THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Budget 2009 - Budget Ministers' Paper 1 - Objectives and Priorities for the Budget Bilaterals

Date	6 March 2009	Report No:	

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Bill English)	Read this report in advance of the Budget Ministers' meeting on Monday 9 March	4.30pm Monday 9 March
Prime Minister (Hon John Key)	Read this report in advance of the Budget Ministers' meeting on Monday 9 March	4.30pm Monday 9 March
Associate Minister of Finance (Hon Simon Power)	Read this report in advance of the Budget Ministers' meeting on Monday 9 March	4.30pm Monday 9 March
Associate Minister of Finance (Hon Steven Joyce)	Read this report in advance of the Budget Ministers' meeting on Monday 9 March	4.30pm Monday 9 March

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
[deleted – privacy]	Senior Analyst - Fiscal Management	[deleted – privacy]	[deleted – privacy]	✓
Chris Bunny	Manager - Fiscal Management	[deleted – privacy]	[deleted – privacy]	

Minister of Finance's Office Actions (if required)

None.

Enclosure: Yes

6 March 2009

Treasury Report: Budget 2009 - Budget Ministers' Paper 1 - Objectives and Priorities for the Budget Bilaterals

Executive Summary

1. International economic conditions have continued to deteriorate since the Treasury published economic and fiscal forecasts in December. Based on preliminary economic forecasts completed on Tuesday 3 March 2009, we now believe we are well below the downside scenario published in December. Preliminary fiscal forecasts are being developed, which show the challenging flow on impacts to the Government's fiscal position. The macroeconomic numbers in this paper have not yet been finalised and may still move, given this they should not be discussed publicly in detail.

2. Given this decline, expectations from credit ratings agencies and international investors for a strong signal of fiscal prudence and strong financial management, and the need to maintain sufficient flexibility to meet the costs of any proposals that arise from the jobs summit, the Treasury is recommending that the Minister of Finance take a very hard line during the bilateral phase of the Budget.

3. While the Government had committed to an operating spending allocation of $1.75 billion in December, we consider there is now a significant opportunity to overachieve relative to that goal. Substantial work has been done by Ministers and Departments in terms of scaling back proposals, finding savings, and rethinking priorities over the last month. This momentum, combined with the economic decline, means we think now is the time to aim for a budget that comes in significantly under the $1.75 billion operating allocation.

4. In this paper we propose total additional operating spending of no more than $1.45 billion. This is $300 million less than the operating allowance announced in the Budget Policy Statement. The Treasury recommended package at this stage would allow you to go as far as $450 million less than the operating allowance in the final year.

5. This is seen as a critical signal of the Government's commitment to fiscal restraint. Further savings beyond this $300 million should be reserved for consideration in the context of high value proposals outside the formal Budget proposals, such as those arising from the Jobs Summit.

6. Due to the need to cushion the economy from the harder edges of the recession in the short term, *and* to ensure that the longer term significant proposals to improve the fiscal situation are well developed, we recommend Ministers look to Budget 2010 for more significant structural improvements. We suggest these discussions of the challenges for future budgets should form the core of your discussions in the Budget bilateral meetings.

Attachments

7. Attached to this report are three sets of annex tables:

   - A summary of emergency pressures submissions listed in order of size – from largest supported by the Treasury to smallest supported by the Treasury;
   - A summary of savings submissions listed in alphabetical order by vote; and
   - A summary of the policy priority submissions grouped into categories.

Recommended Action

We recommend that you:

a **agree** that the objectives for the Budget Bilaterals are to:

- Meet any appropriate emergency pressures from savings found across Government

  Agree / Disagree

- Retain sufficient savings to meet the costs of high profile initiatives currently outside the budget process (such as the Jobs' Summit)

  Agree / Disagree

- Meet all policy priorities and decisions already taken from within operating spending of no more than $1.45 billion in the final year ($5.8 billion across the forecast period)

  Agree / Disagree

- Meet all capital spending from within an allocation of $1.45 billion across the forecast period

  Agree/disagree.

Chris Bunny
Manager – Fiscal Management
for Secretary to the Treasury

Hon Bill English
Minister of Finance

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Purpose of Report

8. This report provides Budget Ministers with:

- An update on the economic situation based on preliminary economic forecasts and recent feedback from international credit ratings agencies;
- Advice on the overall quantum of spending the Treasury considers fiscally prudent in the current environment; and
- Advice on the overall suite of budget initiatives the Treasury is recommending Ministers approve during the forthcoming bilateral meetings.

