

**DRAFT**

Office of the Minister of Finance

Monday 6 April

Chair

Cabinet Strategy Committee

**2009 Budget Package**

**Proposal**

1. This paper seeks approval of the broad outline of the Budget 2009 package. A paper with the final details of the 2009 Budget Package will be submitted for consideration by Cabinet at its meeting of 20 April.
2. High level options regarding future budgets that aim to address the fiscal situation and prevent it deteriorating as far and as fast as currently forecast are contained in the Cabinet Paper *Setting a Fiscal Strategy* that will be considered at Cabinet today.

**Executive Summary**

3. This budget is prepared against a very difficult backdrop. The most recent figures for New Zealand's gross domestic product confirmed that the economy was in recession throughout the 2008 calendar year, and forecasts suggest the economy has entered its sixth consecutive quarter of negative growth. Many of our major trading partners are in worse shape with sharper contractions in growth. In the December quarter of 2008 European economies contracted sharply with France down 1.1 per cent, the UK down 1.6 per cent and Germany down 2.1 per cent. The US economy shrank 1.6 per cent in the same quarter, while the falls in Asia were even more noticeable with Japan contracting 3.3 per cent, Singapore down 4.4 and Korea falling 5.1 per cent. Closest to home, Australia's economy contracted 0.5 per cent in the December quarter.
4. Decision making is made even more complicated by the significant uncertainty that underlies all economic forecasts in the current climate.
5. Following the decline in the economic situation, the fiscal position has deteriorated significantly. We are now facing a forecast of significant budget deficits (peaking at \$12 billion in 2012) and mounting debt. Preliminary projections are for gross debt to reach

73 per cent by 2022/23 – even weaker than the projections published in the 2009 Budget Policy Statement in December where debt was expected to reach 57 per cent by 2023.

6. In the 2009 Budget Policy Statement we were clear that we would not let these forecasts eventuate. Budget 2009 is about meeting the commitments we made during the 2008 election campaign, while recognising that economic conditions have changed significantly and we need to respond appropriately.
7. In line with this, the 2009 Budget has three main parts:
  - i. Helping New Zealanders through the current crisis;
  - ii. Putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand's future economic performance; and
  - iii. Making the first steps towards fiscal consolidation and implementing changes in policy to ensure that the growth in Government debt is minimised.
8. The emphasis to date has been on softening the immediate impact of the global downturn. The current fiscal impulse – from both baseline spending and new measures we put in place in February - is large and will help sustain the economy for a period.
9. Based on current economic forecasts, I expect that in Budget 2010 the main issues to be dealt with will be fiscal rather than economic. While preliminary forecasts show a return to growth from quarter 4 of 2009, the impact on the government's books lasts far longer with deficits persisting beyond 2022/23 and debt continuing to rise.
10. Taking this into consideration, for Budget 2009 I propose new new spending parameters of \$1.45 billion operating and \$1.45 billion capital in total. While on the operating side this is a reduction on the Government's initial plans announced in December, it still represents extra spending of \$7.25 billion over the years 2008/09 to 2012/13.
11. This amount is net of the significant reprioritisation of existing funding which the savings put forward in this Budget have afforded – total spending that has been committed so far is set out in the table below:

*Table 1: Preliminary spending in Budget 2009*

	\$million increase / (decrease)						
	Operating						Capital
	2008/09	2009/10	2010/11	2011/12	2012/13	Total	Total
New spending	211	1,790	1,435	1,859	1,882	7,178	1,397
Savings	(172)	(265)	(482)	(558)	(540)	(2,016)	(90)
<b>Net increase in spending</b>	<b>40</b>	<b>1,525</b>	<b>953</b>	<b>1,301</b>	<b>1,343</b>	<b>5,162</b>	<b>1,307</b>
Allowance	-	1,450	1,450	1,450	1,450	5,800	1,450
<i>Possible contingency</i>	<i>(40)</i>	<i>(75)</i>	<i>497</i>	<i>149</i>	<i>107</i>	<i>638</i>	<i>143</i>

12. As can be seen in the table above, of the \$1.45 billion operating allowance I propose to maintain a reasonable between budget contingency to provide the Government with the flexibility to respond rapidly to events as they unfold - both changes in the economic and

fiscal situation, and emerging policy priorities such as those initiatives that Cabinet will be considering as a result of the Jobs' Summit. The table above shows a total possible across the forecast period, I expect to smooth this across the years before it is finalised.

