Budget Policy Statement 2001

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Budget Policy Statement

Introduction

This Budget Policy Statement (BPS) confirms the long-term fiscal objectives and short-term fiscal policy approach that the Government first set out in Budget 2000.

The BPS sets the broad fiscal parameters within which the next Budget will be constructed. The spending priorities that develop inside those parameters are in turn guided by the Government's key goals, which were defined in detail in BPS 2000.

Budget 2000 "front-end loaded" a substantial portion of the three-year $5.9 billion fiscal provision that was identified in the expense track in BPS 2000. The reason for this was to maximise progress towards meeting core elements of the key goals over this term of government.

It followed that the second and third years of the term would be years of consolidation. That consolidation is taking place in the context of uncertainty in the international economy, driven by the persistently high value of the US dollar occurring alongside a large and uncomfortable increase in international oil prices. This uncertainty emphasises the importance of living within our proposed spending track.

However, forecasts are already showing strengthening of the New Zealand economy as the growth in exporting and tourism starts to flow through to the domestic sector. In these circumstances, it has become much more important to respond to the opportunities, and not only the threats, created by the new international economic environment.

Our economic policy emphasises growth, innovation, new business creation and investment. We have engaged with the business sector on proposals for increased spending and investment in areas such as skills development, funding of research and development and assistance with export market development. Facilitating economic growth will be a priority in Budget 2001.

At the same time, we recognise that sustainable business growth needs the benefit of a stable macroeconomic environment. That dictates that we should continue to place a premium on prudent fiscal management, of both revenue and expenses.

To achieve both these ends, Government initiatives in 2001 will emphasise the quality of spending, the effectiveness of policy interventions, and the relevance of the regulatory environment, rather than any relaxation of the fiscal stance outlined in BPS 2000 and confirmed in Budget 2000.

Careful fiscal management over the next two years will be rewarded by greater opportunities for new policy development in the years that follow. Beyond the current term, the Government is likely to have the scope to consider a range of spending, revenue and investment initiatives to advance our economic and social objectives.

Long-term and short-term fiscal policy unchanged

In our first Budget Policy Statement, published on 8 March 2000, we laid out our fiscal and policy objectives over the three-year term of government. Our long-term fiscal objectives and key policy goals remain unchanged. The long-term fiscal objectives include:

- running operating surpluses so that revenue exceeds expenses on average, to enable ongoing contributions to the New Zealand Superannuation (NZS) Fund
- keeping gross Crown debt below 30% of GDP on average across the economic cycle[1]
- accumulating financial assets to assist with the funding of future NZS costs
- keeping expenses at around current levels of about 35% of GDP.

These objectives are driven by the need to manage the future fiscal pressures associated with an ageing population, particularly in the area of retirement income. Over the current three-year term, we decided to keep new initiatives within a $5.9 billion operating expenditure limit, in order to make progress towards those long-term objectives. We are reconfirming our commitment to remain within the $5.9 billion limit.

On track to achieve our long-term objectives

The latest forecasts contained in the December Economic and Fiscal Update (DEFU) indicate that we remain on track to meet our long-term objectives and to begin building up the NZS Fund[2], as shown in Table 1.

Table 1 - Long-term objectives

% GDP	2000/01 Forecast	2001/02 Forecast	2002/03 Forecast	2003/04 Forecast	2004/05 Forecast
Gross debt	35.0%	32.1%	30.7%	29.4%	28.0%
Net debt	20.2%	18.9%	18.0%	16.7%	15.8%
NZS Fund accumulated assets	-	0.5%	1.5%	3.0%	5.2%
Expense	34.9%	33.5%	33.1%	32.8%	32.3%
Operating balance	0.7%	1.9%	2.3%	2.8%	3.3

Fiscal policy supports continued economic expansion

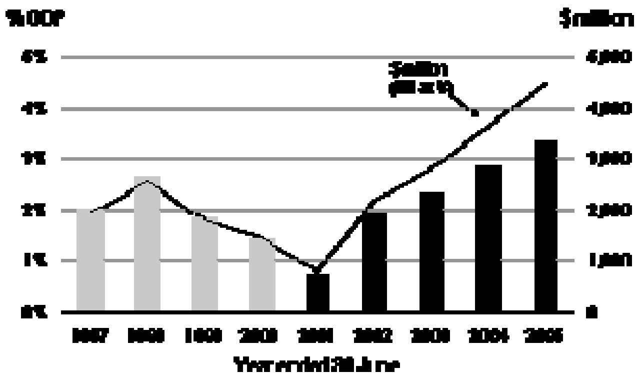
1 Consistent with keeping net Crown debt below 20% of GDP on average across the cycle.

