

OFFICE OF THE MINISTER OF FINANCE

19 April 2007

Chair
CABINET

BUDGET 2007 PACKAGE

Executive Summary

1. Budget 2007 advances policies within our three themes of Economic Transformation, Families – Young and Old and National Identity. Sitting over these, though with links to the objectives within the themes, Budget 2007 is also advancing a significant savings package.
2. Within the Economic Transformation theme Budget 2007 will roll out a significant Business Tax Package which includes reducing the company tax rate from 33% to 30%, introducing a R&D tax credit and reducing business compliance, all of which will make New Zealand a more attractive place for businesses.
3. Families – Young and Old provides additional funding to the health sector – a further \$750 million per annum – support for the elderly through introducing a higher New Zealand Superannuation wage floor and additional funding for early interventions, support for children and the justice sector.
4. National Identity provides significant funding for Official Development Assistance, Defence and the Ministry of Foreign Affairs and Trade all of which helps to increase New Zealand's presence internationally. Locally, we are also increasing funding for our arts and culture.
5. Budget 2007 delivers a significant level of funding as set out in the table below. While the level of funding is higher than signalled in the *Budget Policy Statement*, the package has been developed in the context of the tight macroeconomic situation and is consistent with our fiscal objectives over the forecast horizon. Depending on where the final fiscal forecasts come out some changes to fiscal assumptions may need to be made to ensure that the Government remains on track to meet its objectives over the long term. This paper seeks a delegation to the Prime Minister, the Minister of Finance and the Associate Minister of Finance (Hon Trevor Mallard) to make adjustments if necessary prior to the publication of the *Fiscal Strategy Report*.

Table 1: Overall Budget decisions**BUDGET 2007 ALLOWANCES**

	\$ millions					
	2006/07	2007/08	2008/09	2009/10	2010/11	5 year total
Operating funding for Budget 2007	23	1,897	1,879	1,942	1,971	7,712
Funding for initiatives and contingencies	(108)	2,117	1,791	1,887	1,864	7,551
<i>Plus</i> Savings package	(22)	362	698	1,043	1,277	3,358
Subtotal	(130)	2,479	2,489	2,929	3,141	10,908
Difference from target <i>Under/(Overspend)</i>	153	(582)	(610)	(987)	(1,170)	(3,196)
Capital funding for Budget 2007	20	362	193	283	-	858
Funding for initiatives and contingencies	45	825	387	226	197	1,679
Difference from target <i>Under/(Overspend)</i>	(25)	(463)	(194)	57	(197)	(821)
Total difference (operating and capital)	127	(1,045)	(803)	(930)	(1,367)	(4,018)

* This table excludes the costs of the Business Tax Package from 2008/09, which are funded from the Budget 2008 allowance.

Proposal

6. This paper seeks Cabinet's agreement to the 2007 Budget Package. This paper should be considered alongside the following papers which are also being considered by Cabinet today. All eleven papers make up the 2007 Budget package. The numbers presented in this paper incorporate the total impact of all eleven papers.
 - Budget 2007: Business Tax Reform - Fiscal Decisions
 - Budget 2007: Savings Package
 - Budget 2007: Funding for Rail Development
 - International Tax Review: Key Policy Directions
 - Early Years: Giving Children the Best Start in Life
 - The New Zealand Export Credit Office: US Contract Bond Facility
 - Draft Five-Year Action Plan for Out of School Services: Revised Recommendations
 - C-130 Life Extension Project: Self Protection System Upgrade
 - Design and Implementation of a Regional Fuel Tax
 - Funding for the South Pacific Regional Fisheries Management Organisation
 - Civil Defence Emergencies - Reimbursement of Local Authority Response and Recovery Costs in 2006/07

7. This paper provides Cabinet with the high level details of Budget 2007. These include:
 - the key initiatives and objectives from each of the themes – Economic Transformation, Families – Young and Old and National Identity;
 - key capital spending agreed in Budget 2007; and,
 - the current macroeconomic and fiscal environment backdrop against which the Budget 2007 decisions were based and how this environment is developing as we look ahead to Budget 2008 and beyond.

Budget 2007 Highlights

8. Our eighth Budget advances policies along our three themes of Economic Transformation, Families – Young and Old and National Identity. Sitting outside these themes, though having links to the objectives from each of the themes, is a significant savings package.

