



2008/09 financial review of the Treasury and of the financial statements of the Government of New Zealand for the year ended 30 June 2009

Report of the Finance and Expenditure
Committee

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2008/09 financial review of the Treasury and of the financial statements of the Government of New Zealand for the year ended 30 June 2009

Recommendation

The Finance and Expenditure Committee has conducted the financial review of the 2008/09 performance and current operations of the Treasury and of the financial statements of the Government of New Zealand for the year ended 30 June 2009, and recommends that the House take note of its report.

Introduction

We have combined our report on the Government's annual financial statements with the financial review of the Treasury, as our consideration of these items of business covered many common issues.

We held a joint hearing of evidence with the Minister of Finance, the Hon Bill English, to discuss the annual financial statements, and officials from the Treasury to discuss the financial review of their department.

Total departmental expenditure by the Treasury for the year ended 30 June 2009 increased by 6.71 percent relative to the previous financial year, to \$60.796 million. Most of the Treasury's funding comes from Vote Finance, and it also receives funding from Vote Crown Research Institutes and Vote State-owned Enterprises. In addition to being the Government's lead advisor on economic and financial policy, the department is responsible for administering expenses, revenues, assets, and liabilities on behalf of the Crown. For the year ended 30 June 2009, expenses of \$5.5 billion, revenue of \$3.6 billion, assets of \$30.3 billion, and liabilities of \$58 billion were administered on behalf of the Crown.

Fiscal position for the year ended 30 June 2009

The financial statements of the Government of New Zealand for the year ended 30 June 2009 show an operating deficit of \$10.5 billion, compared with the previous year's surplus of \$2.4 billion. This compares to a 2009 budget forecast deficit of \$9.3 billion, and, according to the commentary to the financial statements, is the largest ever deficit recorded by the Crown.

The Minister emphasised that this deficit is due mainly to the effects of the global financial crisis and the domestic recession, which have reduced revenue and increased expenditure. Core Crown tax revenue for the year ended 30 June 2009 fell from \$56.747 billion to \$54.681 billion, while core Crown expenses increased from \$56.997 billion to \$64.002 billion compared with the previous year.

Government expenditure and debt as a ratio of GDP

We asked the Minister to comment on his statement of 26 November 2009 that baseline Government spending had increased by 45 percent since 2005. We asked the Minister to explain this statement, as Government expenditure as a percentage of GDP dropped from 32.8 percent to 31.8 percent between 1999 and 2008. The Minister said that this ratio has decreased because there has been a strong expansion in nominal GDP during this period. The subsequent fall in nominal GDP, during the recession, has seen the Government expenditure as a percentage of GDP increase. In real terms, the Minister told us that Government expenditure had increased in the five years to 2009.

Some of us noted that to construct the 45 percent growth figure, the Minister had used nominal, not real, data, which excluded GDP growth and included the current year's expenditure under his Government. Labour and Green members consider this to be a potentially misleading use of financial data as expenditure growth is more helpfully described in real and/or GDP-related terms.

The Minister confirmed that the ratio of gross debt to GDP had also dropped between 1999 and 2008. We understand this to be from 35.5 percent to 17.5 percent of gross debt and net debt had been reduced to close to zero. The Minister further pointed out that nominal debt had dropped only slightly during that same period. The Minister said that the Government's concern is to ensure that New Zealanders understand that the expenditure trends of the past few years cannot continue.

We questioned the Minister as to the causes of the remaining real expenditure growth from 2008 to 2009. He confirmed that approximately half of this had resulted from automatic stabilisers such as benefit spending and banking guarantees necessitated by the global recession. He concurred that the remaining growth occurred principally in core portfolios such as health, education, police, and corrections.

Some of us note that the Minister did not provide examples of specific areas for expenditure reduction within these portfolios. Some of us are very concerned about the Minister including 2008/09 expenditure under the current Government in his "45 percent" increase estimate.

Future fiscal challenges

The Minister said that falling revenue and rising expenses are trends that the Government wants to address, as they result ultimately in significant increases in net debt. For the year ended 30 June 2009 net debt increased by \$6.9 billion to \$17.1 billion, amounting to 9.5 percent of GDP. The Minister noted that the Government is borrowing on average approximately \$250 million a week; part of this borrowing is directed towards servicing this debt. This level of borrowing is expected to continue for the next four to five years. To address the issue of rising debt, the Government is looking at both revenue and expenditure.

Regarding revenue the Government is scrutinising the tax system to assess whether it is operating as efficiently as possible and in accordance with sound tax principles. It is our understanding that the work of the Tax Working Group and the 2025 Taskforce will

inform the Government's policy on how the tax system could be reformed to enable the goal to be met.

Regarding expenditure Budget 2009 established a new net operating spending allowance of \$1.45 billion. In the first instance this money will be allocated to meet new Government priorities. In future budgets the allowance will be reduced to \$1.1 billion. Some of us are concerned that this may limit the growth in expenditure in these areas. The Minister emphasised that the Government is asking whether recent expenditure increases in these sectors have resulted in measurable increases in the services delivered. He suggested that the answer to this question is unlikely to be positive. He expressed confidence, however, that with better management equal and sometimes better services could be delivered within the new allowance.

Treasury advised us that they understand that pay increases in the public sector will be constrained by the Government to address expenditure increases. The Minister highlighted that in the year ending 30 June 2009 the average base salary in the public sector had increased by 5.3 percent; we were told that a one-percent increase in the public-sector payroll is the equivalent of \$160 million per year. The Minister said that while the Government is open to negotiating future pay increases, its first priority is to improve public-sector productivity.

Labour and Green members are concerned that the projected level of expenditure compression cannot be achieved without real reductions in service delivery, given automatic cost growth arising from, for example, population growth and ageing.

Economic outlook

Given the position shown in the financial statements we asked the Minister's view as to the robustness of the economy and the reliability of the early signs of the recovery. The Minister said that while the economy appears to be coming through the global financial and economic crisis quite strongly, there will be some hurdles to be cleared before full recovery. He considered that the consequences of the global financial and economic crises would be felt through the next decade, in both the private and the public sector. Anecdotally the Minister noted that he has heard that some smaller entities are struggling more with the recovery than their larger counterparts. This is partly because financial institutions are less inclined to take on the risks of lending to smaller institutions, in the light of the events that led to the global financial and economic crisis.

The Minister said that although confidence measures are high, the continued increase in unemployment is a major concern for the Government. He suggested that unemployment figures could be expected to improve with more investment, and that only then would high confidence measures influence unemployment. While higher confidence did not yet appear to have resulted in increased investment, such an increase could reasonably be expected if confidence remained high.

Closing the income gap with Australia by 2025

In relation to the Government's concrete goal to close the income gap with Australia by 2025 the Minister said that this would require the economy to grow at a rate of 3.8 to 4 percent per annum versus the current estimated growth rate of 2.5 percent. The Minister's

estimate is based upon current growth in the labour force and previous labour productivity trends.

Noting these forecasts, and the fact that the Government has confirmed that it will not adopt some of the recommendations in the report of the 2025 Taskforce,¹ we asked how the Government intends to achieve this goal. He said that the Government will soon announce a plan for closing the gap, which will include initiatives to increase infrastructure investment, increase productivity in the public sector, improve regulation, introduce a world-class tax system, and support business innovation. There would be a strong focus on increasing basic skills. The Minister commented that if people could not read or write then they could hardly be productive.

As the Treasury is the Government's principal advisor on economic and fiscal policy, we asked whether the Treasury had advised the Government as to whether this goal is attainable. The Treasury said that the income gap could be closed, but it would be "a big ask" and "a real stretch goal" unless significant changes were made. The Government has been advised on the issues that would need to be addressed, including fiscal consolidation, the balance between the tradeable and non-tradeable sectors, infrastructure investment, and better regulation. The Treasury also said that there should be a focus on skills and education policies as this would lift not just the growth rate but also the sustainability of growth. Finally, the Treasury is advising the Government on innovation and taxation policy.

Management of the Government's balance sheet

Discount rates for long-term liabilities

The operating balance and the net worth reported in the Government's financial statements are significantly affected by changes in the discount rates applied to key liabilities, particularly the ACC's (Accident Compensation Corporation) outstanding claims liability and the Government Superannuation Fund's retirement plan liability. In the year ended 30 June 2009 ACC's outstanding claims liability rose from \$18.006 billion to \$23.786 billion, and the fund's retirement plan liability (net of plan assets) rose from \$8.257 billion to \$8.988 billion.

When the Treasury reviewed the 2009 year-end consolidation reporting of the ACC and the fund it found significant differences in the long-term discount rates used to value their liabilities—6 percent and 8.6 percent respectively. The Treasury particularly doubted the reasonableness of the long-term discount rates applied to the fund valuation. After the Treasury investigated the reasons for this difference, the Government Actuary was directed to recalculate the fund's retirement plan liability as at 30 June 2009; the fund's recalculated liability was \$807 million higher than the initial valuation.

We asked whether this implied that the same risk-free component of the discount rate should be applied to all long-term liabilities. The Treasury is currently examining this possibility. However, we heard that, while all discount rates are based on market yields for

¹ 2025 Taskforce, *Answering the \$64,000 Question—closing the income gap with Australia*, 30 November 2009.

Government bonds, differences arise when they are extrapolated over the duration of the liabilities.

State highway asset

State highways include land, formation works, road structures, drainage works, and traffic facilities. The financial statements of the Government show that the State highway network has been independently valued at \$24 billion. The State highway network is the largest physical asset on the Government's balance sheet, and we asked how the Government expects to see a return on this substantial investment. The Minister said that, unlike other assets on the Government's balance sheet, the State highway network is fully funded by users through road user charges and petrol taxes. This means that the users are also the investors and therefore the capital costs and the return on capital are internalised. The system brings in enough cash to cover capital investment and maintenance work on the network. As there is no Crown capital invested the Crown cannot reasonably expect to get a return on the State highway network.

Users fund only a small proportion of the investment in other assets, such as the State-owned electricity generators, so the Crown would expect to see a return on its investment in these assets.

