2

Fiscal Outlook

Introduction

This chapter discusses the trends, drivers and assumptions behind the outlook for the Crown's finances, including items such as tax revenue, spending and Crown debt.

The discussion covers:

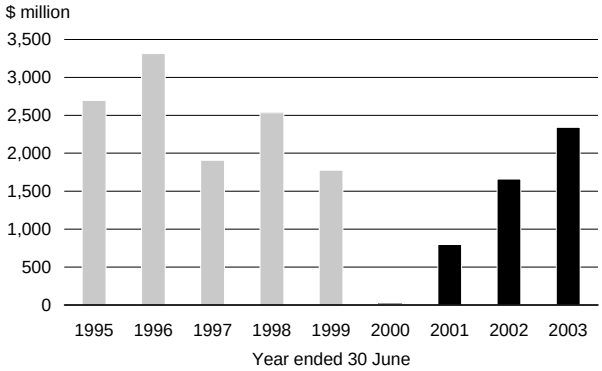
- an overview of the fiscal position, including trends in key fiscal indicators (operating balance, net debt and net worth)
- key components of the operating balance including revenue, expenses, and State-owned enterprises (SOEs) and Crown entity surpluses, and the provision for future initiatives (see Statement of Financial Performance page 97)
- key drivers of net worth and net debt (see Statement of Financial Position page 98), the relation between net debt and the operating balance, and details of the 1999/2000 bond programme
- effects on the fiscal outlook of economic outcomes and policy decisions, as well as the future effects of population ageing
- likely developments in generally accepted accounting practice (GAAP) that may change the way the forecasts are constructed.

Overview

Operating balance grows with revenue growth outpacing expense growth.

The 1998/99 operating balance of $1.8 billion was boosted by large one-off items including gains on sale of assets. Excluding the one-off items, the operating balance was around $150 million.

Figure 2.1 – Operating balance



Source: The Treasury

The 1999/2000 operating balance of $14 million reflects:

- the absence of any similar large one-off items
- lower SOE and Crown entity surpluses, with the ACC outstanding claims liability recognition (around $500 million)
- expense growth, mainly in social welfare, health and education (around $800 million)

offset by:

- growth in tax revenue (around $1,200 million) reflecting nominal economic growth.

Beyond 1999/2000 the operating balance rises, with revenue growth (averaging 4.8% a year) outpacing expense growth (averaging 2.8% a year). Expense growth is higher in 2003 reflecting higher growth in social welfare spending.

Net debt is stable in dollar terms, but falls as a percentage of GDP, over the forecast period.

In 1998/99 net debt was $21.7 billion. Net debt rises in 1999/2000 and 2000/01 before falling to slightly below its 1998/99 level.

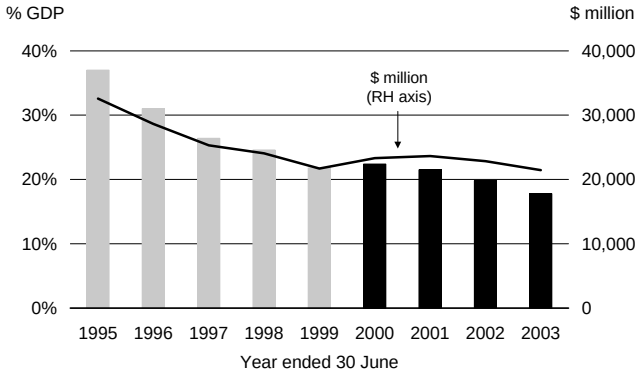
The rise reflects:

- an operating cash deficit
- increased capital investment for health, education and capital investment for At Work Insurance (1999/2000 only).

Improving operating cash-flows drive the fall in 2001/02 and 2002/03.

As a percentage of GDP net debt falls from 22% to 18% between 1998/99 and 2002/03 as nominal GDP grows.

Figure 2.2 – Net debt (% of GDP and $)



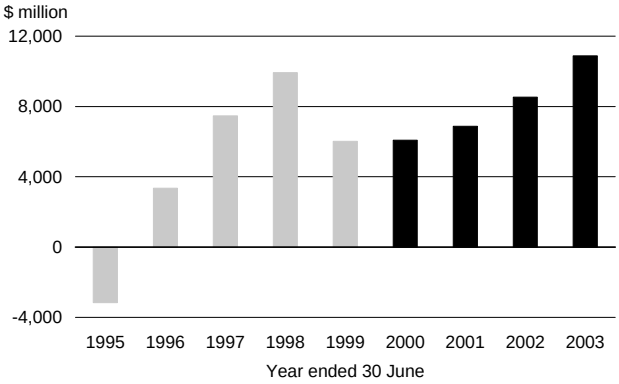
Source: The Treasury

Net worth grows over the forecast period.

In 1998/99 net worth fell from $10 billion to $6 billion. The fall reflects ARCIC's recognition of the net future cost of already accepted ACC claims ($6.1 billion), partly offset by a $1.8 billion operating surplus.

Beyond 1999/2000, net worth increases in line with operating balance surpluses.

Figure 2.3 – Net worth



Source: The Treasury

Compared to Budget, the operating balance is largely unchanged, but net debt and net worth improve.

The operating balance forecasts are largely unchanged from the Budget (higher by $50 million in 1999/2000, $6 million in 2000/01 and $155 million in 2001/02), reflecting:

- higher nominal GDP forecasts, increasing tax revenue and slightly reducing benefit spending
- the removal of the contingency expense provision ($100 million a year - see page 43)

largely offset by:

- a downward revision to the estimated 1998/99 corporate tax base following higher than forecast overpayments of corporate tax. This impacts on all years.
- tax rate reductions. By the end of the forecast period these are largely funded from the provision for future initiatives. The remainder lowers the operating balance by $245 million, $165 million and $85 million in 2000/01, 2001/02 and 2002/03 respectively

Net worth forecasts, however, are stronger by between $650 million and $820 million over the forecast period largely reflecting the lower ACC outstanding claims liability valuation at 30 June 1999 (see page 48).

Net debt forecasts are lower by between $100 million and $300 million. These improvements largely reflect a better starting position in 1998/99 than was forecast in the Budget and stronger dividend forecasts from SOEs in 1999/2000.

The net debt improvement since the Budget, combined with lower student loan advances, results in a reduction in the 1999/2000 bond programme of $800 million (see page 53).

Fiscal forecast assumptions

The fiscal forecasts are based on spending and revenue decisions to 11 October (including the tax cuts) and the central economic forecast. Subsequent Government policy decisions or economic forecast changes could significantly change the fiscal outlook. Chapter 3, Risks and Scenarios shows the sensitivity of the fiscal position to alternative economic forecasts, while Chapter 4, Specific Fiscal Risks discusses potential pressures against the fiscal position.

Fiscal Indicators

Table 2.1 – Fiscal Indicators

($ million)	1999 Actual	2000 PreEFU	2001 PreEFU	2002 PreEFU	2003 PreEFU
Statement of Financial Performance					
Revenue					
Taxation revenue	32,156	33,360	34,855	36,648	38,392
Other revenue	4,201	2,395	2,301	2,441	2,520
Total Revenue	**36,357**	**35,755**	**37,156**	**39,089**	**40,912**
Ratio to GDP (%)	**36.5%**	**34.4%**	**33.8%**	**33.9%**	**33.9%**
Tax ratio to GDP (%)	**32.3%**	**32.1%**	**31.8%**	**31.7%**	**31.8%**
Expenses					
Functional Expenses	33,356	33,889	34,287	34,656	35,326
Finance Costs	2,516	2,310	2,422	2,478	2,394
Net foreign exchange losses/(gains)	(47)	(26)	..	..	..
Provision for future initiatives	..	10	310	920	1,470
Total Expenses	**35,825**	**36,183**	**37,019**	**38,054**	**39,190**
Ratio to GDP (%)	**35.9%**	**34.8%**	**33.7%**	**33.0%**	**32.5%**
Contribution of SOEs and CEs					
Surplus attributable to SOEs and CEs	1,789	907	977	985	1,030
Dividends and other distributions	(544)	(465)	(318)	(361)	(411)
Net Contribution of SOEs and CEs	**1,245**	**442**	**659**	**624**	**619**
Operating Balance	**1,777**	**14**	**796**	**1,659**	**2,341**
Ratio to GDP (%)	**1.8%**	**0.0%**	**0.7%**	**1.4%**	**1.9%**
Statement of Financial Position					
Assets	58,223	56,554	57,615	58,306	59,638
Liabilities	52,201	50,475	50,740	49,772	48,763
Crown Balance	**6,022**	**6,079**	**6,875**	**8,534**	**10,875**
Ratio to GDP (%)	**6.0%**	**5.8%**	**6.3%**	**7.4%**	**9.0%**
Statement of Borrowings					
Crown Debt					
Gross Debt	36,712	35,476	35,719	34,873	34,070
less financial assets	(15,011)	(12,154)	(12,069)	(12,021)	(12,615)
Net Crown Debt	**21,701**	**23,322**	**23,650**	**22,852**	**21,455**
Net Crown Debt to GDP (%)	**21.8%**	**22.4%**	**21.5%**	**19.8%**	**17.8%**
Net Debt Repayment/(Increase)	2,368	(1,621)	(328)	798	1,397
Nominal GDP	99,688	103,931	109,771	115,439	120,591

