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# budget 2001

Hon Dr Michael Cullen
TREASURER
MINISTER OF FINANCE

## • SPEECH •

24 May 2001

# Budget Speech

Mr Speaker, Budget 2001 is the second Budget I am proud to have produced with and for the Labour-Alliance Government. It continues many of the themes and measures announced in Budget 2000.

But there are also substantial differences and a shift in emphasis. Budget 2000 was dominated by the implementation of the core pledges which were central to the formation of this Government and common to both parties' election platforms. As such, it was characterised by its concern with predominantly social issues and the carrying out of pre-election promises with respect to these.

This Budget, on the other hand, is characterised by two core elements:

- a strong commitment to sound fiscal management, which is reflected in the forecast future operating balances and the Government's contribution to national savings; and
- an equally strong commitment to the transformation of the economy, which is reflected in a range of policy announcements and spending proposals made today.

Budget 2001 has been prepared against a background of an uncertain economic environment. Forecasts for growth in the world economy are consistently lower than they were six or nine months ago. As recently as the International Monetary Fund/World Bank conference in Prague in October, there was near universal agreement that the outlook for the world economy was the most positive for many years.

Not for the first time, just when economists were nearly all agreed, reality turned out to be the opposite. At that very moment, the United States economy began to slow as did a number of others, including Australia's.

The most likely outcome still seems to be that the US economy will be in recovery mode by the end of this year. But the uncertainties surrounding the timing and extent of a US pick-up, along with the uncertainties surrounding the Australian and Japanese economies inevitably tinge our own economic prospects.

Nevertheless, the Treasury forecasts, in line with the majority of the private sector's, present a relatively benign view of our own prospects.

The Treasury is forecasting an historically respectable 2.6% rate of growth for the 2002 March year and has increased its growth forecasts for the three years after that, relative to forecasts at the time of the December *Update*.

Growth is forecast to average around 3% over the next four years. More importantly, the growth profile is steady. It does not exhibit the volatile boom-bust pattern that characterised the 1990s.

We also expect to make progress with the balance on our financial transactions with the rest of the world. The deficit on the current account of the balance of payments was around 7% of Gross Domestic Product when this Government took office.

That deficit has to be covered either by selling assets to foreigners or by borrowing from them. In either case, the consequence is that we divert a portion of future earnings to servicing the increase in net assets held by foreigners, and less is available to raise the living standards of New Zealand residents.

I am delighted to report that the deficit is forecast to halve - to around 3.5% of GDP - by the end of the forecast period.

The one factor that has the largest impact on the wellbeing of New Zealanders is employment. The unemployment rate was 6.8% in the quarter before the Government took office. It is forecast to fall to around 5%.

The outlook is for a more balanced and stable economy. It is for steady growth, low inflation, low interest rates, falling unemployment, good returns to exporters, and an improving current account position.

This outlook and the Government's tight control of its finances mean that those finances are in sound shape and in line with the expectations of the *Budget Policy Statement* for the immediate period ahead.

Last year's implementation of core pledges meant, in fiscal terms, two things. First, new spending was dominated by the cost of these core pledges, especially with respect to restoring the level of New Zealand Superannuation and implementing a fairer student loans scheme.

Second, it meant a substantial amount of forecast new spending over the three-year life of this Parliament had to be front-end loaded. Thus net new spending in Budget 2001 is substantially less than Budget 2000. This year there are no changes in tax rates or above-indexation movements in excise duty rates to provide additional revenue.

Net new spending for 2001/02 is $692 million compared with the *Budget Policy Statement* allowance for this year of $600 million. This has been partially offset by a saving of around $60 million in funds set aside for the current fiscal year, 2000/01. This leaves a balance of about $30 million increase above allowance for net new spending in 2001/02.

Budget 2000 also had to make provision for restoring a number of baselines. Cuts forecast to those baselines by the previous Government, or simply noted as fiscal risks, amounted to nearly $570 million and would have led to a serious decline in services in a number of key areas of core government activity and responsibility.

The Government took the decision to absorb those pressures within the $5.9 billion counting limit although they did not represent our new spending priorities. They have been incorporated but at some cost to a wide range of valuable spending proposals put forward by Ministers.

What it has not been fully possible to incorporate within that counting limit has been further pressures associated with preserving our national and regional security.

The Government could have responded by leaving the counting limit unchanged going into next year's Budget round. This would have meant a fiscal allocation for net new spending in Budget 2002 of $550 million. Clearly such an allocation would lack credibility. For these reasons, the counting limit has been lifted.

The new counting limit is $6.125 billion, which leaves a fiscal allocation for net new spending for Budget 2002 of $815 million. That strikes an appropriate combination of sound financial management and credible financial allocation.

The lifting of the indicative provision for 2003/04 onwards to $900 million, more realistic capital provisions, and some reduction in revenue through slightly lower growth forecasts on average have impacted on the forecast surpluses and net debt levels further out.

I signalled some of these changes, and their corresponding impacts, in evidence to the Finance and Expenditure Select Committee on the *Budget Policy Statement*.

The immediate effect of a lowering of the growth outlook in the 2002 year is to reduce the production — and therefore the tax — base compared to that envisaged at the time of the December *Update*. Growth from a lower base will mean that gross revenues follow a lower track than outlined in the December *Update*, and this will impact on forecast operating balances.

The result is that net debt is lower in fiscal 2001 and 2002 compared with the December *Update*. It is almost the same in 2003, but is slightly higher in the outyears.

The dollar level of net debt does increase, although the burden of debt — its size in relation to the economy — is stable. This reflects ongoing investments in a wide range of areas, rebuilding and modernising public assets. Education and defence are prominent in the planned programme, as represented by changes in the capital provision.

The change in the debt profile compared with December forecasts is explained by three principal factors. Tax revenues are higher than forecast in the current year and lower than forecast in the outyears.

There have been delays with a number of capital projects. $300 million of capital spending envisaged for the second half of this financial year has been pushed out to the 2002 and 2003 years. At the same time, the spectrum sale generated $140 million of extra revenue.

Finally, the provisions for the 2004 and 2005 years have been increased to more realistic levels, particularly now that the defence strategy has been finalised. The Budget notes that capital injections of around $1 billion over the next 10 years may be necessary to achieve the required defence capability upgrade. The bulk of this is likely to be required within the next five years.

Overall though, the economic outlook and the associated fiscal outlook are better, at the end of this term of office, than were envisaged at the start of the term.

In the 2000 *Budget Policy Statement*, we envisaged that by the 2002/03 year — the end of this electoral term — expenses would be running at 33.5% of GDP. The Budget projects a fall in that number to 32.9%.

In a similar vein, we projected an operating balance of 1.8% of GDP, but have raised that to 2%. Net debt was forecast to fall to 18.9% of GDP, but we now expect it to fall even further to 17.8%.

One area of concern in recent years has been the large impact that revaluations and accounting policy changes have on the fiscal operating balance. This has become more marked over the past couple of years since the Accident Compensation Corporation's outstanding claims liability was brought onto the books in 1999. Last year, for example, revaluations had a positive impact of nearly $720 million on the final operating balance.

This year, the reverse effect has occurred. Based on 31 March estimates, the total effect of revaluations in the Government Superannuation Fund and the Accident Compensation Corporation has been a $1.1 billion reduction in the operating balance. This is still a provisional estimate, and some of it may yet be reversed when the final figures are calculated on 30 June.

These valuation changes adjust the operating balance in accordance with generally accepted accounting practice.

That same practice can, however, hide major differences in stewardship performance between the years.

Not only are some of the valuation changes the result of factors that are entirely beyond the control of the Government, but they also flow from highly technical and inherently subjective assumptions.

The valuation change does not involve hard cash, is based on essentially theoretical assumptions, and usually reverses out over time. In the meantime, though, it can have huge impacts on the level of operating balance, but more importantly it can conceal or distort the record of the Government as a fiscal manager.

We are therefore producing an additional fiscal indicator that strips out the effects of these valuation and accounting changes. It allows the public to get a more accurate fix on the effectiveness of our financial stewardship without abandoning basic accounting principles. It is another example of the Government's drive to improve the suite of financial indicators available to the public.

The operating balance excluding revaluations and accounting policy changes, or OBERAC, can be seen as the fiscal equivalent of the underlying rate of inflation.

Stripping out the impact of revaluations over the current year and the previous year shows a strong upward trend in the OBERAC, which may be regarded as the measure of the underlying surplus. This trend will, as I have already indicated, continue over the next three to four years.

This will provide ample room for the assumed transfers into the New Zealand Superannuation Fund of $600 million in 2001/02, $1.2 billion in 2002/03, $1.8 billion in 2003/04 and $2.5 billion in 2004/05.

Beyond that point, surpluses are expected to be sufficient to meet the requirements of the Fund despite the lift in the counting limit for the current three-year cycle and the indicative assumptions for the period beyond that.

