Budget
Policy Statement

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Contents

Introduction

This *Budget Policy Statement* (BPS) previews the second Budget of the National-New Zealand First Government. The Coalition Agreement laid out an ambitious policy programme to be achieved within the framework of a $5 billion limit on policy initiatives over the three years to 1999/2000. The 1998 Budget will consolidate progress made in our first year of office. This year will also see reductions in personal income tax rates from 1 July.

The progress of the past year clearly shows that the Coalition Agreement's objectives can be advanced within a prudent fiscal strategy. The Government restates its commitment to the long-term objectives of the 1997 BPS, and we expect to continue our progress towards these goals over the years to 2000/01 and beyond.

Running surpluses and repaying debt remain the essential features of our fiscal strategy. Lower debt levels and rising net worth help the economy adjust more smoothly to shocks and prepare us for the demographic pressures of the next century. With continued responsible fiscal management we should be able to contemplate further tax reductions.

The current financial crisis in Asia confirms the importance of a strategy to run surpluses, providing a buffer against adverse events. The Asian crisis will have a negative impact on New Zealand's economic performance in the short term, although the size of that impact is still unclear. However our fiscal strategy has put us in a good position to weather the changes ahead. Asia may create a weaker economic recovery than the central forecast in the 1997 *December Economic and Fiscal Update* (DEFU) which was finalised prior to the emergence of severe economic difficulties in South Korea. Page 8 looks at a scenario detailing a weaker economic recovery than that forecast in the DEFU. It illustrates the robustness of the fiscal strategy to changes in the economic environment. While next year's surplus would be lower than forecast, debt reduction would continue, and the fiscal outlook would not change significantly. However we cannot be complacent. The current environment demands that the Government continue to be highly prudent in its fiscal management.

The Fiscal Responsibility Act 1994 requires the Government to specify its fiscal intentions for the next three years. This BPS therefore looks towards 2000/01 for the first time, beyond the Coalition Agreement timeframe. In the interests of transparency the Government has made a provision for additional policy initiatives with an impact on the operating balance in 2000/01 of $800 million. This is a technical assumption, based on patterns in the cost of new initiatives. The figure will be reviewed in future BPSs and is discussed further in Annex 1.

This document also specifies the Government's strategic priorities for the 1998 Budget — a Budget designed to build on the progress of our first year, particularly in health, education and law and order, while remaining within the $5 billion limit for new policy initiatives to 1999/2000.

Fiscal Strategy

The fiscal strategy, by controlling spending, reducing debt and enabling continued operating surpluses, will contribute to a stable environment for investment and other business decisions. In turn, the creation of a stable environment in which individuals and businesses have the confidence to plan their futures, is an important element in the Government's economic strategy.

This Government will continue its programme of ***high quality spending in high priority areas*** such as health and education. However uncontrolled spending has no long-term benefits for New Zealand, and the Government's decision to ***limit the cost of additional policy decisions to $5 billion*** over the three years to 1999/2000 is a powerful tool which enables key areas to be addressed while maintaining a credible fiscal and economic strategy. The Government will also seek to provide further funds for policy initiatives by identifying low quality spending and shifting funds to high priority areas.

Total government expenses will grow more slowly than the economy over the period, therefore ***expenses will continue to fall as a percentage of GDP***, dropping to around 33% by 2000/01, a level not seen in New Zealand since 1977/78.

A ***low-rate, broad-based tax regime*** and ongoing economic growth are essential to raise revenue. Maintaining, protecting and improving the tax base is a central issue for the Government to ensure that all New Zealanders pay their fair share of tax.

While government spending's share of GDP continues to decrease, ***revenue largely increases in line with economic growth***, following the next round of tax reductions. Sustained economic growth therefore supports the Government's fiscal strategy, and we will pursue a wide range of pro-growth policies, outlined on pages 9 and 10. Maintaining revenue while decreasing spending increases the surplus so that Crown debt can be reduced to prudent levels in accordance with the principles of responsible fiscal management in the Fiscal Responsibility Act 1994.

A key facet of the Government's fiscal strategy is the ***maintenance of fiscal surpluses***. DEFU forecasts modified to include provision for 2000/01 initiatives show operating surpluses of 1.7% of GDP in 1998/99, 2.0% in 1999/2000 and 2.4% in 2000/01.

Ongoing healthy surpluses will allow us to ***continue the Government's programme of debt reduction***. Lower debt helps the country adjust more smoothly to economic shocks and reduces debt servicing costs, allowing the Government to put money to better use in key social areas — improving health, education, social services, and law and order. Longer term, low debt levels are a key part of any sensible strategy to address the issue of our ageing population. Net debt figures are projected to move from 23.0% of GDP in 1998/99, to 21.1% in 1999/2000, and 18.9% in 2000/01.

A future benefit of the Government's fiscal strategy, to the country and to individual New Zealanders, is ***further tax reductions*** if fiscal and economic conditions permit. Lower tax rates put additional dollars in the hands of New Zealanders, and encourage them to undergo training, gain employment, invest in their businesses, and save for their futures. Sustainable tax reductions can be considered only if the Government continues to reduce its spending as a percentage of GDP over time. The Government will continue to assess the scope for further tax reductions in the light of economic and fiscal conditions.

