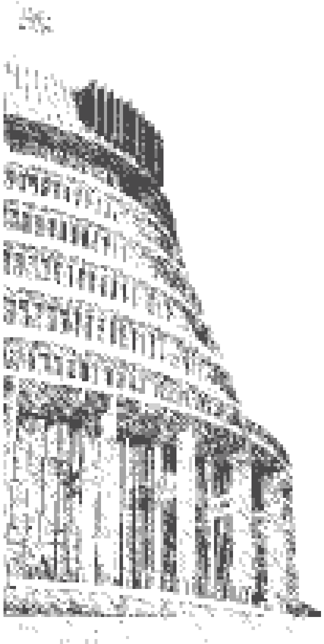


budget 2002

• FISCAL STRATEGY REPORT •

23 May 2002

Hon Dr Michael Cullen

TREASURER
MINISTER OF FINANCE

The Fiscal Responsibility Act 1994 and the *Fiscal Strategy Report*

The Fiscal Responsibility Act 1994 requires the Government to show that it is acting in accordance with the principles of responsible fiscal management through a series of reports presented to the House of Representatives at various times during the financial year. The *Fiscal Strategy Report* is one of these reports and is required to:

- assess the extent to which the fiscal forecasts in the *Budget Update* are consistent with the short-term fiscal intentions given in the *Budget Policy Statement*, and explain the reasons for any departures from those intentions (see Annex 1)
- include progress outlooks for 10 or more years that:
  - include projections for the variables specified for long-term fiscal objectives, illustrating the likely future progress towards achieving those objectives
  - explain the reasons for any significant differences from previous progress outlooks (see Annex 2)
- assess the consistency of the progress outlooks with the long-term fiscal objectives given in the *Budget Policy Statement*, and explain the reasons for any departures of the progress outlooks from those objectives
- include an amended version of the Government's short-term fiscal intentions and long-term fiscal objectives where they have changed from those given in the *Budget Policy Statement* (see Annexes 1 and 2).

Fiscal Strategy Report

Fiscal policy overview

The *2002 Fiscal Strategy Report* (FSR) confirms the Government's fiscal policy approach over the parliamentary term, and demonstrates that we are continuing to balance prudent fiscal management with innovative policy progress.

We are proud of our achievements. We continue to deliver as promised on our policy commitments, and to build up New Zealand's infrastructure. We are putting a strong focus on the future – building up financial assets now to fund the longer-term costs of an ageing population. We are doing this whilst continuing to meet our long-term fiscal objectives.

Our key objective – to run operating surpluses to meet New Zealand Superannuation (NZS) Fund contributions, while meeting capital pressures and priorities and managing debt at prudent levels – continues to drive our fiscal strategy.

A coherent approach to fiscal, economic and social policy

Throughout our term the Government has successfully balanced fiscal prudence with delivering on policy commitments, and designing a framework to raise New Zealand's sustainable growth rate. The 2002 Budget builds on our success.

Prudent fiscal management to achieve objectives

At the start of the parliamentary term, we set ourselves a suite of long-term fiscal policy goals. In 2001 we updated these objectives to make our strategy even clearer.

Progress toward these objectives has generally been faster than was anticipated in the *2000 Budget Policy Statement* (BPS), despite a number of significant surprises. Ongoing operating surpluses will support contributions to the NZS Fund as planned, while the size of government (and therefore services delivered) remains in line with expectations in the *2000 BPS*.

Over the term, the Government has been confronted with some unexpected challenges. Not only have we dealt with them head on, we have also improved monitoring and reporting systems to reduce the likelihood of future surprises. For example, we have increased the robustness of our fiscal management tools, restored realistic baselines for departments, and put a greater focus on capital spending. Of course, there will always be events that can't be anticipated, such as the recapitalisation of Air New Zealand. However, with the improvements in the fiscal position over the term, the Government is well placed to deal with any such surprises in the future.

Despite the recapitalisation of Air New Zealand, progress towards our gross debt objective has been faster than anticipated in the *2000 BPS*. Net debt and expenses are also lower as a percentage of GDP than anticipated at the start of the term.

The better than expected net debt position largely reflects stronger growth in both revenue and nominal GDP. Nominal GDP in 2003 is now expected to be 3.6% higher than was forecast in the *2000 BPS*. Stronger nominal revenue growth, particularly in 2001, was carried through into later years. This helped net and gross debt to fall faster than expected. However, the nominal gross debt improvement was almost completely offset by the cost of the Air NZ recapitalisation. Consequently, in 2003 nominal gross debt remains similar to that forecast in the *2000 BPS*, although it is lower as a percentage of GDP.

Table 1 – Forecasts of key fiscal indicators in 2002/03

% GDP	2000 BPS	2002 FSR	Difference
Revenue	34.8	34.4	(0.4)
Expenses	33.5	33.0	(0.5)
OBERAC[1]	1.8	1.8	0.0
Net debt	18.9	16.8	(2.1)
Gross debt	30.0	28.6	(1.4)

Source: The Treasury

We promised to meet our objectives with a fiscal policy approach that lets automatic stabilisers even out the impact of swings in the economic cycle. Our decision against providing a fiscal stimulus to boost the economy in response to the expected international slowdown and the effects of the 11 September terrorist attacks proved to be correct. Latest forecasts show economic growth staying close to potential.

Continuing to deliver on our policy commitments

Fiscal progress has not been at the expense of policy goals. Looking back to 2000, we worked to implement our policy commitments – creating a fairer student loan scheme, restoring income-related rents for state housing, reducing waiting times for surgery and restoring the 65% wage floor for New Zealand Superannuation.

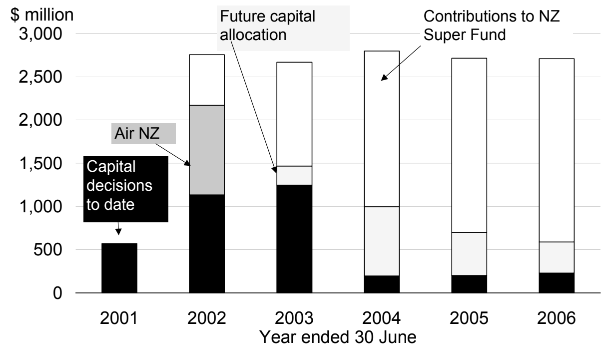
We continue to focus on coherent policy change, planning for the challenges facing New Zealanders in the future. The most important example of this is the NZS Fund. Another example is our work to position New Zealand for the impact of global warming, meet our obligations under the Kyoto Protocol, and act to minimise the impact on vulnerable sectors of our economy.

