B.2 & B.3

Fiscal Strategy Report

19 May 2011

Fiscal Strategy Report

Overview

Budget 2011 is the next step in the Government's programme to build a competitive and balanced economy that delivers higher growth, more jobs and higher incomes. It continues the responsible approach we took in the last two Budgets to tilt the economy towards exports, savings and investment and away from borrowing and consumption.

New Zealand's growth rate is accelerating, assisted by stronger external growth, high terms of trade and the substantial spend on Christchurch reconstruction. Businesses and households have been and will continue to save more, which has dampened consumption but provides a sound basis for future growth. Gross Domestic Product (GDP) growth is forecast to reach 4% next year and the economy is forecast to create 170,000 new jobs over the next four years.

This makes it appropriate to wind back the strong fiscal stimulus of recent years. This was the appropriate policy in the aftermath of the global financial crisis. But as growth strengthens, the focus will shift towards lifting national savings and restoring sound public finances.

Budget 2011 identifies operating savings of $5.2 billion over five years and directs $4 billion of these savings to new initiatives, mostly front-line services in health and education. The savings come from a wide range of sources. These include efficiency savings from departmental spending. They also include changes to KiwiSaver, Working for Families (WFF) and student loans, all of which have experienced rapid cost escalation. These programmes emerge financially sustainable and better targeted towards those they are intended to help.

The Treasury forecasts a return to fiscal surplus in 2014/15, one year earlier than previously forecast, with growing surpluses thereafter. Core Crown net debt peaks at less than 30% of GDP and declines steadily beyond 2015. This is achieved despite absorbing the cost of the Canterbury earthquakes.

Budget 2011 continues to make better use of Crown capital. It contains significant infrastructure investment, including in ultra-fast broadband and KiwiRail. In total, the Government expects to accumulate an additional $34.3 billion of assets by 2015. These investments will in part be funded by proceeds from extending the Mixed Ownership Model. The Government will look to raise $5 billion to $7 billion by extending mixed ownership to four State-owned energy companies and reducing its majority shareholding in Air New Zealand, effectively redeploying this capital to higher-priority areas.

Economic Context

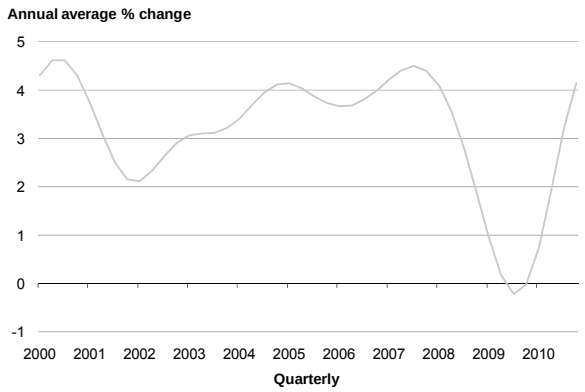
New Zealand's growth rates are likely to lift substantially over the next three years

The economic forecasts envisage an acceleration in growth to levels last seen in the first half of past decade. Continued growth in key trading partner economies, high export commodity prices, the receding effects of the global financial crisis and the stimulus from Canterbury reconstruction are the principal contributors.

Trading-partner growth and export commodity prices are high

Global growth has rebounded as the worst of the global financial crisis has receded. Trading-partner growth has lifted from -0.5% in 2009 to 4.5% in 2010 and is expected to average around 4% over the next few years.

Figure 1 – Trading-partner growth

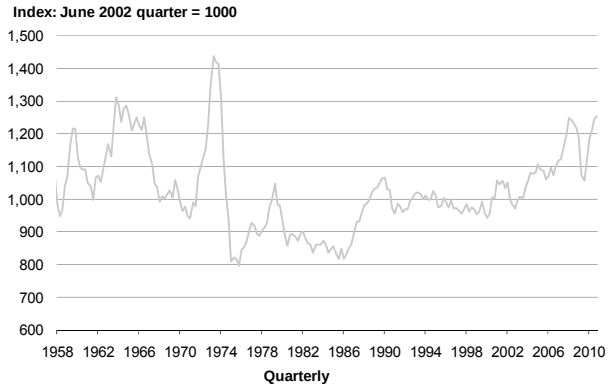


Sources: International Monetary Fund, The Treasury

This has been most apparent in export commodity prices, which are high across the board. The terms of trade has risen 19% since September 2009. A visible indication is Fonterra's dairy payout which is expected to be in the range of $7.90 to $8 per kg of milk solids this year. While there are likely to be some temporary adverse supply factors impacting on export prices currently, the underlying driver of strong demand is expected to see export prices stay strong for some time.

There are some offsets, with global oil prices having increased by 30% over the year to April 2011, but the net effect has still been for New Zealand's terms of trade to reach its highest level since the early 1970s.

Figure 2 – Long-term terms of trade



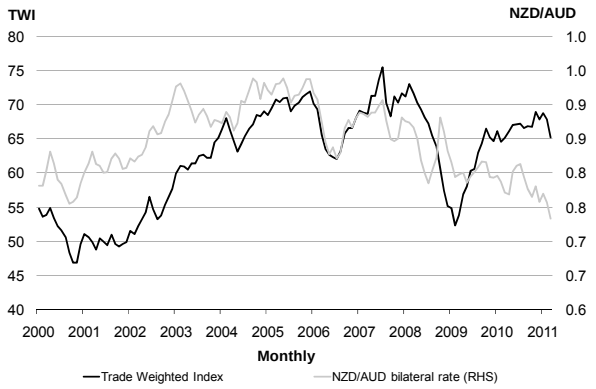
Source: Statistics New Zealand

The exchange rate is partly offsetting favourable terms of trade

The high New Zealand dollar has hindered the ability of exporters to take full advantage of higher trading-partner growth. Services exports such as tourism and education have been particularly held back. The exception is the cross-rate against Australia. Australia's terms of trade has increased nearly 40% over the past five years. The Australian dollar has strengthened accordingly, and New Zealand exporters have benefited directly.

On balance, the trade-weighted New Zealand dollar remains well above longer-term averages, and at a level which makes attaining external balance difficult. The forecasts include a technical assumption of slow reversion to trend for the currency, though as always a wide range of outcomes is possible.

Figure 3 – New Zealand dollar/Australian dollar bilateral exchange rate and the trade-weighted index (TWI)



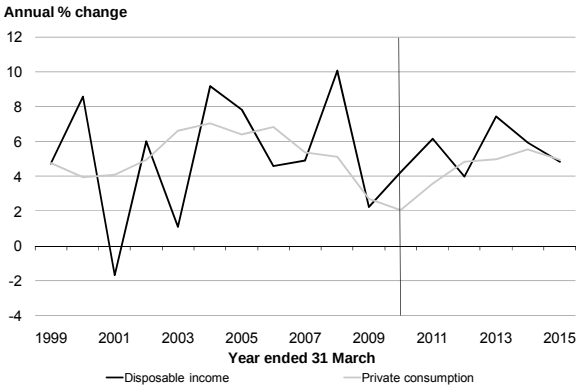
Source: Reserve Bank of New Zealand

Households and businesses are increasing their saving

Over the past year, households, farmers and businesses have remained cautious and looked to strengthen their financial positions. The ratio of household debt to disposable income, which had been rising continuously for the past 20 years, reversed and showed modest declines in 2010. After growing around 14% per annum between 2005 and 2008, private sector credit growth has fallen away with the level of credit in March 2011 little changed from a year earlier. The portion of household income needed to service debt has fallen from over 14% to under 11% during the past two years, owing to a combination of falling interest rates and a slowdown in debt accumulation.

These are necessary pre-conditions for moving the economy onto a more sustainable footing. Household consumption is not expected to lead the increase in growth but, over time, households are forecast to experience higher income growth. After adjusting for the one-off impact of insurance receipts in 2010/11, the Treasury forecasts disposable income growth of over 5% in nominal terms, or around 3% in real terms, on average over the next four years. This, together with households becoming more comfortable with their financial position, is expected to see their spending move more in line with income growth.

