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Budget Speech & Fiscal Strategy Report

Hon Winston Peters
Treasurer

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Working for a Better Future

Mr Speaker, I move that the Appropriation (1998/99 Estimates) Bill be now read a second time.

In 1996 National and New Zealand First signed a Coalition Agreement setting out a three-year policy programme addressing the economic and social issues facing our country.

They are issues of fairness and equity, of inclusion and consultation.

They are about all New Zealanders - regardless of gender, race and socioeconomic background - making a contribution to their country and their fellow countrymen and women.

Halfway through this Coalition Government's term in office, it is important to reflect on our achievements thus far.

This Government has been a **careful manager of the economy**. Inflation, at 1.3 percent, remains low and annual growth averages 2.2 percent at the bottom of the economic cycle.

We have been careful managers of our finances.

At $2.8 billion, the estimated surplus for 1997/98 is $1.3 billion bigger than we forecast at this time last year. This results from a number of one-off items which will not flow through to the 1998/99 surplus.

The *Budget Economic and Fiscal Update* forecasts surpluses of $1.3 billion, $2 billion and $3 billion over the next three years.

This coming financial year will be the sixth consecutive in surplus. We are also on track to reach prudent debt levels early in the next century.

Over the past year we have embarked on significant **microeconomic reform** with the aim of improving the economy.

That is - working to create an environment in which New Zealand firms, as well as the ordinary New Zealander, make the best decisions for themselves.

These include the recently announced changes on electricity.

New Zealand householders and businesses will reap the benefits of significantly **cheaper power bills** resulting from our decision to split ECNZ into three SOEs and to separate electricity supply companies into line and energy businesses.

New Zealanders will also benefit from the already **legislated tax cuts** which will come into effect on 1 July this year.

The effective marginal tax rate on income between $9,500 and $34,200 will reduce from 24 percent to 21 percent, and the rate on income between $34,200 and $38,000 will reduce from 33 percent to 21 percent.

That means, for a person earning the average salary of just under $36,000, the 1 July tax cuts will increase their take-home pay by over $900 a year, or around $18 per week. That's up to a 3.3 percent pay rise.

We have undertaken these measures to improve and strengthen the economy - enabling us to deliver on our economic and social commitments.

New Economic Challenges

This last year has not been without its challenges at home and abroad.

This Budget, for example, was put together during a significant **downturn in Asia's economic fortunes**.

The rapidly growing economies of Asia have slowed dramatically. Some are in recession. At the same time, a cloud of economic uncertainty hangs over Japan, our second largest export market.

Undoubtedly, Asia will continue to be a major issue for the global economy for some time.

This represents a challenge for all New Zealanders - including business and government. There's no doubt that some sectors and firms have been severely affected by the downturn in Asia.

Our flexible and innovative businesses are responding to the challenges posed by this regional downturn. They are taking advantage of the **lower dollar** and at the same time searching out new markets for their products.

Asia is not our only challenge.

Another challenge is our **current account deficit** which has deteriorated significantly over the past year. The current account deficit reflects the low level of saving by New Zealanders.

The deterioration in the current account deficit has made us more vulnerable to any downturn in investor confidence.

To improve the current account, we New Zealanders need to increase our level of savings and thereby reduce our dependence on other people’s savings.

In this context, we are committed to an ongoing programme of microeconomic reform. This will ensure that domestic and international investors are making the right decisions for themselves, the economy and the country at large.

What the past year has shown is that our economy is more capable than ever of coping with adverse economic developments.

Despite serious developments overseas, such as the Asian downturn, we have been able to maintain low and stable inflation, fiscal surpluses, relatively low unemployment and steady growth.

A **sound economic framework** has provided this strength.

Growth in the last year is now expected to be 2.6 percent. However, our short-term growth forecasts have been revised downwards primarily as a result of Asia. Growth is expected to be 2.7 percent for the year to March 1999 before picking up to 3.9 percent in the year to March 2000.

Credible fiscal and monetary policies, transparent financial markets, flexible labour markets, and an open, competitive business environment are the features that will assist New Zealand ride out these and any other unforeseen challenges.

Prudent Fiscal Management

This Government is committed to running fiscal surpluses and repaying government debt.

The Asian downturn has highlighted the wisdom of this approach.

To signal our commitment to fiscal policy credibility, we have decided to take a cautious approach.

Accordingly we have agreed to **set aside $300 million** of the resources available under the $5 billion Coalition Agreement expenditure limit to bolster operating surpluses. That is, a $150 million reduction in spending in 1998/99 and the same in 1999/2000.

This decision will maintain the credibility of our economic and fiscal strategy. We have the capacity to adapt to and overcome whatever the world throws at us.

However, there is more to credibility than just meeting targets. Credibility also requires reassessing and updating fiscal targets as progress is made towards them.

We are forecast to reach our current net debt target of below 20 percent of GDP by 2000/2001. But prudent fiscal managers need to look beyond the next three years. For this reason we have decided to commit ourselves to reducing net debt to below 15 percent of GDP. On current projections we should reach this new prudent level of debt within the next five years.

These measures will continue to enhance New Zealand's reputation as a country with prudent fiscal policies and a stable economic environment.

Microeconomic Policy

Prudent fiscal management is essential for creating the stability necessary to **maintain confidence for all New Zealanders**.

We must also look at ways in which the Government can foster enterprise and innovation, the critical drivers of economic growth.

This is best achieved by removing unnecessary constraints on business behaviour, such as poorly designed government regulation, bureaucratic red tape, and laws that support anti-competitive measures that are adversely affecting business performance in many areas.

The Coalition Government is committed to its programme of microeconomic policies designed to make it easier to do business.

Government-owned businesses

The performance of Government-owned businesses has a significant effect on the economic performance of New Zealand.

As we said last year, whilst the Coalition Agreement identifies the strategic assets that the Crown will continue to own, the Government has agreed to consider the Crown's ownership interest in non-strategic assets on a **case-by-case basis**.

Key issues will be the risks to the taxpayer in continued ownership and whether changed ownership will provide customers with access to better products and services at lower costs.

The reality is that the Government faces major capital requirements in health and education. Its priorities for investing whatever scarce capital it has are schools and hospitals.

Where non-strategic assets are concerned, New Zealanders must make a choice. Are we to build and maintain schools and hospitals to world class standards? Or do we use that money to service interest on unpaid debt and financing developments for which we do not have the funds?

We have low-returning funds locked up in businesses like airports and coal mines which demand future investment from the taxpayer that would be better spent on schools and hospitals.

Accordingly, we are negotiating with other local government shareholders to divest the Crown’s ownership interest in Auckland International Airport, by way of a **public float**.

Our first priority will be to ensure that all New Zealanders who want to buy shares will have the **first** opportunity to do so.

Again, this Government is committed to investing new capital in our schools and in our hospitals.

The Government has also started the process of divesting its coal mining SOE, **Solid Energy**.

ACC

An effective ACC scheme is critical to the Coalition Government delivering social and economic equity and fairness to all New Zealanders.

Back in 1996 we undertook to rebuild confidence in the ACC scheme so that New Zealanders are provided with affordable accident cover and a world class rehabilitation scheme.

We want all New Zealanders to have more choice, better access to rehabilitation, faster compensation and fairer premiums.

We first investigated the costs and benefits of introducing an element of competition to delivery of the ACC scheme.

Too many New Zealanders on ACC with genuine cases are simply not getting a fair go.

As a result we are **introducing competition** between ACC and commercial insurers in the delivery of the Employers' Account and insurance for the self-employed starting from 1 July 1999.

There will be arrangements to ensure that New Zealanders will continue to be covered in the event of either their insurer or employer failing.

Whether insured with the Corporation or with private insurers, the same regime of 24-hour, no-fault, comprehensive insurance cover will apply.

Motor vehicle tariffs

Vehicles are a major cost to New Zealand families and businesses. Reducing these costs is important in improving the strength of the whole economy.

The Government has received representations from the industry that market uncertainty should be brought to an end.

Therefore, the Government has agreed to a request from the assembly industry for a package comprising duty refund for stock imported after 14 February 1998 that remains unsold today and an assistance package of up to $9 million.

Tariffs on motor vehicles, with the exception of motor caravans and ambulances, will be **removed with effect from midnight tonight**.

General tariff review

A review of tariffs on all other goods is currently taking place.

The review is looking at options for **phasing out remaining tariffs** after 1 July 2000 that will meet our commitment to eliminate tariffs well within **APEC's 2010 deadline**.

The Government expects to receive a report on the review in line with the criteria set out in the Coalition Agreement by the end of May.

Producer boards

Continuing to improve New Zealand's performance in our export markets is a key objective for the economy.

Better returns for our primary producers will come with improvements in innovation, efficiency and investment, and from trade negotiations. This will benefit the economy as a whole.

The Government sees the removal of the statutory backing for all New Zealand's producer boards as inevitable over time. We see this removal as an ongoing process, and we will work to ensure that disruptions to the industries are minimised.

We have asked the boards and industries to form plans for how they will operate without specific statutory backing, and to consider the timeline for deregulation. The Government values the leadership that some boards are already showing. We will continue to work with each board to identify and address the particular circumstances of their industry. This recognises that each board and industry has different needs, issues and requirements facing it.

Each board is to report back to the Government with proposals by 15 November this year. The Government will then assess those proposals rigorously and implement change in a way that is appropriate for each industry.

The Government is committed to reform in this area to ensure that New Zealand's vital primary sector continues to increase its performance and contribution to the economy.

Parallel importing

The prohibition on parallel importing of goods protected by copyright is a form of import licensing which often prevents New Zealanders and New Zealand businesses from purchasing at world best prices.

Removing the prohibition will mean increased competition which will mean lower prices and increasing choice for consumers.

As part of the Government's strategy to promote an open and internationally competitive economy, we will be removing the prohibition on parallel importing of such goods that are protected by copyright.

Copyright holders will still be protected. The maximum fine for importing pirated goods will increase from $50,000 to $150,000.

Roading

A key initiative in the Government's comprehensive strategy for growth is to bring about improved decisions on road use and investment.

We are committed to ensuring that New Zealand has a road network that meets the rapidly changing needs of our economy and our society.

The Government has promised an additional $140 million to fund all projects where the benefits are at least four times the costs. This is to be funded by a 2.1 cents a litre increase in petrol tax from midnight tonight and by transferring to the National Roads Fund a further 2.1 cents a litre of the fuel excise used to fund non-roading expenditure.

The Government is still in the process of deciding the longer-term direction of changes for managing and funding roads.