Source: The Treasury

Drivers of the Operating Balance

This section discusses the trends in the three main operating balance components (see Statement of Financial Performance page 97) being:

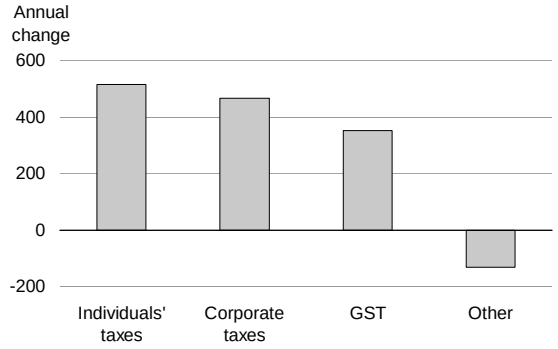
- Tax Revenue
- Expenses
- State-owned enterprises (SOEs) and Crown entity surpluses

Tax revenue

Tax revenue swings up in 1999/2000.

After declining in 1998/99, owing to reductions in personal tax rates and weak economic growth, tax revenue is expected to grow in 1999/2000, in line with the pick-up in economic growth.

Figure 2.4 – Components of tax revenue growth in 1999/2000



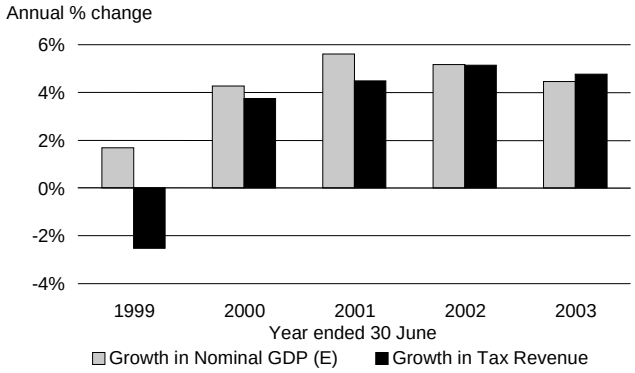
Source: The Treasury

Despite a further tax rate reduction on 1 April 2000, tax revenue on wages and salaries is expected to increase. Improved company profits will result in a rise in net corporate tax. GST is expected to grow, although not at the exceptionally high rate seen in 1998/99. Partly offsetting these increases, the lower interest rate environment will reduce withholding tax on interest income.

Beyond 2000, tax continues to grow in line with forecast economic growth.

From 2000/01 onwards, tax revenue is expected to increase by around 4½% each year. The first full-year effect of the April 2000 tax-rate reduction retards growth in 2000/01. Thereafter, tax revenue growth is expected to follow growth in the economy.

Figure 2.5 – Tax and nominal GDP growth



Source: The Treasury

Forecast changes since the Budget

Tax revenue in 1998/99 was $200 million below the 1999 Budget forecast. As this implies a lower tax base than was assumed in the Budget forecasts, the forecast for 1999/2000 has been revised downward. Stronger forecasts of nominal economic growth than in the Budget result in improvements to underlying tax revenue forecasts from 2000/01 onwards. However, the 1 April 2000 tax rate reductions more than offset these improvements.

Table 2.2 shows the changes to tax forecasts since the Budget across the major tax types. It includes the effect of the tax cuts, as detailed in Table 2.2.

Table 2.2 *– Changes in tax revenue forecasts since the Budget*

($ million)	**1998/99**	**1999/2000**	**2000/01**	**2001/02**
Individuals' taxes	(22)	(156)	(352)	(446)
Corporate taxes	(189)	(173)	(232)	(8)
GST	189	123	174	175
Other	(178)	1	35	(16)
Total tax changes	(200)	(205)	(375)	(295)
Nominal economic growth (annual average % change)				
Pre-Election Update	1.7	4.3	5.6	5.2
Budget	1.2	4.4	5.2	4.5

Source: The Treasury

Risks around the tax forecasts

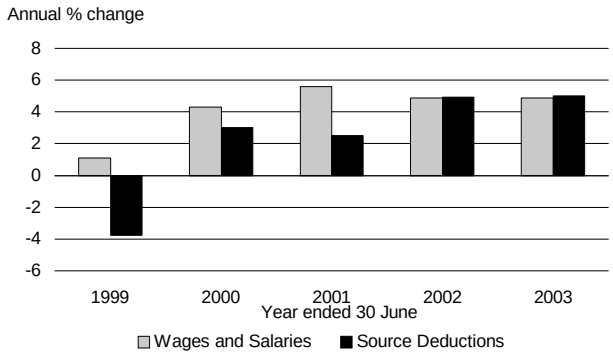
Since tax revenue is closely related to components of nominal income and expenditure, the main risk to the tax forecasts is economic. However, the tax forecasts also incorporate judgments regarding taxpayer behaviour, particularly in response to recent policy and administrative changes. As this behaviour can never be predicted accurately, actual tax revenues are likely to vary from forecasts.

Source deductions are affected by changes to tax rates.

The biggest component of source deductions is PAYE tax on wages and salaries. Forecasts of source deductions are therefore largely dependent on forecasts of aggregate wages and salaries in New Zealand.

The total wage bill is expected to increase by around 4 to 5 percent per annum over the next four years. Source deductions will follow broadly the same trend, except that:

Figure 2.6 – Wage bill and source deductions growth



Source: The Treasury

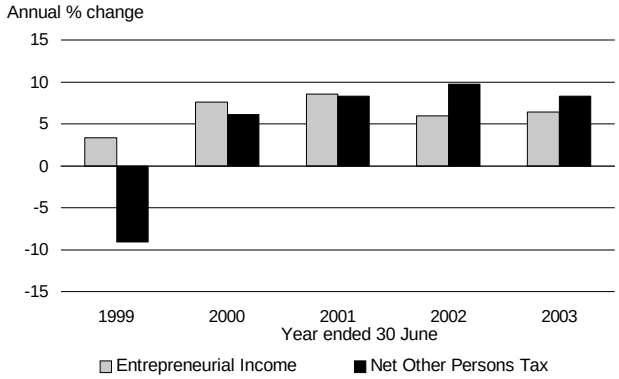
- the April 2000 tax-rate changes will reduce source deductions in the June 2000 quarter
- the first full-year effect of the tax-rate reduction further reduces source deductions growth in the 2000/01 year.

Other persons tax grows steadily.

Growth in other persons tax in 1999/2000 is affected by a number of policy and administrative changes. These forecasts include the judgments that:

- the lower tax rates and the removal of the superannuation surcharge will reduce terminal tax from 1999 tax returns
- Inland Revenue's administrative initiatives to ensure more tax is withheld at the correct rate during the year will also reduce terminal tax

Figure 2.7 – Entrepreneurial income and other persons tax growth



Source: The Treasury

- increasing accuracy of withholding taxes and the removal of the IR5 return from the 1999/2000 year onwards will limit refunds in the short term.

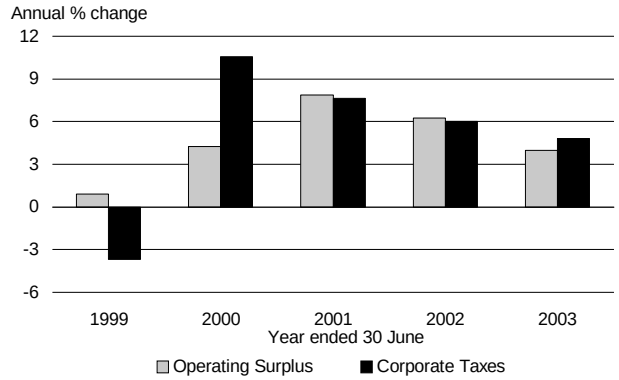
Apart from the effect of these changes, growth in other persons tax is expected to be broadly in line with growth in entrepreneurial income.

Corporate taxes rebound in 1999/2000.