1 Operating balance excluding revaluations and accounting changes. See the *2002 Budget Update* for further information on how the OBERAC is calculated.

In addition, the Government is addressing the tendency for the focus to be on operating activities, by building a more complete picture of government expenses and investment. This means looking at revenues, expenses, partial pre-funding and investing requirements as parts of a coherent picture.

We have strengthened processes for capital decision-making, and as Figure 1 shows, we are planning for a period of significant capital investment.

Figure 1 – Capital spending



Source: The Treasury

Consistent with an ongoing emphasis on economic growth

Sustainable growth has also been a key focus for the Government, along with fiscal responsibility and meeting our policy commitments. We continue to push for sustainable economic growth that will make New Zealanders better off in the long-term, while protecting the environment and enhancing inclusive economy principles.

Policies such as the growth and innovation framework will help to cultivate industries that are economically, socially and environmentally sustainable. The Government has also made changes to improve market functioning and to benefit consumers and small shareholders (such as improvements to the regulatory framework).

Budget 2002 builds from a sound base, and focuses on planning ahead

Building on our progress over the past two years, and as indicated in our *2002 BPS*, our priorities for Budget 2002 are health, education and economic transformation. We are delivering on these priorities within the $6.1 billion operating provision set for the term.

A significant proportion of spending in Budget 2002 aims to put health expenditure on a firm footing, providing district health boards with the certainty they need to undertake financial planning, as well as implementing the primary care strategy. This approach balances the need to provide certainty with a realistic funding track that requires all those in the health sector to contribute to making it work.

While the cost this year of the Budget 2002 decisions is $715 million (excluding the contingency allowance of $230 million), this will rise to close to $900 million in following years. The rising cost reflects the necessary phase-in period for some initiatives, such as the meningococcal meningitis vaccination programme. We can accommodate this increase without changing the allocation for future Budgets or compromising progress towards our fiscal objectives.

Budget 2002 commits an additional $407 million in capital spending, bringing our total new capital spending over the term to just over $4.2 billion. Our focus continues to be in the health, education and housing sectors, with the single biggest area of new investment over the term being education (which includes improvements to the student loan scheme).

Table 2 – Forecasts of long-term fiscal objectives and indicators (% GDP)

Year end June	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
		Actual				**Forecast**		
Financial performance								
Revenue	35.7	34.1	34.6	34.2	34.4	34.4	34.5	34.4
Expenses	35.2	33.8	33.5	32.5	33.0	32.7	32.4	32.3
Operating balance	1.7	1.4	1.2	2.2	1.8	2.3	2.9	3.0
OBERAC	0.2	0.8	1.8	1.9	1.8	2.3	2.9	3.0
Operating expenses + contributions	35.2	33.8	33.5	33.0	33.9	34.1	33.9	33.8
OBERAC ex fund returns	0.2	0.8	1.8	1.9	1.8	2.2	2.6	2.6
Financial position								
Net worth	5.9	8.0	10.0	11.8	13.2	14.9	17.2	19.4
Gross debt	36.1	33.7	32.2	30.2	28.6	29.2	28.8	28.4
Net debt	21.3	20.0	17.5	16.8	16.8	16.8	16.2	15.5
Net debt with NZS Fund assets	21.3	20.0	17.5	16.3	15.2	13.9	11.6	9.3
NZS Fund								
Contributions	-	-	-	0.5	1.0	1.4	1.5	1.5
NZS Fund returns (after tax)	-	-	-	0.0	0.1	0.2	0.3	0.4
Accumulated assets	-	-	-	0.5	1.5	3.0	4.6	6.3

Source: The Treasury

All tracks are presented under the current accounting method. Annex 3 contains tracks by total Crown and core Crown presentation.

A solid foundation for the next parliamentary term

Over the next parliamentary term the Government will continue its fiscal strategy of running structural operating surpluses sufficient to meet the required contributions to the New Zealand Superannuation Fund (NZS Fund). In addition, we will continue to balance capital and operating expenditure to ensure we remain on track to meet our gross debt target.

Balancing expenditure within realistic constraints

The sound fiscal outlook for the medium term and our policy achievements to date place the Government on firm ground as we look to the next parliamentary term.

However, we are aware of a number of challenges in the next parliamentary term, in part reflecting our ambitious fiscal strategy. Over the next couple of years, we require expenses to grow more slowly than GDP to build up structural operating surpluses to meet NZS Fund contributions. This is despite inevitable pressures in a number of areas, such as health. We will manage this constraint through proactive oversight to ensure value for money in spending public resources, and through continual review of expenditure in conjunction with our fiscal tracks. Changes to our fiscal management tools, outlined below, will further support this approach.

Given the anticipated operating surpluses ahead, we have some flexibility in how we balance the operating and capital spending components alongside the NZS Fund contributions in the next term.

The operating balance forecasts include a budget allowance for core operating expense growth of around 2.5% per year, and capital investment on average of around $500 million to $600 million per year.[2] We are comfortable with this level of spending as the resulting tracks are consistent with achieving our fiscal strategy.

We are signalling here the significant scope for investment in New Zealand's infrastructure and assets over the next parliamentary term, within which our priorities continue to be hospitals, schools, defence and housing. Additionally, $175 million has been allocated to the transport strategy, for projects with both operating and capital components, which are yet to be finalised.

Ensuring progress by revising our fiscal management approach

The process of setting spending intentions will change in the next parliamentary term. The changes will mean that:

- the focus will be on the operating and debt tracks and their consistency with our fiscal objectives. This compares with the current focus on a set nominal limit for the parliamentary term
- spending intentions remain relevant as the economic and fiscal outlook changes.

2 As capital spending is one-off in nature, the spending profile is unlikely to smooth. This capital spending is in addition to purchases of physical assets to maintain the asset base, which average around $1 billion per year over the next five years.

