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Budget
Policy Statement
1999

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Treasurer
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Contents

Summary

The purpose of the Government's economic and fiscal policies is to create an environment that generates income and employment, and promotes trade and social opportunities in which all New Zealanders can participate. Over the past eight years we have made substantial progress towards this goal, and this has greatly assisted New Zealand in managing its way through the current international economic turmoil.

Progress towards our goal is continuing. The Government has a comprehensive strategy for economic growth. It continues to implement policies aimed at providing macro-economic stability, progressing microeconomic reform, and investing in the areas, such as education, that will add to New Zealand's prosperity in the future.

The downturn that started in Asia 12 months ago has now spread to other parts of the world. The New Zealand economy has felt the impact from that and from the very severe drought which affected the agricultural sector and most of those who depend on it.

Measures undertaken in the past have enhanced New Zealand's economic framework and its ability to adjust to such adverse events. Micro-economic reform has made possible rapid adjustment to changed circumstances. Net Crown debt has been reduced dramatically. New Zealand's monetary policy framework allows interest and exchange rates to change in response to economic conditions.

The Government continues to improve the efficiency and quality of spending across all areas of government activity to ensure that expenditure takes place only in areas that improve the overall wellbeing of New Zealanders. It has complemented this with on-going microeconomic reform intended to enhance economic growth prospects.

During 1998, the Government has taken action to bolster the medium-term fiscal position, thus enhancing credibility and confidence. As a result of past actions, and this continued focus on prudent fiscal policy, the country is in a good position to weather the international economic situation.

Under these conditions, the Government regards it as appropriate to tolerate fiscal deficits in the short term, in order to avoid putting short-term economic prospects at risk. Simultaneously, it is also setting in place further measures to improve the medium-term fiscal position. Forecasts indicate that these measures will generate surpluses in the medium term.

Clearly, the global situation includes risks that events may not unfold as forecast. In that case, the measures defined in this statement are of great assistance.

Overall Strategy and 1999 Budget Priorities

The document, *The New Zealand Government's Goals and Priorities, 1999-2002*, articulates the Government's strategic priorities and the goals which underlie them. These goals provide a clear set of directions and values to assist the Government in determining future priorities. Consistent with that document, this *Budget Policy Statement* specifies the broad strategic priorities for the 1999 Budget, and the policies and strategies for achieving the economy we want.

Seven overarching goals

In its document, *The New Zealand Government's Goals and Priorities, 1999-2002*, the Government has established seven overarching goals expressed as follows:

1. We want a **strongly growing, internationally competitive enterprise economy**; an economy which generates trade, employment, income and social opportunities in which all New Zealanders can participate. To achieve this we must run sound fiscal and economic policies, we must have open, competitive markets, we must foster a passion for enterprise, hard work, skill and creativity.
2. We value **innovation** and our ability to build on **new ideas and technologies**. Our future prosperity depends on our ability to adapt, and we must be prepared to create and take advantage of new opportunities. As Government, we are committed to lifting educational standards and achievement. We want to encourage New Zealanders to gain and use the skills and knowledge needed to enable us to participate in the global knowledge economy.
3. We place a high value on the pivotal role and **contribution that individuals, families, communities and the private sector** make to building an economically strong and socially cohesive New Zealand. We will seek to enhance and increase that contribution across all areas of activity. As Government, we will continue to ensure for all New Zealanders a strong foundation of safety and security from threats of harm.
4. We want to focus our **social assistance in welfare and housing on those most in need**; making a difference by breaking cycles of disadvantage. We want to reduce the number of New Zealanders who need to rely on welfare. We will support individuals and families taking responsibility for their wellbeing; and our assistance will be focused so that we are not using high taxes to support high-income New Zealanders.
5. We treasure our clean, healthy and **unique environment** and will ensure it continues to sustain nature and people's needs and aspirations. The life-supporting capacity of soil, air, water and ecosystems will continue to be safeguarded and the biological diversity and spectacular scenery that make New Zealand a special place will continue to be able to be enjoyed by future generations.

6. Recognising the importance of the **Treaty of Waitangi**, we will ensure that through the Government's policies and actions we continue in good faith to build relationships between the Crown and Mäori. In order to achieve this, we are committed to continuing the significant progress already made in negotiating and implementing fair, durable and affordable settlements of historical grievances; and improving the social and economic status of Maori.

7. We are proud of our **New Zealand identity** and will celebrate, foster and protect our cultural, historical and environmental heritage. By focusing on achievement and building on the enterprise, creativity and skill of our people, and through constructive international engagement, we are well positioned to place New Zealand at the leading edge.

These seven goals are interdependent and mutually reinforcing. For example, by providing jobs, a strongly growing economy enhances opportunities and supports the efforts of individuals and families to take responsibility for their own wellbeing.

Eight strategic priorities

The Government has identified eight strategic priorities it must focus on to achieve its goals (see *The New Zealand Government's Goals and Priorities, 1999-2002*). These strategic priorities highlight areas where additional effort is required to further improve the economic and social fabric of the nation. They define the Government's key priorities for new action in the short and medium term, which are to:

- encourage savings and investment within a stable and neutral investment environment
- strengthen our external links by liberalising trade, investment and immigration
- encourage the contestable supply of resources and services in areas of public sector responsibilities
- improve the quality of our regulatory environment
- expand our knowledge base and technological capability
- lift educational standards and achievement
- extend economic and social opportunities
- safeguard indigenous biodiversity by protecting habitats and controlling introduced pests.

Each of these strategic priorities serves more than one of the Government's overarching goals, but for convenience they are grouped in the more detailed discussion below under the heading of the goals towards which they most directly contribute.

Policies

At working level, the goals and strategic priorities will be delivered by detailed policies and implementation plans. These are at different stages of development.

In some cases the Government is in the early stages of developing its thinking (for example, in water and wastewater services). In others, such as roading reform, the Government has outlined its thinking and is already consulting key groups. In an MMP environment, consultation and discussion are critical to the process of building political support and winning the wider public confidence required before proceeding.

In areas where policy development is more advanced and support has been achieved, implementation is in progress (for example, electricity reform and ACC). In yet others, change has taken place or been legislated for (for example, tariff reductions).

The Government is confident that, by developing policies consistent with its goals and strategic priorities and by building support for them through comprehensive consultation, it can continue to deliver public policy of benefit to all New Zealanders.

Fostering a Strong, Innovative Economy

Goals One and Two seek a strongly growing economy that has the ability to adapt and build on new ideas. They are supported by the first six of the strategic priorities listed on page 7.

Encouraging savings and investment

Increased savings, invested wisely, will allow New Zealanders to gain a larger share of New Zealand's economic growth, as well as the growth of other countries.

