Fiscal Forecasts – Finalisation Dates and Key Assumptions

Finalisation Dates	
Economic and tax outlook (refer Chapter 1)	18 November
Tax revenue forecasts	23 November
Fiscal forecasts	7 December
Government decisions and circumstances	7 December
Actual asset revaluations	31 October
Foreign exchange rates	30 September
Specific fiscal risks (refer Chapter 4)	7 December
Contingent liabilities and commitments (refer Chapter 4)	31 October

Key assumptions

The fiscal forecasts have been prepared in accordance with the Public Finance Act 1989. They are based on the Crown's accounting policies and assumptions (refer page 90 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):

	2005/06		2006/07	2007/08	2008/09	2009/10
June years	**Pre-EFU**	**HEFU**	**HEFU**	**HEFU**	**HEFU**	**HEFU**
Real GDP (P) (ann avg % chg)	2.2	2.9	1.7	2.5	3.7	3.1
Nominal GDP (E) ($m)[1]	156,481	158,947	163,062	169,897	178,805	187,853
CPI (annual % change)	2.9	3.4	3.1	2.4	2.2	2.0
Govt 10-year bonds (qty avg %)	6.1	6.0	6.2	6.1	6.0	6.0
90-day bill rate (qty avg %)	7.0	7.5	6.8	6.3	6.0	5.8
Unemployment rate ((HLFS) basis ann avg %)	3.9	3.4	3.8	4.1	4.3	4.5
Full-time equivalent employment (ann avg %)	0.8	2.8	0.4	0.6	1.2	1.3
Current account (% of GDP)	-7.6	-9.1	-8.3	-7.2	-6.6	-5.9

Source: The Treasury

New Zealand Superannuation (NZS) Fund

The contribution to the NZS Fund for the year ending 30 June 2007 is $2.351 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. The Government is making the required minimum annual contribution for 2005/06 as calculated by the formula set out in the NZS Act.

$ billion (June year end)	2004	2005	2006	2007	2008	2009	2010
Required contribution	1.879	2.107	2.337	2.351	2.443	2.677	2.819
Actual/Budgeted contribution	1.879	2.107	2.337	2.351	2.443	2.677	2.819

Source: The Treasury

The underlying assumptions in calculating the contributions for 2007 are the nominal GDP series to 2047, the NZS expense series to 2047 and the expected long-term, net after-tax annual return of the NZS Fund (6.1%) (6.1% *Pre-election Update*). The forecast rate of return is based on the Treasury's assumptions for the rate of return on financial portfolios of Crown financial institutions. The Treasury website contains further information on the NZS Fund, as well as a copy of the NZS Fund model.

1 Historical March year nominal GDP was revised in National Accounts data released on November 17.

2

Fiscal Outlook

Summary

The forecast fiscal outlook for the *Half Year Update* reflects:

- the OBERAC as a percentage of GDP declining from 5.9% in 2004/05 to 3.7% in the current year. It drops to a low of 1.9% in 2008/09 before rebounding to 2.7% in 2009/10
- net worth increasing by around $24 billion over the forecast period, largely resulting from the accumulation of financial assets (primarily the NZS Fund)
- the cash equivalent of the OBERAC is not sufficient to fund all of the Government's investing activity over the forecast period, leaving an expected cash shortfall to be met by reducing financial assets and additional borrowing
- gross sovereign-issued debt as a percentage of GDP slowly reducing over the forecast period, while in nominal terms gross debt rises near the end of the forecast period.

Compared to the *Pre-election Update* the OBERAC is lower due to:

- tax revenue being slightly higher in the early forecast years
- the increase in the operating allowance for Budget 2006 for the extension to the Working for Families package announced on 18 August which reduces the OBERAC by around $2.2 billion over the forecast period
- the impact of the fair value changes due to the interest free student loan policy reducing the OBERAC by around $1 billion in the current year (refer page 39)
- the economic assumptions used in compiling the fiscal forecasts is the Central Forecast outlined in the Economic and Tax Outlook chapter.

Fiscal Indicators

There are a number of indicators that are important in understanding the state of the Government's fiscal position. No single indicator provides an all-purpose measure of the financial performance of the Crown and its impact on the economy. For example:

- the total Crown operating balance reflects the difference between current revenues (tax revenue, investment income etc) and current expenses (salaries, benefit payments etc). The operating balance shows whether the Government has generated enough revenue to cover expenses
- the total Crown OBERAC reflects the difference between current revenues and current expenses adjusted for valuation movements and accounting policy changes. The OBERAC provides a measure of the Government's underlying stewardship
- the total Crown net worth reflects the difference between total assets and total liabilities. The change in net worth in any given forecast year is primarily driven by the operating balance
- the cash available/(shortfall to be funded) reflects the net effect of the Government's core Crown operating (cash equivalent of the OBERAC) and investing activities (such as contributions to the NZS Fund and purchases of physical assets). It shows whether the cash generated is sufficient to meet all government spending (both operating and investing)
- gross sovereign-issued debt reflects the debt burden of the core Crown (excluding the activity of the NZS Fund and GSF). The movement over the forecast period is primarily driven by the cash available/(shortfall to be funded)
- net core Crown debt reflects borrowings (financial liabilities) less cash and bank balances, marketable securities and deposits, and advances (financial assets). Net debt excludes the financial assets of the NZS Fund and GSF as these assets are restricted in nature.

Table 2.1 – Summary fiscal indicators[2]

	Year ended 30 June					
($ million)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Total revenue	67,065	69,775	72,141	74,590	77,085	82,131
% of GDP	*44.4*	*43.9*	*44.2*	*43.9*	*43.1*	*43.7*
Total expenses	60,910	64,351	66,381	70,620	73,851	77,173
% of GDP	*40.3*	*40.5*	*40.7*	*41.6*	*41.3*	*41.1*
Operating balance	6,247	5,557	5,893	4,103	3,367	5,091
% of GDP	*4.1*	*3.5*	*3.6*	*2.4*	*1.9*	*2.7*
OBERAC	8,873	5,924	5,893	4,103	3,367	5,091
% of GDP	*5.9*	*3.7*	*3.6*	*2.4*	*1.9*	*2.7*
Net worth	49,983	55,555	61,448	65,551	68,918	74,009
% of GDP	*33.1*	*35.0*	*37.7*	*38.6*	*38.5*	*39.4*
Cash available/(shortfall to be funded)	3,104	492	(1,341)	(2,687)	(3,167)	(1,366)
% of GDP	*2.1*	*0.3*	*(0.8)*	*(1.6)*	*(1.8)*	*(0.7)*
Gross sovereign-issued debt	35,045	33,275	32,967	35,728	36,111	36,195
% of GDP	*23.2*	*20.9*	*20.2*	*21.0*	*20.2*	*19.3*
Net core Crown debt	10,771	10,597	10,434	11,854	14,240	14,998
% of GDP	*7.1*	*6.7*	*6.4*	*7.0*	*8.0*	*8.0*

Source: The Treasury

2 Detailed tables of the key indicators for the *Half Year Update* and *Pre-election Update* are located on pages 48 and 49.

Key Trends

The OBERAC is expected to drop before rebounding towards the end of the forecast horizon…

The OBERAC is forecast to fall from $5.9 billion (3.7% of GDP) in the current year to $3.4 billion (1.9% of GDP) by 2008/09, before rising to $5.1 billion (2.7% of GDP) by 2009/10. However, this is still sufficient to meet the requirements for contributions to the NZS Fund and progress towards the debt objective of 20% of GDP by 2015.

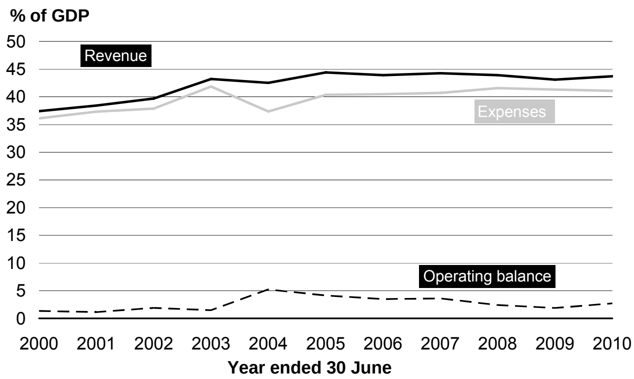
Revenues are forecast to exceed operating expenses…

Over the forecast horizon revenue is expected to be more than sufficient to meet operating expenses (salaries, benefit payments, depreciation costs, etc).

In recent years core Crown revenue growth has exceeded expense growth, largely consistent with strong economic growth. This trend is expected to reverse over the initial stage of the forecast period. This reflects:

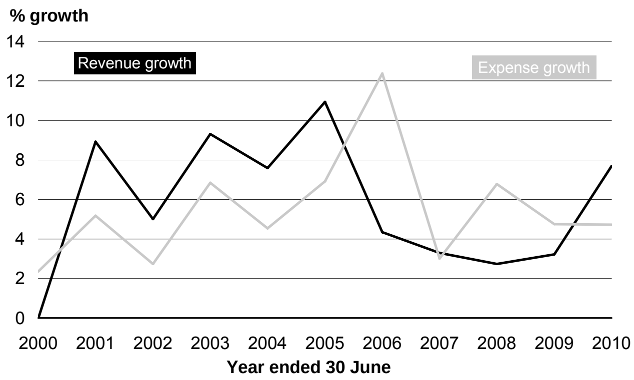
- the fair value measurement of student loans in 2005/06 and an extension to the Working for Families package from 2006/07
- the impact of the forecast economic cycle on tax revenue. Tax revenue growth decreases due to an expected slowdown in economic growth in the early part of the forecasts, before rebounding by 2009/10.

