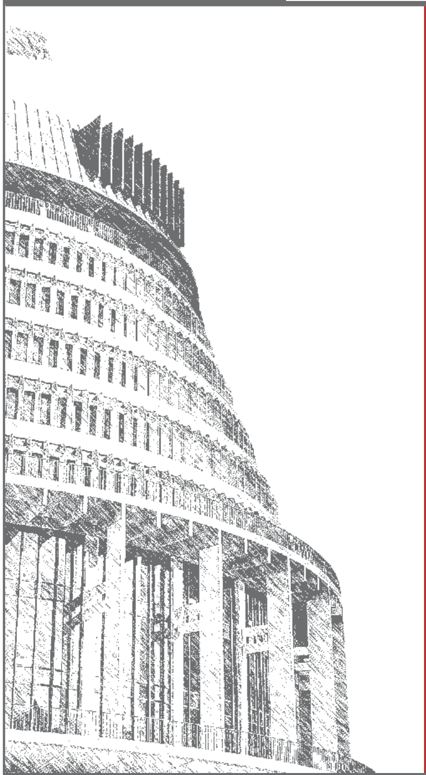
23 May 2002



budget 2002

Executive Summary

Hon Dr Michael Cullen

Treasurer
Minister of Finance

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Minister's Statement

Budget 2002 is a report back to the people of New Zealand on the Government's financial stewardship during this term of office. It outlines spending intentions for the years ahead, and charts a course for a future in which New Zealanders reclaim their place in the global income stakes.

The financial report card for three years establishes that the Government has kept its word and honoured the commitments given during the last election campaign, and has been able to do so alongside a significant strengthening of the Crown accounts. The Budget proves that it is possible to attend to issues of social equity, to fund an improvement in the performance of the economy, and to keep the books in the black.

Budget 2002 consolidates and extends the Government's determination to take the longer view. In addition to putting aside funds to meet the future costs of New Zealand Superannuation, the Government has laid out a three-year, rising funding path for health, has committed itself to a bold land transport strategy, and has increased capital allocations in a range of areas from schools, to hospitals, defence and prisons.

The growth and innovation framework is now taking shape. Its emphasis on improved skills, and economic transformation through new investment in areas where we have a natural aptitude and advantage will create the potential for future generations to once again live and work in a country that ranks among the world's better performing economies and societies.

Consistent with the longer view, there is more emphasis in this Budget on the Government's capital needs, capital budgeting, and debt management. This was an area of neglect in the 1990s.

Estimates of current financial performance and forecast future trends show operating surpluses that are sufficient to meet required transfers into the New Zealand Superannuation Fund and to make a contribution to the financing of the capital programme. The result is that even with a focus on capital spending, we will meet our long-term gross debt objective of 30% of GDP in 2002/03, and continue to track below 30% over the forecast period.

Despite this, capital spending pressures remain and it will be necessary to manage capital spending, the level of the operating balance, and contributions to the New Zealand Superannuation Fund so that we continue to meet the long-term debt objective in the later years of the forecast period.

The operating surpluses are well ahead of those projected at the time of the *December Update*, but are broadly in line with the Budget 2001 forecasts. It is important that fiscal discipline be maintained. The surpluses are not for spending through poorly designed tax distributions. A part of them reflects valuation changes that will reverse out in the short term. A part is a result of a period of sustained economic growth; looking through the economic cycle means banking surpluses in good times as well as maintaining spending when conditions soften.

Equally, though, surpluses have to be maintained to prepare for future cost pressures, to fund increased public investment, and reduce the need for further borrowing.

Budget 2002 makes sensible allowances for realistic spending plans in the next term of office. It establishes the credentials of this Government as a highly effective economic manager, and allows all New Zealanders to have confidence in their future.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

14 May 2002

Budget 2002 Overview

Introduction

Budget 2002 consolidates the past…

As promised in our *Budget Policy Statement* in December, Budget 2002 rounds out this Government's three-year strategy. We made full use of our first Budget to kick-start our election commitments, and focused Budget 2001 on consolidating and maintaining momentum.

Our emphasis throughout the term has been on putting the building blocks in place that position us well to deal with future challenges – most notably with the challenge of an ageing population.

…and strengthens our vision looking forward…

Budget 2002 is consistent with this long-term view. Net new spending is around $957 million operating, including contingency funding, and $407 million capital in 2002/03. The package is outlined in the pages that follow. It is founded on five aims:

- to ensure high quality healthcare into the future
- to support economic growth and innovation
- to build public sector capability, particularly education
- to develop a modern and cohesive society
- to strengthen New Zealand's security.

Budgets are an integral part of Government decision-making. We see Budget 2002 as just one part of a broader and longer-term economic and fiscal strategy that encompasses our aims for economic growth, sound fiscal management and innovative policy.

Fiscal Strategy

…while retaining control of the fiscal reigns

This Budget sits within the context of this Government's fiscal strategy. During our first term in office, the Government has maintained a coherent approach to policy, balancing fiscal prudence with policy priorities and contributions to the New Zealand Superannuation Fund.

As indicated in our 2002 *Budget Policy Statement*, we are delivering on our policy priorities within the $6.1 billion operating provision set for the term. Managing within this limit is based on careful management of resources.

We have given careful attention to capital expenditure over the term, developing better capital forecasting and budgeting processes. In light of the most recent information on capital pressures, the Government has agreed to increase the capital provisions by $200 million in total over 2004/05 and 2005/06, and to rephase our existing provisions to better match the timing of expected capital pressures.

The 2002 *Fiscal Strategy Report* outlines in more detail our plans going forward and demonstrates that the expenditure measures in Budget 2002 (and those planned for future Budgets) are consistent with the Government's long-term fiscal objectives.

Summary of Budget 2002

The tables below summarise key spending decisions in Budget 2002. The total package includes substantial revenue initiatives, reflecting the petrol excise and road user charges, more efficient tax administration and courts' fine collection procedures.

Reflecting our focus on forward planning, the package incorporates a significant amount of contingency funding. This includes resources set aside for education and economic transformation, plus a general contingency for issues that cannot be deferred until Budget 2003.

