2

Fiscal Outlook

Introduction

The *Pre-election Update* fiscal forecasts show a weakening in the fiscal outlook since the *Budget Update*. There are two key factors influencing this change. Firstly, the economic slowdown discussed in the previous chapter has resulted in slower tax growth and increased costs for social welfare benefits. Secondly, some past policies (such as KiwiSaver subsidies and 20 hours free early childhood education) have proven more expensive as a result of higher take-up rates. The combination of these two factors is forecast to result in a sustained period of deficits in both the operating balance before gains and losses (OBEGAL) and residual cash leading to higher debt and its associated financing costs.

The extended period of growth during the past decade has led to a fiscal position as at 30 June 2008 with gross sovereign-issued debt (excluding Settlement Cash) at 17.4% of GDP, net core Crown debt in a net financial asset position of $19 million and $14.2 billion in net assets held by the New Zealand Superannuation Fund (NZS Fund). Therefore the weakening in the fiscal outlook starts from a strong fiscal position.

This chapter outlines key trends for each of the following five areas:

- revenue and expenses
- operating results
- cash position
- debt, and
- the NZS Fund.

The chapter has two sections:

- *Short-term outlook* – This covers the fiscal results for the forecast period from 2008/09 to 2012/13.
- *Medium-term and long-term outlook* – This covers the fiscal projections out to 2022/23. The medium term projections differ from the forecasts. The forecasts are based on comprehensive modelling, whereas the projections extrapolate the conditions existing in the final year of the forecast period.

Following these two sections is a summary of the key risks associated with the fiscal forecasts. In particular, the *Fiscal Outlook* chapter should be read in conjunction with the *Specific Fiscal Risks* chapter (Chapter 4).

Short-Term Outlook

Table 2.1 – Fiscal indicators[2]

Year ended 30 June $million	2008 Actual	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast
Revenue and expenses						
Core Crown revenue (excl NZS Fund)	61,671	61,102	62,820	65,354	68,340	72,091
Core Crown expenses	56,997	62,359	65,849	68,891	72,252	76,157
Operating results						
Total Crown OBEGAL	5,637	(64)	(1,746)	(2,481)	(3,092)	(3,374)
Total Crown OBEGAL (excl NZS Fund retained revenue)	5,586	(31)	(1,665)	(2,376)	(2,962)	(3,224)
Total Crown operating balance	2,385	1,909	374	(71)	(396)	(382)
Cash position						
Core Crown residual cash	2,057	(5,909)	(5,300)	(6,603)	(6,815)	(7,307)
Debt						
GSID (excl Settlement Cash)	31,390	32,087	34,400	43,821	48,626	53,666
Net core Crown debt (incl NZS Fund financial assets)	(12,953)	(10,430)	(8,502)	(5,799)	(3,146)	(380)
Net core Crown debt	(19)	5,207	10,091	16,071	22,352	29,042
NZS Fund						
NZS Fund net worth	14,212	17,440	20,638	24,175	28,024	32,158
Nominal GDP	180,077	184,390	190,713	199,881	210,205	220,574
% of GDP						
Revenue and expenses						
Core Crown revenue (excl NZS Fund)	34.2	33.1	32.9	32.7	32.5	32.7
Core Crown expenses	31.7	33.8	34.5	34.5	34.4	34.5
Operating results						
Total Crown OBEGAL	3.1	(0.0)	(0.9)	(1.2)	(1.5)	(1.5)
Total Crown OBEGAL (excl NZS Fund retained revenue)	3.1	(0.0)	(0.9)	(1.2)	(1.4)	(1.5)
Total Crown operating balance	1.3	1.0	0.2	(0.0)	(0.2)	(0.2)
Cash position						
Core Crown residual cash	1.1	(3.2)	(2.8)	(3.3)	(3.2)	(3.3)
Debt						
GSID (excl Settlement Cash)	17.4	17.4	18.0	21.9	23.1	24.3
Net core Crown debt (incl NZS Fund financial assets)	(7.2)	(5.7)	(4.5)	(2.9)	(1.5)	(0.2)
Net core Crown debt	(0.0)	2.8	5.3	8.0	10.6	13.2
NZS Fund						
NZS Fund net worth	7.9	9.5	10.8	12.1	13.3	14.6

Source: The Treasury

Core Crown vs Total Crown

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

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

Total Crown includes the core Crown, State-Owned Enterprises (SOEs) and Crown Entities (CEs).

2 An historical trend series of the above indicators is available on page 122. The glossary on pages 118 to 121 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.

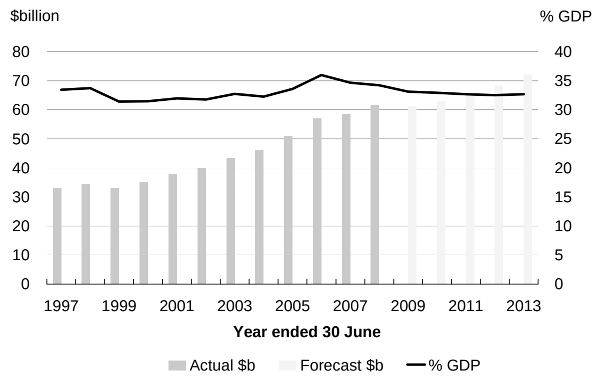
Core Crown revenue excluding the NZS Fund best represents the revenue available to meet the Government's spending needs.

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).

Core Crown revenue growth falls …

Core Crown revenue excluding the NZS Fund is forecast to fall from 34.2% of GDP in 2007/08 to 32.7% of GDP by 2012/13, while in a nominal sense over the same period it is forecast to increase by around $10 billion. The trend in core Crown revenue is primarily driven by what happens in tax revenue.

Figure 2.1 – Core Crown revenue excluding the NZS Fund

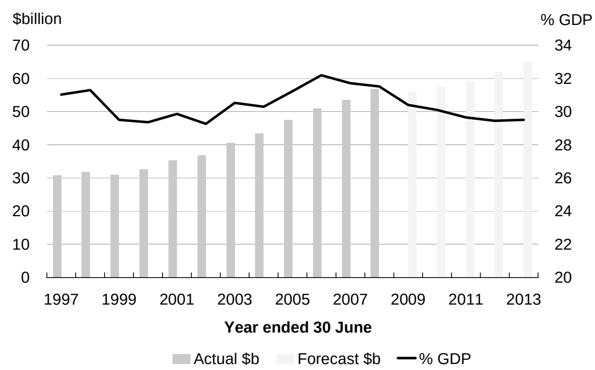


Source: The Treasury

… as the economy slows …

As mentioned in Chapter 1, the forecasts for nominal GDP have been reduced by just over $8 billion since the *Budget Update* (on a June year basis), with GDP in 2011/12 (the final forecast year in the *Budget Update*) being about $2 billion lower than in the *Budget Update*.

Figure 2.2 – Core Crown tax revenue



Source: The Treasury

A reduction in the forecasts for domestic consumption as past imbalances start to unwind over all forecast years is a key feature of the macroeconomic forecasts. This reduces the GST forecasts. It also has flow-on effects for business income taxes as reduced spending leads to lower profits, which have also been squeezed by an increase in the forecast wage growth track. The increased wage forecast provides some offset to the forecast reductions in tax revenue via an increase in the source deductions (PAYE) forecast.