2 The proposed contributions to the NZS Fund for the years 2001/02 to 2004/05 are technical assumptions only at this stage, with the first three years representing transitional contributions. A detailed reconciliation of the operating balance, NZS Fund contributions and the change in net debt is set out in Annex 2.

The New Zealand economy has shown weaker growth in the short term than was predicted in Budget 2000. However, world growth is good, and forecasts are showing a strengthening of the New Zealand economy as the growth in exporting and tourism starts to flow through to the domestic sector. Activity is projected to pick up to around 3.5% by the beginning of 2002.

The forecast 2000/01 operating surplus is around 0.7% of GDP. This is lower than the operating surplus in 1999/2000, because strong growth in tax revenue is outweighed by expense growth, and a positive Accident Compensation Corporation liability revaluation boosted the operating balance in the 1999/2000 year.

Figure 1 – Operating balance

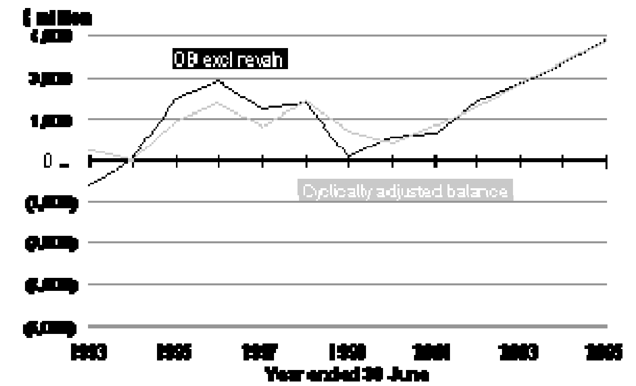


Source: The Treasury

Continued strong revenue growth, combined with lower Budget spending in 2001 and movements in the Government Superannuation Fund liability valuation, contribute to the sharp increase in the operating balance in 2001/02. From that point on, operating balances show a rising track.

Projected operating surpluses are structural, not just cyclical. Figure 2 shows the forecast operating balance adjusted to remove cyclical fluctuations[3]. The resulting structural (or cyclically adjusted) balance also shows revenue growth consistently exceeding expenditure growth.

Figure 2 – Cyclically adjusted balance



Source: The Treasury

In the short term, rising oil prices and a low New Zealand dollar mean that the economy will be facing inflationary pressures. Keeping spending within the $5.9 billion fiscal provision will increase structural surpluses. This will ensure we support economic expansion by not placing undue pressure on monetary policy.

Our fiscal policy settings also recognise the current high levels of external liabilities[4]. Although the forecasts project a significant improvement in the current account deficit, the economy still remains vulnerable to swings in investor confidence. Building up fiscal surpluses should help mitigate this risk.

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3 Note that the cyclically adjusted balance (CAB) has also been adjusted to exclude revaluations. The CAB is sensitive to the latest information available, and is subject to some uncertainty. Trends in the CAB are, however, more reliable.

4 Note that the Government has no net foreign currency debt.

As always, there are risks around the economic forecasts. For example, weak business and consumer confidence and soft domestic demand, together with the recent depreciation in the New Zealand dollar, are particular risks around the evolution of the economy in the short-term.

In general, we do not consider an adjustment in fiscal policy would be required if such risks were to crystallise. Unless the economy is facing a long-lasting shock, our general approach to fluctuations in the economic cycle is to let automatic fiscal stabilisers[5] operate. Provided that surpluses continue to rise in a structural sense, we see no need to adjust our short-term fiscal policy approach.

The second Budget in a three-year programme

Budget 2001 is the second stage in our three-year policy programme. Budget 2000 ushered in a period of intense new policy development covering a number of our key initiatives:

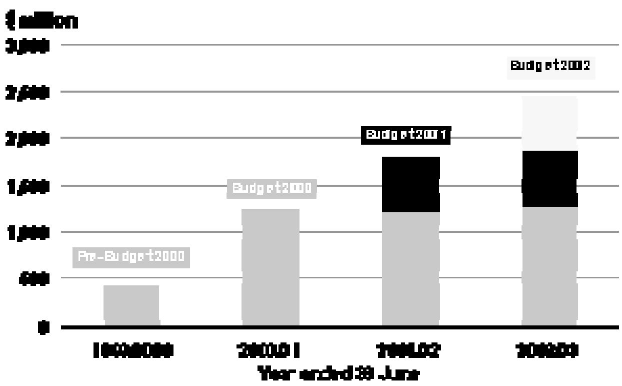
- restoring superannuation rates
- cessation of state housing sales and introduction of income-related rents
- reducing the interest-rate burden of the student loan scheme
- reducing waiting times for elective surgery
- helping create jobs through a three-year package for industry development.