If the balances in the Superannuation Fund are counted as assets for the purposes of calculating net debt, the net debt profile falls steadily to reach a little over 13% of GDP by the 2004/05 year.

The Government has maintained, therefore, a prudent and orthodox approach to fiscal management. We intend to continue to do so.

The coming demographic transition creates an imperative in favour of such an approach. We must exercise sufficient fiscal restraint ourselves in order to leave to our successors reasonable fiscal constraints and greater choices to cope with changing and unforeseen circumstances.

The level of the operating balance will fluctuate over the course of the business cycle, rising in good years and falling when economic activity tapers off. The structural balance is the trend that underlies these cyclical movements. Because revenues are trending above spending, the structural surplus is rising.

That will change. As the proportion of the population in the 65-plus age group rises, the trend growth in spending, particularly on New Zealand Superannuation, will start to increase. For example, the net cost of New Zealand Superannuation payments is currently the equivalent of 3.9% of GDP, but projected to rise to 8.5% of GDP by 2040.

By diverting a part of the emerging structural surplus into a New Zealand Superannuation Fund, this Government helps future governments maintain services, including the provision of a state pension, to later generations.

The Fund is also likely to have positive economic effects by improving the liquidity of capital markets. That effect will be assisted by the diversification of the Government Superannuation Fund, an action that will also have the beneficial effect of improving returns to the Government and reducing the cost of meeting unfunded Government Superannuation Fund liabilities.

The Government has also agreed in principle to a diversification of the Natural Disaster Fund, which will have positive fiscal and capital market effects.

With the creation of the New Zealand Superannuation Fund and the maintenance of fiscal surpluses, the Government is playing its part in lifting our level of savings in New Zealand. But unless this is matched by a substantial improvement in the level of private savings, our national savings record will remain very unsatisfactory.

While in the short term a country can sustain a low level of national savings, over time a failure to more closely match savings with investment leads to a growing wedge between GDP, the measure of what we produce, and Gross National Income, the measure of what we produce which is available to us to consume.

Changes in this area are both controversial and, potentially, fiscally expensive if not well managed. The alternative of compulsion does not sit well with the rest of the social and economic framework in New Zealand and, in any case, has to be at a very high level if it is not to simply crowd out voluntary savings.

I have, in a number of speeches, explained various options with regard to the reform of our savings regime. It is now time to start moving towards action. I intend to instruct my officials to work with savings industry representatives to report by the end of the year on ways to lift private savings. This timetable will allow the task force to take into account the report of the Taxation Review Committee.

Mr Speaker, the economic and fiscal performance that I have outlined so far for New Zealand over the next period is satisfactory. Indeed, it represents the most benign combination of circumstances seen for many years.

But it cannot be described as satisfying. It is good but not good enough. After many years of often painful, disruptive, even destructive restructuring and reform our medium-term growth path is not sufficient to improve our relative standing among the developed nations of the world. We need to set ourselves a goal of being back in the top half of the developed world in terms of per capita GDP — a position we have not occupied since 1970.

Even if we set the target for achieving that goal well into the future, it still means lifting our present sustainable growth capacity from about 3% a year to 4% a year or more. That does not sound a large improvement; but, in fact, it would require something like a doubling of our productivity growth rate to levels we have not experienced for any extended length of time since the 1950s.

Improving the quality and quantity of savings will assist. So will the more proactive role taken by the Government in attracting foreign investment into specific growth opportunities, especially at the higher technology and higher value-added end of the spectrum.

All the evidence from New Zealand and elsewhere indicates that the single most important prerequisite for lifting our productivity and economic growth rates is increasing human capital.

Budget 2001 addresses this imperative at two levels. The first is a series of specific measures to improve the broad base of the education system and to build on last year's initiatives.

Particular attention will be paid to increasing participation in and improving the quality of early childhood education. About $9.5 million a year will be spent on increasing the early childhood education subsidy. Most importantly, some $29 million will be allocated over the next four years to introduce a system of equity funding for early childhood education.

This will improve the availability and quality of early childhood education in low-income and rural communities. It will improve programmes for special education needs, and for children for whom English is a second language.

The Government also recognises the need to improve the level of professional development. New funding for principals' leadership and professional development adds up to about $48 million over four years.

This Budget provides the necessary funding for the introduction of the National Certificate of Educational Achievement (NCEA). The NCEA is a qualification system that will challenge the most exceptional students but still provide meaningful qualifications for the less academically talented. It is vital to invest in ensuring its success.

The most important initiative relates to post-compulsory education. The Government is announcing today the key elements of its planned restructuring of the management and funding of this sector.

The present system has succeeded in lifting overall participation rates to levels consistent with those of other developed countries, although there are significant areas of lower than satisfactory levels of participation, especially amongst Māori and Pacific peoples.

But the present system has significant problems of quality, relevance, duplication and cost effectiveness. This is reflected in a still small but growing list of tertiary education institutions in serious financial difficulties. It is also reflected in lack of differentiation, employer dissatisfaction, the proliferation of degree courses, unnecessary competition, and underproduction of key skills across a wide range.

These problems cannot be addressed within the current structures relating to the overall management and funding of the sector. For that reason, Budget 2001 provides limited additional direct funding to the sector, sufficient to carry it through to the point where stronger structures will give the Government confidence that significantly higher levels of funding will lead to significantly better outcomes.

As I will explain later, there are additional sources of funding made available to the sector in this Budget, especially the universities, which overall places them in a secure position in the meantime.

The Government intends to provide greater leadership to the tertiary education sector through the Tertiary Education Strategy, developed with input from the sector and all stakeholders, including the Government, business and communities.

To implement its Tertiary Education Strategy, the Government will need effective mechanisms and governance arrangements. All publicly funded providers and industry training organisations will be subject to a system of profiles and charters that set out their strategic direction and activities.

The legislation that will provide for this system will also create a new operational Crown entity, the Tertiary Education Commission, to give effect to Government policy. The underlying relationship between the Government and the Commission will need to be a close one, with any areas of relative independence for the Commission carefully defined in statute.

The Tertiary Education Commission will have responsibility for the negotiation of the charters and profiles, administration of funding, building provider capacity, and coordinating broad involvement in the ongoing development of the Tertiary Education Strategy.

The existing functions of Skill New Zealand will be incorporated into the Tertiary Education Commission. This will ensure effective coordination across the post-compulsory education system.

A transition Tertiary Education Commission will be set up as a unit within the Ministry of Education. It will act as an establishment board for the permanent Commission and as an advisory board to work on the further development of the Tertiary Education Strategy.

The new system will lead to significantly enhanced coordination and much greater clarity of purpose in the tertiary education sector. It will point the way towards producing the skills we need, at the level of quality we must have, and in an efficient and cost-effective manner.

As I indicated earlier, the direct lift in funding for tertiary initiatives in Budget 2001 is relatively modest. The institutions have been offered a 5.1% increase on the basic subsidy rate in return for holding student fees in the 2002 academic year. The 5.1% is a result of the grant offered last year compounded by a further 2.6% grant provided in this Budget.

In addition the institutions, especially the universities, will have access to three major sources of funding which arise out of the Government's drive to improve the quality and quantity of research and development, the commercialisation of that research and development, and the growth of new businesses, especially in the higher technology sectors.

Budget 2001 provides substantial additional funding and significant new initiatives in relation to these core elements of economic transformation.

Those of particular relevance include spending and initiatives in relation to seed capital, incubators, and centres of excellence.

Last year, the Budget announced a major increase in direct Government funding of research and the largest ever increase in Government support for private sector research and development.

A programme of increased, but more importantly better allocated funding has been continued in this Budget. $20 million new capital funding has been provisionally set aside, and $26 million spread over three years has been reallocated from the existing operating budget to establish Centres of Research Excellence within the tertiary education system.

This investment will leverage scientific output from the tertiary sector. Money has also been allocated for research into new economy type developments, to increase basic environmental research and to put health research onto a full cost funding basis.

During the year the Government introduced a Bill to remove uncertainties and inconsistencies in the tax treatment of research and development (R&D). While this will be available in respect of all R&D expenditure, the benefit to the software industry in particular is estimated to be over $8 million in the next financial year and nearly $4 million in 2002/03.

The exciting development in our innovation strategy is a bold move to help commercialise science undertaken in both the state scientific infrastructure — the Crown research institutes (CRIs) and universities — and in the private sector by investing in the venture capital market, particularly at the seed and start-up end of the venture capital spectrum.

Consultation with a range of fund managers, investors and officials in New Zealand and from overseas has highlighted the need to accelerate the growth of this country's seed-stage and start-up venture capital market.

Seed-stage investment enables development, testing and preparation of a product or service to the point where it is feasible to start business operations. Start-up investment enables actual business operations to get under way.

The Government will establish the New Zealand Venture Investment Fund.