9. I have signalled for some time that this Government is committed to a substantial *Business Tax Package* in Budget 2007. The accompanying paper provides full details on these changes which aim to lift productivity and international competitiveness. I have worked closely with the Minister of Revenue on this as the package forms part of the support agreement with the United Future Party. The bulk of these changes come into effect from the 2008/09 year so the cost from this year onwards is allocated to Budget 2008. These changes are the cornerstone of the Economic Transformation theme. Sitting alongside the *Business Tax Package* are policies on improved sustainability, energy efficiency and climate change, increasing our international connections, improving tertiary skills, lifting firms' innovative capacity and initiatives to support Export Year 2007.
10. Families – Young and Old will always be a theme which a Labour-led Government will ensure is sufficiently funded. Budget 2007 provides almost \$1 billion per annum of new funding to this theme. The level of funding is driven by a further \$750 million per annum funding boost to Health as well as funding for increases in the teacher/pupil ratio for new entrants to primary schools and funding in the Justice sector for the second tranche of the 1000 new police.
11. Our National Identity theme has had a significant increase in Budget 2007 to further strengthen New Zealand's place in a complex international environment. The funding increases are driven by Official Development Assistance (raising New Zealand's ODA to 0.35% of GNI), the Defence funding package and implementing a step change in capability for the Ministry of Foreign Affairs and Trade.
12. We have been concerned for some time about the level of savings in New Zealand. The Government has been doing its share by establishing and contributing strongly to the New Zealand Superannuation Fund, establishing the *State Sector Retirement Savings Scheme*, and developing *KiwiSaver*. Budget 2007 will help to address this issue by introducing a wider savings package. This package is a cornerstone of Budget 2007 and has links to the objectives of all themes.

Macroeconomic and fiscal backdrop of Budget 2007

The challenge for Budget 2007 was to deliver a package consistent with our macroeconomic and fiscal environment

13. When Cabinet met to consider the Budget Strategy in November I pointed out the fiscal and macroeconomic environment within which Budget 2007 needed to be managed. At the time I mentioned that our long period of strong economic growth had led to some macroeconomic imbalances in the economy. Specifically, these imbalances were manifesting themselves in high inflation pressures and a large current account deficit.
14. The Budget Strategy paper concluded that we needed to stick as close as possible to our 2007 Budget allowances. In the absence of any offsetting increase in revenue, not doing so would risk adding additional fiscal stimulus to the economy and therefore fiscal policy would be working counter to, instead of in tandem with, monetary policy. This would risk higher than necessary inflation and interest rates and could prolong the imbalances in the economy. This risk, combined with the need to preserve some headroom for flagship packages such as the Business Tax Review meant managing to theme allocations. I acknowledge that this was more challenging than in last year's Budget.

Budget 2007 will deliver a package that, while higher than signalled in the Budget Policy Statement, is consistent with our fiscal objectives and takes account of the macroeconomic environment across the forecast period

15. The table below presents the total Budget 2007 decisions.

Table 2: Budget decisions

BUDGET 2007 ALLOWANCES	\$ millions					5 year total
	2006/07	2007/08	2008/09	2009/10	2010/11	
Operating funding for Budget 2007	23	1,897	1,879	1,942	1,971	7,712
Families - Young and Old	(20)	1,001	1,049	994	936	3,960
Economic Transformation	(100)	155	182	165	204	606
National Identity	6	185	224	296	367	1,077
Other	6	476	430	494	523	1,929
First year of Business Tax Package*	-	108	-	-	-	108
Removing personal income tax threshold indexation	-	(85)	(395)	(425)	(535)	(1,440)
Post Budget 2007 contingency	-	100	100	100	100	400
Tagged contingency items	-	177	201	263	269	910
Subtotal	(108)	2,117	1,791	1,887	1,864	7,551
<i>Plus Savings package</i>	(22)	362	698	1,043	1,277	3,358
Subtotal	(130)	2,479	2,489	2,929	3,141	10,908
Difference from target Under/(Overspend)	153	(582)	(610)	(987)	(1,170)	(3,196)
Capital funding for Budget 2007	20	362	193	283	-	858
Families - Young and Old	1	240	91	23	60	414
Economic Transformation	41	350	220	150	119	880
National Identity	4	47	(5)	(3)	(6)	37
Other	0	2	-	-	-	2
Savings package capital costs	-	22	13	-	-	36
Post Budget 2007 contingency	-	45	25	-	-	70
Tagged contingency items	-	119	42	56	23	241
Subtotal	45	825	387	226	197	1,679
Difference from target Under/(Overspend)	(25)	(463)	(194)	57	(197)	(821)
Total difference (operating and capital)	127	(1,045)	(803)	(930)	(1,367)	(4,018)

* This table excludes the costs of the Business Tax Package from 2008/09, which are funded from the Budget 2008 allowance.