We have however determined that any changes will be consistent with the following principles:

- Roads will not be privatised.
- The road network will be retained.
- The roading funding system will be fair and transparent.
- Roads will be managed in a more efficient manner.

Making it easier to do business: improving the quality of regulation

This Government is committed to making it **easier to do business**.

Over-regulation, dated and poor-quality regulation stifles enterprise and innovation without giving the benefits to society at large.

We are committed to introducing processes that will stop poor-quality regulation being introduced in the first place and to weed out unnecessary and dated laws.

As part of this commitment, we will be reviewing this year the legislation **regulating occupations**.

The balance we will be seeking is a framework which maintains public confidence in professions while eliminating any special considerations that unnecessarily inflate the costs of their services.

Work is already underway on improving the quality of regulations more generally, which will include, if necessary, the introduction of a Regulatory Responsibility Bill this year.

We will be considering amendments to the penalties and remedies in the **Commerce Act** to improve the effectiveness of the Act.

A review of the **Securities Commission** is currently under way aimed at lowering the regulatory costs of the Securities Act.

We are currently in the process of investigating which aspects of the **Resource Management Act** may be generating excessive compliance costs for business and individuals.

We have set up a **Committee of Experts on Tax Compliance** to consider amongst other things tax compliance and compliance costs, including how tax laws may be simplified and made more coherent and understandable. This Committee will report back by the end of this year.

The labour market

Improving our labour market is a crucial part of our pro-growth strategy. In the industrial relations area, the Government is making good progress on the initiatives set out in the Coalition Agreement.

We are proposing changes to the personal grievance provisions of the Employment Contracts Act. These changes will improve the employment prospects of people seeking work.

It will bring about a fairer balance between the substance of the employee's conduct and the process the employer has followed.

All workers will retain access to the personal grievance procedures of the Employment Contracts Act.

The Government also recognises the unique nature of the employment relationship and is committed to maintaining a specialist Employment Court.

Finally, following an extensive public consultation exercise, changes are proposed to the Holidays Act to clarify the holidays entitlements of employees, remove anomalies and provide more flexibility.

These changes are those we promised to deliver in the Coalition Agreement. They are based on the principles of flexibility, neutrality and most of all fairness. Detailed announcements will be made shortly.

Social Policy Reform

Economic and fiscal policies are one part of the equation in providing for the wellbeing of all New Zealanders.

But we also face a number of social challenges which are a top priority of the Coalition Government. These are issues that need urgent attention.

We want to work together with New Zealanders to identify the problems facing our families.

Consultation on the **Code of Social and Family Responsibility**, and feedback from New Zealand families, are helping clarify the reciprocal obligations owed by the Government and individuals.

We are committed to helping more New Zealanders move from dependence on the state to independence. This is good for all of us, good for our families, and good for New Zealand.

The Coalition Government signalled in the *Budget Policy Statement* its concern with the rising number of New Zealanders on welfare payments. Welfare dependency damages individuals, families, and the community. It is bad for the country.

No-one wants to be dependent on the state. The Government's role is to help individuals realise their full potential and by helping themselves help their country.

Our social policy programme is driven by the same objective as our economic policy: to help New Zealanders make good decisions for themselves and for their families.

Employment

For this reason the Government's employment strategy is about **assisting people into unsubsidised work**.

It aims to strengthen the focus of employment assistance by encouraging people to work to their full potential. In particular, it aims to reduce the number of long-term unemployed by moving job seekers into unsubsidised work.

The Government has increased the overall level of resources available for implementing the employment strategy by $142 million in 1998/99 and $125 million in 1999/2000.

This includes a transfer from Vote Education of Training Opportunity Programme resources.

These resources will increase the capacity to target assistance to job seekers effectively.

The strategy will reinforce the **individualised case management** approach of assistance with every job seeker's needs being assessed and summarised in an "employment action plan" together with achievable steps towards employment.

From 1 October the Unemployment Benefit will become the "**Community Wage"**. The Community Wage will replace all unemployment benefits currently paid to job seekers.

The term Community Wage better reflects the **mutual obligations** owed by the job seeker to look for work, to work in the community, or to train. It is a give and take relationship between the ordinary New Zealander and the community and the country.

For its part, the Government will provide appropriate assistance and tailored support to those who are looking for work.

To advance the employment strategy, the **integrated employment and income support service** will be up and running from 1 October this year.

The new service will provide a **"one stop shop"** that will address not only people's income support needs but also their employment and training requirements and obligations.

This integration is part of a consistent focus in dealing with working age beneficiaries. It will enable people to access employment services and income support at the one place. This means better services and better value for taxpayers' money.

Regional employment commissioners will be appointed with local knowledge and expertise who will decide what types of employment assistance best meets local needs.

Clearly the needs of job seekers in Northland are different from those of job seekers in Dunedin. The commissioners will be responsible for meeting those needs, helping job seekers to maintain their job habits, motivation and connection to the community.

This will ensure that, in return, job seekers fulfil what should be expected of them.

Requiring job seekers to undertake work in the community will be one option available where it is the best way to assist job seekers into unsubsidised employment quickly and cost effectively.

We must avoid letting the unemployed become alienated from the labour market.

With this strategy, the Coalition Government is recognising that unemployment affects individuals, families and communities. Our aim is to assist New Zealanders to move from state-reliance to self-reliance.

Benefit reform

Invalid and Sickness Benefits

In the past, the benefit system has categorised people according to their incapacity. This Government is turning that approach around.

From now on we will be focusing on people's capacity **to work**.

Most people want to work and given the circumstances should be able to do so.

We believe that if people are capable to do some work then they should. It may be five hours, 10 hours, 20 hours. Clearly where people don't have the capacity to work, they won't have to do so.

To ensure that those who have the capacity to get paid work, do work within that capacity, the Government will **trial work capacity** assessment of invalid and sickness beneficiaries. The trial will begin in November 1998 and be developed over the next two years.

The Government funds an agency called **Workbridge**. It caters for incapacitated people who want to work. Workbridge has people working in many communities. What we are announcing now is a broadening of the Workbridge concept by moving people into unsubsidised employment.

A good welfare system should do more than simply ensure that people face the right incentives to work. It should also be fair to all and provide people in similar circumstances with the same assistance.

For this reason, those people moving onto the Sickness Benefit from 1 July this year will be **paid at the level of the Unemployment Benefit**. The Sickness Benefit will be merged into the Community Wage from 1 October.

Invalids Benefit rates will remain the same, but some other changes will be made. For example, the criteria for the Invalids Benefit will be set out more clearly in legislation so that doctors can be clearer about who should qualify.

These changes are designed to meet the challenge of long-term benefit dependency. We recognise that this challenge cannot be met by either beneficiaries or the Government alone.

We will provide support for those who need it when they need it.

But in turn, we are encouraging New Zealanders to make the most of their own individual talents and opportunities to move from dependency on the state for their wellbeing to independence.

Domestic Purposes Benefit

The world has changed since the Domestic Purposes Benefit was first introduced. In New Zealand around 70 percent of mothers with school-age children are in paid work at least part of the time. We know that most mothers want to stay in touch with the workforce if they have the support.

To assist in providing that support, we will be offering a **childcare subsidy** to low income working parents whose children are aged 5 to 13 for out-of-school care.

The subsidy will be available for those who need to purchase childcare to work or to meet other work test obligations. A sole parent with two school-age children who takes up work will have childcare subsidised by up to $72 a week during the school term and by up to $108 a week during school holidays.

Extra spending on childcare to support benefit policies will be $31 million over the next three years.

We believe that if you can work then you should work.

From 1 February 1999 the Coalition Government will be requiring domestic purposes and widows beneficiaries whose youngest child is aged 6 to 13 to **search for and take up part-time work**. Those whose youngest child is 14 and over will be required to seek **full-time work**.

Those requiring assistance will not be on their own. In addition to the childcare assistance, we are committing an extra $43 million for case management, employment services and training to help those receiving the DPB to find work and to keep it.

Strengthening families

The Coalition Government recognises that some families need more help than others to realise their potential.

To assist those families with children who are demonstrating the need for assistance, we will increase resources to the Children, Young Persons and their Families Service by $52 million over the next three years.

In addition, we have set aside $50 million to further assist children, young people and their families once policy development is completed.

There are also a number of families who for a variety of reasons have become trapped in a cycle of disadvantage from one generation to the next.

The Coalition Government is committed to providing these families with assistance.

This Budget funds **four pilot locations** for a programme called **"Family Start"**. In these places families who face real obstacles to success will be identified and offered a greater amount of intensive home-based assistance for up to five years from the arrival of a new child into the home.

Education

Consistent with the Coalition Agreement's goal of New Zealand becoming the most highly skilled nation in the world, this Budget will bring the total additional amount invested over the coalition period in education by this Government to $1,674 million.

This investment is designed to enhance the capability and performance of the education system, thus increasing the educational opportunities available to all New Zealanders.

We have put in place the **Unified Pay System** for teachers with the settlement this year of the primary teachers' and principals' collective employment contracts.

This will allow teachers to be rewarded for excellence in the classroom.

We want to see more schools able to respond to the needs of our young people - New Zealand's future.

We have therefore changed the way we fund schools that take responsibility for managing all their resources. A new funding formula will apply from the beginning of the third term for these schools.

All schools will be financially better off if they choose to move onto the new formula and significantly more money will go to schools that choose the **Fully Funded** option.

This will allow these schools to more effectively tailor delivery of the curriculum to their students. This could include more specialised or support staff, and better technology - the **choice is theirs**.

Not only will this provide better education, it will also reduce pressure on teachers' workloads.

In keeping with our investment in education, it is planned to build over 1,400 new classrooms to meet roll growth in 1998 and 1999 funded in part by the additional capital funding provided by the Government in the 1997 and 1998 Budgets.

We have been engaged since last year in a comprehensive review of **tertiary education**.

Reform in this area has one clear goal - to position the tertiary sector to meet the challenges of the future.

We have decided to make significant changes to the way tertiary students' education will be funded.

We are removing the cap on the number of students entitled to a government subsidy to help pay for the cost of tuition. By the year 2000 every student enrolled in an approved course will get the new taxpayer-funded **Universal Tertiary Tuition Allowance** paid to their tertiary provider.

The Universal Tertiary Tuition Allowance replaces the current system where only a fixed number of student places in public institutions get taxpayer funding and the institutions themselves have to find the money to pay for any extra students.

With the new Universal Tertiary Tuition Allowance we will move to a transparent dollar-per-course subsidy for all students no matter where they study.

Through these changes overall tuition fees will not rise, and in some cases they should drop.

Health

Quality public health care is fundamental to New Zealanders.

