2

Fiscal Outlook

Overview

Table 2.1 – Fiscal indicators

Year ended 30 June	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
$billions						
Total Crown OBEGAL[1]	(4.4)	(2.4)	0.4	1.3	2.4	3.5
Core Crown residual cash	(5.7)	(3.9)	(4.3)	(1.8)	(0.1)	0.7
Net core Crown debt[2]	55.8	59.4	63.6	65.3	65.5	64.9
Net worth attributable to the Crown	68.1	70.0	73.1	77.3	82.7	89.5
% of GDP						
Total Crown OBEGAL[1]	(2.1)	(1.1)	0.2	0.5	0.9	1.3
Core Crown residual cash	(2.7)	(1.7)	(1.8)	(0.7)	(0.0)	0.3
Net core Crown debt[2]	26.2	25.8	26.4	25.9	24.9	23.8
Net worth attributable to the Crown	32.0	30.4	30.3	30.6	31.5	32.8

Notes: 1 Operating balance before gains and losses.
2 Net core Crown debt excluding the New Zealand Superannuation Fund (NZS Fund) and advances.

Source: The Treasury

- Core Crown tax revenue is expected to increase across the forecast period and by 2017/18 is expected to be $18.9 billion higher than 2012/13, reflecting the growth in the nominal economy, as discussed in the Economic Outlook chapter.

- The 2013/14 tax forecast has been revised downwards owing to weakness in the current year's results to date. However, this weakness is expected to dissipate by 2014/15 owing to higher growth in the drivers of tax revenue that year.

- The Budget 2014 operating allowance averaged $1.0 billion per annum, with the Government's decision to set future allowances at $1.5 billion per annum from Budget 2015 (growing at 2% per annum per Budget). When an increase in social assistance spending is added, core Crown expenses are expected to rise by $11.1 billion by the end of the forecast period. This increase is slower than growth in the nominal economy so by the end of the forecast period core Crown expenses fall to below 30% of GDP.

- These forecasts show that the Government is expected to achieve its fiscal objective of a return to surplus in 2014/15 with an OBEGAL surplus of $0.4 billion. Beyond 2014/15 these surpluses are expected to increase by between $0.9 and $1.1 billion each year and by 2017/18, the OBEGAL surplus is expected to reach $3.5 billion.

- In nominal terms, net core Crown debt increases before falling in 2017/18 as residual cash returns to surplus. As a share of GDP, net core Crown debt declines after 2015, falling to 23.8% by the end of 2017/18.

- The Government Share Offer programme has concluded, with gross proceeds of $4.7 billion available for the Future Investment Fund.

- The Crown's balance sheet continues to strengthen, enabling buffers to be built to sustain government services in the event of future shocks.

- In preparing these fiscal forecasts, key assumptions have been made on the performance of the economy and new operating allowances. As with all assumptions, there is inherent uncertainty and a change in any one assumption could negatively or positively impact the Crown's forecast surpluses and net core Crown debt position. The Risks and Scenarios and the Specific Fiscal Risks chapters outline the key risks to the Crown achieving these forecasts.

Table 2.2 – Reconciliation between OBEGAL and net core Crown debt

Year ending 30 June $billions	**2013 Actual**	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**
Core Crown revenue	64.1	67.8	72.5	76.9	80.8	84.7
Core Crown expenses	(70.3)	(71.6)	(73.1)	(76.0)	(78.7)	(81.5)
Net surpluses/(deficits) of SOEs and CEs	1.8	1.4	1.0	0.4	0.3	0.3
Total Crown OBEGAL	**(4.4)**	**(2.4)**	**0.4**	**1.3**	**2.4**	**3.5**
Net retained surpluses of SOEs, CEs and NZS Fund	(1.2)	(1.2)	(0.9)	(0.3)	(0.2)	(0.2)
Non-cash items and working capital movements	1.1	1.4	1.6	1.9	2.4	1.7
Net core Crown cash flow from operations	**(4.5)**	**(2.2)**	**1.1**	**2.9**	**4.6**	**5.0**
Net purchase of physical assets	(1.2)	(2.0)	(2.2)	(2.0)	(2.1)	(1.8)
Advances and capital injections	(1.7)	(2.0)	(3.5)	(2.1)	(1.9)	(1.6)
Forecast for future new capital spending	-	-	(0.3)	(0.6)	(0.7)	(0.9)
Proceeds from government share offers	1.7	2.3	0.6	-	-	-
Core Crown residual cash balance	**(5.7)**	**(3.9)**	**(4.3)**	**(1.8)**	**(0.1)**	**0.7**
Opening net core Crown debt	50.7	55.8	59.4	63.6	65.3	65.5
Core Crown residual cash deficit/(surplus)	5.7	3.9	4.3	1.8	0.1	(0.7)
Valuation changes in financial instruments	(0.6)	(0.3)	(0.1)	(0.1)	0.1	0.1
Closing net core Crown debt	**55.8**	**59.4**	**63.6**	**65.3**	**65.5**	**64.9**
As a percentage of GDP	**26.2%**	**25.8%**	**26.4%**	**25.9%**	**24.9%**	**23.8%**

Source: The Treasury

Core Crown Tax Revenue

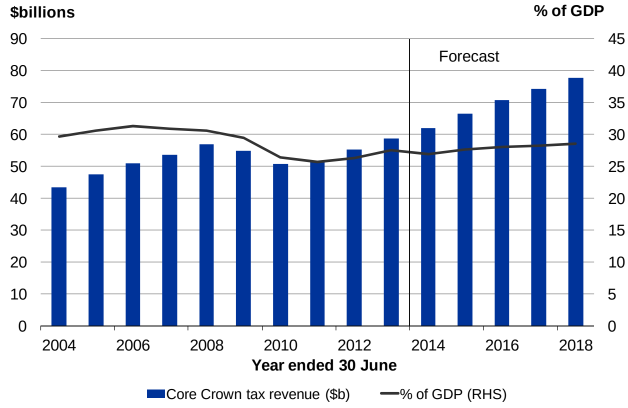
Tax revenue grows by 5.8% per annum on average over the forecast period...

Core Crown tax revenue is forecast to rise in each year of the forecast period, although at a lower rate than previously expected. While tax in the current year is weaker than previously forecast, growth of 5.8% per annum across the forecast period is still expected.

By 2017/18 core Crown tax revenue is expected to reach $77.6 billion, $18.9 billion higher than in 2012/13. Forecast tax revenue increases relative to nominal GDP, reaching 28.5% by the end of the forecast period compared to 27.5% in 2012/13 (Figure 2.1).

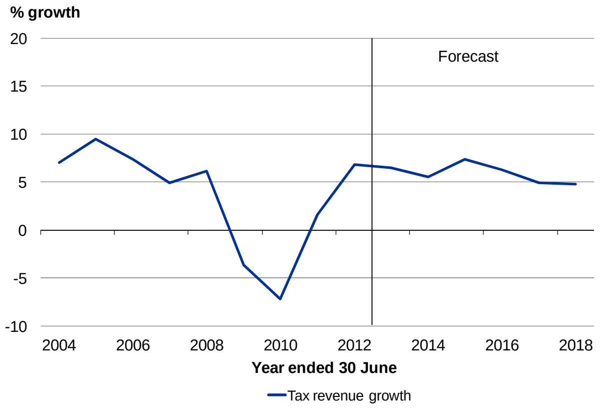
Most of the growth in tax revenue forecasts can be attributed to growth in the nominal economy, with nominal GDP forecast to grow at 5.1% per annum on average over the forecast period. Tax revenue growth increases in 2014/15 before slowing over the remainder of the forecast period as the growth in nominal GDP slows (Figure 2.2).

Figure 2.1 – Core Crown tax revenue



Source: The Treasury

Figure 2.2 – Core Crown tax revenue growth



Source: The Treasury

All tax types are expected to increase across the forecast period, with individuals' source deductions (PAYE) and goods and services tax (GST) showing the most significant growth, as shown in Table 2.3.