16. The first thing to note about this table is that both the operating and capital allocations are higher than our Budget Strategy intentions. However, in taking these decisions we have taken into account the tight macroeconomic environment:

- First, a proportion of our decisions either have little domestic demand or inflationary impact (eg. the Official Development Assistance increase and the savings package). Table 3 below adjusts the additional spending from the *Budget Policy Statement* for these policies to illustrate the impact.
- Second, while the Treasury is yet to finalise its tax forecasts they are expecting an increase in tax revenue over the forecast horizon, due to a stronger short-term growth outlook and higher inflation (see table 4). This will provide a large offset in terms of the aggregate fiscal impulse.

Table 3: Spending with low domestic demand impacts

	\$ millions				
	2006/07	2007/08	2008/09	2009/10	2010/11
Total difference (operating and capital)	127	(1,045)	(803)	(930)	(1,367)
<i>Add back:</i>					
ODA (offshore component is assumed to be 80%)		56	82	139	197
Savings package ¹		362	698	1,043	1,277
Difference from target Under/(Overspend)	127	(627)	(24)	252	107

1. Any leakages to consumption spending are uncertain but are expected to be small. While precise numbers are provided, these should only be considered approximations.

Table 4: Preliminary macroeconomic forecasts

	2006	2007	2008	2009	2010	2011
			Forecast	Forecast	Forecast	Forecast
Real GDP						
Budget Update	2.0	1.7	2.6	1.6	2.8	3.1
Half Year Update	2.2	1.8	2.3	3.2	3.1	3.0
CPI						
Budget Update	3.3	2.6	2.7	2.4	2.4	2.2
Half Year Update	3.3	2.8	2.7	2.0	2.0	2.0
90 day interest rates						
Budget Update	7.6	7.8	8.0	6.7	6.3	6.2
Half Year Update	7.6	7.5	6.0	6.0	6.1	6.0
TWI						
Budget Update	68.3	68.8	69.0	62.3	56.9	54.5
Half Year Update	68.3	63.5	60.1	57.3	54.9	54.4
Unemployment Rate						
Budget Update	3.9	3.8	3.9	4.5	4.4	4.3
Half Year Update	3.9	4.0	4.8	4.6	4.4	4.3

17. We have spent more on capital than what we intended though this is concentrated on infrastructure investment which will have long term benefits.
18. To reflect ongoing capital pressures, I also propose that we increase our capital allowances moving forward. In Budget 2007 we have spent nearly twice the level of capital set aside. For Budget 2008 we originally set aside \$570 million across the forecast horizon which is almost \$300 million less than Budget 2007 allowed for. This reflected Cabinet's previous decision to front-load some capital expenditure. However, given capital pressures, I now consider these levels inadequate so I am proposing that we increase our allowances to \$900 million per Budget, as set out in table 5 below.

Table 5: Capital allowances

Capital allowances	Gross debt impact (\$ millions)						Total
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	
Budget 2008	20	480	250	150	-		900
Budget 2009	-	20	480	250	150		900
Budget 2010	-	-	20	480	250	150	900

19. Our fiscal strategy is to run operating surpluses sufficient to make contributions to the New Zealand Superannuation Fund and for gross sovereign issued debt to be broadly stable around 20 percent of GDP over the next 10 years. Budget 2007 is consistent with our fiscal objectives over the forecast horizon as illustrated in the table below. Over the longer term we may face some challenges and therefore, as I explain below, we may have to reduce the allowance for new operating initiatives in future budgets before we publish the *Fiscal Strategy Report*. I will make that decision based on final fiscal forecasts that Treasury will produce in early May.

Table 6: Preliminary Fiscal Forecasts

(\$ million)	2006	2007	2008	2009	2010	2011
	Actual	Forecast	Forecast	Forecast	Forecast	Forecast
Operating Balance						
Preliminary - Budget Update	11,473	6,716	5,467	4,878	4,816	4,945
Half Year Update		6,260	6,071	5,197	5,826	5,979
Change		456	(604)	(319)	(1,010)	(1,034)
Gross sovereign issued debt						
Preliminary - Budget Update	35,461	38,167	40,453	39,492	38,915	41,382
Half Year Update		37,867	40,153	39,192	38,615	41,082
Change		300	300	300	300	300
Cash Available/(To Be Funded)						
Preliminary - Budget Update	2,985	759	(1,685)	(2,418)	(2,077)	(1,351)
Half Year Update		107	(691)	(1,821)	(978)	(294)
Change		652	(994)	(597)	(1,099)	(1,057)
Net core Crown debt						
Preliminary - Budget Update	7,745	6,135	6,834	8,711	10,390	11,326
Half Year Update		6,382	5,923	7,187	7,697	7,525
Change		(247)	911	1,524	2,693	3,801
Net core Crown debt with NZS Fund assets						
Preliminary - Budget Update	(2,116)	(6,778)	(9,125)	(10,610)	(12,626)	(15,744)
Half Year Update		(6,271)	(9,703)	(11,792)	(14,979)	(19,195)
Change		(507)	578	1,182	2,353	3,451
% of GDP						
Operating balance						
Preliminary - Budget Update	7.3%	4.1%	3.2%	2.7%	2.6%	2.5%
Half Year Update		3.8%	3.6%	2.9%	3.1%	3.0%
Gross sovereign issued debt						
Preliminary - Budget Update	22.7%	23.3%	23.7%	22.1%	20.8%	21.0%
Half Year Update		23.3%	23.5%	21.8%	20.5%	20.7%
Net core Crown Debt						
Preliminary - Budget Update	4.9%	3.8%	4.0%	4.9%	5.5%	5.8%
Half Year Update		3.9%	3.5%	4.0%	4.1%	3.8%
Net core Crown Debt with NZS Fund assets						
Preliminary - Budget Update	-1.4%	-4.1%	-5.3%	-5.9%	-6.7%	-8.0%
Half Year Update		-3.9%	-5.7%	-6.6%	-7.9%	-9.7%