$50 million will be taken from the balance sheets of the CRIs, and we expect that to be matched with $50 million from state-owned enterprises to set up the Fund.

It will accelerate the development of the venture capital industry, develop a larger pool of people in New Zealand's venture capital market with relevant skills and expertise, facilitate the commercialisation of research and get more New Zealand businesses on the path to global success.

The Fund will operate in a way that is designed to launch a robust private sector seed and start-up capital market that does not rely on continued injection of public money. It is a good example of innovative ways of thinking about how the public and private sector can work together to cover the limitations of each acting on their own.

Incubating and growing new businesses is part of the facilitation aspect of economic transformation.

Active support for industrial and regional development was signalled last year, when the Budget announced a programme of escalating funding totalling over $330 million during a four-year period. That was to phase in with $33 million being allocated in year one, $73 million in year two, and $112 million a year for the mature programme. The past year has been one of preparation, and the major funding of industry development kicks in this year.

Much has already been achieved, and the structure is being expanded in this Budget to achieve a lot more. The super yacht development in West Auckland, which is expected to create 200 jobs and to generate sales of $100 million next year, is an example of what can be achieved when government agencies take a coordinated approach to bringing quality investment to New Zealand.

The Government also has an active regional partnerships programme run through Industry New Zealand. It was launched last October and already 14 regions have received funding to pursue locally generated strategic plans.

The Deputy Prime Minister has a detailed industry and regional development package in this Budget. It contains several new initiatives, and expands on existing programmes. Already the Government's hands-on, pro-business, pro-jobs approach is making a positive difference. As more resources are put into it, it will make an even bigger difference.

As the economic development programme has taken shape, the broad base of the Government's strategy has become apparent. That base has been constructed around five core components:

- building the future capability of the economy by creating an economy which supports entrepreneurship and excellence
- building the base of business through a network of incubator supports, technology fellowships and enterprise award programmes
- attracting enterprises with high growth potential by introducing business growth and greenfields investment services
- assisting specific sectors to develop expansion strategies in partnership with the Government; and
- a "smart government" component that expands the role of the Industrial Supplies Office and attracts and coordinates major events.

The economic development programme links the potential of people, ideas, investment capital, and natural resource endowments. It aims to create a rich, diverse and dynamic economy through sectors as different as wood processing, fashion, film and tourism.

It ensures that the interests of regions rank alongside the interests of sectors so that all parts of New Zealand participate in our national transformation.

Lifting our economic performance also requires us to lift our trading performance. There are some who believe that we can achieve economic success without the expansion of our tradeables sector.

I do not share that belief in the slightest degree. The most backward, poorest, and least successful economies are those which are least connected to the rest of the world by means of using their natural or created comparative advantages to expand their productive bases through trade.

This is not some recent discovery or some narrowly ideological assertion. It is the thrust of humanity's experience, from ancient Phoenicians to such stellar contemporary performers as Ireland and Singapore.

It is especially true for a country of our sort. This Government has sought to expand our trading horizons and linkages. It is providing new forms of direct support for exporters.

The majority partner in the coalition has joined with other parties in Parliament to pass legislation enacting a Closer Economic Partnership with Singapore. Already the fruits of that agreement are appearing. Trade with Singapore is right now growing very rapidly.

The Government is also seeking a closer economic partnership with the Hong Kong Special Administrative Region. This extraordinarily vital economic entity provides a high level of complementarity with New Zealand.

At the same time, New Zealand will continue to seek and support wider trading relationships, whether that be a broad-based World Trade Organisation round or such suggestions as a P5 agreement between New Zealand, Australia, the United States, Chile and Singapore.

We will continue to argue for labour and environmental standards to be considered as part of or alongside such negotiations. And, as one of the world's leading agricultural exporters, we will also continue to push for the inclusion of agricultural products in such deals as being in our interests as well as those of many developing nations.

Our trading endeavours in part relate to and depend upon how well we are able to establish an effective branding for New Zealand in the international marketplace. That branding needs to combine innovation, quality, and high technology with our more traditional clean, green image.

To preserve and enhance the latter does not come cheap. Budget 2000 announced very large increases in ongoing funding for such areas as biodiversity. This Budget follows that up with the Eco 2001 Package, released earlier this month.

The Government has increased the Department of Conservation (DoC) Vote by $21.4 million over the next four years. The new money will go toward the establishment of a new national park on Stewart Island and into an extensive upgrade and maintenance programme for DoC visitor facilities.

The Ministry for the Environment gets an extra $30 million over the next four years. Priorities for the new funding include hazardous substance control and a project with local government to establish a national system of environmental performance indicators.

The Budget has also allocated money to continue TB control, strengthen border security against foot and mouth disease and improve the collection of agriculture and horticulture statistics.

A number of initiatives have been undertaken in conjunction with the Green Party. Most of last year's green initiatives have been incorporated in the baseline and the Government has agreed to a number of further initiatives in areas such as biosecurity, conservation, environment, community sector, defence, education, fisheries and agriculture.

A part of the DoC Vote increase involved $10 million over the next four years to extend the conservation awareness programme introduced in the Government's first Budget, funding to develop a set of minimum standards for organic farming and to assist small growers toward certification, and a feasibility survey for the eradication of two freshwater pest species in the South Island.

Further work and consideration will be given to the development of a programme for advice to organic farmers, monitoring of dioxin levels and expansion of the community internship programme. This work will be undertaken during the 2001/02 fiscal year.

Also on the Government's immediate agenda is paid parental leave. It is an area to which the Alliance has assigned high priority. The two parties are still discussing details of the policy but are committed to introducing a paid parental leave scheme by 1 April next year.

Social spending does not have the same prominence in policy terms in this year's Budget as in last year's but it nevertheless continues to take the lion's share of increased spending.

Education spending has already been dealt with in some detail.

Vote Health sees a continuation of the increase in the allocation for mental health funding that was announced last year. A further $338 million over four years is released for elective surgery, $94 million over four years for primary health care, $178 million over four years for the development of disability support services, $16 million over four years to implement the recommendations of the Gisborne cervical screening inquiry and around the same amount to improve maternity services.

This is in addition to the $84 million allocated in 2001/02 to meet demographic changes.

Safe, secure and affordable housing is essential to quality of life. The Budget continues to expand and upgrade the supply of state houses.

It also extends a hand to the most vulnerable and at-risk New Zealanders by allocating funds to build an additional 125 community houses over the next four years and by providing rent relief to cash-strapped community house tenants.

Spending on social services sees a significant level of reallocation. The minimum level of payment for Child Support is to be lifted to $12.75 a week, reflecting indexation for price movements since the present minimum was first set. The cap will also be lifted from 2.0 to 2.5 times the average wage.

Other savings will come from the legislation requiring partners to be permanent residents for income support assessment and from the direct deduction of overseas pension payments.

These savings will assist in supporting new expenditure of $87 million in 2001/02, $84 million in 2002/03 and similar amounts in outyears. The most important single element of this new spending will be an average increase of $43 million a year for Child, Youth and Family Services.

This will be used to provide more residential care beds, increased funding to community providers, and to fund initiatives to recruit more social workers, raise professional standards and reduce the backlog of unallocated cases.

Other major initiatives include $28 million to provide care for children with high and complex needs. The bulk of the money will go towards providing intensive care for around 120 of the highest need cases.

Additional funding will be provided for a youth suicide prevention strategy and for assistance for people with disabilities to gain employment.

The Budget contains an exciting package for Māori built around the themes of cultural and economic empowerment. It reinforces the Government's commitment to capacity building in Māori communities. $3 million has been allocated in 2001/02 and $6 million in each of the following two years to directly resource initiatives developed by Māori whanau, hapu and iwi.

There is also new funding to promote Māori tourism organisations and an allocation of $10.8 million in the 2001/02 year and $10 million a year thereafter for the establishment of a Māori television channel.

The Budget initiatives for Pacific peoples are also directed at cultural and economic empowerment. They include the establishment of the Pacific Sound Archives, a funding boost for the Pacific Business Trust, which makes loans to Pacific Island businesses, and an additional $2.8 million a year for Pacific Island health organisations.

Law and order funding continues the strong upward path established in Budget 2000. That Budget allocated $159 million over three years. This Budget allocates a further $165.5 million over the next four years. The effect of these two increases in the 2001/02 year is to boost Vote Police by $103 million on the baselines we inherited from the previous Government. That represents an increase of 12.5%.

The funding for Vote Corrections will increase by $23 million in 2001/02 and $107 million over the subsequent three years. This will provide most of the additional resources needed for sentencing reform. In addition some $7 million over the next four years will be dedicated to more effective rehabilitative programmes for alcohol and substance abuse treatment. Funding will also be provided for two new prisons in South Auckland.

The Government has already announced a comprehensive — and expensive — programme to build a modern, efficient and high-quality defence force capable of meeting New Zealand's strategic needs and allowing us to meet our international security and peacekeeping obligations. The Budget incorporates changes to Vote Defence Force that increase the net operating funding by more than $300 million over the next five years and by around $700 million over the next 10 years.