Table 2.2 – Changes in core Crown tax revenue forecasts by major tax type

Year ended 30 June $million	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Core Crown tax revenue				
Budget Update	56,523	58,228	60,319	62,712
GST	(193)	(265)	(516)	(340)
Corporate taxes	(183)	(432)	(305)	(471)
Other persons tax	(309)	(94)	(113)	(93)
Source deductions	199	63	41	191
Other	21	(85)	(158)	(106)
Change in core Crown tax revenue	(465)	(813)	(1,051)	(819)
Pre-election update	56,058	57,415	59,268	61,893

… and personal tax cuts began to come into affect from 1 October 2008

The introduction of personal tax cuts announced in Budget 2008 means there has been a structural reduction in tax revenue of $1.6 billion in 2008/09 rising to $4.3 billion by 2012/13. The tax cut was included in the fiscal forecasts at the time of Budget 2008.

The tax cuts were the primary driver for the fall in tax revenue as a percentage of GDP over the forecast period.

Inland Revenue Tax Forecasts

In line with established practice, the Inland Revenue Department 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 are the Crown's official forecasts.

Table 2.3 – The Treasury and Inland Revenue core Crown tax revenue forecasts

Year ended 30 June $billion	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast
Source deductions					
Treasury	23.1	23.7	24.4	25.5	27.2
Inland Revenue	23.1	23.7	24.3	25.5	27.3
Difference	-	-	0.1	-	(0.1)
Net other persons tax					
Treasury	3.5	3.8	3.8	3.9	4.0
Inland Revenue	3.4	3.6	3.7	3.8	3.9
Difference	0.1	0.2	0.1	0.1	0.1
Corporate tax					
Treasury	9.5	9.6	10.4	10.9	11.4
Inland Revenue	9.3	10.3	10.9	11.4	11.8
Difference	0.2	(0.7)	(0.5)	(0.5)	(0.4)
Goods and services tax					
Treasury	11.7	12.0	12.5	13.2	13.8
Inland Revenue	11.6	12.0	12.4	13.1	13.8
Difference	0.1	-	0.1	0.1	-
Other taxes					
Treasury	8.3	8.3	8.2	8.4	8.7
Inland Revenue	8.4	8.2	8.1	8.3	8.5
Difference	(0.1)	0.1	0.1	0.1	0.2
Total tax revenue					
Treasury	56.1	57.4	59.3	61.9	65.1
Inland Revenue	55.8	57.8	59.4	62.1	65.3
Difference	0.3	(0.4)	(0.1)	(0.2)	(0.2)
Total tax revenue (% of GDP)					
Treasury	30.4	30.1	29.7	29.4	29.5
Inland Revenue	30.3	30.3	29.7	29.5	29.6
Difference	0.1	(0.2)	-	(0.1)	(0.1)

Sources: The Treasury, Inland Revenue

The differences between the two sets of forecasts are much smaller than has been the case in recent forecasting rounds. The only significant difference is in corporate taxes where the two agencies have differing opinions on the degree of tax losses accumulating in the short term and on the effect these will have on income tax during the upswing in the business cycle.

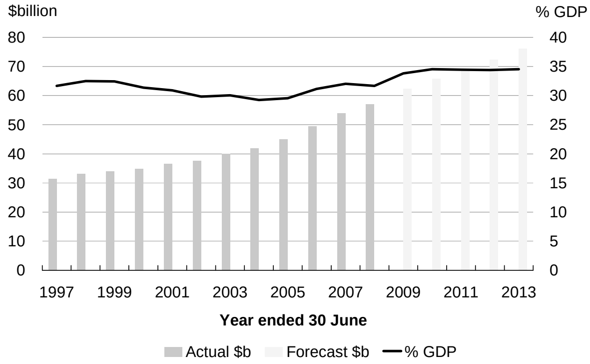
Core Crown Expenses

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

Core Crown expenses rise then stabilise in line with growth in the economy

Core Crown expenses are forecast to increase as a percentage of GDP in 2008/09 and then remain relatively stable at around 34.5% over the rest of the forecast period. In nominal terms, core Crown expenses grow over the forecast period from $57 billion in 2007/08 to $76.2 billion by 2012/13.

Figure 2.3 – Core Crown expenses



Source: The Treasury

Some increases in expenses were forecast at the time of the *Budget Update* because of the normal processes of cost of living adjustments to social welfare benefits, and the inclusion in expenses of allowances to cover new spending in future Budgets. In addition, some of the policy decisions announced in recent Budgets were to be gradually implemented (eg, KiwiSaver), with a consequent rising profile of expenses.

The expected profile for core Crown expenses is higher in this *Pre-election Update* than in the *Budget Update* due to:

- higher social welfare benefits mostly associated with the economic slowdown and higher expected inflation rate
- increased costs of existing policies (such as KiwiSaver and early childhood education) arising from take-up rates being higher than previously forecast, and
- as a consequence of lower tax and higher expenses, a higher debt track is forecast, so higher debt servicing costs are also expected.

Slowing growth leads initially to higher social welfare benefit costs …

The growth of benefit expenses initially exceeds economic growth, but slows after 2009/10 so that by 2012/13 social welfare expenditure, as a percentage of GDP, is slightly lower than its 2008/09 level.

Faster growth in benefit costs in the early years of the forecast period is largely due to higher-than-normal inflation indexation and a lift in recipient numbers, especially in relation to the unemployment benefit. The latter is a consequence of a forecast weaker labour market in these years.

… and there are additional costs from existing policies …

The fiscal costs for the following policies have been revised upwards since the *Budget Update.*

KiwiSaver

Take-up rates for the KiwiSaver scheme over its first year of operations far exceeded original assumptions. The *Pre-election Update* revisions are based on an assumption that growth in applications will continue and membership will reach 56% of the total labour force by 2012/13 (46% at *Budget Update*).

Early childhood education

Forecast costs have been revised upwards for the policy of 20 hours per week free early childhood education announced in Budget 2006. This increase is due to an increase in the volume of funded child hours claimed by service providers and an increase in the number of service providers offering the free 20 hour per week programme.

Treaty of Waitangi settlements

The pace of settlement of Historical Treaty of Waitangi claims is expected to pick up over the forecast period, resulting in an increase in expenses.

… as a result, debt servicing costs also rise

With slower growth in tax revenue and higher government spending, annual core Crown finance costs are forecast to rise from $2.5 billion in 2007/08 to $3.9 billion by 2012/13.

Recent spending decisions have been charged against the Budget 2009 allowance …

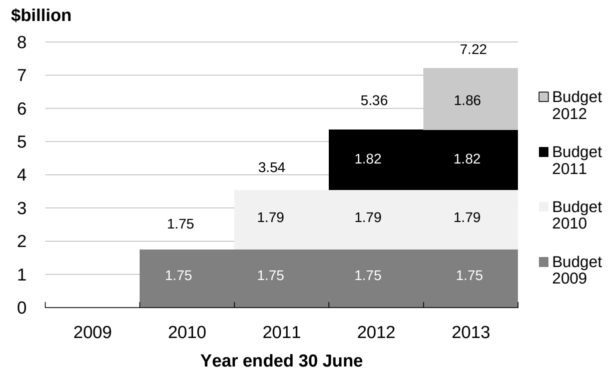
As in previous *Economic and Fiscal Updates*, the forecasts include allowances for new operating initiatives for future Budgets. Budget allowances represent a level of funding that will be allocated to spending and revenue initiatives over the Budgets covered in the fiscal forecasts.

The Budget 2009 allowance was set at $1.75 billion in the *2008 Fiscal Strategy Report* (FSR), and this grows by 2% for each Budget as shown in Figure 2.4.

The fiscal forecasts assume that spending and revenue pressures can be managed within these funding allowances.

The Government has made a number of spending decisions since the Budget. Table 2.4 shows decisions already charged and signalled as pre-commitments against Budget 2009. In addition the *Specific Fiscal Risks* chapter outlines a number of decisions under active consideration which need to be managed within the remaining allowance.