Impact of Changed Economic Conditions on Fiscal Strategy

The Government's short-term intentions assume economic and fiscal outcomes follow the DEFU forecasts. However alternative economic circumstances may lead to changes in the forecast operating balance. The Government's fiscal strategy has been designed to accommodate a range of economic developments and still make progress towards its long-term fiscal objectives.

In general, the Government would not change its tax or spending plans if the economic cycle unfolds in a different manner from that assumed in the projections. This means that stronger-than-expected growth would be reflected in higher-than-forecast operating surpluses and faster progress towards the Government's debt targets. Conversely, lower-than-expected growth would be reflected in lower-than-forecast operating surpluses and slower debt repayment.

This approach to fiscal policy helps to stabilise the economy and reduce the swings in output and employment over the economic cycle. When the economy turns down, maintaining existing spending plans, even if tax revenue growth slows and the operating surplus reduces, is likely to mitigate the impact of an economic slow-down on incomes and jobs.

Similarly, maintaining tax rates and spending plans when the economy is on the upswing and the operating surplus rises through higher tax revenues and lower unemployment will help to sustain the economic recovery by leaning against inflationary pressures and supporting monetary policy.

The Asian crisis provides a good example of this principle in action. A worsening situation in Asia may reduce the short-term growth outlook for the New Zealand economy, affecting the size of the operating surplus and the rate of debt repayment. However the fiscal position is likely to remain robust to these changes. Changing the fiscal position in line with changes in the cycle could itself exacerbate swings in the economy. The uncertainty surrounding Asia is considered further on pages 8 and 9.

However there are limits to this approach over the next few years. Progress towards the goal of prudent debt levels is a fundamental principle of responsible fiscal management, and the Government must run surpluses until those levels are reached. New Zealand's large current account deficit and high level of overall external private sector debt also make it particularly important that the Government maintains fiscal policy credibility by preserving operating surpluses in the short term. Any slippage into deficit would raise concerns about the sustainability of New Zealand's external position, possibly reducing capital inflows and sharply raising interest rates.

While improvements to New Zealand's fiscal balance in recent years are reasonably robust, significant risks remain. Gains in credibility are likely to come from building on our track record of prudent fiscal policy and sustained progress towards announced fiscal goals.

If economic conditions threaten surpluses before prudent debt levels are reached, the Government would be prepared to reconsider its expenditure plans by both deferring some spending and cutting lower priority expenditure to maintain surpluses.

It is often difficult to tell whether changes in the fiscal position reflect cyclical or structural factors. Letting the operating balance vary in line with changes allows time to assess the reasons for the change and to develop a prudent response. An apparent structural change would lead the Government to reassess its tax and spending plans. For example, higher surpluses that appear sustainable would provide us with the option of further tax reductions.

Economic Strategy

The fiscal strategy is but one aspect of the Government's strategy to achieve economic and employment growth. Our standard of living is determined by the numbers and skills of people in employment, the quantity and quality of investment, the efficiency of the economy and the maintenance of environmental quality. A growing economy is the key to a high standard of living for all New Zealanders.

The Fiscal Position and Developments in Asia

Since the DEFU, short-term growth prospects in the Asian region have been revised down, for some countries quite significantly. Uncertainty about Asia has also dented business confidence in New Zealand, with survey measures turning down at the end of 1997. However events are still moving fast in the region and the exact impact on New Zealand is still uncertain.

The fall in business confidence, if sustained, has raised the risk of slower growth in the near term — similar to the "weaker recovery" scenario outlined in the DEFU. This projected a weaker recovery in growth in the short term with growth reduced by around ½% in 1997/98 and 1998/99. However growth would be stronger by around ½% in 1999/2000 and 2000/01.

Figure 1 - DEFU Weaker Recovery Scenario

Lower economic growth in the short term would affect tax flows and would therefore reduce the operating surplus. As a rough rule of thumb, 1% lower economic growth implies a change of around $300 million in the fiscal position. This would imply a surplus in 1998/99 of around $1.5 billion[1].

In the scenario, as economic growth rebounds in 1999/2000 and 2000/01, the reduction in the operating surplus would have a smaller impact than in 1998/99.

This does not represent a new forecast, because there are many events that need be considered for a full forecast revision. Whatever the direct impact of the Asian crisis, it is also important to note the positive factors for economic growth which have come to light since the DEFU (see Annex 1).

The likely impact of uncertainty in Asia on economic growth is not yet clear. Developments in Asia and the possible implications for economic growth in New Zealand are being continually monitored. Annex 1 contains a discussion on the latest economic developments including some of the uncertainty surrounding Asia. The upcoming Budget Update will incorporate a full assessment of all available economic information on the outlook for growth.

