

**Budget Speech
and
Fiscal Strategy Report
2000**



**HON DR MICHAEL CULLEN
TREASURER
MINISTER OF FINANCE**

15 JUNE 2000

© Crown Copyright Reserved
ISBN 0-478-11247-5
Typeset by the Treasury
Printed and bound by PrintLink
(A division of Blue Star Print Group Ltd)
Wellington

Internet

This document will be made available on the New Zealand Treasury's Internet site.
The URL for this site is <http://www.treasury.govt.nz>

Contents

Budget Speech

Introduction	1
1 Developing an Innovative Economy	3
Economic development	3
The knowledge economy	4
E-commerce	4
2 Fostering Education and Skills	5
Education	5
Employment	6
3 Closing the Gaps	7
4 Restoring Trust and Rebuilding Public Services	8
Housing	8
Health	8
Social services	9
Law and order	9
5 Nurturing the Environment	10
6 Building National Identity	10
7 Revenue	11
Making forward provision for the ageing population	12
Conclusion	13

Fiscal Strategy Report

Introduction	17
Fiscal Policy Overview	17
Fiscal Implications of Population Ageing	18
Retirement income implications	18
Implications for other areas of government spending	19
Progress Outlooks (10-year Fiscal Projections)	21
Projection Assumptions	21
Projection Results	22
50-year Fiscal Scenarios	24
Short-term Fiscal Policy	25
Operating Balance and Debt	25
Expenses and Revenues	26
Conclusion	29
Annex 1	30
Short-term Fiscal Intentions and Long-term Fiscal Objectives	30
Annex 2	32
Fiscal Forecasts and Consistency with Short-term Intentions in the <i>Budget Policy Statement</i>	32
Annex 3	34
Assumptions Used in the Forecasts, Projections and Scenarios	34
Economic and demographic assumptions	34
Fiscal assumptions beyond 2003/04	35
Consistency between the Progress Outlooks and the Progress Outlooks in the 1999 <i>Fiscal Strategy Report</i>	36
Annex 4	38
Prefunding Working Assumptions	38

Budget Speech

Introduction

Mr Speaker, I move that the Appropriation (2000/2001 Estimates) Bill be now read a second time.

It is with a sense of honour and privilege that I present today the Labour-Alliance Coalition's first budget. The Budget 2000 does not try to do everything at once. But it does mark out a new direction. It points the way to rebuilding a fair and sustainable social and economic order.

For too long, New Zealanders have voted for one set of policies and got another. This Government will continue to honour its election commitments and thus restore faith in the political process.

For too long, New Zealand governments have ignored the growing gap between rich and poor. This Government is committed to closing the gaps.

For too long, governments have neglected provincial New Zealand. This Government will invest in the regions.

This Budget is about a new start for a new century.

All New Zealanders depend on a thriving economy. It delivers the incomes needed for personal development and fulfilment, and for active participation in society. Within the economy, markets are vital channels through which individuals make choices about employment, production, saving and consumption. The liberating power of the market mechanism must be recognised.

It is important, though, to see economic life as more than materialistic consumption; an economic system as more than a set of markets. It is in this wider context that the Budget 2000 has been constructed.

The Budget moves us, as a society, a step closer to the destination we set for ourselves through the six goals laid out in the March *Budget Policy Statement*.

These are to:

- develop an innovative economy which creates jobs and provides opportunities for all New Zealanders
- foster education and skills
- close the gaps that now divide our society
- restore trust in government and to promote a strong public service
- treasure and nurture our environment, and
- celebrate our identity as a people who defend freedom and fairness, enjoy arts, music, movement and sport, value our cultural heritage and who are committed to the Treaty of Waitangi.

These are the values that drive this Government. They will continue to create the context for our decision-making. They are the framework within which I will present the Budget announcements.

A generation ago, the 1972 Royal Commission on Social Policy defined the task of public policy as enabling all citizens to feel they belong to, and can actively participate, in society. That definition is just as relevant today as it was then.

We cannot, as individuals, as families and as communities, celebrate our identity if we are locked out of participation and made outsiders in our own land.

This means that the Government has to recognise that there are rights of citizenship that exist alongside rights to own and trade property. Honouring rights of citizenship is a fundamental obligation of governments. In meeting that obligation governments provide basic entitlements, and do not merely step in when markets fail.

We have the advantage of a strong economic outlook. Growth is forecast to average around 3% per annum over the next three years on the back of a robust world economy and a competitive exchange rate. Unemployment is expected to reduce to just above 5% by March 2002. I would like it to fall further and remain low.

There is more life in the provinces. Tourism is expanding. Exports are increasing steadily and the export base is widening. We have seen a welcome resurgence in agriculture and the prospects for primary exporters continue to look good.

This should assist in bringing the external deficit closer to sustainable levels. It is now running at around 8% of gross domestic product. We should see it shrink back to about 5% of GDP over the next two years.

On the fiscal front, the Government is looking ahead to substantial and rising surpluses. This year's surplus is forecast at \$763 million. The 2000/2001 figure is expected to rise to \$1.01 billion. This is in line with the *Budget Policy Statement* forecast of \$1.0 billion. Projections for the following two years – 2001/2002 and 2002/2003 – show the same pattern of continuing improvement at a little over \$2 billion and \$2.7 billion respectively.

Those surpluses represent increased national savings. We will not spend them. We have promised that we will be a fiscally conservative Government and we will hold to that promise. The \$5.9 billion spending cap we have imposed on ourselves remains in place, even though it will demand great discipline over the next two budgets.

The Budget consolidates initiatives taken since the election, complements them with new initiatives, and creates a platform from which the country can build a sense of identity, integrity, prosperity and purpose.

The foundations are access to education, to affordable housing, to health services, to a job and to an income in retirement that is consistent with peace of mind, dignity, and a capacity to participate actively in society.

1 Developing an Innovative Economy

Economic development

In the modern age, all economies face a mix of opportunity, stress and challenge. We live in a time of massive and rapid technological change. Global markets and world financial systems are at one level more open and accessible, and at another, less predictable.

Everywhere, governments are reassessing how they can best assist the private sector to manage the risks in the new economic environment, and prosper from the opportunities it presents.

A lot of money is, and always has been, spent in creating and maintaining a framework in which economies operate, change and grow. Government programmes cover a broad spectrum from developing skills, providing infrastructural supports and maintaining stable financial and market systems, to more specific supports like provision of business information and trade assistance.

The challenge now is to coordinate those efforts, continuously monitor them to improve their effectiveness, and to provide resources to upgrade the level and scope of the economic development effort.

As one part of the wider policy framework, we promised that we would increase investment in industry assistance by \$100 million a year before the end of our first term in office.

We have done better than that. Today's budget allocates an additional \$112.5 million a year from 2002/2003. We will get there in three roughly equal instalments beginning with \$34 million in the coming year, rising to just over \$73 million in 2001/2002 and reaching \$112.5 million in the third year.

The money will be spent on a range of services, including a strategic investment service, early stage financing assistance and developing business skills. And not just in the cities, but in the regions also.

We do not want to pick winners. We do not want to regulate, subsidise or compel. We do want to help businesses find new markets and become winners. At times that means getting the regulatory framework right so that short term opportunism does not damage the wider public commercial good. At times it means ensuring the right financing options are available. At times it means taking a direct leadership role.

Industry New Zealand will work with firms with good growth potential to enable them to fully realise that potential. Specifically it will assist them to develop business plans, build partnerships with other businesses and approach financiers. It will also work with Trade New Zealand to actively market New Zealand as an investment destination.

The funding also allows for the establishment of a nationwide regional development strategy to be administered by Industry New Zealand in partnership with local authorities and other local groups. This will be reinforced by a coordinated central government effort, organised through the Ministry of Economic Development, in areas with particularly acute problems.

The Government will provide financial support to help communities through the process of developing their plans, developing the capacity to implement their plans and implementing them. Details of the principal regional development vehicle will be announced soon.

A further increase of just under \$3.5 million a year has been allocated to the Ministry of Economic Development specifically for policy advice on economic development.

The knowledge economy

This Government is committed to assisting the transformation of the economy from our current over-reliance on commodity production to the knowledge intensive industries of the future. The knowledge economy encompasses e-commerce but is bigger than that. It is about adding intelligence, creativity and technological sophistication to our production and export base.

To make this new economy a reality, we need to invest much more in research, science and technology. I am proud to announce today new funding of \$30 million for research and development. Together with initiatives already underway, the total research and development vote will increase by over \$43 million. It is a significant increase. This commitment is central to our economic strategy.

A record \$21 million will go toward encouraging more active research and development by the private sector. This is the largest ever increase in Government support for private sector research and development. The support comprises a \$9 million increase in funding for Technology New Zealand and a new \$12 million grants programme.

The Government decided that grants were a better, safer and fairer option than tax breaks. I expect to see an expansion of the new grants programme in future budgets.

The rest of the package includes an \$3 million increase to the New Economy Research Fund and a \$2 million increase to the Marsden Fund. Both finance long-term, cutting edge research projects. A further \$1.5 million will go toward health research.

To enhance our trade, cultural and other linkages with the important Latin American market, this Budget allocates additional funding for the opening of a new embassy in Brasilia.

