2

Fiscal Outlook

Introduction

This chapter discusses the trends, drivers and assumptions behind the outlook for the Crown's finances.

The discussion covers:

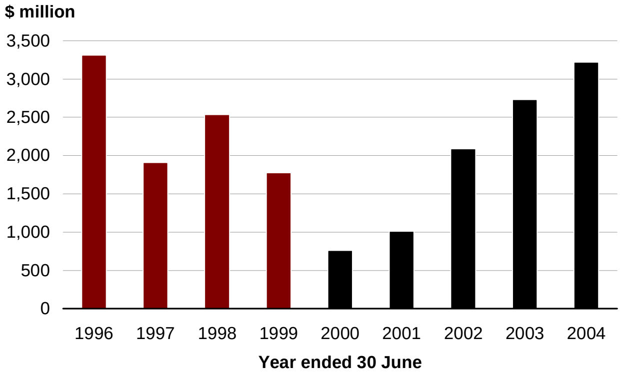
- an overview of the fiscal position, including trends in key fiscal indicators (operating balance, debt and net worth)
- key components of the operating balance including revenue, expenses, and state-owned enterprises (SOEs) and Crown entity surpluses, and the provision for future initiatives (see Statement of Financial Performance page 85)
- key drivers of net worth and debt (see Statement of Financial Position page 86), the relation between debt and the operating balance, and details of the 2000/01 bond programme
- effects on the fiscal outlook of policy decisions
- developments in generally accepted accounting practice (GAAP) that will change the way the forecasts are constructed.

Overview

The operating balance rises steadily over the forecast horizon…

The estimated 1999/2000 operating balance ($763 million or 0.7% of GDP) is boosted by the GSF and ACC liability revaluations totalling around $500 million.

Figure 2.1 – Operating balance



Source: The Treasury

In the early part of the forecast horizon, revenue growth is strong – driving off nominal GDP growth of around 5%, coupled with the full year impact of the increase in tax rates in 2000/01.

Expense growth is around 4% over this period as the Government implements its policy programme, with the full impact of decisions such as increasing the NZS floor back to 65% of the net average wage occurring in 2000/01.

From 2001/02, revenue grows in line with nominal GDP (around 5% each year). Expense growth slows to around 3% a year, reflecting smaller allowances for new policy initiatives.

The resulting operating balances show a rising track. Abstracting from cyclical effects, there is also an increase in the structural operating balance trend as expenditure growth is held below revenue growth from policy decisions such as taxation increases and economic growth.

…leaving cash available for investing and debt repayment

In 1999/2000 and 2000/01, cashflows from operating and investing activities do not generate sufficient cash to reduce debt in dollar terms.

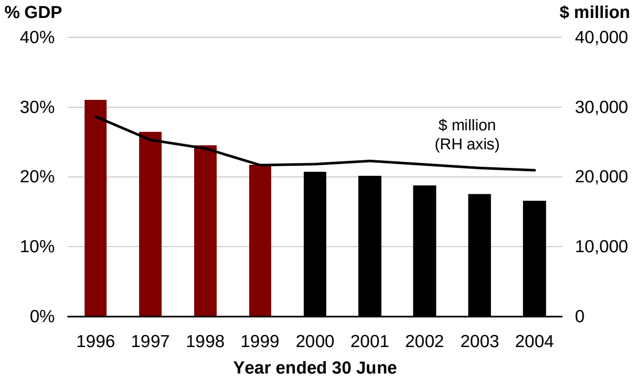
From 2001/02 rising operating balances translate to cashflow surpluses. This cash is applied to pre-funding future New Zealand Superannuation (NZS) expenses, and debt reduction.

NZS Fund assets grow to around $3.8 billion (3.0% of GDP) by 2003/04.

Net debt falls by around $1.3 billion from 2001/02. Gross debt follows a similar track.

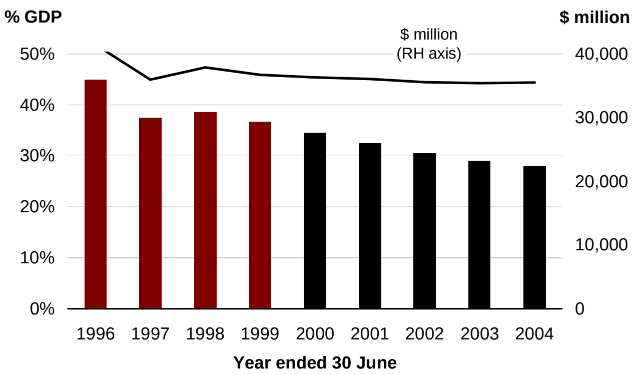
As a percentage of GDP, net debt falls from 20.7% to 16.5% between 1999/2000 and 2003/04 and gross debt declines by 6.5% from 34.5% of GDP to reach 28% of GDP by the end of the forecast period.

Figure 2.2 – Net debt ($ and % of GDP)



Source: The Treasury

Figure 2.3 – Gross debt ($ and % of GDP)



Source: The Treasury

Operating balance forecasts have not changed substantially from the Budget Policy Statement...

The operating balance increases each year but the changes to the forecasts since the BPS are not substantial, as outlined in Table 2.1.

Table 2.1 – Operating balance reconciliation

$ million	1999/00 Forecast	2000/01 Forecast	2001/02 Forecast	2002/03 Forecast	2003/04 Forecast
Operating balance PREFU	**14**	**796**	**1,659**	**2,341**	**-**
Policy changes					
Removal of previous Government's tax cuts	70	395	415	435	
Introduction of higher marginal tax rate of 39%					
Source deductions	46	237	255	286	
Other persons	-	176	250	253	
Fringe benefit tax	-	68	69	70	
Other tax types	-	(14)	(18)	(21)	
Removal of previous Government's fiscal provisions	10	310	920	1,470	
New Government's fiscal provisions	(150)	(1,200)	(1,850)	(2,650)	
Total policy changes	**(24)**	**(28)**	**41**	**(157)**	**-**
Forecasting changes					
Tax revenue forecasting increases	321	211	249	137	
Increases to other revenue	80	-	-	-	
Other	9	21	(49)	(121)	
Total forecasting changes	**410**	**232**	**200**	**16**	**-**
Operating balance BPS	**400**	**1,000**	**1,900**	**2,200**	**2,600**
Policy changes					
Change to Government's provision allocations	(270)	(30)	60	225	235
Forecasting changes					
Tax revenue forecasting increases	68	139	50	116	211
Benefit forecasting decreases	45	130	125	100	90
Treaty settlement forecast revisions	124	37	37	37	37
Finance cost changes	(46)	1	77	110	187
Valuation changes (GSF and ACC liability movements)	510	(140)	(80)	(35)	-
Police (INCIS writedown) and NZDF (inventory accounting policy change)	(155)	-	-	-	-
Other	87	(125)	(78)	(20)	(138)
Total forecasting changes	**633**	**42**	**131**	**308**	**387**
Operating balance Budget	**763**	**1,012**	**2,091**	**2,733**	**3,222**

Source: The Treasury

While the government remains within its overall fiscal provision of $5.9 billion (see page 35), it has bought forward spending into the early years of the forecast horizon. This is fiscally neutral over the term of the Government's provision (1999/2000 to 2002/03).

This re-phasing of new policy expenditure increases the structural operating surplus in the latter half of the forecast horizon.

Other factors driving the increase since the BPS include:

- downward liability revaluations of around $500 million, which increase the operating balance in 1999/2000
- lower benefit forecasts, reflecting lower CPI forecasts and lower benefit uptakes
- marginally higher taxation forecasts, due to a small increase in nominal GDP, particularly in the last two years of the forecast horizon
- lower finance costs, reflecting lower long-term Government stock rates, together with lower debt levels.

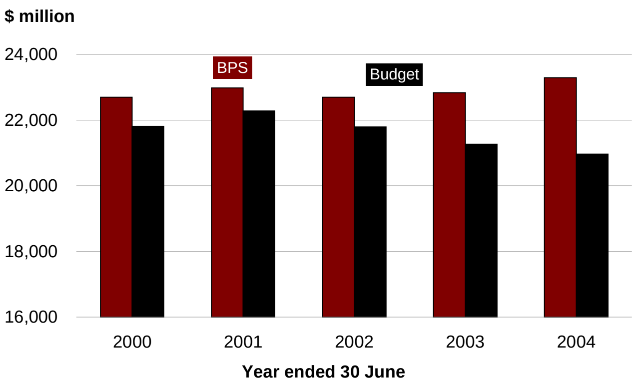
…resulting in a lower net debt position

Compared with the BPS, net debt is lower in the first year. The reduction is broadly maintained in the second year before steadily improving.

The reduction in net debt in 1999/2000 reflects factors that do not impact on the operating balance, including:

- deferred and reduced net purchases of physical assets (for example, cancellation of F16 aircraft purchases)
- spending decisions made in 1999/2000 that will impact on cash flows the following year (for example, the West Coast Package)
- a general shift in the forecast timing of cash flows, which has resulted in some cash relating to this year's expenditure now being forecast to occur early in the next year. This effect flows through to each outyear relative to the BPS forecasts, resulting in a 'level shift' improvement to net debt.