Figure 2.4 – Net amounts of forecast new operating initiatives



Source: The Treasury

As a result, the Budget 2009 allowance is expected to come under pressure, and, if exceeded, the fiscal position would weaken from that shown in the fiscal forecasts.

Table 2.4 – Charges and pre-commitments[3] against Budget 2009

Year ended 30 June **$million**	**2010** **Forecast**	**2011** **Forecast**	**2012** **Forecast**	**2013** **Forecast**
Budget 2009 operating allowance	**1,750**	**1,750**	**1,750**	**1,750**
- Teachers and principals collective agreements	(169)	(192)	(192)	(192)
- KiwiRail operating funding	(148)	-	-	-
Budget 2009 operating allowance in forecasts	**1,433**	**1,558**	**1,558**	**1,558**
Less pre-commitments and indicative funding				
- Health pre-commitment and indicative funding package	(750)	(750)	(750)	(750)
- Economic Transformation: Innovation	(93)	(100)	(100)	(100)
- Defence funding package	(86)	(86)	(86)	(86)
- MFAT funding package	(8)	(8)	(8)	(8)
Budget 2009 operating allowance after pre-commitments and indicative funding	**496**	**614**	**614**	**614**

Source: The Treasury

3 Pre-commitments are not reported in the fiscal forecasts as a final cabinet decision has yet to be made.

Operating Results

Total Crown OBEGAL (excluding the NZS Fund retained revenue)

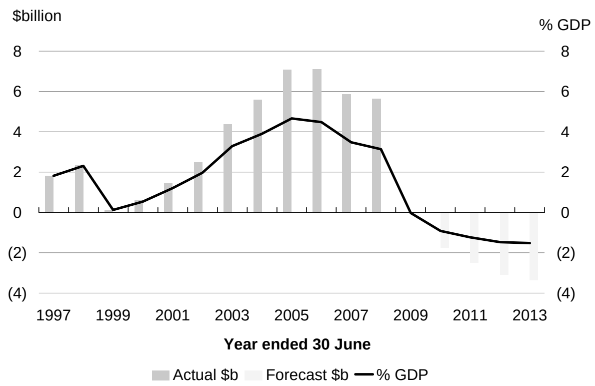
OBEGAL is the operating balance before gains and losses for the total Crown. By excluding gains and losses, the OBEGAL gives a more direct indication of the underlying stewardship of the Government than the operating balance. The OBEGAL (excluding the NZS Fund retained revenue) is a measure of the operating 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 deficits expected …

The OBEGAL (excluding the NZS Fund retained revenue) shifts into a deficit position in the current year of $31 million which worsens to $3.2 billion by the end of the forecast period.

As discussed earlier, slower growth in tax revenue and increases in government spending are the key factors driving the downward trend in the OBEGAL (excluding the NZS Fund retained revenue).

Figure 2.5 – Total Crown OBEGAL (excluding the NZS Fund retained revenue)



Source: The Treasury

Table 2.5 provides a detailed reconciliation of the changes since the *Budget Update*, while Table 2.6 shows the changes since the *Budget Update* by the key drivers.

Table 2.5 – Total Crown OBEGAL (excluding the NZS Fund retained revenue) comparison to the *Budget Update*

Year ended 30 June $million	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
OBEGAL (excluding the NZS Fund retained revenue)				
Budget Update	1,354	1,048	543	207
Core Crown changes				
Tax revenue	(465)	(813)	(1,051)	(819)
Benefit expenses	(358)	(629)	(678)	(543)
Education expense changes	(239)	(111)	(208)	(254)
KiwiSaver expense changes	(71)	(105)	(197)	(280)
Treaty settlements	25	(440)	(130)	(130)
Net finance costs	(435)	(284)	(390)	(675)
Expense transfers[1]	(914)	(10)	(7)	-
Top-down adjustment[2]	1,095	40	(35)	(110)
Emissions Trading Scheme expense rephasing	422	(599)	(107)	(120)
Technical baseline changes	(54)	(3)	(19)	(33)
Rail funding decision	(148)	148	-	-
Other movements	(13)	125	35	18
Core Crown OBEGAL change	(1,155)	(2,681)	(2,787)	(2,946)
Net SOE/CE change (including impact of eliminations)	(230)	(32)	(132)	(223)
Total OBEGAL (excluding the NZS Fund retained revenue) change	(1,385)	(2,713)	(2,919)	(3,169)
Pre-election Update	(31)	(1,665)	(2,376)	(2,962)

Table 2.6 – Total Crown OBEGAL (excluding the NZS Fund retained revenue) comparison to the *Budget Update* by key drivers

OBEGAL (excluding the NZS Fund retained revenue)				
Budget Update	1,354	1,048	543	207
Economic-driven changes				
Tax revenue	(465)	(813)	(1,051)	(819)
Benefit expenses	(358)	(629)	(678)	(543)
Total economic-driven changes	**(823)**	**(1,442)**	**(1,729)**	**(1,362)**
Changes due to policy costs				
Education expense changes	(239)	(111)	(208)	(254)
KiwiSaver expense changes	(71)	(105)	(197)	(280)
Treaty settlements	25	(440)	(130)	(130)
Total changes due to policy costs	**(285)**	**(656)**	**(535)**	**(664)**
Debt servicing change				
Net finance costs	(435)	(284)	(390)	(675)
Total debt servicing change	**(435)**	**(284)**	**(390)**	**(675)**
Other changes	158	(331)	(265)	(468)
Total OBEGAL (excluding the NZS Fund retained revenue) change	(1,385)	(2,713)	(2,919)	(3,169)
Pre-election Update	(31)	(1,665)	(2,376)	(2,962)

Notes:

1 Expense transfers represent underspends from 2007/08 financial year which have been transferred into the forecast period.

2 The top-down adjustment compensates for the fact that departments tend to use appropriations as the basis for their forecasts. Appropriations will overstate expenditure as they are upper limits.

Total Crown Operating Balance

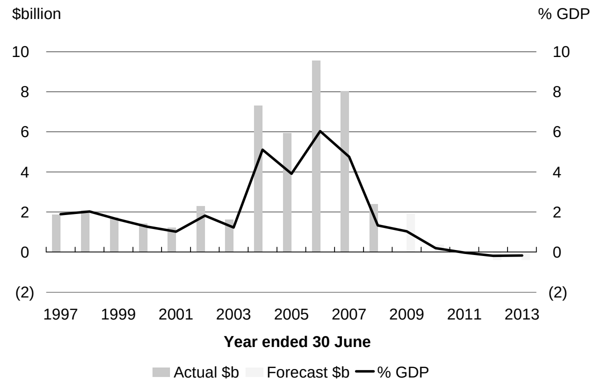
The operating balance shows whether the government sector has generated enough revenues to cover its expenses in any given year.

… while the operating balance is close to breakeven point

The operating balance is forecast to remain positive until 2009/10 before moving into modest deficits thereafter.

The main difference between the OBEGAL trend and operating balance is valuation gains on assets and liabilities are forecast of $1.6 billion in 2008/09 growing to $2.6 billion in 2012/13.

Figure 2.6 – Total Crown operating balance



Source: The Treasury

The expected growth in gains primarily relates to the asset portfolio of the NZS Fund which is forecast to increase by around $3 to $4 billion per annum. The forecast gains on financial instruments are based on long-term benchmark rates of return, in conjunction with the exchange rate and interest rate curves prevailing at the forecast reference date. Gains and losses on assets and liabilities are volatile in the short term. Since completing the fiscal forecasts, equity market conditions have deteriorated so there is a risk that valuation gains in the current year may be lower than forecast.