E-commerce

The Internet has the capacity to substantially improve New Zealand's economic performance. But if we are neither quick enough nor smart enough to take these new technologies and make them our own, we risk falling behind the rest of the world.

We will host an electronic commerce summit later this year to get community and industry input into developing an e-commerce strategy that is world-best.

In the public sector, our aim is that all government information and services should be available on the Internet and other technologies as they emerge. Operational funding of around \$16 million over four years and capital of over \$1 million has been set aside for this purpose.

The Budget also provides Trade New Zealand with an additional \$9.5 million over two years to expand their already impressive trade development networks using e-business solutions.

2 Fostering Education and Skills

Education

Spending on education increases by almost \$300 million next year from pre-election levels, including \$200 million in new initiatives. But our initiatives are not limited to money. We have also ended bulk funding. The redistribution of the associated funds makes a small contribution to the ideal that opportunity in early life should not be determined by who or how well off the child's parents are.

We have committed an additional \$15 million per school year for school operational grants. There will be a capital injection next year of \$160 million. This is the largest ever school property works programme. It will be used to meet roll growth and to upgrade existing schools.

The Government's goal is to ensure that all New Zealanders have the best possible chance to develop their potential, and to equip themselves to meet the demands of a fast changing world.

A good start is crucial to later success. We are increasing funding to early childhood education by over \$10 million a year.

We need also to reduce the number of pupils who leave school without basic literacy and numeracy skills. We will put another \$23 million into this area over the next four years.

Successful students need good study habits. We are providing up to \$2 million a year for primary schools in poorer socio-economic areas to develop homework centres so that all children have an appropriate environment in which to study.

The low educational attainment rates of Māori and Pacific children must be addressed. Additional funding will be provided to attract more Māori and Pacific peoples into teaching and to provide more resources for the development of Māori and Pacific peoples' language and culture.

To put further impetus behind the need to raise Māori achievement, a Hui Taumata of experts and elders will be held in October to develop a path forward.

Modern Apprenticeships is a major new initiative to regain momentum in developing technological skills. Over \$5.5 million will go to rebuilding apprenticeship programmes in the next financial year: \$42 million over the four year period. An additional \$23 million over four years will go to the Industry Training Fund to subsidise trainees' costs.

The Government has already moved to honour its commitment to lower the cost to students of tertiary education. We will write off the interest on student loans while students are studying and have reversed the previous Government's decision to increase the student loan repayment rate. This will significantly increase the subsidy to students through the loans scheme, at a cost of \$420 million over four years.

We will move to further reduce the study costs to students by increasing the tertiary tuition subsidy by \$110 million over the next four years. And we will provide \$12 million over the same period to improve the participation of Māori and other groups currently under-represented at our universities and polytechnics.

Employment

I am confident that an active industry policy, harnessed to a streamlined and much improved training system, and a vibrant research and development programme, will generate quality jobs.

A job though, at any price, is not the standard that a participatory democracy sets itself. We spend too much time at work, are too much defined by work, and express ourselves socially too much through work, for work to be set aside from social policy.

Yet work is the biggest part of the well-being of most of us. That is why the quality of working life is a vital component of the quality of participation in economic and social life. The Government has moved to improve the quality of working life in three critical ways. The minimum wage has been increased, employment law is being rebalanced, and the accident prevention, rehabilitation and compensation system is being refocused in its purpose while ensuring costs are carefully controlled.

This Government will not attempt to create a trade-off between jobs and rights. That is no way to run a modern civilised society. We have to do both.

Unashamedly, this Government sees fairness at work, and even-handed relationships in the workplace as a part of its social and economic objectives.

Every individual should have the opportunity to participate in the labour market – this is an important part of building an inclusive society. The Government will provide \$21 million in additional funding to provide vocational services for people with disabilities.

We know the cost of childcare is an impediment for many parents to taking a job or increasing their hours of work. Accordingly, we are raising from 30 to 37 the maximum number of hours a week for childcare and Out of School Care (OSCAR) subsidies during school holidays.

We will also invest over \$70 million in the next four years on creating new job opportunities in areas of high disadvantage. There will be \$21 million for the development of Māori social employment services, with a further \$14 million targeted specifically to supporting Māori women into business and training.

The Government is spending \$7 million on Pacific peoples' organisational development. This will build the capacity and capability of Pacific organisations so that they can deliver services efficiently, and promote economic and community development.

3 Closing the Gaps

A key task the Government has set for itself is closing the divisive and debilitating gaps that have opened up throughout New Zealand society. There are gaps between the skilled and the unskilled, between employment-rich and employment-poor communities, and between the cities and the provinces.

But the most urgent and visible gaps exist between Māori and Pacific communities and others.

A lot of effort to close the gaps is going through traditional delivery channels: schools, polytechnics, universities, housing agencies and hospitals. A lot is also going through Māori and Pacific controlled and managed organisations.

We need to know whether that effort is achieving the intended results. We are making a significant investment in improving the information base and our monitoring capability. Te Puni Kokiri will receive an extra \$12 million over the next four years to monitor the effectiveness of social policy programmes for Māori.

We are also making government departments more accountable for their delivery to Māori and Pacific peoples. From this year, departmental chief executives will be required to disclose in their annual reports what steps they are taking to close the gaps, and will be held accountable for their effectiveness.

And we are building the ability of Māori and Pacific communities to realise their own aspirations. The Budget dedicates \$114 million over the next four years to build the capacity of Māori and Pacific peoples to design and deliver their own initiatives.

The needs of Māori landowners are often impeded by issues of multiple ownership. The Māori Land Court will get an additional \$8 million over the four year period to help overcome some of these barriers.

This Budget establishes a base on which we will continue to build. Some of the building will be done during the coming year. I have made provision for a fund of \$50 million for Closing the Gaps initiatives that are developed between budgets. This will allow us to put in place innovative programmes as soon as they are developed. But the bulk of further work will be undertaken in the 2001 Budget.

The Government will not stand back on this question. We are determined to close the gaps. Our very foundations as a country demand it.

4 Restoring Trust and Rebuilding Public Services

To restore trust in the political process, we have introduced legislation to discourage MPs from party hopping. We have also moved quickly to honour key election commitments. This Budget continues that process.

Housing

The Government is committed to the elimination of poverty. There is a widespread agreement that the housing policies of the previous Government were poorly targeted. They resulted in empty state houses alongside overcrowding. Poor housing is associated with low health status and poor educational achievement, particularly among the young.

From 1 December this year, low income state tenants will pay no more than 25% of their net income in rent. Around 40,000 households will benefit, by an average of about \$40 a week.

This honours a key election pledge of both Coalition parties. It has not been a low cost option, but the Government is confident that the personal, educational, health, employment and social benefits that will flow from a better housed population will far outweigh the narrow commercial focus that has driven housing policy during the last decade.

Health

New Zealanders receive excellent health services from dedicated health workers. There is no doubt, though, that no amount of dedication and commitment can provide satisfactory service if the health system is poorly aligned and underresourced.

This Government is strongly committed to public health. We have committed \$412 million more to health in the coming year. Our commitment to a healthy nation is also reflected in the reorganisation of health services to put them more directly under the control of the communities they serve.

It is reflected also in a major new injection of \$257 million over the next four years into mental health. Mental health services have been dangerously underfunded for years, at the cost of considerable pain to people with mental illness and to the general community.

Disability support services receive an extra \$40 million over the next four years. Access to home support and personal care services is being improved, as is support to care givers.

And this Budget provides for more elective surgery: \$74 million a year more.

This financial allocation is not necessarily the most important health initiative, but it does symbolise the Government's commitment to facilitating social participation to the fullest possible extent.

Elective treatments could be seen as luxuries: not essential to the maintenance of life. But for those who need them and cannot afford them, the sentence can be exclusion. Participation must not be the preserve of those who can afford it. Funding elective health treatment is a statement that the Government is interested in social well-being, not just social welfare.

It is crucial that the gaps in health status between Māori and Pakeha are closed. Smoking is estimated to cause 4,700 deaths every year. Māori are twice as likely to smoke as non-Māori. We are therefore focusing on Māori with our investment of over \$20 million through the next four years for smoking cessation initiatives. Work is also being undertaken on further anti-smoking initiatives.

Social services

The extension of economic opportunity is not only the basis of economic prosperity, but also of social justice. Meeting the world's demand for innovation and quality requires that every one of us has the opportunity to contribute to New Zealand's economic and social renewal.

This in turn requires strong social institutions, strong families and strong communities that enable people and businesses to grow, adapt and succeed.

The Government has allocated \$36 million in the next financial year, increasing to almost \$40 million in 2003/2004, to the Department of Child, Youth and Family Services to continue improving the quality of its service, particularly for Māori and Pacific clients, and to enhance the role of the community in helping at risk groups.

This includes over \$1 million a year of extra funding to not-for-profit organisations providing family violence prevention services, including women's refuge.

Law and order

A substantial part of this speech has been devoted to removing the barriers to equitable participation in economic and social life. That is the best way of establishing a viable social fabric. There must be an acceptance, though, of social obligation.

Where there are rights there are also responsibilities. The Government therefore makes no apology for measures to strengthen the justice system, and to upgrade crime prevention. Sustainable communities are safe communities.