It supports this investment with a significant capital injection, the actual amount of which will depend upon the details of the purchase agreements we are able to negotiate and the prevailing exchange rates at the time, but is likely to be in the order of around $1 billion over the next 10 years.

Mr Speaker, the style of Budget presentation has changed very considerably in the 20 years I have been a Member of Parliament. Once a mysterious collection of surprises, both pleasant and, more usually, unpleasant they have become more predictable and, therefore, less attention grabbing.

It has been my intention as Minister of Finance to continue this process of demystification concerning the Budget.

Nevertheless, any government's Budget has to be seen as representative of its underpinning values, its ambitions for the future, and its hopes for our country.

Budget 2000 was unashamedly dedicated to redressing the balance, to restoring a sense of social purpose and cohesion to a nation which had become divided against itself, too mean and selfish.

Budget 2001 reinforces that philosophy with carefully targeted increases in spending in key social areas. More than last year, however, it asserts the need for economic growth to be the essential companion to social justice.

The Labour-Alliance Government recognises that building stronger economic growth is a complex process involving many areas of policy. We recognise that change is a continuous process, not a finite one, which has to work with the grain of society — not against it. For that reason, we reject crude and simplistic solutions based on ideology rather than experience and commonsense.

Experience and commonsense tell us that what is required of us is to provide sound financial management, stability and certainty both for business and for ordinary New Zealanders.

The role of government is to contribute to the development of New Zealand's national savings so that we can invest more in growth for the future; to support business and industry development and to form partnerships with business sectors to enable them to realise their potential; to produce the skills we need to take advantage of the huge opportunities that the modern world creates; to build a modern infrastructure system; to promote trade and our exporting sector so that we can pay our way in the world and build high-value, high-technology, high-wage jobs; and to encourage innovation, research and development and the pursuit of knowledge both for their own sakes and for the material benefits they can produce.

At the same time, substantial resources have to be devoted to maintaining and improving our health, providing for an adequate floor of income in retirement, defending our personal and collective security, protecting and enhancing our environment and performing the other myriad tasks that are expected of a government in a modern, civilised society.

None of this comes cheap and the Government awaits with interest the report of the Taxation Review Committee on how best to raise the necessary revenue. The report of this Committee, and the report of the Royal Commission on Genetic Modification, will undoubtedly be two of the most important pieces of policy analysis and recommendation of modern times in New Zealand.

They will challenge all of us to respond in ways which enhance our prospects for growth, development and a stronger, more cohesive society.

Budget 2001 has balanced the competing priorities in a manner consistent with the Government's underlying policy framework. It is an orthodox, prudent Budget with the lowest level of spending as a proportion of GDP since 1978, rising operating balances, provision for contributing to future New Zealand Superannuation costs and stable, low net debt levels.

It marks out some key new directions for creating the human capital which is the most important resource in a modern economy. It recognises the role of government in providing security, opportunity and a sense of national identity.

It is a Budget both for New Zealand today and for the New Zealand we seek to build in the future.

B.2 & B.3

# budget 2001

Hon Dr Michael Cullen
TREASURER
MINISTER OF FINANCE

## • Fiscal Strategy Report •

24 May 2001

**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 Economic and Fiscal 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 2)
- 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 3)
- 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 Annex 1).

# Fiscal Strategy Report

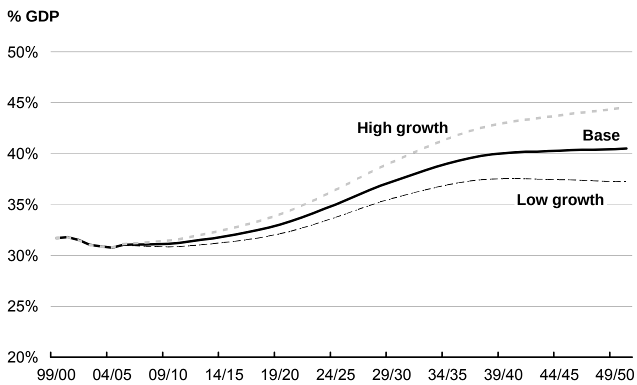
## Fiscal policy overview

### *Fiscal policy approach unchanged*

This *Fiscal Strategy Report (FSR) 2001* confirms the Government's fiscal policy approach, first outlined when we took office, and demonstrates that we are continuing to make progress towards our fiscal policy objectives.

Underpinning our approach is the need to manage future fiscal pressures associated with an ageing population. Although future pressures are very uncertain, it is likely that an ageing population will require significantly higher government spending as demonstrated in Figure 1.

***Figure 1*** – Expenses excluding finance costs: 50 year scenarios[1]




Source: The Treasury

New Zealand Superannuation (NZS) costs (net) are projected to rise from around 4% of GDP currently to around 9% in 2040. The Government is determined to preserve a universal, publicly funded pension without having to resort in future to a significant increase in the average tax rate. Thus we have proposed the NZS Fund to help finance future increases in NZS costs associated with the ageing population. Other costs such as health are also likely to increase, but the magnitude of the increase is more uncertain.

### *Fiscal policy objectives cover the next four decades*

Based on current projections, the next four decades will capture the major part of the changes in the population structure. As a result, the next 40 years provide a useful timeframe for considering fiscal policy and setting objectives. Beyond the next four decades, the demographic changes are more gradual, so that the increase in expense-to-

1 The scenarios refer to alternative expense growth assumptions. See Annex 3 for detail.

GDP ratios driven by the ageing population will slow. A 40-year horizon is consistent with the planned horizon for funding future NZS costs.

Our long-term fiscal objectives include running operating surpluses on average over the economic cycle, to allow us to build up assets to meet future NZS costs. We will do this by keeping expenses around 35% of GDP on average over the horizon used to calculate contributions toward future NZS costs. We will also reduce gross debt below 30% of GDP, and net debt below 20% of GDP, on average over the economic cycle.

***Progress will be considered over the next 10 years***

Although the next 40 years provide a context for our long-term objectives, we will consider progress towards our objectives over a 10-year period. This reflects a trade-off between the considerable uncertainty around outcomes 40 years in the future and the need to allow time for policy adjustments, if required, to be small and incremental.

As the extent of future expense pressures becomes clearer over time, governments will need to decide to what extent they change revenue and expense settings or change fiscal policy objectives, or a mixture of both. The Government recognises that it may be necessary to adjust policy settings to ensure consistency with the full set of objectives. We will make policy adjustments around a 10-year rolling horizon, because it is not reasonable to make all the policy adjustments today given the uncertainty around the impact of demographic trends, behavioural changes, future technologies, and choices to be made by future governments.

***Short-term plans are consistent with long-term fiscal objectives***

We have set our short-term fiscal policy plans so as to be consistent with our long-term fiscal objectives. For example, the Government is building structural surpluses to ensure that we meet our long-term fiscal objectives and deliver on our key spending policies.

## Updated Long-term Fiscal Objectives

In the *Budget Policy Statement (BPS) 2001*, we indicated that we would clarify our long-term fiscal objectives. Our updated objectives are outlined below, and a comparison with our previous objectives is given in Annex 1. These updated objectives do not change our fiscal policy approach, and are consistent with the principles of responsible fiscal management in the Fiscal Responsibility Act 1994. The main changes are:

- clarifying the expense objective to give a better sense of the financing role implied by contributing now towards future NZS costs
- clarifying that the operating balance and debt objective are to be met "on average over the cycle" rather than at each point in the cycle, which could have previously been inferred
- clarifying that the operating balance should be sufficient to ensure consistency with the debt objective, after making contributions toward future NZS costs
- signalling in the net worth objective that the change in composition of the balance sheet will move towards a build-up of assets through saving to meet future NZS costs.

Our long-term fiscal objectives have been set based on the next four decades. The next four decades capture the bulk of the change in demographic structure and this period of time is reflected in the proposed NZS approach.

Our updated long-term fiscal objectives are:

| | |
|---|---|
| **Expenses** | Expenses will average around 35% of GDP over the horizon used to calculate contributions toward future NZS costs. During the build-up of assets to meet future NZS costs, expenses plus contributions will be around 35% of GDP. In the longer term, expenses less withdrawals to meet NZS costs will be around 35% of GDP. |
| **Revenue** | Raise sufficient revenue to meet the operating balance objective.<br><br>A robust, broad-based tax system that raises revenue in a fair and efficient way. |
| **Operating balance** | 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. |
| **Debt** | Gross debt below 30% of GDP on average over the economic cycle.<br><br>Net debt, which excludes the assets to meet future NZS costs, below 20% of GDP on average over the economic cycle. |
| **Net worth** | Increase net worth consistent with the operating balance objective. This will be achieved through a build-up of assets to meet future NZS costs. |

### The Government's Expense Objective

The Government has previously signalled that it would update the expense objective to clarify the financing role implied by contributing towards future NZS costs. This change makes the updated objective more comprehensive than the previous objective.