The progress of the Asian financial crisis highlights the worth of a prudent fiscal strategy and the pursuit of a vigorous pro-growth strategy. The Government's comprehensive strategy for growth aims to:

- ***maintain macro-economic stability***
  - by requiring the Reserve Bank to keep inflation within the 0%-3% target band
  - by maintaining a prudent and transparent fiscal policy

- ***increase openness to international trade and investment***
  - by removing all tariffs well within the 2010 APEC timeframe
  - by removing all motor vehicle tariffs by 1 December 2000
  - by helping make New Zealand an attractive destination for overseas investment
  - by negotiating the Multilateral Agreement on Investment
  - by pursuing trade liberalisation through APEC, particularly in the areas of forestry, fishing and food
  - by advocating liberalisation of trade at the World Trade Organisation
  - by examining the possibility of entering into Free Trade Agreements with the US and Hong Kong

- ***build a high quality labour force***
  - by improving skills and training through education
  - by developing immigration policy so that New Zealand is able to attract high quality immigrants and improve the social and economic mix of the immigration intake

1 The cumulative effect of ½% lower growth in 1997/98 and 1998/99 would be for the level of growth in 1998/99 to be 1% below DEFU forecasts.

- ***continue regulatory reforms to lower cost structures***
  - by reducing the burden of government on business, eg, by reviewing the operation of the Resource Management Act
  - by developing a Regulatory Responsibility Act to improve the quality of regulation and lower compliance costs on businesses
  - by developing proposals for improving decisions on roading use and investment
  - by reforming the ACC levy system and looking at introducing an element of increased competition into the provision of ACC services
- ***encourage enterprise and innovation***
  - by promoting more effective competition in electricity generation and retailing, and greater efficiencies in electricity distribution
  - by examining the Government's ownership interest in non-strategic assets on a case-by-case basis
  - by developing a tax system which does not discourage New Zealanders from making sound spending, investment, saving and work decisions
  - by improving the effectiveness of the Commerce Act
  - by examining the monopoly power of producer boards

The objective of the Government's fiscal, economic and monetary policies is an economic climate conducive to sustainable development and growth. Such a climate provides more employment opportunities, high quality education and social services, which in turn contribute to our overall goal — a society in which the Government helps people to help themselves and their families.

1998 Budget Priorities

In the 1998 Budget, the Coalition Government will take further steps towards achieving such a society. The Government remains committed to the following fiscal priorities:

- a further round of tax reductions from 1 July 1998
- running operating surpluses and continuing debt repayment
- controlled priority spending within the $5 billion limit on new policy initiatives in the three years to 30 June 2000.

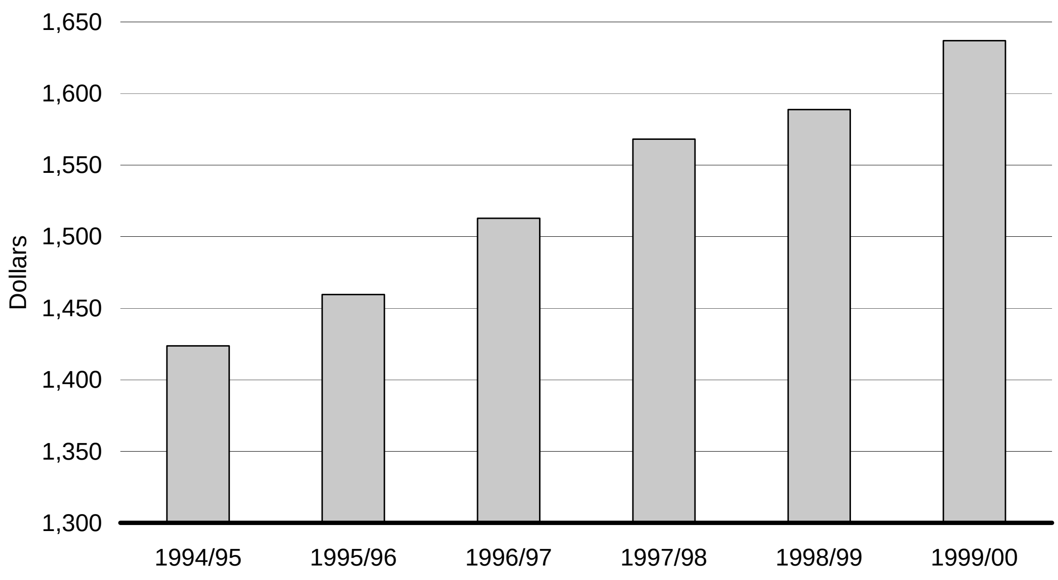
The 1998 Budget will focus on the following priority areas:

Health

The Government is committed to providing a high quality public health service for all New Zealanders. This is reflected by Cabinet's November 1997 confirmation of planning levels indicated in the 1997 Budget providing increases to health spending of $236 million (GST inclusive) in each of 1998/99 and 1999/2000, as outlined in the DEFU. A further $236 million have also been provided for in 1999/2000 subject to confirmation as part of the 1999/2000 Budget process.

As the graph below makes clear, the Government's commitment to health funding is significant and consistent, rising into the next century. Between 1996/97 and 1999/2000 real per capita health expenditure is projected to increase by more than 8%.

Figure 2 – Real per Capita Health Expenditure (1996/97 prices)



But that is not the end of the Government's commitment to health. Further funding of up to $200 million over 1998/99 and 1999/2000 has also been signalled.

