2

Fiscal Outlook

Introduction

The fiscal position is forecast to continue to strengthen over the forecast period.

Based on strong nominal Gross Domestic Product growth forecast over the next few years and its subsequent impact on tax revenue forecasts, the fiscal outlook is stronger than what was expected at the *Budget Update*. This is notwithstanding the inclusion of a revenue reduction contingency of $1.5 billion effective 1 April 2009, rising to $1.7 billion by 2011/12.

This strengthening is reflected in most indicators. For example:

- The operating balance before gains and losses (OBEGAL), while forecast to fall from $6.6 billion in 2007/08 to $3.9 billion in 2011/12, is higher in all years than forecast at the time of the *Budget Update*.
- Cash deficits of $2.6 billion over the forecast period, are less than the $5.7 billion forecast at the *Budget Update*.
- Gross sovereign-issued debt excluding settlement cash is forecast to increase by around $2.3 billion over the forecast period in nominal terms, but continues to fall as a percentage of GDP from 18.5% to 15.6%.

This chapter outlines the trends of the key indicators over the forecast period, before discussing the main drivers of these trends in more detail. The forecasts are then compared to those provided in the *Budget Update*.

The chapter also includes a description of how the fiscal indicators are derived, how they are used and a historical series.

Table 2.1 – Summary fiscal indicators[2]

$million	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
	Year ended 30 June					
Core Crown revenue excluding NZS Fund revenue	58,473	62,130	63,147	65,412	68,965	72,168
Core Crown revenue	58,174	62,409	63,496	65,832	69,458	72,740
Core Crown expenses	53,977	57,137	60,537	63,106	66,632	70,034
OBEGAL	5,339	6,574	4,327	4,062	3,984	3,850
OBEGAL[3] excluding NZS Fund net revenue	5,757	6,405	4,116	3,809	3,688	3,507
Operating balance	7,999	7,388	6,053	5,924	6,094	6,228
Core Crown residual cash	2,653	759	(763)	(779)	(851)	(937)
Gross sovereign-issued debt (excl Settlement Cash)	30,890	33,303	33,034	31,779	34,566	33,172
Net core Crown debt	4,411	1,983	1,756	1,705	1,792	2,105
Net core Crown debt (incl NZS Fund)	(8,112)	(13,102)	(16,224)	(19,545)	(22,990)	(26,414)
% of GDP						
Core Crown revenue excluding NZS Fund revenue	*35.1*	*34.9*	*33.8*	*33.6*	*34.0*	*34.0*
Core Crown revenue	*34.9*	*35.0*	*34.0*	*33.8*	*34.2*	*34.3*
Core Crown expenses	*32.4*	*32.1*	*32.4*	*32.4*	*32.8*	*33.0*
OBEGAL	*3.2*	*3.7*	*2.3*	*2.1*	*2.0*	*1.8*
OBEGAL excluding NZS Fund net revenue	*3.5*	*3.6*	*2.2*	*2.0*	*1.8*	*1.7*
Operating balance	*4.8*	*4.1*	*3.2*	*3.0*	*3.0*	*2.9*
Core Crown residual cash	*1.6*	*0.4*	*(0.4)*	*(0.4)*	*(0.4)*	*(0.4)*
Gross sovereign-issued debt (excl Settlement Cash)	*18.5*	*18.7*	*17.7*	*16.3*	*17.0*	*15.6*
Net core Crown debt	*2.6*	*1.1*	*0.9*	*0.9*	*0.9*	*1.0*
Net core Crown debt (incl NZS Fund)	*(4.9)*	*(7.4)*	*(8.7)*	*(10.0)*	*(11.3)*	*(12.4)*

Source: The Treasury

New Zealand International Financial Reporting Standard (NZ IFRS) - "New GAAP"

The financial statements presented in the 2007 HYEFU have been prepared in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS). All comparatives including the 30 June 2007 are also produced on an NZ IFRS basis, which means they will differ to what was published in the *Financial Statements of the Government of New Zealand for the year ended 30 June 2007* released 10 October 2007. The 30 June 2007 comparatives are provisional and have not yet been subject to audit.

With the adoption of NZ IFRS there is a series break in the graphs and tables presented in the fiscal chapter. For some indicators there is no comparable trend series.

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2 Detailed tables of the key indicators for the *Half Year Economic and Fiscal Update and Budget Economic and Fiscal Update* (BEFU) are located on pages 57 and 58.

3 The operating balance before gains and losses (OBEGAL) less NZS Fund revenue represents the residual of operating revenue and expenses minus the portion of net revenue earned by the NZS Fund. The indicator does not take into account any gains and losses which are now reported in a separate section of the *Statement of Financial Performance* (refer page 115).

Key Trends

This section looks at the trends of the key indicators presented in the fiscal forecasts. It follows the fiscal strategy framework (refer page 4) and focuses primarily on core Crown indicators.

Table 2.2 – Reconciliation of residual core Crown cash

	$million	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
				Year ended 30 June			
	Core Crown revenue	58,174	62,409	63,496	65,832	69,458	72,740
Less	Core Crown expenses	53,978	57,137	60,537	63,106	66,632	70,034
Plus	Core Crown gains/(losses) and other items	2,392	934	1,209	1,362	1,569	1,784
Plus	Net surpluses/(deficits) of SOEs and CEs	1,491	1,182	1,885	1,836	1,699	1,738
Equals	**Operating balance**	**8,079**	**7,388**	**6,053**	**5,924**	**6,094**	**6,228**
Less	Net gains/(losses) and other items	2,740	814	1,726	1,862	2,110	2,378
Equals	**Operating balance before gains and losses (OBEGAL)**	**5,339**	**6,574**	**4,327**	**4,062**	**3,984**	**3,850**
Less	NZS Fund net revenue after-tax[4]	(418)	169	211	253	296	343
Equals	**OBEGAL less NZS Fund net revenue**	**5,757**	**6,405**	**4,116**	**3,809**	**3,688**	**3,507**
Less	Net retained surpluses of SOEs and CEs	1,143	1,305	1,371	1,337	1,161	1,147
	Non-cash items and working capital movements	3,956	1,396	(2,184)	(1,895)	(1,701)	(1,674)
Equals	**Net core Crown cashflow from operations**	**8,570**	**6,496**	**4,929**	**4,367**	**4,228**	**4,034**
Less	Contribution to NZS Fund	2,049	2,103	2,376	2,321	2,316	2,281
Equals	**Net core Crown cashflow from operations after contributions to NZS Fund**	**6,521**	**4,393**	**2,553**	**2,046**	**1,912**	**1,753**
Less	Purchase of physical assets	1,760	1,773	1,097	1,170	949	886
	Advances and capital injections	2,109	1,861	1,216	882	890	694
	Forecast for future new capital spending	-	-	1,003	773	924	1,110
Equals	**Core Crown residual cash**	**2,652**	**759**	**(763)**	**(779)**	**(851)**	**(937)**

Source: The Treasury

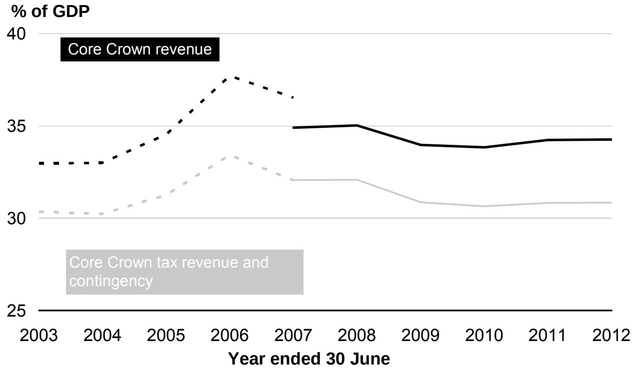
Core Crown revenue falls, then grows broadly in line with the economy …

Core Crown revenue is forecast to decline from 35% of GDP in 2007/08 to 34% of GDP in 2008/09, and to remain relatively stable thereafter.

Tax revenue follows a similar trend, stabilising at around 31% of GDP. The main influences on the tax revenue trend are:

- underlying growth in the economy flowing into source deductions, corporate taxes and other persons taxes

Figure 2.1 – Core Crown revenue and core Crown tax revenue as a % of GDP[5]



Source: The Treasury

[4] NZS Fund net revenue is the sum of its revenue (ie, interest and dividends) less expenses. The figure is also adjusted to add back tax revenue received by Inland Revenue from the NZS Fund.

[5] One of the main presentation changes with the adoption of NZ IFRS is that gains and losses are now recorded in a separate section in the Statement of Financial Performance rather than within revenue and expenses. This has resulted in a downward shift in revenue and expenses.

- the Business Tax Reform announced in Budget 2007, reducing tax revenue by around $1 billion in each year from 2008/09, and
- a revenue reduction contingency, which is outlined in the box below.

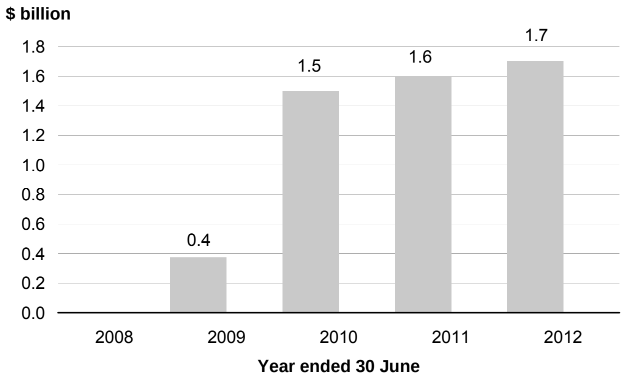
The tax forecasts are subject to potentially greater than usual risks flowing through from the uncertainty in the economic forecasts.

To a lesser extent core Crown revenue is also influenced by additional revenue forecast to be generated from the recently introduced Emissions Trading Scheme of around $0.1 billion in 2008/09 rising to $0.9 billion by 2011/12 (refer page 44).

Revenue reduction contingency

The fiscal forecasts include a revenue reduction contingency for changes to personal tax. The forecasts assume that the contingency of $1.5 billion is effective from 1 April 2009 – the exact shape and timing of any revenue reductions have yet to be determined. The contingency has a rising profile to reflect income growth. The contingency is disclosed separately in the forecast financial statements (refer page 115).

Figure 2.2 – Profile of revenue reduction contingency



Source: The Treasury

The fiscal forecasts also incorporate likely flow-on effects from reducing personal income tax. Increased economic activity resulting from increases in disposable income is expected to generate extra PAYE and GST tax revenue. In addition tax paid on benefits will be lower meaning there will be a reduction in gross benefit payments.

