

Chair
CABINET BUSINESS COMMITTEE

2008 BUDGET PACKAGE

Proposal

1. This paper seeks Cabinet's agreement to the 2008 Budget package. It presents the package at an overview and an initiative-by-initiative level, and sets out the macroeconomic and fiscal backdrop in which the package has been developed.

Executive Summary

2. Budget 2008 is our next step in creating a sustainable, prosperous New Zealand, secure in its identity and proud of its achievements. Through Budget 2008, the last of this parliamentary term, we will build on the success we have had in transforming the economy over the last eight years. We will roll out a range of investments in infrastructure, innovation and services – critical components of building the potential of New Zealanders.
3. The centrepiece of Budget 2008 is our long-term programme for personal tax reform, which follows the tax relief we have introduced in successive Budgets through Working for Families, the Business Tax Reform and KiwiSaver. Personal tax reform is the subject of a separate Cabinet paper, *Budget 2008 Personal Tax Package – Sharing the Dividends*.
4. Other highlights of Budget 2008 are:
 - For **Economic Transformation**, advancing priorities in innovation, skills, infrastructure and international connections, including \$700 million for innovation in the pastoral and food industries through the NZ Fast Forward fund; investment in broadband; a skills package to target workforce literacy and numeracy; and funding for tertiary education and student support;
 - For **Families Young and Old**, \$446 million for social service NGOs through the new sustainable funding path; an extra \$750 million per annum for the health sector; strengthening the justice sector with extra police and capacity in courts and prisons; and investment in education through extra teachers and more resources for schools; and
 - For **National Identity**, bolstering arts and culture funding, including Radio New Zealand, Te Papa and the Historic Places Trust; creating a domestic screen production incentive fund; and funding for a new National Library.

5. As the table below shows, the 2008 Budget package comes within \$566 million (4%) of the allowances set during budget strategy. This has allowed us to develop a programme for personal tax reform that will deliver a dividend of eight years of economic success to taxpayers without jeopardising the fiscal position.

Funding (\$ millions)	2007/08	2008/09	2009/10	2010/11	2011/12	Total
Budget 2008 operating allowance	50	3,015	3,071	3,083	3,122	12,342
Proposed package	161	3,087	3,087	3,151	3,188	12,674
Under/(Overspend)	(111)	(72)	(16)	(68)	(66)	(332)
Budget 2008 capital allowance	48	992	330	200	230	1,800
Proposed package	124	1,165	497	186	63	2,034
Under/(Overspend)	(76)	(173)	(167)	14	167	(234)
Total Under/(Overspend)	(186)	(245)	(183)	(53)	101	(566)

6. Decisions about Budget 2008 are being taken in an environment of uncertainty arising from the global economic situation, and where domestic conditions are providing some challenges. This Budget package demonstrates that we are a government with a plan for the future of our economy, that we are delivering real solutions today, and that we are serious about the challenges we face.

Macroeconomic Context

7. In recent years New Zealand has enjoyed the longest period of economic growth since World War II, the lowest unemployment in a generation, more people in work than ever before, and household incomes, wages, and profits all increasing strongly.
8. Despite these successes, Budget 2008 decisions are being taken in an environment where the New Zealand economy faces a number of challenges and a great deal of uncertainty arising from the global economic situation.
9. The Treasury is currently finalising its forecasts for the *Budget Update*. They expect economic activity over the year ahead to slow more than previously forecast. Economic growth is expected to show early signs of recovery in 2009 before recovering more strongly in later years. Annual CPI inflation is expected to exceed or remain near the top of the 1-3% target band.
10. The international outlook is expected to weigh on export prices and volumes. Domestically, the housing market has slowed markedly and is dampening household spending. Credit conditions have tightened, accentuating pressures facing households and firms. Dry weather conditions are expected to reduce agricultural production and impact on electricity generation over coming months.
11. The high terms of trade, ongoing labour market strength, government spending and personal tax cuts are expected to provide some offset to these negative forces, particularly in 2009 and beyond.
12. There is a risk of more negative and widespread effects coming from weakness in the US economy and the disruption to the credit generating process that has helped support global growth over recent years. At this stage, the Australian and

Asian economies remain relatively strong and New Zealand's export commodity prices look well supported. However, domestic credit conditions are tightening.

