Fiscal Forecasts – Finalisation Dates and Key Assumptions

Finalisation Dates	
Economic outlook (refer Chapter 1)	13 April
Tax revenue forecasts	20 April
Fiscal forecasts	8 May
Government decisions and circumstances	8 May
Actual asset revaluations	28 February
Foreign exchange rates	28 February
Specific fiscal risks (refer Chapter 4)	8 May
Contingent liabilities and commitments (refer Chapter 4)	31 March

Key assumptions

The fiscal forecasts have been prepared in accordance with the Public Finance Act 1989. They are based on the Crown's accounting policies and assumptions (refer page 150 of the GAAP tables). As with all assumptions, there is a degree of uncertainty surrounding them. This uncertainty increases as the forecast horizon extends. A summary of the key economic assumptions that are particularly relevant to the fiscal forecasts is provided below (on a June-year-end basis to align with the Crown's balance date of 30 June):

	2005/06		2006/07	2007/08	2008/09	2009/10
June years	**HEFU**	**BEFU**	**BEFU**	**BEFU**	**BEFU**	**BEFU**
Real GDP (P) (ann avg % chg)	2.9	1.5	1.5	3.7	3.3	3.1
Nominal GDP (E) ($m)	158,947	156,257	160,013	169,104	178,305	187,584
CPI (annual % change)	3.4	3.3	3.2	2.6	2.1	2.0
Govt 10-year bonds (qty avg %)	6.0	5.8	5.9	6.0	6.0	6.0
90-day bill rate (qty avg %)	7.5	7.5	6.8	6.3	6.0	5.8
Unemployment rate ((HLFS) basis ann avg %)	3.4	3.8	4.6	4.7	4.4	4.5
Full-time equivalent employment (ann avg % change)	2.8	1.8	-0.5	0.8	1.6	1.5
Current account (% of GDP)	-9.1	-9.4	-8.3	-7.1	-6.3	-5.9

Source: The Treasury

New Zealand Superannuation (NZS) Fund

The contribution to the NZS Fund for the year ending 30 June 2007 is $2.049 billion. The contribution to the NZS Fund is calculated over a 40-year rolling horizon to ensure that superannuation entitlements over the next 40 years can be met if the contribution rate were to be held constant at that level. The Government is making the required minimum annual contribution for 2005/06 as calculated by the formula set out in the NZS Act.

$ billion (June year end)	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Required contribution	1.879	2.107	2.337	2,049	2,239	2,465	2,651
Actual/Budgeted contribution	1.879	2.107	2.337	2,049	2,239	2,465	2,651

Source: The Treasury

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

2

Fiscal Outlook

Summary of the Budget *Update*

The New Zealand economy has entered a period of slower growth. Combined with past Budget decisions in 2004 and 2005, this translates into a fiscal outlook for the *Budget Update* that shows:

- slower revenue growth relative to recent years, while expenditure growth remains broadly stable
- an OBERAC that declines from 4.5% of GDP in 2005/06 to 2.0% of GDP in 2008/09 before rebounding to 2.9% of GDP by 2009/10
- after taking account of the Government's capital programme the core Crown will record cash deficits from 2006/07
- gross debt rising, but falling slowly as a percentage of GDP over the forecast period
- net debt including the NZS Fund has moved into a net financial asset position during 2005/06 and is forecast to strengthen over the forecast period.

The Government's cash position is forecast to be stronger than anticipated relative to the *Half Year Update*. This is largely due to:

- limited change to tax revenue, despite a more pronounced cycle in tax revenue in growth rate terms than at the *Half Year Update*, due to a higher starting position in 2005/06
- reduction in the forecast contributions to the NZS Fund resulting from higher projections of nominal GDP across the 40-year horizon of the Fund
- reduction in student loan expenditure partly driven by lower than expected uptake of student loans and a forecast reduction in enrolments at tertiary education institutions.

Table 2.1 – Summary fiscal indicators[1]

	Year ended 30 June					
($ million)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Core Crown revenue	52,065	56,652	56,190	57,781	59,728	64,157
% of GDP	*34.5*	*36.3*	*35.1*	*34.2*	*33.5*	*34.2*
Core Crown expenses	46,234	50,445	52,254	55,158	57,973	60,527
% of GDP	*30.6*	*32.3*	*32.7*	*32.6*	*32.5*	*32.3*
Operating balance	6,247	8,486	5,768	4,343	3,561	5,412
% of GDP	*4.1*	*5.4*	*3.6*	*2.6*	*2.0*	*2.9*
OBERAC	8,873	6,977	5,768	4,343	3,561	5,412
% of GDP	*5.9*	*4.5*	*3.6*	*2.6*	*2.0*	*2.9*
OBERAC excluding NZS Fund returns	8,507	6,547	5,093	3,495	2,517	4,147
% of GDP	*5.6*	*4.2*	*3.2*	*2.1*	*1.4*	*2.2*
Cash available/(shortfall to be funded)	3,104	1,755	(1,468)	(2,110)	(2,706)	(1,101)
% of GDP	*2.1*	*1.1*	*(0.9)*	*(1.2)*	*(1.5)*	*(0.6)*
Gross sovereign-issued debt	35,045	35,952	35,013	37,082	36,973	36,348
% of GDP	*23.2*	*23.0*	*21.9*	*21.9*	*20.7*	*19.4*
Net core Crown debt	10,771	9,016	9,209	10,396	12,701	13,511
% of GDP	*7.1*	*5.8*	*5.8*	*6.1*	*7.1*	*7.2*
Net core Crown debt (incl NZS Fund)	4,216	(999)	(3,530)	(5,430)	(6,634)	(9,740)
% of GDP	*2.8*	*(0.6)*	*(2.2)*	*(3.2)*	*(3.7)*	*(5.2)*

Source: The Treasury

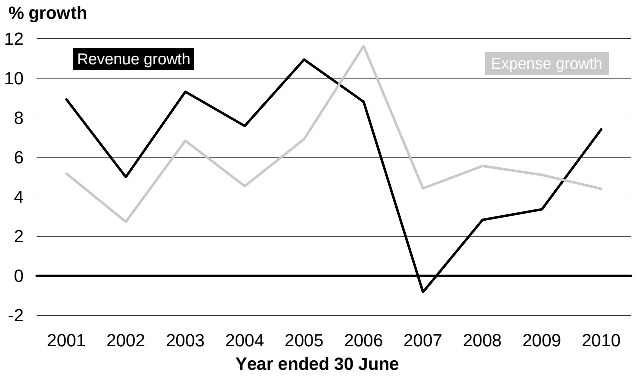
1 Detailed tables of the key indicators for the Budget and *Economic and Fiscal Update* (BEFU) and *Half Year Economic and Fiscal Update* (HEFU) are located on pages 100 and 101. The fiscal fact sheet on pages 105 to 110 provides a guide to the key fiscal indicators used to measure the Government's performance.

Key Trends

The OBERAC is forecast to decline in the short term…

The New Zealand economy has performed strongly over recent years, which has seen revenue growth exceed expense growth. This has resulted in the Government reporting strong fiscal outturns and consistent with the fiscal strategy has enabled the Government to strengthen its net worth to prepare for the increase spending demands associated with an ageing population. In addition the Government has made significant policy investments in the 2004 and 2005 Budget packages, resulting in a structural increase to expenses.

Figure 2.1 – Core Crown revenue and expense (excluding GSF valuation) growth

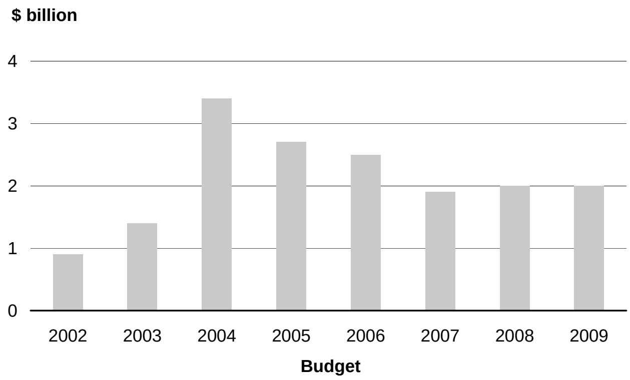


Source: The Treasury

The economy has now entered a period of slower growth. As a result revenue growth is forecast to fall. With expense growth forecast to remain relatively stable, this translates into an OBERAC that declines over the forecast period from $7 billion (4.5% of GDP) in the current year to $5.4 billion (2.9% of GDP) by 2009/10.

As signalled in previous updates with lower forecast operating surpluses the 2006 Budget package and intended spending for future Budgets are smaller than the previous two Budgets.