Figure 4 – Private consumption and disposable income growth



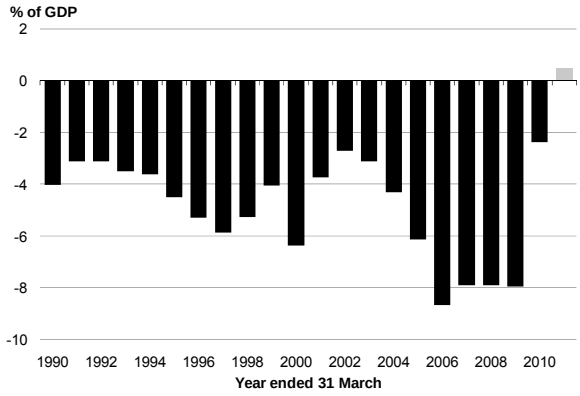
Sources: Statistics New Zealand, The Treasury

Note: Disposable income has been adjusted for insurance receipts in 2011.

Higher saving is being reflected in a reduced external deficit

In aggregate, private saving increased over the past year. This, combined with reinsurance flows associated with the earthquakes, means the current account balance is likely to have temporarily recorded its first annual surplus since 1973.

Figure 5 – Current account deficit

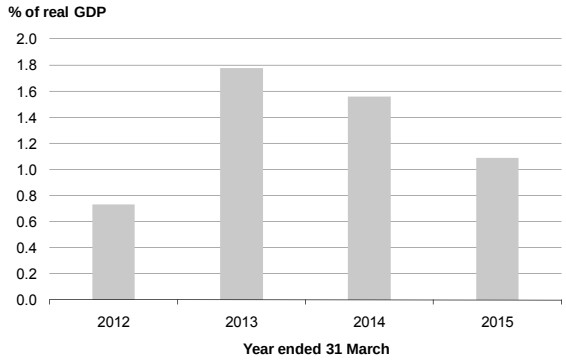


Source: Statistics New Zealand

The reconstruction of Christchurch will be a material stimulus

The Treasury's forecasts assume that $15 billion is spent repairing, replacing or renewing damaged properties over the next seven years. Rebuilding is expected to get fully underway in early 2012 and accelerate quickly thereafter. Rebuilding is likely to add over 1.5% to the level of GDP in each of 2012/13 and 2013/14, broadly coinciding with the planned withdrawal of fiscal stimulus. Construction activity is expected to remain high for most of the 2012 to 2015 forecast period, with the peak level of activity likely to exceed the peak experienced during the past decade. Private consumption is also likely to be higher as possessions are replaced. Some of the higher investment and consumption will be met from imports, meaning the forecast current account deficit will be higher than otherwise.

Figure 6 – Timing of Christchurch rebuilding



Source: The Treasury

Rugby World Cup

Real GDP growth is expected to pick up as 2011 progresses. The Rugby World Cup in late 2011 will attract tens of thousands of visitors to New Zealand and will provide a material boost to the economy. Its contribution to GDP is expected to be approximately 0.3% over the second half of 2011.

Growth is expected to accelerate in the second half of 2011 and through 2012

Taking these factors into account, growth is projected to lift strongly over the next two years. Growth since the global financial crisis has been weak, owing to both direct effects of weaker export demand and indirect effects as debt-funded consumption and investment have been wound back and savings rates have lifted.

The headwinds from this phase are abating. Global growth, particularly from emerging Asia, remains strong. New Zealand's trade patterns are rapidly switching towards this region. Domestically there remains spare capacity in the economy, and underlying inflation pressures remain weak. It is likely that as momentum gathers monetary policy will shift back towards a more normal stance, though neither the Budget forecasts nor the

markets believe this will be particularly rapid. The extent of the stimulus from the Christchurch rebuild, especially beyond that region, is an imponderable that adds to current forecast uncertainty.

On balance, growth is likely to lift substantially from a low base, for a time exceeding the potential growth rate of the economy as spare capacity is reduced. The projected growth rate of 4% to March 2013 would be the strongest since 2004. As a result, employment is forecast to increase by over 170,000 from the end of 2010 to June 2015 and the unemployment rate to fall to 4.5%.

The Government's programme for lifting economic performance

Since coming into office, the Government has been putting in place policies to rebalance the economy and make it more competitive. In 2009, we initiated a broad-based economic agenda across six policy areas – providing better and smarter public services; removing red tape and unnecessary regulation; investing in productive infrastructure; strengthening our tax system; lifting education and skills; and improving performance across science, innovation and trade. This work continues.

Providing better, smarter public services: The previous two Budgets redirected $3.8 billion of resources, primarily to frontline services, and constrained growth in new spending by reprioritising lower value spending towards high value activities. Agencies have contributed to a range of collective processes within the public sector, such as joint procurement, shared services and benchmarking, which are leading to significant savings. We are also lifting the quality of capital investment decisions, through the publication of the Government's first *Investment Statement*, the work of the National Infrastructure Unit and instilling better commercial discipline on capital projects.

Removing red tape and unnecessary regulation: We have already delivered 12 major regulatory reviews since we took office – including in the key areas of resource management and employment relations – and have a further eight reviews under way. We have overhauled regulation-making processes to be far more certain that the benefits of new regulation exceed the costs. We now also have systems in place for ensuring that our existing stock of regulation is regularly examined to determine whether it continues to be fit for purpose.

Investing in productive infrastructure: The previous two Budgets have seen major new investment in ultra-fast broadband, social infrastructure and the state highway network. These assets assist firms to deliver their products and services, and lower domestic cost structures. These assets are also critical to attracting high-skilled individuals and investors to New Zealand. The Government is committed to rebuilding Christchurch's damaged infrastructure, as well as continuing its investment in infrastructure throughout New Zealand that supports increased economic growth. The *National Infrastructure Plan 2011* will set out a framework for how this will occur. There will be continued focus on increasing the use of alternative procurement methods such as Public Private Partnerships, as well improving management of the Crown's assets.

Strengthening our tax system: The tax changes announced in Budget 2010 are now largely in effect – the biggest tax reform seen in New Zealand in 25 years. The changes have produced lower and more uniform effective tax rates across the economy, including on property investment, improving the incentives to work, innovate and take risk. All personal tax rates have been reduced, with the top rate cut to 33%. The company tax rate has been lowered to 28%, and following Budget 2010 almost three-quarters of

income earners face marginal income tax rates no higher than 17.5%. Raising the rate of GST to help pay for these changes has contributed to ongoing efforts to rebalance the economy, reducing debt-fuelled consumption and encouraging more saving. We now have a tax system that is more internationally competitive and attractive to both talent and investment.

Lifting education and skills: Introducing National Standards in our primary schools is a major achievement that will pay off over years to come for our children, for parents and for teaching professionals. We have initiated a wide-ranging set of reforms in tertiary education, with more to come this year. We have also made good progress with one of the biggest challenges to our education system – the retention in education and training of our 15 to 19 year olds. We continue to see education and skills as central to building a strong platform for growth.

Improving performance across science, innovation and trade: This has been a major focus of recent Budgets, with substantial new investment in business innovation and public private partnerships to support research and innovation in the primary sector, conclusion of trade agreements with Malaysia, Hong Kong and ASEAN, conclusion of the CER Investment Protocol with Australia, and major developments arising out of the Food Innovation Network and aquaculture reforms. This area targets building on our competitive advantages, and we cannot be complacent: it is critical to keeping our economy internationally competitive and building new opportunities.

Budget 2011 continues to support the necessary economic adjustment towards a more balanced and competitive economy. The Government will continue to progress these six areas.

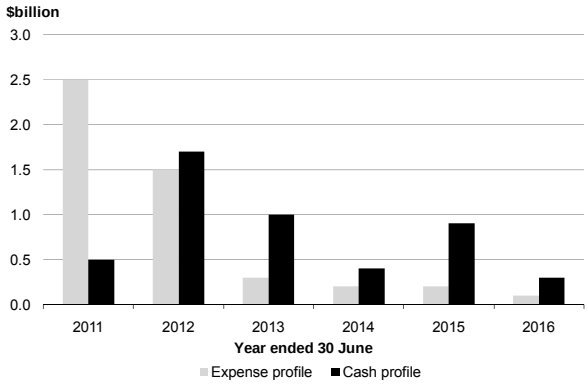
The Canterbury Earthquakes

Economic and fiscal impact

The impact of the earthquake on 22 February 2011, following on from the earthquake on 4 September 2010, has been large in human and economic terms. As a result of the February earthquake, the Treasury estimates that GDP growth will be around 1.5% lower in the 2011 calendar year than it would have been otherwise. The negative impact on GDP is concentrated in the first half of 2011, owing to the disruption to firms and households in the aftermath of the earthquake. This impact will be offset as the reconstruction commences, resulting in higher growth from 2012.