Figure 2.4 – Net debt comparison



Source: The Treasury

Some of the reduction in 1999/2000 reverses in 2000/01, but thereafter the reduction against the BPS is driven by the higher operating balance forecasts.

As a result of the factors outlined above there is additional cash available. The bond programme has been set at $2.85 billion, with $2.35 billion required to fund the maturing domestic debt (after cashflows from operating, investing and the 1999/2000 over-funding are taken into account) and $500 million to refinance foreign-currency reserves.

Fiscal Indicators

Table 2.2 – Fiscal indicators

$ million, year ended 30 June	1999 Actual	2000 BPS	2000 Budget	2001 BPS	2001 Budget
Statement of Financial Performance					
Revenue					
Taxation revenue	32,156	33,797	33,885	35,928	36,152
Other revenue	4,201	2,475	2,435	2,301	2,218
Total revenue	**36,357**	**36,272**	**36,320**	**38,229**	**38,370**
Ratio to GDP (%)	**36.4%**	**34.9%**	**34.5%**	**34.7%**	**34.6%**
Tax ratio to GDP (%)	**32.2%**	**32.5%**	**32.1%**	**32.6%**	**32.6%**
Expenses					
Functional expenses	33,356	34,042	34,105	34,536	35,398
Finance costs	2,516	2,303	2,381	2,480	2,479
Net foreign exchange losses/(gains)	(47)	(26)	(58)	..	..
Provision for future initiatives	..	53	..	872	180
Total expenses	**35,825**	**36,372**	**36,428**	**37,888**	**38,057**
Ratio to GDP (%)	**35.9%**	**35.0%**	**34.6%**	**34.4%**	**34.3%**
Contribution of SOEs and CEs					
Surplus attributable to SOEs and CEs	1,789	965	1,327	977	925
Dividends and other distributions	(544)	(465)	(456)	(318)	(226)
Net Contribution of SOEs and CEs	**1,245**	**500**	**871**	**659**	**699**
Operating balance	**1,777**	**400**	**763**	**1,000**	**1,012**
Ratio to GDP (%)	**1.8%**	**0.4%**	**0.7%**	**0.9%**	**0.9%**
Statement of Financial Position					
Assets (excluding NZS Fund assets)	58,223	56,991	59,459	58,359	60,334
NZS Fund assets	..	..	..	..	..
Liabilities	52,201	50,166	52,155	50,534	52,018
Crown balance (Net worth)	**6,022**	**6,825**	**7,304**	**7,825**	**8,316**
Ratio to GDP (%)	**6.0%**	**6.6%**	**6.9%**	**7.1%**	**7.5%**
Statement of Borrowings					
Crown debt					
Gross debt	36,712	35,017	36,337	35,363	36,092
less financial assets	(15,011)	(12,316)	(14,518)	(12,386)	(13,810)
Net Crown debt	**21,701**	**22,701**	**21,819**	**22,977**	**22,282**
Net Crown debt to GDP (%)	**21.7%**	**21.8%**	**20.7%**	**20.9%**	**20.1%**
Gross debt to GDP (%)	**36.8%**	**33.7%**	**34.5%**	**32.1%**	**32.5%**
Net debt repayment/(increase)	2,368	(1,000)	(118)	(276)	(463)
Nominal GDP	99,894	104,022	105,411	110,141	110,987

Source: The Treasury

Table 2.2 – Fiscal Indicators - continued

$ million, year ended 30 June	2002 BPS	2002 Budget	2003 BPS	2003 Budget	2004 BPS	2004 Budget
Statement of Financial Performance						
Revenue						
Taxation revenue	37,868	38,073	39,552	39,833	41,311	41,697
Other revenue	2,441	2,346	2,520	2,406	2,520	2,444
Total revenue	**40,309**	**40,419**	**42,072**	**42,239**	**43,831**	**44,141**
Ratio to GDP (%)	**34.9%**	**34.7%**	**34.9%**	**34.7%**	**34.8%**	**34.8%**
Tax ratio to GDP (%)	**32.8%**	**32.7%**	**32.8%**	**32.8%**	**32.8%**	**32.8%**
Expenses						
Functional expenses	34,960	35,746	35,708	36,507	36,355	37,288
Finance costs	2,574	2,497	2,554	2,444	2,580	2,393
Net foreign exchange losses/(gains)	..	..	..	..	..	..
Provision for future initiatives	1,507	730	2,299	1,305	3,095	2,105
Total expenses	**39,041**	**38,973**	**40,561**	**40,256**	**42,030**	**41,786**
Ratio to GDP (%)	**33.8%**	**33.5%**	**33.6%**	**33.1%**	**33.4%**	**32.9%**
Contribution of SOEs and CEs						
Surplus attributable to SOEs and CEs	993	883	1,100	1,013	1,210	1,146
Dividends and other distributions	(361)	(238)	(411)	(263)	(411)	(279)
Net Contribution of SOEs and CEs	**632**	**645**	**689**	**750**	**799**	**867**
Operating balance	**1,900**	**2,091**	**2,200**	**2,733**	**2,600**	**3,222**
Ratio to GDP (%)	**1.6%**	**1.8%**	**1.8%**	**2.2%**	**2.1%**	**2.5%**
Statement of Financial Position						
Assets (excluding NZS Fund assets)	59,371	61,162	61,067	62,448	63,003	63,797
NZS Fund assets	615	615	1,875	1,875	3,805	3,805
Liabilities	50,261	51,370	51,017	51,183	52,283	51,240
Crown balance (Net worth)	**9,725**	**10,407**	**11,925**	**13,140**	**14,525**	**16,362**
Ratio to GDP (%)	**8.4%**	**8.9%**	**9.9%**	**10.8%**	**11.5%**	**12.9%**
Statement of Borrowings						
Crown debt						
Gross debt	35,212	35,561	36,174	35,442	37,440	35,558
less financial assets	(12,543)	(13,765)	(13,342)	(14,177)	(14,143)	(14,595)
Net Crown debt	**22,669**	**21,796**	**22,832**	**21,265**	**23,297**	**20,963**
Net Crown debt to GDP (%)	**19.6%**	**18.7%**	**18.9%**	**17.5%**	**18.5%**	**16.5%**
Gross debt to GDP (%)	**30.5%**	**30.5%**	**30.0%**	**29.1%**	**29.7%**	**28.0%**
Net debt repayment/(increase)	308	486	(163)	531	(465)	302
Nominal GDP	115,565	116,492	120,578	121,624	125,920	126,959

Source: The Treasury

Drivers of the Operating Balance

This section discusses the trends in the three main operating balance components, and the significant changes in these components since the BPS (see Statement of Financial Performance page 85).

The first significant component of the operating balance is tax revenue.

Tax Revenue

Tax revenue rises in 1999/2000

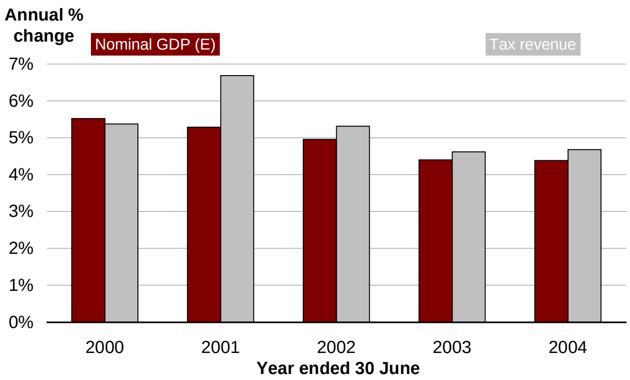
Tax revenue is expected to grow by 5.4% in 1999/2000, which is very close to the forecast growth in nominal GDP for the same period.

Policy changes also come into play, but only in the last quarter of the year.

These changes are:

- the 1 April 2000 rise in the tax-rate on annual personal income above $60,000
- the increase in the excise rate on tobacco on 10 May 2000.

Figure 2.5 – Growth in tax revenue and nominal GDP



Source: The Treasury

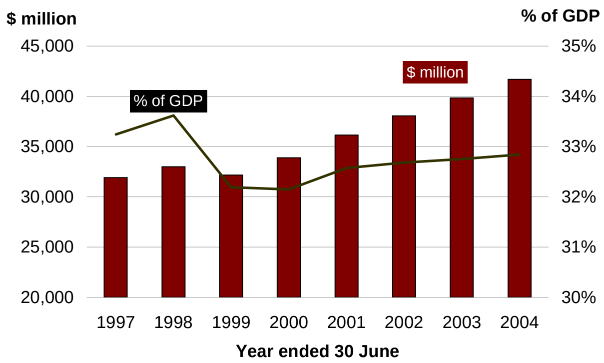
From 2000/01 onwards, tax revenue grows faster than nominal GDP

The full effects of these policy changes are felt in 2000/01. This, together with the tightening of tax law relating to film investment, causes tax revenue to grow faster than nominal GDP, but is partially offset by concessions granted to some existing film and television projects.