The Government is committed to maintaining a broad-based, low-rate tax system, which minimises the negative impact of taxes on people's saving and investment decisions.

The Government decided in September to continue to increase New Zealand Superannuation (NZS) in line with the Consumer Price Index (CPI). This will help to:

- encourage private saving for retirement income
- put the scheme on a sustainable path, given future demographic pressures.

This decision is sensible in light of the current economic situation, but is not in itself a long-term solution to all the problems associated with population ageing. To find a sustainable and affordable solution, a Superannuation 2000 Task Force will be established. This Task Force will have an independent chair, and non-partisan members of the community will work alongside representatives from political parties.

Strengthening external links

Openness to trade fosters competition. This spurs innovation, quality improvements and tighter cost control. Foreign investment contributes to growth and creates jobs.

On Budget night 1998, the Government removed all motor vehicle tariffs and all restrictions on the parallel importing of goods protected by copyright. The Government has legislated to phase out remaining tariffs by 2006, well within APEC's 2010 deadline.

The Government is engaging with producer boards on an examination of how the boards position themselves to:

- generate the best returns for New Zealand producers
- create the opportunity for more rapid growth of primary industries
- meet the challenges of changing arrangements in international trade.

Given the significance of the primary sector for exports and overall economic performance, the Government attaches a high priority to progressing these issues.

Other policies to encourage international links include the development of initiatives to raise New Zealand's profile as a producer of goods and services, and as a destination for immigration, tourism and investment.

As host for APEC in 1999, New Zealand acquires considerable opportunity to influence economic and trade arrangements in the Pacific Rim and internationally. APEC economies account for 70% of New Zealand's trade. The economies belonging to APEC account for 57% of the global economy, including the world's two largest economies - the United States and Japan - and the rapidly growing market of China.

APEC 1999 will also provide New Zealand with a unique opportunity to showcase itself on the world stage to influential visitors and the international media.

Continuing regulatory reform in both the public and private sectors

The Government aims to encourage innovation and efficiency in both the public and private sectors. It is developing new principles to open up opportunities for private sector supply in areas of public sector responsibility where this is in the interest of New Zealanders.

The Government is promoting legislation to introduce competition into the delivery of accident compensation. These changes will lead to a more efficient scheme and will create greater choice and quality of service.

Changes legislated by the Government this year are already introducing more competition and efficiency into electricity generation and distribution. Significant price reductions are now being offered to many electricity users.

The Government is also reviewing:

- the administration of New Zealand's roads, to ensure more efficient management and better pricing
- the rating powers of local authorities
- the provision of water and wastewater services
- legislation regulating occupations, such as conveyancing, to ensure quality services at a reasonable price.

Expanding the knowledge base and lifting educational standards

The Government regards increasing the knowledge base and lifting educational standards as critically important strategic priorities for New Zealand's future.

The recent Policies for Progress programme committed funding to ensure that by 2005, all New Zealand children turning nine will be able to read and do maths. In the tertiary area, the Government has also announced the removal of the funding cap and, from 2000, an alignment in tertiary subsidies for students studying similar courses across public and private providers. There will also be new measures to strengthen accountability and promote efficiency and innovation in tertiary education delivery.

In the coming year, the Government will also work to implement National Assessment to provide better information on learning outcomes at primary school level.

Continuing sound macro- and microeconomic policies

Continuing sound fiscal and economic policies are fundamental to good government. They allow the economy to maximise its potential and deliver higher living standards.

The Government is committed to credible and consistent monetary and fiscal policies that promote stable prices and tax rates. These policies help to reduce variability in interest and exchange rates, and provide a stable environment, allowing individuals and firms to make work, saving and investment plans with greater certainty.

By directing resources to their best use, microeconomic reforms allow individuals and firms to take full advantage of a stable macroeconomic environment. For example, asset sales to the private sector in combination with a stable economic environment can stimulate innovation and growth, while allowing the Crown to better manage the risks it faces.

The Government has recently divested its ownership interests in Auckland and Wellington International Airports, and Capital Properties New Zealand Limited. It is proceeding with the sale of Contact Energy.

Valuing Social Cohesion and Social Assistance

Goals Three and Four aim at building an economically strong and socially cohesive New Zealand where those who can contribute do, and those who need assistance get it. The Government has identified, as the seventh priority in the strategic priorities listed on page 7, the importance of extending economic and social opportunities by:

- strengthening families, especially through intervening and targeting services to break cycles of disadvantage
- significantly improving the health, employment, education and housing status of Maori
- preventing youth offending and re-offending
- expecting and encouraging active participation in work.

Government departments and agencies involved in the Strengthening Families initiative are cooperating to improve the life outcomes of children in families at risk. Cooperation reduces duplication and the risk of losing people in the gaps between services.

The Government is providing additional employment assistance to the long-term unemployed, and has increased its work expectations of sole parents, widows and spouses of beneficiaries. The Government is developing a process for better determining how many hours sick and disabled beneficiaries can realistically work. It has combined services for job seekers and beneficiaries into the Department of Work and Income.

Research in a number of countries, including New Zealand, indicates that a long-term improvement in crime statistics and community wellbeing requires early intervention, preferably before a young person begins criminal activity, and certainly before such activity becomes ingrained and serious. Initiatives being planned for the 1999 Budget aim at reducing youth offending and re-offending, and protecting victims.

Protecting our Heritage

The final three goals focus on protecting our environment and cultural heritage, and recognising the importance of the Treaty of Waitangi. Safeguarding indigenous biodiversity, protecting habitats and controlling introduced pests are identified in the eighth of the strategic priorities listed on page 7.

The Government is committed to safeguarding New Zealand's clean, healthy and unique environment. We will work to ensure that the life-supporting capacity and diversity of New Zealand's natural resources, and the spectacular variety of its scenery, are retained for the enjoyment of future generations. The Government is reviewing the operation of the Resource Management Act 1991 so as to strike a better balance between environmental protection and growth opportunities, while reducing compliance costs. A discussion document has been prepared.

We celebrate the significant progress that has already been made on negotiating and implementing fair Treaty of Waitangi settlements, and intend to continue this process. We will continue to focus on building successful relationships between the Crown and Mäori. At the same time, we are aware of the discrepancies in the social and economic status of the two Treaty partners, and are committed to narrowing the gap.

As New Zealanders, we come from a cultural heritage of creativity, innovation and skill. We are proud of who we are, and of our cultural, historical and environmental heritage.