Beyond the human and economic dimension, the Canterbury earthquakes will have an estimated cost to the Government of $8.8 billion. Figure 7 shows the impact of the Canterbury earthquakes on the Government's core Crown expenses (which exclude the Earthquake Commission (EQC) and the Accident Compensation Corporation (ACC)). The *Budget Economic and Fiscal Update* explains the economic and fiscal impacts of the Canterbury earthquakes in detail.

Figure 7 – Forecast impact of earthquake on core Crown accounts



Source: The Treasury

Interaction with the fiscal strategy

Financially, New Zealand is well covered for natural disasters by international standards – through EQC, private reinsurance and the Government's own finances and ability to borrow. Because the financial costs associated with the earthquakes are one-off and largely occur in the short term, it is appropriate to let the costs to the Government flow through to debt initially and to continue with our fiscal strategy to address medium-term economic challenges. This approach allows the burden to be borne and repaid over time, just as the benefits of rebuilding Christchurch will be permanent. Debt will therefore peak earlier and at a higher level than if we had not been hit with the earthquakes.

Given the costs associated with the Canterbury earthquakes will flow through to debt, we are ensuring these costs are transparent by setting up a Canterbury Earthquake Recovery Fund. The Fund is a means of tracking expenses, and it has been included in the Crown accounts from this year. Funding generated from the Canterbury Earthquake Kiwi Bond will contribute to the Canterbury Earthquake Recovery Fund. The Fund will be wound up in several years time, once the costs of the earthquakes are clear.

Fiscal Strategy

Reconfirming the fiscal strategy

The Government is committed to its fiscal strategy, which includes:

- returning to fiscal surplus as early as practical and returning net debt to prudent levels
- maintaining a broad-base, low-rate taxation system that minimises economic distortions, and
- ensuring Crown capital is used effectively and efficiently.

Budget 2011 outlines how the fiscal strategy will be achieved through a multi-year process of reprioritisation and more efficient use of resources. The Government will ensure that we return to sustainable fiscal surpluses from 2014/15 and that net debt is returned to prudent levels.

Budget 2011 decisions mean that, despite the impacts of the two Canterbury earthquakes, the slower economic recovery and various other setbacks, the forecast return to operating surpluses (before gains and losses) is one year earlier than forecast at the *Half Year Economic and Fiscal Update (Half Year Update)*. Net debt will be slightly higher initially, owing in part to absorbing the cost of the earthquakes. However, in the long term, net debt will be lower than that forecast last year and far below the forecasts the Government inherited in 2008.

An early and sustained return to surplus supports stability and growth

Fiscal policy has an important role to play in reducing New Zealand's economic imbalances and vulnerabilities. Eliminating the fiscal deficit and returning to surplus on a sustained basis will contribute to this by restoring the fiscal buffer provided by low debt, increasing national saving, and reducing future borrowing and finance costs.

- *Restoring the fiscal buffer.* New Zealand's ability to absorb future shocks has been weakened by a series of shocks over the past three years, including the global financial crisis, Canterbury earthquakes, financial sector failures and drought and storms that disrupted agricultural output. These shocks have contributed to a large fiscal deficit and higher government debt than otherwise would be the case and are stretching the limits of the fiscal buffer. Returning to ongoing structural surpluses is the key to restoring the fiscal buffer.
- *Increasing national saving.* The Savings Working Group made a strong case for lifting national savings. The private sector is already playing its part by strengthening its financial position. The Government will also play an important role in lifting New Zealand's national saving by returning to fiscal surplus. In turn, this will reduce New Zealand's vulnerabilities, and result in lower interest rates and a lower exchange rate than otherwise would be the case. This will help to support the tradable sector to expand.
- *Reducing future borrowing and finance costs.* This will help to manage the risks posed by New Zealand's high net international liabilities, and further differentiate us from countries that are currently facing financing difficulties. It will help to reduce the risk of a credit rating downgrade. New Zealand's sovereign debt is already on a negative

outlook with two international credit rating agencies. If New Zealand were to be downgraded, the cost of borrowing would increase, making it harder and more expensive for our productive industries to invest. Net government bond issuance will fall by over two-thirds next year, and we will begin repaying debt in 2014/15.

Rising finance costs also limit our ability to pursue more worthwhile initiatives. Core Crown finance costs are expected to grow from $3.1 billion in 2010/11 to $5.3 billion in 2014/15. This highlights the need for ongoing scrutiny of government expenditure and investment in order to control finance costs.

Achieving the fiscal strategy over a multi-year horizon

Budget 2011 provides a clear path for how the Government's fiscal strategy will be achieved over the next few years. The economic cost of taxes and low-quality spending mean that all programmes need to demonstrate their worthwhile contribution to the Government's priorities.

Total core Crown operating expenses are forecast to increase from $64 billion in 2009/10 to $77.1 billion by 2014/15. This growth reflects a range of factors: new discretionary spending via operating allowances; demographic pressures from population ageing; indexation of most income support measures; the cost of the Canterbury earthquakes; and rising finance costs. These forecasts include the savings made in Budget 2011.

Revised operating allowances

There is total new operating spending of almost $4 billion over five years in Budget 2011, mainly on health, education and justice. These costs will be met from savings, which total $5.2 billion, leaving net savings of $1.2 billion over five years. Table 1 outlines these savings and the amount spent on new initiatives in Budget 2011.

Table 1 – Summary of Budget 2011 spending against the operating allowance

	$million increase / (decrease)					
	Operating					
	2010/11	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**Total**
New spending	110	1,096	990	787	966	3,948
Savings (including revenue initiatives)	145	700	1,338	1,459	1,526	5,168
Net increase / (decrease)	**(35)**	**396**	**(348)**	**(671)**	**(560)**	**(1,219)**

Note: Numbers in tables may not add exactly to the stated totals owing to rounding

For Budgets 2012 and 2013, the forecast operating allowance will be reduced from $1.12 billion to $800 million. That amount will be sufficient to meet government priorities in health, education and justice. From Budget 2014 onwards, the operating allowance will be $1.19 billion, growing at 2% per annum.

Changes to specific programmes

We have closely examined several programmes where costs have expanded rapidly, without full commensurate value to the community or the taxpayer. KiwiSaver, WFF, student loans and ACC are all examples of major programmes where cost escalation has occurred.

– *KiwiSaver*

There is a strong case to lift national saving, as noted by the OECD, the Savings Working Group and others. The changes to KiwiSaver are part of this wider strategy.

Currently, almost one half of the pool of savings across KiwiSaver accounts has been funded directly by the Government. National savings are the sum of public and private savings. At present, KiwiSaver's contribution to national savings is mixed. It helps individuals to save for their retirement, and thus lifts private savings. But it lowers public savings. It means the Government is borrowing, mostly from offshore, to contribute to private savings.

The total impact on national savings depends upon what portion of the private contribution comes from additional savings, versus redirected saving that would have occurred anyway. Given the high public contribution, it is not clear that national savings have benefited greatly.

Budget 2011 makes changes to KiwiSaver that will shift the balance of contributions towards private saving and away from government contributions. Existing Kick-Start payments will remain unchanged. The Government will:

- reduce the Member Tax Credit (MTC) to 50 cents per dollar of individual contribution, with the cap halved to $521 per year, from the year ending 30 June 2012
- remove the Employer Superannuation Contribution Tax (ESCT) exemption for employer contributions from 1 April 2012
- raise the minimum employee contribution rate from 2% to 3% from 1 April 2013, and
- raise the compulsory employer contribution rate from 2% to 3% from 1 April 2013.

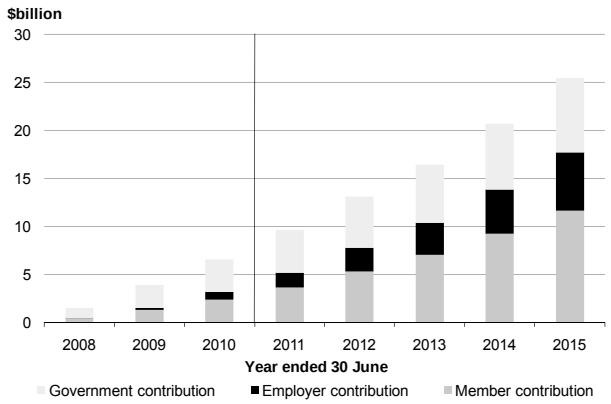
The changes to KiwiSaver will generate savings for the Government of $2.5 billion over four years.