Table 2.3 – Growth in core Crown tax revenue over the forecast period by tax type

Year ending 30 June $billions	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	Total
Movement in core Crown tax owing to:						
Source deductions	1.5	1.4	1.4	1.5	1.7	**7.5**
Other persons tax	0.1	0.4	0.1	0.2	0.1	**0.9**
Corporate tax	0.4	0.5	0.5	0.3	0.3	**2.0**
Residential Withholding Tax (RWT)	-	0.4	0.6	0.4	0.4	**1.8**
Goods and Services Tax (GST)	1.1	1.5	1.1	0.8	0.9	**5.4**
Other taxes	0.1	0.3	0.5	0.3	0.1	**1.3**
Total movement in core Crown tax	**3.2**	**4.5**	**4.2**	**3.5**	**3.5**	**18.9**
Plus: previous year's tax base	58.7	61.9	66.4	70.6	74.1	**58.7**
Core Crown tax revenue	**61.9**	**66.4**	**70.6**	**74.1**	**77.6**	**77.6**
As a % of GDP	**26.8%**	**27.6%**	**28.0%**	**28.2%**	**28.5%**	

Source: The Treasury

Growth in employees' compensation (contributing $6.2 billion to the growth in source deductions and the progressive nature of the personal tax scale (fiscal drag) see source deductions increase by $7.5 billion over the forecast period.

Growth in corporate profits are the main drivers behind corporate tax increasing by $2.0 billion over the forecast period, while growth in private consumption contributes to a $5.4 billion increase in GST.

Increased residential investment continues to contribute to the forecast growth in tax revenue, boosting GST by $1.4 billion by 2017/18 as residential investment is forecast to grow at an average rate of 13.8% per annum. This growth is partly offset by GST refunds to insurers, as a large part of the Canterbury residential rebuild is funded by insurance claims.

The 90-day bank bill interest rate is expected to rise from 2.6% on average in 2012/13 to 5.2% by 2017/18. This rise, together with growth in the interest-bearing deposit base, results in growth in tax on interest earned on residents' savings (RWT) of about $1.8 billion across the forecast period.

Table 2.4 – Composition of growth in core Crown tax revenue over the forecast period

Year ending 30 June **$billions**	**2014** **Forecast**	**2015** **Forecast**	**2016** **Forecast**	**2017** **Forecast**	**2018** **Forecast**	**Total**
Movement in core Crown tax owing to:						
Employees' compensation	1.4	1.2	1.1	1.2	1.3	**6.2**
Entrepreneurial income	0.5	0.2	0.1	0.2	0.1	**1.1**
Corporate profits	0.9	0.5	0.4	0.4	0.2	**2.4**
Private consumption	0.8	1.1	1.1	0.9	0.7	**4.6**
Residential investment	0.3	0.6	0.3	0.1	0.1	**1.4**
Interest rates	(0.1)	0.2	0.4	0.1	0.1	**0.7**
Fiscal drag	0.2	0.2	0.3	0.3	0.4	**1.4**
Policy changes	-	0.1	0.1	0.1	-	**0.3**
Timing and other factors	(0.8)	0.4	0.4	0.2	0.6	**0.8**
Total movement in core Crown tax	**3.2**	**4.5**	**4.2**	**3.5**	**3.5**	**18.9**
Plus: previous year's tax base	58.7	61.9	66.4	70.6	74.1	**58.7**
Core Crown tax revenue	**61.9**	**66.4**	**70.6**	**74.1**	**77.6**	**77.6**

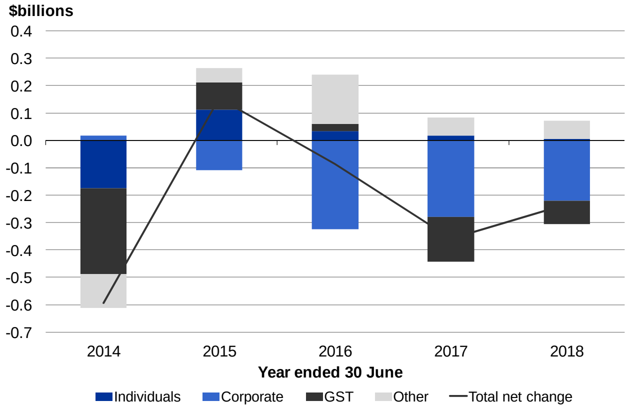
Source: The Treasury

Budget 2014 includes policy changes totalling $0.3 billion across the forecast period. The largest positive changes come from an Inland Revenue initiative targeting unfiled tax returns and a reduction in the duty-free tobacco concession ($0.2 billion each), with other minor changes slightly reducing tax. These policy changes are discussed in further detail in the *Additional Information* document (on the Treasury website).

Although growth in tax revenue is forecast, risks to the forecast tax outturn remain, particularly if the assumptions on the economic outlook do not materialise as expected. The Risks and Scenarios chapter provides further discussion of the risks around tax revenue.

...but is weaker than at the Half Year Update

Figure 2.3 – Movement in core Crown tax revenue since the *Half Year Update*



Source: The Treasury

Overall, tax revenue is $1.1 billion less than the *Half Year Update* across the forecast period, with $0.6 billion relating to the 2013/14 year.

The downward revision in tax revenue in the current year is partly owing to assumptions made at the *Half Year Update* not eventuating – in particular, in individuals' tax, GST and excise duties (eg, higher earthquake-related insurance refunds than previously assumed and strength in excise that was previously assumed to be permanent but is timing-related). The reduction in the current year forecasts of $0.6 billion consists of $0.2 billion for individuals' tax, $0.3 billion for GST and $0.1 billion for other taxes (Figure 2.3).

While the current year's tax take is lower than previously forecast, this weakness is not expected to flow through to 2014/15, as stronger economic growth in that year is expected to boost tax revenues and offset the current year's weakness. Tax policy changes (as discussed above) since the *Half Year Update* also contribute to the increase in tax in 2014/15. However, the forecast for nominal GDP growth from 2015/16 onwards is lower than in the *Half Year Update*, reducing the core Crown tax revenue forecast in those years.

Tax Revenue Relative to GDP: Change Since the *Half Year Update*

Core Crown tax revenue as a percentage of GDP is lower than in the *Half Year Update* for all years of the forecast period. The average reduction across all forecast years is 0.3% of GDP. The largest movement is -0.6% and this occurs in the current year.

Table 2.5 – Drivers of change in core Crown tax revenue relative to GDP

Year ending 30 June **% of GDP**	**2014** **Forecast**	**2015** **Forecast**	**2016** **Forecast**	**2017** **Forecast**	**2018** **Forecast**
GDP revisions	(0.06)	(0.06)	(0.06)	(0.06)	(0.06)
Composition of GDP	(0.19)	(0.12)	(0.27)	(0.24)	(0.29)
Other factors	(0.35)	0.02	0.14	(0.02)	0.03
Total change	**(0.60)**	**(0.16)**	**(0.19)**	**(0.32)**	**(0.32)**
Plus 2013 *Half Year Update* forecast	27.43	27.73	28.18	28.50	28.81
2014 *Budget Update* forecast	**26.83**	**27.57**	**27.99**	**28.18**	**28.49**

Source: The Treasury

Since the *Half Year Update*, values of nominal GDP for the recent past have been revised up by Statistics New Zealand (reducing the tax-to-GDP ratio for the year ended 30 June 2013). Since the 2013 year is the base year from which subsequent years' tax revenue is forecast, this has reduced the tax-to-GDP in all forecast years (by around 0.06%). Revisions to nominal GDP occur regularly as Statistics New Zealand updates for new information or incoporate new statistical standards and classifications.

Also, not all components of GDP grow at the same rate as total nominal GDP. Since the various tax bases are taxed at different rates (eg, salaries and wages are taxed at personal tax rates and domestic consumption is taxed at a flat rate of 15%), changes in the composition of GDP will affect the overall tax-to-GDP ratio. This effect is shown in the "Composition of GDP" line in Table 2.5.

There are many other factors that can cause tax revenue to grow at a different rate to GDP, thereby affecting the tax-to-GDP ratio. These might be timing effects that shift tax revenue from one year to another, or changes in tax on income that is not included in GDP (eg, investment income).