Figure 2.1 – Total Crown revenue, expenses and operating balance



Source: The Treasury

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



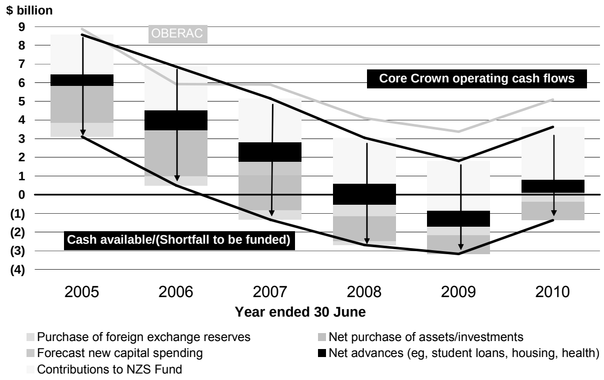
Source: The Treasury

… but not by enough to finance all investments …

In line with the Government's fiscal objectives the OBERAC has been applied to fund the Government's investments. The existing fiscal strategy is to strengthen public finances to prepare for future fiscal costs associated with an ageing population. Over the forecast period total assets are expected to increase by around $29.4 billion.

The OBERAC is not fully available to finance the capital programme. This is because some components of the OBERAC are non-cash (ie, depreciation) or retained by entities within the Crown (ie, SOE/Crown entity surpluses and NZS Fund returns) for the purpose of achieving their long-term objectives. Adjusting for these items gives the core Crown operating cash flows. Figure 2.3 shows how these cash flows are applied across the forecast years.

Figure 2.3 – Core Crown investments on a year-by-year basis

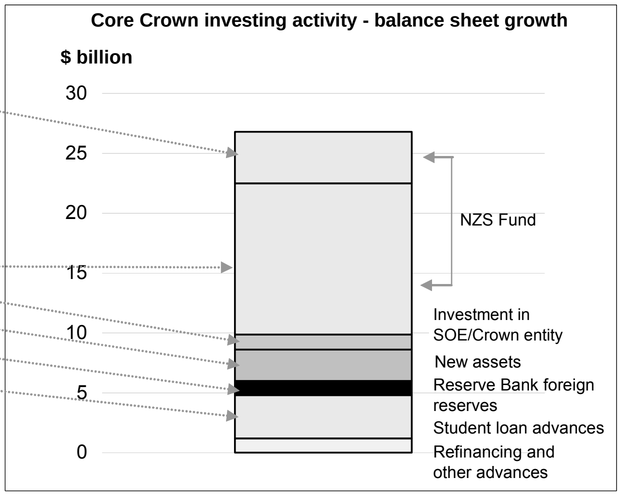


Source: The Treasury

As outlined in Table 2.2 below, the cumulative operating balances are expected to be in surplus by a total of $24 billion over the years from 2005/06 to 2009/10. Adjusting for returns retained by entities within the Crown ($13.4 billion) and non-cash items ($9.9 billion) gives a cash flow from operations which generates around $20.5 billion over the forecast horizon.

Table 2.2 – Impact of Crown operating surpluses on the balance sheet from 2005/06 to 2009/10 inclusive

	$ billion
Operating Balances	24.0
Less	
Retained NZS Fund returns	(4.3)
Retained SOE/Crown entity returns	(9.1)
Add	
Depreciation	6.1
Other	3.8
Operating cash flows	20.5
Invested in	
NZS Fund contributions	(12.6)
SOEs/Crown entities' net capital injections	(1.3)
Increase asset base	(2.6)
Purchase of foreign reserves	(1.2)
Maintain existing asset base	(6.1)
Advances	(4.8)
Other	0.0
Requiring Finance	(8.1)



Source: The Treasury

This will be invested primarily in NZS Fund contributions of $12.6 billion, purchases of physical assets of $8.7 billion (for example, schools and defence equipment), advances of $4.8 billion (mainly student loans and refinancing existing private sector debt of the health and housing sectors), injections into Crown entities for hospitals and housing of $1.3 billion and the purchase of foreign exchange reserves of $1.2 billion.

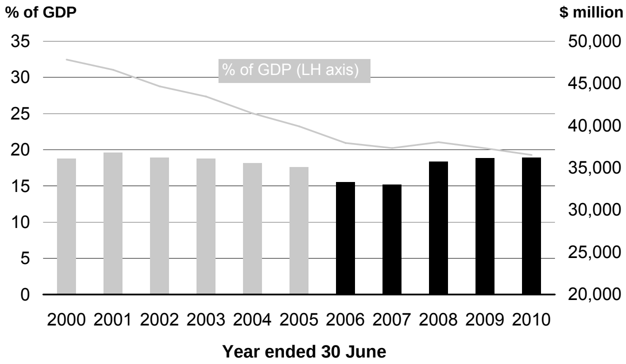
There is a residual financing requirement of around $8.1 billion, which will be partially met by reducing the holdings of marketable securities and deposits which have accumulated from 2003/04 and 2004/05, and by raising some debt.

… while gross debt as a percentage of GDP slowly reduces over the forecast period

As a percentage of GDP, gross debt is expected to fall from 23.2% in 2004/05 to 19.3% by 2009/10. In nominal terms, gross debt is forecast to fall to $33 billion by 2006/07 and then rise to $36.2 billion by the end of the forecast horizon.

The initial decrease in debt in nominal terms reflects residual cash from the strong results in 2003/04 and 2004/05. Gross debt is then expected to slowly rise, reflecting the fact that capital spending will be greater than the funding available due to the OBERAC.

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



Source: The Treasury

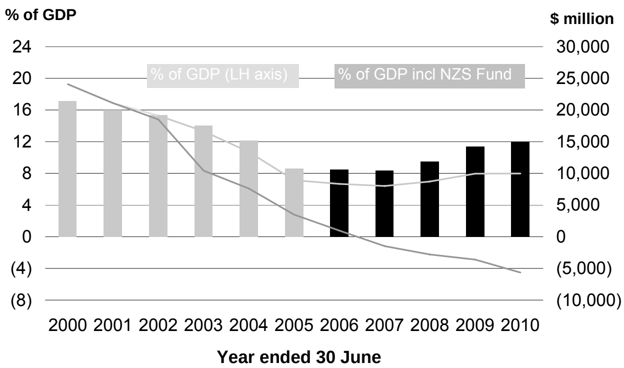
The Government's 2005/06 bond programme has been increased to $2.7 billion, compared with $2.2 billion at the *Pre-election Update*. There have also been increases to the 2006/07, 2007/08 and 2008/09 domestic bond programmes of around $1 billion in each of those years. The changes are attributable to the lower OBERAC's outlined earlier flowing through to higher financing requirements over the forecast horizon, which with this Update now includes 2009/10. The Government's approach is to smooth the size of the bond programme from year to year to provide a steady supply of new bonds to the market, with any over-funding in a year being used to pre-fund part of future years' borrowing requirements.

Net core Crown debt is expected to rise over the forecast horizon

Net core Crown debt[3] in both nominal terms and as a percentage of GDP is forecast to increase due to the financing requirement outlined above.

Net core Crown debt with the financial assets of the NZS Fund is forecast to be below zero by 2006/07.

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



Source: The Treasury

3 Net core Crown debt excludes the assets of the NZS Fund and GSF.

Revenue and Expenses

Table 2.3 – Revenue and expenses comparison with *Pre-election Update*

	Year ended 30 June					
(% of GDP)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Total Revenue						
Half Year Update	44.4	43.9	44.2	43.9	43.1	43.7
Pre-election Update		44.4	44.7	43.8	44.1	
Total Expenses						
Half Year Update	40.3	40.5	40.7	41.6	41.3	41.1
Pre-election Update		39.8	40.8	41.4	41.1	
Core Crown Revenue						
Half Year Update	34.5	34.2	34.4	33.9	33.3	34.1
Pre-election Update		34.5	34.6	33.9	34.3	
Core Crown Expenses						
Half Year Update	30.6	31.9	31.8	32.6	32.5	32.4
Pre-election Update		31.0	31.8	32.5	32.4	
SOE Revenue						
Half Year Update	5.9	7.1	7.3	7.2	7.2	7.1
Pre-election Update		6.9	7.0	6.9	6.9	
SOE Expenses						
Half Year Update	5.5	6.6	6.8	6.7	6.6	6.5
Pre-election Update		6.4	6.5	6.4	6.3	
Crown Entities' Revenue						
Half Year Update	14.0	15.0	15.3	15.1	14.5	13.9
Pre-election Update		14.9	15.0	14.6	14.2	
Crown Entities' Expenses						
Half Year Update	13.0	14.2	14.6	14.4	13.8	13.4
Pre-election Update		14.3	14.3	13.9	13.4	

Source: The Treasury

Over the forecast period, total revenue to GDP is expected to increase initially before dropping in 2008/09 due to a tax policy decision resulting in a change to provisional tax dates (aligning the payment dates for provisional tax and GST will result in payment deferral. For some taxpayers, the deferral pushes a provisional tax payment out of 2008/09 and into the following fiscal year) before returning to previous levels by 2009/10. Total expenses to GDP are also forecast to rise initially before flattening by 2008/09.