Figure 2.2 – Final forecast year impact of Budget packages



Source: The Treasury

…so too is the cash available for investing…

Even though operating surpluses are expected over the forecast period (2006/07 to 2009/10) they cannot be fully used by the Government to help finance its capital programme. This is because some components of the operating balance are isolated for other purposes, for example:

- entities retaining their surpluses for the purpose of achieving their long-term objectives (ACC, EQC, NZS Fund and EQC)
- entities retaining their surpluses to accumulate assets (SOEs' and some Crown entities).

This leaves around 42% (or around on average $2 billion per annum) of the accumulated operating balance available to finance the Government's investing activities, such as contributions to the NZS Fund.

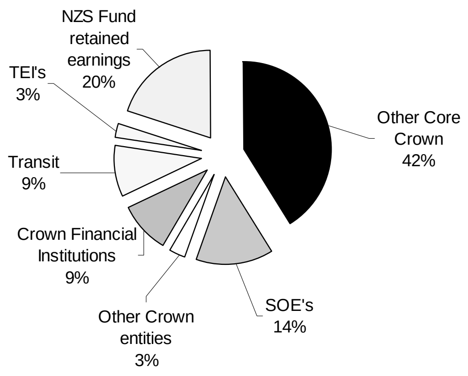
…as a result there is a cash shortfall…

There is a residual financing requirement over the period 2006/07 to 2009/10 of around $7.4 billion, which will be met by raising some debt and reducing the holdings of marketable securities and deposits which have accumulated from 2004/05 and 2005/06.

The cash shortfall results because the Government's capital programme exceeds the cash available.

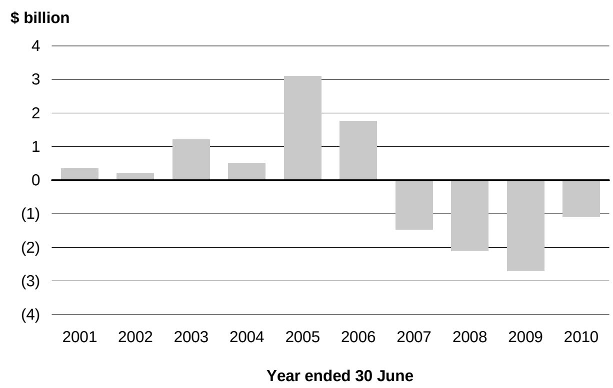
The cash flow from operations generates around $13.6 billion over the forecast period. This will be invested primarily in NZS Fund contributions of $9.4 billion, purchases of physical assets of $7 billion (for example, schools and defence equipment), advances of $3 billion (mainly student loans and refinancing existing private sector debt of the health and housing sectors), injections into Crown entities for hospitals and housing of $1 billion and the purchase of foreign exchange reserves of $0.7 billion.

Figure 2.3 – Accumulated operating balance breakdown for the period 2006/07 to 2009/10



Source: The Treasury

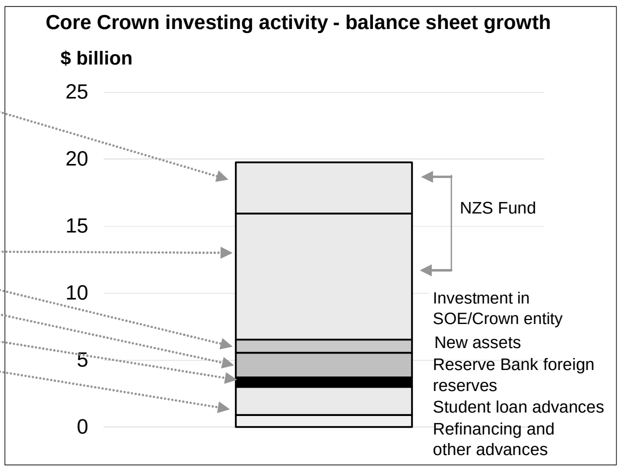
Figure 2.4 – Core Crown cash position on a year-by-year basis



Source: The Treasury

Table 2.2 – Impact of Crown operating surpluses on the balance sheet from 2006/07 to 2009/10 inclusive

	$ billion
Operating Balances	19.1
Less	
Retained NZS Fund returns	(3.8)
Retained SOE/Crown entity returns	(7.1)
Add	
Depreciation	5.1
Other	0.4
Operating cash flows	13.6
Invested in	
NZS Fund contributions	(9.4)
SOEs/Crown entities' net capital injections	(1.0)
Increase asset base	(1.9)
Purchase of foreign reserves	(0.7)
Maintain existing asset base	(5.1)
Advances	(3.0)
Other	0.0
Requiring Finance	(7.4)

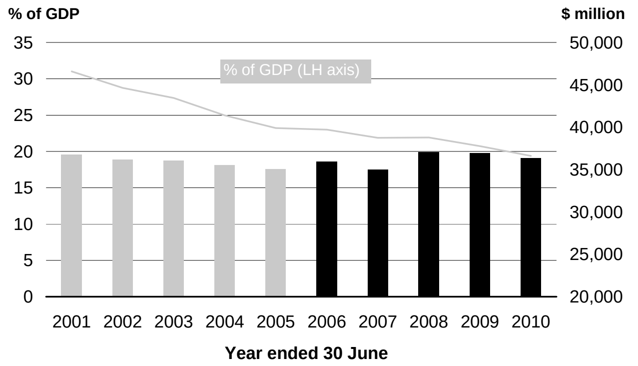


… which is met by borrowing

Gross debt is expected to increase by around $0.9 billion from 2004/05 to 2005/06. This increase comprises of offsetting factors:

- an increase in debt due to an increase in settlement cash levels held by the Reserve Bank from $20 million to $2 billion (that is sustained at this level over the forecast period)
- a reduction in debt due to the repayment of debt during 2005/06, funded from the build-up of assets resulting from recent outturns.

Figure 2.5 – Gross sovereign-issued debt (% of GDP and $ million)



Source: The Treasury

The increase in gross debt beyond 2005/06 is due to the portion of the cash shortfall being met by raising debt.

As a percentage of GDP, gross debt is expected to fall from 23% in 2005/06 to 19.4% by 2009/10. This is consistent with the Government's long-term debt objective to manage debt broadly stable at around 20% of GDP over the next 10 years.

The Government's 2006/07 bond programme has been set at $2.5 billion. For the remaining forecast period the domestic bond programme has also been set at around $2.5 billion per annum.

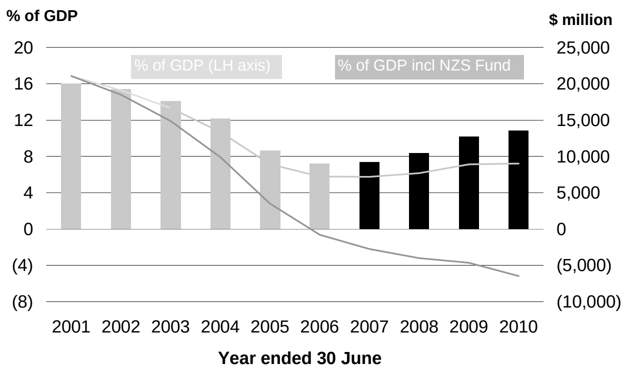
Assets and net worth are still expected to increase

Over the forecast period the Government continues to strengthen its fiscal position, with net worth forecast to increase by around $19.1 billion. The strategy of building up assets is evident across all segments of reported government activity.

The largest part of the increase occurs in the core Crown where the NZS Fund resides.

The NZS Fund is forecast to be $23.3 billion by 2009/10. Net core Crown debt including the financial assets of the NZS Fund has moved into a net financial asset position during 2005/06.

Figure 2.6 – Net debt (% of GDP and $ million) and % of GDP including assets of NZS Fund



Settlement Cash Level

In January and February 2006, the Reserve Bank of New Zealand raised the Settlement Cash Level in two steps, from $20 million to $2 billion. The change in the settlement cash level reflected the Reserve Bank's concern over liquidity pressures in the New Zealand money market.

What is settlement cash?

Settlement cash is the amount of cash the Reserve Bank leaves in the banking system each day. The Reserve Bank aims to leave a relatively constant level of cash in the banking system, although this can be subject to change from time to time. Settlement cash can be used by banks to meet their payment obligations. Hence, settlement cash is a liquidity mechanism used to settle wholesale obligations between the banks and provides the basis for settling most of the retail banking transactions that occur every working day between corporates and individuals.

Why has the settlement cash level increased?

The change in the settlement cash level reflects the Reserve Bank's concern over the liquidity pressures in the New Zealand money market, which were being exacerbated by the pending maturity of the February 2006 New Zealand Government bonds. The bond maturity reduces the amount of collateral available for banks to use to raise funds for their intra-day liquidity, which they also use to meet their payment and settlement obligations. Increasing the settlement cash level provided banks with additional liquidity to meet their payment and settlement obligations.

What is the impact on the fiscal forecasts and fiscal policy?