The expense objective means that expenses will be under 35% of GDP before the impact of the demographic pressures, and over 35% of GDP as the population ageing takes effect. The excess of expenses over 35% of GDP will be financed from the assets that have been accumulated to fund future NZS costs.

There are a number of reasons why expenses plus contributions (or expenses less withdrawals) will be around, rather than equal to, 35% of GDP:

- The economic cycle will impact on the expense to GDP ratio
- There is some uncertainty around the amount of future NZS expenses that will be financed by withdrawals to meet NZS costs because of the uncertainty inherent in projections of demographic trends and rates of return
- The measure of GDP is subject to periodic revision by Statistics New Zealand (SNZ). The recent move to update the New Zealand System of National Accounts (SNA) to SNA 93 increased the level of nominal GDP by around 2% in 1999. Further changes by SNZ in the pipeline may also increase the GDP base but these magnitudes are uncertain. This would reduce the ratio of expenses to GDP.

There is considerable uncertainty around how expense pressures will develop over the next four decades, as discussed on page 18. Over the next 10 years, expenses plus contributions for future NZS costs are projected to be in a range of 33.9% to 35.3% of GDP, as demonstrated on page 25. As the extent of future pressures becomes clearer it may be necessary to adjust policy settings and/or adjust the long-term objectives, including the expense objective.

## Forecasts consistent with Government's fiscal objectives

The latest forecasts, detailed in the *Budget Update 2001*, show that we are progressing towards our long-term fiscal objectives and making substantial contributions to future NZS costs.

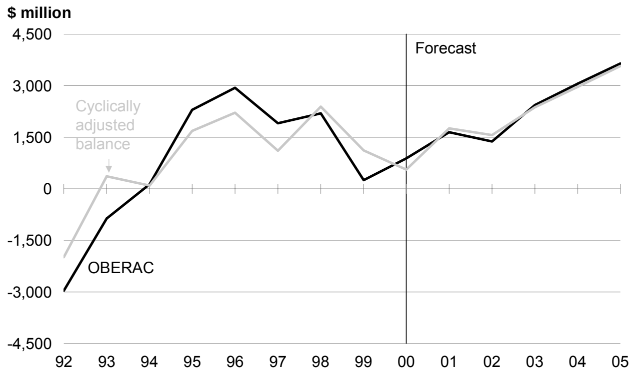
***Table 1*** – Key fiscal indicators

| **June year** **% GDP** | **2001 Forecast** | **2002 Forecast** | **2003 Forecast** | **2004 Forecast** | **2005 Forecast** |
|---|---|---|---|---|---|
| Expenses | 34.0 | 33.6 | 32.9 | 32.7 | 32.6 |
| Revenues | 34.8 | 34.1 | 34.2 | 34.4 | 34.6 |
| Operating balance | 0.6 | 1.2 | 2.0 | 2.4 | 2.7 |
| OBERAC[2] | 1.5 | 1.2 | 2.0 | 2.4 | 2.7 |
| Net debt | 18.1 | 18.3 | 17.8 | 18.0 | 18.0 |
| Gross debt | 32.7 | 30.5 | 29.9 | 30.5 | 30.3 |
| Net worth | 9.4 | 10.2 | 11.7 | 13.5 | 15.7 |
| Proposed NZS Fund contributions[3] | 0.0 | 0.5 | 1.0 | 1.4 | 1.9 |
| Forecast NZS Fund accumulated assets | 0.0 | 0.5 | 1.5 | 3.0 | 5.0 |
| Expenses + proposed NZS Fund contributions | 34.0 | 34.1 | 33.9 | 34.1 | 34.4 |
| Net debt + forecast NZS Fund assets | 18.1 | 17.8 | 16.3 | 15.0 | 13.1 |

### *Rising structural surpluses allow saving for future NZS costs*

The forecast rising structural surpluses (surpluses excluding the effect of the economic cycle) will allow the Government to contribute towards future NZS costs (see Figure 2[4]). When we came into office, the operating position was in broad structural balance. We needed to build structural surpluses to be able to save for future NZS costs and meet our spending priorities while still progressing towards our debt objective.

***Figure 2*** – Structural balance and OBERAC




Source: The Treasury

2 Operating balance excluding revaluations and accounting policy changes. See page 75 of the *Budget Update* for details. Revaluations are not forecast as a matter of policy beyond the current year, and there are no accounting changes included in the forecast period that impact on the operating balance.

3 Cabinet has agreed to the contribution for 2001/02. The contributions beyond this are assumptions only.

4 The cyclically adjusted balance (CAB) is a measure of the OBERAC excluding cyclical economic effects, especially on tax revenue and unemployment spending. The CAB is sensitive to the latest information available, and is subject to some uncertainty. Trends in the CAB are, however, more reliable.

Contributions to future NZS costs will increase gradually over the next three years towards those prescribed in the legislation currently before Parliament[5]. This ensures that only gradual changes in policy settings are required and that the economy has time to adjust to the structural improvement. The gradual building of surpluses has also allowed the Government to meet its key spending priorities.

In addition, building up structural surpluses supports our wider economic aims. The forecast rising structural surpluses will improve the government component of national saving and have a positive effect on the current account deficit.

### *Economic risks may affect fiscal forecasts*

As described in the *Budget Update,* the economic outlook is for solid growth, although there are significant risks around the world outlook. Lower world growth is likely to reduce demand for New Zealand exports. The impact of two alternative economic outlooks on the fiscal position over the next four years is demonstrated in the scenarios on page 90 of the *Budget Update*.

The Government's general approach is to not adjust revenue and expense settings to protect the surplus from the effect of the economic cycle, because the effect of the cycle on the operating balance generally evens out over time.

However, if we think a given shock may be long lasting and threaten the progress toward our fiscal objectives, we will undertake appropriate action to protect the fiscal position.

### *Small changes are consistent with meeting our long-term fiscal objectives*

Our short-term fiscal policy approach is based on building structural surpluses to ensure that we meet our long-term fiscal objectives and our key spending priorities. In the *BPS 2000* we planned to build a sound fiscal platform so that we could meet our policy goals and save for future NZS costs. The $5.9 billion operating limit was developed as a tool to ensure that our short-term decisions were consistent with reaching our fiscal objectives.

Since then we have faced a number of unexpected and unavoidable pressures, mainly around maintaining current service provision levels. We have absorbed nearly $570 million of these pressures within the operating limit. However, there are further pressures of around $270 million relating to preserving our national and regional security that will not be absorbed in the operating limit, effectively increasing the limit from $5.9 billion limit to $6.1 billion[6]. This means there will be around $800 million available for *Budget 2002,* which is achievable although it will require careful review of existing and proposed initiatives.

Within the current parliamentary term (1999/2000 to 2002/03) we have also reduced the capital spending limit by $200 million, to better match funding with capital pressures.

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5 In 2001/02, for example, the full contribution rate under current assumptions would be $1.8 billion, but the Government will contribute $600 million.

6 The $5.9 billion limit is rounded from $5.86 billion, and the $6.1 billion limit is rounded from $6.126 billion.

Our fiscal track over the next four years remains consistent with achieving our long-term fiscal objectives. By the end of the electoral term we are expected to be closer to achieving our long-term fiscal objectives than anticipated in the *BPS 2000*, when the operating limit was first set, as shown in Table 2.

***Table 2*** – Forecasts of key fiscal indicators in 2002/03

| % GDP | 2001 FSR | 2001 BPS | 2000 BPS |
|---|---|---|---|
| Expenses | 32.9 | 33.1 | 33.5 |
| Operating balance | 2.0 | 2.3 | 1.8 |
| Net debt | 17.8 | 18.0 | 18.9 |
| Gross debt | 29.9 | 30.7 | 30.0 |

### *Likely spending in next electoral term outlined*

Beyond the current electoral term the Treasury has previously included in the forecasts technical assumptions for additional operating and capital spending. To provide a better indication of potential future spending we have increased the level of these provisions.

We have included indicative provisions for additional initiatives that will impact on the operating balance of $900 million per year for 2003/04 and 2004/05. This is roughly equivalent to a $5.4 billion operating limit over a three-year parliamentary term. This amount is slightly smaller than that spent over the current term. However, our main policy initiatives, such as restoring the 65% NZS wage floor and reducing state house rentals, have already been made.

We have included indicative capital provisions of $850 million annually for 2003/04 and 2004/05. The provisions reflect expected pressures including additional spending on defence to allow for necessary equipment upgrades, as part of the Government's 10-year plan to upgrade capability.

