2

Fiscal Outlook

Introduction

This chapter discusses the trends, influences 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, state-owned enterprises (SOEs) and Crown entity (CEs) surpluses, and the provision for future initiatives (see Statement of Financial Performance page 87)
- key influences on net worth and debt (see Statement of Financial Position page 88), the relation between debt and the operating balance, and details of the 2000/01 bond programme
- developments in generally accepted accounting practice (GAAP) that will change the way the forecasts are constructed.

Overview

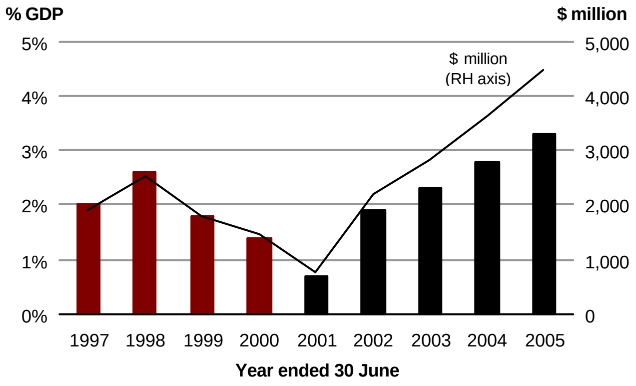
The operating balance rises steadily over the forecast horizon…

The forecast 2000/01 operating balance is $765 million (0.7% of GDP). While tax revenue grows at around 5%, the operating balance has decreased relative to 1999/2000.

This occurs as expense growth is 5.4% coupled with the 1999/2000 year being boosted by a positive ACC liability revaluation of around $520 million.

In 2000/01, the expense growth is the result of demand-driven factors, and:

Figure 2.1 – Operating balance



Source: The Treasury

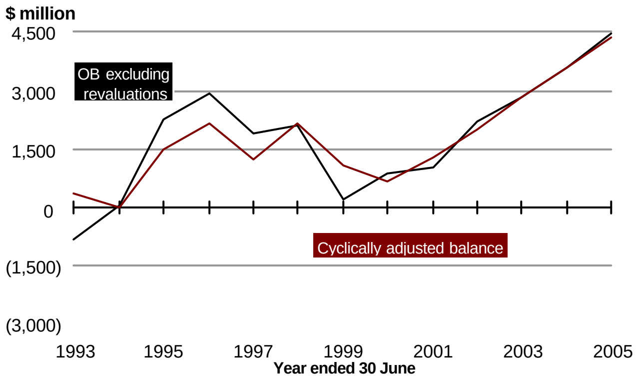
- the implementation of the Government's policy programme, with the full impact of decisions such as increasing the NZS floor back to 65% of the net average wage
- a swing in the GSF liability valuation (that decreased expenses in 1999/2000 by around $200 million, but increases expenses by $245 million in 2000/01).

For 2001/02, tax revenue continues its strong growth (around 7.1%) as growth in nominal GDP spikes at around 7%. This growth, in combination with a smaller $600 million Budget 2001 package and assumed reversal of the impact of GSF valuation movements, contributes to the sharp increase in the operating balance in 2001/02.

Thereafter, tax revenue growth averages around 5% each year, while expense growth from 2001/02 slows to around 3% a year, reflecting smaller allowances for new policy initiatives than the Budget 2000 package.

Abstracting from cyclical effects and revaluation movements, there is also an increase in the structural operating balance trend as expenditure growth is held below revenue growth owing to the Government maintaining its fiscal policy of limiting new initiatives to $5.9 billion out to 2002/03 and the technical provisions of $800 million thereafter[1].

Figure 2.2 – Cyclically adjusted balance



Source: The Treasury

1 The cyclically adjusted balance is sensitive to the latest information available and is subject to some uncertainty. Trends in the cyclically adjusted balance are, however, more reliable.

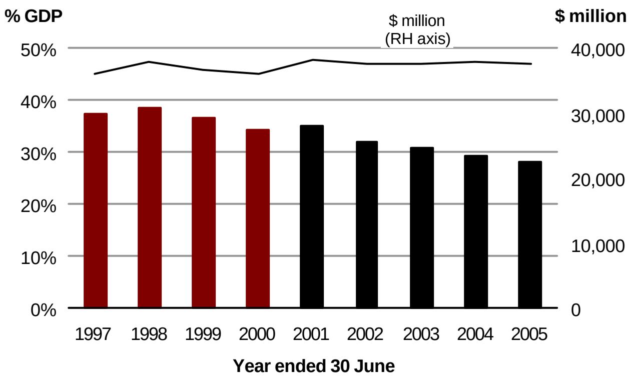
…and the resulting surplus cash is applied to investments

The rising operating surplus translates to a similar cash flow from operations profile, generating just over $14 billion in cash over the forecast period for investing and debt repayment.

Investment claims more than account for these cash flows. These claims include:

- building NZS fund assets ($6.5 billion)
- purchasing physical assets ($6.8 billion)
- funding student loans ($2.6 billion).

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

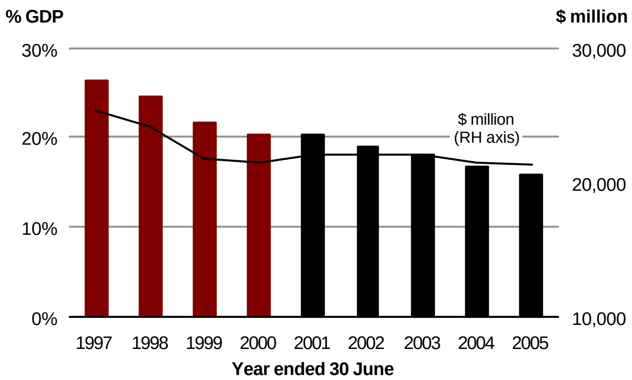


Source: The Treasury

As a result, gross debt rises slightly (and marketable securities and deposits fall) over the forecast period in nominal terms to fund the shortfall in operating cash flows. As a percentage of GDP, gross debt falls from 34.3% of GDP in 1999/2000 to 28.0% of GDP in 2004/05.

Net debt declines as a percentage of GDP from 20.4% in 1999/2000 to 15.8% in 2004/05.

Figure 2.4 – Net debt ($ and % of GDP)



Source: The Treasury

Operating balance forecasts have not changed substantially from the Budget

Weaker macroeconomic forecasts for the 2000/01 year result in a reduced operating balance from the *Budget Update*, which is recovered in later years. There have been no changes in the Government's policy settings since the *Budget Update*.

Relative to the Budget forecasts, in 2000/01 taxation revenue is expected to reduce by around $400 million, and then increase by $200 million, $360 million and $520 million in the following three years, mainly on the back of a spike in nominal GDP due to inflationary pressures. These pressures flow through to higher benefit forecasts (which are CPI indexed) from 2001/02, contributing to an increase of around $200-$250 million.

Other revenue sources such as petroleum royalties and investment income are stronger in 2000/01, and higher debt levels increase net finance expenses, on average, by $75 million from 2002/03 onwards.

GSF and ACC liability valuation adjustments largely offset each other. Marginal changes in the discount rate influences the GSF liability, which increases by $245 million (since 30 June 2000). The ACC liability valuation decreases by around $165 million, resulting from the discount rate change and a lower forecast rate of accident incidence.

All these changes to the forecast since the *Budget Update* are relatively small, generally being within 1% of total expenses and revenues.

Table 2.1 – Operating balance reconciliation

$ million	2000/01 Forecast	2001/02 Forecast	2002/03 Forecast	2003/04 Forecast	2004/05 Forecast
Operating balance Budget 2000	**1,012**	**2,091**	**2,733**	**3,222**	**-**
Policy changes					
Revenue initiatives	1	17	13	13	
Expense initiatives	(100)	(85)	(88)	(88)	
Reduction in the Government's operating provisions	120	60	65	65	
Total policy changes	**21**	**(8)**	**(10)**	**(10)**	-
Forecasting changes					
Tax revenue forecasting changes	(404)	201	362	527	
Other revenue changes[1]	123	42	29	27	
Welfare benefit forecasting increases	(38)	(194)	(223)	(188)	
Valuation changes (GSF and ACC liability movements)	37	29	25	29	
Net finance costs	(15)	(100)	(97)	(32)	
Lower Transport expenses[2]	55	71	68	72	
Change to SOEs and Crown entities (excluding ACC valuation change and NZ Super Fund income reclassification)[3]	(101)	150	53	33	
Other	75	(74)	(108)	(55)	
Total forecasting changes	**(268)**	**125**	**109**	**413**	**-**
Operating balance - *December Update*	**765**	**2,208**	**2,832**	**3,625**	**4,475**

1 In 2000/01 the change includes higher petroleum royalties ($36m) and gains on marketable securities and deposits ($20m).