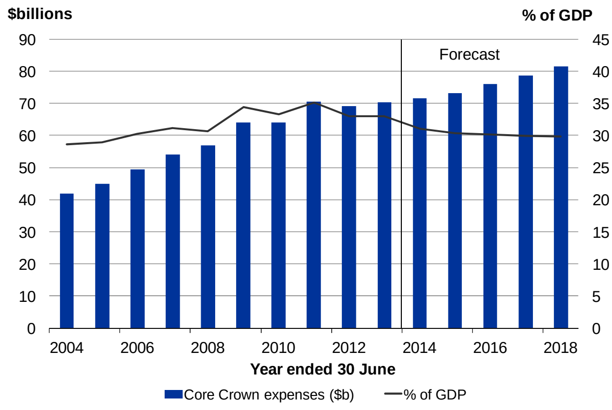
The 2013/14 "Other factors" include changes to the timing of earthquake-related GST refunds, growth in source deductions that is not as strong as underlying economic drivers, and changes to assumptions on tobacco excise.

Core Crown Expenses

Core Crown expenses grow across the forecast period...

Core Crown expenses are expected to increase in nominal terms by $11.1 billion over the forecast period (Figure 2.4). However, as growth in core Crown expenses is forecast to be at a slower rate than growth in the nominal economy, they fall from 33.0% of GDP in 2012/13 to 29.9% of GDP by the end of the forecast period. In 2015/16, core Crown expenses are expected to stand at 30.1% of GDP, consistent with the Government's target of reducing expenses to around 30% of GDP by 2015/16.

Figure 2.4 – Core Crown expenses



Source: The Treasury

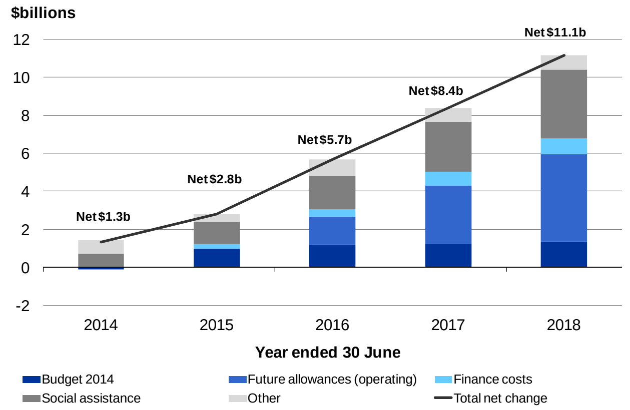
Nominal growth in core Crown expenses is largely attributable to new budget spending, along with increased social assistance spending as shown in Figure 2.5.

Offsetting these increases, core Crown expenses for the Canterbury rebuild decrease over the forecast period as the most significant operating expenses have already been recognised and the Crown moves into more of an investment phase (refer to box on page 34 for details of the profile and phasing of earthquake expenses).

The Budget 2014 package includes an average net spend of $1.0 billion each year (Table 2.6). As a portion of the package relates to revenue initiatives, the gross increase in expenditure averages $1.2 billion.

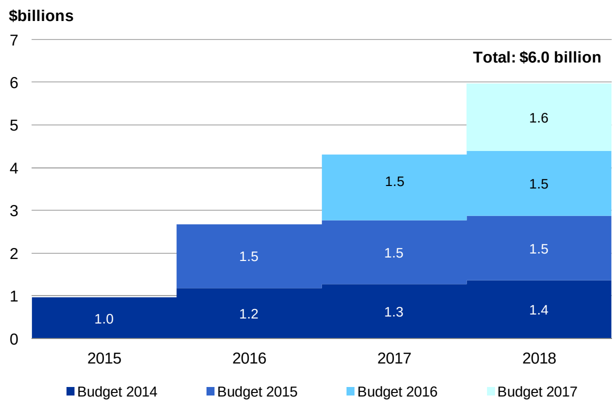
Future operating allowances are $1.5 billion per annum from Budget 2015 (increasing by 2% each Budget thereafter). Without further information on how these will be allocated, these allowances are assumed to flow through as expenses. When combined, new spending reaches $6.0 billion by 2017/18 (Figure 2.6). However, these operating allowances can be used for a combination of both revenue and expense initiatives when allocated.

Figure 2.5 – Increase in core Crown expenses



Source: The Treasury

Figure 2.6 – Budget 2014 and future Budget allowances



Source: The Treasury

The following table summarises the impact of the Budget 2014 package on core Crown revenue and expenses.

Table 2.6 – Summary of changes in revenue and expenses arising from Budget 2014

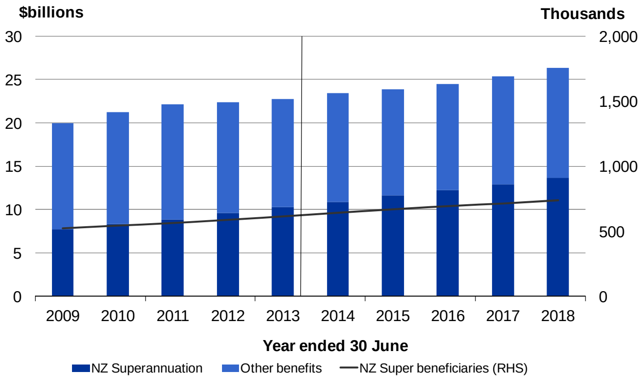
Year ending 30 June **$billions**	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**	**4-year Average**
Core Crown revenue	-	0.1	0.2	0.2	0.2	**0.2**
Core Crown expenses	(0.1)	1.0	1.2	1.3	1.4	**1.2**
OBEGAL impact	**(0.1)**	**0.9**	**1.0**	**1.1**	**1.2**	**1.0**
Composition of core Crown expense increase:						
Health	-	0.4	0.5	0.4	0.5	**0.4**
Education	-	0.1	0.2	0.2	0.3	**0.2**
Defence	-	0.1	0.1	0.2	0.2	**0.1**
Social development	-	0.1	0.1	0.1	0.1	**0.1**
Families package	-	0.1	0.1	0.1	0.1	**0.1**
Business Growth Agenda initiatives	-	0.1	0.2	0.1	0.1	**0.1**
Other (including savings)	(0.1)	0.1	-	0.2	0.1	**0.2**
Increase in core Crown expenses	**(0.1)**	**1.0**	**1.2**	**1.3**	**1.4**	**1.2**

Source: The Treasury

Refer to the *Minister's Executive Summary* document for further details of the Budget 2014 package.

Outside new budget spending, social assistance spending is expected to increase by $3.6 billion across the forecast period. New Zealand Superannuation payments (which makes up around half of social assistance costs), grow by $3.4 billion as payments are linked to wage growth and recipient numbers increase (Figure 2.7). Other benefit types also increase marginally over the forecast period.

Figure 2.7 – Social assistance spending



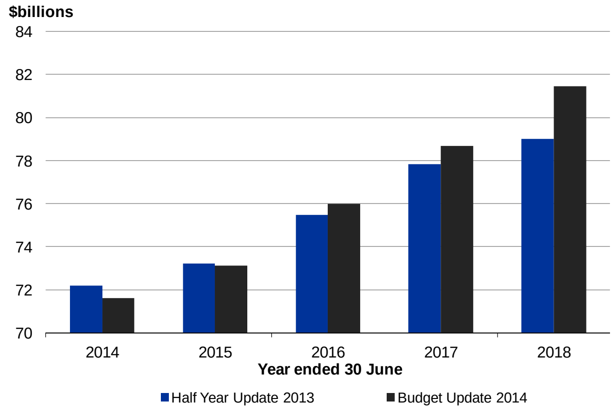
Source: The Treasury

Finance costs increase by $0.8 billion over the forecast period as gross debt continues to increase alongside rising interest rates.

...and have increased since the previous forecasts

While current year's expenses are slightly lower than forecast at the *Half Year Update*, by the end of the forecast period expenses are around $2.4 billion higher than previously expected (Figure 2.8). This increase is largely owing to the Government's decision to increase operating allowances for future Budgets to $1.5 billion, up from $1.0 billion at the *Half Year Update*.