In addition, we delivered on other high priority initiatives, including mental health and the biodiversity strategy.

As a result, additional spending allocations are smaller in the 2001 and 2002 Budgets as the Government moves into a period of consolidation.

In total, we expect around $4.1 billion of the operating provision to have been committed by the time of Budget 2001.

Figure 3 – Operating provision allocation



Source: The Treasury

By carefully managing the allocation set aside for meeting new risks arising in the current financial year, we expect to be able to increase the 2001 allocation by at least $50 million per year compared with the Budget 2000 forecast. This leaves projected spending allocations of around $600 million per year for Budget 2001 and $575 million per year for Budget 2002.

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5 If government spending and tax plans remain unchanged during an economic 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 "fiscal stabilisers" to operate across the economic cycle takes the pressure off monetary policy and reduces fluctuations in employment and output.

Key commitments are consolidated in 2001

In Budget 2001, we will place priority on those spending areas that we believe best advance our key policy goals, as outlined in BPS 2000.

The first of these is education, where we will be seeking to invest in higher skill levels, particularly for young people. In the coming year, the Government will work towards raising quality and achievement across the education sector. The focus will be on promoting and extending the learning and development of participants in early childhood education, the effectiveness of teaching in schools, and quality and capability within the tertiary sector.

A significant level of investment in health and disability services will continue. The Government's aim is to ensure that the health sector works together cooperatively toward achieving common goals. These goals include improvement in the health of our community and, within the money available, the highest quality care for people who are sick or disabled.

We are committed to improving social services, and accordingly this will be a priority in Budget 2001. Our aim is to shift to a positive approach where we invest in people so they can contribute in the knowledge society. We will also be investing in the Department of Child, Youth and Family Services and the Department of Work and Income, to ensure that they have sufficient service capacity to provide effective assistance to their clients.

Finally, we will place a high priority on those initiatives that we consider can contribute to enhancing economic growth and innovation. This will include, for example, our ongoing work to give more certainty in the tax treatment of research and development expenditure by New Zealand businesses. We will also benefit from the rising profile for industry and regional development spending that was agreed in Budget 2000, which will see significant funding come on stream in 2001/02 to boost development initiatives.

Delivering within constrained resources

It will be a challenge for us to achieve all that we are seeking from Budget 2001 within a relatively constrained funding allocation. We recognise that delivering on our priorities will mean that resources are scarce in other policy areas, and some sectors will receive no further funding in Budget 2001. This does, however, need to be put in context. Many core policies received funding early in the three-year cycle with the result that they enjoyed a funding boost for longer than would have been the case otherwise. Over the next two years we expect to focus in these areas on successful implementation of our policies.

Further new initiatives may be funded by redirecting existing spending. We believe much can be done to improve the value for money that taxpayers receive from existing government expenditure of over $38 billion per annum at 30 June 2001. Government initiatives in 2001 will also focus on improving the effectiveness of existing policy interventions, managing risks, improving the quality of government regulation, and eliminating unnecessary compliance costs.

No change in revenue policy

No substantive changes to revenue policy are planned over the remainder of the term. We have commissioned a Tax Review to examine the structure and effects of the present tax system and formulate proposals for improving that system. This work will inform our views on revenue policy over the longer term.

Health and defence requirements drive increase in capital limit

In Budget 2000, we established an indicative three-year capital expenditure provision of $2.4 billion. Around $1.9 billion of the provision has already been committed, primarily to school property, hospitals and increased student loans. Budget 2001 will see a continuation of our existing investment policies, particularly in the education sector, where we will continue to provide for new capital spending on school property. Funding will be also provided for ongoing capital investment programmes in the areas of Defence and Corrections.

We signalled in Budget 2000 that we were likely to revise our capital spending provision upwards. A more detailed assessment of our investment needs over the three-year term has led us to increase the provision from $2.4 billion to $3.2 billion. Significant factors in the increase in forecast capital requirements were the increase in Defence Force acquisition costs resulting from the fall of the New Zealand dollar against the US dollar, and a decision to replace private sector hospital financing with Crown financing for new hospital projects.