This Government is committed to ensuring that New Zealanders have access to a high-quality **public health service**.

As part of that commitment, last year we delivered on our promise for free doctors' visits for children under six years. In the Northern region alone, around 800,000 subsidised visits have taken place since 1 July last year.

In addition to the $709 million extra for health in 1998/99 and 1999/2000 indicated in last year's Budget, we have allocated a further $253 million over the next three years to fund additional elective surgery.

This extra funding means that about 30,000 additional people each year will be able to receive elective surgery.

The Government will be publishing a hospital plan by 1 September this year which will provide New Zealanders with certainty and surety about what services will be available at each hospital.

Legislation will be introduced later this year to better protect the rights of people with intellectual disabilities and provide clarity for service providers and caregivers about their care where this is required.

An extra $45 million will be put into meeting our mental health needs over the next three years. For example, $1.8 million has been used to purchase a regional coordination service in Northland, South Auckland, Auckland Central and Waitemata.

As part of our commitment in the Coalition Agreement, under legislation to be introduced today, **Hospitals will again be called Hospitals** - not Crown Health Enterprises.

Hospitals will now not be required to earn a profit but to deliver services efficiently.

While there will be no restrictions on hospitals making a surplus, any surplus that is earned can be retained by the hospital and reinvested in more services.

We are making substantial capital investments that will ensure that our hospitals remain world-class.

In this financial year, hospitals are expected to invest a quarter of a billion dollars in hospital facilities. Over the following two years, hospitals have forecast that they will invest more than $650 million.

For example, Palmerston North hospital will see $53 million over the next three years go towards redevelopment.

$28 million will go to redeveloping facilities at Princess Margaret and Sunnyside hospitals in Christchurch. $52 million will go into Healthcare Hawkes Bay for the redevelopment programme including the regional hospital and the Brain Injury Unit.

The Coalition Government has also made good on its promise to remove **income and asset testing** for older people in long-stay public hospital care and asset testing for older people in long-stay private hospital care.

These changes, costing $63 million a year, will take effect from 1 October this year.

To reinforce the Government's smoking reduction strategy, we will increase the tobacco excise by 50 cents for a packet of 20 cigarettes or equivalent. This rise will take effect from midnight tonight.

The Health Sponsorship Council will have its funding increased by $6.7 million over the next three years to assist the development and funding of smoke-free programmes.

Law and order

There are other challenges that this Government must respond to.

New Zealanders are entitled to feel safe in their homes and communities.

Since this Government took office 286 additional Police have been employed. This Budget provides funding for the remaining 214 to ensure we meet the Coalition Agreement commitment of **500 additional Police** within the Government's three-year term.

This increase will enable the Police to boost the number of frontline officers, increase the specialist targeting of organised crime and gang activities, and increase road safety.

A total of $194 million extra will be provided over the next three years to the Police to ensure they are adequately resourced for modern policing.

Under this Government, Police are funded at a higher level than ever before. We need to ensure that this money is being well spent.

The Government has therefore launched a review to ensure Police have the most cost-effective administration and management structures.

To deliver on our commitment for safer communities, the Department of Corrections will receive $63 million over the next three years to improve the capability of its staff, to upgrade the security and safety of its prisons and provide new prisons.

This total funding includes $8.9 million for new programmes in prisons to **reduce re-offending** and find more cost-effective methods of operating.

These programmes include skills programmes which aim to improve the level and extent of inmates' education, and skill and therapy programmes designed to reduce re-offending.

Also included is funding for the expansion of home detention in order to provide a more cost-effective alternative to imprisonment.

Conservation

The state has a role in keeping New Zealanders and our visitors safe in other areas.

The Department of Conservation has been allocated additional funds for **managing visitor structures** on the conservation estate.

The Government will be allocating an additional $6.75 million per year on an ongoing basis from 1999 to upgrade and maintain the 16,000 visitor structures on conservation land.

A Quality Conservation Management system has been introduced to make sure all aspects of the Department of Conservation's work meet nationally consistent standards and priorities.

Mäori Land

The Government has agreed to undertake a review of the **Te Ture Whenua Mäori Act**. It will cover the principles and policies of the existing Act and all other relevant material such as case law, academic comment and publications of other organisations such as the Law Commission.

The review will also address issues such as the role and jurisdiction of the Mäori Land Court, Mäori land tenure, land title system, succession, economic development and taxation status of relevant bodies under the Act.

The Ministry of Mäori Development, Te Puni Kokiri, will receive $1.3 million in 1997/98 and $1.2 million in 1998/99 to carry out statutory obligations under the **Mäori Reserved Land Amendment Acts**.

Conclusion

This Budget presents a clear programme with one main objective: a better future for all New Zealanders.

A sound economy is the key to that future.

That is why we are managing the public finances so carefully in this time of international uncertainty.

That is why we are pursuing pro-growth policies that make it easier to do business - bringing investment, employment, higher wages and a better standard of living for all New Zealanders.

Our social policies also work towards providing a better and fairer future for all of us.

For our children to reach their potential:

- they must be safe
- they must have access to high-quality education
- they must have access to quality public health care
- they must grow up in an economy of opportunity and
- they must have the confidence and the support to succeed.

The Government has a role in providing these springboards to success.

In this Budget this Coalition Government is taking bold steps to meet the economic and social challenges facing New Zealand.

In this Budget we have considered the interests of all New Zealanders. We have not taken a sectional, segmented approach.

Good government is inclusive. It is for everybody:

- male/female
- worker/employer
- farmer/businessman
- young/old
- regardless of race.

Our past has taught us that self-reliance is the key to success in life and in business. Our programme provides an environment for such success.

The 1998 Budget, **firm, fair and visionary** opens the door to success for all New Zealanders.

Fiscal Strategy Report

Introduction

In recent times, New Zealand has successfully reversed a difficult fiscal position that threatened our social and economic development. Despite pressures on expenditure and recent strains caused by external developments, the Government continues to make progress towards its fiscal objectives. Today, our task is to retain the gains of the past, while capitalising on them to improve our social and economic wellbeing.

Good fiscal management is a key part of the Government's overall economic strategy. With good fiscal management and continuing economic growth, there will be more fiscal options in terms of debt reduction, lower taxes and social expenditure.

When Crown debt was high, its reduction was the over-riding priority. By setting new long-term objectives for Crown debt this report signals that debt reduction remains a very important priority. However, as debt is lowered, priorities change. In the short term, maintaining an operating surplus and continued debt reduction are a necessary cushion against unexpected events. In the medium term, controlling expenditure growth ensures that we continue to make progress towards both our tax reduction and debt repayment objectives.

Throughout our term in office, our fiscal strategy has shown that we are aware that we live in uncertain times. Many factors combine to affect the New Zealand economy; an example is the financial crisis in Asia, which is causing changes to macroeconomic and fiscal forecasts. While we will react prudently, we believe that drastic changes to our fiscal strategy are not necessary. We wish to signal that it is not our intention to change our overall policy direction, but to appropriately modify our tax and spending plans in light of the current economic situation.

As required by the Fiscal Responsibility Act 1994, this report:

- assesses the consistency of the Budget with the *Budget Policy Statement*
- provides progress outlooks for the Government's long-term fiscal objectives
- considers the consistency of the Budget three-year economic and fiscal update with short-term fiscal intentions in the *Budget Policy Statement*.

This report also looks at issues beyond the 10-year horizon.

The Government's fiscal strategy is sufficiently robust in both the short and the medium term to manage the impact of adverse conditions. The message of this report is that the New Zealand Government is, and will continue to be, fiscally responsible.

Fiscal Responsibility Act 1994

The Fiscal Responsibility Act 1994 states the principles of responsible fiscal management as:

- reducing debt to prudent levels
- controlling operating expenses in relation to operating revenues
- achieving appropriate levels of net worth
- managing fiscal risks
- pursuing policies that give stability to and predictability about tax rates.

The Act requires the Government to show that it is acting in accordance with these principles through a series of reports presented to the House of Representatives at various times during the financial year. On the day of the first Appropriation Bill for the financial year, the Government is required to present a report on its fiscal strategy. This *Fiscal Strategy Report* shall 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 10 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*.

Ten-Year Fiscal Strategy

The themes of this section:

- expenditure management
- tax revenue management
- debt reduction
- building up net worth

are consistent with the principles of responsible fiscal management as outlined in the Fiscal Responsibility Act. Each theme is considered under its own heading. Consideration of the fifth principle, managing fiscal risks, is incorporated as appropriate throughout the report, since it has an impact on all areas of fiscal strategy.

Managing Expenditure

Expenditure management is a key factor in our ability to meet our fiscal objectives. If expenses go up, they must be financed - by increasing revenue from taxes either now or in the future. Therefore, managing the growth of expenditure remains a key focus of our 10-year strategy, to ensure that increases are kept at an appropriate level, and are in areas with greatest benefit to society.

Controlling operating expenses while maintaining the tax base helps to maintain operating surpluses, and this accords with the principles of the Fiscal Responsibility Act.

There are always some services and payments that a government needs to provide to meet its social and economic objectives. However, as discussed in the 1998 *Budget Policy Statement*, international evidence suggests that too high a level of government spending can reduce economic and social wellbeing. The taxes needed to fund spending impose costs on the economy by distorting labour supply, investment and saving decisions, and by imposing administration costs on government and compliance costs on taxpayers. The Government will continue to review its spending and seek the mix of private and public provision that best meets its social and economic objectives.

We have a long-term objective of reducing expenditure to under 30% of Gross Domestic Product (GDP). Even with expenses below 30% of GDP, the Government will still have a large involvement in the economy, particularly in areas such as health, education and welfare.

Reaching the expenditure objective

With both the Government restricting expenditure increases to priority spending and the economy growing, expenses have continued to fall as a percentage of GDP. Government expenditure has been significantly reduced through lower debt-servicing costs, lower numbers of unemployment benefit recipients and the increased age of eligibility for New Zealand Superannuation (NZS).

Although expenses continue to fall as a percentage of GDP, achieving a target of 30% of GDP while maintaining priority spending will be challenging. Our task is to continue to meet social goals while reducing the spending ratio. Attaining the 30% target while meeting our other fiscal objectives requires:

- the right mix of debt repayment, tax cuts and priority spending
- fiscal policy settings that are consistent with the underlying performance of the economy.

The *Charting a Path to the Future - the Progress Outlooks* section below presents scenarios showing the impact on the Government's fiscal objectives of various rates of expenditure growth. From these it is clear that we must keep firm control of expenditure growth to achieve the 30% objective in the medium term.