The trend in total revenue and expenses over the forecast horizon will largely be driven by activity in the core Crown segment of reported government activity.

The following section discusses revenue and expenses of the Crown by segment of reported government activity (ie, core Crown, SOEs and Crown entities).

Core Crown – Revenue

Tax revenue is the major source of core Crown revenue.

Table 2.4 – Tax revenue indicators

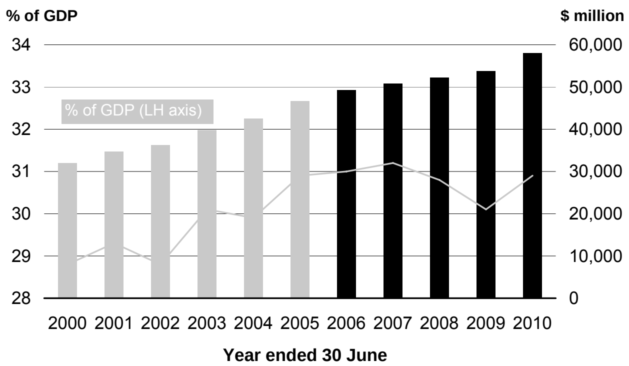
Tax Revenue	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
($ billion)						
Total Crown	46.6	49.2	50.8	52.3	53.8	58.0
Core Crown	47.1	49.7	51.4	52.8	54.4	58.7
(% of GDP)						
Total Crown	30.9	31.0	31.2	30.8	30.1	30.9
Core Crown	31.2	31.3	31.5	31.1	30.4	31.2

Source: The Treasury

Ignoring such things as cyclical effects and tax policy changes, tax revenue should grow slightly faster than nominal GDP. This is because the influence of fiscal drag, caused by the progressive nature of the personal tax system, outweighs the influence of some of the tax types for which growth is not necessarily linked to any component of GDP, e.g. excise taxes.

The small rise in tax revenue to GDP in 2006/07 comes mainly through source deductions. Source deductions is closely linked to the economic aggregate of Compensation of Employees (COE). As COE accounts for an ever-increasing portion of GDP through the forecast period, so too does source deductions, most noticeably in 2006/07. Source deductions growth is more muted later in the forecast period as the threshold adjustments announced as part of Budget 2005 start to take effect from 2007/08.

Figure 2.6 – Tax revenue forecasts



Source: The Treasury

There is a pronounced business cycle present in the economic forecasts. This will necessarily be reflected in the business-related tax types of corporate tax and other persons tax. In addition, through the trough of the business cycle, we are likely to see above-average tax loss accumulation. The subsequent utilisation of these losses will suppress tax growth in 2007/08 and 2008/09. This is the major cause of the drop in tax relative to GDP in 2007/08. The further drop in 2008/09 can be ascribed to changes in the provisional tax system that will push a major revenue recognition point across the fiscal year boundary into 2009/10. Note that this occurs a year later than in the *Budget Update* and the *Pre-election Update* as the implementation of this change has been delayed for one year.

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 broad macroeconomic trends that underpin Treasury's tax forecasts.

Table 2.5 – Treasury and Inland Revenue tax revenue forecasts

($ million)	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Individuals' Taxes					
Treasury	23,272	24,439	25,553	26,434	28,161
Inland Revenue	23,423	24,545	25,851	26,859	28,532
Difference	(151)	(106)	(298)	(425)	(371)
Corporate Taxes					
Treasury	9,141	9,070	8,568	8,357	9,983
Inland Revenue	9,172	8,693	8,925	8,731	9,617
Difference	(31)	377	(357)	(374)	366
Resident Withholding Tax (interest)					
Treasury	1,745	1,814	1,801	1,852	1,975
Inland Revenue	1,826	1,881	1,900	1,976	2,075
Difference	(81)	(67)	(99)	(124)	(100)
Goods and Services Tax					
Treasury	10,341	10,507	10,926	11,609	12,210
Inland Revenue	10,334	10,787	11,132	11,726	12,240
Difference	7	(280)	(206)	(117)	(30)
Other Taxes					
Treasury	4,750	4,991	5,405	5,508	5,655
Inland Revenue	4,801	5,083	5,482	5,558	5,661
Difference	(51)	(92)	(77)	(50)	(6)
Total Tax					
Treasury	49,249	50,821	52,253	53,760	57,984
Inland Revenue	49,556	50,989	53,290	54,850	58,125
Difference	(307)	(168)	(1,037)	(1,090)	(141)

Inland Revenue's total tax forecasts are higher than Treasury's in all years. The differences in 2006/07 and 2009/10 are small, given the size of total tax revenue. The difference in 2005/06 is a bit larger and is evident mainly in the individuals and resident withholding tax types.

The differences in 2007/08 and 2008/09, at just over $1 billion, are much larger than in the other years and also much larger than the differences seen in previous forecast Updates. In individuals' taxes, the differences arise mainly in source deductions as a result of the different methods used by the respective forecasting teams to model the effect of fiscal drag. The differences in corporate taxes result from differing views around how company income tax will be affected by the business cycle with the Treasury forecast incorporating a build-up of tax losses over the next few years. In RWT on interest, the two forecasting teams have different views about the effect of interest rates on the size of the deposit base, with Treasury forecasting that the recent rate of growth in deposits will not be sustained over the full forecast period. The Treasury and Inland Revenue use different methods for forecasting GST, with Treasury putting more weight on residential investment than does Inland Revenue. With residential investment forecast to decline in each of the next two March years, Treasury's GST forecasts are somewhat lower than Inland Revenue's.

Detailed comparisons of Treasury and Inland Revenue tax forecasts can be found at www.treasury.govt.nz/forecasts/hyefu/2005/.

Core Crown – Expenses

Table 2.6 – Expenses indicators

Expenses	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
($ billion)	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Core Crown	46.2	50.7	51.9	55.4	58.0	60.8
Core Crown (excluding GSF valuation)	44.8	50.4	51.9	55.4	58.0	60.8
(% of GDP)						
Core Crown	30.6	31.9	31.8	32.6	32.5	32.4
Core Crown (excluding GSF valuation)	29.7	31.7	31.8	32.6	32.5	32.4

Source: The Treasury

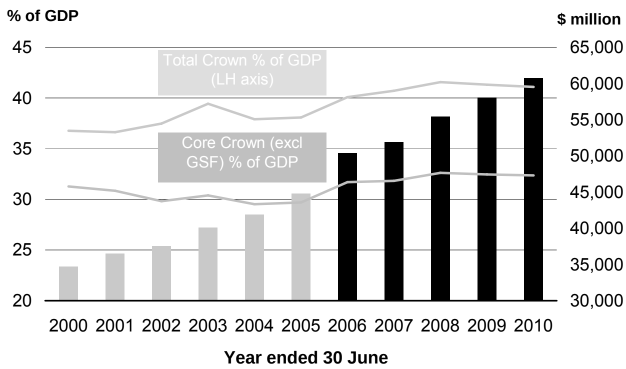
Core Crown operating expenses (excluding valuation items) are expected to rise by around 0.7% of GDP from 31.7% in 2005/06 to 32.4% of GDP by 2009/10. This represents the continuing impact of the 2004 Budget (which has an impact on expenses going forward, reflecting the implementation phase of the Working for Families initiative), the 2005 Budget and spending allocated for future Budgets.

As indicated in the 2005 FSR, the core Crown spending areas of health and education were allocated a significant portion of the 2005 Budget, with Health already allocated $489 million from Budget 2006. In part this reflects the current spending pressures within these sectors.

Health expenses as a percentage of GDP are forecast to increase from 5.6% to 6.2% between 2000/01 and 2005/06, while education expenses as a percentage of GDP are forecast to increase from 5.2% to 6.3% over the same period (mainly due to the move to the fair value measurement of student loans in the current year).

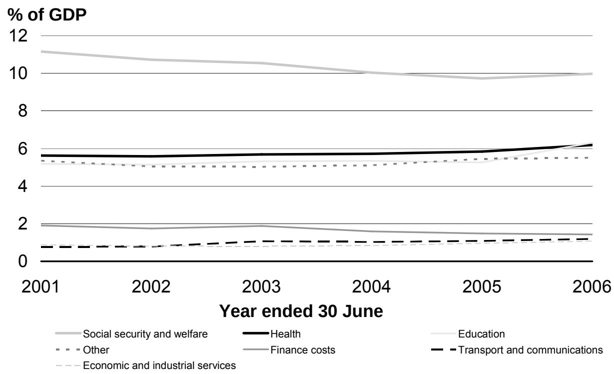
Health spending as a proportion of core Crown expenses is forecast to increase from 18.2% in 2000/01 to 19.5% by 2005/06. Education spending as a proportion of core Crown spending is also expected to increase from 16.8% in 2000/01 to 19.9% by 2005/06.