Corporate taxes dipped a little in 1998/99, despite a small rise in corporate profits, as proxied by corporate operating surplus.

The key judgment in this pre-election update is determining the underlying level of corporate tax liability in 1998/99 as this sets the starting point for forecasts in 1999/2000 and beyond. The judgments are based around companies' level of under- or over-estimation of their tax liability in 1998/99, and the degree to which corporate operating surplus encapsulates corporate profitability.

Figure 2.8 – Growth in corporate operating surplus and corporate taxes



Source: The Treasury

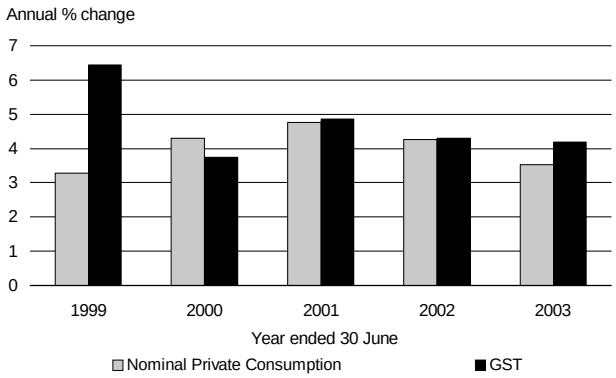
Tax is expected to rise in 1999/2000 as profitability increases. Profitability is enhanced by the impact of low interest rates, which reduce the cost of borrowing and allow for an improved margin for lending institutions. Tax receipts in 1999/2000 will be boosted by a lower level of refunds than in 1998/99, although this will have a lesser impact on revenue.

Historically, corporate tax follows a more volatile path than does corporate operating surplus. Although we have predicted a fairly strong bounce-back in 1999/2000, the outcome may be a weaker, or an even stronger, recovery. The forecasts in 2001/02 and 2002/03 have corporate tax tracking corporate operating surplus, partly based on the assumption that, over time, the accuracy of provisional tax estimation will improve. This should mean that there will be less of a time delay between the generation of profits and the receipt of tax on those profits.

GST growth slows after exceptional year.

As GST is ultimately paid by final consumers (ie individuals and households), growth in GST tends to track growth in total consumption. However, in 1998/99, GST growth far outstripped growth in consumption. This was especially evident in the March quarter.

Figure 2.9 – Growth in consumption, GST



Source: The Treasury

Some judgment has been used to decide what this implies for the future. In 1999/2000, GST growth is expected to lag consumption growth. The gap is reduced a little by a rebound in residential investment[1], which declined significantly in 1998/99. From 2000/01 onwards, growth in GST and consumption are expected to be similar.

This judgment in the 1999/2000 year is crucial to the forecast. Actual GST growth in 1999/2000 could be higher (tracking consumption) or lower (rebounding from the bumper 1998/99 year) than forecast, with the variance being compounded in later years. This forecast adopts an intermediate position so that the risks to the forecast are evenly balanced.

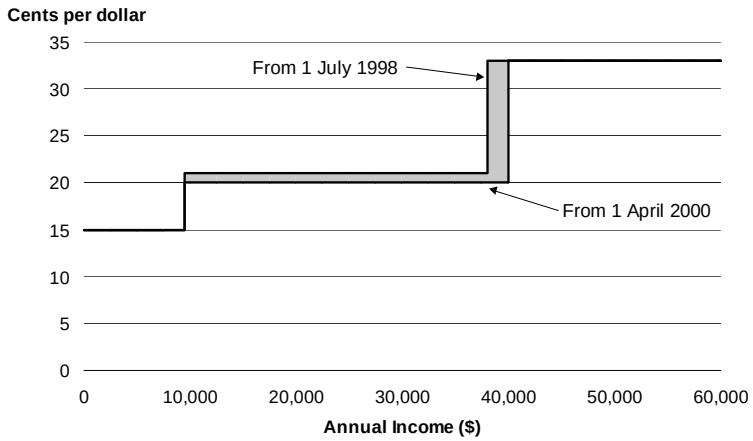
1 Residential investment attracts GST, but is not included in consumption.

Impact of Changes in Individuals' Income Tax Rates

The revenue forecasts include the Government's decision to reduce individuals' tax rates from 1 April 2000. This package creates a three-step personal tax rate of 15%, 20% and 33% by:

- reducing the tax rate between $9,500 and the upper threshold from 21% to 20%
- increasing the upper threshold from $38,000 to $40,000
- allowing investment income to be taxed at the lowest marginal rate within the first $9,500 of total annual income (currently the case for superannuitants only).

Figure 2.10 – Effect of tax rate changes



Source: The Treasury

These changes will increase the disposable income of most individuals. The maximum increase in disposable income is $545 per annum. The total impact of the tax rate reductions is expected to lower tax revenue by $70 million, $395 million, $415 million and $435 million in 1999/2000, 2000/01, 2001/02 and 2002/03 respectively. The estimated impact includes short-run indirect effects, eg, higher consumption in the macroeconomic forecasts translates into higher indirect taxes such as GST.

The tax cut cost is largely met from the provision for future initiatives, with the remainder lowering the operating balance (see page 46).

Customs duty hit by tariff rate reductions

With the removal of motor vehicle tariffs in the 1998 Budget and general tariff reductions on 1 July 1998, customs duty declined by about 30% in 1998/99. It is expected to grow a little in 1999/2000 with increased imports of dutiable goods being partly offset by further tariff cuts on 1 July 1999. Further tariff cuts in July 2000 and July 2001 cause customs duty to decline in 2000/01 and 2001/02. As no more large tariff rate reductions are scheduled until 2004, customs duty levels off in 2002/03.

RWT bounces back in 2000/01

Tax on New Zealand residents' interest income is expected to decrease substantially in 1999/2000. This is a direct result of interest rates being lower than they have been over recent years. However, resident withholding tax on interest is expected to grow in 2000/01 and beyond, as interest rates pick up again. The pick-up in resident withholding tax will lag behind the increase in interest rates since most interest-bearing deposits are locked into fixed-term, fixed-rate arrangements.

Investors may now elect to have tax on interest withheld at their marginal tax rate. As with all policy changes, it is difficult to predict the response of taxpayers to this change. However, we estimate that this will have a small positive impact on resident withholding tax from 1999/2000 onwards.

Inland Revenue's forecasts

Inland Revenue has prepared an alternative set of tax forecasts. These independent forecasts were developed in parallel with the Treasury's forecasts and used the Treasury's view of the macroeconomy.

Treasury's forecasts are higher than Inland Revenue's by up to $230 million in each year. The differences between the forecasts are spread across all tax types, with no particular tax type standing out.

Both Departments consider that the differences between the two sets of forecasts are within the ranges of uncertainty of their own forecasts, over the time horizons involved.

Annex A on page 131 contains tables showing the detailed Treasury and Inland Revenue forecasts on both an accrual revenue and a cash receipts basis.

Expenses

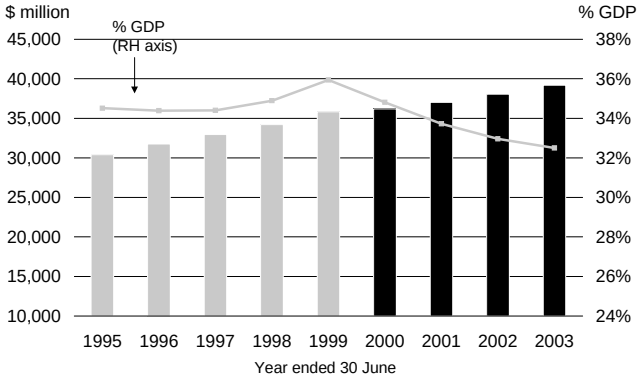
Expenses decline slowly as a share of GDP over the forecast period.

Expenses as a percentage of GDP spike in 1998/99 with low nominal economic growth, a significant increase in the valuation of the GSF pension liability and expense growth.

Expenses fall between 1999/2000 and 2002/03 from 35% to 33% of GDP.

Over the same period, expenses increase from $36 billion to $39 billion reflecting:

Figure 2.11 – Expenses ($ and % of GDP)



Source: The Treasury

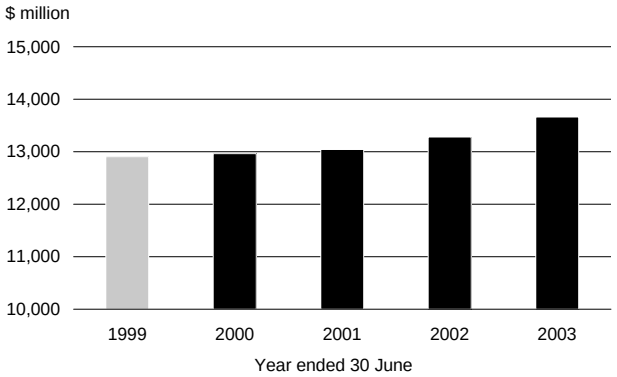
- growth in the provision for future initiatives of $1,460 million, providing for the cost of future policy decisions
- health and education spending increases of $800 million
- CPI indexation and beneficiary growth of $760 million– most growth is after 2001 when the New Zealand Superannuation (NZS) eligibility age settles at 65.