KiwiSaver funds will continue to accumulate rapidly. Current projections are for total funds to rise from $7.9 billion (as at December 2010) to around $25 billion by 2015, and almost $60 billion in 10 years' time (Figure 8).

KiwiSaver will remain an attractive, subsidised saving option. An employee earning $50,000 per year and who joins KiwiSaver at age 30 can expect government contributions to make up between 10% and 12% of their final retirement balance, depending on their own contribution rates. Employees will also continue to receive increased contributions from their employer.

The decisions to lift the contribution rate, to keep KiwiSaver voluntary and to remove the ESCT exemption were all recommendations of the Savings Working Group.

Figure 8 – Projected cumulative KiwiSaver contributions



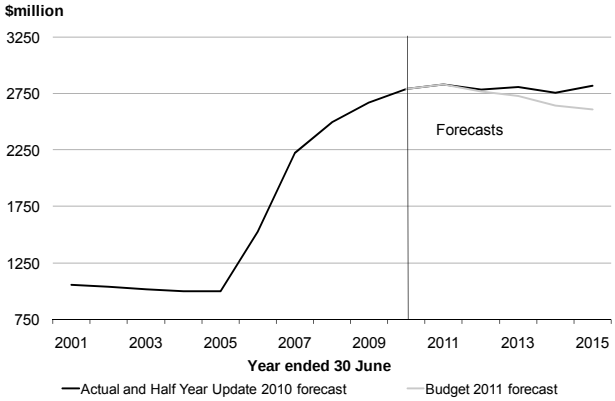
Source: The Treasury

– *Working for Families*

Budget 2011 makes changes to WFF to simplify the scheme and put it onto a more sustainable footing, while minimising the impact on families and lessening effects on work incentives.

In 2006, $1.5 billion of WFF tax credits were paid out to 159,000 people. By 2009, this had risen to $2.7 billion paid out to 419,200 people (Figure 9).

Figure 9 – The cost of Working for Families



Source: The Treasury

Note: Prior to 2004, WFF tax credits were known as "Family Assistance".

WFF will remain essentially in its current form. The changes consist of small adjustments to the abatement threshold and abatement rate, and a gradual alignment of the over-16 amount with the 13-to-15-year-old amount. The abatement rate and threshold changes will be phased in over four steps as Family Tax Credit (FTC) rates are adjusted for inflation. This is a gradual transition which is expected, given current inflation forecasts, to take eight years.

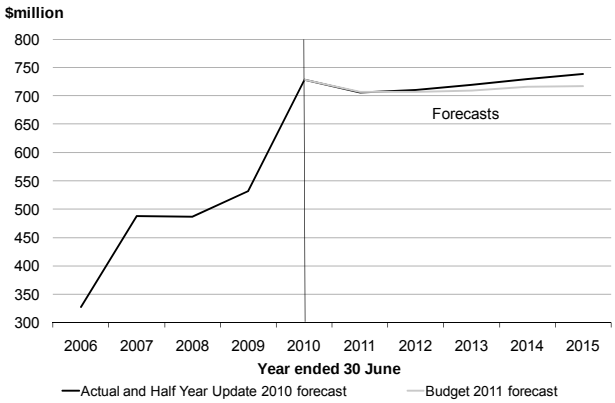
Lower-income families and beneficiaries will be largely unaffected by these changes, and the majority will receive an increase in their WFF payments after 1 April 2012. A number of families higher up the WFF scale, however, will receive a little less than they currently do now, or will no longer qualify. In most cases the impacts will be small.

These changes are expected to generate $448 million of savings over the four years to 2014/15. As a result, the total cost of WFF will reduce from $2.8 billion in 2011/12 to $2.6 billion in 2014/15.

– *Student loans*

In 2010/11 the Crown will lend almost $1.6 billion to assist students, up 50% over the past five years. There are currently more than $12 billion of loans outstanding. However, at present, for every dollar lent out the Government receives only around 55 cents back in 2011 dollar terms.

Figure 10 – The cost of student loans



Source: The Treasury

Budget 2011 tightens the lending criteria so that the scheme is better focused on those who really need assistance. The measures tighten borrowing conditions for those aged over 55, for part-time, full-year students and for those already overdue or in default. There are a number of additional changes.

The changes result in operating savings of $277 million and capital savings totalling $170 million over five years. This compares with the $1.58 billion in student loans the Government is lending in 2010/11 (Figure 10 shows the cost to the Government from these loans). The Government will continue to look for ways to improve the value and effectiveness of the student loan system.

– *ACC*

Over the past two years, ACC has been successful in managing its quickly escalating costs. This has resulted in the Government needing to contribute $638 million less to the non-earners' account over the next four years than previously projected. ACC members in other accounts will also benefit, with future levies also remaining lower as a result of the cost savings within the scheme.

The ACC scheme has not yet reached maturity, which means that more claims are entering the scheme than exiting, and therefore it is expected to grow above CPI inflation. However, ACC is continuing to develop initiatives targeting the most significant cost drivers that it considers will have the potential to further reduce costs and lower the growth rate.

Efficiency and effectiveness

In its first two Budgets, the Government successfully reprioritised $3.8 billion of spending into higher-priority areas.

Budget 2011 continues the focus on improving efficiency in the public sector and shifting resources towards areas of high priority. The Government expects the State sector to find $980 million in savings over three years.

Agencies will be required to find the savings from 1 July 2012. A key component of this initiative is a new requirement on State sector employers to meet the costs of KiwiSaver, the State Sector Retirement Savings Scheme (SSRSS) and the Teachers' Retirement Savings Scheme (TRSS) from within their own budgets. At present, many State sector employers are centrally funded for the costs of these schemes. Savings generated by the removal of central funding for KiwiSaver, SSRSS and TRSS equate to $650 million over three years. A further $330 million in efficiency savings will be sought from core government agencies.

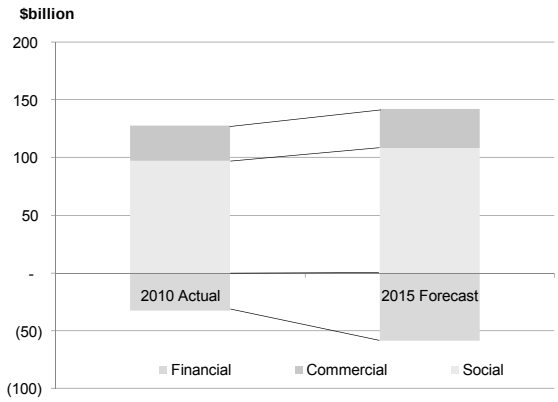
These efficiency savings, starting from 1 July 2012, will serve as a catalyst for significant changes to agencies' business models without compromising critical frontline services to the public. Delivering more for less will be an ongoing feature of the public sector, and will ensure that resources are being put to best possible use.

These approaches support the work already underway through the Better Administrative and Support Services (BASS) programme, which is driving changes to business models across government departments and is part of a broader programme of work to review the effectiveness of all expenditure. The first annual report on administrative and support services, including human resources, information and communication technology, property and finance, found that approximately $235 million in annual savings can be achieved by moving all agencies working below the New Zealand agency average level of efficiency to that average. The quality and transparency of information from the benchmarking exercise will enable robust, evidence-based decisions about how business is done and it will also help to identify opportunities for improvement.

Capital expenditure and its funding

The Government is releasing a *Supplement to the 2010 Investment Statement of the Government of New Zealand* alongside the other Budget 2011 documents. The Supplement outlines the Government's medium-term investment priorities, and signposts how the Government is working to improve asset management. It also provides details on how future investment will be funded.

Figure 11 – Net worth by asset class



Source: The Treasury

The Crown's balance sheet has more than doubled over the past 10 years, and there is extensive investment planned in the years ahead. The Government will acquire net additional assets of $34.3 billion (with gross additions of $78 billion), over the five years between 2010 and 2015, with total assets increasing to $257.7 billion. There is substantial planned infrastructure investment in roads, rail, broadband and electricity transmission. Investment in infrastructure remains a key part of the Government's overall growth agenda. The Government will also continue to accumulate financial assets via its various investment arms, including the New Zealand Superannuation (NZS) Fund and ACC.