Analysis

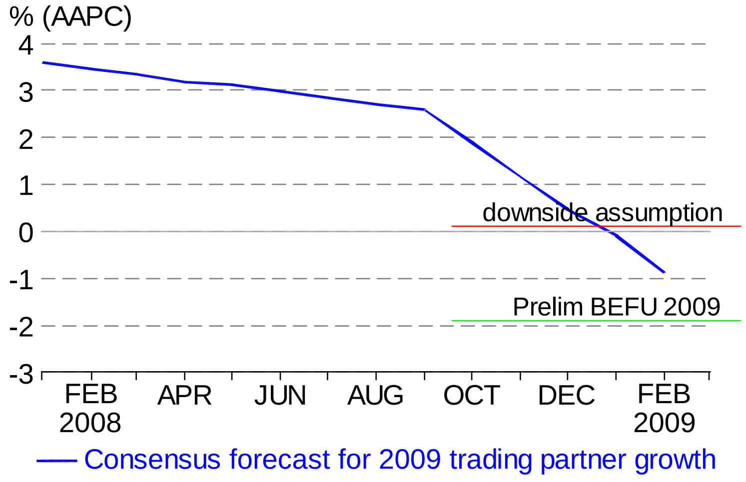
Preliminary economic forecasts.

International economic conditions have continued to deteriorate since the Treasury published economic and fiscal forecasts in December . . .

9. Based on preliminary economic forecasts completed on Tuesday 3 March 2009, we now believe we are well below the downside scenario published in December.

10. The graph below show the continuing decline in expectations for trading partner growth. Our discussions with the International Monetary Fund (IMF) suggest they are increasingly concerned about the outlook and further downward revisions to their forecasts are likely, particularly for 2010.

Figure 1: Trading Partner Growth

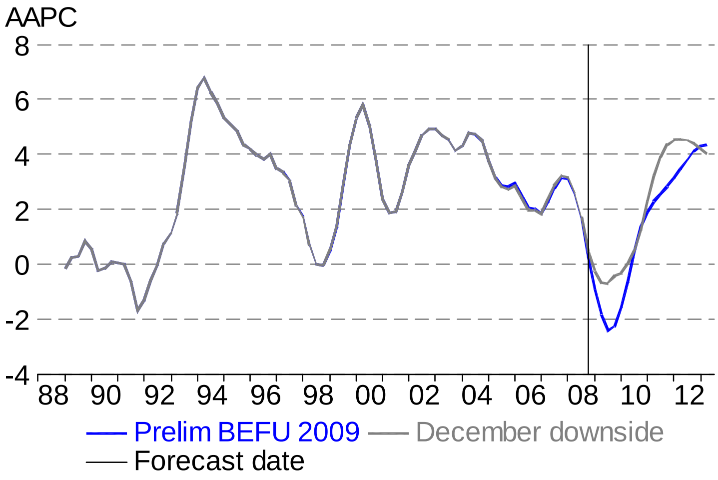


. . . contributing to a deeper and more prolonged slowdown in NZ

11. Based on this decline, we are now forecasting annual average real growth in gross domestic product (GDP) of -0.9 per cent in 2009, -1.6 per cent in 2010, 1.9 per cent in 2011, 3.1 per cent in 2012 and 4.3 per cent in 2013 (March years). In particular, the

investment and export components are likely to be particularly hard hit given weak global demand and lack of confidence amongst firms and in credit markets.

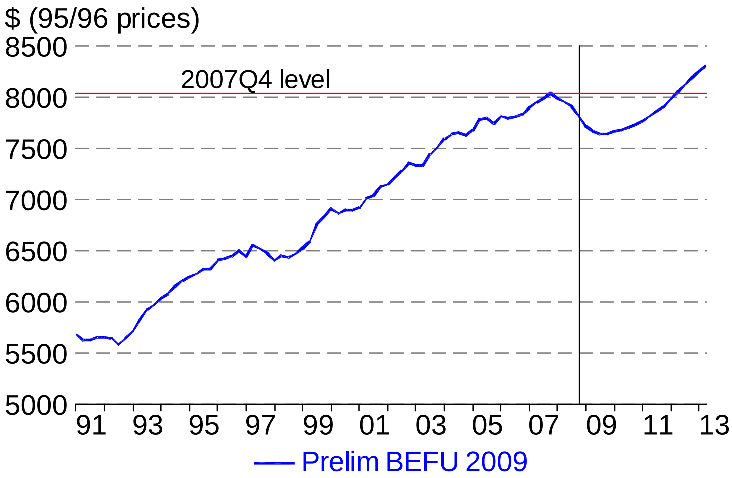
Figure 2: Real growth in gross domestic product in New Zealand – 1988 – 2012 forecast.



