CHAPTER 1

OVERVIEW

1.1 A sound economic position

The incoming Government inherits a sound economy and does not face a fiscal or policy crisis. Since the recession ended in mid-1991, the economy has performed strongly. Output has grown by 19.2% and employment has increased by over 220,000 jobs. The government's finances have improved significantly.

Over the past five years the economy has performed strongly.

The economy has slowed over recent months. However, this is not cause for concern. Most economic forecasters consider the New Zealand economy to be around the low point in the economic cycle. In our pre-election forecasts, we estimated that this low point would have growth remaining at over 2%, employment continuing to rise, and inflation at just over 2%. Even at this low point, we are seeing performance that is better than the average for the 1970s and 1980s.

Relative to New Zealand's recent history, the incoming Government can set its sights higher than its predecessors. Internationally, many people now see New Zealand as a country whose economic prospects are among the best in the world. But the Government will need to guard against complacency — strong economic prospects still need to be turned into real gains for individuals.

1.2 The basis for prosperity

New Zealand has had some prosperous spells in the past. For example, in the early 1950s the Korean war wool boom saw New Zealanders enjoying some of the highest per capita incomes in the world. Similarly, the commodity boom of the early 1970s was also a heady time for New Zealanders. However, the booms did not last. Both of these periods of prosperity were followed by a resumption of the steady relative decline that New Zealand has endured for much of the period since the second world war. Clearly, a central issue for economic policy is whether the recent improvement is a repetition of past brief upswings.

The basic difference between the growth that New Zealand has seen in the 1990s, and the temporary upswings of the past, is that on this occasion growth is not the result of improvements in the terms of trade or some other lucky

event in international activity. In addition, fiscal surpluses and moderate inflation demonstrate that New Zealand's growth is not the result of fiscal or monetary stimulus.

The recent increases in employment, exports, investment and output are derived from the efforts of many people, supported by significant changes in economic policy over the past decade.

Key priorities include fiscal policy, training and skills issues, savings and retirement policy, and reducing social welfare benefit dependency.

Economic growth comes from the productive work of individuals. This is supported by efficient investment as businesses develop products and markets. The growth in employment and business investment that we have seen in recent years shows that economic policy settings have provided a consistent and supportive balance, so that it is worthwhile for people to pursue productive opportunities. The combination of openness to trade and capital flows, flexibility in the labour market, stability in prices, and control of the fiscal position has been the key factor underlying the improvement in confidence in the economy. The overall effectiveness of economic policy depends on these policies reinforcing each other.

This does not mean that the current key policy settings are perfect. There are areas where improvements would be desirable. However, before changing fundamental economic policy settings, it is critical to be confident that the results of the change will be better than would occur under existing policies. Given our recent economic success, that is an exacting test.

On the other hand, as long as some key policy priorities are attended to, there are real prospects of improved performance in future years. In addition to maintaining an open and competitive economy, the key priorities for the next few years include fiscal policy, training and skills issues, savings and retirement policy, and policies to ensure that compassionate support for those in need does not create a trap that excludes people from participating in society.

1.3 Responsible fiscal management

The fiscal position is stronger now than it has been for many years. However, this does not mean that there is an opportunity for additional generosity. On the contrary, any Minister of Finance must guard a strong fiscal position. It is very easy to lose a fiscal surplus in the short-term pursuit of pressing goals. The problem is that, once lost, a fiscal surplus is very painful to regain, and the pain commonly falls on those with the lowest incomes and

the fewest assets. Our own recent history demonstrates the costs associated with re-establishing a strong fiscal position. Similarly, many other countries have found that their ministers of finance have had to undertake very unpopular measures in order to restore fiscal stability, lost as a result of a short-term reaction to apparent fiscal strength.

During the term of this Government, we expect a steady demand for resources to be devoted to important public services, especially education and health care, as well as to social welfare support and other costs of public administration. Alternatively there may be pressures for further tax reductions. Pressures for more spending are always there, and are an inevitable result of the public supply of valuable social services at low cost to the consumer. Providing services free or below cost requires rationing. The question is rationing at what level? There are good reasons why it is important to avoid adding the cost of more expenses to budgeted expense growth or further tax cuts in the short term.

Current policy settings are approaching the upper limits of stress that can be reasonably imposed on macroeconomic stability.

- Recent increases in spending have already provided substantial extra funding, particularly in education and health, and the effects of those decisions will become apparent in 1997/98. The existing budget baselines allow for new expenditure growth and mean that expenditure in 1999/2000 on health will be 11.4% higher than in 1995/96, education 15.7% higher and welfare 6.4% higher.
- This extra spending, combined with the current two-year tax cut programme, represents a significant level of economic stimulus. In our judgment, the current policy settings are approaching the upper limits of stress that can reasonably be imposed on macroeconomic stability; and additional stimulus would have adverse effects on interest or exchange rates. If there were to be spending initiatives or tax reductions in the coming two years, we would recommend that this should be offset by adjustments to the current tax programme or reductions in other expenditure.
- Though the fiscal forecasts are our best estimate of likely outturns on the basis of existing policy, it is inevitable that any forecast has an element of uncertainty. A current example of this is company tax. In the month since the Pre-election Economic and Fiscal Update (PreEFU) forecasts were completed, company tax receipts have dropped below our forecast track. It is too early to be sure how much this simply reflects a change

in the timing of tax payments, which will be restored by later tax flows. Alternatively, receipts could be a few hundred million dollars less than what we forecast in the Pre-Election Economic and Fiscal Update. This is normal uncertainty, which illustrates the need for caution in fiscal planning.

- The incoming Government should not determine its ability to spend on current priorities simply by reference to the current balance of receipts and payments; a prudent eye should be kept on future fiscal developments. We need to plan for sufficiently comfortable surpluses so that we have some buffer against unforeseen adverse events. In addition, we have an aging population. In decades to come, support for that aging population will create greatly increased pressure, and it is hard to imagine a better time to save to meet that pressure.

The key longer-term fiscal issue is the aging of our population over the next few decades.

The Fiscal Responsibility Act 1994 requires forward-looking fiscal management with a transparent, prudent and medium-term approach. Prudence demands that we identify long-term fiscal pressures and move to address them before they become severe. It also demands that we maintain a "buffer" against adverse events, in the form of a surplus at about current levels, until the balance sheet strengthens. The Fiscal Responsibility Act requires the government to look continually for fiscal threats, and to publish a full account of the fiscal position so that everyone concerned can see the short-term and long-term pressures.

The key longer-term fiscal issue is the need to address the aging of our population over the next few decades. On current policies, the costs of superannuation and healthcare will rise substantially as the population ages. The Government has a chance, over the next few years, to initiate long-term policy adjustments which will improve our ability to manage the costs of caring for the elderly in the next century. We are well placed right now, because the economy is strong and the numbers becoming eligible for superannuation payments are low. Well-designed policy changes that address the looming costs of an older population could contribute substantially both to the strength of the economy, and to the welfare of the aged in New Zealand in years to come.

Three specific issues that will be significant for fiscal planning, and for the economy, include the promotion of a skilled labour force, the development of a robust savings environment, and the improvement of our welfare system.