Education

Education remains a key priority for this Government. Investment in a child's development from early childhood throughout the years of schooling is crucial in building the knowledge, skills and motivation we need to succeed in the 21st century. The emphasis of this year's education spending will build on last year's approach. The focus is on quality improvements in the compulsory sector, building participation in early childhood education and maintaining our current tertiary education approach while policy reviews are completed.

This Government has made a significant commitment to education investment, with the latest projections contained in the DEFU showing total education expenditure increasing by close to $600 million during the term of this Government, including a 2% increase in real per capita compulsory education funding. However these figures tell only part of the Government's commitment to education investment. Further education expenditure will be committed as part of the 1998 and 1999 Budgets as progress is made across a range of Coalition policies.

Employment

The key goal of the Government's employment strategy is to reduce long-term unemployment among all working age beneficiaries by getting job-seekers into real work as quickly and cost effectively as possible. A complementary goal is maximising the involvement of job-seekers in community work or training. To further the advancement of these goals the Government has decided to establish a new agency, integrating the delivery of employment and income support services. The new agency will deliver a seamless service to working age beneficiaries seeking employment assistance, income maintenance and training assistance. Regional Employment Commissioners will assist the new agency to be more responsive to local labour market needs.

Strengthening families

The Government is committed to ensuring that social services are well targeted to reach children and families at risk. The strengthening families strategy is designed to identify families at risk, assessing and meeting their needs through well coordinated and proactive services. Better local coordination between service providers will significantly improve the quality of life for our children, and the quality of government social spending.

Law and order

In the 1998 Budget, we will allocate further resources to the New Zealand Police and other justice sector agencies, demonstrating the Government's commitment to safe communities and safe streets throughout New Zealand.

Fiscal Savings

Advancing priority spending while preserving fiscal surpluses into the next decade requires the Government to identify areas of low quality spending. These savings can be moved to high quality spending initiatives. Ministers have devoted considerable energy to identifying areas of low quality spending so that this money can be reallocated into high priority areas, bolstering the amount of money available for new initiatives in the next two Budgets. The Government will continue to review government spending to ensure taxpayers get good value for the money spent on their behalf. The following guidelines have been used to identify fiscal savings:

- Where there is little value added by government assistance to business, the Government will aim to reduce this spending.

- The Government should reduce its welfare benefit costs by:
  - reviewing the relative levels of different benefits
  - tightening eligibility rules and administration
  - enhanced targeting of social assistance to those most in need.
- Progressive reductions in spending should be sought where private gains are large in relation to public gains.
- There should be constant pressure to reduce spending, and institutional or policy reviews should be used as an opportunity to make savings wherever possible.

Long-term Objectives and Short-term Intentions

The Fiscal Responsibility Act 1994 requires that the Government specify in the BPS its long-term fiscal objectives and short-term fiscal intentions in terms of operating expenses, operating revenues, the operating balance, and the levels of Crown debt and net worth. The BPS must also show the consistency of the Government's objectives and intentions with the principles of responsible fiscal management set down in the Fiscal Responsibility Act 1994.

Fiscal Responsibility Act 1994

The Fiscal Responsibility Act 1994 lays out five principles of responsible fiscal management:

1. 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.
2. 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.
3. 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.
4. Managing prudently the fiscal risks facing the Crown.
5. Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Long-term objectives

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 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 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 cycle.
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.
Crown net worth	The Government will maintain net worth at significantly positive levels.

In the long-term, the Government intends to reduce its operating expenses to below 30% of GDP. Some international evidence suggests that an increase in the share of the economy taken up by government spending can reduce economic and social well-being. Taxes to fund government expenditure impose costs on the economy, resulting in lower output than would otherwise be the case, and restricting employment growth.

The Government's responsibilities are therefore to reduce the level of spending, while increasing the quality of that spending. Responsible management of risks facing the Crown requires us to constantly improve the quality of public spending to ensure that the Government spends efficiently to meet social goals, and gets value for money for the taxpayer. Superannuation and social welfare benefits are key drivers of the level of public expenditure. The boxes which follow look at these two issues, which are facing governments around the world, in the light of our fiscal strategy to reduce the Government's operating expenses.

Long term, the Government's objective is to maintain a broad-based tax regime, and to reduce tax rates, providing a reasonable degree of predictability about the level and stability of tax rates into the future. Lower taxes will enable New Zealanders to spend, invest and save their money in ways that most benefit themselves and their families. Monitoring, protecting and improving the tax base is a central issue for the Government to ensure the tax revenue it needs is collected at the lowest possible tax rates, and that individuals and companies all pay their fair share of tax.

Reducing operating expenses while maintaining the tax base helps keep operating revenues above operating expenses, in accordance with the principles of responsible fiscal management. Continued surpluses enable the Government to keep debt at prudent levels by living within its means over time.

The Government is committed to maintaining surpluses until its debt targets are reached, and then continuing to run surpluses over the cycle. The Government intends to lower the level of gross Crown debt to 30% of GDP, consistent with reducing net Crown debt to 20% of GDP. Such levels provide a buffer against factors that may impact adversely on the level of total Crown debt in the future. Surpluses also provide the Government with opportunities for further tax reductions over time.