If realised, these forecasts imply a significant setback for the economy

12. Compared to past levels of GDP, the scale of the decline becomes stark. It will be nearly 5 years before the economy recovers to 2007 levels of GDP per capita.

Figure 3: Real gross domestic product per capita in New Zealand (level): 1991 – 2013 forecast.

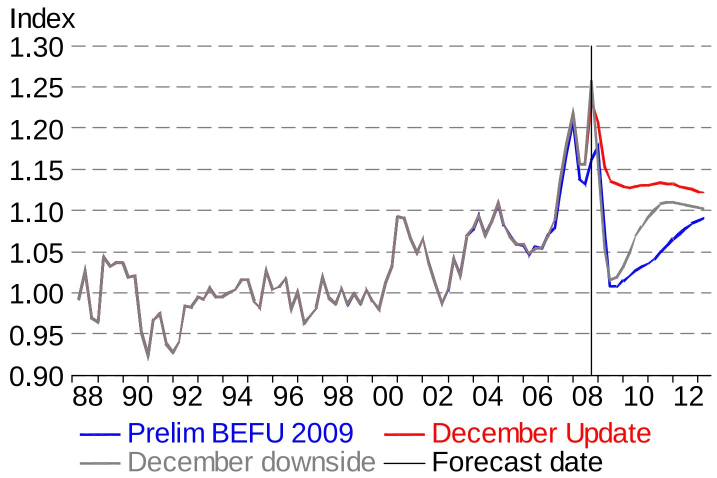


Global conditions to drive down the terms of trade

13. New Zealand's terms of trade are facing strong adverse pressure from international developments. Commodity prices have fallen significantly in the past year, with world dairy prices down 54 per cent since January 2008.

14. The terms of trade are an important influence on the level of New Zealand's gross domestic product (and given the volatility an area of considerable uncertainty and debate).

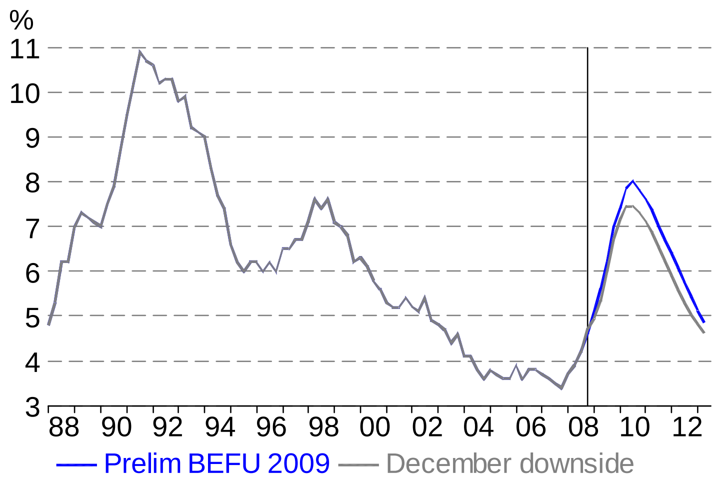
Figure 4: New Zealand Terms of Trade: 1991 – 2012 forecast (system of national accounts)



These weaker activity levels lead to a lower demand for labour, and by extension higher unemployment

15. We are now forecasting unemployment to peak at 8 per cent in the third quarter of 2010. While inflation pressures are relatively weak, a lower exchange rate has the potential to see inflation in December 2009 higher than previously forecast. This has fiscal implications as benefit rates are adjusted based on annual inflation in the December quarter).