Figure 2.7 – Core expenses excluding valuations ($ and % of GDP)



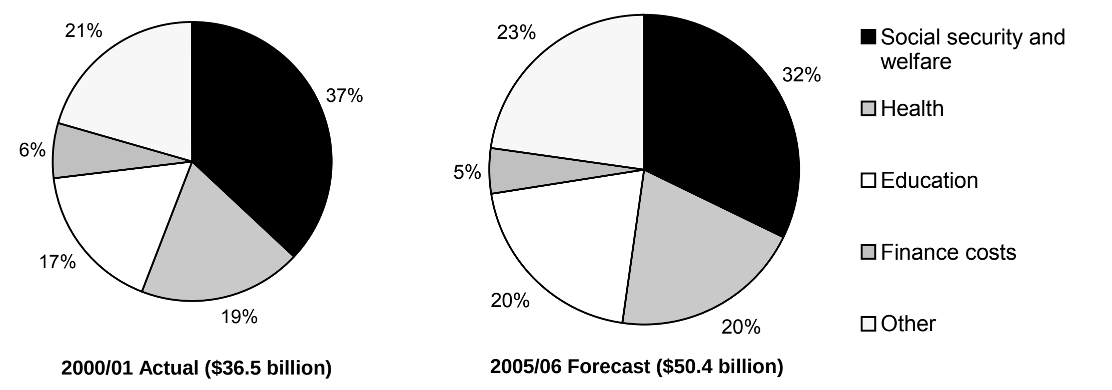
Source: The Treasury

Figure 2.8 – Core Crown functional expenses as a percentage of GDP (excluding valuations)



Source: The Treasury

Figure 2.9 – Core Crown functional expenses as a percentage of total expenses (excluding valuations)



Source: The Treasury

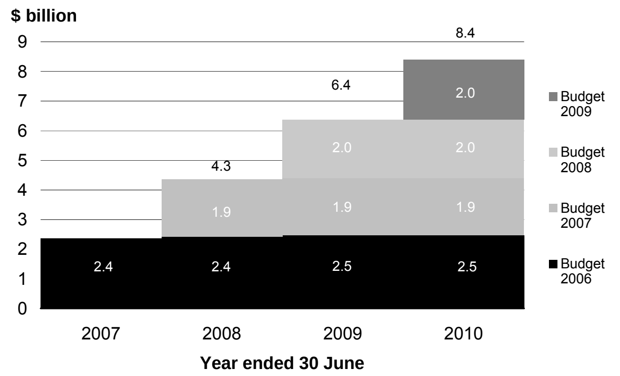
In nominal terms, core Crown expenses are expected to increase by around $10.1 billion between 2005/06 and 2009/10. Removing the GSF liability movements, expenses are forecast to increase by $10.4 billion over the same period. The major drivers of these expense increases are indexation of benefits, the 2005 Budget package and forecast new spending for future Budgets.

Forecast new spending

The 2005 *Budget Update* allowed for $1.9 billion in new initiatives (including revenue initiatives) for Budget 2006. The 2006 BPS has signalled an increase in the allowance for new initiatives in Budget 2006 to $2.4 billion per annum from 2006/07. This is to allow for the extension of the Working for Families package. Since the *Pre-election Update,* the Government has agreed $100 million per annum of policy to be met from the in between Budget spending amount.

Allowances for the 2007 and 2008 Budgets remain around $1.9 billion as indicated in the 2005 FSR.

Figure 2.10 – Net Allowance for new operating initiatives (GST exclusive)



Source: The Treasury

Post Budget Decisions

Operating

The 2006 Budget has incorporated new operating spending of between $2.4 billion and $2.5 billion. The table below provides a summary of the policies already agreed as part of Budget 2006.

Table 2.7 – Budget 2006 Operating decisions

($ million) GST exclusive	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Budget 2006 forecast new operating spending	**2,365**	**2,415**	**2,465**	**2,465**
Health funding package	489	489	489	489
Official development assistance	19	19	19	19
Working for Families extension	360	485	500	500
Defence funding package	73	73	73	73
Tertiary student component funding rate changes	29	59	59	59
No interest student loans	218	256	286	269
Budget 2006 decisions taken to date	**1,188**	**1,381**	**1,426**	**1,409**
Remaining Budget 2006 forecast new operating spending	**1,177**	**1,034**	**1,039**	**1,056**

Source: The Treasury

Capital

The *Pre-election Update* incorporated new forecast capital spending of $2.3 billion. The table below provides a summary of subsequent decisions against these allowances.

Table 2.8 – Post Budget 2005 Capital decisions

($ million) GST N/A	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Forecast new capital spending (per *Pre-election Update*)	**56**	**569**	**656**	**577**	**451**
Rephasing of forecast new capital spending	(61)	(151)	(4)	127	(44)
Additional funding for the Boeing 757 modification project	35	15	27	-	-
Other capital decisions	17	-	-	-	-
Total capital decisions since Pre-election Update	**(9)**	**(136)**	**23**	**127**	**(44)**
Total forecast new capital spending remaining	**65**	**705**	**633**	**450**	**495**

Source: The Treasury

Student Loan Policy

In November the Government agreed that interest will not be charged on student loans where certain criteria, largely related to being domiciled in New Zealand, are met. To better reflect the value of student loans under this no-interest policy, the accounting policy for reporting loans has also been updated. The accounting policy is to initially recognise student loans at their fair value and to subsequently report them at amortised cost. This accounting policy is to apply from 2005/06 and is consistent with the 'loans and receivables' designation under International Accounting Standard 39 (IAS 39) for financial instruments. The Crown will be adopting the New Zealand equivalent to IAS 39 for all financial instruments from 1 July 2007.

The key changes resulting from the no-interest student loan policy and adopting a new accounting policy are:

- There is a one-off write-down in 2005/06 of the existing stock of loans to fair value (approximately $1.5 billion)
- The difference between the fair value of new loans and the amount lent is recognised as an expense in the year the loan is provided
- The initial fair value write-down will be unwound (i.e. recognised as income) over the maturity of the loans. The value will be adjusted for any impairment (e.g. non repayments caused, for example by death or bankruptcy of the borrowers).

The methodology and data for measuring the unwind of the fair value write-down and impairment under the new accounting policy is being developed. For this Economic and Fiscal Update student loans are presented at their forecast fair value with changes in fair value flowing through the statement of financial performance. These forecast changes in fair value may differ to those actually reported under IAS 39 using the amortised cost approach. Fair values have been calculated using a model constructed for the Ministry of Education. This model applies a number of assumptions on future income levels, repayment behaviour in addition to economic assumptions (the discount rate, inflation and so on). As such, the estimated fair value of existing and new loans at initial recognition is sensitive to changes in these assumptions.

The difference between net interest accrued (interest less provision for write off) under the previous policy and net interest accrued under the new policy has been included as a Budget 2006 policy decision. These amounts are outlined with all the decisions taken since the *Pre-election Update* on page 38.

Actual results for 2005 and forecasts for the *Pre-election Update* were compiled under the previous accounting policy, which was to value the loans at the amounts expected to be ultimately collected in cash.

State-Owned Enterprises (SOEs) – Revenue and Expenses

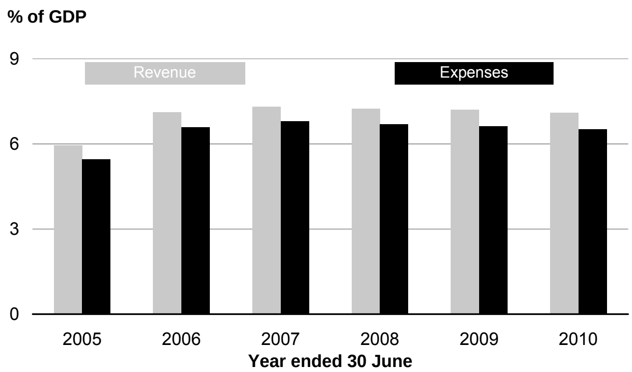
SOE revenue and expenses to GDP follow a similar trend over the forecast horizon.

The initial increase in both revenue and expenses is largely driven by the electricity sector, reflecting forecasts based on the initial use of short-term assumptions around electricity spot prices, before moving to medium-term assumptions beyond the current year.

Over the rest of the forecast period, both revenue and expenses are expected to remain relatively flat, reflecting the fact that growth in SOEs is consistent with overall growth in the economy.

SOEs are forecast to run total operating surpluses of $4.7 billion over the forecast period. Around $2.1 billion of the operating surpluses will be returned as dividends. The remainder of the operating surpluses will be retained by individual entities for investment according to individual asset strategies.