Managing Tax Revenue

The Government needs to monitor and protect the tax base to ensure that tax rates are predictable, that tax revenue is collected at the lowest possible tax rates, and that all individuals and companies pay their fair share of tax. In some cases, specific taxes should increase for public policy reasons (for example, tobacco excise). In other cases, taxes or levies will decrease because of microeconomic reform (for example, motor vehicle tariffs). However, in previous reports the Government has signalled its intention to reduce tax rates generally if economic and fiscal conditions permit.

The benefits of tax reductions

There is a direct link between government revenue from taxes and government expenditure - without incurring debt, sustainable tax reductions are possible only when growth in nominal GDP is higher than growth in expenditure.

Tax reductions:

- can enhance economic growth by affecting the size of the labour force, productivity gains, and investment and saving decisions. The empirical and theoretical evidence suggests that tax reductions in themselves may have a positive effect on economic growth. Even small increases in economic growth will lead to substantial improvements in living standards in the long term
- increase social wellbeing by reducing distortions to individuals' work, investment and saving decisions. Tax reductions deliver these gains even if they do not lead to increases in economic growth. For example, although tax reductions may not generate an overall increase in labour supply, they may allow individuals and households to adjust their work and leisure patterns to better suit their preferences
- reduce incentives to avoid and evade tax.

Given the link between the levels of tax revenue and public expenditure, the Government must weigh up the benefits of reducing taxes against the benefits of further expenditure, taking into consideration all of its social and economic objectives.

Overall, the Government believes that there is a good case for further reducing taxes. Therefore, tax reductions remain a key part of the Government's medium-term fiscal and economic strategy. The Government's long-term objective to reduce expenditure to below 30% of GDP, and to gradually reduce the operating surplus, implies that we should also look to the tax-to-GDP ratio falling below 30%.

Reducing Debt

Net public debt at over 50% of GDP in 1991/92 was an unacceptable risk to both the economy and the security of health, education and welfare services. When public debt is high adverse economic shocks may force sharp increases in tax or large reductions in spending. New Zealand's net public debt has been reduced from over 50% of GDP in 1991/92 to 26% of GDP in 1996/97.

20% and beyond - setting a new objective

Under the Fiscal Responsibility Act 1994 the Government specifies what it considers to be a prudent level of debt. A prudent level of net public debt makes the fiscal position more robust to economic shocks and foreseeable demographic pressures and lowers the cost of debt servicing in relation to total government expenditure.

The Budget forecasts indicate that the Government will reduce net debt to below 20% of GDP in 2000/01[1]. As discussed in *Charting a Path to the Future - the Progress Outlooks* below, the current long-term objectives mean that steady debt repayment continues beyond the existing net debt target of 20%.

However, to demonstrate an ongoing commitment to giving a high priority to debt repayment, the Government has changed its long-term objectives for Crown debt. The gross debt objective has been changed from 30% to 25% of GDP, and the net debt objective from 20% to 15% of GDP.

[1] Gross public debt is projected to fall to 30.6% of GDP in 2000/01.

Long-term objectives

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.

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.

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.

Crown debt

The Government will steadily reduce the level of gross Crown debt to 25% of GDP, consistent with reducing net Crown debt to 15% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.

Crown net worth

The Government will maintain net worth at significantly positive levels.

As discussed in *Charting a Path to the Future - the Progress Outlooks*, attainment of net debt below 15% of GDP over the next five years is challenging but achievable, although it will require managing expenditure pressures.

The long-term objectives state that once net debt is below 15% of GDP, the Government will gradually reduce the operating surplus through a mix of increased priority spending and tax reductions.

As illustrated in *Charting a Path to the Future - the Progress Outlooks*, even with expenditure growth and tax reductions, net debt will continue to fall to under 15% of GDP by 2002/03 and to under 5% of GDP by the end of the period (2008/09).

Building up Net Worth

Lower debt and positive Crown net worth help the Government to meet future obligations without sharp changes in policy settings, and help cushion the economy against external economic shocks and the impact of natural disasters. Recent reforms and diversification of the tradeable sector have enabled the New Zealand economy to become more robust and flexible, but it remains vulnerable to changing external conditions and adverse movements in its terms of trade. In the short term, we will maintain operating surpluses as a defence against adverse changes in internal or external conditions. In the longer term, significantly positive levels of net worth will cushion the economy against adverse events.

The focus of fiscal policy has been on debt reduction, which increases net worth. The Crown's financial strength also depends on the overall composition of assets and liabilities on the balance sheet.

In managing its balance sheet the Government must also consider the role it wishes to play in the economy. Divestment of non-strategic assets where private ownership will increase efficiency is part of the Government's overall economic strategy. The Government will continue to examine its ownership interest in non-strategic assets on a case-by-case basis, seeking to retain them where there is a solid public policy rationale for their continued public ownership.

Charting a Path to the Future - the Progress Outlooks

The Fiscal Responsibility Act 1994 requires the Government to present projections for the variables specified in its long-term objectives. These projections are in the form of scenarios which illustrate likely future progress towards achieving the Government's long-term objectives.

This section outlines the projections, or progress outlooks, and summarises their impact on each of the fiscal objectives. The detailed assumptions behind the scenarios are given in Annex 1. Until 2000/01, all the scenarios use the three-year fiscal settings and macroeconomic assumptions detailed in the 1998 *Budget and Fiscal Update*. Alternative expenditure, tax and economic growth assumptions start from 2001/02. Four scenarios have been used:

- The Baseline scenario assumes 1% real and real per capita[2] expenditure growth per year and maintenance of current tax rates. For 2001/02 a 1% assumption allows around $600 million for baseline increases to expenses not driven by indexation or demographic factors. The 1% assumption reflects additional policy initiative trends evident over the period 1993/94 to 1996/97.

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[2] Expenditure on items where growth is driven by demographic trends, increases in real per capita terms. Other expenditure increases in real terms.

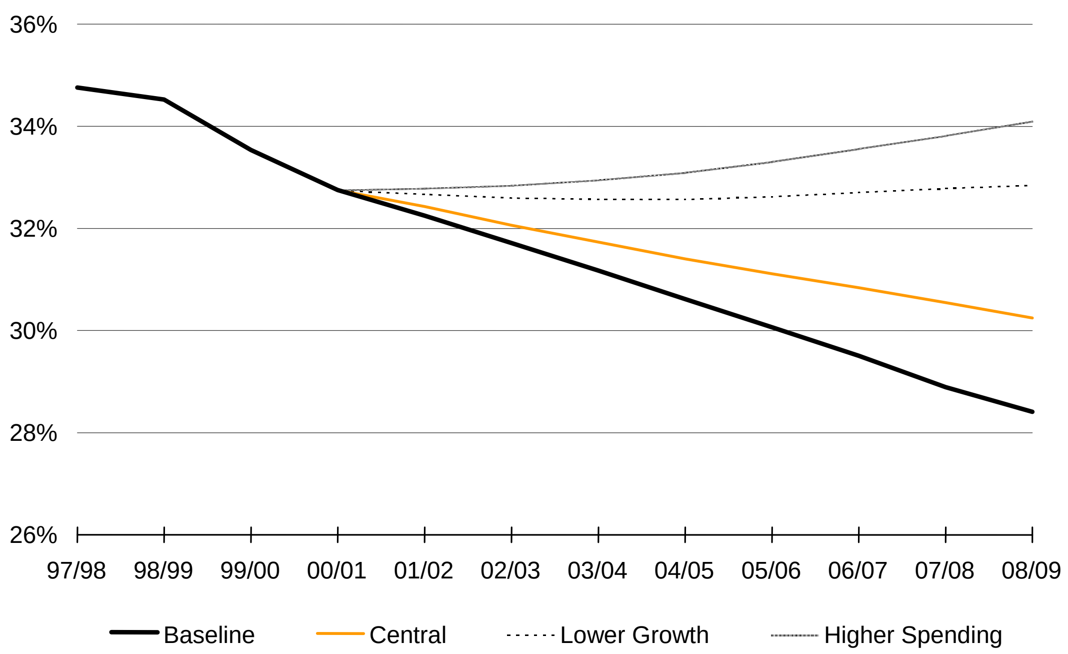
- The Central scenario assumes 1.5% real and real per capita expenditure growth. For 2001/02 the 1.5% assumption allows around $800 million for baseline increases to expenses not driven by indexation or demographic factors. The 1.5% assumption reflects additional policy initiative trends evident over the period 1994/95 to 1999/2000. This scenario also includes a number of small tax reductions, starting in 2001/02 and equivalent to 0.3% of GDP each year. The expenditure increases and tax cuts in this scenario are illustrative, and not policy intentions.

- The Lower Growth scenario assumes that the economic growth rate is 2% per year, compared with 3% per year in the Central scenario. This scenario presents the fiscal position under a trend growth rate below that in the Central scenario and assumes no fiscal policy response to the change in growth.

- The Higher Spending scenario assumes real and real per capita expenditure growth rates of 3% per year. This scenario presents the fiscal position with higher expenditure growth than that assumed for the Central scenario.