Social welfare benefits rise slowly reflecting CPI indexation and increased beneficiary numbers.

Between 1998/99 and 2000/01 social welfare expenses are relatively flat – increasing from $12.9 billion to $13.0 billion. In 2001/02 and 2002/03 they increase to reach $13.7 billion.

The two main drivers of benefit growth are:

Figure 2.12 – Social welfare spending



Source: The Treasury

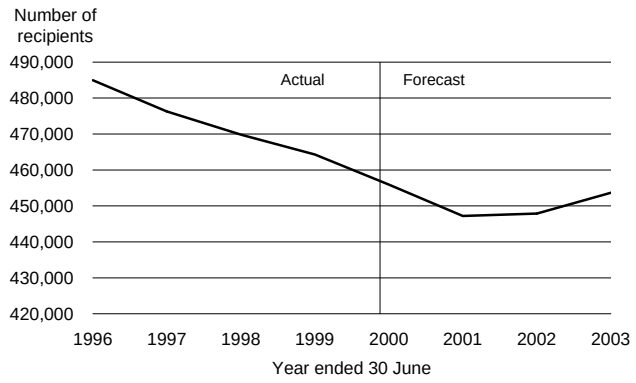
- CPI indexation. Most benefits increase each April by the CPI movement over the previous calendar year. The forecast CPI adjustments are 1.6%, 1.8%, 2.0% and 1.8% in April 2000, 2001, 2002 and 2003 respectively.
- Movements in beneficiary numbers. Beneficiary numbers can be affected by policy changes, demographic movements (eg, NZS) or the economy (eg, unemployment).

In addition the 60% wage floor for NZS payments is forecast to be hit in April 2003. From this date NZS payments will be indexed to wage growth rather than CPI growth, increasing the growth in NZS spending. The April 2003 adjustment is expected to be 2.5%, which is higher than the CPI adjustment of 1.8%.

Beneficiary numbers change significantly over the forecast period in three main areas being:

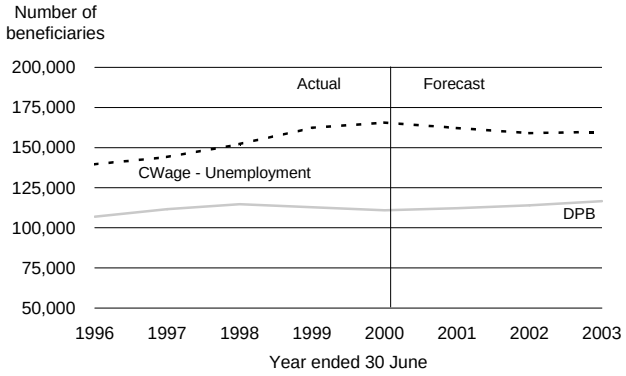
- **New Zealand Superannuation (NZS)**. In April 2001 the age of eligibility for NZS will settle at 65. This will reverse the downward trend in NZS recipient numbers. Prior to this, the eligibility age has been increasing three months every six months.
- **Community Wage – unemployment**. The number of unemployment beneficiaries reflects movements in the unemployment rate. The unemployment rate is forecast to fall from 7.3% in 1998/99 to 5.8% in 2001/02, before rising to 5.9% in 2002/03.
- **Domestic Purposes Benefit** – Following the introduction of work-testing in some situations, beneficiary numbers fell slightly. The fall is expected to continue to mid 2000, before numbers begin increasing gradually.

Figure 2.13 – NZS recipients



Source: Department of Social Welfare

Figure 2.14 – Unemployment and DPB beneficiaries



Source: Department of Social Welfare

The cost of benefit rate changes, or new benefits, will come from the provision for future initiatives. The cost of CPI and wage indexation, and movements in beneficiary numbers, are forecast changes and do not come from the provision for future initiatives.

Compared to the Budget, total welfare spending forecasts are relatively similar. Recent actual out-turns have lowered Domestic Purposes Benefit, Community Wage – Sickness and Community Wage – Training forecasts while increasing NZS and Invalids Benefit forecasts. In addition higher forecasts of Benefits Paid in Australia reflect a recent agreement with the Australian government and a weaker New Zealand dollar.

Health spending rises with additional services purchased and demographic growth…

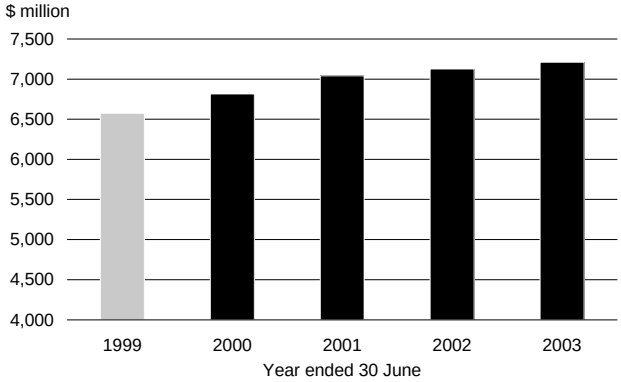
Between 1998/99 and 2000/01 health spending increases steadily from $6.6 billion to $7.0 billion. Health spending reaches $7.2 billion in 2002/03.

The increase between 1998/99 and 2000/01 reflects extra funding for:

- demographic growth
- maintaining existing services
- additional health services.

Offsetting this is a lower level of elective surgery funding in 2000/01 as 1999/00 is the last year of a four-year appropriation to reduce the backlog in elective surgery.

Figure 2.15 – Health expenses



Source: The Treasury

Increases of around $85 million in 2001/02 and 2002/03 reflect demographic growth in these years.

Since the Budget the 2000/01 Health Funding Package has been announced. It provides additional funding of $175 million a year from 2000/01 for health to maintain services and to purchase additional services.

Health funding packages for 2001/02 and 2002/03 have not been decided. Any spending increases will be funded from the provision for future initiatives.

Table 2.3 – Growth in Health spending between years

($ million)	1997/98	1998/99	1999/2000	2000/01	2001/02	2002/03
Health spending	**6,001**	**6,573**	**6,816**	**7,041**	**7,127**	**7,211**
Growth in health spending						
Demographic adjustment, and maintaining and improving services[1]		276	266	253	84	83
Extra electives		94	..	(70)	..	..
Mental health		15	18	15	..	..
ACC changes		52	(28)	11	1	..
Increased prices to hospitals		146	..	..	..	..
Other		(11)	(13)	16	1	1
Total growth		**572**	**243**	**225**	**86**	**84**

1 2001/02 and 2002/03 include a demographic adjustment only.

Source: The Treasury

…while policy and demographic changes boost education spending...

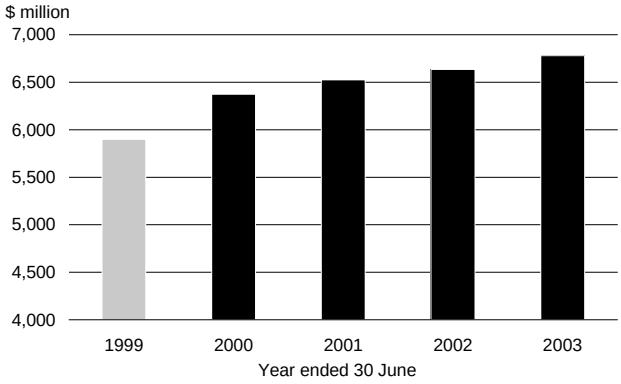
Education expenses are projected to increase from $5.9 billion to $6.8 billion between 1998/99 and 2002/03.

The growth largely reflects:

- the 1997/98 primary teachers' and principals' pay settlement, along with the recent secondary teachers' settlement
- a range of new policy initiatives, eg, Special Education 2000 policies and changes to tertiary education funding
- demographic changes – the number of primary students is expected to remain constant, while secondary and tertiary student numbers are forecast to increase.