Youth crime and burglary are the stepping-stones to serious criminal careers. The Government is taking both a preventative and treatment approach to each problem. For youth crime this takes the form of youth mentoring projects and resourcing for Police to address youth offending. For burglary, the strategy is to prevent repeat burglary victimisation by funding education and security measures while also increasing funding for Police to target burglars.

In the past the criminal justice system has tended to focus on the perpetrators of crimes, while ignoring the victims. This Government will remedy that imbalance. We have extended services for victims and established a fund for them to attend court hearings outside their residential area.

We have also identified restorative justice as an alternative means of resolution that addresses the needs of the victim and the problems of the offender. Early success in pilot programmes and strong international evidence suggest that these strategies produce better results for both parties. An extra \$6.6 million over four years will be allocated to this purpose.

5 Nurturing the Environment

No economic or social system can survive if the ecological system within which it is located is not sustained.

The Government has announced that we intend to ratify the Kyoto Protocol on Climate Change by mid-2002 and has allocated funding of over \$2 million a year for work on measures to ensure that we are able to meet our climate change commitments.

Improving New Zealand's energy efficiency will help us meet these obligations. The Energy Efficiency and Conservation Authority is being established as a Crown entity, and is getting a \$3 million funding boost.

Many of New Zealand's indigenous species are unique to this country. This uniqueness makes responsibility for their continued existence entirely ours: the kiwi and the tuatara cannot be conserved in nature anywhere else on earth.

The New Zealand Biodiversity Strategy, released in March this year, sets out the Government's plan to halt the decline in New Zealand's indigenous biodiversity – our native species and the ecosystems that support them. It sets national goals, over a 20 year timeframe. The Government has made a commitment to provide additional funding of \$18 million in the coming year and up to \$28 million in the following year toward the achievement of these goals. This amount will then be increased by a further \$10 million each year, peaking at \$55 million in 2004/2005.

Implementation of the Biodiversity Strategy has begun already. Priority actions have been identified that will lead to the greatest gains for biodiversity in the first five years.

6 Building National Identity

Outside of work, New Zealanders express themselves and develop their talents through participation in the arts and music, through movement and sports, and in recreational pursuits.

It is with pride that the Government is able to talk about this in a budget statement and to make substantial financial allocations to the arts, to culture, and for sport and fitness programmes.

The Prime Minister and Minister for Arts, Culture and Heritage has already announced a package of \$146 million for the creative industries. We are allocating \$16 million to fund three high performance sports centres for the 2004 Olympic Games and another \$5 million for the 2003 America's Cup Defence.

To encourage emerging young sports talent, we are establishing funding for Sports Education Scholarships. These will assist athletes to juggle tertiary study with the demands of representing New Zealand at an international and elite level.

7 Revenue

This Government is committed to a robust, broad-based tax system that raises revenue both fairly and efficiently. We also want to ensure that the business and wider community have certainty about the way in which tax issues will be managed in the current term of this Government.

To this end we have adopted the following revenue strategy: "To generate the Government's revenue requirements at least possible economic cost, whilst supporting the Government's equity objectives."

This leads to the following tax policy priorities:

- maintaining revenue flows
- minimising the economic costs of the tax system
- tax simplification
- maintaining the integrity of the tax system by encouraging voluntary compliance and reducing avoidance, and
- maintaining a direct tax system augmented by broadly based indirect taxes.

We are continuing to strengthen anti-avoidance measures and to simplify tax compliance, particularly for small and medium sized businesses. Some of the recommendations outlined in the discussion document *Less Taxing Tax* are in the process of being legislated in the March and May tax bills this year. Other proposals from that document will be developed for legislation in the October bill this year.

Another initiative with the potential to simplify the way taxpayers interact with the Inland Revenue Department is the development of technology-based systems that expand the role of third party intermediaries in the tax system. Officials are working closely with business groups to further develop proposals in this area.

Other simplification ideas are on the drawing board or are under way, including the rewrite of the Income Tax Act and the post-implementation review of the compliance and penalties regime.

But we are also mindful that the tax system's fairness and efficiency is constantly challenged by changing technology, growing globalisation and its own increasing complexity. We will set up a broad-based and wide ranging tax review to advise on the principles and structures best suited to sustaining a robust revenue base over the long term.

I am reaffirming the Government's very clear commitment to seeking a popular mandate at the next election for any major recommendations made by the review.

Tax policy will not stand still until the review is completed. This Budget contains two new initiatives designed to maintain the tax base: we will move to prevent the inappropriate use of a trust for income-splitting with a minor; and we will remove the ability of a company to elect the 19.5% resident withholding tax when the 33 cent rate should apply.

Making forward provision for the ageing population

We have safeguarded the relative living standards of today's superannuitants by restoring the floor for New Zealand Superannuation to 65% of the average ordinary time net wage. We did this because we are committed to providing, from age 65, a universal pension that is capable of supporting a reasonable standard of living.

All the evidence suggests that this is very much what the New Zealand public wants and expects. The political challenge now is to deliver on that aspiration by putting New Zealand Superannuation onto a sustainable long-term footing.

The ratio of those aged 65 and over to those in the working age population is projected to more than double by 2051. This means that spending on New Zealand Superannuation and health are likely to grow faster than GDP.

The problem is not confined to New Zealand. It is not even most acute in New Zealand. But it does demand a response. There are no easy options. There is still time but the window of opportunity will soon blow shut.

We can prepare for this by setting aside an allowance now to smooth out the anticipated costs of supporting the baby-boomers in their retirement.

The Government has not yet finalised details of its policy approach towards prefunding. But the implications at a general level are clear. In the medium term, prefunding will require the Government to generate cash flows sufficient to meet our debt commitments and to make the necessary payments to the proposed New Zealand Superannuation Fund.

This means the Government must increase structural fiscal surpluses from current estimated levels, which means in turn, forgoing opportunities we would otherwise have had to increase spending or reduce taxes. But while it may appear attractive to increase spending or reduce taxes now, it is not responsible in view of future fiscal pressures.

The risk is in delays. If we do not act soon, and act decisively, a core element in our support structure will become unsustainable. At that point, future governments will have only three equally unpalatable options: large tax hikes, big cuts in the level of New Zealand Superannuation or tough age, work, income or asset tests to limit eligibility.

Conclusion

Education, housing, health and dignity in retirement are the core challenges of any civilised democracy. These programmes improve the participation of all New Zealanders in the full range of opportunities that a productive economy makes possible. The problem that we face as a society is that for too long participation has been a privilege, not a right.

This Budget begins to redress the balance. There is something in this Budget for everyone, but because capacity to engage in social life is uneven, improving that capacity will require more to be spent on those who have been excluded.

I have talked about enabling people to participate in a vibrant social democracy. That is a strand that runs through the broader design and particular detail of this Budget. We must acknowledge, though, that participation, to be effective, has to be sustainable.

The Government has set itself conservative fiscal targets and established tight financial disciplines. More work needs to be done to get full value for the public dollar. That aside, the Government is determined to maintain positive operating balances, on average, over the economic cycle.

The money we are spending is money we have raised. We are not raiding the piggy bank or mortgaging the future.

There is one regret. I would dearly have liked to have spent more on many deserving projects that would have contributed to our goals. They will have to wait. I have had to make grudging provision for what I have called the \$200 million pile of bones in the cupboard. I refer to a series of unrealistic spending cuts which had been built into budget baselines and which I have had to backfill.

At the start of this speech I indicated that the Budget 2000 was but one step in a longer journey. There is a lot to be done, and patience will need to be the country's watchword.

Patience will be rewarded if the measures we take are integrated and consistent with our overarching objectives. This Budget fuses the requirement to rebuild a democracy in which all of its citizens can feel a sense of belonging with the need for sustainable public finances, a sustainable economy and a sustainable environment.

This Budget reflects the objectives set out in the Speech from the Throne. There has been careful and responsible cooperation between Labour and the Alliance in working through these details. The result is a coherent programme reflecting the election platforms of Labour and the Alliance in the shared social goals of economic growth, social equity and environmental responsibility.

I am particularly grateful for the support from my Labour and Alliance Ministerial colleagues in charting a new course together. It will take many years to restore New Zealand's public, social and economic infrastructure. In this Budget, we make the new beginning that was expected by the people of New Zealand in the last election.

It reflects an exciting project, and one all New Zealanders can feel proud of.

Fiscal Strategy Report

The Fiscal Responsibility Act 1994 and the Fiscal Strategy Report

The Fiscal Responsibility Act 1994 requires the Government to show that it is acting in accordance with the principles of responsible fiscal management through a series of reports presented to the House of Representatives at various times during the financial year. The *Fiscal Strategy Report* is one of these reports and is required to:

- assess the extent to which the fiscal forecasts in the *Budget Economic and Fiscal Update* are consistent with the short-term fiscal intentions given in the *Budget Policy Statement*, and explain the reasons for any departures from those intentions (see Annex 2)
- include Progress Outlooks for ten or more years that:
 - include projections for the variables specified for long-term fiscal objectives, illustrating the likely future progress towards achieving those objectives
 - explain the reasons for any significant differences from previous Progress Outlooks (see Annex 3)
- assess the consistency of the Progress Outlooks with the long-term fiscal objectives given in the *Budget Policy Statement*, and explain the reasons for any departures of the Progress Outlooks from those objectives
- include an amended version of the Government's short-term fiscal intentions and long-term fiscal objectives where they have changed from those given in the *Budget Policy Statement* (see Annex 1).