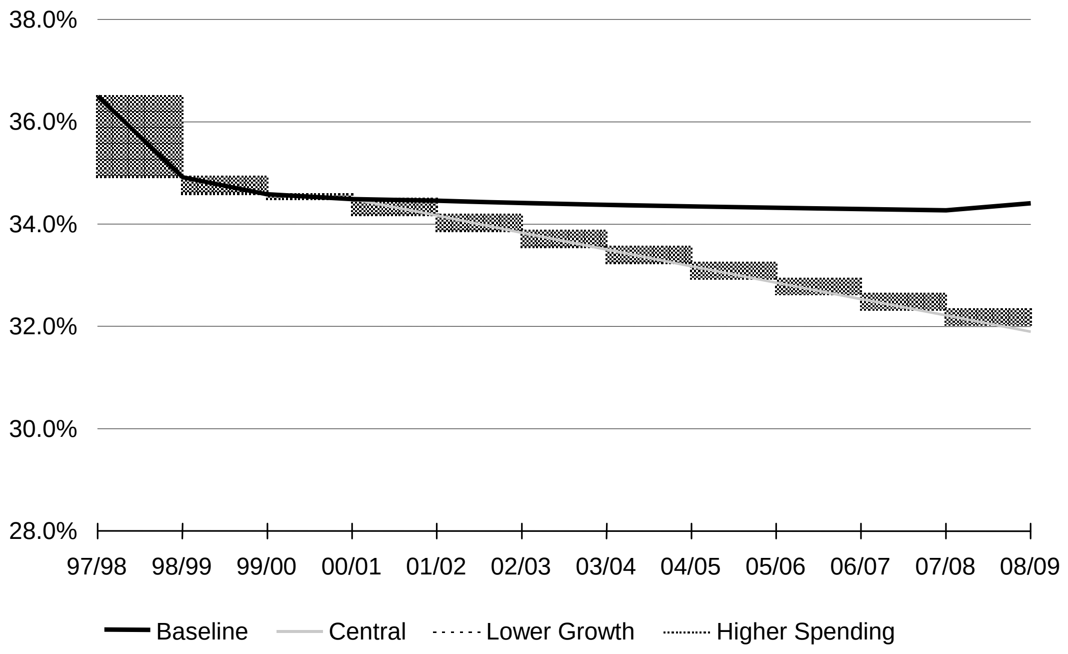
Results and consistency with long-term fiscal objectives

Figure 1 - Operating Expenses



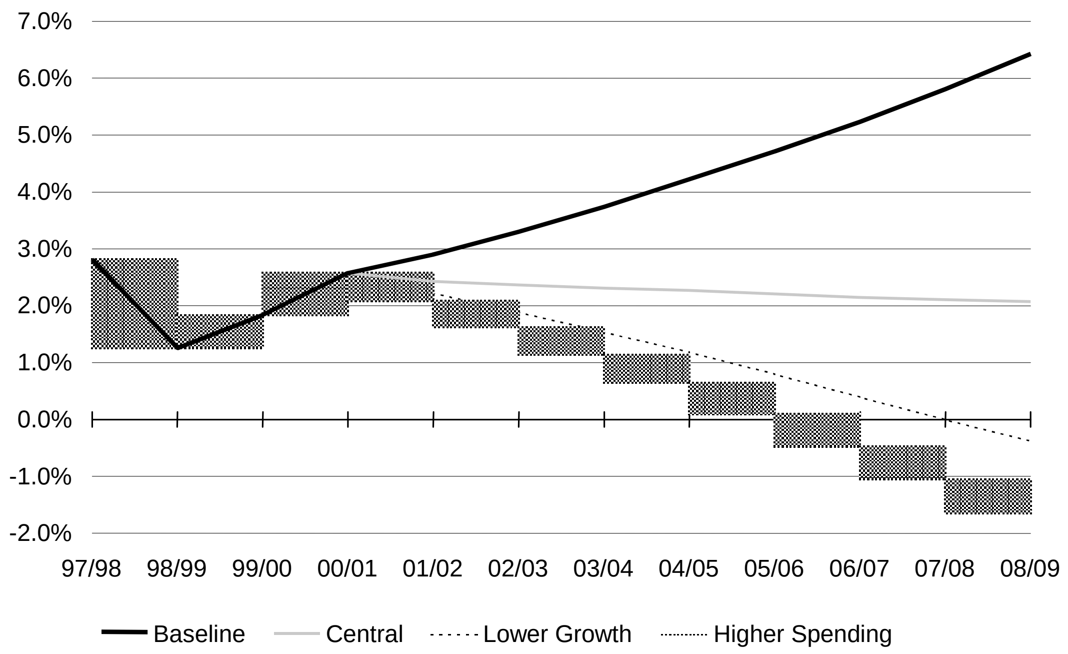
Operating expenses continue to fall as a share of GDP under both the Baseline and Central scenarios. The 30% of GDP expense objective is achieved in 2006/07 under the Baseline scenario. The Central scenario is consistent with the direction of change implied by the long-term expense objective, and the ratio of expenses-to-GDP reaches 30.2% in 2008/09. Reaching the objective in the medium term will require a degree of expenditure control tighter than that assumed in the Central scenario. Neither the Lower Growth nor the Higher Spending scenario reaches the 30% of GDP expense objective.

Figure 2 - Operating Revenue



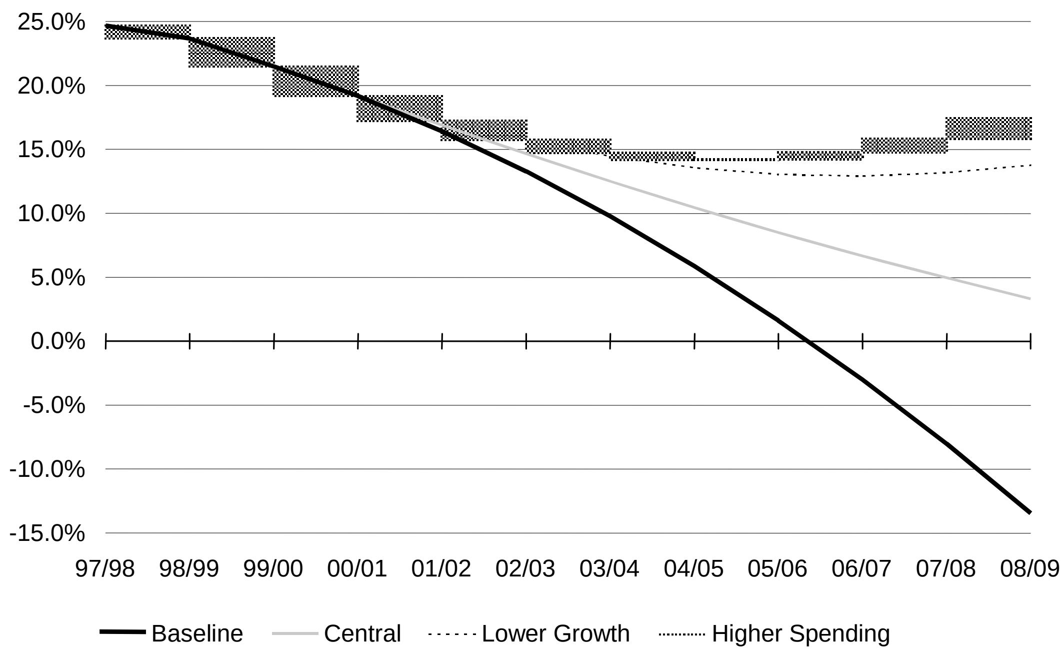
There is very little difference in impact on operating revenue between the Central, Lower Growth and Higher Spending scenarios. In contrast to the Baseline, tax revenues as a share of GDP fall in all the other scenarios because they include the tax reductions.

Figure 3 - Operating Balance



Over the next three years, operating surpluses are maintained as outlined in the short-term intentions. Following this, the operating balance remains in surplus under both the Baseline and Central scenarios. However, the projected rise in the operating balance in the Baseline scenario is inconsistent with the long-term operating balance objective, which requires a gradual reduction in the operating surplus. In contrast, the Central scenario shows a gradual reduction in the operating balance. In the Lower Growth scenario the operating balance goes into deficit in 2008/09. Under the Higher Spending scenario, the operating balance goes into deficit in 2006/07.

Figure 4 - Net Debt



Over the three-year forecast period, net debt continues to fall as a share of GDP. Net debt is reduced to below 20% of GDP (the previous prudent debt level) by 2000/01.

Under the Baseline scenario, net debt is eliminated by 2006/07 and net financial assets accumulate to just under 14% of GDP by 2008/09. This scenario is not consistent with the long-term objective to gradually reduce the operating balance.

Even with the expenditure growth and tax reductions assumed in the Central scenario, net debt falls below 15% of GDP (the new prudent debt level) in 2002/03, and continues to fall throughout the period, to under 5% of GDP by 2008/09.[3]

In the Higher Spending scenario, net debt falls below 15% of GDP in 2003/04 and then begins to rise again. With lower economic growth, net debt is reduced to below 15% of GDP but does not fall below 10%.

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[3] Under the Central scenario, gross debt falls to below 25% of GDP in 2003/04 and to 11.3% by 2008/09.

Figure 5 - Net Worth

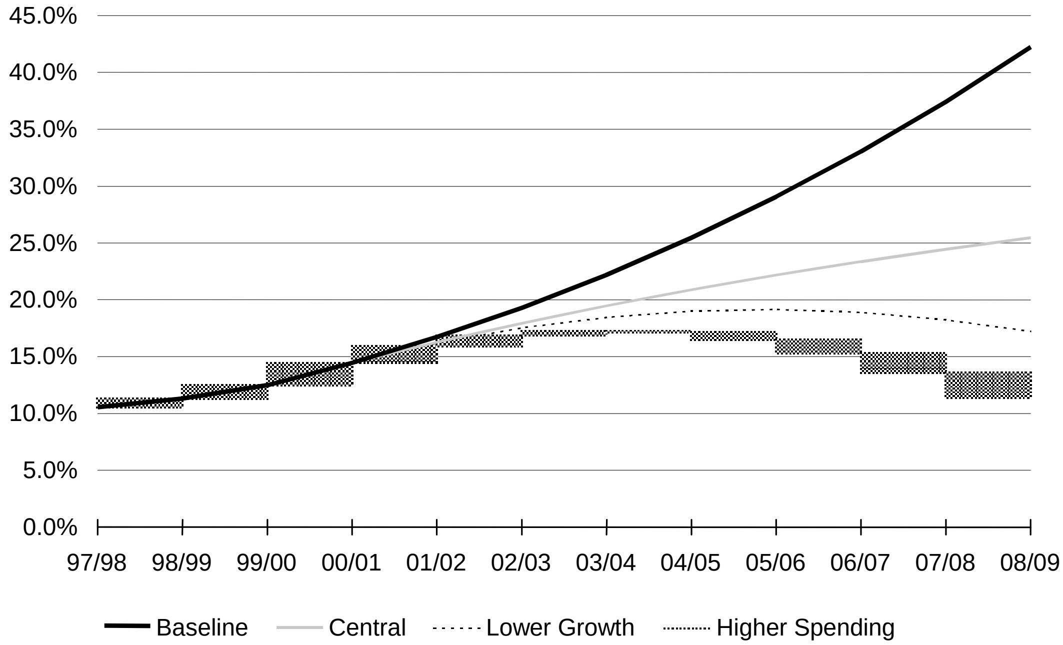

Figure 5 shows the impacts on net worth of the changes discussed above under operating balance and net debt.

Policy consequences

The progress outlook scenarios demonstrate how alternative policy choices (spending and taxes) influence the future fiscal position. In doing this, they highlight the trade-offs between such choices. Only the Central scenario is consistent with the Government's long-term objectives.

The scenarios show that expenditure control is crucial to achieving the Government's long-term fiscal management objectives. The Central scenario illustrates that ongoing debt reduction is compatible with tax cuts and controlled expenditure growth. The Central scenario demonstrates that we must keep firm control of expenditure growth to reach the 30% objective in the medium-term.