To achieve this, we plan to review spending intentions twice yearly with reference to updated economic and fiscal forecasts and our long-term fiscal objectives. We will look through major volatilities such as revaluations and cyclical tax re-forecasts. The changes will also allow high-level trade-offs between operating spending and investment.

Revising the framework will sharpen the focus on our fiscal strategy, which remains unaffected by these changes.

Spending intentions to take account of uncertainties and economic outlook

Future spending intentions will be set with regard to progress towards our fiscal objectives, but also take into account:

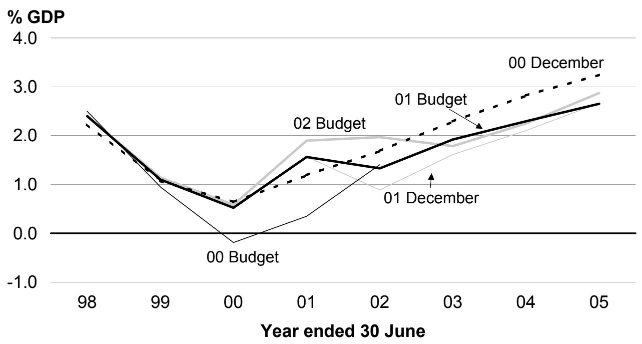
- the uncertainty in the economic and fiscal forecasts around the economic cycle and underlying structural growth

- the likely impact of any change in spending intentions on the macro-economy.

While the global uncertainty associated with the events of 11 September 2001 has abated, risks around the domestic and international economic outlook remain. Examples of alternative economic tracks and their impact on debt and the operating balance are shown in the Risks and Scenarios chapter of the *Budget Update*. These show a debt impact of up to 3% of GDP.

The Government is also cognisant of uncertainties in calculating the structural OBERAC. Even over the current parliamentary term, where fiscal policy has been relatively stable, estimates of the structural OBERAC have altered significantly. The uncertainty appears to be greatest over the period one to two years ahead.

Figure 2 – Structural OBERAC



Source: The Treasury

In addition, an increase in government spending over and above that forecast may make the Reserve Bank's job of controlling inflation harder. A spending increase will generally increase demand, and as the economy is forecast to grow at close to its potential rate, the supply response is likely to be limited in the short-run, leading to pressure on prices.

Line-by-line Consolidation of the Crown Financial Statements

Richer information, but fiscal policy is unchanged

As set out in the *2002 BPS*, changes to accounting standards require changes to the way the Crown financial statements are prepared from the Budget 2002. These changes are required for consistency with generally accepted accounting principles (GAAP) and do not alter the Government's fiscal policy.

In the future, the Crown financial statements will record the revenues, expenses, assets and liabilities of all Crown-controlled entities (eg, departments, state-owned enterprises (SOEs) and Crown entities). Currently, only the net surplus, net investment and net worth of SOEs and Crown entities are recorded. Future statements will also remove the GST on Crown expenses. Net worth and the operating balance are unaffected.

The Crown will publish fully consolidated ("total Crown") accounts, as described above, but will split out "core Crown" information. The core Crown revenues and expenses are similar to the current accounts, except that they remove GST on Crown expenses.

This change means that the Government needs to alter the presentation of its fiscal objectives, as noted in the *2002 BPS* and the *2001 FSR*. The new presentation ensures ongoing compliance with the Fiscal Responsibility Act 1994, and the clear articulation of existing fiscal policy (refer Annex 2).

Aggregates look different, but consistent with Government objectives

The table below outlines how expenses as a percentage of GDP are presented currently, and how changes impact on both core Crown expenses (eg, removal of GST on Crown expenses) and fully line-by-line consolidated Crown expenses (eg, including SOE and Crown entity expenses). Refer Annex 4 for the effect on other fiscal variables.

Expenses to GDP ratios	2001	2002	2003	2004	2005	2006
Current accounting treatment	33.5	32.5	33.0	32.7	32.4	32.3
Core Crown (eg, GST excl)	32.2	31.2	31.7	31.4	31.0	30.9
Total Crown (eg, including SOE and Crown entity expenses, less internal transactions)	39.7	40.3	41.4	41.0	40.5	40.3

Source: The Treasury

Giving effect to the Government's fiscal objectives

The Government's fiscal objectives are for *total* Crown. However, to give effect to our objectives, we focus on *core* expenses, *core* revenues, and net SOE and Crown entity results.

Reflecting this, we are maintaining our focus on expenses (35% of GDP) at the core Crown level (refer table 3) and gross sovereign-issued debt (30% of GDP). While there is little change in the measured level of gross sovereign-issued debt, core Crown expenses are expected to be around 1.3% lower than under the current accounting treatment.

Changes arising from the new accounting treatment do not increase spending headroom because the Government will continue to be constrained by the gross debt and operating balance objectives. As a result the Government is not changing its focus on a target of *core* expenses at 35%. The expense target is a means by which the primary objectives of operating balance and gross debt – as articulated in our fiscal strategy – are met. Increasing expenses would impact negatively on both the operating balance and gross debt, and thus be inconsistent with our strategy.

In addition this target is set as an average over a long, 40-year horizon. In the years in which the NZS Fund builds up, expenses excluding Fund contributions will be less than the target. In years when the Fund is being drawn down, expenses, excluding contributions from the Fund, will be more than the target. It is not meant to be a point-to-point reference target, and changing the level of the expense target would imply a degree of specificity that is simply not there.

Longer-term fiscal objectives on target

Looking out over a 10-year horizon, we are on target to meet our fiscal objectives.

Progress towards meeting our objectives is better than expected in the *2001 FSR*. For example, we now expect to reach the 30% gross debt objective by 2002/03, rather than in 2008/09 as expected in the *2001 FSR*. This progress largely reflects normal variability in the economic and fiscal forecasts, and actual progress may be different.

The tracks beyond the five-year forecast period are projections based on the technical and policy assumptions outlined in Annex 3.