Fiscal Strategy Report

Introduction

The broad framework for *Budget 2000* was set out in March in the *Budget Policy Statement 2000*. In that document I set out the Government's key goals and the parameters required to ensure that the Government manages our finances responsibly.

This *Fiscal Strategy Report* now provides an opportunity to revisit the statements we made in the *Budget Policy Statement*, and to update the progress we expect to make towards our stated objectives with a more formal longer-term perspective.

One of this Government's goals is restoring trust in government, in its institutions and processes. The *Budget Policy Statement* and the *Fiscal Strategy Report* are an opportunity to be open and transparent about the framework within which the Budget is prepared, and about how the Budget compares to the Government's financial intentions.

Fiscal Policy Overview

The Government has taken an integrated approach to setting fiscal policy for this Budget, for the next ten years, and over the period further out when the demographic pressures begin to bite. We remain committed to achieving the fiscal policy objectives we outlined in the *Budget Policy Statement*. In putting together the Budget, we have kept in mind the impact that decisions today will have on the progress we make towards those objectives. And in setting the long-term fiscal objectives, we took account of the fiscal implications of the ageing population.

The Government believes that our objective to reduce gross debt to below 30% of Gross Domestic Product (GDP) and net debt to below 20% of GDP is fiscally prudent. As explained in the *Budget Policy Statement*, debt is now relatively low in both historical and international terms.

The Government considers, as a general rule, that keeping revenues and expenses in at least broad balance on average, would be an appropriate fiscal policy consistent with good economic performance. This approach allows the automatic fiscal stabilisers to operate across the economic cycle, so taking pressure off monetary policy and reducing fluctuations in employment and output. However, the Government will increase fiscal surpluses from their current levels. This is because the Government’s plan to partially prefund the increase in New Zealand Superannuation (NZS) expenses associated with population ageing, as outlined in the *Budget Policy Statement*, is based on running fiscal surpluses.

Fiscal Implications of Population Ageing

In setting fiscal policy, we need to recognise that New Zealand’s population, like that of many developed nations, is ageing. The ratio of those aged 65 and over to those in the working age population is projected to more than double by 2051. This means that government spending on NZS and Health are likely to grow faster than GDP.

Retirement income implications

Projections show that the cost of NZS (net of tax) rises from 4% of GDP now to 9% of GDP over the next 50 years. These long-term projections require us to make assumptions about such uncertainties as future net migration, fertility and mortality rates. Notwithstanding these issues, the number of retirees over the next 50 years can be reasonably well projected (they are already born).

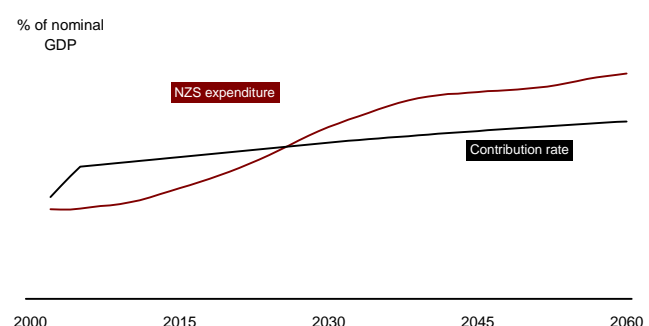
NZS is indexed to average wages, which means there is a link to GDP. This means that economic growth is unlikely to generate the extra 5% of GDP needed to cover the higher cost of NZS.

The Government is determined to preserve a universal publicly funded pension and the link between that pension and the average wage, without having to resort in future to a significant increase in the average tax rate. We have the opportunity now to set aside contributions in a fund to meet some of the future costs associated with the provision of retirement income.

Currently, the annual cost of NZS is met by taxes of those in the workforce. Partially prefunding NZS requires the Government to “pay in advance” a part of the future costs, rather than solely relying on “pay as you go”.

The Government has not yet finalised the policy approach towards partial prefunding. However, we have made a number of working assumptions, as outlined in Annex 4, based on development work since the *Budget Policy Statement*.

Figure 1 – Partially prefunding NZS



Source: The Treasury

Figure 1 is a stylised representation illustrating how the “pay in advance” approach operates. During the period to around 2025, the excess of the contribution rate over each year’s NZS costs will be retained in a fund. In the short-term, contributions to the NZS Fund are somewhat lower than the required contribution rate, because the Government is re-building operating surpluses¹. As shown in Figure 1, after the transition period the amount of “retained” contribution declines. In later years, when the costs of NZS exceed the contribution rate, the balance is generated from the Fund.

The effect of the approach is to smooth the costs of NZS so that they are paid at a more even rate over time. The contribution rate is initially higher than the current “pay as you go” cost of NZS alone. Given demographic projections beyond the next 40 years (the working assumption time horizon), the rate is likely to rise through time (see Annex 4). However, the smoothing effect means that the “pay as you go” element further out is lower than it would otherwise have been. The degree of smoothing actually achieved will be influenced by demographic trends and the rate of return on Fund assets.

Implications for other areas of government spending

Over the next 50 years, population ageing is likely to affect other areas of the budget, especially Health spending. Compared to NZS, projections for future Health spending are more problematic. Increasing per capita incomes may lead to higher demand for services. New technologies may reduce the cost of some services, but create a demand for new services that we cannot even imagine today. The effect of population ageing on future Health costs will also depend on the degree to which longer life shifts health care costs to later ages, rather than extending the period of care.

On the other hand, the structural change in our population may reduce cost pressures in areas such as education that are primarily used by young people. Other areas of government expenditure such as administration and defence are less sensitive to changes in the population structure.

Overall, the share of government expenses in GDP is likely to rise as a result of population ageing. Because it seems probable that NZS expenses will increase, it is responsible to put in place now measures to help deal with them. This has motivated the Government’s approach to NZS. The approach to partially prefunding NZS is a major step forward in dealing with the projected rise in expenses.

However, the Government has not decided how to respond to the increased future costs beyond the partial prefunding of NZS. Rather, we will respond to them progressively as they become more certain over time. As the demographic pressures approach, we will continue to evaluate and adjust our fiscal policy approach. We recognise that, depending on how they develop, we may need to revise our approach to meeting them. In the interim, we will adopt a cautious approach to ensure that we meet our long-term fiscal objectives as the demographic pressures impact.

¹ The “retained” contributions to the NZS Fund in the transition path are assumed to be \$600 million in 2001/02, \$1.2 billion in 2002/03, and \$1.8 billion in 2003/04, the same as those assumed in the *Budget Policy Statement*.

Fiscal Indicators

In the *Budget Policy Statement*, we said that we would look at a wider suite of fiscal indicators to see whether they can be used to further enhance the assessment of the Government's finances and explain our policy approach.

Debt indicators

The key indicator of progress towards the Government's debt objective has been net debt. Net debt is the value of selected government financial liabilities less selected financial assets, including student loans. A number of issues point to an increased focus on gross debt.

- Gross debt is a more appropriate indicator of the amount of funding that the government is requiring from capital markets through borrowing. Higher funding requirements may increase the Crown's cost of borrowing and the cost of private sector borrowing.
- The definition of net debt is somewhat arbitrary and varies across countries. The usefulness of net debt as a fiscal measure can be affected by the type and quality of the financial assets that are included in the net debt definition. Gross debt might provide a more appropriate basis for international comparisons.
- Gross debt is in line with the concept of total Crown debt in the Fiscal Responsibility Act 1994, which seeks to ensure responsible fiscal management by reducing total Crown debt to prudent levels.
- When the government borrows to fund advances, such as student loans, gross debt increases but the face value of net debt remains unchanged. As more students borrow, the difference between gross and net debt grows. If this difference became more significant, it could raise questions about what is the most appropriate measure for progress towards our debt objective.

This *Fiscal Strategy Report* has included ten-year projections of gross debt and net debt. At this stage we are not changing the specification of our long-term debt objective, which includes both gross and net debt. Over the next few months we will consider the merits of using gross debt as the key debt indicator. We will need to consult key users of the Government's financial statistics, and to consider whether historic cost or market value is the most appropriate basis for measuring gross debt. Either way, net debt will continue to be published and will remain an indicator of the Government's debt burden.

Long-term fiscal indicators

Projections of the Long-term Fiscal Model are used to illustrate the fiscal position over time periods that capture demographic changes (for example, 50 years). But it is also possible to capture these longer-term fiscal pressures in a single numerical indicator, such as generational accounting, comprehensive net worth, and the fiscal gap.

In the next few months, we will look at whether there are credible and robust indicators that will help us communicate more transparently the projections of the fiscal position in the long term. In particular, the Government will be looking at the fiscal gap. The fiscal gap shows the difference between the current tax rate and the tax rate required to fund a particular path of future expenses, for a given level of debt at the end of the projection period.