1.4 Improving skills

Our success in the world depends critically on the ability of New Zealanders. In the foreseeable future, New Zealand will not be a dominant supplier of any product. We cannot expect to dictate terms in any market. Instead, we will be a small producer and a niche marketer.

This is not a problem, if we are quick to identify opportunities and act on them. That quickness will depend crucially on the skills of individuals.

We need to be world class at management, technology and communication. Both the more formal skills of mathematics, literacy and language, and the more personal skills of working and living together, are vital ingredients in the recipe.

Education is crucial for economic success and for New Zealand's success as a cohesive society.

We need to set high standards and that requires a strong and flexible school system, top-class tertiary education and training institutions, and workplaces that prize learning opportunities for all their employees. Schooling and training can never be seen solely as private or public issues. There are many students and workers with different learning needs, and many skills are needed. These cannot all be prescribed centrally. We cannot hope to address the goal of a highly skilled population through one single approach to education and training, but we can build a culture which prizes learning and rewards personal development.

The importance of education and training does not relate solely to our economic success as a nation. It is also crucial to the success of New Zealand as a cohesive society. Statistics tell us that many of those whose lives are blighted by long-term benefit dependency have never enjoyed a successful education. The more that our education and training systems can become places of success for Maori, Pakeha and all races, for young men and young women, and for older people learning new skills, then the more our economic success will be strengthened to the benefit of all.

1.5 Saving for the future

As well as our natural endowments, another key contributor to the future prosperity of New Zealanders is their accumulation of assets which can be used to generate future earnings.

There is no simple test of whether a country is saving enough. However:

- The deficit in the current account of the balance of payments tells us that more is being spent in New Zealand (both in investment and consumption) than we are earning. We have to access foreign savings to sustain current investment rates.
- Looking further ahead, the aging of our population, and the increase in the number of people who will be dependent on the efforts of each working-age New Zealander, means it is important for people to build their assets now to produce an income in years to come.

At present, other people's savings are funding much of our investment, largely through foreign direct investment. That is good news in itself, because the economy is growing and we are able to utilise international capital to accelerate growth and create jobs. We are also enjoying extra benefits through the access to technology, materials or markets that international investment can bring. However, foreigners only invest here because they expect a share in the returns. If New Zealanders want a larger share of the economic growth, and to benefit more from growth in other countries, they will have to save more and invest these savings wisely.

Superannuation is important because of the effect it has on the work and savings plans of individuals.

This does not mean that we should introduce specific policies to encourage savings. Rather we should be wary of government policies which discourage savings. For example, we should always examine taxation policies to see whether they are biased against saving. Similarly, maintaining price stability is important because inflation can discourage saving. But most importantly, we must always look to the potential problems that are created by the state acting on behalf of individuals, in a way that removes the need for them to accumulate their own savings (especially if the state will not save enough by running large enough surpluses).

Superannuation is particularly important. To the extent that current policies create an expectation of state support, then people are less likely to accumulate the assets they need to support themselves. The adoption of a sustainable superannuation policy is not simply a fiscal priority, it is also important because of the effect it has on the work and savings plans of individual New Zealanders throughout their working lives.

1.6 Reducing levels of dependency

Economic growth in New Zealand has recently been very broad-based with many people moving into employment. This job-rich growth has spread the fruits of prosperity more widely, and is vital to the social success of economic policy. The main process by which inequality is reduced is through increased employment, and the recent growth in jobs has reduced earlier income disparities.

However, though the unemployment rate has dropped, the overall level of dependency on social welfare benefits remains high. The number of sickness, invalids and domestic purposes beneficiaries is still high and rising. In particular, the proportion of beneficiaries who have been on the benefit for long periods remains high.

Life on the benefit can be hard, and prolonged periods on the benefit damage the employability and income prospects of beneficiaries. Unfortunately, any attempt to improve life for those on the benefit comes at the cost of making it harder (or less attractive) to get off a benefit. This points to the fact that policies to alleviate poverty should not focus solely on the short-term position of low income households.

Reducing dependency remains a priority issue for both fiscal and social reasons.

A high proportion of those who receive low incomes in any one year (perhaps as a result of job loss or a family break-up) can expect to enjoy better incomes in future years (as they re-enter employment or a relationship). However, some are less successful, and they must be the focus of policy.

In recent years a series of policy approaches have had different successes with different groups. The 1991 cuts in benefit rates improved the relative returns from paid employment. Recent statistical studies suggest this has contributed to the increase in the number of people in jobs. The 1996 tax cuts, combined with the Independent Family Tax Credit and the alterations to abatement rates for part-time earnings for sole parents, are designed to create a similar effect. In addition, both the Department of Labour and the Department of Social Welfare have implemented a series of individual case management programmes to encourage and assist long-term beneficiaries into work.

These policies are helping to reduce dependency but this will remain a priority issue, both because of its fiscal consequences and the social significance of high rates of welfare dependency.

1.7 Conclusion

Our own recent experience, and recent international experience, provide graphic examples of the effect that the overall policy approach can have on the success of an economy. In particular, the differences between North and South Korea, and between East and West Germany, demonstrate the very real effects that different approaches to policy can achieve between two parts of the same country. Similarly in New Zealand, the difference between the slower economic growth of the 1950s to 1980s and the current dynamism is largely attributable to the shift in the approach to economic management.

There is no one single policy that matters most. The object is to assemble a range of complementary and consistent policies that provide a reasonably stable policy environment. This is because individual decisions to work, save or spend are made every day in thousands of homes and workplaces. If people are to take a forward-looking approach to these decisions they need to know that there is a reasonable prospect that saving more, working harder, and investing in skills will leave them much better off over time.

If the credibility of overall policy is maintained, the incoming Government can build from a firm foundation.

For most people, most of the time, it is the overall stance of government policy that matters. Do the various policies make sense as a whole? Do they complement each other, so that fiscal settings, the monetary framework and underlying microeconomic incentives reward effort and saving? Do current policies have an eye to the future so that they are sustainable, and investors need not plan on some future policy correction? This can all be summed up in a word — are government policies to deliver growth and jobs *credible*?

Credibility is not gained in a day. It depends on getting many things right, year-in and year-out. This requires good processes for the design and implementation of policy and for managing the business of government. It has been the bitter experience of many governments around the world that credibility is easily lost. A short-term focus on supporting particular groups is easily spotted. If faith is lost in the future of policy, individuals will be less willing to take the risks associated with saving, working and training for tomorrow — and firms will be less willing to employ, to train, to invest and to develop new products and markets.

On the other hand, if the credibility of overall policy is maintained, the incoming Government can build from a firm foundation. Currently the economy is strong and the fiscal position is strong. A constant focus on preserving these assets and continuing to strengthen them could pay off hugely for New Zealanders in years to come, through more and better jobs, higher incomes and improved security.

CHAPTER 2

PRUDENT FISCAL POLICY

2

Good fiscal policy is an essential part of economic management.

2.1 Introduction

The scope of fiscal policy is wide. In its broadest sense it covers almost everything the government does — its spending and revenue decisions, how it runs its institutions and businesses, and the assets and liabilities it holds. The government's fiscal decisions therefore affect the whole economy, and are an important part of the overall economic environment that people work in. Good fiscal policy is thus an essential part of good economic management.