In later years the gap closes, although some timing effects from the tax-rate increase are still felt in 2001/02.

Consequently, the tax-to-GDP ratio rises in 2000/01 but stays fairly level after that.

Figure 2.6 – Tax revenue ($ and % of GDP)



Source: The Treasury

Tax forecasts have increased since the Budget Policy Statement[4]

Tax revenue is marginally higher in all years than it was in the BPS forecasts. The increases are greatest in the final two years of the forecast.

Table 2.3 – Details of changes to tax revenue forecasts since BPS

($ million)	1999/00	2000/01	2001/02	2002/03	2003/04
Changes due to specific policies:					
Tobacco excise rate increase[5]	20	120	120	125	130
Tariff rate freeze	-	35	80	85	90
Multi-rate FBT	-	(80)	(65)	(65)	(65)
Anti-avoidance measures	-	10	20	20	20
Total changes due to policy	20	85	155	165	175
Forecasting changes	68	139	50	116	211
Total change since BPS	88	224	205	281	386

Source: The Treasury

The current-year revision is largely due to the inclusion of new tax outturn information. The biggest outturn changes have occurred in GST and customs duty.

From 2000/01 onwards, some significant policy changes from the situation at BPS push up tax revenue forecasts. The most notable of these are:

- the increase to the tobacco excise rate
- the freezing of tariff rates at their present levels.

Risks around the tax forecasts

Forecasts of nominal income and expenditure are the main drivers of the tax forecasts. Hence, the major source of risk in the tax forecasts is the accuracy of the economic forecasts. However, judgements about taxpayer behaviour in response to policy and administrative changes are also required in forecasting. The accuracy of these judgements is another source of risk in the tax forecasts.

Major behavioural judgements in this forecast include:

- the degree of tax avoidance activity in response to the personal tax-rate increase
- the effect of the new rate structure on fringe benefit tax revenue
- the changes to the timing and size of refunds to individuals owing to more accurate PAYE withholding and the elimination of IR5 tax returns
- the degree by which consumption of tobacco will decline in response to the excise rate increase.

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4 Changes to tax revenue forecasts between the Pre-election Economic and Fiscal Update (PREFU) and BPS forecasts can be found in Table 2.1

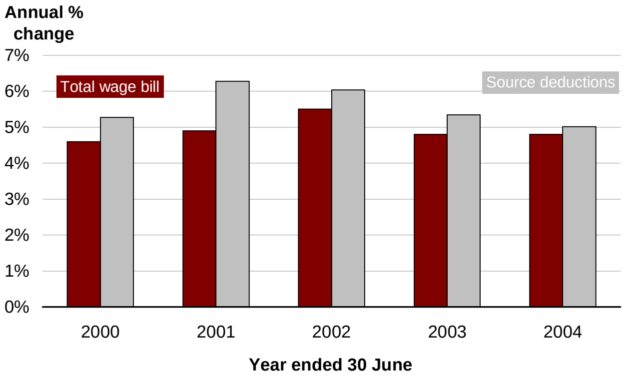
5 This represents additional gross revenue. In Table 2.6, this policy initiative is disclosed as the net revenue increase to the Crown (as there are some offsetting increases to benefit costs caused by the higher CPI resulting from the decision to increase the tobacco excise rate).

PAYE growth comes from stronger labour market and tax-rate rise

Within this overall picture, source deductions (PAYE) is the biggest component of tax revenue. PAYE increases over the forecast period for several reasons.

There is growth in both employment and wages in each year of the forecast. PAYE usually grows slightly faster than employment and wages because, as wages increase over time, people move into higher tax brackets. This is known as the fiscal drag effect.

Figure 2.7 – Growth in total wage bill and source deductions



Source: The Treasury

PAYE has also increased as a result of the new top personal tax rate on income over $60,000 per year, which came into effect on 1 April 2000.

The effect of the tax-rate rise is biggest in 2000/01 because it applies to the entire year. Increases to NZS also add to PAYE growth.

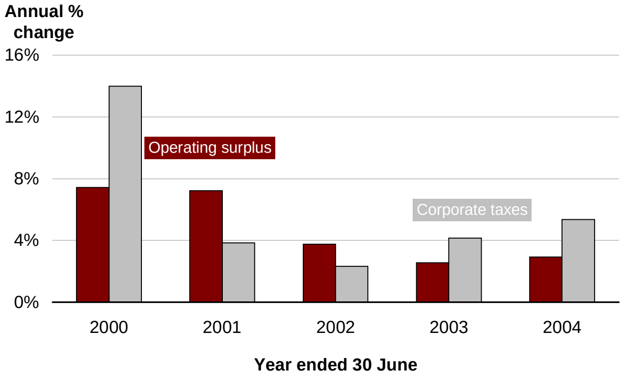
From 2001/02 onwards, PAYE grows slightly faster than the total wage bill as a result of the fiscal drag effect.

Corporate taxes strong in 1999/2000 and keep growing

Assessments of corporate tax for 1999/2000 are much stronger than in 1998/99. This is mainly due to growth in corporate profits, further boosted by adjustments to corporate tax revenue to recognise some prior period payments.

Corporate profits (as proxied by corporate operating surplus) continue to grow strongly in 2000/01. Tax revenue growth does not match this, owing to the effects of interest rate rises and film-related tax concessions.

Figure 2.8 – Growth in corporate operating surplus and corporate taxes



Source: The Treasury

In the following year rising interest rates and a continuation of film-related concessions see tax revenue growing less rapidly than corporate profits.

Interest rates peak and then start to decline in the last two years, which boosts growth in corporate tax revenue. The tax concessions expire in 2003/04, contributing to the increase in corporate tax revenue growth over that in profits.

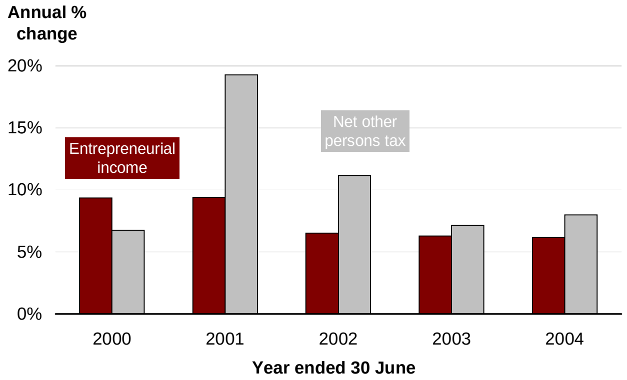
Increase in personal tax-rate flows through to other persons tax

Net other persons tax refers to the provisional tax received mainly from small-business owners, farmers and investors, less refunds to all individuals.

Net other persons tax has grown in 1999/2000, after several years of decline. The reasons are:

- stronger growth in entrepreneurial income
- a drop-off in personal refunds
- the 1 April 2000 tax-rate increase, although this has only a limited effect in the last quarter of the year.

Figure 2.9 – Growth in entrepreneurial income and net other persons tax



Source: The Treasury

In 2000/01, with entrepreneurial income continuing to grow strongly and the full-year effect of the tax-rate rise, there is a considerable increase in the growth of other persons tax.

Some of the impact of the tax-rate increase is delayed by timing effects. Consequently, in 2001/02, other persons tax continues to grow faster than entrepreneurial income.

These timing effects are finished by 2002/03. Hence, net other persons tax increases broadly in line with entrepreneurial income for the final two years of the forecast.

GST grows at a steady rate over the forecast period

Some exceptionally large GST outturns occurred in the June quarter of 1998/99, followed by more subdued outturns in the first quarter of 1999/2000. Because of this variation, GST revenue in 1999/2000 does not grow as fast as consumption, even with the inclusion of the GST generated by the second ANZAC frigate.

Consumption and GST grow at similar rates in 2000/01.

In the later years stronger growth in residential investment pushes growth in GST slightly ahead of that in consumption.

Customs duty maintained over the forecast period due to the tariff freeze

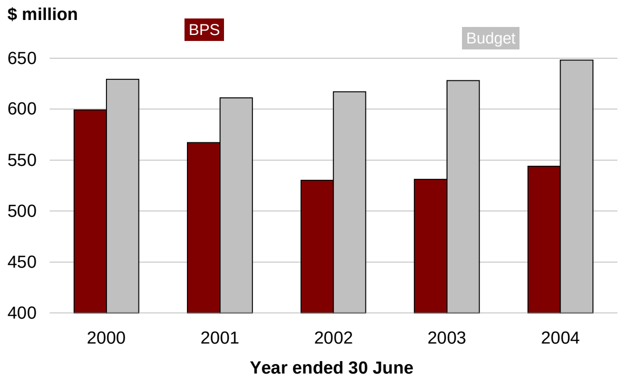
Customs duty runs higher throughout the forecast period than in the BPS forecasts.

In 1999/2000 the difference is caused mainly by the inclusion of more recent tax outturn data.