2 Transport expenses are lower than the *Budget Update* due to lower forecast revenues from motor vehicle fees and road user charges and a reallocation of existing baselines to capital purchases associated with roading (therefore reducing expenses).

3 The change from the *Budget Update* shown above excludes the ACC valuation improvement to the DEFU forecasts (as this is included in a separate item in the table). The change also excludes the impact of the reclassification of NZ Super Fund income - at the time of the *Budget Update* the accrued income was included in the net SOE/Crown entity line - this has now been classified within investment income.

Source: The Treasury

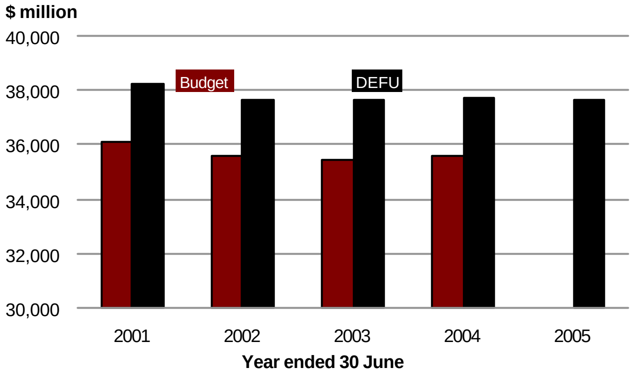
Gross debt increases from the Budget forecast

Compared with the *Budget Update*, gross debt is, on average, higher by around $2.2 billion in all years. Much of the level increase occurs in the first two years, reflecting the following factors (that do not affect net debt):

- funding new advances to hospitals refinancing their private sector debt, which adds around $500 million to gross debt
- the drop in the exchange rate (the USD/NZD was forecast at 0.495 in the *Budget Update* – the current forecasts are based on around 0.39). The impact is to significantly increase the value in NZD terms of both foreign currency debt and foreign currency reserves since 30 June 2000 by around $1 billion.

One other factor increasing both gross and net debt is the increase to the capital provision of $800 million from $2.4 billion at the time of the *Budget Update* to $3.2 billion.

Figure 2.5– Gross debt comparison



Source: The Treasury

Net debt ($ and % of GDP) is, on average, slightly higher in all years from the Budget forecasts, reflecting the increase in the capital provisions.

Fiscal Indicators

Table 2.2 – Fiscal Indicators

$ million, year ended 30 June	2000 Actual	2001 Budget	2001 DEFU	2002 Budget	2002 DEFU
Statement of Financial Performance					
Revenue					
Taxation revenue	34,035	36,152	35,748	38,073	38,274
Other revenue	2,491	2,218	2,405	2,346	2,419
Total revenue	**36,526**	**38,370**	**38,153**	**40,419**	**40,693**
Ratio to GDP (%)	**34.8%**	**34.6%**	**34.9%**	**34.7%**	**34.7%**
Tax ratio to GDP (%)	**32.4%**	**32.6%**	**32.7%**	**32.7%**	**32.7%**
Expenses					
Functional expenses	33,860	35,398	35,567	35,746	36,008
Finance costs	2,373	2,479	2,527	2,497	2,588
Net foreign exchange losses/(gains)	(62)	..	(43)	..	..
Provision for future initiatives	..	180	60	730	670
Total expenses	**36,171**	**38,057**	**38,111**	**38,973**	**39,266**
Ratio to GDP (%)	**34.4%**	**34.3%**	**34.9%**	**33.5%**	**33.5%**
Contribution of SOEs and CEs					
Surplus attributable					
to SOEs and CEs	1,532	925	989	883	1,013
Dividends and other distributions	(438)	(226)	(266)	(238)	(235)
Net contribution of SOEs and CEs	**1,094**	**699**	**723**	**645**	**778**
Operating balance	**1,449**	**1,012**	**765**	**2,091**	**2,205**
Ratio to GDP (%)	**1.4%**	**0.9%**	**0.7%**	**1.8%**	**1.9%**
Statement of Financial Position					
Assets (excluding NZS Fund assets)	60,423	60,334	63,667	61,162	64,512
NZS Fund assets	..	..	..	615	613
Liabilities	51,840	52,018	54,317	51,370	53,570
Crown balance (Net worth)	**8,583**	**8,316**	**9,350**	**10,407**	**11,555**
Ratio to GDP (%)	**8.2%**	**7.5%**	**8.6%**	**8.9%**	**9.9%**
Statement of Borrowings					
Crown debt					
Gross debt	36,041	36,092	38,239	35,561	37,664
less financial assets	(14,645)	(13,810)	(16,140)	(13,765)	(15,545)
Net Crown debt	**21,396**	**22,282**	**22,099**	**21,796**	**22,119**
Net Crown debt to GDP (%)	**20.4%**	**20.1%**	**20.2%**	**18.7%**	**18.9%**
Gross debt to GDP (%)	**34.3%**	**32.5%**	**35.0%**	**30.5%**	**32.1%**
Net debt repayment/(increase)	305	(463)	(703)	486	(20)
Nominal GDP	105,036	110,987	109,337	116,492	117,213

Source: The Treasury

Table 2.2 – Fiscal Indicators (continued)

$ million, year ended 30 June	**2003 Budget**	**2003 DEFU**	**2004 Budget**	**2004 DEFU**	**2005 DEFU**
Statement of Financial Performance					
Revenue					
Taxation revenue	39,833	40,195	41,697	42,224	44,186
Other revenue	2,406	2,519	2,444	2,718	2,953
Total revenue	**42,239**	**42,714**	**44,141**	**44,942**	**47,139**
Ratio to GDP (%)	**34.7%**	**34.8%**	**34.8%**	**35.1%**	**35.1%**
Tax ratio to GDP (%)	**32.8%**	**32.8%**	**32.8%**	**32.9%**	**32.9%**
Expenses					
Functional expenses	36,507	36,845	37,288	37,532	38,231
Finance costs	2,444	2,512	2,393	2,446	2,285
Net foreign exchange losses/(gains)	..	..	..	..	..
Provision for future initiatives	1,305	1,240	2,105	2,040	2,840
Total expenses	**40,256**	**40,597**	**41,786**	**42,018**	**43,356**
Ratio to GDP (%)	**33.1%**	**33.1%**	**32.9%**	**32.8%**	**32.3%**
Contribution of SOEs and CEs					
Surplus attributable to SOEs and CEs	1,013	976	1,146	979	975
Dividends and other distributions	(263)	(264)	(279)	(281)	(283)
Net contribution of SOEs and CEs	**750**	**712**	**867**	**698**	**692**
Operating balance	**2,733**	**2,829**	**3,222**	**3,622**	**4,475**
Ratio to GDP (%)	**2.2%**	**2.3%**	**2.5%**	**2.8%**	**3.3%**
Statement of Financial Position					
Assets (excluding NZS Fund assets)	62,448	66,021	63,797	67,679	68,707
NZS Fund assets	1,875	1,869	3,805	3,797	6,940
Liabilities	51,183	53,506	51,240	53,470	53,166
Crown balance (Net worth)	**13,140**	**14,384**	**16,362**	**18,006**	**22,481**
Ratio to GDP (%)	**10.8%**	**11.7%**	**12.9%**	**14.0%**	**16.7%**
Statement of Borrowings					
Crown debt					
Gross debt	35,442	37,641	35,558	37,714	37,608
less financial assets	(14,177)	(15,605)	(14,595)	(16,306)	(16,373)
Net Crown debt	**21,265**	**22,036**	**20,963**	**21,408**	**21,235**
Net Crown debt to GDP (%)	**17.5%**	**18.0%**	**16.5%**	**16.7%**	**15.8%**
Gross debt to GDP (%)	**29.1%**	**30.7%**	**28.0%**	**29.4%**	**28.0%**
Net debt repayment/(increase)	531	83	302	628	173
Nominal GDP	121,624	122,656	126,959	128,191	134,327

Source: The Treasury

Influences on the Operating Balance

This section discusses the trends in the three main operating balance components, and any significant changes in these components since the *Budget Update* (see Statement of Financial Performance page 87).