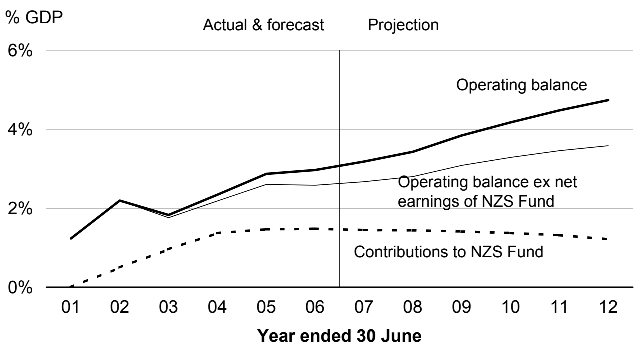
All 10-year tracks are presented under the current accounting method. The fiscal aggregates under total Crown and core Crown are in Annex 3.

Operating surpluses more than cover contributions to the NZS Fund

Looking ahead, operating surpluses (excluding retained NZS Fund earnings) cover the Government's annual contributions to the NZS Fund.

The rising operating balance over 2006/07 and 2011/12 reflects revenue growth greater than nominal GDP, while expenses grow at 3.7% per year, in line with demographic changes and an annual budget allowance of around 2.2% of expenses.[3]

Figure 3 – Operating balance



Source: The Treasury

The wedge between the operating balance excluding net NZS Fund returns and the NZS Fund contributions grows from 1.7% of GDP in 2001/02 to 2.4% by 2011/12 as the operating surplus grows and NZS Fund contributions plateau and then fall. This wedge will be used to meet capital pressures and priorities at a level consistent with our gross debt objective.

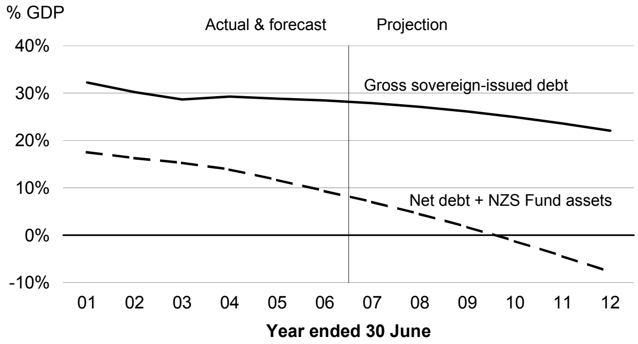
3 The allowance is cumulative, meaning the amount, adjusted for inflation and a real growth factor, is added to government spending in each projected year. This provides the Government with fiscal flexibility, as it may be used for spending and revenue initiatives, increasing contributions to the NZS Fund or responding to developments in the economic and fiscal position.

On track to achieve debt objectives

Gross sovereign-issued debt is expected to be below our goal of 30% of GDP by 2002/03. It is projected to fall to 22% of GDP by 2011/12.

Continuing emphasis on investment means that debt does not fall as quickly initially as it might otherwise. Investment is central to our plans, but we continue to balance it against our debt objective. Net debt plus the NZS Fund assets falls much faster as the NZS Fund assets grow. By 2009/10 we expect to be in a net financial asset position.

Figure 4 – Debt



Source: The Treasury

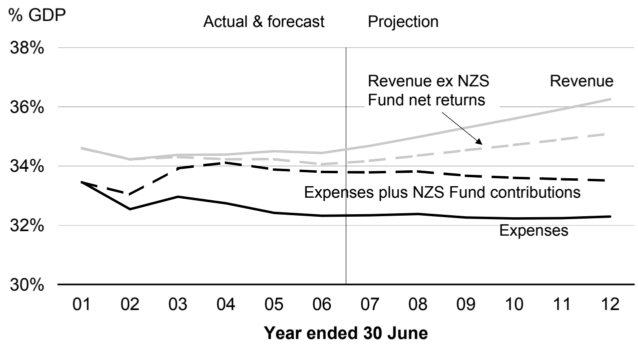
Expense growth more muted

Over 2006/07 to 2011/12, expense growth is 3.7%, compared with revenue growth of 4.6%.

Over the forecast period, expenses grow more slowly than GDP, reflecting the Government's commitment to building structural surpluses to meet NZS Fund contributions. Beyond the forecast period, expenses grow in line with GDP out to 2011/12.

Revenue rises as a percent of GDP over 2006/07 to 2010/11, reflecting the assumption of fixed tax rate boundaries. As incomes grow, taxpayers will move into higher tax brackets.

Figure 5 – Expenses and contributions to NZS Fund

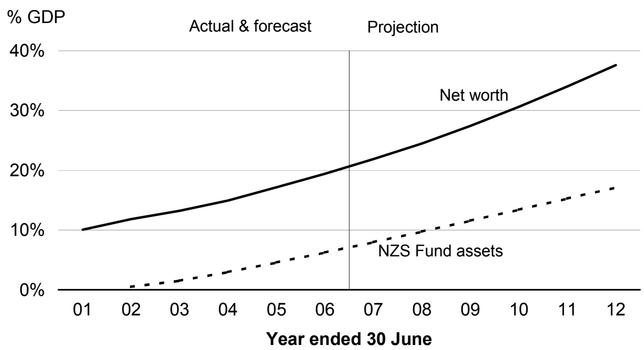


Source: The Treasury

Forward planning for future superannuation costs reflected in growing net worth

Net worth rises throughout the projection period, reflecting the forecast operating surpluses, which include the rising surplus of the NZS Fund. The Fund's assets are expected to reach over 17% of GDP by 2011/12.