13. The housing market correction also has the potential to see a larger than expected decline in house prices, with implications for residential investment and consumption. The ongoing strength in the labour market and tax cuts represent a key buffer for household behaviour.

The Fiscal Situation

14. There have been several developments relating to the government's fiscal position since the *Half Year Update* was released in December. The most significant of these are:
 - While the *Half Year Update* forecasts included a \$1.5 billion per annum revenue reduction contingency, our proposed programme for personal tax reform is larger than this. In 2011/12, when the tax package is fully implemented, households will receive an extra \$5.0 billion in the hand. This increase is not unexpected: the *Budget Policy Statement* signalled that more than \$1.5 billion of headroom was available, but that we wanted to observe how domestic and international conditions developed in early 2008 before taking final decisions;
 - The 2008 Budget package proposed in this paper comes within 4% of the allowances set in December;
 - A reduction in the Treasury's economic growth forecasts will reduce the amount of tax revenue expected to be collected over the forecast period;
 - The take-up rate for KiwiSaver has been much faster than expected, which flows through into higher Crown contributions; and
 - Given the factors above, to ensure consistency with our long-term fiscal objectives, the size of future Budget operating allowances has been reduced from \$2 billion per annum to \$1.8 billion per annum.
15. These developments will have implications for key fiscal indicators. The Treasury's initial fiscal forecasts indicate that:
 - The operating balance before gains and losses (OBEGAL) will fall. While the OBEGAL is expected to remain in surplus, it will be close to zero for a number of years and below the level needed to meet the contribution to the New Zealand Superannuation Fund for a sustained period; and
 - The ratio of gross sovereign-issued debt (excluding Reserve Bank settlement cash) to GDP is expected to rise from its current level of 18%, but to remain consistent with our long-term fiscal objective of being broadly stable around 20%.
16. I will need to explain in the *Fiscal Strategy Report* how the projected fall in the OBEGAL described above is consistent with our long-term operating balance objective to run operating surpluses, on average, large enough to fund the

required contributions to the New Zealand Superannuation Fund. I consider that the fall in the OBEGAL is consistent with our fiscal strategy because greater than expected operating surpluses over the last few years have allowed us to build up financial assets and reduce the ratio of gross sovereign-issued debt (excluding Reserve Bank settlement cash) below the target level of 20%. The magnitude of the proposed 2008 Budget package, including personal tax reform, is consistent with moving back to a level of debt consistent with the long-term debt objective.

17. All of this means that we have been able to deliver a Budget package and a programme for personal tax reform without jeopardising our reputation as prudent fiscal managers.
18. As the Treasury's fiscal forecasts for the *Budget Update* are finalised in coming weeks, I will monitor the fiscal outlook to ensure consistency with our fiscal objectives. Downside risks remain around the economic outlook, which may be reflected in weaker final fiscal forecasts. If this proves to be the case, further refinement to future Budget allowances may be necessary. I seek Cabinet's agreement to delegate authority to me and the Prime Minister to set final allowances for future Budgets to be included in Budget 2008 documentation.

Overview of 2008 Budget Package

19. The costs of the proposed 2008 Budget package are set out in the table below.

Funding (\$ millions)	2007/08	2008/09	2009/10	2010/11	2011/12	Total
Budget 2008 operating allowance	50	3,015	3,071	3,083	3,122	12,342
Pre-commitments:						
Business Tax Reform	-	1,056	1,135	1,130	1,130	4,451
MFAT	-	25	58	79	94	256
Defence Funding Package	-	69	69	69	69	276
Budget 2007 Contingency Overspend	43	11	5	3	3	65
Proposed packages:						
Families - Young and Old	(32)	371	457	514	541	1,851
Economic Transformation (Innovation)	(3)	193	181	180	179	731
Economic Transformation (Other)	(3)	146	113	97	87	440
National Identity	(62)	103	23	25	24	113
Other	216	130	102	107	116	671
Health	-	750	750	750	750	3,000
Revenue policy changes	2	32	43	48	45	171
Post Budget 2008 general contingency	-	200	150	150	150	650
Under/(Overspend)	(111)	(72)	(16)	(68)	(66)	(332)
Budget 2008 capital allowance	48	992	330	200	230	1,800
Proposed package	124	1,115	447	186	63	1,934
Post Budget 2008 general contingency	-	50	50	-	-	100
Under/(Overspend)	(76)	(173)	(167)	14	167	(234)
Total Under/(Overspend)	(186)	(245)	(183)	(53)	101	(566)