Valuation of assets and liabilities

The Government's financial statements show that the net worth of the Crown had declined from \$105.514 billion at 30 June 2008 to \$99.515 billion by 30 June 2009. We note that although total liabilities have increased by \$22.315 billion to \$117.636 billion, total assets also grew by \$16.3 billion to \$217.151 billion. We recognise the importance of valuing the Crown's assets and liabilities accurately. The Treasury said that it is working to improve its valuations, particularly of the student loan asset and the State enterprises.

We also asked about the consistency of the assumptions used in valuing the Crown's assets and liabilities. The Treasury said that it would prefer more consistent valuation of assets and liabilities on the Government balance sheet, but that technical issues would need to be resolved, and in some instances different valuation assumptions might be justified.

Retail deposit guarantee scheme

On 12 October 2008 the Government announced a retail deposit guarantee scheme. The scheme seeks to ensure that retail depositors can maintain confidence in New Zealand's financial system despite the global financial crisis and its effect on the domestic economy. Participating institutions pay a fee to the Government if they hold deposits of more than \$5 billion, or if they have grown by an amount greater than 10 percent of their deposits

As at 30 June 2009, 73 financial institutions had joined the scheme and deposits totalling \$124.2 billion had been guaranteed. The Crown has made a provision of \$816 million to cover future payments under the scheme. This provision is based upon an assessment of the non-bank financial institution guarantees that are likely to be called on, and on the estimated interest that would be payable to qualifying depositors where a defaulting event is considered probable.

Management of liability

The Treasury is responsible for managing the Crown's significant insurance liability under the scheme. The Treasury told us it had contracted out data gathering and analysis to the Reserve Bank of New Zealand, recognising its relevant expertise. An inspector is appointed to gather information on and assess the risk exposure of high-risk entities. The Treasury also said that two recently announced measures will improve its ability to manage this liability: extending the scheme to 31 December 2011, as announced on 25 August 2009; and replacing existing deeds with revised guarantee deeds to make the current scheme more flexible, as announced on 18 November 2009.

We heard that while structural changes, such as mergers between institutions within the scheme, could affect the Crown's liability, such structural changes are subject to approval by the Treasury. This should allow the Treasury to assess the probable effect on the Crown's liability of any proposed changes.

Tax package

We understand that, under the confidence and supply agreement between New Zealand National and United Future, the Tax Working Group is examining the possibility of aligning the top personal, company, and trust tax rates at 30 cents in the dollar. The final report from the group will be presented some time after its last meeting on 11 December 2009. The Minister said that if the report recommended aligning these tax rates the Government would be willing to consider how such a recommendation could be implemented; the Minister did not rule out the possibility of alignment.

The Minister said that the group is taking a first-principles look at the system, considering a whole range of reforms of the tax system, and that one of which is increasing GST. The Government will consider the reform options recommended by the group early next year. It will determine whether the benefits of changes to the tax system clearly outweigh associated difficulties.

Management of State enterprises

We asked about the projections for the year ahead for dividends to be paid out to shareholders of State enterprises. For the year ended 30 June 2009 State enterprises distributed \$245 million. The future dividends expected to be received from State enterprises are set out in Budget 2009; for 2009/10 it is estimated that \$927 million will be received.

State enterprises' boards have been told that the focus should be on financial performance and ensuring that these entities operate in accordance with the wishes of taxpayers. The Minister said that better financial performance in some instances will lead to larger dividends for shareholders. We were interested to hear that many State-owned enterprises recognise that their overheads and operating costs are too high and need to be managed. If costs are managed, the Minister said that money saved could be channelled into delivering core services.

We asked whether this shift in focus would affect the three State-owned electricity enterprises—Genesis Power Limited, Meridian Power Limited, and Mighty River Power Limited. In particular we were concerned that this new focus might raise power prices for

consumers. The Treasury said that electricity prices are determined by the supply of and demand for electricity, rather than the level of dividends paid by State enterprises. Therefore the Treasury has not assessed what future dividends mean for possible increases in power prices. It did however emphasise that in order to ensure that consumers are not faced with significant power increases a regulatory mechanism that encourages competition and discourages anti-competitive pricing needs to be in place.

Leaky homes

We asked how the Government expects to manage the issues associated with the leaky home problem. The Government accepts some responsibility for resolving this problem, and has been discussing with local authorities how it can help them deal with this potentially very significant issue. The Minister said that these discussions are continuing. While the Minister did not want to pre-empt the result of these discussions, he said a major issue is reducing the complexity of the regulations affecting the construction sector.

Proposed changes to the ACC scheme

The Minister agreed with our proposition that the ACC scheme was never originally designed as a user-pays system, but was designed to provide comprehensive compensation to people who suffered personal injuries. We then asked the Minister whether he was concerned with some of the changes proposed to the scheme by the Injury Prevention, Rehabilitation, and Compensation Amendment Bill, which would reduce some entitlements under the scheme, for example excluding people who suffer a hearing loss of less than 6 percent from compensation under the scheme.

The Minister did not discuss the details of such proposed policy changes, many of which he said are to address the increased costs of the system that have arisen in recent years. He said that basic entitlements under the scheme have expanded in recent years, and the resultant costs have to be brought under control. He said that the proposed changes would put boundaries around some of the entitlements currently available, to prevent big levy increases. Such levy increases are not desirable, given that the economy is coming out of a recession.

Climate Change Response (Moderated Emissions Trading Scheme) Amendment Bill

The Treasury stood by the advice of its Regulatory Impact Analysis Team on the Regulatory Impact Statement (RIS) that accompanied the Climate Change Response (Moderated Emissions Trading Scheme) Amendment Bill—that the level and quality of analysis presented in the RIS was not commensurate with the significance of the proposals to amend the emissions trading scheme.

On our last day of consideration of the bill an error in the Cabinet paper dated 21 September 2009 was brought to our attention. It related to the effect of the proposed changes to the emissions trading scheme on Government debt. Initially the Treasury estimated that the proposed policy setting would result in a comparative cumulative increase in Government debt of 6 to 8 percent of GDP by 2050. The Treasury subsequently revised this estimate upwards, to approximately 13 to 17 percent of GDP.

While we welcomed the Treasury's apology for the way we were informed about this error, we wanted the Treasury to explain how this error occurred. The Treasury said that the Ministry for the Environment was responsible for preparing the information in this Cabinet paper. The Treasury was then responsible for checking the accuracy of the figures involved. In the initial checking of the paper it was found that both the Treasury and the Ministry for the Environment had failed to alter the figures in one paragraph, to reflect new assumptions about the way the carbon price would change during the period to 2050. Some of the figures in the Cabinet paper were amended to reflect the new assumptions, but others were not. It was these differences that were drawn to our attention on our last day of consideration of the bill.

Overseas investment rules

We note that the first phase of changes to the rules relating to overseas investment has been announced. The changes are aimed at making overseas investment in New Zealand simpler and more attractive.

In its review of overseas investment rules the Government is considering whether the strategic asset test could be removed. We asked the Minister whether the removal of this test would encourage more investment in New Zealand. The Minister said while the test was established by the previous Government to block the sale of the Auckland airport, it was never used or legally tested; criteria in the rules for the sale of sensitive land were used instead of the test for this purpose.

The Minister said that the removal of the test is one of the options being considered in the context of the wider review of the overseas investment rules. Regardless of whether the test is removed, he pointed out that the purpose of the review is to make overseas investment simpler, cheaper, and therefore more attractive, which should help New Zealand recover strongly from the global financial and economic crises.

New Zealand Export Credit Office

The New Zealand Export Credit Office provides financial guarantee products for New Zealand exporters and banks. We heard that while the office seeks to provide services that complement rather than compete with services provided by private-sector credit insurance providers, the global financial crisis has made commercial providers less willing to take on credit risks. We asked what changes have been made in the office to manage the increased capital expenditure that has been announced in recent months. As a result of recent capital injections, the availability of three products offered by the office have been extended, increasing opportunities for New Zealand exporters. We were pleased to hear that with the assistance of the office export sales of approximately \$680 million have been supported.

Appendix A

Approach to financial review

We met on 9 and 16 December 2009 to consider the financial review of the Treasury and the financial statements of the Government of New Zealand for the year ended 30 June 2009. Evidence was heard from the Treasury and the Minister of Finance, the Hon Bill English, and advice received from the Office of the Auditor-General.

Committee members

Craig Foss (Chairperson)
Amy Adams
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Aaron Gilmore
Raymond Huo
Rahui Katene
Peseta Sam Lotu-Liga
Stuart Nash
Dr Russel Norman

Evidence and advice received

New Zealand Government, *Financial Statements of the Government of New Zealand for the year ended 30 June 2009*.

Office of the Auditor-General, Briefing on the Treasury and the Financial statements of the Government of New Zealand for the year ended 30 June 2009, dated 25 November 2009.

The Treasury, *Annual Report 2009*.

The Treasury, Response to Supplementary Questions for year ended 30 June 2009.

The Treasury, *Statement of Intent 2008–2013*.

Appendix B

Corrected transcript of hearing of evidence 9 December 2009

Members

Craig Foss (Chairperson)
Amy Adams
Chris Auchinvole
David Bennett
John Boscawen
Brendon Burns
Hon David Cunliffe
Aaron Gilmore
Raymond Huo
Stuart Nash
Dr Russel Norman

Witnesses

Minister of Finance
Hon Bill English

The Treasury

John Whitehead, Secretary to the Treasury
High Packer, Manager Fiscal Reporting
Nicola Haslam, Senior Accounting Policy Advisor
Dr Peter Bushnell, Special Adviser and Fiscal Environment

Foss Welcome Minister English, Mr Whitehead, and officials. Mr English, the committee is of a mind and had quite a discussion—and I appreciate your time is tight, but we'd really appreciate being able to go for probably 40 minutes, maybe a few minutes after that.

OK, so we'll cut straight to the chase. Minister, I invite you to make an opening statement. I'll ask a question of that and then I'll go straight to Mr Cunliffe.