The Government will agree on the level of these provisions at the start of the next parliamentary term, when we will have better information on likely pressures and priorities. The economic and fiscal outlook may change between now and when these limits are set, which may influence their appropriate size. In addition, we have not decided how spending in the next parliamentary term should be spread over the three years. In the current term we front-loaded many of the operating initiatives, but in future we are more likely to spread spending evenly across the term to allow greater space for opportunities and pressures that arise during the term.

Meeting the indicative operating and capital provisions in 2003/04 and 2004/05 will demand good decision-making processes. The provisions need to meet both new initiatives and cost pressures from existing initiatives (such as potential teachers' pay settlements). While it is difficult to measure the amount of the provision spent on cost pressures, the main cost pressures come from health and education (for example, teachers' pay and health resourcing). Cost pressures and new initiatives for health and education have made up an average of 60% of the allocated provision over 1997 to 2001. This compares with their 36% share of government expenditure. We will continue to review current low value expenditure and to prioritise funding requirements for existing and new initiatives.

### *Improvements to the provision-setting process in the pipeline*

To improve our decision-making processes, we are reviewing how the operating and capital provisions are set and operate. On the operating side, the review will clarify the extent to which the provisions meet pressures from existing government programmes and completely new initiatives. On the capital side, the review will investigate how we can move from a short-term decision horizon to a more comprehensive and long-term horizon.

## On track looking forward

The previous section measured progress towards our fiscal objectives over the next four years using the *Budget Update* forecasts. The forecasts incorporate judgements of likely outcomes based on known risks. For example, the economic forecasts balance the risk of a global slowdown with that of a stronger domestic recovery.

To track progress towards our fiscal objectives over the next 10 years, we project out from the end of the forecast period for a further five years. The projections are based on long run assumptions. For example, the projections assume no economic cycle with constant long run interest rate, inflation rate and unemployment assumptions. These are the progress outlooks required by the Fiscal Responsibility Act 1994. The projections are based on the technical and policy assumptions discussed in Annex 3.

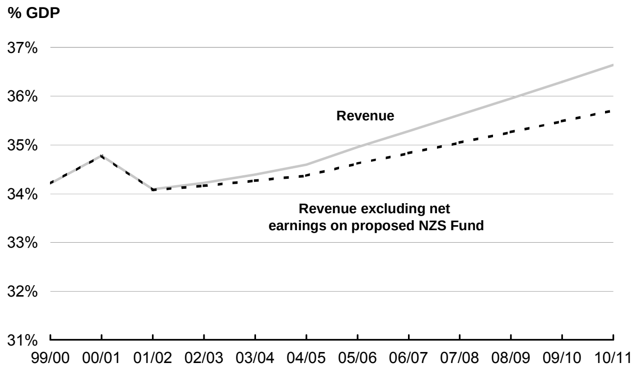
### *Operating surpluses as revenue growth outpaces expense growth*

We remain on track to meet our objectives over the next 10 years.

Revenue is projected to rise from 34.8% of GDP in 2000/01 to 36.6% in 2010/11. Tax revenue and the earnings on the proposed NZS Fund, which is based on assumed market returns of 9% per annum, largely drive the growth.

By 2010/11 the gross returns on the proposed NZS Fund assets are 1.4% of GDP and returns net of tax, which are retained in the Fund, are 0.9%.

Figure 3 – Revenue and earnings on proposed NZS Fund




Source: The Treasury

Consistent with our objective, expenses track below 35% of GDP over the projection period. After the transition period, expenses plus contributions towards future NZS costs are around 35% of GDP.

The expense track allows for a $1.2 billion (GST inclusive) fiscal allowance[7]. This provides the Government with fiscal flexibility, as it may be used for spending and revenue initiatives, accelerating contributions to the NZS Fund and responding to developments in the economic and fiscal position and the sensitivity of the fiscal position to key assumptions.

The growing wedge between revenue and expenses translates into rising operating surpluses reaching 3.9% of GDP by 2010/11, which allows the Government to meet the required contribution towards future NZS costs. In 2010/11 the proposed NZS Fund will grow with the 1.7% of GDP contribution and the 0.9% net return on previous contributions.

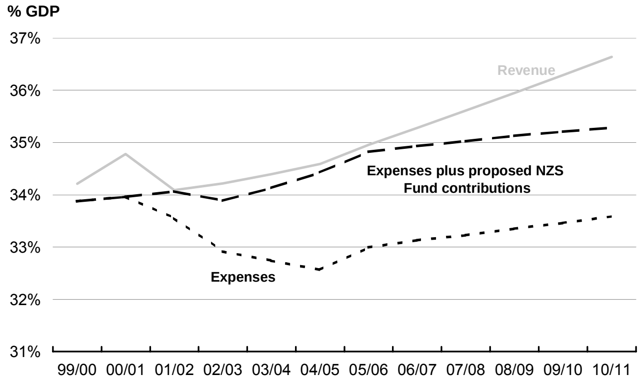
Surpluses from state-owned enterprises and Crown entities do not contribute significantly towards the operating balance growth, as they are relatively steady at 0.7% of GDP across the projection period.

### *Debt consistent with objective*

Both debt measures are projected to be below our long-term debt objective by 2010/11.

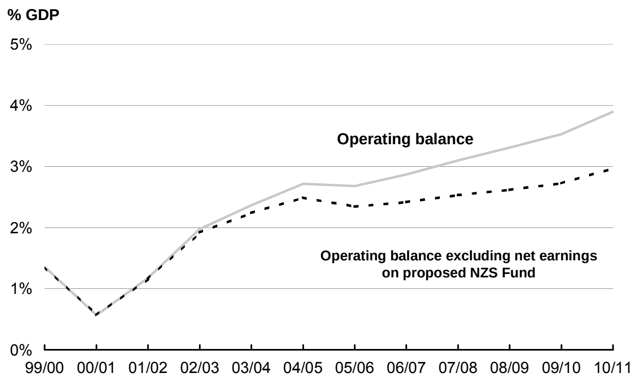
Net and gross debt in the base projection decline over the next 10 years partly reflecting the rising operating surpluses. The fall in debt is less than the operating balance in part because the return on the proposed NZS Fund assets (net of tax), which is included in the operating balance, is not available for debt repayment.

***Figure 4*** – Revenue and expenses



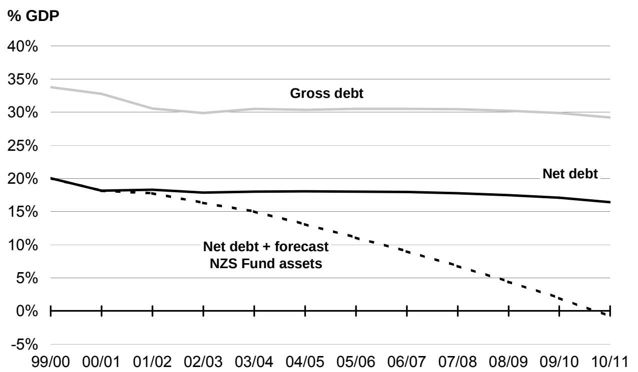

Source: The Treasury

***Figure 5*** – Operating balance




Source: The Treasury

***Figure 6*** – Net debt and gross debt




Source: The Treasury

7 The fiscal allowance is cumulative. In 2005/06 $1.2 billion is added to government spending. Each following year an additional $1.2 billion, adjusted for inflation and real wage pressures (3%), is added.

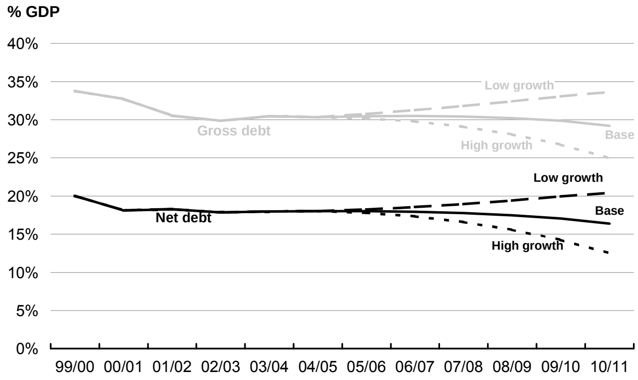
The proposed NZS Fund assets are not included in the net debt measure used for the Government's long-term debt objective.

### *Alternative economic outcomes could require revised fiscal settings*

Our base scenario assumes average real economic growth of 2.2% over 2005/06 to 2010/11, based on labour force projections from Statistics New Zealand and assumed labour productivity growth of 1.5%.

If trend economic growth is lower on a sustained basis and fiscal policy is not changed, gross debt will be rising and above 30% in 2010/11 as shown in Figure 7[8]. This Government would alter fiscal settings to ensure that the 10-year projections are consistent with progress towards our long-term fiscal objectives.