Figure 5: New Zealand Unemployment: 1988 – 2012 forecast

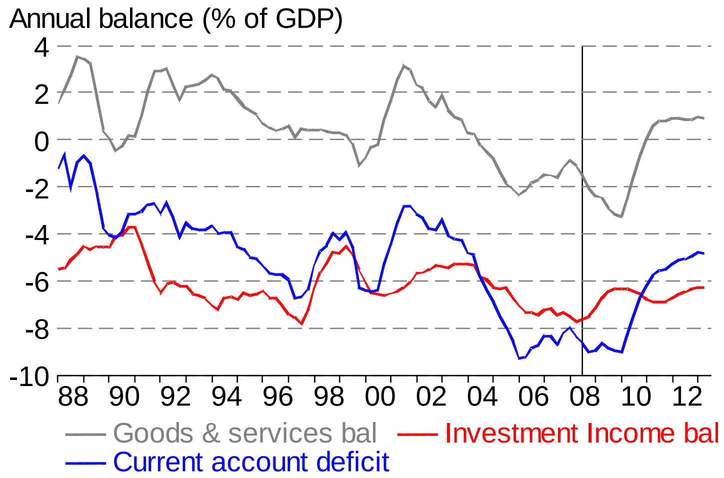


The current account deficit is expected to widen to around 9 per cent of GDP

16. In the near-term, the current account deficit remains elevated because of weak export volumes and higher import prices stemming from the lower exchange rate. The forecasts do not incorporate any material narrowing of the deficit until the second half of 2010.

17. Investment income balance developments are key to the health or otherwise of the current account, but they are extremely hard to forecast. If the investment income deficit was to narrow further, the current account would adjust more rapidly

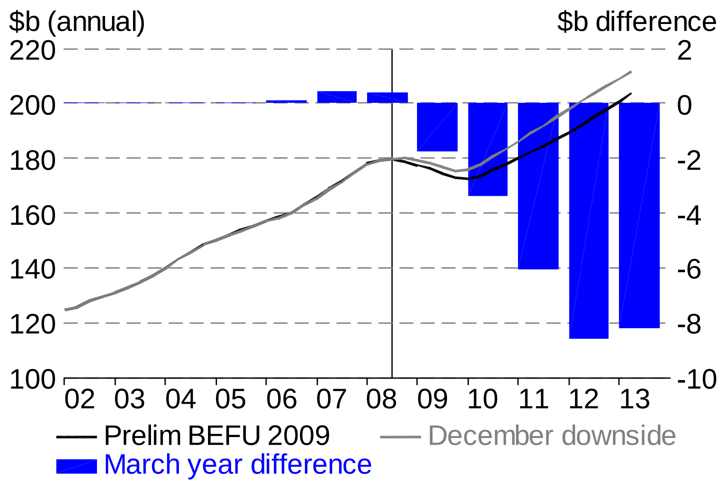
Figure 6: New Zealand Current Account Balance: 1988 – 2012 forecast



All of this means that nominal GDP is forecast to be well below the December Update downside scenario

18. Over the 2009 to 2013 March years nominal GDP is forecast to be a cumulative $28 billion below the December update downside scenario, or $50 billion below the main December update forecast. Preliminary fiscal forecasts are being developed, which indicate serious impacts on the Government's fiscal position. A useful rule of thumb here is that the ratio of tax to GDP is approximately one to three, which would indicate a decline in tax revenue of $17 billion across the forecast period.

Figure 7: New Zealand Nominal Gross Domestic Product: 2002– 2012 forecast



Ratings agencies expect strong signals of fiscal prudence

19. In all our recent discussions with Moody's and Standard & Poor's, both agencies have indicated their concerns at the forecast debt track and have emphasised that they would be looking to the forthcoming Budget for an indication of a credible and achievable medium-term fiscal plan to address the issue.

20. In discussions during their annual visit to Wellington this week, Moody's indicated that they would view a Budget which came in significantly under the Budget operating allowance as a concrete first step and a promising signal in demonstrating the government's resolve to gain control of the fiscal outlook.

Implications for spending in Budget 2009

21. The Government committed to an operating spending allocation of $1.75 billion in December. Given the precipitous decline in the economic situation and expectations from credit ratings agencies, **Treasury is recommending that you work within an operating allowance of $1.45 billion per year, $300m less than the total operating allowance.** The Treasury recommended package presented in this paper indicates a possible package of $1.3 billion per year by the final year - $450 million lower than the operating allowance.