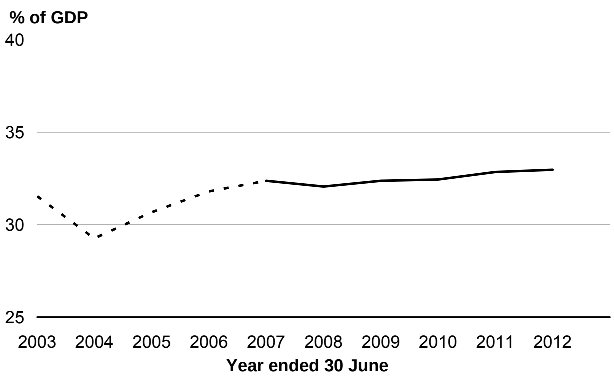
These impacts are built into the tax and benefit forecasts incorporated in the fiscal forecasts.

… and core Crown expenses grow faster …

Core Crown expenses are forecast to increase by around 1% of GDP between 2007/08 and 2011/12.

The forecast growth in expenses largely arises from expense initiatives introduced in recent Budgets. A number of policy decisions made in previous Budgets have rising spending profiles to allow sufficient time for full implementation. The enhancement to the KiwiSaver initiative announced in Budget 2007 is one of the main drivers of this rising profile,

Figure 2.3 – Core Crown expenses as a % of GDP



Source: The Treasury

at around $0.8 billion in 2007/08 rising to around $1.4 billion by 2011/12, which has been revised since the *Budget Update* based on forecast uptake.

In addition, the recently introduced Emissions Trading Scheme results in an increase in the expense base.

… as a result the OBEGAL declines …

The OBEGAL is forecast to be $6.6 billion (3.7% of GDP) in 2007/08. As the impact of the tax initiatives and recent spending decisions takes effect, the OBEGAL declines over the rest of the forecast period to $3.9 billion (1.8% of GDP) in 2011/12.

Not all components of the OBEGAL expected over the forecast period are drawn upon by the Government to help fund its operations. For example, entities retain their surpluses for the purpose of achieving their long-term objectives, such as ACC building up financial assets to help meet its outstanding claims liability and SOEs investing in their capital base.

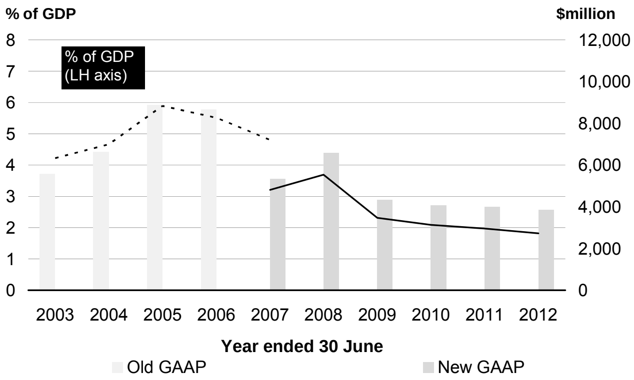
This leaves around two-thirds of the accumulated OBEGAL available to finance the Government's investment activities, such as contributions to the NZS Fund and its general capital programme.

… and cash surpluses become deficits …

The portion of the OBEGAL that is available to the Government translates into about $24.1 billion of cash over the forecast period.

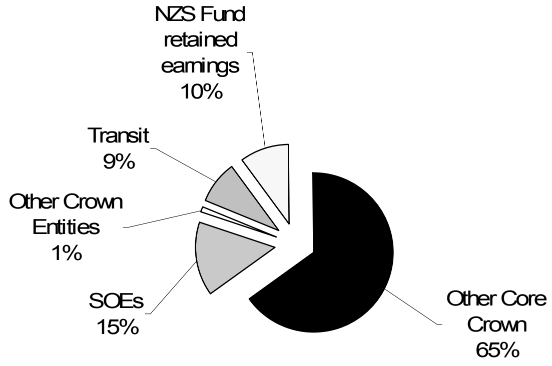
This is sufficient to meet the Government's required contributions to the NZS Fund of $11.4 billion. With the purchase of physical assets of $9.7 billion (for example, schools and defence equipment), advances of $4.4 billion (mainly student loans and refinancing debt of the health and housing sectors), injections into Crown entities for hospitals and housing of $1.1 billion, there is a residual financing requirement over the forecast period of around $2.6 billion.

Figure 2.4 – Operating balance before gains and losses (OBEGAL)



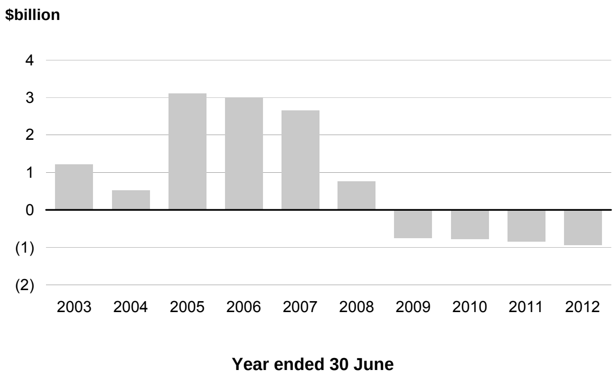
Source: The Treasury

Figure 2.5 – Accumulated OBEGAL breakdown for the period 2007/08 to 2011/12



Source: The Treasury

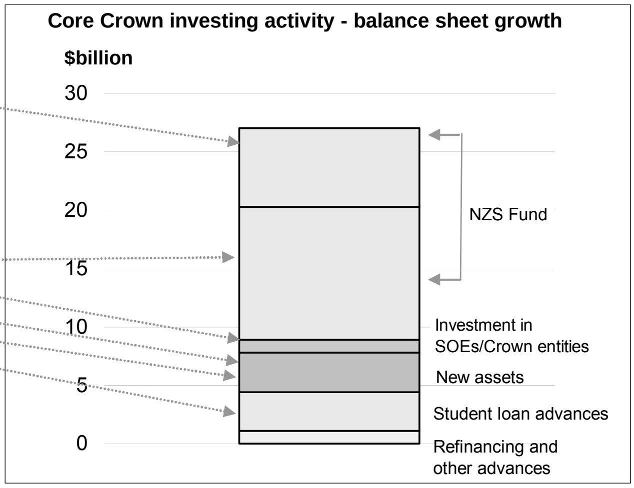
Figure 2.6 – Core Crown residual cash on a year-by-year basis



Source: The Treasury

Table 2.3 – Impact of Crown operating surpluses on the Statement of Financial Position from 2007/08 to 2011/12 inclusive

	$billion
Operating balances	31.7
Less	
Retained NZS Fund returns	(6.7)
Retained SOE/Crown entity returns	(8.3)
Add	
Depreciation	6.3
Other	1.1
Operating cash flows	24.1
Invested in	
NZS Fund contributions	(11.4)
SOEs'/Crown entities' net capital injections	(1.1)
Increase asset base	(3.4)
Maintain existing asset base	(6.3)
Advances	(4.4)
Other	-
Requiring finance	(2.6)



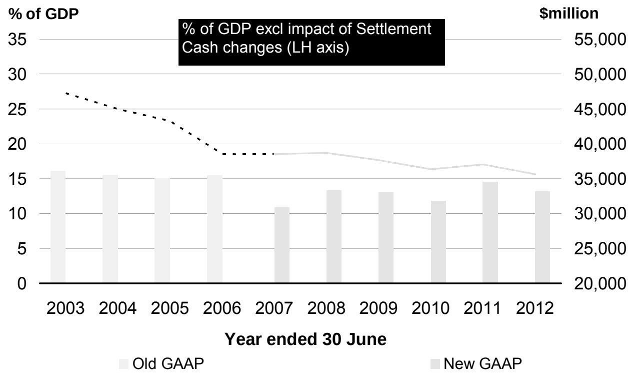
Source: The Treasury

… which are met by borrowings …

Gross sovereign issued debt (GSID) (excluding Settlement Cash) is forecast to increase by around $2.3 billion from 2006/07 to 2011/12, primarily to finance the forecast cash shortfall of $2.6 billion. As a percentage of GDP, GSID (excluding Settlement Cash) is expected to fall from 18.5% to 15.6% over the same period.

The Government's bond programme is forecast to be around $2.5 billion per annum, amounting to $12.5 billion of new borrowings over the forecast period. After meeting the cash shortfall the residual new borrowing replaces maturing debt.

Figure 2.7 – GSID (excluding Settlement Cash)



Source: The Treasury

By increasing borrowings to meet the cash shortfall, financial assets (around $6.5 billion) built up over recent years from strong cash outturns are left intact over the forecast period. These financial assets can be used to meet forecast cash shortfalls beyond 2012.

Why Settlement Cash is excluded from gross sovereign-issued debt

Settlement Cash is the amount of money deposited with the Reserve Bank by banks. It is a liquidity mechanism used to settle wholesale obligations between banks and provides the basis for settling most of the retail banking transactions that occur every working day between corporates and individuals.

Settlement Cash is technically a form of borrowing by the Reserve Bank, which is part of the core Crown. Unlike other core Crown borrowing, however, Settlement Cash represents a liability that is matched by a corresponding increase in financial assets.

Since early 2006, Settlement Cash has increased from $20 million to around $8 billion. This increase was a result of a review of the liquidity management arrangements available to banks. Given the increase in Settlement Cash is net debt neutral and the increase in borrowings does not arise out of any change in cash requirements of the Government, it is appropriate that fiscal policy "looks through" this increase.

The 2007 *Fiscal Strategy Report* (page 52) states that "the Government is effectively targeting a level of Gross Sovereign-Issued Debt (GSID) excluding the increase in debt on the Reserve Bank balance sheet as a result of the change in the liquidity management regime". As the Reserve Bank decided to fund $1.6 billion of the previously announced increase in its reserves from Settlement Cash rather than borrow from the NZ Debt Management Office, the amount to be excluded from GSID should be adjusted by this amount.

For these forecasts, the GSID excluding Reserve Bank Settlement Cash is:

	Year ended 30 June					
$billion	**2007 Actual**	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**
GSID (includes Settlement Cash)	36.8	39.6	39.3	38.1	40.9	39.5
Reserve Bank Settlement Cash	7.5	7.9	7.9	7.9	7.9	7.9
Reduced NZ DMO borrowing due to Settlement Cash	1.6	1.6	1.6	1.6	1.6	1.6
GSID excluding Settlement Cash	30.9	33.3	33.0	31.8	34.6	33.2
As a % of GDP	18.5	18.7	17.7	16.3	17.0	15.6

For forecast purposes the amount of Settlement Cash is held constant. In practice, Settlement Cash does fluctuate through time so the actual amount deducted from GSID will vary when actual results are reported.

... while financial assets increase ...

Financial assets (including NZS Fund) are forecast to increase by around $20.2 billion over the forecast period.