Figure 2.8 – Changes in core Crown expenses since the *Half Year Update*



Source: The Treasury

Slightly stronger real growth coupled with the ongoing impact of welfare reform see unemployment-related benefit recipient numbers reduce over the forecast period and associated social assistance expenses fall compared to the *Half Year Update*. Refer Table 2.7 in the Operating Balance section for changes to benefit expenses since the *Half Year Update*.

Operating Balance

The Crown is forecast to return to surplus in 2014/15…

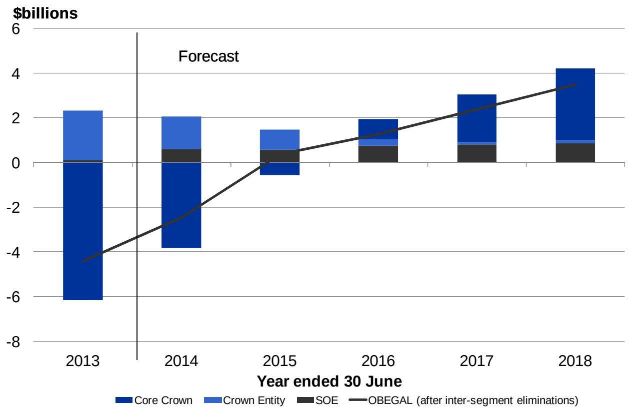
The operating balance before gains and losses (OBEGAL) is expected to return to surplus in 2014/15 with a surplus of $0.4 billion forecast. Beyond 2014/15 surpluses are expected to increase by between $0.9 billion and $1.1 billion per annum.

Figure 2.9 shows the composition of OBEGAL from the different segments of the Government.

The core Crown segment moves from a forecast OBEGAL deficit of $3.8 billion in 2013/14 to a forecast $3.2 billion surplus by 2017/18, largely reflecting growth in tax revenue.

The State-owned Enterprise (SOE) and Crown entity (CE) segments together contribute $2.1 billion to the OBEGAL surplus in 2013/14, halving to $1.0 billion by the end of the forecast period largely reflecting reductions in ACC levy rates announced in Budget 2013. The SOE segment's contribution stays relatively static across the forecast.

Figure 2.9 – Components of OBEGAL by segment



Source: The Treasury

Surpluses are achieved in 2014/15 and continue to increase over the forecast period to a level that translates to being sufficient to fund the Government's capital spending as well as a reduction of debt. Maintaining a level of fiscal restraint while the economy grows will allow surpluses to be built up. These surpluses are important to enable a buffer to be built in the case of future shocks such as a global financial crisis or another large natural disaster.

...although post-2014/15 OBEGAL is lower compared to previous forecasts

OBEGAL is lower in all years with the exception of 2014/15. While lower than what had previously been forecast, nevertheless by the end of the forecast period an OBEGAL surplus of $3.5 billion is expected (Table 2.7).

Table 2.7 – Changes in OBEGAL since the *Half Year Update*

Year ending 30 June $billions	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**
OBEGAL – 2013 *Half Year Update*	**(2.3)**	**0.1**	**1.7**	**3.1**	**5.6**
Changes in forecasts:					
Tax revenue	(0.6)	0.1	(0.1)	(0.2)	(0.3)
Budget 2014 package	0.1	0.1	-	(0.1)	(0.2)
Increase in future budget allowances	-	-	(0.5)	(1.0)	(1.5)
Social assistance expenses	-	(0.1)	0.1	0.2	0.1
ACC forecasts	0.1	-	0.1	0.2	0.3
EQC forecasts	0.1	0.2	0.1	-	-
Net finance costs	(0.2)	-	-	(0.1)	(0.2)
Other changes	0.4	-	(0.1)	0.3	(0.3)
Total changes since the *Half Year Update*	(0.1)	0.3	(0.4)	(0.7)	(2.1)
OBEGAL – 2014 *Budget Update*	**(2.4)**	**0.4**	**1.3**	**2.4**	**3.5**

Source: The Treasury

Major changes include:

- Tax revenue is slightly weaker than the *Half Year Update* (refer page 25).
- The Budget 2014 package has a positive impact in the first two years as spending is rephased to later years. The Government has made a number of decisions in Budget 2014 to manage the fiscal impact of spending on the 2014/15 year.
- An increase in new operating allowances from Budget 2015 ($1.5 billion increasing by 2% annually per Budget thereafter) reduces OBEGAL in the later years.
- Social assistance expenses, while higher than previously forecast in 2014/15, are expected to be less than previously forecast largely as a result of the declining number of benefit recipients.
- The positive ACC result largely reflects updated assumptions on the 2015/16 proposed reductions in the Work Account levy (now less than expected). In addition, a reduction in insurance claim expenses is expected, reflecting lower rates of growth in the cost of claims.
- Earthquake Commission (EQC) results are more positive owing to lower forecast insurance expenses after an updated valuation of EQC's insurance liabilities at 31 December 2013.
- Finance costs have increased compared to the *Half Year Update* largely as a result of rising interest costs and higher nominal net core Crown debt than previously forecast.

Operating Balance Indicators

In addition to OBEGAL and the operating balance (both of which are total Crown indicators), other operating indicators are useful in measuring different aspects of performance.

Cyclically Adjusted Balance (CAB)

The underlying nature of OBEGAL can be seen using CAB. This measure adjusts for the state of the economic cycle and significant one-off expenses. Figure 2.10 shows CAB tracking close to OBEGAL in recent years, indicating that the operating deficits between 2009 and 2013 have been largely structural. The projected size of the economy reduced during the recession, implying a smaller tax base while, in contrast, expenses continued to grow.

Government Financial Statistics (GFS)[3]

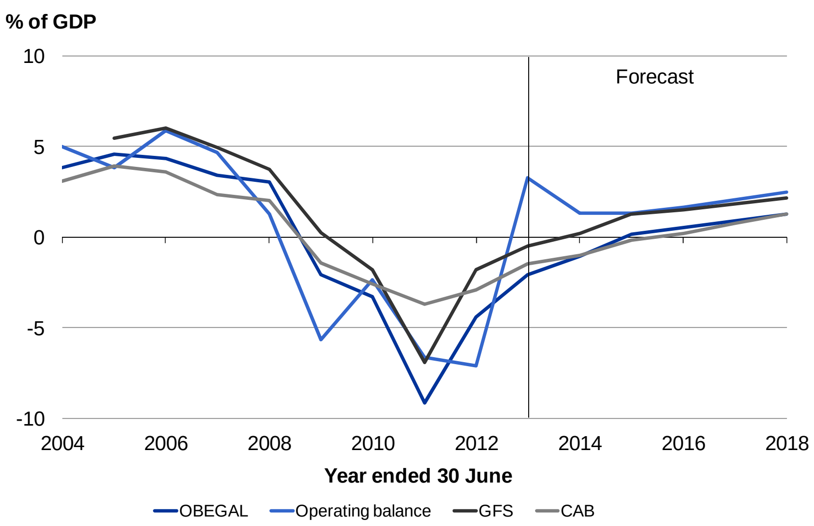
The net operating balance uses the framework developed by the International Monetary Fund called Government Financial Statistics and is specifically designed for government reporting. It is therefore a useful measure to compare with other countries. The net operating balance represents revenue and expenses of the core Crown (excluding the Reserve Bank) and CEs, and therefore excludes SOEs. It also excludes a wider range of valuation movements than OBEGAL, such as impairments and write-offs.