The scale of this demand for capital, all of which is ultimately funded by taxpayers, reinforces the need for the Government to prioritise where its capital is used.

We are applying the same restraint on capital spending as on operating spending. Investment in productive capital remains a major priority for this Government, but the key change will be how this is funded. Much of the capital spending within the total Crown operation, including that by State-owned enterprises (SOEs), is funded either commercially, by retained earnings or by dedicated taxes or levies (for example, with the New Zealand Transport Agency (NZTA), ACC and EQC). About $21 billion will be funded directly by the Crown over the next five years, including most core social infrastructure.

The Government is continuing to explore ways to better use its balance sheet. One way of freeing up capital to reduce debt accumulation is to extend the Mixed Ownership Model – of the type adopted for Air New Zealand – to more of the Government's commercial assets. As well as freeing up capital for priority areas, extending this model will broaden the pool of investments for New Zealand savers, help to raise the productivity of the businesses involved through sharper commercial disciplines and give the companies involved access to wider sources of capital.

The Government has decided to seek a mandate to extend the Mixed Ownership Model, having been assured the following tests can be met:

- the Government maintains a controlling stake in the company
- New Zealand investors are at the front of the queue
- the companies involved present good opportunities for investors

- the capital freed up from this is used on behalf of taxpayers to fund new public assets, thereby reducing the pressure on the Government to borrow, and
- New Zealand consumers are protected by appropriate regulatory regimes.

The Government intends to apply the Mixed Ownership Model to Mighty River Power, Genesis Energy, Meridian Energy and Solid Energy, along with reducing its shareholding in Air New Zealand, over a three to five-year period starting in 2012 – subject to the Government receiving a mandate in the 2011 general election. No decisions have been taken on precisely how much of each company will be sold or when, other than that the Government will retain a majority shareholding.

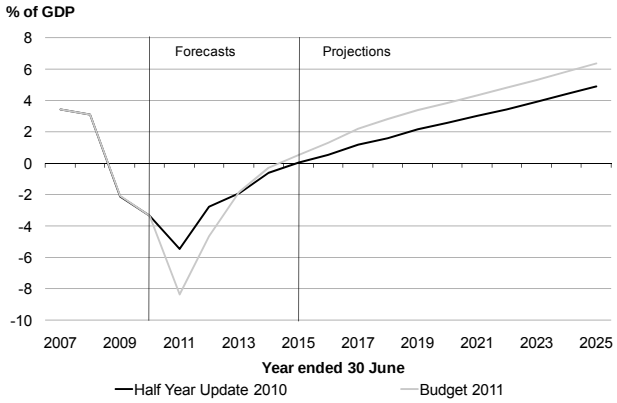
The expected proceeds are in the order of $5 billion to $7 billion. Extending the Mixed Ownership Model will thus fund approximately one-third of the Government's increased investment in core social infrastructure and student loans. This represents the reallocation of capital to higher priority areas, rather than simply borrowing more.

Spending on infrastructure associated with the Canterbury earthquakes is treated separately from the capital allowances, with all costs covered by the Canterbury Earthquake Recovery Fund.

Short-term Fiscal Intentions and Long-term Fiscal Objectives

The Public Finance Act 1989 requires that the *Fiscal Strategy Report* (FSR) state the Government's long-term fiscal objectives, for 10 years or more, for operating expenses, operating revenues, the balance between operating expenses and revenues, the level of debt and the level of net worth. The Government is also required to indicate short-term fiscal intentions for those variables for at least three financial years. Our short-term fiscal intentions and long-term fiscal objectives are consistent with the principles of responsible fiscal management, as set out in section 26G(1) of the Public Finance Act 1989. These intentions and objectives are formally laid out in Annex 2.

Figure 12 – Total Crown operating balance (before gains and losses)



Source: The Treasury

Short-term fiscal intentions

Our intention is to return the total Crown operating balance (before gains and losses) to a surplus no later than 2015/16. Current forecasts show that a meaningful surplus will be achieved in 2014/15. The deficit is expected to peak at $16.7 billion or 8.4% of GDP in 2010/11. Since the *Half Year Update* in December 2010, we have experienced a series of shocks, including the costs associated with the second Canterbury earthquake. These one-off costs impact on the operating balance (before gains and losses) in the 2010/11 year. In the following year, the deficit then almost halves to $9.7 billion or 4.7% of GDP, illustrating the one-off nature of many of these expenses.

Although the total Crown operating balance (before gains and losses) includes SOE and Crown entity revenue and expenses, it is core Crown revenue and expenses that are most directly under the control of the Government. Table 2 outlines the controlled growth in core Crown expenses over the next four years.

Table 2 – Growth in core Crown expenses

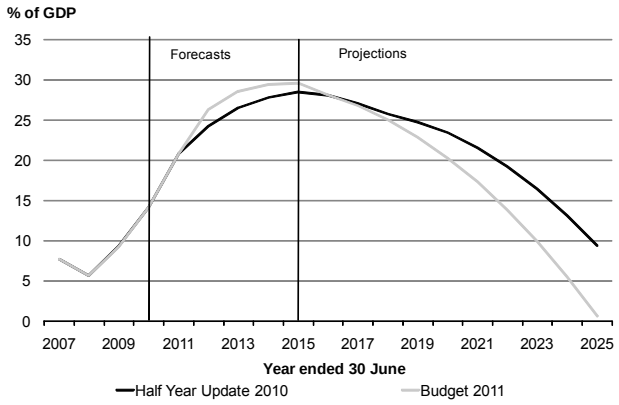
Year ended 30 June $billion	2011 Forecast	2012 Forecast	2013 Forecast	2014 Forecast	2015 Forecast
Movements in expenditure					
New spending					
Budget 2010 decisions	1.4	1.2	1.2	1.2	1.2
Budget 2011 decisions	-	0.4	(0.1)	(0.4)	(0.3)
Budget 2012 allowance	-	-	0.8	0.8	0.8
Budget 2013 allowance	-	-	-	0.8	0.8
Budget 2014 allowance	-	-	-	-	1.2
Existing policies					
Increases in New Zealand Superannuation costs	0.5	1.3	1.9	2.6	3.4
Increase in other social assistance	0.5	0.7	0.7	0.7	0.8
Emissions Trading Scheme	1.2	0.6	0.3	0.3	0.3
Debt impairments	0.2	0.5	0.5	0.6	0.7
Finance costs	0.8	1.4	2.0	2.4	2.9
Short-term expenses					
Canterbury earthquakes	2.5	1.5	0.3	0.2	0.2
Weathertight homes	0.7	-	-	-	-
Deposit Guarantee Scheme	0.3	-	-	-	-
Other movements	0.7	1.4	1.0	0.9	1.1
Increase in core Crown expenses	8.8	9.0	8.6	10.1	13.1
Baseline expenses (June 2010)	64.0	64.0	64.0	64.0	64.0
Core Crown expenses	**72.8**	**73.0**	**72.6**	**74.1**	**77.1**

Core Crown expenses are forecast to increase by $4.3 billion over the next four years. Some areas of expenditure will continue to increase, such as NZS, health care and education. The Government is committed to ensuring that operating expenses grow more slowly than the economy. Our intention is to support a return to surplus by controlling the growth in operating expenses, so that core Crown expenses fall as a percentage of GDP to around 31% of GDP by 2014/15. This is a similar share to that in 2006/07, and slightly higher than the average of core Crown expenses in the first half of the 2000s.

Long-term fiscal objectives

The Government remains committed to controlling the level at which net debt peaks and ensuring that net debt is no higher than 20% of GDP by the early 2020s. We have amended our long-term debt objective to reinforce this commitment, by reducing the upper ceiling for net debt from 40% of GDP to 35% of GDP. This will also help build up net worth and ensure the long-term sustainability of the Government's finances. The choices around the longer-term path of net debt are discussed below.