Underlying macroeconomic imbalances still exist and there is no remaining fiscal headroom

20. Treasury has updated their macroeconomic forecasts. The key points are:

- Growth is expected to be stronger in the short term than in the *Half Year Update* as a result of stronger domestic demand.
 - Inflation pressures remain high with inflation expected to track above the middle of the Reserve Bank inflation band through until 2009.
 - The exchange rate remains at a high level so it is still putting pressure on exporters.
21. The Reserve Bank has been closely monitoring the inflation pressures in the economy with a particular eye on the strong housing market and the stance of fiscal policy. Given Treasury's updated economic forecasts, particularly the upwards revision in inflation, we can expect the Reserve Bank will remain concerned about these areas for some time.
22. For the past eight years we have prided ourselves on being prudent fiscal managers. Throughout this time we have been able to advance our priorities while at the same time running surpluses sufficient to meet the contributions to the New Zealand Superannuation Fund.
23. Budget 2007 has committed more funding than what we signalled in the *Budget Policy Statement* though we have balanced this against the types of policies we have advanced. I have already mentioned that some of the policies have a less stimulatory effect but we have also invested significant funding into infrastructure needs that will have benefits for many years. However, from a fiscal angle, our increased spending in Budget 2007 has not been costless. To maintain our commitment to the long-term fiscal objectives, I may need to make some adjustments to future Budgets. These are likely to be:
- that future operating Budget allowances are reduced by \$50 - \$100 million per annum. This paper is seeking a delegated authority to the Prime Minister, the Minister of Finance and the Associate Minister of Finance (Hon Trevor Mallard) to take these final decisions prior to the publication of the *Fiscal Strategy Report*.
 - that we do not adjust tax thresholds in the medium term thereby retaining fiscal drag and potentially allowing tax to GDP ratios to rise slightly. Accordingly, this paper seeks Cabinet's agreement to rescind our previous decision to adjust income tax thresholds on a three-yearly basis. Within the projection period (i.e. from 2011/12 onwards) we will adjust the tax thresholds for inflation, but some portion of fiscal drag might need to be retained to finance our decisions.
24. These adjustments that I may need to make need to sit alongside changes that we all need to make to ensure we remain on target to achieve our long term fiscal objectives. Specifically I would ask all Ministers to consider the following two points as we head into Budget 2008.
- **Level of Budget aspirations.** In Budget 2007 themes had to reprioritise a significant amount of funding given the level of aspirations against the level of funding the themes we allocated. Themes were initially oversubscribed by factors of around 7:1. Given known pressures we will face in future Budgets, themes should not expect to receive net new allocations that are significantly different to the allocations managed within this year. For this reason, I would encourage themes to use the Budget Strategy phase to set theme objectives

that are more tightly focussed than the theme objectives chosen for Budget 2007. This should help to reduce the level of aspiration and therefore the level of reprioritisation required in Budget 2008.