Tariff rates were frozen at current levels, with very few exemptions, on 1 June 2000.

The increasing differences between the forecasts in 2000/01 and 2001/02 are attributable chiefly to the tariff freeze.

Figure 2.10 – Change in customs duty forecasts between *Budget Policy Statement* and *Budget 2000*



Source: The Treasury

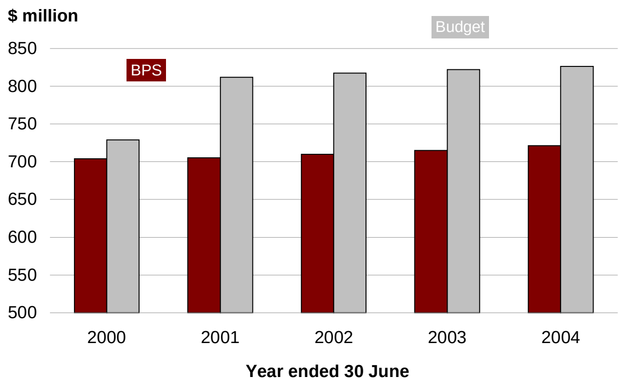
Excise duties boosted by increase to tobacco excise rate

On 10 May 2000, the excise rate on tobacco products was raised, adding about $1 to the price of a packet of 20 cigarettes.

This increase accounts for most of the difference between the *Budget 2000* and the BPS excise forecasts. Changes to both alcohol and fuel excise forecasts were quite small.

The excise rate rise has an effect on revenue only for the last six weeks of 1999/2000.

Figure 2.11 – Change in tobacco excise forecasts between *Budget Policy Statement* and *Budget 2000*



Source: The Treasury

From 2000/01 onwards the rate increase applies to the entire year, resulting in ongoing revenue increases of over $100 million relative to the BPS forecast.

Inland Revenue's Forecasts

Inland Revenue has prepared an alternative set of tax forecasts that were used in the Treasury's quality assurance process. These independent forecasts were developed at the same time as the Treasury's forecasts and used the Treasury's view of the macroeconomy.

Inland Revenue's forecasts of aggregate tax revenue are similar to but slightly firmer than the Treasury's for 1999/2000, with minor differences spread across all tax types. The agreement is even closer in the 2000/01 year. The Treasury's forecasts are successively higher throughout the final three years of the forecast, with the greatest difference being $255 million. The differences between the forecasts are spread over several tax types, with no particular tax type standing out.

Both departments consider that the differences between the two sets of forecasts are well within the ranges of uncertainty of their own forecasts, over the time horizons involved.

Annex A on page 119, contains tables showing the detailed Treasury and Inland Revenue forecasts on both an accrual revenue and cash receipts basis.

Expenses

Expenses are the next significant component of the operating balance.

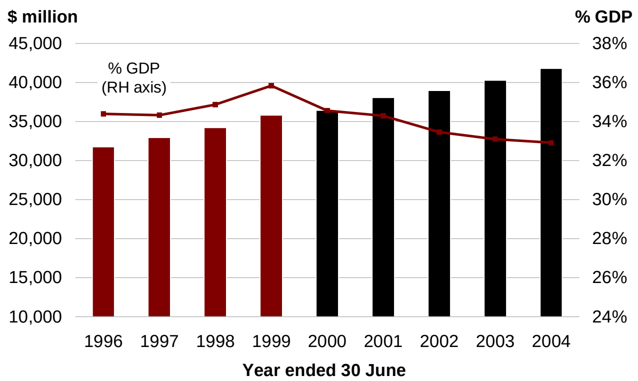
Expenses decline slowly as a share of GDP over the forecast period

Expenses fall as a percentage of GDP between 1999/2000 and 2003/04 from around 34.5% to around 33% of GDP.

Over the same period, nominal expenses increase by $5.4 billion from $36.4 billion to $41.8 billion reflecting mainly:

- the fiscal provision increasing expenses by around $3.2 billion
- health and education forecast increases (for example, increases due to demographic changes) of around $0.6 billion
- CPI indexation, NZS recipient and other benefit recipient growth of around $1.4 billion.

Figure 2.12 – Expenses ($ and % of GDP)



Source: The Treasury

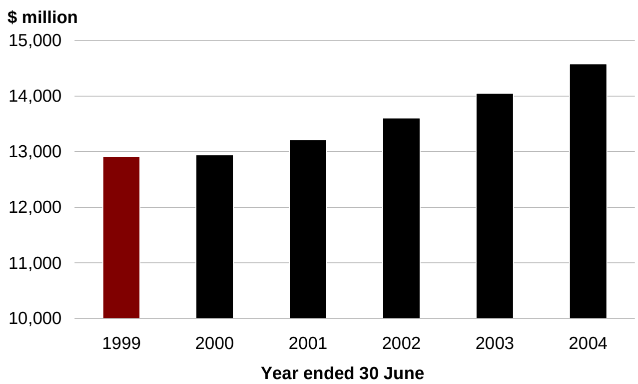
Social security and welfare expenses grow from policy spending in early years…

Social security and welfare expenses (SSW) increase by around $300 million in 2000/01 due to *Budget 2000* initiatives.

The key initiatives behind this increase are superannuation rate increases (around $200 million), and the introduction of income-related rents (net of accommodation supplement changes) for Housing New Zealand tenants (around $50 million).

The effect of CPI indexation of benefits in these years is broadly offset by a downward trend in the number of superannuitants and unemployment benefit recipients.

Figure 2.13 – Social welfare spending



Source: The Treasury

…with demographic and CPI changes driving increases in the out years

From 2001/02, SSW expenses increase by around $400 – $500 million each year to $14.6 billion in 2003/04. These increases in each year are largely due to the following factors:

- the growth in the *Budget 2000* policy initiatives increasing expenses by a small amount in each year

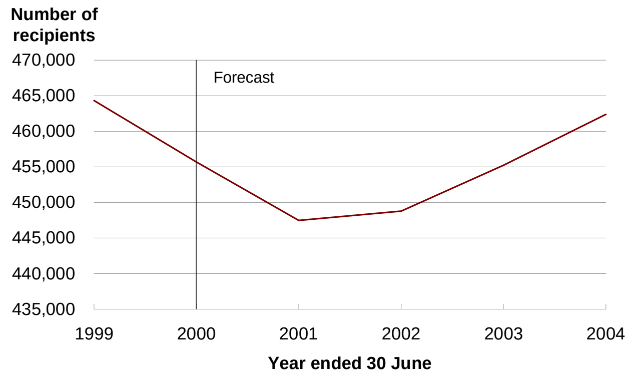
- CPI indexation of around 2% each year, for which most benefits are adjusted[6]. A 1% CPI increase has around a $100 million impact on expenses. As the adjustment is made each April the adjustment has a greater impact on the following financial year
- increases in the number of superannuitants beyond 2001, partly offset by a dip in unemployment recipients as outlined below.

New Zealand Superannuation (NZS)

From April 2001 the eligibility age for superannuation recipients settles at 65, resulting in an increase in recipient numbers of 15,000 between 2000/01 to 2003/04. Expenses therefore increase by around $180 million in this period.

The age eligibility increases by three months every six months until April 2001.

Figure 2.14 – NZS recipients



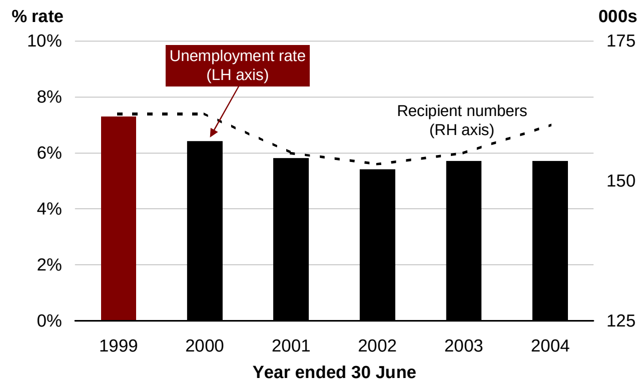
Source: The Treasury

Community Wage – unemployment

Improved economic conditions result in a dip in unemployment numbers by around 9,000 from around 162,000 in 1999/2000 to 153,000 in 2001/02 before rising to 160,000 in 2003/04.

The unemployment rate is forecast to fall from 6.4% in 1999/2000 to 5.4% in 2001/02, before rising to 5.7% in 2002/03.

Figure 2.15 – Unemployment Benefit recipients



Source: The Treasury

SSW expenses are higher than Budget Policy Statement from 2001/02

SSW expense levels are similar to BPS forecasts in 1999/2000 and 2000/01. New policy initiatives announced are broadly offset by forecasting changes in these years, including a lower CPI adjustment than forecast in the BPS.

Social Welfare expenses increase compared to the BPS by around $100 million each year from 2001/02. These increases are largely due to the policy initiatives announced in the *Budget*, partly offset by decreases in demand-driven factors.

