2

Fiscal Outlook

Introduction

The fiscal position has strengthened over recent times. Operating and cash surpluses over the past few years have led to a build up of financial assets and to a lowering of debt (as a percentage of GDP).

Looking forward, growth in nominal GDP is forecast to slow resulting in a corresponding slowing in tax revenue growth. Additionally, Budget 2008 introduces personal tax cuts which results in core Crown revenue falling as a percentage of GDP. This is the main contributor to a reduction in OBEGAL and cash surpluses becoming deficits. These cash deficits are met by reducing financial assets accumulated in recent years and borrowing consistent with the debt objective of around 20% of GDP.

This chapter outlines the key trends for each of the indicators along with a comparison to the forecasts provided in the *Half Year Update* and should be read in conjunction with the financial statements (chapter 5) and the executive summary on pages 1 to 22. The chapter covers the fiscal results for the forecast period (2007/08 to 2011/12). The long-term fiscal outlook can be found on pages 42 to 64.

Each section in the chapter follows the five components of the fiscal strategy (outlined on page 45):

- Revenue and expenses
- Surpluses
- Cash position
- Debt, and
- The New Zealand Superannuation Fund (NZS Fund).

Table 2.1 – Fiscal indicators[2]

Year ended 30 June $ million	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Revenue and expenses						
Core Crown revenue excl NZS Fund	58,482	61,814	61,787	63,552	66,284	69,004
Core Crown expenses	54,003	57,364	61,883	63,890	67,016	69,943
Surpluses						
Total Crown OBEGAL	5,860	5,227	1,318	1,004	493	154
Total Crown OBEGAL excl NZS Fund retained revenue	6,250	5,219	1,354	1,048	543	207
Total Crown operating balance	8,023	2,559	3,105	3,009	2,779	2,734
Cash position						
Core Crown residual cash	2,877	908	(3,478)	(3,302)	(3,447)	(3,457)
Debt						
GSID (excl Settlement Cash)	30,647	31,763	32,498	32,251	35,974	35,499
Net core Crown debt (incl NZS Fund financial assets)	(7,467)	(11,254)	(11,337)	(11,787)	(12,348)	(12,970)
Net core Crown debt	4,109	1,846	4,578	7,272	10,145	13,193
NZS Fund						
NZS Fund net worth	12,973	14,461	17,721	21,152	24,947	29,011
Nominal GDP	168,106	180,137	185,478	192,125	201,802	211,800
% of GDP						
Revenue and expenses						
Core Crown revenue excl NZS Fund	34.8	34.3	33.3	33.1	32.8	32.6
Core Crown expenses	32.1	31.8	33.4	33.3	33.2	33.0
Surpluses						
Total Crown OBEGAL	3.5	2.9	0.7	0.5	0.2	0.1
Total Crown OBEGAL excl NZS Fund retained revenue	3.7	2.9	0.7	0.5	0.3	0.1
Total Crown operating balance	4.8	1.4	1.7	1.6	1.4	1.3
Cash position						
Core Crown residual cash	1.7	0.5	(1.9)	(1.7)	(1.7)	(1.6)
Debt						
GSID (excl Settlement Cash)	18.2	17.6	17.5	16.8	17.8	16.8
Net core Crown debt (incl NZS Fund financial assets)	(4.4)	(6.2)	(6.1)	(6.1)	(6.1)	(6.1)
Net core Crown debt	2.4	1.0	2.5	3.8	5.0	6.2
NZS Fund						
NZS Fund net worth	7.7	8.0	9.6	11.0	12.4	13.7

Source: The Treasury

Core Crown vs Total Crown

The Fiscal Outlook chapter refers to both core Crown and total Crown results.

Core Crown includes Ministers, Departments, Offices of Parliament, the NZS Fund and the Reserve Bank of New Zealand.

Total Crown includes the Core Crown, State-Owned Enterprises and Crown Entities.

2 An historical trend series of the above indicators is available on page 188. The glossary on pages 184 to 187 includes a definition of these indicators.

Revenue and Expenses

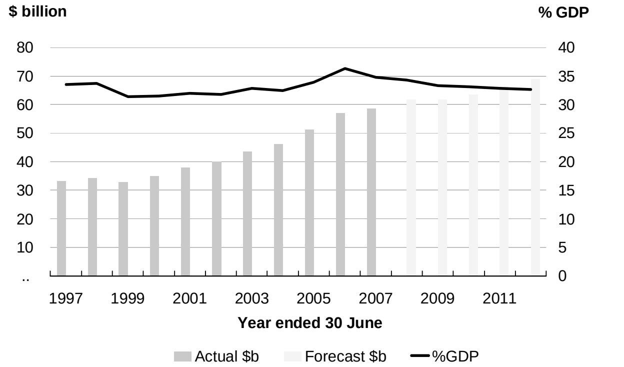
Core Crown Revenue

Core Crown revenue consists mainly of tax revenue. Also included are interest and dividend revenues, and sales of goods and services.

The key indicator used to measure core Crown revenue is core Crown revenue excluding the NZS Fund. This best represents the revenue available to meet the Government's spending needs.

Core Crown revenue excluding the NZS Fund treats the NZS Fund as a third party (ie, its revenue is not included but the tax it pays is).

Figure 2.1 – Core Crown revenue excluding the NZS Fund



Source: The Treasury

Core Crown revenue falls as a percentage of GDP …

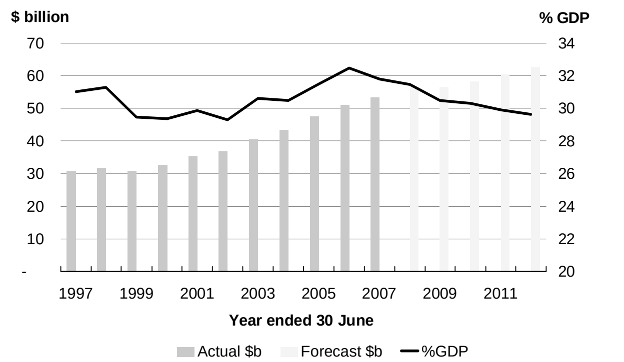
While core Crown revenue excluding the NZS Fund grows over the period from $58.5 billion in 2006/07 to $69 billion by 2011/12, it falls as a percentage of GDP as initiatives such as the personal tax cuts and business tax reform (announced in Budget 2007) take effect.