Table 2.8 – Operating balance indicators

Year ending 30 June % of GDP	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
OBEGAL	(2.1)	(1.1)	0.2	0.5	0.9	1.3
Operating balance	3.2	1.3	1.3	1.6	2.0	2.5
Cyclically-adjusted balance (CAB)	(1.5)	(1.0)	(0.2)	0.2	0.8	1.2
Net operating balance (GFS)	(0.5)	0.2	1.3	1.5	1.8	2.1

Source: The Treasury

Figure 2.10 – Operating balance indicators



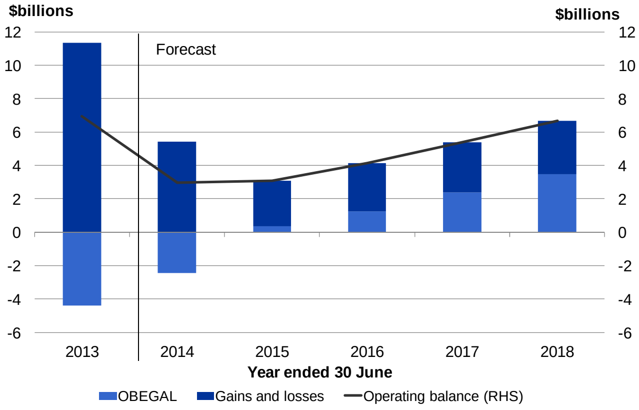
Source: The Treasury, IMF (GFS 2005-2006 years, GFS data unavailable for 2004)

3 For more details of both CAB and GFS, see the *Additional Information* document on the Treasury website www.treasury.govt.nz

... and strength in equity markets lifts the operating balance

When gains and losses are included, the total Crown operating balance is forecast to be in surplus across the forecast period. While growth in the operating balance is initially subdued, from 2014/15 the operating balance grows steadily (Figure 2.11). The current year's surplus is largely a result of gains expected to be made by Crown financial institutions (CFIs), largely ACC and NZS Fund, and reflects strong global equity returns (eg, by 31 March 2014 NZS Fund had made year-to-date gains of $2.6 billion). While the 2013/14 year reflects the current strong market growth, future years assume a lower long-term rate of return, resulting in subdued growth in these years. These gains play a part in increasing the Government's financial assets and the Crown's net worth (discussed on page 37).

Figure 2.11 – Components of operating balance



Source: The Treasury

In addition, updated long-term liability valuations for ACC (at 31 December 2013 updated for movements in discount rates to 31 March 2014) and the Government Superannuation Fund (GSF) (at 28 February 2014) have led to significant actuarial gains in the 2013/14 year (around $1.8 billion) which also contribute to the Crown's operating balance.

Given the size of the balance sheet, market movements can have a significant impact on the operating balance, as can be seen by comparing the current year's forecast with that of the 2012/13 year (Figure 2.11). The 2012/13 year included net gains of around $11.3 billion, largely as a result of gains on the investment portfolios of ACC and NZS Fund ($6.2 billion) and changes in discount rates leading to actuarial gains ($3.6 billion). While the current year's forecast includes strong returns for ACC and NZS Fund, the market is not as strong as the 2012/13 year, leading to a reduction in investment gains contributing to the operating balance. In addition, actuarial gains are forecast at just under half of the 2012/13 level, owing to smaller movements in discount rates in the year.

Cost to the Crown of the Canterbury Rebuild

Latest estimates for the total cost to the Crown are $15.4 billion to the end of the forecast period (compared to $14.9 billion in the *Half Year Update*). While core Crown costs have increased as new projects progress, Crown entity costs have reduced.

Core Crown costs have increased since the *Half Year Update* primarily owing to additional capital spending as the rebuild gets underway. These increases largely relate to the Greater Christchurch Education Renewal Programme as estimates of programmes in the outyears become clearer ($0.4 billion), the new Christchurch Housing Accord ($0.1 billion) and updated estimates for the new Canterbury hospitals. In addition, Budget 2014 allocated additional funding for the Christchurch central city anchor projects.

The increase in the core Crown costs was partially offset by a reduction in EQC costs arising from an updated actuarial valuation of its liability.

Table 2.9 outlines the latest estimates of the net impact of the earthquakes included in these forecasts, the operating/capital split and the expected cash profile of earthquake costs.

Table 2.9 – Net earthquake expenses (operating and capital)

Year ending 30 June $millions	2011-13 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast	Total *Budget Update*	*Total Half Year Update*
Local infrastructure	1,364	101	150	113	50	50	1,828	*1,828*
Crown assets[1]	40	214	586	420	456	280	1,996	*1,475*
Land zoning	912	(22)	-	92	52	-	1,034	*1,034*
Christchurch central city rebuild[2]	115	456	294	135	48	(18)	1,030	*909*
Welfare support	269	19	9	4	3	2	306	*292*
Southern Response support package	458	67	(72)	(23)	(13)	(2)	415	*360*
Other costs	508	128	154	120	55	32	997	*975*
Core Crown Canterbury earthquake recovery costs	**3,666**	**963**	**1,121**	**861**	**651**	**344**	**7,606**	***6,873***
EQC (net of reinsurance proceeds)	8,026	(412)	(198)	(125)	-	-	7,291	*7,528*
Other SOE and CEs	(217)	25	247	283	127	41	506	*507*
Total Crown	**11,475**	**576**	**1,170**	**1,019**	**778**	**385**	**15,403**	***14,908***
Operating and capital expenses								
Operating expenditure (OBEGAL)	11,253	(64)	251	358	212	122	12,132	*12,092*
Capital expenditure	222	640	919	661	566	263	3,271	*2,816*
Total Crown	**11,475**	**576**	**1,170**	**1,019**	**778**	**385**	**15,403**	***14,908***
Total cash payments[3]	**6,595**	**1,331**	**4,207**	**1,575**	**917**	**381**	**15,006**	***14,693***

Notes:
1. Crown assets includes capital expenditure on Canterbury hospitals, schools, Tertiary Education Institutions, housing and the Justice and Emergency Services Precinct.
2. Central city rebuild costs include land acquisition and are net of expected recoveries.
3. Some expenses are non-cash (eg, asset write-offs and impairments) and therefore do not have a cash element to them.

Source: The Treasury

These are the latest estimates of the cost to the Crown of the Canterbury rebuild as included in these forecasts. The Specific Fiscal Risks chapter discusses the fiscal risks associated with the Canterbury earthquake forecast net expenses.

While the expenses are largely recognised up front and indicate the Crown's obligation, the cash profile reflects the expected timing of payments to settle these obligations. As with the expenses, risks also remain regarding the timing of cash payments.

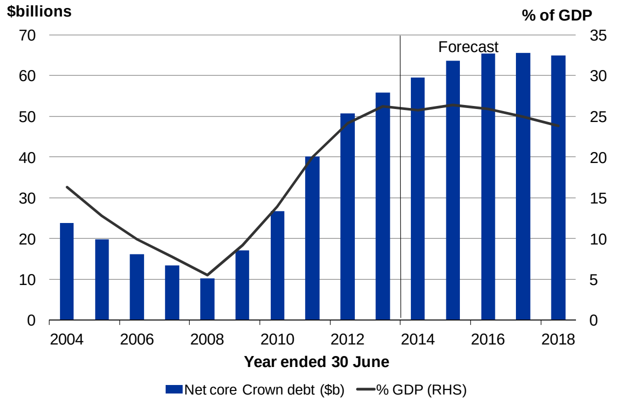
Net Core Crown Debt

Net core Crown debt peaks as a share of GDP in 2014/15...

Cash deficits are funded by an increase in net core Crown debt[4] (through additional borrowing or a reduction in financial assets), while cash surpluses reduce net core Crown debt.

While operating cash flows return to surplus in 2014/15, net capital spending is forecast to exceed operating cash flows until 2017/18, resulting in core Crown residual cash[4] remaining in deficit until then.

