Budget Speech and Fiscal Strategy Report

Rt Hon Bill Birch
Treasurer

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Introduction

Mr Speaker, I move that the Appropriation (1999/2000 Estimates) Bill be now read a second time.

In six months time the world enters a new millennium. This country will be the first in the world to see the sun that morning. Visitors are coming from all over the world to participate in that event, because it is such a powerful symbol of hope and transformation.

A thousand years ago, the dawn of the second millennium brought the end of the Dark Ages, a revival of world trade, a renaissance of culture, and the flowering of science which produced eventually the technology that so vastly enriches our world today.

We are all aware, as the year 2000 approaches, that the world has begun to enter a new age. When I was a boy, I talked to the kids on the other side of the street. My grandchildren talk on the Internet to kids on the other side of the planet - and international business has been totally transformed.

Our young people today stand in the anteroom of a challenging, and ultimately very much richer, world. But they will not gather the fruit of the information revolution unless we prepare them now, to live and work in a new, knowledge-based society.

The thrust and purpose of the 1999 Budget is to open a door for them into that richer world.

We must have, available to all our children, an education system of competitive international quality. Moreover, if we want that education used to the full, then we will also need our families to have the strength to give their young children a keen desire to enjoy learning, and to do well as adults.

This Budget is about preparing the nation's children for success in the 21st century, improving the capability for that task of all New Zealand working families, and giving disadvantaged families and children a much fairer shot at a good life in the future.

Sound Foundation for Future Progress

The 1990s have laid the foundation for New Zealand's future success. Through quality policy, the country is growing, on data to date and current forecasts, three times faster in the decade to 2002 than it did in the previous decade.

Inflation is at the lowest level for 50 years. We have cut net Crown debt by half, and been able, at the same time, to drop the middle income tax rate by 25%. The benefit of the hard decisions taken last September is evident in this year's better outlook.

We've given consumers an improved deal. Tariff reform has slashed the price of cars. Parallel importing is reducing the retail price of some imported goods. Further tariffs, which impose, right now, $255 million in consumer costs, will vanish by 2006.

Competition has lowered prices and improved service, in telecommunications and the petrol industry, for example. Householders now have choice, for the first time, between competing retailers of electricity.

In tertiary institutions, enrolments are up more than 50%. Maori enrolments are nearly 200% up. Women have risen from 49% to 56% of all tertiary enrolments. We have a way to go before all primary children leave school with good skill in reading and maths - but that's what this Government demands, and we intend to achieve it.

Creating the Future

The strength of the policies in this Budget arises from a new approach to policy formulation. Ministers now work in teams across portfolios, sharing ideas and consulting the public, to develop a diverse range of quality policies which have been designed to interlock and reinforce each other, in the service of integrated objectives.

In this speech, I can only sample that work. More detailed information will be released by team leaders today, targeting five goals:

- All our young people must get an education of competitive world quality.
- Low and middle income mums and dads get further practical recognition of their needs, the effort they make, and their responsibilities.
- Severely disadvantaged people leading dysfunctional lives get the hand-up they need to give them, and in particular their children, a fair chance at a better future.
- We have to work, all of us, to gear up business and the public sector for the new millennium; to reward innovation; to use the information revolution, and greatly reduce the separation, between us and the rest of the world.
- Last but not least, Government must ensure a solid foundation for enterprise and innovation - openness, price stability, low debt, quality spending, and lower taxes.

Economic Performance and Prospects

Last year, drought and economic collapse in Asia threatened our standard of living. The shroud-wavers were out in force. But thanks to the sound policy framework established under this Government, the fall in world prices was more than offset by lower exchange rates. Interest rates fell to a 30-year low. The recession was shorter and less painful than predicted. In six months, the economy turned round and is now forecast to grow by an annual average of more than 3%, in the next three years.

Across the decade to 2002, we will, on current data, average 3% growth a year - something none of our political opponents believed possible. Certainly, the current account deficit, about 6% of GDP, is large by international standards. But the risks around the US growth rate and the Japanese economy are less than last year, and the other Asian economies are now recovering.

Sixth Consecutive Fiscal Surplus

This Budget announces the Government's sixth consecutive fiscal surplus, and they are the only surpluses achieved in this country since 1978. No other government in that period had a surplus, not even once. Growth ahead of anticipation has helped give us healthier accounts than anyone expected last December.

The 1998-99 balance shows an $800 million surplus, before counting a $1.4 billion gain on Contact Energy's book value, which takes our total surplus to $2.2 billion. Next year should be close to balance. Surpluses then rise to just over $1.5 billion dollars by 2001/02.

15% Net Crown Debt Target Re-affirmed

The Asian crisis underlined our vulnerability to swings of international investor confidence. Sustainably lower debt has put the nation in a far better position to deal with any future adverse event. Net Crown debt, in 1998/99, reached its lowest level since 1981/82. Debt reduction has improved the economic security of the nation. Lower debt has reduced debt servicing costs. They are now about $2.1 billion down on their 1991 level, a major saving which has helped fund increases in education and health expenditure.

The Government re-affirms its long-term target for net Crown debt of below 15% of GDP. Treasury projections show that goal being achieved in 2004/05. If we decide to make further significant business sales, it could be a year earlier than that. As debt heads below 15%, new options will open up to achieve higher living standards through further tax cuts.

A Wider Shareholding Democracy

The successful public float of Auckland International Airport, Capital Properties and Contact Energy reveals a very strong popular desire by the public to become shareholders in such businesses. More than 225,000 Kiwis, a lot of them ordinary mums and dads, aided no doubt by tax reductions, bought shares in at least one of those enterprises. In fact more than 170,000 New Zealanders have become shareholders for the first time as a result of our new approach to the sale of government businesses. I welcome this wider involvement by ordinary New Zealanders in our equity markets.

This year, we intend to scope our ownership interests in MetService Limited, and enter a sale process for Vehicle Testing New Zealand. Anticipating that, legislation will be introduced today permitting the removal of VTNZ and MetService from the SOE Act schedule if final sale decisions are taken.

It has been the policy of this Government to examine government businesses case by case, and sell where that is in the public interest. That remains our approach. Not every case suits a public float, but where appropriate, we will go on creating opportunities for Kiwis of every level to participate as shareholders, in the ownership of such organisations.

1999 Tax Reductions Package

Tax is a cost of doing business. Unnecessary tax reduces the ability of our businesses to export and to grow. High tax impacts adversely on working families, reduces take-home pay, limits choice, and does not promote prosperity.

This country is still picking itself up, right now, after the impact of a very severe drought and the Asian crisis. Government revenue will take time to recover fully. We are, however, in a position already to make further progress immediately with tax reductions worth more than $200 million a year to the taxpaying public.

Abolition of Public Broadcasting Fee

The Public Broadcasting Fee imposes a tax of up to $110 a year on 1.1 million families who own TV sets. Only 45% of the $97 million raised last year was spent on TV programmes. Collection took 11%. The rest subsidises radio, music, Maori broadcasting and so on. No one can justify isolating TV owners as the right people to pay those bills. Legislation will be introduced today to abolish the fee from 1 July 2000. Services funded from the fee will in future be funded from general taxation. From today, people will pay only the pro rata amount for the period to that date.

Support for Working Families with a New Child

Lifting the disposable incomes of low and middle income working families has been an ongoing goal of this Government. This Budget enhances the tax credit package already provided for them and gives that package a wholly new name, *Family Plus*.

Family Plus is for working families, on top of the $32 - $60 a week per child paid as Family Support to all low and middle income families. *Family Plus* has three components:

- A new *Parental Tax Credit* for working families will be available for the first time from 1 October this year. Low and middle income parents who are not on income support will be entitled to a tax credit of up to $150 a week for eight weeks from the birth of a child. Legislation will be introduced today.

- A *Child Tax Credit,* formerly called the Independent Family Tax Credit, pays low and middle income working families up to $15 a week per child, on top of the 1996 - 98 reduction of 25% in the middle income tax rate.

- A *Family Tax Credit,* formerly the Guaranteed Minimum Family Income, ensures a minimum income for parents working at least 30 hours a week.

The new Parental Tax Credit will ease financial stress on low and middle income working families after the birth of a child. About 26,000 families per year - 45% of births - will qualify. The tax credit will be available to families earning up to about $37,000 for first babies, and for fifth babies, dependent on the age of the other children in the family, to nearly $74,000.

Abolition of Stamp Duties

Conveyancing and lease duties, often known as stamp duties, usually collect about $77 million a year net. Large commercial businesses increasingly avoid them. An unfair and growing share of the burden falls on farmers and small businesses. These are not efficient taxes. They create costly distortions. Both will be abolished by legislation from midnight tonight. The saving on the sale of a $750,000 farm is about $14,000.

Estate Duty

Estate Duty, though not payable since 1992, has remained on the statute book. In our view, death duty has no place in a modern economy. A Bill will be introduced today to remove it from our laws entirely.

Outlook for Future Income Tax Reductions

This Government has, since 1996, cut the middle income tax rate by 25% to reward work, given tax credits to encourage working families, and increased the allowable part-time income of beneficiaries. It is just as important to reward the contributions of saving and investment to future economic growth.

Tax can rarely be reduced in large chunks - but it is very practicable, by consistent action, to make reductions over time that leave taxpayers much better off. This Government are very strongly committed over time to boost priority social programmes, reduce debt, and make further incremental reductions in income tax rates to improve living standards. The hard work of New Zealand families deserves that reward.

The Government is confident that, with good fiscal management, a continuation of the current domestic and international economic prospects, and a steady reduction in debt, we will be able to commit further income tax reductions within the next term of Parliament.

Role of Savings in Future Growth

Our growth prospects in the future depend on better savings and more productive investment. In the past, household savings have been low and heavily focused on housing. The response to our recent public floats suggests the start of a welcome diversification. The Superannuation 2000 Taskforce will, among other things, examine the impact of superannuation on incentives to save. This Government is committed to providing a tax and expenditure system conducive, not only to saving, but to investing those savings where they generate the best return for New Zealand. We will continue to work to improve tax neutrality for savers across savings products.

Increasing International Trade Growth

Growth in international and regional business activity in the Asia Pacific Region has lifted countries like Hong Kong, Korea, and Singapore from relative poverty into the ranks of the wealthier nations of the world. For a small open economy like ours, the success of our region is vital. New Zealand's contribution to open markets and free trade has been fundamental in achieving higher growth rates for our economy. New Zealand has a vital role to play to further these ideals in international forums like the World Trade Organisation and APEC.

The part we play in the WTO, and Prime Minister Jenny Shipley's challenging task chairing APEC this year, will be key and influential contributions. These are opportunities for New Zealand to show leadership, to shape the APEC 1999 agenda both for and beyond our own region, and to influence preparations for the next round of WTO negotiations. Simultaneously, in this Budget, we fund a new business migrant liaison unit, and more support for the Asia 2000 Foundation and trade access development.

Role of Growth in Social Progress

Growth is not an end in itself. We value growth because it widens the choices available to New Zealanders. It funds the extra care we want to give to every child, every person in pain, and all families who need a helping hand to overcome a history of disadvantage.

Growth is what enabled us in the 1991 - 99 period to increase Government spending per head of population by 23% on education, and by 51% on health. In this year's Budget initiatives, the central focus is on children and the family. A multiplicity of programmes, big and small, interlock to assist families of every kind, at every level.