Figure 6 – Net worth



Source: The Treasury

Table 3 – Long-term fiscal objectives

<table>
<tr><th>Long-term fiscal objectives:</th><th>To achieve the objectives of fiscal policy, the Government's high level focus is on:</th></tr>
<tr><td>Operating balance:
Operating surplus on average over the economic cycle sufficient to meet the requirements for contributions to the NZS Fund and ensure consistency with the long-term debt objective.</td><td rowspan="3">• Rising surpluses[4] (measured by the OBERAC) during the transition and build up phase of the NZS Fund, with a focus on core Crown revenue and expenses, including:
- tax-to-GDP around current levels
- core Crown expenses (plus the net payment/withdrawal to the NZS Fund) averaging around 35% of GDP over the horizon used to calculate NZS Fund contributions.
• A robust, broad-based tax system that raises revenue in a fair and efficient way.
• SOEs and Crown entities contributing to surpluses consistent with their enabling legislation and Government policy.</td></tr>
<tr><td>Revenue:
Ensure sufficient revenue to meet the operating balance objective.</td></tr>
<tr><td>Expenses:
Ensure expenses are consistent with the operating balance objective.</td></tr>
<tr><td>Net worth:
Increase net worth consistent with the operating balance objective.</td><td rowspan="2">• Focus on building the NZS Fund assets rather than reducing debt. Increasing net worth consistent with the operating balance objective will see net worth at around 30% of GDP by 2011.
• Consistent with the net worth objective, there will also be a focus on quality investment.
• SOEs will have debt structures that reflect best commercial practice. Changes in the level of debt will reflect specific circumstances.
• Net debt will be at levels that are consistent with the gross debt objective and the Government policy of holding financial assets. Net debt, including NZS Fund assets, is expected to fall below 0% of GDP by the end of the decade.</td></tr>
<tr><td>Debt:
Manage total debt at prudent levels. In the longer term, gross sovereign-issued debt below 30% of GDP on average over the economic cycle.[5]</td></tr>
</table>

Table 2 outlines our progress against these objectives.

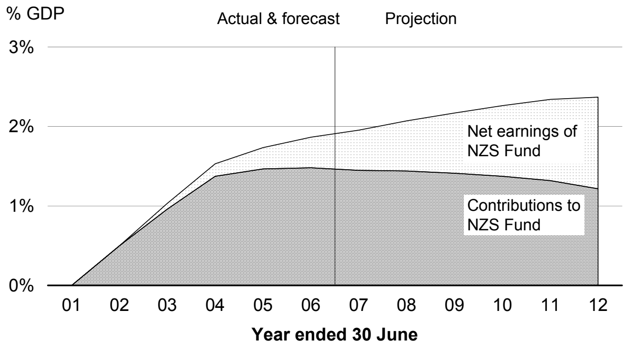
4 The surplus includes the net (after tax) return on the NZS Fund, which the NZS Fund will retain. Effectively the Government is targeting operating surpluses excluding the NZS Fund's retained investment returns.

5 Sovereign-issued debt is debt issued by the New Zealand Debt Management Office (NZDMO) and the Reserve Bank; it excludes debt issued by SOEs and Crown entities and the sovereign-guaranteed debt of SOEs and Crown entities. Gross sovereign-issued debt includes any New Zealand government stock held by the NZS Fund.

While Government contributions drive initial NZS Fund growth, by 2011/12 retained after-tax earnings on the Fund contribute to half the annual Fund growth.

Beyond the 10-year outlook, the Government recognises that an ageing population will increase demand for New Zealand Superannuation and health services. While there are alternative ways to deal with future cost pressures, the NZS Fund is less likely to require future policy change.

Figure 7 – Drivers of NZS Fund growth



Source: The Treasury

For example, significant changes are more likely to be required if tax cuts are used. In the first instance, tax cuts weaken the fiscal position through a declining operating balance. And, even if they bear a growth dividend (on which empirical evidence is unclear), changes to New Zealand Superannuation would still be required, as it is wage indexed and wages would be expected to increase with economic growth.

Fiscal position affected by trend economic growth

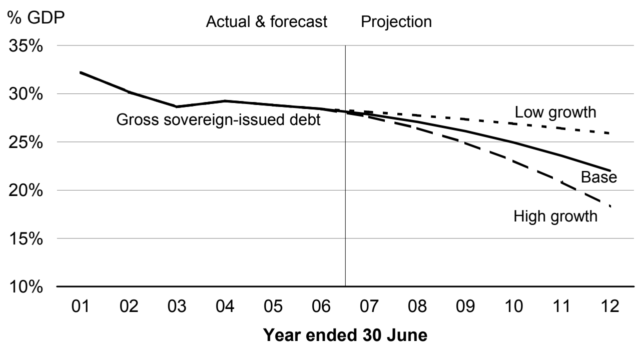
While there are always uncertainties in forecasts, the 10-year projections confirm that the Government's current fiscal policy is consistent with our long-term objectives. We are investing in areas that will help to grow the New Zealand economy and acting now to meet future expense pressures.

The Government will continue to evaluate fiscal policy over a 10-year rolling horizon to ensure that we take account of changing fiscal and economic conditions. This incremental approach to change enhances stability in both economic and fiscal settings.

If, for example, trend economic growth is consistently lower than assumed, and fiscal policy is not changed, gross debt will be about 4% of GDP higher than under the base scenario in 2011/12.

Even in this circumstance, the Government would still expect to achieve the debt objective. A change in fiscal settings would only be required if short-run economic growth was significantly less than projected in the low growth scenario and the ability to achieve the objectives was threatened.

Figure 8 – Gross sovereign-issued debt – alternative economic outcomes



Source: The Treasury

On the other hand, if trend economic growth is higher than expected, this would allow the Government a wider set of fiscal choices. Initiatives such as reducing taxes, increasing spending, accelerating contributions to the NZS Fund, reducing debt, or a combination of some or all of these, could be pursued.

Conclusion: On track looking forward

Looking forward, the Government is well placed to build on the sound base established over the past three years. We will continue to make incremental policy changes as we work to achieve our goal of an innovative, inclusive economy, whilst retaining consistency with our long-term fiscal objectives.

We acknowledge the challenges ahead, and our strategy is to take the steps now that will position us well to meet them in the future. We will continue to be constrained by our gross debt objective over the next 10 years, and we are conscious of continuing expense pressure – particularly in the health and education sectors.

Forward planning, combined with a continuing focus on ensuring value for money, means we can manage these pressures into the future.

