Budget Policy Statement
2000

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Budget Policy Statement

Introduction

This *Budget Policy Statement* (BPS) is the first action in the process of preparing the Budget 2000. It sets the broad fiscal parameters within which the details for the Budget will be determined and states the Government's priorities for the Budget. The BPS also includes Treasury's updated economic and fiscal forecasts. These forecasts are based on current prospects and policies. The forecasts do not represent desired outcomes for economic performance, which over time the Government intends to improve.

The BPS is a report required by the Fiscal Responsibility Act 1994. The Fiscal Responsibility Act in turn places an obligation on the Government to show that it is acting in accordance with the principles of responsible fiscal management.

The BPS signals that government discretion will be exercised and specific decisions will be taken within the context of prudent financial standards and defined financial parameters.

This BPS is unique. The Fiscal Responsibility Act came into effect in 1994. All Budget Policy Statements produced since then have been produced under conditions where the fiscal implications of the government's policy programme were more immediately apparent.

Even in 1997, the BPS could work off agreed tax and spending change sequences and limits that were formally agreed as part of the 1996 Coalition Agreement.

The BPS 2000 is produced under circumstances where some government policies are still under development in terms of content and timing. The BPS provides the fiscal framework within which this development will occur. For example, the updated fiscal forecasts include technical provisions for capital spending and an allowance for funding future New Zealand Superannuation costs.

The BPS sets out two key decisions that will shape the priorities of the Budget 2000 and subsequent Budgets. One is that the Government has decided on its key goals to guide public sector policy and performance. The other is that it has developed the parameters required to ensure responsible management of its finances.

Government goals

The Government has set itself key goals that provide a clear framework for prioritising budget and legislative proposals and for monitoring progress in major policy areas. The Government intends to:

1 Celebrate our identity in the world as people who support and defend freedom and fairness, who enjoy arts, music, movement and sport, and who value our cultural heritage; and resolve at all times to endeavour to uphold the principles of the Treaty of Waitangi.

2 Develop an economy that adapts to change, provides opportunities and increases employment, and while closing the gaps, increases incomes for all New Zealanders.

3 Restore trust in government by working in partnerships with communities, providing strong social services for all, building safe communities and promoting community development, keeping faith with the electorate, working constructively in Parliament and promoting a strong and effective public service.

4 Foster education and training to enhance and improve the nation's skills so that all New Zealanders have the best possible future in a changing world.

5 Support and strengthen the capacity of Maori and Pacific Island communities, particularly through education, better health, housing and employment, and better co-ordination of strategies across sectors, so that we may reduce the gaps that currently divide our society and offer a good future for all.

6 Treasure and nurture our environment with protection for eco-systems so that New Zealand maintains a clean, green environment and rebuilds our reputation as a world leader in environmental issues.

Financial parameters

These goals are premised on a different and more balanced view about the appropriate role and size of government than we have seen in New Zealand for some time. They also depend on and, in turn, reinforce a sound and growing economy.

Our policy programme will only be sustainable if it is grounded in sound fiscal policy. Sound fiscal policy takes a longer view and recognises the emergence of spending pressures long before they impact. In the New Zealand context, a particular dimension of soundness and sustainability must be providing for the inevitable costs associated with demographic change: the growth in the proportion of older New Zealanders to the population of working age.

Accordingly, the Government's fiscal policy approach involves:

- Running operating surpluses so that revenue exceeds expenses on average to enable ongoing contributions to pre-fund future New Zealand Superannuation (NZS) costs.
- Keeping net Crown debt below 20% of Gross Domestic Product (GDP), on average.
- Accumulating financial assets to assist with the funding of future NZS costs.
- Keeping expenses around current levels of about 35% of GDP.

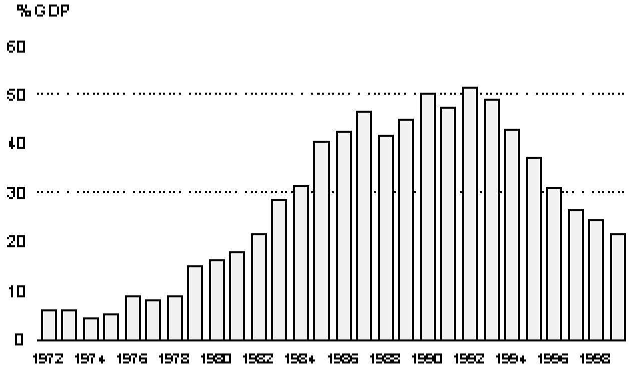
Long-term Fiscal Policy

Our approach to fiscal policy is based on an assessment of the current state of Government finances, the emergence of future spending pressures, and the potential role of shorter-term influences.

Operating balance and debt

The Government considers, as a general rule, that keeping revenues and expenses in at least broad balance on average, would be an appropriate fiscal policy consistent with good economic performance. This is possible as net debt is now down to prudent levels. For example, net debt is relatively low in historical and international terms. Achieving broad balance means that net Crown debt, as a share of GDP would decline slowly over time. Keeping net debt below 20% of GDP sees much lower debt levels than those that were building up in the 1980s and early 1990s.

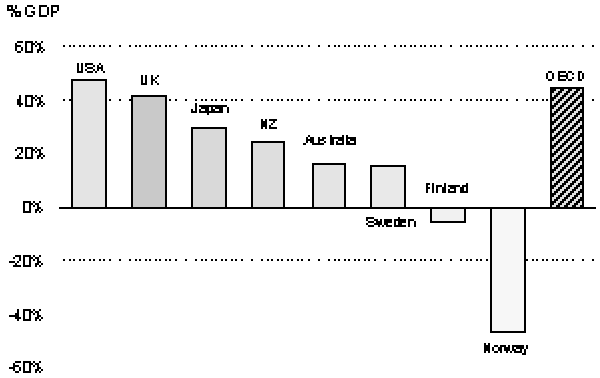
Figure 1 – New Zealand's net Crown debt (% of GDP)



Source: The Treasury

The previous Government altered the net debt objective from under 20% of GDP to below 15% of GDP in 1998. As there was no obvious rationale for this change and there was relatively wide support for the previous Government's earlier objective, the Government considers net debt under 20% of GDP to be an appropriate goal.