***Figure 7*** – Net debt and gross debt – alternative economic outcomes



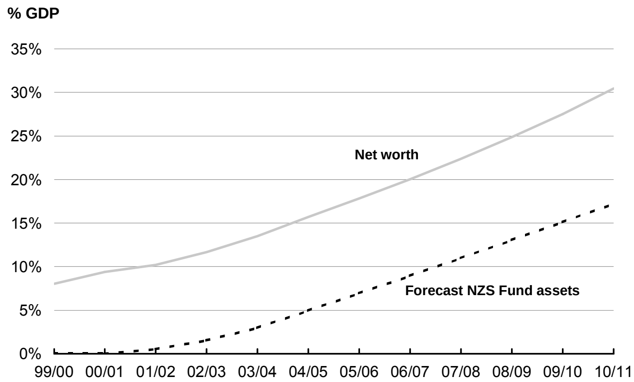

Source: The Treasury

In contrast, if trend economic growth is higher than expected this would provide the Government with some space to reduce taxes, to increase spending on key priority areas, to accelerate contributions to the proposed NZS Fund or to reduce debt further.

### *Assets set aside for future NZS costs drive rising net worth*

Consistent with our fiscal objectives, net worth shows a rising profile. By 2011 assets set aside to contribute to future NZS costs will be around 17% of GDP.

***Figure 8*** – Net worth




Source: The Treasury

### *Our current fiscal policy remains appropriate*

The 10-year projections confirm that our fiscal policy approach is appropriate given what we currently know about the future. The Government will continue to evaluate our approach over a 10-year rolling horizon to ensure that we take account of changing economic and fiscal conditions.

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8 The average growth in the high growth scenario is 2.8%, and in the low growth is 1.8% over 2005/06 to 2010/11.

## Conclusion

One of this Government's key goals set at the start of our term was to restore faith in government.  We are now two Budgets into the three Budgets of this electoral term.  We have shown that the Government can deliver on our key commitments and maintain a prudent fiscal position.

We are on track to meet our long-term fiscal objectives, and we have taken positive steps to address the challenges that will arise from an ageing population.  The proposed NZS Fund will ensure security in retirement by preventing future governments from raiding the kitty for short-term political gain.

The Government recognises that as future expense pressures evolve, it may be necessary to adjust policy settings to ensure consistency with the full set of fiscal objectives.  Under this Government, the steps will be small and incremental, trading off the uncertainty inherent in long-term projections while allowing sufficient time for the economy to adjust.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

16 May 2001

# 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 *Budget Policy Statement 2001.*

| Short-term fiscal intentions | *Fiscal Strategy Report 2001* | *Budget Policy Statement 2001* |
|---|---|---|
| **Operating balance** | On current forecasts, operating balances will be:<br>• $0.6 billion in 2000/01<br>• $1.4 billion in 2001/02<br>• $2.4 billion in 2002/03<br>• $3.1 billion in 2003/04. | On current forecasts, operating balances will be:<br>• $0.8 billion in 2000/01<br>• $2.2 billion in 2001/02<br>• $2.8 billion in 2002/03<br>• $3.6 billion in 2003/04. |
| **Crown debt** | If forecast economic conditions prevail, gross Crown debt/net Crown debt will be:<br>• $36.9 billion/$20.4 billion in 2000/01<br>• $35.8 billion/$21.5 billion in 2001/02<br>• $36.9 billion/$22.0 billion in 2002/03<br>• $39.4 billion/$23.2 billion in 2003/04.<br>In 2003/04 gross and net Crown debt will be 30.5% and 18.0% of GDP respectively. | If forecast economic conditions prevail, gross Crown debt/net Crown debt will be:<br>• $38.2 billion/$22.1 billion in 2000/01<br>• $37.7 billion/$22.1 billion in 2001/02<br>• $37.6 billion/$22.0 billion in 2002/03<br>• $37.7 billion/$21.4 billion in 2003/04.<br>In 2003/04 gross and net Crown debt will be 29.4% and 16.7% of GDP respectively. |
| **Operating expenses** | On current forecasts, operating expenses will be:<br>• $38.3 billion in 2000/01<br>• $39.4 billion in 2001/02<br>• $40.7 billion in 2002/03<br>• $42.3 billion in 2003/04.<br>If forecast economic conditions prevail, expenses will be 32.7% of GDP, and NZS Fund contributions will be 1.4% of GDP, in 2003/04. | On current forecasts, operating expenses will be:<br>• $38.1 billion in 2000/01<br>• $39.3 billion in 2001/02<br>• $40.6 billion in 2002/03<br>• $42.0 billion in 2003/04.<br>If forecast economic conditions prevail, expenses will be 32.8% of GDP in 2003/04. |
| **Operating revenues** | On current forecasts, operating revenues will be:<br>• $39.2 billion in 2000/01<br>• $40.0 billion in 2001/02<br>• $42.3 billion in 2002/03<br>• $44.4 billion in 2003/04. | On current forecasts, operating revenues will be:<br>• $38.2 billion in 2000/01<br>• $40.7 billion in 2001/02<br>• $42.7 billion in 2002/03<br>• $44.9 billion in 2003/04. |

| Short-term fiscal intentions | *Fiscal Strategy Report 2001* | *Budget Policy Statement 2001* |
|---|---|---|
| **Crown net worth** | Subject to forecast economic conditions prevailing, net worth will be:<br>• $10.6 billion in 2000/01<br>• $12.0 billion in 2001/02<br>• $14.4 billion in 2002/03<br>• $17.5 billion in 2003/04. | Subject to forecast economic conditions prevailing, net worth will be:<br>• $9.4 billion in 2000/01<br>• $11.6 billion in 2001/02<br>• $14.4 billion in 2002/03<br>• $18.0 billion in 2003/04. |

## Long-term fiscal objectives

In accordance with the Fiscal Responsibility Act 1994, the Government's updated long-term fiscal objectives are given below. These are compared with the long-term objectives specified in the *Budget Policy Statement 2001.* We have clarified our long-term objectives to provide a better sense of the financing role of the proposed NZS Fund and the time horizon of the objectives. The new objectives improve the clarity of the objectives, but do not change our fiscal policy approach. See the box on Updated Long-term Fiscal Objectives for further discussion.

| Long-term fiscal objectives | *Fiscal Strategy Report 2001* | *Budget Policy Statement 2001* |
|---|---|---|
| **Operating balance** | 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. | Operating surplus across the economic cycle to ensure:<br>• government revenues and spending (excluding the allowance for funding the costs associated with the ageing population) are at least in broad balance and net debt is below 20% of GDP<br>• an allowance for prefunding the costs associated with the ageing population. |
| **Crown debt** | Gross debt below 30% of GDP on average over the economic cycle.<br>Net debt, which excludes the assets to meet future NZS costs, below 20% of GDP on average over the economic cycle. | Gross debt below 30% of GDP, consistent with net debt (excluding the accumulated allowance for funding the costs associated with the ageing population) below 20% of GDP, across the economic cycle. |
| **Operating expenses** | Expenses will average around 35% of GDP over the horizon used to calculate contributions toward future NZS costs. During the build-up of assets to meet future NZS costs, expenses plus contributions will be around 35% of GDP. In the longer term, expenses less withdrawals to meet NZS costs will be around 35% of GDP. | Expenses around current levels of 35% of GDP. |

| **Long-term fiscal objectives** | ***Fiscal Strategy Report 2001*** | ***Budget Policy Statement 2001*** |
|---|---|---|
| **Operating revenues** | Raise sufficient revenue to meet the operating balance objective.<br>A robust, broad-based tax system that raises revenue in a fair and efficient way. | Raise sufficient revenue to meet the operating balance objective.<br>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. This will be achieved through a build-up of assets to meet future NZS costs. | The Government will increase net worth. |

# Annex 2

## 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 3.

***Table 3*** **–** Changes in fiscal forecasts since *Budget Policy Statement* (June years)

| Change | 2000/01 | 2001/02 | 2002/03 | 2003/04 |
|---|---|---|---|---|
| **$ million** | | | | |
| Net worth | 1,231 | 402 | 14 | (551) |
| Net debt | (1,667) | (656) | 5 | 1,822 |
| Gross debt | (1,335) | (1,833) | (754) | 1,654 |
| Revenues | 1,048 | (697) | (427) | (511) |
| Expenses | 169 | 99 | 77 | 272 |
| Operating balance | (124) | (829) | (388) | (565) |
| | | | | |
| **% GDP** | | | | |
| Net debt | (2.1) | (0.6) | (0.2) | 1.3 |
| Gross debt | (2.3) | (1.6) | (0.8) | 1.1 |
| Expenses | (0.9) | 0.1 | (0.2) | (0.1) |
| Revenues | (0.1) | (0.6) | (0.6) | (0.7) |
| Operating balance | (0.1) | (0.7) | (0.3) | (0.4) |
| NZS Fund contributions | 0 | 0 | 0 | 0 |

The differences in nominal terms reflect changes in the fiscal forecasts, while the differences as a percentage of GDP reflect both changes in the economic and fiscal forecasts and an increase in the measured GDP base by Statistics New Zealand.