English Thank you, Mr Chairman. I'll just make a few remarks regarding an overview of the public accounts. The Government's approach to deal with the effects of the local recession and the global recession coming on top of that has been to take the shock of that on its balance sheet to cushion the effects of that recession. Now, of course, that comes at a cost to our fiscal situation, and the 2009 accounts make that quite clear. So they show a picture of falling tax revenues, fairly significantly rising Government expenses through that year, and that's been driven to some extent by the

expenditure momentum built into the system but also, of course, by increased welfare costs.

The fiscal outlook may improve if the economy improves and if the improvements in the economy flow through to the books. By that I mean it's quite possible we could end up with an economy in slightly better shape than people thought, say, back in March or April. But, for instance, so far this year the company tax take is running significantly under forecast. So even if growth was a bit better it doesn't automatically flow through to the accounts.

In terms of the Government's fiscal position looking ahead, there was action taken in the Budget 2009 to start dealing with the problem of falling revenue and rising expenses. We've set a \$1.1 billion operating allowance target. That was announced in the Budget in 2009. That is going to be pretty challenging because it's a significant step down in new operating allowance for a system that's got used to fairly significant increases, and there's a fair bit of momentum built into the expenditure side of the Government's books. For instance, in the year to 30th June 2009 the average base salary in the public sector went up by 5.3 percent. That's just up to June 2009. Every 1 percent increase is about another \$160 million, so clearly significant increases would have quite an impact on that operating allowance. There's a process there of the public sector getting a bit more aligned to the wage pressures in the private sector in the economy.

There's a number of ongoing significant issues, in particular Crown entities and Government departments, strong cost pressures in the law and order area, and continuing pressure on ACC. The Government is one of the principal levy payers into the non-earner's account so in the 2009 accounts we had to put in about \$400 million to keep the non-earner's account able to meet its cash requirements. The non-earner's account is the one that deals with non-work accidents. Also across health and education there's been a culture where automatic increases, both in pay and in operating costs, have been assumed. So we are dealing with a picture where, if you think of it as services the Government is purchasing on behalf of the taxpayer, the price of those services has been rising quite rapidly. There's been some expansion in the quantity of the services, but largely the increase has been price driven. So we need to go through a process of getting on top of those price increases through productivity gains and better ways of working.

I was going to say to the committee if I'd come a couple of weeks ago that the BPS and the half-year update will be released next Tuesday, but you're already familiar with that, and the content of that, of course, will be published at the time. But the Government is going about the business of economic rebalancing and fiscal control in a fairly predictable manner, and I think I'll stop there.

- Foss Thanks very much Mr English. Just to kick-off, and you also note this in your statement at the start of the accounts where you note tax revenue has fallen by \$2 billion since last year—this was at 30th June—and that expenses have increased sharply by \$7 billion in the past year. What are the implications if that were to continue as far as our debt is concerned?
- English Well, of course, it can't continue. The Government is already, on average, borrowing about \$250 million a week. In fact, it's borrowing a bit more than that currently because the programme is front loaded, but it's \$250 million a week, per week, for the next 4 or 5 years. That's just dealing with essentially the effect of the recession starting in 2008 and the global financial crisis. Any further shocks—for instance, if there is more difficulty in credit markets and that affects our growth—will, of course, be in addition to that. So we're working on both sides of that equation. One is, the tax revenue is dropping. We want to make sure that we've had a thorough look at the tax system to ensure that we're collecting as efficiently as possible according to sound tax principles, and on the expenditure side the \$1.1 billion operating allowance plus strong reinforcement of existing disciplines in the public management system are starting to bring that growth under control. But we've set a target of restraining the growth. We're not actually going to be cutting the absolute amount of Government expenditure.
- Cunliffe Thanks very much, Minister. Obviously there's a lot of shared public concern in the state of the Crown accounts. On 26 November you issued a press statement entitled *Budget Spending Jumps 45 Percent in 5 Years*. What are the 5 years that you were referring to?
- English Oh, I'd have to just get the document out, but we issued a set of figures that just show a change in baseline spending. I think it starts in 2004.
- Cunliffe Yes, the attachment to your press release starts in 2004 and goes on to 2010, but the question about that is that it covers 6 years. If the 45 percent is driven over 6 years, which includes the first year of your Government, why did you say 5 years in the title and the data is a 6-year spread?
- English Well, my understanding is it's 2004 to 2009.
- Cunliffe You've got six financial years listed in the table—2004-05 through to 2009-10—so it's a 6-year spread. There are six columns of numbers.
- English Yes, I'm happy to go back and check that.
- Cunliffe Do you think it there might have been an element of hyperbole, Minister?
- English No I don't. The fact is, there's been in that period a 45 percent increase, and we just want to make it clear that no one should expect a further 45 percent increase over the next 5 or 6 years.

- Cunliffe I'm sure nobody does, Minister. But the Government spending as a percentage of GDP, can you recall what it was in 1999?
- English Oh no, I don't off the top of my head.
- Cunliffe Well, it's one of the things you referred to in your press release, the increase in Government spending, and for the record it was 32.8 percent. Can you recall what it was in 2008?
- English It's possible that it was lower than that.
- Cunliffe It was lower than that. It was 31.8 percent. Minister, given that Government spending as a percentage of GDP dropped by a percent between 1999 and 2008, do you think it's fair to imply that there was a huge blow-out in Government expenditure under the previous Government?
- English Yes, I do. I mean the reason that ratio dropped is because there was a very strong expansion in nominal GDP. It's measured against nominal GDP. And what we found, of course, is that as nominal GDP has dropped off there's a big momentum in the increase in that expenditure. It's a bit of the same story with debt. The debt ratio dropped quite considerably over that period. Very little debt was actually paid off.
- Cunliffe So what you're saying Minister, if I might put it in plain English—to quote a phrase that's quite often used in the media—is that when your economy is growing strongly and you've got strong tax revenues you've got more money to play with and you can either spend it or reduce debt, and the previous Government did both. Is that what you are saying?
- English Well, I was just making a point. It actually made very little reduction to debt. The absolute debt—
- Cunliffe Can you recall what—
- English Well, hang on—
- Foss Excuse me members. We are not here for a debate. We're asking questions; we're getting responses. So let's keep it there, please.
- Cunliffe The Minister said that debt wasn't reduced and therefore it's appropriate that I ask a supplementary in that regard. What was gross debt to GDP in 1999? Can you recall?
- English Oh well, I think I just explained. The ratio dropped considerably, but the actual nominal amount of debt—the billions of dollars the New Zealand Government owned—only dropped a bit. But frankly I'm not overly concerned about that. My concern is to make sure people understand that the dynamics of the last decade can't be maintained for the next 5 years. And that is taking a third of the economy, which is the public services—it's going to take them through a challenging transition process. Regardless of

the reasons or whose fault, or whatever, the fact is we've got to make a transition during which we need to provide for people better, smarter public services, because the demand doesn't go away—in fact, it increases because of recession—and we need to do that with a lot less new money than they used to, and, for some parts of the Government, with less money than they used to.

Cunliffe Do you think that there would have been a continuation of previous spending trends post the global financial crisis if there hadn't been a change of Government, in your opinion?

English Oh yes, quite—

Cunliffe That any Government would have taken into account the change in tax revenue?

English Well, listening to the pleadings of various members of the Opposition, I think, yes, spending trends would have maintained.

Cunliffe Well, there you go.

Foss If we go down hypotheticals like that we're going to get into a little debate. Let's just stick to what's in front of us.

Burns Given, Minister, that you've been critical of the increases in Government spending, even though your own Government has substantially increased education and health spending, can you tell us what were the 2025 Taskforce report's recommendations on education, cutting the childcare subsidies, or the removal of interest-free students loans you are likely to adopt, or in health, perhaps, might it be the removal of the subsidies for pharmaceuticals?

English Well, we made a number of undertakings during the campaign and we've made it clear that propositions from the 2025 commission that would breach those undertakings are not propositions the Government would look at.

Norman Just to take up David Cunliffe's question. I think it's an important question—the line of questioning was—because on the one hand David Cunliffe's argument is that Government spending as a proportion of GDP was dropping over that period. On the other hand you've said on a number of occasions that Government spending grew faster than GDP growth. How do those two things fit together to get us where we are now _____ in front of us?

English Oh, because over the last 4 or 5 years, that's correct, and that's when GDP growth was, through that mid-2000s period, pretty strong.

Norman So it depends on what period you're looking at—whether it's a 5-year or a 9-year—

- English Yes. What we've got to deal with is the momentum in the system as we find it. OK? And the momentum in the system as we find it, particularly since 2005, is to big increases both in entitlements and in the cost of delivery of service. Now we made undertakings about the entitlements that we're sticking to. To control expenditure growth we're going to have to work quite hard on the cost of the delivery of services.
- Cunliffe Given that in your statement of 26 November you've chosen to include current year spending under the current Government so they're decisions that your Government has made, and that most of the growth in nominal expenditure has occurred—well, certainly, most of it's occurred in the past 2 years, part of which you are responsible for—how much of that growth in nominal spending is related to increased costs as a result of the global financial crisis? Can you give us some idea of the numbers there?
- English You mean in the last 12 months?
- Cunliffe Particularly in the last 12 months.
- English Probably, maybe at a rough guess, half of it. So you've got the automatic stabilisers clicking in as you would expect. And the rest of it is continued cost growth.
- Cunliffe And if I can just unpack that a little, Minister, that half of that is an automatic stabiliser. You have no argument with that because your Government's been elected on the platform of not cutting into the entitlements that people enjoyed under the previous Government. You recognise that that is counter-cyclical, so you have no problem with that half and will take that as an indication?
- English Well, I wouldn't say I have no problem with it. The fact is we've still got to go out and borrow that money, and that's transferring the cost of current consumption to people who are still in secondary school today, because that's who's going to be paying it off. So it all bothers me, yes.
- Cunliffe So of the other half, the three biggies, you would presumably agree, are education, health, and corrections?
- English Look the issues with the cost growth are largely to do with whether you're more—when you're paying more are you getting more? And the answer too often is no. And when, outside of the entitlements, when we're delivering services, are they all effective? And the answer to that is a lot of them have been unexamined for quite some time. And that is what you might expect after a period when every time the Minister of Finance went to the cupboard he found another extra billion. Well, politicians being politicians, they're going to get through it.
- Cunliffe To avoid political hyperbole, Mr Chairman, the Minister's agreed with the numbers previously that expenditure as a percentage of GDP actually dropped during the previous Government from 1999 to 2008. We're now

examining the difference. Since 2008 the Minister's agreed that half of that is automatic stabilisers and the other half is health, education, and corrections, mainly. Which bits of health and education, Minister, were a waste of money? Or to quote you on 26 November—your video briefing—quote: “The big question is: have we got anything for it? The answer is: no we didn't”. Well, what bits of health and education would you therefore plan to cut?