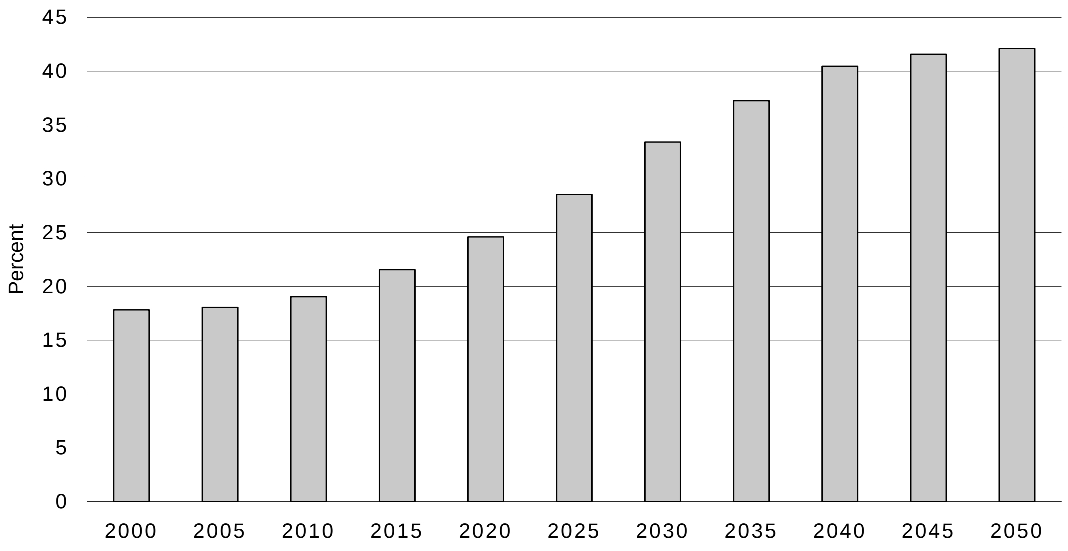
The most recent fiscal projections published in the DEFU forecast that the target of net Crown debt at 20% of GDP will be achieved in 2000/01.

Lowering debt also helps the Government to increase Crown net worth to provide a buffer against shocks and to enable the Government to meet future obligations without sharp changes in policy settings. Increasing net worth is also a key tool in addressing the impact of demographic trends and consequent rising levels of spending on health and superannuation next century.

New Zealand's Ageing Population

Much of the Government's long-term fiscal strategy is designed to respond prudently to the issue of New Zealand's changing demographic structure. The ratio of those aged 65 years and above to those aged 15 to 64 is projected to double over the next 40 years.

***Figure 3* -** Ratio of Population Aged 65+ to those Aged 15-64



This looming demographic pressure demands a prudent fiscal response.

The proposed Retirement Savings Scheme (RSS) formed one option in the Government's strategy towards ensuring income security in retirement without creating excessive fiscal pressures or unfairly burdening future taxpayers with higher tax rates. With the referendum's rejection of the RSS, the Government intends to examine other options for dealing with future demographic pressure.

The Retirement Income Act 1993 requires periodic reports on retirement income policies at six-yearly intervals. The Periodic Report Group released its concluding report in December 1997.

The Periodic Report Group discussed a number of options to deal with the fiscal challenges of an ageing population including:

- increasing the age of eligibility, altering indexation arrangements and/or targeting New Zealand Superannuation
- amending the Fiscal Responsibility Act 1994 so that statements on fiscal policy intentions addressing demographic and other pressures extend beyond 10 years
- continuing to reduce net Crown debt to around zero by 2015.

The Government is considering the Report with the aim of ensuring income security in retirement without creating excessive fiscal pressures or unfairly burdening future taxpayers with higher tax rates.

A fiscally sound framework for coping with demographic pressure requires an emphasis now on controlling expenditure and achieving efficiency improvements in the delivery of services in coming years. Running surpluses to repay debt now allows us to best use the time before the baby boomers start to retire.

The Rising Cost of Welfare

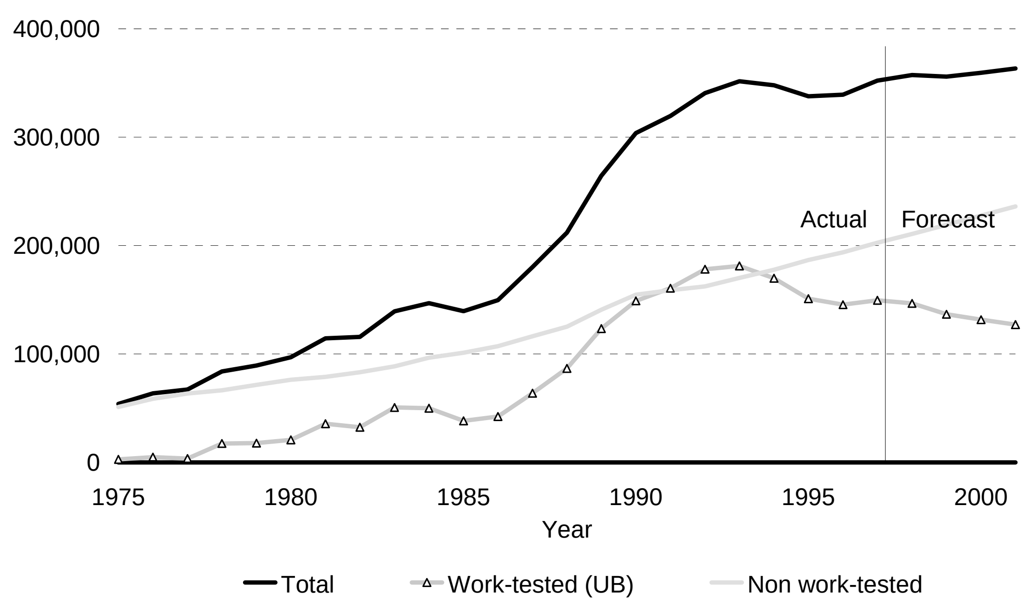
Welfare costs represent a significant and growing proportion of government expenditure. This is an issue being faced around the world by countries with developed social welfare systems.