… as personal tax cuts are introduced …

Core Crown tax revenue increases over the period from $53.5 billion in 2006/07 to $62.7 billion by 2011/12, but falls as a percentage of GDP.

The fall in percentage of GDP is due, in the main, to the introduction of personal tax cuts. The resulting core Crown tax revenue reduction is detailed in Table 2.2 and ranges from $1.6 billion in 2008/09 to $4.2 billion in 2011/12.

Figure 2.2 – Core Crown tax revenue



Source: The Treasury

- These tax cuts have now been incorporated into the tax forecasts, whereas in the *Half Year Update* it was separately identified as a revenue reduction contingency that appeared below the tax revenue line in the forecast financial statements. Further detail of personal tax cuts can be found on page 81.

Table 2.2 – Reconciliation of reduction in core Crown tax revenue

Year ended 30 June $ million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	Total
Reduction in core Crown tax revenue	-	1,633	2,440	3,351	4,152	11,576
Change to benefits and superannuation	-	(118)	(166)	(290)	(393)	(967)
Increase in taxpayers' disposable income	-	1,515	2,274	3,061	3,759	10,609

Source: The Treasury

The tax package will result in a reduction in core crown tax revenue of nearly $11.6 billion over the forecast period. Part of this revenue reduction represents reduced tax on benefits and superannuation payments. Under the personal tax reductions, after-tax benefit payments do not change while after-tax New Zealand Superannuation (NZS) payments increase. Given this, gross benefit appropriations are reduced to the extent that tax paid on them is lower following the personal tax changes. With NZS, the increased after-tax payments are accompanied by decreased tax paid stemming from the tax changes, meaning gross NZS appropriations change. The change in disposable income (being $10.6 billion over the forecast period) represents the reduction in tax paid by those working and the increase in the after-tax income of superannuitants.

In addition to the personal tax cuts, there have been two changes to tax forecasts in comparison to the *Half Year Update*:

- Forecasting changes mainly related to changes in the macroeconomic forecasts. However, some other factors have also led to forecasting changes, eg, changes in the estimated effective tax rate on “other persons” taxpayers’ income and changes in the assumed future rate of growth of fuel consumption in response to historically-high fuel prices. Further detail on the tax forecasting changes can be found on page 85.

- Other tax policy changes have also reduced forecasts of tax revenue compared to the *Half Year Update*. Details of these policies can be found on page 95.

… and other core Crown revenue increases over the forecast period

Other core Crown revenue increases slightly over the forecast period from $5 billion in 2006/07 to $6.3 billion in 2011/12. The main highlights are:

- The Emissions Trading Scheme (ETS) revenue is forecast to increase to $0.9 billion by 2011/12. Forecasts of carbon units to be surrendered by emitters under the ETS have been reduced reflecting the decision to defer introducing liquid fossil fuels to the scheme until 2011. Compared to the *Half Year Update,* revenue forecasts associated with the surrender of units have reduced by $0.3 billion over the forecast period.

- Forecasts for the Kyoto liability incorporate revised expectations of net emissions over the commitment period 2008 to 2012. Forecasts assume the net position will be 21.7 m tonnes compared with 45.5 m tonnes reported in the *Half Year Update*. The $0.4 billion reduction in the liability in 2007/08 due to fewer expected emissions is recognised as revenue. Changes to the liability from carbon prices and exchange rates are reported in Table 2.8 on page 100 as a change in gains and losses.

- Investment income increases slightly over the forecast period but reduces in comparison to the *Half Year Update* in line with a reduction in financial assets in addition to netting out interest on the Crown settlement account (with a corresponding reduction in interest expense).

Table 2.3 – Core Crown revenue excluding the NZS Fund comparison to the *Half Year Update*

Year ended 30 June **$ million**	**2008** **Forecast**	**2009** **Forecast**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**
Core Crown revenue excluding NZS Fund					
Half Year Update	62,130	63,147	65,412	68,965	72,168
Personal tax cuts	-	(1,633)	(2,440)	(3,351)	(4,152)
Tax forecasting changes	(491)	170	(336)	(277)	(96)
Other tax policy changes	(2)	(86)	(114)	(184)	(247)
Revenue reduction contingency	-	375	1,500	1,600	1,700
Decrease in core Crown tax revenue	(493)	(1,174)	(1,390)	(2,212)	(2,795)
Kyoto valuation due to emissions	368	-	-	-	-
Emissions trading scheme	-	47	(191)	(148)	30
Investment income	(254)	(366)	(445)	(509)	(615)
Other core Crown revenue	63	133	166	188	216
Increase/(decrease) in other core Crown revenue	177	(186)	(470)	(469)	(369)
Budget update	61,814	61,787	63,552	66,284	69,004

Source: The Treasury

Inland Revenue 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.

The main differences between the Treasury's and Inland Revenue's forecasts (Table 2. 4) are in:

- source deductions (mostly PAYE), where Inland Revenue is more optimistic than the Treasury in the current year and the gap widens in later years in line with forecast growth in underlying incomes, and
- GST, in which the departments have taken different views on the extent to which the housing downturn will affect the tax take, causing the Treasury's forecast to be generally lower than Inland Revenue's forecast.

These differences are not large compared to differences between the two sets of forecasts in the past.