Figure 2.11 – SOE revenue and expenses to GDP



Source: The Treasury

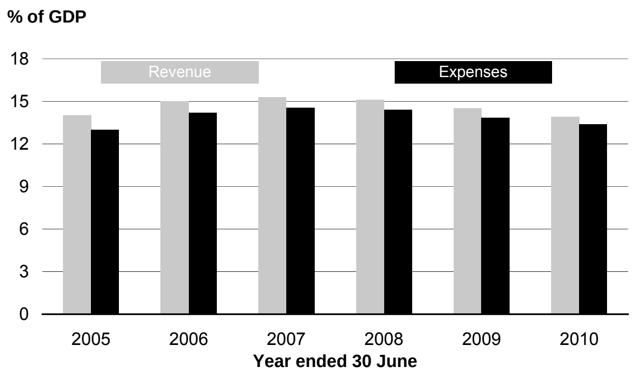
Crown Entities – Revenue and Expenses

Both revenue and expenses to GDP are expected to remain flat initially, before decreasing from 2008/09.

The primary source of revenue for Crown entities is funding from core Crown departments. Since spending for future Budgets has yet to be allocated and therefore passed on to delivery agents (such as district health boards and schools) this leads to revenue and expenses to GDP falling near the end of the forecast period. Future allocations to delivery agents would lead to revenue and expenses rising back to similar levels.

Crown entities are also forecast to generate operating surpluses over the forecast period, which total around $6.5 billion. There are only a few Crown entities expected to generate significant operating surpluses. These entities will retain their surpluses for long-term purposes. For example, the Accident Compensation Corporation (ACC) will retain its surplus in order to build up its asset portfolio to help meet its outstanding claims liability, while the Earthquake Commission (EQC) will use its operating surplus to build up assets to cover claims in the event of any future natural disasters.

Figure 2.12 – Crown entities' revenue and expenses to GDP



Source: The Treasury

Net Worth

Table 2.9 – Net worth comparison with *Pre-election Update*

Net Worth ($ billion)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
			Year ended 30 June			
Total Crown Net Worth						
Half Year Update	50.0	55.6	61.4	65.6	68.9	74.0
Pre-election Update		49.2	55.5	59.7	65.2	65.2
Core Crown Net Worth						
Half Year Update	28.3	32.0	36.2	38.5	39.9	43.2
Pre-election Update		30.7	35.2	37.6	41.1	41.1
SOE Net Worth						
Half Year Update	10.1	10.6	11.1	11.6	12.3	13.0
Pre-election Update		9.1	9.7	10.2	10.8	10.8
Crown Entities' Net Worth						
Half Year Update	34.8	36.8	38.4	39.9	41.3	42.4
Pre-election Update		33.1	34.6	36.0	37.6	37.6

Source: The Treasury

The change since the *Pre-election Update* reflects revaluations of property, plant and equipment at June 2005 partially offset by lower operating balances over the forecast period. Net worth is forecast to increase from $50 billion in 2004/05 to $74 billion by 2009/10. The growth in net worth reflects the Government's strategy to run operating surpluses to strengthen its fiscal position. This strategy is evident across the whole of the Crown. The following section discusses the net worth of the Crown by segments of reported government activity.

Core Crown

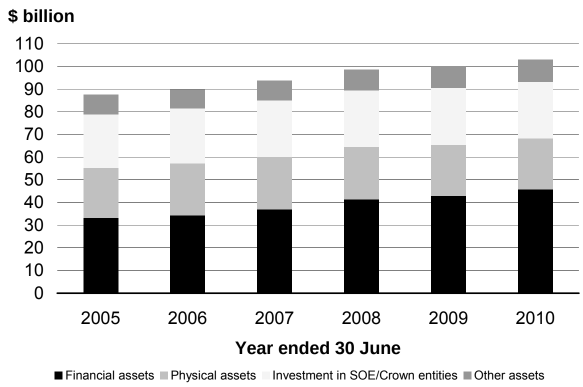
Table 2.10 – Components of core Crown net worth

($ billion)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
			Year ended 30 June			
Total assets	87.5	89.8	93.7	98.5	100.0	103.0
Total liabilities	59.2	57.8	57.5	60.1	60.0	59.7
Net worth	28.3	32.0	36.2	38.5	39.9	43.2

Source: The Treasury

Over the forecast horizon, core Crown assets are expected to increase from $87.5 billion to $103 billion, largely reflecting the application of the OBERAC and additional borrowing to build-up assets. As Figure 2.13 illustrates, the majority of growth occurs within financial assets, which increase by around $12.8 billion, while investments in Crown entities (primarily to fund hospitals and housing capital projects) and physical assets also increase slightly.

Figure 2.13 – Core Crown asset growth



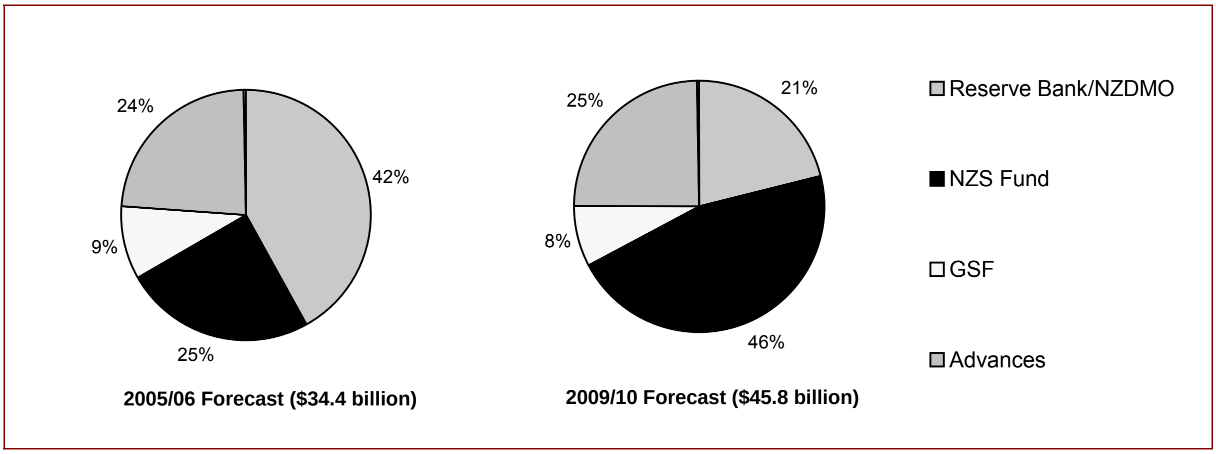
Source: The Treasury

Within the financial asset portfolio of the core Crown:

- the NZS Fund is expected to increase by around $15.6 billion over the forecast period. These funds are being set aside to assist in meeting pressures on future NZS payments associated with an ageing population
- advances are forecast to increase by around $2.6 billion, primarily due to student loans which are provided to help students to access tertiary education, offset by the move to the fair value measurement of those loans
- the Reserve Bank's and New Zealand Debt Management Office's (NZDMO's) financial asset portfolio is expected to decrease over time largely due to the unwinding of the past build-up of financial assets to assist in funding some of the Government's operating and investment programme partially offset by foreign reserves build-up
- GSF holdings are forecast to remain relatively flat at around $3.4 billion over the forecast period. The assets held by the GSF have been built up from employee contributions over time and are used to partially offset the GSF unfunded liability, which is forecast to be $15 billion by 2009/10.

By 2009/10 the make-up of the financial asset portfolio is expected to have changed significantly, primarily driven by the increase in the holdings of the NZS Fund.

Figure 2.14 – Core Crown financial assets by portfolio

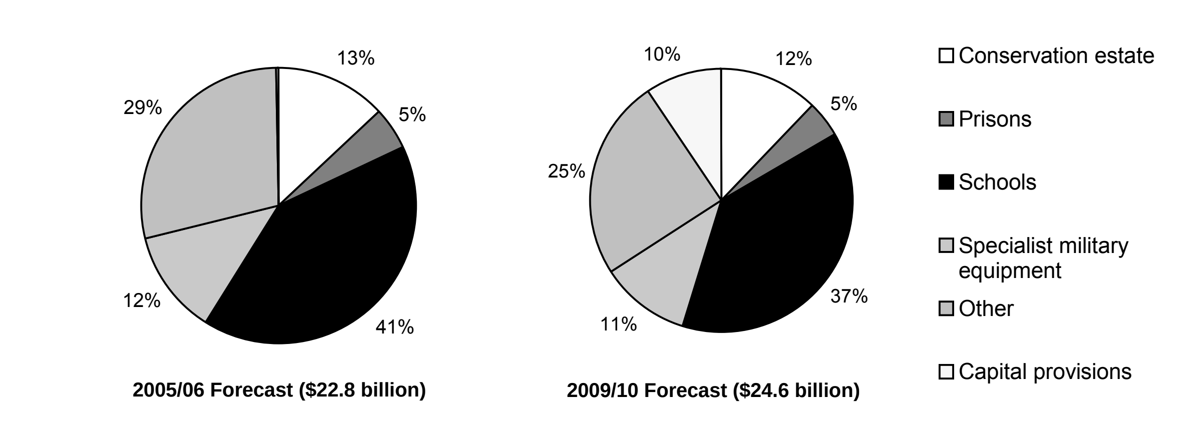


Source: The Treasury

Investments in Crown entities are forecast to increase by around $1.2 billion to allow for maintenance and improvement to the asset base, especially within the health and housing sectors.