The specific changes to the fiscal aggregates in nominal terms, as compared with those in the *Budget Policy Statement*, include:

- operating revenues – higher in 2000/01 owing to higher tax revenues ($740 million), particularly company tax ($290 million), and spectrum sales ($140 million). In 2001/02 company tax growth is expected to unwind, and be lower than the *BPS* by $180 million. Lower forecast nominal GDP growth also reduces expected tax growth over 2001/02 to 2003/04, such that by 2003/04 tax revenue forecasts are lower than the *BPS* by $560 million.

- operating expenses – slightly higher in each year largely reflecting policy changes partially offset by forecast changes. The main policy changes are the increase in the operating limit that covers spending initiatives over 1999/2000 to 2002/03, from $5.9 billion to $6.1 billion, and the increase in the provision for future initiatives in 2003/04 from $800 million to $900 million. Offsetting these changes, benefit forecasts are lower by $100 million, $200 million and $290 million over 2001/02 to 2003/04 largely reflecting the lower unemployment rate and inflation rate forecasts.

- operating balance – lower in all years. In 2000/01 the lower operating balance reflects the higher tax revenue forecast being more than offset by negative liability revaluations for GSF and ACC of around $1.1 billion. Over 2001/02 to 2003/04 the reduction in the operating balance forecasts reflects the lower tax revenue and higher expense tracks discussed above.

- net debt – lower in 2000/01 and 2001/02 reflecting the higher cash surplus in 2000/01 from the higher company tax receipts and the deferral of capital spending. By 2003/04 this effect is more than offset by the increase in the capital provisions in 2003/04 from $250 million to $850 million, and the smaller forecast cash surpluses, which over 2001/02 to 2003/04 cumulate to $1.4 billion.

- gross debt – lower in all years, except 2003/04 reflecting the factors impacting net debt as well as higher forecast demand for student loans in each year ($500 million higher by 2003/04), and higher forecast Crown entity debt refinancing ($1 billion higher by 2003/04).

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

# Annex 3

## Assumptions used in the projections and scenarios

This Annex summarises the assumptions used in producing the 10-year projections and the 50-year scenarios. It also meets the Fiscal Responsibility Act 1994 requirement to explain the reasons for any significant differences from the previous 10-year projections.

From 2000/01 to 2004/05, all projections incorporate the economic and fiscal assumptions detailed in the *Budget Update*.

### *Economic and demographic assumptions*

The following assumptions apply to both the 10-year projections and the 50-year scenarios beyond 2004/05:

- Nominal GDP grows with labour productivity (annual rate of 1.5%), projected changes in the labour force (from Statistics New Zealand) and inflation (annual rate of 1.5%). Under the high and low economic growth scenarios in the 10-year projections labour productivity is set at 2.0% and 1.0% respectively.
- Demographic trends are based on Statistics New Zealand population projections with medium fertility, medium mortality and net migration of 5,000 a year.

***Table 4*** – Summary of economic assumptions*

| June year[9] | 2002 | 2003 | 2004 | 2005 | 2006-2011 projections | 2006-2051 scenarios |
|---|---|---|---|---|---|---|
| Real GDP | 2.7 | 3.4 | 2.9 | 2.8 | 2.2 | 1.6 |
| Consumer price index | 2.1 | 1.7 | 1.7 | 1.5 | 1.5 | 1.5 |
| Government 10-year bonds (quarterly average %) | 6.1 | 6.3 | 6.6 | 6.7 | 6.5 | 6.5 |
| Unemployment rate | 5.4 | 5.1 | 5.1 | 5.1 | 5.9 | 6.0 |

* Annual average % change unless otherwise stated

### *Fiscal assumptions beyond 2004/05*

Fiscal policy settings in the 10-year projections are an extension of current policy settings (for example, no change in tax brackets, CPI indexing of benefits only). In comparison, the 50-year scenarios include long-run fiscal policy assumptions. For example, expenses grow with their appropriate demographic cohorts, CPI and a real growth factor linked to real wage growth.

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

***Table 5*** – Summary of fiscal assumptions

| | **10-year projections** | **50-year non-finance expense scenarios** |
|---|---|---|
| **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 | Demographically adjusted and linked to nominal wages |
| **Health and education** | Demographically adjusted | Demographically adjusted and linked to CPI (1.5%) and real wage growth (1.5%). Real per capita growth under the high and low expense growth scenarios is 2% and 1% a year respectively |
| **Finance costs** | A function of debt levels and interest rates | |
| **Other** | Not demographically adjusted | Linked to CPI (1.5%) and real wage growth (1.5%) |
| **Fiscal allowance** | $1.2 billion in 2005/06, increasing with CPI and real wages, is added cumulatively each year | |
| **Capital provision** | $550 million in 2005/06, increasing with CPI and real wages, is added each year | |
| **NZS Fund** | Contributions to the proposed Fund are assumed to be consistent with the legislation currently before Parliament. Returns are assumed at 9% per annum | |

Further details of the modelling approach can be found in Treasury Working Paper 00/02 '*Manual for the Long-Term Fiscal Model*'. This is available on the Treasury website.

### *Consistency of 10-year projections with those in the 2000 Fiscal Strategy Report*

The 10 year projections in this *Fiscal Strategy Report* are not strictly comparable with those in the 2000 *Fiscal Strategy Report* because the short-term economic and fiscal forecasts have changed. Other changes are:

- an increase in the capital provision for beyond 2004/05 to $550 million a year, from $400 million, to better reflect likely on-going capital pressures
- a technical amendment to the Long-term Fiscal Model to correct for an inconsistent treatment of valuations for physical and transport assets in the model's gross debt calculation. Net and gross debt are higher in 2010 by three percentage points as a result
- a reduction in the 10 year government bond rate to 6.5% from 7.0% (nominal) and 5.0% from 5.5% (real) to more closely align with OECD projections of the world real interest rate.

# Annex 4

## Future developments in the long-term fiscal objectives

As signalled in the *Fiscal Strategy Report 2000* and *Budget Policy Statement 2001*, the introduction of full line-by-line consolidation in the 2002 Budget, in line with generally accepted accounting practice (GAAP), will have implications for the long-term expense and debt objectives.

In February 2001, the Treasury released a discussion document for consultation outlining a proposal for changes to the fiscal objectives in response to full line-by-line consolidation.

The Government has not yet made a final decision on how to specify our objectives under full line-by-line consolidation. To give an idea of where thinking is currently at, a set of draft objectives is outlined below. The term "core" in these objectives refers to the Crown excluding state-owned enterprises and Crown entities.[10]

The draft objectives are based largely on the Treasury's proposed changes to the fiscal objectives in the discussion document. However, there are still some issues to resolve, including:

- how to specify the expense and debt objectives with respect to "total" and "core" Crown
- the Government has previously signalled that we are considering specifying our long-term debt objective in terms of gross debt rather than both net and gross debt. The level of the Crown's gross debt will be affected by the introduction of full line-by-line consolidation and Debt Management Office (DMO) and Reserve Bank financing activities. We will need to undertake further work about the appropriate target level for gross debt before making any decisions.

The draft objectives are as follows:

| | |
|---|---|
| **Expenses** | Total expenses consistent with the operating balance objective. The Government will give effect to the operating balance objective through a focus on core expenses.<br><br>Core expenses will average around 35% of GDP over the horizon used to calculate contributions toward future NZS costs. During the build-up of assets to meet future NZS costs, core expenses plus contributions will be around 35% of GDP. In the longer term, core expenses less withdrawals to meet NZS costs will be around 35% of GDP. |

[10] Core Crown revenue and expenses under full line-by-line consolidation will:

- include government funding to Crown entities such as hospitals and schools as is currently the case
- not be comparable to existing revenues and expenses in the current financial statements. This is because under full line-by-line consolidation, all GST on Crown expenses will be eliminated. The current expenses of the Crown are reported inclusive of GST on all spending except departmental spending. This change will reduce expenses (and correspondingly tax revenue) by over $1 billion. This will also impact on the core Crown expenses-to-GDP ratio. Adjustments will need to be made to historical data to ensure a comparable series is provided.

| | |
|---|---|
| **Revenue** | Raise sufficient revenue to meet the operating balance objective.<br>A robust, broad-based tax system that raises revenue in a fair and efficient way. |
| **Operating balance** | Operating surplus on average over the economic cycle sufficient to meet the requirements for contributions towards future NZS costs and ensure consistency with the debt objective. |
| **Debt** | Total gross debt at prudent levels, where the Government will give effect to the debt objective through a focus on:<br>• gross, Crown issued debt below 30% of GDP on average over the economic cycle.<br>• gross, Crown issued debt less core financial assets (other than those to meet future NZS costs) below 20% of GDP on average over the economic cycle. |
| **Net worth** | Increase net worth consistent with the operating balance objective.  This will be achieved through a build-up of assets to meet future NZS costs. |