Figure 2 – Net government debt of selected OECD countries (% of GDP, 1998)



Note: General government basis except New Zealand (Central government). Negative indicates net financial assets.

Sources: OECD Economic Outlook December 1999, The Treasury

We must also recognise that New Zealand's population, like that of many OECD countries, will undergo a structural change in coming decades. The ratio of those aged 65 and over to those in the working age population is projected to more than double by 2051. This shift suggests that the Government needs to do more than maintain a broad fiscal balance.

Long-term projections of the fiscal pressures associated with population ageing are highly uncertain. Thinking about the demographic changes themselves requires assumptions about future net migration and fertility rates. New technologies may increase or reduce pressures on government costs. Increasing per capita incomes may lead to higher demand for services.

Improving health may allow people to work longer before they retire. All of these are issues with a significant degree of uncertainty. Nonetheless, the consequence is that government expenses are likely to rise as a share of GDP.

We have the opportunity to prepare for these fiscal costs by setting aside an allowance to pre-fund the future costs associated with the provision of retirement income. We need to allow for this in our long-term objectives. We also need to recognise that we may need to revise our long-term objectives in the future as the uncertainties evolve.

For this reason, the Government's fiscal policy will involve running fiscal surpluses and increasing levels of assets. Although there is always uncertainty around the future fiscal position, pre-funding will require the Government to increase structural fiscal surpluses from their estimated current levels. The mechanism and extent of pre-funding are issues to be discussed by the Government in coming months.

Expenses and revenues

While the Government aims to run operating surpluses through time, the levels of expenses and revenues reflect our views about the appropriate role for government. The previous Government's projections suggested that their expense objective of below 30% of GDP was unlikely to be achieved and sustained without significant reductions in the provision of government services over the long-term.

Our long-term objective is to keep expenses around current levels. Expenses in 1999/2000 are around 35% of GDP. The ratio will vary with the economic cycle and will trend down slightly from its current level over the next few years[1].

Impact of the economic cycle

The Government's fiscal policy approach also needs to allow for shorter-term influences. Economic output tends to grow over time as the quantity and quality of labour and capital increase and as productivity grows. But this economic growth is uneven. The economy moves through downturns and upswings. This in turn affects the flows of Government revenues and spending, and so the fiscal balance.

If government spending and tax plans remain unchanged during an upswing, higher tax revenues and lower spending on unemployment result in improving fiscal surpluses (and vice versa in the case of a downturn). Allowing these so-called "automatic stabilisers" to operate across the economic cycle takes pressure off monetary policy and reduces fluctuations in employment and output. For these reasons the Government's general approach is to let the automatic stabilisers operate.

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[1] For the purposes of the BPS and the fiscal forecasts contained in Annex 2, it is assumed that the vehicle for pre-funding will be a Crown entity or similar type arrangement. Any contributions by the Government to such a vehicle would be capital in nature and therefore do not affect expenses or the operating balance.
Further work on the appropriate accounting treatment of pre-funding and NZS expenses will occur in coming months. This will include an examination of the merits of presenting future NZS costs as a liability on the Crown's balance sheet with an associated expense that records the annual present value movement of the net liability. Deciding the appropriate treatment is a complex issue and is the subject of debate in other countries facing similar demographic trends, such as the United States.

Although the automatic stabilisers operate through both revenues and expenses, evidence across the OECD suggests they are more noticeable on the revenue side. This is also true in the New Zealand case, where tax revenue reflects the growth in GDP and unemployment benefits are the main cyclical expense. Removing the cyclical influences on revenues and expenses provides an estimate of the underlying or "structural" fiscal balance (see Figure 4 below).

However, in practice it is difficult to distinguish between cyclical movements and a change in the medium-term economic outlook. If a change appears to be long lasting, it will be appropriate to make sure policy settings ensure progress toward longer-term goals and adjust them if they do not.

In sum, this means that the Government will take a cautious approach to future trends in its revenue and spending. Low levels of net Crown debt will give us time to assess changes in the economic outlook and plan for any necessary adjustments.

Long-term objectives

This balanced approach to fiscal policy, combining a long-term view with consideration of short-term influences, is expressed in the following long-term objectives[2].

Long-term fiscal objectives

Operating balance

Operating surplus across the economic cycle to ensure:

- Government revenues and spending (excluding the allowance for funding the costs associated with the ageing population) are at least in broad balance and net debt is below 20% of GDP
- an allowance for pre-funding the costs associated with the ageing population.

Crown debt

Gross debt below 30% of GDP, consistent with net debt (excluding the accumulated allowance for funding the costs associated with the ageing population) below 20% of GDP, across the economic cycle.

Operating expenses

Expenses around current levels of 35% of GDP.

Operating revenues

Raise sufficient revenue to meet the operating balance objective.

A robust, broad-based tax system that raises revenue in a fair and efficient way.

Net Worth

The Government will increase net worth.

2 A comparison with the previous objectives of the 1999 *Fiscal Strategy Report* is contained in Annex 1.

Our decision to pre-fund some future expenses will require re-working these objectives in order to provide greater clarity once decisions about the mechanism and extent of pre-funding are made. For example, consideration of the appropriate accounting treatment in the Crown's accounts of pre-funding and NZS expenses could have implications for the specification of operating balance, expense and net worth objectives.

The Government's fiscal policy and long-term fiscal objectives represent a prudent approach and so satisfy the requirements of responsible fiscal management set out in the Fiscal Responsibility Act 1994 (see Annex 1). In the lead up to the Budget we will look at a wider suite of fiscal indicators to see whether they can be used to further enhance the assessment of the Government's finances and explain its policy approach.

Short-term Fiscal Policy

Consistent with Labour's pre-election fiscal policy, the Government has extended the forecast period from three to four years.