Raising Education Standards for the New Millennium

The best way to empower people and strengthen their security is to give them a chance to fulfil their potential. This Budget will help to improve the quality of education for all our children, including children at risk.

More Accountable Schools Performance

Through *Tomorrow's Schools,* we have been making education more responsive to student needs and more accountable to the community. The Fully-Funded Option is giving school boards the opportunity to manage a school's resources more flexibly. Secondary school qualifications have been reviewed. New curriculum statements are progressively being implemented. Special education funding has been greatly increased, and structured more equitably. Those changes help all schools to do a much better job. Operational funding will be boosted by a further 1.6% from 1 January 2000.

New Funding for Information Technology in Schools

To move New Zealand forward faster in the 21st century, the Government is determined to help make New Zealanders skilled and passionate about becoming better equipped to participate in a highly successful knowledge-based society. Information and communications technology (ICT) play a growing role in education, the workplace and wealth creation. Primary schools average only one computer per 14 students and secondary schools one per eight students. Half their computers are more than three years old.

This Budget invests to see that our next generation is equipped to build a stronger New Zealand. A new $25 million funding pool will encourage every school to have an ICT plan and an Internet connection by 2000, with money over for other ICT needs. A typical primary school will get more than $6000, and typical secondary schools more than $20,000.

A further boost of $10 million per fiscal year in operational funding, starting from 1 January 2000, will let schools achieve adequate long-term ICT maintenance and support.

Massive School Building Programme

The Government is proud of its ongoing achievements in school accommodation. This year, we are committing school accommodation works worth $537 million. Some 200 new primary and 80 new secondary classrooms will be set in place during 1999/2000. Work begins on five new secondary schools due to open by 2004/05.

More Rigorous Assessment

Standards matter. The Budget funds the Education Review Office to evaluate teacher training, in-service training on the new curriculum, and the use and exchange of literacy and numeracy information in and between pre-school and primary school.

Overcoming Educational Disadvantage

People with skill are increasingly valued worldwide. People without skills face growing problems which can often impact adversely on their children. The Government makes a major commitment in this Budget to strengthen families to achieve improving success in their future lives.

New programmes reinforce each other across the span of education, health, welfare, justice, and other agencies. Together they constitute the most serious effort so far mounted in this country, to overcome the problems that put children at risk.

Setting national goals for basic education skills

The Government is determined to see that all children can read, write and do maths by nine years of age. We see that as fundamentally important. We are asking everyone in New Zealand to support our children and our teachers, so that we can achieve this goal. If we succeed, far fewer children will fall out of school in later years.

70 more social workers move into schools

A pilot trial using 12 social workers in primary schools will be extended now by putting up to 70 more social workers into schools. They will in due course cover 35,000 students at a cost of $4.5 million per annum. They will identify at-risk children, and develop and manage culturally appropriate intervention plans with family, whanau and school, and work with other agencies.

Alternative learning centres for problem teens

Research suggests that up to 2000 14 - 15 year-olds, many with serious behaviour problems, spend significant time alienated from schooling every year. An enhanced programme will now provide $11,100 per student to give schools more incentive to meet the needs of up to an extra 600 alienated students in 1999/2000 and potentially up to a further 800 in 2000/01 - a total of 1400, in addition to 400 already covered.

Strengthening Families and Helping Those at Risk

A small but significant number of families face multiple disadvantages - unemployment; poor skills, health, income and housing; behaviour disorders; and criminal histories. Children growing up in such families may fall into similar patterns. The cycle of disadvantage has to be broken. The Government's *Strengthening Families* strategy offers them interlocking services, new and extended.

Family Start for Up to 2700 More Families

Family Start, a major home-based support service, targets families with newborn babies facing difficulties. A support worker visits the home until the child is two, or more if necessary, to help with immunisation, health problems, relationships, parenting skills, and to create links with community services.

Family Start is working well in Christchurch, Whangarei, West Auckland and Rotorua. It will expand to 13 more centres, and up to 2700 more at-risk families a year. This additional intensive long-term help will cost $41 million in the next three years.

Facing up to Child and Youth Mental Health Problems

New Zealand has one of the highest rates of youth suicide in the world. There has been a gap in provision for young people with severe mental health needs. Since 1996/97, we have provided extra mental health funding to implement the Mason report. The extra funding will top $100 million next year, for more and better services, infrastructure such as workforce development, wider public awareness and knowledge, and prevention. Priorities include children, youth, Maori, Pacific Islanders, and people with severe psychiatric disabilities:

- About 10% of the 7000 children in the care of or contact with the Department of Child, Youth and Whanau Services (to be established on 1 October this year) have severe mental health needs - 2-3 times the community average. A new scheme gives the Health Funding Authority an extra $2.8 million next year for additional mental health services for those children.

- We are funding training for 500 caregivers a year to manage behaviour problems, anger, non-violent crises, suicide, depression, eating disorders and sex abuse.

- Funds are provided for specialist day services to help young adults with severe disabilities, and their families.

Welfare Dependency

One in seven working-age New Zealanders today depends on welfare for their main source of income. The Government's welfare strategy encourages them to work to their full capacity. The number registered as unemployed for more than two years was reduced by 52% from mid-1994 to mid-1998. The number of domestic purposes beneficiaries earning part-time income rose by 56% between August 1994 and November 1998.

The number on the DPB fell by 2.5% in the year to March 1999, the largest decline in the history of the benefit. The number of sickness beneficiaries decreased by 6.4% in the year to March 1999, compared to a 6.2% increase in the year to March 1998. A method is being trialed to test the work capacity of sickness and invalid beneficiaries.

Improving Outcomes for Maori People

Maori health, education and employment are a national priority. No nation can afford to leave significant numbers of its people lagging behind the rest of the population as a result of historical disadvantage. The Budget builds on many of the proposals developed by the Maori Commission. It allocates additional resources and improves the focus of existing spending to make further progress in these areas. A sample of these initiatives will give an idea of the approach taken.

Land and business development

The Budget provides $8.2 million over three years for a new special-purpose vehicle, complementing the Ministry of Commerce BIZ scheme, for pre-commercial facilitation for Maori landowners and potential entrepreneurs.

Improved training and employment

A new Maori industry-based training programme, piloted in two areas over the next two years, will place unemployed Maori in permanent jobs using a wage subsidy. The Government, Maori organisations and employers will share the costs involved in employment and training contracts designed to ensure that the promise of better trade training is secured.

New education and language initiatives

The Government consults closely with Maori people in developing strategies to make schools responsive to their needs and accountable for delivering improved outcomes. This Budget funds, for example, $6.5 million more over three years for Maori language materials for immersion classes; an extra $8.1 million to promote Maori language and develop the first Maori-only dictionary; and a campaign to raise Maori expectation about the potential of their children in school.

Health initiatives

Giving Maori communities the resources and responsibility to respond to their own health needs is a key strategy in improving Maori health. Next year, the Health Funding Authority will spend about $47 million on health services for Maori by Maori, in addition to services from mainstream providers.

Improvements include:

- Regular home health visits for up to 30% of Maori children and their whanau, and funding to reduce paediatric waiting times. These services are already being developed in 18 locations.

- Work to develop Maori dental health services (Oranga Niho) including a pilot community-based service from July 1999, and work with the Maori Health Commission over the next year on proposals for a Maori primary mental health care programme (Kaimahi Awhina).

Justice and Security

Justice must ensure that criminals are caught and punished. The Government is very serious about getting tough on crime. But we also want to turn young people from a life of crime, and to ensure they don't re-offend after release.

Youth in prisons

Young offenders should not be in adult prisons alongside hardened criminals. The Budget puts $17.7 million over three years into a new specialist regional youth prison unit in Hawkes Bay and three more new youth units in existing prisons, with new measures to prevent youth suicide in custody, to improve rehabilitation, education, psychological and work skills programmes and to reduce re-offending.

Extension of specialist Maori programs in prisons

Ten new programmes give 540 Maori inmates rehabilitative support over three years by involving whanau and emphasising cultural heritage as a way of reducing re-offending.

Cracking Down on Crime Hot-Spots

Police hot-spot teams

In eight regions where crimes like burglary, car theft or violent offending significantly exceed the national average, the Budget will now fund new hot-spot teams of about 10 Police each and two support staff, to hit those activities and hit them hard.

By 30 June 2000, after the implementation of this hot-spots initiative and the Police Review, there will be 6989 sworn Police officers in New Zealand - more than we have ever had before in the history of this country.

Safety in courts

Security breaches in courts, from verbal abuse to murder, averaged 134 a year in 1996-98, up from 63 a year in 1993 - 95. The Budget funds uniformed security officers for the ten courts shown by incident statistics to be most at risk.

Home invasion legislation and bail reform

The Prime Minister in February announced reforms imposing tougher penalties on violent home invasion, and tightening up on bail for serious repeat offenders.

Improving Health Care and Facilities

The Government is making major investments to upgrade health care and health care facilities across the country.

Major investment in hospitals

We have put $920 million into replacing, upgrading and modernising health equipment and buildings in the last five years. In the 1998 Budget the Government forecast a $1 billion investment in hospitals over the next three years. Decisions in the 1999 Budget include the $250 million go-ahead already given for a new Central Auckland hospital.

Increase in funding for care

The health care improvements funded by this Budget were announced in November. This financial year, health funding totals more than $6.3 billion, up 24% since 1995-96. It will rise again next year to almost $6.7 billion. These increases, targeted to priority areas, include an extra $75 million over three years for mental health, and an extra $25 million in 1999/2000 for elective surgery.

Some 180,000 acute and elective operations are being carried out in 1998/99, up 14% from 158,000 in 1995/96. Funding increases will see mental health services delivered by June 2002 to 50% more adults than in 1998/99, and more than twice as many children.

Funding for children's spectacles

Another new move will now provide financial assistance towards the cost of eye examinations, lenses and frames for children under six who have High-Use Health Cards or whose families hold Community Service Cards. This measure will remove another barrier, and assist us to meet our goal of having every New Zealand child reading by age nine by 2005.

Encouraging Enterprise and Innovation

International competitiveness is the key to New Zealand's success as a trading nation. The Ministerial team responsible for enterprise and innovation, led by Max Bradford, has developed a five-point strategy to:

- lift our skills and knowledge base
- focus the direction of Government R&D
- improve access to risk and investment capital
- ensure regulations and laws support innovation
- and build a culture of innovation by actively promoting success.

The Government is promoting seminars in centres across the country to consult with business, education and research sector representatives, local body and other relevant interests.

Innovation through research and development

To help keep New Zealand agriculture and industry ahead of international competitors, the Government already invests $610 million a year in research and development. This Budget boosts science and technology funding by a further $28.1 million in the next three years. Work will focus on R&D likely to seed new high-tech industries.

Y2K

Business has six months left to get to grips with the Y2K computer problem. The Government is playing its part. Good Samaritan legislation has been passed to encourage businesses developing remedies to share that information. The Budget provides $2.2 million for the Y2K Readiness Commission's communications program.

ACC reform

Legislation ending the State monopoly of workplace accident compensation and rehabilitation insurance has been enacted. Competition will, over time, improve accident prevention and get people back to work faster, so reducing costs. Amendments to the Accident Insurance Act will be made tonight to assist smooth implementation from 1 July this year. The first competitors in the new market are now entering into contracts with employers.