English Oh well the question is, as I said before: are we getting more for what we're paying for? So if primary schooling costs 50 percent more than 10 years ago are we getting that much better result? The answer is we're probably getting about the same results. In health, if the budget is a lot larger than it was 10 years ago, and it is—I can't give you the figure exactly, but it'd be of the order of 60-80 percent bigger—are we getting 60 or 80 percent more services, and the answer is certainly no. So when I am sitting there as a Minister of Finance and trying to put a Budget together I'm not finding a lot of compelling evidence that these things have all been sorted through in the last 2 or 3 years. I'm finding a lot of compelling evidence that we have a big job to get on top of mixed objectives, weak governance, lack of focus on effectiveness, and an assumption that people who are on \$25,000 a year should keep paying tax to drive up the price of services. (*Interruption*)

Cunliffe Mr Chairman, I'm trying to ask a specific question—

Foss Look, we're stretched for time, and you are arguing with me. The Minister was about to finish. You asked three things; he's answered two and was getting on to the third—

Cunliffe The question was quite specific about what elements of expenditure the Minister would cut, and what we got was a political lecture about the quality of services in each of those three areas. We've had no examples given of expenditure the Minister thinks was—

English With respect, it's a stupid question. If the answer is: spend what you like with no regard for responsibility, or you're cutting things, then that's the kind of stupid rhetoric that has allowed the Public Service to run away with itself. What we're saying is we have to focus on the effectiveness of the spending, get hold of the cost drivers, strengthen the governance, protect the vulnerable, and recognise the reality that we can't keep doing what we were doing.

Foss That's right, and thank you Minister. Just one thing members, let's keep the adjectives out of cost forecasting. We're here to find out some facts. There are facts in this forecast and we're asking the Minister for the facts. Yes, there's a little bit of politics, let's not take it too far, because I'll tell you what, the 40-odd minutes we have will be eaten in no time.

Burns Minister, given that the financial statements were quite heavily influenced by the dividends by the SOEs, what is the projection in the year ahead in terms

of those dividends, and what are the consequences for things like power prices?

English We have said to the boards of SOEs that they need to focus on financial performance. We have said to them that the relationship management model is no longer applicable. The taxpayer owns these businesses, and they should be functioning in accord with the wishes of the shareholders. So there will be more pressure on them for better financial performance, in some cases more dividends, and having for instance yesterday attended the Meridian annual general meeting—because I think it’s important that the representatives of the owners show up and talk to the board and tell them what they really think—that organisation is going through a major cost-reduction process. So I think the effect of it will be less wasted money in the administration of an entity that had seen itself as a political favourite, and more cash coming back to the taxpayer that we can spend to meet recession-driven demand.

Burns Minister, you got a \$150 million windfall from Meridian alone and that was paid for by the power prices of New Zealanders, was it not?

English Well, no I think that you can argue where it comes from. I can tell you what we’re trying to do as the current representatives of the owners. These organisations have not focused enough on financial performance. Their overheads and operating costs have got too high. Most of them recognise that and they’re getting on with fixing that problem. And if we can reduce bureaucratic waste in those organisations and channel the cash into getting young people into jobs, I think that’s a plus.

Boscawen Minister, I’ve got three questions. Yesterday afternoon in response to a question from me, the Prime Minister confirmed that it’s still the Government’s concrete intention to try and raise New Zealand’s living standards, or close the gap between our living standards and the gap between ourselves and Australia by 2025. My first question is: what is the Government’s best estimate of the forecast growth rate of New Zealand through to 2025?

English Well, you’ll get another stab at that next week through the half-year update. The Treasury can explain just how they work it, but they basically have a forecast period, which is 4 or 5 years, where they calculate actual growth rates and then they have a projection period with a set of assumptions, and those assumptions are driven by current policy settings. So if they think that New Zealand’s long run growth potential is 2.5 percent then that’s what it will be in those projections. And I’ve found in working with Treasury—and I’m sure other Governments have—you have to have a pretty convincing case to get them to change assumptions from, for instance, the kinds of averages that they’re used to over the last couple of decades.

- Boscawen OK. My second questions is: what growth rate do you think New Zealand would have to achieve to close the income gap between ourselves and Australia by 2025?
- English Well, I think it's something like an average of just under 4 percent over that whole period; 3.8—is that the correct figure?
- Boscawen So if the current assumption is 2.5 percent, if we need to achieve approximately 4 percent to close that gap, and given that you have ruled out some of the suggestions made by the 2025 commission, what does the Government actually plan to do to reduce that gap? What are your own plans to reduce that gap? Given that you've ruled out the commission's plan, what are your plans?
- English Well, some of the differences between the Government and the commission are to do with rate of progress. For instance, if you take the commission's view about reduction in Government spending, they want to see it happen tomorrow—\$7 billion taken out of the baseline. We don't think that's practical. In the long run we do want to see a more efficient leaner Government, but I imagine we'll take quite a bit longer to get there than the 2025 commission would like. We've outlined a set of policy drivers that we're working through and some are more developed than others, but they're all related to lifting the growth rate, infrastructure investment, more productivity in the public service, better regulation, which we're working hard on with your own party, a world-class tax system; we're developing a lot of work on business innovation and business support, trying to pick out the best of what's worked in the last 10 years, and a strong focus on basic skills development, because if people can't read and write they can't be that productive.
- Norman I have three questions, the first one about the leaky houses. What's your thinking currently about the kind of contingent liability, or the liability the Crown might face around the leaky houses? It's a two-barrel question—how does that inform your approach for regulatory reform, because one of the issues with leaky houses, in my view, is too much deregulation, and yet you've got a deregulating programme, if you like? So there's kind of two parts: how much do you think you're going to end up paying, and how does that inform your thinking about regulatory reform?
- English Well, the Government has shifted position slightly. The previous Government said that Government had no liability whatsoever. The current Government's had some discussions with local bodies about how to assist them with what is a potentially very significant problem for Auckland, Wellington, and Tauranga ratepayers, and those are ongoing discussions and I wouldn't want to pre-empt where they'd get to. With respect to the regulation, in response to leaky homes there was a big change in the construction sector regulation, and that was probably required. We're going through a process of starting where it is now and trying to get some more clarity about where liability lies, build further on some of the things like

licensed building practitioners, and so on, that were inherent in the legislation but we think could be implemented better. But we are also focusing on reducing the complexity so we can reduce the cost. So we're trying to take what was there and get it a bit more focused and less costly.

Norman Are you concerned that in the process you may create the problem again? That is, in the process of doing that you might say: "Well, we're saving short term costs in terms of deregulation in the building of houses but creating long-term liabilities for the taxpayer who's going to have to fix this up in 10 years' time?"

English Well, we certainly want to avoid that. We tend to focus more on the incentives on the participants as a better underpinning to getting, say, high-quality building construction, and a bit less on overly prescriptive rules. But, look, the regime, by the time we've been through the Building Act, will still be quite a bit more directive than it was when the leaky homes problem developed.

Norman The other one's about return on capital invested in State highways. My reading of how Treasury currently approaches this, and the Government approaches it, is that road users basically pay for new State highways and they pay for maintenance on existing State highways, but there's no real return on the capital invested. So you expect a return from Meridian, for example—the capital invested—but you don't seem to expect a return on State highways. So effectively road transport and road freight is subsidised, whereas, say, the ports, or rail, have to get a return on their investment, particularly the ports shipping. What's your thinking around getting a return on the State highway investment in the same way you get a return on your Meridian investment?

English Well, in the first place, one difference is one has obvious consumers and the other one's got less obvious consumers on the roads. But it depends how you conceptualise it, doesn't it? You can see, if you look at the NZ Transport Authority, it's got this very large asset. It has a user-charge system, because you pay a use-related petrol price road-user charge, and those are about half each. So it's got a couple of billion of cash flow it collects in, which you can see as an asset with users who pay to use it. So there's enough cash comes in with changes that have been made under the previous Government to fund all the operating and maintenance, plus all the capital out of cash flow. Now, I haven't actually done a calculation of return on capital, but there's no other entity we have that is able to do that—to fund all its capital out of cash flow. So road users are on a sort of full pay-as-you-go system. They pay to use it and it pays for everything that we want, pretty much, now. So they're paying a lot compared to people using an electricity system. They're paying a return on capital but they're not funding all the capital investment purely out of what they pay for electricity. So roads are very well funded in that respect.

Norman Just a final one. The retail deposit scheme contingent liability. Are you concerned that some of the players are thinking about gaming the system, such as—without going into details—some of the proposed coming together of some of the troubled companies in order to qualify for the scheme? Are you keeping your eyes on the rules around the scheme in order to avoid people gaming it to get access to the deposit guarantee—
[Interruption]

English There's a big contingent liability in the accounts, and, yes, we're very aware of that. I'm not involved operationally with it; that's up to the Treasury. But my direction to them is this is a potential multi-hundred million liability. They've provisioned, I think, \$800 million, and it is well worth the investment of time and expertise to reduce that liability, because if it materialises that's real cash out of the pockets of people who pay their PAYE every week. So the Secretary might be able to give you a bit more detail about the supervision of it.