Operating

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Health	7	446	915	1,271	1,283	3,922
Supporting growth and innovation	1	25	30	31	33	119
Building public sector capability	14	219	327	322	329	1,210
Developing a modern and cohesive society	21	311	325	337	327	1,321
Strengthening New Zealand's security	1	12	13	13	13	53
Revenue initiatives[1]	(50)	(285)	(303)	(311)	(317)	(1,267)
Total 2002 Budget	**(6)**	**727**	**1,307**	**1,662**	**1,667**	**5,359**
Post-Budget contingency	-	230	200	180	180	790
Total	**(6)**	**957**	**1,507**	**1,842**	**1,847**	**6,149**

1 Comprises Land Transport revenue, tax revenue and increased efficiency in collecting court fines.

Capital

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Health	(16)	154	137	152	194	621
Supporting Growth and Innovation	5	15	0	-	-	21
Building Public Sector Capability	25	159	10	(3)	(8)	183
Developing a Modern and Cohesive Society	10	77	46	51	39	224
Strengthening New Zealand's Security	1	2	-	-	-	3
Air New Zealand [2]	1,035	-	-	-	-	1,035
Auckland Rail	91	-	-	-	-	91
Total 2002 Budget	**1,151**	**407**	**195**	**200**	**224**	**2,177**

2 This consists of $885 million already provided, and a further commitment by the Government to provide $150 million before June 2003 in a form that is appropriate for Air New Zealand's capital structure at the time required. Air New Zealand has indicated that it will not require the additional capital prior to 30 June 2002.

Ensuring High-quality Healthcare into the Future

Budget 2002 reflects the high priority we put on quality healthcare…

Improving healthcare continues to be a priority for this Government. Locally elected district health boards (DHBs) are in place, and the Government is supporting them by implementing a three-year funding package to allow District Health Boards to plan health and disability services with certainty.

The Government is committing $2.4 billion in new operating funding for a Health Funding package for the next three years. We are also committing over $620 million capital for the health sector over the next four years.

This is the first time any government has committed to a three-year funding path of such magnitude for the health sector, and it will allow DHBs to genuinely plan service delivery in a strategic way.

The table below outlines the health funding path, as well as other key health initiatives.

Key initiatives

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Health package	-	400	800	1,200	1,200	3,600
Meningococcal vaccine	4	37	82	30	33	187
Community Services Card	3	9	17	25	34	88
Other health	-	-	16	16	16	48
Total (operating)	**7**	**446**	**915**	**1,271**	**1,283**	**3,922**
Health (capital)	***(16)***	***154***	***137***	***152***	***194***	***621***

…including a comprehensive three-year health package…

The new funding covers a range of health and disability services. It includes:

- providing DHBs with funding certainty that provides the resources and time required to plan for, and deliver, the services that best meet the needs of their local communities
- an additional $7.4 million per annum for mental health funding
- $5.6 million to provide greater access to cancer drugs
- $12.5 million, growing to $35 million, to provide residential care services
- $3 million, increasing to $5 million, for breast screening services, to fund greater numbers of people in the target age range

- $15 million to subsidise sewerage schemes for lower socio-economic rural communities.

…a new approach to primary care services…

This Government has set aside $410 million over three years to substantially improve early access to primary healthcare services. We will focus on low-income, high-health-need New Zealanders in the short term and extend coverage as funding becomes available, to provide free or low-cost primary healthcare services.

The priorities will be reducing costs for school-age children, followed by the elderly and others with high health needs.

The funding includes up to $8 million to increase the General Medical Subsidy for GP services to children under six years of age.

The purpose of the primary healthcare strategy is to improve, maintain and restore New Zealanders' health through prevention and early intervention.

…provision to develop a meningitis vaccine…

We are providing for the development of a New Zealand-specific meningococcal vaccine and intend to implement a vaccination campaign to address the current meningococcal epidemic. We are aiming to vaccinate at least 90% of all under-20-year-old New Zealanders.

Budget 2002 also makes provision for increasing the threshold for receiving a Community Services Card. This change brings this entitlement into line with other social security benefits, which are regularly increased to reflect changes in the Consumer Price Index (CPI).

Significant capital investment

…and a significant capital injection

The total package also includes a capital allocation of just over $620 million over the next four years. This new spending is additional to the just under $500 million in baselines, giving a total of $1,120 million for health capital.

The allocation includes already approved projects – in particular Auckland Health Services Development Plan, Capital and Coast, as well as a provision for possible future projects. It reflects a realistic level of capital spending for DHBs, given the history of DHBs' actual capital spending and considering operating impacts.

The spending will be used to maintain health facilities.

Supporting Growth and Innovation

Budget 2002 continues our drive towards economic growth…

As we signalled in the *Budget Policy Statement*, a significant theme in Budget 2002 is expenditure to support the Government's growth and innovation framework.

Our aim is to build on existing fundamentals, with policies that actively focus on growth and innovation. We give particular focus to policies that enhance the economy's potential to foster innovation, encourage the commercialisation of good ideas, develop skills and talent and increase New Zealand's global connectedness.

Budget 2002 provides funding totalling around $244 million over the next four years to initiatives that will strengthen New Zealand's performance in these areas.

Key initiatives

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Skills and talent	-	9	13	14	14	52
Innovation	-	17	19	21	22	79
Global connectedness	-	13	14	15	15	57
Focus	-	11	9	10	11	41
Foundations	1	4	4	3	3	15
Total (operating, gross)	**1**	**55**	**59**	**63**	**66**	**244**
Total (capital)	***5***	***15***	***-***	***-***	***-***	***21***
Funding in baselines[3]	-	30	30	32	34	126
Total (operating, net)	**1**	**25**	**30**	**31**	**33**	**119**

[3] Funding agreed in Budget 2000 in Vote Economic, Industry and Regional Development Baselines

…aiming to foster innovation and strengthen New Zealand's performance in the key drivers of growth

Funding is primarily allocated across the key economic development portfolios, and includes:

- skills development, through programmes such as Centres of Research Excellence, Fast Forward New Zealand and Business Cluster Development
- promoting innovation and research through the Technology for Business Growth initiative, Research Consortia, the New Economy Research Fund and the Marsden Fund
- enhancing global connectedness through additional resources for export promotion and a new Strategic Investment Fund to build linkages with major foreign investors
- programmes to promote the development of focus sectors: biotechnology, Information and Communication Technology and Creative Industries.