In addition, until now, the future cost of past motor vehicle accidents has been transferred to future owners and users. From 1 July this year, to facilitate wider and more competitive options for the future management of the Motor Vehicle Account, the total funds gathered in each year will cover the future cost of that year's accidents.

To make that transition, the future cost of past accidents, estimated at $1.4 billion, must also be covered. To meet these extra costs, motor vehicle registration fees will be increased. For a car, this will mean an increase of $47.50 in the annual licence fee from the next re-registration after 1 July 1999.

Resource Management Act reform

Amendments to the Resource Management Act will confirm its environmental goals, but minimise opportunities to abuse the Act for private advantage. The Minister for the Environment is preparing modifications to streamline the process of application and appeal, and the issue of policy statements by central government to give national consistency where necessary on environmental issues.

Revision of Commerce Act

The Commerce Act is being reviewed to deal better with the worst cases of anti-competitive behaviour. Decisions can be expected about mid-June. Commerce Commission funding will be boosted by $7.6 million over the next three years to enhance enforcement.

Occupational licensing under review

The Government is reviewing the costs and benefits of occupational regulations which limit competition in, for example, conveyancing, legal and real estate industries. Reducing real estate commissions from 4% to 3% would bring New Zealand's commissions in line with Australia's, and save buyers about $1700 on the purchase of an average $170 000 home.

Safeguarding Our Environmental Heritage

The pressures of population on New Zealand's environment have been growing steadily, ever since the arrival here of the first humans. About 1000 of our known animal, plant and fungi species are considered under threat.

The Government is developing a strategy for the next 20 years to halt the decline in biodiversity. This Budget funds the development of a National Policy Statement on biodiversity, development of biodiversity indicators and control of stoats. It extends work on the eradication of pests on selected offshore islands. In addition, this Budget includes funding to address the legacy of contamination and hazardous waste. Regulations are being developed for the management of used oil. Further funding is provided for national standards for organochlorine contamination and the cleaning up of New Zealand's worst contaminated site.

Importance of Rural Economy to New Zealand

Primary industries and primary product processing account for nearly 60% of New Zealand exports. They have been under triple pressure from declining commodity prices, a very severe drought, and the Asian crisis. Improved world growth and low interest rates will be welcomed by rural communities. The pressure on them has encouraged the Government to abolish stamp duties this year, rather than later.

Reforms implemented over the last decade to drive costs down and improve competitiveness are of continuing benefit to farmers. The two new SOEs established last year to deliver former MAF services are likely to reduce costs. It is envisaged that Asure New Zealand will achieve cost reductions of around $5.5 million a year that will pass straight to meat producers and processors.

The Budget provides $1.1 million for joint research into regional water supplies, water management, and feasibility studies for water enhancement schemes. It also provides for ongoing funding of $44.1 million over the next three years to control tuberculosis-carrying animal pests, and develop new strategies in particular against possums.

The change of greatest potential long-term value to the rural community is undoubtedly, in the view of the Government, producer board reform. In last year's Budget, we asked producer boards to focus their attention on the changes required in the future to encourage better outcomes for farmers.

We are very pleased with the energy and commitment that rural industries and their leaders have put into developing proposals for change to ensure that stronger growth is planned for the future of land-based industries.

Policy Progress into the New Millennium

In the last 15 years, New Zealand has made unprecedented progress in reshaping incentives, industries and institutions for increasing prosperity in a competitive global economy. But the challenge of the new millennium is large. We cannot afford to neglect any sector in our endeavour to improve New Zealand's performance. As the year 2000 approaches, we are mid-stream in consultation on a wide range of fronts.

- Our roads are, in many places, congested. The present system doesn't always put its money in the right place, and is fundamentally handicapped in its ability to raise money. Fully detailed reform proposals are now in front of the public.
- A consultation document was released last year for a review of local government rating powers to improve transparency, target costs more fairly, improve efficiency, and ensure a more even-handed impact on local communities.
- Our water system in many communities is antique. It delivers water whose quality is not always adequate, and is often managed inappropriately. The Government has initiated a review of water and waste-water management.

These are all difficult issues. The Government deserves great credit for bringing them forward on to the public agenda for action. No one should be surprised if they take time to resolve, but a constructive consensus is critical to growth in the 21st century.

In a very different category, this Budget provides $44.4 million for a five-year programme defining the continental shelf around New Zealand for a seabed claim by 2006 under the United Nations Convention of the Law of the Sea. If that claim succeeds, it would double the area under New Zealand jurisdiction and make it the 11th largest in the world.

Conclusion

Since 1990, this Government has laid a very solid foundation for this country. Across the decade to 2002, we will, on current data, average 3% growth a year. We have demonstrated that New Zealand can continue to achieve solid and sustainable growth.

That creates a virtuous circle. First, it improves the security of the nation by reducing our debt burden. The saving thus achieved helps us fund major increases in health and education spending, and cut taxes across the board.

Because we were getting the growth, we have been able, for four years in a row, to make significant improvements year after year in the take-home pay of low and middle-income working families.

The Parental Tax Credit is just the latest example of that.

Those changes are undoubtedly improving the incentives of people at every level, from students upwards, to improve their education, their skills, their productivity and their rewards, as a means to on-going improvement in the life of their families.

That's what New Zealanders want. That's what this Government has proved it can deliver. And everyone in the country knows the policy mix required to do that.

With this much progress safely under our belt as a nation, there is no doubt whatsoever in my mind that this country is set up for ongoing gains of the greatest possible value to family life and to the nation, in the next decade to 2010.

We enter the 21st century with a strong, growing economy, a prudent and improving fiscal position, a policy framework which has brought us successfully through the Asian crisis, our lowest interest rates for 50 years, and a social programme of which any nation could feel justly proud.

Mr Speaker, the succession in this portfolio has been ensured. A smooth transition is in place. The quality evident in Government economic and fiscal management during this decade will continue into the next century. I am happy that the prudence of those policies in my period as Minister of Finance and Treasurer has helped to give the nation a solid platform from which to make those achievements.

Fiscal Strategy Report

Fiscal Strategy Report

Summary

The Government's fiscal strategy is an important part of its overall economic strategy, which is leading to lasting improvements in New Zealanders' living standards. In this report we restate our commitment to a sound fiscal strategy based on reducing debt, reducing taxes and spending wisely.

Our short-term fiscal position is healthier than we anticipated in the 1999 *Budget Policy Statement* because the economy has recovered earlier and more strongly. However, risks to the economic and fiscal positions remain. We will continue to take a prudent approach, holding on to short-term gains in the fiscal position and remaining within our allowance for additional policy initiatives. The 1999 Budget shows that we can allocate resources to important spending areas and implement some tax reductions while keeping to our allowance for policy initiatives.

Medium-term projections show that operating surpluses will continue to improve, and that the Government will reach its net debt objective in around six years and will make ongoing progress towards its expense objective over the coming decade. As debt approaches, and then falls below, the Government's objective, new options will open up for New Zealanders to achieve higher living standards through further tax reductions.

The Government will continue to focus on the quality and effectiveness of its spending. In the medium term this will give us greater scope for tax reductions and increases in priority spending. It will also allow the Government to reduce its expenditure in a measured way if the economic and fiscal positions are consistently worse than we expect.

Fiscal policy must also take into account longer-term pressures. Population ageing will lead to increasing fiscal pressures from around 2015. As these demographic changes get close it will become increasingly important to make explicit how we will deal with them. Meeting the Government's fiscal objectives will help to ensure that we are well placed to deal with these pressures. The Government will continue to seek ways to ensure a reasonable degree of certainty and fairness in the future level of government-funded services and tax rates.

The Government's Ten-year Fiscal Strategy

Fiscal strategy plays a crucial role in overall economic strategy, each reinforcing and supporting the other. The Government's fiscal strategy has three key elements:

- Reducing debt

  By reducing net debt to below 15% of Gross Domestic Product (GDP) the Government will be in a better position to respond to economic shocks in a measured way, and so avoid significant short-term disruption to the economy.

- Reducing taxes

  The Government is committed to further tax reductions consistent with a broad-based low-rate tax system and progress towards its net debt objective. Further tax reductions will improve New Zealanders' disposable incomes and ability to save for the future, in turn supporting policies designed to improve economic growth and New Zealand's living standards.

- Spending wisely

  The Government is committed to reducing operating expenses to below 30% of GDP by improving the quality and effectiveness of government spending. Over the medium term, this will improve the prospects for further tax reductions.

The Fiscal Responsibility Act 1994 outlines guiding principles for responsible fiscal management. The Government's policies are consistent with the Act (see Annex 1).

Reducing debt

Since 1990, the Government has made substantial progress in reducing the burden of public debt on its finances and the economy as a whole. Net public debt has come down from over 50% of GDP early this decade to less than 23% of GDP now. This has substantially reduced the proportion of the Government's finances committed to debt servicing, and has assisted the Government to reduce taxes and to devote more resources to important areas of social need, particularly in health and education.

Getting net debt to below 15% of GDP well within the next decade will help to ensure that the fiscal position is strong enough to withstand any adverse events that could affect our financial health or that of our trading partners.

Sustained progress toward the net debt objective is particularly important given that New Zealand is potentially vulnerable to swings in investor confidence as a result of projected ongoing large current account deficits and high levels of external liabilities. We face the risk of sharp and disruptive changes to interest rates and the exchange rate if New Zealand is hit by a substantial economic shock, such as the recent Asian economic crisis.

Rebuilding the operating surplus and making progress toward the net debt objective will help to reassure investors that the Government is committed to sensible fiscal and economic policies, thus ensuring confidence in the overall economic framework and limiting the risks.

Reducing taxes

Tax reductions are important to improving New Zealand's living standards because they:

- reduce the effect of taxes on work and savings decisions
- reduce the effect of taxes on investment
- improve incentives to undertake education and training
- reduce incentives to avoid and evade tax
- promote economic growth.

The Government is committed to further tax rate reductions over time, implemented in a way that is consistent with its goal of making progress toward, and then maintaining, the Government's net debt objective. We will also ensure that further tax reductions are consistent with continuing to maintain a high standard of the government-funded services that are valued by New Zealanders.

The Government is also committed to a broad-based low-rate tax system. A broad-based system will encourage New Zealanders to invest their savings to best effect. Ongoing measures to improve the fairness, simplicity and effectiveness of the tax system will ensure that, for a given level of tax revenue, the effect of taxes on New Zealanders' decisions is minimised.

Spending wisely

It is important that taxpayers' money is spent wisely in areas that improve the overall economic and social wellbeing of New Zealanders. The Government will continue to fund quality services that New Zealanders value highly, such as health care, education, addressing disadvantage, and law and order.

To ensure the best use of taxpayers' money, the Government will continue to scrutinise the quality and effectiveness of its spending. This may mean that the Government funds private sector organisations to provide services where they can give better value for money. Avoiding wasteful expenditure will reduce the debt and tax burden on New Zealanders now and in the future.

Fiscal strategy in the longer term

New Zealand's population is ageing. This is a phenomenon common to many developed countries. Population ageing will lead to upward pressure on government expenditure from around 2015, in areas such as health care and New Zealand Superannuation.