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

Tax Revenue

Tax revenue rises in 2000/01

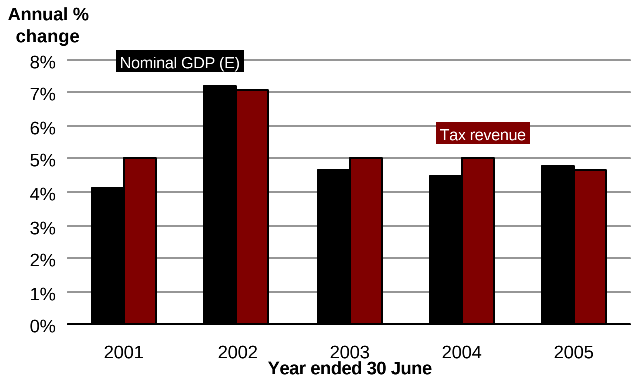
Tax revenue is expected to grow by 5% to the end of this year, faster than nominal GDP. The 2000/01 year is the first year to feel the full effects of two policy changes:

- 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.

This strong growth from policy changes is partially offset by:

- concessions granted to some existing film and television projects
- a shift in the timing of refunds to individuals resulting from the elimination of IR5 tax returns and other related tax changes
- a tobacco production shift into the 1999/2000 year as a result of the increase in the excise rate.

Figure 2.6 – Tax revenue and nominal GDP growth

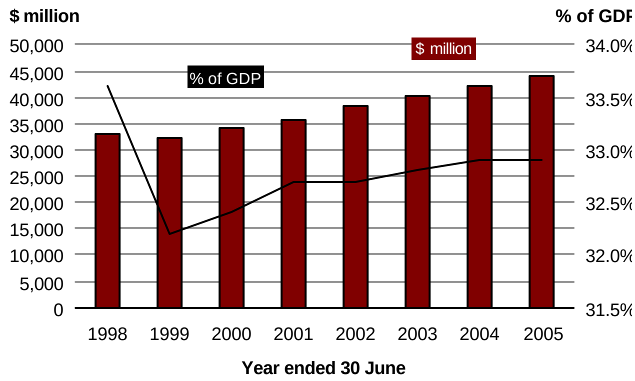


Source: The Treasury

From 2001/02 onwards, tax revenue grows in line with nominal GDP

Over the next four years, tax revenue grows roughly in line with nominal GDP growth. There is a slight increase due to "fiscal drag" – the tendency for wage growth over time to move more people into higher tax brackets.

Figure 2.7 – Tax revenue ($ and % of GDP)



Source: The Treasury

Tax forecasts compared with the Budget forecast have fallen in the current year and risen after that

Tax revenue forecasts are 1.1% lower for the current fiscal year than the Budget forecasts. The main causes of this are:

- slightly weaker forecast employment levels have reduced PAYE (source deductions)
- refunds to individuals relating to the 1999/2000 income tax year were delayed into the current fiscal year
- GST is reduced by weaker private consumption and residential investment
- tobacco excise duty was less than forecast at the *Budget Update* owing to a combination of a revenue shift from the 2000/01 year to the 1999/2000 year and consumption declining by more than was expected.

In the following years, tax revenue is forecast to be between 0.5% and 1.3% higher than it was in the *Budget Update*, since nominal GDP is higher. This stronger tax revenue is caused mainly by the following factors:

- PAYE growth increases so that by 2003/04 the forecast is only slightly lower than the Budget forecast
- company tax growth is higher than at the *Budget Update,* due to higher corporate operating surplus growth
- tax on residents' interest (RWT) is increased by a larger deposit base
- GST is forecast to be higher than at the *Budget Update* in 2003/04, owing to stronger consumption and residential investment growth.

There are risks around the tax forecasts from judgements about taxpayers' response to policy changes

Tax forecasts are driven by forecasts of nominal income and expenditure, and so the main risk is the accuracy of the economic forecasts. However, tax forecasts also include judgements about taxpayer behaviour in response to policy and administrative changes. The accuracy of these judgements is another source of risk in these forecasts.

Particular risks in this forecast relate to uncertainties around:

- the degree of tax avoidance 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 the size of refunds to individuals following the elimination of IR5 tax returns
- the degree by which consumption of tobacco will decline in response to the May 2000 excise rate increase and the increased activity in government-sponsored anti-smoking programmes shortly after this
- the claiming of some film-related tax concessions.

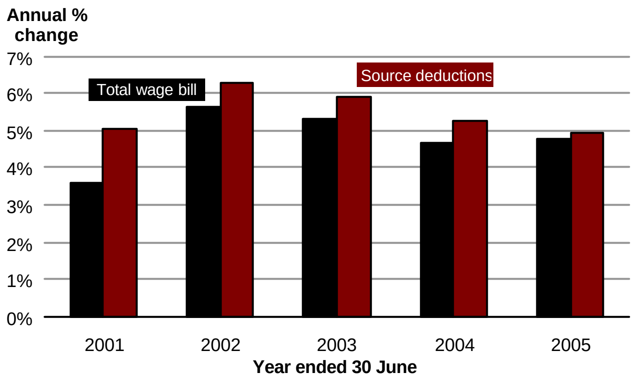
PAYE growth is driven by the wage bill

Source deductions (PAYE) revenue is the largest component of tax revenue. PAYE is determined by the size of wages and the amount of employment.

In the current year, PAYE has grown faster than the total wage bill, since this is the first year to feel the full effect of the new 39% tax rate on annual income over $60,000, which came into effect on 1 April 2000. The increase in New Zealand Superannuation has also added to PAYE growth.

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

Figure 2.8 – Growth in total wage bill and source deductions



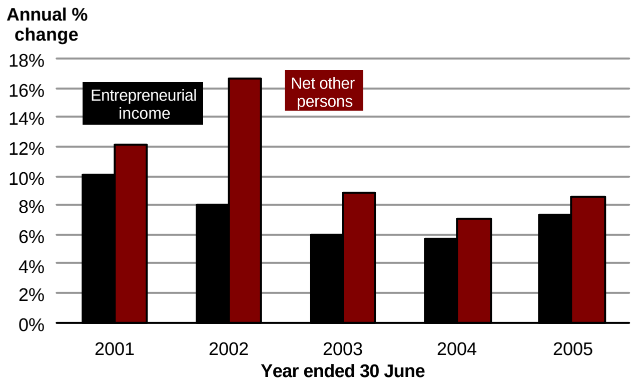
Source: The Treasury

Net other persons tax is affected by policy changes

Net other persons tax refers to tax from small business owners, farmers, other self-employed people and investors, minus refunds paid to all individuals.

This tax type has grown in 2000/01, partly due to the tax rate increase on April 1 2000. Timing effects also mean some of the strong growth in entrepreneurial income from last year will increase tax payments this year, pushing up tax growth.

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



Source: The Treasury

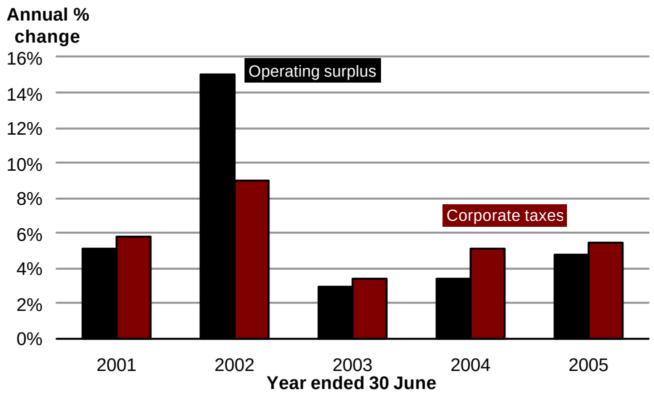
However, refunds to individuals in 2000/01 are larger than usual due to altered administrative timing. The removal of IR5 tax returns and the introduction of personal tax summaries delayed many claims for refunds relating to the 2000 income tax year into the current fiscal year, with the consequence that net other persons tax is lower than would otherwise be the case.