Figure 13 – Core Crown net debt

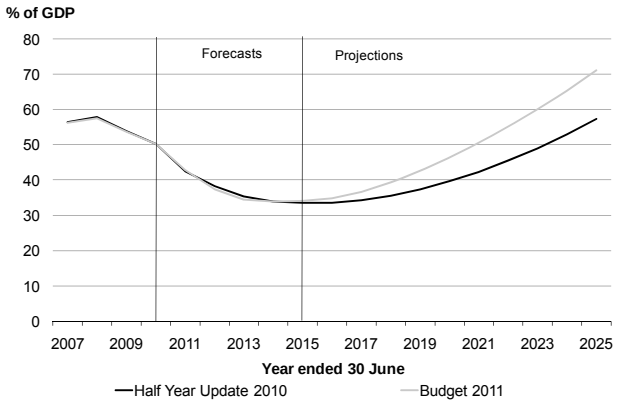


Source: The Treasury

Core Crown net debt is forecast to peak at 29.6% of GDP in 2014/15, earlier than forecast at the *Half Year Update*, as shown in Figure 13. Net worth as a percentage of GDP is expected to start building up from 2013/14.

Contributions to the NZS Fund are projected to resume in 2016/17, two years earlier than forecast at the *Half Year Update*. This prefunding of the future costs of New Zealand Superannuation will assist in meeting some, but not all, of the future fiscal pressures from population ageing. These pressures are now upon us as the first of the baby boomer generation retire this year.

Figure 14 – Total Crown net worth

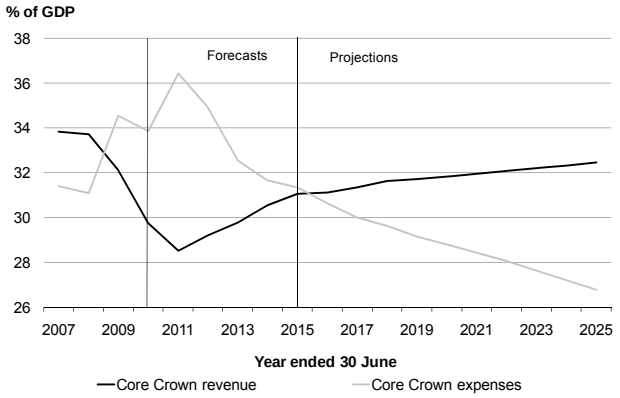


Source: The Treasury

Getting on top of our fiscal position, and rebalancing the economy towards the tradable sector, necessarily means the Government being a smaller part of the economy than it is now. Ongoing expenditure restraint will be critical to New Zealand's long-term fiscal sustainability. Expenditure restraint is also critical to putting New Zealand back on a sustainable growth path, with economic growth led by the private sector.

Our long-term objective for operating expenses is consistent with our objectives of running sufficient surpluses and, over time, returning debt to prudent levels. This means that the Government will control the growth in government spending so that, over time, core Crown expenses as a percentage of GDP are reduced to around 30%.

Figure 15 – Core Crown revenue and expenses



Source: The Treasury

Figure 15 shows the projected paths for core Crown revenue and expenses. Expenditure restraint will allow us to better manage the tax burden on the economy. Annex 1 outlines the Government's revenue strategy.

Reconciliation with long-term fiscal projections

The fiscal projections in Figures 12 to 15 are based on a continuation of current policy as represented by Budget 2011 forecasts and assumptions about operating allowances, capital allowances and tax rates (eg, extra revenue created by the non-indexation of tax thresholds – known as fiscal drag). Details of the projection assumptions are set out in Annex 3.

The projections indicate that a continuation of current policy settings into the medium term would create fiscal policy choices in the future. They would allow future governments to cut taxes, increase spending, or both.

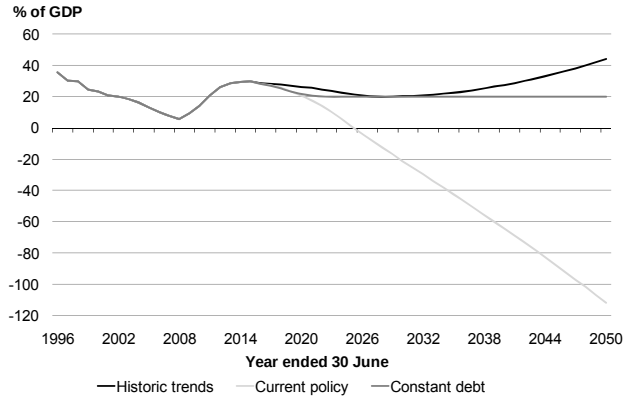
The Budget projection period extends to 2025. In the long run, a range of demographic factors come into play. The accelerating effects of population ageing and bottom-up cost pressures in areas like health will place increasing and significant upward pressure on expenses, such as NZS and healthcare.

For these reasons the Treasury also publishes *Long-term Fiscal Projections* every three or four years, which extend to 2050. Figure 16 highlights how net debt could evolve, given projected demographics, in the long term under three alternative sets of policy assumptions:

- The "Current policy" scenario assumes operating allowances of $1.19 billion (growing at 2%) out to 2025, with spending reverting to historic growth patterns thereafter. Under this scenario the Crown eventually generates sufficient surpluses that debt implodes, and the Crown becomes a large net owner of financial assets.
- The "Historic trends" scenario allows spending in health, education and other expenses to grow more rapidly. Under this scenario, spending in health, education and other expenses grows more rapidly, and debt starts to increase steadily from the late 2020s.
- The "Constant debt" scenario adjusts revenues and expenses within the context of longer-term fiscal challenges and a 20% of GDP net debt objective. Although this scenario suggests some scope to increase operating allowances in the medium term, the ratio of government spending to GDP would not rise to the levels seen in the last cycle.

These scenarios do not downplay the long-term demographic challenge. For example, the "Constant debt" scenario is challenging in that with broadly constant tax-to-GDP and unchanged NZS settings, the required spending adjustments are made elsewhere in the Budget. Although the operating allowance does eventually increase, it will need to cover rising costs, including rising demographic effects.

Figure 16 – Core Crown net debt under three scenarios



Source: The Treasury

Figure 16 does highlight how fiscal decisions in the near to medium term can substantially alter the longer-term fiscal outlook. Budget 2011 takes responsible fiscal decisions that limit the near-term lift in debt, and therefore create wider options for future taxpayers and governments.

The assumptions behind these scenarios, and how they compare with those in the Treasury's *2009 Long-term Fiscal Statement*, are set out in Annex 4.

Conclusion

Budget 2011 builds a strong platform for economic growth. In the near term, a range of factors, including the rebuild of Christchurch, are likely to lift growth. Longer term, the Government believes that a balanced and competitive economy can deliver substantially more jobs and growth. Budget 2011 takes a range of measures that will continue to tilt the economy away from government spending and debt-funded consumption. The adjustments to its spending programmes will assist in lifting national savings and deliver sound government finances.

The economy is likely to experience both positive and negative shocks in the coming years. If the recovery is stronger than forecast, revenue windfalls will be used to pay down debt. This will enable the Government to make an earlier return to surplus with lower net debt. If the economy is weaker than forecast, the Government will consider further fiscal adjustments in future Budgets. The Government is committed to returning to surplus and will continue to look for opportunities to achieve this as quickly as is practical.

Annex 1

Revenue Strategy

Government's objectives for the tax system

The Government is committed to building a stronger economy and increasing productivity.

The tax system should be as fair and efficient as possible in raising the revenue required to meet the Government's needs. The Government supports a broad-base, low-rate tax system that minimises economic distortions.

The Government considers these goals are best supported by a tax system that:

- maintains revenue flows to pay for valued public services and reduce debt
- responds to New Zealand's medium-term needs in a planned and coherent way
- biases economic decisions as little as possible – which allows people to work, save, spend or invest in ways that they believe are best for them
- rewards effort and individuals' investment in their own skills
- has low compliance costs and low administrative costs
- minimises opportunities for tax avoidance and evasion, and
- shares the tax burden as fairly as possible.

The Government's strategy is to raise revenue in ways that meet these objectives.

Relationship with economic and fiscal strategy

This revenue strategy has been produced as part of the strategic phase of the generic tax policy process. It supports the Government's economic and fiscal strategy. In particular, it is consistent with returning to fiscal surplus promptly in order to maintain prudent levels of government debt, while providing the right incentives to achieve stronger and more sustainable economic growth.