In considering how best to make fiscal decisions, two key criteria are:

- making sure the money is well-spent
- financing the government's spending decisions in a way which imposes the lowest cost on the economy.

The incoming Government will have many competing demands for expenditure. It could spend money on assets such as roads or public hospitals, or on important public services, such as health and education and social welfare support. Getting value for money means not only ensuring that the money goes where it is most needed — that is, that the most valued projects and activities are undertaken — but also that government activities and investments are run efficiently and achieve their goals effectively.

Government decisions do not solely affect the amount of income people have. They also influence how people make decisions. Influencing the way that people behave is an important part of the economic impact of any policy. If policies discourage people from taking up sound investment or employment opportunities, then the economy is significantly worse off. In general, policies that distort individual decisions as little as possible are least likely to impose substantial costs on society.

One of the most obvious ways in which the government influences behaviour is through the tax system. Taxation is costly, not just because of the direct cost to individuals, and the costs involved in collecting it and administering the system, but also because it can reduce people's willingness to work, save and invest.

These factors suggest that much of the success of fiscal policies is largely related to detailed design and implementation; that is, the overall outcome depends on the quality of the decisions made at every level of government. Subsequent chapters cover some of the issues in this area. This chapter focuses largely on the aggregate constraints within which those decisions are made.

2.1.1 Prudent fiscal management

While there are many competing objectives, there are also constraints on how much government can spend at any one time. Prudent fiscal management means ensuring that these constraints are met over time and that the fiscal position does not deteriorate to an unsustainable level. This means concentrating on:

- maintaining the sustainability of the fiscal position
- managing the risks around the fiscal position to minimise the impact of unwanted shocks
- providing stability and predictability to fiscal policy settings.

The Fiscal Responsibility Act 1994 is designed to encourage good-quality forward-looking fiscal management, through improved accountability and better decision-making. This is achieved through provision for a clear and transparent reporting regime; full disclosure of the short- and long-term impacts of existing fiscal policy settings; and the requirement for a consistent set of short-term fiscal intentions and long-term fiscal objectives.

As a result of good fiscal management and economic growth, the fiscal position looks substantially stronger now than it has been for many years. But there are a number of constraints on the current outlook which may limit the policy options over the next three years. These include:

- the uncertainty surrounding the fiscal projections — this includes both specific fiscal risks and generic risks, such as those surrounding the tax base; the risk from adverse economic shocks; and the uncertainty surrounding trend economic growth
- the balance between monetary and fiscal policy, and the impact on the macroeconomy
- the long-term implications of existing policies on fiscal sustainability.

These factors are discussed in the following sections.

Fiscal Responsibility Act 1994

This Act sets out to do five things:

- increase the transparency of policy intentions and the economic and fiscal consequences of policy
- bring a long-term (as well as an annual) focus to budgeting
- disclose the aggregate impact of a Budget in advance of the detailed annual Budget allocations
- ensure independent assessment and reporting of fiscal policy
- facilitate parliamentary and public scrutiny of economic and fiscal information and plans.

It does so by requiring the government of the day to:

- follow a set of principles of fiscal management, and assess fiscal policies against these principles
- publish reports which detail both its long-term objectives and short-term intentions for fiscal policy
- fully disclose the impact of fiscal decisions over a three-year period in regular economic and fiscal updates prepared by the Treasury, based on its best professional judgment
- use Generally Accepted Accounting Practice (GAAP) to present all fiscal information
- refer all reports required under this Act to the House of Representatives.

These requirements do not bind any government to any particular fiscal strategy, but by requiring high standards of monitoring and disclosure, they encourage responsible fiscal management.

Principles of responsible fiscal management

The Act lays out five principles of responsible fiscal management:

- reducing total Crown debt to prudent levels, so as to provide a buffer against future adverse events, by achieving operating surpluses every year until prudent levels of debt have been achieved
- maintaining total Crown debt at prudent levels by ensuring that, on average, over a reasonable period of time, total operating expenses do not exceed total operating revenues
- achieving levels of Crown net worth that provide a buffer against adverse future events
- managing prudently the risks facing the Crown
- pursuing policies that are consistent with a reasonable level of predictability about the level and stability of tax rates for future years.

2.2 The current situation

The past five years have seen significant improvements in the fiscal position:

- The operating balance moved from deficit to surplus in 1993/94, and has continued to improve, with surpluses reaching $3.3 billion or 3.7% of GDP in 1995/96.

- Crown net worth moved into positive figures in 1995/96, with assets exceeding liabilities by $3.3 billion.
- Net public debt has fallen from over 50% of GDP in 1991/92 to 32.4% of GDP in 1995/96. Net foreign-currency debt was eliminated at the end of September 1996.

In the Pre-election Economic and Fiscal Update, these trends were forecast to continue, given existing policy settings.

The improvement has been due to a number of factors:

- **Strong growth in revenue**. This reflects both ongoing growth in incomes, and a rise in the tax-to-GDP ratio. Tax revenue grew by over 8% per annum between 1991/92 and 1995/96. In particular, company tax rebounded as companies used up losses and began paying more tax. Over the same period, company tax increased by $1.7 billion, or by over 75%.