There are two main drivers of this increase:

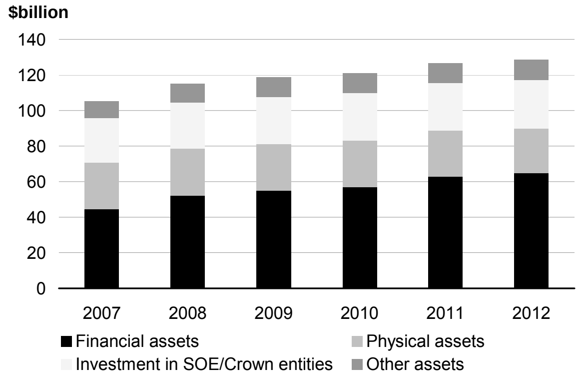
- Investment in the NZS Fund. In line with the fiscal strategy, a portion of the cash generated from the Government's operations is set aside to make contributions to the NZS Fund. In addition, the NZS Fund financial assets by the reinvestment of its retained grow surpluses.
- More advances are being made, primarily in the form of student loans. Student loans are not readily convertible into cash.

... and the Government continues to strengthen its net financial asset position

Including the financial assets held by the NZS Fund, the Government is forecast to move from an $8.1 billion (or 4.9% of GDP) net financial asset position in 2006/07 to $26.4 billion (or 12.4% of GDP) by 2011/12.

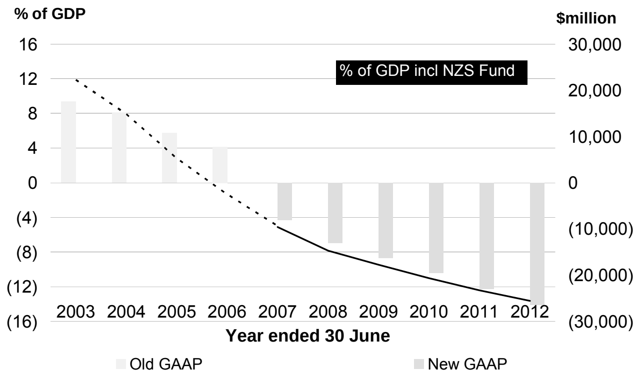
Without the NZS Fund, net debt remains relatively stable at around 1% of GDP over the forecast period. This trend reflects the fact that some increases in GSID (excluding Settlement Cash) are being invested in financial assets (eg, student loans) and are net debt neutral.

Figure 2.8 – Core Crown asset growth



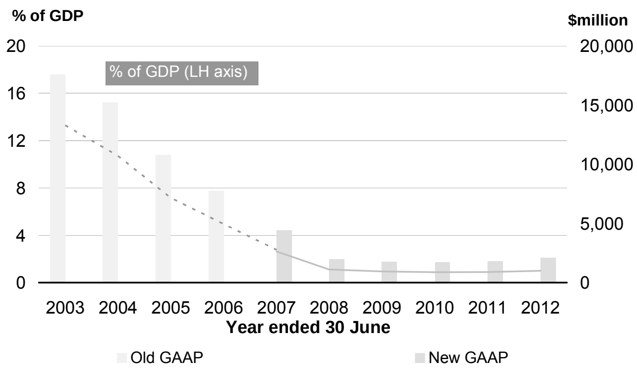
Source: The Treasury

Figure 2.9 – Net debt (% of GDP and $million) including financial assets of NZS Fund



Source: The Treasury

Figure 2.10 – Net debt (% of GDP and $million)



Source: The Treasury

The New Zealand Superannuation Fund

The NZS Fund is an important component of the Government's fiscal strategy. The NZS Fund's assets provide the means for the Government to partially pre-fund future fiscal pressures, particularly those pressures arising from an ageing population.

The NZS Fund's assets are to be built up through a combination of investment returns earned on the Fund's portfolio and Government contributions. The Government's contributions to the NZS Fund are calculated over a 40-year rolling horizon on the basis of funding superannuation payments over the next 40 years with a constant contribution rate over that period. The Government is forecast to make the required minimum annual contribution for 2007/08 and 2008/09 as calculated by the formula set out in the NZS Act.

$billion (June year end)	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Required contribution	2.337	2.049	2.103	2.376	2.321	2.316	2.281
Actual/Budgeted contribution	2.337	2.049	2.103	2.376	2.321	2.316	2.281

The underlying assumptions in calculating the contributions for 2008 are the nominal GDP series to 2048, the New Zealand Superannuation expense series to 2048 and the expected long-term, net after-tax annual return of the NZS Fund (6.1%) (6.1% *Budget 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.

The Fund's assets are forecast to grow over the forecast period to $31.1 billion, an increase of $18.1 billion. Over $6.7 billion of this increase is expected to come from the NZS Fund's investment performance, with the remaining increase from Government contributions.

	Year ended 30 June					
	2007 Actual	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**
$million						
Opening net worth	9,855	12,973	15,993	19,488	23,140	27,016
Gross contribution from the Crown	2,049	2,103	2,376	2,321	2,316	2,281
NZS Fund net revenue	282	432	532	633	747	868
NZS Fund gains and losses	1,520	761	923	1,097	1,283	1,482
Income tax	(733)	(276)	(336)	(399)	(470)	(545)
Closing net worth	**12,973**	**15,993**	**19,488**	**23,140**	**27,016**	**31,102**

Introduction of an Emissions Trading Scheme

On 4 December 2007, the Government introduced legislation to establish an Emissions Trading Scheme (ETS) to encourage industries and businesses to reduce greenhouse gas emissions. Key features of the ETS from a forecasting perspective are:

- The ETS creates a limited number of tradable units (the NZ Unit), which the Government can allocate freely or sell to entities.
- Specified emitters ("points of obligation") will be required to surrender NZ Units or International Units to the Crown based on the level of carbon dioxide equivalent they emit or that will be emitted downstream of their activities.
- The Government will exchange NZ Units for internationally tradable units if parties holding NZ Units wish to sell their units offshore.

Detail on the operation of the ETS is available at www.climatechange.govt.nz/

Reporting of the ETS

The economic impacts of the ETS are not included in these forecasts, as Cabinet's decisions on the ETS were made after the HYEFU's economic forecasts were finalised.

The fiscal forecasts do, however, capture the core policy decisions made by Cabinet (ie, transactions associated with the Government's allocation of NZ Units to forestry and industrial process sectors and payment of units to the Crown by emitters). There is little guidance on how to report Emission Trading Schemes, with practices varying internationally. The following outlines the approach reflected in this *Half Year Update*. This approach is being discussed with the Office of the Auditor-General.

The allocation of NZ Units creates a liability (and an expense if allocated for free). The liability arises from the Crown being prepared to swap allocated units into International Units. This is similar to how currency issued by the Crown is reported. The liability is reduced, and revenue recognised, as NZ Units are paid back to the Crown by emitters. The forecast revenues and expenses are transacted in NZ Units (valued at the recent international carbon prices) – no cash is exchanged.

The ETS impact on the fiscal forecasts is:

	Year ended 30 June				
	2008	2009	2010	2011	2012
$millions	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Revenue - levies payable under ETS	-	84	480	864	864
Expense - free allocations of units	-	597	477	477	477
OBEGAL	**-**	**(513)**	**3**	**387**	**387**
Balance sheet - change in OBEGAL					
Liability - outstanding NZ Units	-	513	510	123	-
Asset - International Units	-	-	-	-	264

Reporting of the Kyoto liability

The ETS is designed to encourage reductions in greenhouse gas emissions at least cost. Reductions in emissions will in turn reduce the Crown's international Kyoto obligations. For the *Half Year Update*, the Kyoto liability has been updated for exchange rates and international carbon prices only, bringing the carbon price in New Zealand dollars to $21.01 ($15.48 at 30 June 2007). The price change increased the liability to $956 million (up $252 million since 30 June 2007).

Revenue and Expenses

This section discusses the trends in the three main OBEGAL components: core Crown revenue, core Crown expenses and SOEs'/CEs' OBEGAL. The trend in total Crown is primarily driven by the core Crown segment activity so is the focus of this section.

Table 2.4 – Revenue and expenses comparison with *Budget Update*

% of GDP	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
			Year ended 30 June			
Total revenue						
Half Year Update	44.6	44.7	43.5	43.4	43.7	43.6
Budget Update		44.4	44.4	44.5	44.3	
Total expenses						
Half Year Update	41.4	41.0	41.2	41.3	41.8	41.8
Budget Update		41.5	42.2	42.6	42.5	
Core Crown revenue						
Half Year Update	34.9	35.0	34.0	33.8	34.2	34.3
Budget Update		34.3	34.1	34.1	34.1	
Core Crown expenses						
Half Year Update	32.4	32.1	32.4	32.4	32.8	33.0
Budget Update		32.4	32.8	33.0	33.1	
SOE revenue						
Half Year Update	7.1	7.1	7.1	7.2	7.1	7.1
Budget Update		7.5	7.6	7.5	7.2	
SOE expenses						
Half Year Update	6.6	6.7	6.6	6.7	6.6	6.5
Budget Update		6.9	6.9	6.9	6.7	
Crown entities' revenue						
Half Year Update	15.7	15.4	14.7	14.2	13.8	13.3
Budget Update		15.9	15.6	15.2	14.6	
Crown entities' expenses						
Half Year Update	15.4	15.1	14.5	14.1	13.7	13.2
Budget Update		15.5	15.3	14.9	14.4	

Source: The Treasury

Total revenue to GDP is forecast to fall over the forecast period from 44.7% in 2007/08 to 43.6% by 2011/12. Total expenses to GDP are forecast to increase from 41% to 41.8% over the same period.

The trend in total revenue and expenses over the forecast horizon is largely driven by activity in the core Crown segment of reported Government activity. The following section discusses the core Crown activity in more detail.

Core Crown – Revenue

Table 2.5 – Core Crown revenue

	Year ended 30 June					
	2007 Actual	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**
$ billion						
Tax revenue and revenue reduction contingency	53.4	57.2	57.7	59.6	62.5	65.5
Investment revenue	2.6	3.0	3.5	3.5	3.7	4.0
Other core Crown revenue	2.2	2.2	2.3	2.7	3.3	3.2
Total core Crown revenue	58.2	62.4	63.5	65.8	69.5	72.7
% of GDP						
Tax revenue and revenue reduction contingency	32.0	32.1	30.9	30.6	30.8	30.8
Investment revenue	1.6	1.7	1.9	1.8	1.8	1.9
Other core Crown revenue	1.3	1.2	1.2	1.4	1.6	1.5
Total core Crown revenue	34.9	35.0	34.0	33.8	34.2	34.3

Source: The Treasury

Tax Revenue and Revenue Reduction Contingency

There are a number of factors that are influencing the trend in tax revenue over the forecast period. In summary the main drivers are:

- growth in the economy
- tax initiatives
- the revenue reduction contingency, and
- accounting disclosure changes.

Economic growth

Tax revenue is expected to grow by around 7% to the end of this year, which is broadly consistent with forecast growth in nominal GDP for the same period. In nominal terms, tax revenue is forecast to grow by about $4 billion. The three largest components of this growth are:

- source deductions ($1.5 billion), coming from growth in underlying salaries and wages of about 6%
- corporate taxes ($0.8 billion), owing to forecast growth in profits, and
- other persons tax ($0.6 billion), with much of this a result of the 50% increase in the 2008 dairy payout.