Timing effects from the 2000/01 year's strong entrepreneurial income growth and the stabilisation of refunds means that net other persons tax grows strongly in the 2001/02 year. From then on, net other persons tax grows slightly faster than entrepreneurial income due to the fiscal drag effect.

Corporate taxes are strong in 2000/01 and keep growing

Corporate profits (as proxied by corporate operating surplus) grow by around 5% in the year to June 2001. However, not all companies have a March or June balance date. Companies with different balance dates, particularly September and December balance date companies, are expected to achieve aggregate profit growth in excess of 5%, which pushes tax growth ahead of profit growth. There is also a noticeable effect from many companies coming out of loss and returning to tax-paying positions.

Figure 2.10 - Growth in corporate operating surplus and corporate taxes



Source: The Treasury

Conversely, not all companies are expected to achieve profits that match the June-year operating surplus growth of 15% in 2001/02, an effect which sees tax growth lagging profit growth in that year. Peaking interest rates and film-related tax concessions also serve to dampen tax growth.

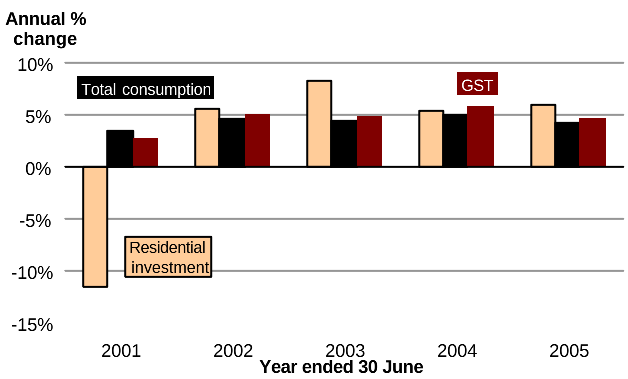
From 2002/03 onwards, corporate tax revenue grows broadly in line with corporate profits, although easing interest rates and the cessation of film-related tax concessions in 2002/03 provide a positive boost for tax growth in each year.

GST growth is initially low but it picks up over the forecast period

A substantial decline in residential investment is the main reason why growth in GST is unable to match that of its main driver, total consumption, in 2000/01. To a lesser extent, an increase in the proportion of New Zealanders' consumption spent overseas also dampens GST growth.

In 2001/02, residential investment begins to pick up again. With NZ residents' overseas spending staying static, while spending by tourists visiting NZ grows, the overall result is that growth in GST exceeds that in consumption.

Figure 2.11 – Growth in consumption, residential investment and GST



Source: The Treasury

Considerable growth in residential investment helps to keep the growth rate of GST ahead of that of consumption in 2002/03. The amount by which GST growth outstrips that in consumption would be more in this year were it not for an administrative change that transfers around $60 million of GST to FBT[2]. While an equal amount is transferred in each of the final three years of the forecast, the dampening effect on growth is most pronounced in the transitional year 2002/03.

In the final two years of the forecast, it is again largely the fact that residential investment grows faster than consumption that keeps GST growth above that of total consumption.

Customs duty grows gradually over the forecast period

Oil refinery shutdowns, supermarket sales of beer and millennium celebrations were among factors that saw imports of fuel, alcohol and tobacco at higher levels than usual in 1999/2000. Fuel and alcohol imports are unlikely to be as high again in 2000/01 and are not expected to grow strongly over the forecast period. Hence, while the growth track of customs duty on goods such as apparel, footwear, machinery, etc. is fairly well in line with that of imported goods, the overall growth track for customs duty is much flatter over the forecast period.

Little change in excise duties reflects low consumption growth

In 2000/01, excise duties on fuels pick up slightly from 1999/2000 owing to an increase in the proportion of petrol refined in New Zealand. The growth track in the other years rises slightly in line with moderate consumption growth.

Tobacco excise duties in 2000/01 are expected to decline from 1999/2000. This is due to:

- a shift of revenue back into 1999/2000 caused by a production shift in response to the May 2000 excise rate hike
- a considerable reduction in consumption due to both the excise rate rise and increased anti-smoking campaigns.

Revenue in 2001/02 picks up considerably. This is because, with no extraordinary excise rate increase, production returns to its normal seasonal pattern and the decline in consumption is much smaller. The growth track remains flat in later years as inflation-indexed excise rate rises balance consumption falls.

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2 GST on fringe benefits is currently included with other GST payments. From 1 April 2002 GST on fringe benefits will be included in fringe benefit tax payments.

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 but slightly stronger than the Treasury's for 2000/01, with differences spread across all tax types. In the 2001/02 year the Treasury's forecast is higher than Inland Revenue's, with the larger differences being spread among the income taxes (taxes paid directly on personal and company income). The Treasury's income tax forecasts are successively higher than Inland Revenue's throughout the final three years of the forecast. In the last two years of the forecast the Treasury's GST revenue forecasts are also considerably higher.

Both departments consider that the differences between the two sets of forecasts are 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.

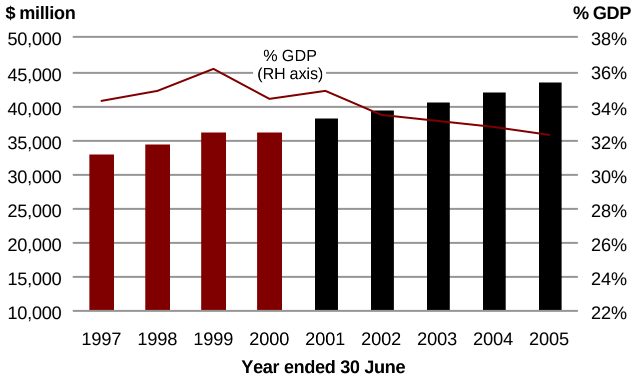
Expenses decline slowly as a share of GDP over the forecast period

Expenses fall as a percentage of GDP between 1999/2000 and 2004/05 from 34.4% to 32.3% of GDP.

Over the same period, nominal expenses increase by $7.2 billion from $36.2 billion to $43.4 billion, mainly reflecting:

- the fiscal provision and technical provisions increasing expenses by around $2.3 billion and $1.6 billion respectively
- health and education forecast increases (for example, increases due to demographic changes) of around $700 billion
- CPI indexation, NZS recipient and other benefit recipient growth of around $2.3 billion.

Figure 2.12 – Expenses ($ and % of GDP)



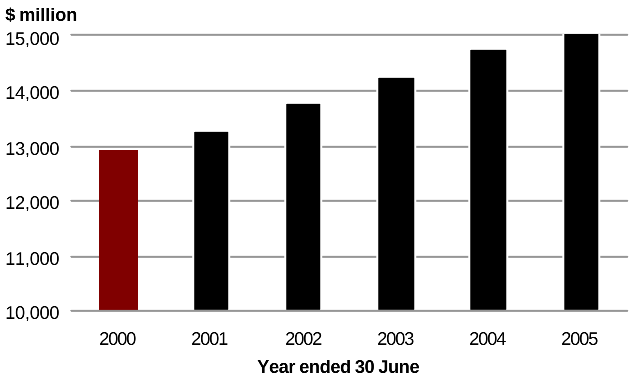
Source: The Treasury

Social security and welfare expenses grow due to cost-of-living adjustments…

Social security and welfare expenses (SSW) are projected to increase from $12.9 billion in 1999/2000 to $15.2 billion in 2004/05.

Three quarters of this $2.3 billion increase reflects cost-of-living adjustments for NZS and welfare benefits, which reflect inflationary pressures. Most benefits are adjusted each April by the CPI movement over the previous calendar year.