Building Public Sector Capability

Ensuring fairness and capability in the public sector

Building the public sector's ability to provide high-quality services now and in the future underpins our aims looking ahead. We have given consistent focus over the term to boosting the capability of the public sector, ensuring fairness in pay and opportunities, and developing capacity.

Key initiatives

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Education – operating	7	105	180	164	165	621
Education - capital	*25*	*139*	*(11)*	*(12)*	*(12)*	*128*
Conservation - operating	-	4	7	12	19	42
Conservation - capital	*-*	*4*	*4*	*4*	*4*	*16*
Corrections - operating	-	2	2	6	6	15
Corrections - capital	*-*	*12*	*18*	*5*	*-*	*35*
Courts	3	19	19	20	22	83
Defence	3	23	22	19	19	86
Police	(8)	(3)	27	27	27	72
IRD	3	28	38	40	40	149
E-procurement - capital	*-*	*4*	*-*	*-*	*-*	*4*
Other operating	5	41	32	34	30	142
Total (operating)	**14**	**219**	**327**	**322**	**329**	**1,210**
Total (capital)	***25***	***159***	***10***	***(3)***	***(8)***	***183***

Budget 2002 continues to put a strong emphasis on developing the public sector. In particular, we are continuing to focus on education and skill development. We are also supporting pay levels in the Police and Defence Forces, and boosting capability in core public sector agencies.

Improving the quality of education

A comprehensive education package, which…

Education remains a top priority for this Government, and is a key component of both our growth and innovation and public sector packages. The expenditure includes provision to build capability and boost the quality and responsiveness of education provision for all students, at all levels of the system.

The Budget package features (over four years):

- additional funding of $61 million for early childhood education (ECE) to improve the quality and sustainability of early childhood services (including increasing the number of registered ECE teachers), increase participation and manage early childhood services to meet community needs

…provides additional resources to improve schools…

- an increase in general funding for schools of $183 million. This includes $61 million for the 2003 annual inflation adjustment to schools' operational funding, $72 million for extra teachers, and just under $48 million for improvements to school property. A further $11 million will support effective school administration and management
- new funding of $104 million has been allocated for technology, professional development, curriculum resources and specific programmes to support effective teaching and learning in schools. In addition, new funding of $18 million is being provided to meet the needs of specific groups of students such as Māori , refugees, students at risk of low educational achievement, and those with special needs

…and makes tertiary education and training more affordable and accessible

- a net increase in tertiary education spending of $244 million. This includes $207 million to improve the affordability of tertiary education, $41 million for the expansion of Modern Apprenticeships and $36 million for the introduction of a performance-based research fund.

New capital funding includes a $168 million investment in school property to ensure that school property is maintained in terms of quality, and expanded to respond to demographic change.

Funding has also been set aside for initiatives that will be introduced throughout the year or will require additional resources. This includes funding for the Tertiary Education Commission, improved internet access for schools, the secondary teachers' collective employment contract and further investment in school property.

Supporting quality public services

Budget 2002 supports fairness and quality across New Zealand's public sector

Budget 2002 helps to ensure the capability of the sector to deliver quality services to New Zealanders. Key initiatives include:

- an allowance for the impact of the wage settlement with Police, to provide stability in this sector in the period looking ahead
- increased funding for regular Defence Force pay of $9.5 million in 2002/03 and $19 million in 2003/04 and outyears for a targeted increase in Defence Force pay
- a medium-term strategy to continue to improve the administration of the tax system, focusing on compliance with the tax laws. This is supported by a funding increase totalling $146 million over four years
- capital funding of just under $24 million over three years to address prison asset maintenance, and a further $11 million to enhance security at prison sites to stop breakouts and enhance staff safety

With a focus on getting the best results from our people and our public assets

- to maintain current service levels, a $43 million Courts package that includes funding for cost pressures within the department, and funding to implement a new remuneration structure, staff training and development. We are also investing to enhance Courts' fines collection capability, with net fiscal benefits to the Crown
- $43 million over four years to cover the financial implications of assets that were not previously included on the Department of Conservation's balance sheet or substantially undervalued; plus capital funding of just over $14 million over the next four years, and $305 million over the next 20 years to maintain Conservation visitor facilities, such as huts and tracks
- $21 million over four years to establish and develop a new Food Safety Authority, aimed at enhancing domestic food safety
- funding to increase the capacity of the Office of Ethnic Affairs, and to manage staffing issues at the National Library and the Office of the Clerk.

Developing a Modern and Cohesive Society

We are investing in New Zealand society, to make the best use of its human and natural resources

More broadly, the Budget 2002 package builds on previous Budget decisions that help us to take New Zealand society forward, demonstrating that it is innovative, modern and cohesive, and makes the best use of its human and natural resources.

Key initiatives

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Land transport strategy	50	178	188	187	181	785
Social services - initiatives	1	50	55	57	59	223
Social services - savings	(26)	(21)	(23)	(18)	(23)	(110)
Housing - operating	-	1	2	2	3	8
Housing - capital	-	*42*	*46*	*51*	*39*	*178*
Justice	-	3	3	3	2	10
Arts culture and heritage	-	3	10	10	10	33
Paid parental leave	1	39	41	41	41	163
Broadcasting	-	18	18	18	18	72
Agriculture& environment	-	14	16	16	15	61
Intelligence & security	-	6	7	7	8	27
Other (operating)	(5)	21	8	13	13	50
Other (capital)	*10*	*35*	*1*	*1*	*1*	*47*
Total (operating)	**21**	**311**	**325**	**337**	**327**	**1,321**
Total (capital)	***10***	***77***	***47***	***52***	***40***	***225***

A comprehensive land transport strategy

Including a comprehensive land transport strategy

Our comprehensive Land Transport package gives emphasis to projects that will help alleviate congestion, but this is by no means the sole focus of the package. Our objective is to provide a safe and integrated transport system that spans all transport modes, and is accessible to all New Zealanders.