Progress Outlooks (10-year Fiscal Projections)

The Government's long-term fiscal objectives embody our view of the appropriate fiscal position over the longer-term. We set our long-term fiscal objectives with future increases in NZS expenses in mind. Our fiscal policy approach over the next ten years also recognises other potential expense pressures over the next 50 years.

The Progress Outlooks are ten-year fiscal projections that illustrate the progress that the Government is likely to make towards our long-term fiscal objectives, given a number of assumptions².

Projection Assumptions

Until 2003/04, the Progress Outlooks are the fiscal forecasts in the *Budget Economic and Fiscal Update* 2000. This includes the fiscal provision of \$5.9 billion over 1999/2000 to 2002/03, and a technical assumption of \$800 million in 2003/04 (see *Budget Economic and Fiscal Update* for details).

Beyond 2003/04 the Progress Outlooks use spending and tax assumptions that are illustrative and represent the Government's general approach rather than specific policy intentions. In particular, the assumptions surrounding the NZS Fund are working assumptions and subject to further policy development. (See Annex 3 for details of the projection assumptions and Annex 4 for prefunding working assumptions.)

The Progress Outlooks include a "fiscal allowance" that indicates the fiscal flexibility that the Government has for such things as spending and revenue initiatives, accelerating contributions to the NZS Fund, and responding to developments in the economic and fiscal position that differ from our projection. For the purposes of the ten-year projections, the fiscal allowance has been set at \$1.2 billion per year beyond 2003/04 and has been allocated to expenses. It provides a broad indication of flexibility rather than a specific policy commitment.

This allowance is not directly comparable to the \$600 million fiscal allowance assumed in the 1999 *Fiscal Strategy Report*. After taking into account changes to the assumptions, the \$1.2 billion is broadly equivalent to \$860 million under the 1999 *Fiscal Strategy Report* approach³.

Undoubtedly, the future will turn out differently than the ten-year projections show. If economic growth is lower than the rates built into the projections, or if there is an erosion of the revenue base as a result of new forms of Internet trading or similar, less would be available for any new fiscal initiatives. As events unfold, the Government will review the fiscal allowance and the path of the projected operating surplus on a regular basis so that we continue to meet our long-term fiscal objectives.

² The Progress Outlooks are required by the Fiscal Responsibility Act 1994. Longer-term projections of this type are also used as part of other countries' budgetary processes, such as the US and UK.

³ Changes to the assumptions used in the Long-term Fiscal Model relating to fiscal drag, benefit indexation, and the treatment of GST account for the difference. See Annex 3, Tables 7 and 8 for details of the changes to the assumptions.

Projection Results

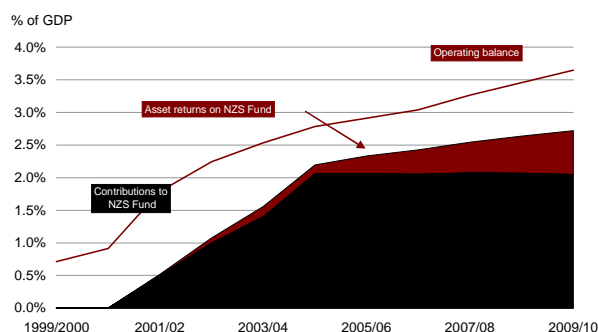
The Progress Outlooks show that under reasonable assumptions the Government’s policies are consistent with meeting our fiscal objectives.

Partial prefunding of NZS will require cash flows sufficient to maintain the debt objective and to make the necessary contributions to the Fund⁴. The projection for the operating balance in Figure 2 shows that the Government is able to build up surpluses from where we are now sufficient to meet the cash flow requirements for debt, for prefunding goals and for other capital requirements. Leaving aside the contribution to the NZS Fund, the operating balance is consistent with keeping expenses and revenues at least in broad balance.

During the transition to prefunding, the Government needs to build structural (cyclically adjusted) operating surpluses. By increasing fiscal surpluses, the Government is effectively forgoing opportunities we would otherwise have had to increase spending or reduce taxes. While it may appear attractive to increase spending or reduce taxes now, it is not responsible in view of future fiscal pressures.

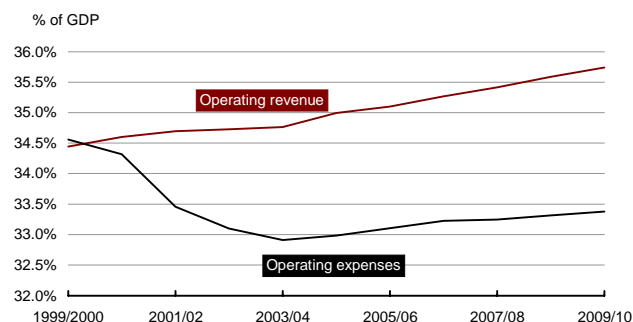
There are considerable uncertainties around the strength of the fiscal position in both the forecast period and the ten-year projections. Even under more unfavourable economic assumptions the Government continues to meet our long-term fiscal objectives – confirmation that our fiscal policy is robust and prudent.

Figure 2 – Operating balance



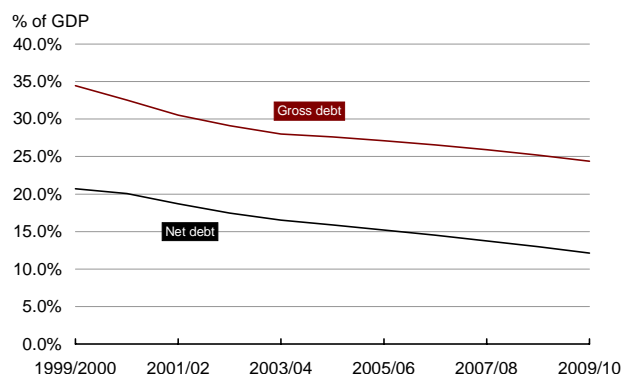
Source: The Treasury

Figure 3 – Revenue and expenses (revenue excludes SOE/CE surpluses)



Source: The Treasury

Figure 4 – Gross and net debt

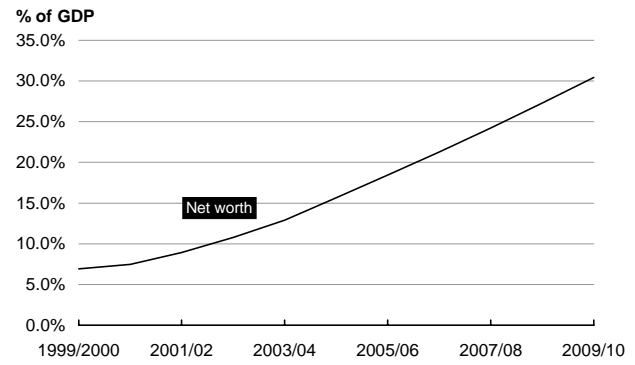


Source: The Treasury

⁴ These contributions reflect the “retained” component in Figure 1. Because any contributions used to build up Fund assets will be capital contributions, they do not impact on the operating balance. Instead, payment to the Fund is disclosed in the Statement of Cash Flows. A separate line has also been included in the Statement of Financial Position illustrating the growth in the Fund.

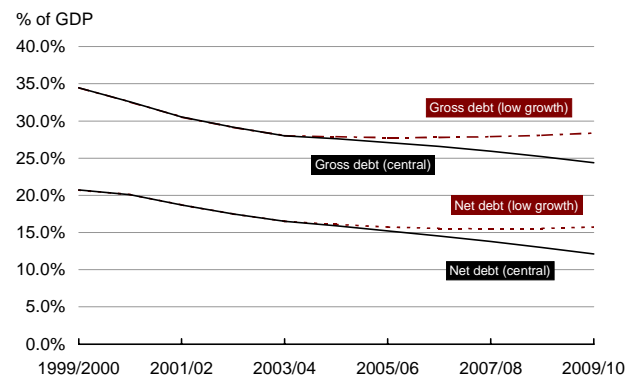
Figure 6 presents an alternative projection that demonstrates this. For the purpose of these projections, labour productivity growth is assumed to be lower for a prolonged period, and all other assumptions used in the previous projections have been held constant. Projections of net and gross debt under the alternative assumptions show that the Government’s fiscal policy plan will still be consistent with achieving its debt objective over the next ten years.

Figure 5 – Net worth



Source: The Treasury

Figure 6 – Net and gross debt alternative projections

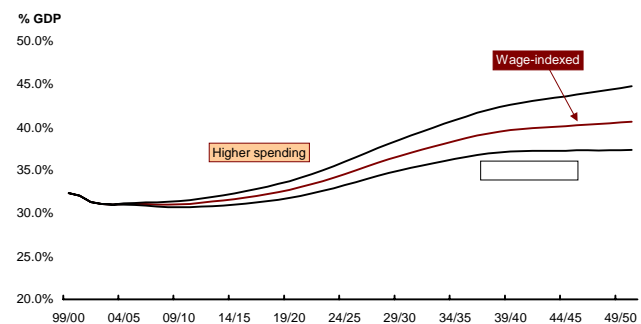


Source: The Treasury

50-year Fiscal Scenarios

As noted above, the Government will be deciding how to deal with the longer-term expense pressures as they become clearer. While these developments are quite uncertain, demographic factors are likely to increase future expenses. To illustrate this, Figure 7 provides “what if?” scenarios of (non-finance) expenses over the next 50 years. These scenarios give a context for interpreting the Government’s fiscal stance over the next ten years. All three scenarios incorporate the likely change in NZS expenses, together with alternative assumptions for other expense areas (see Annex 3 for details)⁵.