Figure 2.13 – Social welfare spending



Source: The Treasury

…and increased beneficiary numbers in the out years

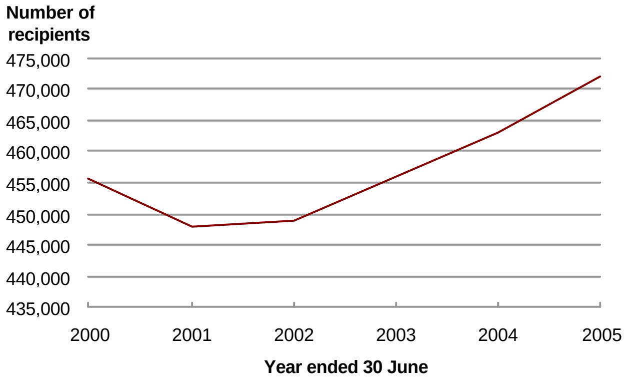
The remaining quarter of the increase in SSW expenditure reflects higher beneficiary numbers, including superannuitants. Beneficiary numbers are projected to rise from 842,000 in 1999/2000 to 872,000 in 2004/05. Over half of this increase is due to superannuitants.

New Zealand superannuation (NZS)

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

From April 2001, the age of eligibility settles at 65, resulting in an increase in recipient numbers of 24,000 between 2000/01 to 2004/05. This increase in recipient numbers increases NZS expenditure by around $280 million over this period.

Figure 2.14 – NZS recipients



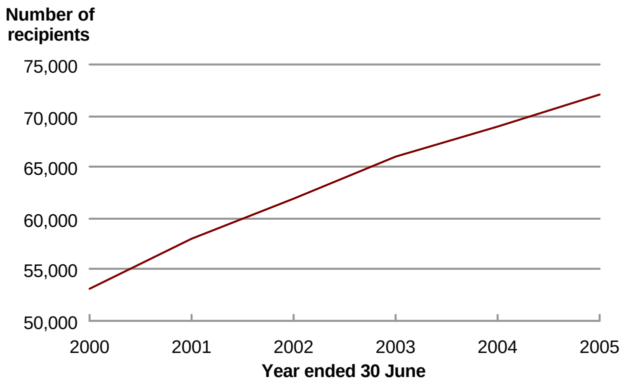
Source: The Treasury

Invalids benefit

The ageing population contributes to an increase in the incidence of invalidity, influencing the amount of invalids benefits being paid.

Growth in invalids benefit recipients is expected to average 6% per annum between 1999/2000 to 2004/05, increasing invalids benefit expenditure by around $245 million over this period.

Figure 2.15 – Invalid benefit recipients



Source: The Treasury

CPI adjustments are higher compared to the Budget Update…

SSW expenses are higher compared with the Budget forecasts by between $40 million to $200 million each year from 2000/01. These increases are largely due to higher cost-of-living adjustments, and increased expenditure on supplementary benefits.

GSF unfunded liability revaluation decreases the operating balance…

The GSF pension liability is revalued from year to year on the basis of:

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

The GSF valuation has been updated for changes to financial assumptions only. This results in a loss of around $245 million in 2000/01 due to a slightly lower average discount rate (4.7% at 30 June 2000 over the long-term to 4.6% for the *December Update*), though the movement improves slightly in the latter half of the forecast horizon.

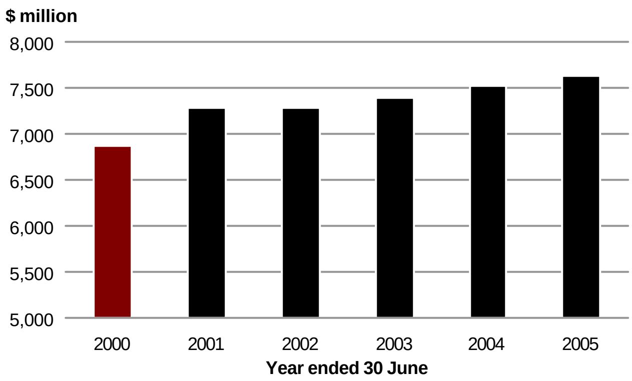
Health spending rises with additional services and demographic growth…

Health expenses are forecast to increase from $6.9 billion to $7.6 billion between 1999/2000 and 2004/05. This $700 million increase reflects extra funding for:

- demographic growth
- maintaining existing services
- new policy initiatives announced with Budget 2000.

New policy initiatives for 2001/02 will be announced in Budget 2001.

Figure 2.16 – Health expenses



Source: The Treasury

Health spending has increased by around $50 million each year since the *Budget Update,* mainly reflecting forecast changes to the ACC Non-Earners' account payments.

Table 2.3 – Growth in health spending between years

$ million	**1999/00 Actual**	**2000/01 Forecast**	**2001/02 Forecast**	**2002/03 Forecast**	**2003/04 Forecast**	**2004/05 Forecast**
Health spending	**6,874**	**7,288**	**7,275**	**7,400**	**7,520**	**7,623**
Sources of growth						
Demographic adjustment		95	84	94	96	98
Maintaining and improving services		160	..	..	..	..
Other Budget policy initiatives[1]		65	8	30	20	..
Other initiatives since the Budget		40	(22)	1	..	..
Other (includes forecasting)[2]		54	(83)	..	4	5
Total growth		**414**	**(13)**	**125**	**120**	**103**

1 A breakdown of these was included in the 2000 *Budget Economic and Fiscal Update* .

2 The $83 million reduction in 2001/02 is mainly due to a correction to the Health baselines.

Source: The Treasury

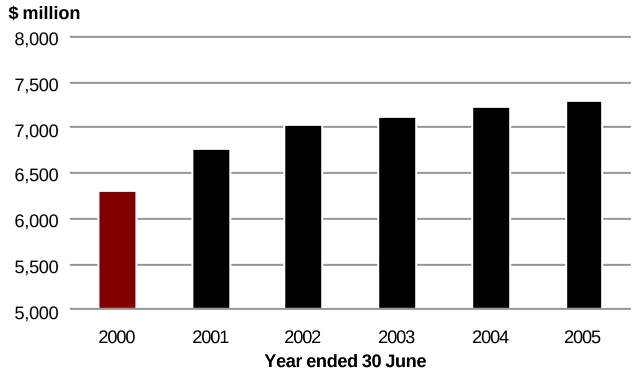
…while demographic changes boost education spending...

Education expenses are forecast to increase from $6.3 billion to $7.3 billion between 1999/2000 and 2004/05.

The growth largely reflects:

- new policy initiatives announced at the time of Budget 2000
- demographic changes – the number of primary school students is not expected to change significantly. Secondary rolls and tertiary student numbers (on an effective full-time basis) are expected to increase by a total of almost 60,000 over the next five years, resulting in around $300 million additional education expenses. The various sources of growth in education spending are summarised in Table 2.4 below.

Figure 2.17 – Education expenses

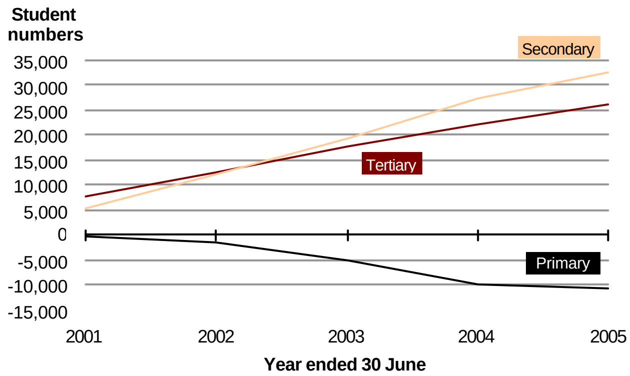


Source: The Treasury

Additional new policy initiatives for 2001/02 will be announced in Budget 2001.

The latest forecast represents an upward revision of between $70 million to $100 million in each year compared to the *Budget Update*. The key components of the revision are changes to student loan provisioning and revisions to the base forecast (forecasting changes).

Figure 2.18 – Roll forecasts – yearly changes



Source: Ministry of Education

Table 2.4 – Growth in education spending between years

$ million	1999/00 Actual	2000/01 Forecast	2001/02 Forecast	2002/03 Forecast	2003/04 Forecast	2004/05 Forecast
Education spending	**6,310**	**6,774**	**7,024**	**7,127**	**7,227**	**7,307**
Sources of growth						
Student allowance changes		12	24	24	21	23
Student loan provisioning		57	60	13	13	16
Forecast impact of school roll growth[1]		23	30	19	20	20
Forecast impact of tertiary student numbers[1]		46	46	36	35	32
New initiatives and other[2]		326	90	11	11	(11)
Total growth		**464**	**250**	**103**	**100**	**80**

1 School roll growth and tertiary student figures are estimates derived from a disaggregation of the *December Update* forecasts. These estimates are indicative only.