22. In addition, to maintain sufficient flexibility to meet the costs of any proposals outside the formal Budget process, such as those that arise from the jobs summit, the Treasury is recommending that you seek additional savings of at least another $400 million per year from the savings and emergency pressures submissions (i.e. $700 million savings per year in total compared to the Budget Policy Statement).

23. This will require the Minister of Finance to take a very hard line during the bilateral phase of the Budget.

24. In this paper, we therefore propose that during bilateral briefings the Ministry of Finance aim to:

- Fund all policy priority initiatives, including decisions that have already been made by Cabinet, from within a total additional operating spending of $1.45 billion per year, $300 million less than the total operating allowance;

- Ensure that there are sufficient savings presented across Government to meet the costs of any emergency pressures the Government chooses to fund; and

- Ensure that there are sufficient savings presented across Government to meet the costs of any proposals that arise from the Jobs Summit and any other decisions outside the formal budget process.

25. Treasury's recommended package supports policy priorities initiatives at $1.3 billion per year, $450 million less than the total operating allowance. Treasury's recommended package also includes an additional $400 million per year in savings after funding emergency pressures.

26. The Government committed to a capital allowance of $1.45 billion in December. Of this, $750 million has been agreed. Treasury's recommended package includes a total of $600 million in further capital spending, i.e. $100 million less than the remaining capital allowance.

27. Treasury is also proposing that the Minister of Finance use the budget bilaterals to set expectations for future Budgets – both in terms of Ministers managing pressures within baselines and also in fulfilling the Government's stated intention to "deliver more and better services, for less."

Treasury recommendations on Budget initiatives, savings submissions, and emergency pressures submitted in Budget 2009.

Savings and emergency pressures submissions

28. As set out above, savings are needed to meet the costs of any emergency pressures the Government chooses to fund and also to provide sufficient headroom to meet unexpected costs outside the formal Budget process, such as proposals arising from the Jobs Summit.

29. Total savings and emergency pressures submissions for Budget 2009 are set out in the table below:

Table 1: Emergency Pressures and Savings

	Operating						Capital
	2008/09	2009/10	2010/11	2011/12	2012/13	Total	Total
Emergency Pressure	29	496	558	623	624	2,330	301
Savings	(179)	(276)	(387)	(487)	(514)	(1,843)	(71)
Total	**(150)**	**220**	**170**	**136**	**110**	**486**	**230**

30. Based on the submissions from departments, pressures exceed savings by approximately 25 per cent across the forecast period. To meet your objectives, Treasury recommends you *do not support all emergency pressures* that have been submitted. Treasury has also identified additional savings above what was offered by Vote Ministers. Treasury recommends you *support these additional savings* as well as all savings offered.

Table 2: Treasury recommendations on savings and pressures

	Operating						Capital
	2008/09	2009/10	2010/11	2011/12	2012/13	Total	Total
Savings	(182)	(367)	(527)	(573)	(578)	(2,227)	(110)
Pressures	29	277	169	174	171	821	46
(Surplus) / Deficit	**(153)**	**(90)**	**(358)**	**(398)**	**(407)**	**(1,406)**	**(64)**

Savings submissions

31. The savings submitted so far are commendable, totalling $1.8 billion across the forecast period, and Treasury recommends you accept the full amount of these savings. Treasury has also identified a further $386 million across the forecast period in immediate savings, which we recommend you seek in bilaterals. This would bring total savings in Budget 2009 to $2.2 billion across the forecast period with $578m in savings in the final year of the forecast period.

Table 3: Savings Recommendations

	Operating						Capital
	2008/09	2009/10	2010/11	2011/12	2012/13	Total	Total
Department	(179)	(276)	(387)	(487)	(514)	(1,843)	(71)
Treasury	(182)	(367)	(527)	(573)	(578)	(2,227)	(110)
Difference (more savings) / less savings	**(3)**	**(91)**	**(140)**	**(85)**	**(64)**	**(384)**	**(39)**

32. The savings submitted show considerable unevenness across government with some agencies offering up far more than others. The *additional* Treasury recommended savings only go part of the way to addressing this issue. For this Budget, the intention will be to ensure that over the short to medium term government expenditure is aligned with the priorities of the new government, and that no one agency or sector bears a disproportionate burden when it comes to meeting the fiscal challenge.