Table 2.4 – The Treasury and Inland Revenue core Crown tax revenue forecasts

Year ended 30 June $ billion	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Source deductions					
Treasury	22.7	22.9	23.6	24.4	25.3
Inland Revenue	22.9	23.1	24.0	24.8	25.7
Difference	(0.2)	(0.2)	(0.4)	(0.4)	(0.4)
Net other persons tax					
Treasury	3.7	3.8	3.9	3.9	4.0
Inland Revenue	3.8	3.8	3.9	4.0	4.0
Difference	(0.1)	-	-	(0.1)	-
Corporate tax					
Treasury	10.4	9.7	10.1	10.7	11.3
Inland Revenue	10.2	9.4	10.1	10.7	11.1
Difference	0.2	0.3	-	-	0.2
Goods and services tax					
Treasury	11.8	11.9	12.3	13.0	13.5
Inland Revenue	11.7	12.1	12.6	13.3	13.9
Difference	0.1	(0.2)	(0.3)	(0.3)	(0.4)
Other tax					
Treasury	8.1	8.2	8.3	8.3	8.6
Inland Revenue	8.1	8.4	8.5	8.4	8.5
Difference	-	(0.2)	(0.2)	(0.1)	0.1
Total tax revenue					
Treasury	56.7	56.5	58.2	60.3	62.7
Inland Revenue	56.7	56.8	59.1	61.2	63.2
Difference	-	(0.3)	(0.9)	(0.9)	(0.5)
Total tax revenue (% of GDP)					
Treasury	31.5	30.5	30.3	29.9	29.6
Inland Revenue	31.5	30.6	30.8	30.3	29.8
Difference	-	(0.1)	(0.5)	(0.4)	(0.2)

Sources: The Treasury, Inland Revenue

Tax Policy Changes

Table 2.5 – Effect of policy changes on tax forecasts since the *Half Year Update*

Year ended 30 June **$ million**	**2008** **Forecast**	**2009** **Forecast**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**
Personal tax cuts[1]	-	(1,633)	(2,440)	(3,351)	(4,152)
Petrol tax - no indexation[2]	-	(30)	(56)	(81)	(107)
Tariff rate reductions[3]	-	-	(10)	(50)	(90)
Gas exploration[4]	(2)	(17)	(24)	(31)	(38)
Life insurance - taxing risk income[5]	-	-	8	22	35
Life insurance - extending PIE treatment[6]	-	-	(21)	(23)	(26)
SMEs - thresholds[7]	-	(16)	(5)	(15)	(15)
Other[8]	-	(23)	(6)	(6)	(6)
	(2)	(1,719)	(2,554)	(3,535)	(4,399)

Source: The Treasury

Summary of Policy Changes

1. Personal income tax rates and thresholds will be adjusted (refer table 2.2).
2. Annual indexation of the National Land Transport Fund (NLTF) portion of the petroleum fuel excise rate has been suspended so as to better align the contributions to the NLTF from the various transport-related taxes.
3. As a result of the Free Trade Agreement signed with China, tariff rates on some goods imports will be gradually reduced.
4. A number of tax measures intended to remove disincentives that may affect investment in oil and gas exploration and development in New Zealand.
5. The taxation of risk income of life insurers will be comprehensively reformed.
6. The Portfolio Investment Entity rules will be extended to include certain life insurance products.
7. A number of tax thresholds will be raised in order to lower compliance costs for businesses, especially small and medium enterprises.
8. A range of policy measures, each of which is below the materiality threshold of $10 million.

Core Crown Expenses

Core Crown expenses represent the day-to-day operating spending of the Government (ie, it does not include purchases of physical assets or capital spending).

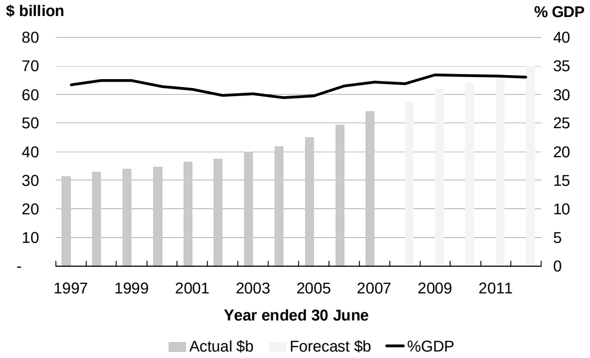
Core Crown expenses increase initially as a percentage of GDP but level off …

The forecast growth in expenses largely arises from expense initiatives introduced in recent Budgets. These policy decisions tend to have rising profiles to allow sufficient time for full implementation.

Core Crown expenses grow over the forecast period from $54 billion in 2006/07 to $69.9 billion by 2011/12 (an increase of $15.9 billion).

These expenses rise as a percentage of GDP in 2008/09 as the full impact of past Budget decisions such as KiwiSaver ($1 billion in 2008/09) and the Emissions Trading Scheme ($0.7 billion in 2008/09) take effect. Subsequent forecast years remain at around 33% of GDP.

Figure 2.3 – Core Crown expenses



Source: The Treasury

… as Budget 2008 operating initiatives are introduced …

Page 5 presents an overview of the new operating expenditure committed in Budget 2008. The Budget 2008 package includes a revenue reduction relating to business tax reform and the personal tax cuts. These have been deducted in Table 2.6 to show the impact on core Crown expenses.

Table 2.6 – Net amounts of new operating expenditure

Year ended 30 June $ million	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**
Budget 2008 operating initiatives	-	4,752	5,417	6,236	6,972
Less increase in taxpayers' disposable income	-	(1,515)	(2,274)	(3,061)	(3,759)
Less business tax reform revenue decrease	-	(916)	(915)	(870)	(870)
New operating expenditure	-	2,321	2,228	2,305	2,343

Source: The Treasury

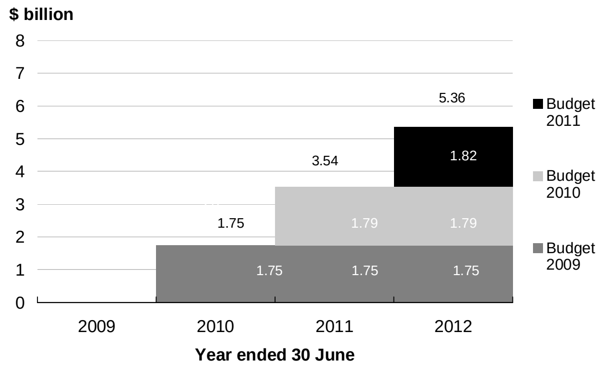
Budget 2008 operating initiatives increase expenditure by $2 billion by 2011/12 including:

- Health spending of $0.75 billion
- Education receive almost $0.6 billion
- Non Government Organisations receive $0.2 billion to improve partnership with community-based social services, and
- Strengthening New Zealand's international connections receive $0.1 billion.