Figure 7 – Non-finance expense scenarios



Source: The Treasury

These scenarios are subject to uncertainty regarding demographic changes, technology, social trends and behavioural responses. They also require assumptions about the future role of government. Whether to continuously increase benefits in line with real incomes, or meet higher demand for health services as incomes rise, are choices for future governments.

The Government is committed to achieving our long-term fiscal objectives in the face of likely future increases in expense pressures. This includes maintaining the expense objective over the longer-term.

The fiscal strategy the Government has adopted means that it will be well placed when the demographic pressures impact. First, as the Progress Outlooks above show, expenses run down below 35% of GDP over the next 10 years. This means that there will be greater headroom for demographic changes to increase expenses while remaining consistent with our long-term expense objective. Second, debt falls below the levels we regard as prudent, reducing financing costs and giving greater scope for other expenses to rise. Third, the Government’s proposal to prefund NZS means that some of the increased expenses will be met by the Fund rather than by taxation, meaning that taxation can run below the increased expenses. In addition, the Government will consider other options for dealing with the longer-term expense pressures. For example, the Government could use some of the fiscal allowance to repay debt and therefore increase the extent of prefunding.

The Government intends to monitor developments annually and make adjustments around a rolling ten-year fiscal horizon to ensure that its long-term fiscal objectives are met.

⁵ In the Wage-indexed scenario, expenses driven by demographic factors (health, education and most welfare benefits) increase by 1.5% a year in real per capita terms, the same as average labour productivity growth. In the case of the Higher Spending scenario, Health and Education spending increase at 2% a year in real per capita terms. In contrast, the Lower Spending scenario constrains Health and Education real per capita spending to 1% per year.

Short-term Fiscal Policy

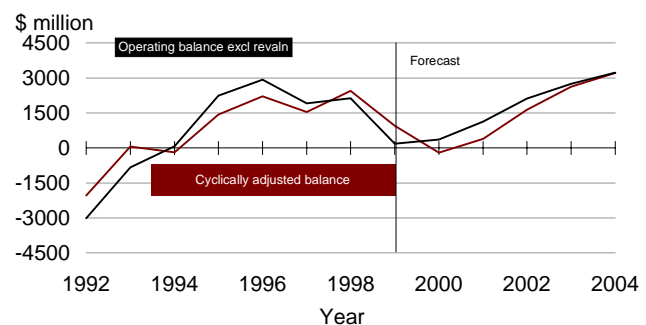
As noted above, the Government has set its fiscal policy plans in the short-term so that they are consistent with making progress towards our long-term fiscal objectives. The fiscal impact of these plans over the next four years are outlined in the *Budget Economic and Fiscal Update* and are discussed below.

Operating Balance and Debt

The Government will build operating surpluses over the next four years.

The fiscal forecasts in the *Budget Economic and Fiscal Update* show the operating balance rising from \$763 million in 1999/2000 to \$3,222 million in 2003/04. Part of the operating surplus in 1999/2000 is the result of positive revaluation movements. For example, the forecast operating balance in 1999/2000 will be boosted by around \$500 million from ACC and GSF liability valuation movements. The operating balance excluding revaluations is shown in Figure 8.

Figure 8 – Estimated cyclically adjusted balance



Source: The Treasury

Because the operating balance is influenced by cyclical fluctuations as well as structural factors, the Government is interested in the structural (or cyclically adjusted) fiscal position⁶. The estimated cyclically adjusted fiscal balance is shown in Figure 8. The estimated cyclically adjusted balance also removes the effects of some revaluation movements, such as ACC and GSF liability valuation movements, which are subject to volatility.

The fiscal position is currently in broad balance in a structural sense. The forecast operating surplus itself is stronger than the estimated cyclically adjusted fiscal balance as a result of the economic upswing.

⁶ In considering the fiscal position, it is important to focus on trends and to abstract from short-term fluctuations about the trends. These fluctuations occur because actual output in the economy fluctuates about its productive potential. The cyclically adjusted fiscal balance corrects the operating balance for these fluctuations and so provides a picture of the underlying trend fiscal position. This provides an indication of the effects of policy decisions on the operating balance.

The calculation of the cyclically adjusted balance is based on a number of assumptions, such as estimated potential output and the responsiveness of tax revenues and unemployment spending to fluctuations in economic growth. Because these assumptions are based on, and are sensitive to, the latest information available, the estimated cyclically adjusted balance is subject to some uncertainty. Trends in the cyclically adjusted balance are, however, more reliable.

As noted earlier, broad balance is not sufficient to meet both the Government’s debt objective and partial prefunding commitments. In the transition to prefunding, the Government will be building up the contribution rate to the NZS Fund. This requires that the structural fiscal position be strengthened over the next few years – meaning there will be less scope for increases in spending than in the absence of prefunding. This should help reduce the pressure on monetary policy.

If the economic cycle turns out different to expectations, the Government will keep tax and spending plans unchanged and let the automatic fiscal stabilisers operate. This should support monetary policy, help moderate cyclical movements in interest rates and the exchange rate, and contribute to sustainable economic growth.

Increasing structural fiscal surpluses from estimated current levels should also help mitigate the vulnerability arising from New Zealand’s large current account deficit. In particular, sound fiscal policy should help maintain investor confidence, and so limit unwarranted and disruptive swings in interest rates and the exchange rate.

The surpluses resulting from the economic upswing and the improving structural position are more than sufficient to meet the contributions to the NZS Fund. As a result, gross and net debt are projected to fall over the next few years.

Table 1 – Debt and prefunding (% GDP)

	1999/2000	2000/01	2001/02	2002/03	2003/04
Net debt	20.7%	20.1%	18.7%	17.5%	16.5%
Gross debt	34.5%	32.5%	30.5%	29.1%	28.0%
Cumulative fund contributions	-	-	0.5%	1.5%	3.0%

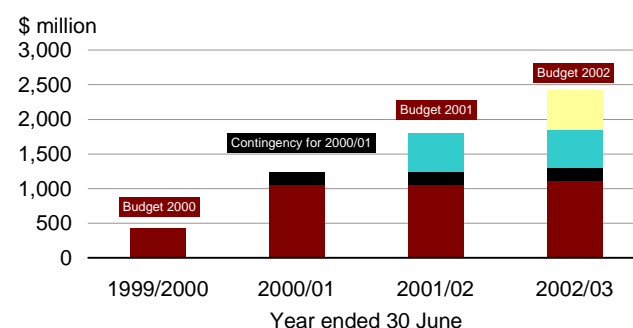
Source: The Treasury

Expenses and Revenues

The Government has set its short-term spending and revenue plans so as to build structural fiscal surpluses, as shown above.

The Government’s expense track includes a fiscal provision of \$5.9 billion (GST inclusive) for the next four years to be used on priority policy objectives. The Government has set this fiscal provision so that it is consistent with our long-term fiscal objectives. The allocation of the provision has been finalised during the Budget 2000 process on a cumulative basis at (GST inclusive) \$420 million for 1999/2000, \$1.2 billion in 2000/01, \$1.8 billion in 2001/02, and \$2.4 billion in 2002/03⁷.

Figure 9 – Revised allocation of provisions



Source: The Treasury

⁷ A technical fiscal provision of an additional \$800 million (GST inclusive) has been incorporated into 2003/04.

Although the Government has remained within the indicative fiscal provision of \$5.9 billion set out in the *Budget Policy Statement*, we have brought forward spending by around \$300 million into the first two years of the forecast horizon. Therefore, allocations for future budgets have been reduced.

There are a number of reasons why we have chosen to commit more of the allocation in Budget 2000 than in the Budgets for the following two years:

- The Government has chosen to honour what it considers to be high priorities in the first year. Now that most of these have been implemented, we do not expect the same volume of new policy in future budgets.
- In some areas, existing levels of baseline funding were inadequate. We have chosen to address these issues in the Budget 2000 package, as we believe it is important that ongoing baseline funding is set at a level that can credibly deliver the Government's policy commitments.

The Government is determined to get better value out of available resources and is working to identify low value spending in existing baselines. Identifying areas for potential reprioritisation will help the Government to fund more new initiatives in future budgets.

The Government is committed to a robust, broad based tax system that raises revenue both fairly and efficiently. We have introduced a new 39 cent tax step on income over \$60,000 and have ruled out, for this term, any other increases in personal tax rates, company tax rates or GST.

We are continuing to strengthen anti-avoidance measures and to simplify the tax system, particularly for small and medium sized businesses.

Together, these expense and revenue measures will help ensure that the Government builds structural surpluses and meets our long-term objectives.