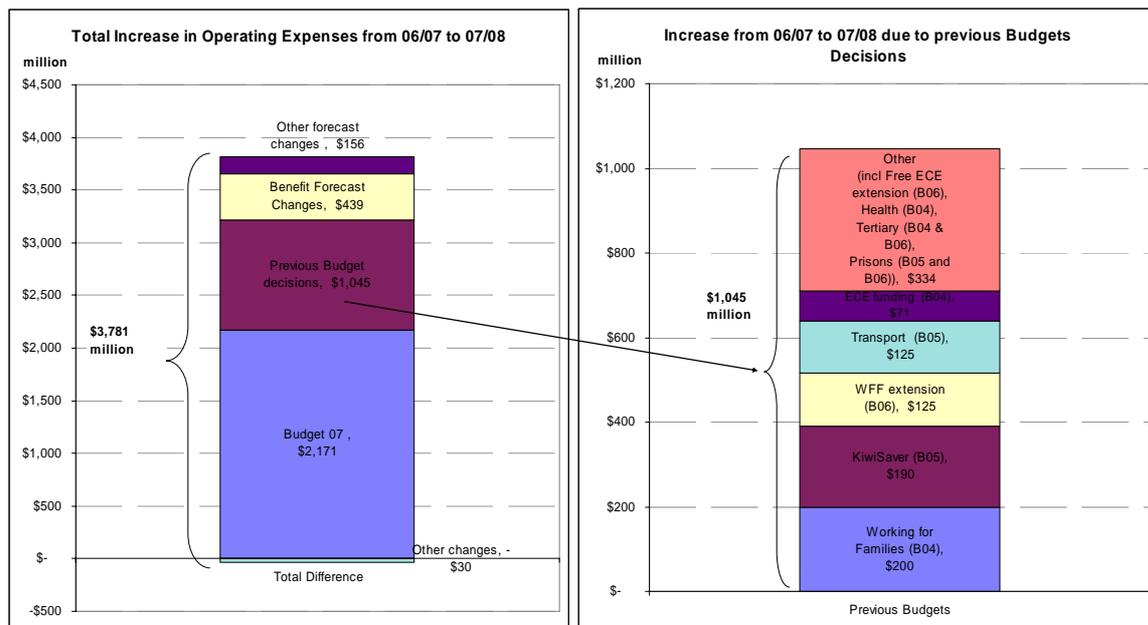
- **More focus on baselines.** Given my point above on the level of future allocations, it will be increasingly necessary for Ministers to find significant savings within their baselines to fund some of the initiatives they wish to implement. I plan to discuss these issues with Senior Minister colleagues in the near future.

Total change in spending from 2006/07 to 2007/08

25. This Budget I intend to introduce more focus on the overall increase in expenses rather than just the new funding we have decided in recent bilaterals. This stems from the fact that setting a Budget for 2007/08 not only includes the decisions we take as a Cabinet today but also reflects many decisions we have taken:

- in previous Budgets – to the extent that some programmes are phased in over a number of years e.g. Working for Families, *KiwiSaver*, and
- outside the Budget context but nevertheless make a significant impact to New Zealanders e.g. annual adjustments to benefit rates.

26. The chart below presents the total change between 2006/07 and 2007/08 of \$3.6 billion. Out of this nearly \$2 billion is due to the decisions we are making today on Budget 2007. Over \$1 billion is due to our previous decisions in Budgets 2004, 2005 and 2006, with half of those decisions associated with Working for Families and *KiwiSaver*. Finally, around \$700 million is due to forecasting changes mainly due to movements in benefit indexation.



Summary of Key Budget 2007 Theme Operating Initiatives

27. The table below sets out the key theme objectives and initiatives that are being progressed through Budget 2007. A full list of all initiatives can be found in the

attached annex or in the attached detailed financial recommendations (arranged by Vote).

Theme	Key Initiatives
<p><i>Economic Transformation</i></p>	<p>The Economic Transformation package includes:</p> <ul style="list-style-type: none"> • <i>Business tax reform, to lift productivity and international competitiveness, through:</i> <ul style="list-style-type: none"> ➤ Reducing the company tax rate from 33% to 30%, so that successful businesses are able to keep more of their profits, and so that New Zealand is a more attractive location internationally to generate profits ➤ Introducing an R&D tax credit, to encourage greater innovation and dynamism in New Zealand businesses, and to make New Zealand a more attractive location for innovative businesses ➤ Developing potential simplification of the business tax system to reduce the compliance cost, so that the tax system is less of a burden on businesses, in particular smaller businesses ➤ Introducing a tax exemption for the active income of New Zealand controlled foreign companies, allowing New Zealand firms to globalise at a lower tax and compliance cost • <i>Increasing international connections, through:</i> <ul style="list-style-type: none"> ➤ Expanding in market assistance to support firms to overcome the constraints of size and distance by supporting firms offshore activities and working with the food and beverage sector to increase its international activity ➤ Developing better links with China including promoting tourism and NZ businesses in China ➤ Partnering with industry leader Nextspace to build a high value 3D digital cluster harnessing their knowledge and reputation and building links with universities and CRIs • <i>Improving tertiary skills and lifting firms' innovative capacity, by:</i> <ul style="list-style-type: none"> ➤ Implementing Tertiary Education Reforms to further improve alignment between tertiary education and the research and skills businesses need now and into the future ➤ Investment of \$15 m p.a. to facilitate the commercialisation of R&D and support innovation in high value sectors ➤ An Auckland innovation hub to encourage collaboration, with R&D support for threshold firms and a Research Park • <i>Improving Sustainability and energy efficiency, including:</i> <ul style="list-style-type: none"> ➤ Steps towards achieving a carbon neutral future including moving the public sector towards carbon neutrality and showing Government leadership in sustainable procurement ➤ Measures to encourage investment in home energy efficiency and clean heating as well as supporting greater technology update and development
<p><i>Families – Young and Old</i></p>	<p>The Families – Young and Old package includes:</p> <ul style="list-style-type: none"> • \$750 million to the Health Sector for <i>better health for all</i> including: <ul style="list-style-type: none"> ➤ \$474 million to maintain service coverage by meeting cost pressures, demographic pressures and technological change ➤ expanding the elective surgery initiative ➤ increasing the focus on obesity through Healthy Eating-Healthy