The decision to provide Crown finance for hospital loans is a technical change that will increase the Crown's gross debt. Because it brings a financial asset onto the Crown's balance sheet, however, there is no impact on net debt. We expect a reduction in finance costs overall, as Crown finance costs are generally lower than the cost of private finance.

The revised capital budget is consistent with our objectives for debt repayment and NZS Fund contributions. While the increase in capital provision will have a gross debt impact of roughly 0.7% of GDP by the end of 2002/03 compared to Budget 2000 forecasts, DEFU forecasts show that we are still on target to meet our debt objectives (see Table 1 above).

A more strategic approach to investment

We have reviewed our investment needs over the longer term, and believe that there are a number of issues we need to address to improve the Government's framework for capital expenditure decisions. The capital provision provides us with the flexibility to respond to the identification of new issues. However, uncertainty around our long-term investment needs may lead to changes in the provision as specific needs emerge, sometimes with little warning.

Fiscal policy trade-offs have already been taken into consideration when setting the capital provision. However, we need a more comprehensive overall framework which reflects the Government's broader social and economic objectives, and which will guide capital investment decisions within sectors and across the whole of government.

The Treasury has been directed to address the above issues, in consultation with relevant departments, as a basis for more comprehensive work by Ministers and departments after Budget 2001.

Good prospects looking forward

Careful management of the Crown's finances over the near term will place us in a position where we can draw maximum benefit from the economic growth expected over the next two years and beyond. By maintaining the prudent spending limits established last year, we will help ensure that fiscal and macroeconomic policy work together for future growth.

Once we have built up the structural surpluses required to meet the contributions to the NZS Fund, we will be in a position to consider new policy options. The 10-year projections in the *Fiscal Strategy Report 2000* included a "fiscal allowance" of $1.2 billion from 2004/05 onwards. The fiscal allowance indicates the fiscal flexibility that the Government has for such things as spending and revenue initiatives, accelerating contributions to the NZS Fund, and responding to developments in the economic and fiscal position that differ from current projections. The $1.2 billion allowance provides a broad indication of flexibility rather than a specific policy commitment.

The level of the fiscal allowance suggests that there may be room for greater flexibility in policy spending beyond the current term. Given the uncertainties around the economic environment, however, we have chosen in the interim to retain the technical provision of $800 million for forecast new operating spending in each of 2003/04 and 2004/05.

The technical provision is a broad average of annual new spending over the last two terms of government, and provides a conservative estimate of likely future policy spending. Spending intentions beyond the current term of government will be reviewed in 2001, and the technical provision will then be replaced by an indicative Government policy commitment for 2003/04 onwards.

Conclusion

Budget 2001 will be the second Budget in a three-year policy programme. Budget 2000 delivered a substantial portion of the Government's core policy commitments. Budget 2001 will see us moving into a period of implementation and consolidation, while still making progress towards achieving our key policy goals.

We will continue to make progress towards our long-term objectives, and we will start accumulating assets to help manage the future fiscal pressures associated with an ageing population. By smoothing the costs of NZS over time, we will bring greater stability to retirement income policy.

To achieve all our objectives, we will need to maintain spending within the $5.9 billion three-year spending limit that was agreed in Budget 2000. Careful fiscal management is required if we are to build to the level of surpluses we need to meet the projected contributions to the NZS Fund. By achieving our policy goals within a prudent fiscal framework, we will deliver a sustainable programme that will foster New Zealand's economic growth and welfare in the long term.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

8 December 2000

Annex 1

Short-term Fiscal Intentions and Long-term Fiscal Objectives

The Government's long-term fiscal objectives are unchanged from the *Budget Policy Statement 2000* and *Fiscal Strategy Report 2000*. The Government's short-term intentions have been updated since the Fiscal Strategy Report 2000 to reflect the latest fiscal forecasts. Our short-term fiscal intentions are consistent with our long-term fiscal objectives and the principles of responsible fiscal management, as shown below.

Principles of Responsible Fiscal Management

- 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.