From 2009 onwards, the composition of forecast growth changes slightly. In particular tax types:

- Source deductions are still the main driver of tax growth. With aggregate salaries and wages forecast to grow at around 5% per annum, source deductions continue to grow by about $1.5 billion each year, with fiscal drag contributing $250 million to $300 million of this.
- Corporate tax continues to grow, but only by about $300 million each year, excluding the effects of the Business Tax Reform announced in the *Budget Update*.

- Other persons tax growth also slows, adding about $200 million each year.
- GST makes a more prominent contribution in these later years, adding $300 million to $600 million each year.

Tax revenue forecasts have also incorporated some second round effects from the revenue reduction contingency. They assume that such a revenue reduction would increase disposable income and also spur some additional employment and wage growth. This would generate some extra PAYE and GST, as well as providing a small boost to some of the other income taxes. This additional revenue from second round effects is estimated to be as much as $500 million by 2011/12.

Tax revenue initiatives

The Business Tax Reform has a significant effect in 2008/09 and beyond, reducing tax revenue by nearly $1 billion each year. Without the business tax package, core Crown tax revenue would have a much flatter profile, hovering around 32% of GDP.

Revenue reduction contingency

The fiscal forecasts include a revenue reduction contingency of $1.5 billion effective from 1 April 2009 and rising to $1.7 billion by the end of the forecast period. As signalled in the *2008 Budget Policy Statement (BPS),* the contingency reflects possible reduction to personal income tax.

Accounting disclosure changes

There has been a change in the disclosure of bad debt write-offs of tax receivables. Tax write-offs are now shown as an expense rather than netted off against revenue. The change in the write-off treatment has resulted in a $450 million per annum increase in revenue and a corresponding increase in expenses. The main tax types affected are other persons, corporate tax and GST.

Other Revenue

Other core Crown revenue is forecast to increase slightly as a GDP over the forecast period. This is primarily due to the introduction of an ETS. The ETS will create tradable units (the NZ Unit) and will generate revenue when surrendered to the Government by emitters. Further information on the ETS can be found on page 44.

Inland Revenue's tax forecasts

In line with established practice, Inland Revenue has also prepared a set of tax forecasts, which, like the Treasury's tax forecast, is based on the Treasury's macroeconomic forecast. Inland Revenue's forecasts are shown here for comparative purposes. The Treasury's forecasts remain the Crown's official forecasts.

Table 2.6 – The Treasury and Inland Revenue core Crown tax revenue forecasts (excluding the revenue reduction contingency

$billion	2007/08 Forecast	2008/09 Forecast	2009/10 Forecast	2010/11 Forecast	2011/12 Forecast
Source deductions					
Treasury	22.6	24.0	25.4	27.1	28.7
Inland Revenue	22.7	24.1	25.4	26.9	28.5
Difference	(0.1)	(0.1)	-	0.2	0.2
Net other persons tax					
Treasury	3.9	4.2	4.3	4.5	4.7
Inland Revenue	3.8	3.8	4.0	4.2	4.4
Difference	0.1	0.4	0.3	0.3	0.3
Corporate taxes					
Treasury	10.8	9.3	10.2	10.4	10.9
Inland Revenue	11.0	9.7	10.2	10.4	10.7
Difference	(0.2)	(0.4)	-	-	0.2
Goods and services tax					
Treasury	11.8	12.1	12.5	13.1	13.5
Inland Revenue	11.7	12.3	12.7	13.3	13.8
Difference	0.1	(0.2)	(0.2)	(0.2)	(0.3)
Other taxes					
Treasury	8.1	8.5	8.7	9.0	9.4
Inland Revenue	7.9	8.3	8.6	8.9	9.1
Difference	0.2	0.2	0.1	0.1	0.3
Total tax					
Treasury	57.2	58.1	61.1	64.1	67.2
Inland Revenue	57.1	58.2	60.9	63.7	66.5
Difference	0.1	(0.1)	0.2	0.4	0.7
Total tax (% of GDP)					
Treasury	32.1	31.1	31.4	31.6	31.6
Inland Revenue	32.0	31.1	31.3	31.4	31.3
Difference	0.1	-	0.1	0.2	0.3

Source: Inland Revenue, The Treasury

The main differences between the Treasury's and Inland Revenue's forecasts occur in:

- net other persons tax, where the two agencies have differing views on the amount of tax that will be payable on the additional dairy income
- corporate taxes, where Treasury's forecast is initially lower than Inland Revenue's, but is higher by 2012, owing to Treasury forecasting a higher average growth rate than Inland Revenue, and
- GST, where Inland Revenue's implicit GST rate on nominal private consumption is higher than the Treasury's from 2009 onwards.

Core Crown – Expenses

Table 2.7 – Expenses indicators

Expenses	2007	2008	2009	2010	2011	2012
	Year ended 30 June					
$billion	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Core Crown	54.0	57.1	60.5	63.1	66.6	70.0
Total Crown	69.1	73.0	77.0	80.4	84.7	88.8
% of GDP						
Core Crown	32.4	32.1	32.4	32.4	32.8	33.0
Total Crown	41.4	41.0	41.2	41.3	41.8	41.8

Source: The Treasury

Expense growth

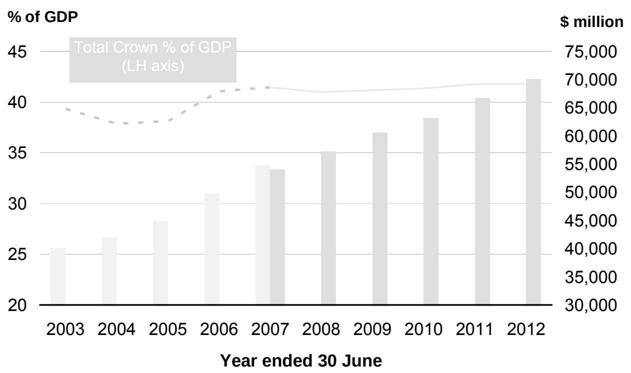
Core Crown expenses are forecast to increase by around 1% of GDP between 2007/08 and 2011/12. In nominal terms, expenses are forecast to increase by $12.9 billion over the same period.

Budget initiatives

The forecast growth in expenses largely arises from expense initiatives introduced in recent Budgets. A number of policy decisions made in previous Budgets have rising spending profiles to allow sufficient time for full implementation. The enhancement to the KiwiSaver initiative announced in Budget 2007 is one of the main drivers of this rising profile (around $0.8 billion in 2007/08 rising to around $1.4 billion by 2011/12).

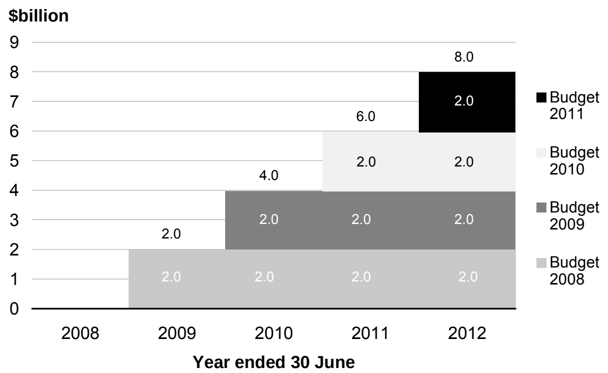
The fiscal forecasts also include indicative amounts for new operating initiatives for future Budgets. The allowances for each of the next four Budgets have been set at around $2 billion, so are broadly consistent with the forecast growth in the economy. New operating spending initiatives add around $8 billion to the expense base by the end of the forecast horizon.

Figure 2.11 – Core expenses ($ and % of GDP)



Source: The Treasury

Figure 2.12 – Net amounts for new operating initiatives



Source: The Treasury

Emissions Trading Scheme

As part of the new ETS the Government has agreed to allocate NZ Units to emitters free of charge. This has resulted in an increase to expenses of $0.6 billion in 2008/09 and $0.5 billion in subsequent forecast years. Further information on the ETS can be found on page 44.

Benefit expenses

Social security and welfare expenses are forecast to broadly grow in line with the forecast growth in the economy. In nominal terms they are forecast to increase from $17.9 billion in 2007/08 to $20.4 billion in 2011/12. Around $1.7 billion of this reflects cost of living adjustments for New Zealand Superannuation payments and welfare benefits, which reflect inflationary pressures. Most benefits are adjusted each April by the CPI movement over the previous calendar year.

Partly offsetting nominal growth in benefit expense forecasts are second round effects from the assumed revenue reduction contingency. They assume tax paid on benefits will be lower, resulting in reduced gross payment of benefits for the Government.

Top-down adjustment to spending

Forecasts are initially compiled from returns provided by individual entities. The need for a top-down adjustment to core Crown expense and capital expenditure forecasts arises from the extent to which departments use appropriations, which are an authority for the maximum that a department may spend, rather than a mid-point estimate for these forecasts. As appropriations apply to the core Crown only, no adjustment is required to SOE or Crown Entity forecasts.

The size of the adjustment reflects analysis of key departments, trend analysis of expense variances across all departments and a review of results to September 2007. This analysis includes identifying where appropriations have been used as proxy for forecasts, where appropriations and hence forecasts reflect contingencies that may have low probability of being realised in any one year, and past trends of variances between results and forecasts.

In this update the outyear forecasts also have a top-down adjustment in order that aggregate department forecasts better reflect mid-point estimates, rather than appropriation levels, for Government policies. The top-down adjustment is applied to both cash and accrual forecasts and is explicitly identified in the financial statements. The adjustment is:

	Year ended 30 June				
	2008	2009	2010	2011	2012
$millions	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
Operating expenditure	750	275	250	200	150
Capital expenditure	250	100	100	100	100
Total	**1,000**	**375**	**350**	**300**	**250**

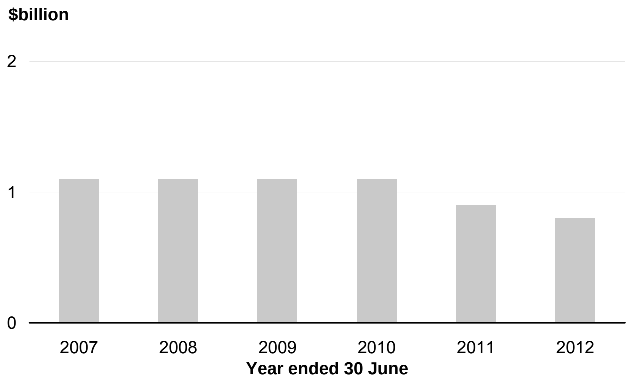
The adjustment for the 2007/08 financial year is higher than the outyears because it reflects the extent to which some expenses will be transferred from 2007/08 to subsequent outyears in Budget 2008. While we expect transfers to be made in the years beyond 2007/08, the amounts transferred into each of those years will be largely offset by the transfers out at the end of those same years.

State-owned Enterprises and Crown Entities – OBEGAL

The OBEGAL of the SOEs and CEs are forecast to total $8.5 billion over the forecast period. Around $2.1 billion of the operating surpluses will be returned as dividends, and will be available to fund spending elsewhere in the Crown (ie, it forms a part of residual cash).

