

Chair  
CABINET EXPENDITURE CONTROL COMMITTEE

## **DESIGN OF THE 2010 BUDGET PROCESS**

### **Proposal**

1. This paper seeks approval of the broad design for the 2010 Budget process.

### **Executive Summary**

2. In the past year the world economy has experienced its deepest and most synchronised recession since at least World War II. In Budget 2009 we reacted appropriately to this and reduced the operating allowance for future budgets permanently to \$1.1 billion from 2010/11, and set the capital allowance at \$1.45 billion per budget from Budget 2010 to Budget 2012 inclusive. Since the Budget Economic and Fiscal Update forecasts were finalised most major domestic economic data have been close to expectations and the international economic outlook has stabilised. However, deficits are likely to continue for a prolonged period and the persistent imbalances in the economy pose a significant risk to the sustainability of the recovery. Given this economic and fiscal background we will need as a minimum to continue to follow a constrained fiscal path.

3. The budget process used in recent years worked adequately in allocating the substantial operating and capital allowances available in times of fiscal surpluses. However, this process is not as effective for managing within the much reduced new funding allowances now available.

4. I propose that we adopt a new process for Budget 2010 with the following broad features:

- An initial strategic phase in which the Government collectively sets priorities and allocates shares of the operating allowance to relevant Votes.
- A separate process for Cabinet to consider options to reduce spending in a discrete number of specific areas, with these savings offsetting the impact on spending of the \$1.1 billion operating allowance.
- Ministers and Chief Executives work together to align baselines with priorities and report back to Budget Ministers on how they propose to deliver the Government's priorities from within available funding.
- A multi-year ECC work programme to establish appropriate relativities between areas of expenditure and update baselines to reflect these.

5. Due to our need to exercise fiscal constraint, our ability to deliver our priorities and have a meaningful programme of initiatives to advance in Budget 2010 is dependent on identifying areas of higher and lower value expenditure and then making the necessary trade-offs.

## **Fiscal and Economic Background**

6. The New Zealand economy has built up sizable imbalances in recent years. Economic growth was concentrated in private and government consumption, pulling imports into the country, while exports were weak. This meant household debt reaching record levels and the current account recording prolonged high deficits, adding to New Zealand's external indebtedness.

7. New Zealand moved into recession early in 2008. Meanwhile, international conditions deteriorated, pushing the world economy into its deepest and most synchronised recession since at least World War II. In turn, the New Zealand economy shrank further, the imbalances in the economy intensified and the Crown accounts moved into deficit, with debt expected to grow sharply. In the *Fiscal Strategy Report*, released as part of this year's Budget, we set a long term fiscal objective of stabilizing and then reducing the net debt to GDP ratio and returning net debt to around 30% of GDP by the early 2020s. To assist in achieving this we committed to reducing the growth in government spending and permanently reduced the operating allowance for future budgets from \$1.75 billion to a maximum of \$1.1 billion from 2010/11, growing at 2% per annum thereafter. Additionally, we agreed the capital allowance is to be \$1.45 billion per budget from Budget 2010 to Budget 2012 inclusive.

8. The 2009 *Budget Economic and Fiscal Update* forecast that the New Zealand economy would continue shrinking through most of 2009, before posting weak positive growth from the end of 2009. At an aggregate level the economy has evolved broadly in line with the forecast, although looking ahead there are several key drivers that will influence future forecasts. These include a stronger world outlook relative to the Budget forecasts and stronger population growth from higher levels of net migration. These drivers are likely to result in upward revisions to the GDP forecasts and a slightly lower peak in the unemployment rate. Nevertheless these forecast revisions are likely to be minor compared with the downward revisions to forecasts over the past year.

9. Underlying tax revenue is currently running behind forecast, meaning stronger GDP forecasts may not result in a stronger outlook for revenue than was forecast at Budget 2009. Given this fiscal and economic background we will need to continue to follow a constrained fiscal path, both to prevent debt growing further, but also to avoid exacerbating the persistent imbalances in the economy.

## **Need for Change in Budget Process**

10. Maintaining appropriate public services and meeting new spending needs within the reduced allowance is challenging and requires a fundamental shift in the way the State sector goes about its business. There needs to be a much greater focus on efficiency, effectiveness and innovation as a priority for all State sector agencies so that they can deliver better, smarter public services for less.