Physical assets are expected to increase slightly over the forecast horizon, illustrating the maintenance and expansion of the core Crown's physical asset base. Figure 2.15 provides a breakdown of the physical assets held by the core Crown, by major asset classes.

Figure 2.15 – Core Crown physical assets by asset class (including capital provisions)



Source: The Treasury

The level of liabilities is expected to remain relatively stable over the forecast period at just under $60 billion. The major component of core Crown liabilities is gross debt, which as previously mentioned is forecast to decrease as a percentage of GDP over the forecast period.

SOEs

Table 2.11 – Components of SOE net worth

($ billion)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
	Year ended 30 June					
Total assets	19.7	21.8	24.3	26.5	27.4	28.0
Total liabilities	9.6	11.2	13.2	14.9	15.1	15.0
Net worth	10.1	10.6	11.1	11.6	12.3	13.0

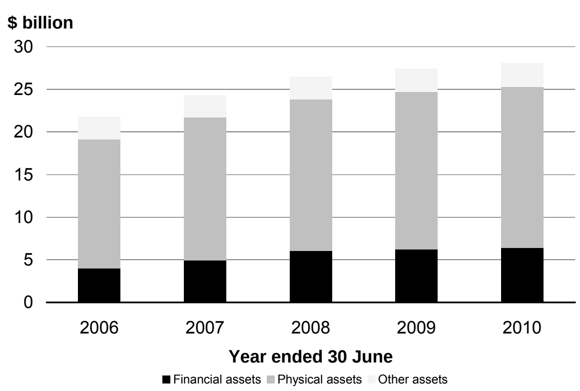
Source: The Treasury

SOE assets are forecast to increase by around $8.3 billion by 2009/10.

Similar to the core Crown, the expansion in assets will be driven by the use of retained surpluses. In addition, a portion of this growth has been funded by raising debt (which is net worth neutral). The majority of the growth will come from:

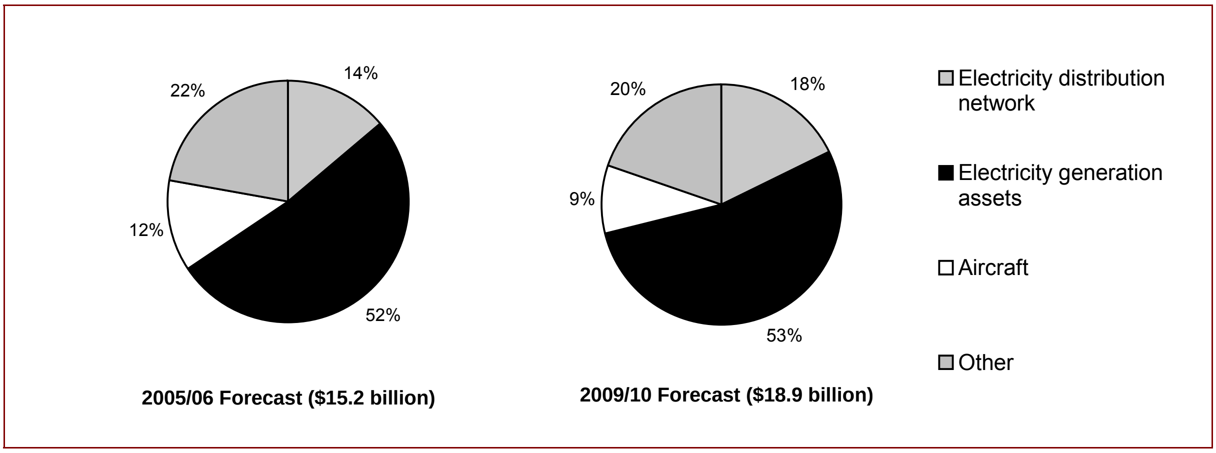
- physical assets, which are forecast to increase by around $5.6 billion, reflecting the expansion of assets in line with individual entities' asset strategies. Figure 2.17 provides a breakdown of assets by the major asset classes held by SOEs
- financial assets are forecast to increase by $2.4 billion, showing the expected growth in Kiwibank deposits. This growth is net worth neutral, as borrowings also increase by a similar level.

Figure 2.16 – SOE asset growth



Source: The Treasury

Figure 2.17 – State-owned enterprises' physical assets



Source: The Treasury

Crown Entities

Table 2.12 – Components of Crown entities' net worth

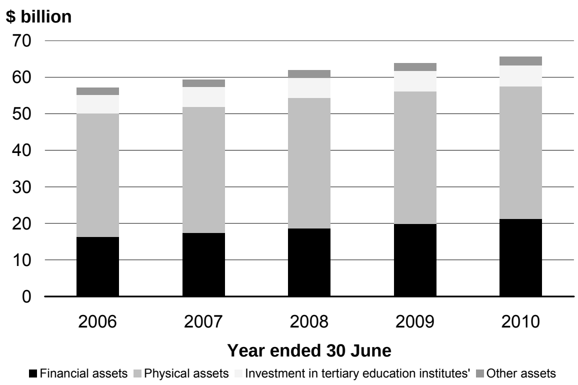
	Year ended 30 June					
($ billion)	**2005 Actual**	**2006 Forecast**	**2007 Forecast**	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**
Total assets	55.4	57.2	59.3	61.9	63.8	65.6
Total liabilities	20.6	20.4	20.9	22.0	22.6	23.2
Net worth	34.8	36.8	38.4	39.9	41.3	42.4

Source: The Treasury

Crown entities' assets are forecast to increase by around $10.2 billion by the end of the forecast horizon. The growth in assets is largely driven by physical assets and financial assets.

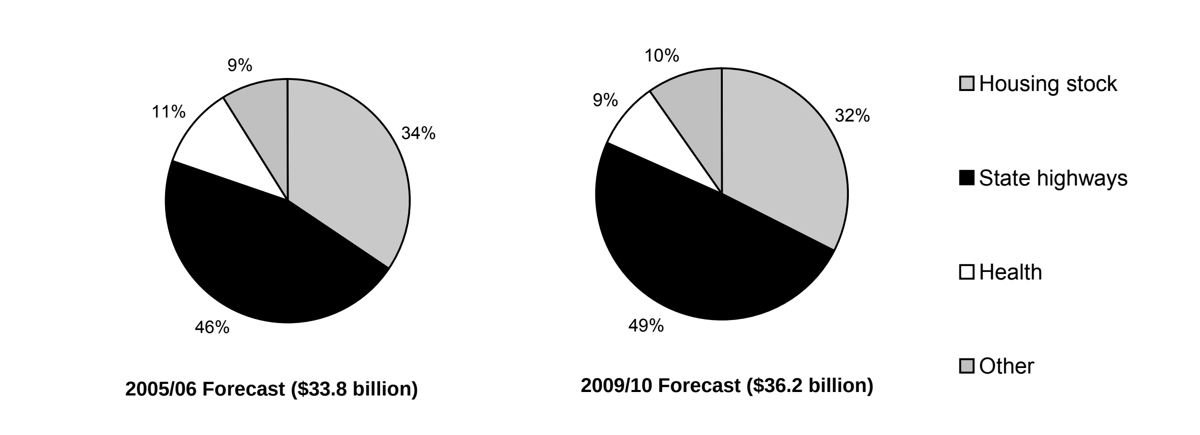
Physical assets are forecast to increase by around $4 billion. This growth is largely in the health, housing and transport sectors. These sectors make up the majority of the physical assets held by Crown entities. The primary source of funding for the asset expansion in these sectors will be injections from the core Crown.

Figure 2.18 – Crown entity asset growth



Source: The Treasury

Figure 2.19 – Crown entities' physical assets broken down by major sectors

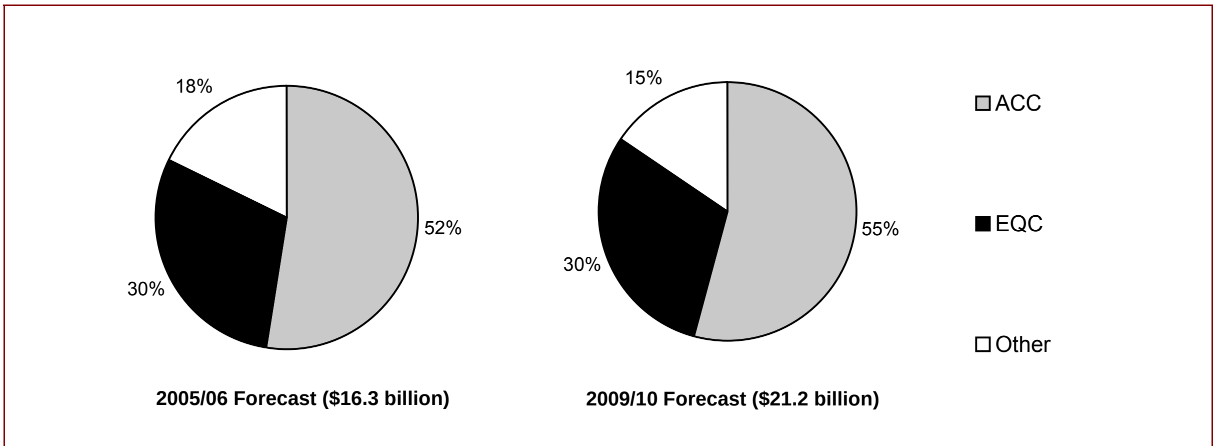


Source: The Treasury

Financial assets are forecast to increase by around $5.6 billion due to growth in the ACC and EQC investment portfolios, resulting from the investment of these entities' expected retained surpluses. These portfolios are expected to grow over time, reflecting the fact that:

- ACC is building an asset portfolio to match the outstanding claims liability associated with past claims. The portfolio is expected to be $8.5 billion in the current year, rising to around $11.5 billion by 2009/10. ACC's aim is to have the residual claims fully funded by 2014.
- EQC is New Zealand's primary provider of seismic disaster insurance to residential property. To help meet future claims in case of a natural disaster, EQC is building up its financial asset portfolio.