Over the forecast period SOE/CEs' OBEGAL after dividends are on average $1 billion.

Figure 2.13 – SOE and Crown entities operating balance



Source: The Treasury

SOE/CEs' OBEGAL after payment of dividends total $6.4 billion. This residual is maintained within the entities that have generated the net surpluses and so is not available to fund spending elsewhere in the Crown. In broad terms, the majority of the accumulated net surpluses are forecast to build up financial and physical assets.

Physical Asset Purchases and Capital Spending

Table 2.8 – Net purchases of physical assets by segment[6]

	Year ended 30 June					
	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	Total
$million						
Core Crown (after top-down adjustment)	1,773	1,097	1,170	949	886	5,875
Crown entities	2,542	2,232	2,046	2,157	2,086	11,063
State-owned enterprises	2,234	2,423	3,039	3,158	2,872	13,727
	6,549	**5,752**	**6,255**	**6,264**	**5,844**	**30,664**

Source: The Treasury

Core Crown capital spending forecasts comprise net physical asset purchases met from existing baselines plus new capital allocated in Budgets.

As part of the Budget 2007, the Government allocated $1.6 billion of new capital over the next four years. Amounts for the 2008, 2009 and 2010 Budgets have been set at $0.9 billion phased in over four years, some of which falls outside the forecast horizon. On a year-by-year basis, capital spending is forecast to be on average $2 billion per annum over the next five years.

6 Net purchases of physical assets are net of any sales of physical assets.

Table 2.9 – Core Crown capital spending

	Year ended 30 June					
	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	Total
$million						
Net purchase of physical assets	**1,773**	**1,097**	**1,170**	**949**	**886**	**5,875**
Budget 2008	48	992	330	200	230	1,800
Budget 2009	-	20	480	250	150	900
Budget 2010	-	-	20	480	250	750
Budget 2011	-	-	-	20	480	500
Total Budget allocation for capital	**48**	**1,012**	**830**	**950**	**1,110**	**3,950**
Total capital spending	**1,821**	**2,109**	**2,000**	**1,899**	**1,996**	**9,825**

Source: The Treasury

Comparison with *Budget Update*

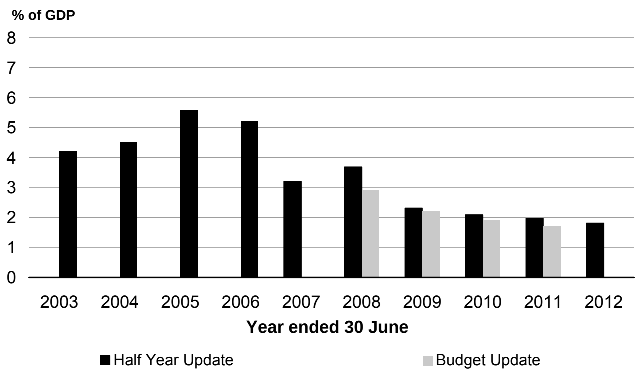
This section compares the key indicators for the *Half Year Update* with the *Budget Update*.

OBEGAL

Compared to the *Budget Update* the OBEGAL is expected to be around $1.6 billion higher than forecast for the 2007/08 year. Over the rest of the forecast period the OBEGAL is on average about $0.5 billion higher than the *Budget Update*.

Both core Crown revenue and expenses have increased since the *Budget Update.* The key changes are outlined in Table 2.10 and discussed below.

Figure 2.14 – OBEGAL comparison



Source: The Treasury

Tax revenue

Tax revenue forecasts have been increased by about $2 billion each year over the forecast period since the *Budget Update*.

Much stronger price growth and, to a lesser extent, a higher level of real economic activity contributes to the level of nominal GDP being significantly higher than in the *Budget Update* in each year of the forecast period. The economic forecasts take into account increased activity spurred by the revenue reduction contingency.

This increase in the nominal GDP forecast has the largest effect on income taxes, as follows:

- **Other persons tax** – Shortly after the 2007 Budget was released, Fonterra announced that the dairy payout for the year to May 2008 would be about 50% up on 2007. This large increase in dairy farm incomes has prompted the Treasury to significantly revise up its projections for unincorporated profits for 2008 and beyond. In turn, this has led to increases of as much as $400 million in some years for other persons tax.

- **Corporate taxes** – As well as unincorporated profits, the Treasury has also increased its projections of corporate profits and hence corporate taxes. The biggest effect occurs in 2009/10 where the corporate tax forecast is more than $600 million higher than in the *Budget Update*.

- **Source deductions** – Forecasts of aggregate salaries and wages have been increased by as much as $3 billion in some years, prompting some large increases in the source deductions forecasts.

- **RWT on interest** – There have also been some significant increases made to the RWT forecasts. However, these increases are more the result of changes to the forecasting model than changes in the forecasts of any underlying economic parameter. RWT on interest has increased by an average of nearly 20% per annum. for each of the past five years. With no sign of this growth abating, the Treasury has revised up the forecast growth rates for RWT in most years of the forecast.

With increased incomes, we might also expect to see an increase in the forecasts of domestic consumption and hence GST. Yet, despite increases in the consumption forecasts, the GST forecasts are little changed from the *Budget Update* owing to changes in judgements around the average effective rate of GST on consumption. Note that not all consumption is subject to GST, eg, residential rents, and there are things outside of the System of National Accounts measure of consumption that attract GST, eg, residential construction.

The change in the way bad debt write-offs of tax receivables are disclosed has resulted in a $450 million per annum increase in tax revenue. As previously mentioned, tax write-offs are now shown as an expense rather than being netted off against revenue. The change in the write-off treatment also results in a corresponding increase in expenses compared to the *Budget Update*.

Table 2.10 – OBEGAL reconciliation (explains changes to the operating balance since the *Budget Update)*

$million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast
OBEGAL 2007 *Budget Update*	4,958	3,957	3,530	3,347
Core Crown revenue changes				
Tax revenue (forecasting)	2,010	1,342	1,791	1,720
Tax revenue (accounting policy change)	450	450	450	450
Revenue reduction contingency	-	(375)	(1,600)	(1,700)
Net Investment income	(156)	131	77	222
Kyoto - ETS levies	-	84	480	864
Impact of OBU	149	130	135	167
Other revenue	(4)	21	26	(40)
Total core Crown revenue changes	**2,449**	**1,783**	**1,359**	**1,683**
Core Crown expense changes				
KiwiSaver uptake	(344)	(172)	(49)	12
Benefit forecast	(24)	(45)	106	17
Tax revenue (accounting policy change)	(450)	(450)	(450)	(450)
ETS expenses	-	(597)	(477)	(477)
Kyoto liability increase	(252)	-	-	-
Transport full hypothecation funding	-	-	(35)	(182)
Impact of OBU	(354)	(150)	(154)	(63)
Top-down expense adjustment	750	275	250	200
Other operating expenses	187	(4)	26	(13)
Total core Crown operating expense changes	**(487)**	**(1,143)**	**(783)**	**(956)**
Core Crown OBEGAL change	**1,962**	**640**	**576**	**727**
Net SOE/CE change (including impact of eliminations)	(346)	(270)	(44)	(90)
Total changes	**1,616**	**370**	**532**	**637**
OBEGAL 2007 *Half Year Update*	6,574	4,327	4,062	3,984
Core Crown OBEGAL change	**1,962**	**640**	**576**	**727**
Kyoto liability increase (no cash impact)	252	513	(3)	(387)
Top-down capital adjustment	250	100	100	100
Capital allocation	-	(503)	(23)	(24)
Capital transfers	(268)	-	-	-
NZS Fund	-	(157)	12	156
Advances	(236)	(157)	(83)	(141)
Other changes (eg, working capital. PPE)	(223)	523	291	144
Residual cash change	1,735	924	870	575

Source: The Treasury

Revenue reduction contingency

The fiscal forecasts include a revenue reduction contingency of $1.5 billion effective from 1 April 2009, rising to $1.7 billion by the end of the forecast period. This is on top of the operating allowances signalled in the *2007 FSR*.

Net investment income

The stronger cash position compared to the *Budget Update* has meant the Government has built up more financial assets and in turn is forecast to generate more investment income (around $100 million per annum) than previously expected at the time of the *Budget Update*.

KiwiSaver

Take-up for the KiwiSaver scheme over the first four months of its operation has proved to be higher than that forecast in the *Budget Update*. The *Half Year Update* revisions are based on an assumption that growth in applications will ease in the new year, and that the total number of applications will reach around 563,000 by June 2008 (this includes members of non-KiwiSaver superannuation schemes but who are eligible to access some KiwiSaver benefits).

Some uncertainty arises from the nature of the extra applications received to date. Some of the unanticipated take-up has come from children (nearly 16,000 applications for those aged under 15 years to date), and people nearing retirement (37,000 applications to date are for those aged 60-64). For these groups, the main fiscal impact is on the $1,000 kick-start contribution. However, extra growth from people in employment affects all aspects of the scheme. There is even greater uncertainty over whether the strength in applications to date is simply a bring forward of applications (faster growth), or will lead to genuinely higher than assumed take-up in the long run.

Benefit forecasts

Benefit expense forecasts have not changed substantially from the *Budget Update*. However, there are two offsetting factors:

- New Zealand Superannuation payments are forecast to be higher owing to greater expected indexation growth since the *Budget Update* flowing from higher CPI inflation and wage growth; offset by
- the $1.5 billion revenue reduction contingency will result in lower gross benefit payments for the Government as a result of lower tax payable.

Kyoto Protocol liability

The Kyoto Protocol liability has been revised up in the current year to reflect updated carbon prices. The carbon price used for the *Half Year Update* fiscal forecasts is $21.01 (NZD), compared to $13.52 (NZD) used in the *Budget Update*.

Top-down adjustments

The top-down adjustment is now being rolled out in each year of the fiscal forecasts. Applying the adjustment across the forecast horizon compensates for departments using appropriations as the basis for their forecasts. Appropriations will overstate actual expenditure as they set upper spending limits, not mid-point estimates, and in some instances they reflect contingencies.

Residual Cash

Similar to the OBEGAL, residual cash is forecast to be stronger compared to the *Budget Update*. The majority of the drivers that influenced the upwards revision in the OBEGAL are also present in residual cash. In addition:

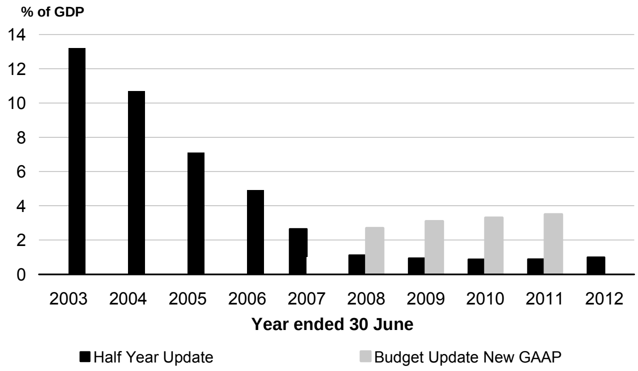
- The *Half Year Update* allows for a $900 million higher capital allowance in Budget 2008 than that signalled in the *2007 FSR*. The majority of the increase in the capital allowance is forecast to occur in the 2008/09 fiscal year.
- The capital top-down adjustment has resulted in a reduction in capital payments compared to the *Budget Update* ($250 million in 2007/08 and $100 million in the other outyears).
- Repayments of advances are forecast to be lower than expected at the *Budget Update*, primarily due to student loans.