11. Although the budget process used in previous years was adequate for allocating the substantial operating and capital allowances available in times of fiscal surpluses, it does not assist with managing the much reduced allowances available during a time of forecast fiscal deficits. Particular weaknesses of the current budget process are:

- It focuses almost exclusively on the increment of additional expenditure rather than on assessing whether existing baseline expenditure is consistent with the Government's priorities and is providing good value for money.
- Most of the Minister of Finance's, Vote Ministers' and senior officials' time and effort during the budget process has been focussed on the proposed initiatives competing for the increment of additional expenditure.
- There has tended to be inadequate articulation of the Government's collective priorities at the start of the budget process, which has reduced the extent of collective ministerial ownership of the budget process and decisions.

12. It is clear we need a changed budget process that focuses on the budget as a whole and facilitates collective ministerial ownership of decisions. The objectives of the budget process need to be to assist the Government both to maintain appropriate services (but to deliver them more efficiently and effectively), and to implement our policy priorities from within the very constrained allocations of additional funding and the much wider base of existing funding. This suggests that the key attributes of the budget process need to be:

- A clear articulation of the Government's priorities for the short and the medium term at the start of the process to provide Ministers with a focus and give direction to departments and agencies for the remainder of the process.
- A focus on the total spending, not just the increment of additional funding.
- A process that has collective ministerial involvement and ownership of decisions.
- An imperative for each Minister and departmental Chief Executive to jointly examine existing baselines to ensure they are aligned with Government priorities, identify higher and lower value activities and where services can be delivered differently for less, and realign baselines to reflect the Government's priorities.
- A presumption that cost pressures relating to a Vote will be met within the total funding available to that Vote.
- A process that is flexible enough to accommodate existing work programmes and reviews, such as the Economic Ministers' and the Social Sector Ministers' work programmes, regulatory reviews, tax reform, possible adoption of a spending cap, and ECC and other reviews currently underway.

## Proposed Budget Process

13. To meet these objectives I propose that we adopt a new budget process from Budget 2010 and initiate a multi-year work programme to ensure baselines reflect the appropriate relativities between areas of expenditure. The new process is underpinned by a strong strategic phase during which the Government collectively sets clear priorities. This, in conjunction with an up-front sharing of the operating allowance among relevant Votes, will focus effort on the delivery of our priorities. Ministers and Chief Executives will work together to align baselines with priorities and cater for costs pressures relating to their Vote from within the total funding available to that Vote and report back to Budget Ministers (the Prime Minister, Minister of Finance and Associate Ministers of Finance) on how they propose to deliver the Government's priorities from within available funding. Post-budget a multi-year ECC work programme will be needed to establish appropriate relativities between areas of expenditure and adjust baselines to reflect these.

14. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions].*

15. The proposed budget process breaks down into four phases (see Annex A for a list of key dates):

a. *Strategic Phase (October – December)*

- The Prime Minister will convene a half-day meeting at Premier House on 12 October 2009 at which Ministers will discuss the economic and fiscal situation, and discuss the Government's policy priorities for the forthcoming year, which will provide the focus for Budget 2010.
- Any new operating funding available for Budget 2010 be allocated across Votes early in the process. Budget Ministers will propose to Cabinet what, if any, share each Vote will be allocated in the weeks after the Premier House meeting. This is so that most of the budget process focuses on total funding available rather than solely on the increment of additional expenditure.
- In Budget 2009 we agreed to allocate a maximum of \$1.1 billion in new operating funding through Budget 2010. However, some of this will be required to make good any shortfall in the 2009/10 between budget contingency, some for a 2010/11 between budget contingency, some for uncontrollable forecast expenses that nevertheless need to be met from within the overall budget, and some may be reserved for operating expenses associated with new capital expenditure. Additionally, Budget Ministers may decide to not allocate any share of the new operating funding to some Votes.
- Budget Ministers propose indicative shares for each Vote to Cabinet on Monday 19 October and may also propose groupings of Ministers and Votes as part of the budget process that may support the delivery of the priorities discussed at Premier House (this could include Economic and Social Sector groupings of Ministers).
- Ministers and Chief Executives would then work together to identify how in their Votes (or groups of Votes), they can contribute to the direction discussed at Premier House from within their adjusted baselines. There is a strong presumption that cost pressures

relating to a Vote will be catered for from within the total funding available to that Vote and are not to result in calls on the funding available to other Votes.