Income support provides an important safety net so people can sustain themselves and their families in times of adversity — as they look for a new job, exit a dangerous relationship, or recover their health. Income support is intended to help people move from one state to another. It was never designed as a permanent solution.

In June 1997 over 350,000 New Zealanders were the primary recipients of the main income-tested benefits, around 15% of the working age population. This is almost a five-fold increase since 1975 in both total numbers and percentage of the working age population. More than 28% of New Zealand's children are now living in families receiving income-tested benefits.

Increasing beneficiary numbers have raised expenditure on the main income-tested benefits from $610 million in 1974/75 (in 1996 dollars) to $3,772 million in 1996/97. This now represents 12% of government expenditure.

Figure 4 – Total Number of Beneficiaries on Work-tested and Non Work-tested Benefits



Note: *Non-work tested benefits are the domestic purposes, widows, sickness and invalids benefits.*

The rising number of beneficiaries partly reflects people staying on benefits long term. In June 1996 54% of working age beneficiaries had been in receipt of a benefit for more than one year.

Long-term benefit receipt can reduce the quality of life of beneficiaries and their families. Having little or no income from employment inevitably reduces the resources available to individuals and households, and being on a benefit long term makes it more difficult to get into a job. Growing up in a long-term benefit-dependent household is associated with poorer outcomes later in life.

Like governments of other countries, the Government is looking at the issues raised by the rising numbers of people on welfare benefits with the intention of developing a welfare strategy that provides support for those in need while helping people to move back into paid work.

Short-term intentions

Short-term Intentions	
Operating expenses	The Government will maintain firm control over expenses and a steady decline in the ratio of expenses to GDP. Consistent with the Coalition Agreement, policy initiatives including the abolition of the surcharge will cost 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.
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 the operating expenses and revenues 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 $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.
Crown debt	The Government will 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.
Net worth	The Government will steadily increase levels of net worth to $9.1 billion in 1997/98, $10.9 billion in 1998/99, $13.1 billion by 1999/2000, and $15.8 billion in 2000/01 subject to expected economic conditions prevailing.

In the short term the Government's focus is on maintaining firm control over expenses and reducing the ratio of expenses to GDP, key elements of responsible fiscal management. Good progress has been made in this regard, and government costs have been significantly reduced through lower debt servicing costs, lower numbers of unemployment benefit recipients, and the increased age of eligibility for New Zealand Superannuation. The Government's commitment to limiting additional policy costs to $5 billion in the three years to 1999/2000 further progresses this intention.

Revenue levels will remain sufficiently high to ensure significant operating surpluses into the next century. Tax cuts reducing personal income tax rates will come into force on 1 July 1998. These cuts were deferred from 1 July 1997 to accommodate additional spending on priority areas in 1997/98 and to limit inflation pressures. If economic and fiscal conditions permit, further tax reductions will be considered in future years. Any lowering of tax rates will require continued reductions in spending as a percentage of GDP, producing healthy surplus forecasts well into the future to provide a buffer against future adversity.

The Government will run surpluses consistent with the short-term operating revenue and expense intentions. On current forecasts, this will produce operating balances of $1.8 billion in 1998/99, $2.2 billion in 1999/2000 and $2.7 billion in 2000/01. In the short term, running surpluses is crucial. Large current account deficits and high levels of overall external private sector debt make it particularly important that the Government maintains fiscal policy credibility by maintaining operating surpluses in the short term.

It is important to remember that money available for debt repayment is only a proportion of the operating surplus, much of which is made up of the surpluses of State-owned enterprises and Crown entities which do not directly provide cash for debt repayment. The Government's operating surpluses must be significant in order to keep up our prudent programme of debt repayment.

Gross and net debt will reduce steadily. Subject to expected economic conditions prevailing, gross Crown debt and net Crown debt are forecast to decrease from $35.3 billion and $24.3 billion in 1998/99, to $33 billion and $21.9 billion in 2000/01. This will represent the prudent levels of 28.5% and 18.9% of GDP respectively in 2000/01.

The Government intends to continue to increase Crown net worth over the forecast period through debt repayment and maintaining surpluses. Net worth is forecast to rise from $9.1 billion at the start of 1998/99 to $15.8 billion by the end of 2000/01, providing a buffer against factors that may impact adversely on the Crown's net worth in the future.