The Government's current long-term fiscal objectives were set with the fiscal pressures resulting from population ageing in mind. For instance, reducing expenses to below 30% of GDP before these pressures emerge will help ensure lower taxes than would otherwise be the case. Similarly, reducing net debt to below 15% of GDP before these pressures emerge will give the Government increased flexibility in deciding how to respond to them. Running surpluses and reducing net debt gives the Government room to evaluate the best method of dealing with the fiscal pressures while ensuring they do not become more pressing.

As the fiscal pressures draw closer, they will warrant more explicit attention. A reasonable degree of certainty about the future level of government services and tax rates is vitally important so that people can adequately plan for their future needs. The Government is committed to ensuring that people have this degree of certainty, while ensuring that taxes do not place an unreasonable burden on future generations of New Zealanders. In particular, in setting its long-term fiscal objectives, both now and in the future, the Government will continue to consider the implications of population ageing.

The Path Ahead

The medium-term and long-term approaches to fiscal strategy outlined above provide a context for evaluating the future fiscal position. The following sections set out the likely progress toward the Government's fiscal objectives and highlight the risks around this path. Policy implications are then discussed.

The three-year fiscal outlook and strategy

The three-year fiscal projections in the 1999 *Budget Economic and Fiscal Update* show an improvement over those in the 1999 *Budget Policy Statement*, with an improvement in operating surpluses in every year and faster progress toward the Government's net debt and operating expenses objectives (see Table 1. Further details in Annex 2).

Table 1 – Key Elements of the Fiscal Forecasts

	1998/99	**1999/00**	**2000/01**	**2001/02**
(June years, Central Outlook)	*Estimate*	*Projection*	*Projection*	*Projection*
Operating balance ($ billion)				
December Economic and Fiscal Update	(0.1)	(1.3)	(1.0)	0.1
Budget Economic and Fiscal Update	2.2	(0.0)	0.8	1.5
Net debt (% of GDP)				
December Economic and Fiscal Update	26.1	27.1	27.8	26.9
Budget Economic and Fiscal Update	22.5	22.8	21.8	20.2
Operating expenses (% of GDP)				
December Economic and Fiscal Update	36.1	36.4	36.0	35.0
Budget Economic and Fiscal Update	35.5	35.1	34.3	33.8

Source: The Treasury

The economic projections show that the New Zealand economy has recovered earlier and more strongly than anticipated in the 1999 *Budget Policy Statement*. However, we have no reason, on the basis of information received so far, to believe that this better-than-expected short-term growth reflects an improvement in the trend growth of the economy, and hence, the medium-term fiscal position. Accordingly, we will continue to take a cautious approach to the stronger-than-expected short-term fiscal position.

The Government currently has total expenses of $35.3 billion. In addition, it is committed to allocating up to $600 million to policy initiatives in 2000/01 and a further $600 million in 2001/02, as announced in the 1999 *Budget Policy Statement*. This will fund additional policy initiatives, including further increases in priority spending and some tax reductions. Given the risks that we have identified, the Government will also consider the merits of not using some of the allowance on policy initiatives and instead reducing debt more rapidly.

The 1999 Budget is consistent with this approach. It shows that effective management of its expenditure allows the Government to reduce debt, allocate resources to important spending areas and undertake some tax reductions, while remaining within its allowance for additional policy initiatives.

The Government intends maintaining its existing plans and remaining within its allowances for additional policy initiatives. This is consistent with its general intention not to change tax and spending plans if the economy evolves otherwise than assumed in the short-term projections. As the economy improves in the short-term, unemployment declines and peoples' incomes rise. This automatically leads to lower spending on unemployment benefits and higher tax revenues, leading to a short-term improvement in the Government's operating balance. By not taking action to counteract this process, the Government ensures that it contributes to a stable economic environment, which supports monetary policy and helps sustain and extend the economic recovery.

With the above considerations in mind, over the next three years the Government will assess the scope for further tax reductions funded through:

- allocations from the $600 million per year allowance for additional policy initiatives
- additional savings resulting from ongoing assessments of the Government's existing spending
- tax changes in areas that improve the simplicity, fairness and effectiveness of the overall tax system, and/or
- reductions in projected operating surpluses, if subsequent fiscal projections indicate larger operating surpluses in the medium term and more rapid progress towards the net debt objective.

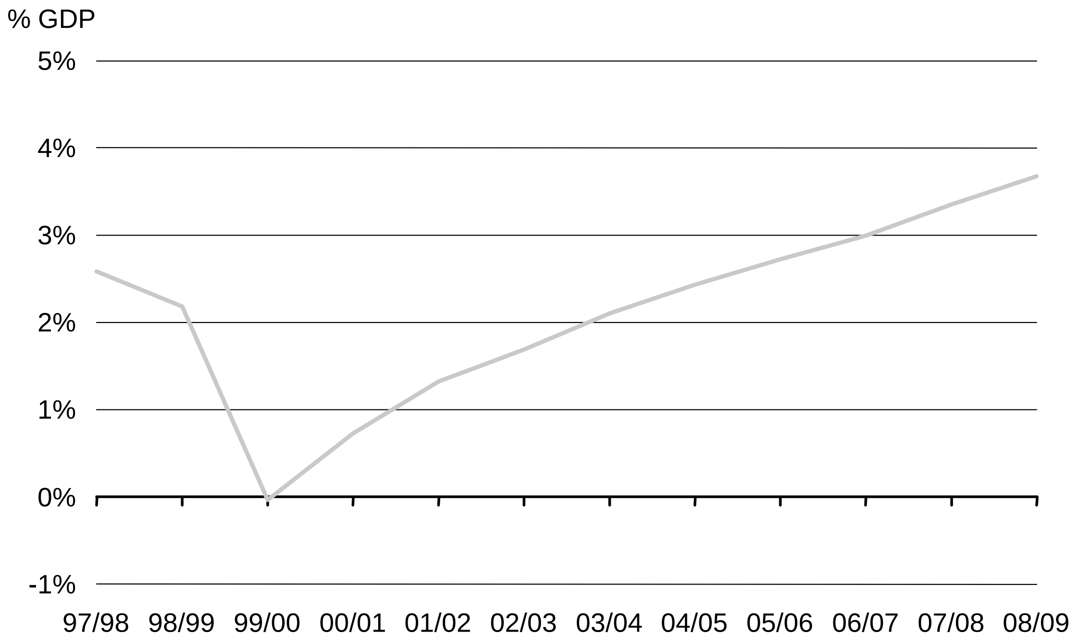
Progress beyond the next three years

The measures undertaken by the Government in 1998, including the Policies for Progress and its commitment to $600 million per year for additional policy initiatives in 2000/01 and 2001/02, significantly bolstered the projected medium-term fiscal position. This has made it more likely that the Government will make satisfactory progress toward its long-term fiscal objectives, without sharp and disruptive short-term adjustments, should the fiscal position turn out worse than expected.

Central scenario

The Government's plans should yield substantial progress towards its fiscal objectives. Based on plausible economic and fiscal assumptions, including extending the allowance for additional policy initiatives in 2000/01 and 2001/02 out to 2008/09[1], fiscal projections (the Progress Outlooks) show that surpluses build gradually and the Government meets its net debt objective in 2004/05. This is illustrated by the Central scenario in Figures 1 and 2. Progress is also made toward the Government's operating expenses objective, as shown in Figure 3[2]. An explanation of how these projections are derived is provided in Annex 3.

Figure 1 – Central Scenario: Operating Balance (June years)

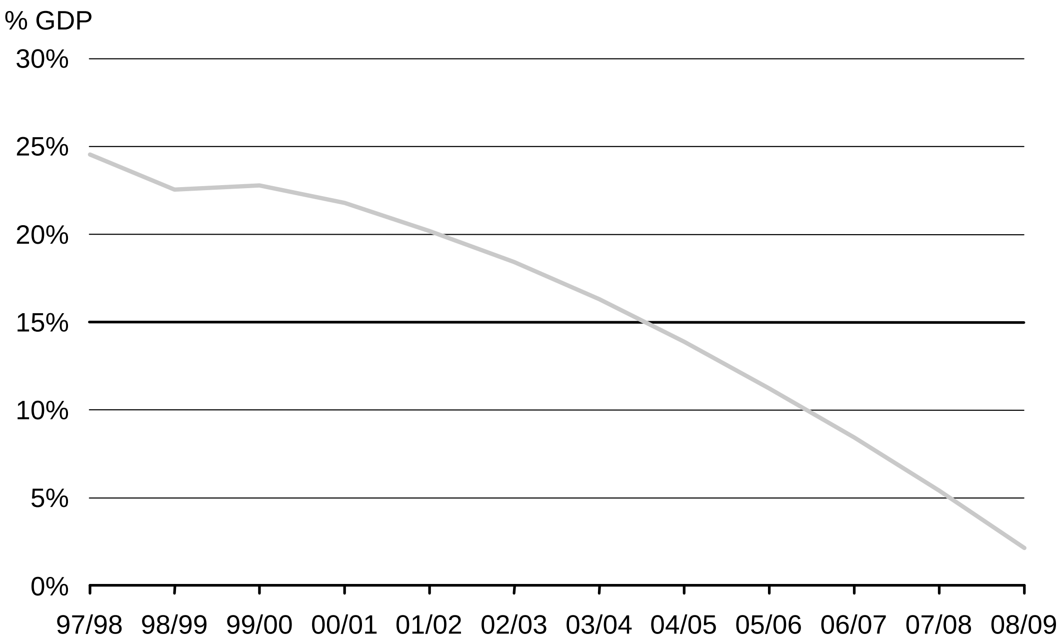


Source: The Treasury

1 This allowance equates to $600 million in 2001/02. In the Progress Outlooks the allowance grows over the period 2002/03 to 2008/09, in line with changes in prices and real growth in expenses (see Annex 3).

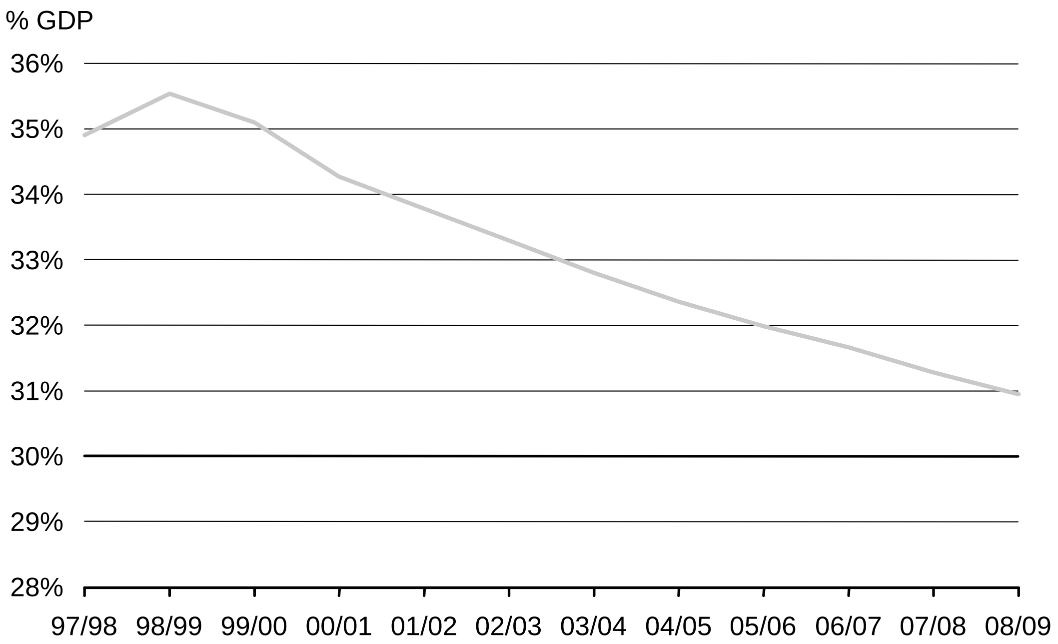
2 Although the allowance for additional policy initiatives covers both revenue and expenses, for the purposes of the Progress Outlooks the initiatives are allocated to expenses. Therefore, this is likely to overstate the path of expenses, understating the progress towards the 30% of GDP operating expenses objective.