2 In 1999/2000 there was an underspend of $135 million, some of which was due to timing issues and so increased the amount forecast in 2000/01.

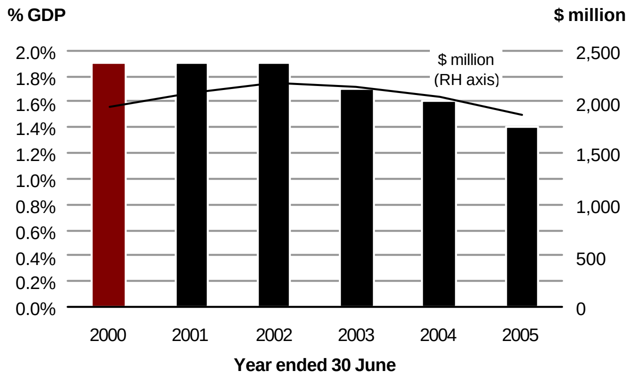
Source: The Treasury

…and net finance costs remain relatively stable

Net finance costs rise slightly in 2000/01 and 2001/02, due to higher debt levels, before falling away due to falling interest rates.

Compared with the *Budget Update*, net finance costs are on average $75 million higher from 2002/03 onward, due primarily to higher levels of debt.

Figure 2.19 – Net finance costs (% of GDP and $)



Source: The Treasury

Provisions for new initiatives

Within Budget 2000, the Government committed $3.65 billion of its $5.9 billion fiscal provision. The Government also set aside a contingency for further initiatives in 2000/01 of $180 million a year ($540 million over three years).

Approximately $240 million of the $540 million available from the contingency has been committed. Table 2.5 below shows the most significant initiatives that make up this $240 million.

Table 2.5 – Decisions taken against the contingency provision

2000 Contingency decisions ($m, GST inclusive)	**2000/01**	**2001/02**	**2002/03**	**Total**
Revenue initiatives:				
Taxing beneficiary income of minors	-	(13)	(13)	(26)
Other revenue initiatives	(1)	(4)	-	(5)
Total revenue initiatives	**(1)**	**(17)**	**(13)**	**(31)**
Expenditure initiatives:				
Managing impacts of the Ministry of Justice forecast of the prison population	7	12	12	31
Accident compensation initiatives	-	10	13	23
Nicotine replacement therapy	6	6	6	18
Developing effective schools	3	7	7	17
Well-settled over-stayers	6	7	3	16
Transfer from Vote Health Services Providers to Vote Health (from capital to operating)	15	-	-	15
Alexandra flooding issues and proposed solutions	10	5	-	15
Safety (Administration) Programme costing adjustments	(2)	(6)	(6)	(14)
Other expense initiatives[1]	55	44	53	152
Total expense initiatives	**100**	**85**	**88**	**273**
Net impact on the 2000 contingency	**99**	**68**	**75**	**242**

1 A number of individual initiatives, each with an operating cost of less than $10 million over three years.

The Government has decided that around $100 million of the amount remaining in the contingency will be used to boost the provision for new initiatives in Budget 2001. This has been achieved by transferring at least $50 million in 2001/02 and 2002/03 from the contingency to the Budget 2001 provision. This increases the Budget 2001 provision to $600 million per annum, compared to the $550 million allocated in Budget 2000.

In addition, some minor rephasing of the existing contingency provision has occurred.

This leaves $193 million of the original $540 million contingency uncommitted as at 27 November (refer Table 2.6 below).

Any amounts that remain uncommitted from the contingency will be available for use during the 2001 or 2002 Budgets.

Table 2.6 – Remaining contingency provision

2000 Contingency ($m, GST inclusive)	2000/01	2001/02	2002/03	Total
Original contingency	**180**	**180**	**180**	**540**
Less funding allocated to initiatives	(99)	(68)	(75)	(242)
Unallocated contingency funding	**81**	**112**	**105**	**298**
Less/plus minor rephasing	(19)	6	8	(5)
Less transfer to Budget 2001 provision	-	(50)	(50)	(100)
Remaining 2000 contingency provision	**62**	**68**	**63**	**193**

Source: The Treasury

Overall, the Government's fiscal provision remains unchanged at $5.9 billion.

Table 2.7 – The Government's fiscal provisions

Operating provisions ($m, GST inclusive)	1999/00	2000/01	2001/02	2002/03	Total
Budget 2000 decisions (Budget Update p36)	420	1,050	1,060	1,120	3,650
2000 contingency decisions (Table 2.5)	-	99	68	75	242
2000 contingency provision left (Table 2.6)	-	62	68	63	193
Budget 2001 provision	-	-	600	600	1,200
Budget 2002 provision	-	-	-	575	575
Total provision	**420**	**1,211**	**1,796**	**2,433**	**5,860**

Source: The Treasury

Technical provision in 2003/04 and 2004/05

For 2003/04 and 2004/05, the forecasts assume a technical fiscal provision of $800 million (GST inclusive) for each year. This represents an estimate of potential future policy impacts on the operating balance[3].

The FSR 2000 included a "fiscal allowance" of $1.2 billion from 2004/05 onwards for the ten-year progress outlooks. The fiscal allowance indicates the fiscal flexibility that the Government has for such things as spending and revenue initiatives, accelerating contributions to the NZS Fund, and responding to developments in the economic and fiscal position that differ from current projections. The $1.2 billion provided a broad indication of flexibility rather than a specific policy commitment.

Now that 2004/05 is included in the forecast horizon for the first time, $800 million has been assumed as a technical assumption to indicate the impact of new policy initiatives, with the $400 million difference increasing the operating balance. Given the uncertainties around the economic environment, continuing with the $800 million, while conservative, is considered appropriate.

The Government has signalled in the *Budget Policy Statement* its intent to review, during 2001, the level of new spending intentions beyond the current term of government. The technical provisions will be replaced by an indicative Government policy commitment at that stage.

Stop Press Item

After the fiscal forecasts were finalised, the Government made one material decision that impacts on its fiscal provisions and expenses – and therefore has no impact on the operating balance and debt. The item has been removed from the Specific Fiscal Risks chapter.

- Work and Income – Computer Operating Costs.

  The Government has decided to provide funding to the Department of Work and Income for the operating cost pressures associated with the FOCIS information technology programme mainframe computer at $2.4 million in 2000/01 and around $20 million from 2001/02 onwards.

This will be included in the 2001 *Budget Economic and Fiscal Update* as a charge against the Government's fiscal provisions.

3 $800 million is broadly based on average new spending over the last two terms of Government. The $800 million is technical, providing an illustration of potential spending patterns and the impact on the fiscal position.

State-Owned Enterprises and Crown Entities

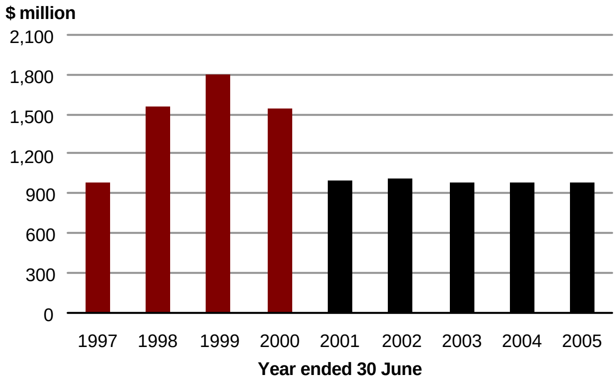
The third and final component of the operating balance is state-owned enterprises and Crown entities.

SOEs and Crown entities surpluses remain constant ...

SOEs' and Crown entities' gross surpluses remain flat across the forecast period, averaging around $985 million per annum.

Surpluses are lower than in the past few years. This is primarily due to ACC surpluses being around $500 million permanently lower than in 1999/2000, due to the recognition of future costs of previously-accepted ACC claims and a number of one-off gains in 1999/2000.

Figure 2.20 – SOEs' and Crown entities' gross surpluses



Source: The Treasury

In 2000/01, SOEs' and Crown entities' gross surpluses include a $165 million gain resulting from the decrease in the ACC liability revaluation as a result of:

- forecast reductions to both claims incidence and average cost of claims ($75 million)
- a 0.2% increase in the discount rate ($90 million).