Figure 2.20 – Crown entities' financial assets broken down by major portfolios



Source: The Treasury

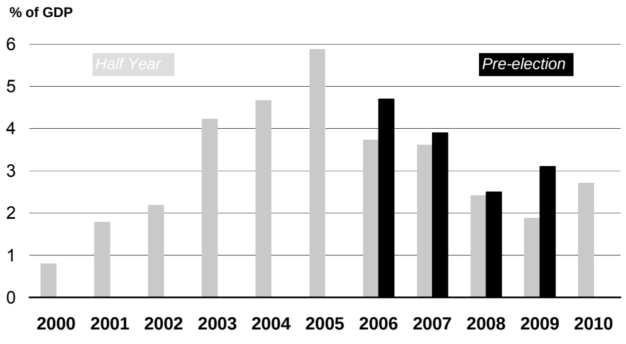
Comparison with *Pre-election Update*

OBERAC and operating balance

Compared with the *Pre-election Update* the OBERAC is expected to be lower over the forecast period due to:

- the move to fair value measurement of student loans in 2005/06 (refer page 39)
- the working for families package extension from 2006/07
- reforecast transport spending including a change in mix between operating and capital spending
- higher net finance costs (finance costs less interest income) due to the increase in net core Crown debt
- other core Crown functional expenses higher including increases to family support debt provisioning and decisions made from the future new operating spending.

Figure 2.21 – OBERAC comparison



Source: The Treasury

This has been partially offset by higher forecast tax revenue in 2005/06, 2006/07 and 2007/08 reflecting increases in nominal GDP.

Table 2.13 – OBERAC reconciliation (explains changes to the OBERAC since the *Pre-election Update*)

($ million)	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
OBERAC 2005 *Pre-election Update*	7,293	6,344	4,217	5,512
Changes (revenue)				
Tax revenue (forecasting)	416	378	75	(47)
Tax revenue (policy)	-	-	760	(760)
Reduction in student loan interest	(258)	(462)	(503)	(546)
Other sovereign revenue	(51)	(66)	(111)	(151)
Investment income	85	123	(100)	(179)
Other revenue	63	126	132	156
Changes to SOE/CE results	(81)	(129)	18	(96)
Total revenue changes	**174**	**(30)**	**271**	**(1,623)**
Changes (core Crown expenses)				
Student loan interest free policy	(940)	90	82	99
Working for families extension	(85)	(360)	(485)	(500)
Welfare benefit forecast changes	79	88	(4)	26
Transport forecast changes	60	92	201	136
Future new operating spending	44	168	248	238
Other core Crown functional expenses	(679)	(327)	(276)	(334)
Finance costs	(22)	(172)	(151)	(187)
Total core Crown expenses changes	**(1,543)**	**(421)**	**(385)**	**(522)**
Total Changes	**(1,369)**	**(451)**	**(114)**	**(2,145)**
OBERAC 2005 *Half Year Update*	5,924	5,893	4,103	3,367

Source: The Treasury

Table 2.14 – Consolidated tax revenue forecasts

($ million)	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
Tax revenue 2005 *Pre-election Update*	48,833	50,443	51,418	54,567
Changes				
Source deductions	189	160	242	370
Other persons tax	(32)	9	(185)	(338)
Corporate taxes	223	144	17	(57)
RWT	181	307	352	330
GST	(88)	(192)	(312)	(322)
Other	(57)	(50)	(39)	(30)
Gross changes	**416**	**378**	**75**	**(47)**
Policy changes	-	-	760	(760)
Total Changes	**416**	**378**	**835**	**(807)**
Tax revenue 2005 *Half Year Update*	49,249	50,821	52,253	53,760
% of GDP	31.0%	31.2%	30.8%	30.1%

Source: The Treasury

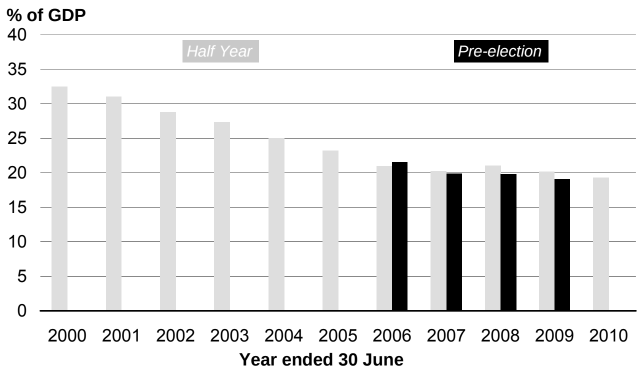
Cash available/(shortfall to be funded)

The amount required to be financed (cash shortfall) is around $2.5 billion higher across the forecast period than the *Pre-election Update* mainly due to a reduction in cashflow from operations.

Debt indicators

Compared to the *Pre-election Update* both gross sovereign-issued debt and net core Crown debt are forecast to be higher over the forecast period. Gross sovereign-issued debt is higher due to the borrowing requirement mentioned above. Net core Crown debt is expected to be higher due to the reduction in financial assets as a result of the move to fair value measurement of student loans and the increased borrowing requirement.

Figure 2.22 - Gross sovereign-issued debt comparison



Source: The Treasury

Table 2.15 – 2005 *Half Year Update* fiscal indicators

Fiscal Indicators ($ million)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
	Year ended 30 June					
Revenue						
Total revenue	67,065	69,775	72,141	74,590	77,085	82,131
Core Crown revenue	52,065	54,328	56,116	57,654	59,508	64,088
Tax revenue	46,624	49,249	50,821	52,253	53,760	57,984
Expenses						
Total expenses	60,910	64,351	66,381	70,620	73,851	77,173
Core Crown expenses	46,234	50,665	51,888	55,406	58,039	60,782
Operating balance - Core Crown	5,831	3,663	4,228	2,248	1,469	3,306
Operating balance - Crown entities	(101)	1,412	1,283	1,358	1,291	1,136
Operating balance - SOEs	958	843	847	914	1,028	1,089
Dividend elimination	(441)	(361)	(465)	(417)	(421)	(440)
Operating balance	6,247	5,557	5,893	4,103	3,367	5,091
OBERAC	8,873	5,924	5,893	4,103	3,367	5,091
OBERAC (excluding net NZS Fund asset returns)	8,381	5,418	5,247	3,270	2,327	3,818
Cash available/(shortfall to be funded)	3,104	492	(1,341)	(2,687)	(3,167)	(1,366)
Debt Indicators						
Gross sovereign-issued debt	35,045	33,275	32,967	35,728	36,111	36,195
Total gross Crown debt	36,864	36,054	36,778	40,032	39,617	38,678
Net core Crown debt	10,771	10,597	10,434	11,854	14,240	14,998
Net core Crown debt with NZS Fund assets	4,216	1,199	(1,961)	(3,817)	(5,148)	(8,482)
Net worth	49,983	55,555	61,448	65,551	68,918	74,009
Domestic bond programme	2,146	2,663	3,039	3,083	3,116	3,062
Nominal GDP	150,966	158,947	163,062	169,897	178,805	187,853
Fiscal Indicators as a % of GDP						
Revenue						
Total Crown revenue	44.4	43.9	44.2	43.9	43.1	43.7
Core Crown revenue	34.5	34.2	34.4	33.9	33.3	34.1
Tax revenue	30.9	31.0	31.2	30.8	30.1	30.9
Expenses						
Total Crown expenses	40.3	40.5	40.7	41.6	41.3	41.1
Core Crown expenses	30.6	31.9	31.8	32.6	32.5	32.4
Operating balance	4.1	3.5	3.6	2.4	1.9	2.7
OBERAC	5.9	3.7	3.6	2.4	1.9	2.7
OBERAC (excluding net NZS Fund asset returns)	5.6	3.4	3.2	1.9	1.3	2.0
Debt Indicators						
Gross sovereign-issued debt	23.2	20.9	20.2	21.0	20.2	19.3
Total gross Crown debt	24.4	22.7	22.6	23.6	22.2	20.6
Net core Crown debt	7.1	6.7	6.4	7.0	8.0	8.0
Net core Crown debt with NZS Fund assets	2.8	0.8	(1.2)	(2.2)	(2.9)	(4.5)
Net worth	33.1	35.0	37.7	38.6	38.5	39.4
New Zealand Superannuation Fund						
Fund asset returns (after tax)	492	506	646	833	1,040	1,273
Fund contributions	2,107	2,337	2,351	2,443	2,677	2,819
Fund assets (year end)	6,555	9,398	12,395	15,671	19,388	23,480
% of GDP	4.3	5.9	7.6	9.2	10.8	12.5