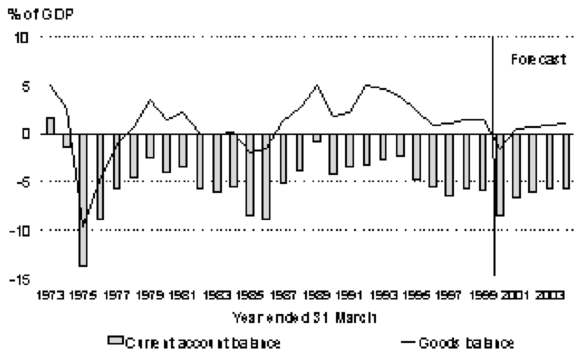
Operating balance and debt

Over the next four years the Government plans to build fiscal surpluses.

A stronger operating surplus will allow us to start pre-funding the future fiscal costs associated with population ageing. While the extent of pre-funding has yet to be determined, the Government will need to build structural fiscal surpluses to undertake this saving.

Building operating balances to bank the gains from the economic upswing also takes some pressure off monetary policy. This will moderate likely movements in interest rates and the exchange rate and help to support continuing economic growth.

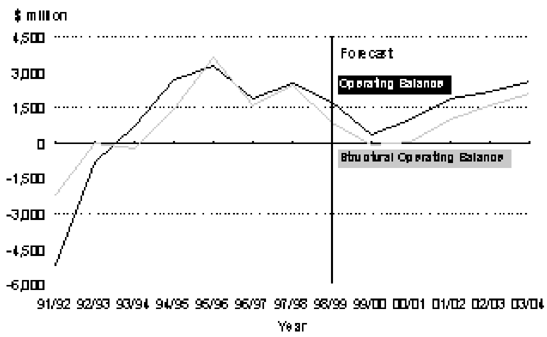
Figure 3 – Current account (% of GDP)



Sources: Statistics New Zealand, The Treasury

It will also help maintain confidence in the Government's policy approach. New Zealand has a large current account deficit and high levels of external liabilities. Sound Government finances help to provide confidence in the economic framework and guard against disruptive swings in interest and exchange rates that might occur if there were a sharp change in investor confidence or a substantial economic shock.

Figure 4 – Estimated structural fiscal balance



Source: The Treasury

The Treasury's updated fiscal forecasts show an operating surplus building from a forecast 0.4% of GDP in 1999/2000 to around 2% of GDP in 2003/04. This improvement is partly cyclical and partly an improvement in the underlying structural surplus, as shown in Figure 4[3]. The operating surplus track is broadly in line with the *Pre-election Economic and Fiscal Update* (PREFU) and will reverse the trend of recent years that has seen the operating balance deteriorate.

The Government's pre-funding approach will see a build up of assets. From 2001/02, the forecasts have assumed that the surpluses will contribute to building up financial assets rather than solely paying down debt. The assumed contribution is 0.5% of GDP in 2001/02, 1% in 2002/03 and 1.5% in 2003/04. On a cumulative basis, the accumulated contributions reach 3% of GDP by the end of 2003/04.

Table 1 – Net debt and pre-funding

	2000 Forecast	2001 Projection	2002 Projection	2003 Projection	2004 Projection
Net debt (% GDP)	21.9	20.9	19.6	18.9	18.5
Cumulative contributions (% GDP)	-	-	0.5	1.5	3.0

Note: It is assumed that the contributions start in 2001 and the vehicle for pre-funding is a Crown entity or similar type arrangement. The assets do not form part of net debt. The table shows only the cumulative contributions from the Government. Interest on these contributions would be around 0.1% of GDP for 2002/03 and 2003/04. See Annex 2 for further details. The assumptions are indicative because the mechanism and extent of pre-funding have not been finalised.

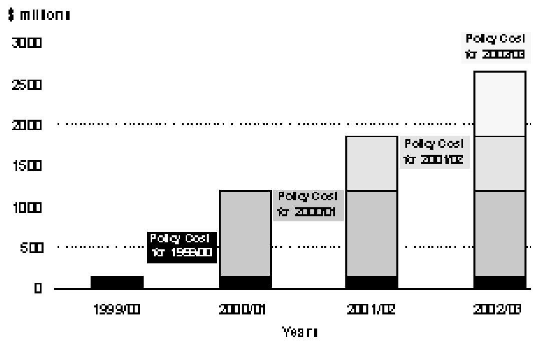
Source: The Treasury

Expenses and revenues

Expenses are projected to be a third of GDP in 2003/04 while revenue is relatively stable at around 35% of GDP across the forecast period. The proposed expense levels can be met with these revenues while also allowing us to build operating surpluses.

Delivering on our policy commitments and building the capacity of the public sector requires a new level of resources. The Government intends to deliver its programme on a sustainable basis – doing so has required an increase in taxation. The expense track includes a fiscal provision of $5.9 billion (GST inclusive) allowing us to deliver on our priority policy objectives. The indicative

Figure 5 – Cumulative fiscal provisions



Source: The Treasury

[3] The estimation of the structural fiscal balance requires a number of assumptions including those surrounding potential output. These assumptions are important in determining the level of the structural balance, but are less important for the trend.

allocation of these provisions has been set on a cumulative basis at (GST inclusive) $150 million for 1999/00, $1.2 billion in 2000/01, $1.85 billion in 2001/02 and $2.65 billion in 2002/03. This allocation is illustrated in Figure 5.

The Government is in the process of determining its capital spending requirements. The forecasts presented here use the technical provision of $400 million from the PREFU and the additional capital spending on student loans. The Government will set a higher provision as part of the Budget process.

Spending priorities

This government was elected with a commitment to make real and sustainable improvements in the lives and living standards of New Zealanders – at work, in their homes and communities, in education and in retirement.

We have already taken significant steps to deliver on our most urgent pledges. We have made significant increases to New Zealand Superannuation rates, restoring the relative living standards of retired New Zealanders. Changes to the student loan scheme have significantly reduced tertiary costs for students. The new top tax rate on income over $60,000 a year will generate the revenue needed to fund these and other commitments.