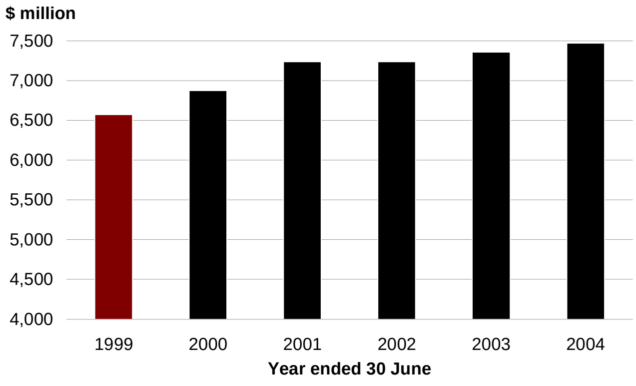
6 The forecast CPI adjustments are 2.8%, 2.2% and 2.2% and 1.9% for each April year from 2001 to 2004 respectively.

Health spending rises with additional services and demographic growth…

Health expenses are projected to increase from $6.9 billion to $7.5 billion between 1999/2000 and 2003/04. This $600 million increase reflects extra funding for:

- demographic growth
- maintaining existing services
- new policy initiatives, which comprise around $150 million of this change.

Figure 2.16 – Health expenses



Source: The Treasury

Funding of additional elective services of around $70 million for each year is included in the *Budget 2000* initiatives. Previously, this funding was due to expire in 1999/2000.

The change in Health spending since the BPS is largely due to the *Budget 2000* initiatives.

Table 2.4 – Growth in Health spending between years

$ million	**1998/99 Actual**	**1999/2000 Forecast**	**2000/01 Forecast**	**2001/02 Forecast**	**2002/03 Forecast**	**2003/04 Forecast**
Health spending	**6,573**	**6,873**	**7,236**	**7,239**	**7,357**	**7,471**
Growth in Health spending						
Demographic adjustment, and maintaining and improving services[1]		264	255	84	93	95
Extra electives[2]		22	(18)	..	..	..
Mental health		15	42	23	30	20
ACC changes		(17)	12	2	..	..
Other new initiatives[3]		27	29	(17)	..	..
Other[4]		(11)	43	(89)	(5)	(1)
Total growth		**300**	**363**	**3**	**118**	**114**

1 2001/02, 2002/03 and 2003/04 include a demographic adjustment only.

2 2000/01 decrease is because of a one-off injection of $21.5 million in 1999/2000 only, and an additional $74 million in 2000/01 and outyears that replaces a $70 million fund that was due to expire in 1999/2000.

3 Includes smoking cessation, disability support services, pharmaceutical and laboratory services, compulsory care, new blood screening techniques and other initiatives.

4 The $89 million reduction in 2001/02 is mainly due to a correction to the Health baselines.

Source: The Treasury

…while policy and demographic changes boost education spending...

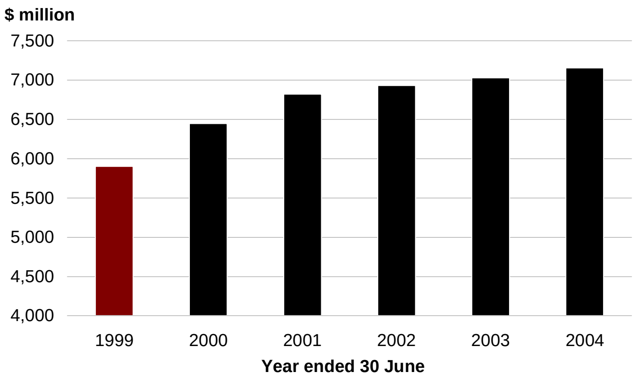
Education expenses are projected to increase from $6.4 billion to $7.2 billion between 1999/2000 and 2003/04.

The growth largely reflects:

- previous teacher wage settlements and increases to principals' resourcing
- a range of new policy initiatives, for example, increases to schools resourcing and tertiary education funding. Significant changes have also been made to the student loan scheme
- demographic changes – the number of primary students is expected to remain constant, while secondary and tertiary student numbers are forecast to increase.

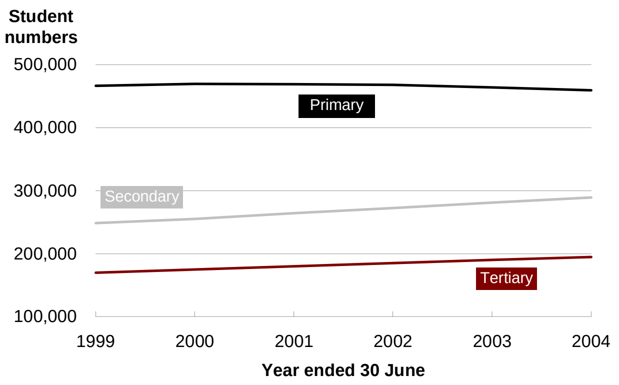
Education spending has increased significantly since the BPS reflecting the *Budget 2000* initiatives, offset to some extent by changes in student loan provisioning forecasts and reductions in forecasts resulting from lower roll projections.

Figure 2.17 – Education



Source: The Treasury

Figure 2.18 – Roll forecasts – primary, secondary and tertiary



Source: Ministry of Education

…and finance costs remain relatively stable

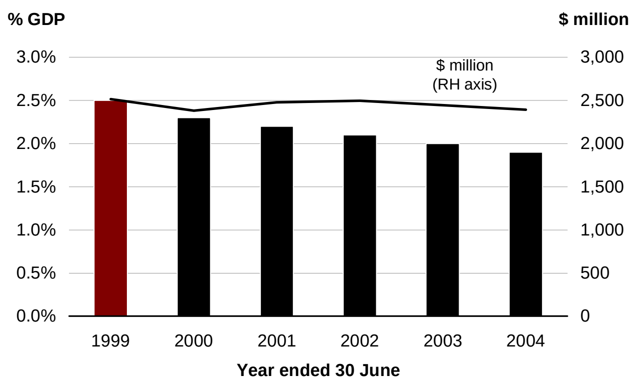
Finance costs rise slightly in 2000/01 and 2001/02, as higher interest rates offset slightly lower debt levels.

From 2002/03, finance costs begin to fall due to lower debt levels.

Compared to the BPS, finance costs are lower in 2001/02 onwards due to:

- lower levels of debt
- slightly lower longer-term interest rates.

Figure 2.19 – Finance costs (% of GDP and $)



Source: The Treasury

Revisions to Treaty forecasts

As noted in Table 2.1, Treaty settlement forecast revisions impact positively on the operating balance by $124 million in 1999/2000, and $37 million from 2000/01.

The positive impact in 1999/2000 reflects the level of settlements that have occurred this year, and so the forecast from the BPS has been revised downwards accordingly.

The Government has revised the formula for calculating the multi-year appropriation. Previously it was based on the remaining amount of the (disestablished) fiscal cap of $1 billion and was due to terminate on 21 September 2002. The revised method is based on an assessment of reasonable and sufficient resources to settle historical Treaty claims for the five-year period from 1999/2000 to 2003/04. The change in formula does not represent any change in the Government's policy of settling all historical Treaty claims.

Settlements may differ significantly from the amount set aside for forecasting purposes in each year.

The Government's fiscal provision

The fiscal provision is included in the Statement of Financial Performance. It provides funding for Government decisions to:

- undertake new initiatives, such as decisions taken over the introduction of income-related rents, or the biodiversity strategy
- provide for cost or volume increases in existing initiatives, such as increasing teachers' pay or increasing funding for the Police.

Although the provision is recorded in expenses, it is available for decisions that relate to changes in revenue, expenses, or SOE and Crown entity surpluses.

For example, in this Budget the Government has agreed to changes to Housing New Zealand that have reduced its forecast surplus, impacting on the provisions in the same way as a decision to increase government spending.

Some items in the Statement of Financial Performance are linked directly to economic variables. Movements in these items are forecasting rather than policy changes, and so are not met from within the provisions. For example, changes to interest rates that affect finance costs are not met within the provisions; nor are changes to unemployment, which result in changes in the number of people receiving the Community Wage.

In addition, the provisions do not cover changes in funding based on existing Government policy. For example, Government policy is to increase welfare benefit rates by the change in the CPI each year. Forecasts in the Statement of Financial Performance include an allowance for future increases in welfare benefits based on forecasts of future changes in the CPI. If the CPI forecasts change, then the forecasts of welfare benefit expenses also change, but this does not impact on the provisions.

Similarly, demographic changes to health funding in line with Government policy are not met within the provisions (but a Government policy decision to increase health funding above the demographic adjustment would impact on the provisions).

Settlement of existing liabilities, and settlement of Treaty of Waitangi claims, are also not met from within the provisions.

Operating provisions for 1999/2000 to 2002/03

In the BPS, the Government set out a provision for new spending over the four years from 1999/2000 to 2002/03 of $5.9 billion (GST inclusive). The allocations have altered since those outlined in the BPS, as illustrated in the following table.