The package also incorporates a comprehensive land transport package, covering roading, public transport, rail, the needs of pedestrians and cyclists, road safety and regional development. The costs of this package are largely offset by revenue from petrol excise and road user charges.

Providing high-quality social services

Social services and employment initiatives will…

We are providing a total package of $223 million over four years to enhance the quality and availability of social services in the community. The total package includes:

- a range of initiatives to address disincentives to entering the workforce, including subsidies for out-of-school care and payments to beneficiaries moving into employment to ensure that there is no discontinuity in income during the transition

…encourage greater participation in the workforce

- increasing the number of case workers for recipients of Domestic Purposes and Widow's benefits. This will reduce caseloads and allow adequate contact time with recipients
- funding aimed at increasing the participation of people with disabilities in paid employment and in their communities. The strategy aims to reduce disparities in service provision to groups under-represented in current vocational services, including Māori with disabilities, Pacific people with disabilities, people living in rural areas, and those experiencing psychiatric disability.

We will provide more and better quality housing…

The Budget 2002 funding package includes an allocation of $178 million capital over four years for housing. This includes:

- $100 million for state house acquisitions and modifications to existing state houses under the "Healthy Housing" project
- $30 million for community house acquisitions
- $48 million to address substandard housing in Northland, the East Coast and the Bay of Plenty.

Budget 2002 supports this Government's policy of reducing the incidence and impact of crime. Initiatives include:

…and help ensure that New Zealand is a fair, safe and culturally vibrant country…

- reducing youth offending and violent crime in partnership with Police, local authorities and community groups
- rehabilitating serious adolescent offenders who are at risk of progressing to adult imprisonment using Day Reporting Centres and a pilot Youth Residential Programme
- reducing intergenerational offending by integrating offenders effectively back into their families and the community
- putting extra resources into both the Crown prosecution service and the Serious Fraud Office
- providing benefits to society through initiatives such as a human rights plan of action and enhanced electoral processes.

A modern society is one that celebrates our unique culture and identity. The Budget package continues and strengthens the arts, an area that has received our ongoing attention. We will:

- maintain current funding levels for Creative New Zealand
- develop the Auckland War Memorial Museum
- provide $72 million for the TVNZ Charter and New Zealand On Air, over four years.

…that puts particular emphasis on Maori and Pacific Island needs…

The package reflects this Government's emphasis on meeting the needs of Māori and Pacific Island people. This emphasis runs throughout the package, and includes:

- a particular focus on meeting Māori educational needs (for example Kura Kaupapa Māori Teacher Study Awards and Le@rning Federation and Te Kete Ipurangi: The Online Learning Centre)
- contributing to Māori language outcomes through continued support for Te Mangai Paho
- supporting Māori and Pacific Island interests throughout the community (for example measures to address substandard housing in Northland, the East Coast and the Bay of Plenty, Anau Ako Pasifika, professional development for teachers of Samoan and continuing the Youth Court Pacific Community Liaison Service at Manukau).

…and which values and nurtures our natural environment

Budget 2002 also continues to balance the protection of our environment and natural resources with encouraging innovation and growth. Initiatives include:

- biotechnology funding to harness the benefits of genetic modification and biotechnology, while ensuring society's and the environment's values are preserved
- implementing the New Zealand Waste Strategy, and establishing a fund for the clean-up of contaminated sites
- funding to strengthen our capability to respond to an increasing number of biosecurity threats in NZ
- funding to implement the National Energy Efficiency and Conservation Strategy.

Strengthening New Zealand's Security

Budget 2002 supports our desire to keep New Zealand and New Zealanders safe

The Budget package incorporates a package of spending that responds to the terrorist attacks of 11 September. The new funding is shared across eight Votes, and includes enhancing border control, aviation security, and protective security measures at high-profile or significant facilities.

The package also allows for improvements to New Zealand's capacity to respond to specific security incidents such as terrorist emergencies, including those of a chemical or biological nature.

Key initiatives

($ million) GST incl	2001/02	2002/03	2003/04	2004/05	2005/06	Total
Customs	-	3	3	3	3	12
Immigration	-	2	2	2	2	8
Intelligence agencies	1	5	5	5	5	21
Police	-	1	3	3	3	9
Defence (capital)	-	2	-	-	-	2
Total	**1**	**12**	**13**	**13**	**13**	**52**

Summary

The Government is proud of its achievements over the past three years, which are consolidated in Budget 2002. We are signalling a course that will help move New Zealand forward as an innovative, skilled and dynamic nation, in balance with sound fiscal management.

Budget 2002 – Summary of the Treasury's Economic and Fiscal Forecasts

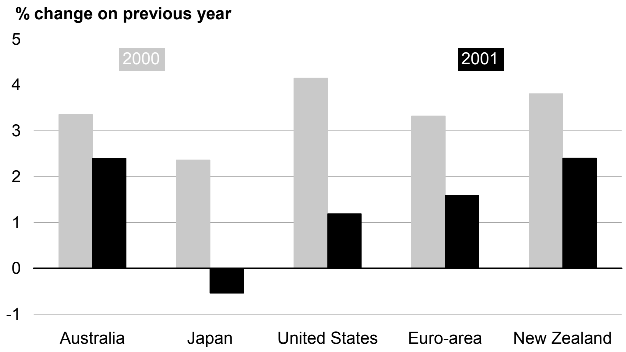
Economic Outlook

The New Zealand economy has weathered the slowdown in global growth well

- The New Zealand economy has evolved somewhat better than expected at the 2001 *December Economic and Fiscal Update (December Update).*

- Quarterly GDP growth averaged around 0.4% over the second half of 2001, with the economy growing 2.4% in the year to December 2001. Growth in both the September and December quarters was characterised by strong domestic demand, partially offset by a weaker external sector.

