Fiscal Forecasts – Finalisation Dates and Key Assumptions

Finalisation Dates	
Economic outlook (refer Chapter 1)	19 November
Tax revenue forecasts	24 November
Fiscal forecasts	2 December
Government decisions and circumstances	2 December
Actual asset revaluations	31 October
Foreign exchange rates	30 September
Specific fiscal risks (refer Chapter 4)	2 December
Contingent liabilities and commitments (refer Chapter 4)	31 October

Key assumptions

The fiscal forecasts have been prepared in accordance with the Fiscal Responsibility Act 1994. They are based on the Crown's accounting policies and assumptions (refer page 84 of the GAAP tables). As with all assumptions, there is a degree of uncertainty surrounding them. This uncertainty increases as the forecast horizon extends. A summary of the key economic assumptions that are particularly relevant to the fiscal forecasts is provided below (on a June-year-end basis to align with the Crown's balance date of 30 June):

	2004/05		2005/06	2006/07	2007/08	2008/09
June years	**BEFU**	**DEFU**	**DEFU**	**DEFU**	**DEFU**	**DEFU**
Real GDP (P) (ann avg % chg)	2.4	4.0	2.3	2.8	3.1	3.0
Nominal GDP (E) ($m)	144,441	150,400	155,871	161,625	169,487	178,029
CPI (annual % change)	2.5	2.9	2.6	2.4	2.1	2.0
Govt 10-year bonds (qty avg %)	6.3	6.5	6.4	6.0	6.0	6.0
90-day bill rate (qty avg %)	5.8	6.8	6.3	5.8	5.8	5.8
Unemployment rate ((HLFS) basis ann avg %)	4.7	3.7	4.0	4.3	4.4	4.4
Full-time equivalent employment (ann avg %)	1.0	2.9	0.6	0.7	1.2	1.2
Current account (% of GDP)	-5.9	-5.4	-6.0	-6.2	-5.8	-5.6

Source: The Treasury

New Zealand Superannuation (NZS) Fund

The estimated annual contribution to the NZS Fund for the year ending 30 June 2006 is $2.207 billion. The contribution to the NZS Fund is calculated over a 40-year rolling horizon to ensure that superannuation entitlements over the next 40 years can be met if the contribution rate were to be held constant at that level for 40 years.

The Government is making the required minimum annual contribution for 2004/05 as calculated by the formula set out in the NZS Fund Act.

$ billion (June year end)	2003	2004	2005	2006	2007	2008	2009
Required contribution	N/A	1.879	2.107	2.207	2.213	2.343	2.528
Actual/Budgeted contribution	1.200	1.879	2.107	2.207	2.213	2.343	2.528

The underlying assumptions in calculating the contribution are the nominal GDP series to 2048, the New Zealand Superannuation (NZS) expense series to 2048, and the expected long-run net after-tax annual return of the NZS Fund (6.8%) (6.8% *Budget Update*). The forecast rate of return is based on the forecasts of the Guardians of NZS. The GDP and NZS expense series were projected using the assumptions stated on page 29 of the 2004 FSR.

The Treasury website contains further information on the NZS Fund, as well as a copy of the NZS Fund model.

2

Fiscal Outlook

Summary of the *December Update*

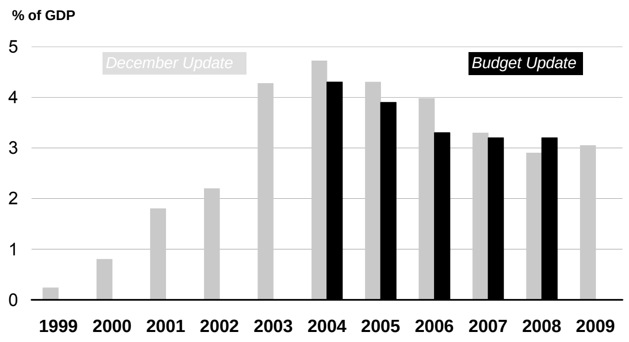
The forecast fiscal outlook is strong and remains consistent with the Government's long-term objectives, with the OBERAC (operating balance excluding revaluations and accounting policy changes) remaining around 3% of GDP and debt-to-GDP drifting down. These tracks are initially stronger than the *Budget Update* before weakening, reflecting:

- a stronger starting debt position resulting from higher-than-forecast OBERAC and cash flows in 2003/04
- a stronger forecast economic position for 2004/05 resulting in stronger tax revenues
- offsetting these improvements is the Government's decision to increase spending as outlined in the 2005 Budget Policy Statement (2005 BPS)

For the OBERAC these changes translate into:

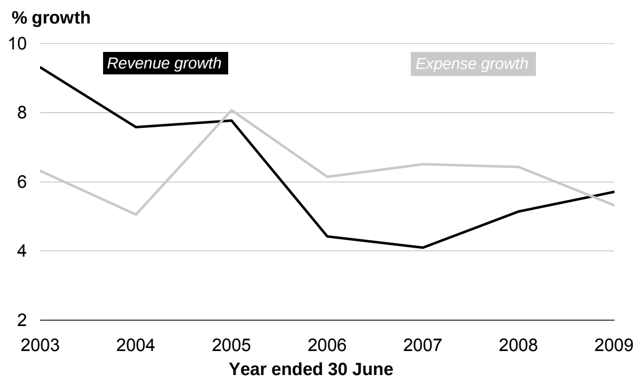
- a pattern that is broadly similar to the *Budget Update*, but shows a more pronounced cycle
- a level of $6.5 billion (4.3% of GDP) in 2004/05, which is slightly lower than 2003/04 largely due to the impact of the 2004 Budget outpacing revenue growth
- a level that decreases from 4.0% of GDP in 2005/06 to 2.9% of GDP in 2007/08 mainly due to the additional spending as outlined in the 2005 BPS

Figure 2.1 – OBERAC comparison



Source: The Treasury

Figure 2.2 – Core Crown revenue and expense growth (excluding GSF valuation)



Source: The Treasury

outpacing revenue growth, and then rising to 3.0% of GDP in 2008/09 as the higher economic growth generates higher tax revenue growth.