Figure 2.12 – Net core Crown debt



Source: The Treasury

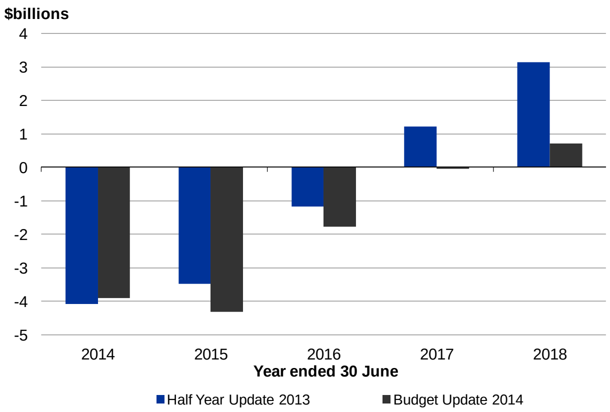
Over the forecast period, the Government is expected to generate cash flows from core Crown operations of $11.4 billion and will receive the remaining proceeds ($2.9 billion) from the Government share offer. The core Crown is forecast to spend $23.7 billion on capital items, which include purchasing physical assets (eg, school buildings), advances (eg, student loans) and future new capital spending. Overall, there is therefore a residual cash shortfall of $9.4 billion. As a result of the residual cash shortfall, net core Crown debt is expected to increase in nominal terms and to peak on an annual basis in 2016/17 at $65.5 billion, and then reduce once residual cash surpluses are achieved.

Net core Crown debt as a share of GDP peaks in 2014/15 at 26.4% (Figure 2.12). By 2017/18 net core Crown debt is expected to be 23.8% of GDP, consistent with the Government's medium-term target of net core Crown debt at a level no higher than 20% of GDP by 2020.

...but is higher than the Half Year Update*...*

Core Crown residual cash returns to surplus one year later and at a lower level than forecast in the *Half Year Update* (Figure 2.13), largely owing to higher operating allowances and lower tax receipts than previously forecast. As a result, net core Crown debt in nominal terms is forecast to be higher than at the *Half Year Update.* However, as a share of GDP, it is similar to that previously forecast.

Figure 2.13 – Core Crown residual cash



Source: The Treasury

4 Net core Crown debt and residual cash indicators are measured on a core Crown basis. Residual cash includes both operating and capital activity. This differs from OBEGAL, which is measured at a total Crown level and includes operating activity only.

...with government bond issuances funding residual cash deficits

The bond programme to 2017/18 is $3.0 billion higher than forecast in the *Half Year Update,* largely owing to a greater cash shortfall over the forecast period ($9.4 billion compared to the previous forecast of $4.4 billion). In order to fund this shortfall, along with bond maturities, the bond programme is expected to raise funds of $36.3 billion over the forecast period, while $25.3 billion of existing debt will be repaid, providing net cash proceeds of $11.0 billion (Table 2.10). Any excess cash proceeds raised from the bond programme will be invested in financial assets and used to meet future debt maturities.

Table 2.10 – Net increase in government bonds

Year ending 30 June $billions	**2014 Forecast**	**2015 Forecast**	**2016 Forecast**	**2017 Forecast**	**2018 Forecast**	**5-year Total**
Face value of government bonds issued (market)	8.0	8.0	7.0	7.0	7.0	37.0
Cash proceeds from government bond issue						
Cash proceeds from issue of market bonds	7.8	8.0	6.9	6.8	6.8	36.3
Repayment of market bonds	(2.0)	(8.8)	(1.8)	-	(11.3)	(23.9)
Net proceeds from market bonds	5.8	(0.8)	5.1	6.8	(4.5)	12.4
Repayment of non-market bonds	-	(1.4)	-	-	-	(1.4)
Net repayment of non-market bonds	-	(1.4)	-	-	-	(1.4)
Net cash proceeds from bond issuance	**5.8**	**(2.2)**	**5.1**	**6.8**	**(4.5)**	**11.0**

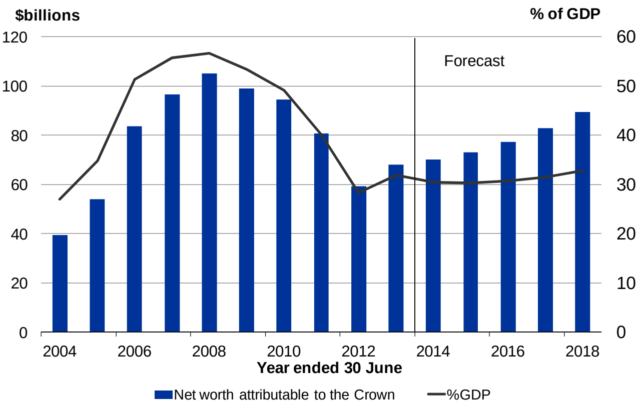
Source: The Treasury

Total Crown Balance Sheet

Operating balance surpluses result in a stronger balance sheet...

Following on from the 2012/13 increase (the first increase in five years), net worth attributable to the Crown is forecast to grow steadily in nominal terms across the forecast period largely owing to forecast operating balance surpluses. Beyond 2014, net worth attributable to the Crown is expected to grow by $19.4 billion to stand at $89.5 billion by 2017/18. As a share of GDP this is 32.8%, still below the peak of 56.6% of GDP in 2007/08 as shown in Figure 2.14.

Figure 2.14 – Net worth attributable to the Crown



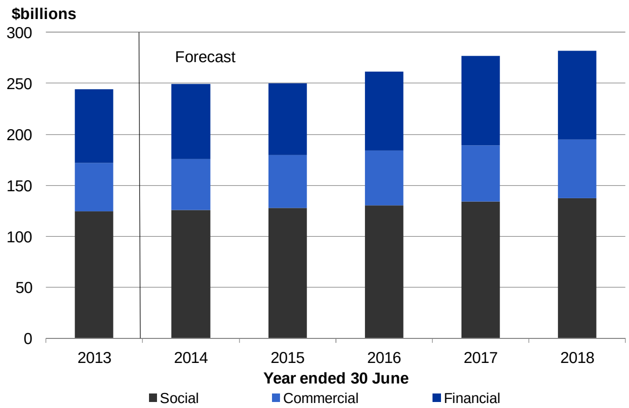
Source: The Treasury

...with assets increasing by $38 billion over the forecast period...

Total assets are forecast to grow by $37.6 billion over the forecast period, made up of additional investments in assets (both physical and financial) of $76.2 billion, partially offset by reductions (largely depreciation) of $38.6 billion.

The largest asset growth over the forecast period is in the financial assets portfolio (Figure 2.15). This growth reflects investments in Crown Financial Institutions (CFIs), with much of this growth recognised as gains in the Crown's operating balance.

Figure 2.15 – Total Crown assets



Source: The Treasury

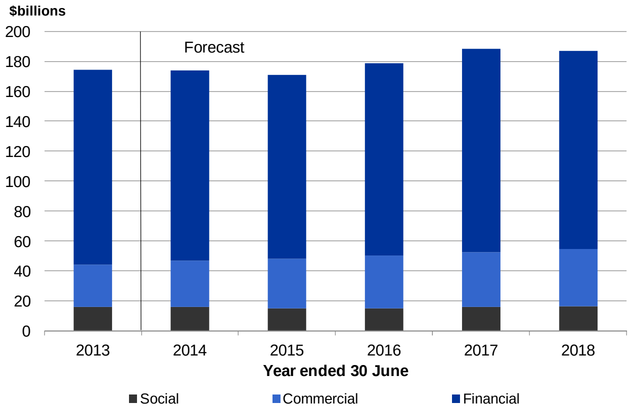
The commercial asset portfolio is expected to increase by $9.6 billion over the forecast period, with growth in Kiwibank mortgages comprising $8.0 billion of this increase, with the remainder from SOEs increasing their investment in physical assets.

Social assets (eg, schools, hospitals and social housing) are expected to increase by $13.3 billion by the end of the forecast period, primarily as a result of new capital spending. The Future Investment Fund contributes to the funding of these asset purchases, as detailed on page 41.

...and liabilities beginning to fall by the end of the forecast period

The Crown's liabilities are expected to increase by $12.5 billion (Figure 2.16) over the forecast period, largely driven by increased borrowing ($14.6 billion over the forecast period) (Figure 2.17) before beginning to fall in 2017/18. Borrowings are mostly held by the Treasury's Debt Management Office and the Reserve Bank, and are forecast to peak at $118.5 billion in 2016/17 before decreasing slightly to stand at $114.7 billion by 2017/18.