Foss Would you like to hold that one over until we commence the Treasury review?

English Yes.

Adams Given that the position of Government set out in the accounts and the recent indicators you've seen coming through about the state of the economy, what's your view of the robustness of the recovery, and how much faith should we be putting in these early signs of recovery?

English Well, I think the description of them as early signs is probably about right. I think there's going to be a few bumps on the road to recovery, not just here but globally, and you see that coming up in the Dubai problem, or figures here just this week in New Zealand, I think, that showed that building activity might actually have gone down a bit. The fact is you've had such a significant destruction of wealth in global markets that it can't all wash through in just 12 or 18 months. The consequences of it are going to go on for a decade, both in the private market and in Government finances, and some of those consequences will be destabilising. So in New Zealand the picture is patchy.

For instance, if I go around asking people in the business area why business tax take is down I'm getting told that by and large larger entities are doing OK. So, you know, the banks are still going to be paying quite a bit of tax, we hope, but smaller companies are finding it pretty tough, and that whole credit tightening around SMEs, some people are telling me, continues to tighten. The banks aren't opening up to lend to them. They are stretching out their creditors and they can't keep doing that, and actually some are getting near the end of the rubber band. On the other hand I go and visit particular businesses that are doing very well. So I'd say it's patchy and we've got to be pretty careful to keep focusing on measures that build that confidence.

Confidence measures are quite high but we've yet to see whether they turn into real investment and real jobs, because we're quite concerned about the unemployment legacy you'll get. The economy's started to grow a bit but unemployment's still growing, and because people have reduced hours rather than lose jobs you're not going to find unemployment dropping off quickly; people will just increase their hours of work again to get back to where they were rather than more. So to get people back into jobs we need business to make investment decisions, and they'll only make those investment decisions if they're confident in that recovery and in their markets. We've got to really focus on that.

- Nash First, this is just a yes-no. The Government is committed in various places. You noted down that you favour a line between a company, the top marginal and the cross rates of tax. Is that still your medium-term goal?
- English That's in the agreement between National and United Future and it's come out of the tax working group. The Government's yet to make decisions about whether it'll make changes, and, if so, what changes it will make.
- Nash If you rely on those it will cost about \$1.65 billion. How would you do that?
- English Well as I said, we've yet to make decisions about that.
- Nash So you're still considering everything's on the table?
- English Everything's still on the table. One of the features of the tax working group is that we've made an attempt to change the environment in Wellington to have open public debate about things that Government's wouldn't normally like to talk about or that the current Government might not like, and that's worked very well.
- Nash Are you still considering an increase in GST, perhaps?
- English All those things are on the table. We've got, I think, through the game of saying "Rule this out, rule that out. Why don't you rule that out?" and that has actually enabled a process that I think most people have found informative, at least, and hopefully it may turn into some progress. But we'd welcome your views on it.
- Nash You haven't ruled out an increase in GST, for example?
- English The only thing really that's been ruled out has been capital gains on family homes, but really nothing else.
- Huo Does the Minister agree that ACC was never designed as a pure user-pays insurance system and it was intended as a new form of a comprehensive system of protection for people who suffer injuries?
- Foss I guess you are asking: "Are you concerned about the contingent liabilities in the accounts?"

- English Well, yes we probably do agree with that, and we haven't fundamentally set out to change the policy around ACC as we found it when we came into Government. What we're trying to do is save it from the mismanagement it suffered from. We're not fundamentally altering the policy.
- Huo If you do agree to that, is the Minister happy to see that changes to ACC, such as up to 6 percent hearing loss, will not be covered which will result in a return to the right to sue for earners?
- English That's a policy decision that will be debated through the Parliament. Yes, I'm happy with it. I think we need to bear in mind here some pretty simple maths. If you expand the entitlements and don't increase the levies, the scheme goes backwards. So we're trying to deal with a situation where the entitlements have expanded and costs have spiralled out of control, and levies haven't reflected that. So we've got to go through a process of trying to control the costs and get some boundaries around the entitlement so that we don't end up sucking hundreds of millions out of the economy in the middle of a recession in levies. So that's a reasonably complex set of circumstances, but there'll be plenty of opportunity about whether the inherent structure of ACC is the right one. We're dealing with the immediate problem of trying to stabilise it, get control of the costs, and get the right balance between levy payers understanding that this is now a much more expensive scheme than it used to be, but in the middle of a recession we don't want to strangle them with big levy increases.
- Foss Just a quick supp. The current account of ACC is not too bad, but the balance sheet for ACC as per these accounts is not very flash. Is that fair?
- English Oh yes, that's a fair description. The non-earner's account, for which the Government's a levy payer, was in bad shape. We've had to find \$1.6 billion over 4 years to plug the hole.
- Burns Minister, you've announced the first phase of foreign investment review laws and now you're looking at a review of strategic assets. When you announce that do you envisage that that will allow more easy purchase by foreign ownership of investments such as airports, water schemes, schools—where are you going to draw the line and what's a strategic asset open to foreign investment?
- English Well, look, that's still under consideration. Just as a bit of history: the strategic asset provision, as I understand it—well, there wasn't one there, and the proposition the previous Government put up as a mechanism for stopping the Auckland Airport purchase wasn't actually used, so that concept remains untested in a legislative or legal sense. But we're having a look at the Act as I signalled and we haven't made decisions yet about it.
- It's a pretty tricky area trying to get the balance right between—you know, for a country that needs overseas investment, not because we want it but because that's where a lot of our investment comes from. So we've got to

be relatively attractive, particularly as we've got to grow out of this recession. Bank credit is going to be tight; equity is going to matter more. Who's got equity with us? The Australians, for instance, have \$85 billion worth of investment in New Zealand, so we've got to stay relatively attractive but there are legitimate concerns in the public that that's under control.

Burns Are you getting any submissions from Ministers, former or past, on the issue of any strategic assets being allowed for sale under the current rules?

English Not specifically, no.

Cunliffe I've got a couple of questions about—from your point of view, Minister—about being fair to our kids, and spreading the load over time. How much worse off would the Government's accounts have been if not for the upward revaluation of assets on ACC and the New Zealand Superannuation Fund?

English Well, the operating balance would be worse without the revaluation, but all that's doing is clawing back some of the large losses. As you know, it doesn't make much difference to the cash situation; we've still got to go out and borrow.

Cunliffe Do you now regret suspending pre-funding contributions when the assets were cheaper, given the rate of recovery?

English No not at all, as we have discussed a number of times.

Cunliffe As we have. So that's led into the next question. Given that you don't regret that and given that the Prime Minister's ruled out any change to the age of retirement or the nature of the entitlements, how will you expect future taxpayers to pick up the increased cost of superannuation? What's your plan for fiscal sustainability, given that, depending how you measure it, there's a \$35 billion to \$50 billion hole—a decade of deferral?

English Well, I don't agree with that analysis, but our plan's a pretty straightforward one, which we think we can execute. You can't sort of buy the future with accounting changes. You have to focus on two things. One is getting fiscal control so that our future generations don't end up with a very large burden of debt, and as it is public debt's going to more than double just based on the decisions that have already made, just in the last couple of years. Right? That is going to drive a doubling of public debt, so we want to keep—

Cunliffe Just to be more precise, Minister, and not wanting to engage in debate—

English You asked me about the strategy, so I'm explaining it to you.

Cunliffe Indeed, so therefore is it a fair assumption to say that if you are not going to add it to debt and you're not going to pre-fund it, will it come out of future revenue flows? Is that a fair assumption?

English As I was going to say, get on top of fiscal control so we don't have too much consumption now that has to be paid for by people who also have to support an ageing population, and, secondly, lift the growth potential of the economy so that there is actually just more resource. Because in the end a super scheme of any sort—whether it's the super fund, or defined contribution, or defined benefit, or pay-as-you-go—is just a way of dividing the resources at the time between those who work and those who don't. All it is, is building up entitlement. It's not cash.

Cunliffe Yes, we get the theology of that, Minister. Speaking of another intergenerational issue, when Treasury briefed you, as I assume that they did, that there was a \$50 billion to \$60 billion error, resulting in the difference in a Cabinet paper between 6 to 7 percent of GDP and 14 to 17 percent of GDP debt implications as a result of the emissions trading scheme subsidies to big polluters, were you a little cross, and, if so, what corrective action have you put in place to make sure that those egregious variances do not occur?

English Well, I understand there was some explanation to the committee about whatever it was. The fact is all those numbers—at least with the ageing population you've got a rough idea who's going to be there because they're generally walking around now so you know they'll be here in 40 years' time. I have to say that calculations about 50-year impacts of something like an ETS, in my view, is somewhat speculative. The beauty of the ETS is a price mechanism that gives everyone in the economy the incentive to reduce carbon. I think there are a lot of quite smart people out there who are well incentivised and they will find the solutions, and I don't think Treasury or anyone else is in a position to, with that degree of certainty, speculate about the costs 50 years out.

Cunliffe So to answer the question, you haven't put in place any process changes as a result of those errors?

English Well, that's up to Treasury really. I don't run their office or their paperwork; they sort that out.

Foss Thank you very much members. Thank you, Mr English.

The Treasury

Foss OK, we're still in open committee everybody. Thank you and welcome to the middle seat—the hot seat. I'm sure that members have questions in picking up from what the Minister was saying. There are two pertinent questions that I think members are interested in. I will just go straight back to the point that Russel Norman was raising—and I hope you don't mind me deferring to it now. Could you talk about the contingent liability in regard to the deposit guarantee scheme, an extension of—eight hundred and?—

Whitehead Sixteen million, yes—

Foss —and your ability to manage, measure, run it, and any other issues you think pertinent. Although we are talking about these in your financial review, actually, we're going to be pretty lateral here, I'm sure. So I'll leave it at that and then I might pass back to Mr Norman after that to continue that discussion.

Whitehead Thank you, Mr Chairman. In terms of the deposit guarantee scheme, I mean obviously this is a new field for the Treasury. It's not something we looked for to take on, so it's been, I think, quite an interesting learning experience for us as well. I'm actually very confident about the way we're managing it. I think there are some lessons we've learnt as we've gone through and we've tried to build on those lessons.