1999 Budget Priorities

Priority for additional spending in the 1999 Budget will be given to initiatives that help the Government to meet the strategic priorities outlined above. The total amount committed to additional policy initiatives over the three years from 1997/98 to 1999/2000 is now $4.25 billion (see page 16 for details).

Decisions already taken relating to the 1997 and 1998 Budgets account for approximately $3.35 billion of this amount. In addition, a further $300 million has been provided for spending on additional policy initiatives in the 1998/99 year. Some of the decisions on this will be included in the 1999 Budget.

In the 1999 Budget, $600 million remains available for additional policy initiatives in the 1999/2000 year. Of this, the 1999 Health package will account for approximately $200 million.

The 1999 Budget will be prudent and responsible, bearing in mind the uncertainties surrounding future global economic conditions and their possible economic and fiscal impacts on this country. It will reflect the Government's wish simultaneously to maintain its priority spending and to effectively manage the medium-term fiscal pressures.

Fiscal Strategy

Prudent and credible fiscal management is central to any strategy for the provision of a stable economic environment conducive to sound investment, saving and work decisions. The Government's fiscal goals reflect this priority.

Economic Conditions have Deteriorated

When the May 1998 Budget was written, the trade-weighted growth of New Zealand's top 10 trading partners was being forecast at 2.4% for 1998 and 2.7% for 1999. In the seven months since then, those figures, as shown in the *December Economic and Fiscal Update*, have declined to 1.2% and 0.8%. This decline is a key driver of the changes to the three-year fiscal forecasts detailed in Annex 1 of this statement.

Table 1 - Key Elements of the Fiscal Forecasts

(June years, Central Outlook)	**1998/99 Forecast**	**1999/2000 Projection**	**2000/01 Projection**	**2001/02 Projection**
Budget Economic and Fiscal Update	1.3	2.0	3.0	-
December Economic and Fiscal Update	(0.1)	(1.3)	(1.0)	0.1
Net debt (% of GDP)				
Budget Economic and Fiscal Update	23.7	21.5	19.2	-
December Economic and Fiscal Update	26.1	27.1	27.8	26.9

Source: The Treasury

The new fiscal forecasts signal operating deficits and a pause in the process of reducing net Crown debt. The Fiscal Responsibility Act 1994 provides for temporary departures from the principle that New Zealand governments must run an operating surplus every year until prudent debt levels are reached. But the Act requires the Government to specify the reasons for any such departure, the approach it intends taking to remedy the situation, and the time it expects that remedy to take (see Annex 2).

The present departure from fiscal surplus is driven by two critical fiscal changes since the 1998 Budget:

Recognition of the future cost of past ACC claims

Accident Rehabilitation Compensation Insurance Corporation's (ARCIC) recognition of the future cost of past ACC claims, and associated revenue recognition changes, lowers net Crown worth by around $7.4 billion. This does not alter net debt or in substance reflect any increase in Crown obligations, but it does lower the operating balance by around $500 million a year from 1999/2000.

Lower nominal economic growth

More importantly, lower real GDP growth in combination with lower levels of inflation will result in significantly lower growth in the nominal economy over the three years ahead (see Figure 1).

Nominal economic growth is a key driver of tax revenue. Lower growth therefore contributes to significantly lower tax forecasts for 1998/99, 1999/2000 and 2000/01.

While lower inflationary pressures reduce some government spending (for example, CPI-linked welfare benefits), most expenditure does not change directly in response to changes in inflationary pressures. The path of government expenditure is therefore largely unchanged (see Figure 2).

Overall, lower revenue rather than increased expenditure has been driving the changes in the operating balance since the 1998 Budget.

Figure 1 - Changes in Forecast Nominal GDP since the *Budget Economic and Fiscal Update*

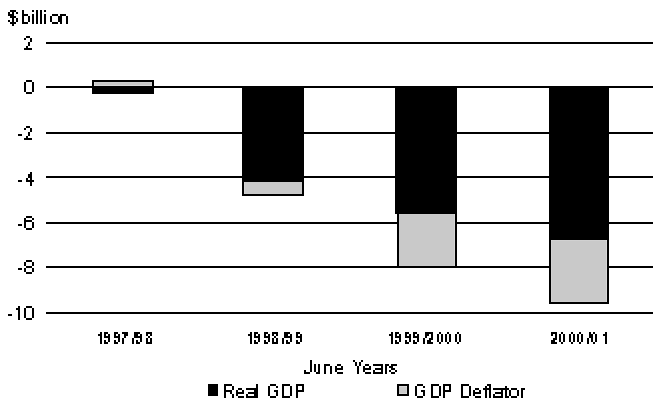
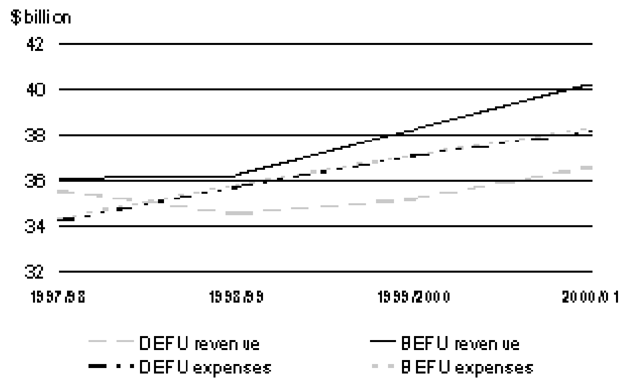


Figure 2 - Total Revenue and Expenses



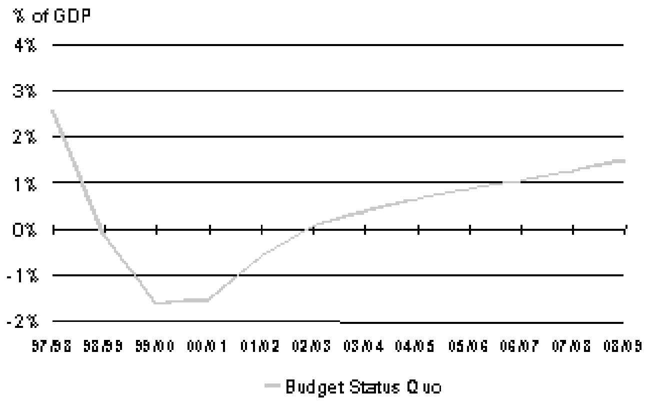
Source: The Treasury

Although the downward forecast of real GDP growth reflects cyclical factors, and is therefore expected to reverse over time, the price level is expected to remain permanently lower. As a result, the lower nominal economic growth will have a lasting impact on tax revenues. This will in turn adversely affect the fiscal position over the medium term.