Future Developments in the Long-term Fiscal Objectives

The Government's long-term fiscal objectives reflect our view about the appropriate size and role of government and about prudent fiscal policy. There are a number of developments that could require these objectives to be re-examined in the future:

- As the Government develops its policy approach towards future demographic pressures, we will re-examine the long-term fiscal objectives in order to provide greater clarity. For example, following the transition period to the NZS Fund, the Government may want to more clearly signal the period over which it will run surpluses to build up NZS Fund assets.
- Line by line consolidation is due to be introduced in the 2002 Budget, in line with Generally Accepted Accounting Practice (GAAP). This will have implications for the specification of the long-term expense and debt objectives⁸.
- In a few months time, Statistics New Zealand is scheduled to release a comprehensively revised set of GDP data. Statistics New Zealand has indicated that the changes are likely to increase the measured level of nominal GDP by something in the order of 3%. The long-term objectives may have to be re-examined because they are expressed as a % of GDP.
- As outlined in the fiscal indicator box on page 20, the Government is considering using gross debt as the key debt indicator. This could eventually lead the Government to specify its long-term debt objective in terms of gross debt rather than both net and gross debt. Any decisions will depend on the outcome of discussions with key users of the Government's financial statistics. The move to line by line consolidation will also have a material effect on gross debt. The Government will need to consider whether gross debt inclusive of SOE and CE debt is the appropriate debt objective.

Any re-specification will not change the intent of the Government's long-term fiscal objectives.

The merits of recognising NZS as a liability on the Crown's balance sheet, as foreshadowed in the *Budget Policy Statement*, have been examined. The liability will not be recognised for the following reasons:

- There is currently little to distinguish NZS from other government responsibilities such as other income support arrangements or education and health commitments.
- When the amount payable is subject to change by the entity, it is not usual accounting practice to consider it a liability.
- Existing practice is consistent with treatments adopted by governments in other countries.

⁸ Line by line consolidation will not affect reported net worth and the operating balance, but as SOE and Crown entity revenues, expenses, assets and liabilities are included with each revenue, expense, asset and liability line in the financial statements, the reported value of these items will increase. The change will have a significant effect on total operating expenses-to-GDP and gross debt. Based upon present figures, there will be no material change to the reported net debt figure.

Conclusion

The *Budget Policy Statement* released in March set out the broad framework for *Budget 2000* and the Government's thinking on fiscal policy. The Government has taken an integrated approach to setting fiscal policy for this Budget, over the next ten years, and over the period further out when population ageing begins to take effect.

Although the fiscal implications of population ageing are uncertain, it seems probable that expenses will increase. This prospect has motivated the Government's view that some of the future costs of NZS should be met on a "pay in advance" basis. Given the importance of the issue, the Government is taking a measured approach to policy development. This *Fiscal Strategy Report* has outlined the essence of partial prefunding and a set of working assumptions. In addition, the Government is taking a cautious approach to create headroom for expenses to grow in the future while remaining consistent with our expense objective.

The Government has not decided how to respond to future fiscal pressures beyond the partial prefunding of NZS. But as the demographic pressures approach, we will continue to evaluate and adjust our fiscal policy approach.

The Government's fiscal policy over the short-term, expressed through our expense and revenue plans, will see a strengthening of the structural fiscal position. Through the next ten years our approach will build fiscal surpluses, meet our debt and prefunding goals, and leave some scope for future initiatives. However, there is uncertainty about the economic outlook, especially beyond the four-year forecasts. The Government will take a prudent approach that involves ongoing reviews of where we are heading, and balances the longer-term fiscal pressures with the needs of today.

Hon Dr Michael Cullen
Treasurer and Minister of Finance

8 June 2000

Annex 1

Short-term Fiscal Intentions and Long-term Fiscal Objectives

The Fiscal Responsibility Act 1994 requires the *Fiscal Strategy Report* to include an amended version of the Government's short-term fiscal intentions and long-term fiscal objectives where they have changed from those given in the *Budget Policy Statement*. An amended version of the Government's short-term fiscal intentions is set out below. The Government's long-term fiscal objectives are also given for convenience.

	Short-term fiscal intentions	Long-term fiscal objectives
Operating balance	On current forecasts, operating balances will be \$0.8 billion in 1999/00, \$1.0 billion in 2000/01, \$2.1 billion in 2001/02, and \$2.7 billion in 2002/03.	Operating surplus across the economic cycle to ensure: <ul style="list-style-type: none"> Government revenues and spending (excluding the allowance for funding the costs associated with the ageing population) are at least in broad balance and net debt is below 20% of GDP an allowance for prefunding the costs associated with the ageing population.
Crown debt	If forecast economic conditions prevail, gross Crown debt and net Crown debt will be \$36.3 billion and \$21.8 billion in 1999/00, \$36.1 billion and \$22.3 billion in 2000/01, \$35.6 billion and \$21.8 billion in 2001/02, and \$35.4 billion and \$21.3 billion in 2002/03. In 2002/03 gross and net Crown debt will be 29.1% and 17.5% of GDP respectively.	Gross debt below 30% of GDP, consistent with net debt (excluding the accumulated allowance for funding the costs associated with the ageing population) below 20% of GDP, across the economic cycle.
Operating expenses	On current forecasts, operating expenses will be \$36.4 billion in 1999/00, \$38.1 billion in 2000/01, \$39.0 billion in 2001/02, and \$40.3 billion in 2002/03. If forecast economic conditions prevail, expenses will be 33.1% of GDP in 2002/03.	Expenses around current levels of 35% of GDP.
Operating revenues	On current forecasts, operating revenues will be \$36.3 billion in 1999/00, \$38.4 billion in 2000/01, \$40.4 billion in 2001/02, and \$42.2 billion in 2002/03.	Raise sufficient revenue to meet the operating balance objective. A robust, broad-based tax system that raises revenue in a fair and efficient way.

	Short-term fiscal intentions	Long-term fiscal objectives
Crown net worth	Subject to forecast economic conditions prevailing, net worth will be \$7.3 billion in 1999/00, \$8.3 billion in 2000/01, \$10.4 billion in 2001/02, and \$13.1 billion in 2002/03.	The Government will increase net worth.

The long-term fiscal objectives are the same as those specified in the *Budget Policy Statement*. The short-term intentions have been changed to reflect the fiscal forecasts in the *Budget Economic and Fiscal Update*. These changes are outlined in Tables 2, 3 and 4 of Annex 2.

Annex 2

Fiscal Forecasts and Consistency with Short-term Intentions in the *Budget Policy Statement*

The Fiscal Responsibility Act 1994 requires the *Fiscal Strategy Report* to assess the extent to which the fiscal forecasts in the *Budget Economic and Fiscal Update* are consistent with the short-term fiscal intentions given in the *Budget Policy Statement*, and explain the reasons for any departures from those intentions

The *Budget Economic and Fiscal Update's* fiscal forecasts are set out in Tables 2 and 3 below. Changes in fiscal variables since the *Budget Policy Statement* are presented in Table 4. Changes in fiscal forecasts are largely the result of changes in macro-economic assumptions (see *Budget Economic and Fiscal Update*)⁹.

Table 2 – Four-year fiscal forecasts (\$ million, June years)

Nominal	1999/2000		2000/01		2001/02		2002/03	
	2000 BPS	2000 FSR	2000 BPS	2000 FSR	2000 BPS	2000 FSR	2000 BPS	2000 FSR
Net worth	6,825	7,304	7,825	8,316	9,725	10,407	11,925	13,140
Net debt	22,701	21,819	22,977	22,282	22,669	21,796	22,832	21,265
Gross debt	35,017	36,337	35,363	36,092	35,212	35,561	36,174	35,442
Revenues	36,272	36,320	38,229	38,370	40,309	40,419	42,072	42,239
Expenses	36,372	36,428	37,888	38,057	39,041	38,973	40,561	40,256
Operating balance	400	763	1,000	1,012	1,900	2,091	2,200	2,733

Source: The Treasury

Table 3 – Four-year fiscal forecasts (% GDP, June years)

	1999/2000		2000/01		2001/02		2002/03	
	2000 BPS	2000 FSR	2000 BPS	2000 FSR	2000 BPS	2000 FSR	2000 BPS	2000 FSR
Net worth	6.6%	6.9%	7.1%	7.5%	8.4%	8.9%	9.9%	10.8%
Net debt	21.8%	20.7%	20.9%	20.1%	19.6%	18.7%	18.9%	17.5%
Gross debt	33.7%	34.5%	32.1%	32.5%	30.5%	30.5%	30.0%	29.1%
Revenues	34.9%	34.5%	34.7%	34.6%	34.9%	34.7%	34.9%	34.7%
Expenses	35.0%	34.6%	34.4%	34.3%	33.8%	33.5%	33.6%	33.1%
Operating balance	0.4%	0.7%	0.9%	0.9%	1.6%	1.8%	1.8%	2.2%

⁹ The total revenue and expenses as published in the *Budget Policy Statement* have been restated slightly for a classification change. The impact is to increase revenue and increase expenses slightly.

Source: The Treasury

Table 4 – Changes in fiscal forecasts since *Budget Policy Statement* (\$ million)

Change	1999/2000	2000/01	2001/02	2002/03
Net worth	479	491	682	1,215
Net debt	(882)	(695)	(873)	(1,567)
Gross debt	1,320	729	349	(732)
Revenues	48	141	110	167
Expenses	56	169	(68)	(305)
Operating balance	363	12	191	533

Source: The Treasury

The short-term intentions in the *Fiscal Strategy Report* differ from those in the *Budget Policy Statement* because of changes in the fiscal forecasts. Overall, the changes are minor, reflecting the fact that the economic forecasts in the *Budget Economic and Fiscal Update* are broadly similar to those in the *Budget Policy Statement*.