Figure 2 – Central Scenario: Net Debt (June years)



Source: The Treasury

Figure 3 – Central Scenario: Operating Expenses (June years)



Source: The Treasury

In the next three years and beyond the Government will consider further tax reductions funded from within the allowances for policy initiatives, further savings and changes to the tax system. The medium-term projections suggest that there is also likely to be some scope beyond the next three years for further tax reductions financed through reductions in projected operating surpluses. As net debt levels come down, and the achievement of the net debt objective nears, there is likely to be greater confidence that the Government will meet its objective. In this situation, the Government will consider adjusting fiscal policies while ensuring that net debt continues to reduce until it can be sustained at below 15% of GDP. This may then involve smaller operating surpluses than those implied by the Central scenario.

Once the Government has achieved its net debt objective and is confident these debt levels will be sustained, it will be in a position to allow net debt to fluctuate in response to changes in the economic cycle. This will mean aiming for operating surpluses, on average, over the economic cycle. It may involve the Government running deficits in some years as long as these are offset by surpluses in others. The size of average surpluses in the medium term will be influenced by the approach the Government chooses to deal with the fiscal pressures resulting from population ageing. These are discussed in more detail in this report, in the section *Fiscal Strategy Beyond the Next Ten Years*.

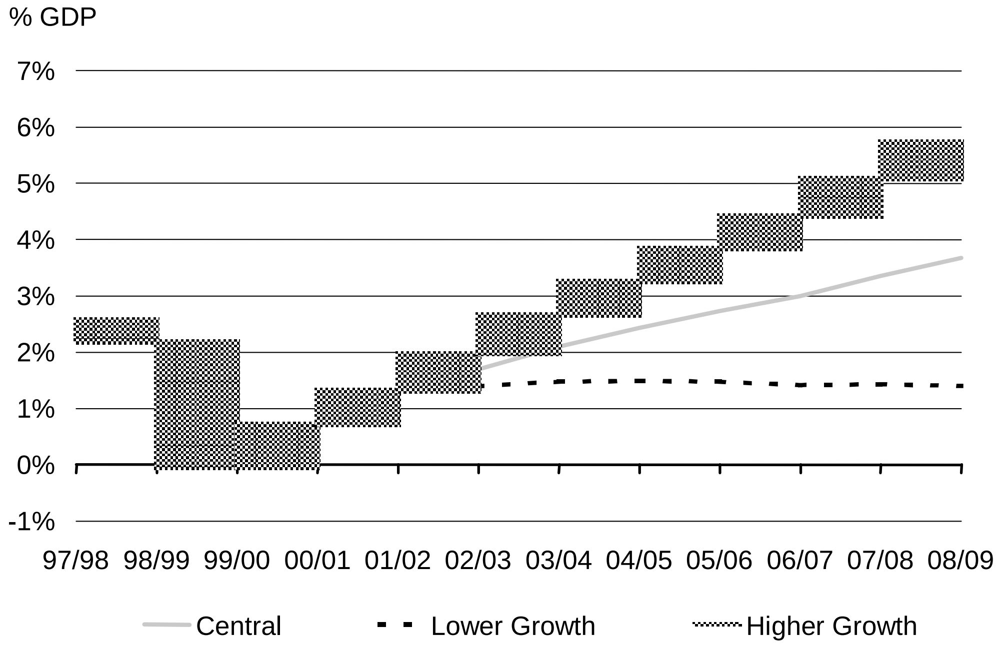
When considering further tax reductions financed through reductions in projected operating surpluses, the Government will ensure that no undue pressure is placed on monetary policy. This is consistent with the approach followed by the Government in 1996 and 1998 when it introduced social policy measures and tax reductions, phasing them in partly to ease the burden on monetary policy.

Alternative scenarios

Over the ten-year period of the Progress Outlooks there are considerable uncertainties surrounding the economic outlook and the projected fiscal position. Small changes in economic growth rates can compound to have a substantial effect on the projected medium-term fiscal outlook.

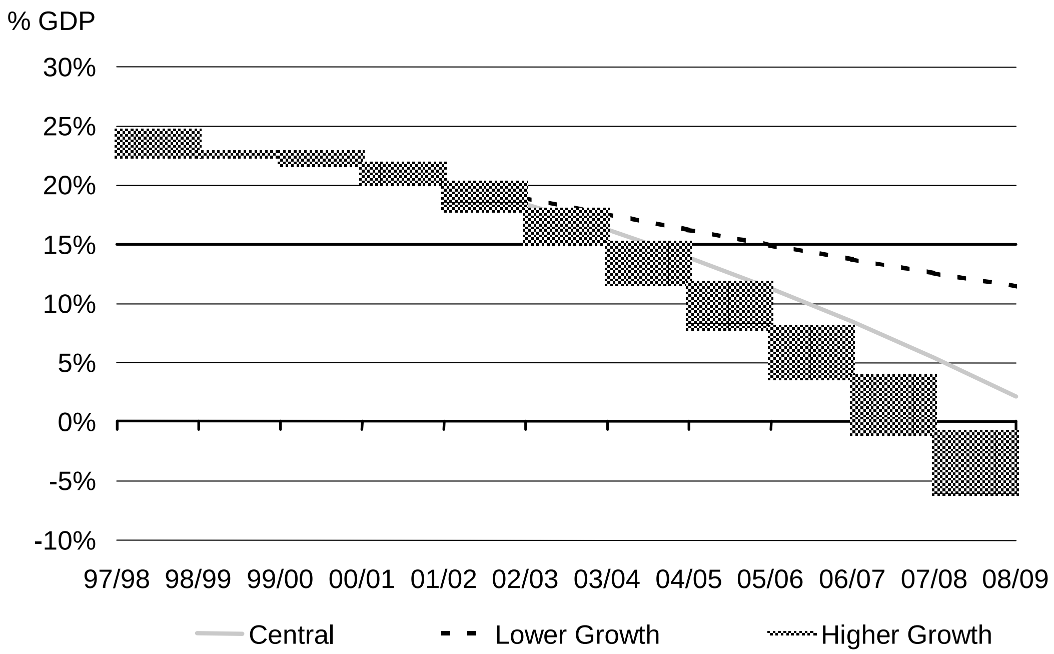
For example, if the Government maintains disciplined spending and economic growth is consistently stronger than projected, this will allow faster progress toward the Government’s fiscal objectives, while also allowing more scope for tax reductions. This is illustrated by the Higher Growth scenario in Figures 4, 5 and 6, which assumes higher average economic growth than under the Central scenario.

Figure 4 – Higher and Lower Growth: Operating Balance (June years)



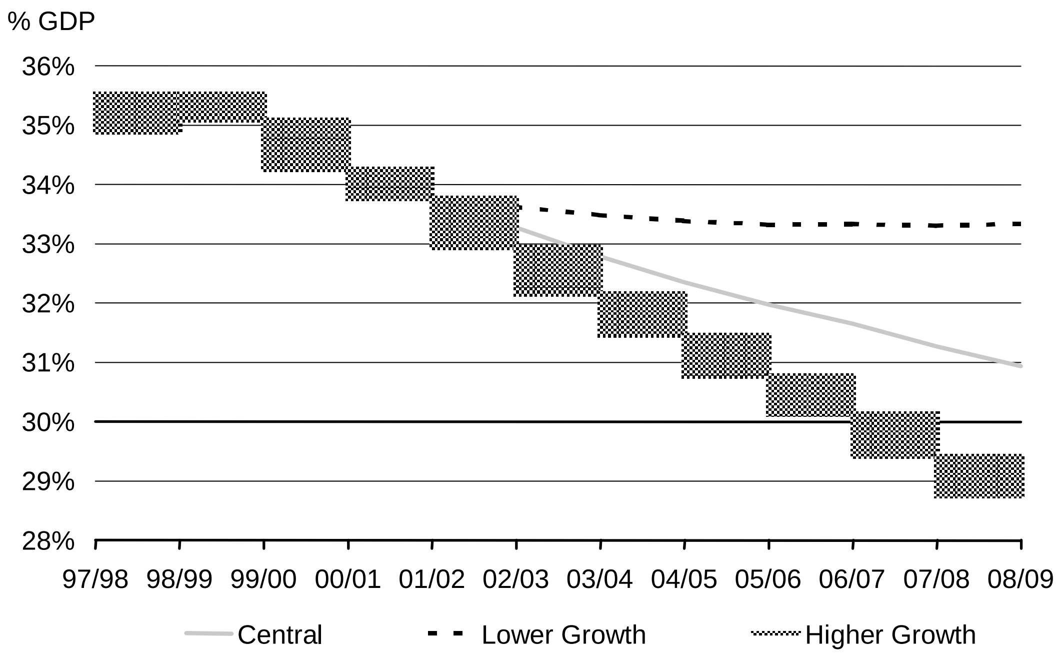
Source: The Treasury

Figure 5 – Higher and Lower Growth: Net Debt (June years)



Source: The Treasury

Figure 6 – Higher and Lower Growth: Operating Expenses (June years)



Source: The Treasury

However, if economic growth is consistently lower than expected, as shown by the Lower Growth scenario, the achievement of the net debt objective will be pushed out further into the future (see Figure 5). Operating expenses over the next ten years will be significantly higher than the Government's objective (see Figure 6). This will make the fiscal position less able to absorb the pressures of population ageing that begin to emerge in around 10 to 15 years time. If economic growth is consistently lower than expected, the Government will aim to further reduce expenses as a share of GDP so as to achieve its long-term fiscal objectives.

Policy consequences

There are both upside and downside risks to the economic outlook and the projected fiscal position. It is prudent for the Government to err on the side of caution when setting its fiscal policies. This both increases the chances that the Government's fiscal objectives will be achieved and gives more time to correct the situation if economic and fiscal outcomes are worse than expected. Experience in New Zealand and overseas shows that it is difficult and costly to correct a weak fiscal position resulting from lower-than-expected average economic growth or higher-than-expected expenses growth.

The Government will not be complacent. It will constantly monitor the emerging fiscal position and take any necessary steps to ensure its long-term fiscal objectives are achieved. The Government also recognises that remaining within the allowance for policy initiatives in the medium term, as assumed in the Central scenario, will require it to constantly reassess the quality and effectiveness of its existing spending programs. We will therefore be actively considering reducing the provision of government services in some areas where the private sector can provide better value for money. As discussed earlier, this does not necessarily mean that the Government will withdraw from funding these services.