A Deteriorating Medium-term Fiscal Outlook

Figures 3 and 4 show the increased fiscal pressure which the Government would have to face in the future, if it had failed to respond to changes in the economic outlook since the Budget. (An explanation of how these projections are derived is provided in Annex 3.)

Figure 3 -Budget Status Quo: Operating Balance

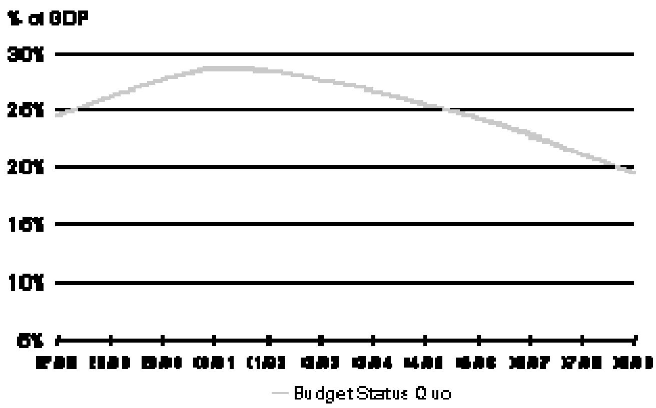


Source: The Treasury

Treasury projections indicate that the Government would face four years of fiscal deficits (1998/99 to 2001/02 inclusive). Its net debt objective would not be reached within the next ten years. Moreover, the ratio of expenses to GDP would still be around 33% in 2008/09, as demographic pressures build. It is therefore unlikely that the expense-to-GDP objective of below 30% would be reached.

Within this Status Quo scenario, the fiscal position might eventually move into surplus, but would build up relatively slowly, and provide only a limited "buffer" against further adverse events.

Figure 4 - Budget Status Quo: Net Debt



Source: The Treasury

There would be a real risk of a return to operating deficits in the event of a further cyclical downturn. In addition, the fiscal settings in the Status Quo scenario are less robust to a lower-than-expected trend rate of economic growth in the medium term.

It would therefore have been irresponsible to ignore the deterioration in economic conditions as it became apparent after the 1998 Budget. Important decisions had to be taken. The Government will continue to take appropriate action in response to evolving conditions.

Policy Response since May 1998

In 1996, the Coalition Government committed $5 billion to additional policy initiatives for the years 1997/98 to 1999/2000, based on a careful assessment of the risks facing the fiscal position as perceived at that time. However, subsequent economic events have made this quantity of extra spending unsustainable. Some concern also exists that the rate of growth of government spending may have led to some lower-quality spending being undertaken.

The Government has therefore taken steps progressively to improve the medium-term fiscal position by reducing the growth rate and improving the quality of its spending.

The Coalition Government announced the first step in this process in the 1998 Budget. It decided to reduce its planned spending on additional policy initiatives by $300 million for the years 1997/98 to 1999/2000. This moderation in the growth of spending on additional policy initiatives signalled that the Government was aware of the emerging risks to the economic and fiscal outlook, and was prepared to take action to bolster the fiscal position against adverse events.

Since the Budget, the Government has closely monitored the evolving domestic and international economic situation and its likely impact on New Zealand's fiscal position. The worsening international outlook required further action to bolster New Zealand's fiscal position. In July the Coalition Government announced a further $300 million reduction in its spending intentions.

In addition to these initial steps, a further move to bolster the medium-term fiscal position was required. In September, the National minority Government launched its Policies for Progress programme, which will save a further $25 million in 1998/99 and $125 million in 1999/2000, and substantially more in the medium term. The programme includes a decision to continue to increase NZS in line with the CPI (see box). Policies for Progress will enhance economic growth and improve the medium-term and long-term fiscal outlook.

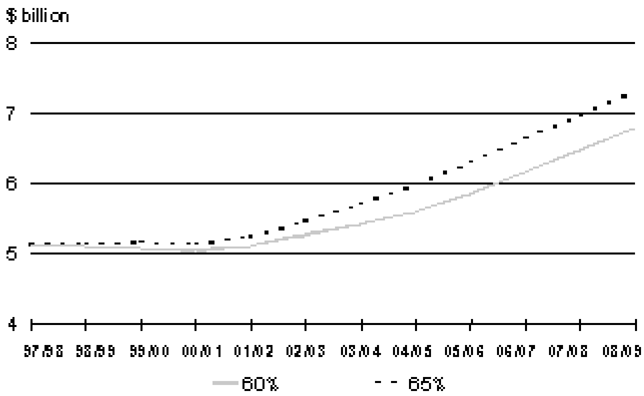
The spending changes announced in the 1998 Budget and in the period since have been achieved by instituting sound policy initiatives, desirable even without a pressing need to restrain medium-term expenditure growth. They included fully funding the ACC Motor Vehicle Account and targeting assistance to those in need (for example, retaining income and asset testing of long-stay public and private hospital geriatric care).

New Zealand Superannuation

The Government has regarded it as important to ensure that publicly funded retirement incomes retain their present purchasing power. NZS will therefore continue to be adjusted, as it has been since 1993, in line with changes in the CPI. At the same time, it is equally important to make NZS fiscally sustainable in the future.

Under previous policies put in place in 1993, the married couple rate of NZS was to remain within 65% to 72.5% of the net average wage. That rate was adjusted in line with inflation, provided it stayed within that range. If the rate dropped to less than 65%, it was to be linked with wage growth to bring it up to 65%. Until recently, NZS has been more than 65% so it has been adjusted only in line with inflation, not in line with wages. Over time, wages tend to grow faster than prices, so linking NZS to wages would mean that NZS would increase faster than the cost of living. A change to indexation to wages under current economic conditions, and given rapidly rising demographic pressures in the future, would be irresponsible and unsustainable.

NZS Spending



Source: The Treasury

Therefore, NZS will in future continue to be adjusted in line with the CPI unless it drops below 60% of net average wages. The Australian equivalent is set at around 58% of net average wages and is subject to an income and assets test.

NZS remains among the most generous universal pension schemes in the world. On the basis of the projections in this *Budget Policy Statement*, adjusting superannuation in line with the CPI will save an estimated $2.1 billion over 10 years.

Taking Further Appropriate Action

Determining the extent and nature of any necessary further action has been central to the decision-making processes embodied in this *Budget Policy Statement*. Until now, no agreed commitment or limit has been established for government spending beyond 1999/2000. To date, fiscal forecasts for 2000/01 have provided $800 million for additional policy initiatives. That figure was a technical assumption based on average projected additional spending over the period 1994/95 to 1999/2000.