The key changes to the fiscal forecast from raising the settlement cash level are:

- an increase in gross sovereign-issued debt of $2 billion
- a corresponding increase in financial assets of $2 billion
- no impact on net core Crown debt.

The Government's long-term debt objective is to manage debt broadly stable at around 20% of GDP over the next 10 years. The expression of this objective takes into account short-term volatility caused by financial transactions, such as changes in Reserve Bank settlement cash levels.

Revenue and Expenses

Table 2.3 – Revenue and expenses comparison with *Half Year Update*

(% of GDP)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
			Year ended 30 June			
Total Revenue						
Budget Update	44.4	47.4	45.4	44.3	43.5	44.1
Half Year Update		43.9	44.2	43.9	43.1	43.7
Total Expenses						
Budget Update	40.4	42.1	41.9	41.8	41.6	41.3
Half Year Update		40.5	40.7	41.6	41.3	41.1
Core Crown Revenue						
Budget Update	34.5	36.3	35.1	34.2	33.5	34.2
Half Year Update		34.2	34.4	33.9	33.3	34.1
Core Crown Expenses						
Budget Update	30.6	32.3	32.7	32.6	32.5	32.3
Half Year Update		31.9	31.8	32.6	32.5	32.4
SOE Revenue						
Budget Update	5.9	8.0	7.5	7.4	7.4	7.3
Half Year Update		7.1	7.3	7.2	7.2	7.1
SOE Expenses						
Budget Update	5.5	6.9	6.8	6.8	6.7	6.6
Half Year Update		6.6	6.8	6.7	6.6	6.5
Crown Entities' Revenue						
Budget Update	14.0	16.2	16.0	15.5	14.9	14.3
Half Year Update		15.0	15.3	15.1	14.5	13.9
Crown Entities' Expenses						
Budget Update	13.0	15.2	15.3	14.9	14.4	13.9
Half Year Update		14.2	14.6	14.4	13.8	13.4

Source: The Treasury

Over the forecast period, total revenue to GDP is expected to fall initially before increasing in 2009/10. Total expenses to GDP are forecast to decline.

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

Core Crown – Revenue

Tax revenue is the major source of core Crown revenue.

Table 2.4 – Tax revenue indicators

Tax Revenue	Year ended 30 June 2005 Actual	 2006 Forecast	 2007 Forecast	 2008 Forecast	 2009 Forecast	 2010 Forecast
($ billion)						
Total Crown	46.6	49.6	50.7	52.1	53.6	57.7
Core Crown	47.1	50.1	51.3	52.7	54.3	58.4
(% of GDP)						
Total Crown	30.9	31.7	31.7	30.8	30.1	30.8
Core Crown	31.2	32.1	32.0	31.2	30.5	31.1

Source: The Treasury

A discussion of trends in total tax and the major tax types is included in the Economic Outlook. The main points are:

- corporate tax declines, both in nominal terms and as a percentage of GDP, for three years running as business profits fall, more companies move into loss, tax on investment income reduces and 2008/09 loses a major provisional tax payment date (which is restored in 2009/10)
- source deductions continue their momentum of recent years in 2005/06, but slow markedly in 2006/07 in line with wage and salary income, although they do not decline as much as corporate tax does
- GST growth has slowed from over 10% in 2003/04 to around 1.5% in 2005/06 and this relatively low growth is expected to continue through the bottom of the economic cycle.

Inland Revenue's tax forecasts

In line with established practice, the Inland Revenue Department has prepared an independent set of tax forecasts, based in the short term on analysis of taxpayer information, and in the longer term on the same broad macroeconomic trends that underpin Treasury's tax forecasts.

Table 2.5 – Treasury and Inland Revenue tax revenue forecasts

($ million)	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Source deductions					
Treasury	19,817	20,534	21,513	22,513	23,804
Inland Revenue	19,885	20,910	22,110	23,390	24,870
Difference	(68)	(376)	(597)	(877)	(1,066)
Corporate Taxes					
Treasury	9,037	8,855	8,748	8,709	10,254
Inland Revenue	9,113	9,087	9,830	9,849	10,615
Difference	(76)	(232)	(1,082)	(1,140)	(361)
Goods and Services Tax					
Treasury	10,363	10,514	10,887	11,503	12,105
Inland Revenue	10,279	10,481	10,812	11,353	11,925
Difference	84	33	75	150	180
Other Taxes					
Treasury	10,390	10,766	10,961	10,912	11,546
Inland Revenue	10,430	10,562	10,835	10,940	11,468
Difference	(40)	204	126	(28)	78
Total Tax					
Treasury	49,607	50,669	52,109	53,637	57,709
Inland Revenue	49,707	51,040	53,587	55,532	58,878
Difference	(100)	(371)	(1,478)	(1,895)	(1,169)
Total Tax (% of GDP)					
Treasury	31.7%	31.7%	30.8%	30.1%	30.8%
Inland Revenue	31.8%	31.9%	31.7%	31.1%	31.4%
Difference	-0.1%	-0.2%	-0.9%	-1.0%	-0.6%

Sources: Inland Revenue, The Treasury

Inland Revenue's total tax forecasts are higher than Treasury's in all years, with the gap between the two sets of forecasts larger than we have seen for some time. Most of the differences occur in the corporate and source deductions tax types.

The difference in corporate taxes starts to open up in 2006/07 owing to the different forecasting approaches taken by the respective teams: Treasury's forecast is based on a macroeconomic forecast of profits, whilst Inland Revenue also uses a survey of taxpaying companies. Thereafter, differences in corporate tax forecasts result from differing views around how company income tax will be affected by the business cycle, with the Treasury forecast incorporating a build-up of tax losses followed by a subsequent run-out over the next few years.

In source deductions, the differences arise mainly as a result of the different forecasting methods used by the respective forecasting teams. While both forecasting teams have used similar estimates for fiscal drag effects and tax threshold changes, Inland Revenue's forecast incorporates a stronger underlying growth track for PAYE.

Detailed comparisons of Treasury and Inland Revenue tax forecasts can be found at www.treasury.govt.nz/forecasts/befu/2006/.

Core Crown – Expenses

Table 2.6 – Expenses indicators

Expenses	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
($ billion)						
Core Crown	46.2	50.4	52.3	55.2	58.0	60.5
Core Crown (excluding GSF valuation)	44.8	50.0	52.3	55.2	58.0	60.5
(% of GDP)						
Core Crown	30.6	32.3	32.7	32.6	32.5	32.3
Core Crown (excluding GSF valuation)	29.7	32.0	32.7	32.6	32.5	32.3

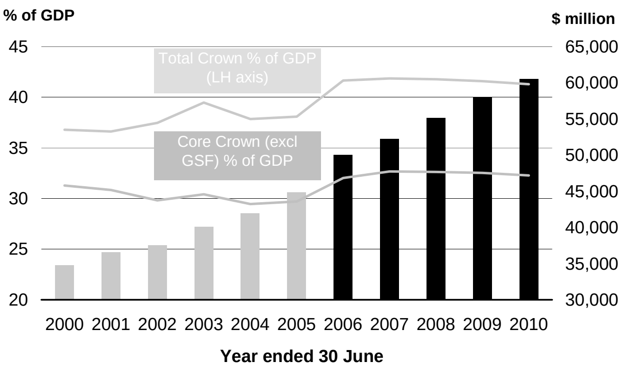
Source: The Treasury

Core Crown expenses (excluding GSF valuations) have increased from 29.5% of GDP in 2003/04 to 32.0% of GDP by 2005/06. The growth in expenses is due to:

- the impact of the 2004 and 2005 Budgets
- one-off fair value write-down of student loans.

Beyond 2005/06, core Crown expenses (excluding GSF valuation) are expected to stay relatively flat over the forecast period at around 32% of GDP (assuming all of the forecast new operating initiatives are allocated to spending).