In terms of the provision in the accounts, as at 30th June we were estimating \$816 million. There is a bit of debate amongst the accountants on the appropriate treatment but I think it was sort of settled and accepted that the approach we took was appropriate. Essentially, what it does is it looks at those organisations that, if you like, are more likely than not to fail and what the provision would need to cover that.

In terms of, I think Dr Norman's questions in terms of managing the risk—

Foss Can I just put it into context. You've allocated eight hundred and—I forget: sixteen?

Whitehead Eight hundred and sixteen as at 30th June.

Foss What's the notional amount currently ensured as of these accounts, in actual retail deposits?

Whitehead In terms of the retail deposit scheme around about \$130 billion.

Foss \$130 billion. OK, thanks.

Whitehead There's also the wholesale scheme. In terms of managing that (retail) process, we've had certain processes in place right from the beginning. We were gathering information from the Reserve Bank and others that held information about the risk. What we've done is, over time, appointed inspectors covering the biggest areas of the risk. I think, effectively we've covered about 98 percent of what is the high risk end of the spectrum. In addition, I think the extension of the scheme was partly designed to manage that risk going forward. There's always a risk as you got near the end of the current guarantee period if markets were not yet settled, and there's still, I think, some fragility there that you could get some reaction, and therefore I think the extension itself was partly a process of seeking to manage that.

Secondly—and my colleague, Mr Little, will talk about that a moment—in terms of the revised deed, which we are instituting for the scheme, that also gives us a few more levers that we can actually operate to manage the risk. I should say that there were a number of levers in there right from the

- beginning, and one of the more controversial actions we took—and you may recall this—was to withdraw the guarantee in a particular situation, going forward, relating to a particular institution, and that was because we were looking to manage the risk where we felt there were inappropriate actions being taken. But Struan perhaps you could talk a little about that.
- Little Yes, the current deeds have provisions in them where structural changes of the companies covered require approval for exactly the sort of concerns you're worried about to ensure that the firms in there don't have the opportunity to do untoward things.
- Norman Let me try a direct question. The Chair may rule it out of order and you may not be able to answer it, but I will just ask a direct question. Do you have any concerns about the proposed merger between Allied and Hanovers in terms of the contingent liability to the Crown? That's the straight question.
- Whitehead I understood that was where you're coming from. I do have a difficulty, and Mr Chairman, I have to ask your indulgence on this.
- Norman Shall I repeat the question? It was a straight question—I was drawing your attention but you were a bit distracted, so I will just repeat it and you can deal with it how you think is the appropriate way to deal with it. The straight question is: do you have any concerns in terms of the contingent liability to the Crown of the fusing that's been proposed, the coming together of Allied and Hanover?
- Whitehead My problem is I can't comment on individual organisations. I think it would be inappropriate.
- Norman Shall I try it in a generic way?
- Foss If you want to ask a generic question, fine; specifics won't—
- Norman So do you have mechanisms in place that can protect the Crown from further contingent liabilities that result from various restructuring of finance company operations?
- Whitehead I think the short answer is yes, we do.
- Norman And what kind of things are they to give a sense of how to view it?
- Whitehead In doing that, the deed is set out for a particular firm, but if you want to change your structure or the nature of your firm then it requires the approval of the Treasury to do that. So that would involve the Treasury looking at any of those transactions and determining that there is nothing untoward what it was accepting.
- Norman So when you say “changing the structure, if one company buys another company, for example, would you consider that over the threshold of

- changing the structure, even though they might argue that they are just buying another company?
- Whitehead The answer to that is yes.
- Boscawen I want to come back to the issues of the 2025 commission I raised with the Minister earlier this morning. What is Treasury's best estimate of our growth rate between now and 2025?
- Whitehead Well, we don't actually forecast growth rates over that period, but what we do do is beyond the immediate forecast period of the next 4 years or so we approach it by looking at, first of all, what's happening in terms of labour participation—the demographics if you like; so what will happen in terms of the growth of the labour force. Then, secondly, we make an assumption based on, to a fair degree, past experience—historical experience—about what labour productivity will be. And if you add those two together—or not quite additions; they're sort of multiplication, I guess—you end up with a growth figure. So my recollection of that, Peter, was 1.5 percent productivity growth, so you're looking at about 2.5 percent in terms of overall growth figures based on that assumption.
- Boscawen What do you think New Zealand's growth rate would be required to be for us to close the income gap with Australia by 2025?
- Whitehead Well, the way we looked at that was to look at labour productivity rates, and if you start from that figure of 1.5 percent, which is a broad historical average, you would have to increase that to 3.3 percent year-on-year to achieve that.
- Boscawen What things have you seen the Government do in the last 12 months since coming into power to actually reduce that income gap?
- Whitehead We have to be fairly careful about being a report card on the Government.
- Foss Do you want to rephrase that question? It's a financial review of the Treasury's annual report as at June 30th, and I'm sure you could link that question into these accounts in another way, John.
- Boscawen Well let me ask another question then. Have you done any work in the course of the last 12 months that shows New Zealand's on track to eliminate the income gap between ourselves and Australia by 2025?
- Whitehead I think the work we've done and the advice we've given has been fairly clear in that—to sort of say well there are more you would need to do in terms of sets of policies that we have in place going back in time and now. I think the judgment about that is very much how quickly you move on some of those, and there's quite a debate about that sort of issue. But they certainly include going forward, issues around fiscal consolidation, because I think we'd all agree a structural fiscal deficit is a drag on growth. There're issues about how you improve the balance between the tradable and the non-

tradable sector. I think there are issues about public sector value for money and performance more generally. But, fundamentally, broadly it's a story about productivity and issues of skills. The way we use our natural resources, investment, international connections, the whole enterprise story, I think, are key issues about how you would seek to shift the growth rate over time.

Boscawen And the final question is: do you believe that we can eliminate that income gap by 2025 by continuing to have universal access to superannuation at the age of 65? Has Treasury done any work in the past 12 months?

Whitehead I think there's two parts to that question. Could we basically eliminate that gap by 2025? Technically, yes, you could. There are some countries that have demonstrated sustained growth rates to do that—Ireland, some of the Asian tigers have, for example. It's a big ask, I think. It's a real stretch goal. Can you do it while maintaining the superannuation scheme? Let me say what we were saying in the long-term fiscal statement about superannuation. We actually never stated—never claimed—that superannuation by itself was unaffordable; what we were saying is that you look forward, based on certain assumptions and plot, where the set of policies go in terms of public spending and taxation and revenue. Put all of that together, then you've got an affordability issue. There's no one thing that you can choose and say “that will sort our problem out”, and superannuation would fall into that category.

Boscawen As a supp. then to that, and looking at your annual report, I see it's to give advice to the Government. You've just said that it's technically possible. You've said it's a big ask. You've said it's a stretch goal. But the Prime Minister confirmed yesterday afternoon in question time that it's a concrete goal of the Government to eliminate that income gap by 2025. I just wondered if you could advise the committee on suggestions you'd put to the Government to do just that?

Whitehead Well, in many respects a whole range of our work is relevant to that question, I think. Certainly, we've been giving advice on issues about regulation. We've been giving advice on infrastructure, and you'll recall one of our new responsibilities is the national infrastructure unit and that coordination role. We've been giving advice on public sector performance, value for money issues; certainly been giving advice on fiscal policy. I think it's probably well known, our advice on that. We've been giving advice on skills and education policies that I think are relevant to that, and I think that's very important in terms of not only the growth prospects but the sustainability of growth. If you can bring the productivity skills and capability of the broader population up I think that will help the sustainability of your growth objectives. Taxation, of course, is one of the big issues before us, and we've been working with the tax working group on those sorts of issues. The innovation policy, I think, is the other one where we've focused quite a bit of advice over recent times.

- Burns Mr Whitehead, given your commentary of concern about debt projections, have you provided any recent advice to the Minister on the future of the New Zealand Superannuation Fund and whether that might be retained or not?
- Whitehead Nothing recent, no. We advise in the lead-up to the Budget, obviously, and then of course there was a comment to the long-term fiscal statement, but that was more about superannuation than the fund itself.
- Burns And in terms of the SOEs, what projections are you suggesting are required in terms of dividend streams to Government to offset the issues of debt prevention?
- Whitehead Dividend streams from SOEs will not offset the Government's whole debt.
- Burns _____
- Whitehead I don't have figures with me at the moment. I don't know whether anyone can advise on that. But we would certainly, for example, be looking to raise the rate of return, and if you think about that every \$1 billion of assets that you've got, if you can raise that rate of return by 1 percent, well that's another \$10 million of earnings that are available. That's not a simple proposition but that's the basic message.
- Burns And do you, in making those projections, take into account what the cost might be on taxpayers via mechanisms such as power prices?
- Whitehead Well, in one sense, yes, but what we expect the State-owned enterprises to do is operate commercially and within the rule of law, and that certainly in terms of Commerce Act provisions and so forth ensure that they are acting in an appropriate way in that sense. So you're looking, I think, to wider rules and mechanisms to ensure that those concerns are met in terms of price behaviour, and, if you like, quasi-monopoly behaviour if that's your concern.
- Burns And if past increases have been twice the level of inflation, is that still appropriate in the current environment? I'm referring specifically to power price increases by SOEs.
- Whitehead I think the whole question of power pricing is quite a difficult one because you are also having to be concerned about the replacement of assets, and the long-run marginal cost of replacing those assets is, I think, an important consideration you have to bed into there. I'm conscious there's quite a debate and examination of this whole question, and Ministers have looked at that process from the point of view of the potential of managing asset structure and the State-owned enterprise performance more generally better to actually ensure that we're actually getting full competition going in there.
- I would say, though, that if you look at the accounts this year, of the three State generators one actually had a significant reduction in profit, so it's not

a simple story one way or the other. It's a more complicated story, which is why there's quite a bit of examination going into that issue.