Debt Indicators

Net core Crown debt is forecast to be lower in each forecast year compared to the *Budget Update*. Net debt is forecast to be around 1% of GDP in 2010/11 compared to 3.5% in the *Budget Update*. In nominal terms, net core Crown debt is forecast to be around $5 billion lower compared to the *Budget Update*. The main reason for the lower net core Crown position since the *Budget Update* is the flow-on impact of the increase in residual cash.

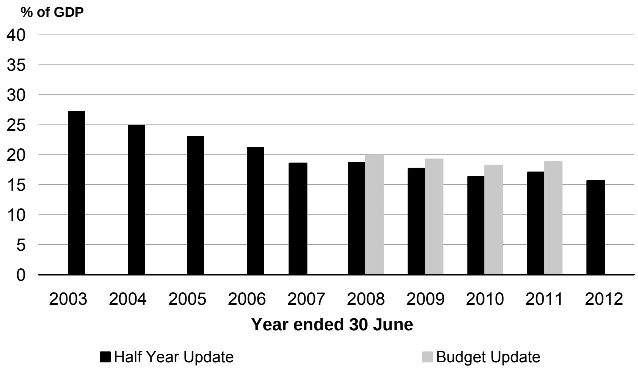
GSID (excluding Settlement Cash) is also forecast to be lower than forecast at the *Budget Update*, despite no change in forecast debt issuance. This is primarily owing to revisions to the forecast tenor of bond issuance, and consequentially increasing bond maturities within the forecast period.

Figure 2.15 – Net debt comparison



Source: The Treasury

Figure 2.16 – GSID (excl Settlement Cash) comparison



Source: The Treasury

Table 2.11 – 2007 *Half Year Update* fiscal indicators

Fiscal indicators $million	Year ended 30 June 2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Revenue						
Total Crown revenue	74,427	79,608	81,280	84,482	88,710	92,612
Core Crown revenue	58,174	62,409	63,496	65,832	69,458	72,740
Core Crown tax revenue and contingency	53,445	57,166	57,697	59,618	62,531	65,507
Expenses						
Total Crown expenses	69,088	73,034	76,953	80,420	84,726	88,762
Core Crown expenses	53,976	57,137	60,537	63,106	66,632	70,034
Operating balance - Core Crown	6,498	6,206	4,166	4,089	4,395	4,489
Operating balance - Crown entities	1,006	580	1,135	968	938	901
Operating balance - SOEs	821	986	1,125	1,251	1,173	1,368
Dividend elimination	(326)	(384)	(373)	(384)	(412)	(530)
Total operating balance	7,999	7,388	6,053	5,924	6,094	6,228
OBEGAL	5,339	6,574	4,327	4,062	3,984	3,850
OBEGAL excluding NZS Fund revenue	5,757	6,019	3,642	3,243	3,021	2,733
Cash available/(shortfall to be funded)	2,653	759	(763)	(779)	(851)	(937)
Debt indicators						
GSID (excluding Settlement Cash)	30,890	33,303	33,034	31,779	34,566	33,172
Total gross Crown debt	41,914	46,363	47,956	49,351	53,106	52,434
Net core Crown debt	4,411	1,983	1,756	1,705	1,792	2,105
Net core Crown debt with NZS Fund assets	(8,112)	(13,102)	(16,224)	(19,545)	(22,990)	(26,414)
Net worth	96,704	104,315	110,372	116,313	122,417	128,652
Domestic bond programme	2,294	2,453	2,459	2,487	2,507	2,497
Nominal GDP	166,714	178,199	186,956	194,528	202,865	212,364
Fiscal indicators as a % of GDP						
Revenue						
Total Crown revenue	44.6	44.7	43.5	43.4	43.7	43.6
Core Crown revenue	34.9	35.0	34.0	33.8	34.2	34.3
Core Crown tax revenue and contingency	32.1	32.1	30.9	30.6	30.8	30.8
Expenses						
Total Crown expenses	41.4	41.0	41.2	41.3	41.8	41.8
Core Crown expenses	32.4	32.1	32.4	32.4	32.8	33.0
Operating balance	4.8	4.1	3.2	3.0	3.0	2.9
OBEGAL	3.2	3.7	2.3	2.1	2.0	1.8
OBEGAL excluding NZS Fund revenue	3.5	3.4	1.9	1.7	1.5	1.3
Debt indicators						
GSID (excluding Settlement Cash)	18.5	18.7	17.7	16.3	17.0	15.6
Total gross Crown debt	25.1	26.0	25.7	25.4	26.2	24.7
Net core Crown debt	2.6	1.1	0.9	0.9	0.9	1.0
Net core Crown debt with NZS Fund assets	(4.9)	(7.4)	(8.7)	(10.0)	(11.3)	(12.4)
Net worth	58.0	58.5	59.0	59.8	60.3	60.6
New Zealand Superannuation Fund						
Fund asset returns (after tax)	1,069	917	1,119	1,331	1,560	1,805
Fund contributions	2,049	2,103	2,376	2,321	2,316	2,281
Fund assets (year end)	12,973	15,993	19,488	23,140	27,016	31,102
% of GDP	7.8	9.0	10.4	11.9	13.3	14.6

Source: The Treasury

Table 2.12 – 2007 *Budget Update* fiscal indicators

Fiscal indicators $ million	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast
			Year ended 30 June		
Revenue					
Total Crown revenue	74,427	76,872	79,576	83,178	86,819
Core Crown revenue	58,174	59,402	61,172	63,825	66,993
Core Crown tax revenue	53,445	54,707	56,280	58,877	61,960
Expenses					
Total Crown expenses	69,088	71,914	75,619	79,648	83,472
Core Crown expenses	53,976	56,096	58,819	61,677	64,898
Operating balance - Core Crown	6,498	4,463	3,667	3,630	3,781
Operating balance - Crown entities	1,006	1,241	1,169	974	960
Operating balance - SOEs	821	1,068	1,141	1,155	1,065
Dividend elimination	(326)	(341)	(408)	(449)	(440)
Operating balance	7,999	6,431	5,569	5,310	5,366
OBEGAL	5,339	4,958	3,957	3,530	3,347
OBEGAL (excluding NZS Fund revenue)	5,757	4,860	3,862	3,438	3,260
Cash available/(shortfall to be funded)	2,653	(976)	(1,687)	(1,649)	(1,426)
Debt indicators					
GSID (excluding Settlement Cash)	30,890	34,477	34,308	33,971	36,814
Total gross Crown debt	41,914	46,364	47,050	46,522	49,691
Net core Crown debt	4,411	4,655	5,529	6,217	6,860
Net core Crown debt with NZS Fund assets	(8,112)	(10,784)	(13,145)	(16,008)	(19,287)
Net worth	96,704	96,061	101,645	107,024	112,421
Domestic bond programme	2,294	2,520	2,500	2,483	2,515
Nominal GDP	166,714	173,187	179,132	186,985	196,177
Fiscal indicators as a % of GDP					
Revenue					
Total Crown revenue	44.6	44.4	44.4	44.5	44.3
Core Crown revenue	34.9	34.3	34.1	34.1	34.1
Core Crown tax revenue	32.1	31.6	31.4	31.5	31.6
Expenses					
Total Crown expenses	41.4	41.5	42.2	42.6	42.5
Core Crown expenses	32.4	32.4	32.8	33.0	33.1
Operating balance	4.8	3.7	3.1	2.8	2.7
OBERAC	3.2	2.9	2.2	1.9	1.7
OBERAC (excluding net NZS Fund asset returns)	3.5	2.8	2.2	1.8	1.7
Debt indicators					
GSID (excluding Settlement Cash)	18.5	19.9	19.2	18.2	18.8
Total gross Crown debt	25.1	26.8	26.3	24.9	25.3
Net core Crown debt	2.6	2.7	3.1	3.3	3.5
Net core Crown debt with NZS Fund assets	(5.1)	(6.5)	(7.7)	(9.0)	(10.3)
Net worth	58.0	55.5	56.7	57.2	57.3
New Zealand Superannuation Fund					
Fund asset returns (after tax)	1,069	965	1,150	1,351	1,573
Fund contributions	2,049	2,103	2,194	2,312	2,458
Fund assets (year end)	12,973	15,977	19,321	22,984	27,015
% of GDP	7.8	9.2	10.8	12.3	13.8

Source: The Treasury

Risks to fiscal forecasts

The fiscal forecasts were finalised on 5 December 2007 in accordance with the forecast accounting policies. There are certain risks associated with 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 5 December 2007. 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 also presented in the *Risks and Scenarios* chapter on page 69.

KiwiSaver risks

IRD baselines incorporate an assumed take-up profile for the KiwiSaver regime. Actual take-up could be higher or lower than assumed, or faster or slower than assumed, representing an unquantified risk to the operating balance. This could impact on the operating balance.

SOEs' and CEs' forecasts

The forecasts for large SOEs and CEs were provided on 30 September 2007 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 NZ dollar (from 30 June 2008) 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 will next be valued for the 2008 Budget. Any change in discount rates will affect the present fiscal forecast. For example, if the discount rate rises, the value of the liabilities will decrease.

Tertiary education institutes' accounting treatment

The forecast information presented in the 2007 *Half Year Update* combined Tertiary Education Institutes (TEIs) on an equity accounting basis. This treatment has been under consideration by accounting standard setters. The Financial Reporting Standards Board has recently advised that the question of whether to consolidate autonomous and independent entities will be considered by delivering its deliberations of the International Accounting Standards Board (IASB) project on consolidation.

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 *2007 Financial Statements of the Government*.

The key indicators are unchanged as a result of the combination approach for TEIs (refer page 64 of the *30 June 2007 Financial Statements of the Government*).

Indicators of the Government's Fiscal Performance and Position

This section aims to help readers better understand the Government's fiscal performance and position.

Each indicator in this section gives valid insights into the Government's historical, current and forecast fiscal situation, but no one indicator gives a complete picture. Individual indicators do, however, come into greater or lesser focus as circumstances change.

When, for example, the New Zealand Government's net worth was low and gross and net debt-to-GDP ratios were high, much of the focus of Government and public commentary at that time was on eliminating annual operating deficits and on the need to attain, and later to maintain, annual operating surpluses.