Expenditure control will require a commitment to carefully considering the Government's role in the provision of certain services and payments. By identifying and reducing such expenditure, the Government will increase the scope for debt reduction and/or tax reductions. A fiscally sound framework for dealing with future expenditure pressures, including emerging demographic pressures, will require an emphasis on controlling expenditure and achieving improvements in the delivery of services in coming years (see *Future Developments in Long-Term Fiscal Strategy*, page 34).

The Government indicated in the *Budget Policy Statement* an intention to reduce tax rates over time, if economic and fiscal conditions permit, to enable New Zealanders to make their own decisions about how they spend, invest and save their money.

The Central scenario demonstrates that tax reductions are sustainable when expenses continue to fall as a share of GDP. The Higher Spending scenario shows that further tax reductions, in association with 3% real and real per capita expenditure growth, are not sustainable. The expense and operating balance objectives are not reached, and the net debt objective is not sustained. The Lower Growth scenario shows that with tax reductions, and 1.5% real and real per capita expenditure growth, we miss the expense and operating balance objectives.

The Lower Growth and Higher Spending scenarios reflect in part the consequences of maintaining fiscal policy settings that are at odds with the underlying performance of the economy. For example, in both scenarios real and real per capita expenditure growth exceed labour productivity growth. If these differences persist they would eventually require a shift in policy settings. Lower levels of net debt and the maintenance of operating surpluses provide time to recognise when change is needed.

Future Developments in Long-Term Fiscal Strategy

This section looks at issues beyond the 10-year fiscal horizon. Currently the four major areas of government spending are: health; education; NZS; and welfare benefits. Changes in the level of spending on these government services reflect a number of factors, such as:

- demographic developments affecting the key age group for the service
- the need within these age groups (for example, educational needs, or rates of unemployment or sole parenthood)
- the proportion of the service provided by the public sector.

Some of these factors, such as demographic developments, are outside government control, but others can be influenced by government policies and actions.

Previous *Budget Policy Statements* and the 1997 *Fiscal Strategy Report* discussed the impact of demographic pressures on the long-term fiscal position. The ratio of those aged 65 and over to those in the working age group of 15 to 64 years is projected to more than double over the next 40 years. This demographic change will have significant consequences for long-term fiscal outcomes. For example, without any policy changes, expenditure on NZS is projected to almost double as a share of GDP by 2050/51.[4]

Other demographic changes may allow the opportunity for reductions in the proportion of GDP spent on education, since there may be fewer children in our schools. It is important to our longer-term fiscal strategy that we reflect these population changes in our expenditure patterns.

4 This result is derived using the Treasury's Long-Term Fiscal Model (LTFM), which covers a longer time period (50 years) and uses different assumptions from those in the progress outlooks. For example, the LTFM assumes that real per capita spending in areas such as health and education equals the rate of labour productivity growth. The progress outlooks, which illustrate alternative scenarios over a shorter period, allow expenditure and labour productivity growth to differ.

The overall rise in expenditure is a long-term problem; the full impact of demographic change occurs after the medium-term period covered by this report. However, the Government believes it will need to carefully consider all government expenditure over the next 10 years to ensure that New Zealand continues to prosper into the second half of the next century.

How to meet the pressures imposed by an ageing population is a controversial issue, with many different views expressed by different parties. This was shown by the debate surrounding the referendum on the proposed compulsory Retirement Savings Scheme (RSS). It will clearly require much time, discussion and negotiation to produce solutions that will have the support of a majority of New Zealanders, yet this support is essential for long-term policy stability.

Meanwhile, current government fiscal policies place us in a good position to take beneficial action in the medium term. As regards the long-term superannuation debate, our policies are not inconsistent with the approach suggested by the 1997 Periodic Report Group. Lower debt and a positive operating balance will put us in a strong economic position to face a challenging future with confidence.

Short-Term Fiscal Strategy

The Fiscal Responsibility Act 1994 requires operating surpluses every year until prudent levels of debt have been achieved. The 1998 *Budget Policy Statement* indicated that if economic conditions were to threaten surpluses before prudent debt levels were reached, the Government would be prepared to reconsider its expenditure plans by both deferring some spending and cutting lower priority spending to maintain surpluses.

New Zealand's Current Situation

The *Budget Policy Statement* also stressed the importance of maintaining fiscal policy credibility. Recent events make this even more important:

- The financial crisis in Asia has had an impact on economic and fiscal projections.
- The current account deficit has increased to 7.7% of GDP (in December 1997) and net external liabilities were 76% of GDP (at March 1997).
- Moody's Investors Service (an international credit rating agency), while maintaining New Zealand's credit rating at Aa1, has changed the associated outlook from stable to negative. Moody's cited the widening in the imbalance in the country's external accounts, as well as the potential impact of the events now unfolding in Asia.

Moody's is not the only external agency to have noted and commented on recent developments. For example:

- the International Monetary Fund (IMF) report on New Zealand in 1997, while noting continuing international confidence, considered that the sizeable external imbalance posed risks, given New Zealand's already high stock of external liabilities and its vulnerability to external shocks. The IMF advised a tighter fiscal policy to minimise the risks, particularly in light of current regional uncertainties
- the Organisation for Economic Cooperation and Development (OECD) 1998 Survey of New Zealand, while positive about New Zealand's economic prospects and structural framework, acknowledged that Asia and the current account deficit posed significant risks to the New Zealand economy. As a result, the OECD stressed the importance of at least meeting current fiscal targets and thereby maintaining investor confidence in the New Zealand economy.

An appropriate response to events

The Government wants to signal its commitment to maintaining fiscal and economic policy credibility. A perception of a fiscal deficit at this time is likely to reduce confidence in the future course of fiscal policy and raise concerns about the sustainability of New Zealand's external position. This could lead to a rapid and significant fall in the exchange rate, a sharp increase in interest rates, and weaker short-term economic prospects.

Maintaining fiscal policy credibility at this time is the key contribution the Government can make to maintaining investor confidence in New Zealand and minimising short-term instability. In addition, the Government is committed to its programme of microeconomic reform.

Lowering debt is a fundamental principle of responsible fiscal management and an important step in establishing and maintaining fiscal credibility. As a result, the Government must run surpluses sufficient to ensure that prudent debt levels are reached.

Current fiscal projections indicate that operating surpluses will be maintained, even if economic events unfold somewhat differently. Even under the alternative economic scenarios discussed below, net debt as a share of GDP will fall over time. However, given the recent developments surrounding the economic outlook, the Government is committed to higher fiscal surpluses than otherwise, so that confidence is enhanced.

New Zealand's current account deficit reflects an imbalance between private sector saving and investment. The Government has been running fiscal surpluses and repaying debt. The Government continues a programme of debt reduction, and net debt is projected to fall below 20% of GDP within the next three years. Running significantly larger fiscal surpluses would involve costs in terms of foregone tax reductions and increases in expenditure. Indeed, it is not clear that even tighter fiscal policy would actually raise national saving and lead to a lower current account deficit. But the Government will continue to ensure that the economic strategy provides an environment conducive to saving and investment.

Given New Zealand's current situation, the Government is strengthening its commitment to running operating surpluses so that net debt reaches prudent levels. This requires us to bolster operating surpluses, with some changes to previous short-term intentions. If circumstances change we would be prepared to further reconsider our plans.

Maintaining Fiscal Surpluses

In the current uncertain economic conditions, maintaining an operating surplus is crucial. It helps to maintain confidence in debt repayment and other key fiscal objectives, and investor confidence in the New Zealand economy.

An operating surplus allows the Government to react to unforeseen economic circumstances that might otherwise cause the fiscal balance to move into deficit and prevent progress being made on the Government's long-term fiscal objectives. The move to a 15% net debt objective will mean a commitment to running larger surpluses for a longer period than would be the case under the 20% net debt objective.

Reducing spending intentions

In light of the uncertainty surrounding the impact of external events, it is prudent not to commit all of our available resources to expenditure increases. Our forecasts indicate that we can expect operating surpluses. However, the Government intends to reduce by $300 million the resources available under the $5 billion Coalition Agreement limit on policy initiatives ($150 million reduction in spending in 1998/99 and the same in 1999/2000). So, for reasons discussed above, the cost of additional initiatives will be limited to $4.7 billion in the three years to 1999/2000, rather than $5 billion.

If the situation worsens, the Government will continue to react appropriately. Alternatively, if the situation clarifies and improves, the Government will be able to reconsider its mix of spending, tax cuts and debt reduction.

Taxation intentions

Our objective is a low-rate, broad-based tax regime, with all New Zealanders paying a fair share of the revenue required to provide government services. In the short term, revenue levels will remain high enough to maintain operating surpluses.

To be able to lower tax rates after 1998 will require moderate expenditure growth so that a continued reduction in spending as a percentage of GDP occurs. Current forecasts indicate that tax reductions in 1999/2000 will not be possible. Economic and fiscal conditions permitting, we would wish to consider a tax reduction in 2000/01. However, this needs to be balanced against the long-term objectives, including further progress towards debt repayment. The move to a 15% net debt objective will mean greater expenditure control than otherwise would be the case, if significant tax reductions are to be possible in 2000/01.

Short-term intentions[5]

Operating expenses

The Government will maintain firm control over expenses and a steady decline in the ratio of expenses to GDP. Policy initiatives, including the abolition of the surcharge, will cost up to $4.7 billion over the years 1997/98 to 1999/2000. The indicative spread of the $4.7 billion is approximately $0.8 billion in 1997/98, $1.5 billion in 1998/99 and $2.4 billion in 1999/2000. Provision of a further $800 million has been made for policy initiatives with an impact in 2000/01.

Operating revenues

Tax reductions will take effect on 1 July 1998. The Government will introduce further tax reductions if economic and fiscal conditions permit.

Operating balance

The Government will run surpluses consistent with its operating expenses and revenue intentions. On current forecasts, the Coalition Agreement fiscal parameters and the inclusion of a provision for initiatives in 2000/01, this will result in operating balances of $2.8 billion in 1997/98, $1.3 billion in 1998/99, $2 billion in 1999/2000 and $3 billion in 2000/01.

Crown debt

The Government will steadily reduce gross and net Crown debt. If expected economic conditions prevail, gross Crown debt and net Crown debt will be $36.9 billion and $24.4 billion in 1997/98, $36.9 billion and $24.6 billion in 1998/99, $36.3 billion and $23.6 billion in 1999/2000 and $35.4 billion and $22.2 billion in 2000/01.

Net worth

The Government will steadily increase levels of net worth to $10.4 billion in 1997/98, $11.7 billion in 1998/99, $13.7 billion in 1999/2000, and $16.7 billion in 2000/01, subject to expected economic conditions prevailing.