Priority will now be given to initiatives that support the Government's key goals, with attention paid first to those issues where the policy development or implementation lead-times are longest, in order to be able to see the fruits of our efforts by the end of our first term.

The Budget 2000 will need to make provision for "non-discretionary" proposals, where the Government has little choice but to approve additional funding.

Conclusion

The first *Budget Policy Statement* of the new Government is the fiscal expression of the change of direction sought by voters at the 1999 election. It is a preview of and a key part of our preparation for the Budget 2000.

The Government has set itself key goals that emphasise the importance of innovative businesses, effective Government and strong communities together contributing to the well being of New Zealanders. They also highlight this Government's focus on improving skills, enhancing our environment, strengthening national identity and closing gaps.

These goals are premised on a different and more balanced view about the appropriate size and role of government. They will provide a standard against which to prioritise new initiatives and to measure our progress.

This Statement has also set out the Government's thinking on longer term fiscal policy, in particular our plans for pre-funding some of the costs associated with New Zealand's changing demographics. In an economy promising to do well in the short term but facing some difficult and unresolved issues, it is important that this Government sets out transparently its proposals for meeting the biggest long term challenge to fiscal management facing any government.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

2 March 2000

Annex 1

The Fiscal Responsibility Act 1994 and the *Budget Policy Statement*

The Fiscal Responsibility Act 1994 requires the Government to show that it is acting in accordance with the principles of responsible fiscal management through a series of reports presented to the House of Representatives at various times during the financial year. The *Budget Policy Statement* (BPS) is one of those reports, and is required to:

- specify the Government's long-term objectives for fiscal policy: operating expenses, operating revenues, the operating balance, total debt, and the level of Crown net worth; and explain how these accord with the principles
- specify the broad strategic priorities for the Budget, and the explicit short-term intentions for each of the long-term objectives
- assess the extent to which the indicated short-term intentions are consistent with the principles of responsible fiscal management and the long-term objectives
- specify any reasons for departure from the principles or the objectives, or both, and state the approach intended to become consistent and the period of time this is expected to take
- assess the extent to which the indicated long-term objectives are consistent with the immediately preceding BPS or the most recent *Fiscal Strategy Report* (FSR)
- justify any change in the long-term objectives from the immediately preceding BPS or the most recent FSR
- assess the extent to which the indicated short-term intentions are consistent with the immediately preceding BPS or the most recent FSR
- justify any change in the short-term intentions from the immediately preceding BPS or the most recent FSR.

Principles of responsible fiscal management

The principles of responsible fiscal management, as set out in the Fiscal Responsibility Act, are:

- Reducing total Crown debt to prudent levels so as to provide a buffer against factors that may impact adversely on the level of total Crown debt in the future, by ensuring that, until such levels have been achieved, the total operating expenses of the Crown in each financial year are less than its total operating revenues in the same financial year.
- Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.
- Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future.
- Managing prudently the fiscal risks facing the Crown.
- Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

The Government's short-term intentions and long-term objectives

The Government's short-term fiscal intentions are consistent with the principles of responsible fiscal management and its long-term fiscal objectives, as the following table shows.

	Short-term fiscal intentions	**Long-term fiscal objectives**
Operating balance	On current forecasts, operating balances will be $0.4 billion in 1999/00, $1 billion in 2000/01, $1.9 billion in 2001/02, and $2.2 billion in 2002/03.	Operating surplus across the economic cycle to ensure: Government revenues and spending (excluding the allowance for funding the costs associated with the ageing population) are at least in broad balance and net debt is below 20% of GDP an allowance for pre-funding the costs associated with the ageing population.

	Short-term fiscal intentions	Long-term fiscal objectives
Crown debt	If forecast economic conditions prevail, gross Crown debt and net Crown debt will be $35 billion and $22.7 in 1999/00, $35.4 billion and $23 billion in 2000/01, $35.2 billion and $22.7 billion in 2001/02, and $36.2 billion and $22.8 billion in 2002/03. In 2002/03 gross and net Crown debt will be 30% and 18.9% of GDP respectively.	Gross debt below 30% of GDP, consistent with net debt (excluding the accumulated allowance for funding the costs associated with the ageing population) below 20% of GDP, across the economic cycle.
Operating expenses	On current forecasts, operating expenses will be $36.3 billion in 1999/00, $37.8 billion in 2000/01, $38.9 billion in 2001/02, and $40.4 billion in 2002/03. If forecast economic conditions prevail, expenses will be 33.5% of GDP in 2002/03.	Expenses around current levels of 35% of GDP.
Operating revenues	On current forecasts, operating revenues will be $36.2 billion in 1999/00, $38.1 billion in 2000/01, $40.2 billion in 2001/02, and $41.9 billion in 2002/03.	Raise sufficient revenue to meet the operating balance objective. A robust, broad-based tax system that raises revenue in a fair and efficient way.
Crown net worth	Subject to forecast economic conditions prevailing, net worth will be $6.8 billion in 1999/00, $7.8 billion in 2000/01, $9.7 billion in 2001/02, and $11.9 billion in 2002/03.	The Government will increase net worth.

Comparison of the *Budget Policy Statement 2000* and the 1999 *Fiscal Strategy Report*

The Fiscal Responsibility Act requires the long-term objectives and short-term intentions in this statement to be compared with the long-term objectives and short-term intentions in the previous BPS, or if updated in the subsequent FSR, with those in the FSR. The reasons for changes in the long-term objectives since the 1999 FSR are discussed in the main text of this Statement. The following table compares the 2000 BPS long-term objectives with the long-term objectives in the 1999 FSR.