However, as net worth has risen, and gross and net debt-to-GDP ratios have fallen, the Government in more recent years has increasingly focused on how to maintain debt ratios around current levels and, accordingly, has given more focus to the Government's annual cash balance.

Most of the indicators in this section may be useful regardless of the particular fiscal strategy being followed. In a few cases (such as the formulation of OBEGAL excluding NZS Fund net revenue), the indicator is used to throw light on the impact of a particular strategy (in this case the build-up of financial assets in the NZS Fund).

Accounting equations

Flow indicators (a worked example of how these flows interact is provided in this chapter, see Table 2.2 – Reconciliation of residual core Crown cash).

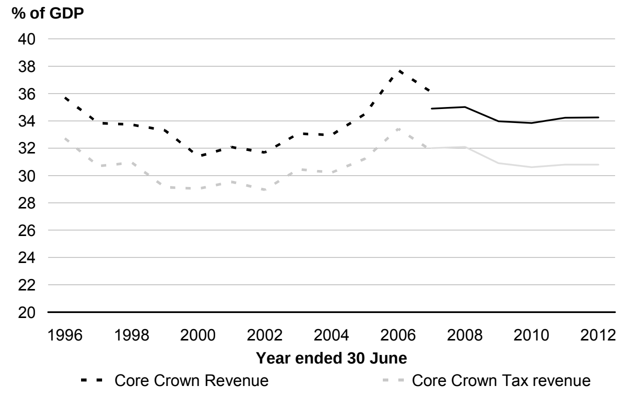
- Core Crown revenues – core Crown expenses net gains and losses + net surplus of SOEs (ie, after dividends) and Crown entities = **Operating balance.**
- Operating balance – net gains and losses = Operating balance before gains and losses (OBEGAL).
- OBEGAL – retained items (eg, net surplus of SOEs/CEs and NZS Fund net revenue) – non-cash items (eg, depreciation) = **Net core Crown cash flow from operations.**
- Net core Crown cash flow from operations – net investing activities (eg, contributions to NZS Fund, purchases of assets, loans to others) = **Residual cash.**

Stock indicators

- Gross sovereign-issued debt (GSID) = debt issued by the core Crown.
- **GSID (excluding Settlement Cash)** = GSID – Reserve Bank Settlement Cash.
- **Core Crown net debt** = GSID – core Crown's financial assets.
- **Net worth** = Crown's total assets – Crown's total liabilities. The operating balance in any year largely drives the change in net worth.

Ratio of core Crown revenue (excluding NZS Fund net revenue) to GDP

Ratio of core Crown revenue (excluding NZS Fund net revenue) to GDP = the amount of revenue the core Crown receives as a percentage of GDP. Core Crown revenue mostly consists of tax revenue collected by the Government, but also includes investment income, sales of goods and services and other receipts. Tax revenue is an accrual measure of taxation (ie, it is a measure of tax due, regardless of whether or not it has actually been paid).



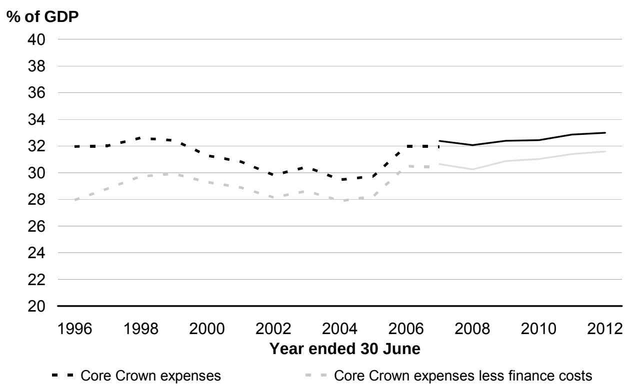
The revenue collected is used to meet the Government's spending needs. It is important to look at this alongside expenses, operating balance and gross debt indicators for insights into the sustainability of current policy settings.

Core Crown revenue (excluding NZS Fund net revenue) to GDP is expected to be broadly stable at around 34% over the forecast period, while core Crown tax to GDP is expected to fall then remain relatively flat over the forecast period.

Ratio of core Crown expenses to GDP

Ratio of core Crown expenses to GDP = the day-to-day spending (eg, salaries, welfare benefit payments, finance costs and maintaining national defence etc) that do not build physical assets for the Government. This is an accrual measure of expenses and includes items such as depreciation on physical assets.

The forecasts of operating expenses assume that the entire forecast operating allowance is allocated to spending.



By reducing gross debt, the Government has also reduced finance costs. However, in the years ahead, finance costs are likely to be fairly flat with gross debt forecast to be broadly stable.

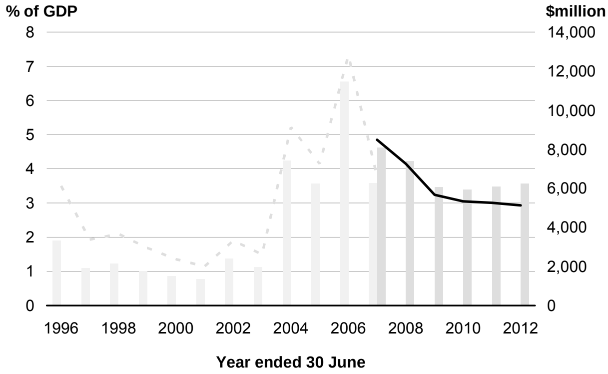
Core Crown expenses to GDP rise slightly over the forecast period.

Operating balance

Operating balance = revenues less expenses, plus net gains and losses.

The operating balance shows whether the government sector has generated enough revenues to cover its expenses in any given year.

This measure can be volatile from year to year owing to events outside of the Government's direct control (such as changes in interest rates and revaluations etc); therefore, it is generally not used as a measure of the Government's short-term fiscal stewardship.



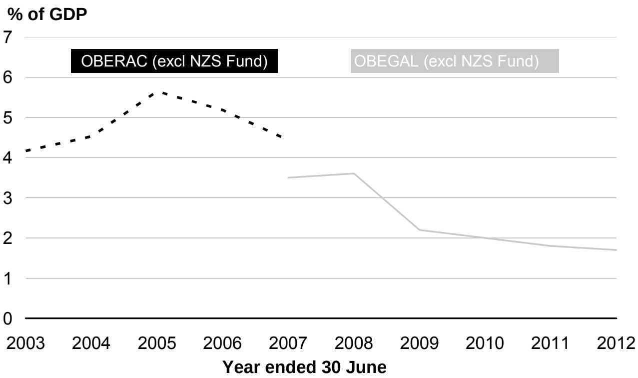
The Government has been running operating surpluses since the early 1990s. The operating balance was just under 5% of GDP in 2007 and is expected to decline to around 3% of GDP by the end of the forecast period.

OBEGAL

OBEGAL = the operating balance before net gains and losses.

OBEGAL excluding NZS Fund net revenue = a measure of the operating balance that recognises the role of the NZS Fund in accumulating assets and returns to meet future NZS cost.

By excluding net gains and losses the OBEGAL gives a more direct indication of the underlying stewardship of the Government.



The NZS Fund retains its after tax investment returns. These investment returns comprise mostly gains and losses. Because it excludes gains and losses the OBEGAL already recognises a large part of the Fund's role. The final adjustment needed is to exclude from the OBEGAL the remaining NZS Fund net revenue.

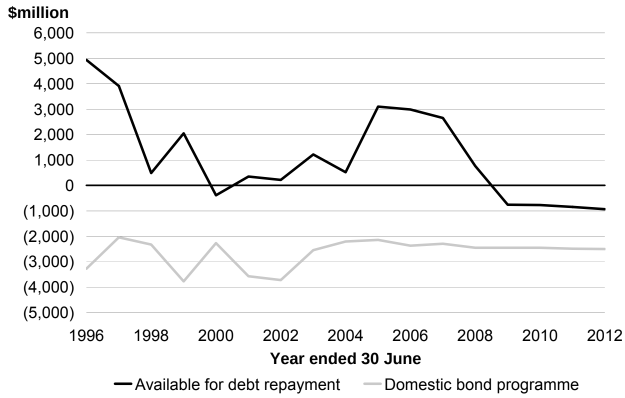
The OBEGAL excluding the NZS Fund net revenue is expected to decline over the forecast period to just under 2% of GDP.

Residual cash and domestic bond programme

Residual cash = the level of money the Government has available to repay debt or, alternatively, needs to borrow in any given year. Residual cash is alternatively termed "Cash available/(shortfall to be funded)".

Domestic bond programme = the amount of new government stock expected to be issued over the financial year.

The cash available measure includes capital investment and NZS Fund contributions; therefore, it is the flow contributing to changes in debt. This balance cannot be looked at independently from GSID.



The domestic bond programme raises term debt for the Government, the proceeds of which contribute to funding operating and investing activity, and the repayment of maturing debt. The programme tends to be different from the cash available figure in any given year as financing activity, such as the repayment of debt, needs to be considered.

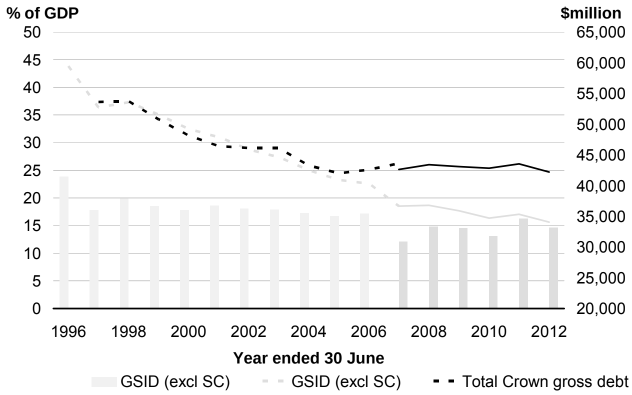
The Government is currently moving from a period of having cash available to repay debt, to a need, in subsequent years, to generate cash through borrowing and reductions in marketable securities.

Gross debt

Total Crown gross debt = the total borrowings (both sovereign-guaranteed and non-sovereign guaranteed) of the total Crown.

Gross sovereign-issued debt = debt issued by the sovereign (ie, core Crown) and includes Government stock held by the NZS Fund, GSF, ACC or EQC for example.

Total gross debt represents the complete picture of whole-of-government obligations to external parties. However, debt issued by SOEs and CEs is not explicitly guaranteed by the Crown.



The debt that is issued by the sovereign and guaranteed by the sovereign is in GSID. The Government has a long-term objective to maintain GSID broadly stable at around 20% of GDP. Since the Reserve Bank is part of the core Crown, settlement cash flows directly GSID. However, Settlement Cash activity is financed from commercial banks and not by Government funding, with the debt matched by a corresponding increase in financial assets.

The *2007 Fiscal Strategy Report* (page 52) states that "the Government is effectively targeting a level of gross sovereign-issued debt excluding the increase in debt on the Reserve Bank balance sheet as a result of the change in the liquidity management regime".