This pragmatic approach to fiscal policy places New Zealand well to face the challenges that lie ahead and to take full advantage of the opportunities created by higher economic growth in the future.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

14 May 2002

Annex 1

Short-term fiscal intentions

In accordance with the Fiscal Responsibility Act 1994, the Government's updated short-term fiscal intentions are listed below. These are compared with those given in the *2002 Budget Policy Statement.*

Short-term fiscal intentions	2002 *Fiscal Strategy Report*	2002 *Budget Policy Statement*
Operating balance	On current forecasts, operating balances will be: • $2.6 billion in 2001/02 • $2.3 billion in 2002/03 • $3.1 billion in 2003/04 • $3.9 billion in 2004/05 • $4.2 billion in 2005/06.	On current forecasts, operating balances will be: • $1.0 billion in 2001/02 • $1.8 billion in 2002/03 • $2.9 billion in 2003/04 • $3.7 billion in 2004/05 • $3.9 billion in 2005/06.
Crown debt	If forecast economic conditions prevail, gross Crown debt will be: • $36.3 billion in 2001/02 • $35.8 billion in 2002/03 • $38.4 billion in 2003/04 • $39.5 billion in 2004/05 • $40.7 billion in 2005/06. In 2005/06 gross Crown debt will be 28.4% of GDP.	If forecast economic conditions prevail, gross Crown debt will be: • $37.1 billion in 2001/02 • $38.7 billion in 2002/03 • $41.4 billion in 2003/04 • $42.3 billion in 2004/05 • $43.4 billion in 2005/06. In 2005/06 gross Crown debt will be 30.7% of GDP.
Operating expenses	On current forecasts, operating expenses will be: • $39.1 billion in 2001/02 • $41.2 billion in 2002/03 • $43.0 billion in 2003/04 • $44.5 billion in 2004/05 • $46.2 billion in 2005/06. If forecast economic conditions prevail, expenses will be 32.3% of GDP, and NZS Fund contributions will be 1.5% of GDP, in 2005/06.	On current forecasts, operating expenses will be: • $39.6 billion in 2001/02 • $40.5 billion in 2002/03 • $42.3 billion in 2003/04 • $43.8 billion in 2004/05 • $45.6 billion in 2005/06. If forecast economic conditions prevail, expenses will be 32.4% of GDP, and NZS Fund contributions will be 1.5% of GDP, in 2005/06.

Operating revenues	On current forecasts, operating revenues will be: • $41.2 billion in 2001/02 • $43.0 billion in 2002/03 • $45.1 billion in 2003/04 • $47.3 billion in 2004/05 • $49.3 billion in 2005/06.	On current forecasts, operating revenues will be: • $40.3 billion in 2001/02 • $41.5 billion in 2002/03 • $44.3 billion in 2003/04 • $46.6 billion in 2004/05 • $48.6 billion in 2005/06.
Crown net worth	Subject to forecast economic conditions prevailing, net worth will be: • $14.2 billion in 2001/02 • $16.5 billion in 2002/03 • $19.6 billion in 2003/04 • $23.5 billion in 2004/05 • $27.8 billion in 2005/06. If forecast economic conditions prevail, net worth will be 19.4% of GDP, including NZS Fund assets of 6.3% of GDP, in 2005/06.	Subject to forecast economic conditions prevailing, net worth will be: • $12.4 billion in 2001/02 • $14.3 billion in 2002/03 • $17.2 billion in 2003/04 • $20.8 billion in 2004/05 • $24.7 billion in 2005/06. If forecast economic conditions prevail, net worth will be 17.5% of GDP, including NZS Fund assets of 6.4% of GDP, in 2005/06.

Fiscal forecasts and consistency with short-term intentions in the *Budget Policy Statement*

The Fiscal Responsibility Act 1994 requires the *Fiscal Strategy Report* to assess the extent to which the fiscal forecasts in the *Budget Update* are consistent with the short-term fiscal intentions given in the *Budget Policy Statement*, and explain the reasons for any departures from those intentions.

The differences between the fiscal forecasts in the *Budget Update* and the short-term fiscal intentions given in the *Budget Policy Statement* are shown in table A1.1.

Table A1.1 – Changes in fiscal forecasts since the *2002 Budget Policy Statement* (June years)

Change	2001/02	2002/03	2003/04	2004/05	2005/06
$ million					
Revenue	882	1,421	859	699	677
Expenses	(455)	640	709	634	587
Operating balance	1,651	465	170	267	388
Gross debt	(806)	(2,927)	(3,009)	(2,783)	(2,712)
Net debt	(1,541)	(2,367)	(2,540)	(2,454)	(2,636)
Net worth	1,796	2,261	2,431	2,698	3,086
% GDP					
Revenue	0.3%	0.7%	0.3%	0.1%	0.0%
Expenses	(0.8%)	0.1%	0.1%	0.0%	(0.1%)
Operating balance	1.4%	0.3%	0.1%	0.2%	0.3%
Gross debt	(1.0%)	(2.8%)	(2.7%)	(2.5%)	(2.3%)
Net debt	(1.4%)	(2.1%)	(2.2%)	(2.0%)	(2.1%)
Net worth	1.3%	1.6%	1.7%	1.8%	1.9%

Source: The Treasury

The differences in nominal terms and as a percentage of GDP reflect changes in the economic and fiscal forecasts. The specific changes to the fiscal aggregates in nominal terms, as compared with those in the *2002 Budget Policy Statement* (BPS), include:

- operating revenues – Revenue is higher in all years, predominately driven by higher tax revenue forecasts. The tax forecasts have been increased by at least $600 million in each year compared with the *2002 BPS*, with the biggest forecast increase of $1.2 billion in 2002/03. This largely represents an unwinding of the downward revisions of the *2002 BPS* compared with the previous *FSR*, and the effect of policy changes.

- operating expenses – Expenses are lower in 2001/02 than in the *2002 BPS*, largely reflecting the change in the GSF liability revaluation of $400 million. Expenses are higher in 2002/03 and beyond due to demographic movements in education and welfare recipient numbers, and the indexing of benefits to the CPI. The Budget 2002 decisions carry cost increases of around $200 million beyond 2002/03 year in excess of the $715 million budget package.

- operating balance – Higher in all years. In 2001/02 higher tax revenue, combined with lower expenses due to revaluations, causes an upward revision of $1.65 billion to the operating balance. In future years increased expense growth lessens the impact of expected higher revenue, resulting in upwards revisions in the operating balance of between $170 million and $465 million.

- net debt – Lower in all years. This is largely due to higher forecast cash from operating balances of around $2.5 billion over the forecast period.