Long-term fiscal objectives	Budget Policy Statement 2000	1999 Fiscal Strategy Report
Operating expenses	Expenses around current levels of 35% of GDP.	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	Raise sufficient revenue to meet the operating balance objective. A robust, broad-based tax system that raises revenue in a fair and efficient way.	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	Operating surplus across the economic cycle to ensure: • Government revenues and spending (excluding the allowance for funding the costs associated with the ageing population) are at least in broad balance and net debt is below 20% of GDP • an allowance for pre-funding the costs associated with the ageing population.	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	Gross debt below 30% of GDP, consistent with net debt (excluding the accumulated allowance for funding the costs associated with the ageing population) below 20% of GDP, across the economic cycle.	The Government will steadily reduce the level of gross Crown debt to below 25% of GDP, consistent with reducing net Crown debt below 15% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.
Crown net worth	The Government will increase net worth.	The Government will maintain net worth at significantly positive levels.

Line by line consolidation is due to be introduced in the Budget 2002, in line with Generally Accepted Accounting Practice (GAAP). This will have implications for the specification of the long-term expense and debt objectives[4].

4 Line by line consolidation will not affect reported net worth and the operating balance, but as SOE and Crown entity revenues, expenses, assets and liabilities are included with each revenue, expense, asset and liability line in the financial statements, these items will increase. The change will have a significant effect on total operating expenses-to-GDP and gross debt. Based upon present figures, there will be no material change to the net debt figure.

The following table compares the 2000 BPS short-term intentions with the short-term intentions in the 1999 FSR.

Short-term intentions	Budget Policy Statement 2000	1999 Fiscal Strategy Report
Operating expenses	On current forecasts, operating expenses will be $36.3 billion in 1999/00, $37.8 billion in 2000/01, $38.9 billion in 2001/02, and $40.4 billion in 2002/03. If forecast economic conditions prevail, expenses will be 33.5% of GDP in 2002/03.	Policy initiatives will be lowered to $4.25 billion over the years 1997/98 to 1999/00. A commitment has been made for up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02. If expected conditions prevail, expenses will be 33.8% of GDP in 2001/02.
Operating revenues	On current forecasts, operating revenues will be $36.2 billion in 1999/00, $38.1 billion in 2000/01, $40.2 billion in 2001/02, and $41.9 billion in 2002/03.	Further tax reductions if economic and fiscal conditions permit.
Operating balance	On current forecasts, operating balances will be $0.4 billion in 1999/00, $1 billion in 2000/01, $1.9 billion in 2001/02, and $2.2 billion in 2002/03.	On current forecasts, which include a commitment of up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02, operating balances will be $2.2 billion in 1998/99, -$36 million in 1999/00, $0.8 billion in 2000/01, and $1.5 billion in 2001/02.
Crown debt	If forecast economic conditions prevail, gross Crown debt and net Crown debt will be $35 billion and $22.7 in 1999/00, $35.4 billion and $23 billion in 2000/01, $35.2 billion and $22.7 billion in 2001/02, and $36.2 billion and $22.8 billion in 2002/03. In 2002/03 gross and net Crown debt will be 30% and 18.9% of GDP respectively.	If expected economic conditions prevail, gross Crown debt and net Crown debt will be $36.1 billion and $22.4 billion in 1998/99, $36.1 billion and $23.6 billion in 1999/00, $36.9 billion and $23.8 billion in 2000/01, and $36.3 billion and $23.0 billion in 2001/02. In 2001/02 gross and net Crown debt will be 31.9% and 20.2% of GDP respectively.
Crown net worth	Subject to forecast economic conditions prevailing, net worth will be $6.8 billion in 1999/00, $7.8 billion in 2000/01, $9.7 billion in 2001/02, and $11.9 billion in 2002/03.	Subject to expected economic conditions prevailing, net worth will be $5.5 billion in 1998/99, $5.4 billion in 1999/00, $6.2 billion in 2000/01, and $7.7 billion in 2001/02. (The initial recognition of ARCIC outstanding claims obligations is expected to have a net negative impact of around $6.9 billion on net worth at 30 June 1999.)

The short-term intentions have changed since the 1999 FSR to reflect the updated economic and fiscal forecasts and changes to policy intentions.

Annex 2

Economic and Fiscal Forecasts

These economic and fiscal forecasts update Treasury's *Pre-election Economic and Fiscal Update* (PREFU). Although not a full update in the nature of an Economic and Fiscal Update, these forecasts are based on:

- A comprehensive set of macro economic forecasts, used to update taxation revenue, welfare benefit expenditure and finance cost forecasts.
- Changes to policy (for example, the reversal of the previous Government's tax cuts and the introduction of increases to the top marginal tax rate).
- Fiscal provisions that the Government has established to implement its proposed new policy initiatives.

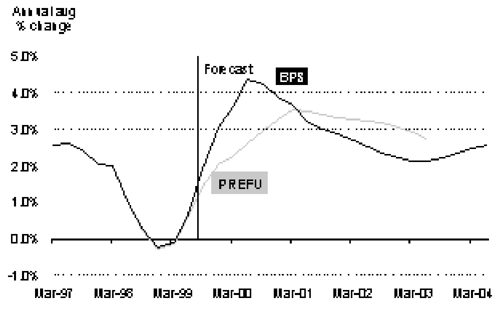
These forecasts are based on current prospects and policies. The forecasts do not represent desired outcomes for economic performance, which over time the Government intends to improve.

Finalisation Dates	
Government decisions	14 February
Economic and fiscal outlook	22 February

Outlook for economic growth remains positive

The fundamentals for New Zealand's economic growth remain favourable. In particular, the world economy is expected to post healthy expansion in 2000 and beyond, building on the recovery in 1999. The lagged effects of domestic monetary conditions are expected to stimulate growth in the short term, and sustain growth further out.

Figure 6 – Production GDP



Sources: Statistics New Zealand, The Treasury

Economic growth is now expected to peak at around 4% pa in the short term before easing to around 2½%p a in the latter part of the forecast horizon. Largely reflecting this economic cycle, inflation is expected to ride just above 2% during most of the forecast period but ease in the final year.