… along with forecast new initiatives …

The fiscal forecasts include indicative amounts for new operating initiatives for future Budgets. The allowance for these initiatives has been set at $1.75 billion for each of the forecast years (adjusted for inflation), resulting in an increase of $5.4 billion by the end of the forecast horizon. These allocations have reduced from the $2.0 billion annual increase included in the *Half Year Update*.

Figure 2.4 – Net amounts of forecast new operating initiatives



Source: The Treasury

… and benefit costs increasing …

Benefit expenses are forecast to grow in line with the forecast growth in the economy. In nominal terms they are expected to increase $4.4 billion over the forecast period.

Around $2 billion of this reflects cost of living adjustments for New Zealand Superannuation (NZS) payments, welfare benefits and Working For Families (WFF) Tax Credits.

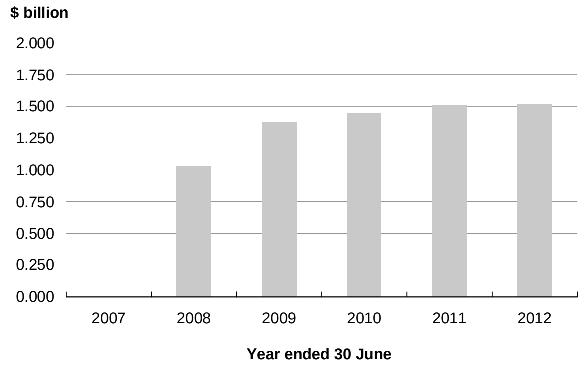
Most benefits are adjusted each April by the CPI movement over the previous calendar year and NZS rates are increased by the greater of average wage or CPI growth at the same time. Cumulative inflation increases to Family Tax Credit rates and WFF abatement thresholds are also encapsulated in the forecasts.

Partly offsetting this nominal growth in forecasted benefit expenses are the impacts of personal tax reductions, which lower the tax paid on both benefits and NZ Superannuation and hence result in reduced gross payments.

… as well as KiwiSaver …

In addition, expenses associated with the KiwiSaver scheme (including the $1,000 kickstart subsidy, fees subsidy, member tax credit and employer tax credit) increase to $1.5 billion by the end of the forecast period (Figure 2.5).

Figure 2.5 – KiwiSaver expenses



Source: The Treasury

…partially offset by the top down adjustment

An adjustment is made to core Crown expenses as department forecasts are often based on maximum spending limits (or appropriations) rather than mid-point estimates. This reduces forecast expenditure and is referred to as a “top down adjustment”. The top down adjustment ranges is $0.2 billion in 2007/08 and $0.5 billion in the remaining years reflecting the increased uncertainty of forecasts in the later forecast years. This is slightly higher than the *Half Year Update*.

Table 2.7 – Core Crown expenses comparison to the *Half Year Update*

Year ended 30 June **$ million**	**2008** **Forecast**	**2009** **Forecast**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**
Core Crown expenses					
Half Year Update	57,137	60,537	63,106	66,632	70,034
Increase in baseline expenses	266	158	143	114	78
Expenditure above allocations	186	332	200	164	328
Reduction in operating allowances	-	-	(178)	(359)	(552)
Expense transfers	(494)	339	131	117	(91)
Kiwisaver	195	390	285	211	67
Benefits	42	170	386	98	192
Finance costs[1]	(277)	(317)	(305)	(219)	(159)
Asset impairment (eg, student loans, tax receivables)	303	169	187	207	226
Emissions Trading Scheme	-	152	(121)	46	46
Top down adjustment	-	(100)	(100)	(150)	(200)
Other core Crown expenses	6	53	156	155	(26)
Total core Crown expense impact	227	1,346	784	384	(91)
Budget update	57,364	61,883	63,890	67,016	69,943

Source: The Treasury

1. Finance costs reduced in comparison to the *Half Year Update* due in the main to netting out interest on the Crown settlement account (with a corresponding reduction in interest income).

Surpluses

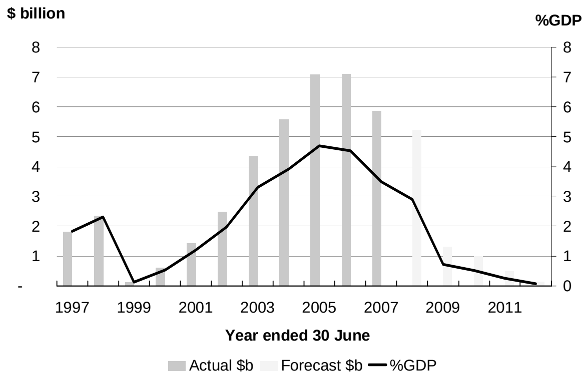
Total Crown OBEGAL

OBEGAL is the operating balance before gains and losses for the total Crown. By excluding gains and losses the OBEGAL gives a more direct indication of the underlying stewardship of the Government than the operating balance.

OBEGAL reduces reflecting Budget decisions …

The OBEGAL reduces over the forecast period from $5.9 billion in 2006/07 to $0.2 billion in 2011/12.

Figure 2.6 – Total Crown OBEGAL



Source: The Treasury

This fall reflects Budget decisions, including the reduction in core Crown tax revenue discussed earlier. State-Owned Enterprises (SOEs) and Crown Entities (CEs) OBEGAL forecasts have declined in line with tighter market conditions associated with macroeconomic forecasts of slower growth.

The OBEGAL (excluding the NZS Fund retained revenue) is a measure of the operating balance that recognises that the NZS Fund has been set up to meet future spending pressures and as a result the returns it earns are not available to the Crown to meet current spending requirements. OBEGAL (excluding the NZS Fund retained revenue) reduces over the forecast period from $6.3 billion in 2006/07 to $0.2 billion in 2011/12.