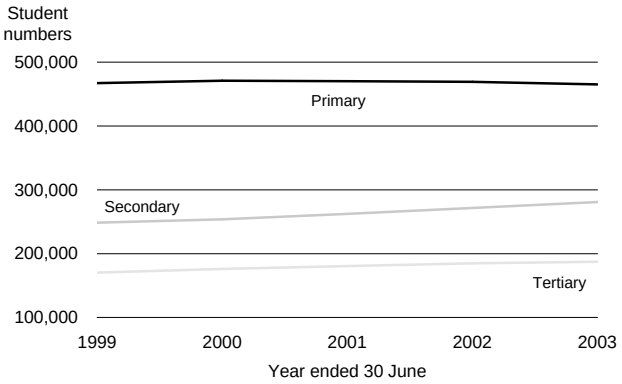
Forecast spending on education does not allow for any wage increases or increases in services other than those covered by an explicit policy decision. Increases in any of these items will be met from the provision for future initiatives. No additional funding has yet been allocated for education initiatives in 2001 and beyond.

Figure 2.16 - Education



Source: The Treasury

Figure 2.17 – Roll forecasts – Primary, Secondary and Tertiary



Source: Ministry of Education

Since the Budget, education spending has increased largely reflecting:

- the recent teachers' pay settlement costing $128 million in 1999/2000 and around $150 million in each following year
- the *Bright Future - 5 Steps Ahead* policy package including additional tertiary education scholarships. The education initiatives in the package cost $5 million, $11 million, $19 million and $28 million in 1999/2000, 2000/01, 2001/02 and 2002/03 respectively.
- further Special Education 2000 policies costing $7 million in 1999/2000 and $12 million in each following year.

These are partly offset by

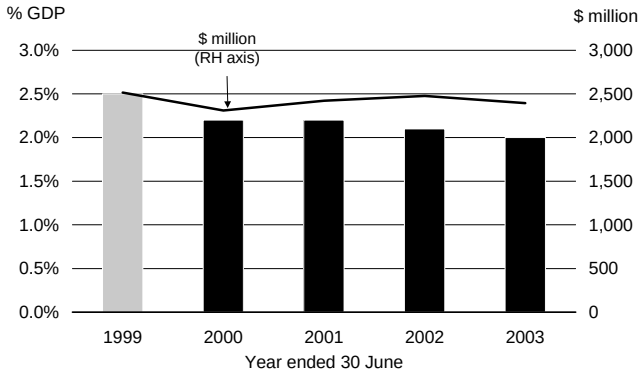
- forecasting changes – reflecting lower roll projections and lower than forecast uptake by schools of the Fully Funded Option.

…and finance costs remain broadly stable.

Finance costs fall by 0.3% of GDP in 1999/2000 as net debt falls with the sale of Contact Energy Limited.

Beyond 2000/01 finance costs are broadly stable as a percentage of GDP as lower debt levels offset rising interest rates.

Figure 2.18 – Finance costs (% of GDP and $)



Source: The Treasury

Contingency expense provision not currently required.

The fiscal forecasts in the 1999 Budget included an annual contingency expense provision of $100 million. The provision was to meet costs from potential crystallisation of guarantees and indemnities and the settlement of legal liabilities. See page 70 of Chapter 4, Specific Fiscal Risks.

The limit is assessed regularly. It was reduced from $200 million to $100 million in the 1998 Budget following the resolution of several significant contingent liabilities including the Equiticorp cross appeal and the West Coast Accord claim.

The contingency provision has been excluded from these forecasts because future settlements are likely to be substantially lower than the provision. The overall level of quantified contingent liabilities for legal proceedings and disputes at 30 June 1999 of around $460 million has not changed significantly in the past year. In general, it is very difficult to assess the likelihood of liabilities crystallising. A number of these have existed for some years and are unlikely to crystallise for significant amounts.

Looking forward, if the level of contingent liabilities increases significantly, or if large settlements for some contingent liabilities become likely, a provision will be included in the fiscal forecasts.

The provision for future initiatives allows for future policy decisions.

The provision for future initiatives, included in the Statement of Financial Performance (page 97), is a government commitment to constrain the cost of policy decisions. It provides funding for Government decisions to:

- undertake new initiatives, such as abolishing stamp duty or funding for Mäori broadcasting announced in the 1999 Budget
- provide for cost or volume increases in existing initiatives, such as increasing teachers' pay.

Although the provision is recorded in expenses, it is available for decisions that relate to revenue, expense or SOE and Crown entity surpluses.

Some items in the Statement of Financial Performance are linked directly to economic variables. Movements in these items are forecasting not policy changes, and so are not met within the provision, but are included in the fiscal forecasts. Examples include:

- CPI inflation which affects benefit costs
- demographic movements which affect education and health spending
- interest rates, which affect finance costs.

Provision for 1997/98 to 1999/2000

The operating balance limit for policy initiatives for the three years 1997/98 to 1999/2000 was originally $5 billion. This was reduced in three steps in 1998 to $4.25 billion.

Table 2.4 – Operating Limit

($ million)	1997/98	1998/99	1999/00	Three-year total
Operating Balance Impact ($4.25 billion limit)				
1997 Budget Initiatives	606	787	889	***2,282***
1997 December Update Initiatives	135	112	155	***402***
1998 Budget Initiatives	118	307	363	***788***
1998 December Update Initiatives	..	83	16	***99***
1999 Budget Initiatives	..	24	373	***397***
Decisions since 1999 Budget[1]				
Revenue Initiatives				
Tax cuts	..	..	70	*70*
Expense Initiatives				
Teachers Collective Employment Contracts (CEC)	..	..	114	*114*
Revised social security agreement with Australia	..	..	27	*27*
Defence: East Timor	..	..	43	*43*
Other initiatives	..	..	37	*37*
	..	***..***	***291***	***291***
SOE/Crown Entity Initiatives	..	..	7	*7*
Total Initiatives since 1999 Budget	**..**	**..**	**298**	**298**
Provision For Future Initiatives - Education[2]	..	..	12	*12*
Total Operating Balance Impact[3]	**859**	**1,289**	**1,733**	**4,278**
Changes in Operating Balance Limit				
May '98 - Reduction in spending intentions	..	150	150	***300***
July '98 - Savings package	..	80	220	***300***
Sept '98 - Policies for Progress package	..	25	125	***150***
May '99 - Budget package	..	15	40	***55***
Sept '99 - Decisions since 1999 Budget[3]	..	..	(83)	***(83)***
				5,000

1 Decisions taken since the Budget are reported here exclusive of GST.

2 The provision for future initiatives is the unspent portion of the education allocation within the $4.25 billion operating balance limit.

3 The operating balance limit has been exceeded by $28 million. Decisions made, excluding education, since the 1999 Budget have exceeded the amount available by $83 million. This is largely offset by the $55 million savings made in the 1999 Budget.

Source: The Treasury

Provision for 2000/01 and beyond

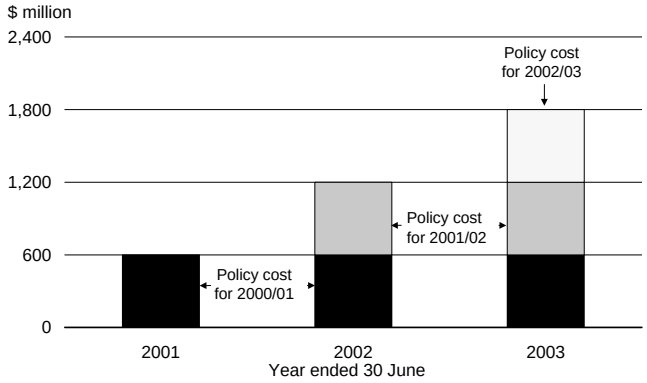
At the Budget, the government committed to contain the annual policy initiative cost to $600 million (GST exclusive) from 2000/01.

As shown in Figure 2.19 the out-year cost of these initiatives is constrained to the same level.

Some of the provision has already been allocated for policy decisions that affect the fiscal years beyond 1999/2000. These are the 2000/01 Health Funding package (see page 41) and part of the tax cut cost.

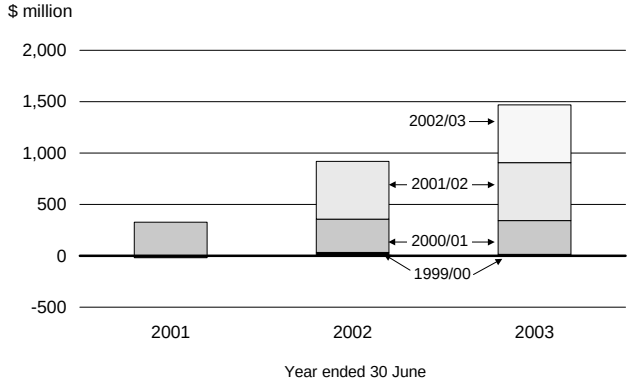
In 2000/01 $150 million of the tax cut costs is met from the provision. In 2001/02 and 2002/03 an additional $100 million is met from that year's annual policy initiative provision. The remainder of the tax cut cost reduces the operating balance.