Source: The Treasury

Table 2.16 – 2005 *Pre-election Update* fiscal indicators

Fiscal Indicators ($ million)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast
	Year ended 30 June				
Revenue					
Total revenue	67,065	69,506	72,246	74,201	78,399
Core Crown revenue	52,065	54,034	56,017	57,401	61,035
Tax revenue	46,624	48,833	50,443	51,418	54,567
Expenses					
Total expenses	60,910	62,352	66,041	70,123	73,026
Core Crown expenses	46,234	48,449	51,467	55,021	57,517
Operating balance - Core Crown	5,831	5,585	4,550	2,380	3,518
Operating balance - Crown entities	(101)	1,159	1,270	1,312	1,469
Operating balance - SOEs	958	873	915	933	997
Dividend elimination	(441)	(324)	(391)	(408)	(472)
Total operating balance	6,247	7,293	6,344	4,217	5,512
OBERAC	8,873	7,293	6,344	4,217	5,512
OBERAC (excluding net NZS Fund asset returns)	8,381	6,821	5,698	3,378	4,457
Cash available/(shortfall to be funded)	3,104	548	(747)	(2,615)	(1,346)
Debt Indicators					
Gross sovereign-issued debt	35,045	33,628	32,177	33,473	34,019
Total gross Crown debt	36,864	36,226	34,717	35,573	35,659
Net core Crown debt	10,771	8,987	8,570	10,314	11,123
Net core Crown debt with NZS Fund assets	4,216	(377)	(3,878)	(5,546)	(8,562)
Net worth	49,983	49,150	55,494	59,711	65,223
Domestic bond programme	2,146	2,200	2,050	2,050	2,050
Nominal GDP	150,966	156,481	161,771	169,336	177,697
Fiscal Indicators as a % of GDP					
Revenue					
Total Crown revenue	44.4	44.4	44.7	43.8	44.1
Core Crown revenue	34.5	34.5	34.6	33.9	34.3
Tax revenue	30.9	31.2	31.2	30.4	30.7
Expenses					
Total Crown expenses	40.3	39.8	40.8	41.4	41.1
Core Crown expenses	30.6	31.0	31.8	32.5	32.4
Operating balance	4.1	4.7	3.9	2.5	3.1
OBERAC	5.9	4.7	3.9	2.5	3.1
OBERAC (excluding net NZS Fund asset returns)	5.6	4.4	3.5	2.0	2.5
Debt Indicators					
Gross sovereign-issued debt	23.2	21.5	19.9	19.8	19.1
Total gross Crown debt	24.4	23.2	21.5	21.0	20.1
Net core Crown debt	7.1	5.7	5.3	6.1	6.3
Net core Crown debt with NZS Fund assets	2.8	(0.2)	(2.4)	(3.3)	(4.8)
Net worth	33.1	31.4	34.3	35.3	36.7
New Zealand Superannuation Fund					
Fund asset returns (after tax)	492	472	646	839	1,055
Fund contributions	2,107	2,337	2,438	2,573	2,770
Fund assets (year end)	6,555	9,364	12,448	15,860	19,685
% of GDP	4.3	6.0	7.7	9.4	11.1

Source: The Treasury

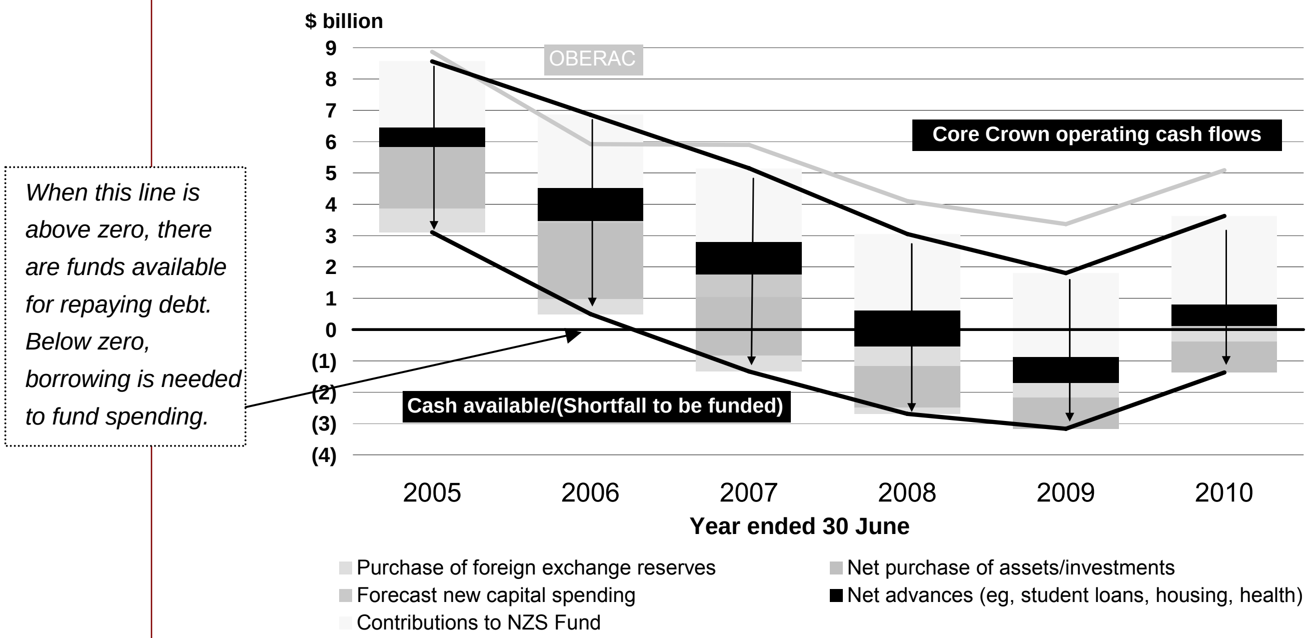
Why is there an Operating Surplus?

A surplus represents the difference between operating revenues (eg, taxes) and operating spending (eg benefit payments, health and education spending, etc.). It is a measure of the ongoing operations of a government.

A government also has a capital expenditure programme whereby it provides money for student loans, saves some money by making contributions to the New Zealand Superannuation Fund, invests in asset acquisitions (eg building more roads, prisons, new hospitals, schools and defence equipment) and other capital activity. None of this shows up as operating expenses as it is the purchase of an asset (with a useful life in excess of one year and will provide benefits through time rather than an operating expense such as a benefit payment). All of this type of activity is called investment expenditure.

The cash generated from the operating balance is not always sufficient to meet all investing decisions. There may still be a need to borrow in order 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 can increase even when there is a "surplus".



Source: The Treasury

The following table explains how the operating surplus/OBERAC is calculated for the 2005/06 and the 2006/07 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	2005/06	2006/07	Description of Items
	54,328	56,116	**Core Crown revenues** – these are the revenues the Government collects. They are mainly taxes.
	50,665	51,888	**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 do not create government assets. They also include the amount for new initiatives in forecast years (refer page 111 of GAAP Series Tables).
	1,894	1,665	**Net surplus of SOEs and Crown entities** – this is the net surplus (after dividends) that SOEs and Crown entities make.
Operating balance	**5,557**	**5,893**	**Operating balance** – the residual of revenues less expenses plus surpluses from SOEs and Crown entities. It is the Government's operating profit or loss.
	367	-	**OBERAC adjustments** – removal of revaluation movements.
OBERAC	**5,924**	**5,893**	**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	931	(738)	**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, impact on the level of net cash flows from operations.
Equals surplus cash flows	**6,855**	**5,155**	**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 in funding capital spending.
Less capital spending	(2,337)	(2,351)	**Contributions to the NZS Fund** – the Government's annual contribution to the NZS Fund to build up assets to contribute to future NZS payments.
	(1,876)	(1,501)	**Purchase of assets** – departments buy assets including computer equipment, new buildings and defence equipment.
	(1,048)	(1,045)	**Loans to others (advances)** – these are mainly student loans (the Government is committed to help students access tertiary education by funding student loans).
	(537)	(394)	**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.
	(65)	(705)	**Capital forecast** – an amount set aside for further capital activity. The Government has not yet decided on the specific initiatives.
What is left	**492**	**(1,341)**	**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 7 December 2005 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 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 7 December 2005. 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 *Half Year 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 65.

SOEs and Crown entities' forecasts

The forecasts for large SOEs and Crown entities were provided in October 2005 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 2005) 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 2006 *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 2005 *Half Year Update* combined 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 (ie, TEI revenues, expenses, assets and liabilities are not included on a line-by-line basis). This is consistent with the treatment adopted in the 2005 Crown financial statements.

The key indicators are unchanged as a result of the combination approach for TEIs (refer page 60 of the 30 June 2005 Crown financial statements).