- Prime responsibility for realigning baselines with priorities is with Ministers; their chief executives and departments. However, I am open to requests from Ministers for the Treasury and the State Services Commission to provide supplementary assistance to Ministers if required. Additionally, the Senior Executives Group (SEG), which performed a useful role in Budget 2009 will be available to assist Chief Executives.
- I propose running a separate process for identifying specific areas of savings as part of the Budget. I will bring a variety of options to Cabinet to reduce spending, with the goal of identifying significant savings to help offset the impact of the increased spending in the operating allowance. Such savings would help reduce public debt levels and reduce the economy's vulnerability for future shocks. This would unwind the recent increase in Government expenditure as a percentage of GDP more quickly than was assumed in Budget 2009, which is part of the reforms necessary to begin moving towards a faster growing economy, and a shift in resources from the non-tradables to the tradables sector.
- There are several parallel work programmes underway that are likely to inform or influence the analysis of baselines and/or the final composition of the budget package. These include Economic and Social Sector Ministers' work programmes, regulatory and tax reform, the possible adoption of a spending cap, and ECC and other reviews. In particular, the adoption of substantial tax reform could have a significant impact on the overall shape of the budget.
- Ministers who consider that they are unable to deliver priorities and cater for cost pressures from within the indicative share and baseline would be invited to advise the Minister of Finance of this by 16 November 2009. The funding of these priorities or pressures from sources external to the Vote would reduce the funding available to all other Votes.
- The final shares of the operating allowance to be allocated to each Vote would be discussed by Budget Ministers and brought to Cabinet in mid-December 2009. The final shares will be influenced by updated fiscal forecasts, any decisions to unwind the increase in government spending more quickly than currently planned and the implications of any instances where Ministers are unable to deliver priorities and cater for cost pressures from within the indicative share and baseline. Cabinet will also be invited to authorise Budget Ministers to develop a Budget package for consideration by Cabinet in April 2010.
- The *Budget Policy Statement* will be published in mid-December 2009 and will set out our economic and fiscal strategies, our priorities, and net new spending for Budget 2010.

b. *Align Baselines (March – April)*

- Ministers will be invited to provide a report to the Minister of Finance by 8 March 2010 setting out how they intend to redistribute baselines within and across Votes to give effect to the priorities discussed at Premier House.

- Capital bids would be submitted in late January, supported by business cases as appropriate. The bids would be informed by the priorities discussed at Premier House and for the 15 capital intensive agencies by the annual capital intentions data submitted in late October 2009. Capital bids from capital intensive agencies will need to include both stage I and stage II business case decisions required in Budgets 2010 and 2011, and also be subject to additional information requirements. Ministers will have the option to approve, decline, or defer Budget 2010 decisions, and to indicate when they would like to see business cases for deferred and Budget 2011 decisions. Any decisions sought after Budget 2010 would need to be supported by business cases prepared in accordance with standard guidelines to be issued in late 2009.
- In March and April 2010 Budget Ministers meet several times to consider these reports and develop a consolidated budget package for Cabinet's consideration. This may include separate meetings with Economic and Social Sector Ministers to consider relative priorities and trade-offs within and between their areas. The more thorough Ministers are in identifying higher and lower value expenditure within their areas of responsibility, the less likely it is that Budget Ministers will be required to make cross cutting trade-offs. The impacts of any tax reform and other workstreams would also be integrated into the overall package by Budget Ministers. Budget Ministers will be supported by Treasury, the other Central Agencies, and the SEG throughout this period.
- This process does not anticipate any bilateral meetings between Vote Ministers and the Minister of Finance.
- Our ability to deliver our priorities and have a meaningful programme of initiatives to advance in Budget 2010 is dependent on identifying areas of higher and lower value expenditure both within and between Votes, and then making the necessary trade-offs. If we do not identify the savings required we will be unable to deliver our priorities within our fiscal constraints, and Budget 2010 will fail to meet our economic and fiscal objectives.
- Cabinet will consider the proposed budget package in mid-April 2010.

c. *Production Phase (April – May)*

- There is no substantive change to the process used in previous years. Efforts to improve the overall quality of the performance information included in budget documents will continue in order to provide a clearer basis for assessing subsequent delivery.