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5 Recognition of Accident and Rehabilition Compensation Insurance Corporation outstanding claims obligations in the Government's accounts at 30 June 1999 will imply a significant one-off reduction to net worth. Recognition is also likely to imply a lower operating balance in 1999/2000 and 2000/01, but will not affect net debt. The impact of this intended change in accounting policy is not included in the Budget forecasts, but will be included in the 1998 *December Economic and Fiscal Update* (see the box in the 1998 *Budget Economic and Fiscal Update* for details).

The Current Fiscal Projections

The Budget forecasts show a different profile from those presented in the *December Economic and Fiscal Update*. In particular, the recovery has been delayed and growth in the domestic economy is now forecast to be slower in the short term, with annual average GDP growth now forecast to be 2.7% in the year to March 1999, compared with a forecast of 4.0% in the *December Update*.

Three-year fiscal projections are outlined in the *Budget Economic and Fiscal Update* and details are provided in Annex 2 of this report. In terms of the Government's fiscal objectives:

- operating expenses are projected to decline from 34.5% of GDP in 1998/99 to 33.1% of GDP in 2000/01
- operating revenues are expected to decline from 34.9% of GDP in 1998/99 to 34.8% of GDP in 2000/01
- operating surpluses are projected to remain positive, and increase from 1.3% of GDP in 1998/99 to 2.6% of GDP in 2000/01
- Crown debt is expected to decline, with net debt falling from 23.7% of GDP in 1998/99 to 19.2% of GDP in 2000/01, and gross debt from 35.5% of GDP in 1998/99 to 30.6% of GDP in 2000/01
- Crown net worth is projected to increase from 11.3% of GDP in 1998/99 to 14.5% of GDP in 2000/01.

The underlying fiscal position

The central forecast in the *Budget Economic and Fiscal Update* presents the expected path of the economy over the next few years. In general, the Government does not change tax and spending on the basis of how the economic cycle unfolds. Stronger than expected growth boosts operating surpluses and allows faster debt repayment (and vice versa). This approach helps to stabilise the economy and reduce swings in output and employment during the cycle.

To assess whether changes in the fiscal position reflect cyclical or structural factors, it is necessary to remove the impact of temporary economic factors, such as the impact of changing economic growth on employment. This removal of cyclical factors shows the underlying fiscal trends. A cyclically adjusted balance, based on the cash flow equivalent of the operating balance, is included in the *Budget Economic and Fiscal Update*. It suggests an underlying fiscal improvement through to 1995/96. The deterioration in the actual fiscal position in 1997/98 and 1998/99 in part reflects cyclical factors, as the cyclically adjusted balance exceeds the fiscal balance. The analysis broadly confirms the strength of the underlying fiscal position.

Alternative fiscal outcomes

The central forecast in the *Budget Economic and Fiscal Update* is based on a set of judgments. If these judgments turn out to be incorrect, then the economy is likely to evolve differently. The *Budget Economic and Fiscal Update* also outlines alternative paths for the economy and explores the impact of these on the fiscal position, namely:

- a more gradual recovery than forecast. Under this path, tax revenue will be lower, and the operating balance will be reduced by around $450 million in 1998/99, $850 million in 1999/2000 and $725 million in 2000/01

- a more rapid recovery. If this comes about, the operating surplus could be higher by around $300 million in 1998/99, $800 million in 1999/2000 and $875 million in 2000/01.

Under either case, operating surpluses are still forecast over the period, rising from 1998/99 to 2000/01, and net Crown debt continues to fall. This analysis suggests that the Government's fiscal strategy can accommodate a range of economic developments and still make progress towards its long-term objectives.

Conclusion

The direction of the Government's fiscal policy, as presented in the 1998 *Budget Policy Statement,* is unchanged, although some short-term intentions have been amended in light of the changed environment and the most recent projections.

The Government's strategy is fiscally responsible and recognises the risks and uncertainty in New Zealand's current situation.

It is clear that we continue to make progress towards the long-term fiscal objectives, although the current economic situation makes it necessary for decisions to be weighted toward debt reduction rather than larger spending increases or tax cuts.

Setting new long-term objectives for Crown debt shows the high priority that the Government gives to debt repayment. Achieving the 15% net debt objective within the next five years is challenging, but possible. It will require running large operating surpluses for a longer period than would have been the case under the 20% of GDP objective.

A prudent level of debt makes the fiscal position more robust to economic shocks, and reduces the cost of debt servicing. Lower debt provides a foundation for taking positive action in the medium term to meet future developments, including the expected impact of long-term demographic changes.

The new debt objectives, in conjunction with the $300 million reduction in spending intentions, clearly demonstrates the Government's commitment to continuing prudent stewardship, and its ability to respond to changing needs over time.

Hon Winston Peters
Deputy Prime Minister and Treasurer

Annex 1

Progress Outlooks

This Annex provides the technical details of the progress outlooks summarised in the *Charting a Path to the Future - the Progress Outlooks* section. In line with the requirements of the Fiscal Responsibility Act 1994, the scenarios explore progress outlooks for each of the Government's long-term fiscal objectives. The Fiscal Responsibility Act requires the outlooks to relate to a period of 10 or more years.

Progress outlooks are not fiscal forecasts. They are long-term projections of what the fiscal position might be under alternative assumptions.

The Annex also provides an assessment of the consistency of the progress outlooks with those in the 1997 *Fiscal Strategy Report*, and the long-term objectives in the 1998 *Budget Policy Statement*.

Key Assumptions

All scenarios

Until 2000/01, all scenarios use the fiscal settings and macroeconomic assumptions summarised in Annex 2, and detailed in the 1998 *Budget Economic and Fiscal Update*. As outlined in the *Budget Update*, projections for 2000/01 include a technical assumption for new initiatives of $800 million (GST exclusive).

From 2001/02 the assumptions are:

- average inflation rate 1.5%
- average interest rate:
  - short term 6.0%
  - long term 6.5%
- average rate of unemployment 6%
- demographic trends based on the 1996 Census:
  - medium fertility and medium mortality
  - net migration of 10,000 per year.

Baseline scenario

This scenario assumes that the three-year fiscal projections apply up to 2000/01 and that thereafter:

- real GDP growth averages 3%
- expenditure on items driven by demographic trends (education, health and most welfare benefits) increases by 1% a year in real per capita terms
- NZS expenditure grows in line with nominal wages after reaching its wage floor (in line with existing legislation)
- other expenditure rises by 1% a year in real terms
- current tax rates (ie, those existing after 1 July 1998).

In 2001/02 the 1% spending assumption allows around $600 million for baseline increases to expenses not driven by indexation and demographic factors. The implication for total expenses (excluding finance costs) is around $1.1 billion: $600 million for baseline increases; $300 million for indexation; and $200 million for demographic factors. Indexation includes both Consumers Price Index (CPI) indexation of benefits and wage indexation of NZS. Beyond 2001/02 the $600 million increases in line with the real growth factor and inflation.

Central scenario

This scenario uses the same assumptions as in the Baseline scenario, except that:

- expenditure on items driven by demographic trends grows at 1.5%
- other expenditure items grow by 1.5% a year in real terms
- tax cuts equivalent to 0.3% of GDP are implemented each year from 2001/02.

In 2001/02 the 1.5% spending assumption allows around $800 million for baseline increases to expenses not driven by indexation and demographic factors. The implication for total expenses (excluding finance costs) is around $1.3 billion: $800 million for baseline increases; $300 million for indexation; and $200 million for demographic factors. Beyond 2001/02 the $800 million increases in line with the real growth factor and inflation.

The $800 million amount is based on policy initiative trends that have had an operating balance impact over 1994/95 to 1999/2000.

Lower Growth scenario

This scenario uses the same assumptions as the Central scenario, but with the assumed economic growth rate reduced from 3% to 2%.

Higher Spending scenario

This scenario uses the same assumptions as the Central scenario, except that expenditure on items driven by demographic trends increases by 3% a year in real per capita terms, and other expenditure items by 3% a year in real terms.

Consistency Between the Progress Outlooks and the Progress Outlooks in the 1997 *Fiscal Strategy Report*

The 1997 and 1998 *Fiscal Strategy Reports* use the economic and fiscal assumptions underlying the 1997 and 1998 Budget fiscal projections respectively for the first three years of the progress outlooks.

Four scenarios were used in the 1997 *Fiscal Strategy Report*: Baseline; Central; Lower Growth; and Higher Spending.

The key assumptions are unchanged from those in the 1997 *Fiscal Strategy Report*, with the following exceptions:

- a net migration assumption of 10,000 per year. (The Government has moved to a net migration target of 10,000 per year.) The 1997 *Fiscal Strategy Report* assumed net migration of 15,000 a year until 1999, and 5,000 a year thereafter

- 1.5% real per capita growth in spending in areas driven by demographic factors, and 1.5% real growth in spending in other areas in the Central and Lower Growth scenarios. The 1.5% assumption reflects policy initiative trends evident over the period 1994/95 to 1999/2000. In the 1997 *Fiscal Strategy Report* the Central and Lower Growth scenarios used the Baseline expenditure assumptions

- tax cuts in the 1997 *Fiscal Strategy Report* scenarios (Central, Lower Growth, and Higher Spending) were based on the implementation of the proposed compulsory RSS. These tax cuts were equivalent to 2%, 1%, 1% and 1% of the base for contributions to the RSS from 1999/2000 to 2002/03.

These differences in policy and assumptions mean that the progress outlooks in the 1997 and 1998 *Fiscal Strategy Reports* are not strictly comparable.

Annex 2

Three-Year Fiscal Projections

This Annex summarises the three-year fiscal projections contained in the 1998 *Budget Economic and Fiscal Update*. As required by the Fiscal Responsibility Act 1994, it also assesses the consistency of the projections with the Government's short-term intentions in the 1998 *Budget Policy Statement*. The full details of the projections are contained in the 1998 *Budget Economic and Fiscal Update*.

Fiscal outturns 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 an unexpected economic shock. If any of these events occurs, outturns may differ significantly from these fiscal projections.

Summary of the Projections

The Budget's three-year fiscal projections and the underlying economic assumptions are set out in the first three tables below. The three-year fiscal projections are broadly consistent with the short-term intentions presented in the 1998 *Budget Policy Statement*. The changes in fiscal variables result largely from movements in macroeconomic variables (see Table 3) not under the Government's control. These changes in economic conditions lead to changes in fiscal outcomes, as Table 4 shows.