20. The proposed package comes within \$566 million (4%) of the total allowances that we set in December. This is in no small part due to the hard work

undertaken by theme groups to deliver balanced packages. I would like to thank Ministers for their efforts.

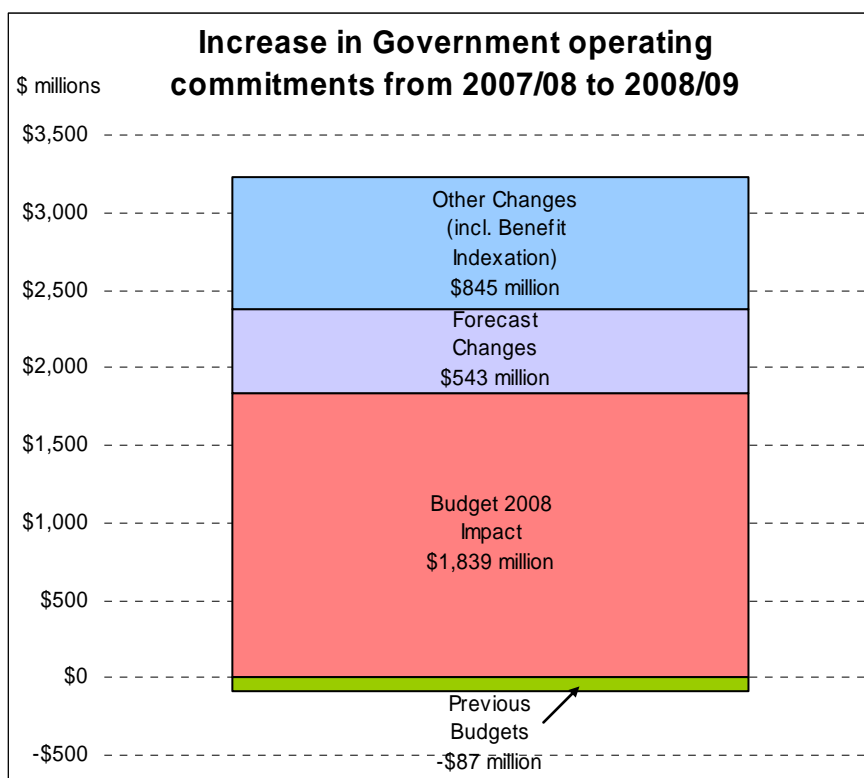
21. In terms of communicating the 2008 Budget package, items in the table above will be reconfigured. For instance, pre-commitments will be incorporated into the relevant theme, and Health will be incorporated into Families – Young and Old.
22. The table below sets out the highlights of the proposed 2008 Budget package. A full list of initiatives can be found in the Annex and in the attached detailed financial recommendations.