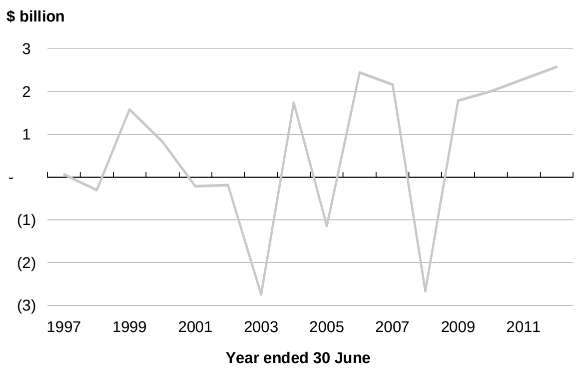
Total Crown Operating Balance

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

… which coupled with a financial market downturn …

Losses of $2.7 billion are forecast in 2007/08. This is a reflection of the recent decline in overseas equity markets and increases in the ACC claims liability and GSF liability. Looking forward, net gains are forecast to range from $1.6 billion in 2008/09 to $2.4 billion in 2011/12. These later forecasts are based on long term benchmark rates of return, in conjunction with the exchange rates and interest rate curves prevailing at the forecast reference date.

Figure 2.7 – Total Crown gains and losses



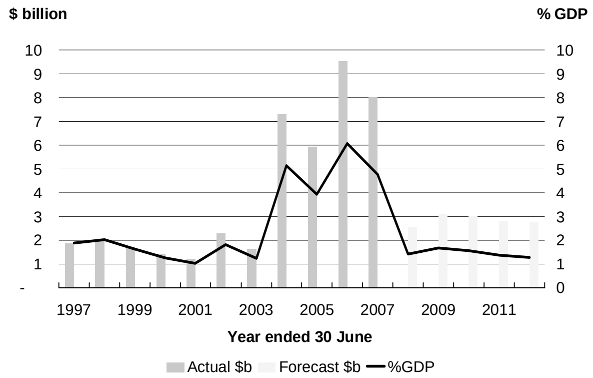
Source: The Treasury

… leads to a reduction in the operating balance …

The operating balance is forecast to remain positive over the forecast period from $2.6 billion in 2007/08 to $2.7 billion in 2011/12.

The total Crown operating balance is not available to be drawn upon to fund core Crown operations, as current policy is for the NZS Fund, SOEs and CEs to retain a portion of their surpluses for the purpose of achieving their long-term objectives. Over the forecast period SOE and CE surpluses total $7.6 billion. Approximately $2.3 billion of these surpluses will be returned as dividends. This becomes cash available to the core Crown.

Figure 2.8 – Total Crown operating balance



Source: The Treasury

Table 2.8 – Total Crown OBEGAL and operating balance comparison to the *Half Year Update*

Year ended 30 June **$million**	**2008** **Forecast**	**2009** **Forecast**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**
OBEGAL					
Half Year Update	6,574	4,327	4,062	3,984	3,850
Core Crown revenue impact	(316)	(1,360)	(1,860)	(2,681)	(3,164)
Core Crown expense impact	(227)	(1,346)	(784)	(384)	91
CE/SOE results	(648)	(64)	(111)	(64)	(230)
Other items	(156)	(239)	(303)	(362)	(393)
Total OBEGAL impact	(1,347)	(3,009)	(3,058)	(3,491)	(3,696)
Budget Update	5,227	1,318	1,004	493	154
Operating balance					
Half Year Update	7,388	6,053	5,924	6,094	6,228
Decrease in OBEGAL	(1,347)	(3,009)	(3,058)	(3,491)	(3,696)
GSF valuation	(643)	-	-	-	-
Kyoto valuation due to changes in carbon price	(145)	-	-	-	-
Core Crown gains and losses	(1,099)	195	289	353	404
CE/SOE gains and losses	(1,704)	(152)	(165)	(357)	(336)
Other gains	109	18	19	180	134
Total operating balance impact	(4,829)	(2,948)	(2,915)	(3,315)	(3,494)
Budget Update	2,559	3,105	3,009	2,779	2,734

Source: The Treasury

Cash Position

Core Crown Residual Cash

Core Crown residual cash represents core Crown operating cash flows less capital investment and contributions to the NZS Fund.

Table 2.9 – Reconciliation of residual core Crown cash

				Year ended 30 June			
		2007	2008	2009	2010	2011	2012
	$million	**Actual**	**Forecast**	**Forecast**	**Forecast**	**Forecast**	**Forecast**
	Core Crown revenue	58,211	61,936	61,891	63,664	66,416	69,159
Less	Core Crown expenses	(54,003)	(57,364)	(61,883)	(63,890)	(67,016)	(69,943)
Plus	Core Crown gains/(losses) and other items	2,395	(841)	1,422	1,670	1,925	2,172
Plus	Net surpluses/(deficits) of SOEs and CEs	1,420	(1,172)	1,675	1,565	1,454	1,346
Equals	**Operating balance**	**8,023**	**2,559**	**3,105**	**3,009**	**2,779**	**2,734**
Less	Net total Crown (gains)/losses and other items	(2,163)	2,668	(1,787)	(2,005)	(2,286)	(2,580)
Equals	**Operating balance before gains and losses (OBEGAL)**	**5,860**	**5,227**	**1,318**	**1,004**	**493**	**154**
Less	NZS Fund net revenue after tax	390	(8)	36	44	50	53
Equals	**OBEGAL excluding NZS Fund retained revenue**	**6,250**	**5,219**	**1,354**	**1,048**	**543**	**207**
Less	Net retained surpluses of SOEs and CEs	(1,652)	(655)	(1,310)	(1,230)	(1,093)	(938)
	Non-cash items and working capital movements	3,988	2,454	2,507	2,171	2,455	2,275
Equals	**Net core Crown cash flow from operations**	**8,586**	**7,018**	**2,551**	**1,989**	**1,905**	**1,544**
Less	Contribution to NZS Fund	(2,048)	(2,103)	(2,242)	(2,151)	(2,270)	(2,290)
Equals	**Net core Crown cash flow from operations after contributions to NZS Fund**	**6,538**	**4,915**	**309**	**(162)**	**(365)**	**(746)**
Less	Purchase of physical assets	(1,755)	(1,544)	(1,541)	(1,683)	(1,327)	(1,146)
	Advances and capital injections	(1,906)	(1,773)	(1,985)	(855)	(978)	(638)
	Forecast for future new capital spending	-	(690)	(261)	(602)	(777)	(927)
Equals	**Core Crown residual cash**	**2,877**	**908**	**(3,478)**	**(3,302)**	**(3,447)**	**(3,457)**