Figure 2.19 – Provision for future initiatives at 1999 Budget (GST exclusive)



Source: The Treasury

Figure 2.20 – Current provision for future initiatives (GST inclusive)



Source: The Treasury

Table 2.5 – Estimated effect of the 1 April 2000 tax reductions

($ million)	**2000/01**	**2001/02**	**2002/03**
Reduction in tax revenue	395	415	435
Funded by:			
Provisions for future initiatives	150	250	350
Reduction in operating balance	245	165	85

Source: The Treasury

The following table reconciles the $600 million annual cost of policy initiatives with the provision for future initiatives in the Statement of Financial Performance.

Table 2.6 – Reconciliation of additional policy spending to provision for future initiatives

($ million)	**1999/00**	**2000/01**	**2001/02**	**2002/03**
Remainder of 1999/00 provision	12	(16)	29	13
Cost of policy initiatives for year	..	600	600	600
Flow on of 2000/01 policy initiatives	..	..	600	600
Flow on of 2001/02 policy initiatives	..	..	..	600
Portion of tax cut funded from provision	..	(150)	(250)	(350)
Effect of 2000/01 Health Funding package	..	(158)	(160)	(156)
	12	276	819	1,307
GST and rounding (nearest $10 million)	(2)	34	101	163
Total as per the Fiscal Forecasts (GAAP tables)	**10**	**310**	**920**	**1,470**

Source: The Treasury

The provision for future initiatives includes $29 million in 2001/02 and $13 million in 2002/03 that remains available for further decisions to be made in the 1999/2000 financial year. There is a shortfall of $16 million in 2000/01.

Chapter 3, Specific Fiscal Risks indicates there may be significant pressure against the provision over the forecast period. The quantified fiscal risks total $100 million in 2000/01, $50 million in 2001/02 and 2002/03. In addition, there are a number of unquantified fiscal risks that may affect each of these years. However, experience suggests that some risks will not eventuate, while the cost of others will be significantly less than originally expected.

State-Owned Enterprises and Crown Entities

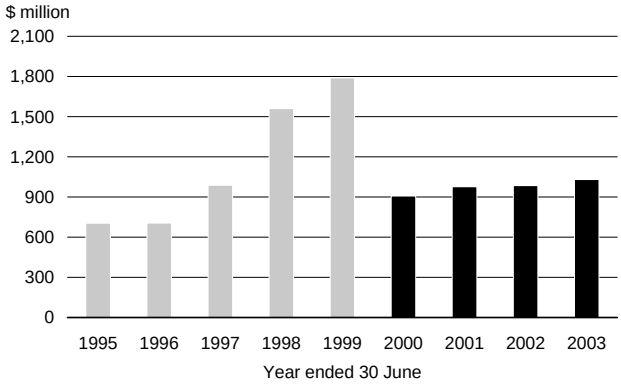
SOEs and Crown entities surpluses steady in 1999/2000 and beyond.

In 1998/99 SOEs and Crown entities gross surpluses were $1.8 billion. Their net surplus was $1.2 billion.

Gross surpluses fall to $900 million in 1999/2000 as:

- ARCIC surpluses fall by around $500 million with the recognition of the future costs of previously accepted ACC claims

Figure 2.21 – SOE and Crown entity gross surplus



Source: The Treasury

- a reduction in surpluses from the electricity sector, partly owing to the removal of future Contact Energy Limited surpluses following its sale in late 1998/99.

Over 2000/01 and 2001/02 surpluses are stable around $980 million, before rising marginally to $1,030 million in 2002/03.

Compared with the Budget, the SOE and Crown entities gross surplus is higher in 1999/2000 by $46 million, and around $75 million higher in 2000/01 and 2001/02.

The difference in 1999/2000 reflects improved operating balances for Hospital and health services ($41 million). The higher surpluses in 2000/01 and 2001/02 largely result from improvements in SOE forecasts.

ACC Premiums

The estimated value of the ACC outstanding claims liability fell from $7.6 billion at the 1999 Budget, to $6.9 billion at 30 June 1999. This reflects higher interest rate levels and lower numbers of long term claimants, partly offset by increases in forecast rehabilitation payments.

Government policy has been to collect levies from motor vehicle owners, earners and employers to fund the outstanding claims liability in each of those Accounts, as at 30 June 1999, within 15 years. Claims in the old ACC Employers' Account, which were still active on 30 June 1999, have been transferred to a new Residual Claims Account. The level of levy income collected by ACC has a direct impact on the Crown's operating balance. The levy income forecast at the time of the Budget was sufficient to fully fund these accounts within 15 years.

However, the lower claims liability valuation has allowed for a lower amount of residual claims levies to be collected than estimated at the Budget. The Government has decided on an average rate of 40 cents (excluding GST) per $100 of liable earnings for the residual claims levy, and $1.30 (including GST) per $100 for the combined earners' levy and premium of which the levy portion comprises $0.20 (excluding GST). Under the Accident Insurance Act, premiums are set at a fully funded rate.

Overall, there has only been a marginal change to the ACC surplus for 1999/00 and outyears as a result of the change in levies. While the Residual Claims Account will still be fully funded over fifteen years, the Earners Account will be fully funded in around five years at these rates.

Drivers of Net Worth and Net Debt

As outlined in the introduction, this section discusses the key drivers of net worth and net debt (see Statement of Financial Position and Statement of Borrowings), the relation between net debt and the operating balance and the 1999/2000 bond programme.

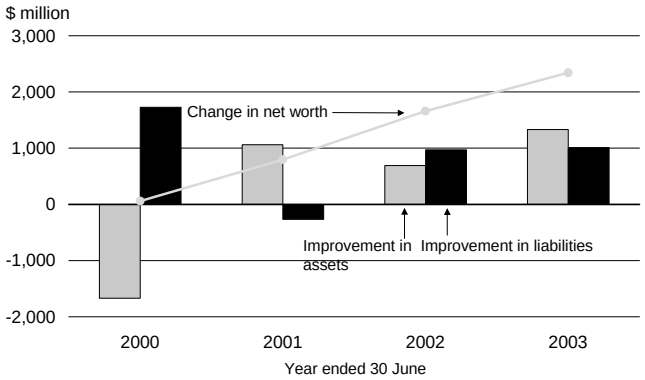
Net worth and net debt

Net worth rises each year from 1999/2000 driven by operating surpluses.

In 1999/2000 the reduction in liabilities is largely offset by the decline in assets. Beyond 1999/2000 both assets and liabilities are generally expected to improve.

Movements in assets and liabilities often offset each other leaving net worth unchanged. For example, an increase in student loans may be financed by increased borrowing (increase both assets and liabilities by the same amount) or from cash (no net change to assets or liabilities).

Figure 2.22 – Improvement in assets and liabilities



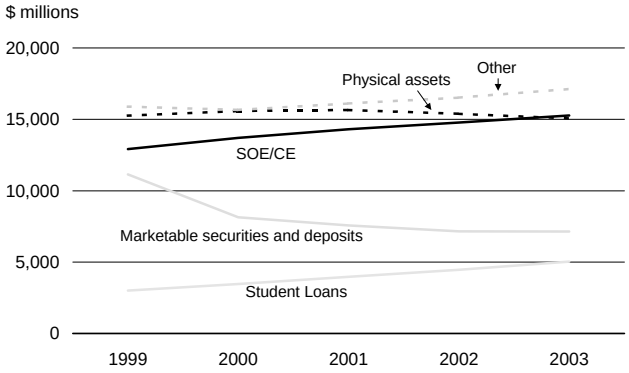
Source: The Treasury

Total assets move with student loans and SOE and Crown entity investment.

The 1999/2000 fall in financial assets reflects lower marketable securities and deposits as the receipts from the sale of Contact Energy Limited (in 1998/99) are used to repay outstanding debt.

Beyond 1999/2000 the increase in assets reflects rising student loans and increasing investment in SOEs and Crown entities. Student loans are forecast to be $5 billion by 2003.

Figure 2.23 – Components of total assets



Source: The Treasury

Physical assets and ‘other’, which includes the $400 million contingency capital provision, (see page 50) are fairly stable.

Compared to the Budget, financial assets are lower, reflecting cash used to repay debt. Student loans are forecast to be over $500 million lower in 2002, as recent trends suggest the take-up rate will fall.