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



Source: The Treasury

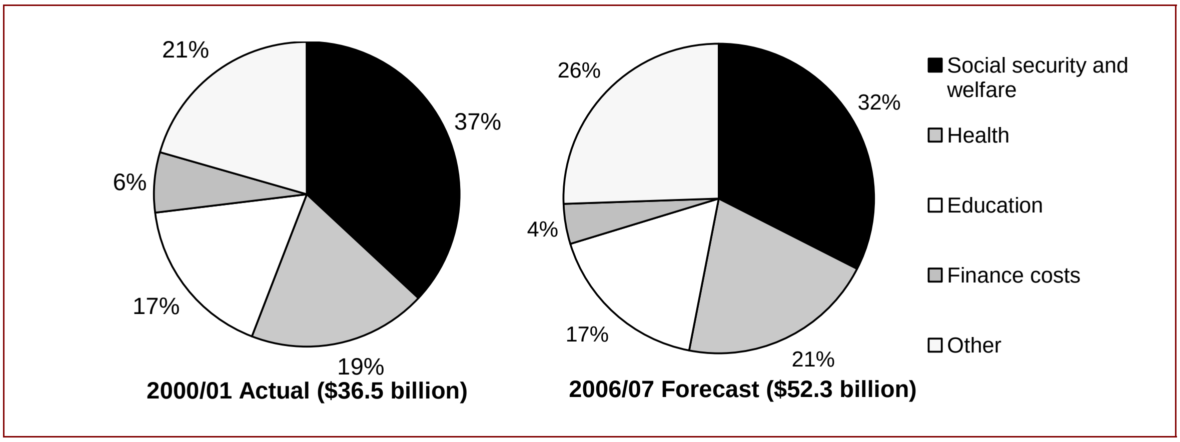
Core Crown expenses are expected to increase by around $10.1 billion between 2005/06 and 2009/10. Removing the GSF liability movements, expenses are forecast to increase by $10.5 billion over the same period. The major drivers of these expense increases are indexation of benefits (around $1.5 billion), the 2006 Budget package and forecast new operating initiatives for future Budgets.

The core Crown spending areas of health, education and social security and welfare were allocated a significant portion of the 2006 Budget. This reflects:

- the impact of making student loans interest free, expanding the Working for Families package and lifting the rate of New Zealand Superannuation to 66% of the net average ordinary time weekly wage
- the current spending pressures within the health sector.

Health expenses are forecast to increase from 5.6% to 6.7% of GDP between 2000/01 and 2006/07, while as a proportion of core Crown expenses they are forecast to increase from 18.2% in 2000/01 to 20.5% by 2006/07.

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



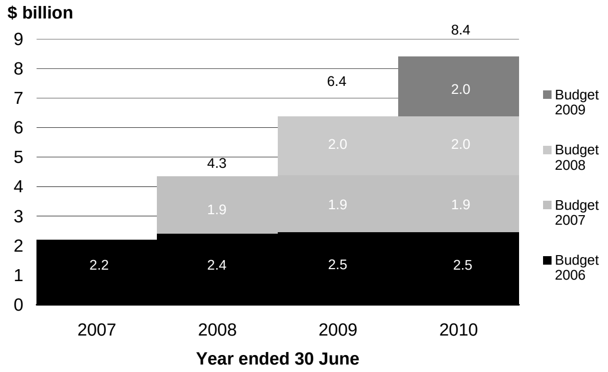
Source: The Treasury

Forecast new operating initiatives

A detailed breakdown of the 2006 Budget package is provided on pages 6 and 7. In summary, Budget 2006 has an ongoing commitment of new operating resources rising to around $2.5 billion by 2009/10, which is consistent with what was signalled in the *2006 Budget Policy Statement (BPS)*.

Allowances for the 2007, 2008 and 2009 Budgets remain at around $1.9 billion and $2.0 billion.

Figure 2.9 – Net allowance for new operating initiatives (GST exclusive)



Source: The Treasury

State-Owned Enterprises and Crown Entities – Net Surpluses

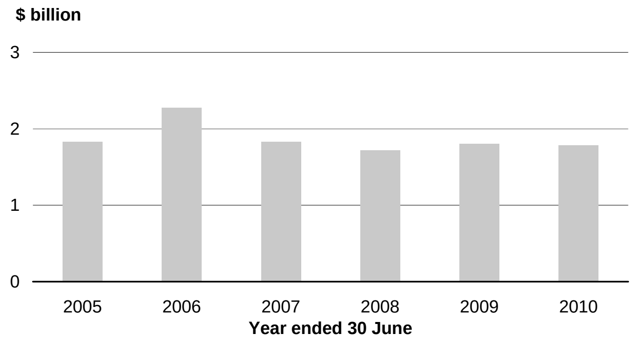
SOEs' and Crown entities' are forecast to run total operating surpluses of $9 billion over the forecast period. Around $1.9 billion of the operating surpluses will be returned as dividends and is available to fund spending elsewhere in the Crown.

Beyond 2005/06 the SOE/CE net surpluses are forecast to remain relatively flat at around $1.8 billion per annum.

The SOE/CE net surpluses are not expected to stay at the level expected in 2005/06 of $2.3 billion, as the current year results include large investment gains from:

- the gain from the on sale of Southern Hydro by Meridian Energy of $0.6 billion (which is a one-off transaction)
- higher investment returns on ACC's and EQC's asset portfolios' (due to current strength in global equity markets). It is forecast that investment income will be consistent with the portfolios' expected rate of returns in the out-years.

Figure 2.10 – SOE and CE net operating balance



Source: The Treasury

Net Worth

Table 2.7 – Net worth comparison with *Half Year Update*

Net Worth ($ billion)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
			Year ended 30 June			
Total Crown Net Worth						
Budget Update	50.0	58.5	64.3	68.6	72.2	77.6
Half Year Update		55.6	61.4	65.6	68.9	74.0
Core Crown Net Worth						
Budget Update	28.3	34.5	38.5	41.1	42.8	46.5
Half Year Update		32.0	36.2	38.5	39.9	43.2
SOE Net Worth						
Budget Update	10.1	10.7	11.4	12.1	12.8	13.6
Half Year Update		10.6	11.1	11.6	12.3	13.0
Crown Entities' Net Worth						
Budget Update	34.8	36.8	38.5	39.8	41.0	42.1
Half Year Update		36.8	38.4	39.9	41.3	42.4

Source: The Treasury

Net worth is forecast to increase from $50 billion in 2004/05 to $77.6 billion by 2009/10. The growth in net worth reflects the Government's strategy to run operating surpluses to strengthen its fiscal position. This strategy is evident across the whole of the Crown. The following section focuses on the net worth of the core Crown segments for reported government activity.

Core Crown

Table 2.8 – Components of core Crown net worth

($ billion)	2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
			Year ended 30 June			
Total assets	87.5	95.2	97.9	102.2	103.3	105.8
Total liabilities	59.2	60.7	59.4	61.2	60.5	59.3
Net worth	28.3	34.5	38.5	41.1	42.8	46.5

Source: The Treasury

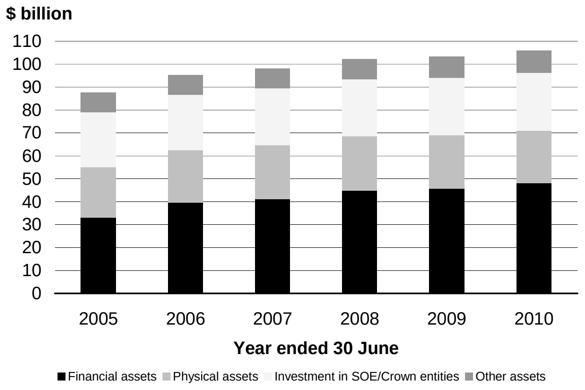
Over the forecast period, core Crown assets are expected to increase from $95.2 billion to $105.8 billion, largely reflecting the application of the OBERAC (refer Table 2.2) and additional borrowing to build up assets.

As Figure 2.11 illustrates, the majority of growth occurs within financial assets, which increase by around $8.5 billion, while investments in Crown entities (primarily to fund hospitals and housing capital projects) and physical assets also increase slightly.

Within the financial asset portfolio of the core Crown:

- the NZS Fund is expected to increase by around $12.3 billion over the forecast period. These funds are being set aside to assist in meeting pressures on future NZS payments associated with an ageing population
- advances are forecast to increase by around $2.5 billion, primarily due to student loans, offset by the move to the fair value measurement of those loans
- the financial asset portfolio's of the Reserve Bank and New Zealand Debt Management Office are expected to decrease over time largely due to the use of assets to assist in funding some of the Government's investment programme
- GSF holdings are forecast to remain relatively flat over the forecast period. The assets held by the GSF have been built up from employee contributions over time and are used to partially offset the GSF unfunded liability, which is forecast to be $15.1 billion by 2009/10.