Foss The Export Credit Office has had an injection of capital and there's been further announcements over recent months. Can you talk us through as to where that office is located? Has there been any increase in management of it, there's quite substantial sums involved there?

Whitehead Yes, it's been quite a focus for us in the last year, and, in fact, it's one of the impacts of the global economic international crisis where I think you've seen the private sector—in the circumstances, of course, explainable I think—willing to take on less risk in certain areas. And what we've tried to do very carefully with the Export Credit Office is to ensure that where we are expanding our services we are checking with firms that basically the service that's required is not available from the private sector. So there has been—you're right—a significant increase in exposure; I think maybe upwards to five fold over a period of time.

Foss Seven hundred and fifty million higher, is that right?

Whitehead Yes, whatever - it's quite significant.

Whitehead But I think that's actually been quite helpful for exports in the sense that we're now supporting something in the order, I think, of about \$680 million of exports that might not have happened otherwise. And in answer to your question re management, yes, we've had to expand the amount of resource going into this area considerably to meet that demand and to ensure that we're managing the risks appropriately.

Foss So regarding the reporting lines to that office, will that change because of the increased risk there, or are you quite comfortable of where it is now?

Whitehead It has changed under the restructuring process that I've been doing, and eventually with that interim arrangement the intention is to bring a lot of that financial operations areas together so you're getting some economies of scale but also some interface between various folk managing risk and getting mutual learnings across those boundaries.

Gilmore With the net worth of about \$100 billion, I guess, coming out of the accounts, the valuation of assets and liabilities are quite critical in terms of some of the details behind some of the valuations. We have seen some quite big movements in valuations of both some of the liabilities and some of the assets. Can you talk us through some of the work that you have done this year to try to improve the quality of those valuations of both assets and liabilities?

Whitehead Yes, I guess we've worked on a number of areas, and we had a bit of debate with audit about the priorities. With the benefit of hindsight maybe we might have done a different order of priorities on this, but we did quite a bit of work on the student loan scheme to get a better handle on what was

happening in that area.—I forget whether it is the biggest or second biggest liability now; it is a pretty large one, anyway. So we've looked to get a better handle on what actual behaviour is in terms of repayments and so forth. Partly that's being reflected in some changes in these accounts.

Another area, obviously, where we did quite a bit of work is in the deposit guarantee schemes. Over a period of time, I think now that we have a much better handle, say, between the Budget and now or the end of September, on just what those risks were, and getting some quantification on those. That has required bit of detailed work, including examination of individual agencies obviously through an inspector's process. We have done some preliminary work on the question of long-term discount rates, and that came up in the ACC and Government Superannuation Fund context. Obviously, some more work needs to be done there as well. There is a fourth area, which escapes me for the moment, where we have done some further work as well.

? On SOEs, as well

Whitehead Yes, SOE work, as well.

? There will be some questions around that topic, anyway.

Gilmore I guess one of the questions I was going to go to from there is, are you moving to commonality of valuation—the discount rate you touched on, for example, is one. There are a whole lot of other _____ valuation methods that exist and choice of valuation methodology. Are you looking at commonality movement for those sorts of funds, because that seems to have been the problem in valuing both assets and liabilities?

Whitehead Yeah, I think probably what I would say on that is that there is a tendency to move towards more consistency. I think there are quite technical issues around here, where in some cases it might actually make sense when you work through individual agency situations to have a different set of approaches. But, broadly, the kind of difference we have between ACC and Government Superannuation Fund, GSF, did not look sensible. Hence we moved to intervene on that and changed the long-term rate.

Cunliffe Just to pick up on that same point. I appreciate that questions from my colleague mirror some of my own. The discount rates that were being used in ACC and GSF pre the review were how far apart—the risk-free rate?

Whitehead So you mean the discount rates at the time?

Cunliffe Yes.

Whitehead I am just trying to get a handle on the timing here.

Foss In these accounts, are the discount rates consistent; if not, how different are they?

- Cunliffe I was looking prior to the 2009 review. Some of my information here is 6 percent ACC, GSF 8.6 percent, so it is 2.6 percent difference. Does that sound like prior to the review?
- Whitehead That was the figure that came through July-August as we did these accounts. Those are the figures on which we said no, those are too far apart, that doesn't make sense, and we intervened at that point. In previous years they have been much closer together, I think—not identical, but much closer together.
- Cunliffe So the action that you took, Secretary, resulted in the GSF discount rate being changed and another \$800-odd million liability coming on the Crown's account.
- Whitehead That's right.
- Cunliffe Given that this is the risk-free component that we are talking about, not the risk premium, which is entity-specific, why is there not an underlying Crown risk-free rate that is applied across institutions (leaving aside institution-specific risk premia)?
- Whitehead We are getting fairly technical here. Peter do you want to comment on that?
- Bushnell In each case the actuaries and the boards of the institutions have to decide on what the appropriate risk-free rate is, going forward. In the past that has led to almost no difference. They have been much the same sort of rates because they had a reasonably stable yield curve, and looking out they have been able to judge that. This time they came up with a different view and in a sense that was the trigger to say, well, that does not make sense to us, and therefore you took it back. I think your question was why not just have one that you specify and then apply it? I think that is something that is going to be looked at as part of this process of working forward. We thought, in the short term for this year's one, that we needed to have a judgment that got the institution to relook at it, and then it was something that their boards would sign up to and so on without having changed the whole system on them.
- Cunliffe I just want to pick up again on the implications for the ACC of this. ACC, of course, moved its discount rate prior to the review, and that had resulted in a sharp increase in its future liabilities. You were comfortable with the ACC taking the lower discount rate.
- Whitehead . I should emphasise that in both of these cases the auditors for each agency were, I think, comfortable with the discount rate assumptions taken, because they were within the accounting standards, if I can put it that way. Once we did the analysis we were comfortable with where the ACC had come out. We are talking here about the discount rate that I think applies, Nicky, from 10 years out and beyond.

- Cunliffe But it would be fair to say, Secretary, that ACC had moved prior to your review to take more conservative assumptions?
- Whitehead I think that is probably correct, yes.
- Cunliffe Can I just come back quickly, and I won't be labouring any of the political rhetoric that went around it, but I just want to quickly validate an exchange with the Minister in relation to Government expenditure as a percentage of GDP figures. They were taken from the Budget documents. We can have confidence in those. They have not changed, historical numbers, since the Budget 2009 was published? So they would be correct would they?
- Whitehead I do understand that the Government Statistician has just revised GDP figures or is in the process of doing so.
- Cunliffe So could somebody advise whether the 1999 figure of 32.8 percent of GDP is correct?
- Whitehead I couldn't give you a precise answer on that. I doubt if his revision goes back that far.
- Cunliffe And the 2008 31.8 correction was correct at least, was it?
- Whitehead I know his revision for recent years is quite significant, so that could shift things around a bit. I can't tell you exactly how, but—
- Cunliffe Can Treasury advise why, when the Minister was talking about spending over 5 years, he used 6 years' worth of data?
- Foss We can't do that, but if you want to—
- Cunliffe Had Treasury provided advice to the Minister on which he based his statements about increased Government expenditure over a 6-year period?
- Whitehead I'll just check and ask Peter to answer about the advice question, but in terms of the 6 years, as I understand it, there were 6 years mentioned there. If you take the first year away from the sixth year you've got a 5-year-change period. I would have to go back and look at the numbers.
- Cunliffe The table attached—the \$45 billion appears to be a 6-year difference, but we would be happy to cross-check that again. Secretary, on the Kyoto calculations the Treasury's Regulatory Impact Unit did a pretty brave thing in the preparation of advice on the emissions trading bill. It kind of blew the whistle by saying that they felt the quality of the analysis underlining the objections was really not adequate given the magnitude of the issue. They made a number of suggestions to us in the select committee, one of which was there could have been more explicit modelling of scenarios and sensitivities. So, Secretary, from your point of view, that is the regulatory impact unit doing its job as it should?

- Whitehead Yes, I think it is another way in which we make ourselves unpopular, I think, but it is part of what we see as our job to try and be - respected but not liked.
- Cunliffe Part of who may have not liked it, of course, were other parts of Treasury who were involved in advising the Climate Change Working Group who had to front, I imagine, both the Minister for Climate Change Issues and the Minister of Finance to advise that the Cabinet paper of 21 September had a material error in it around the difference between 6 or 7 percent of GDP liabilities and 14 to 17 percent of GDP. I asked the Minister if any corrective processes have been put in place to ensure that sort of thing didn't happen again, and he, of course, deferred to you as it was a hard question so I am now putting it to you.
- Foss Just ignore the last part. You were doing so well!
- Cunliffe I was. I'll be well behaved for the next two questions.
- Whitehead Perhaps it's helpful if I just stand back and explain my understanding of what happened with those figures. In fact, the Ministry for the Environment put together the Cabinet paper. There was a process whereby the assumption was put in going beyond the immediate 4-year-period of a \$50 assumption for the carbon price. That required some changes on an early draft of the paper where the assumption had been \$25 right through. They corrected figures in the table, recalculated them. There was actually only one set of figures all along, I think, and that is probably a point that we need to come back to. They then asked Treasury to check those figures. Treasury did so. Those figures in the table were correct. What the Ministry for the Environment hadn't done and what we didn't pick up was a separate explanatory paragraph, which had been in the earlier paper based on the \$25 assumption, which the 6 to 7 percent GDP figure was right. But if you take that bigger assumption, the assumption of a larger carbon price, you get up to a bigger GDP figure.
- Cunliffe That, of course, was our understanding. But just for those who might be listening into this discussion and from your point of view, Secretary, I just want to clear about what the numbers were because they are substantial, and they mean trade-offs between other expenditure or debt reduction off the taxes. \$50 billion liability based on Treasury's mid-range scenario of \$50 a tonne, post 2012 figure, I think it was. That was \$50 billion without compounding effects, \$110 billion with compounding effects. Is that correct?
- Whitehead I think the difference, if I'm correct, and Struan can correct me if I'm wrong here, the difference between the \$50 billion and the \$110 billion is building in the debt-servicing cost. I apologise to the committee for the untidiness of that process, but, again, the same set of figures, essentially, but one has the debt-servicing costs and the other doesn't.

