula set out in the NZSF Act. This transition period will prevent undue pressure being placed on the fiscal position while structural surpluses are raised to the required levels.

$ billion (June year end)	**2002**	**2003**	**2004**	**2005**	**2006**
Required contribution	1.573	1.749	1.973	2.093	2.169
Actual contribution[9]	0.600	1.200	1.800	2.093	2.169

The underlying assumptions in calculating the contribution are the:

- GDP series to 2045
- New Zealand Superannuation series to 2045
- opening Fund balance (zero as at 1 July 2001)
- expected net after-tax annual return of the Fund (7.5%)

The GDP series was projected following the assumptions stated on page 31. In calculating the required capital contribution to the NZS Fund the following explicit assumptions were made:

	2001 *December Update*	**2001 Budget**
Expected nominal bond rate	6.2%	6.5%
Equity premium	5.0%	-
Portfolio composition (equities)	70.0%	-
Management fees	0.3%	-
Expected return before tax	9.4%	9.0%
Tax	20.0%	33.0%
Expected return after tax	7.52%	6.0%

9 In the fiscal forecasts the level of contribution was rounded to the nearest $50 million.

When preparing the 2001 Budget there was less certainty about the future shape of the Fund, so the expected returns were assessed to the nearest whole percentage point, taking into account the ranges of views about their composition but without needing to make specific assumptions about each element.

The other key change from the 2001 Budget is the expected tax rate. The Fund is subject to New Zealand tax as if it were a body corporate. The current marginal rate of tax on assessable income is 33%. However, depending on the portfolio composition and investment style, a significant proportion of the returns might not be subject to tax. In particular, capital gains on equities, particularly if held as passive investments, attract less tax than bonds. For the purpose of this calculation, an average rate of 20% is assumed.

Sensitivity

The forecasts of capital contributions for 2004/05 and 2005/06 exhibit sensitivities to the various assumptions made above as follows:[10]

Variable	**Marginal Change** (%age points)	**Effect on Net Return After Tax** (%age points)	**Effect on Capital Contribution ($ billion)**	
			2004/05	**2005/06**
Nominal bond rate	+1%	+0.80%	–0.183	–0.196
Equity premium	+1%	+0.56%	–0.130	–0.139
Portfolio composition (equities)	+5%	+0.20%	–0.047	–0.050
Management fees	+0.1%	–0.08%	+0.019	+0.021
Tax	+5%	–0.47%	+0.112	+0.121

These sensitivities are well within the bounds of reasonable forecasting accuracy three to four years ahead.

10 The effects shown in this table are the marginal effects (that is, all else held equal). This overstates the effects for some variables that are interdependent. For example, a portfolio with a higher weighting in equities would be likely to have a lower average tax rate.

Full line-by-line consolidation

Extracts from a discussion document Treasury published in February 2001, titled *Implications of Line-by-Line Consolidation of State Owned Enterprises and Crown Entities for the Crown Financial Statements and for Setting Fiscal Objectives* – a full version is contained on Treasury's website www.treasury.govt.nz

Current Obligations on the Crown

The Public Finance Act 1989 (PFA) and Fiscal Responsibility Act 1994 require a government to produce actual and forecast financial statements in accordance with Generally Accepted Accounting Practice (GAAP). This ensures that the financial statements and forecasts of the Crown are prepared on a basis consistent with other financial statements – providing a transparent and independently established set of principles on which to measure a government's financial activity.

GAAP is Changing

GAAP is refined over time in line with international and New Zealand specific accounting developments. GAAP will soon require the *full line-by-line consolidation* of State-owned enterprises (SOEs) and Crown entities.

The Crown financial statements and forecasts are currently prepared by:

- the line-by-line consolidation of the revenues, expenses, assets and liabilities of all departments (and the activity they undertake on behalf of the Crown, for example benefit payments) and the Reserve Bank; and
- consolidation of the SOEs and Crown entities – but ONLY their net results (net surplus in the operating balance and net investment/net worth in the balance sheet) – NOT the full revenues, expenses, assets and liabilities.

The Crown will continue to prepare consolidated financial statements – but the form of that consolidation will be changing to comply with forthcoming changes to GAAP.

From the 2003 financial year, the Crown financial statements and forecasts will FULLY consolidate line-by-line the revenues, expenses, assets and liabilities of ALL entities making up the Crown reporting entity. The change from current practice will be the inclusion of ALL revenues, expenses, assets and liabilities of SOEs and Crown entities. The forecasts in the 2002 Budget will be prepared under the new consolidation approach.

The change to how consolidation will operate will impact upon the composition and look of the financial statements (both forecast and actual financial statements). Although the net results for the Crown will be materially the same (ie, operating balance and net worth), the composition and total of items such as revenues, expenses, assets and liabilities will change.

In summary, as an illustration, the key fiscal aggregates (as at 30 June 2000) will change as follows:

Table: Illustration of change to fiscal aggregates (numbers updated since February 2001 version)

Headline fiscal indicators *(highlighted)*	**Impact of full consolidation**	**Current numbers (30 June 2000) $billion**	**New numbers[11] $billion**
Revenue	Increase	36.5	42.5
Expenses	Increase	(36.2)	(41.6)
Net SOE and CE surplus	Removed	1.1	0.0
Valuation movements	New category	0.0	0.5
Operating Balance	No change	1.4	1.4
Gross Debt	Increase	36.0	38.1
Net Debt	Currently little change	21.4	20.2
Total Assets	Increase	60.4	70.9
Physical Assets	Increase	24.9	43.5
Net Worth	No change	8.6	8.6

The main drivers of the changes to the numbers are:

- Expenses (and revenues) increase from including the expenses of SOEs (especially electricity SOEs), ACC, and additional expenses in the Education sector.
- Net debt decreases, because the added debt (mainly from SOEs) is outweighed by the investment portfolios of ACC and EQC.

The increase in spending is not as simple as adding existing core Crown spending to all spending of SOEs and CEs. For example, a lot of the expenses of Crown entities are funded from the Crown, for example, health spending. In a set of fully consolidated financial statements, the health spending of District health boards would replace the current core Crown spending, so that the same expenses are not counted twice.

We will be providing further detail on the impacts of full line-by-line consolidation in the lead up to the 2002 Budget.

11 These are illustrative impacts to provide a likely indication of new numbers. A full set of fully consolidated results using 30 June 2001 data is in the process of being completed (including new internal eliminations that will be required). Once completed a more accurate indication of changes will be available.