	<ul style="list-style-type: none"> ➤ Action and Get Checked <ul style="list-style-type: none"> ➤ furthering the Cancer Control strategy ➤ modernising information technology infrastructure ➤ improving services for people with disabilities and older people ➤ addressing workforce issues arising from low-paid workers in DHBs and within aged residential and home based support settings ➤ addressing emerging pressures on DHB pharmaceutical budgets ➤ including the pneumococcal vaccine in the National Immunisation Schedule to protect the public from this disease, and ➤ providing for the implementation of the Joint Trans-Tasman Therapeutics Agency. • Increased support for providers of <i>home based rehabilitation services</i> for ACC claimants. • <i>Support for the elderly</i>, including ensuring New Zealand Superannuation is at least 66% of the average wage. • Measures to ensure <i>early intervention and support for children</i>, including: <ul style="list-style-type: none"> ➤ staffing improvements for new entrants to reduce teacher : student ratios in year 1 ➤ an inflation adjustment to ECE centre funding rates and an increased contribution to Kohanga Reo to help meet their costs. ➤ an inflation adjustment to schools' operational funding ➤ funding to meet the teachers and principals collective contracts. ➤ maintaining support for Child Youth and Family Services demand pressures. ➤ funding to meet remuneration pressures in Child Youth and Family Services ➤ continuing support for key youth programmes such as Project K and Aim High. • Providing safer communities through increased funding to <i>Justice, Police and Emergency Management</i>, including: <ul style="list-style-type: none"> ➤ the second tranche of extra frontline police officers and the first phase of replacing the Police radio network ➤ modernising and expanding Youth Justice facility in the lower North Island to reduce the number of youths remanded in Police cells ➤ funding to meet corrections and courts wage pressures. ➤ Human Rights Commission infrastructure and wage support ➤ funding to improve New Zealand's emergency management capability.
<p><i>National Identity</i></p>	<p>The National Identity package advances three key <i>theme objectives</i> with additional initiatives that range across a number of other ones, such as:</p> <ul style="list-style-type: none"> • <i>Connecting to our heritage:</i> <ul style="list-style-type: none"> ➤ Funding to meet the Government's commitment to Vietnam veterans ➤ Funding to support the Government's Digital Content Strategy. • <i>New Zealand in the world:</i> <ul style="list-style-type: none"> ➤ Funding for Official Development Assistance will taken to 0.35% of GNI by 2010/11 (extra \$216m in 2010/11). This increase will redress New Zealand's ODA levels relative to other OECD donors and allows us to address urgent Pacific and Asian development needs ➤ Continuing to meet our <i>Defence</i> Funding commitments by increasing the Defence Funding Package by \$58 million per annum

	<ul style="list-style-type: none"> ➤ Ministry of Foreign Affairs and Trade received \$30m increase in baselines to increase the Ministry's capability to deal with our international priorities. ➤ Continuation of the Solomons Islands Police deployment for a further two years. • <i>Reconciliation:</i> <ul style="list-style-type: none"> ➤ <i>Maori and Treaty</i> related initiatives totalling \$19 million over the period, including support for the Waitangi Tribunal settlements and the establishment of a Moriori Trust. • <i>Further initiatives across other theme objectives are:</i> <ul style="list-style-type: none"> ➤ Critical capability needs within <i>National Identity agencies</i> are being addressed ➤ Funding for New Zealand on Air to maintain services and to develop appropriate programming for the emerging digital environment ➤ Intensive, Integrated Biodiversity Management on Conservation Land.
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Summary of Key Budget 2007 Capital Initiatives