Table 2.5 – Change in cumulative fiscal provisions

$ million	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**Total**
Indicative fiscal provisions BPS	150	1,200	1,850	2,650	5,850
Fiscal provisions BEFU	420	1,230	1,790	2,425	5,865
Change	**270**	**30**	**(60)**	**(225)**	**15**

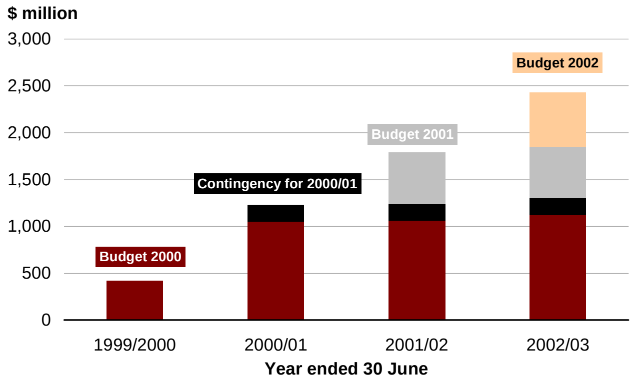
Source: The Treasury

These amounts include a contingency for further initiatives to be developed during 2000/01. The contingency is $180 million a year in 2000/01 and subsequent years.

Since the BPS, the Government has decided to bring forward some spending into 1999/2000 and 2000/01.

To remain within the overall provision of $5.9 billion, the provisions for spending in the 2001 and 2002 Budgets have been reduced to $550 million and $575 million.

Figure 2.20 – Final provision allocations



Source: The Treasury

Technical provision in 2003/04

For 2003/04, the forecasts assume a technical fiscal provision of $800 million (GST inclusive). This is unchanged from the BPS.

Budget 2000 decisions and the fiscal provisions for 1999/2000 to 2002/03

The Government has allocated $3.65 billion of the $5.9 billion as part of the *Budget 2000* process. This is detailed in the following table.

Table 2.6 – *Budget 2000* policy decisions

2000 Budget initiatives (operating) ($ million, GST inclusive)	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**Total**
Revenue initiatives:[7]					
Multi-rate fringe benefit tax	-	80	65	65	210
Cancellation of tariff reductions	-	(35)	(80)	(85)	(200)
Tobacco excise increase	(20)	(110)	(78)	(82)	(290)
Anti-avoidance measures for 39% tax rate	-	(10)	(20)	(20)	(50)
Total revenue	**(20)**	**(75)**	**(113)**	**(122)**	**(330)**
Expense initiatives:					
Student loan changes	32	92	103	110	337
Other education	9	108	177	178	472
Increases in NZ Super rates	52	208	212	212	684
Health[8]	32	137	57	88	314
Housing – income-related rents	-	55	98	104	257
Industry and economic development	-	37	77	116	230
Social services	(2)	56	66	71	191
Police	27	54	54	54	189
West Coast package	135	-	-	-	135
Inland Revenue	-	36	36	36	108
Arts, culture and heritage	55	16	16	16	103
Research, science and technology	-	30	30	30	90
Cancellation of border charging	-	29	29	29	87
Biodiversity strategy	-	17	27	38	82
Other environment initiatives	2	21	23	22	68
Māori Affairs	14	19	15	15	63
Foreign Affairs and TradeNZ	-	18	16	12	46
Justice	5	22	19	19	65
All other initiatives	49	91	48	22	210
Total expenses	**410**	**1,046**	**1,103**	**1,172**	**3,731**
SOE/Crown entity changes					
Housing – changes to Housing NZ	30	79	70	70	249
Total 2000 Budget	**420**	**1,050**	**1,060**	**1,120**	**3,650**
Contingency for further initiatives in 2000/01	-	180	180	180	540
Total 2000 Budget including contingency	**420**	**1,230**	**1,240**	**1,300**	**4,190**
Provision for 2001 Budget	-	-	550	550	1,100
Provision for 2002 Budget	-	-	-	575	575
Total fiscal provision	**420**	**1,230**	**1,790**	**2,425**	**5,865**

Source: The Treasury

7 A "negative" number represents an initiative that is generating a saving (or an increase in revenue) and therefore reduces the total amount accumulated against the fiscal provisions.

8 This includes a correction to the Health baseline of ($84 million) in 2001/02 and 2002/03. Total new spending excluding this adjustment is $481 million.

State-Owned Enterprises and Crown Entities

The third and final component of the operating balance is state-owned enterprises and Crown entities.

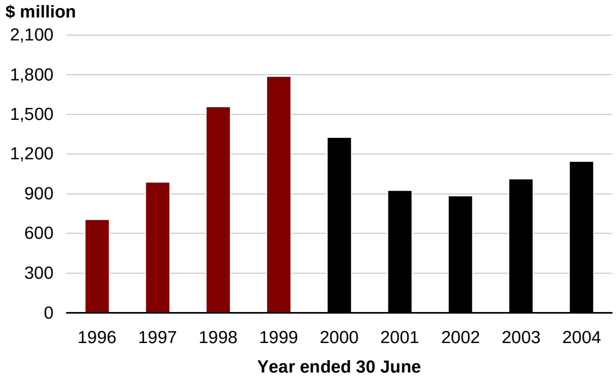
SOEs and Crown entities surpluses take a level shift down...

As in 1998/99, SOEs and Crown entities gross surpluses in 1999/2000 contain a component of one-off gains, being a reduced revaluation of the ACC outstanding claims liability of $340 million.

The decrease to the ACC liability results from:

- an increase in the discount rate used to calculate the present value of the liability (as at 31 March 2000 the average discount rate was around 7%, (previously 6.7%))
- improved exit rates.

Figure 2.21 – SOE and Crown entity gross surplus



Source: The Treasury

However, there is an underlying level drop in surpluses of $500 million reflecting:

- a permanent reduction in surpluses from the electricity sector of around $100 million, partly owing to the removal of future Contact Energy Limited surpluses following its sale in late 1998/99
- ACC surpluses being around $500 million permanently lower from 1999/2000 due to the recognition of future costs of previously accepted ACC claims.

A further reduction occurs in 2000/01 with the *Budget 2000* housing package resulting in lower Housing New Zealand surpluses of around $100 million in each year.

…until the returns on NZS Fund assets begin to grow

From 2001/02, NZS Fund asset returns contribute around $15 million, $60 million and $130 million to SOE and Crown entities surpluses. This new income stream boosts gross surpluses to around $1.1 billion by 2003/04. These asset returns are retained within the Fund (see box on the following page).

Compared with the BPS, the SOE and Crown entities gross surplus is around $350 million higher in 1999/2000 due to the decreased ACC outstanding claims liability revaluation. From 2000/01 surpluses are around $50 to $100 million lower than forecast in the BPS.

Prefunding future NZS expenses

The Government intends to prefund some of the costs of future New Zealand Superannuation (NZS) expenses (as outlined in the *2000 Fiscal Strategy Report*).

The structure of the scheme and the method and level of prefunding are yet to be finalised. These forecasts are based on a number of technical assumptions:

- the Fund will build assets from capital contributions from the Crown, and from Fund asset returns
- the Fund asset rate of return is equal to the Crown's cost of long-term debt (10 year Government stock rate)
- the forecasts assume the following transitional capital contributions and returns as shown in the table below.

Table 2.7 – NZS Fund assumptions

$ million	**2001/02**	**2002/03**	**2003/04**
Capital contributions	600	1,200	1,800
% of GDP	*0.5%*	*1.0%*	*1.4%*
Fund asset returns	15	60	130
Fund assets	**615**	**1,875**	**3,805**
% of GDP	***0.5%***	***1.5%***	***3.0%***

The Fund is separately recorded in the Statements of Financial Position and Cashflows.

Drivers of Net Worth and Debt

This section discusses the key drivers of net worth and debt (see Statement of Financial Position and Statement of Borrowings), the relationship between net debt and the operating balance and the 2000/01 bond programme.

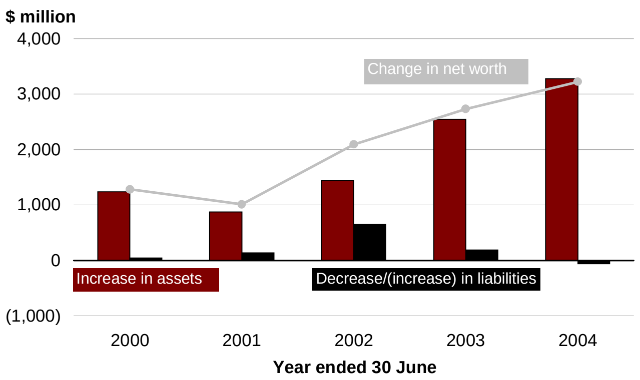
Net worth

The Crown balance sheet expands…

Operating surpluses increase net worth by around $9 billion to $16 billion by the end of the forecast period.

This increase is reflected in higher assets while liabilities are expected to remain relatively constant throughout the forecast period.