Table 2 – Economic forecasts underpinning the BPS[1]

Annual average % change, March years	1999 Actual	2000 Forecast	2001 Projection	2002 Projection	2003 Projection	2004 Projection
Private consumption	1.5	3.2	2.7	2.0	1.8	2.4
Private investment[2]	(3.3)	6.3	8.1	5.9	3.5	2.3
Gross national expenditure[3]	(0.4)	4.6	2.6	2.5	1.8	2.1
Exports of goods and services	2.3	5.0	9.6	5.6	4.6	3.8
Imports of goods and services[3]	3.1	7.7	6.5	5.0	4.0	2.8
GDP (production measure)	(0.1)	3.6	3.7	2.7	2.1	2.5
Unemployment rate[4]	7.2	6.1	5.4	5.5	5.8	5.8
90-day interest rate[5]	4.5	5.8	7.3	7.8	7.5	6.5
TWI[5]	57.6	54.2	56.6	59.5	61.5	60.0
CPI[6]	1.3	1.9	2.4	2.3	2.2	2.0
Current account balance (% of GDP)	(5.8)	(8.5)	(6.6)	(6.0)	(5.6)	(5.6)
Nominal expenditure GDP	0.7	3.8	5.9	5.1	4.4	4.4

Sources: Statistics New Zealand, The Treasury

Notes:
1 At the end of May, Statistics New Zealand is due to release a revised history of GDP data, incorporating many methodological changes. Most notably "chain-linked" volume indexes will replace the present "fixed-based" method on which Treasury's forecasts are based.
2 Excludes an estimated computer component to give a better underlying picture.
3 Excludes computers and frigate *Te Mana*.
4 Percentage of labour force, March quarter, seasonally adjusted.
5 Average for March quarter.
6 Annual % change. The figures at March 1999 and 2000 are for CPI excluding credit services and section prices, which allows a better comparison to the latest CPI, re-based from June 1999 onwards.

Compared to the PREFU, the latest forecasts portray a more pronounced cycle in annual growth – with more in the near term and less further out. This profile principally reflects stronger-than-expected economic momentum in the second half of 1999 and less spare capacity than anticipated, which results in monetary conditions tightening sooner in order to contain inflation pressures ahead.

Strong growth has reduced spare capacity

Since last year's PREFU, GDP figures were released showing a higher-than-expected economic expansion of 2.3% in the September 1999 quarter. Growth in the December quarter looks to have been more moderate but still reasonably solid.

With this strong growth in the final half of 1999, indications of reduced spare capacity have emerged. For example, the December quarter *Quarterly Survey of Business Opinion* recorded a sharp increase in its capacity utilisation index, and finding staff became more difficult. The unemployment rate dropped to 6.3% in the December quarter (from 6.8% in September) as employment growth surprised on the upside.

Monetary conditions expected to move to a more neutral position

With signs of shrinking spare capacity, and fundamentals in place for robust growth ahead, monetary conditions are expected to tighten sooner than expected in the PREFU.

However, it is important to recognise that this "tightening" starts from a stimulatory position – the present Monetary Conditions Index is comparable to the previous low point seen in the early 1990's. And despite an upward trend, interest rates and the exchange rate peak considerably below the levels seen in 1996 (and they ease from early 2003 as inflation pressures abate).

Exports to perform well, especially in the near term

As with the PREFU, these forecasts for the BPS embody a steady expansion, tilted somewhat toward the export sector. Export growth reaches 10% in the year to March 2001 and averages around 6% over the entire forecast period. This profile is reinforced by a lower-than-expected starting point for the TWI and upward revisions to world growth prospects. Economic growth for New Zealand's top-10 trading partners is expected to be 3.5% in the 2000 calendar year (compared with 2.9% expected at the time of the PREFU) with similar growth expected for calendar 2001.

Recovering from earlier droughts, agriculture exports are on a firmer footing with particularly strong growth expected in the near term. Non-commodity manufactured exports will continue to benefit from a very competitive NZ dollar and strong growth in key export markets.

Household spending is steady despite strong income growth ahead

Income growth for employees is expected to be robust in the years ahead. Employment growth is strong in the near term, leading to a relatively tight labour market by mid-2001 with the unemployment rate at around 5½%. Moderate labour force growth – partly reflecting little net immigration (especially in relation to the 1994-96 period) – acts as a supply constraint during the economic upturn. The tight labour market leads to an acceleration in wage rates (and unit labour costs) into 2002, although beyond this wage pressures ease.

Despite healthy income growth, household spending in comparison expands less rapidly. Growth in consumer spending is limited, in part, because of higher debt servicing costs. These result from rising interest rates and from the further debt accumulation implied by low (albeit rising) household saving and a sustained level of spending on new houses.

House construction was buoyant in 1999, although other indicators of the housing market, such as existing house sales and prices, were more muted. The housing market is expected to post moderate gains during the forecast period.

Investment picks up during the next two years but eases thereafter

During calendar 2000 and 2001 investment spending is expected to respond to capacity constraints, improving profitability and the general pick up in overall economic activity. From calendar 2002, the lagged effects of higher interest rates are expected to bring investment growth more in line with GDP growth.

The current account deficit peaks in March 2000 but then gradually reduces

As anticipated in the PREFU, the current account deficit is expected to peak at around 8% of GDP in the year to March 2000. This partly reflects the import of the second ANZAC frigate, *Te Mana*, in December, as well as the higher import cost of oil.

Beyond the early part of 2000, the current account deficit is expected to gradually reduce, largely reflecting a growing balance of goods and services. The trade balance benefits mostly from export volumes growing faster than import volumes. The terms of trade provide a little support but, in general, moderate increases to world export prices are largely matched by increases in world import prices. The current account deficit is expected to fall to around 5½% of GDP by March 2004.

Compared to the PREFU, the nominal economy is largely unchanged by 2002/03

Although the forecast of real GDP toward the end of the forecast horizon has been revised down somewhat from that presented in the PREFU, economy-wide inflation is a little stronger throughout. Inflation pressures are expected to build a little in the next couple of years, largely reflecting the anticipated cycle in real economic activity. But the monetary tightening built into the forecasts ensures that these inflation pressures ease toward the end of the forecast horizon.