Conclusion

The Government's long-term objectives are consistent with prudent and consistent fiscal policy. The short-term intentions provide the steps for the achievement of these goals.

This BPS presents a fiscal strategy that is prudent and robust. Prudent and conservative fiscal management is essential to delivering quality government services and a growing economy that brings employment, opportunity and security to all New Zealanders.

Our commitment to controlling spending, maintaining operating surpluses and reducing debt will ensure the Government spends money where it is needed but leaves New Zealanders with more of their own money to spend, invest and save in a way that best meets their own priorities.

Annex 1

Three-year Fiscal Projections

This Annex contains the projections on which the Government's short-term intentions and long-term objectives are based. This Annex also details the changes in the short-term fiscal projections that have occurred since the 1997 *Fiscal Strategy Report* (FSR), discusses the latest economic developments and outlines the sensitivity of the fiscal position to changes in economic growth.

Assumptions Underlying Projections

The BPS is based on the 1997 DEFU economic forecasts. It is not an economic and fiscal update. A revised set of economic and fiscal forecasts will be published with the 1998 Budget. The forecasts contained in the 1997 DEFU assumed no further policy decisions beyond the Coalition Agreement's $5 billion three-year spending limit.

The projections contained in this BPS are those published in the 1997 DEFU, modified to include the aggregate impact of provision for 2000/01 initiatives. This consists of initiatives with an operating balance impact of $800 million and capital initiatives of $300 million.

Table 1 - Three-year Fiscal Projections ($ million)

	1998/99		1999/2000		2000/01	
Nominal $ million	**1997 FSR**	**1998 BPS**	**1997 FSR**	**1998 BPS**	**1997 FSR**	**1998 BPS**
Net worth	9,486	10,899	12,054	13,090	-	15,825
Net debt	24,319	24,258	22,685	23,358	-	21,906
Gross debt	33,839	35,281	32,530	34,479	-	32,978
Revenues	36,732	37,067	38,553	38,547	-	39,952
Expenses[2]	35,419	36,013	36,689	37,266	-	38,232
Operating balance	1,927	1,833	2,568	2,191	-	2,735

2 The projections contained in this BPS assume that the provision for initiatives with an impact in 2000/01 will impact entirely on expenses.

Table 2 - Three-year Fiscal Projections (% of GDP)

	1998/99		1999/2000		2000/01	
% GDP	**1997 FSR**	**1998 BPS**	**1997 FSR**	**1998 BPS**	**1997 FSR**	**1998 BPS**
Net worth	9.0	10.3	10.9	11.8	-	13.7
Net debt	23.2	23.0	20.5	21.1	-	18.9
Gross debt	32.3	33.4	29.4	31.1	-	28.5
Revenues	35.0	35.1	34.8	34.8	-	34.5
Expenses	33.8	34.1	33.2	33.6	-	33.1
Operating balance	1.8	1.7	2.3	2.0	-	2.4

The following table shows changes in the short-term projections that have occurred since the 1997 FSR.

Table 3 - Changes in Fiscal Projections Since 1997 FSR ($ million)

Changes $ million	**1998/99**	**1999/2000**
Net worth	1,413	1,036
Net debt	(61)	673
Gross debt	1,442	1,949
Revenues	335	(6)
Expenses	594	577
Operating balance	(94)	(377)

The fiscal projections for 1998/99 and 1999/2000 are broadly consistent with those released in the 1997 FSR. The changes in fiscal variables since the 1997 FSR largely reflect additional forecasting information and movements in macroeconomic variables not directly under the Government's control.

Provision for 2000/01 Policy Initiatives

The $5 billion limit on new policy initiatives constrains Budget decision making over the three years of Coalition Government to 1999/2000. Fiscal projections contained in the 1997 DEFU contained no provision for further policy initiatives beyond the Government's three year $5 billion package. To increase the transparency of fiscal forecasts for 2000/01, provisions for further policy initiatives with an operating balance impact of $800 million and capital initiatives of $300 million have been included.

The operating provision is based on average policy initiative expenditure growth over the period 1994/95 to 1999/2000. The provision for capital initiatives of $300 million is the same as the provision used in the 1996 DEFU and Coalition Agreement fiscal parameters. This was based on likely additional capital spending requirements such as extra spending on school properties.

Both provisions are forecasting assumptions rather than a precise spending commitment for 2000/01. The provisions are indicative and will be revised according to Government decisions and the economic and fiscal conditions as the year 2000 approaches. The provision for further policy initiatives with an operating balance impact includes initiatives with an impact on revenue or expenses.

Economic Projections

The BPS is based on economic projections contained in the 1997 DEFU. Since the forecasts were finalised on 7 November new information has come to hand, including GDP and balance of payments data for the September quarter, business confidence indicators and CPI data for the December quarter, and more recent interest and exchange rates.

Growth in the September quarter was slightly weaker than forecast, but upward revisions to historical GDP mean that the economy is growing at an annual 2.5% — faster than the DEFU forecast of 2.3%. The current account deficit for the year ended September was $6.2 billion (6.4% of GDP), with an increasing invisibles deficit being partially offset by an improving trade surplus.