Table 1 - Three-Year Fiscal Projections ($ million, June years)

Nominal	**1998/99**		**1999/2000**		**2000/01**	
	1998 BPS	**1998 FSR**	**1998 BPS**	**1998 FSR**	**1998 BPS**	**1998 FSR**
Net worth	10,899	11,720	13,090	13,741	15,825	16,725
Net debt	24,258	24,572	23,358	23,625	21,906	22,204
Gross debt	35,281	36,860	34,479	36,299	32,978	35,428
Revenues	37,067	36,257	38,547	38,229	39,952	40,206
Expenses	36,013	35,832	37,266	37,114	38,232	38,280
Operating balance	1,833	1,305	2,191	2,021	2,735	2,984

Source: The Treasury

Table 2 - Three-Year Fiscal Projections (% GDP, June years)

	1998/99		**1999/2000**		**2000/01**	
	1998 BPS	**1998 FSR**	**1998 BPS**	**1998 FSR**	**1998 BPS**	**1998 FSR**
Net worth	10.3	11.3	11.8	12.5	13.7	14.5
Net debt	23.0	23.7	21.1	21.5	18.9	19.2
Gross debt	33.4	35.5	31.1	33.0	28.5	30.6
Revenues	35.1	34.9	34.8	34.8	34.5	34.8
Expenses	34.1	34.5	33.6	33.8	33.1	33.1
Operating balance	1.7	1.3	2.0	1.8	2.4	2.6

Source: The Treasury

Note: Exchange-rate gains or losses on net foreign-currency Crown debt are not projected. The 1998 *Budget Policy Statement* net debt projections are based on the nominal exchange rate (TWI) as at 31 October 1997; the 1998 FSR projections are based on the nominal exchange rate as at 31 March 1998.

Table 3 - Macroeconomic Assumptions (June years)

	1998/99		1999/2000		2000/01	
	1998 BPS	**1998 FSR**	**1998 BPS**	**1998 FSR**	**1998 BPS**	**1998 FSR**
Real GDP (annual average % change)	4.2	3.3	3.0	3.7	2.7	3.5
Nominal GDP ($ million)	105,618	103,825	110,854	109,959	115,666	115,696
Consumers Price Index (annual average % change)	2.5	1.5	0.8	1.7	0.7	1.6
Interest rates on Government 10-year bonds (annual average %)	7.1	7.5	7.4	7.1	7.5	7.0
Household labour force survey unemployment rate (annual average % level)	6.6	6.8	6.0	6.1	5.6	5.7

Source: The Treasury

The economic assumptions which underlie the fiscal projections in this *Fiscal Strategy Report* are the same as those contained in the 1998 *Budget Economic and Fiscal Update*.

The economic assumptions that underpin the fiscal projections in the 1998 *Budget Policy Statement* were the same as those contained in the 1997 *December Economic and Fiscal Update*.

All assumptions are for years ended 30 June.

Table 4 - Changes in Fiscal Projections since 1998 *Budget Policy Statement* ($ million)

Change	**1998/99**	**1999/2000**	**2000/01**
Net worth	821	651	900
Net debt	314	267	298
Gross debt	1,579	1,820	2,450
Revenues	(810)	(318)	254
Expenses	(181)	(152)	48
Operating balance	(528)	(170)	249

Source: The Treasury

Consistency Between the Three-Year Fiscal Projections and the Short-term Intentions in the 1998 *Budget Policy Statement*

The short-term intentions in the 1998 *Budget Policy Statement* were:

- Operating expenses - maintaining firm control over expenses and a steady decline in the ratio of expenses to GDP while allowing for implementation of the Coalition Agreement fiscal programme totalling up to $5 billion over the years 1997/98 through to 1999/2000.
- Operating revenue - implementing tax reductions as at 1 July 1998, and introducing further tax reductions if economic and fiscal conditions permit.
- Operating balance - running surpluses consistent with the operating expenses and revenue intentions, which provide for surpluses of $1.5 billion in 1997/98, $1.8 billion in 1998/99, $2.2 billion in 1999/2000 and $2.7 billion in 2000/01.
- Gross debt - reducing gross Crown debt from $35.8 billion in 1997/98 to $33 billion in 2000/01, subject to expected economic conditions prevailing.
- Net debt - reducing net Crown debt from $24.7 billion in 1997/98 to $21.9 billion in 2000/01, subject to expected economic conditions prevailing.
- Net worth - increasing positive levels of net worth, rising from $9.1 billion in 1997/98 to $15.8 billion in 2000/01, subject to expected economic conditions prevailing.

Despite the delay in the economic recovery the Government has been broadly successful, with only minor changes in percentages and dollar figures expressed in the intentions. The three-year fiscal projections demonstrate:

- operating surpluses consistent with operating expense and revenue intentions
- overall reductions in gross and net debt
- increasing net worth.

Apart from the changed percentages and dollar figures flowing through from the variations in macroeconomic assumptions, the major difference between the short-term intentions in the *Budget Policy Statement* and the three-year fiscal projections is the reduction in the amount to be committed to new policy initiatives: $4.7 billion in the three years to 1999/2000 rather than $5 billion.

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

- Operating expenses - operating expenses rise from $35.8 billion in 1998/99 to $38.3 billion in 2000/01. Compared with the *Budget Policy Statement*, the ratio of expenditure to GDP is marginally higher in 1998/99 and 1999/2000 because nominal GDP is lower than in the *Budget Policy Statement*. However, expenses as a share of GDP continue to fall over the three years.

- Operating revenues - revenues rise from $36.3 billion in 1998/99 to $40.2 billion in 2000/01. Tax revenue forecasts have been revised down by about $850 million and $300 million in 1998/99 and 1999/2000 respectively. This largely reflects downward revisions in nominal economic growth in 1997/98 and 1998/99 and the removal of tariffs on motor vehicles.

- Operating balance - the operating surplus is forecast to be $1.3 billion in 1998/99, but rises to $3 billion in 2000/01. Lower projected economic growth causes taxation to deteriorate in 1998/99 and 1999/2000. Beyond 1998/99 the operating surplus increases as economic growth accelerates and revenue grows at a faster rate than total expenses.

- Gross debt - gross Crown debt is expected to fall from $36.9 billion in 1998/99 to $35.4 billion in 2000/01.

- Net debt - net Crown debt is expected to fall from $24.6 billion in 1998/99 to $22 billion in 2000/01.

- Net worth - net worth rises from $11.7 billion in 1998/99 to $16.7 billion in 2000/01. This is an increase over the *Budget Policy Statement* projections in all three years. Projected net worth is higher than in the *Budget Policy Statement* owing to the significant improvement in the 1997/98 operating balance.

Annex 3

Consistency of the Long-Term Objectives and Short-Term Intentions with the 1998 *Budget Policy Statement*

The Fiscal Responsibility Act 1994 requires the long-term objectives and short-term intentions in the *Fiscal Strategy Report* to be compared with the long-term objectives and short-term intentions in the previous *Budget Policy Statement*.

Long-Term Objectives

Long-term objectives	**1998 BPS**	**1998 FSR**
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.	No change.
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.	No change.
Operating Balance	Once gross Crown debt is reduced to below 30% of GDP, consistent with net Crown debt below 20% 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.	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.

Long-term objectives	**1998 BPS**	**1998 FSR**
Crown Debt	The Government will steadily reduce the level of gross Crown debt to 30% of GDP, consistent with reducing net Crown debt to 20% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.	The Government will steadily reduce the level of gross Crown debt to 25% of GDP, consistent with reducing net Crown debt to 15% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.
Crown Net Worth	The Government will maintain net worth at significantly positive levels.	No change.

Short-Term Intentions

Short-term intentions	**1998 BPS**	**1998 FSR**
Operating Expenses	Maintaining firm control over expenses and a steady decline in the ratio of expenses to GDP. Consistent with the Coalition Agreement, policy initiatives and the abolition of the surcharge will be up to $5 billion over the years 1997/98 to 1999/2000. The indicative spread of the $5 billion is approximately $0.9 billion in 1997/98, $1.6 billion in 1998/99 and $2.5 billion in 1999/2000. A provision of $800 million has been made for initiatives with an impact in 2000/01.	Maintaining firm control over expenses and a steady decline in the ratio of expenses to GDP. Consistent with the Coalition Agreement, policy initiatives and the abolition of the surcharge will be up to $4.7 billion over the years 1997/98 to 1999/2000. The indicative spread of the $4.7 billion is approximately $0.8 billion in 1997/98, $1.5 billion in 1998/99 and $2.4 billion in 1999/2000. Provision of a further $800 million has been made for policy initiatives with an impact in 2000/01.
Operating Revenues	Implementing tax reductions as at 1 July 1998. Introduce further tax reductions if economic and fiscal conditions permit.	No change.

Short-term intentions	**1998 BPS**	**1998 FSR**
Operating Balance	Run surpluses consistent with the operating expenses and revenue intentions. On current forecasts, the Coalition Agreement fiscal parameters and the inclusion of a provision for initiatives in 2000/01, this means operating balances of $1.5 billion in 1997/98, $1.8 billion in 1998/99, $2.2 billion in 1999/2000 and $2.7 billion in 2000/01.	Run surpluses consistent with the operating expenses and revenue intentions. On current forecasts, the Coalition Agreement fiscal parameters and the inclusion of a provision for initiatives in 2000/01, this means operating balances of $2.8 billion in 1997/98, $1.3 billion in 1998/99, $2 billion in 1999/2000 and $3 billion in 2000/01.
Crown Debt	Steadily reduce gross and net Crown debt. Subject to expected economic conditions prevailing, gross Crown debt and net Crown debt will be $35.8 billion and $24.7 billion in 1997/98, $35.3 billion and $24.3 billion in 1998/99, $34.5 billion and $23.4 billion in 1999/2000 and $33 billion and $21.9 billion in 2000/01.	Steadily reduce gross and net Crown debt. Subject to expected economic conditions prevailing, gross Crown debt and net Crown debt will be $36.9 billion and $24.4 billion in 1997/98, $36.9 billion and $24.6 billion in 1998/99, $36.3 billion and $23.6 billion in 1999/2000 and $35.4 billion and $22.2 billion in 2000/01.
Crown Net Worth	Steadily increasing positive levels of net worth to $9.1 billion in 1997/98, $10.9 billion in 1998/99, $13.1 billion in 1999/00, and $15.8 billion in 2000/01, subject to expected economic conditions prevailing.	Steadily increasing positive levels of net worth to $10.4 billion in 1997/98, $11.7 billion in 1998/99, $13.7 billion in 1999/2000, and $16.7 billion in 2000/01, subject to expected economic conditions prevailing.