33. The most important steps in improving the fiscal situation will come in future budgets. We will highlight those agencies where we think more can be done in the relevant bilateral briefings.

Emergency pressures submissions

34. Ministers were requested to only submit bids for emergency pressures *where there are no other funding or delivery options available* and *where the decision to cease funding would directly result in an unacceptable service failure to the public.*

35. As can be seen in the table below, a large number of the emergency pressures that have been submitted by Ministers constitute requests for additional capability.

Table 3: Pressures	Departmental Submission Operating 2008/09	2009/10	2010/11	2011/12	2012/13	Total	Department Capital Total
Baseline Holes	-	13	14	14	13	54	0
[deleted – prejudice security]							
IT	-	11	7	4	4	25	17
CUSMOD	-	2	18	25	35	81	97
Capability	24	358	409	468	462	1,721	82
Cost or revenue pressures	5	110	109	111	108	443	0
Infrastructure	-	-	-	-	-	-	99
Total	29	496	558	623	624	2,330	301

36. Treasury's recommendation is to support less than half of the emergency pressures submitted:

Table 4: Emergency Pressures

	Operating 2008/09	2009/10	2010/11	2011/12	2012/13	Total	Capital Total
Department request	29	496	558	623	624	2,330	301
Treasury recommendation	**29**	**277**	**169**	**174**	**171**	**821**	46
Difference (less costs) / more costs	(0)	(218)	(388)	(448)	(453)	(1,509)	(251)

37. Treasury's recommendations are guided firstly by the criteria for emergency pressures as set out by the Minister of Finance (paragraph 34 above). In addition we are guided by the Senior Executives Group convened to provide advice on savings and emergency pressures bids across agencies. This Group recommended that Ministers do not support:

- bids for capability funding where there is not a direct linkage to the delivery of services (consistent with the philosophy that the '*Government doesn't purchase capability it buys services')*;

- bids which seek to *commence* or *increase* the scope or scale of services are not recommended for funding;

- bids that seek additional funding to cover increases in input costs, e.g. remuneration and property cost pressures, are not be supported unless the respective department has found savings which could be used to offset these costs.

38. [deleted – negotiate without prejudice
]. These are inconsistent with your overall expectation is that any remuneration pressures be self funded by agencies except for those very rare situations where, to maintain critical services, some remuneration changes may be necessary.

39. A number of Ministers have noted that transferring funding from low priority or inefficient programmes to the centre reduces their ability to reprioritise funding as unforeseen events arise. We support this approach of centralising savings, but it will require a disciplined approach to considering between budget spending given the contingency is currently $50 million per annum.

40. In terms of the large departmental emergency pressures, bids for Votes Courts, Education, Corrections have been supported at significantly lower level of funding than requested and the bid for Police is not supported. The emergency pressures in each bid must be taken in the context of the savings identified by each department. The individual positions of these agencies and their ability to manage ongoing risks will be a matter for discussion in the relevant bilaterals.