What ultimately matters for the government's tax revenue is growth in the nominal economy. This is expected to average just below 5% pa during the forecast period, very similar to expectations in the PREFU.

Table 3 – Change in nominal GDP

Nominal expenditure GDP $ millions, June years	2000 Forecast	2001 Projection	2002 Projection	2003 Projection	2004 Projection
BPS	104,022	110,141	115,565	120,578	125,920
PREFU	103,931	109,771	115,439	120,591	N/A
Change	91	370	126	(13)	N/A

Source: The Treasury

A sound fiscal position

Table 4 – Aggregate fiscal indicators

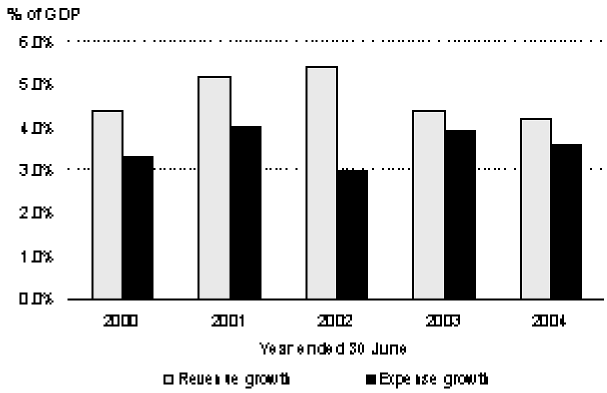
Nominal ($ billion)	2000 Forecast	2001 Projection	2002 Projection	2003 Projection	2004 Projection
Operating Balance	0.4	1.0	1.9	2.2	2.6
Net Debt	22.7	23.0	22.7	22.8	23.3
Net Worth	6.8	7.8	9.7	11.9	14.5
% GDP					
Operating Balance	0.4%	0.9%	1.6%	1.8%	2.1%
Net Debt	21.9%	20.9%	19.6%	18.9%	18.5%
Net Worth	6.6%	7.1%	8.4%	9.9%	11.5%
Gross Debt	33.7%	32.1%	30.5%	30.0%	29.7%
Revenue	34.8%	34.6%	34.8%	34.8%	34.7%
Expenses	34.9%	34.3%	33.7%	33.5%	33.3%

Source: The Treasury

Revenue growth is in line with growth in the nominal economy, averaging around 5% in the first half of the forecast period, before falling back to around 4½% in the latter years.

Expenses rise over the forecast period. Expense growth averages around 3½%, but is higher in 2000/01 and 2002/03 (4.0% and 3.9% respectively).[5] The growth pattern is driven by a number of factors including the allocation of the Government's fiscal provisions.

Figure 7 – Revenue and expense growth



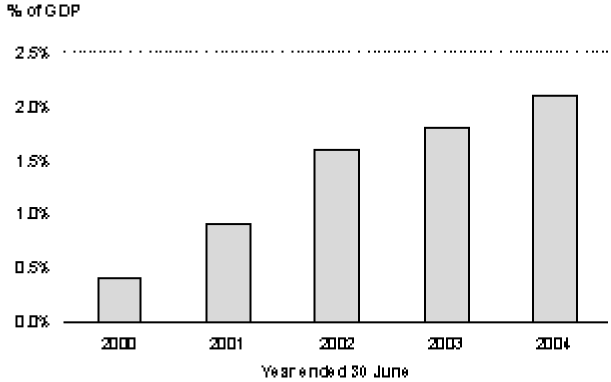
Source: The Treasury

[5] To calculate the revenue and expense growth between 1998/99 and 1999/2000, the one-off items of 1998/99 (ie, sale of Contact Energy and GSF Liability revaluation) have been removed to better reflect the underlying growth in revenues and expenses.

The resulting operating balance growth is higher in the early part of the forecast horizon.

As a percentage of GDP, net debt continues to fall. However, in nominal terms, net debt is reasonably static across the forecast horizon. From 2001/02 onwards where operating surpluses are growing above 1.5% of GDP, the associated additional cash flows are used for investment as well as repaying debt. This investment is primarily used to build up assets to begin pre-funding future superannuation costs.

Figure 8 – Operating balance (% of GDP)



Source: The Treasury

Changes from PREFU

Table 5 – Change from PREFU

Nominal ($ billion)	2000 Forecast	2001 Projection	2002 Projection	2003 Projection	2004 Projection
BPS Operating Balance	0.4	1.0	1.9	2.2	2.6
PREFU Operating Balance	..	0.8	1.7	2.3	
Change	0.4	0.2	0.2	(0.1)	
BPS Net Debt	22.7	23.0	22.7	22.8	23.3
PREFU Net Debt	23.3	23.7	22.9	21.5	
Change	(0.6)	(0.7)	(0.2)	1.3	

Source: The Treasury

Operating balance

The operating balance has improved since the PREFU forecasts by around $700 million across the period 1999/2000 to 2002/03. Key points include:

Policy changes

- As noted on page 11 the Government has established a fiscal provision of $5.9 billion (GST inclusive), $3 billion of which has been funded by tax changes.[6]

[6] The reversal of the previous Government's announced tax cuts totals $1.3 billion, and the increase in the top marginal tax rate of 39% adds a further $1.7 billion to tax revenue between 1999/2000 and 2002/03.

- The allocation of the fiscal provisions is currently $150 million in 1999/2000, $1.05 billion in 2000/01, $650 million in 2001/02 and $800 million in 2002/03.[7] These allocations may change somewhat as policy decisions develop.[8]

- To date, the Government has committed around $1.1 billion of the $5.9 billion, as illustrated in the table below.