... and are slightly higher compared with the Budget forecasts

Compared with the Budget forecasts, SOEs' and Crown entities' gross surpluses are higher by around $65 million, $150 million, $55 million and $35 million in 2000/01 through to 2003/04[4].

In 2000/01, the increase is driven by the ACC liability valuation decrease and premium levels, partially offset by a number of other factors in other Crown entities.

For the other years, the increase is primarily driven by higher surpluses generated by ACC as a result of the ACC premium decisions taken by the Government on 27 November 2000.

4 These increases exclude the impact of NZS Fund asset returns. These returns were included in the gross SOE and Crown entities surplus classification at the time of the Budget forecasts. They have now been recorded in the investment income section of revenue (reflecting the nature of the NZS Fund's entity structure, which was not known at the time of the Budget forecasts).

Prefunding future NZS expenses

At the time of the *Budget Update*, it was assumed that NZS Fund assets would be held by a Crown entity. Legislation has been drafted on the basis that the Fund assets will be Crown assets, while still managed by an independent board.

The SOE/CE surpluses have therefore decreased relative to the *Budget Update*, to reflect the returns on NZS Fund assets now being included as part of investment income.

Until the Board has developed an investment strategy, the forecasts will retain the following technical assumptions used in the *Budget Update*:

- 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 transitional capital contributions to 2003/04 and returns as shown in Table 2.8 below.

The Board is likely to invest the NZS Fund assets in a mixed portfolio. This is expected to do better than the cost of the Crown's long-term debt.

The forecast contribution for 2004/05 is based on the formula for calculation stated in the New Zealand Superannuation Bill that has been introduced to Parliament.

Table 2.8 – NZS Fund assumptions

$ million	**2001/02**	**2002/03**	**2003/04**	**2004/05**
Capital contributions	600	1,200	1,800	2,900
% of GDP	*0.5%*	*1.0%*	*1.4%*	*2.2%*
Fund asset returns (after tax)	13	56	128	243
Fund assets	613	1,869	3,797	6,940
% of GDP	*0.5%*	*1.5%*	*3.0%*	*5.2%*

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

Influences on Net Worth and Debt

The key influence on net worth and debt (see Statement of Financial Position and Statement of Borrowings) is operating surpluses. This section explains how operating surpluses translate through to net worth by showing how the cash generated from operating surpluses is invested, and the subsequent impact on debt. Changes to the 2000/01 bond programme are also explained.

Operating surpluses increase net worth and generate cash

Operating surpluses increase net worth by $13.9 billion from $8.6 billion to $22.5 billion between 1999/2000 and 2004/05.

Table 2.9 below shows how the forecast operating surpluses translate through to the balance sheet over the five-year forecast period.

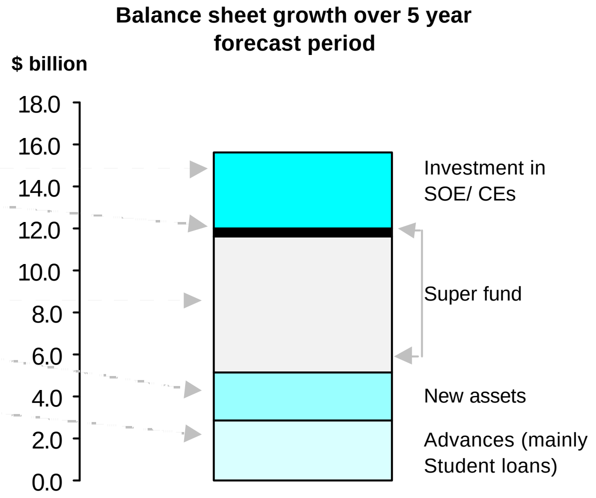
Some portions of the operating surplus are non-cash in nature, including:

- depreciation of $4.5 billion, for which a broadly equivalent amount of cash is earmarked for maintaining existing physical asset levels
- SOE/Crown entity net surpluses of $3.6 billion, which are retained by the SOEs and Crown entities and increase the Crown's investment in this asset
- NZS Fund returns (after tax) of $0.4 billion, which are retained by the NZS Fund, and increase the Crown's investment in this asset.

Adjusting for these items, the rising operating surplus profile translates into a similar operating cash flows profile over the forecast period, generating around $14.3 billion in cash. The Crown can use this cash to either invest in assets, or repay debt.

Table 2.9 – Impact of operating surpluses on the balance sheet

	$ billion
Total Operating balances	13.9
Add	
Depreciation	4.5
Less	
Retained net SOE/CE surplus	(3.6)
Retained NZS fund returns	(0.4)
Other	(0.1)
Operating cashflows	14.3
Invested in	
NZS Fund contributions	(6.5)
Increase asset base	(2.3)
Maintain existing asset base	(4.5)
Advances	(2.8)
Other	(0.3)
Requiring finance	(2.1)



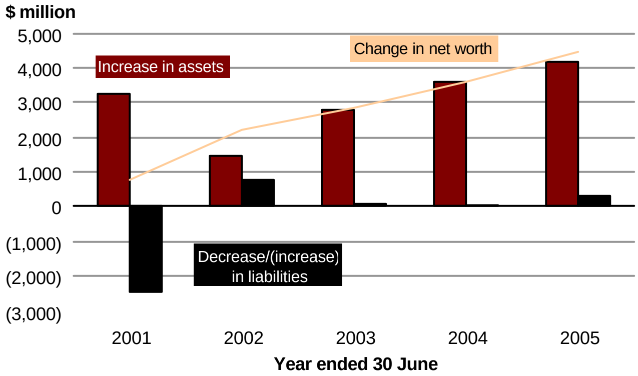
Source: The Treasury

Surplus cash is invested in assets…

The Crown invests around $16.4 billion cash (slightly more than its operating cash flows) over the forecast period:

- maintaining and improving the existing asset base ($6.8 billion, which includes the increased capital provision of $3.2 billion – (see box on page 44)
- investing in the NZS Fund ($6.5 billion)
- funding advances ($2.8 billion), the bulk of which are student loans ($2.6 billion).

Figure 2.21 – Assets and liabilities



Source: The Treasury

…with borrowing making up the shortfall in operating cash

To fund the difference of $2.1 billion between operating cash flows and investing, the Crown uses existing marketable securities and deposits (MSDs) and debt. The result is a small increase in nominal gross debt and a decrease in MSDs.

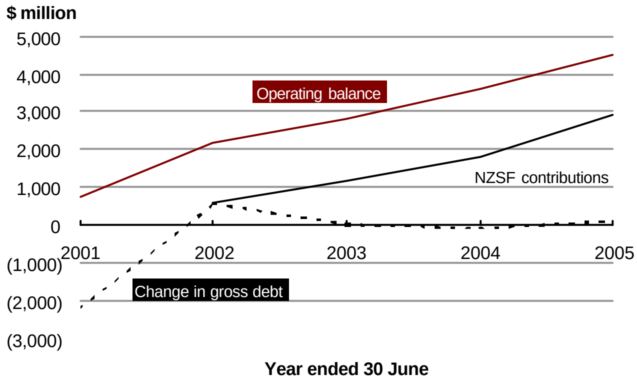
Gross debt increases by around $1.6 billion and MSDs decrease by around $1.1 billion over the forecast horizon. Taken together, the change in these financial assets and liabilities fund the $2.1 billion additional investment in the balance sheet as well as other working capital movements (for example, movements in accounts payable).

Movement in debt can be linked to the operating balance

Previously, the general change in debt tended to match the operating balance trend, reflecting the use of surpluses to retire debt.

However, this general trend has now altered as a result of decisions to invest more in assets (represented by the increase in the capital provision) and to pre-fund future NZS expenses by building up financial assets. As a result, the improvement to debt reduces.

Figure 2.22 – Operating balance compared with change in gross debt



Source: The Treasury

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 (and gross) debt primarily reflect cash flows.

As a result, the movement in net debt does not match the operating balance in a given year. Net capital investment in physical assets, retained surpluses of SOEs' and Crown entities and the NZS Fund activity largely produce this difference.

The following table outlines this relationship.