The total Crown operating balance is not available to be drawn upon to fund core Crown operations, as current policy is for SOEs and CEs to retain a portion of their surpluses for the purpose of achieving their long-term objectives and for the NZS Fund to retain all of its after tax surpluses. Over the forecast period, SOE and CE surpluses total $9.4 billion. Approximately $2.4 billion of these surpluses will be returned as dividends. This becomes cash available to the core Crown.

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 2.7 – Reconciliation of core Crown residual cash

$million	**2008 Actual**	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**	**2013 Forecast**
	Year ended 30 June					
Core Crown revenue	61,819	61,207	62,888	65,422	68,408	72,161
Core Crown expenses	(56,997)	(62,359)	(65,849)	(68,891)	(72,252)	(76,157)
Core Crown gains/(losses) and other items	(930)	1,380	1,619	1,869	2,123	2,398
Net surpluses/(deficits) of SOEs and CEs	(1,507)	1,681	1,716	1,529	1,325	1,216
Operating balance	**2,385**	**1,909**	**374**	**(71)**	**(396)**	**(382)**
Net total Crown (gains)/losses and other items	3,252	(1,973)	(2,120)	(2,410)	(2,696)	(2,992)
Operating balance before gains and losses (OBEGAL)	**5,637**	**(64)**	**(1,746)**	**(2,481)**	**(3,092)**	**(3,374)**
NZS Fund net revenue after tax	(51)	33	81	105	130	150
OBEGAL excluding (NZS Fund retained revenue)	**5,586**	**(31)**	**(1,665)**	**(2,376)**	**(2,962)**	**(3,224)**
Net retained surpluses of SOEs and CEs	(815)	(1,088)	(1,215)	(988)	(752)	(622)
Non-cash items and working capital movements	2,521	1,905	2,659	2,071	2,007	1,785
Net core Crown cash flow from operations	**7,292**	**786**	**(221)**	**(1,293)**	**(1,707)**	**(2,061)**
Contribution to NZS Fund	(2,104)	(2,242)	(1,977)	(2,096)	(2,167)	(2,194)
Net core Crown cash flow from operations after contributions to NZS Fund	**5,188**	**(1,456)**	**(2,198)**	**(3,389)**	**(3,874)**	**(4,255)**
Purchase of physical assets	(1,433)	(1,516)	(1,729)	(1,397)	(1,251)	(1,306)
Advances and capital injections	(1,698)	(2,753)	(875)	(1,009)	(790)	(666)
Forecast for future new capital spending	-	(184)	(498)	(808)	(900)	(1,080)
Core Crown residual cash	**2,057**	**(5,909)**	**(5,300)**	**(6,603)**	**(6,815)**	**(7,307)**

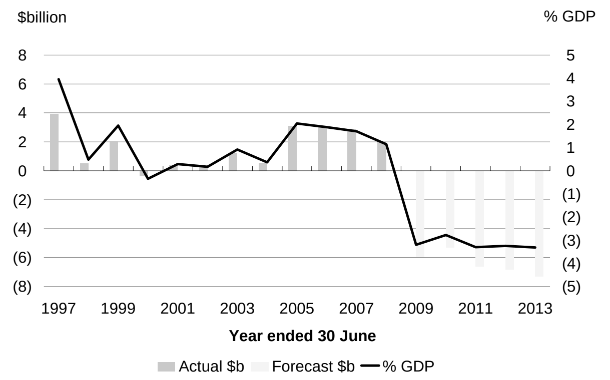
Source: The Treasury

A sustained period of large cash deficits is forecast

Core Crown residual cash is in deficit over the entire forecast period ranging from $5.9 billion in 2008/09 to $7.3 billion in 2012/13.

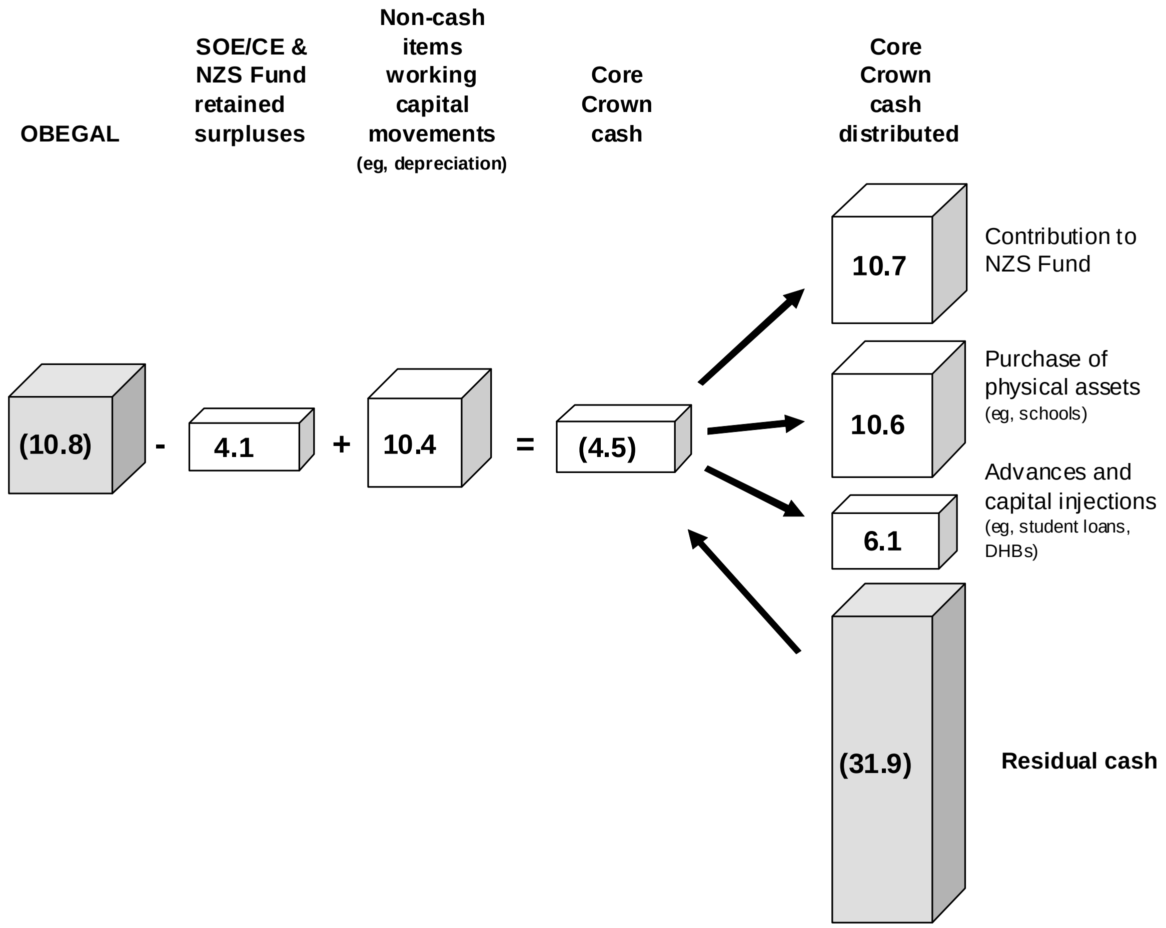
The decline in the OBEGAL is broadly mirrored in net core Crown cash flow from operations.