- Cunliffe It was a very unusual process.
- Foss In these accounts, let's say you have got a line here for health, OK, so it is the health notional spend at this time that is reported. Do you apply an opportunity cost, a debt-funding cost, or whatever to that health spend?
- Whitehead For the current year, we don't apply debt servicing, no.
- Foss But there is a line for debt servicing for the entire Crown somewhere else in here, right?
- Whitehead Yes, which builds in all of those figures. That's right.
- Boscawen I'd like to come back to some earlier work that Treasury has done relating to _____. Mr Cunliffe is making a point that that explanatory paragraph didn't accord with that; we are talking about the potential deficit of 15 percent of GDP as opposed to 7 percent of GDP. If I am correct, Treasury has done a forecast to 2050 showing that our debt is likely to blow out from 20 percent of GDP to 220 percent of GDP. So on the basis of the deficit that the current Government inherited and on policy projections Treasury's current forecasts are 20 times the magnitude of error that the Labour Party _____. Am I correct in saying that? Putting that ETS error in context, it is basically chicken feed if Treasury was right and our debt blows out to 220 percent of GDP by 2050.
- Whitehead Well, as someone who worries about every dollar, I never describe anything as chicken feed.
- Boscawen I'm just putting it into context. I am saying that on current policy projections I understand that you guys are saying we are going to go to 220 percent of GDP.
- Whitehead Arithmetically, I think your point is right. I would say though, in terms of the long-term fiscal statement, that those are projections that are heavily dependent on assumptions. We varied those assumptions. They are reasonably robust. You end up with a nasty figure on most reasonable assumptions. You could halve it on some assumptions, but it is still a pretty big and worrying figure at that rate. So arithmetically you are right. The point we are making is that a lot of uncertainly going forward, but the trajectory of existing policies gives you some issues that are going to have to be addressed over time.
- Cunliffe And Mr Boscawen has pointed exactly to the last part of my question, which is around that long-term fiscal outlook and, obviously, one of the biggest drivers, probably the biggest driver is assumptions around New Zealand Superannuation—what level of entitlement, age of entitlement, how it is funded. Assuming for a moment, no change to the age of entitlement and no change to the basis of calculation as per the Prime Minister's undertaking, 65 percent to 66 percent of the average wage going forward, and given the whole, assuming we don't resume pre-funding to

- 2021 as per Budget 2009, what are the options post 2021 for making up the difference, and if that difference is not made up, what implication is there for the Crown accounts?
- Whitehead Well, the options, I think, in many respects are already in the statute. Effectively, the way it would work is that the formula means that once we are back into surplus and contributions resume, the formula generates a higher value of contribution than would have applied if we had been funding all the way through.
- Cunliffe But with respect, Secretary, just to clarify that. It is not retrospective. It doesn't catch up the 10-year gap.
- Whitehead No, it doesn't catch up. No. My understanding is that, combined with a delay in when it would start paying out, which I think is around 3 years, it makes up roughly about half the difference.
- Cunliffe That's right, half the pre-funding contribution. So assuming these figures depend on what assumptions you take, but, roughly, seven taxpayers per retiree today, 2030. I've seen some numbers, which say it is roughly half that; let us say it is 3½ taxpayers per retiree. I think it is 2½ at 2050, something like that. Assuming that those people who are currently our children, they are probably school kids today, there is no change to super entitlements, they enter the workforce, assuming all else is equal, because we have no basis for changing other assumptions, what kind of additional tax impost on them would result from maintaining current superannuation levels?
- Whitehead I don't have that particular figure with me. I do know that the assumption at Budget time was that we would end up, rather than pre-funding about 11 percent of superannuation by 2050, we would pre-fund about 8 percent. So it is that kind of order of difference.
- Cunliffe Can you help me in any way to translate that, say, 3 percent to tax rates or even rough dollar amounts in today's dollars? How might we think about that constructively? I am just trying to get an order of magnitude. Joe Average Taxpayer in 2021 has got to make this wedge up as well as face the different demographic curve, that there is a whole lot more senior citizens per taxpayer. How big are those effects? Are they something that we need to be concerned about?
- Whitehead I couldn't give you a figure off the top of my head. I'm bound to be wrong. I think that it does illustrate, though, the importance of moving to gain fiscal control earlier rather than later, because the later, if you like, you deal with that issue and all the other issues we are facing, the more the change would have to be to make it up.
- Cunliffe Obviously that's a two-level general fiscal control and fiscal control around superannuation. That is just a section my colleagues considered yesterday—

- Nash Have you provided or are providing any advice to Government about possible changes in taxes?
- Whitehead We are in conversation with the Government on that and we will be advising them as we go forward in the Budget process, yes.
- Nash Are you able to enlighten us on the sort of advice you provide?
- Whitehead Well, I think probably the best form of enlightenment on that is the Tax Working Group work where we have been, with Inland Revenue, providing assistance to that process. That is deliberately aimed to be as open a process as possible. They are putting the work on the website, including the officials' contributions.
- Nash What recommendations did you make in those actual papers?
- Foss Just bring it back. You can answer the question. We are about the annual report, about these, and if you are giving advice, etc, which can affect the tax structure system, that is of interest. It is kind of another way of asking the same question.
- Whitehead I think probably the best way of answering that is that we are not yet at that stage of the process where we are giving specific advice to Government. We are approaching that stage. We are not there yet. I think in some of my public speeches, other comments, and information that we put up on the website we've tried, if you like, to give some of the parameters of the debate and throw some challenging issues in there for folk to consider. I think that is all on the public record, but in terms of advice to Government we are approaching that period, but we are not yet at that specific advice stage.
- Nash So what are your recommendations for actually _____ the scheme? Do you stand by that recommendation?
- Whitehead Well, one of the options we canvassed was increasing GST, in the advice we gave to the Tax Working Group. Part of the rationale for that is to kind of shift the economy away from consumption and more towards production, but we highlighted that there are issues around that, of course, in terms of equity and in terms of fairness that you would want to address as part of that kind of move.
- Nash Given the Minister said that every 1 percent increase in salary and wages in the public sector, he quotes about \$160 million, the Minister has indicated that there is a freeze on wage and salary for up to 5 years. Do you guys model the sort of stimulus or fiscal impact of \$160 million in the economy?
- Whitehead Not specifically in that context, no. I do think though, if I understand what the Minister was saying, he was saying you will not get money from the centre to justify wage increases over the next period. In other words, if you are going to increase your pay you are going to have to find it from within the organisation's funding that it already has. So the macroeconomic

- implications for that would depend on what actual movements there were on wages over that time period.
- Burns It's back to the ETS issue, Dr Whitehead. Can you confirm, because there has been a lot of conjecture around the Treasury's estimates, that you are stating to the committee that the \$110 billion assessment you made of the cost to taxpayers does stand, that is based on the mid-point pricing of \$50 a tonne for carbon, and that the indications of that for taxpayers, in terms of household costs, would be of the order of \$92,000 over a prolonged period.
- Whitehead The last number I would have to check. In terms of the numbers we provided, based on the assumptions that are made—I would emphasise that because, frankly, who knows what the carbon price will be as we go forward and there are a number of other assumptions as well that could affect that—I think the calculations are accurate. I am in no doubt about that; the numbers have been worked through properly. But who knows what the world will bring.
- Boscawen I just need to come back to Brendon Burns' comment, and he put up a submission to you and you were a bit uncertain about what he was saying, and you concluded by saying that his figures are correct. I can't leave that assertion to go unchallenged, because what Mr Burns said to you [*Interruption*]. No this is important, because we have got to get this all right. The question is that you were asked if the changes to the ETS will result in the extra cost to the taxpayer of \$110 billion. Surely what you should have said—[*Interruption*—is you have an ETS that overtaxes people. You have this massive tax windfall and the effect of the Government's amendment is simply to take that tax windfall back to zero. Is that not a more accurate description of what the Government did?
- Whitehead Let me very quickly clarify that. What we were modelling there was the impact of the changes, vis-a-vis the previous scheme. What the net effect will be to the taxpayer of course depends in the future on what is done in recycling revenue and so forth. I think the policy of the previous Government, and the policy of this Government is that that will be fiscally neutral, and so in that sense, yes, it would not have an imposition on the taxpayer.
- Norman It's about the infrastructure unit. It's about the decision-making process and the rigour of it. One of the concerns that Dr Graves has raised in his interim report on transport is whether there is actually proper cost-benefit analysis being undertaken. And so with the infrastructure unit _____ and the plan we have established here, we have a Government that announces that it will build these roads of national significance, with cost-benefit analysis and there will be billions of dollars allocated to it, and yet this is long before there is any rigorous process for deciding and leave the infrastructure plan in place but having a cost-benefit analysis. What is your process to actually get some rigour around these kinds of infrastructure investments? At the moment it seems to be just a _____

- Whitehead Well, two comments. As individual projects are worked through there is of course a cost-benefit process they have to go through at the right stage. In terms of the infrastructure unit, its job is actually not to do all of those calculations. Its job is to provide guidelines, support, requirements, if you like, to make sure they are done well and done accurately.
- Norman Will those guidelines require that, before decisions on individual projects are made and money is allocated to them, there is some analysis done as to whether this should be the top priority for spending millions of dollars?
- Whitehouse Well, you certainly hope that would be the order of things.
- Norman It does not appear to be the order at the moment—
- Whitehead I think that is probably a debatable point. I think sometimes Governments are giving indications of direction or intention, but then at other times they will have to be worked through in terms of the actual numbers. I take your point and there may be a bit of tidiness that we can insert into that process. I am not quite sure. I would say the Governments are announcing well before they have done all the work on it. I think often there is quite a bit of preliminary work done before that point.
- Norman Except that they don't have any cost-benefit analysis, when we ask them.
- Foss Thank you very much, Mr Whitehead, and your team.

conclusion of evidence