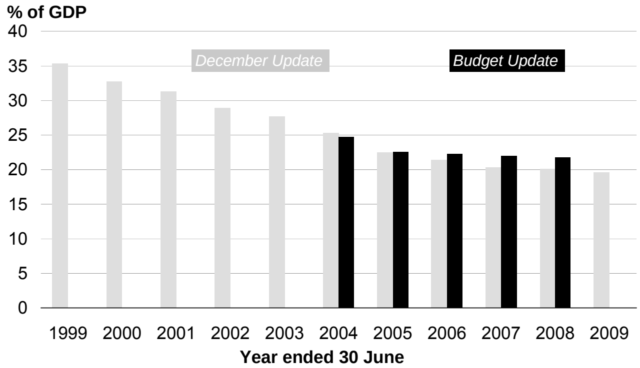
The OBERAC is more than fully utilised on the building up of financial assets (NZS Fund) and funding the Government's capital programme (refer page 46)

Core Crown expenses (excluding GSF valuation movements) are forecast to increase by around 2% of GDP over the forecast period from 30.1% in 2004/05 to 32.3% by 2008/09. Average core Crown expense growth has, as a result of Budget 2004, and higher Budgets 2005 to 2008, gone to around 6.5% per annum.

Gross sovereign-issued debt (gross debt) in nominal terms is forecast to fall until 2006/07, as residual cash surpluses from actual outturns are adequate to fund the Government's spending commitments and repay debt, but beyond 2007/08 is forecast to slowly rise as the capital spending is not fully funded from operating surpluses.

Gross debt is forecast to fall from 25.3% of GDP in 2003/04 to 19.6% of GDP by 2008/09, a rate slightly faster than forecast in the *Budget Update* due to the stronger 2003/04 actual outturn and forecast 2004/05 positions. The 2005 BPS (page 7) outlines how the current debt position enables the Government to meet its long-term fiscal objectives

Figure 2.3 – Gross sovereign-issued debt comparison



Source: The Treasury

As a result of the increased overall cash position through 2003/04 and the current year (2004/05) the Government's domestic bond programme for 2004/05 has been lowered to $2.15 billion from the $2.35 billion outlined in the *Budget Update*. The remaining increase in cash has been used to pre-fund part of the 2005/06 and 2006/07 borrowing requirements. The Government's planned domestic bond programme is $2.5 billion for 2005/06, $2.8 billion for 2006/07, $1.8 billion for 2007/08 and $3.4 billion for 2008/09.

Tables of the key indicators are located on pages 44 and 46.

OBERAC and Debt Trends

The OBERAC remains strong over the forecast horizon…

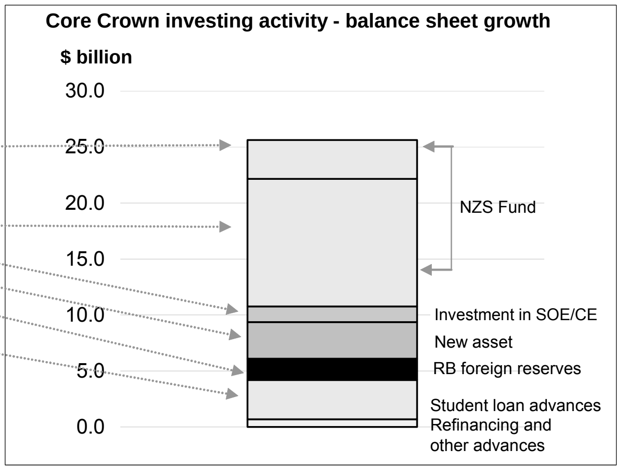
The OBERAC is forecast at $6.5 billion (4.3% of GDP) in the current year, falling to $4.9 billion (2.9% of GDP) in 2007/08 before rebounding to $5.4 billion (3.0% of GDP) by 2008/09.

… enabling the Government to utilise the cash surpluses to fund its investment programme…

The core Crown cash flow from operations generates cash for the core Crown of around $24.4 billion in total over the 2004/05 to 2008/09 forecast period.

Table 2.1 – Impact of core Crown operating surpluses on the balance sheet from 2004/05 to 2008/09 inclusive

	$ billion
Total Core Crown Operating Balances	20.3
Add	
Depreciation	5.4
Less	
Retained NZS Fund returns	(3.5)
Other	2.1
Operating cash flows	24.4
Invested in	
NZS Fund contributions	(11.4)
SOE/Crown entities net capital injections	(1.4)
Increase asset base	(3.3)
Purchase of foreign reserves	(1.9)
Maintain existing asset base	(5.4)
Advances	(4.2)
Other	0.1
Requiring Finance	(3.2)



Source: The Treasury

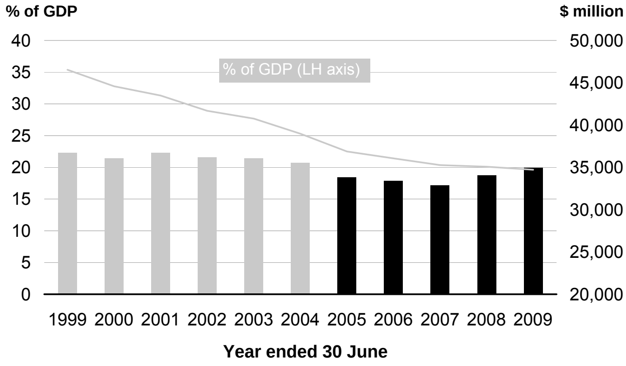
As outlined in Table 2.1, this cash is invested primarily in NZS Fund contributions of $11.4 billion, advances of $4.2 billion (mainly student loans and refinancing existing private sector debt of the health and housing sectors), purchases of physical assets of $10.1 billion (schools, hospitals, defence equipment, for example) and the purchase of foreign exchange reserves of $1.9 billion. There is a residual financing requirement of around $3.2 billion, which is partially met by reducing the holdings of marketable securities and deposits which have accumulated from 2003/04 and raising some debt.

… while gross debt as a percentage of GDP continues to drift down…

Gross debt falls in nominal terms to $32.9 billion by 2006/07, and then rises to $34.9 billion by the end of the forecast horizon. As a percentage of GDP, gross debt falls from 25.3% in 2003/04 to 19.6% by 2008/09.

The initial decrease in debt reflects surplus cash from the strong OBERAC result in 2003/04 and the expected result in 2004/05. Gross debt then slowly rises, reflecting the fact that capital spending is greater than the funding available due to the OBERAC.

Figure 2.4 – Gross sovereign-issued debt (% of GDP and $ million)



Source: The Treasury

The increased cash position for 2003/04 and 2004/05 will be used to reduce the Government's 2004/05 bond programme to $2.15 billion compared with $2.35 billion at the *Budget Update*, and pre-fund part of the 2005/06 and 2006/07 borrowing requirement. The Government's domestic bond programme is forecast at $2.5 billion for 2005/06, $2.8 billion for 2006/07, $1.8 billion for 2007/08 and $3.4 billion for 2008/09.