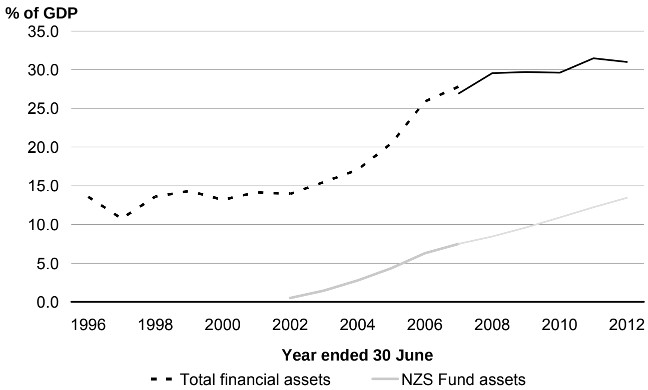
For forecast purposes the amount of Settlement Cash is held constant. In practice, Settlement Cash held by the Reserve Bank does fluctuate through time so the actual amount of Settlement Cash deducted from GSID will vary when actual results are reported.

Debt is often expressed as a percentage of GDP to put the level into perspective, in terms of a country's ability to generate growth to repay the debt and/or income to service this debt. A high ratio of debt to GDP can have an adverse impact on credit ratings and perceived sustainability of current policy settings. So as a general rule, a relatively low ratio is considered to be prudent. A low ratio of debt to GDP can also provide the Government with more flexibility in their accounts to respond to adverse shocks through increasing debt.

The ratio of GSID (excluding Settlement Cash) to GDP has been steadily declining since the early 1990s but is expected to decline more gradually over the forecast period.

Core Crown financial assets

Core Crown financial assets = the financial assets of the core Crown. These are either cash, marketable securities or shares (equity) or a right to receive a financial instrument, which can be converted to cash. The assets of the NZS Fund are becoming the dominant feature of the Crown's financial assets. The NZS Fund is the Government's means of building up assets to partially pre-fund future NZS expenses. The Government's contributions to the NZS Fund are calculated over a 40-year rolling horizon to ensure superannuation entitlements over the next 40 years can be met.



Established under the New Zealand Superannuation and Retirement Income Act 2001, the NZS Fund was created to partially provide for the future cost of NZS, which is expected to almost double in cost owing to population ageing.

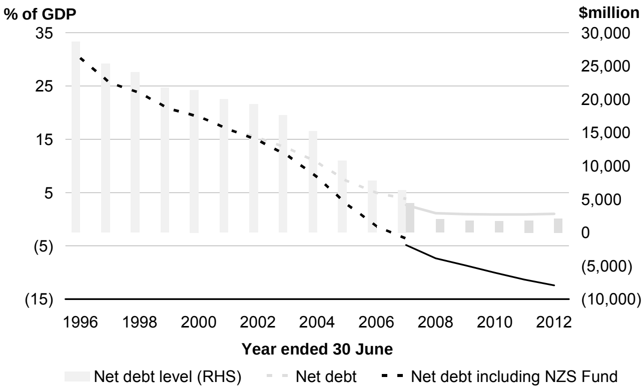
The Government plans to allocate around $2 billion a year to the NZS Fund over the next 20 years. The NZS Fund's mandate is to invest money in a way that maximises its returns, without undue risks.

As the cost of providing NZS increases, future governments will draw on the NZS Fund to help smooth the impact of the cost of New Zealand Superannuation on their finances.

For the year ended June 2007, NZS Fund assets totalled $13 billion or around 7.8% of GDP. The NZS Fund is expected to grow to around $31 billion or 14.6% of GDP by the end of the forecast period.

Core Crown net debt

Core Crown net debt = borrowings (financial liabilities) less cash and bank balances, marketable securities and deposits, and advances (financial assets). Net debt excludes the assets of the NZS Fund and GSF.



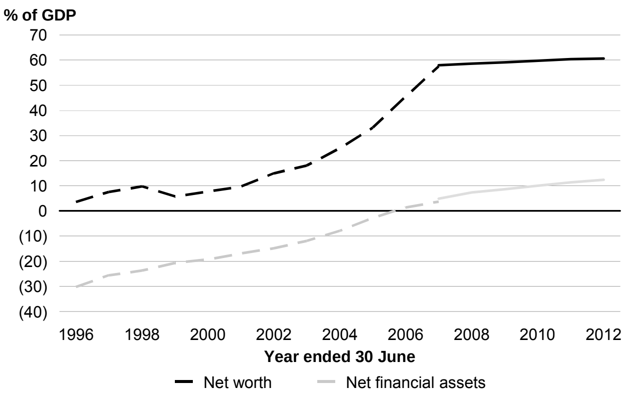
By including financial assets, net debt can provide additional information about the sustainability of the Government's accounts. Many international agencies believe the quantity of off-setting financial assets is important when determining the credit-worthiness of a country. That is, if a country has a high ratio of financial assets to GDP, it is better able to justify a high ratio of debt to GDP.

However, as some financial assets are not very liquefiable (or easily converted into cash), it is important to view net debt alongside GSID.

After declining steadily since the early 1990s, net debt is projected to consolidate in the years ahead at around 1% of GDP. If the assets of the NZS Fund are included, the Government's net debt position is in a net financial asset position.

Net worth

Net worth = assets less liabilities (also referred to as the Crown balance). The change in net worth in any given forecast year is largely driven by the operating balance.



Total Crown net worth is one indicator of the degree to which current government activities are sustainable. This indicator should be considered alongside the Crown's debt position, as relatively high debt-to-GDP ratios may still be considered sustainable if the Crown has relatively high ratios of saleable or commercial assets to GDP.

Building up net worth is also consistent with preparing for population ageing.

Net worth is projected to continue to rise, moving from around 58% in 2006 to around 60% at the end of the forecast period.

Historical trend series of key indicators

Key indicators as a percentage of GDP

	1997 Actual	1998 Actual	1999 Actual	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Actual	2005 Actual	2006 Actual	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
% of GDP																
Revenue																
Core Crown tax revenue	30.7	31.0	29.1	29.0	29.6	29.0	30.3	30.1	31.2	33.3	32.1	32.1	30.9	30.6	30.8	30.8
Core Crown	33.9	33.7	33.3	31.4	32.1	31.7	32.9	32.9	34.5	37.6	34.9	35.0	34.0	33.8	34.2	34.3
Total Crown	40.2	40.5	40.1	37.4	38.4	39.7	43.0	42.3	44.4	48.7	44.6	44.7	43.5	43.4	43.7	43.6
Expenses																
Core Crown	32.0	32.4	32.8	31.1	31.0	30.2	31.5	29.1	30.6	31.7	32.4	32.1	32.4	32.4	32.8	33.0
Total Crown	38.3	38.5	38.5	36.1	37.3	37.9	41.6	37.2	40.3	41.4	41.4	41.0	41.2	41.3	41.8	41.8
OBEGAL	..	..	..	..	..	..	..	..	..	..	3.2	3.7	2.3	2.1	2.0	1.8
OBERAC	1.9	2.2	0.2	0.8	1.8	2.2	4.2	4.6	5.9	5.5	4.4	..	..	..	..	..
Operating balance	1.9	2.1	1.7	1.4	1.1	1.9	1.5	5.2	4.1	7.3	4.8	4.1	3.2	3.0	3.0	2.9
Core Crown residual cash	4.0	0.5	2.0	-0.3	0.3	0.2	0.9	0.4	2.1	1.9	1.6	0.4	-0.4	-0.4	-0.4	-0.4
Gross sovereign-issued debt (excl SC)	36.3	37.3	35.1	32.4	31.0	28.8	27.2	24.9	23.2	21.3	18.5	18.7	17.7	16.3	17.0	15.6
Net core Crown debt	25.6	23.7	20.7	19.3	16.9	15.3	13.2	10.7	7.1	4.9	2.6	1.1	0.9	0.9	0.9	1.0
Net core Crown debt (including NZS Fund)	25.6	23.7	20.7	19.3	16.9	14.8	11.8	7.9	2.8	-1.3	-4.9	-7.4	-8.7	-10.0	-11.3	-12.4
NZS Fund balance	0.0	0.0	0.0	0.0	0.0	0.5	1.4	2.8	4.3	6.3	7.8	9.0	10.4	11.9	13.3	14.6
Net worth	7.5	9.8	5.8	7.7	9.7	15.0	17.9	24.8	33.1	45.4	58.0	58.5	59.0	59.8	60.3	60.6

Key indicators in nominal terms

	1997 Actual	1998 Actual	1999 Actual	2000 Actual	2001 Actual	2002 Actual	2003 Actual	2004 Actual	2005 Actual	2006 Actual	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
$million																
Revenue																
Core Crown tax revenue	30,387	31,429	30,525	32,248	34,995	36,459	40,168	43,008	47,118	52,444	53,445	57,166	57,697	59,618	62,531	65,507
Core Crown	33,533	34,222	34,899	34,891	38,005	39,907	43,624	46,932	52,065	59,170	58,174	62,409	63,496	65,832	69,458	72,740
Total Crown	39,803	41,092	41,985	41,557	45,506	49,979	57,027	60,387	67,065	76,581	74,427	79,608	81,280	84,482	88,710	92,612
Expenses																
Core Crown	31,708	32,852	34,367	34,536	36,699	37,970	41,749	41,608	46,234	49,900	53,977	57,137	60,537	63,106	66,632	70,034
Total Crown	37,940	39,044	40,280	40,128	44,213	47,653	55,224	53,057	60,910	65,084	69,088	73,034	76,953	80,420	84,726	88,762
OBEGAL	..	..	..	..	..	..	..	..	..	..	5,339	6,574	4,327	4,062	3,984	3,850
OBERAC	1,904	2,191	246	884	2,115	2,751	5,580	6,629	8,873	8,648	7,290	..	..	..	..	..
Operating balance	1,908	2,127	1,763	1,503	1,358	2,391	1,966	7,424	6,247	11,473	8,079	7,388	6,053	5,924	6,094	6,228
Core Crown residual cash	3,913	484	2,048	(386)	349	216	1,217	520	3,104	2,985	2,653	759	(763)	(779)	(851)	(937)
Gross sovereign-issued debt (excl SC)	35,972	37,892	36,712	36,041	36,761	36,202	36,086	35,527	35,045	33,497	30,890	33,303	33,034	31,779	34,566	33,172
Net core Crown debt	25,324	24,069	21,701	21,396	19,971	19,250	17,577	15,204	10,771	7,745	4,411	1,983	1,756	1,705	1,792	2,105
Net core Crown debt (including NZS Fund)	25,324	24,069	21,701	21,396	19,971	18,635	15,693	11,248	4,216	(2,116)	(8,112)	(13,102)	(16,224)	(19,545)	(22,990)	(26,414)
NZS Fund balance	..	..	..	..	..	615	1,884	3,956	6,555	9,861	12,973	15,993	19,488	23,140	27,016	31,102
Net worth	7,470	9,921	6,022	8,583	11,463	18,820	23,781	35,463	49,983	71,403	96,704	104,315	110,372	116,313	122,417	128,652