Theme	Key Initiatives
<p>Economic Transformation</p>	<p>Innovation: The NZ Fast Forward fund will help to transform New Zealand's pastoral and food industry via targeted investments with matching industry support (<i>\$700 million capital</i>). There is significant new investment in a research, science and technology package aligned to Economic Transformation priorities, including skills and capability that underpin innovation (<i>\$200 million over four years</i>).</p> <p>Skills: The Skills Package targets workforce literacy, language and numeracy needs (<i>\$166 million over four years</i>). Funding for tertiary education and student support initiatives will make tertiary education and skills training more accessible and affordable to a wider group of people (<i>\$380 million over four years plus \$135 million capital</i>).</p> <p>Infrastructure: The Broadband package will provide contestable funding to progress the Government's long term goal of fibre to the premise, improve Broadband services in rural areas, and facilitate the building of a second international cable (<i>\$325 million over five years plus \$15 million capital</i>). Additional investment will be provided to maintain and upgrade the rail network (<i>\$28 million in 2008/09 plus \$65 million capital</i>). Together, these investments will improve the flow of goods and services, and links between people and firms, both within New Zealand and with the rest of the world, in an environmentally sustainable manner.</p> <p>International Connections: New Zealand's linkages with the world will be strengthened by investment to secure and support increased market access for New Zealand firms, coupled with extra funding for Globally Competitive Firms to give effect to business internationalisation policies (<i>\$166 million over four years</i>). The package also includes funding for New Zealand's participation at the 2010 Expo in Shanghai.</p>
<p>Families Young and Old</p>	<p>NGOs: An extra \$446 million will be provided to social service NGOs through the new sustainable funding path. This will provide full funding for contracted essential social services delivered by community organisations, including regular and ongoing funding increases to reflect changes in costs and demand.</p> <p>Health: An extra \$750 million per annum will be provided for the health sector, including maintaining service coverage by meeting cost pressures, demographic pressures and technological change (<i>\$1,984 million over four years</i>); and expanding elective surgery (<i>\$160 million over four years</i>).</p> <p>Justice sector: The third and final tranche of 1000 extra Police will be rolled out (<i>\$163 million over four years</i>); extra capacity will be added to prisons (<i>\$114 million over five years</i>) and courts (<i>\$21 million capital</i>); and Mt Eden prison will be replaced (<i>\$14 million over four years, plus \$117 million capital</i>).</p>

Theme	Key Initiatives
Families Young and Old (continued)	Education: Funding is provided for the teachers' wage settlement (\$605 million over four years); there will be a 5% increase in the schools operational grant (\$172 million over four years); and extra staff and classrooms will be provided to reduce year one class sizes (\$182 million over four years, plus \$34 million capital).
National Identity	The National identity package includes: <ul style="list-style-type: none"> Investment in arts and culture including maintaining Radio New Zealand's core services (\$11 million over four years), maintaining services from Te Papa (\$12 million over four years), and bolstering the capability of the Historic Places Trust (\$8 million over four years); Creating a New Zealand screen production incentive fund (\$12 million over four years); and Building a National Library for the 21st century (\$36 million over five years, plus \$51 million capital).

Total Change in Spending from 2007/08 to 2008/09

23. As the chart below demonstrates, government operating expenses in 2008/09 are expected to be \$3.1 billion greater than in 2007/08. The majority of this increase is due to the funding provided in the proposed 2008 Budget package (noting that much of the cost of the Business Tax Reform is a reduction in revenue rather than an increase in expenses). The remainder is due to decisions taken outside the budget process which nevertheless have a significant impact, e.g. KiwiSaver forecast changes and annual adjustments to benefit rates.



Between-Budget Funding

24. Several initiatives included in the 2008 Budget package will not have funding appropriated now. Instead, funding tagged for these initiatives will be set aside to be accessed during the course of 2008/09 as and when it is needed. Ministers will need to submit papers to Cabinet during the year in order to access the funding for these initiatives.
25. In addition to specific tagged initiatives, we inevitably face unexpected funding demands between budgets. To meet these, I propose establishing general contingencies for urgent issues that cannot be deferred to Budget 2009. The contingencies are as set out below:

General contingencies (\$ millions)	2008/09	2009/10	2010/11	2011/12 & outyears
Operating	200	150	150	150
Capital	50	50	-	-

26. In order to manage between-budget funding pressures, Ministers should only seek funding from the general contingency for urgent issues that cannot be deferred to Budget 2009. Ministers will be expected to demonstrate that they have considered opportunities to fund pressures from existing baselines before seeking funding from the contingency.

Moratorium on Papers with Financial Implications

27. Once Budget 2008 has been agreed by Cabinet, there are important production processes that must be completed. In order to ensure that the documentation tabled in the House of Representatives on Budget Day is accurate, Ministers are requested not to submit any papers that have fiscal and/or appropriation implications for agreement by Cabinet between now and 22 May.