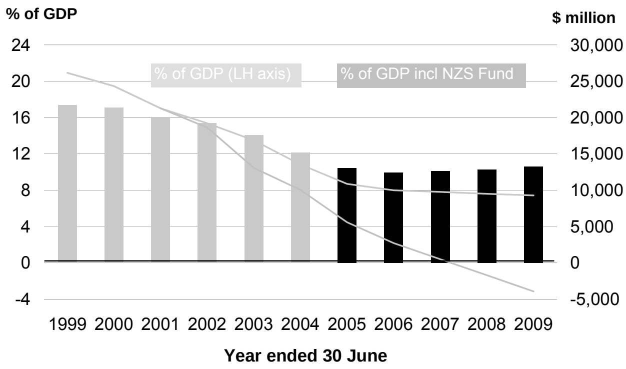
… net debt also falls before flattening by the end of the forecast horizon.

Net debt[4] in nominal terms falls in the current year reflecting the stronger cash position achieved in 2003/04 and that expected in 2004/05. Net debt remains relatively flat between 2005/06 and 2008/09. The difference with the trend of gross debt arises because some of the expected borrowing will be used to fund financial assets including student loans and reserves.

Net debt as a percentage of GDP reduces from 10.8% in 2003/04 to 7.4% by 2008/09.

Net core Crown debt with the financial assets of the NZS Fund is forecast to be below zero by 2007/08.

Figure 2.5 – Net debt (% of GDP and $ million) and % of GDP including assets of NZS Fund



Source: The Treasury

4 Net debt excludes the assets of the NZS Fund and GSF.

Revenue and Expenses Summary

Table 2.2 – Revenue and expenses comparison with *Budget Update*

Revenue and Expenses (% of GDP)	2004 Actual	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
Core Crown Revenue						
December Update	33.4	33.6	33.9	34.0	34.1	34.3
Budget Update		33.9	33.8	33.8	33.8	
Total Tax Revenue						
December Update	30.3	30.4	30.6	30.5	30.5	30.6
Budget Update		30.6	30.4	30.3	30.2	
Total Crown Revenue						
December Update	43.0	43.0	43.7	43.9	43.9	44.0
Budget Update		43.3	43.3	43.2	43.1	
Core Crown Expenses						
December Update	29.6	30.4	30.9	31.7	32.2	32.3
Budget Update		30.8	31.5	31.6	31.6	
Total Crown Expenses						
December Update	37.8	39.3	39.8	40.7	41.1	41.0
Budget Update		39.5	40.1	40.1	40.0	

Source: The Treasury

Over the forecast period total Crown revenue-to-GDP increases.

This is initially driven by two factors, tax revenue growth (which is discussed in more detail under the Tax Revenue heading below), and SOE revenue growth (offset by expense growth).

Total Crown expenses-to-GDP ratios show an increase over the forecast period.

The core Crown expenses-to-GDP ratio follows a similar trend to total Crown expenses, reflecting the impact of the increase in new spending signalled in the 2005 BPS and also the rising profile of the 2004 Budget package.

Tax Revenue

Table 2.3 – Tax revenue indicators

Tax Revenue	2004 Actual	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
($ million)						
Total Crown	42,532	45,669	47,634	49,340	51,721	54,549
(% of GDP)						
Total Crown	30.3	30.4	30.6	30.5	30.5	30.6

Source: The Treasury

Tax revenue as a percentage of GDP is forecast to rise slightly through the forecast period mainly as a result of tax policy changes and a rising profile in the forecasts of personal taxes. This differs from the *Budget Update*, where the profile of tax-vs-GDP was declining.

With economic performance having exceeded expectations since the *Budget Update*, higher total tax revenue is forecast for 2004/05, with flow-on effects for later years. Details are provided in Table 2.4.

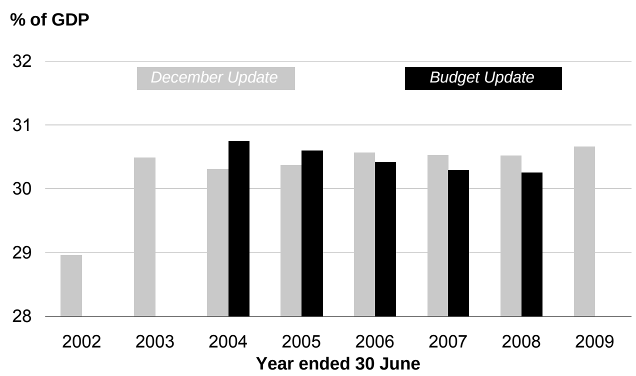
Table 2.4 – Change in tax revenue forecasts since *Budget Update*

($ million)	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast
Tax revenue 2004 *Budget Update*	44,193	45,915	48,048	50,532
Changes				
Source deductions	474	611	507	542
Corporate taxes	568	575	370	224
Goods and services tax	295	113	(14)	18
Withholding tax on resident interest	87	89	(30)	(22)
Thin Capitalisation for banks	-	240	360	360
Other	52	91	99	67
Total Changes	**1,476**	**1,719**	**1,292**	**1,189**
Tax Revenue 2004 *December Update*	45,669	47,634	49,340	51,721

As can be seen from Figure 2.6, tax revenue relative to GDP is actually lower than in the *Budget Update* up to and including 2004/05 and higher subsequently. Substantial upward revisions to the level of nominal GDP up to 2004 since the *Budget Update* have, in turn, resulted in increases to the nominal GDP forecasts for 2005 and beyond.

From 2005/06 onwards, tax revenue is higher than at the *Budget Update* (relative to GDP), mainly due to increases in the source deductions and corporate tax forecasts. There has also

Figure 2.6 – Comparison of tax revenue forecasts



Source: The Treasury

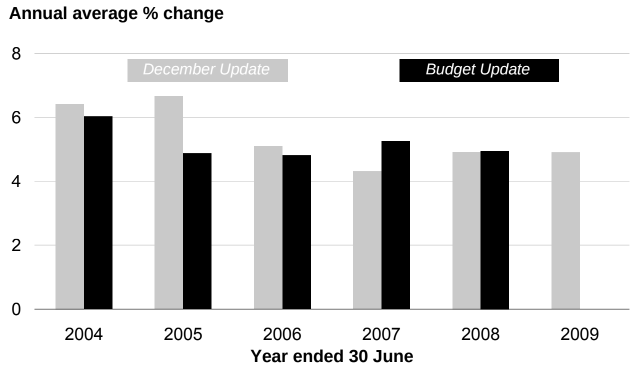
been an increase with the new thin capitalisation rules for banks and a change in the treatment of tax paid by the NZS Fund in the forecast period.