In deciding an appropriate level of commitment and limit for additional policy spending, a variety of conflicting factors have to be balanced. On the one hand, the fiscal deficits now being projected arise, to a degree, from the operation of automatic stabilisers (see box). Sound arguments exist for permitting the automatic stabilisers to do their job. At the same time, as the 1998 *Budget Policy Statement* and *Fiscal Strategy Report* signalled, there are limits to the wisdom of that approach.

Automatic Fiscal Stabilisers

When spending plans and tax rates are maintained without change in an economy experiencing a downturn, then lower tax revenues and higher spending on unemployment result in a deteriorating fiscal balance. On the other hand, such a policy response can play an important role in reducing the impact of the downturn on individuals, families and businesses in the economy.

If an economy is, by contrast, on the upswing of the economic cycle, then maintaining tax rates and spending plans results in rising tax revenue and lower unemployment benefits. That process leads to an operating surplus that supports monetary policy by leaning against inflationary pressures, and thus helps to sustain and extend the economic recovery.

Allowing the automatic stabilisers to operate is consistent with the medium-term focus of the Fiscal Responsibility Act 1994.

It would not be responsible for the Government to fully counteract the automatic stabilisers by implementing further policies designed to correct the short-term fiscal imbalance. Doing so would risk exacerbating the weaker economic situation. The Government's previous actions to reduce public debt mean that short-term action is not required to maintain credibility.

New Zealand has, for example, run a persistent current account deficit that is forecast to remain at around 5% to 7% of GDP. With persistent and large current account deficits, and already high external liabilities, there is a risk that overseas investors may withdraw their funds. This could lead to a rapid and significant fall in the exchange rate, a sharp rise in interest rates, and weaker short-term economic prospects. A more robust fiscal position helps guard against such an outcome by helping to maintain investor confidence.

It is also important to continue making progress towards the Government's long-term debt and expense objectives. Building on a track record of sustained progress towards announced fiscal goals would further enhance fiscal credibility. The 1998 Budget defined the Government's long-term objective for net Crown debt as below 15% of GDP. Lower public debt contributes to lower real interest rates throughout the economy. It strengthens the Government's ability to manage adverse economic conditions. Lower net debt also allows more time for the Government to distinguish between temporary and permanent economic shocks, and to plan for and make necessary adjustments. Reducing expenses as a share of GDP over the medium term will help secure lower taxes than would otherwise be required, as future demographic pressures begin to build.

Tax revenues are likely to grow in line with nominal GDP. So, government spending needs to grow more slowly than nominal GDP in order to rebuild operating surpluses, and strengthen the medium-term fiscal position.

Balancing all these considerations, the Government has, therefore, decided now to commit to up to $600 million of spending on additional policy initiatives in 2000/01, and a further $600 million in 2001/02[1]. This amount is similar to spending on additional policy initiatives in the 1999 Budget for 1999/2000. The $600 million is cumulative, so the amount committed each year will be continued in future years and government spending from this source grows by $600 million a year.

Spending on additional policy initiatives of up to $600 million in each of 2000/01 and 2001/02 recognises the impact of the global situation on the fiscal outlook in the medium term. It represents a shift towards a more restrained spending increase as compared with the period of the Coalition Government. It aims to strike a much-improved balance, better suited to the current outlook, between fiscal prudence and necessary spending priorities.

The Government will continue its rigorous examination of new and existing expenditure to ensure that money is spent only where it is justified. This will enable us to meet important spending priorities while keeping within $600 million for additional policy expenditure beyond 2001/02.

This approach both ensures a more robust medium-term fiscal position, and allows the automatic stabilisers to operate, minimising short-term economic impacts.

1. The $600 million is to provide for specific decisions on policy initiatives. It is in addition to increases due to indexation to inflation (for example, CPI indexation of benefits) and demographic changes (for example, population adjustments to health and education funding).

Figures 5 and 6 illustrate the Central scenario, which shows the effect of the Government's decisions over a longer timeframe. It incorporates the outcome of all existing policies, including those initiated since the 1998 Budget, plus a continuation of the new spending commitment into the medium term. (The Central scenario is detailed in Annex 3.)

This scenario shows the benefits of the Government's commitment to rigorous examination in the medium term of all new and existing expenditure to keep the focus on its quality.

By the end of the 10 years the operating balance rises above 3% of GDP, compared with 1.5% under the Budget Status Quo scenario.

Net debt reaches the Government target of below 15% of GDP around 2007/08. Under the Budget Status Quo scenario, 15% is not achieved within the 10-year projection horizon. Much more substantial progress is also made during those 10 years toward the Government's long-term objective of 30% for the ratio of expenses to GDP.

Figure 5 - Central Scenario: Operating Balance

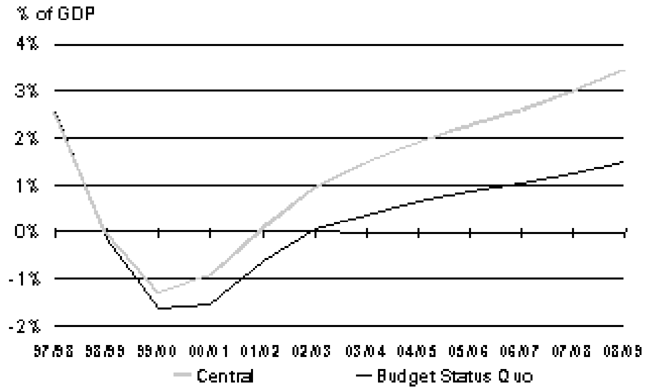
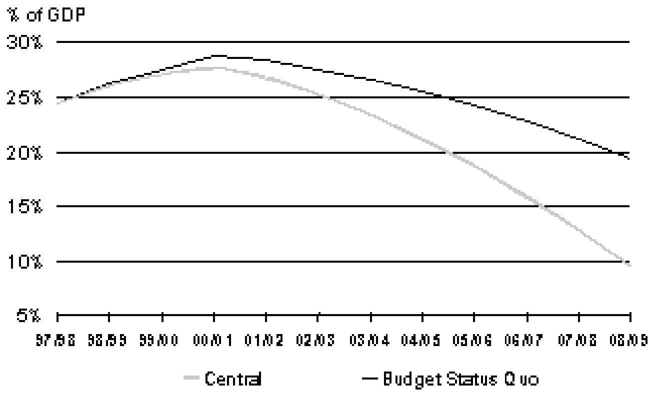


Figure 6 - Central Scenario: Net Debt



Source: The Treasury

The Central scenario indicates that under assumed economic conditions (that is, 3% trend economic growth), restrained expenditure growth in the medium term provides:

- increased insurance against further economic shocks
- increased ability to reduce debt and taxes and to increase priority expenditure should conditions turn out better than expected.