Fig. 2.1 Operating balance

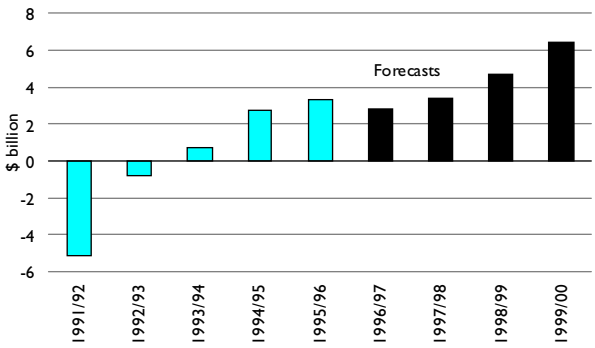


Fig. 2.2 Net public debt

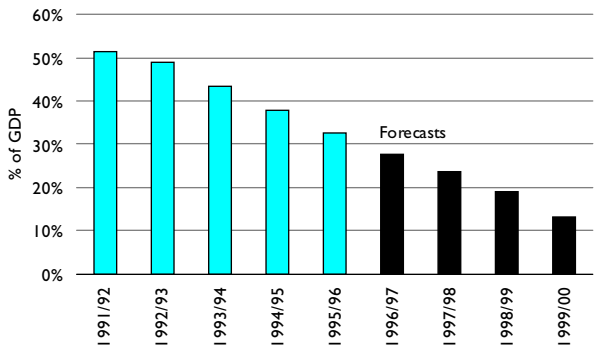


Fig. 2.3 Contribution to the change in operating balance

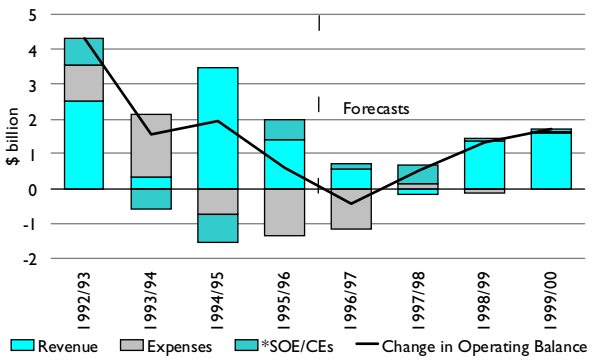
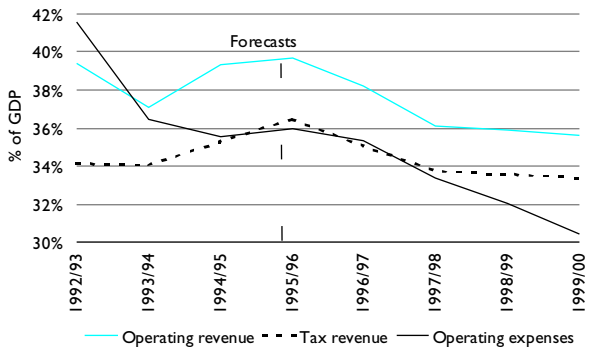


Fig. 2.4 Expenses and revenue as percentage of GDP



* State-Owned Enterprises/Crown entities surplus

Source: The Treasury

- **Slower overall expense growth**. Despite some growth in priority areas such as health and education, total expenses fell in 1992/93 and 1993/94, and grew only moderately in 1994/95. Excluding the one-off effects of foreign exchange gains and other valuation changes, expenses grew in total by 5.5% between 1992/93 and 1995/96.

Post-1994/95, the improvement in the operating balance has slowed, due to increased expense growth and slower revenue growth. In part this reflects the progress made in achieving fiscal gains. Once the operating balance moved into substantial surplus, and net public debt fell to below 40% of GDP, this gave the Government greater capacity to undertake new spending while remaining on track to achieve longer-term fiscal goals.

The cyclically adjusted balance provides a way of judging how policy changes have contributed to the fiscal position.

The strength of the current fiscal position can also be assessed by considering what the underlying "trend" in the operating balance is. The *cyclically adjusted balance* provides a means of judging how much policy changes have contributed to the improvement (that is, permanent or structural changes), and how much might be attributed to temporary fluctuations in economic growth, that is, to cyclical influences that are likely to be reversed over time.

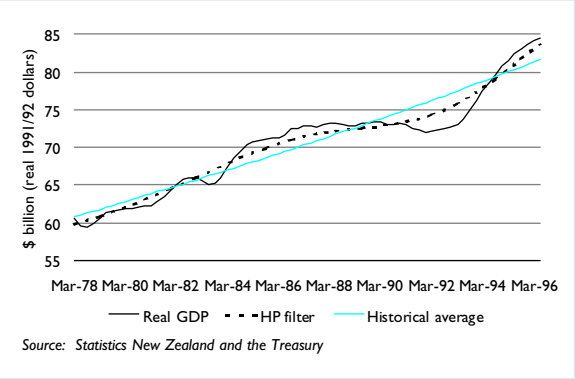
A key assumption is the underlying trend rate of growth; that is, what the average rate of growth might be over a period of time. The higher this rate of growth is, the stronger revenue growth is likely to be on average, and hence the more favourable fiscal outturns are likely to be in the future.

However, the economy rarely grows smoothly over time. At any point in time the economy may be moving above or below its trend level. Uncertainty over the size and timing of such cyclical movements around the trend makes it difficult to judge how much of a change in the fiscal position is sustainable, and how much is likely to disappear as the economy moves through the economic cycle. Thus any method of adjusting the balance for cyclical factors is likely to be indicative of underlying trends, rather than a definitive measure.

The cyclically adjusted balance

The cyclically adjusted balance tries to remove the impact of purely cyclical factors on the fiscal position, such as the impact of changing economic growth on unemployment, or on revenue collected.

Actual GDP and trend GDP



Source: Statistics New Zealand and the Treasury

Picking what the trend rate of growth might be is a difficult judgment, and depends on the method used. Our forecasts in the Pre-election Economic and Fiscal Update incorporated a view of trend growth in the range of 3 to 3½%. The graph shows trend growth of 3½% derived from a standard filtering method to smooth GDP.[1] As an indication of the range of uncertainty around the growth rate, a conservative alternative method is to use the historical average since quarterly GDP data was available, which suggests trend growth of 1.6%.

Once the trend level of GDP is estimated, the operating balance is adjusted based on the gap between actual GDP and trend GDP (or the output gap). The cyclically adjusted balance is therefore a picture of what the operating balance would have been had the rate of growth of GDP been consistent with a steady trend. That is, it removes the influence of temporary fluctuations in growth which are reversed over time.

An important assumption in this calculation is the relationship between growth and tax revenue. Over the long run, the two should be closely correlated. But evidence from outturns over the last four years indicates that some revenue components have shown a high variability to economic growth in the short term.

While nominal GDP has grown by around 20% over the past four years,[2] individual income tax has grown by over 30% and company tax by around 75%. However, from 1987/88 to 1991/92, company tax declined by around 9%. Reasons for the rapid change in tax revenue include the progressive nature of the individual income tax system, the volatility of company income, the use of past losses to reduce tax liabilities for several years, and significant changes to the tax base.

These factors suggest that tax revenue can be very sensitive to changes to GDP. The estimates given here assume that cyclical changes in GDP above or below trend have been associated with percentage changes in company tax revenue that are around 2½ times that of GDP; and that other tax types have changed approximately in proportion with GDP.

In deriving a cyclically adjusted balance, the operating balance is also adjusted for the impact of weaker growth on the unemployment rate, and hence on benefit payments, although these adjustments are small relative to those relating to revenue. Altogether, these estimates suggest that every percentage point GDP has been above or below trend in the past could have led to a change of as much as $400-$500 million in the operating balance.

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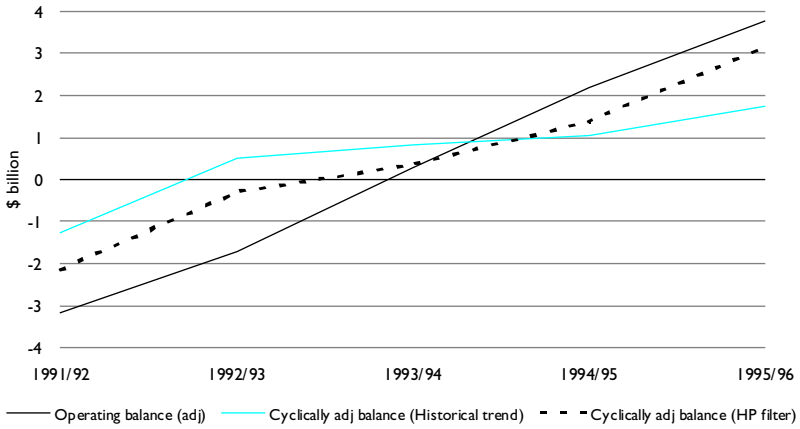
1 The Hodrick-Prescott Filter (HP filter)

2 Four quarter running total, expenditure series, Statistics New Zealand

Fig. 2.5 Operating balance and cyclically adjusted balance using different trend GDP measures[3]



Source: The Treasury

The above graph shows the operating balance, compared with two estimates of the cyclically adjusted balance using different methods of estimating trend GDP (these methods are discussed in the previous box). The extent to which the operating balance is above or below the "trend" balance gives an idea of how much of the surplus may be a result of cyclical economic changes.