The Government has implemented two rounds of personal tax cuts and is committed to further fiscally-neutral reductions in income tax rates as economic and fiscal conditions allow. Maintaining revenue flows is particularly important in the current economic environment. The Government will consider whether there are other desirable revenue-enhancing measures to help finance further reductions in tax rates consistent with the medium-term goal of reducing and aligning personal, trust and company tax rates.

Tax policy work programme

The tax policy work programme is designed to implement the Government's revenue strategy. It will deliver tax policy:

- consistent with a broad-base, low-rate tax system that raises revenue in the most efficient manner to support the medium-term goal of reducing and aligning personal, trust and company tax rates at a maximum rate of 30%
- appropriate for the current economic situation
- that is simple and certain, and
- that supports New Zealand as an internationally competitive economy.

The Government recognises that, over the longer term, the tax system will need to adapt to the effects of population ageing and increased international mobility of people, capital and businesses on the revenue base.

A tax policy work programme will continue to be released publicly.

Government commitments

The Government, through its confidence and supply agreements with United Future and ACT, is committed to:

- a desirable medium-term goal of reducing and aligning personal, trust and company tax rates at a maximum rate of 30% as favoured by United Future (and included in the confidence and supply agreement with ACT), and
- supporting appropriate legislation on income splitting to First Reading in Parliament (United Future agreement). This commitment has now been met.

Annex 2

Long-term Objectives and Short-term Intentions

The Public Finance Act 1989 requires that the FSR state the Government's long-term fiscal objectives, for 10 years or more, for operating expenses, operating revenues, the balance between operating expenses and revenues, the level of debt and the level of net worth. The Government is also required to indicate short-term fiscal intentions for those variables for at least three financial years.

The Government's long-term objectives are not materially different from those outlined in the *2011 Budget Policy Statement* (BPS). There has been a change to the wording of the net debt objective, with the upper ceiling being reduced from 40% of GDP to 35% of GDP to underline the Government's commitment to keeping net debt under control. The long-term objective for operating expenses has been quantified to reflect the degree of spending control involved in securing and maintaining an operating surplus.

Table A2.1 – Long-term fiscal objectives

Fiscal Strategy Report 2011
Debt Manage total debt at prudent levels. Over the short to medium term it is prudent to allow an increase in debt to deal with the current economic and fiscal shock. However, we need to ensure that this increase is eventually reversed and that we return to a level of debt that can act as a buffer against future shocks. We will do this by ensuring that net debt remains consistently below 35% of GDP, and is then brought back to a level no higher than 20% of GDP by the early 2020s. We will work towards achieving this earlier as conditions permit.
Operating balance Return to an operating surplus sufficient to meet the Government's net capital requirements, including contributions to the New Zealand Superannuation Fund, and ensure consistency with the debt objective.
Operating expenses To meet the operating balance objective, the Government will control the growth in government spending so that over time, core Crown expenses are reduced to around 30% of GDP.
Operating revenues Ensure sufficient operating revenue to meet the operating balance objective.
Net worth Ensure net worth remains at a level sufficient to act as a buffer to economic shocks. Over the medium term, net worth will continue to fall as the impact of the global financial crisis unfolds. Consistent with the debt and operating balance objectives, we will start building up net worth ahead of the demographic change expected in the mid-2020s.

The Government has revised its short-term fiscal intentions from those in the *2011* BPS, as set out in Table A2.2 below. Our short-term intention for operating expenses outlines the degree of spending control involved in securing an earlier return to surplus, in 2014/15. The revised short-term fiscal intentions are consistent with the *2011 Budget Forecasts*. The revised short-term fiscal intentions are also consistent with the revised

long-term fiscal objectives and the principles of responsible fiscal management and reflect the Government's view of prudent debt over time.

Table A2.2 – Short-term fiscal intentions

Fiscal Strategy Report 2011	**Budget Policy Statement 2011**
Debt Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 37.2% of GDP in 2014/15. Core Crown net debt (excluding NZS Fund and advances) is forecast to be 29.6% in 2014/15.	***Debt*** Gross sovereign-issued debt (including Reserve Bank settlement cash and Reserve Bank bills) is forecast to be 36.9% of GDP in 2014/15. Core Crown net debt (excluding NZS Fund and advances) is forecast to be 28.5% in 2014/15.
Operating balance Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2015/16, subject to any significant shocks. Based on the operating allowance for the 2011 Budget, the operating deficit is forecast to be 3.5% of GDP in 2011/12. The operating balance is forecast to be 1.9% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance. The operating deficit (before gains and losses) is expected to be 4.7% in 2011/12.	***Operating balance*** Based on the operating allowance for the 2011 Budget, the operating deficit is forecast to be 1.9% of GDP in 2011/12. The operating balance is forecast to be 1.1% of GDP in 2014/15. This is consistent with the long-term objective for the operating balance. Our intention is to return the operating balance (before gains and losses) to surplus as soon as practical and no later than 2015/16, subject to any significant shocks.
Expenses Our intention is to support a return to fiscal surplus by restraining the growth in core Crown expenses – so that they are reduced to around 31% of GDP by 2014/15. Core Crown expenses are forecast to be 31.3% of GDP in 2014/15. Total Crown expenses are forecast to be 40.5% of GDP in 2014/15. This assumes a new operating allowance of $800 million per annum for Budgets 2012 and 2013, then returning to $1.19 billion, growing at 2% for Budgets thereafter (GST exclusive).	***Expenses*** Total Crown expenses are forecast to be 40.8% of GDP in 2014/15. Core Crown expenses are forecast to be 31.7% of GDP in 2014/15. This assumes a new operating allowance of $1.12 billion per annum, continuing to grow at 2% for Budgets thereafter (GST exclusive).
Revenues Total Crown revenues are forecast to be 41% of GDP in 2014/15. Core Crown revenues are forecast to be 31% of GDP in 2014/15. Core Crown tax revenues are forecast to be 27.8% of GDP in 2014/15.	***Revenues*** Total Crown revenues are forecast to be 40.8% of GDP in 2014/15. Core Crown revenues are forecast to be 30.9% of GDP in 2014/15. Core Crown tax revenues are forecast to be 27.7% of GDP in 2014/15.
Net worth Total Crown net worth is forecast to be 34.1% of GDP in 2014/15. Core Crown net worth is forecast to be 7.9% of GDP in 2014/15.	***Net worth*** Total Crown net worth is forecast to be 33.6% of GDP in 2014/15. Core Crown net worth is forecast to be 8.6% of GDP in 2014/15.

Annex 3

Projection Assumptions

The economic and fiscal forecasts, from 2010/11 to 2014/15, are detailed in the *2011 Budget Economic and Fiscal Update*. The projection period begins in 2015/16 and ends in 2024/25. These post-forecast fiscal projections are based on the long-run technical and policy assumptions outlined below. The projection model can be found on the Treasury website at http://www.treasury.govt.nz/government/fiscalstrategy/model

Table A3.1 – Summary of economic and demographic assumptions*

June year[1]	2011	2012	2013	2014	2015	2016	2017	2018	2019	…..	2025
	Forecasts					Projections					
Labour force	1.3	0.5	1.4	1.4	1.1	1.3	1.0	0.7	0.5		0.5
Unemployment rate**	6.7	5.9	4.9	4.8	4.6	4.5	4.5	4.5	4.5		4.5
Employment	1.2	1.3	2.5	1.6	1.3	1.4	1.0	0.7	0.5		0.5
Labour productivity growth***	-1.2	1.6	1.5	1.2	1.5	1.7	1.7	1.3	1.3		1.5
Real GDP	0.7	2.5	4.0	2.7	2.8	3.4	3.0	2.3	2.0		2.0
Consumer price index (CPI) (annual % change)	5.3	2.7	2.5	2.4	2.6	2.4	2.2	2.0	2.0		2.0
Government 5-year bonds (average % rate)	4.6	5.0	5.3	5.6	5.8	5.9	6.0	6.0	6.0		6.0
Nominal average hourly wage	2.1	3.9	4.0	4.2	4.0	4.1	4.0	3.3	3.4		3.5

* Annual average % change unless otherwise stated

** Unemployment as a percentage of the labour force

*** Hours worked measure

Sources: The Treasury, Statistics New Zealand

Transition of economic variables from the end of forecast

Given the difficulty in projecting cycles and shocks beyond the forecast horizon, the projections use trend or long-run averages for the growth rates or levels of key variables.