Figure 1.1 – Real GDP growth



Sources: Datastream, Statistics New Zealand

- The economy looks to have grown by around 1% in the March quarter, driven by household spending and a rebound in exports.

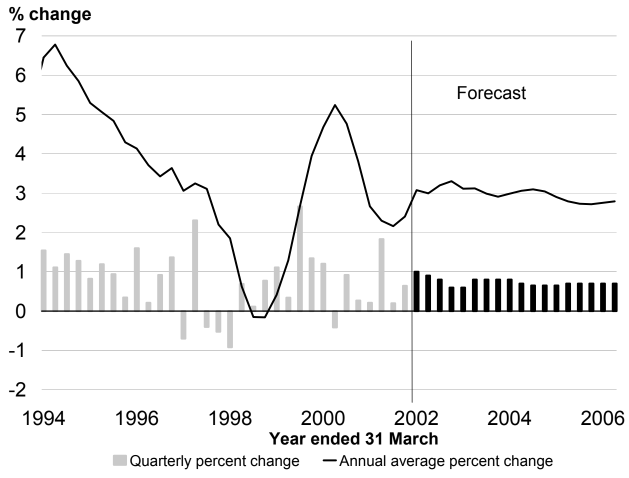
- Since the *December Update,* expected trading partner growth for 2002 has been revised up from 1.9% to 2.6%, owing to a better than expected end to last year and start to 2002, rather than stronger growth going forward. While growth for 2002 is expected to be stronger than actual growth in 2001, trading partner growth remains below trend.

Economic growth is set to remain robust…

- Looking forward, New Zealand's GDP growth is expected to be 3.1% to March 2003, which is significantly better than the 1.9% expected in December.

- One of the key changes since December is a substantial turnaround in net migration. In the short term, the impact is likely to be more on demand than supply, putting pressure on the economy's capacity. Over the medium term, the demand and supply effects of the increase in net migration will become more balanced as migrants enter the labour force.

Figure 1.2 – GDP growth



Sources: Statistics New Zealand, The Treasury

…although domestic demand is expected to slow

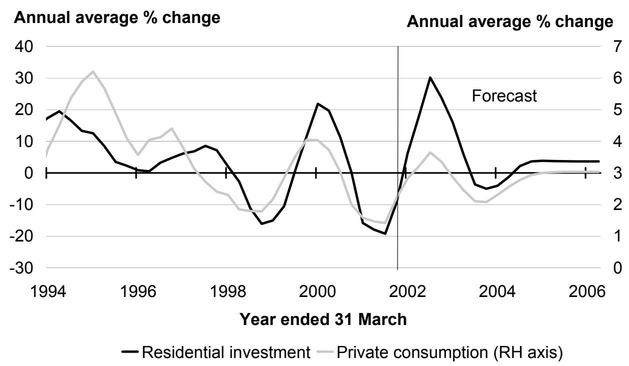
- After displaying strong growth over the second half of 2001 and the first quarter of 2002, employment growth is forecast to slow over the rest of 2002 as some of the drivers over the past year are not repeated and as firms seek to improve productivity. Nevertheless, the labour market is expected to remain tight by historical standards, with the unemployment rate staying close to current levels. Wage growth is expected to rise slightly.

- After accelerating over the year to March 2002, quarterly consumption growth is expected to moderate over the year ahead, reflecting slower growth in labour income, a decline in farm income and rising interest rates.

- Residential investment is expected to display ongoing growth over much of 2002, before contracting over late 2002 and early 2003.

- Business investment is forecast to accelerate over 2002 and early 2003, growing at around 2% in the year to March 2003 underpinned by two good years of economy-wide profit growth and strong growth in domestic demand. Investment growth loses momentum in the second half of 2003 as profit growth slows.

Figure 1.3 – Consumption and residential investment



Sources: Statistics New Zealand, The Treasury

Solid export volume growth in the year ahead

- The recent recovery of merchandise export volumes, largely in dairy and meat exports, will become more modest in the year ahead. Non-commodity manufactured exports are projected to display robust quarterly growth, benefiting from the delayed impact of the depreciation in the currency and stronger trading partner growth.
- The projected strength in services exports in the year ahead reflects tourism picking up after the fall following 11 September, as "normal" travel patterns resume more quickly than was assumed in the *December Update*.
- The full impact of the sharp drop in global growth on export prices has still to be felt, with world export prices forecast to decline through until the second half of 2002, and New Zealand dollar export prices expected to fall by 12% in the March 2003 year.

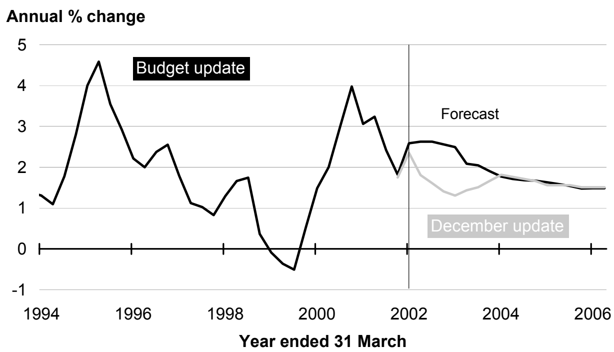
Inflation remains persistently high over 2002

- Annual CPI inflation has been strong recently, and is expected to remain at or above 2.5% over the remainder of 2002. This reflects some one-off price increases, wage growth in excess of productivity, together with strong GDP growth in the year ahead which allows some room for firms to rebuild margins. Inflation is likely to reduce going into 2003, largely because of slowing unit labour cost growth.
- With growth set to remain strong in the year to March 2003, the Reserve Bank is assumed to move monetary policy back to a more neutral footing, by taking the Official Cash Rate (OCR) to 6% by the end of 2002.

GDP growth remains robust in the medium term

- With trading partner growth accelerating to 3.6% in 2003, as well as the economy benefiting from business investment and employment growth, GDP growth of 3% is expected in the year to March 2004. Growth converges back to around the economy's long-run trend towards the end of the forecast period.