Contingency Capital Provision

The limit for new capital initiatives for the three years 1997/98 to 1999/2000 was $900 million ($300 million per year). The limit is overspent by $47 million. The following table summarises capital spending over this period.

Table 2.7 – Contingency capital limit

($ million)	1997/98	1998/99	1999/00	Three-year total
Capital spending ($900 million limit)				
Decisions taken up to the 1999 Budget				
Capital decisions in 1997 Budget	266	200	186	652
Capital decisions in 1997 December Update	(483)	167	60	(256)
Capital decisions in 1998 Budget	284	267	16	567
Capital decisions in 1998 December Update	..	31	(4)	27
Capital decisions in 1999 Budget	..	(245)	145	(100)
	67	420	403	890
Decisions since the 1999 Budget				
Solid Energy: refinancing package	..	..	42	42
Other initiatives	..	..	15	15
	..	0	57	57
Total Capital Spending	**67**	**420**	**460**	**947**

Source: The Treasury

Beyond 1999/2000 there is a $400 million annual provision for capital initiatives. This provision is a working assumption not a capital limit, and is based on known pressures over the next three years.

In contrast to the previous $300 million annual limit for the period 1997/98 to 1999/2000 determined in the Coalition Agreement, the Government has not yet set a capital limit for 2000/01 to 2002/03.

Chapter 4, Specific Fiscal Risks discusses the known risks that will need to be managed within the capital provision. While these risks total around $2 billion, being significantly more than the provision of $1,200 million over three years, the proportion of risks that have materialised in previous years, and the probability of current risks being met were assessed when setting the provision.

The capital provision is intended to cover capital spending over and above existing baselines. For example, any new schools built will be funded from this provision. Departments will continue to make capital purchases funded from their own balance sheets.

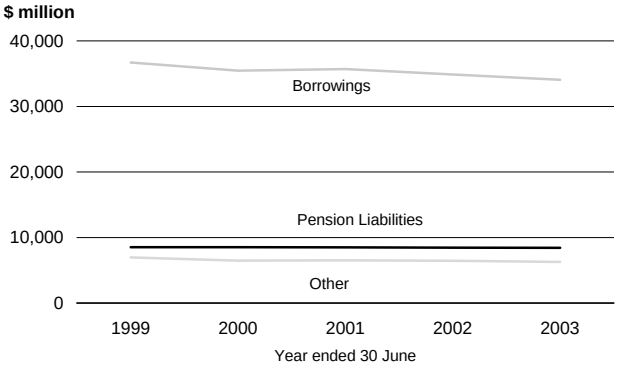
Liabilities fall with lower borrowings

Total liabilities fall each year reflecting decreases in borrowings. Other components are relatively stable.

Borrowings fall each year as debt is repaid with cash from the sale of marketable securities and deposits in 1999/2000 and cash surpluses in the following years.

A fall in foreign currency borrowing is partly offset by a small increase in New Zealand dollar borrowing.

Figure 2.24 – Liabilities



Source: The Treasury

Valuation of future liabilities

Net worth can change because of movements in the valuation of two liabilities:

- the ACC outstanding claims liability, which is managed by ARCIC and is included in the Crown's investment in SOEs and Crown Entities. It represents the Crown's obligation to pay on-going costs of already accepted ACC claims.
- the GSF liability which is directly included in liabilities. It represents the obligation to pay pensions to members of the Government Superannuation Fund (closed to new members).

The next valuations of the ACC and GSF liabilities will be for the 2000 Budget and the 1999/2000 Crown Financial Statements. The expected payment in each future year is calculated, and then discounted back to be expressed in current dollar terms (as one dollar today is worth more than one dollar in ten years time).

The size and nature of the liabilities (ACC around $7 billion and GSF around $11 billion) means that small changes in interest rates can result in large changes in the liability. In addition both liabilities are affected by other assumptions. For example, for every 1,000 claimants that exit the ACC scheme, the ACC outstanding claims liability is estimated to fall by around $200 million. Any valuation change is recorded in the Statement of Financial Performance, and therefore affects the operating balance.

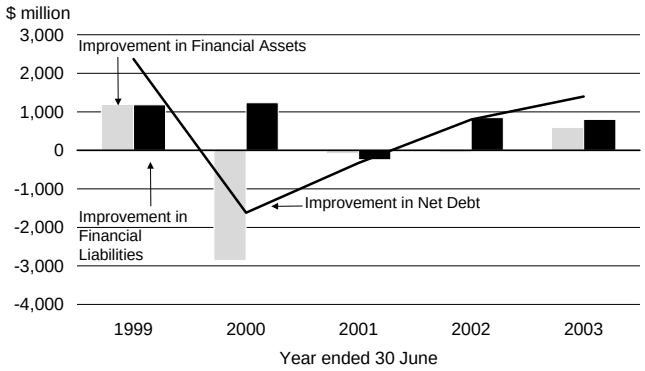
Chapter 3, Risks and Scenarios includes estimates of the interest rate sensitivities around the valuations.

Net debt, a subset of net worth, improves with cash surpluses.

Net debt improved in 1998/99, is expected to deteriorate in 1999/00, but improve in following years.

Net debt is a subset of net worth – its components are financial assets (largely marketable securities and deposits and student loans) and financial liabilities (borrowings). The trends in these are described above.

Figure 2.25 – Improvement in financial assets and financial liabilities



Source: The Treasury

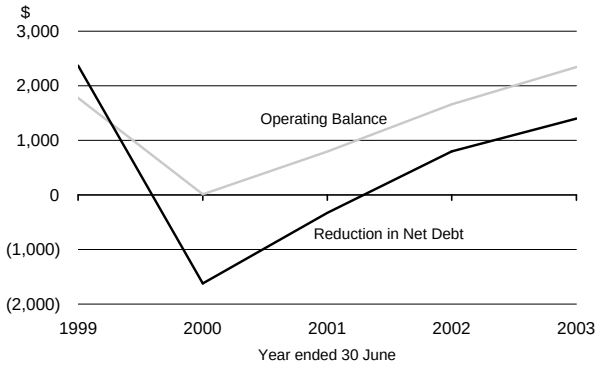
The net debt change does not match the operating balance in any given year.

Operating surpluses are generally used to repay debt. However, the movement in net debt does not match the operating balance in a given year.

The operating balance is an accrual measure and recognises non-cash items such as the retained surpluses of SOEs and Crown entities, whereas movements in net debt reflect cash flows.

Net capital investment in physical assets and the retained surpluses of SOEs and Crown entities largely drive the difference between the operating balance and the change in net debt.

Figure 2.26 – Operating balance compared with change in net debt



Source: The Treasury

In 1999/2000 the difference is somewhat larger due to an injection of capital into At Work Insurance Limited and transfer of capital underspends in 1998/99, relating to education and health, into 1999/2000.

Table 2.8 – Relation between operating balance and net debt

($ million)	1999 Actual	2000 Forecast	2001 Projection	2002 Projection	2003 Projection
Operating balance	1,777	14	796	1,659	2,341
Change in net debt	2,368	(1,621)	(328)	798	1,397
Difference	**591**	**(1,635)**	**(1,124)**	**(861)**	**(944)**
This difference comprises:					
SOE/CE retained surplus net of dividends	(1,245)	(442)	(659)	(624)	(619)
Depreciation	765	833	885	902	914
GSF unfunded liability movement	429	3	(28)	(54)	(26)
Gain on sale of assets	(1,625)	(14)	..	..	..
Net purchase of physical assets including capital contingency provision	(903)	(1,411)	(1,274)	(1,148)	(1,107)
Asset sale receipts	2,818	82	..	..	..
Net capital withdrawals/(injections)	(80)	(307)	60	144	122
Timing and other working capital items	432	(379)	(108)	(81)	(228)
	591	**(1,635)**	**(1,124)**	**(861)**	**(944)**

Source: The Treasury

Net debt and the domestic bond programme

The domestic bond programme for 1999/2000 has been revised down to $2.05 billion, a decrease of $800 million from the bond programme established at the time of the 1999 Budget.

The bond programme is calculated on the basis of the Crown's operating, investing and financing cashflows. The cashflow improvement since the 1999 Budget forecasts has enabled the reduction in the domestic bond programme, primarily reflecting:

- the 1998/99 Crown financial statements showing an improved position against the 1999 Budget of operating and investing cashflows of around $1 billion. However, around $500 million of this is timing and has flowed into the 1999/2000 year.
- improved forecast flows in 1999/2000 including:
  - increased dividend flows from SOEs and Crown entities ($185 million) reflecting the return of larger than expected 1998/99 surpluses.
  - a reduction in the forecast uptake of student loans ($170 million) reflecting changes to forecast assumptions brought about by last years changes to the Student Loan Scheme, reduced growth in loan accounts and more conservative borrowing by students than previously expected.