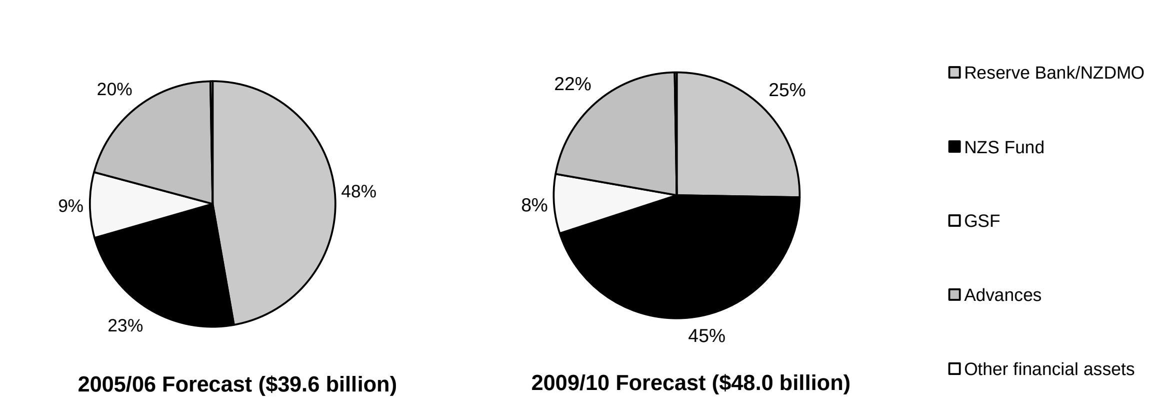
Figure 2.11 – Core Crown asset growth



Source: The Treasury

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

Figure 2.12 – Core Crown financial assets by portfolio

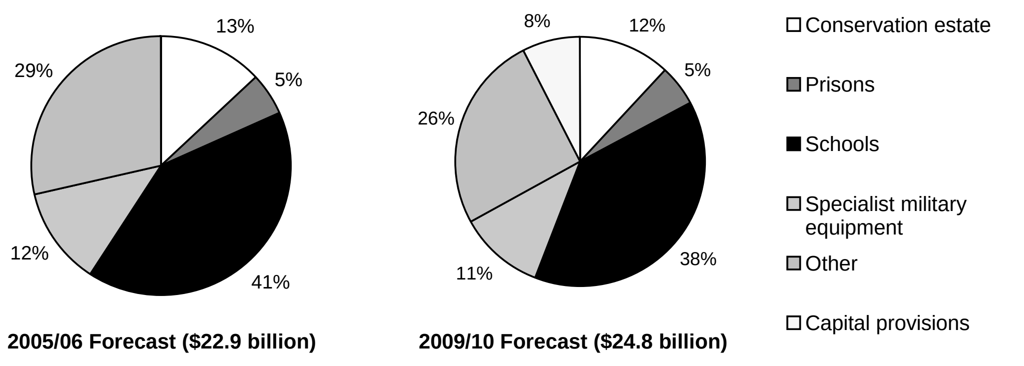


Source: The Treasury

Investments in Crown entities are forecast to increase by around $0.8 billion to allow for maintenance and improvement to the asset base, especially within the health and housing sectors.

Physical assets are expected to increase slightly over the forecast horizon, illustrating the maintenance and expansion of the core Crown's physical asset base. Figure 2.13 provides a breakdown of the physical assets held by the core Crown, by major asset classes.

Figure 2.13 – Core Crown physical assets by asset class (including capital provisions)



Source: The Treasury

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

State-Owned Enterprises and Crown Entities

SOEs' and Crown entities' net worth is forecast to increase by around $8.2 billion. Similar to the core Crown the increase in net worth is mainly within assets, which have been funded by:

- the use of operating balances generated by entities
- capital injections provided by core Crown departments.

Comparison with *Half Year Update*

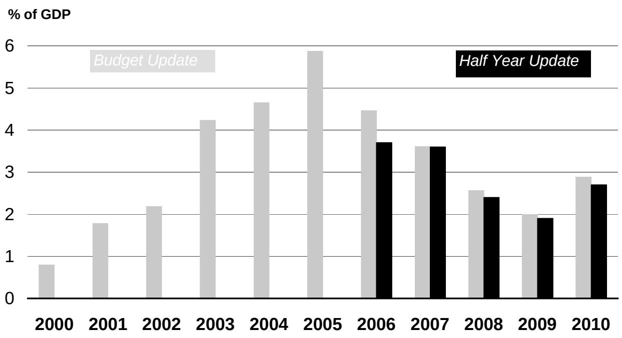
OBERAC and operating balance

Over the forecast period the OBERAC is forecast to be similar to the *Half Year Update.*

The improvement in the current year OBERAC compared with the *Half Year Update* is largely due to:

- increase in revenue comprising higher tax revenue primarily in source deductions where PAYE is showing some resilience despite evidence of employment growth slowing and withholding tax on resident interest, which has steadily moved ahead of forecast throughout the year
- delays in spending (of which some has been transferred into 2006/07)
- lower net finance cost due to the decrease in net core Crown debt and fluctuations in exchange rates
- higher SOE/CE returns, spread across a number of entities.

Figure 2.14 – OBERAC comparison



Source: The Treasury

Table 2.9 – OBERAC reconciliation (explains changes to the OBERAC since the *Half Year Update*)

($ million)	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
OBERAC 2005 *Half Year Update*	**5,924**	**5,893**	**4,103**	**3,367**	**5,091**
Changes (revenue)					
Tax revenue (forecasting)	345	(44)	249	275	136
Tax revenue (policy)	13	(108)	(393)	(398)	(411)
Other sovereign revenue	-	2	34	67	76
Investment income	728	144	195	221	209
Other revenue	155	80	42	55	8
Changes to SOE/CE results	(522)	167	(135)	(92)	48
Total revenue changes	**719**	**241**	**(8)**	**128**	**66**
Changes (core Crown expenses)					
Welfare benefit forecast changes	6	14	33	62	81
Doubtful debt provision	(66)	(148)	(152)	(200)	(213)
Future new operating spending	99	1,011	1,452	1,409	1,421
Other core Crown functional expenses	134	(1,300)	(1,112)	(1,291)	(1,157)
Finance costs	161	57	27	86	123
Total core Crown expenses changes	**334**	**(366)**	**248**	**66**	**255**
Total Changes	**1,053**	**(125)**	**240**	**194**	**321**
OBERAC 2006 *Budget Update*	**6,977**	**5,768**	**4,343**	**3,561**	**5,412**

Source: The Treasury

Cash available/(shortfall to be funded)

The amount required to be financed (cash shortfall) is around $1.2 billion lower across the forecast period than in the *Half Year Update* mainly due to:

- improvement of around $0.1 billion in tax receipts (excluding policy changes) across the forecast period
- reduction of around $0.9 billion in the forecast contribution to the NZS Fund across the forecast period
- reduction of around $0.5 billion in student loan advances across the forecast period.

These have been partially offset by additional transport capital spending to what was indicated in the *2006 BPS*.

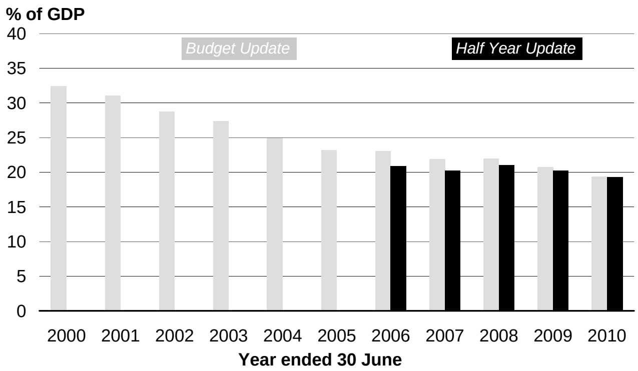
Debt indicators

Compared with the *Half Year Update,* gross debt is initially higher, due to the increase in settlement cash levels held by the Reserve Bank.

By the end of the forecast period the raising of the settlement cash level has been offset by the improvement in the cash shortfall (as mentioned above), resulting in gross debt being similar to the *Half Year Update*.

Net core Crown debt is expected to be lower due to the improvement in the cash shortfall.

Figure 2.15 – Gross sovereign-issued debt comparison



Source: The Treasury

Net core Crown debt including the financial assets of the NZS Fund has moved into a net asset position during 2005/06. This has occurred sooner than previously expected, due to:

- the current year financial assets of the NZS Fund being higher because of stronger investment returns
- the current year improvement in the cash position since the *Half Year Update.*