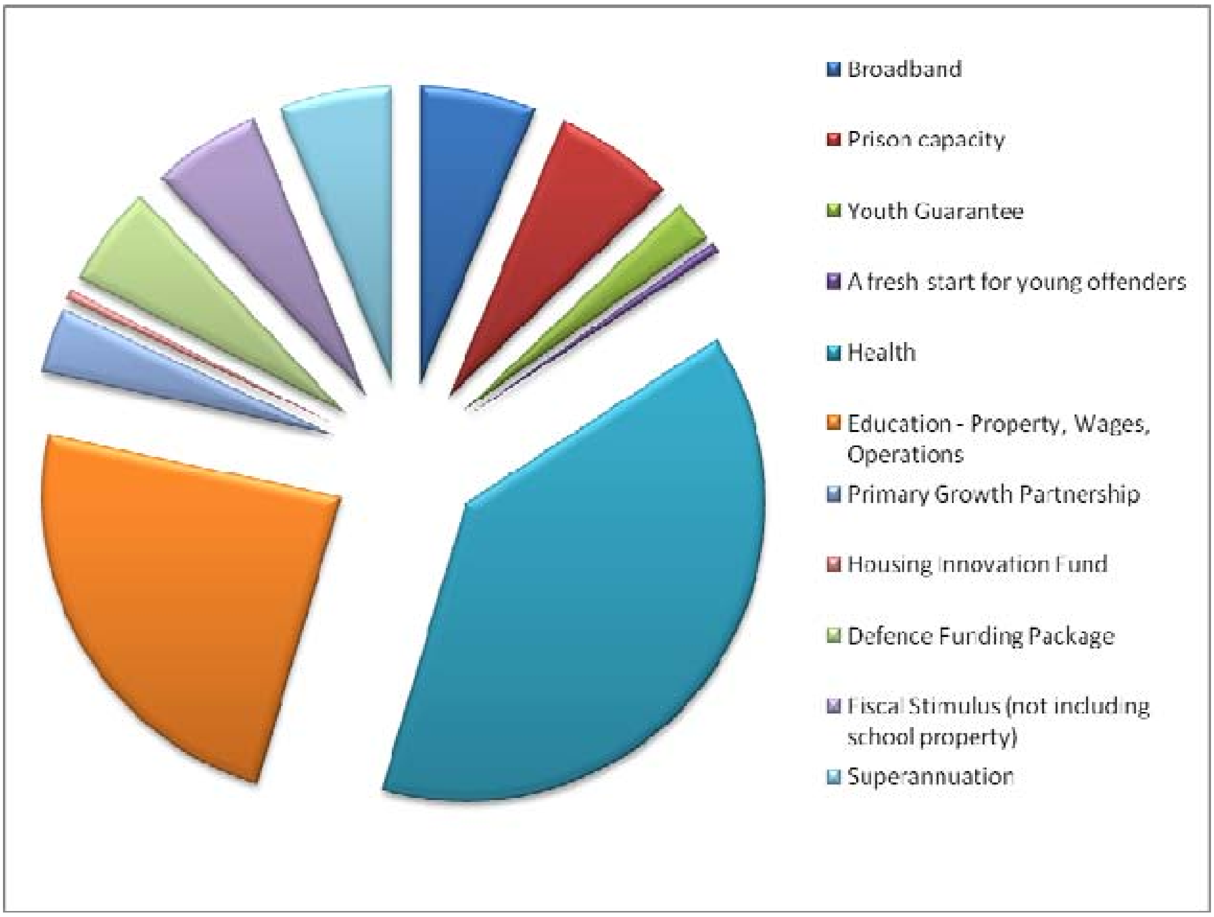
Policy priorities

41. The Treasury has assessed initiative submissions from Ministers and put together a package of initiatives that does not exceed $1.45 billion in the final year, and includes all decisions that have been taken by Cabinet in advance of the budget bilaterals. This is set out in the table below

Table 5: Treasury Base Package

	Operating						Capital
	2008/09	2009/10	2010/11	2011/12	2012/13	Total	Total
Cabinet decisions	100	428	(213)	109	109	533	594
Teachers Wages	-	169	192	192	192	746	
Kiwirail Debt							140
Health	2	544	544	544	544	2,178	1
Other Policy Priorities	(66)	135	291	373	403	1,136	611
Contingency		50	50	50	50	50	
Total	**36**	**1,326**	**865**	**1,268**	**1,299**	**4,644**	**1,345**
(Surplus) / Deficit relative to allocation	**36**	**(424)**	**(885)**	**(482)**	**(451)**	**(2,356)**	**(105)**

Figure 8: Main features of Treasury base package (Note legend reads clockwise from 12 o'clock)



42. The main features of the Treasury base package are:

- A health allocation of $545 million per annum, a 35 per cent reduction on the requested funding (see below for details)
- Funding for teachers' wage agreements that have already been agreed by unions ($740 million across the forecast period)
- Additional funding for school property ($530 million across the forecast period - $200 million operating, $330 million capital)
- The fiscal stimulus package that was agreed by Cabinet in February ($300 million across the forecast period) – except the $200 million on school property which is included in the school property section.
- The fifth year of the defence funding package ($300 million across the forecast period)
- The student loans voluntary bonus repayment scheme
- Funding for the first year or two of the broadband rollout ($72 million operating, $319 million capital)
- Funding to set the future costs of Superannuation at 66 per cent of the average wage
- Additional funding for prison capacity of $210 million operating and $150 million capital – almost entirely to meet the cost of double bunking
- $200 million for the primary growth partnership – more than offset by unwinding the New Zealand Fast Forward Fund

- $195 million for the Youth Guarantee - To ensure young people have access to training. The bid is not well developed but the area is seen as a priority in the current economic conditions

Health allocation

43. The Government has publicly committed to a $750 million allocation for the Health sector. A Health allocation of this size easily accommodates all health sector emergency pressures and all signalled government priorities. This is not the case in other areas of spending where significant trade-offs are required. Notwithstanding the commitment to a $750 allocation, there are scaling and deferral options within the health package that could free up money for other priorities while at the same time enabling the government's highest priorities in health to be met.