Sector	Key Initiatives
<i>Transport</i>	<ul style="list-style-type: none"> • Funding of \$145m for the cost escalation guarantee for the five-year State Highway Construction Plan as part of the government's commitment in Budget 2006 to increase certainty and investment in State highway construction. • ONTRACK funding of \$105m to meet the Crown's existing legal obligations. • Other significant rail initiatives as discussed in the accompanying Cabinet paper - Budget 2007: Funding for Rail Development.
<i>Education</i>	<ul style="list-style-type: none"> • Further investment in School Property and to deliver staffing increases for new entrant students \$210m. • Tertiary Education - \$177m capital to be spent in Budget 2007 partially funded by operating savings of \$110m. Tertiary capital includes \$84m for Tertiary Education Institutions seeking capital to improve their infrastructure, capability and sustainability and \$55m for enhancing the capability and distinctive contribution of the Institutes of Technology and Polytechnic (ITP) sub-sector in line with the Tertiary Education Strategy.
<i>Police</i>	<ul style="list-style-type: none"> • Capital funding of \$55m required to support the second tranche of additional police staff from the Government's commitment of an extra 1000 sworn and 250 non sworn staff over budget years 2006 - 2008. • Capital funding of \$40m for the first phase of a programme for the complete replacement of the Police radio network in the Auckland, Wellington and Christchurch areas.
<i>Health</i>	<ul style="list-style-type: none"> • Additional funding of \$60m to Health including the rollout of the Health Capital Budget.
<i>Other</i>	<ul style="list-style-type: none"> • Capital investment as part of the Long-term Development Plan for Defence of \$44m. • Initiatives in the Justice sector, including \$49m for the establishment of the Supreme Court permanent premises.

Between-Budget Funding

28. During the Budget bilaterals/themes process, a number of specific operating and capital initiatives were noted as items to receive funding during the course of the 2007/08 fiscal year. Funding was tagged to these particular initiatives, and has been added to the size of the contingency available for 2007/08 between-Budget funding. Ministers will need to submit papers during the year to Cabinet in order to get approval for these between-Budget initiatives.
29. In addition to specific tagged initiatives, we inevitably face unexpected demands for spending between Budgets. Therefore once again I propose to establish a general contingency for urgent issues that cannot be deferred to Budget 2008. Given the fiscal pressures we faced in Budget 2007 I am only proposing to set aside \$100 million per annum of operating funding and \$70 million of one-off capital funding (over two years).
30. This operating contingency is half the size of the contingency we set aside in Budget 2006 and this proved to be insufficient. Therefore, in order to ensure that we are able to manage between-Budget funding pressures we will need to be diligent to only seek funding from the general contingency for urgent issues that **cannot** be deferred to Budget 2008. I would expect that before Ministers seek funding from the contingency that they will have already considered opportunities to fund pressures from reprioritising existing baselines. Ministers will be expected to demonstrate this in any requests for between-Budget funding including demonstrating how they have sought to reprioritise or substitute existing spending before seeking new funding (consistent with CO(02)17). Any overspending that does occur will reduce theme allocations in Budget 2008.

Papers seeking funding between now and Budget Day

31. Once Budget 2007 has been agreed by Cabinet there are important production processes, including preparing Budget legislation, that must be completed in time for Budget Day on 17 May. In order to ensure that the documentation tabled in the House on Budget Day is accurate, Ministers are requested not to submit any papers to Cabinet that have fiscal and/or appropriation implications until after 17 May.

Legislative Implications

32. The detailed financial recommendations tabled in Cabinet will feed through to the production of the Appropriation (2007/08 Estimates) Bill and the Appropriation (2006/07 Supplementary Estimates) Bill.

Other Implications

33. There are no Treaty or Human Rights Act implications. A Regulatory Impact Statement is not required.

Publicity

34. Budget Day is 17 May 2007. The Office of the Minister of Finance coordinates all communications relating to Budget 2007, including requests for early announcements. The Minister of Finance's written approval is required for any early announcements.

Consultation

35. This package reflects discussions between Finance Ministers and Vote Ministers at Budget bilateral meetings and two Budget-related Senior Ministers' meetings.
36. Departments were consulted for the bilateral meetings, the Theme processes and on the detailed financial recommendations to give effect to the 2007 Budget initiatives.