Table 2.10 – 2006 *Budget Update* fiscal indicators

Fiscal Indicators ($ million)	**Year ended 30 June 2005 Actual**	**2006 Forecast**	**2007 Forecast**	**2008 Forecast**	**2009 Forecast**	**2010 Forecast**
Revenue						
Total revenue	67,065	74,087	72,611	74,842	77,560	82,716
Core Crown revenue	52,065	56,652	56,190	57,781	59,728	64,157
Tax revenue	46,624	49,607	50,669	52,109	53,637	57,709
Expenses						
Total Crown expenses	60,910	65,734	66,976	70,632	74,132	77,437
Core Crown expenses	46,234	50,445	52,254	55,158	57,973	60,527
Operating balance - Core Crown	5,831	6,207	3,936	2,623	1,755	3,630
Operating balance - Crown entities	(101)	1,702	1,233	1,086	1,084	994
Operating balance - SOEs	958	1,618	1,111	1,079	1,195	1,258
Dividend elimination	(441)	(1,041)	(512)	(445)	(473)	(470)
Operating balance	6,247	8,486	5,768	4,343	3,561	5,412
OBERAC	8,873	6,977	5,768	4,343	3,561	5,412
OBERAC (excluding net NZS Fund asset returns)	8,507	6,547	5,093	3,495	2,517	4,147
Cash available/(shortfall to be funded)	3,104	1,755	(1,468)	(2,110)	(2,706)	(1,101)
Debt Indicators						
Gross sovereign-issued debt	35,045	35,952	35,013	37,082	36,973	36,348
Total gross Crown debt	36,864	38,889	38,388	41,412	41,367	40,113
Net core Crown debt	10,771	9,016	9,209	10,396	12,701	13,511
Net core Crown debt with NZS Fund assets	4,216	(999)	(3,530)	(5,430)	(6,634)	(9,740)
Net worth	49,983	58,485	64,253	68,596	72,157	77,569
Domestic bond programme	2,146	2,682	2,438	2,484	2,472	2,394
Nominal GDP	150,914	156,257	160,013	169,104	178,305	187,584
Fiscal Indicators as a % of GDP						
Revenue						
Total Crown revenue	44.4	47.4	45.4	44.3	43.5	44.1
Core Crown revenue	34.5	36.3	35.1	34.2	33.5	34.2
Tax revenue	30.9	31.7	31.7	30.8	30.1	30.8
Expenses						
Total Crown expenses	40.4	42.1	41.9	41.8	41.6	41.3
Core Crown expenses	30.6	32.3	32.7	32.6	32.5	32.3
Operating balance	4.1	5.4	3.6	2.6	2.0	2.9
OBERAC	5.9	4.5	3.6	2.6	2.0	2.9
OBERAC (excluding net NZS Fund asset returns)	5.6	4.2	3.2	2.1	1.4	2.2
Debt Indicators						
Gross sovereign-issued debt	23.2	23.0	21.9	21.9	20.7	19.4
Total gross Crown debt	24.4	24.9	24.0	24.5	23.2	21.4
Net core Crown debt	7.1	5.8	5.8	6.1	7.1	7.2
Net core Crown debt with NZS Fund assets	2.8	(0.6)	(2.2)	(3.2)	(3.7)	(5.2)
Net worth	33.1	37.4	40.2	40.6	40.5	41.4
New Zealand Superannuation Fund						
Fund asset returns (after tax)	492	1,123	675	848	1,044	1,265
Fund contributions	2,107	2,337	2,049	2,239	2,465	2,651
Fund assets (year end)	6,555	10,015	12,739	15,826	19,335	23,251
% of GDP	4.3	6.4	8.0	9.4	10.8	12.4

Source: The Treasury

Table 2.11 – 2005 *Half Year Update* fiscal indicators

Fiscal Indicators ($ million)	**Year ended 30 June** 2005 Actual	2006 Forecast	2007 Forecast	2008 Forecast	2009 Forecast	2010 Forecast
Revenue						
Total revenue	67,065	69,775	72,141	74,590	77,085	82,131
Core Crown revenue	52,065	54,328	56,116	57,654	59,508	64,088
Tax revenue	46,624	49,249	50,821	52,253	53,760	57,984
Expenses						
Total expenses	60,910	64,351	66,381	70,620	73,851	77,173
Core Crown expenses	46,234	50,665	51,888	55,406	58,039	60,782
Operating balance - Core Crown	5,831	3,663	4,228	2,248	1,469	3,306
Operating balance - Crown entities	(101)	1,412	1,283	1,358	1,291	1,136
Operating balance - SOEs	958	843	847	914	1,028	1,089
Dividend elimination	(441)	(361)	(465)	(417)	(421)	(440)
Total operating balance	6,247	5,557	5,893	4,103	3,367	5,091
OBERAC	8,873	5,924	5,893	4,103	3,367	5,091
OBERAC (excluding net NZS Fund asset returns)	8,381	5,418	5,247	3,270	2,327	3,818
Cash available/(shortfall to be funded)	3,104	492	(1,341)	(2,687)	(3,167)	(1,366)
Debt Indicators						
Gross sovereign-issued debt	35,045	33,275	32,967	35,728	36,111	36,195
Total gross Crown debt	36,864	36,054	36,778	40,032	39,617	33,457
Net core Crown debt	10,771	10,597	10,434	11,854	14,240	14,998
Net core Crown debt with NZS Fund assets	4,216	1,199	(1,961)	(3,817)	(5,148)	(8,482)
Net worth	49,983	55,555	61,448	65,551	68,918	74,009
Domestic bond programme	2,146	2,663	3,039	3,083	3,116	3,062
Nominal GDP	150,966	158,947	163,062	169,897	178,805	187,853
Fiscal Indicators as a % of GDP						
Revenue						
Total Crown revenue	44.4	43.9	44.2	43.9	43.1	43.7
Core Crown revenue	34.5	34.2	34.4	33.9	33.3	34.1
Tax revenue	30.9	31.0	31.2	30.8	30.1	30.9
Expenses						
Total Crown expenses	40.3	40.5	40.7	41.6	41.3	41.1
Core Crown expenses	30.6	31.9	31.8	32.6	32.5	32.4
Operating balance	4.1	3.5	3.6	2.4	1.9	2.7
OBERAC	5.9	3.7	3.6	2.4	1.9	2.7
OBERAC (excluding net NZS Fund asset returns)	5.6	3.4	3.2	1.9	1.3	2.0
Debt Indicators						
Gross sovereign-issued debt	23.2	20.9	20.2	21.0	20.2	19.3
Total gross Crown debt	24.4	22.7	22.6	23.6	22.2	17.8
Net core Crown debt	7.1	6.7	6.4	7.0	8.0	8.0
Net core Crown debt with NZS Fund assets	2.8	0.8	(1.2)	(2.2)	(2.9)	(4.5)
Net worth	33.1	35.0	37.7	38.6	38.5	39.4
New Zealand Superannuation Fund						
Fund asset returns (after tax)	492	506	646	833	1,040	1,273
Fund contributions	2,107	2,337	2,351	2,443	2,677	2,819
Fund assets (year end)	6,555	9,398	12,395	15,671	19,388	23,480
% of GDP	4.3	5.9	7.6	9.2	10.8	12.5

Source: The Treasury

The following table explains how the operating surplus/OBERAC is calculated for the 2005/06 and the 2006/07 financial years and then how it is applied. Any extra spending or reduced tax revenue would add to the bottom-line cash shortfall (and add to the need to borrow).

$ million	**2005/06**	**2006/07**	**Description of Items**
	56,652	56,190	**Core Crown revenues** – the revenues the Government collects. They are mainly taxes.
	50,445	52,238	**Core Crown expenses** – represent most of the Government's spending, *BUT not all of it*. They are the day-to-day spending (salaries, benefit payments, etc) that do not create government assets. They also include the amount for new initiatives in forecast years (refer page 154 of GAAP Series Tables).
	2,279	1,832	**Net surplus of SOEs and Crown entities** – the net surplus (after dividends) that SOEs and Crown entities make.
Operating balance	**8,486**	**5,768**	**Operating balance** – the residual of revenues less expenses plus surpluses from SOEs and Crown entities. It is the Government's operating profit or loss.
	1,509	-	**OBERAC adjustments** – removal of revaluation movements.
OBERAC	**6,977**	**5,768**	**OBERAC** – the residual from revenues and expenses less removal of large valuation movements (the OBERAC and operating balance are the same in forecast years).
Less	1,092	(1,080)	**Retained items and non-cash items** – items such as the net surplus of SOEs/Crown entities and the net investment returns of the NZS Fund are retained by these entities. The surpluses generated (unless withdrawn from the entities) cannot be used for other purposes so do not aid in funding other government spending. Depreciation expense is also removed as it is non-cash (it is captured in the actual purchase of assets below). Additionally, the actual working capital movements, such as payment of creditors, impact on the level of net cash flows from operations.
Equals surplus cash flows	**8,069**	**4,688**	**Cash from operations** – the cash flows from core Crown operations (excluding the NZS Fund). This is the cash equivalent of the operating surplus and is available to assist in funding capital spending.
Less capital spending	(2,337)	(2,049)	**Contributions to the NZS Fund** – the Government's annual contribution to the NZS Fund to build up assets to contribute to future NZS payments.
	(1,988)	(1,953)	**Purchase of assets** – departments buy assets including computer equipment, new buildings and defence equipment.
	(975)	(957)	**Loans to others (advances)** – mainly student loans (the Government is committed to helping students access tertiary education by funding student loans).
	(514)	(441)	**Net capital injections** – investments in Crown entities to enable them to build hospitals and housing.
	(500)	(500)	**Reserve Bank reserves** – purchase of extra reserves to assist the Reserve Bank to maintain financial stability.
	-	(256)	**Capital forecast** – an amount set aside for further capital activity. The Government has not yet decided on the specific initiatives.
What is left	**1,755**	**(1,468)**	**Cash available**/(**shortfall**) – the amount needed to be funded if it is a shortfall. Funding is provided by selling surplus financial assets (because of surplus cash from prior years) or borrowing more.