Future Responses

The Central scenario illustrates substantial progress towards the Government's long-term fiscal objectives on the basis of current expectations of economic performance in the short and medium term.

However, economic events may not unfold as planned. The *December Economic and Fiscal Update*, responding to the current global uncertainties, indicates a wide range of possible fiscal outcomes.

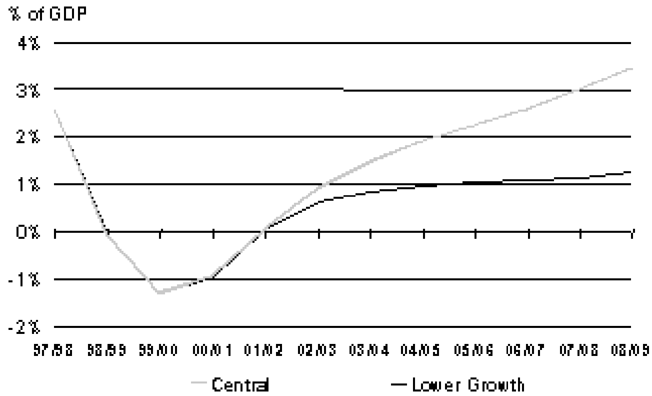
In general, the Government does not plan to change tax and spending in response to cyclical economic variations, but to let the automatic stabilisers operate.

However, the Government will continue to assess the medium-term fiscal outlook and respond to permanent changes in the fiscal position. If future economic growth is stronger than currently expected, a sustained improvement in the fiscal position would result, giving the Government the flexibility to consider further tax cuts as well as high-priority spending and further debt reduction.

Alternatively, the medium-term position could prove weaker than currently expected because of a very prolonged international recession or lower trend growth.

Figures 7 and 8 give the Lower Growth scenario, showing the effect of assuming 2% economic growth on average over the medium term, compared with the 3% of the other two scenarios. (The Lower Growth scenario is detailed in Annex 3). In this event, operating surpluses are likely to be maintained in the medium term and progress is likely to continue toward the Government's net debt objective. Less progress is made towards the 30% expense-to-GDP objective.

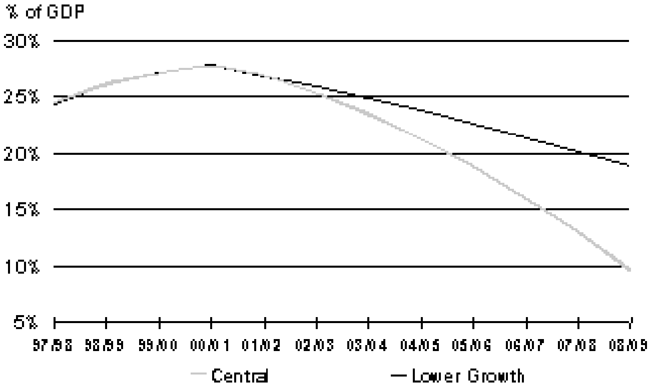
Figure 7 - Lower Growth: Operating Balance



Source: The Treasury

If such an outcome eventuated, the Government would need to consider whether further policy action would be required to achieve its medium-term fiscal objectives over a reasonable period. In that case, the Government's actions to date will significantly improve its ability to adopt a measured medium-term approach to identifying and addressing relevant areas of potential savings.

Figure 8 - Lower Growth: Net Debt



Source: The Treasury

Table 2 summarises the projected fiscal position in 2008/09 under the three scenarios.

Table 2 *- Projected Fiscal Position in 2008/09 (% of GDP)*

	Operating Balance	**Net Debt**	**Expenses**
Budget Status Quo	1.5	19.4	33.3
Central	3.5	9.6	31.1
Lower Growth	1.3	18.9	33.4

Source: The Treasury

Conclusion

The actions taken by the Government in the past eight years, and enhanced in this statement, permit the economy to survive the deterioration in world economic conditions without major damage.

The Government's economic policies, budget priorities and fiscal strategy are clearly specified in *The New Zealand Government's Goals and Priorities, 1999-2002* and this statement. They are a prudent response to current conditions. They demonstrate that our commitment to a strongly growing, enterprise economy remains firm despite the international downturn.

The Government intends, in the next three years, to maintain priority spending while continuing to improve the efficiency and quality of its expenditure across all areas of government activity. Priority for additional spending will be given to initiatives that help the Government to meet its strategic priorities, which will benefit all New Zealanders.

The forecasts and scenarios indicate that the Government will not run operating surpluses in 1998/99, 1999/2000 and 2000/01, and progress towards the long-term objectives has stalled under the impact of the reductions in growth of our trading partners. But those operating deficits are also due in part to a cyclical downturn. Action since the 1998 Budget, and the further action described in this statement, will both mitigate the impact of that downturn and support economic recovery.

If the New Zealand economy recovers as forecast, the Government will return to surplus in 2001/02, and can over the medium-term continue the process of reducing its debt.

Clearly, the global situation includes risks that events may not unfold as forecast. In that case, the measures described in this statement are of great assistance. Fiscal credibility is critical in current economic conditions. New Zealand's fiscal credibility is enhanced by these ongoing actions to safeguard the Government's fiscal goals.

Rt Hon W F Birch
Treasurer and Minister of Finance
3 December 1998

Annex 1

Three-year Fiscal Projections

This Annex summarises the three-year fiscal projections contained in the 1998 *December Economic and Fiscal Update*.

Fiscal out-turns will be influenced by factors outside the Government's control. For example, it is not possible to forecast the realisation of contingent liabilities, significant valuation changes, changes in accounting policy, or unexpected economic shocks. If any of these events occurs, out-turns may differ significantly from these fiscal projections.

The *December Economic and Fiscal Update's* three-year fiscal projections and their underlying economic assumptions are set out in Tables 3, 4 and 5 below. The changes in fiscal variables since the Budget result largely from:

- movements in macro-economic variables (see Table 5) not under the Government's control
- policy decisions including changes to provisions for additional policy initiatives
- recognition of ARCIC outstanding claims obligations.

These changes lead to changes in fiscal outcomes, as Table 6 shows.