Table 6 – Fiscal provisions

$ millions (GST inclusive)	1999/00	2000/01	2001/02	2002/03	**Total**
Total fiscal provisions	150	1,200	1,850	2,650	**5,850**
Decisions as at 14 February					
Changes to student loans	31	103	124	138	**396**
NZ Superannuation rate change	52	208	212	212	**684**
Other decisions	14	17	4	4	**39**
Total decisions	97	328	340	354	**1,119**
Remaining fiscal provisions	**53**	**872**	**1,510**	**2,296**	**4,731**

Source: The Treasury

Forecasting changes

- Tax revenue forecasts, excluding policy changes, have been revised upwards by around $300 million in 1999/2000, $200 million in 2000/01, $210 million in 2001/02 and $100 million in 2002/03.[9]

  In 1999/2000 the change is mostly attributable to personal income tax, reflecting the change in the forecast of employees' compensation, with the remainder stemming from judgements surrounding the underlying level of corporate taxes, based on revenue outturns to date. In the later years, the net change is more moderate with personal income tax increases offsetting reduced forecasts of corporate taxes. The other key change is an increase to withholding tax on residents' interest due to higher actual and forecast interest rates.

- The welfare benefit forecasts, excluding policy changes, have reduced by about $50 million in 1999/2000, $110 million in 2000/01, $40 million in 2001/02 and increased by $30 million in 2002/03.

  This reflects a combination of favourable changes to CPI forecasts compared to PREFU forecasts in the earlier years and reduced forecast up-take of benefits due to improved labour market conditions.

7 The cumulative provisions for each year are illustrated in Figure 5 on page 11 and in Table 6 above.

8 The previous Government's provisions in the PREFU totalled $2.7 billion (GST inclusive) across 1999/2000 to 2002/03. The new Government's provisions total $5.9 billion (GST inclusive) – an increase of $3.2 billion.

9 Inland Revenue has prepared an alternative set of tax forecasts that were used in the Treasury's quality assurance process. Inland Revenue's forecasts of aggregate tax revenue are similar to the Treasury's with minor differences spread across all tax types.

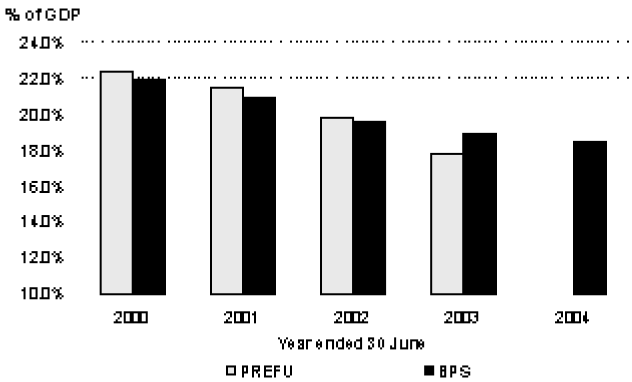
- Increases in forecast interest rates result in an increase to net finance costs from 2000/01 forward of around $70 million each year.

Net debt

Overall, net debt as a percentage of GDP is generally more favourable compared to the PREFU track. This is due to:

- the favourable cashflow impact of the operating balance changes
- the withdrawal of prudential capital from @Work Insurance
- improved year-to-date outturns.

Figure 9 – Net debt (% of GDP)



Source: The Treasury

As illustrated on page 11, the forecasts contain an assumed level of contribution to meet future New Zealand Superannuation costs, starting from 2001/02. The contribution (excluding ongoing revenue earned on the contributions) is around 0.5% of GDP ($600 million) in 2001/02, 1% ($1.2 billion) in 2002/03 and 1.5% ($1.8 billion) in 2003/04. The treatment adopted in these forecasts in incorporating this contribution is:

- The assets are assumed to be building up in a Crown entity or similar type arrangement, and therefore the assets do not form part of net debt (this explains why nominal net debt does not reduce over the forecast horizon).
- Additional finance costs result in 2001/02 to 2003/04 as gross debt does not reduce at the rate forecast previously. This increases gross expenses and worsens the net operating cash flows of the Crown.
- The revenue earned by the build up of assets flow through the net SOE and Crown entity surplus line, not as interest or other revenue to the Crown. The rate of return on the contributions is assumed to match the Government Stock rate.

The domestic bond programme

There is a forecast improvement in the expected cash position of the Crown for 1999/2000 (reflected in improved net debt forecasts). At this stage, however, the domestic bond programme remains unchanged from that announced with the PREFU.

The remaining programme for 1999/2000 will be reviewed as more information becomes available with the release of the *Current Year Fiscal Update* and the *Budget Economic and Fiscal Update*.

Assumptions in the fiscal forecasts

A number of assumptions have been used to compile these forecasts. In some cases this is because the Government intends to consider the issues more fully as part of the forthcoming Budget 2000 process:

- The Government has indicated its fiscal provisions out to 2002/03. A technical fiscal provision of $800 million (GST inclusive) has been incorporated into 2003/04.
- The forecasts incorporate the cost of Government capital decisions (ie, student loans) plus the current capital provision of $400 million as a working assumption from 2000/01 onwards. This $400 million has also been included in 2003/04. The $400 million limit is to be increased as part of the Budget 2000 process.
- Included in the PREFU forecasts was an allocation of around $130 million in each year to 2002/03 to settle Treaty claims. The forecasts have included a further allocation for the 2003/04 financial year. These allocations may change once the Government has determined its policy in relation to Treaty settlements.
- The contributions to fund future New Zealand Superannuation costs outlined earlier are likely to change once the Government has finalised its policy and mechanism for pre-funding future superannuation pressures.
- No revaluation exercises have been included. Valuations of the GSF unfunded liability and the ACC outstanding claims liability will be incorporated into *the Current Year Fiscal Update* and the *Budget Economic and Fiscal Update*.

Risks to the economic and fiscal forecasts

The economic forecasts are based on Treasury's best estimate of the central track the economy is expected to take. There are a number of risks surrounding any set of economic forecasts.

Factors such as changes in the outlook of the world economy, New Zealand's terms of trade, labour productivity performance or net migration expectations are likely to produce outcomes where forecast economic growth could be stronger or weaker.

Should changes to the economic forecasts occur, this will impact on the fiscal forecasts.