New Zealand International Financial Reporting Standards (NZ IFRS)

The Accounting Standards Review Board (ASRB) announced in December 2002 that New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) will apply to financial reporting by both public and private sector entities from 1 January 2007, with entities having an option to adopt from 1 January 2005.

The Crown will adopt NZ IFRS for its financial reporting from 1 July 2007. The 2007 Budget will be prepared on an NZ IFRS basis. NZ IFRS adoption will affect how transactions and balances are grouped and presented in the Crown financial statements (e.g., defined benefit retirement plan liabilities and assets will be presented net in the Statement of Financial Position) and will also impact on their recognition and measurement (e.g., it is expected there will be greater use of fair values, notably when measuring financial instruments).

FRS-29 *Prospective Financial Statements* requires prospective information to be prepared in accordance with the financial standards that will be effective in these periods, which will be NZ IFRS for periods beginning 1 July 2007. However, as the impact of the transition to NZ IFRS has not been fully identified and clarified, the forecast financial statements in this Economic and Fiscal Update have been prepared under current financial reporting standards.

Risks to fiscal forecasts

The fiscal forecasts were finalised on 8 May 2006 in accordance with the forecast accounting policies. There are certain risks around the forecast results. To assist in evaluating such risks the following chapters should be read in conjunction with the fiscal forecasts:

- Risks and Scenarios (Chapter 3) – The fiscal forecasts are based on the economic forecasts presented in Chapter 1 and any variation from the economic forecast will affect the fiscal forecasts, in particular tax revenue and benefit expenses. The Risks and Scenarios chapter discusses the effect on the forecasts under different circumstances.

- Specific Fiscal Risks (Chapter 4) – The fiscal forecasts incorporate government decisions up to 8 May 2006. The Specific Fiscal Risks chapter covers specific policy decisions that are under active consideration by the Government at the time of the finalisation of the forecasts.

In addition to the specific fiscal risks and the link to the economic forecasts, there are a number of forecasting issues explained below that may arise in future.

Tax forecasting risks

The tax forecasts prepared for this *Budget Update* are based on current tax policy and on the macroeconomic central forecast. Sensitivities of tax revenue to changes in economic conditions are presented in the Risks and Scenarios chapter on page 123.

SOEs' and Crown entities' forecasts

The forecasts for large SOEs and Crown entities were provided in March 2006 based on their best assessments at that time.

Revaluation of property, plant and equipment

Crown accounting policy is to revalue certain classes of property, plant and equipment on a regular basis. In certain circumstances the valuation will be affected by foreign exchange rates, so any appreciation in the New Zealand dollar (from 30 June 2006) will adversely affect the current physical asset values included in the fiscal forecasts.

Discount rates

The GSF and ACC liabilities included in these forecasts have been valued as at 28 February and 31 March respectively. The liabilities are to be next valued as at 30 June 2006. Any change in discount rates will affect the presented fiscal forecast. For example, if the discount rate rises, the value of the liabilities will decrease.

Tertiary education institutes' (TEIs') accounting treatment

The forecast information presented in the 2006 *Budget Update* combined TEIs on an equity accounting basis. As noted in previous publications, the combination treatment of TEIs remains unresolved.

The combination method adopted in these forecasts is to equity account for the TEIs' net surpluses and net investment (i.e., TEI revenues, expenses, assets and liabilities are not included on a line-by-line basis). This is consistent with the treatment adopted in the 2005 Crown financial statements.

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

Indicators of the Government's Fiscal Performance

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

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

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

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

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

Accounting equations

Flow indicators (a worked example of how these flows interact is provided in the Fiscal Outlook chapter)

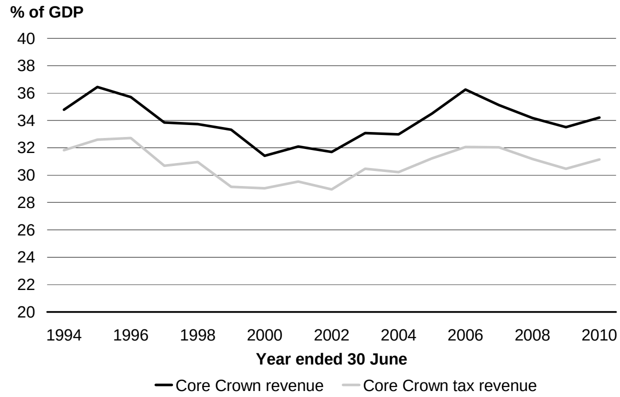
- Core Crown revenues – core crown expenses + net surplus of SOEs (i.e., after dividends) and Crown entities = **Operating balance.**
- Operating balance – revaluation movements – accounting changes = **OBERAC.**
- OBERAC – retained items (e.g., net surplus of SOEs/CEs and net investment returns of the NZS Fund) – non-cash items (e.g., depreciation) = **Core Crown cash flow from operations.**
- Core Crown cash flow from operations – net investing activities (e.g., contributions to NZS Fund, purchases of assets, loans to others) = **Cash available/shortfall.**

Stock indicators

- **Gross sovereign-issued debt (GSID)** = debt issued by the core Crown. (Cash available/shortfall in any year largely drives the change in gross sovereign-issued debt.)
- **Core Crown net debt** = gross sovereign-issued debt – core Crown's financial assets.
- **Net worth (NW)** = Crown's total assets – Crown's total liabilities. (Operating balance (OB) in any year largely drives the change in Net Worth.)

Ratio of core Crown revenue to GDP

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

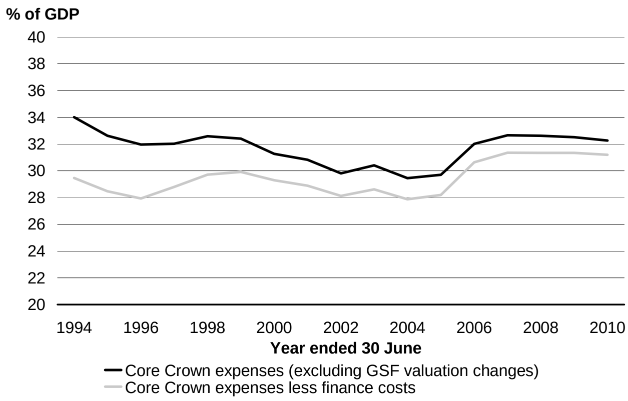


The revenue collected is used to meet the Government's spending needs. It is important to look at this alongside expenses, operating balance and gross debt indicators for insights into the sustainability of current policy settings.

Core Crown revenue to GDP is expected to be broadly stable at around 35% over the forecast period, while core Crown tax to GDP is expected to be broadly stable at slightly above 30% of GDP.

Ratio of core Crown expenses to GDP

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



This shows the day-to-day spending of the core Crown – i.e., it excludes spending by SOEs and Crown entities – and highlights the size of government in the economy and potential scope for crowding out the private sector. This also excludes GSF valuation changes.

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

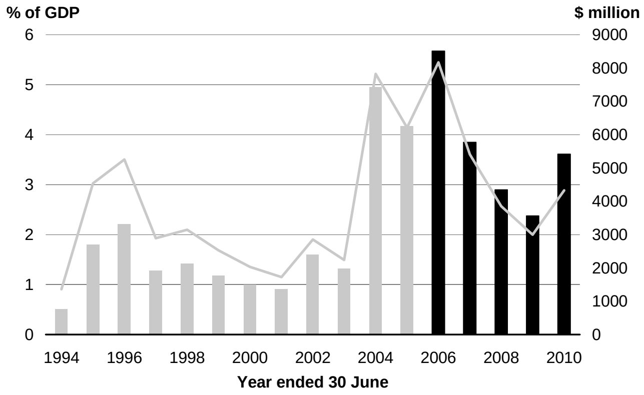
By reducing gross debt, the Government has also reduced finance costs. However, in the years ahead, finance costs are likely to be fairly flat with gross debt forecast to be broadly stable.

Core Crown expenses to GDP are expected to remain broadly stable at around 32% of GDP over the forecast period.

Operating balance

Operating balance = the residual of revenues less expenses plus surpluses from State-owned enterprises and Crown entities.