Figure 2.16 – Total Crown liabilities

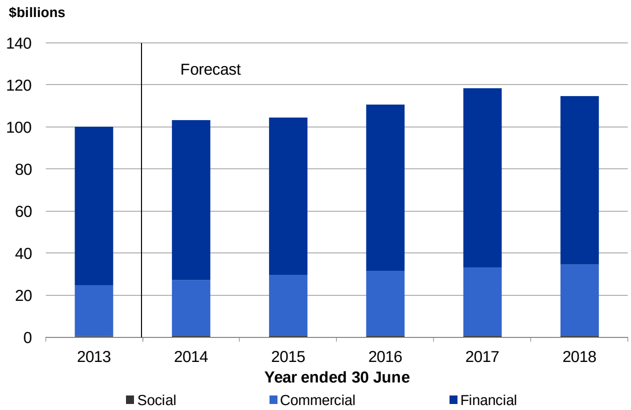


Source: The Treasury

Borrowings in the financial portfolio increase by $4.9 billion over the forecast period to meet the Crown's cash deficits (refer to page 36 for discussion of the bond programme). The remainder of borrowing is in the commercial portfolio, of which two-thirds relates to Kiwibank deposits, which continue to grow in line with Kiwibank's mortgages.

Partially offsetting the growth in borrowings are reductions in liabilities as a result of settling the Crown's obligations related to the Canterbury earthquakes (around $9.4 billion at 30 June 2013). These are all expected to be settled by 2017/18.

Figure 2.17 – Total Crown borrowings



Source: The Treasury

The Crown's balance sheet remains sensitive to market movements...

Many of the assets and liabilities on the Crown's balance sheet are measured at "fair value" in order to disclose current estimates of what the Crown owns and owes. While the measurement at fair value is seen as the most appropriate value of these items, it can be volatile, resulting in fluctuations in the value of the assets and liabilities reflecting changes in the market and underlying assumptions.

Financial assets are the largest asset group on the Crown's balance sheet and have increased significantly in recent years. CFIs (eg, NZS Fund and ACC) hold investments to make financial returns, and those asset values are dependent on market prices, interest rates and exchange rates, which can all be volatile. For example, a 10% change in the New Zealand dollar exchange rate or share prices can impact the Crown's operating balance by $1 billion to $2 billion.

In addition, the Crown has a number of significant long-term liabilities (eg, ACC claims and GSF retirement liability) which are actuarially valued based on estimated future cash flows 50 years into the future. As part of the actuarial valuation, inflation rates are used to help estimate future cash flows, while discount rates are used to obtain the value of those future cash flows in today's dollars (their present value). Even small changes in these assumptions can have significant impacts on the valuation because the cash flows are so large and over such long periods.

...and judgements and estimates will also impact on the balance sheet...

Outside of market factors, valuations are subject to a number of judgements and estimates. In general, as time goes on, better information becomes available and initial estimates are updated to reflect current information. Some examples of this include: ACC rehabilitation costs, earthquake-related insurance liabilities, and student wage growth.

...while other risks still remain

In addition to those items on the balance sheet there are a number of liabilities (and assets) that may arise in the future but are not yet included in our forecasts, either because they are contingent on an uncertain future event occurring (eg, outcome of litigation) or the liability cannot be measured reliably. If these liabilities crystallise, there will be associated costs with a negative impact (or positive in the case of contingent assets) on the operating balance or net debt. Refer to page 76 for a list of the contingent liabilities that the Crown was exposed to at 31 March 2014. The Risks and Scenarios chapter also includes further discussion on risks to the Crown's balance sheet.

The Treasury recently released its 2014 *Investment Statement,* which further discusses the Crown's balance sheet. In particular, it provides information on the shape and health of the Crown's portfolio of assets and liabilities, as well as a discussion on balance sheet management, including financial risk management.

Government Share Offer Programme

The Government's Share Offer programme has now concluded. Minority shareholdings in Mighty River Power, Meridian Energy and Genesis Energy have been sold, and the Crown has reduced its shareholding in Air New Zealand. Since the *Half Year Update*, the Genesis Energy share offer has been completed and the proceeds from the Crown reducing its shareholding in Air New Zealand have been finalised. Refer to Table 2.11 for the final proceeds of the programme.

Table 2.11 – Proceeds of programme (core Crown)

Year ended 30 June $billions	May 2011 Low estimate	 High estimate	Gross proceeds	Net proceeds[1]	% sold
Mighty River Power	1.350	1.870	1.686	1.642	48.24
Meridian Energy	2.290	3.180	1.884	1.826	48.98
Air New Zealand	0.160	0.290	0.365	0.364	20.05 [2]
Genesis Energy	0.580	0.810	0.733	0.696	47.60
Solid Energy (did not proceed)	0.620	0.850	-	-	-
	5.000	7.000	4.668	4.528	

Note: 1 Net of direct costs and present value discounting of the Meridian Energy deferred settlement.

2 This represents the additional reduction in the Crown's shareholding as part of this programme.

Source: The Treasury

Total gross proceeds for the programme are $4.7 billion, compared to a range of $5.0 billion to $7.0 billion as estimated in May 2011. The May 2011 estimates included estimates for Solid Energy; however, a decision was made not to proceed with a Solid Energy share offer. For the transactions that did proceed:

- actual proceeds for the Mighty River Power share offer were slightly above the mid-point of the estimated range from May 2011
- actual proceeds for Meridian Energy were below the estimated range from May 2011, with proceeds affected by the falls in the share prices of comparable New Zealand electricity companies, and the revised contract between Meridian Energy and New Zealand Aluminium Smelters
- actual proceeds for the Air New Zealand transaction were above the May 2011 estimated range, as a result of the significant increase in Air New Zealand's share price, and
- actual proceeds for Genesis Energy were within the upper half of the May 2011 estimated range.

Although the Share Offer programme has now been completed, owing to the use of instalment receipts for the Meridian Energy share offer some proceeds (approximately $0.6 billion) are expected to be received next year.

Future Investment Fund

Proceeds from the Government Share Offer programme have been set aside to fund future capital spending through the Future Investment Fund (FIF) – a fund established in Budget 2012. So far, $3.0 billion of this fund has been allocated. A large portion of the fund is expected to be spent on investments in health and education ($1 billion each), as well as the Canterbury rebuild and irrigation initiatives.

Table 2.12 – Analysis of Future Investment Fund

$billions	**Total fund**
Cash proceeds	4.668
Allocated in Budget 2012	(0.533)
Allocated in Budget 2013	(1.420)
Allocated in Budget 2014	(1.039)
To be allocated	**1.676**

Source: The Treasury

Budget 2014 allocates $1.0 billion of new spending from the fund, including $0.2 billion for KiwiRail, $0.2 billion for school property expansion, $0.2 billion for health initiatives, as well as smaller amounts for irrigation infrastructure. Refer to the *Minister's Executive Summary* document for further details of the Budget 2014 package.

With the proceeds from the Government Share Offer programme totalling $4.7 billion, the amount remaining to be allocated in future Budgets is $1.7 billion.

Table 2.13 – Estimated fiscal impact of the Government Share Offer programme

	Note	**Actual to date and forecast**
Completed transactions		
Gross cash proceeds		$4.7 billion
Net cash proceeds		$4.5 billion
Loss on disposal recorded in taxpayers' funds		$384 million
Forecasts		
Cash impact		
Forecast foregone dividends	1	$336 million p.a.
Estimated finance cost savings	1	$191 million p.a.
Reduction in net debt		$3.7 billion by 2017/18
Accrual impact		
Forecast foregone profits	1	$290 million p.a.
Estimated finance cost savings	1	$191 million p.a.
Net decrease in OBEGAL	1	$99 million p.a.

Note: 1 Based on an average of the fiscal forecasts subsequent to the programme being completed.

Source: The Treasury

The average profits and dividends estimated to be foregone have been updated since the *Half Year Update*, largely as a result of the Government selling slightly less than the 49% originally forecast, in addition to including updated forecasts from the companies.

The figures in Table 2.13 are based on the current profit and dividend forecasts supplied by the companies, and forecast interest rates on government debt.