Figure 2.7 – Core Crown residual cash



Source: The Treasury

Table 2.8 – Application of core Crown residual cash from 2008/09 to 2012/13 inclusive ($billion)



Source: The Treasury

After taking into account contributions to the NZS Fund of $10.7 billion, purchases of physical assets (including new capital spending) of $10.6 billion and advances and capital injections of $6.1 billion, there is a residual financing requirement of $31.9 billion. The cash shortfall will be mainly met by additional borrowings of around $22 billion with the rest met by reducing financial assets that have accumulated from recent strong cash outturns (refer Table 2.13).

As in previous *Economic and Fiscal Updates*, the forecasts include allowances for new capital initiatives for future Budgets. As part of Budget 2009, the Government has allocated $900 million of new capital over the next four years. Amounts for the 2010, 2011 and 2012 Budgets have also been set at $900 million phased over four years. In total the fiscal forecasts incorporate $3.1 billion over the next five years to be spent on new capital commitments between 2008/09 to 2012/13.

Table 2.9 – Forecast future new capital allowances

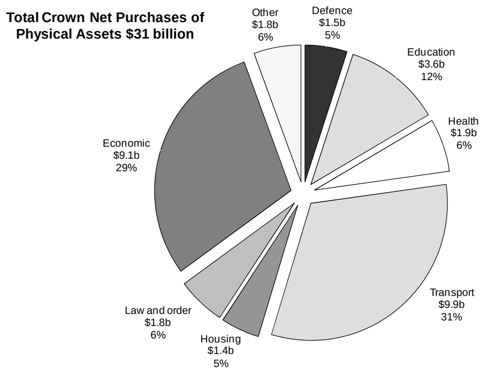
Year ended 30 June	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast	Total
$million						
Budget 2009	20	480	250	150	-	900
Budget 2010 (three years of phasing)	-	20	480	250	150	900
Budget 2011 (two years of phasing)	-	-	20	480	250	750
Budget 2012 (one year of phasing)	-	-	-	20	480	500
Budget 2013	-	-	-	-	20	20
Future capital allowances	20	500	750	900	900	3,070

Source: The Treasury

Core Crown forecasts for the purchase of physical assets ($10.6 billion) and advances and capital injections ($6.1 billion) comprise purchases met from existing baselines plus the $3.1 billion new capital allocation mentioned above.

Advances and capital injections are often used by CEs and SOEs to purchase physical assets (such as roading and rail assets). Therefore, to give an indication of the Government's capital investment it is important to consider total Crown physical asset purchases. Figure 2.8 shows the total purchases of physical assets by sector.

Figure 2.8 – Total purchase of physical assets by sector ($billion and % of total spend)



Source: The Treasury

Taking into consideration capital and operating cash flows, the cash position is weaker than what was forecast at the *Budget Update*.

Table 2.10 – Residual cash comparison to the *Budget Update*

Year ended 30 June $million	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast
Residual cash				
Budget Update	(3,478)	(3,302)	(3,447)	(3,457)
Tax receipts	(748)	(1,022)	(1,268)	(954)
Benefit expenses	(358)	(629)	(678)	(543)
KiwiSaver uptake change	(71)	(105)	(197)	(280)
Education forecast change	(239)	(111)	(209)	(254)
Treaty settlements	25	(440)	(130)	(130)
Net finance costs	(382)	(171)	(358)	(641)
Top-down adjustment	1,090	(100)	(175)	(250)
Expense transfers	(1,604)	(10)	(7)	11
National Provident Fund call on guarantee	(17)	(99)	(99)	(99)
NZS Fund contributions	-	158	167	116
Capital allocation	(140)	140	-	-
Rail funding decision	(45)	45	-	-
Other movements	58	346	(202)	(334)
Total residual cash impact	(2,431)	(1,998)	(3,156)	(3,358)
Pre-election Update	(5,909)	(5,300)	(6,603)	(6,815)

Source: The Treasury

Debt

Gross Sovereign Issued Debt (GSID) (Excluding Settlement Cash)

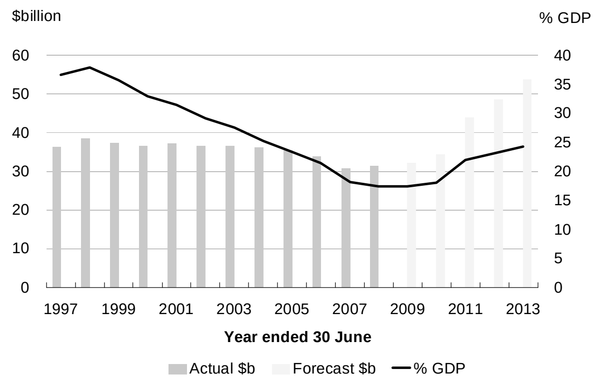
GSID (excluding Settlement Cash) represents the debt issued by the sovereign (ie, core Crown) and includes government stock held by the NZS Fund, ACC and EQC but excludes money deposited with the Reserve Bank by banks (Settlement Cash). Settlement Cash is excluded as it is financed from commercial banks and not from government funding.

GSID (excluding Settlement Cash) is forecast to climb…

The increase in GSID (excluding Settlement Cash) is primarily due to the need to raise finances to meet the residual cash deficits over the forecast period.

GSID (excluding Settlement Cash) is forecast to increase in both nominal terms (by around $22.3 billion) and as a percentage of GDP (by around 6.9%) over the forecast period. By the end of the forecast period in 2012/13 GSID (excluding Settlement Cash) is expected to be $53.7 billion or 24.3% of GDP.

Figure 2.9 – GSID (excluding Settlement Cash)



Source: The Treasury

The issuance of domestic bonds (market) for 2008/09 has been set at $4 billion and rises to $9.2 billion in 2012/13. After meeting debt maturities, the accumulated net bond issuance over the forecast period is $23 billion and this will translate into an increase in GSID (excluding Settlement Cash).

Table 2.11 – Net increase in domestic bonds

Year ended 30 June $million	**2009 Forecast**	**2010 Forecast**	**2011 Forecast**	**2012 Forecast**	**2013 Forecast**	**Total**
Issue of domestic bonds (market)	4,048	6,070	9,114	9,189	9,216	37,637
Repayment of domestic bonds (market)	(2,900)	(4,097)	-	(4,483)	(4,518)	(15,998)
Net increase in domestic bonds (market)	1,148	1,973	9,114	4,706	4,698	21,639
Issue of domestic bonds (non-market)	738	843	258	826	832	3,497
Repayment of domestic bonds (non-market)	(451)	(599)	-	(585)	(533)	(2,168)
Net increase in domestic bonds (non-market)[4]	287	244	258	241	299	1,329
Net bond issuance	1,435	2,217	9,372	4,947	4,997	22,968

Source: The Treasury

4 Non-market domestic bonds are bonds held by EQC.

Net Core Crown Debt

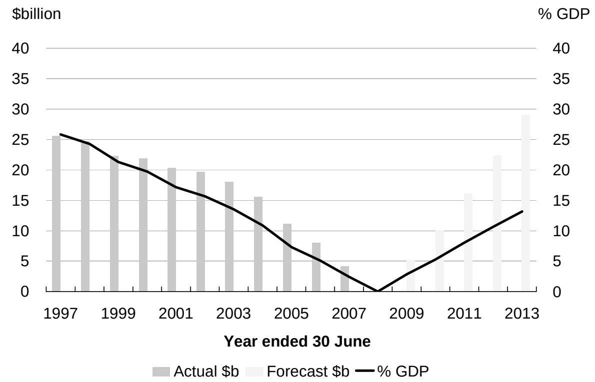
Net core Crown debt equates to core Crown borrowings less core Crown financial assets (excluding the financial assets of the NZS Fund).

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 (eg, student loans) are not easily converted to cash.