d. *Update Baseline Relativities (June onwards)*

- Given that the Government's priorities adapt and change over time, the existing relativity of expenditure across Votes may not necessarily accurately reflect the Government's economic and social priorities, or our 3-5 year economic and fiscal agenda. I therefore propose that we initiate a multi-year rolling ECC work programme to establish, and update, new relativities between areas of government expenditure based on:
  - the Government's overall priorities as refreshed annually at the start of each budget process;
  - ECC's ex-post reviews of what is achieved with government expenditure (based on consideration of Central Agencies' six monthly reports on priority departments and Crown entities, and 12 monthly reports on a sample of other departments [CAB Min (09) 17/10], the six monthly reports on performance issues and risks in selected Crown entities [ECC Min (09) 8/2], and any specific reviews ECC may commission); and
  - the ongoing programme of developing and implementing Performance Improvement Actions [CAB Min (09) 17/10].
- ECC would update baselines based on the new relativities between areas of government expenditure, taking into account the changes to baselines that have been made through the budget process. The updated baselines would then form the basis for allocating any new operating funding available for future budgets. I intend to submit a paper to ECC setting out fuller details of this process of updating relativities between areas of government expenditure.

16. The key features of the proposed budget process are summarised in the box below:

- **Premier House session on 12 October 2009 to discuss priorities.**
- **Up-front allocation of shares of new operating funding available in Budget 2010 to relevant Votes.**
- **No bids for additional operating funding.**
- **Bids for additional capital funding, for the capital intensive agencies these will be informed by capital intentions data.**
- **Ministers and Chief Executives work together to align baselines with priorities.**
- **No bilateral meetings between the Minister of Finance and Vote Ministers.**
- **Budget Ministers make trade-offs based on relative priorities, and discuss these with Economic Ministers and Social Sector Ministers.**
- **A separate process for Cabinet to consider savings to help offset the impact on spending of the operating allowance.**
- **Budget Ministers draw together a consolidated budget package.**
- **Ongoing ECC work programme to establish appropriate relativities for government expenditure and update baselines to reflect these.**

17. The success of this process is reliant on Ministers and Chief Executives working collaboratively to align their baselines with the priorities we discuss at Premier House on 12 October. Our ability to deliver our priorities and have a meaningful programme of initiatives to advance in Budget 2010 is dependent on identifying areas of higher and lower value expenditure both within and between Votes, and then making the necessary trade-offs. If we do not do this the process will fail and we will have to revert to a traditional bilateral-based process. More importantly, we are likely to be unable to deliver our priorities within our fiscal constraints.

### **Communications to Ministers Outside Cabinet and Support Party Ministers**

18. The Minister of Finance will convey Cabinet's decisions on this paper to Ministers Outside Cabinet and Support Party Ministers, and the Prime Minister is likely to separately convey to them the priorities discussed at Premier House.

### **Consultation**

19. This paper was prepared by the Treasury. The Department of the Prime Minister and Cabinet and the State Services Commission have been consulted in the development of the paper.

### **Recommendations**

20. The Minister of Finance recommends that Cabinet:

1. **note** that the economic and fiscal background to the 2010 budget process includes:
  - 1.1 the world economy experiencing its deepest and most synchronised recession since at least World War II, on top of a recession in New Zealand that began in the first half of 2008;
  - 1.2 the government's decision as part of Budget 2009 to set the operating allowance for future budgets at a maximum of \$1.1 billion a year from Budget 2010 and the capital allowance at \$1.45 billion a year from Budget 2010 to Budget 2012 inclusive;
  - 1.3 that since the Budget 2009 Economic and Fiscal Update forecasts were finalised most major domestic economic data has been close to expectations and the international economic outlook has stabilised, but underlying tax revenue is currently running below forecast and hence stronger GDP forecasts may not result in stronger revenue forecasts than in Budget 2009; and
  - 1.4 that fiscal deficits are likely to continue for a prolonged period, and the persistent imbalances in the economy pose a significant risk to the sustainability of the recovery;
2. **agree** that given the economic and fiscal background the government will as a minimum follow a constrained fiscal path in Budget 2010;
3. **note** that as part of our overall strategy I will bring specific options to Cabinet that would identify savings to offset the impact on spending of the operating allowance;
4. **note** our ability to deliver our priorities and have a meaningful programme of initiatives to advance in Budget 2010 is dependent on reprioritising expenditure between areas of lower and higher value;