Both economic growth and policy changes have contributed to the improvement in the operating balance.

Overall, the results suggest that while economic growth has been an important factor behind the improvements in the operating balance, the cyclically adjusted balance has also improved, suggesting that policy changes have contributed as well.

Estimates of how much of the operating surplus is cyclical in 1995/96 range from around $600 million to $2 billion. That is, a substantial proportion of the current operating surplus is likely to be due to structural factors.

This analysis broadly confirms that the fiscal position seems strong. However, there are many factors to be considered before arriving at a full assessment, and before it is possible to decide how much room there is to adjust current fiscal settings further.

[3] The operating balance has been adjusted for several one-off factors which distort the trend in the operating balance over this period, including the impact of foreign exchange gains, revaluations and other extraordinary items. It therefore differs from the numbers provided in Fig. 2.1.

2.3 Risks to the fiscal outlook

The Pre-election Economic and Fiscal Update forecasts project ongoing operating surpluses and rapid reductions in net public debt.

The forecasts include significant new policy initiatives undertaken in the 1996 Budget, as well as additional initiatives undertaken since then. These new initiatives, together with initiatives undertaken in the 1995 Budget, have resulted in significant increases in spending, in particular in health and education, with health expenses expected to increase by $938 million between 1994/95 and 1999/2000, and education expenses by $925 million over the same period.

The 1996 Budget also introduced tax reductions to be implemented from 1 July 1996, with further reductions planned from 1 July 1997. The full-year costs amount to around $2.3 billion over two years.

These factors explain why the operating surplus is expected to decline in 1996/97, and to rise only slightly in 1997/98, reflecting the impact of the second round of tax cuts. Thereafter, the operating surplus is expected to continue to improve, from a combination of rising tax revenues, falling finance costs, and slow expense growth in other areas.

Behind the favourable outlook are a number of key forecasting assumptions.

The forecasts partly reflect structural factors, such as favourable demographics leading to a decline in the number of superannuitants. However, behind the favourable outlook, particularly in the latter years of the projections, are a number of key forecasting assumptions:

- No new spending or tax initiatives are assumed. Increased spending or tax reductions would also increase debt levels (compared with the forecasts), and hence debt servicing.
- Growth is expected to remain robust, with the underlying trend rate of growth assumed to be around 3½% per annum, and with growth remaining at around this level on average over the forecast period. Slower growth would imply lower tax revenue, higher unemployment benefit expenditure, and higher debt servicing costs.
- The tax base is assumed to remain robust — that is, no significant base erosion is assumed. This implies that tax law will be continually reviewed to offset any new tax avoidance developments.

A 1% error in the tax forecasts changes the fiscal position by more than $300 million.

- There are a number of specific fiscal risks identified in the Pre-election Economic and Fiscal Update which could significantly affect the fiscal position, such as a review of ACC premiums; the impact of a unified pay system for teachers; the contingent liabilities associated with resolution of the Synfuels contract dispute; and liabilities relating to Maui Developments. These are not incorporated into the projections. However, the crystallisation of such risks in previous years (e.g. the Equiticorp judgment) has had significant impact on the projections.

The largest change in the fiscal projections is likely to arise from specific policy decisions, and consequent impacts on finance costs. However, this is largely at the government's discretion.

There are two significant factors beyond the government's control. The uncertainty surrounding the tax forecasts is one of the largest possible sources of errors in the fiscal forecasts. Annual tax revenue is currently around $32 billion, so an error of only 1% has an impact of over $300 million on the fiscal position. Errors may arise not only because of errors in the economic projections, but also because of the difficulty of forecasting taxpayer behaviour, and forecasting the impact of changing tax policies.

A typical example of the uncertainty involved is the current variation in tax flow receipts, with September company tax receipt outturns being substantially below forecast. It is unclear how much of this reflects a real change in profitability, and how much is a change in the timing of tax flows as a result of revised treatment of international dividend payments. Potentially this could lead to a substantial revision of company tax forecasts relative to the Pre-election Economic and Fiscal Update.

In addition, the forecasts are dependent on projections of ongoing economic growth. The uncertainty around these projections is discussed below.

2.3.1 Risks surrounding the economic projections

The fiscal forecasts depend on projections of economic activity. As discussed above, there are several sources of uncertainty surrounding future projections of GDP:

- What is the trend rate of growth? That is, what is the average rate of growth expected over time?
- What is the amount by which GDP might be expected to fluctuate around its trend level? That is, what is the size of the economic cycle?

While cyclical variations around the trend may have significant short-term impacts, by their nature they are likely to be reversed. A greater source of risk is the possibility of miscalculating the trend rate of growth.

2.3.2 The impact of cyclical variations

Minor changes in growth are likely to have only small impacts on the fiscal position. Small changes in economic activity are unlikely to affect the underlying tax base, and will have only minimal impacts on other expenditure components. Treasury estimates of the sensitivity of the fiscal position to small changes in growth suggest that the fiscal position would remain well in surplus. For changes in real GDP of around 1%, the fiscal position would be likely to change by $400 million per annum.[4]

Large changes in the growth rate could impact significantly on the operating balance.

However, historically fluctuations in GDP have been quite large. For example, growth declined substantially from 1974 to 1978, from 7% in 1974 to -2.8% in 1978. More recently, real GDP[5] fell by 0.4% in 1991 and by 1.2% in 1992, before growing by 6.2% in 1994 and 5.3% in 1995.

The impact on the fiscal position could be much greater for large changes in GDP. This is especially true for a strong negative shock, because of the interaction with the tax system. As growth slows and profits decline, companies are able to accumulate tax losses, leading to a sharp reduction in tax paid. This was the case in the early 1990s; tax revenue from companies fell away substantially following the economic recession. So for large changes to growth, the direct impact on the operating balance could be substantially greater than $400 million.

2.3.3 Uncertainty around trend economic growth

The Pre-election Economic and Fiscal Update economic projections assume that the underlying trend rate of growth is around 3½% per annum. However, this represents an increase from the historical average. By comparison, the Reserve Bank's most recent forecasts assume potential growth is around 2.75% per annum. Thus there is a risk that the potential for ongoing revenue growth might be overstated.

If the trend rate of growth were to be significantly different to that projected, then this would change the longer-term prospects for fiscal policy. For example, permanently lower growth outcomes would quickly accumulate over time to lower the projected surpluses.

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4 This includes the effect of lower revenue, higher unemployment benefits and higher debt-servicing costs.

5 Production-based, March years.

The graphs below illustrate how lower *trend* growth might affect the fiscal position. The scenario illustrated assumes that since 1993/94 the underlying trend rate of growth has been 2%, rather than 3½%. This would imply that much of the growth experienced over the past few years has been largely cyclical. Thus at some stage real GDP might be expected to return to its underlying (lower) trend level.