Figure 2.22 – Assets and liabilities



Source: The Treasury

…as assets are set aside to prefund future superannuation costs

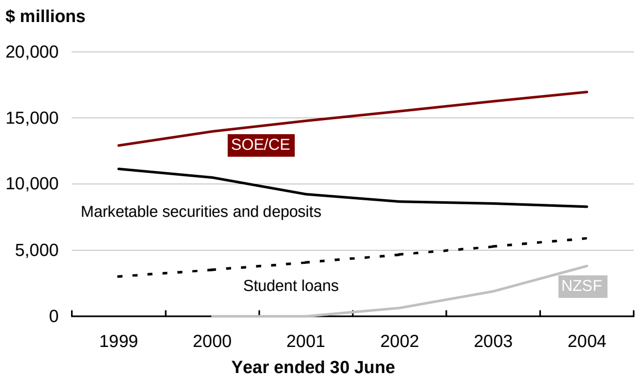
Cashflows from operations and investing activities are applied primarily to building up assets to prefund future New Zealand superannuation costs, as well as debt retirement. By 2003/04, the assets available to prefund future NZS expenses reach around $4 billion (3.0% of GDP).

Student loans and SOE and Crown entities continue to grow

The increase in the SOE and Crown entity investment is boosted by a $340 million decrease in the ACC outstanding claims liability revaluation in 1999/2000.

Beyond 1999/2000 the increase in assets reflects rising student loan balances and an increasing investment in SOEs and Crown entities (in addition to NZS prefunding) reflecting net surpluses. These two items are forecast to increase from current levels by around $2.5 billion and $3 billion by 2003/04.

Figure 2.23 – Components of total assets



Source: The Treasury

The 2000/01 fall in financial assets reflects lower marketable securities and deposits as the excess cash from 1998/99 and 1999/2000 (for example, receipts generated by the sale of Contact Energy Limited (in 1998/99)) is used to repay outstanding debt.

The capital spending provision

The capital provision provides funding for increased Government investment in departments, SOEs and Crown entities, advances (for example increased student loans), and a reduction in dividend flows from SOEs and Crown entities.

Any capital withdrawals from departments, SOEs or Crown entities count as a saving against the capital provisions. For example, the Government's decision to disestablish @Work Insurance Limited will result in around $160 million in capital being returned to the Crown over 1999/2000 and 2000/01.

Changes in expected dividend payments from SOEs and Crown entities that are the result of a Government policy decision also impact on the capital provision. For example, as part of Budget 2000, the Government has agreed on changes to Housing NZ which are expected to reduce the company's dividend payments by around $400 million over 1999/2000 to 2002/03. This has impacted on the capital provision.

Changes to dividend payments from SOEs and Crown entities that are not the result of a Government policy decision (for example, changes in dividends due to changes in the profitability of an SOE) do not impact on the capital provisions.

In the Budget Policy Statement, the Government set out a technical provision pending review as part of the Budget for new capital funding. The technical provision covered the four years from 1999/2000 to 2002/03 of $1,200 million, plus the capital cost of the changes to student loans. In the Budget, the Government has increased the capital provision to $2,400 million (including student loans), an increase of $48 million compared to the BPS.

Spending against the capital provision in Budget 2000

Total capital spending as part of the *Budget 2000* process is $1,917 million over four years, as shown in the table below. This leaves $483 million remaining in the capital provision.

Table 2.8 – *Budget 2000* capital initiatives

$ million (GST inclusive)	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**Total**
Education – student loans	169	295	337	351	1,152
Education – school property	-	166	-	-	166
Housing	-	208	93	110	411
Health	(102)	116	89	87	190
Justice	-	50	33	-	83
Culture and heritage	32	12	10	10	64
Parliamentary Services	-	6	11	9	26
Disestablishment of @Work Insurance	(120)	(40)	-	-	(160)
All other capital decisions	(33)	14	3	1	(15)
Total 2000 Budget capital	**(54)**	**827**	**576**	**568**	**1,917**
Capital provisions		900	750	750	2,400
Remaining capital provisions		**127**	**174**	**182**	**483**

The remaining amount is unlikely to fully cover future capital spending pressures. However, the capital provision has not been increased significantly at this stage, as there is still uncertainty about how much capital spending will be required in the future. In addition, the Government plans to investigate the possibility of significant withdrawals of capital from state-owned enterprises. These withdrawals would increase the amounts remaining within the provision for capital spending.

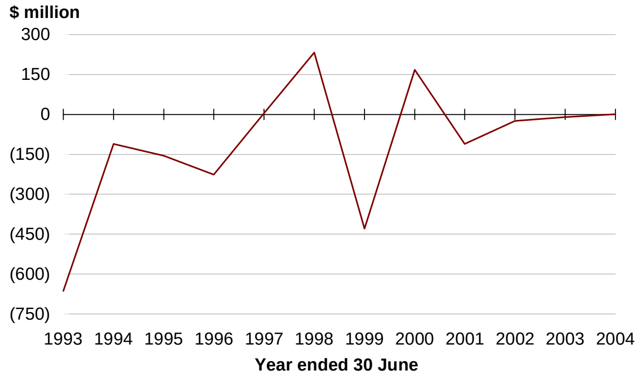
GSF pension liability fluctuates

The GSF pension liability fluctuates from year to year due to changes in:

- long-term financial assumptions (inflation, expected investment return – the discount rate, and salary growth)
- fund experience (rates of withdrawal, mortality, and actual investment returns).

Since the unfunded liability represents such a large component of the Crown's liabilities (16% as at 30 June 1999), relatively small movements in the liability have a significant impact on the Crown's operating balance.

Figure 2.24 – Operating balance impact of GSF liability



Source: The Treasury

The Government Actuary's most recent actuarial valuation, as at 31 December 1999 (updated with 31 March 2000 discount rates), resulted in a gain of around $170 million in 1999/2000, reflecting the increase in the discount rate since last year (from 4.7% to 4.9%).

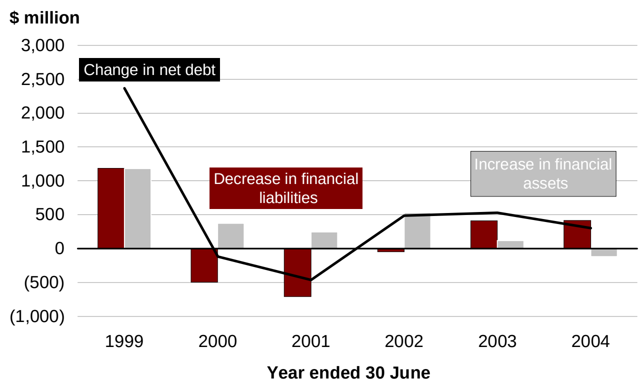
However, there is an increase in the liability of around $110 million, $25 million and $10 million in 2000/01, 2001/02 and 2002/03 respectively, resulting from the scheme peaking later than previously estimated and the reversal of the current year positive discount rate movement over time.

Gross debt and net debt follow similar tracks

Nominal gross debt (or borrowings) remains relatively static, starting off at around $36.5 billion, before dropping off to $35.5 billion by the end of the forecast horizon. This reflects the use of surplus cashflows primarily to build up assets to fund future NZS expenses, rather than to retire existing debt.

Net debt follows a similar track, decreasing from around $22 billion to around $21 billion by 2003/04. Net debt comprises borrowings less financial assets (largely marketable securities and deposits and student loans).

Figure 2.25 –Financial assets and financial liabilities



Source: The Treasury

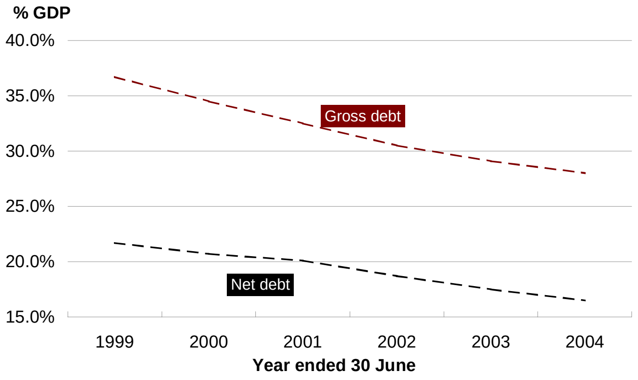
Normally net and gross debt would trend differently in nominal terms, as increases in student loans would result in higher gross debt. However, student loan increases are broadly offset by decreases in marketable securities and deposits over the forecast period, as surplus cash is utilised.

As a percentage of GDP, net debt and gross debt also follow a similar track.

Net debt declines by 4.2% of GDP from 20.7% to reach 16.5% of GDP by the end of the forecast period.

Gross debt declines by 6.5% from 34.5% of GDP to reach 28% of GDP by the end of the forecast period.