	Long-term fiscal objectives	Short-term fiscal intentions
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 prefunding the costs associated with the ageing population.	On current forecasts, operating balances will be: • $0.8 billion in 2000/01 • $2.2 billion in 2001/02 • $2.8 billion in 2002/03 • $3.6 billion in 2003/04
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.	If forecast economic conditions prevail, gross Crown debt/net Crown debt will be: • $38.2 billion/$22.1 billion in 2000/01 • $37.7 billion/$22.1 billion in 2001/02 • $37.6 billion/$22.0 billion in 2002/03 • $37.7 billion/$21.4 billion in 2003/04 In 2003/04 gross and net Crown debt will be 29.4% and 16.7% of GDP respectively.
Operating expenses	Expenses around current levels of 35% of GDP.	On current forecasts, operating expenses will be: • $38.1 billion in 2000/01 • $39.3 billion in 2001/02 • $40.6 billion in 2002/03 • $42.0 billion in 2003/04 If forecast economic conditions prevail, expenses will be 32.8% of GDP in 2003/04.
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.	On current forecasts, operating revenues will be: • $38.2 billion in 2000/01 • $40.7 billion in 2001/02 • $42.7 billion in 2002/03 • $44.9 billion in 2003/04

	Long-term fiscal objectives	Short-term fiscal intentions
Crown net worth	The Government will increase net worth.	Subject to forecast economic conditions prevailing, net worth will be: • $9.4 billion in 2000/01 • $11.6 billion in 2001/02 • $14.4 billion in 2002/03 • $18.0 billion in 2003/04

We are committed to our long-term fiscal objectives, which represent our view about the appropriate size and role of government and about prudent fiscal policy. The *Fiscal Strategy Report 2000* signalled possible future developments that may require these objectives to be re-examined (page 28).

These future developments include:

- the introduction of line-by-line consolidation in the 2002 Budget, in line with Generally Accepted Accounting Practice (GAAP). This will have implications for the specification of the long-term expense and debt objectives.

- possible clarifications as the Government further develops its policy approach towards future demographic pressures. For example, the Government may want to link the fiscal objectives more closely to the build-up of the NZS Fund.

- the possible adoption of gross debt as the Government's key debt indicator. This could eventually lead the Government to specify its long-term debt objectives in terms of gross debt rather than both net and gross debt.

The *Fiscal Strategy Report 2000* signalled that the Government would be consulting key users of the Government's financial statistics about whether the Government should adopt gross debt as the key debt indicator. We have consulted with the IMF, the OECD, rating agencies, and a range of bank analysts. These consultations showed that there is a need for both net and gross debt to remain available for people to use.

The results of our consultations, as well as other work undertaken on the impact of line-by-line consolidation and the introduction of the NZS Fund, will be incorporated into a technical discussion paper to be released early next year. The Government will then make decisions about technical changes to its long-term fiscal objectives. Any re-specification will not change the intent of the objectives.

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 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, and
- justify any change in the short-term intentions from the immediately preceding BPS or the most recent FSR.

Annex 2

Operating Balance, NZS Fund and Net Debt

This Annex shows how the operating balance ultimately translates into cash available to reduce debt, after allowances have been made for non-cash items, valuation changes, cash payments for investment in physical assets and for contributions to the New Zealand Superannuation Fund. Although the capital contributions to the Fund do not directly affect the operating balance, partial pre-funding will require cashflows sufficient to maintain the debt objectives, contributions to the Fund and other capital requirements.

Changes in net debt do not equal the operating balance because the latter is an accrual measure and recognises non-cash items such as the GSF unfunded liability movement, depreciation and the state-owned enterprises/Crown entities (SOE/CE) retained surplus. Movements in net debt primarily reflect cash flows. The table below makes the adjustment for non-cash items, includes the return to the Fund (counted as income to the Crown but retained by the Fund), and shows the application of cash to areas other than debt reduction. This includes the Fund (via capital contributions) and purchases of physical assets, including the capital contingency provision.

Table 2 - Operating balance, contributions to NZS Fund and change in net debt

Year ended June ($ million)	**2000 Actual**	**2001 Forecast**	**2002 Forecast**	**2003 Forecast**	**2004 Forecast**	**2005 Forecast**
Operating Balance	**1,449**	**765**	**2,205**	**2,829**	**3,622**	**4,475**
Adjustments for non-cash items e.g. depreciation, SOE/CE surplus	(303)	149	127	158	90	(22)
Valuation change GSF unfunded liability movement	(201)	244	6	(11)	(24)	(29)
Cash payments Contribution to NZSF	..	..	(600)	(1,200)	(1,800)	(2,900)
Net purchase of physical assets	(910)	(1,654)	(1,409)	(1,431)	(1,074)	(1,183)
Other items[6]	270	(207)	(349)	(262)	(186)	(168)
Equals						
Reduction/(Increase) in net debt	305	(703)	(20)	83	628	173
Net Debt	21,396	22,099	22,119	22,036	21,408	21,235
Net Debt (% of GDP)	20.4%	20.2%	18.9%	18.0%	16.7%	15.8%

[6] For more detail, see Table 2.10 in the December Economic and Fiscal Update.