Figure 1.4 – CPI inflation

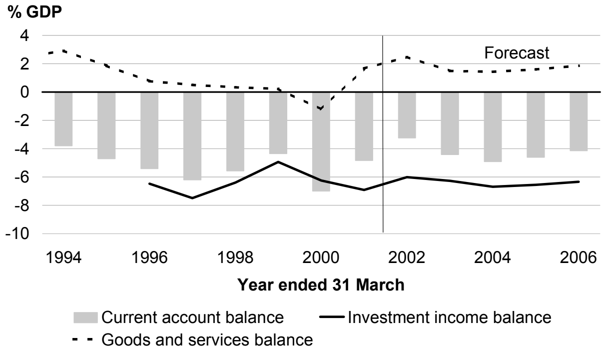


Sources: Statistics New Zealand, The Treasury

The current account deficit is expected to increase over the short term

- Despite total export volumes gaining some momentum in the year ahead, the current account deficit is expected to increase to around 4.5% of GDP in the second half of 2002 and to around 5% in 2003/04. This is largely due to the impact of stronger consumption and investment on import growth over the March 2003 year. Government defence spending also adds to the import profile over the forecast horizon.

Figure 1.5 – Current account balance



Sources: Statistics New Zealand, The Treasury

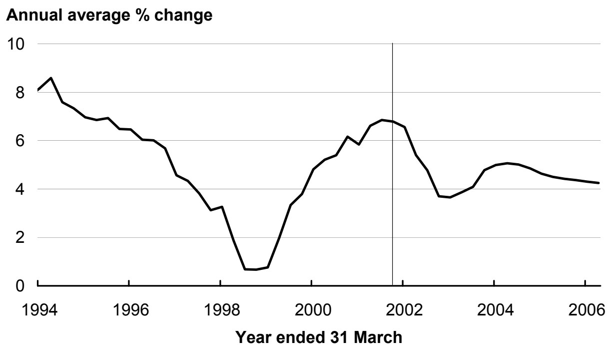
- Following the forecast increase in the current account deficit over the March 2003 and 2004 years, the current account deficit is expected to reduce somewhat towards the end of the forecast horizon. The initial improvement in the deficit is driven by a slowdown in import growth, as consumption and investment growth slows in the March 2004 year and into 2005. A continued steady improvement in services exports also helps to underpin the decrease in the current account deficit.

Nominal GDP growth is more cyclical

- While the near-term profile for GDP growth is relatively flat, nominal GDP growth is considerably more cyclical, owing to movements in the GDP deflator accentuating the cycle in GDP.

- After growing 6.6% in the year to March 2002, nominal GDP growth is forecast to slow to 3.7% in the year to March 2003, before rising to 5% in the year to March 2004.

Figure 1.6 – Nominal GDP



Sources: Statistics New Zealand, The Treasury

- Over the last two years of the forecast horizon the nominal economy is expected to grow at around 4% to 5%, owing to the combination of steady GDP growth and inflation around the mid-point of the Reserve Bank's target band. The higher level of nominal GDP throughout the entire forecast period, compared with the *December Update*, underpins the solid growth in tax revenue feeding through to an improved fiscal position.

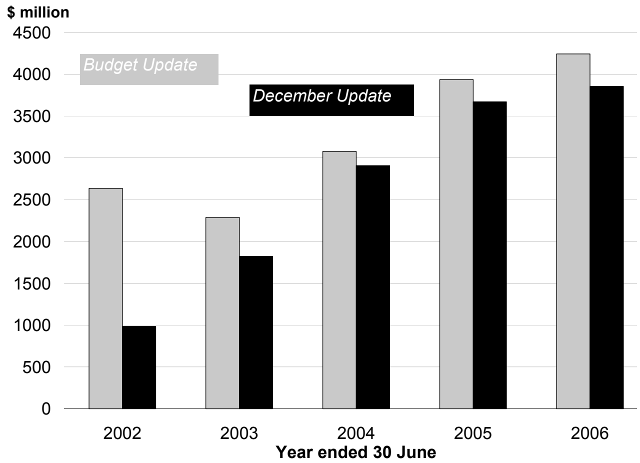
Fiscal Outlook

The fiscal outlook has improved since the December Update

- The *December Update* forecasts reflected a weaker position from the 2001 *Budget Economic and Fiscal Update*, largely reflecting changes to the economic forecasts, particularly the world outlook. The fiscal forecasts are much improved on those in the *December Update*, driven in large part by the economic forecasts discussed in the previous section.

- Tax revenues are higher by at least $600 million per year, largely representing the unwinding of the downwards revisions in the *December Update*, driven by changes to the nominal economy forecasts. The forecasts for nominal GDP are between 1-1.5% higher than they were in the *December Update.*

Figure 1.7 – Operating balance (comparison with the *December Update*)



Source: The Treasury

- Benefit expenses continue to fall but are more than offset by increases in education expenses owing to demographic forecast changes, and a $200 million impact on the operating balance from 2003/04 resulting from 2002 Budget decisions.

- Positive net ACC and GSF valuation changes of $570 million since the *December Update* have also increased the operating balance in the 2001/02 year.

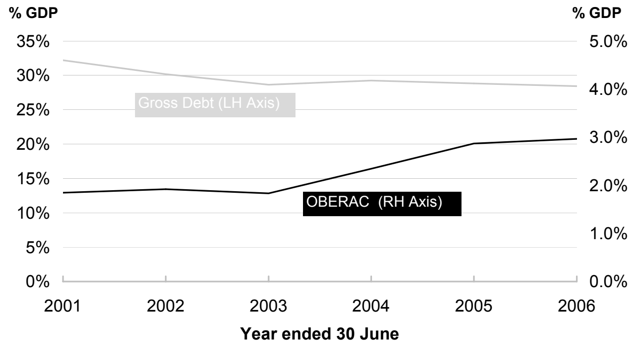
- Relative to the *December Update* the forecast cash outflows for the period 2001/02 to 2005/06 have reduced by a net $2.4 billion, reflecting improved cash flows from operations. As a result, both gross and net debt decrease relative to the *December Update.*

- A consequence of the cash flow improvements is that the 2001/02 bond programme has been reduced by $350 million (accommodated by the cancellation of the 20 June 2002 bond tender). The 2002/03 bond programme has been established at $3.4 billion, significantly lower than the $5.1 billion signalled in the *December Update.*

- Much of the change to the fiscal forecasts since the *December Update* bring the operating balance forecasts broadly back to the levels in the 2001 *Budget Update* from 2002/03.