Consumer price information for the December quarter showed annual inflation (ex-credit services) at 1.6% — broadly in line with expectations. Growth in the housing component picked up and (apart from used cars) there was little evidence of the lower exchange rate putting upward pressure on prices.

Indicators suggest that momentum in the economy has continued since the September quarter. Retail trade in the three months to November, excluding the cyclical auto component, grew by an annual rate of 3.3%. However, the housing market is beginning to show signs of slowing, reflecting higher short-term interest rates since the middle of last year.

Compared with the 1997 DEFU interest rates are currently slightly higher than expected, while the exchange rate is considerably lower than assumed. The lower exchange rate, in part, reflects a deteriorating outlook for Asia which has resulted in the New Zealand dollar falling to its lowest rate against the US dollar in almost four years. Uncertainty over Asia has also dented business confidence with the NZIER's Quarterly Survey of Business Opinion recording a net 20% of respondents in December expecting the general business situation to deteriorate in the first half of 1998. However, respondents still expected their own output to expand in the months ahead.

The fall in business confidence has raised the risk of slower growth over coming quarters similar to the "weaker recovery" scenario outlined in the DEFU year (as outlined on page 8). In that scenario the Asian crisis undermines GDP growth by around a half a percentage point in 1998/99 and increases growth by a similar amount in the following year. This would pare back growth to 3.5% in 1998/99 from 4.0% previously forecast and increase growth in 1999/2000 to 3.8%, similar to the growth profile projected in the latest Reserve Bank forecasts.

However, growth in 1998/99 will depend on the extent to which uncertainty over Asia persists and momentum in the economy is undermined by high short-term interest rates in the coming months. There have also been developments since the DEFU which may enhance growth prospects. These include ongoing momentum recorded by two of our main trading partners, Australia and the US, the recent approval by AMP policyholders to demutualise (which is expected to add around 0.4% to consumption growth in 1998/99) and changes to New Zealand's immigration policy that include a medium-term net inward migration target of 10,000 per annum.

The upcoming 1998 Budget Update will incorporate a full assessment of all available economic information on the outlook for economic growth.

Annex 2

Consistency of the Long-term Objectives and Short-term Intentions with the 1997 BPS and 1997 FSR

The Fiscal Responsibility Act 1994 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 that FSR.

Long-term objectives

The long-term objectives are the same as the long-term objectives specified in both the 1997 BPS and 1997 FSR.

Short-term intentions

The Government's net worth, Crown debt, operating expenses and operating balance intentions are broadly the same as those in the 1997 FSR but have been updated to reflect the latest fiscal projections.

The Government's short-term operating revenue intention has been changed to reflect the rejection of the proposed Retirement Savings Scheme.

The following table compares the 1997 BPS short-term intentions with the short-term intentions in the 1997 FSR.

	1997 FSR **Short-term Intention**	**1998 BPS** **Short-term Intention**
Operating Expenses	Maintaining firm control over expenses and a steady decline in the ratio of expenses to GDP. Consistent with the Coalition Agreement, additional spending and abolition of the surcharge will be up to $5 billion over 1997/98 to 1999/2000. The spread of the $5 billion is up to $0.95 billion in 1997/98, up to $1.7 billion in 1998/99 and up to $2.35 billion in 1999/2000.	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.

	1997 FSR Short-term Intention	1998 BPS Short-term Intention
Operating Revenues	Delay the tax reductions scheduled for 1 July 1997 to 1 July 1998. If economic and fiscal conditions permit and if the referendum supports a compulsory superannuation scheme, introduce further tax reductions on 1 July 1999, 2000, 2001 and 2002 equivalent to 2%, 1%, 1% and 1% of the base for contributions to the compulsory superannuation scheme. If the referendum does not support a compulsory superannuation scheme, and if economic and fiscal conditions permit, consider further tax reductions in 1999/2000 and future years.	Implementing tax reductions as at 1 July 1998. Introduce further tax reductions if economic and fiscal conditions permit.
Operating Balance	Run surpluses consistent with the operating expense and revenue intentions. On current forecasts and the Coalition Agreement fiscal parameters, this means operating balances of $1.5 billion in 1997/98, $1.9 billion in 1998/99 and $2.6 billion in 1999/2000.	Run surpluses consistent with the operating expense and revenue intentions. On current forecasts, the Coalition Agreement fiscal parameters and the inclusion of 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.
Crown Debt	Steadily reduce gross and net Crown debt. Subject to expected economic conditions prevailing, gross Crown debt and net Crown debt will be $34.3 billion and $25.2 billion in 1997/98, $33.8 billion and $24.3 billion in 1998/99 and $32.5 billion and $22.7 billion in 1999/2000.	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.
Crown Net Worth	Steadily increasing positive levels of net worth to $7.6 billion in 1997/98, $9.5 billion in 1998/99, $12.1 billion by 1999/2000, subject to expected economic conditions prevailing.	Steadily increasing positive levels of net worth to $9.1 billion in 1997/98, $10.9 billion in 1998/99, $13.1 billion by 1999/2000, and $15.8 billion by 2000/01 subject to expected economic conditions prevailing.