…so too is net core Crown debt …

As at 30 June 2008, net core Crown debt was in a small net asset position of $19 million. Over the forecast period, net core Crown debt is forecast to rise to $29 billion or 13.2% of GDP. The increase in net core Crown debt is due to the run-down of NZDMO financial assets and increases in borrowings expected during the forecast period. Table 2.12 provides a breakdown of core Crown net debt by portfolio. Net debt is forecast to increase faster than GSID (excluding Settlement Cash) as net debt takes into consideration the run-down of financial assets which is not captured by the GSID (excluding Settlement Cash) indicator, so it is important to look at the two indicators together.

Figure 2.10 – Net core Crown debt



Source: The Treasury

Table 2.12 – Net core Crown debt (excl NZS Fund[5]) by portfolio as at 30 June 2008 and 30 June 2013

Year ended 30 June	**NZDMO**	**Reserve Bank**	**Student loans**	**Other**	**Total (excl. NZS Fund)**
	2008 ($million)				
Core Crown borrowings	28,861	8,689	-	195	37,745
Core Crown financial assets	17,001	13,735	6,741	287	37,764
Core Crown net debt	11,860	(5,046)	(6,741)	(92)	(19)
	2013 ($million)				
Core Crown borrowings	51,314	8,513	-	194	60,021
Core Crown financial assets	5,793	16,115	8,851	220	30,979
Core Crown net debt	45,521	(7,602)	(8,851)	(26)	29,042

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

… in order to meet the cash shortfall

Table 2.13 shows New Zealand Debt Management Office (NZDMO) borrowings are forecast to increase by $22.5 billion and its financial assets are forecast to reduce by $11.2 billion over the forecast period.

Table 2.13 – NZDMO net debt movement between 30 June 2008 and 30 June 2013

$million	Opening balance 2008	Movements	Closing balance 2013
Borrowing			
Government stock	23,203	23,846	47,049
Treasury bills	1,487	(200)	1,287
Other borrowings	4,171	(1,193)	2,978
Total	**28,861**	**22,453**	**51,314**
Financial assets			
Advances	4,293	702	4,995
Other	12,708	(11,910)	798
Total	**17,001**	**(11,208)**	**5,793**
NZDMO net debt	**11,860**		**45,521**

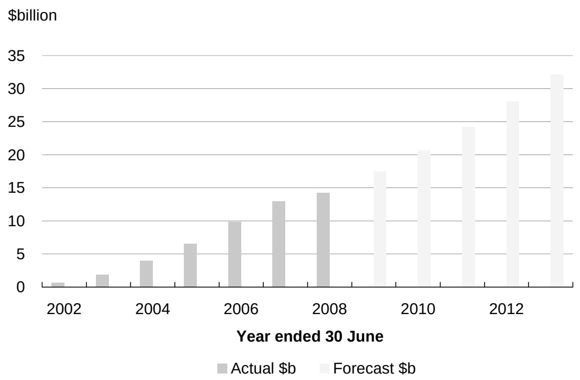
NZS Fund

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.

The NZS Fund is forecasting an operating surplus of $1 billion in 2008/09 growing to $1.9 billion in 2012/13.

A combination of holding gains and new investments funded by the Government's annual contribution of around $2 billion per annum is expected to increase the NZS Fund's net worth from $14.2 billion in 2007/08 to $32.2 billion in 2012/13.

Figure 2.11 – NZS Fund net worth



Source: The Treasury

Table 2.14 – NZS Fund net worth

Year ended 30 June $million	2008 Actual	2009 Forecast	2010 Forecast	2011 Forecast	2012 Forecast	2013 Forecast
Opening net worth	12,973	14,212	17,440	20,638	24,175	28,024
Revenue	385	431	487	562	642	725
Other expenses	(34)	(156)	(168)	(196)	(221)	(245)
Tax expenses	(237)	(326)	(419)	(494)	(574)	(655)
Gains/(losses)	(995)	1,037	1,321	1,569	1,836	2,114
Gross contributions from the Crown	2,104	2,242	1,977	2,096	2,167	2,194
Other movements in reserves	16	-	-	-	(1)	1
Closing net worth	**14,212**	**17,440**	**20,638**	**24,175**	**28,024**	**32,158**

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 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 2008/09 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 (6.6%) (also 6.6% in the *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 (http://www.treasury.govt.nz/government/assets/nzsf/contributionratemodel).

Medium-Term and Long-Term Outlook

Medium-Term

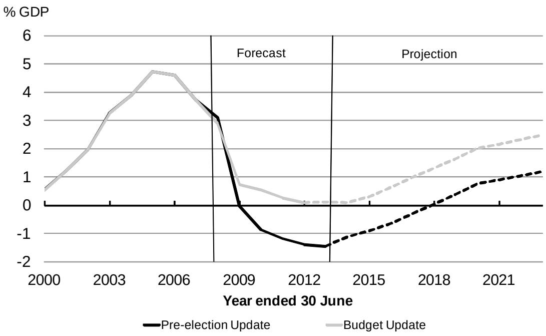
The preceding parts of the *Fiscal Outlook* chapter have focused on the fiscal forecasts covering the period 2008/09 to 2012/13. This section provides medium-term fiscal projections, covering the subsequent 10 years (2013/14 to 2022/23). In previous *Pre-election Updates* these projections have been published separately on the Treasury website. For this and subsequent *Pre-election Updates*, the projections are incorporated into the document, to make this information easier to access and to provide a fuller picture of the medium-term implications of developments in the fiscal forecasts.

The forecasts are based on comprehensive modelling of the macroeconomy, which flows through into forecasts of tax revenue and the overall fiscal position. The projections, on the other hand, extrapolate the conditions existing in the final year of the forecast period, using assumptions about how elements of revenue and expenditure will change over time.

Updated medium-term projections

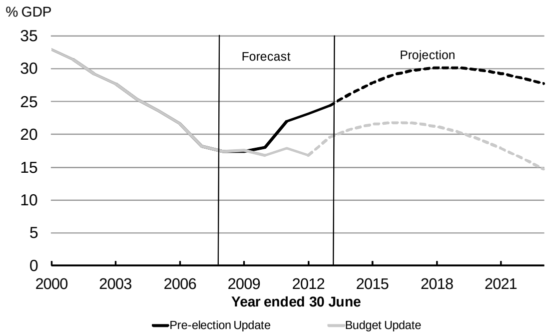
Building on the deterioration since the *Budget Update* in the fiscal outlook in the forecast period discussed earlier in this chapter, the medium-term projections show that this deterioration continues throughout the 10-year projection period.[6]

Figure 2.12 – OBEGAL (excluding NZS Fund retained revenue)



Source: The Treasury

Figure 2.13 – GSID (excluding Settlement Cash)

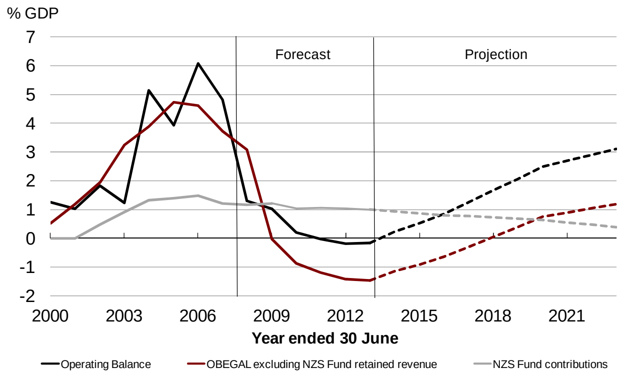


Source: The Treasury

6 The projections show that the deterioration in the fiscal outlook, which is driven by the weaker economy, is expected to be long-lasting. The projections are dependent on the starting point and there is considerable uncertainty around the short-term economic outlook. The extent to which the weaker economic outlook affects the short-term fiscal outlook can also be approached by considering estimates of the cyclically-adjusted balance. As has been the case in recent Updates, information on this is included in the Additional Information for the 2008 Pre-election Update, which is available at www.treasury.govt.nz/budget/forecasts/prefu2008

OBEGAL (excluding NZS Fund retained revenue) is forecast to be 1.5% of GDP in deficit in 2012/13. In the projection period, we assume that revenue growth exceeds expenditure growth, largely because personal income tax revenue grows faster than the allowance for new operating spending. This sees OBEGAL (excluding NZS Fund retained revenue) move into surplus in 2017/18, and end the projection period with a surplus of 1.2% of GDP in 2022/23.