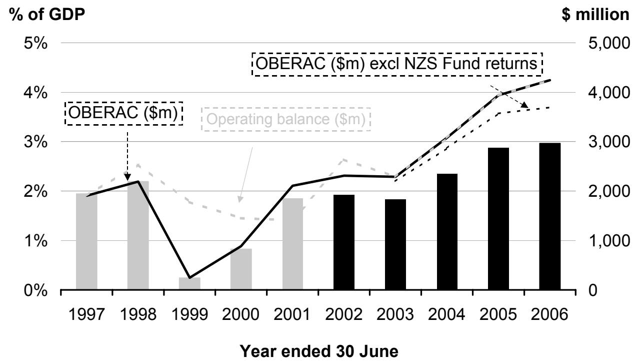
- Other key features relative to the 2001 *Budget Update* are:
  - The operating balance for the 2001/02 year is higher, mainly owing to higher tax revenue and GSF valuation movements ($420 million).
  - Debt is lower in all years reflecting the stronger 2001/02 year and the improved opening debt position reflected in the actual 30 June 2001 Crown financial statements.
- The positive operating balances are sufficient to enable gross debt to remain just below the Government's debt target of 30% of GDP, given the level of investment activity. The factors contributing to this are discussed in the following sections.

Figure 1.8 – Gross debt and OBERAC as a % of GDP



Source: The Treasury

Figure 1.9 – OBERAC (% of GDP and $ million)

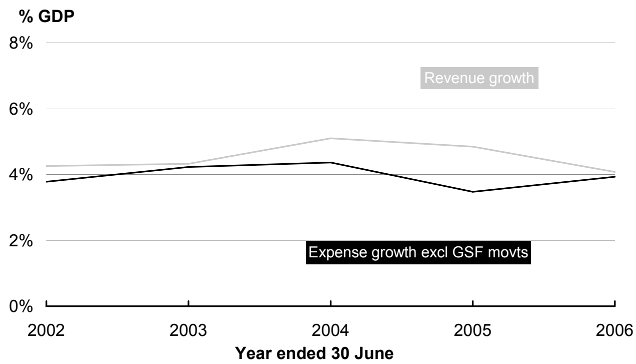


Source: The Treasury

Operating balance rises over the forecast horizon…

- The forecast 2001/02 operating balance is $2.6 billion (2.2% of GDP).
- Excluding the ACC and GSF valuations, the OBERAC (operating balance excluding revaluations and accounting policy changes) for 2001/02 is $2.3 billion (1.9% of GDP).
- The OBERAC falls in 2002/03 as a percentage of GDP.
- The operating balance is expected to rise to 3% of GDP by 2005/06 ($4.2 billion).

Figure 1.10 – Revenue and expense growth



Source: The Treasury

…due to tax revenue growth remaining higher than expense growth…

- Tax continues to grow by an average of 4.5% across the forecast period. The strong growth continues in line with previous updates, but is moderated by reduced (but still positive) growth in business tax in 2001/02.

- Expense growth averages around 4% per annum over the forecast period.
- Downward revisions in benefit expenses, owing largely to lower unemployment benefit numbers, remain a feature of overall expense growth.
- Health and education demographics continue to be a key driver in expense growth in addition to the forecast new spending.

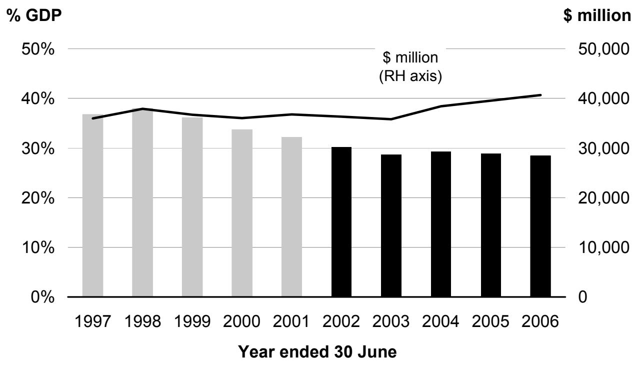
...enabling the Government to continue to apply surplus cash to its investment programme

- The rising operating surplus translates to a similar level of cash flows from operations, generating approximately $15.8 billion operating cash surpluses over the period 2001/02 to 2005/06 to fund investing activity.
- Investment outlays of $24.1 billion outweigh operating cash surpluses by $8.3 billion. These outlays include: maintaining and improving the existing asset base and providing injections (e.g. for the Air New Zealand recapitalisation package); investing in the New Zealand Superannuation Fund (NZS Fund); and funding advances (which mainly include student loans and Crown entity private debt refinancing).

Debt is relatively flat as a percentage of GDP, although rises in nominal terms

- Over the period, gross debt falls as a percentage of GDP from around 32% at 30 June 2001 to 30.2% in 2001/02. Thereafter it averages around 29% and is 28.4% by 2005/06. For the same period, net debt averages around 17% of GDP before falling in the last two years to 15.5% by 2005/06.
- Gross and net debt rise slightly in the middle of the forecast period. This is mainly due to the timing of planned capital spending.
- Gross debt increases by $3.9 billion in nominal terms from 30 June 2001 to the end of the forecast period. This, in conjunction with a decrease in marketable securities and deposits of $4.8 billion, funds the shortfall between operating cash flows and investment outlays.
- The domestic bond programme for 2002/03 has been set at $3.4 billion, down from the forecast $5.1 billion in the *December Update*.