The specific changes to the fiscal aggregates, as compared with those in the *Budget Policy Statement*, include:

- Operating expenses – policy initiatives over the years 1999/2000 to 2002/03 remain within the Government’s \$5.9 billion limit. However, the Government has brought forward spending into the early years of the forecast horizon. Expense forecasts are higher in 1999/2000 and 2000/01, and lower in 2001/02 and 2002/03.
- Operating revenues – tax revenues are marginally higher in all years, due to a small improvement in the nominal economic outlook. From 2000/01 onwards, tax revenue forecasts are also increased due to the increase to the tobacco excise rate and the freezing of tariff rates at their present levels.
- Operating balance – the operating balance is slightly higher in all years. Tax revenue is marginally higher and benefit spending is lower. Favourable liability revaluations of around \$500 million improve the operating balance in 1999/2000.
- Crown debt – net debt is lower in all years. Gross debt is higher up to 2001/02, and is lower in 2002/03.
- Crown net worth – net worth is higher in all years, reflecting higher operating balances.

These changes are covered in more detail in the *Budget Economic and Fiscal Update*.

Annex 3

Assumptions Used in the Forecasts, Projections and Scenarios

For convenience, this Annex summarises in one place the assumptions used in producing the four-year forecasts, the ten-year Progress Outlook projections, and the 50-year scenarios. From 1999/2000 to 2003/04, all projections and scenarios incorporate the economic and fiscal assumptions detailed in the *Budget Economic and Fiscal Update*. This Annex also meets the Fiscal Responsibility Act 1994 requirement to explain the reasons for any significant differences from the previous Progress Outlooks.

Economic and demographic assumptions

The key economic assumptions used in the forecasts, projections and scenarios are summarised in the table below.

Table 5 – Summary of economic assumptions (June years)

	2000/01	2001/02	2002/03	2003/04	2004/05 to 2009/10	2004/05 to 2050/51
Real GDP ¹⁰ (annual average % change)	3.0	2.6	2.2	2.7	2.3 ¹¹	1.5 ¹¹
Consumer Price Index (annual average % change)	2.3	2.3	2.2	1.8	1.5	1.5
Interest rates: 90-day bill rate (quarterly average %)	7.8	7.8	7.5	6.5	6.0	6.0
Interest rates: Government 10-year bonds (quarterly average %)	7.6	7.5	7.4	7.3	7	7
Household Labour Force Survey unemployment rate (annual average %)	5.8	5.4	5.7	5.7	6.0	6.0

Source: The Treasury

NOTE: Real GDP growth averages 1.8% over the period 2004/05 to 2009/10 in the case of the lower economic growth ten-year projection.

The following assumptions apply to both the ten-year Progress Outlook projections and the 50-year fiscal scenarios beyond 2003/04:

- Changes in nominal GDP drive tax revenues. Nominal GDP grows in line with labour productivity (average annual rate of 1.5%), projected changes in the labour force, and inflation (average annual rate of 1.5%).

¹⁰ Production-based measure.

¹¹ Real GDP growth from 2004/05 to 2050/51 is calculated as the product of labour productivity and labour force growth.

- In the ten-year projection assuming lower economic growth, labour productivity grows at 1% a year from 2004/05.
- Expense projections (see below) are influenced by demographic trends. These trends are based on Statistics New Zealand population projections with medium fertility, medium mortality and net migration of 5000 a year.
- The labour force projections, which together with assumed labour productivity drive real GDP growth, are from Statistics New Zealand. They are consistent with the population projections above and use medium labour force participation assumptions.

Fiscal assumptions beyond 2003/04

The ten-year projections incorporate a “fiscal drag” effect on tax revenue. If the Government made no changes to tax rates, as incomes increase over time, taxpayers earn relatively more income in the higher tax brackets. This implies an effective increase in average tax rates (referred to as “fiscal drag”). The result is that tax revenues would increase by around 0.5% of GDP by 2010.

Beyond 2003/04, the 50-year scenarios are projected differently than the ten-year Progress Outlooks. However, over the period to 2009/10, the expense track of the Wage-indexed scenario is broadly equivalent to the expense track in the ten-year Progress Outlook.

The following table summarises the assumptions used in projecting expenses and capital beyond 2003/04.

Table 6 – Summary of expense and capital assumptions

	10-year Progress Outlooks: 2004/05–2009/2010	50-year Fiscal Scenarios: 2004/05–2050/51
NZS	Demographically adjusted and grows in line with nominal wages after reaching 65% of the average wage	
Benefits	Demographically adjusted and indexed to inflation	Demographically adjusted and indexed to wages
Health	Demographically adjusted	Demographically adjusted. Increases at 1.5% a year in real per capita terms under Wage-indexed scenario. Increases at 2% and 1% a year in real per capita terms in Higher Spending and Lower Spending scenarios respectively
Education	Demographically adjusted	Demographically adjusted. Increases at 1.5% a year in real per capita terms under Wage-indexed scenario. Increases at 2% and 1% a year in real per capita terms in Higher Spending and Lower Spending scenarios respectively
Other	Not demographically adjusted	Increases at 1.5% a year in real terms

	10-year Progress Outlooks: 2004/05–2009/2010	50-year Fiscal Scenarios: 2004/05–2050/51
Fiscal allowance	\$1200 million increasing at a real growth rate of 1.5% a year. Although the fiscal allowance covers both revenue and expenses, for the purposes of the ten-year projections, the initiatives are allocated to Health, Education and Other expenses.	Not applicable
Finance costs	A function of debt levels and interest rates	Not applicable
Capital provision	\$400 million increasing at a real growth rate of 1.5% a year.	Not applicable

Source: The Treasury

Further details of the modelling approach can be found in Treasury Working Paper 00/02 “*Manual for the Long-term Fiscal Model*”. This is available on the Treasury website at: www.treasury.govt.nz

Consistency between the Progress Outlooks and the Progress Outlooks in the 1999 Fiscal Strategy Report

The ten-year Progress Outlooks in this *Fiscal Strategy Report* are not strictly comparable to those in the 1999 *Fiscal Strategy Report* because the short-term economic and fiscal forecasts have changed. There have also been changes to the fiscal policy assumptions to more accurately reflect current policy, as outlined in Table 7.

Table 7 – Changes to fiscal assumptions

1999 FSR assumptions	2000 FSR assumptions
No fiscal drag	Fiscal drag
Wage indexation of benefits	Inflation indexation of benefits
GST exclusive allowance	GST inclusive allowance
\$600 million allowance grows at real growth rate of 1% a year	\$1200 million allowance grows at real growth rate of 1.5% a year
Tariffs reduced to zero by 2010.	No change to tariffs.

Source: The Treasury

Under these changes the allowance in the Progress Outlooks will behave in a similar manner to the provision used in the Budget forecasts. For the purposes of broad comparison, the \$600 million allowance used in the 1999 *Fiscal Strategy Report* translates to around a \$900 million allowance, as shown in Table 8.

Table 8 – Comparison of fiscal allowances

	\$ million	\$ million
1999 FSR assumptions	600	860
Fiscal drag	+120	+120
Inflation indexation of benefits	+90	+90
GST inclusive	+100	+130
2000 FSR assumptions	910	1200

Source: The Treasury

Annex 4

Prefunding Working Assumptions

The following are the working assumptions used to calculate the impact of the proposed NZS Fund in this Report.

- Until around 2025, NZS payments are funded solely on a “pay as you go” basis. During this period, the excess of the rate of contribution over each year’s NZS costs is retained in the Fund. In later years, when the costs of NZS exceed the contribution rate, the balance comes from accumulated assets.
- The contributions to the Fund in the first three years are \$600 million in 2001/02, \$1.2 billion in 2002/03, and \$1.8 billion in 2003/04.
- After this three-year transition, the contribution rate is a percentage of GDP sufficient to finance NZS over a 40-year time frame. At this stage, projections show that the initial required contribution to the Fund immediately after the transition is likely to be around 6% of GDP under the assumptions in this Annex. This includes both the “pay as you go” cost of current NZS, plus the “retained” contribution for future NZS costs. The “retained” contribution for future NZS costs is likely to be around 2% initially, and would decline to zero by around 2025.
- Over time, the contribution rate needs to be revised because of two different effects: forecasts will change in the light of new information; and the 40 year period to be covered by the calculation shifts out by an extra year. Given current projections of demographics beyond the next 40 years, the required contribution rate is likely to rise through time.
- The contribution rate calculation is based on a number of other assumptions, for example the rate of return on the Fund’s assets and the tax rate on the Fund’s returns. The assumptions used for the purposes of the projections are as follows:
 - The rate of return on the assets in the Fund is assumed to be equivalent to the long-term Government stock rate. This is assumed to be 7.0%, as in the Long-term Fiscal Model. The expected rate of return will depend on the investment strategy adopted by an independent Board, yet to be established. In practice, the Board is likely to pursue an investment strategy that would earn a rate of return above that of a portfolio invested solely in government stock.
 - The return on the Fund is taxed at the rate of 33%.