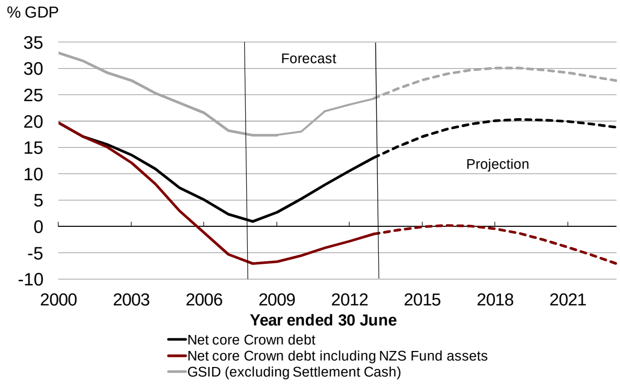
Figure 2.14 – Operating balance, OBEGAL (excluding NZS Fund retained revenue), NZS Fund contributions



Source: The Treasury

Figure 2.15 shows GSID (excluding Settlement Cash) and net core Crown debt continuing to grow as a share of GDP at the start of the projection period, because of the scale of borrowing required to cover OBEGAL deficits and the Government's capital programme. As OBEGAL moves back into surplus towards the end of the projection period, GSID and net debt begin to fall as a share of GDP.

Figure 2.15 – GSID (excluding Settlement Cash), net core Crown debt, net core Crown debt including NZS Fund assets

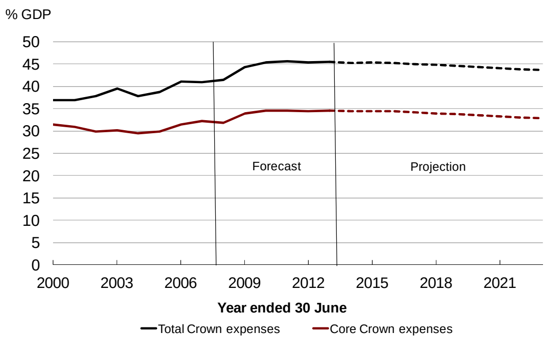


Source: The Treasury

Figure 2.16 shows that core Crown expenses are projected to stabilise and then fall slightly as a percentage of GDP. This is because the allowance for new operating spending grows at the rate of inflation, which is assumed to be lower than the rate of GDP growth.

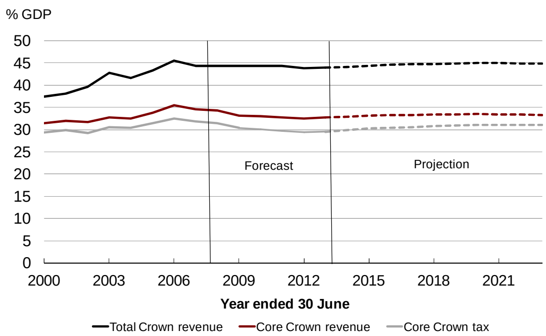
Figure 2.17 shows that from the start of the projection period until 2020 the tax-to-GDP ratio is assumed to rise as fiscal drag pushes people into higher tax brackets. From 2020 the tax-to-GDP ratio then flattens as fiscal drag is assumed to be mitigated by changes to personal tax rates and/or thresholds. This is assumed so that the tax-to-GDP ratio remains at average historical levels.

Figure 2.16 – Expenses



Source: The Treasury

Figure 2.17 – Revenue



Source: The Treasury

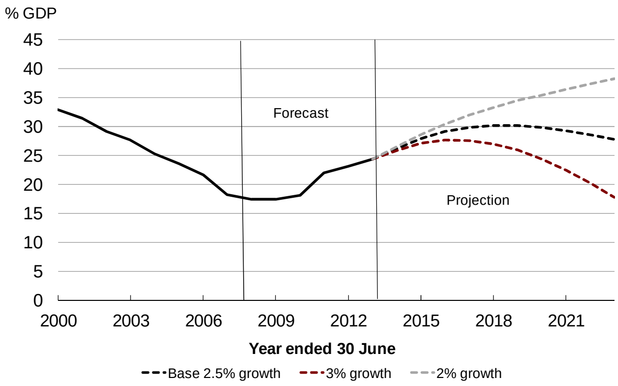
The projections are sensitive to the assumptions used …

The projections are dependent on the assumptions chosen about how elements of revenue and expenditure will change over time. Differences in these assumptions would result in different medium-term fiscal projections.

The Treasury has decided to use the same assumptions in the *Pre-election Update* projections as those used in the *2008 FSR*. These are outlined in the annex below. This reflects the Treasury's best judgement as to the most appropriate interpretation of current policy for the purposes of medium-term budgeting decisions. This is because medium-term assumptions around operating and capital allowances reflect the budgeting approach currently used and also applied in the forecast period.

To illustrate the sensitivity of the projections to assumptions, Figure 2.18 shows the impact on GSID (excluding Settlement Cash) of real GDP growth in the projection period being 0.5% higher or lower in each year than the 2.5% rate assumed in the central projection. In this scenario an increase in real GDP growth is assumed to be driven by an increase in productivity, which flows through into higher wages and nominal GDP and higher tax revenue. Because in the projections most expenditure is not linked to wage growth and instead grows at 2% per annum, the overall impact would be to reduce GSID (excluding Settlement Cash) as a percentage of GDP by ten percentage points by the end of the projection period.

Figure 2.18 – Changing the real GDP growth assumption in the projection period (impact on GSID excluding Settlement Cash)



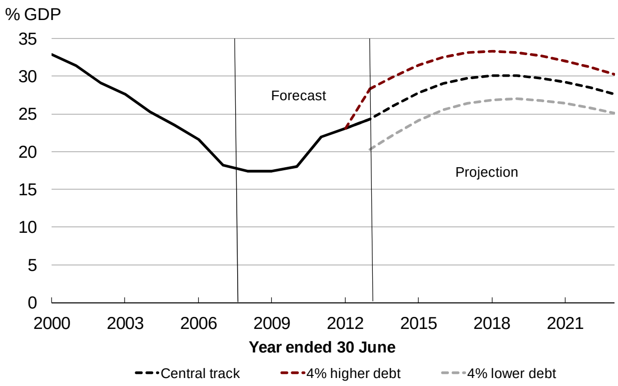
Source: The Treasury

… and to the starting point

The projections are also dependent on the fiscal forecasts for the period 2008/09 to 2012/13, as these are the starting point from which the projections grow. If fiscal results turn out to be higher or lower than in the forecasts, this would result in a different debt ratio in 2012/13, and debt would then develop from that higher or lower starting point.

To illustrate this, Figure 2.19 shows how GSID (excluding Settlement Cash) as a share of GDP would evolve in the projection period if the starting debt ratio in 2012/13 were to be four percentage points higher or lower.