Forecast source deductions benefits from stronger labour market outlook

PAYE revenue has outstripped the *Budget Update* forecast in the four months to October. The labour market is continuing to exceed expectations, with the unemployment rate at its lowest level since the HLFS began and employment at very high levels.

With the current strength in employment and forecast increases in salaries and wages, source deductions are forecast to be around $500 million higher in every year compared to the *Budget Update*.

Figure 2.7 – Comparison of salary and wage forecasts



Source: The Treasury

Compensation of Employees is expected to account for an increasing portion of GDP through the forecast period. Source deductions therefore contributes to the rise in tax revenue relative to GDP.

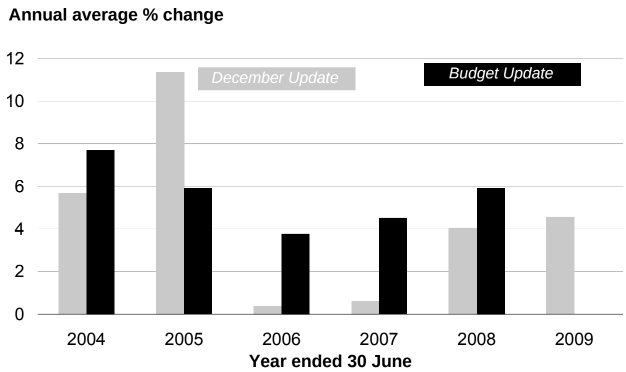
Corporate taxes are linked to the business cycle …

There is now a stronger cycle built into the corporate profit forecasts above that present in the *Budget Update* forecast.

Profit expectations for 2004/05 are higher than in the *Budget Update.* Recent outturns of corporate taxes have exceeded forecasts by about 6%.

We have changed the treatment of the income tax paid by the NZS Fund. The Fund is set to grow rapidly over the next few years. We now separately forecast the NZS Fund income tax rather than include it within the total corporate tax forecasts.

Figure 2.8 – Comparison of business profit forecasts



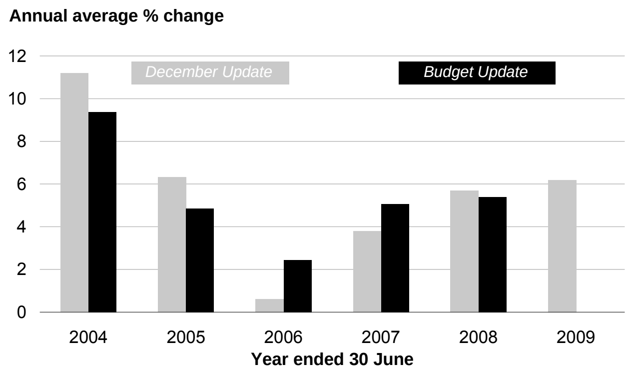
Source: The Treasury

… and a larger cycle in GST too

There is also a cycle in the GST forecasts, although the timing is a little different to the cycle in the corporate tax forecasts.

Current personal income growth supports domestic consumption in 2004/05 and we see an increase of around $300 million in the current year's GST forecast. But slowing income growth combined with increasingly-high household debt levels constrain further consumption growth and residential investment declines in 2005/06. This sees GST growth slow to under 1% in 2005/06 so that increases to the forecast are much less than the $300 million increase seen in 2004/05. The GST forecast hits its trough a year earlier than the corporate tax forecasts, which helps to smooth the aggregate tax forecasts through the economic cycle.

Figure 2.9 – Comparison of GST forecasts



Source: The Treasury

Effects of Tax Policy Changes on the Tax Forecasts

An up coming additional requirement included in the Public Finance (State Sector Management) Bill is an annual statement of tax policy changes that materially affect the tax revenue forecasts. In anticipation of that change, Table 2.5 details the effect of tax policy changes that have been included in these *December Update* forecasts.

Table 2.5 – Material changes in tax revenue forecasts owing to changes in tax policy since *Budget Update*[5]

($ million)	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
Material policy changes					
Thin Capitalisation for banks	-	240	360	360	360
Business environmental expenditure	-	(20)	(20)	(20)	(20)
Total changes (GST exclusive)	**-**	**220**	**340**	**340**	**340**

The details of each policy change are as follows:

Thin capitalisation for banks

A change to the thin capitalisation rules as they apply to banks will increase company tax revenue from 1 October 2005 onwards.

Tax deductions for business environmental expenditure

The rules covering tax deductions for business environmental expenditure to avoid, remedy or mitigate the discharge of contaminants are to be clarified and expanded. This will reduce company tax revenue from 1 July 2005 onwards.

5 Inclusive of GST, where applicable

Inland Revenue's tax 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 on the same underlying macroeconomic trends that underpin Treasury's tax forecasts.

Inland Revenue's forecasts are around $200 million higher than Treasury's in 2005/06 and 2006/07. Detailed comparisons of Treasury and Inland Revenue forecasts can be found at www.treasury.govt.nz/forecasts/defu/2004.

Expenses

Table 2.6 – Expenses indicators

Expenses	2004	2005	2006	2007	2008	2009
($ million)	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Core Crown	41,608	45,751	48,092	51,225	54,521	57,423
Core Crown (excluding GSF valuation)	41,923	45,308	48,092	51,225	54,521	57,423
Total Crown	53,057	59,157	62,009	65,825	69,622	73,016
(% of GDP)						
Core Crown	29.6	30.4	30.9	31.7	32.2	32.3
Core Crown (excluding GSF valuation)	29.9	30.1	30.9	31.7	32.2	32.3
Total Crown	37.8	39.3	39.8	40.7	41.1	41.0

Source: The Treasury

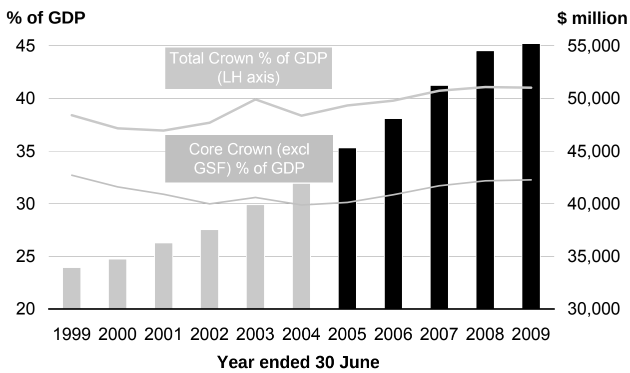
Expenses rise as a percentage of nominal GDP before stabilising

Core Crown operating expenses (excluding valuation items) are expected to rise by around 2% of GDP from 30.1% in 2004/05 to 32.3% of GDP by 2008/09. This reflects the 2004 Budget package including the *Working for Families* initiative and spending allocated for future budgets.