By constantly evaluating the value for money of its expenditure the Government will be in a better position to reduce its expenditure in a measured way if the economic and fiscal positions turn out consistently worse than expected.

Fiscal Strategy Beyond the Next Ten Years

An ageing population will change the balance between working people and retired people. Over the next 40 years the ratio of those aged 65 and over to those in the working age group of 15 to 64 is projected to more than double. Given current levels of government-funded services, population ageing will lead to increased spending on publicly funded health services and New Zealand Superannuation.

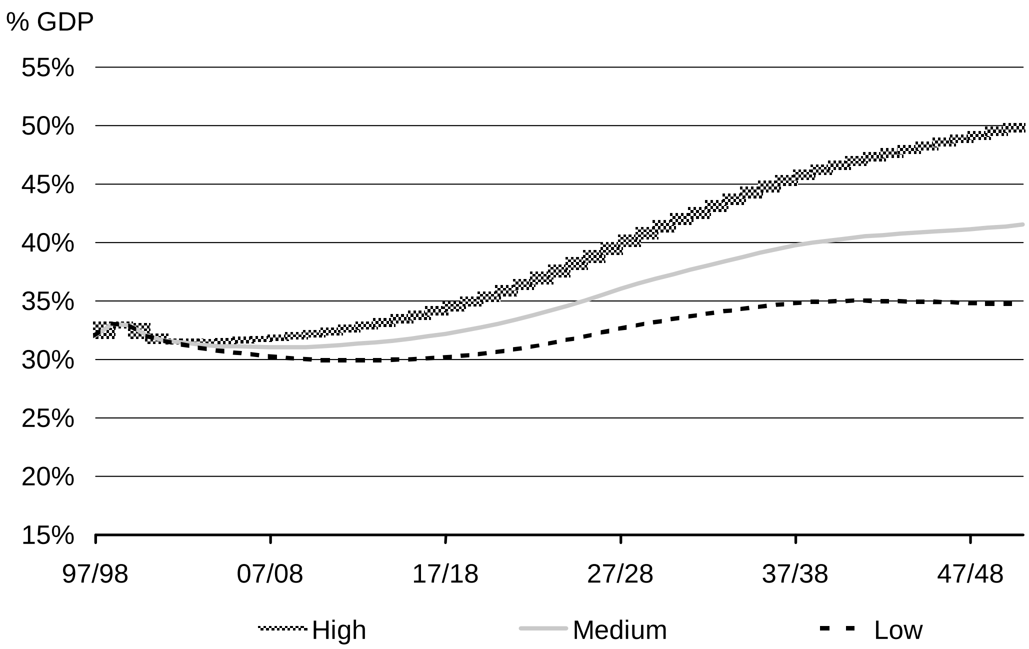
As discussed above, the Government has taken account of the fiscal pressures resulting from population ageing in setting its current long-term fiscal objectives. In setting its long-term fiscal objectives in the future, the Government will continue to do so.

There is a high degree of uncertainty surrounding the long-term outlook and the magnitude of the fiscal pressures that will emerge as a result of population ageing. This stems from uncertainty about:

- demographic changes, for example, changes in net migration and fertility rates
- spending pressures, for example, pressures on government costs resulting from technology changes, or pressures on the demand for government services as peoples' incomes rise over time
- adjustments by New Zealanders, for example:
    - greater reliance on privately provided health care
    - people working longer before they retire as a result of improving health and quality of life
- the level of benefits compared to wages
- social trends, such as participation in education and trends in crime
- economic growth.

However, regardless of how these factors turn out in practice, expenses are likely to rise as a share of GDP. This is illustrated by Figure 7, which examines three alternative expense growth assumptions over the next 50 years (details in Annex 3).

Figure 7 - Long-term, Non-Finance Expenses Under Low, Medium and High Expense Growth Assumptions (June years)



Source: The Treasury

As previously noted, the Government's current long-term fiscal objectives have been set with these demographic changes in mind. Pursuing these objectives means that the Government can take the time to examine how to deal with the fiscal pressures without them becoming more pressing. In dealing with these pressures, the Government will focus on ensuring that future spending commitments can be met, while ensuring that taxes do not place an unreasonable burden on future generations of New Zealanders.

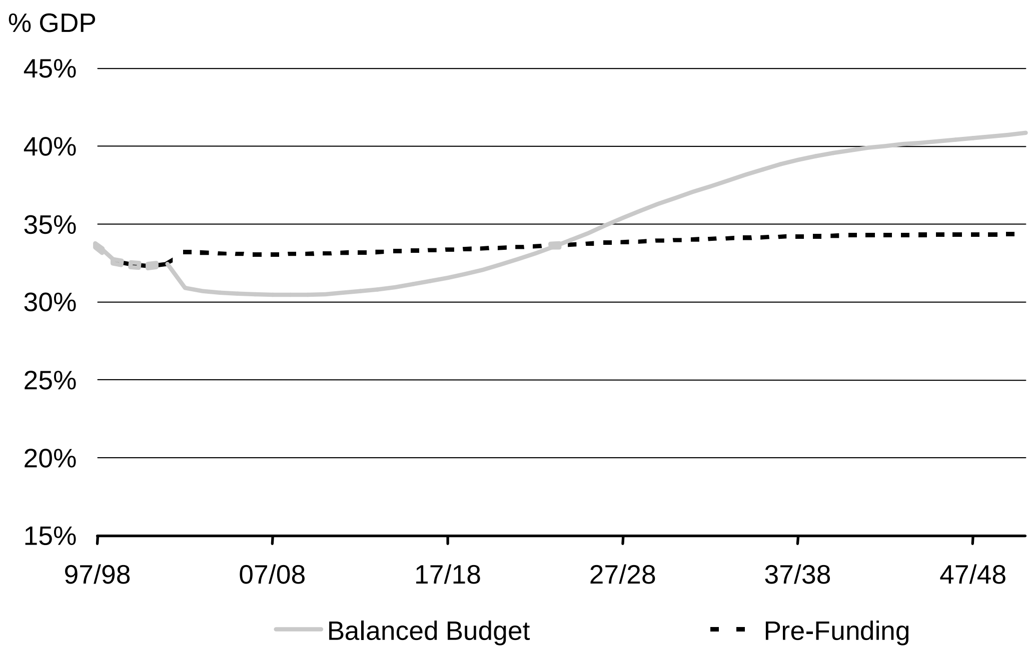
There are a variety of ways the fiscal pressures can be dealt with. The Government could, for example, seek to reduce the growth rate in expenditure over time, by improving the quality and effectiveness of its spending.

Whatever expense path eventuates, it must be funded. This could be achieved in a number of ways[3]. One option is for the Government to *pre-fund* the emerging fiscal pressures. This would mean further reducing debt, or building up some financial assets, before the pressures emerge, so that tax rates can be kept relatively constant over time.

Another is to run *balanced budgets* over the economic cycle. This implies that tax reductions and/or further increases in priority spending in the short- to medium-term are offset by a combination of tax rises and expenditure reductions as the demographic pressures emerge.

The possible implications of two such funding options, based on the Medium Expenses track, for the long-term tax and net debt paths are shown in Figures 8 and 9.

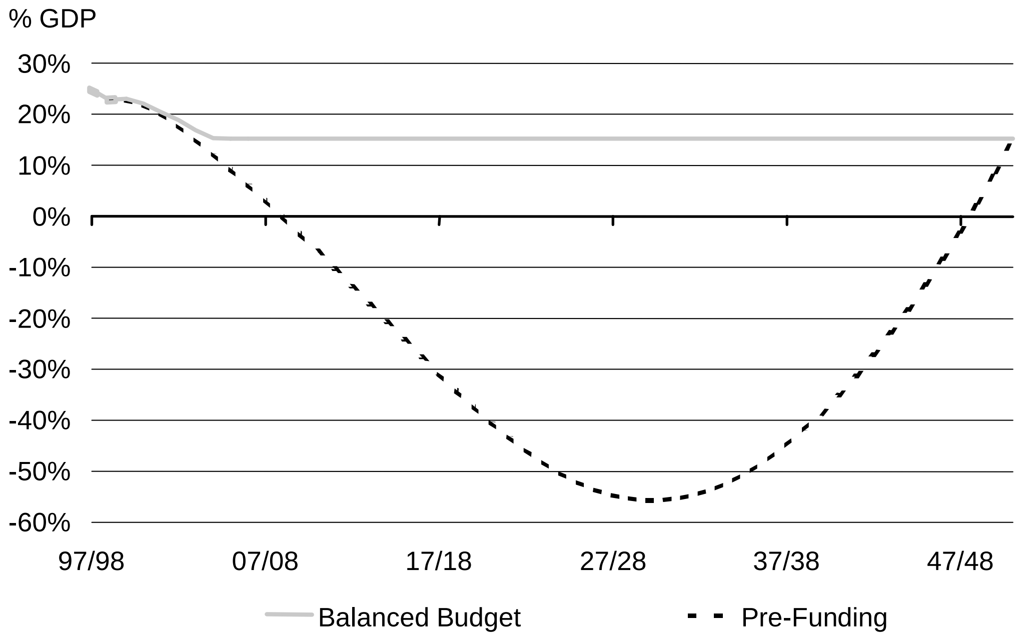
Figure 8 - Tax Implications of Pre-funding versus Balanced Budget (June years)



Source: The Treasury

3 The World Bank has investigated the fiscal effects and financing options related to population ageing in New Zealand. See Hana Polackova, *Population Ageing and Financing of Government Liabilities in New Zealand*, World Bank Policy Research Working Paper 1703, February 1997.

Figure 9 - Net Debt Implications of Pre-funding versus Balanced Budget (June years)



Source: The Treasury

The option chosen to fund the future spending pressures has implications for the setting over time of the Government's long-term fiscal objectives. For instance, if the Government chooses to *pre-fund* some of the future pressures, this may mean running substantial operating surpluses, followed by an extended period of operating deficits. This is likely to require changes to the long-term operating balance, debt and expenses objectives. Alternatively, if the Government chooses a *balanced budget* approach, which entails altering its tax and expenditure settings, this will require it to change its long-term objective for expenses.

In choosing the best way to deal with the future spending pressures, the Government will consider issues such as fairness between generations and the possible effect of the funding options on saving, investment and economic growth.

Regardless of the approach chosen, it is important that policy commitments do not necessitate large unforeseen policy adjustments, such as substantial tax rises or spending cuts, in the future. Lack of clarity over the future path of tax rates and government spending will undermine peoples' ability to plan for the future. If tax rates and government expenditure are subject to large and unpredicted changes, peoples' spending and savings plans are disrupted, resulting in costs to the economy as a whole.

Because the fiscal pressures of population ageing are getting closer, the Government will be more explicit about how it will deal with them. The Government will use the next few years to look at further ways of ensuring a reasonable degree of certainty and fairness in the future level of government-funded services and tax rates. In the area of New Zealand Superannuation, the Government has already taken some action to ensure that it is placed on a more affordable path, by continuing to increase New Zealand Superannuation in line with the Consumer Price Index until it reaches 60% of the average wage.

The Government recognises that it is important to set up further processes that deliver more certainty in the future provision of its services. With this in mind, the Government has established the Superannuation 2000 Taskforce, an independent group of experts who will look at how New Zealand Superannuation can be provided fairly and on a sustainable basis.