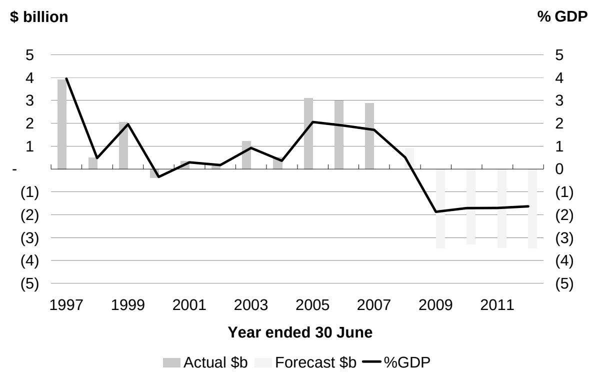
Source: The Treasury

Cash surpluses become deficits …

Core Crown residual cash is in deficit for most of the forecast period. The cash deficits are around $3.5 billion for each forecast year from 2008/09.

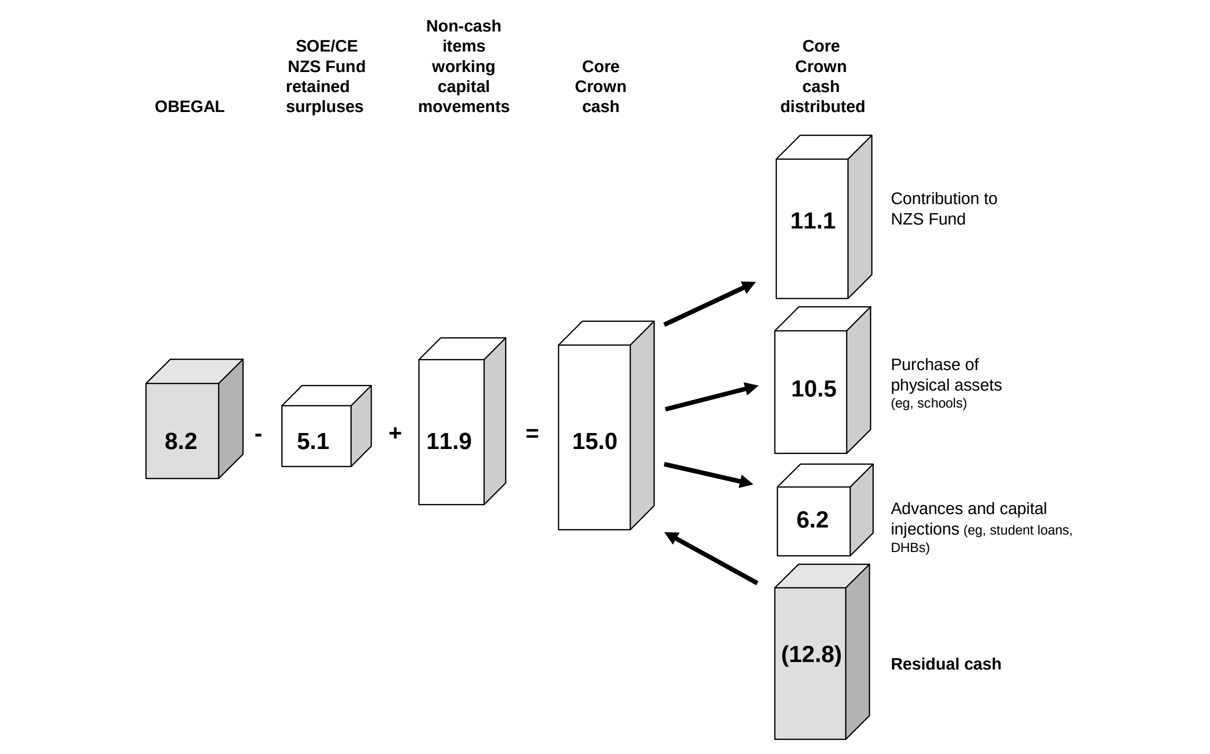
Net core Crown cash flow from operations decreases in line with movements in core Crown revenue and core Crown expenses.

Figure 2.9 – Core Crown residual cash



Source: The Treasury

Table 2.10 – Application of core Crown residual cash from 2007/08 to 2011/12 inclusive ($ billion)



Source: The Treasury

After taking into account contributions to the NZS Fund of $11.1 billion, purchases of physical assets (including new capital spending) of $10.5 billion and advances and capital injections of $6.2 billion, there is a residual financing requirement of $12.8 billion. This will be met by a decrease in net financial assets of $6.4 billion and monies raised from the Government's domestic bond programme, after meeting repayments on maturing debt of $6.4 billion.

... while capital investment continues

New capital commitments are $0.813 billion in 2007/08 and $1.911 billion for 2008/09 to 2011/12, totalling $2.7 billion. In addition $2.2 billion is committed in future Budgets at $0.9 billion per year phased over four years (Table 2.11). The total new capital investment is $4.9 billion ($2.7 billion plus $2.2 billion).

Table 2.11 – Forecast future new capital allowances

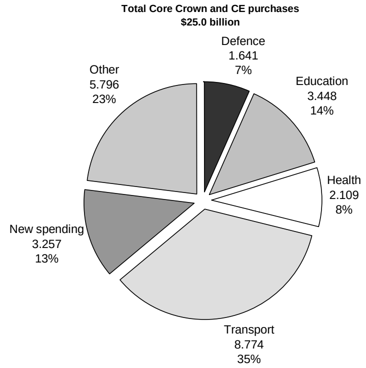
Year ended 30 June	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	Total
$ million						
Budget 2009	-	20	480	250	150	900
Budget 2010 (three years of phasing)	-	-	20	480	250	750
Budget 2011 (two years of phasing)	-	-	-	20	480	500
Budget 2012 (first year of phasing)	-	-	-		20	20
Future capital allowances	-	20	500	750	900	2,170

Source: The Treasury

Core Crown forecasts for the purchase of physical assets ($10.5 billion) and advances and capital injections ($6.2 billion) comprise purchases met from existing baselines plus the $4.9 billion new capital allocation above.