- gross debt – Lower in all years as a result of the higher cash operating balances. Overall the change has resulted in the scaling back of the 2001/02 bond programme by $350 million and a lower 2002/03 bond programme at $3.4 billion than that signalled in the *2002 BPS.*

- net worth – higher in every year due to the higher expected operating balances.

These changes are explained in more detail in the *Budget Update.*

Annex 2

Long-term fiscal objectives

In accordance with the Fiscal Responsibility Act 1994, the Government's updated long-term objectives are given below. These are compared with the long-term objectives specified in the *2002 Budget Policy Statement*.

Long-term fiscal objectives	***2002 Fiscal Strategy Report***	***Budget Policy Statement 2002***
Operating balance	Operating surplus on average over the economic cycle sufficient to meet the requirements for contributions to the NZS Fund and ensure consistency with the long-term debt objective.	Operating surplus on average over the economic cycle sufficient to meet the requirements for contributions toward future NZS costs and ensure consistency with the debt objective.
Crown debt	Manage total debt at prudent levels. In the longer term, gross sovereign-issued debt below 30% of GDP on average over the economic cycle.[6]	Gross debt below 30% of GDP on average over the economic cycle.
Operating expenses	Ensure expenses are consistent with the operating balance objective.	Expenses will average around 35% of GDP over the horizon used to calculate contributions toward future New Zealand Superannuation costs. During the build-up of assets to meet future New Zealand Superannuation costs, expenses plus contributions will be around 35% of GDP. In the longer term, expenses less withdrawals to meet New Zealand Superannuation costs will be around 35% of GDP.
Operating Revenues	Ensure sufficient revenue to meet the operating balance objective.	Raise sufficient revenue to meet the operating balance objective. A robust, broad-based tax system that raises revenue in a fair and efficient way.
Crown net worth	Increase net worth consistent with the operating balance objective.	Increase net worth consistent with the operating balance objective. This will be achieved through a build-up of assets to meet future New Zealand Superannuation costs.

The Government's fiscal objectives, outlined above, are for *total* Crown. However, to give effect to our objectives we will focus on *core* expenses, *core* revenue and net SOE and Crown entity results. This reflects the arms-length relationship that the Government has with SOEs and Crown entities. Further detail on the Government's core Crown focus is outlined in Table 3.

6 Sovereign-issued debt is debt issued by the New Zealand Debt Management Office (DMO) and the Reserve Bank. It excludes debt issued by SOEs and Crown entities and the sovereign-guaranteed debt of SOEs and Crown entities. Gross sovereign-issued debt includes any NZ government stock held by the NZS Fund.

The change in the objectives was signalled in the *2001 Fiscal Strategy Report* and the *2002 Budget Policy Statement*. They are unchanged from the proposed objectives outlined in the *2002 Budget Policy Statement*.

The objectives are re-specified to ensure:

- ongoing compliance with the Fiscal Responsibility Act 1994, while
- outlining more explicitly the underlying nature of the Government's fiscal policy approach as it relates to the various components of the Crown (ie, departments, SOEs and Crown entities). Refer to Table 3 for more details.

The changes to the presentation of the fiscal objectives present a clearer articulation of existing fiscal policy, while ensuring that the re-specified Crown financial statements do not alter the Government's fiscal policy approach.

Annex 3

Assumptions used in the forecasts and projections

This Annex summarises the assumptions used in producing the four-year forecasts and the projections beyond these. It also meets the Fiscal Responsibility Act 1994 requirement to explain the reasons for any significant differences from the previous projections. The projections, which are beyond 2005/06, are based on long-run technical and policy assumptions, not forecasts.

Economic and demographic assumptions

From 2002/03 to 2005/06, all projections incorporate the economic and fiscal forecasts detailed in the *Budget Update*. The following assumptions apply beyond 2005/06:

- Nominal GDP grows with labour productivity (average annual rate of 1.5%), projected changes in the labour force (from Statistics New Zealand) and inflation (annual average rate of 1.5%).
- Demographic trends are based on Statistics New Zealand population projections with medium fertility, medium mortality and net migration of 5,000 a year.

As a result, the projections beyond 2005/06 are not forecasts – but the result of bottom-up assumptions about the long-run economic drivers of growth. For example, slower projections of labour force growth (from Statistics New Zealand) will, with unchanged assumptions for labour productivity, lead to a lower projection of real GDP growth.

Table A3.1 – Summary of economic assumptions*

June year[7]	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	Forecasts				**Projections**					
Labour productivity growth	2.3	1.9	1.3	1.0	1.5	1.5	1.5	1.5	1.5	1.5
Labour force growth	1.7	1.0	1.3	1.3	1.0	0.9	0.8	0.8	0.6	0.5
Unemployment rate	5.4	5.2	5.1	5.2	5.4	5.4	5.5	5.5	5.5	5.5
Employment growth	1.6	1.2	1.4	1.2	0.9	0.8	0.8	0.7	0.6	0.5
Real GDP	3.1	3.1	2.8	2.8	2.4	2.3	2.3	2.2	2.1	2.0
Consumer price index (annual % change)	2.0	1.7	1.6	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Government 10-year bonds (quarterly average %)	6.4	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2	6.2
Nominal average hourly wage growth	3.7	3.5	3.5	2.9	3.0	3.0	3.0	3.0	3.0	3.0

* Annual average % change unless otherwise stated

Source: The Treasury, Statistics New Zealand

7 Note that the economic forecasts in the *Budget Update* are based on a March year.

Fiscal assumptions beyond 2005/06

Fiscal policy settings in the projections are an extension of current policy settings (for example, no change in tax brackets, CPI indexing of benefits only).

Table A3.2 – Summary of fiscal assumptions

	10-year projections
Tax revenue	GDP linked, constant tax rate boundaries assumed.
NZS	Demographically adjusted and linked to nominal wages after reaching 65% wage floor.
Other benefits	Demographically adjusted and linked to inflation.
Health and education	Demographically adjusted.
Finance costs	A function of debt levels and interest rates.
Other	Not demographically adjusted.
Fiscal allowance	$1.2 billion (GST inclusive) in 2006/07, increasing with CPI and real wages.
Capital allowance	$550 million in 2006/07, increasing with CPI and real wages.
NZS Fund	Contributions to the proposed Fund are assumed to be consistent with the New Zealand Superannuation Fund Act 2001[8]. Returns are assumed at 9.4% per annum (7.52% per annum after tax).