The forecasts of company profits and dividends inherently contain more risk and uncertainty than forecasts of the Government's cost of borrowing. As a result, you would expect the return on commercial assets to reflect that additional risk and be generally higher than the Government's cost of borrowing. Whether forecast profits are actually delivered will depend on actual company performance.

The Forecast Financial Statements (Chapter 5) disclose forecasts for minority interests' share of profits and dividends for all minority interests of the Government. While these amounts include the forecasts as a result of the government share offer, they also include the pre-existing minority shareholding in Air New Zealand, along with minority interests in the Crown Fibre Holdings Group and Solid Energy (resulting from their recent restructure). As a result, the amounts in the Forecast Financial Statements are larger than those in Table 2.13 above.

Fiscal Forecast Assumptions

The fiscal forecasts are based on assumptions and judgements developed from the best information available on 29 April 2014, when the forecasts were finalised. Actual events are likely to differ from these assumptions and judgements. Furthermore, uncertainty around the forecast assumptions and judgements increases over the forecast period. The impact of the Canterbury earthquakes add further uncertainty to the economic and fiscal forecasts.

The fiscal forecasts are prepared on the basis of underlying economic forecasts. Such forecasts are critical for determining revenue and expense estimates. For example:

- A nominal GDP forecast is needed in order to forecast tax revenue.
- A forecast of CPI inflation is needed because social assistance benefits are generally indexed to inflation.
- Forecasts of interest rates are needed to forecast finance costs, interest income and discount rates.

A summary of the key economic forecasts that are particularly relevant to the fiscal forecasts is provided in Table 2.14 below (on a June-year-end basis to align with the Government's balance date).

Table 2.14 – Summary of key economic forecasts used in fiscal forecasts

Year ended 30 June	2013 Actual	2014 Forecast	2015 Forecast	2016 Forecast	2017 Forecast	2018 Forecast
Real GDP[1] (ann avg % chg)	2.2	3.4	3.9	2.6	2.1	2.2
Nominal GDP[2] ($m)	213,188	230,717	241,090	252,307	262,989	272,612
CPI (ann avg % chg)	0.8	1.6	1.7	2.3	2.4	2.1
Govt 10-year bonds (ann avg, %)	3.6	4.6	4.8	5.0	5.1	5.2
5-year bonds (ann avg, %)	2.9	4.1	4.5	4.9	5.1	5.2
90-day bill rate (ann avg, %)	2.6	2.9	4.1	4.8	5.0	5.2
Unemployment rate (ann avg, %)	6.7	6.0	5.5	5.2	4.8	4.5
Employment (ann avg % chg)	0.4	3.1	2.7	1.6	1.3	1.2

Notes: 1 Production measure.
2 Expenditure measure.

Source: The Treasury

In addition, a number of other key assumptions are critical in the preparation of the fiscal forecasts.

<table>
<tr><td>Government decisions</td><td>The forecasts incorporate Government decisions and other circumstances known to the Government and advised to the Treasury up to 29 April 2014.</td></tr>
<tr><td>Tax revenue</td><td>Tax policy changes enacted and announced by the Government will take place as planned and will affect tax revenue and receipts as calculated and agreed between Inland Revenue and the Treasury.</td></tr>
<tr><td>Earthquake costs</td><td>Expenditure (accrual measure) is forecast based on estimates of when key decisions will be taken. The timing of cash payments is based on estimates of when actual spending will take place. Refer to page 34 for further discussion.</td></tr>
<tr><td>Operating allowance</td><td>Operating allowances are net $1.5 billion from Budget 2015, growing at a rate of 2.0% per annum for subsequent Budgets. For further details, see note 8 of the Forecast Financial Statements.</td></tr>
<tr><td>Provision for new capital spending</td><td>Capital allowances are $0.9 billion in Budget 2015 and Budget 2016, then growing at a rate of 2% per annum for subsequent Budgets. For further details, see note 8 of the Forecast Financial Statements.</td></tr>
<tr><td>Finance cost on new bond issuances</td><td>Based on the 5-year rate from the main economic forecasts and adjusted for differing maturities.</td></tr>
<tr><td>Top-down adjustment</td><td>A top-down adjustment is made to compensate for departments that tend to forecast upper spending limits (appropriations) rather than best estimates.

Top-down adjustment to operating and capital expenses are as follows:

<table>
<tr><th>Year ending 30 June
$billions</th><th>2014
Forecast</th><th>2015
Forecast</th><th>2016
Forecast</th><th>2017
Forecast</th><th>2018
Forecast</th></tr>
<tr><td>Operating</td><td>0.7</td><td>0.9</td><td>0.5</td><td>0.4</td><td>0.4</td></tr>
<tr><td>Capital</td><td>0.4</td><td>0.4</td><td>0.1</td><td>0.1</td><td>0.1</td></tr>
</table>
The adjustment will be higher at the front end of the forecast period as departments' appropriations (and therefore expenses) tend to be higher in these years, reflecting the flexibility departments have around transferring underspends to later years.</td></tr>
<tr><td>Property, plant and equipment</td><td>For the purposes of the forecast financial statements, no revaluations of property, plant and equipment are projected beyond the current year. Valuations as recorded for the 2013 annual financial statements and any additional valuations that have occurred up to 31 March 2014 are included in these forecasts.</td></tr>
<tr><td>Student loans</td><td>The carrying value of student loans is based on a valuation model adapted to reflect current student loans policy. As such, the carrying value over the forecast period is sensitive to changes in a number of underlying assumptions, including future income levels, repayment behaviour and macroeconomic factors such as inflation and discount rates used to determine the effective interest rate for new borrowers. Any change in these assumptions would affect the present fiscal forecasts.</td></tr>
</table>

<table>
<tr><td>Investment rate of returns</td><td>The forecasts incorporate the actual results to 31 March 2014. Beyond this time, gains on financial instruments are based on long-term benchmark rates of return for each portfolio.</td></tr>
<tr><td>GSF and ACC liabilities</td><td>The GSF and ACC liabilities included in these forecasts have been valued as at 28 February 2014 and 31 December 2013 respectively. The ACC liability has also been adjusted for the 31 March 2014 discount rate. Both liabilities are valued by projecting future cash payments, and discounting them to the present. These valuations rely on historical data to predict future trends and use economic assumptions such as inflation and discount rates. Any changes in actual payments or economic assumptions would affect the present fiscal forecast. For example, if the discount rate decreases, the value of the liabilities would increase.

GSF's assets are offset against the gross liability and have been updated to reflect market values. The value of assets over the forecast period reflects long-run rate of return assumptions appropriate to the forecast portfolio mix.</td></tr>
<tr><td>ACC levies</td><td>The forecasts include the Government's intention to further reduce ACC levies in the 2015/16 levy year. A final decision on levy rates will be made after ACC's public consultation.</td></tr>
<tr><td>NZS Fund contributions</td><td>No contribution is assumed in the forecast period in line with the Government's stated intentions to commence contributions once net core Crown debt has reached 20% of GDP as set out in the Fiscal Strategy Report (FSR).

<table>
<tr><th>Year ending 30 June
$billions</th><th>2015
Forecast</th><th>2016
Forecast</th><th>2017
Forecast</th><th>2018
Forecast</th></tr>
<tr><td>Required contribution[1]</td><td>2.3</td><td>2.3</td><td>2.3</td><td>2.2</td></tr>
<tr><td>Actual contribution</td><td>-</td><td>-</td><td>-</td><td>-</td></tr>
</table>

1. Calculations of annual contributions if they were to resume in 2013/14

The underlying assumptions in calculating the required contribution in each year are the previous year's NZS Fund balance and projected series, over the ensuing 40 years of nominal GDP, net (after-tax) New Zealand superannuation expenses, and the government 5-year bond rate. The latter is used in calculating the Fund's expected long-run after-tax annual return. Over the forecast years, all Fund variables, apart from the capital contributions, are provided by the NZS Fund itself.

Refer to the Treasury's website for the NZS Fund model.</td></tr>
</table>