Fig. 2.6 Trend GDP under different growth rates

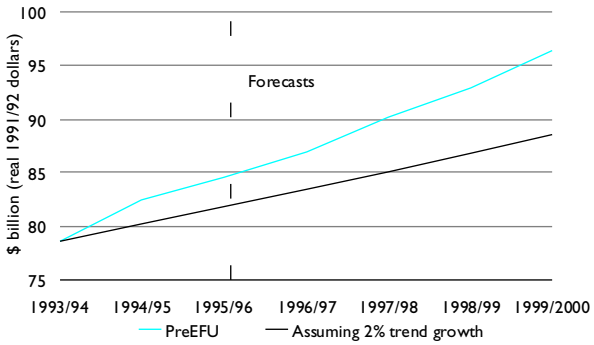
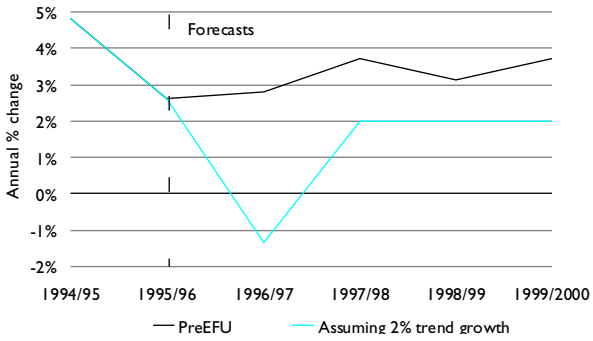


Fig. 2.7 Comparison of growth rates of GDP

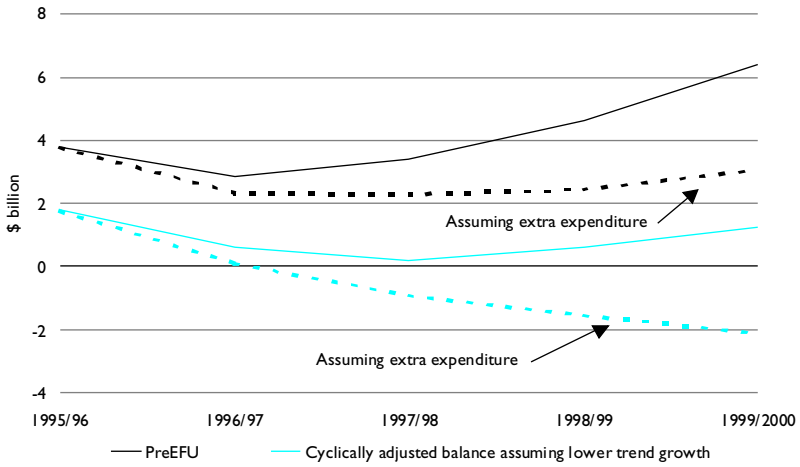


Source: Statistics New Zealand and the Treasury

If the level of GDP were to return to that implied by a 2% trend growth path, then growth would be likely to fall away substantially in the future. To give an idea of the magnitude of the change, Fig. 2.7 compares rates of real GDP growth under the Pre-election Economic and Fiscal Update forecasts and under the alternative scenario. If real GDP were to return to a 2% trend growth path in 1996/97, real GDP would fall by 1.3% rather than growing by 2.8%, as projected in the Pre-election Economic and Fiscal Update.

The implications of this scenario for the fiscal position would be substantial. As Fig. 2.8 shows, if the operating balance were to move to a level consistent with a 2% trend growth path in 1996/97, it would be roughly in balance, rather than in surplus by $2.9 billion.

Fig. 2.8 Operating balance — PreEFU Forecast vs 2% trend growth
No policy change vs additional expenditure[6]



Source: The Treasury

The impact on the operating balance would be magnified if the government undertook additional tax reductions or increased spending. The graph shows what would be likely to occur if additional expenditure of $500 million in 1996/97 and $1 billion in each of the following years were undertaken. Combined with lower projected growth, this would be likely to push the operating balance well into deficit.

Spending initiatives of this size are not improbable, given the experience of the past two years. Excluding the impact of valuation changes and foreign exchange gains, non-finance-cost-related expenses rose by $1.4 billion in 1995/96, and are projected to rise by a further $1.3 billion in 1996/97 (5% per annum). This partially reflects the impact of inflation on indexed benefits, but also reflects new policy initiatives announced in the 1995 and 1996 Budgets.

2.3.4 International experience

Large and sudden changes to the fiscal position are not inconceivable. As indicated in the following table, a number of countries in the late 1980s ran surpluses for some time, but found themselves in deficit following the onset of recession.

[6] This assumes that company tax revenues move in line with GDP. However, this is a lower level of sensitivity than demonstrated in the past, and could potentially understate the degree to which the operating balance would be lowered in response to lower growth.

Other countries with fiscal surpluses have moved back into deficit following an economic reverse.

For some countries this represented the impact of a real economic shock — for example, Finland suffered a significant drop in economic growth owing to the break-up of the Soviet Union. For others, non-cyclical factors exacerbated the downturn in the fiscal position. Fiscal outturns in both the UK and Australia deteriorated relative to projections, owing to a more severe recession than expected. However, the deterioration in their fiscal position was accelerated by discretionary increases in spending and by tax cuts.

Table 2.1 General government financial balances as a percentage of GDP[7]

Fiscal year	United Kingdom	Australia	Finland	Sweden	New Zealand[8]
1983	-3.3	-3.9	0.6	-5.0	-4.6
1984	-3.9	-3.3	3.0	-2.9	-6.5
1985	-2.8	-2.8	3.0	-3.8	-5.1
1986	-2.4	-3.0	3.5	-1.2	-2.6
1987	-1.4	-0.3	1.1	4.2	-3.3
1988	1.0	1.0	4.1	3.5	-2.1
1989	0.9	1.0	6.3	5.4	-1.4
1990	-1.2	0.6	5.4	4.2	-1.3
1991	-2.5	-2.7	-1.5	-1.1	-3.5
1992	-6.3	-4.0	-5.8	-7.8	-3.3
1993	-7.8	-3.8	-8.0	-12.3	-1.1
1994	-6.8	-4.0	-6.3	-10.8	0.9
1995	-5.7	-2.4	-5.6	-8.1	3.1
1996[9]	-4.8	-1.9	-3.2	-5.5	3.7

2.3.5 Implications for the fiscal strategy — managing risk

The key point from the above discussion is that the fiscal position is not immune to risk. A combination of economic change and policy change which are both well within past experience could see the fiscal position deteriorate severely. This has happened to a number of other countries in recent years. Given uncertainty around the fiscal position, fiscal policy needs to remain flexible and prudent enough to react to unforeseen events.

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7 Figures are from the OECD *Economic Outlook 59*, June 1996.

8 Figures for New Zealand are on a fiscal year basis. Prior to 1993, figures given are for the adjusted financial balance. Operating balance figures from 1993 onwards.

9 Figures for 1996 are OECD and Treasury estimates.

In general, the impact of temporary economic shocks on the fiscal position should be able to be accommodated without changing existing policy settings. In turn, this will help to stabilise the economy, by smoothing changes in individual incomes.