Conclusion

After the shocks of 1998, it is pleasing to report that the fiscal outlook is strong, and we are on track to achieve our fiscal objectives. This report has confirmed our commitment to these objectives, which are important to producing lasting improvements in New Zealanders' living standards.

The pleasing picture presented in this report is a result of sound economic policies and prudent fiscal policies implemented by the Government over the last few years. Although the short-term picture is more promising than it was six months ago, we will continue to be cautious; a prudent approach in the short- and medium-term will allow us to consolidate. It will also make it possible for us to maintain a strong fiscal position in the face of future adverse events and the pressures of population ageing.

Within a framework of prudence, we look forward to continuing to reduce debt, reduce taxes, and spend wisely in areas of maximum benefit to New Zealanders.

Rt Hon W F Birch
Treasurer

Annex 1

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

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

- an assessment of the extent to which the fiscal projections in the *Budget Economic and Fiscal Update* are consistent with the short-term fiscal intentions given in the *Budget Policy Statement*, and an explanation of any departures from those intentions
- progress outlooks for ten years or more, giving:
  - projections for variables specified for long-term fiscal objectives in the *Budget Policy Statement*, illustrating the likely future progress towards achieving those objectives
  - an explanation of any significant differences from the previous progress outlooks
- an assessment of the extent to which the progress outlooks are consistent with the long-term fiscal objectives given in the *Budget Policy Statement*, and an explanation of the reasons for any departures of the progress outlooks from those objectives
- an amended version of the Government's short-term intentions and long-term objectives where they have changed from those given in the *Budget Policy Statement.*

The Government's long-term fiscal objectives and short-term fiscal intentions, together with the principles of responsible fiscal management specified in the Fiscal Responsibility Act, are set out below:

	Long-term Objectives	**Short-term Intentions**	**Principles of Responsible Management**
Operating Expenses	The Government will limit the burden of State spending on current and future taxpayers by focusing on the efficiency and quality of expenditure and by reducing expenses to below 30% of GDP.	Policy initiatives will be lowered to $4.25 billion over the years 1997/98 to 1999/00. A commitment has been made for up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02. If expected conditions prevail, expenses will be 33.8% of GDP in 2001/02.	Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.

	Long-term Objectives	Short-term Intentions	Principles of Responsible Management
Operating Revenues	The Government will use a low-rate, broad-based tax regime to raise sufficient revenue to meet its long-term operating balance objective of running surpluses, on average, over the economic cycle.	Further tax reductions if economic and fiscal conditions permit.	Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.
Operating Balance	Once gross Crown debt is reduced to below 25% of GDP, consistent with net Crown debt below 15% of GDP, the Government will gradually reduce the operating surplus through a mix of increased priority expenditure and tax reductions. In the longer term, the Government will run surpluses, on average, over the economic cycle.	On current forecasts, which include a commitment of up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02, operating balances will be $2.2 billion in 1998/99, -$36 million in 1999/00, $0.8 billion in 2000/01, and $1.5 billion in 2001/02.	Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future. Managing prudently the fiscal risks facing the Crown.
Crown Debt	The Government will steadily reduce the level of gross Crown debt to below 25% of GDP, consistent with reducing net Crown debt below 15% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.	If expected economic conditions prevail, gross Crown debt and net Crown debt will be $36.1 billion and $22.4 billion in 1998/99, $36.1 billion and $23.6 billion in 1999/00, $36.9 billion and $23.8 billion in 2000/01, and $36.3 billion and $23.0 billion in 2001/02. In 2001/02 gross and net Crown debt will be 31.9% and 20.2% of GDP respectively.	Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.
Crown Net Worth	The Government will maintain net worth at significantly positive levels.	Subject to expected economic conditions prevailing, net worth will be $5.5 billion in 1998/99, $5.4 billion in 1999/00, $6.2 billion in 2000/01, and $7.7 billion in 2001/02. (The initial recognition of ARCIC outstanding claims obligations is expected to have a net negative impact of around $6.9 billion on net worth at 30 June 1999.)	

The long-term objectives are the same as those specified in the 1999 *Budget Policy Statement*. The short-term intentions have been changed to reflect the three-year fiscal projections in the 1999 *Budget Economic and Fiscal Update*. These changes are outlined in Tables 2, 3 and 4 of Annex 2.

Annex 2

Three-year Fiscal Projections

This Annex summarises the three-year fiscal projections contained in the 1999 *Budget Economic and Fiscal Update*. Fiscal out turns will be influenced by factors outside the Government's control. For example, it is not possible to forecast the realisation of contingent liabilities, significant valuation changes, changes in accounting policy, or unexpected economic shocks. If any of these events occurs, outturns may differ significantly from these fiscal projections.

The *Budget Economic and Fiscal Update's* three-year fiscal projections are set out in Tables 2 and 3 below. Changes in fiscal variables since the 1999 *Budget Policy Statement* are presented in Table 4. Changes in fiscal projections result largely from changes in macro-economic assumptions (see Table 5).

Table 2 - Three-year Fiscal Projections ($ million, June years)

Nominal	1999/00		2000/01		2001/02	
	1999 BPS	**1999 FSR**	**1999 BPS**	**1999 FSR**	**1999 BPS**	**1999 FSR**
Net worth	1,155	5,420	162	6,210	236	7,714
Net debt	27,605	23,607	29,473	23,756	30,149	22,990
Gross debt	40,156	36,096	42,248	36,857	43,094	36,349
Revenues	35,200	35,741	36,620	37,559	38,754	39,428
Expenses	37,095	36,358	38,145	37,345	39,260	38,453
Operating balance	(1,320)	(36)	(993)	790	74	1,504

Source: The Treasury

Table 3 - Three-year Fiscal Projections (% GDP, June years)

	1999/00		2000/01		2001/02	
	1999 BPS	**1999 FSR**	**1999 BPS**	**1999 FSR**	**1999 BPS**	**1999 FSR**
Net worth	1.1	5.2	0.2	5.7	0.2	6.8
Net debt	27.1	22.8	27.8	21.8	26.9	20.2
Gross debt	39.4	34.8	39.9	33.8	38.4	31.9
Revenues	34.6	34.5	34.5	34.5	34.5	34.6
Expenses	36.4	35.1	36.0	34.3	35.0	33.8
Operating balance	(1.3)	(0.0)	(0.9)	0.7	0.1	1.3

Source: The Treasury

Note: The 1999 *Budget Policy Statement* net debt projections were based on the nominal exchange rate (TWI) as at 31 October 1998. For the purposes of calculating net debt, the projections assume the nominal exchange rate remains fixed at 31 March 1999 exchange rates. Projected exchange rate losses or gains are not included in the forecasts.

Table 4 - Changes in Fiscal Projections since 1999 *Budget Policy Statement* ($ million)

Change	1999/00	2000/01	2001/02
Net worth	4,265	6,048	7,478
Net debt	(3,998)	(5,717)	(7,159)
Gross debt	(4,060)	(5,391)	(6,745)
Revenues	541	939	684
Expenses	(737)	(800)	(797)
Operating balance	1,284	1,783	1,430

Source: The Treasury

Table 5 – Macro-economic Assumptions (June years)

	1999/00		2000/01		2001/02	
	1999 BPS	**1999 FSR**	**1999 BPS**	**1999 FSR**	**1999 BPS**	**1999 FSR**
Real GDP[4] (annual average % change)	1.7	3.1	2.7	3.5	4.2	2.7
Nominal GDP ($ million)	101,872	103,606	106,005	109,018	112,200	113,887
Consumer Price Index (annual average % change)	1.3	1.0	1.2	1.8	1.5	2.0
Interest rates: 90-day bill rate (quarterly average %)	5.1	5.0	6.2	6.0	7.0	6.5
Interest rates: Government 10-year bonds (quarterly average %)	5.4	6.6	5.3	7.3	5.6	7.5
Household Labour Force Survey unemployment rate (annual average %)	8.4	7.4	7.8	6.8	7.1	6.0
Full-time equivalent employment (annual average % change)	0.3	1.2	1.6	2.0	3.0	2.0

Source: The Treasury

Note: The economic assumptions that underpin the fiscal projections in the 1999 *Budget Policy Statement* were the same as those contained in the 1998 *December Economic and Fiscal Update*.

The economic assumptions that underpin the fiscal projections in the 1999 *Fiscal Strategy Report* are the same as those contained in the 1999 *Budget Economic and Fiscal Update*.

Consistency Between the Three-year Fiscal Projections and the Short-term Intentions in the 1999 *Budget Policy Statement*

The short-term intentions in the 1999 *Budget Policy Statement* were:

- Operating expenses – Policy initiatives will be lowered to $4.25 billion over the years 1997/98 to 1999/2000. A commitment has been made for up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02. If expected conditions prevail, expenses will be 35% of GDP in 2001/02.

- Operating revenues – Further tax reductions if economic and fiscal conditions permit.

- Operating balance – On current forecasts, which include a commitment of up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02, operating balances will be -$0.1 billion in 1998/99, -$1.3 billion in 1999/2000, -$1.0 billion 2000/01, and $0.1 billion in 2001/02.

4 Production-based measure.

- Crown debt – If expected economic conditions prevail, gross Crown debt and net Crown debt will be $37.8 billion and $25.8 billion in 1998/99, $40.2 billion and $27.6 billion in 1999/2000, $42.2 billion and $29.5 billion in 2000/01, and $43.1 billion and $30.1 billion in 2001/02. In 2001/02 gross and net Crown debt will be 38.4% and 26.9% of GDP respectively.

- Crown net worth – Subject to expected economic conditions prevailing, net worth will be $2.5 billion in 1998/99, $1.2 billion in 1999/2000, $0.2 billion in 2000/01, and $0.2 billion in 2001/02. (The initial recognition of ARCIC outstanding claims obligations is expected to have a net negative impact of around $7.4 billion on net worth at 30 June 1999.)

The 1999 *Budget Economic and Fiscal Update* fiscal forecasts are generally stronger than projected in the 1998 *December Economic and Fiscal Update*. This is largely due to an upward revision in the three-year economic forecasts and one-off factors, such as the sale of Contact Energy Limited. As a result of the stronger fiscal position, the three-year *Budget Economic and Fiscal Update* projections show improved progress toward the Government's long-term fiscal objectives compared to that shown in the 1999 *Budget Policy Statement* short-term intentions.

The three-year fiscal projections demonstrate:

- improvements in operating balances

- reductions in gross and net debt as a share of GDP

- increasing net worth

- falling expenses as a share of GDP.

The specific changes to the fiscal aggregates, as compared with those in the 1999 *Budget Policy Statement*, include:

- Operating expenses – policy initiatives over the years 1997/98 to 1999/2000 total $4.2 billion, within the Government's $4.25 billion limit. In addition, expense projections are lower by around $450 million (1.3%) in 1998/99, and over $800 million (2.0%) lower in 2001/02. This largely reflects demand changes to benefit spending, lower Treaty of Waitangi settlement expenses in 1998/99, lower finance costs and the operating balance impact of the lower Government Superannuation Fund valuation.

- Operating revenues – tax revenue in all years is significantly higher. This is largely a result of an improved economic outlook.