To give an indication of how core Crown capital investment is distributed by sector, it is necessary to consider the purchase of physical assets by both the core Crown and Crown entities (Figure 2.10).

Figure 2.10 – Core Crown and Crown Entity purchase of physical assets by sector ($billion and % of total spend)



Source: The Treasury

These purchases will include new capital spending in addition to the replacement of exisiting physical assets. The recently announced purchase of Toll Holdings Limited ($0.690 billion) and the NZ Fast Forward initiative ($0.7 billion) are included as new spending.

Table 2.12 – Residual cash comparison to the *Half Year Update*

Year ended 30 June $million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Residual cash					
Half Year Update	759	(763)	(779)	(851)	(937)
Tax receipts	180	(1,790)	(1,506)	(2,229)	(2,917)
Changes to baselines	3	(3)	41	96	112
Expense transfers (operating and capital)	761	(546)	(175)	(158)	91
Payments (above)/below allocations	(952)	(505)	(368)	(231)	(161)
Reduction in operating allowances	-	-	178	359	552
Benefits	(42)	(170)	(386)	(98)	(192)
KiwiSaver	54	(45)	(188)	(210)	(57)
Net finance costs	(57)	(54)	(168)	(347)	(560)
Top down adjustment	-	345	-	50	100
Other items	202	53	49	172	512
Total residual cash impact	149	(2,715)	(2,523)	(2,596)	(2,520)
Budget Update	908	(3,478)	(3,302)	(3,447)	(3,457)

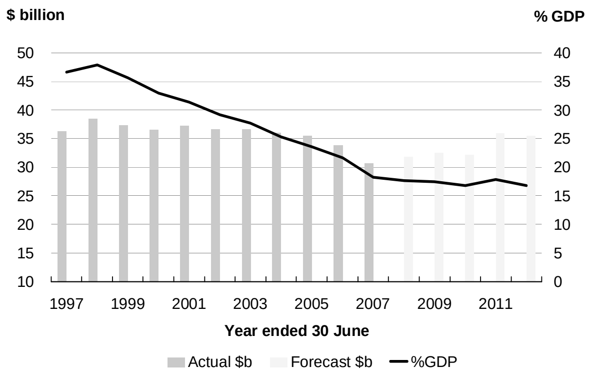
Source: The Treasury

Debt

Gross Sovereign Issued Debt (GSID) Excluding Settlement Cash

GSID (excluding Settlement Cash) represents the debt issued by the sovereign (ie, core Crown) and includes Government stock held by the NZS Fund, ACC and EQC but excludes money deposited with the Reserve Bank by banks (Settlement Cash).

Figure 2.11– GSID (excluding Settlement Cash)



Source: The Treasury

Gross debt falls as a percentage of GDP …

Although GSID (excluding Settlement Cash) increases over the forecast period from $30.6 billion in 2006/07 to $35.5 billion by 2011/12 it falls as a percentage of GDP from 18.2% to 16.8% over the same period.

The $4.9 billion nominal increase in GSID (excluding Settlement Cash) is primarily due to the net bond issuance of $6.4 billion (Table 2.13); partially offset by a $1.5 billion decrease in other core Crown financial liabilities such as Treasury bills.

Table 2.13 – Net increase in domestic bonds

Year ended 30 June $ million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	Total
Issue of domestic bonds (market)	2,415	3,314	3,393	3,394	3,365	15,881
Repayment of domestic bonds (market)	-	(2,700)	(3,947)	-	(3,976)	(10,623)
Net increase in domestic bonds (market)	2,415	614	(554)	3,394	(611)	5,258
Issue of domestic bonds (non-market)	189	662	851	245	1,286	3,233
Repayment of domestic bonds (non-market)	-	(451)	(599)	-	(1,046)	(2,096)
Net increase in domestic bonds (non-market)[3]	189	211	252	245	240	1,137
Net bond issuance	2,604	825	(302)	3,639	(371)	6,395

Source: The Treasury

3 Non-market domestic bonds are bonds held by the Earthquake Commission.

Table 2.14 – GSID (excluding Settlement Cash) comparison to the *Half Year Update*

Year ended 30 June $ million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
GSID (excluding Settlement Cash)					
Half Year Update	33,303	33,034	31,779	34,566	33,172
Domestic bonds (market)	(38)	817	1,753	2,640	3,508
Domestic bonds (non-market)	(30)	(37)	(16)	(17)	(28)
Reduction in treasury bills	(1,387)	(1,289)	(1,289)	(1,289)	(1,289)
Movements in other financial liabilities	(85)	(27)	24	74	136
	(1,540)	(536)	472	1,408	2,327
Budget Update	31,763	32,498	32,251	35,974	35,499

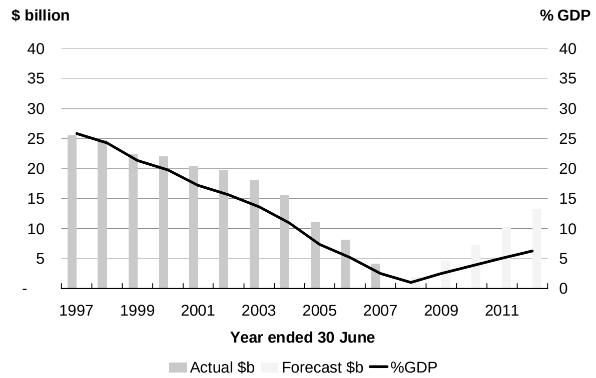
Source: The Treasury

Net Core Crown Debt

Net core Crown debt equates to core Crown borrowings less core Crown financial assets (excluding the financial assets of the NZS Fund).

By deducting financial assets (excluding the NZS Fund), net debt can provide additional information about the sustainability of the Government's accounts. However, it is important to view net debt alongside GSID (excluding Settlement Cash) as some financial assets are not very easily converted to cash.