Future Budgets

28. At the start of this parliamentary term we agreed to set operating allowances for future Budgets of \$1.9 billion, growing by 2% per Budget. The allowance for Budget 2009, for instance, was to be \$2.0 billion.
29. As discussed above, in order to ensure that we achieve our long-term fiscal objectives, I propose that these allowances be reduced to \$1.8 billion, growing by 2% per Budget, as follows:

Operating allowances (\$ millions)	2009/10	2010/11	2011/12	2012/13 & outyears
Budget 2009	1,800	1,800	1,800	1,800
Budget 2010	-	1,836	1,836	1,836
Budget 2011	-	-	1,873	1,873

30. This reduction will make trade-offs in future Budgets more difficult, and will place a higher premium on identifying savings and efficiencies. Based on our performance in recent Budgets, however, these allowances will be achievable.

31. As mentioned above, depending on the shape of the final *Budget Update* fiscal forecasts, further refinement to these allowances may be necessary to ensure consistency with our long-term fiscal objectives.
32. Within the operating allowance for Budget 2009, there are already a number of pre-commitments:

Pre-commitments against Budget 2009 operating allowance (\$ millions)	2009/10	2010/11	2011/12	2012/13 & outyears
Defence Funding Package	86	86	86	86
Economic Transformation: Innovation	93	100	100	100
Health	-	2	16	14
Foreign Affairs	8	8	8	8
TOTAL	187	196	210	207

33. As part of our decisions on Budget 2007 we agreed to set capital allowances of \$900 million for future Budgets. I propose that we continue with this approach, which would entail the following capital allowances for the next three Budgets:

Capital allowances (\$ millions)	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Budget 2009	20	480	250	150	-	-	900
Budget 2010	-	20	480	250	150	-	900
Budget 2011	-	-	20	480	250	150	900

Consultation

34. The 2008 Budget package reflects discussions between Ministers at budget bilateral meetings, theme meetings and a Senior Ministers' meeting.
35. Departments were consulted in preparing briefings for bilateral meetings, through theme processes, and on the detailed financial recommendations accompanying this paper.

Financial Implications

36. This paper seeks Cabinet's agreement to the 2008 Budget package, the costs of which are set out in paragraph 5.

Legislative Implications

37. The detailed financial recommendations accompanying this paper will be incorporated into the Appropriation (2008/09 Estimates) Bill and the Appropriation (2007/08 Supplementary Estimates) Bill, which will be introduced on Budget Day.

Other Implications

38. There are no Treaty of Waitangi, human rights, gender or disability implications. A Regulatory Impact Statement is not required.

Publicity

39. Budget Day is 22 May 2008. The Office of the Minister of Finance coordinates all communications relating to Budget 2008, including requests for early announcements. The Minister of Finance's written approval is required for any early announcements.

Recommendations

I recommend that the Cabinet Business Committee:

2008 Budget package

1. **note** that decisions on Budget 2008 are being taken in an environment where the economy faces a number of challenges and a great deal of uncertainty arising from the global economic situation;
2. **agree** to a 2008 Budget package with the following fiscal impacts:

Funding (\$ millions)	2007/08	2008/09	2009/10	2010/11	2011/12	Total
Budget 2008 operating allowance	50	3,015	3,071	3,083	3,122	12,342
Pre-commitments:						
Business Tax Reform	-	1,056	1,135	1,130	1,130	4,451
MFAT	-	25	58	79	94	256
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Under/(Overspend)	(76)	(173)	(167)	14	167	(234)
Total Under/(Overspend)	(186)	(245)	(183)	(53)	101	(566)

3. **agree** to the initiatives for Budget 2008 as set out in the Annex and in the financial recommendations accompanying this paper;
4. **agree** to delegate authority to the Minister of Finance and the Minister of Foreign Affairs to approve changes to funding for Vote Official Development Assistance based on final *Budget Update* GNI forecasts;