Table 3 - Three-year Fiscal Projections ($ million, June years)

Nominal	1999/2000		2000/01		2001/02	
	1998 FSR	**1999 BPS**	**1998 FSR**	**1999 BPS**	**1998 FSR**	**1999 BPS**
Net worth	13,741	1,155	16,725	162	-	236
Net debt	23,625	27,605	22,204	29,473	-	30,149
Gross debt	36,299	40,156	35,428	42,248	-	43,094
Revenues	38,229	35,200	40,206	36,620	-	38,754
Expenses	37,114	37,095	38,280	38,145	-	39,260
Operating balance	2,021	(1,320)	2,984	(993)	-	74

Source: The Treasury

Table 4 - Three-year Fiscal Projections (% GDP, June years)

	1999/2000		2000/01		2001/02	
	1998 FSR	**1999 BPS**	**1998 FSR**	**1999 BPS**	**1998 FSR**	**1999 BPS**
Net worth	12.5	1.1	14.5	0.2	-	0.2
Net debt	21.5	27.1	19.2	27.8	-	26.9
Gross debt	33.0	39.4	30.6	39.9	-	38.4
Revenues	34.8	34.6	34.8	34.5	-	34.5
Expenses	33.8	36.4	33.1	36.0	-	35.0
Operating balance	1.8	(1.3)	2.6	(0.9)	-	0.1

Source: The Treasury

Note: Exchange rate gains or losses on net foreign currency Crown debt are not projected. The 1998 *Fiscal Strategy Report* net debt projections are based on the nominal exchange rate (TWI) as at 31 March 1998; the 1999 *Budget Policy Statement* projections are based on the nominal exchange rate as at 31 October 1998.

Table 5 - Macro-economic Assumptions (June years)

	1999/2000		2000/01		2001/02	
	1998 FSR	**1999 BPS**	**1998 FSR**	**1999 BPS**	**1998 FSR**	**1999 BPS**
Real GDP (annual average % change)	3.7	1.7	3.5	2.7	-	4.2
Nominal GDP ($ million)	109,959	101,872	115,696	106,005	-	112,200
Consumer Price Index (annual average % change)	1.7	1.3	1.6	1.2	-	1.5
Interest rates on Government 10-year bonds (annual average %)	7.1	5.6	7.0	5.3	-	5.6
Household Labour Force Survey unemployment rate (annual average % level)	6.1	8.4	5.7	7.8	-	7.1

Source: The Treasury

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

The economic assumptions that underpin the fiscal projections in the 1998 *Fiscal Strategy Report* were the same as those contained in the 1998 *Budget Economic and Fiscal Update*.

All assumptions are for years ended 30 June.

Table 6 - Changes in Fiscal Projections since 1998 *Fiscal Strategy Report* ($ million)

Change	**1999/2000**	**2000/01**
Net worth	(12,586)	(16,563)
Net debt	3,980	7,269
Gross debt	3,857	6,820
Revenues	(3,029)	(3,586)
Expenses	(19)	(135)
Operating balance	(3,341)	(3,977)

Source: The Treasury

Annex 2

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

The Act 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* 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 of responsible fiscal management set out in the Act
- 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 *Budget Policy Statement* or the most recent *Fiscal Strategy Report*
- justify any change in the long-term objectives from the immediately preceding *Budget Policy Statement* or the most recent *Fiscal Strategy Report*
- assess the extent to which the indicated short-term intentions are consistent with the immediately preceding *Budget Policy Statement* or the most recent *Fiscal Strategy Report*
- justify any change in the short-term intentions from the immediately preceding *Budget Policy Statement* or the most recent *Fiscal Strategy Report*.

The Government's long-term fiscal objectives and short-term fiscal intentions, together with the principles of responsible fiscal management, are set out below.

	Long-term Objectives	Short-term Intentions	Principles of Responsible Management
Operating Expenses	The Government will limit the burden of State spending on current and future taxpayers by focusing on the efficiency and quality of expenditure and by reducing expenses to below 30% of GDP.	Policy initiatives will be lowered to $4.25 billion over the years 1997/98 to 1999/2000. A commitment has been made for up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02. If expected conditions prevail, expenses will be 35% of GDP in 2001/02.	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.
Operating Revenues	The Government will use a low-rate, broad-based tax regime to raise sufficient revenue to meet its long-term operating balance objective of running surpluses, on average, over the economic cycle.	Further tax reductions if economic and fiscal conditions permit.	Once prudent levels of total Crown debt have been achieved, maintaining these levels by ensuring that, on average, over a reasonable period of time, the total operating expenses of the Crown do not exceed its total operating revenues.
Operating Balance	Once gross Crown debt is reduced to below 25% of GDP, consistent with net Crown debt below 15% of GDP, the Government will gradually reduce the operating surplus through a mix of increased priority expenditure and tax reductions. In the longer term, the Government will run surpluses, on average, over the economic cycle.	On current forecasts, which include a commitment of up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02, operating balances will be -$0.1 billion in 1998/99, -$1.3 billion in 1999/2000, -$1.0 billion in 2000/01, and $0.1 billion in 2001/02.	Achieving and maintaining levels of Crown net worth that provide a buffer against factors that may impact adversely on the Crown's net worth in the future. Managing prudently the fiscal risks facing the Crown.

	Long-term Objectives	Short-term Intentions	Principles of Responsible Management
Crown Debt	The Government will steadily reduce the level of gross Crown debt to 25% of GDP, consistent with reducing net Crown debt to 15% of GDP. Gross and net Crown debt will then be lowered at a rate consistent with the operating balance objective.	If expected economic conditions prevail, gross Crown debt and net Crown debt will be $37.8 billion and $25.8 billion in 1998/99, $40.2 billion and $27.6 billion in 1999/2000, $42.2 billion and $29.5 billion in 2000/01, and $43.1 billion and $30.1 billion in 2001/02. In 2001/02 gross and net Crown debt will be 38.4% and 26.9% of GDP respectively.	Pursuing policies that are consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.
Crown Net Worth	The Government will maintain net worth at significantly positive levels.	Subject to expected economic conditions prevailing, net worth will be $2.5 billion in 1998/99, $1.2 billion in 1999/2000, $0.2 billion in 2000/01, and $0.2 billion in 2001/02. (The initial recognition of ARCIC outstanding claims obligations is expected to have a net negative impact of around $7.4 billion on net worth at 30 June 1999.)	

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

The long-term objectives are the same as those specified in the 1998 *Fiscal Strategy Report*. The short-term intentions have been updated since the 1998 *Fiscal Strategy Report* to reflect the latest fiscal projections.

The reasons for the changes in short-term intentions, and the Government's approach for returning to intentions consistent with the long-term objectives, are discussed in the *Fiscal Strategy* section of this statement.