13. A full Budget package within these new spending parameters will be presented to Cabinet for approval at its meeting of 20 April.
14. The Cabinet Paper *Setting a Fiscal Strategy*, considered at Cabinet today, sets out some higher level options regarding future budgets that aim to address the fiscal situation and avoid a possible negative response from credit rating agencies and international investors that could severely limit future economic growth.

## **Background**

15. Two factors have complicated the Government's response to the economic situation and the development of this Budget. The first is the rapid deterioration in the world economy following the financial crisis, and the continuing and sharp downward revisions in the forecasts for our trading partners. This has affected both the New Zealand economy and our fiscal position. The most recent GDP figures have confirmed that the economy was in recession throughout the 2008 calendar year and New Zealand has entered its sixth consecutive quarter of negative growth.
16. The second has been the Government's spending path. In the five years from 2005 to 2010 levels of Core Crown expenses grew by almost 50 per cent from \$45 billion in 2005 to a forecast \$66 billion in 2010. When combined with the economic crisis (which has caused Government revenue to fall), this has seen the fiscal position deteriorate significantly. As is set out in the table below, we are now facing a forecast track of significant budget deficits and mounting debt (based on preliminary Treasury forecasts and in the absence of any corrective action).

Table 2: Economic and Fiscal Indicators – Preliminary Economic and Fiscal Forecasts

	2008	2009	2010	2011	2012
Gross Domestic Product (\$m)	176,244	173,639	182,281	192,069	203,749
<i>Change compared to DEFU increase / (decrease)</i>	<i>(4,895)</i>	<i>(10,867)</i>	<i>(11,627)</i>	<i>(13,320)</i>	<i>(12,773)</i>
Revenue (\$ million)	79,546	80,668	82,808	85,359	90,663
<i>Change compared to DEFU increase / (decrease)</i>	<i>(1,905)</i>	<i>(871)</i>	<i>(1,638)</i>	<i>(3,008)</i>	<i>(2,899)</i>
Operating balance excluding gains and losses (\$ million surplus / (deficit))	(4,801)	(7,785)	(10,245)	(12,230)	(11,311)
<i>Change compared to DEFU increase / (decrease)</i>	<i>(3,989)</i>	<i>(3,758)</i>	<i>(4,342)</i>	<i>(6,055)</i>	<i>(5,136)</i>
Gross Debt (% of GDP)	22.30%	26.50%	34.90%	40.40%	45.00%
<i>Change compared to DEFU increase / (decrease)</i>	<i>3.10%</i>	<i>5.50%</i>	<i>8.90%</i>	<i>11.00%</i>	<i>11.90%</i>

17. The Budget Policy Statement released in December 2008 set out our intention to meet policy priorities for Budget 2009 within an operating allowance of \$1.75 billion and a capital allowance of \$1.45 billion in total.
18. I also established a process to meet the costs of any emergency pressures that could not be met from baselines through Ministers offering back savings from low value activities within their Votes – through this process more than \$2 billion in savings across the forecast period were realised. In addition some policy commitments of the previous Government were unfunded and the 2008 Budget contingency was oversubscribed by more than \$200 million in total, so initial policy responses to the recession taken by the government this year have had to count against the 2009 Budget.

### Comment

19. Since we came to Government we have had to face the immediate challenges of the unfolding international financial crisis, while at the same time taking longer term actions to create the high growth economy that is our primary objective. Budget 2009 balances these challenges against meeting the commitments we made during the 2008 election campaign.
20. As discussed earlier, the 2009 Budget is in three parts:
- i. Helping New Zealanders through the current crisis;
  - ii. Putting in place longer-term initiatives to lift productivity, improve competitiveness and sharpen New Zealand's future economic performance; and
  - iii. Making the first steps towards fiscal consolidation and implementing changes in policy to ensure that the growth in Government debt is minimised.
21. The best policies in this budget deal with two or more of these objectives. For example the SME regulatory and tax reforms measures reduced short-term compliance costs on businesses and will help lift longer term productivity. Increasing the efficiency of public sector agencies can lift productivity in the sector and provide fiscal savings.