Core Crown operating expenses increase on average by around 6.5% per year which flows through into the total Crown expenses trend.

Nominally, core Crown expenses increase around $11.7 billion between 2004/05 and 2008/09. Removing the GSF liability movements, expenses increase by $12.1 billion over the same period. The major drivers of these expense increases are indexation of benefits and forecast new spending for future Budgets.

Figure 2.10 – Core expenses excluding valuations ($ and % of GDP)



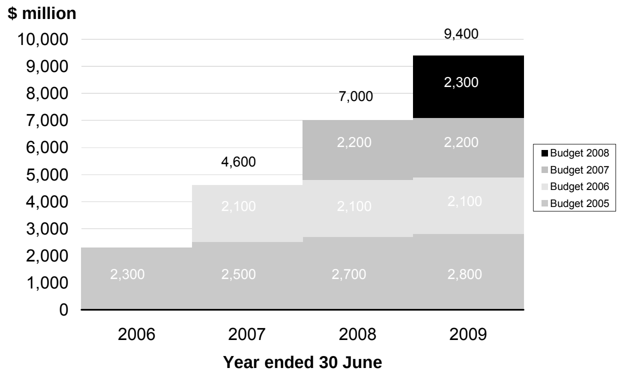
Source: The Treasury

The core spending areas of health and education are taking an increasing portion of the Budget each year. Health spending as a proportion of total core Crown expenses increases from 18.1% in 2000/01 to 19.3% in 2004/05. Education spending as a proportion of total core Crown spending also increases from 16.7% in 2000/01 to 17.8% in 2004/05. Health spending grows by 32.4% from 2000/01 to 2004/05. Education spending from 2000/01 to 2004/05 also grows by 32.4%. Over the same period health spending increases from 5.7% of GDP in 2000/01 to 5.9% of GDP in 2004/05. Education spending follows a similar trend and increases from 5.2% of GDP in 2000/01 to 5.4% of GDP in 2004/05.

Forecast new spending

The 2004 *Budget Update* allowed for $1.8 billion (GST inclusive) in new operating spending for Budget 2005. The 2005 BPS has signalled an increase to the 2005 Budget new spending package to $2.1 billion (GST inclusive) in 2005/06 rising to $2.4 billion (GST inclusive) by 2008/09, net of revenue initiatives such as the thin capitalisation rule for banks. The overall impact of the 2005 Budget package on the level of expenses is $2.3 billion (GST inclusive) rising to $2.8 billion (GST inclusive).

Figure 2.11 – New Budget spending (GST inclusive)



Source: The Treasury

Figure 2.11 represents the cumulative new operating spending for the 2005 Budget through to Budget 2008 excluding revenue initiatives. It shows:

- the 2005 Budget new spending is $2.3 billion rising to $2.8 billion. It has a rising profile, as some initiatives are expected to have increasing costs due to implementation phasing
- Budget 2006 new spending is $2.1 billion (GST inclusive), while Budget 2007 and Budget 2008 allow for $2.2 billion (GST inclusive) and $2.3 billion (GST inclusive) of new operating spending respectively. These are all higher than what was incorporated in the 2004 *Budget Update* which had $1.6 billion allocated to future budgets. A portion of the future Budget packages have already been allocated to baselines (eg, health funding package).

The capital provisions in 2005/06 and 2006/07 are higher than the *Budget Update* by $750 million in both years recognising upcoming capital pressures taking new capital expenditure to a total of $2.9 billion spread over the next four years, plus the legislatively required NZS Fund contributions.

SOE and Crown entity surpluses

Over the forecast horizon SOEs and Crown entities contribute $7.2 billion to the operating balance. These surpluses are largely retained by these entities to maintain and expand their asset bases (a total of $2.0 billion in dividends are expected to be returned). The Government is forecast to provide $1.4 billion of injections (primarily in Health and Housing) to build assets in the Crown entity segment from past budgets. Further injections from the forecast new capital spending will be considered in Budget 2005 and other future budgets.

Comparison with *Budget Update*

OBERAC and operating balance

Compared with the *Budget Update* the OBERAC is forecast to be initially stronger, largely reflecting improvements to tax revenue being sufficient to offset increases to new operating spending. This trend reverses in 2007/08.

Table 2.7 – OBERAC reconciliation (explains changes to the OBERAC since the *Budget Update*)

($ million)	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast
OBERAC *2004 Budget Update*	5,671	4,994	5,111	5,365
Changes (revenue)				
Tax revenue	1,476	1,719	1,292	1,189
Other sovereign revenue	(41)	(10)	13	27
Investment income	193	105	103	99
Other revenue	125	13	12	19
Other change to SOEs and Crown entities (excluding ACC valuation change)	(180)	(54)	(34)	(4)
Total revenue change	**1,573**	**1,773**	**1,386**	**1,330**
Changes (core Crown expenses excluding GSF 2004/05 valuation)				
Change to future new operating spending	(20)	(44)	(625)	(1,267)
Welfare benefit forecast changes	147	285	237	201
Social Security & Welfare (excluding welfare forecast changes)	(51)	(129)	(170)	(180)
Education	(263)	(361)	(365)	(356)
Health	8	19	42	65
Transport	(122)	(71)	(74)	(81)
Other core Crown functional expenses	(347)	(162)	(139)	(159)
Finance costs	(129)	(103)	(69)	5
Total core Crown expense change	**(777)**	**(566)**	**(1,163)**	**(1,772)**
Total Changes	**796**	**1,207**	**223**	**(442)**
OBERAC *2004 December Update*	6,467	6,201	5,334	4,923

Source: The Treasury

The difference between the OBERAC and the operating balance for the year ended 30 June 2005 is mainly due to the ACC ($296 million) and net GSF ($409 million) valuation movements. The *Budget Update* had no adjustments to reconcile the OBERAC with the operating balance.