Recommendations

I recommend that Cabinet:

2007 Budget Package

- a **agree** to a 2007 Budget package with the following fiscal impact:

BUDGET 2007 ALLOWANCES	\$ millions					5 year total
	2006/07	2007/08	2008/09	2009/10	2010/11	
Operating funding for Budget 2007	23	1,897	1,879	1,942	1,971	7,712
Families - Young and Old	(20)	1,001	1,049	994	936	3,960
Economic Transformation	(100)	155	182	165	204	606
National Identity	6	185	224	296	367	1,077
Other	6	476	430	494	523	1,929
First year of Business Tax Package*	-	108	-	-	-	108
Removing personal income tax threshold indexation	-	(85)	(395)	(425)	(535)	(1,440)
Post Budget 2007 contingency	-	100	100	100	100	400
Tagged contingency items	-	177	201	263	269	910
Subtotal	(108)	2,117	1,791	1,887	1,864	7,551
Plus Savings package	(22)	362	698	1,043	1,277	3,358
Subtotal	(130)	2,479	2,489	2,929	3,141	10,908
Difference from target Under/(Overspend)	153	(582)	(610)	(987)	(1,170)	(3,196)
Capital funding for Budget 2007	20	362	193	283	-	858
Families - Young and Old	1	240	91	23	60	414
Economic Transformation	41	350	220	150	119	880
National Identity	4	47	(5)	(3)	(6)	37
Other	0	2	-	-	-	2
Savings package capital costs	-	22	13	-	-	36
Post Budget 2007 contingency	-	45	25	-	-	70
Tagged contingency items	-	119	42	56	23	241
Subtotal	45	825	387	226	197	1,679
Difference from target Under/(Overspend)	(25)	(463)	(194)	57	(197)	(821)
Total difference (operating and capital)	127	(1,045)	(803)	(930)	(1,367)	(4,018)

* This table excludes the costs of the Business Tax Package from 2008/09, which are funded from the Budget 2008 allowance.

- b **note** that the package is higher than signalled in the *Budget Policy Statement* though in taking these decisions we have taken into account the tight macroeconomic environment and our long term fiscal objectives;
- c **agree** to the detailed initiatives for Budget 2007 as outlined in Annex 1;

- d **note** that in addition to this paper on the Budget 2007 package, Cabinet is also considering several other Budget-related papers and that the full cost of these papers have been included in the table in recommendation a;
- e **agree** that the fiscal implications of the Cabinet papers identified in recommendation (d) be communicated as part of Budget 2007;

Rescinding the decision to index personal tax income thresholds

- f **note** that, on 11 April 2005, Cabinet agreed to provide for the fiscal impact of the indexation of personal income tax thresholds from 1 April 2008, subject to final decisions by the Cabinet Policy Committee on 13 April 2005, and authorised the Cabinet Policy Committee to have Power to Act to make final decisions in respect of the 2005 Budget [CAB Min (05) 13/6 paragraphs 1 and 11 refers];
- g **note** that, on 13 April 2005, Cabinet Policy Committee agreed to provide for the fiscal impact of the indexation of personal income tax thresholds from 1 April 2008, and authorised Budget Ministers to take final decisions, for inclusion in the final Budget documents, on this initiative [POL Min (05) 9/1 paragraphs 2 and 3 refers];
- h **note** that Budget Ministers agreed to index personal income tax thresholds from 1 April 2008, and this was included in the final documents for Budget 2005;
- i **agree** to rescind the decision noted in recommendation h;

Between-Budget Funding

- j **note** that contingency funding has been tagged to a number of specific operating and capital initiatives, that Ministers will need to submit papers to Cabinet during the course of the year in order to get approval for these initiatives;
- k **agree** that given the limited general contingencies that exist for unanticipated operating and capital requirements during the course of the year, Ministers should only seek funding from the general contingency for urgent issues that cannot be deferred to Budget 2008, and will be expected to demonstrate they have considered opportunities to fund pressures from reprioritising existing baselines (consistent with CO(02)17);
- l **agree** that no papers should be submitted to Cabinet that have fiscal or appropriation implications between now and 17 May, to ensure that the documentation tabled in the House on Budget Day is accurate;

Future Budgets

- m **agree** to the following capital allowances for future Budgets

Capital allowances	Gross debt impact (\$ millions)						Total
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	
Budget 2008	20	480	250	150	-		900
Budget 2009	-	20	480	250	150		900
Budget 2010	-	-	20	480	250	150	900

- n **note** that pressures against Budget 2008 are sizeable, and that themes should use the Budget Strategy phase to set theme objectives that are more focussed than the objectives pursued in Budget 2007; and explore baselines to fund some initiatives through baseline savings;

Altering fiscal assumptions

- o **note** that I may need to alter the fiscal assumptions to be included in the 2007 *Fiscal Strategy Report* by:
- Reducing future operating allowances by \$50 - \$100 million per annum;
 - In the projection period (i.e. from 2011/12 onwards) we will adjust the tax thresholds for inflation, but some portion of fiscal drag might need to be retained to finance our decisions;
- p **authorise** the Prime Minister, the Minister of Finance and the Associate Minister of Finance (Hon Trevor Mallard) to take final decisions on the fiscal assumptions for the 2007 *Fiscal Strategy Report* once fiscal forecasts are finalised.

Hon Dr Michael Cullen
Minister of Finance