Table 2.10 – Relationship between the operating balance and net debt

($ million)	2000 Actual	2001 Forecast	2002 Forecast	2003 Forecast	2004 Forecast	2005 Forecast
Operating balance	1,449	765	2,205	2,829	3,622	4,475
Change in net debt	305	(703)	(20)	83	628	173
Difference	**(1,144)**	**(1,468)**	**(2,225)**	**(2,746)**	**(2,994)**	**(4,302)**
This difference comprises:						
Non-cash elements of the operating balance						
SOE/CE retained surplus net of dividends	(1,094)	(723)	(778)	(712)	(698)	(692)
Depreciation	791	872	918	926	916	913
GSF unfunded liability movement	(201)	244	6	(11)	(24)	(29)
NZS Fund accrued income	..	..	(13)	(56)	(128)	(243)
(Gain)/loss on sale of assets	(7)	3	..	..	..	..
Commercial forests and net FX movements	(66)	(87)	..	..	..	..
Other one-off non-cash items	155	..	..	..	..	..
Student loan influences	(16)	(16)	(2)	6	2	(4)
Cash elements not in the operating balance						
Circulating currency	275	177	..	..	..	..
New Zealand Super contributions	..	..	(600)	(1,200)	(1,800)	(2,900)
Net purchase of physical assets including capital contingency provision	(910)	(1,654)	(1,409)	(1,431)	(1,074)	(1,183)
Asset sale receipts	..	62	..	..	..	..
Net capital injections	(130)	(117)	(102)	(98)	(26)	(9)
Other working capital movements	59	(229)	(245)	(170)	(162)	(155)
	(1,144)	**(1,468)**	**(2,225)**	**(2,746)**	**(2,994)**	**(4,302)**

Source: The Treasury

Capital Provisions

For Budget 2000, the Government set a capital spending provision of $2,400 million over four years (1999/2000 to 2002/03). After capital spending during Budget 2000, $483 million of this provision remained uncommitted.

Subsequent to Budget 2000, capital spending decisions have committed a further $43 million from the capital provision. A final return of capital from the disestablishment of At Work Insurance has increased the amount remaining within the provision by $80 million. Details are shown in Table 2.11 below.

The *Budget Update* signalled that the remaining provision was unlikely to cover future capital spending pressures. However, because of uncertainty around the exact amount of capital spending required, the provision was not increased at that time.

As explained in *Budget Policy Statement 2001*, the Government has undertaken an assessment of likely capital spending and withdrawals over the next three years and, as a result, has decided to increase the capital spending provision from $2,400 million to $3,200 million.

The net effect of the recent decisions and the increase in the capital provision is that $1,320 million remains from the new capital provision of $3,200 million. Supplemented by withdrawals of capital from SOEs, this amount should be sufficient to cover capital spending over the next three years.

Table 2.11 – Post-Budget capital decisions

($m, GST inclusive)	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**Total**
Managing impacts of Ministry of Justice forecast of prison population	-	29	-	-	29
Loans to polytechnics	-	25	-	-	25
Transfer from Vote Health Services Providers to Vote Health	(15)	-	-	-	(15)
Northland Regional Corrections Facility	-	(45)	(4)	40	(9)
Other capital initiatives[1]	-	13	-	-	13
Total	**(15)**	**22**	**(4)**	**40**	**43**

1 A number of individual initiatives, each with a capital cost of less than $10 million.

Table 2.12 – Capital provisions

($m, GST inclusive)	**1999/00**	**2000/01**	**2001/02**	**2002/03**	**Total**
Budget 2000 provision		900	750	750	2,400
Increase in the provision		100	350	350	800
New provision		**1,000**	**1,100**	**1,100**	**3,200**
Budget 2000 decisions (BEFU p40)	(54)	827	576	568	1,917
Post-Budget decisions	(15)	22	(4)	40	43
Return of capital from At Work Insurance	-	(80)	-	-	(80)
Total decisions to date	**(69)**	**769**	**572**	**608**	**1,880**
Remaining provision	**-**	**300**	**528**	**492**	**1,320**

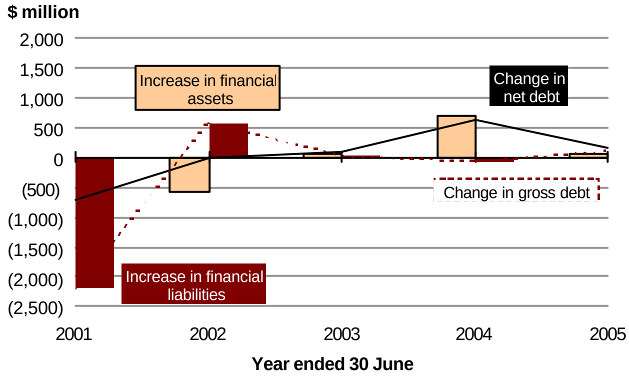
Source: The Treasury

Gross debt and net debt tracks are broadly similar

Nominal gross debt (or borrowings) increases in 2000/01 by around $2.2 billion and then decreases slightly over the remainder of the forecast horizon.

Most of this increase occurs in 2000/01. The increase in gross debt reflects the impact of additional investment (advances to hospitals) and the drop in the exchange rate, increasing the value of the foreign currency denominated debt (offset by a similar increase in the value of foreign currency reserves). Gross debt remains relatively static thereafter, reflecting the use of all available cash being applied to investing activity or the build-up of assets to fund future NZS expenses.

Figure 2.23 – Financial assets and financial liabilities



Source: The Treasury

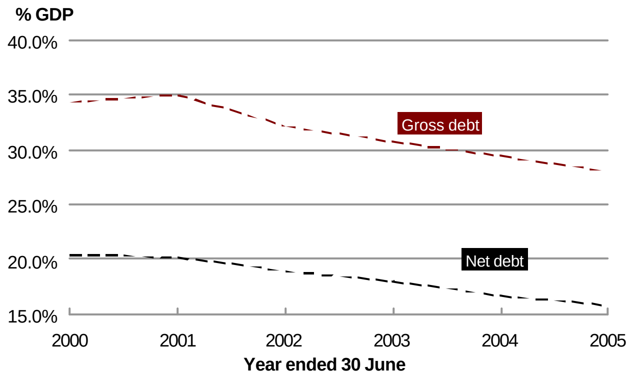
Net debt follows a similar track, increasing in 2000/01 by around $700 million due to the additional physical asset purchases and increase in the capital provisions. Net debt slowly falls thereafter.

Gross and net debt decrease to $37.6 billion and $21.2 billion respectively by 2004/05.

As a percentage of GDP, gross debt declines from 34.3% of GDP to reach 28.0% of GDP by the end of the forecast period.

Net debt declines from 20.4% to reach 15.8% of GDP by the end of the forecast period.

Figure 2.24 – Net and gross debt – % of GDP



Source: The Treasury

Net debt and the domestic bond programme

The domestic bond programme for 2000/01 was set at $2.85 billion at the time of the *Budget Update*. The bond programme finances the Crown's operating, investing and financing cash flows.

Since the *Budget Update*, the bond programme has been increased by $800 million – bringing the total programme for 2000/01 to $3.65 billion. This increase reflects the need to fund the impact of changes to the fiscal position resulting from changed economic conditions and the implementation of the Government's policy programme.

While the operating cash flows have reduced by around only $350 million (reflecting the decrease to the operating balance), additional financing is required to fund a number of new investment decisions during 2000/01. These funding decisions have no impact on net debt. These include:

- additional advances to refinance private sector hospital debt with Crown debt, along with a net increase in the capital provision
- the refinancing of non-market government securities issued to EQC as a result of the in-principle agreement for EQC to diversify the investments in the Natural Disaster Fund.

Partially offsetting these impacts on the domestic bond programme is the cash available from the better than expected 1999/2000 financial year.

Changes in Accounting Policy

At present, there are a number of areas where GAAP developments are likely to affect the *Crown Financial Statements* in the near future, including:

- A new financial reporting standard on accounting for property, plant and equipment is expected to be issued during 2001. The new standard will change the basis for determining the market value of some Crown assets. The effect of this change is expected to result in slightly higher reported values for the Crown's property, plant and equipment during 2001/02.
- 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, and 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, because a portion of it will be capitalised as it is enhancing the value of the asset. This will be partially offset by an increase in depreciation expenses.