Figure 1.11 – Gross debt (% of GDP and $ million)



Source: The Treasury

Government Budget decisions

- The Government has allocated all but $230 million of the $6.1 billion fiscal provision since Budget 2000. The $230 million is set aside as a contingency to manage risks in between the 2002 and 2003 Budgets. The tables below provide a breakdown of the Government's three-year fiscal provision from 1999/2000 to 2002/03 for both operating and capital:

Table 1.1 – Fiscal provisions to 2002/03

Fiscal provisions ($ million, GST inclusive)	**1999/2000**	**2000/01**	**2001/02**	**2002/03**	**Total**
Budget 2000 decisions	420	1,050	1,060	1,120	3,650
2000 contingency decisions	-	99	74	78	251
Budget 2001 decisions	-	52	532	526	1,110
2001 contingency decisions	-	-	51	125	176
Budget 2002 decisions	-	-	(7)	715	707
2002 contingency provision	-	-	-	230	230
Total	**420**	**1,201**	**1,710**	**2,794**	**6,124**

Source: The Treasury

Table 1.2 – Capital spending to 2002/03

Capital provisions ($ million, GST inclusive)	**1999/2000**	**2000/01**	**2001/02**	**2002/03**
Capital provision - *December Update*	(69)	639	2,291	1,585
Budget 2000 decisions	(54)	827	576	568
December Update 2000 decisions	(15)	(58)	(4)	40
Receipts from spectrum sale	-	(135)		
Budget 2001 decisions	-	5	369	204
December Update 2001 decisions	-	-	76	27
Budget 2002 Decisions	-	-	1,151	407
Total decisions to date	(69)	639	2,168	1,246
Planned commitments pre-Budget 2002	-	-	123	339
Budget 2002 rephasing of commitments	-	-	(123)	(119)
Budget 2002 increase to forecast commitments	-	-	-	-
Forecast capital commitments	-	-	-	220
Total provision to 2002/03	**(69)**	**639**	**2,168**	**1,466**

Source: The Treasury

- In the next parliamentary term, the Government plans to revise the provisions framework to ensure the focus will be on the operating and debt tracks and their consistency with the fiscal objectives. This compares with the current focus on a set nominal limit for the electoral term.

- Looking forward, the Government will balance the operating and capital components alongside NZS Fund contributions.

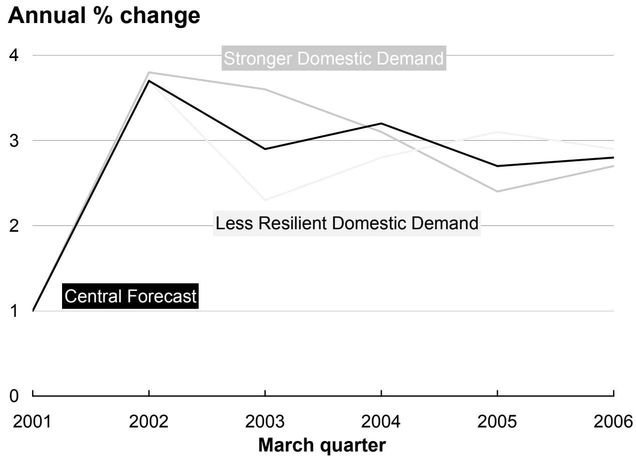
- Under current operating balance projections, the Government could accommodate operating expense growth of around 2.5% per year and capital investment on average of around $500 million to $600 million per year. This is consistent with making contributions to the NZS Fund as planned. The forecasts reflect amounts for forecast new spending consistent with this approach.

The fiscal forecasts are highly sensitive to risks around the economic forecasts

- The Central Forecast is determined by balancing both the upside and downside risks facing the economy, to provide the best assessment of the way the economy is likely to evolve. Some of the key judgements or risks may evolve differently, resulting in the economy deviating from the Central Forecast.

- If domestic demand is stronger than assumed in the Central Forecast, a possible growth path for the economy is one where private consumption and residential investment hold up through 2002/03 by more than anticipated, and where the turnaround in net migration adds less to productive capacity. This would see GDP growth accelerate to 3.5% in 2002/03 compared with 3.1% in the Central Forecast. However, with the economy growing above capacity, inflationary pressures would build up and monetary conditions tighten to bring inflation to within the target band. This would lead to slower growth in the following years.

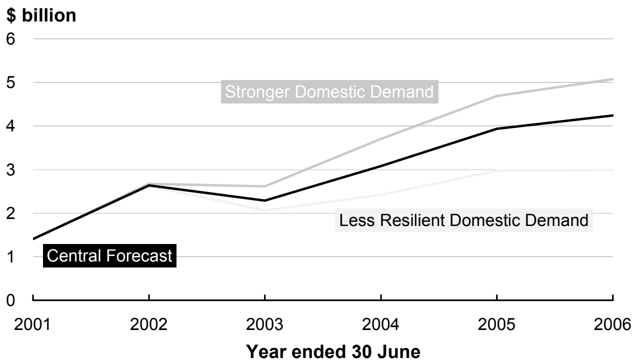
Figure 1.12 **–** Real GDP growth



Sources: Statistics New Zealand, The Treasury

- Alternatively, domestic demand may lose its momentum more quickly, with lower consumption, residential investment and employment growth in the near term compared with the Central Forecast. Under this scenario, GDP growth would slow to 2.7% in 2002/03 and 2.3% in 2003/04. Growth would recover to 3.3% in 2004/05 as monetary conditions remain stimulatory for longer.

Figure 1.13 **–** Operating balance



Sources: Statistics New Zealand, The Treasury

- These effects will flow through into the Government's operating balance. Under a Stronger Domestic Demand scenario, a higher nominal GDP relative to the Central Forecast will result in a higher operating balance throughout the forecast period. However, if domestic demand were less resilient, the operating balance would be lower throughout the forecast period compared with the Central Forecast.

- The changes in the operating balance will also have an impact on gross debt. A higher operating balance would lead to lower gross debt as a percentage of GDP, because both GDP and operating surpluses would be higher. The converse is true in the case of a lower operating balance.