Influences on the Fiscal Position

The fiscal position is affected by both economic and non-economic events. Some of these the government has direct control over (eg, funding for new projects) and some the government does not have direct control over (eg, tax revenue largely moves with nominal GDP).

In addition, both tax and benefit forecasts are sensitive to behavioural assumptions. For example, tax forecasts assume responses to recent policy changes and economic outcomes, while benefit forecasts include estimates of the proportion of eligible people that actually apply for benefits. Behavioural responses are difficult to estimate in advance.

Estimates of policy effects

The operating balance is affected by:

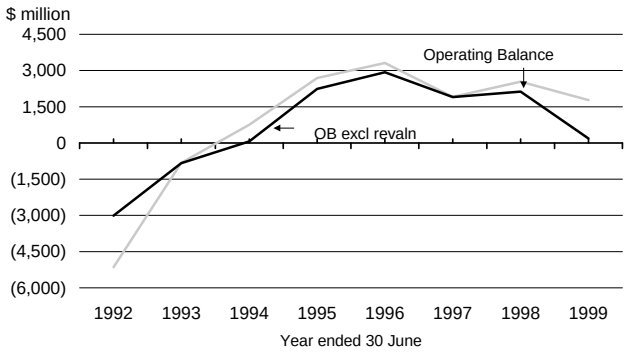
- large revaluation movements – such as foreign exchange losses or gains on asset sales
- short term fluctuations in economic growth.

Removing revaluation movements and the estimated effect of short term economic growth fluctuations on tax revenue and unemployment spending provides an indication of the effects of policy decisions on the operating balance.

The operating balance excluding revaluation movements[2] shows an underlying operating trend. Revaluation movements in total have typically been positive. The negative revaluation movement in 1992 reflects large foreign exchange losses.

The cyclically adjusted balance (CAB) indicates the effect of policy changes on the fiscal position. The CAB is calculated by removing an estimate of the effect of short-term fluctuations on economic growth from the operating balance excluding revaluation effects.

Figure 2.27 – Operating balance and operating balance excluding revaluation effects



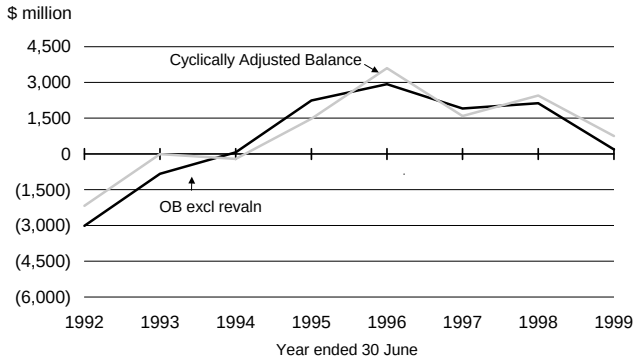
Source: The Treasury

2 Revaluation movements adjusted for are: losses (gains) on foreign exchange and marketable securities and deposits, increases (decreases) in GSF pension liability, losses (gains) on sale of assets, decreases (increases) in forest revaluations.

The CAB shows:

- growing fiscal surpluses between 1991/92 to 1995/96 reflecting tight fiscal policy
- the impact of the first tax cut in 1996/97 and the second cut in 1998/99
- the increased spending introduced by the $4.25 billion operating balance limit covering 1997/98 to 1999/2000.

Figure 2.28 – Cyclically adjusted balance



Source: The Treasury

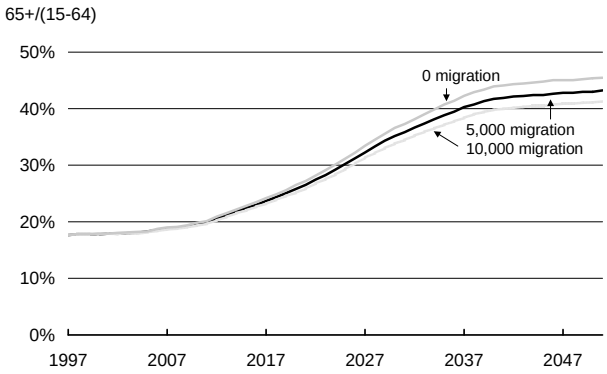
The calculation of the CAB requires a number of assumptions including estimating underlying or trend economic growth. These assumptions are important in determining the level of the CAB, but are less important for the trend. The results should be treated as indicative only of the policy impacts on the operating balance.

Population effects

Future pressure on the fiscal position is expected to come from an ageing population. A higher average age will lower tax revenue from workers, and increase health and superannuation spending.

Under a medium migration assumption (5,000 net inflow a year) the ratio of people aged over 64 to those aged 15 to 64 is projected to rise from 18% in 1997 to 43% in 2051.

Figure 2.29 – Ratio of people over 64 to the working aged population (15-64)



Source: The Treasury

The demographic projections are sensitive to a range of assumptions including the number of migrants per year, and the birth and death rates.

Similarly the size of the potential problem is sensitive to a range of assumptions including technology change (which will influence health costs), the nature and timing of possible policy actions and the labour force participation rate of people aged over 65.

Changes in Accounting Policy

The Fiscal Responsibility Act requires the Crown to prepare its forecast financial statements in accordance with generally accepted accounting practice (GAAP). The Crown's use of GAAP ensures quality financial information and confers greater credibility on its financial reports because GAAP reporting requirements are independently established.

GAAP is continually evolving to deal with new situations, such as the increasing sophistication of the financial markets.

At present there are a number of areas where GAAP developments are likely to impact on the Crown Financial Statements. Two areas that could or will have significant implications for the Crown within the next two years are "consolidation", and the use of "current values". Clarification of the Crown's reporting requirements for State highways held by local authorities may also impact on the Crown's reported financial position.

These developments will have implications for both the presentation of the financial statements and how policy decisions are reflected in the financial statements.

Consolidation

At present the Crown has an exemption from the consolidation accounting standard. The accounting standard setters have issued an exposure draft (ED-84) recommending that any entities controlled by another entity need to be "fully consolidated" and the Crown's current exemption will be removed.

This will result in all the assets, liabilities, revenue and expenses of SOEs and Crown entities being recorded on a line-by-line basis in the Crown's financial statements. Currently, only the net investment (the difference between the assets and liabilities) is recorded in the Statement of Financial Position and any surplus (including dividend distributions) is recorded in the Statement of Financial Performance.

Although the total assets and liabilities of the Crown will increase (for example, physical assets would have increased from $15.3 billion to $33.2 billion as at 30 June 1999), net worth will remain unchanged. Similarly total revenue and expenses will increase but the operating balance will remain unchanged. Net debt could change (for example, it was estimated that net debt would improve by $900 million as at 30 June 1999).

Further implications of changing the basis of combination of the Crown's financial statements are disclosed on page 70 of the 1998/99 Crown financial statements.

Current values

There is a trend in GAAP towards increasing use of "current values" (market values and market value proxies) to measure assets and liabilities for financial reporting purposes.

Using current values ensures asset and liability valuations incorporate the most up to date information on all relevant factors, and ensures that the current and future impact of policy decisions are reflected in the valuation of an asset or liability. Historical cost methodologies (used presently) do not sufficiently reflect changing circumstances that impact on the valuation of the underlying asset or liability.

An example where a current value approach is adopted is the GSF unfunded liability. The recent GSF liability valuation included the impact of recent government decisions such as the teachers' pay settlement, current wage and salary growth information, current information about retirement behaviour and discount rates. If this liability was based on a historic cost methodology, the valuation would not reflect real changes to the underlying resource obligations the Crown is required to meet.

Other assets and liabilities on the Crown's balance sheet may in future be valued on a "present value" basis. For instance, the feasibility of recording student loans and other financial assets at current value is being assessed. However, the size and impact of any potential adjustment will depend on the difference between the previous book value and the current value.

State highways

Local authorities own some sections of State highways within their boundaries. It is under consideration as to whether these sections of highway should be recorded as an asset of the Crown because the Crown is responsible for their upkeep. Including this portion in the Crown's financial statements would increase the asset value, but reduce the total reported expenses. This reduction in expenses would occur because:

- Current work performed on this section of the State highway network is currently recorded as an expense.
- If the Crown "owned" the asset, much of this expenditure would be capitalised, and then depreciated (the amount of depreciation being less than the amount currently recorded as an expense).

This issue requires further work before any adjustment is made.