5. **note** that the budget process used in recent years has been overly focussed on marginal expenditure and funding, has suffered from the Government's priorities being inadequately articulated at the start of the process, and has not supported collective ownership of the process and decisions;
6. **agree** to adopt a new process for Budget 2010 with the following broad features:
  - 6.1 an initial strategic phase in which the Government collectively sets priorities and allocates shares of the operating allowance to relevant Votes;
  - 6.2 Ministers and Chief Executives working together, either in pairs or in groups, to align baselines with priorities and reporting back to Budget Ministers on how they propose delivering the Government's priorities from within available funding; and
  - 6.3 a multi-year ECC work programme to establish appropriate relativities between areas of expenditure and update baselines to reflect these;
7. *[information deleted in order to maintain the effective conduct of public affairs through the free and frank expression of opinions];*
8. **note** that the Prime Minister is convening a meeting at Premier House on 12 October 2009 to discuss the Government's priorities for the forthcoming year, which will provide the focus for Budget 2010;
9. **invite** the Prime Minister, Minister of Finance and Associate Ministers of Finance as Budget Ministers to report back to Cabinet on 19 October 2009 with:
  - 9.1 an indicative sharing across relevant Votes of new operating funding for Budget 2010; and
  - 9.2 any grouping of Ministers and Votes for the remainder of the budget process;
10. **agree** that any new initiatives to deliver priorities and any cost pressures are expected to be funded from within the total operating funding available to each Vote or group of Votes and that therefore there will be no separate bidding process for operating funding in Budget 2010;
11. **note** that although prime responsibility for realigning baselines with priorities is with Ministers and their chief executives and departments, Ministers may request supplementary assistance from the Treasury and the State Services Commission;
12. **note** that there will be no bilateral meetings between Vote Ministers and the Minister of Finance;
13. **invite** Ministers who consider that they will be unable to deliver priorities and cater with cost pressures from within the indicative share and the baseline available within their Votes to advise the Minister of Finance of this by 16 November 2009;
14. **invite** the Prime Minister, Minister of Finance and Associate Ministers of Finance as Budget Ministers to report back to Cabinet on 14 December 2009 with the final sharing across relevant Votes of any new operating funding for Budget 2010;
15. **agree** that capital bids are to be submitted in late-January 2010, supported by business cases as appropriate;

16. **invite** Ministers to provide reports to the Minister of Finance by 8 March 2010 setting out how they intend to align the baselines of their Votes to give effect to the priorities discussed at Premier House on 12 October 2009;
17. **note** that regulatory and tax reform, and other processes and reviews are operating in parallel to the budget process, and that Budget Ministers will integrate the results of these processes and other reviews into the final budget package;
18. **note** the following key steps in the remainder of the process:
  - 18.1 The Budget Policy Statement setting the Government's economic and fiscal strategies, priorities, and net new spending for Budget 2010 will be published on 17 December 2009; and
  - 18.2 Budget Ministers will meet several times in March and April 2010 to consider Ministers' reports and develop a consolidated budget package for Cabinet's consideration;
19. **note** that the Minister of Finance proposes a multi-year rolling ECC work programme to establish and update relativities between areas of government expenditure;
20. **invite** the Minister of Finance to report back to ECC in due course with details of this process of updating relativities between areas of government expenditure;
21. **note** that the Minister of Finance will be conveying Cabinet's decisions on this paper to Ministers Outside Cabinet and Support Party Ministers, and that the Prime Minister is likely to convey to them the results of the Premier House meeting.

Hon Bill English  
**Minister of Finance**

September 2009

## Annex A: Key Dates

<b>Date</b>	<b>Event</b>
21 September 2009	Cabinet considers process for Budget 2010
22 September 2009	Secretary of the Treasury writes to Chief Executives advising them of the process for Budget 2010
12 October 2009	Premier House session
19 October 2009	Cabinet notes indicative allocations and groupings
14 December 2009	Cabinet considers final allocation of any new funding
17 December 2009	Budget Policy Statement published
8 March 2010	Vote Minister submissions due to the Minister of Finance
12 March – 7 April 2010	Budget Minister meetings (x3) to draw together budget package
19 April 2010	Cabinet considers budget package
Mid to late May 2010	Budget Day