There are more reasons to be worried about the impact of negative shocks when net debt is at high levels. If debt levels are too high, then countries may face a loss of investor confidence and a rise in the cost of capital. Hence adverse shocks may force difficult decisions to be made. This was the case in New Zealand in 1991.

Permanent shocks, such as a change to the trend rate of growth, would change the underlying fiscal picture. If the change were large enough, it would eventually require a shift in current policy settings, such as an increase in taxes. There may, however, be some difficulty in recognising the difference between temporary and permanent shocks. Lower net debt levels and higher surpluses provide a buffer which gives the government time to recognise when change is needed before reaching an unsustainable position.

Ideally, net debt should be reduced to levels that are sufficient to permit large one-off shocks to affect the fiscal position without forcing changes in tax or expenditure settings, and also to provide a buffer against possible changes in trend economic growth. There is still sufficient risk around the fiscal position to justify further reductions in net public debt beyond current levels.

As debt reduction continues, maintaining a large operating surplus buffer will become less important. However, as the discussion above demonstrates, the current surpluses provide important assurance that debt reduction will continue even in the event of a substantial deterioration in growth.

2.4 The relationship between fiscal and monetary policy, and the macroeconomy

Changes in fiscal policy have a short-term impact on domestic demand, and hence on inflation and the current account. Large reductions in the operating surplus run the risk of increasing inflationary pressures, leading to higher interest and exchange rates. This suggests a gradual approach to change.

Fiscal policy initiatives need to be phased in gradually to reduce disruption to the macroeconomy.

In theory, these problems could be avoided to some degree, if fiscal initiatives were timed to avoid the peak of the economic cycle. However, it is always difficult to predict the path of the economy. For example, the current slowdown in growth was flagged last year. However, the timing and length of the slowdown has proved unpredictable. Because it is difficult to change the timing of new fiscal policy initiatives, they may impact on a very different economy from the one first envisaged. For this reason, it is unwise to use fiscal policy for active stabilisation purposes. Rather, fiscal policy initiatives need to be based on medium-term goals and phased in gradually, so that they do not run significant risk of disrupting the macroeconomy.

Another reason for being cautious about the speed of change is that past attempts to increase the supply of services, without regard for the underlying capacity of the institutions to deliver, have led to wage increases. Bottlenecks and pressures on public sector wages may arise if governments attempt to increase programmes too quickly.

Policies which promote macroeconomic stability are discussed in more detail in chapter 4. In general, fiscal policy can assist monetary policy to contain inflation by limiting the degree of stimulus arising from fiscal policy at any one time. This suggests that significant new policy initiatives may be best spread over a number of years.

Prior to the introduction of the 1996 Budget policy package, Treasury advice was that new initiatives of more than 2% of GDP represented the upper limit of what might be considered to be prudent, given current economic and fiscal conditions. There appears to be no evidence that the economy has a greater capacity to absorb a significantly larger fiscal change. If anything, inflation pressures have proved to be more persistent than first thought.

This suggests that over the next two years, given the initiatives already in place, the scope for additional spending or tax reductions is limited, if the Government wishes to avoid placing further upward pressure on interest and exchange rates, and on overall macroeconomic stability.

2.5 Long-term considerations

Today's fiscal policy affects both current and future generations.

In the long term, fiscal sustainability means that eventually all government purchases, plus current holdings of debt, must be paid for by taxes and by revenue from Crown assets. This is often described as the government's "inter-temporal budget constraint". In any one year a government may be able to run a deficit; but the inter-temporal budget constraint means that over time the government must pay its way.

Today's fiscal policy affects both current and future generations. If the government does not pay off its net debt now, then taxes will be higher in the future. Higher expenditure now must be paid for either by higher taxes now, or by higher taxes in the future.

Comprehensive net worth and the government's inter-temporal budget constraint

Comprehensive net worth (CNW) provides a means of calculating whether the government is meeting its inter-temporal budget constraint:

CNW = Reported net worth + net present value (expected future cashflows)

The formula supplements reported net worth with the net present value of expected net cashflows into the future.

These net expected cashflows are projections of the difference between the amount of cash the government expects to receive (e.g. from taxes, sales of assets etc) and the amount of cash the government expects to pay (e.g. transfer payments, purchases of assets). This stream of cashflows is "discounted" by an interest rate to calculate a "present value". The present value of a stream of cashflows represents what this stream is worth today.

The inter-temporal budget constraint states that all government cash payments, now and in the future, must be met by cash receipts plus the existing stock of net realisable assets. The government's long term fiscal health can therefore be assessed by projecting out into the future current fiscal policy settings and seeing whether expected revenue is sufficient to meet all future spending commitments.

Thus comprehensive net worth is equal to zero if the inter-temporal budget constraint is exactly met for any given path of cashflows, and is positive if future tax payments appear to be more than enough to fund both existing net liabilities and future expenditure.

The key point is that the level of reported net worth at any point in time is not sufficient to interpret whether fiscal policy settings are sustainable or not. If future flows look positive, then negative reported net worth may not be a problem; for example, policy settings probably should not change in response to short-term cyclical fluctuations in the operating balance. However, if there are likely to be significant future commitments, then saving now will reduce the risk of future fiscal insolvency.

There are a number of possible paths for fiscal policy which are consistent with meeting this long-term budget constraint. However, some of these may involve considerably higher taxes in the future. Doubts as to whether future governments would in fact raise taxes create uncertainty over the fiscal position in the future.

One way to avoid such risks would be to set tax rates at a level where no further changes would be needed to meet existing and future commitments. This policy, which is called "tax-smoothing", is a useful benchmark to consider. It is theoretically more efficient, because it avoids fluctuations in the tax rate and the associated costs. Because it avoids changes in either taxes or spending policies, it may also create less uncertainty.

However, there are large uncertainties in projecting out the fiscal position longer-term. This means that there is likely to be no single right tax rate that holds for all time. However, the government should think carefully about whether current spending plans are likely to lead to large changes in taxes in the future, and whether the possible gains from this outweigh possible efficiency gains from a smoother path for taxes.

2.5.1 Impacts of an aging population

One of the key pressures on the longer-term fiscal position arises from demographic changes. The percentage of elderly, relative to those aged 15 to 64, is expected to rise from just below 18% now to over 40% in the future. That is, while there are currently around 5½ people of working age for every person over 64, there are likely to be only 2½ people of working age per person over 64 in the future. This means that government expenses associated with retirement are likely to be carried by a increasingly smaller proportion of taxpayers in the future.

Long-term fiscal modelling assumptions

The source for the figures quoted in this section is a study by Hana Polackova, "Population Aging and Financing of Government Liabilities in New Zealand", presented to the New Zealand Association of Economists Conference, August 1996.

The study used the Treasury's medium-term fiscal model to project the government's fiscal position to 2050/51. Key assumptions of the model are shown below.