Changes to components within the OBERAC/operating balance forecast include:

- tax revenue is higher than the *Budget Update* over the forecast horizon. The changes reported are a mix of forecasting and policy changes (as outlined earlier in the chapter)

In summary over the forecast horizon expenses are higher than the *Budget Update,* largely reflecting the signalled increase in new spending for future Budgets outlined in the 2005 BPS. Other expense changes include:

- welfare forecast changes are lower over the forecast period primarily due to lower unemployment levels than forecast in the *Budget Update*

- education expenses are higher over the forecast period mainly due to demographic changes and the specific allocation of new policy spending since the *Budget Update*

- transport expenses have increased reflecting forecast changes, funded by an increase in transport-related taxes and also a change in the split between operating and capital spending
- the change in other core Crown functional expenses mainly represents the allocation of the between budget spending up to Budget 2005.
- The specific allocation of new policy spending since the *Budget Update* is outlined in Table 2.8 and 2.9.

Table 2.8 – Specific decisions for new policy since the 2004 *Budget Update*

($ million)	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast
Secondary teachers' collective agreement	59	117	158	159
Primary and area school teachers' collective agreement	55	125	182	183
Principals' collective agreement	8	18	31	32
Early childhood education & Maori medium teacher scholarships	9	16	20	22
Business environmental expenditure	-	20	20	20
Department of Labour capability and strategic direction	2	9	9	9
Customs and MAF quarantine service capability	6	7	8	8
Other decisions	161	116	87	73
Total decisions since the 2004 *Budget Update (GST inclusive)*	**300**	**428**	**515**	**506**

Source: The Treasury

Table 2.9 – New capital spending since the 2004 *Budget Update*

($ million)	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast
Growth in the female custodial population	-	70	-	-
Meeting prison inmate demand pre-2008	33	92	-	-
Defence acquisition of light operational vehicles	37	16	-	-
Special operations capability: special forces equipment requirements	16	-	-	-
Refurbishment of the executive wing: final stages	-	15	-	-
Other decisions	43	23	16	-
Total decisions since the 2004 *Budget Update (GST inclusive)*	**129**	**216**	**16**	**-**

Source: The Treasury

Debt indicators

Gross sovereign-issued debt for 2004/05 has increased from that forecast in the *Budget Update* in 2004/05 by around $1.2 billion mainly due to the higher starting position from 2003/04 (debt neutral as the value of financial assets had a corresponding increase) offset by reductions in the 2004/05 borrowing requirement.

Further into the forecast horizon the increased cash position from 2003/04 and 2004/05 contributes to debt being lower than the *Budget Update* in 2005/06. Gross debt is forecast to be lower by $2.3 billion in 2007/08.

Net debt follows the same trend as gross sovereign-issued debt and is also lower by $2.3 billion by 2007/08.

Table 2.10 – 2004 *December Update* fiscal indicators

Fiscal Indicators ($ million)	**Year ended 30 June** 2004 Actual	2005 Forecast	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
Revenue						
Total revenue	60,387	64,643	68,071	71,020	74,406	78,305
Core Crown revenue	46,932	50,581	52,818	54,983	57,812	61,116
Tax revenue	42,532	45,669	47,634	49,340	51,721	54,549
Expenses						
Total expenses	53,057	59,157	62,009	65,825	69,622	73,016
Core Crown expenses	41,608	45,751	48,092	51,225	54,521	57,423
Operating balance - Core Crown	5,324	4,830	4,726	3,758	3,291	3,693
Operating balance - Crown entities	1,709	448	897	1,021	1,070	1,177
Operating balance - SOEs	672	785	900	929	955	1,014
Dividend elimination	(281)	(436)	(322)	(374)	(393)	(456)
Operating balance	7,424	5,627	6,201	5,334	4,923	5,428
OBERAC	6,629	6,467	6,201	5,334	4,923	5,428
OBERAC (excluding net NZS Fund asset returns)	6,436	6,184	5,699	4,648	4,035	4,317
Cash available/(shortfall to be funded)	520	1,436	(705)	(1,555)	(1,415)	(972)
Debt Indicators						
Gross sovereign-issued debt	35,527	33,846	33,409	32,905	34,056	34,931
Total gross Crown debt	36,825	36,093	36,648	36,241	36,857	36,780
Net core Crown debt	15,204	13,065	12,461	12,612	12,873	13,215
Net core Crown debt with NZS Fund assets	11,248	6,719	3,406	658	(2,312)	(5,609)
Net worth	35,463	41,109	47,310	52,644	57,567	62,995
Domestic bond programme	2,212	2,052	2,473	2,754	1,750	3,367
Nominal GDP	140,336	150,400	155,871	161,625	169,487	178,029
Fiscal Indicators as a % of GDP						
Revenue						
Total Crown revenue	43.0	43.0	43.7	43.9	43.9	44.0
Core Crown revenue	33.4	33.6	33.9	34.0	34.1	34.3
Tax revenue	30.3	30.4	30.6	30.5	30.5	30.6
Expenses						
Total Crown expenses	37.8	39.3	39.8	40.7	41.1	41.0
Core Crown expenses	29.6	30.4	30.9	31.7	32.2	32.3
Operating balance	5.3	3.7	4.0	3.3	2.9	3.0
OBERAC	4.7	4.3	4.0	3.3	2.9	3.0
OBERAC (excluding net NZS Fund asset returns)	4.6	4.1	3.7	2.9	2.4	2.4
Debt Indicators						
Gross sovereign-issued debt	25.3	22.5	21.4	20.4	20.1	19.6
Total gross Crown debt	26.2	24.0	23.5	22.4	21.7	20.7
Net core Crown debt	10.8	8.7	8.0	7.8	7.6	7.4
Net core Crown debt with NZS Fund assets	8.0	4.5	2.2	0.4	-1.4	-3.2
Net worth	25.3	27.3	30.4	32.6	34.0	35.4
New Zealand Superannuation Fund						
Fund asset returns (after tax)	193	283	502	686	888	1,111
Fund contributions	1,879	2,107	2,207	2,213	2,343	2,528
Fund assets (year end)	3,956	6,346	9,055	11,954	15,185	18,824
% of GDP	2.8	4.2	5.8	7.4	9.0	10.6