	1998 *Fiscal Strategy Report*	1999 *Budget Policy Statement*
Operating Expenses	The Government will maintain firm control over expenses and a steady decline in the ratio of expenses to GDP. Policy initiatives, including the abolition of the surcharge, will cost up to $4.7 billion over the years 1997/98 to 1999/2000. The indicative spread of the $4.7 billion is approximately $0.8 billion in 1997/98, $1.5 billion in 1998/99 and $2.4 billion in 1999/2000. Provision of a further $800 million has been made for policy initiatives with an impact in 2000/01.	Policy initiatives will be lowered to $4.25 billion over the years 1997/98 to 1999/2000. A commitment has been made for up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02. If expected conditions prevail, expenses will be 35% of GDP in 2001/02.
Operating Revenues	Tax reductions will take effect on 1 July 1998. The Government will introduce further tax reductions if economic and fiscal conditions permit.	Further tax reductions if economic and fiscal conditions permit.
Operating Balance	The Government will run surpluses consistent with its operating expenses and revenue intentions. On current forecasts, the Coalition Agreement fiscal parameters and the inclusion of a provision for initiatives in 2000/01, this means operating balances of $2.8 billion in 1997/98, $1.3 billion in 1998/99, $2 billion in 1999/2000 and $3 billion in 2000/01.	On current forecasts, which include a commitment of up to $600 million on additional policy initiatives in each of 2000/01 and 2001/02, operating balances will be -$0.1 billion in 1998/99, -$1.3 billion in 1999/2000, -$1.0 billion in 2000/01, and $0.1 billion in 2001/02.
Crown Debt	The Government will steadily reduce gross and net Crown debt. If expected economic conditions prevail, gross Crown debt and net Crown debt will be $36.9 billion and $24.4 billion in 1997/98, $36.9 billion and $24.6 billion in 1998/99, $36.3 billion and $23.6 billion in 1999/2000 and $35.4 billion and $22.2 billion in 2000/01.	If expected economic conditions prevail, gross Crown debt and net Crown debt will be $37.8 billion and $25.8 billion in 1998/99, $40.2 billion and $27.6 billion in 1999/2000, $42.2 billion and $29.5 billion in 2000/01, and $43.1 billion and $30.1 billion in 2001/02. In 2001/02 gross and net Crown debt will be 38.4% and 26.9% of GDP respectively.
Crown Net Worth	The Government will steadily increase levels of net worth to $10.4 billion in 1997/98, $11.7 billion in 1998/99, $13.7 billion in 1999/2000, and $16.7 billion in 2000/01, subject to expected economic conditions prevailing.	Subject to expected economic conditions prevailing, net worth will be $2.5 billion in 1998/99, $1.2 billion in 1999/2000, $0.2 billion in 2000/01, and $0.2 billion in 2001/02. (The initial recognition of ARCIC outstanding claims obligations is expected to have a net negative impact of around $7.4 billion on net worth at 30 June 1999.)

Annex 3

Medium-term Fiscal Projections

The medium-term fiscal projections contained in this statement are modelled using the Treasury's Medium-term Fiscal Model. This model projects the path of fiscal aggregates beyond the period of the current forecasts. The difference between projected expenses and revenues determines the future operating balance, which in turn affects net debt.

Expense projections

The three main expense drivers in the model are demographics, inflation and a real growth factor.

Demographic changes, using *i*projections, influence spending in areas such as education and health. For example, the model has different average health costs for a range of age groups, with higher costs among the very young and very old. By allocating expense growth across different age groups, which change through time according to demographic factors, the model captures the expense consequences of changes in the composition and size of the population. Changes in the population, particularly population ageing, will be significant in the period just beyond that covered in these scenarios.

Beyond the three-year formal forecast period the model assumes most expenses, except finance costs, grow with inflation (the middle of the target band, 1.5%) and a real growth factor.

The real growth factor represents additional policy initiatives and the increasing cost of existing initiatives. It is applied on a per capita basis for spending that is demographically driven, such as education and health, and on an aggregate basis for other spending (see below).

The model also incorporates other assumptions that influence future expenses (for example, the unemployment rate and interest rates on public debt).

Revenue projections

The future path of revenues is modelled by applying tax rates to various tax bases, which are in turn driven by growth in nominal GDP. Nominal GDP grows according to a real economic growth assumption and the inflation rate.

Limitations to the projections

Although the model incorporates a fiscal feedback from public debt to finance costs, it does not include economic feedbacks. This means that the possible economic consequences of fiscal policies (such as lower debt or higher spending) are not reflected in the results.

The projections are not fiscal forecasts. They are medium-term projections of what the fiscal position might be under alternative assumptions. The projections are indicative of the trend in the fiscal position and may not reflect the actual position at any point in time. This is because they do not incorporate the effect of economic cycles on the fiscal position in the medium term.

Key Assumptions

All scenarios

Until 2001/02, all scenarios incorporate the economic assumptions summarised in Annex 1, and detailed in the 1998 *December Economic and Fiscal Update*. They exclude any effects on the short-term macroeconomic outlook from the second round of $300 million savings and Policies for Progress.

From 2002/03 the assumptions are:

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

Budget Status Quo scenario

This scenario incorporates the fiscal projections of the *December Economic and Fiscal Update*, excluding the impact of the:

- second $300 million savings package announced in July
- Policies for Progress.

In addition, this scenario assumes that the $800 million technical provision for additional policy expenditure in 2000/01 is rolled over into 2001/02.

Other assumptions include:

- average real GDP growth of 3% a year
- beyond 2001/02, expenditure on items driven by demographic trends (education, health and most welfare benefits) increase by 1.5% a year in real per capita terms, and other expenses increase in aggregate at 1.5% a year in real terms. This equates to around $800 million a year on additional policy initiatives. Beyond 2001/02, the $800 million increases in line with the real growth factor and inflation. The $800 million does not include increases to expenses driven by indexation, demographic factors, or finance costs
- NZS expenditure growth in line with nominal wages after reaching its level of 65% of the average wage (pre-Policies for Progress)
- current tax rates.

Central scenario

This scenario incorporates the full fiscal settings outlined in the 1998 *December Economic and Fiscal Update*. It includes both rounds of $300 million fiscal savings, savings from the Policies for Progress and the $600 million commitment for additional policy initiatives in each of 2000/01 and 2001/02. It assumes:

- average real GDP growth of 3% a year
- beyond 2001/02, expenditure on items driven by demographic trends (education, health and most welfare benefits) increase by 1% a year in real per capita terms, and other expenses increase in aggregate at 1% a year in real terms. This equates to around $600 million a year on additional policy initiatives. Beyond 2001/02, the $600 million increases in line with the real growth factor and inflation. The $600 million does not include increases to expenses driven by indexation, demographic factors, or finance costs
- NZS expenditure growth in line with nominal wages after reaching its level of 60% of the average wage (as announced in the Policies for Progress)
- current tax rates.

Lower Growth scenario

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