Long-term demographic assumptions

The study uses population projections produced by Statistics New Zealand, with the following assumptions:

Mortality:	medium
Fertility:	medium
Immigration:	15,000 per annum to 1999, 5,000 per annum thereafter

Long-term economic assumptions

Growth in output per hour:	1.5% per annum
Unemployment rate:	6%
Participation rate:	77% of the working age population (15-64 year-olds)
Average weekly hours:	39.9

Policy assumptions

Up to 1999/2000 the model uses the 1996 Budget projections, but with additional spending of $600 million per annum from 1997/98 onwards until 1999/2000. Thereafter the model assumes the following key spending assumptions:

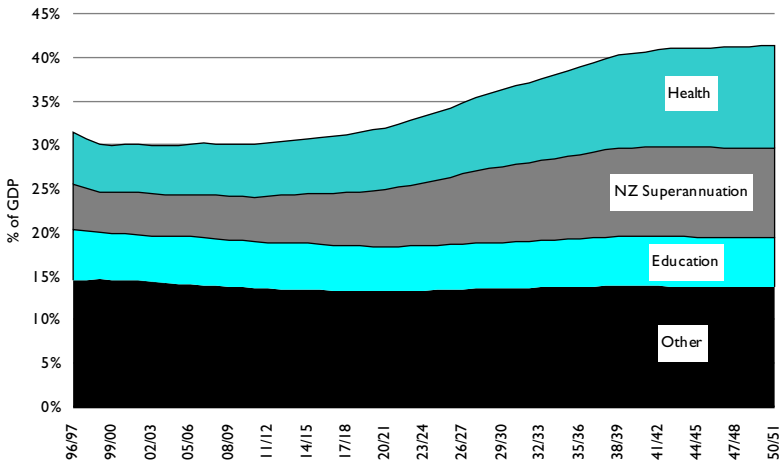
Real growth of spending per annum in:

• health:	2% per capita
• education:	2% per capita
• social welfare:	1.5% per capita
• other spending (excluding debt servicing):	equal to productivity growth
Superannuation benefits:	as per the Retirement Income Accord, assumed to grow in line with inflation until the level reaches 65% of the average wage; thereafter, in line with growth in the average wage.

Superannuation and health costs could almost double as a proportion of GDP by 2050.

As Fig. 2.9 indicates, current pressures on spending from demographic factors are relatively weak. However, from about 2010, this picture changes substantially, with the rise in the proportion of elderly in the population leading to non-debt-servicing expenses rising to over 40% of GDP by 2040. This increase is largely driven by increases in superannuation and health, with both almost doubling as a proportion of GDP over the period.

Fig. 2.9 Operating expenses (excluding debt servicing costs) as a percentage of GDP



Source: H Polackova. "Population Aging and Financing of Government Liabilities in New Zealand", August 1996.

The stronger the economy, the higher the level of spending any government can afford. But if spending outstrips the economy's capacity to grow, then funding that spending is likely to become increasingly expensive. If growth were to be lower than assumed above, then maintaining the rate of growth of expenses is likely to lead either to a higher average tax rate or a higher debt burden. Maintaining growth contributes to the ongoing sustainability of the fiscal position.

2.5.2 Funding choice

Given the long timeframe involved, governments and society have considerable choice about how to fund the cost of an aging population. If current policies on health and superannuation are to be maintained, options include:

- balancing the budget year-to-year — reducing taxes now, then increasing taxes in the future, as expenses increase

- pre-funding the cost of health and superannuation — reducing the degree to which taxes rise in the future by keeping taxes relatively high now, and continuing to run surpluses, thus further reducing debt and, eventually, increasing Crown assets which can then be run down at a later date when expenses increase.

An alternative would be reducing the overall amount to be funded by the government, by reducing government commitments to fund health and superannuation in the future, and relying more heavily on private provision.

As long as public provision of health and superannuation remains the choice of future governments, the exact size of entitlement that any individual can expect will remain uncertain. This uncertainty is costly to individuals. Such uncertainty may be magnified if the cost of the scheme is so large that it requires a substantial change in tax settings to meet that cost.

Fully pre-funding health and superannuation might require government asset holdings to reach 90%-100% of GDP in the 2030s.

If the Government chose to fully pre-fund its commitments, then our estimates suggest that this might require government holdings of assets comprising as much as 90%-100% of GDP in the 2030s. This would represent an increasingly large proportion of New Zealand's national assets which would need to be managed by the government.

However, reducing future commitments also poses difficulties. The lower the level of public provision, the greater the risk that some individuals face real hardship. If such a change were to be made, it would need to be clearly signalled in advance to encourage people to reduce the prospect of hardship by saving to a greater degree now for future private provision.

The upcoming review of retirement incomes policies is an important part of the decision process. While the issue remains uncertain, continued government saving now is a way of preserving options and limiting the costs to be borne in the future.

2.6 Conclusion

The current fiscal position is now better than it has been for many years. The outlook also appears very positive. The Pre-election Economic and Fiscal Update projections suggest that ongoing surpluses and reductions in debt are achievable over the next three years and beyond.

This improvement reflects good economic and fiscal management. The Fiscal Responsibility Act provides ongoing support for prudent fiscal management by establishing a framework focused on:

- high-quality reporting and monitoring
- clear short- and long-term objectives
- predictability of policy settings
- emphasis on achieving and maintaining a prudent fiscal position
- management of risks.

The fiscal gains made so far are real. But preserving them needs careful management. There are a number of constraints which limit the degree to which further increases in spending and tax reductions can be implemented, particularly over the next two years.

The current baseline already includes substantial new spending and tax reductions for 1996/97 and 1997/98. Adding to these through further tax and spending initiatives might place considerable pressure on interest and exchange rates. This suggests that there are "speed-limits" to changing fiscal policies. If the Government wishes to undertake new spending initiatives over this period, we would recommend a reconsideration of some areas of current spending and tax reduction commitments, to find appropriate offsetting savings.

In addition, net public debt levels still appear sufficiently high to leave the fiscal position vulnerable to shocks to growth. Providing a buffer lessens the risk of a significant fiscal deterioration.

Long-term demographics suggest there is still a need to save.

Looking beyond the next two years, if debt falls to 20% of GDP and below, then the need for a continuing surplus buffer is likely to be reduced. However, considerations surrounding macroeconomic stability would suggest a gradual approach to reducing surpluses even when debt is low. In addition, long-term demographic considerations suggest there is still a need to save, given the current "window of opportunity" in demographic developments. Saving now can help reduce the need for future increases in tax rates or reductions in spending in some areas to fund further spending on health and superannuation.

These constraints do not rule out undertaking further tax and spending initiatives, but rather suggest that fiscal policy should approach substantial new commitments cautiously. Over the next few years, they imply continuing to lean towards running substantial surpluses, rather than moving rapidly toward a balanced budget, for example.

In addition, the discussion in this chapter has highlighted a number of major factors affecting the fiscal outlook. These include the importance of ongoing economic growth for fiscal health. If growth were to slow, then the scope for new fiscal initiatives would be considerably weakened, and the long-term sustainability of the fiscal position may be put at risk.

Looking further ahead, given long-term demographic projections, increasing certainty over future superannuation commitments is an important step, before making further significant commitments to other priorities. The potential gains from reduced personal uncertainty and reduced fiscal instability mean that this is one of the highest priorities for policy attention within the next three years.