In previous forecast rounds the five-year forecast period was generally sufficient for the effects of current cycles and shocks to have worked their way through the economy. By the end of the forecast period key variables such as unemployment, the terms of trade and labour force participation have usually returned to trend growth rates or levels.

[1] Note that the economic forecasts in the *Budget Economic and Fiscal Update* are based on a March year.

In recent forecast rounds, shocks to the economy, either on the demand or supply side, have caused key variables to remain above or below trend at the end of the forecast period. For example, in Budget 2010, some of the key economic variables were not predicted to fully converge to their long-term values at the end of the forecast period, owing to the persistent effects of the recession. Those variables were adjusted from their end-of-forecast values to the long-term averages, using a relevant convergent rate for each variable.

In the Budget 2011 forecasts, the flow-on effect from the earthquake rebuild is assumed to continue into some early years of the projection period. Accordingly, real GDP growth for these years is assumed to grow above the trend rate until 2018/19. Labour productivity growth is adjusted to reflect the faster real GDP growth track.

Four other economic variables have also been adjusted from their end-of-forecast values. These all contribute to the projection of nominal GDP, which is both a driver of a number of important fiscal variables, such as tax revenue, and the denominator in key fiscal ratios (ie, debt-to-GDP). These variables are:

- age-and-gender group labour force participation rates
- CPI inflation
- unemployment rate, and
- average hours worked.

From 2015/16 to 2018/19, labour productivity growth is modelled as a function of real GDP growth and labour force. From 2019/20 onwards, labour productivity growth is assumed to return to the estimated long-term value of 1.5% per annum.

For labour force participation rates, the adjustment technique involves using growth rates for participation rates from projections produced by Statistics New Zealand.

For the other three variables – CPI inflation, unemployment rate and average hours worked – a long-term average is determined, together with a convergence path. The long-term averages are based on historical data, making allowance for factors that could alter their future values, such as the Policy Target Agreement with CPI inflation.

By 2019/20, all these variables have returned to their trend rates or levels.

Table A3.2 – Summary of fiscal assumptions

Tax revenue	Linked to growth in nominal GDP. Source deductions (mainly PAYE tax on salary and wages) is grown using employment growth and nominal average hourly wage growth. The latter is multiplied by a fiscal drag elasticity of 1.35. The two other major tax categories, Corporate tax and Other taxes (dominated by GST), are gradually returned, from their end-of-forecast values, to long-term constant ratios to GDP. This transitional adjustment is to ensure that tax revenue projections are based on ratios to GDP that are neither higher nor lower than would be expected when the economy is performing at its potential. Both tax categories change at a rate of 0.2% of GDP per annum, with final ratios-to-GDP of 4.5% for Corporate tax and 13% for Other taxes. The long-term ratios are based on historical data, taking into account tax rate and policy changes that could affect these. Once the long-term ratios are reached the tax types remain at them in later projected years.
New Zealand Superannuation (NZS)	Demographically adjusted and linked to net wage growth, via the "66% wage floor". The latter refers to the net (after-tax) weekly NZS rate for a couple being constrained to lie between 66% and 72.5% of net average weekly earnings. As tax on average weekly earnings, being a part of overall PAYE, increases owing to fiscal drag, the net average weekly earnings do not grow as quickly as the gross earnings.
Other benefits	Demographically adjusted and linked to inflation.
Health and education	Held constant at the end-of-forecast values, because their growth is assumed to come from a share of the projected Operating Allowance annual increment.
Other expenditure	Held constant at the end-of-forecast values, because their growth is assumed to come from a share of the projected Operating Allowance annual increment.
Finance costs	A function of debt levels and interest rates.
Operating allowance	$1.21 billion in 2015/16, which is equivalent to the Budget 2010 Operating Allowance of $1.1 billion, growing at 2% per annum in intervening years. Operating Allowances for subsequent projected years grow at 2% per annum from this value.
Capital allowance	$0.936 billion in 2014/15. This is based on $0.9 billion in Budget 2014, growing at 2% per annum.
Surplus NZDMO financial assets	Nil.
NZS Fund	Contributions to the Fund suspended until 2015/16. Contributions begin again in 2016/17, and are consistent with the New Zealand Superannuation and Retirement Income Act 2001.

Emission Trading Scheme (ETS)	The fiscal impact of the ETS depends on several highly uncertain factors, most notably future carbon prices and New Zealand's emissions targets from future international climate change agreements. The ETS has been modelled as having no net fiscal impact in the projection period (expenses equal revenues), as the net impact of the ETS and future international obligations is highly uncertain. Any net revenue (the value of credits received after free allocation of credits to participating industries) is assumed to be required to meet future international obligations, or alternatively used for fiscally equivalent, unspecified tax reductions or spending increases.
Future emissions liabilities	The Kyoto liability included in fiscal forecasts reflects the Government's obligation for Commitment Period 1, which is for the period 2008 to 2012. Projections beyond 2014/15 do not incorporate a quantitative estimate of any net emissions liability that may eventuate from New Zealand's obligations under future international climate change agreements.

Annex 4

FSR Projections and the Treasury's Long-term Fiscal Statement

Fiscal projections are currently produced in two forms. The FSR projections cover the period to 2025 and assume the continuation of current policy. The Treasury includes projections out to 2050 in its *Long-term Fiscal Statement*. This annex reconciles the two approaches and sets out the assumptions behind Figure 16.

The *2009 Long-term Fiscal Statement* included a scenario where the path of government spending was adjusted over the period to 2050 to achieve "sustainable net debt" (20% of GDP), and a scenario where spending was influenced by "historic trends" and net debt was unanchored (eventually exceeding 200% of GDP).[2] In both scenarios, NZS and welfare spending were projected in line with current policy. NZS spending is driven by demographics and wages, and welfare spending is driven by demographics and CPI indexation of benefits. The *2009 Statement* used Budget 2009 as the base for the projections.

The 2011 FSR projections also assume current policy for NZS and welfare. This is consistent with the approach used to guide Budget decisions (ie, the Fiscal Management Approach). Operating allowances are assumed to cover spending increases in health, education and other expenses. These spending increases could include new policy initiatives, cost pressures and demand-driven increases stemming from demographics. Capital allowances are assumed to cover net increases to property, plant and equipment.

The key assumptions behind the three scenarios in Figure 16 are as follows:

- "Current assumptions" – assumes FSR operating and capital allowances until net debt reaches near zero in 2025. After 2025, the revenue from fiscal drag is removed and historic spending growth trends for health, education and other expenses are assumed.
- "Constant debt" – assumes FSR allowances until net debt reaches 20% of GDP in 2022. After 2020, the revenue from fiscal drag is removed and operating allowances are set so as to stabilise net debt at 20% of GDP.
- "Historic trends" – assumes that historic spending growth trends for health, education and other expenses take effect from 2016 and the revenue from fiscal drag is removed from 2026.

In all three scenarios, NZS and welfare spending are determined by the factors discussed above and tax-to-GDP is broadly constant. Contributions to the NZS Fund are assumed to restart in 2016/2017 in all three scenarios. Although they use the 2011 Budget as the base, the "Constant debt" and "Historic trends" scenarios are similar in method to the respective "Sustainable debt" and "Historic trends" scenarios in the *2009 Long-term Fiscal Statement.*

Operating allowances of $1.19 billion in 2014/15 (growing at 2% per year) equate to around 0.5% of GDP per year. In the "Constant debt" scenario, operating allowances are maintained at this size before eventually settling at around 0.8% of GDP per year. The

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2 http://www.treasury.govt.nz/government/longterm/fiscalposition/2009

profile for *specific* spending areas in this scenario depends on the *allocation* of the operating allowance. For example, if health's allocation of the allowance is based on recent shares then health spending to GDP declines from around 7% now to 6% by 2020, before rising to around 8% in 2050. This compares with projected health spending rising above 9% of GDP in the "Historic trends" scenario.

In terms of overall spending, the "Constant debt" scenario has non-finance core Crown expenses at 30.5% of GDP in 2050. This compares with 32.1% of GDP in the "Historic trends" scenario. Although net debt is lower than the "Historic trends" scenario in the *2009 Long-term Fiscal Statement*, it remains on an upward path. The "Current policy" scenario has non-finance spending at 28.1% of GDP in 2050.