44. Treasury's recommended package funds $620 million of new initiatives and would require a contribution of only **$545 million** from the operating allowance. The remaining $75 million can be funded from baseline savings and reserves, and ACC Public Health Acute Services revenue. Treasury's recommended package funds:

    - The key health sector emergency pressures (i.e. funding for DHB price and volume pressures and provision for DHB deficits);
    - All 100 Day commitments; and
    - Seven top government priorities and the only two identified pressures within Ministry-managed contracted services (Maternity demand pressure and Intellectual disability compulsory care and rehabilitation volumes).

45. This package also provides $230 million in 'one-off' funding for health capital so no further capital should be sought. Funding is not provided for risk reserves or a price and volume adjustment for the remainder of the Ministry-managed contracted services.

46. Treasury considers there to be significant scope for reprioritisation in Vote Health baselines to manage any further risks or pressures that arise. Other initiatives can all be deferred, including the electives training initiative.

Outside the package

47. There are some significant initiatives outside the package:

    - Treaty settlements – *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*. Treasury recommends that given the priority afforded to Treaty settlements a final decision on this initiative not be taken until the second Budget Minister's meeting on 27 March, by which time the overall shape of the Budget package will be clearer.
    - Police – additional funding of $580 million across the forecast period, comprising an emergency pressures bid of $330 million and $250 million in funding for additional staff.
    - Research, Science and Technology – initiatives totalling $430 million across the forecast period which seeks to use the savings from the removal of the R & D tax credit. A related education bid of $70 million across the forecast period has also not been supported.
    - Customs – additional funding of $180 million across the forecast period to develop a new Joint Border Management System. Several related smaller bids in other agencies have also been excluded from the package.

- Education – additional funding of $140 million across the forecast period, comprising a bid of $60 million to improve literacy and numeracy standards and $80 million for the 20 hours Early Childhood Education scheme.
- Inland Revenue – additional funding of $90 million across the forecast period, [deleted – confidentiality of advice], and the remainder to develop a business case for transforming employer information.

48. Should you wish to fund any of these initiatives Treasury recommended costings will be provided in the relevant bilateral briefings.

Arriving at a final package

49. The Treasury recommended package has approximately $550 million in headroom in the final year (in addition to using around $300 million per year to retire debt as a signal of your medium term fiscal intentions) to meet pressures as they materialise and to provide funding for additional priorities.
50. This headroom will come under significant stress from a range of pressures and priorities including:

- Items that are outside the Treasury recommended package, such as:
  - $200 million per year in Health initiatives,
  - [deleted – negotiate without prejudice],
  - $150 million per year additional funding for Police, and
  - $110 million per year for research, Science and Technology initiatives.
- Initiatives developed as a result of the Jobs Summit that will require government funding (we have allowed for around $300m per year for Budget 2009).
- [deleted – confidentiality of advice]
- Any funding required to meet Retail Guarantee obligations above the fees revenue collected.

51. In part you will be able to fund these pressures and priorities by trading low priority initiatives currently included within the package for higher priority initiatives outside the package, or by eating into your headroom.

52. However, should ministers decide that a significant portion of the priorities outside of the package are to be funded, and the other pressures prove to be substantial, then the headroom generated by the Treasury recommended package will be insufficient.

53. There are several options open to you to generate additional funding to meet the pressures and priorities if required. These include:

- Returning funding to the centre form departmental balance sheets, particularly where that funding has been retained in anticipation for projects that may no longer proceed, e.g. [deleted – commercial activities].
- Considering across the board baseline cuts of 5 to 10 per cent.
- Reducing the level of expenditure on, or cutting, costly flagship programmes, e.g. interest free student loans.
- Revisiting the savings opportunities we identified for you in December 2008 – such as the growth path for Overseas Development Assistance and the MFAT step change programme.