Source: The Treasury

Further details of the modelling approach can be found in Treasury Working Paper 00/02 *Manual for the Long-term Fiscal Model*, available at www.treasury.govt.nz.

Consistency of 10-year projections with those in the 2001 Fiscal Strategy Report

The fiscal projections show a significant improvement in progress towards achieving our long-term objectives. This improvement reflects a combination of factors including the much stronger fiscal forecasts from which the projections are driven, an increase in the expected rate of return on the NZS Fund to better reflect more likely outcomes, and a reduction in the long-run unemployment rate.

The largest driver is the improved economic and fiscal position at the end of the forecast period – which improves the debt position by around 2.0% of GDP by 2011/12. This is within the range of normal variability in the projections. The change in the NZS Fund returns accounts for lower debt of 1.5% of GDP by 2011/12, while the change in the unemployment rate accounts for around 1.5% of GDP.

The assumed long-run unemployment rate was reduced to 5.5% from 6.0%. The Treasury general equilibrium model of the New Zealand economy incorporates a steady state assumption of 5.5%. In addition, recent labour market outturns appear consistent with a fall in the structural unemployment rate, and the unemployment rate at the forecast period

8 A more detailed review of the assumptions involved in projecting the NZS Fund contributions and earnings can be found on pages 68 and 69 of the *2002 Budget Policy Statement*, which was released with the *2001 December Economic and Fiscal Update*. Further details can be found in Financing New Zealand Superannuation, a Treasury Working Paper by McCulloch and Frances, available at www.treasury.govt.nz.

is expected to be in the range of 5% to 5.5%. The effect of this change is to increase the average economic growth rate (real) over 2006/07 to 2011/12 from 2.2% to 2.3%.

The average return on the NZS Fund was increased to 7.52% after tax from 6.0% to more fully reflect the likely investment profile of the Fund and tax liability. Further details of this change can be found on page 68 of the *2001 December Update*.

Annex 4

Full line-by-line consolidation

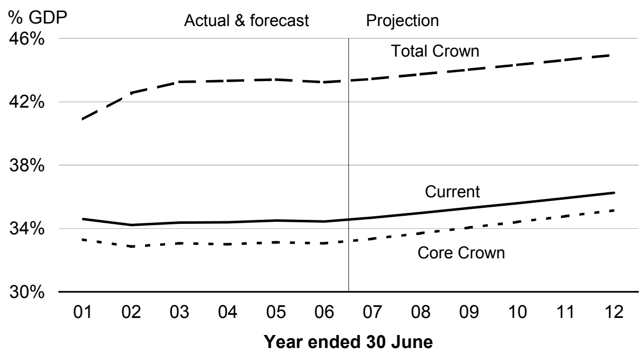
This Annex compares the tracks for the key fiscal variables under:

- the current presentation of the forecasts (net surplus and net equity of SOEs/Crown entities)
- the future presentation of the total Crown as measured by line-by-line consolidation
- the future presentation of the core Crown.

The operating balance and net worth are the same under the current presentation and future presentation under line-by-line consolidation. However the components of gross revenues, expenses, assets and liabilities do alter as the SOEs and Crown entities are line-by-line consolidated rather than just having their net surpluses and net worth included.[9]

Revenue is around 9% of GDP higher under the total Crown measure than under the current measure, reflecting the inclusion of third-party revenue from SOEs and Crown entities. Revenue received by SOEs and Crown entities from parts of the Crown is excluded. For example, New Zealand Post revenue from the sale of stamps to the private sector is included, but government research funding provided to CRIs is excluded.

Figure A4.1 – Revenue



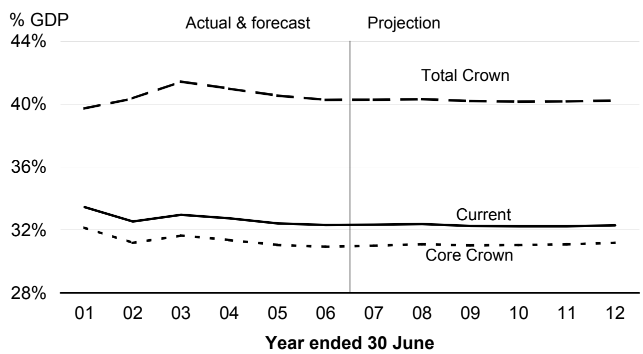
Source: The Treasury

Revenue is around 1% of GDP lower under the core Crown measure than under the current measure, largely reflecting the elimination of GST on Crown spending. For example the GST on health funding is excluded from GST revenue.

Expenses are around 8% of GDP higher under the total Crown measure than under the current measure. As with revenue, this largely reflects the inclusion of the expenses of SOEs and Crown entities. For example the payroll costs of NZ Post are included.

Expenses are around 1% of GDP lower under the core Crown measure than under the current method largely reflecting the elimination of GST.

Figure A4.2 – Expenses

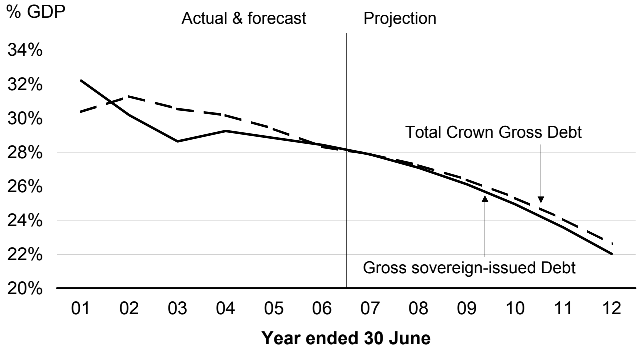


Source: The Treasury

9 A detailed section is included in the Fiscal Outlook chapter of the *2002 Budget Update*, which explains the change to the presentation of the Crown financial statements.

Gross sovereign-issued debt appears to be only marginally different from total Crown gross debt. This may not occur in the future. It reflects that the additional debt held by SOEs and Crown entities is largely offset by their current cross holdings of government stock.

Figure A4.3 – Gross debt



Source: The Treasury