Figure 2.26 – Net and gross debt – % of GDP



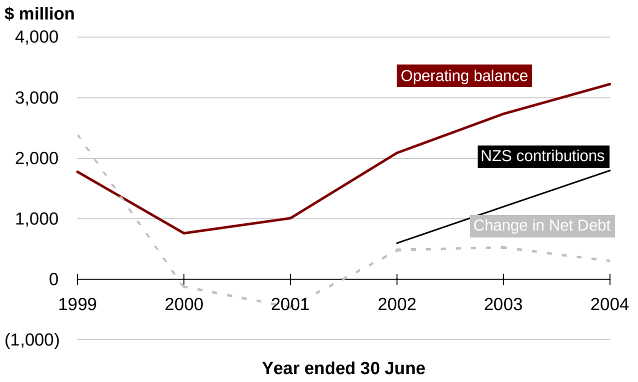
Source: The Treasury

The change in net debt does not match the operating balance in any given year

The general trend in net debt tends to match the operating balance trend, reflecting the use of surpluses to retire existing debt. Once pre-funding future NZS expenses begins to occur (by building up assets), the improvement in net debt tapers away.

The operating balance is an accrual measure and recognises non-cash items such as the retained surpluses of SOEs and Crown entities, whereas movements in net debt reflect cashflows.

Figure 2.27 – Operating balance compared with change in net debt



Source: The Treasury

The movement in net debt does not match the operating balance in a given year.

Net capital investment in physical assets and the retained surpluses of SOEs and Crown entities largely drive the difference between the operating balance and the change in net debt.

The following table outlines this relationship in more detail.

Table 2.9 – Relationship between operating balance, NZSF contributions and net debt

$ million, year ended 30 June	**1999 Actual**	**2000 Forecast**	**2001 Forecast**	**2002 Forecast**	**2003 Forecast**	**2004 Forecast**
Operating balance	1,777	763	1,012	2,091	2,733	3,222
Less contributions to the NZSF	..	..	..	(600)	(1,200)	(1,800)
	1,777	763	1,012	1,491	1,533	1,422
Change in net debt	2,368	(118)	(463)	486	531	302
Difference	**591**	**(881)**	**(1,475)**	**(1,005)**	**(1,002)**	**(1,120)**
This difference comprises:						
SOE/CE retained surplus net of dividends	(1,245)	(871)	(699)	(645)	(750)	(867)
Depreciation	765	805	877	889	888	874
GSF unfunded liability movement	429	(168)	111	24	10	(1)
Student loan influences	51	(51)	(69)	(42)	(39)	(42)
Gain on sale of assets	(1,599)	(27)	..	..	..	..
Revaluations of forests and FX movts	40	(82)	..	..	..	..
Other non-cash expenses	5	122	15	15	5	1
Circulating currency issues	151	292	..	..	..	..
Net purchase of physical assets including capital contingency provision	(903)	(918)	(1,274)	(1,026)	(875)	(929)
Asset sale receipts	2,818	84	..	..	..	..
Net capital withdrawals/(injections)	(80)	(214)	(87)	(100)	(97)	(26)
Timing and other working capital items	159	147	(349)	(120)	(144)	(130)
Difference	**591**	**(881)**	**(1,475)**	**(1,005)**	**(1,002)**	**(1,120)**

Source: The Treasury

Net debt and the domestic bond programme

The domestic bond programme for 2000/01 has been set at $2.85 billion. The bond programme finances the Crown's operating, investing and financing cashflows.

During 2000/01, the Crown will:

- repay maturing domestic bonds of around $2.7 billion
- finance operating and investing (excluding marketable securities and deposits activity) cashflows of around $0.9 billion[9].

Over-funding from 1999/2000 of around $1 billion reduces this financing requirement. There is also a slight offset from other miscellaneous borrowing and investing activity of around $0.3 billion.

Therefore, the bond programme to fund these activities is around $2.3 billion.

In addition, a further $0.5 billion of domestic bonds are to be issued to fund foreign currency reserves, via the swap market. The total amount of foreign currency reserves will not increase as a result of these transactions.

9 The $0.9 billion incorporates cashflows from operations, net purchase of physical assets, net increase in advances, net purchase/(sale) of investments (essentially capital injections/(withdrawals) to SOEs and Crown entities) and the capital contingency provision.

Estimates of Policy Effects on the Fiscal Position

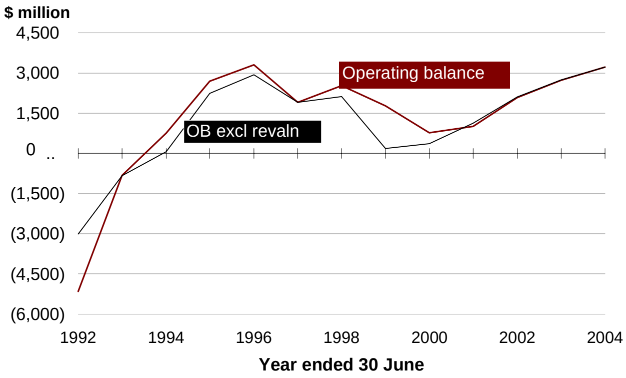
The operating balance is affected by:

- large revaluation movements – such as foreign exchange losses or gains or movements in liability valuations
- short-term fluctuations in economic growth.

Removing revaluation movements and the estimated effect of short-term economic growth fluctuations on tax revenue and unemployment spending provides an indication of the effects of policy decisions on the operating balance.

The operating balance excluding revaluation movements[10] shows an underlying operating trend. Revaluation movements in total have typically been positive. The negative revaluation movement in 1992 reflects large foreign exchange losses.

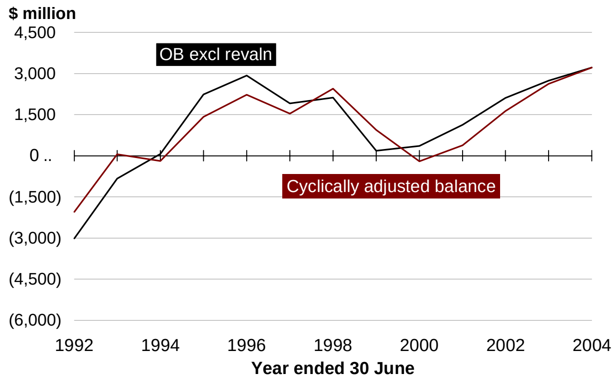
Figure 2.28 – Operating balance and operating balance excluding revaluation effects



Source: The Treasury

The cyclically adjusted balance (CAB) indicates the effect of policy changes on the fiscal position. The CAB is calculated by removing an estimate of the effect of short-term fluctuations on economic growth from the operating balance excluding revaluation effects.

Figure 2.29 – Cyclically adjusted balance



Source: The Treasury

The CAB shows:

- growing fiscal surpluses between 1991/92 to 1995/96 reflecting tight fiscal policy
- the impact of the tax cuts in 1996/97 and 1998/99
- the increased spending introduced by the $4.25 billion limit covering 1997/98 to the start of 1999/2000
- growing fiscal surpluses from 1999/2000 as increased spending is not as strong as taxation increases resulting from policy decisions (higher tax rates) and economic growth.

The calculation of the CAB is based on a number of assumptions, such as estimated potential output and the responsiveness of tax revenues and unemployment spending to fluctuations in economic growth. Because the assumptions are based on, and sensitive to, the latest information available, the estimated CAB is subject to some uncertainty.

10 Revaluation movements adjusted for are: losses/(gains) on foreign exchange and marketable securities and deposits, increase/(decreases) in GSF pension liability and ACC outstanding claims obligation, losses/(gains) on sale of assets, decreases/(increases) in forest revaluations.

The results should be treated as indicative only of the fiscal policy impacts on the operating balance.

Changes in Accounting Policy

The Fiscal Responsibility Act requires the Crown to prepare its forecast financial statements in accordance with generally accepted accounting practice (GAAP). The Crown's use of GAAP ensures quality financial information and confers greater credibility on its financial reports because GAAP reporting requirements are independently established.

At present there are a number of areas where GAAP developments are likely to impact on the Crown Financial Statements. The following areas could or will have significant implications for the Crown within the next two years:

- The Crown will present the 2002 *Budget* and the 2002/03 *Crown Financial Statements* on a fully consolidated basis. This will result in all the assets, liabilities, revenue and expenses of SOEs and Crown entities being recorded on a line-by-line basis in the Crown's financial statements.

  More specific implications of changing the basis of combination of the Crown's financial statements are disclosed on page 70 of the 1998/99 Crown financial statements.

- There is a current trend in GAAP to require increasing use of "current values" (market values and market value proxies) to measure assets and liabilities for financial reporting purposes. Using current values ensures asset and liability valuations incorporate the most up to date information on all relevant factors, and ensures that the current and future impact of policy decisions are reflected in the valuation of an asset or liability.

  The GSF and ACC liabilities are currently recorded on this basis. The recording of student loans and other financial assets using a current value basis is also being considered.

- Local authorities own sections of State highways that fall within their boundaries. General agreement has been reached that these sections of highway should be recorded as an asset of the Crown because the Crown is responsible for their upkeep, though the adjustment is likely to occur in 2000/01 once all the issues are fully resolved.

  The Crown currently incurs expenses maintaining these highway sections. Once the asset is recorded on the Crown's books, this expense will decrease, as a portion of it will be capitalised as it is enhancing the value of the asset.