Source: The Treasury

Table 2.11 – 2004 *Budget Update* fiscal indicators

Fiscal Indicators ($ million)	**Year ended 30 June 2004 Actual**	**2005 Forecast**	**2006 Forecast**	**2007 Forecast**	**2008 Forecast**
Revenue					
Total revenue	60,387	62,525	65,374	68,565	72,000
Core Crown revenue	46,932	48,910	51,027	53,586	56,499
Tax revenue	42,532	44,193	45,915	48,048	50,532
Expenses					
Total expenses	53,057	57,005	60,531	63,605	66,786
Core Crown expenses	41,608	44,474	47,526	50,062	52,749
Operating balance - Core Crown	5,324	4,436	3,501	3,524	3,750
Operating balance - Crown entities	1,709	749	936	1,050	1,078
Operating balance - SOEs	672	835	928	934	965
Dividend elimination	(281)	(349)	(371)	(397)	(428)
Total operating balance	7,424	5,671	4,994	5,111	5,365
OBERAC	6,629	5,671	4,994	5,111	5,365
OBERAC (excluding net NZS Fund asset returns)	6,436	5,340	4,492	4,421	4,464
Cash available/(shortfall to be funded)	520	(808)	(1,176)	(1,466)	(1,541)
Debt Indicators					
Gross sovereign-issued debt	35,527	32,663	33,622	34,946	36,344
Total gross Crown debt	36,825	34,857	36,579	37,572	37,684
Net core Crown debt	15,204	15,336	15,162	14,985	15,136
Net core Crown debt with NZS Fund assets	11,248	9,013	6,118	2,909	(345)
Net worth	35,463	35,403	40,397	45,508	50,873
Domestic bond programme	2,212	2,311	2,958	3,556	538
Nominal GDP	140,336	144,441	150,947	158,626	167,051
Fiscal Indicators as a % of GDP					
Revenue					
Total Crown revenue	43.0	43.3	43.3	43.2	43.1
Core Crown revenue	33.4	33.9	33.8	33.8	33.8
Tax revenue	30.3	30.6	30.4	30.3	30.2
Expenses					
Total Crown expenses	37.8	39.5	40.1	40.1	40.0
Core Crown expenses	29.6	30.8	31.5	31.6	31.6
Operating balance	5.3	3.9	3.3	3.2	3.2
OBERAC	4.7	3.9	3.3	3.2	3.2
OBERAC (excluding net NZS Fund asset returns)	4.6	3.7	3.0	2.8	2.7
Debt Indicators					
Gross sovereign-issued debt	25.3	22.6	22.3	22.0	21.8
Total gross Crown debt	26.2	24.1	24.2	23.7	22.6
Net core Crown debt	10.8	10.6	10.0	9.4	9.1
Net core Crown debt with NZS Fund assets	8.0	6.2	4.1	1.8	-0.2
Net worth	25.3	24.5	26.8	28.7	30.5
New Zealand Superannuation Fund					
Fund asset returns (after tax)	193	331	502	690	901
Fund contributions	1,879	2,107	2,219	2,342	2,504
Fund assets (year end)	3,956	6,323	9,044	12,076	15,481
% of GDP	2.8	4.4	6.0	7.6	9.3

Source: The Treasury

Fiscal Indicators and the Use of the Operating Surplus

There are a number of indicators that are important in understanding the state of the Government's fiscal position. All provide important information on the Government's activity and no one indicator can explain everything. For example:

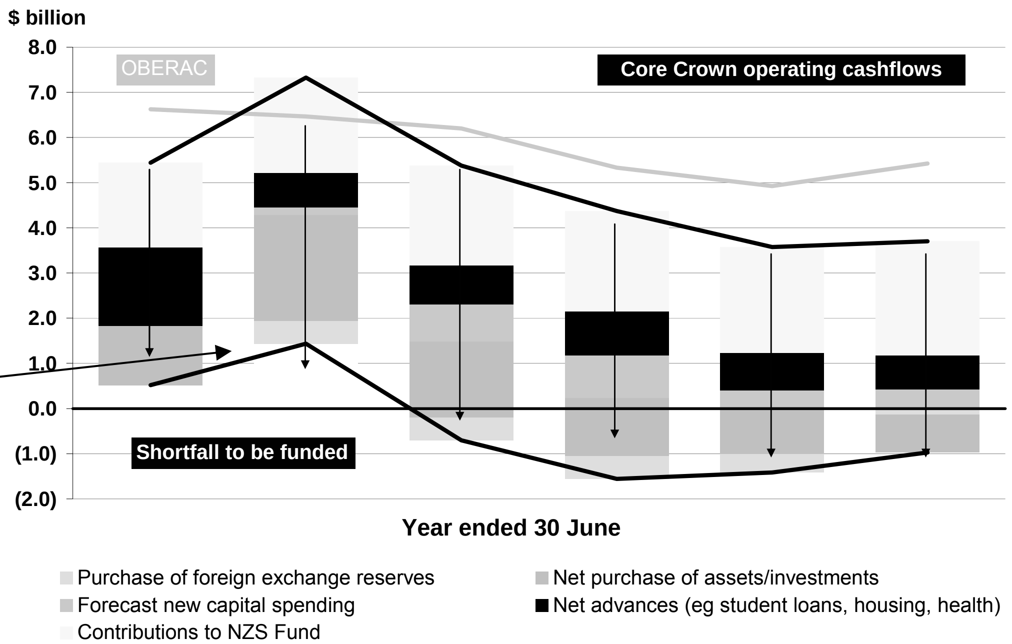
- the operating surplus reflects the difference between current revenues and current expenses. It also includes the results of SOEs and Crown entities. It is an accrual measure showing whether the Government is raising sufficient revenue to cover current expenses. It does not capture all spending, especially new capital spending
- cash flows provide an indicator of the net effect of all activity, operating and capital, and how it will be financed. Put another way, cash flows can be used to show how any operating surplus is utilised. They show the cash effect of any operating surplus and how it is then either used to repay debt (which happened through the 1990s when government debt was high) or spent on acquiring assets (which has been the focus recently to save in the NZS Fund or allocate more to new assets)
- gross debt is a stock (a balance sheet item). The debt burden captures the effect of government decisions in that all operating and capital expenditure not funded by revenues or asset sales will need to be funded by borrowing. The Government is working to ensure debt is falling through 20% of GDP before 2015.

Why does the Government run an operating surplus? Why is it not "available" for more spending or tax cuts?

The answer to these questions is the Government's fiscal strategy. The Government runs an operating surplus to help it save for future demographic issues (hence the contributions to the NZS Fund) and to assist in the financing of the Government's capital programme. The Government still needs to borrow some money in most years to fund the shortfall between the forecast operating surplus and the capital programme (which is often larger than the surplus).