22. While the balance sheet is in reasonably good shape right now, the size and structural nature of the deterioration in the Crown accounts means the sooner corrective action is applied the better.
23. In addition, maintaining New Zealand's credit rating means responding to the expectations of credit rating agencies that the Government make definite steps to address the projected rise in debt. Over time it will also be important to reduce the current fiscal stimulus to reduce any pressure on the export sector, and to rebuild the government balance sheet to provide flexibility to face future shocks.

### **The Budget 2009 Package**

24. As set out earlier in this paper, the 2009 Budget is set out in three parts: Helping New Zealanders through the current crisis, putting places measures to improve economic growth, and taking the first steps in terms of fiscal consolidation.

#### *Helping New Zealanders through the current crisis*

25. Health: \$750 million per annum which includes funding to meet our pre-election commitments including 12 months' funding for Herceptin; fully funding Plunketline; boosting medical student places; Healthy Housing initiatives and \$25 million per year towards the New Zealand Insulation Fund (see below).
26. Education: [deleted – confidentiality of advice] and \$370 million in capital across the forecast period, which includes funding to meet our pre-election commitments of the teachers and principals' collective agreements, the first tranche of the 21st century school building commitment and support for numeracy and literacy standards, as well as increasing the operational funding for schools.
27. New Zealand Insulation Fund: \$244 million across the forecast period, including \$84 million per annum in outyears that will help New Zealanders to improve the energy efficiency of their homes, improve Health outcomes, and provide new green jobs to cushion the effects of the recession.
28. Justice: [deleted – confidentiality of advice] and \$214 million in capital across the forecast period to lift prison capacity and fund emergency pressures in the Department of Corrections. In addition, Police will be receiving \$113 million (out-year cost) in operating and \$25 million in capital across the forecast period to fund additional police as well as emergency pressures in the Police. There are other justice sector initiatives in Courts of \$23 million in operating and initiatives in Vote Justice of \$14 million.

#### *Improving Economic Growth*

29. The Government's growth strategy encompasses a wide range of measures, with the common theme of raising future living standards of New Zealanders and having the economy emerge stronger than it entered this recession. This is best achieved by lifting productivity and competitiveness throughout the economy. The initiatives fall into two broad areas, those that improve the business environment, and those related to infrastructure.
  - Resource Management Act (RMA): \$2 million operating for reform of the RMA and the establishment of an Environmental Protection Agency

- Building Act
- ACC review
- Transport and communications infrastructure, including a \$234 million capital investment in broadband across the forecast period and \$56 million in operating in 2009/10.

*Fiscal consolidation*

30. Line by line reviews have identified savings that total \$2 billion across the forecast period (see table 1). These savings have helped fund spending in our priority areas and helped limit increases in debt. Further efforts in these reviews are likely to be necessary in the future as we seek to increase the efficiency of government services and fund future spending priorities.
31. Cabinet will shortly be considering a paper entitled *Setting a Fiscal Strategy*. This paper includes a number of approaches to setting fiscal policy that help address the projected increases in debt, touching on both revenue and spending options. Decisions made here regarding future Budget allowances will determine the size new spending in future Budgets.

**Consultation**

32. This paper was prepared by the Treasury. The preliminary Budget package described in the paper was agreed between the Minister of Finance and Vote Ministers through the bilaterals process. The draft package was confirmed by Budget Ministers in a meeting on Monday night.

**Financial Implications**

33. This paper proposes a net new spending of \$1.45 billion operating and \$1.45 billion capital in total for Budget 2009. While this is a reduction on the Government's initial plans of \$1.75 billion, across the years 2008/09 to 2012/13 it still represents extra spending of \$7.25 billion over and above current baselines. .
34. Of the \$1.45 billion operating allowance, a reasonable amount will be held as a between budget contingency to enable the Government to respond rapidly to events as they unfold – both changes in the economic and fiscal situation, and emerging policy priorities such as those initiatives that Cabinet will be considering as a result of the Jobs' Summit.

Hon Bill English

**Minister of Finance**