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



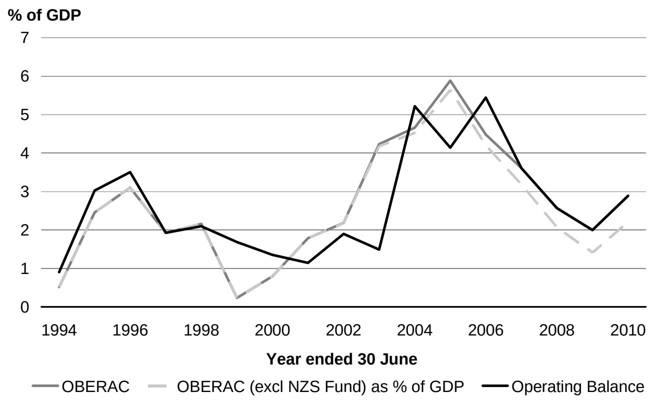
This measure can be volatile from year to year due to events outside of the Government's direct control (such as changes in interest rates and revaluations etc); therefore, it is generally not used as a measure of the Government's short-term fiscal stewardship.

The Government has been running operating surpluses since the early 1990s. These are expected to reach a peak of 5.4% of GDP in 2006 and are expected to remain above 2% of GDP over the forecast period.

OBERAC

OBERAC = the operating balance adjusted for revaluation movements and accounting policy changes (which are deemed to be outside of the Government's direct control).

OBERAC excluding NZS Fund returns = OBERAC excluding the NZS Fund returns (which are retained in the NZS Fund).



By excluding revaluations and accounting changes, or things that are outside of the Government's direct control, the OBERAC gives a more direct indication of the underlying stewardship of the Government.

The current Government wishes to retain the NZS Fund investment returns in the Fund. Therefore, to ensure the Government is meeting its fiscal objectives, the Government has stated that it will be focusing on the OBERAC excluding NZS Fund returns.

The Treasury does not forecast accounting or revaluation changes; therefore, over the forecast period the operating balance and the OBERAC are the same.

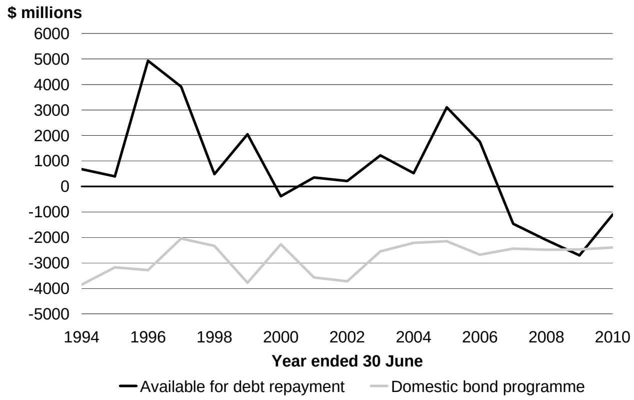
The OBERAC excluding NZS Fund returns is expected to come down from its recent peak of a surplus equivalent to around 5.6% of GDP in 2005, toward 2% of GDP in 2008 and beyond.

Cash available/(shortfall to be funded) and domestic bond programme

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

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

The cash available measure includes capital investment and NZS Fund contributions; therefore, it is a flow measure that contributes to the change in gross debt. This indicator is best looked at alongside the operating balance and gross debt measures. For instance if gross debt is at low levels a government has more leeway to borrow while still being considered a prudent fiscal manager.



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

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

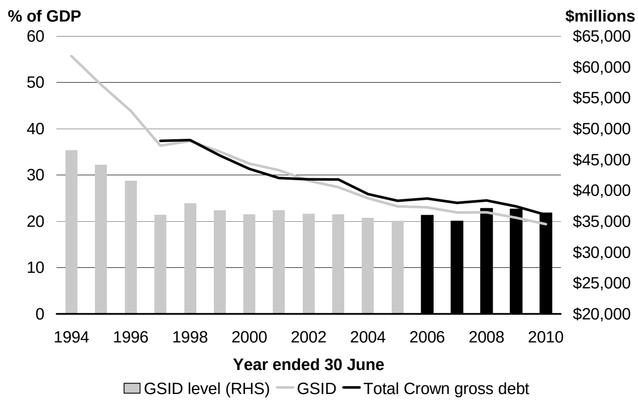
Crown gross debt

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

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

Total gross debt and GSID are often expressed as a percentage of GDP to put the level of debt into perspective, in terms of a country's ability to generate growth to repay the debt and/or income to service this debt.

Total gross debt represents the complete picture of whole-of-government obligations to external parties. However, debt issued by SOEs and Crown entities is not explicitly guaranteed by the Crown. The debt that is issued by the sovereign and guaranteed by the sovereign is in GSID. The Government's long-term debt objective is formulated in terms of GSID.



A high ratio of debt to GDP can have an adverse impact on credit ratings and perceived sustainability of current policy settings. So as a general rule, a relatively low ratio is considered to be prudent. A low ratio of debt to GDP can also provide the Government with more flexibility in their accounts to respond to adverse shocks through increasing debt.

GSID has been steadily declining since the early 1990s and is expected to remain broadly stable around 20% of GDP in the forecast period.

Core Crown financial assets

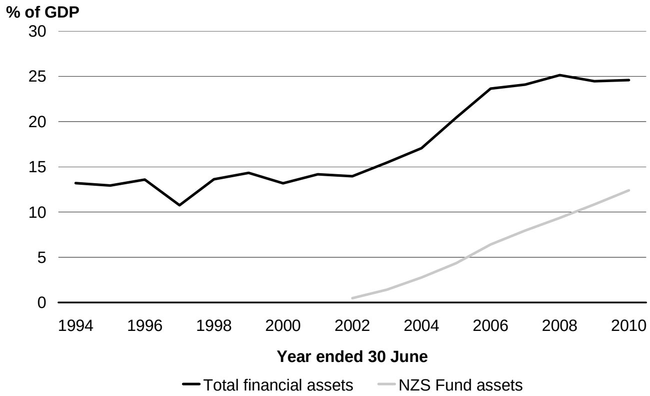
Core Crown financial assets = the financial assets of the core Crown. These are either cash or shares (equity) or a right to receive a financial instrument, which can be converted to cash.

The assets of the New Zealand Superannuation (NZS) Fund are becoming the dominant feature of the Crown's financial assets. The NZS Fund is the Government's means of building up assets to partially pre-fund future NZS expenses. The Government's contributions to the NZS Fund are calculated over a 40-year rolling horizon to ensure superannuation entitlements over the next 40 years can be met.

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

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

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

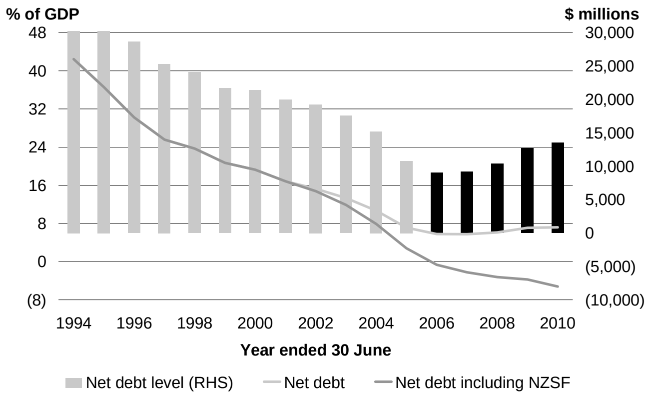


As at 31 March 2006, the NZS Fund's assets totalled $9.2 billion or around 5% of GDP. The NZS Fund is expected to grow to around $23 billion or 12.4% of GDP by the end of the forecast period and to reach around $120 billion by 2025.

Core Crown net debt

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

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



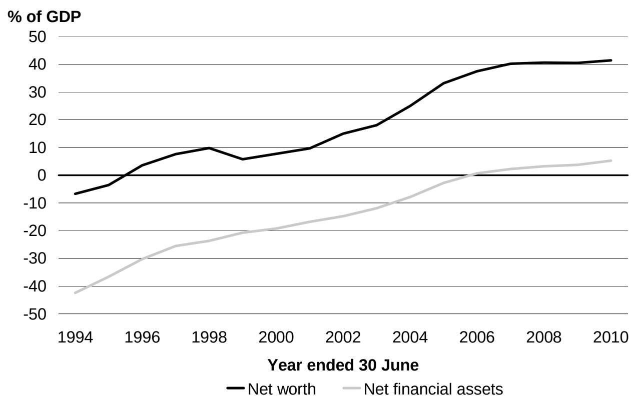
However, as some financial assets are not very liquefiable (or easily converted into cash), it is important to view net debt alongside GSID.

After declining steadily since the early 1990s, net debt is projected to consolidate in the years ahead at around 7% of GDP, rising slightly towards the end of the projection period (partially reflecting the trend in GSID). If the assets of the NZS Fund are included, the government's net debt position moved into a net financial asset position during this financial year.

Net worth

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

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



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

Net worth is projected to continue to rise at a rapid rate, moving from around 5% in 2000 to over 33% in 2005 and moving above 40% by the end of the forecast period.