The following graph shows how the operating surplus (or OBERAC) is used in each year over the forecast horizon, and therefore why nominal debt has to increase even when there is a "surplus".

When this line is above zero, there are funds available for repaying debt. Below zero, borrowing is needed to fund spending.



Source: The Treasury

The following table explains how the operating surplus/OBERAC is calculated for the 2004/05 and the 2005/06 financial years and then how it is applied. Any extra spending or reduced tax revenue would add to the bottom-line cash shortfall (and add to the need to borrow).

$ million	2004/05	2005/06	Description of Items
	50,581	52,818	**Core Crown revenues** – these are the revenues the Government collects. They are mainly taxes.
	-45,751	-47,992	**Core Crown expenses** – these represent most of the Government's spending, *BUT not all of it*. They are the day-to-day spending (salaries, benefit payments, etc) that does not create Government assets.
	797	1,475	**Net surplus of SOEs and Crown entities** – this is the net surplus (after dividends) that SOEs and Crown entities make.
Operating balance	**5,627**	**6,201**	**Operating balance** – the residual of revenues less expenses plus surpluses from state-owned enterprises and Crown entities. It is the Government's operating profit or loss.
	840	-	**OBERAC adjustments** – removal of revaluation movements
OBERAC	**6,467**	**6,201**	**OBERAC** – the residual from revenues and expenses less removal of large valuation movements (the OBERAC and operating balance are the same in forecast years).
Less	861	-822	**Retained items and non-cash items** – items such as the net surplus of SOEs/Crown entities and the net investment returns of the NZS Fund are retained by these entities. The surpluses generated (unless withdrawn from the entities) cannot be used for other purposes so do not aid in funding other government spending. Depreciation expense is also removed as it is non-cash (it is captured in the actual purchase of assets below). Additionally, the actual working capital movements such as payment of creditors impacts on the level of net cashflows from operations.
Equals surplus cash flows	**7,328**	**5,380**	**Cash from operations** – these are the cash flows from core Crown operations (excluding the NZS Fund). This is the cash equivalent of the operating surplus and is available to assist fund capital spending.
Less capital spending	-2,107	-2,207	**Contributions to the NZS Fund** – the Government's annual contribution to the NZS Fund to build up assets to contribute to future NZS payments.
	-1,705	-1,396	**Purchase of assets** – departments buy assets including computer equipment, new buildings and defence equipment.
	-772	-868	**Loans to others (advances)** – these are mainly student loans (the Government is committed to help students access tertiary education by funding student loans).
	-650	-299	**Net capital injections** – investments in Crown entities to enable them to build hospitals and housing.
	-500	-500	**Reserve Bank reserves** – purchase of extra reserves to assist the Reserve Bank to maintain financial stability.
	-158	-815	**Capital forecast** – an amount set aside for further capital activity. The Government has not yet decided on the specific initiatives.
What is left	**1,436**	**-705**	**Cash available**/ (**shortfall)** – this amount needs to be funded if it is a shortfall. Funding is provided by selling surplus financial assets (because of surplus cash from prior years) or borrowing more.

Risks to Fiscal Forecasts

The fiscal forecasts were finalised on 2 December 2004 in accordance with the forecast accounting policies. There are certain risks around the forecast results. To assist in evaluating such risks the following chapters should be read in conjunction with the fiscal forecasts:

- Risks and scenarios (Chapter 3) – The fiscal forecasts are based on the economic forecasts presented in Chapter 1 and any variation from the economic forecast will affect on the fiscal forecasts, in particular tax revenue and benefit expenses. The risks and scenarios chapter discusses the effect on the forecasts under different circumstances.

- Specific fiscal risks (Chapter 4) – The fiscal forecasts incorporate government decisions up to 2 December 2004. The specific fiscal risks chapter covers specific policy decisions that are under active consideration by the Government at the time of the finalisation of the forecasts.

In addition to the specific fiscal risks and the link to the economic forecasts, there are a number of forecasting issues explained below that may arise in future.

Tax forecasting risks

The tax forecasts prepared for this *December Update* are based on current tax policy and on the macroeconomic central forecast. Sensitivities of tax revenue to changes in economic conditions are presented in the Risks and Scenarios chapter on page 60.

State-owned enterprises and Crown entities forecasts

The forecasts for large SOEs and Crown entities were provided in October 2004 based on their best assessments at that time.

Revaluation of property, plant and equipment

Crown accounting policy is to revalue certain classes of property, plant and equipment on a regular basis. In certain circumstances the valuation will be affected by foreign exchange rates, so any appreciation in the New Zealand dollar (from 30 June 2004) will adversely affect the current physical asset values included in the fiscal forecasts.

Discount rates

The GSF and ACC liabilities included in these forecasts have been valued as at 31 October and 30 September respectively. The liabilities are to be next valued for the 2005 *Budget Update*. Any change in discount rates will affect the presented fiscal forecast. For example, if the discount rate rises, the value of the liabilities will decrease.

International financial reporting standards

The New Zealand Accounting Standards Review Board announced in December 2002 that International Financial Reporting Standards (IFRSs) will apply to financial reporting by both public and private sector entities from 1 January 2007, but with entities having the option to adopt from 1 January 2005.

The Crown plans to adopt the New Zealand IFRSs in the 2007 Budget.

Tertiary education institutes' (TEIs') accounting treatment

The forecast information presented in the *2004 December Update* combine TEIs on an equity accounting basis. As noted in previous publications the combination treatment of TEIs remains unresolved.

The combination method adopted in these forecasts is to equity account for the TEIs' net surpluses and net investment and not the TEI revenues, expenses, assets and liabilities on a line-by-line method. This is consistent with the treatment adopted in the 2004 Crown financial statements.

The key indicators are unchanged as a result of the combination approach for TEIs (refer page 56 of the 30 June 2004 Crown financial statements).

Foreshore and seabed recognition

The Foreshore and Seabed Act 2004 vests in the Crown the full legal and beneficial ownership of the public foreshore and seabed. Whether the public foreshore and seabed, or parts of, meet the requirements for asset recognition for the purposes of reporting in the Crown Financial Statements and fiscal forecasts is currently being considered. Any recognition of public foreshore and seabed for reporting purposes will increase the value of physical assets, revenue and net worth included in the fiscal forecasts but is excluded from the calculation of the OBERAC.