5. **agree** to delegate authority to the Minister of Finance and the Prime Minister to approve changes to other initiatives where this proves necessary in finalising the 2008 Budget package;
6. **note** that personal tax reform is the subject of a separate Cabinet paper, *Budget 2008 Personal Tax Package – Sharing the Dividends*;

Between-Budget funding

7. **note** that tagged contingency funding has been set aside for specific initiatives, access to which may be sought from Cabinet between budgets;
8. **agree** that Ministers should only seek funding from the general between-budget contingency for urgent issues that cannot be deferred to Budget 2009, and will be expected to demonstrate that they have considered opportunities to fund pressures from existing baselines before seeking funding from the contingency;
9. **agree** that no papers with fiscal and/or appropriation implications should be submitted for agreement by Cabinet between now and 22 May 2008, to ensure that Budget Day documentation is accurate;

Future Budgets

10. **agree** to the following allowances for future Budgets:

Operating allowances (\$ millions)	2009/10	2010/11	2011/12	2012/13 & outyears
Budget 2009	1,800	1,800	1,800	1,800
Budget 2010	-	1,836	1,836	1,836
Budget 2011	-	-	1,873	1,873

Capital allowances (\$ millions)	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	Total
Budget 2009	20	480	250	150	-	-	900
Budget 2010	-	20	480	250	150	-	900
Budget 2011	-	-	20	480	250	150	900

11. **note** the following pre-commitments against Budget 2009:

Pre-commitments against Budget 2009 operating allowance (\$ millions)	2009/10	2010/11	2011/12	2012/13 & outyears
Defence Funding Package	86	86	86	86
Economic Transformation: Innovation	93	100	100	100
Health	-	2	16	14
Foreign Affairs	8	8	8	8
TOTAL	187	196	210	207

12. **agree** to delegate authority to the Prime Minister and the Minister of Finance to set final allowances for future Budgets based on final *Budget Update* forecasts;

Technical changes from the March Baseline Update

13. **note** that three technical changes proposed through the March Baseline Update, which do not impact on 2008 Budget funding allowances, require Cabinet approval, which is sought in recommendations 14 to 18 below;

Transforming Employer Information and Payments – Stage One

14. **approve** the following changes to appropriations to use a leasehold improvements capital surplus to fund the *Transforming Employer Information and Payments* stage one business case, with a corresponding impact on the operating balance and debt:

Vote Revenue Minister of Revenue	\$ million – increase / (decrease)				
	2007/08	2008/09	2009/10	2010/11	2011/12 & Outyears
Departmental Output Expense: Service to process obligations and entitlements (funded by revenue Crown)	1.037	-	-	-	-
Net asset schedule of Inland Revenue: Capital Withdrawal	(1.037)	-	-	-	-

Review of the Maori Trustee - Transitional Funding

15. **note** that the paper *Review of the Māori Trustee*, which was considered by Cabinet Business Committee in October 2007 [CBC Min (07) 23/10 refers], omitted recommendations to fully provision for transitional funding for services to the Māori Trustee;
16. **approve** the following changes to appropriations to recognise the increase in the provision for Māori Trustee debt to the Crown, with a corresponding impact on the operating balance:

Vote Māori Affairs Minister of Māori Affairs	\$ million – increase / (decrease)				
	2007/08	2008/09	2009/10	2010/11	2011/12 & Outyears
Other Expenses to be Incurred by the Crown: Provision for Māori Trustee debt	2.027	-	-	-	-

Neighbour Support NZ

17. **approve** the following changes to appropriations to provide additional funding for Neighbour Support NZ, with no impact on the operating balance or debt:

Vote Justice Minister of Justice	\$ million – increase / (decrease)				
	2007/08	2008/09	2009/10	2010/11	2011/12 & Outyears
Departmental Output Expense: Sector Leadership and Support (funded by revenue Crown)	-	(0.050)	-	-	-
Non-Departmental Output Expense: Crime Prevention and Community Safety	-	0.050	-	-	-

18. **agree** that the proposed changes to appropriations and projected balances of net assets for 2007/08 above be included in the 2007/08 Supplementary Estimates and that, in the interim, the increases be met from Imprest Supply.

Hon Dr Michael Cullen
Minister of Finance