Figure 2.12 – Net core Crown debt

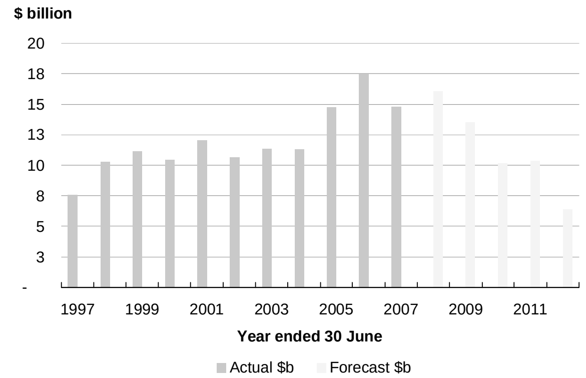


Source: The Treasury

Net debt increases …

Net debt rises from $1.9 billion in 2007/08 to $13.2 billion by 2011/12 (from 1.0% to 6.2% as a percentage of GDP).

Figure 2.13 – DMO/RB financial assets (excluding Settlement Cash impact)



Source: The Treasury

… as financial assets fall …

Net debt increases as a result of cash deficits of almost $13 billion over the forecast period. Funding of these deficits is met through a combination of domestic bond issuance and a reduction in the financial assets which have been built up by the New Zealand Debt Management Office (NZDMO) over the past few years.

Financial assets of the NZS Fund are excluded from the calculation of net debt as they are set aside to partially pre-fund the future cost of New Zealand Superannuation.

Table 2.15 – Net core Crown debt comparison to the *Half Year Update*

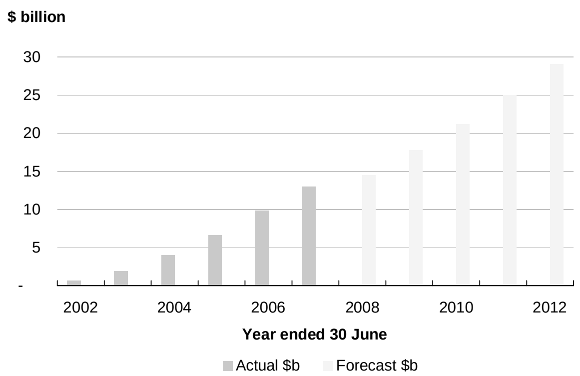
Year ended 30 June **$ million**	**2008** **Forecast**	**2009** **Forecast**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**
Net core Crown debt					
Half Year Update	1,983	1,756	1,705	1,792	2,105
Core Crown residual cash impact	(149)	2,566	5,089	7,685	10,205
Valuation of financial instruments	181	438	386	558	659
Other items	(169)	(182)	92	110	224
Total net debt impact	(137)	2,822	5,567	8,353	11,088
Budget Update	1,846	4,578	7,272	10,145	13,193

Source: The Treasury

NZS 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.

Figure 2.14 – NZS Fund net worth



Source: The Treasury

The NZS Fund makes a deficit in the current financial year …

The NZS Fund is forecasting an operating deficit of $0.6 billion in 2007/08. This is a result of the recent downturn in overseas equity markets (particularly in the United States).

… but the Fund's net worth grows by $16 billion over the forecast period

Despite the 2007/08 deficit the Fund's net assets are forecast to grow to $29 billion by 2011/12, an increase of $16 billion. More than $4.9 billion of this increase is expected to come from the NZS Fund's investment performance; with the remaining $11.1 billion increase from Government contributions.

Table 2.16 – NZS Fund net worth

Year ended 30 June $million	2007 Actual	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Opening net worth	9,855	12,973	14,461	17,721	21,152	24,947
Revenue	436	381	427	516	612	715
Other expenses	52	(51)	(154)	(177)	(204)	(231)
Tax expenses	(707)	(259)	(323)	(404)	(480)	(560)
Gains/(losses)	1,313	(686)	1,068	1,345	1,597	1,850
Gross contributions from the Crown	2,049	2,103	2,242	2,151	2,270	2,290
Other movements in reserves	(25)	-	-	-	-	-
Closing net worth	**12,973**	**14,461**	**17,721**	**21,152**	**24,947**	**29,011**

Source: The Treasury

The Government's contributions to the NZS Fund are 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 to be constant at that level. 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 New Zealand Superannuation and Retirement Income Act 2001.

The underlying assumptions in calculating the contributions for 2008 are the nominal GDP series to 2048, the NZS expense series to 2048 and the expected long-term, net after-tax annual return of the NZS Fund (6.6%) (6.6% in the *Half Year 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 (http://www.treasury.govt.nz/government/assets/nzsf/contributionratemodel).

Table 2.17 – NZS Fund net worth comparison to *Half Year Update*

Year ended 30 June $ million	2008 Forecast	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
NZS Fund net worth					
Half Year Update	15,993	19,488	23,140	27,016	31,102
Change in contributions	-	(134)	(170)	(45)	9
Change in Fund performance	(1,532)	(1,633)	(1,818)	(2,024)	(2,100)
Total net worth impact	(1,532)	(1,767)	(1,988)	(2,069)	(2,091)
Budget Update	14,461	17,721	21,152	24,947	29,011

Source: The Treasury

Risks to Fiscal Forecasts

The fiscal forecasts were finalised on 9 May 2008 in accordance with 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 7 May 2008. 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 *Budget 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 111.

KiwiSaver risks

Baselines reported by IRD 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.

Emission Trading Scheme risks

Baselines reported by the Ministry for the Environment on the Emission Trading Scheme are based on a number of assumptions and projections, all of which can change through time. Notably they incorporate an assumed take-up profile for forestry participation in the scheme. Actual take-up could be higher or lower than assumed. These potential changes represent an unquantified risk to the operating balance.

SOEs' and Crown entities' forecasts

The forecasts for large SOEs and CEs were based on results to 29 February 2008 and 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 29 February 2008 and 31 March 2008 respectively. The liabilities will next be valued as at 30 June 2008. 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.

Other market rates

Forecasts use the exchange rates, interest rate curves and electricity pricing curves prevailing at the forecast reference date. Any subsequent change to these rates will affect the fiscal outcome.

Tertiary education institutes' accounting treatment

The forecast information presented in the *2008 Budget 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.