Figure 2.19 – Changing the starting point: GSID (excluding Settlement Cash) with a higher or lower starting point in 2012/13



Source: The Treasury

Long-Term

Beyond the 10-year projection period presented here, the proportion of New Zealand's population aged over 65 will start to rise significantly relative to the working age population. In the Treasury's 2006 *Statement of the Long-term Fiscal Position* we outlined how this will put pressure on the costs of health care and New Zealand Superannuation in particular, under the assumption of continuation of existing policies and cost trends over the next 40 years. The long-term fiscal situation is still subject to the same challenges outlined in the 2006 *Statement*, particularly the pressures of an ageing population. We have not updated the 2006 report, but our preliminary assessment is that the long-term fiscal position has deteriorated, in that debt rises more quickly than was set out previously. A full statement is likely to be published in 2009.

Annex: Assumptions for Medium-term Fiscal Projections

The assumptions for the medium-term fiscal projections are outlined below. The full assumptions can be found in the *2008 FSR*, at http://www.treasury.govt.nz/budget/2008/fsr/

Table A1 – Summary of economic and demographic assumptions*

June year[7]	2009	2010	2011	2012	2013	2014	2015	2016	2017	…..	2023
	Forecasts					Projections					
Labour force	0.9	0.6	0.7	1.1	1.4	0.9	1.0	0.9	0.8		0.6
Unemployment rate**	4.3	5.0	5.1	4.9	4.6	4.6	4.6	4.6	4.6		4.6
Employment	0.2	-0.2	0.5	1.3	1.7	0.9	1.0	0.9	0.8		0.6
Labour productivity growth***	0.2	2.5	2.7	1.9	1.2	1.5	1.5	1.5	1.5		1.5
Real GDP	0.2	2.3	3.4	3.4	3.1	2.5	2.5	2.4	2.4		2.1
Consumer price index (annual % change)	3.4	2.3	2.4	2.5	2.4	2.2	2.0	2.0	2.0		2.0
Government 10-year bonds (quarterly % rate)	6.3	6.3	6.2	6.1	6.0	6.0	6.0	6.0	6.0		6.0
Nominal average hourly wage	5.4	4.1	4.0	3.7	3.5	3.8	3.6	3.5	3.5		3.5

* Annual average % change unless otherwise stated.

** Level of unemployment.

*** Full-time equivalent employed measure.

Sources: The Treasury, Statistics New Zealand

[7] Note that the economic forecasts in the *Pre-election Update* are based on a March year.

Table A2 – Summary of fiscal assumptions

Tax revenue	Linked to growth in nominal GDP, with a constant tax-to-GDP ratio assumed for all components except for PAYE. PAYE is grown by multiplying nominal GDP growth by an elasticity of 1.4.
New Zealand Superannuation	Currently indexed to inflation but is constrained for a married couple to the equivalent of 65% to 72.5% of average weekly earnings. By 2013/14, the 65% wage floor is reached and growth in the expense is driven by demographic changes and nominal wage growth. Assumes the average tax rate on New Zealand Superannuation increases due to fiscal drag which arises due to PAYE growing faster than nominal GDP.
Other benefits	Demographically adjusted and linked to inflation.
Health and education	Demographically adjusted.
Finance costs	A function of debt levels and interest rates.
Other	Not demographically adjusted.
Operating allowance	$1.694 billion in 2013/14. This is equivalent to $1.894 billion with a $200 million adjustment which is the approximate expense that is already included in projected baselines as a result of demographic growth. $1.894 billion is based on the $1.750 billion new spending allowance set for Budget 2009, with subsequent operating allowances increasing at the rate of inflation over the forecast and projection periods.
Capital allowance	$900 million in 2013/14, increasing at inflation.
Surplus NZDMO financial assets	$0 billion.
NZS Fund	Contributions to the Fund are assumed to be consistent with the New Zealand Superannuation Fund Act 2001[8].
Future emissions liabilities	The Kyoto liability included in fiscal forecasts reflects the Government's obligation for Commitment Period 1, which is for the period 2008 to 2012. Base case projections beyond 2013/14 do not incorporate a quantitative estimate of any net emissions liability that may eventuate from New Zealand's obligations under future international climate change agreements.

Source: The Treasury

Assumptions about the Emissions Trading Scheme (ETS)

The fiscal impact of the ETS depends on several highly uncertain factors, most notably future carbon prices and New Zealand's emissions targets from future international climate change agreements. The ETS has no impact on debt beyond 2012/13 in fiscal projections as a policy of full recycling of revenue is assumed. Net revenue (the value of credits received after free allocation of credits to participating industries and after meeting future emission liabilities) is assumed to be recycled back to the public through fiscally equivalent, unspecified tax reductions or spending increases.

---

8 The *Pre-election Update* provides details on contributions over the next four years. Further details can be found in "Financing New Zealand Superannuation", a Treasury *Working Paper 01/20*, available at www.treasury.govt.nz/workingpapers/2001/01-20.asp

An indication of possible net revenue from the ETS is presented in the table below based on assuming:

- a carbon price of $25 or $50 per tonne CO2-equivalent, and
- three potential emissions targets New Zealand might face under future international agreements, where the target is set relative to emissions in 1990.

Table A3 – possible ETS net revenue

Projections, $millions, calendar years	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Crown net revenue if carbon price							
= $25/tonne of CO^2-equivalent							
Scenario 1: target 100% of 1990 emissions	484	522	546	526	499	667	482
Scenario 2: target 90% of 1990 emissions	331	370	393	373	346	514	329
Scenario 3: target 80% of 1990 emissions	176	214	238	218	191	359	174
Crown net revenue if carbon price							
= $50/tonne of CO^2-equivalent							
Scenario 1: target 100% of 1990 emissions	1,011	1,068	1,045	1,033	937	1,166	975
Scenario 2: target 90% of 1990 emissions	706	763	740	727	632	861	670
Scenario 3: target 80% of 1990 emissions	395	452	429	417	321	550	359

These estimates assume 50% of post-1989 foresters receive credits and the associated liabilities when forests are harvested. Revenue to the Government from unallocated credits exceeds the cost of liabilities from harvesting activities each year until 2020. Beyond 2020, this reverses in line with projected increases in harvesting.

Estimates also incorporate the fiscal impact of higher revenue to renewable electricity generators who do not face a corresponding increase in fuel costs. It is assumed the Government receives 30% of the revenue gain to private companies through tax. For SOE electricity producers, the Crown receives 50% of the revenue increase through both tax and dividends.

Risks to Fiscal Forecasts

The fiscal forecasts were finalised on 17 September 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 17 September 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 *Pre-election Update* are based on current tax policy and on the macroeconomic central forecast. Given the many tax policy changes that have been enacted recently (cut in company income tax rate, movements in personal income tax thresholds, introduction of PIE and FDR regimes for taxation of investments, etc), there is considerable uncertainty around exactly how these changes will pan out and their effect on the tax take. Sensitivities of tax revenue to changes in economic conditions are also presented in the *Risks and Scenarios* chapter on page 56.

KiwiSaver risks

Baselines reported by Inland Revenue incorporate an assumed take-up rate profile for the KiwiSaver regime. The actual take-up rate could be higher or lower than assumed, or faster or slower than assumed, representing an unquantified risk to the operating balance.

ETS risks

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

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 change in the NZ dollar (from 30 June 2008) may affect the current physical asset values included in the fiscal forecasts.

Discount rates

The Government Superannuation Fund and ACC liabilities included in these forecasts have been valued as at 30 June 2008. The liabilities are to be next valued for the *2009 Budget Update*. 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 Pre-election 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 (FRSB) 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 *2008 Financial Statements of the Government*.