- Operating balance – the operating balance is over $1 billion higher in all years. This is largely due to an improved economic outlook resulting in higher tax revenue, lower benefit spending and lower finance costs.

- Crown debt – net debt is lower by $7.2 billion in 2001/02 reflecting the cash proceeds from the sale of Contact Energy Limited of $2.3 billion in 1998/99 (this was not included in the 1998 *December Economic and Fiscal Update*, consistent with forecasting policy) and the cumulative impact of improved cash flows.

- Crown net worth – net worth is $7.5 billion higher in 2001/02 reflecting higher operating balance forecasts and a lower valuation of the ARCIC outstanding claims liability.

Annex 3

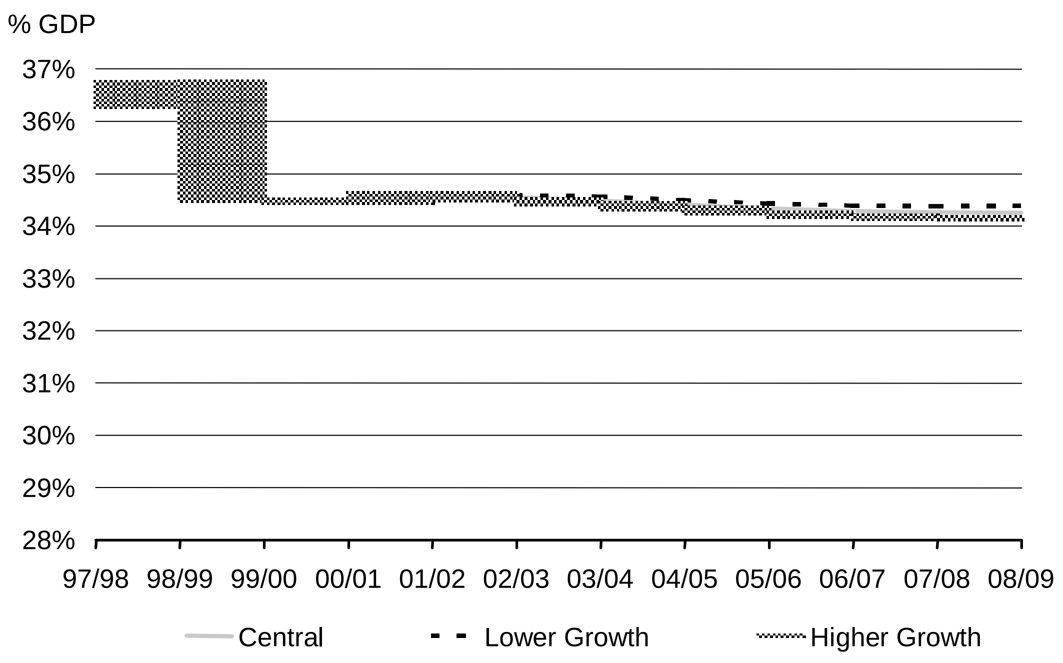
Progress Outlooks and Longer-term Projections

This Annex provides the details of the progress outlooks and longer-term projections. The outlooks and longer-term projections are not fiscal forecasts. They indicate what the fiscal position might be under alternative assumptions. The results are indicative of the trend in the fiscal position rather than the actual position at any point in time. In addition, the results do not include the possible economic consequences of fiscal policies.

The Fiscal Responsibility Act 1994 requires progress outlooks for all of the Government's long-term fiscal objectives. Figures 10 and 11 show the outlooks for operating revenues and net worth under the three scenarios.

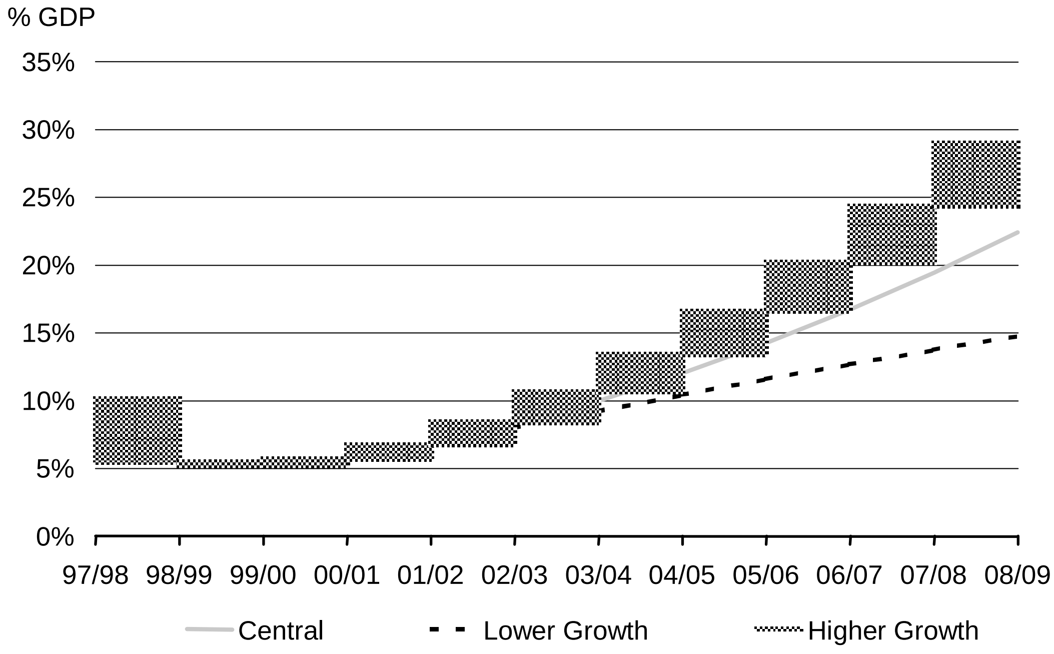
The outlook for net worth is consistent with the Government's objective of maintaining net worth at significantly positive levels.

Figure 10 – Operating Revenue (June years)



Source: The Treasury

Figure 11 – Net Worth (June years)



Source: The Treasury

Key Assumptions

Progress outlooks

All scenarios

Until 2001/02, all scenarios incorporate the economic and fiscal assumptions summarised in Annex 2, and detailed in the 1999 *Budget Economic and Fiscal Update*. From 2002/03 the assumptions are:

- average annual inflation rate 1.5%
- average interest rate:
  - short term 6%
  - long term 6.5%
- average unemployment rate 6%
- demographic trends based on Statistics New Zealand population projections with:
  - medium fertility and medium mortality
  - net migration of 5,000 per year
- expenses increase with demographics, benefit indexation and finance costs

- beyond 2001/02, the allowance for additional policy initiatives increases in line with:
  - 1.5% per year inflation
  - expenditure on items driven by demographic trends (education, health and most welfare benefits) increasing by 1% a year in real per capita terms
  - other expenses increasing in aggregate by 1% a year in real terms
- the allowance does not include increases to expenses driven by benefit indexation, demographics, or finance costs. Although the allowance covers both revenue and expenses, for the purposes of the progress outlooks the initiatives are allocated to expenses
- NZS expenditure growth in line with nominal wages after reaching its level of 60% of the average wage
- current average effective tax rates.

Central scenario

- average labour productivity growth of 1.5% a year from 2002/03.

Higher Growth and Lower Growth scenarios

Both the Higher Growth and Lower Growth scenarios use the same assumptions as the Central scenario, but with average economic growth beyond 2001/02:

- increased by around 1% in the Higher Growth scenario, and
- reduced by around 1% in the Lower Growth scenario.

The changes in economic growth rates are modelled via changes in labour productivity growth rates. In practice, the changes in economic growth would likely comprise changes in productivity and labour force growth, with the latter reflecting the response of net migration and participation rates.

Longer-term projections

The fiscal projections to 2050/51 in Figure 7 use the same economic assumptions as the Central scenario, together with the following expense assumptions beyond 2001/02:

- *Low Expense:* expenditure on items driven by demographic trends increase by 1% a year in real per capita terms, and other expenses increase in aggregate at 1% a year in real terms. This is equivalent to a continuation of the $600 million allowance for additional policy initiatives in the Progress Outlooks Central scenario.

Medium Expense: expenditure on items driven by demographic trends increase by 1.5% a year in real capita terms, and other expenses increase in aggregate at 1.5% a year in real terms. This is broadly equivalent to $800 million for additional policy initiatives, increased in the same manner as the $600 million allowance.

- *High Expense*: expenditure on items driven by demographic trends increase by 2% a year in real per capita terms, and other expenses increase in aggregate at 2% a year in real terms.

Figures 8 and 9 use the same economic assumptions as the Central scenario, together with the *Medium Expense* assumption. Pre-funding involves setting direct tax rates to ensure a net debt level in 2050/51 that is equivalent to that under the balanced budget case. The scenario does not take into account any change in debt to GDP as a result of divergences between the expense path and revenue path after 2050/51. The scenario therefore implies no pre-funding before 2050/51 of expenses after that date.

Consistency Between the Progress Outlooks and the Progress Outlooks in the 1998 *Fiscal Strategy Report*

The progress outlooks in the 1998 and 1999 *Fiscal Strategy Reports* are not strictly comparable because:

- the three-year economic and fiscal projections have changed. The progress outlooks are sensitive to the operating balance and net debt positions at the end of the three-year period, as the fiscal model drives all future trends from this initial starting point
- the Central scenario in the 1999 report includes Policies for Progress and the $600 million limit on additional policy initiatives
- there have been changes to the fiscal model.

Changes to the Fiscal Model

Progress outlooks in previous reports were generated using Treasury's Medium-term Fiscal Model (MTFM).[5] Central scenarios assumed that real economic growth beyond the three-year projections averaged 3% per year.

Economic growth can be viewed as the sum of growth in the labour force and growth in labour productivity. Labour force growth is projected to slow down in the next few decades as the population ages. As these changes start to feature in the ten-year horizon, a 3% economic growth assumption in the model would imply increasingly higher labour productivity growth.

5 The medium-term fiscal projections in the 1999 *Budget Policy Statement* also used the MTFM.

Instead of applying 3% economic growth, the progress outlooks now assume that economic growth is the sum of labour force growth and labour productivity growth.[6] Using labour force projections from Statistics New Zealand, and labour productivity growth of 1.5% per year generates average economic growth of 2.5% per year over the period 2002/03 to 2008/09.

Projections of labour force growth and labour productivity growth are subject to uncertainty. For example, growth in the labour force is influenced by demographic trends, net migration and participation rates. The labour force projections are consistent with the population projections outlined above and use medium labour force participation assumptions. Unlike labour force assumptions used in previous versions of the model, the labour force projections from Statistics New Zealand now used in the model incorporate some increase in participation rates. Statistics New Zealand considers these population and labour force projections to be the most suitable for assessing long-term future changes.

Although a number of factors are likely to influence future labour productivity growth, including how quickly New Zealand adopts innovations, their size and timing is difficult to quantify. The 1.5% assumption is broadly consistent with recent historical estimates of New Zealand's labour productivity growth.[7]

6 This is the approach used in Treasury's previous 50-year fiscal projections, generated using the Long-term Fiscal Model (LTFM).

7 See Lawrence, D and Diewert, E, "Measuring New Zealand's Productivity". Report prepared for the Department of Labour, Reserve Bank of New Zealand and The Treasury, March 1999.