

Chair  
CABINET

## **2005 BUDGET PACKAGE**

### **Proposal**

1. This paper seeks Cabinet's agreement to the 2005 Budget package.
2. The paper summarises the Budget package, provides the fiscal and economic context that the Budget is set against and discusses the Government's plan to fit within our long term fiscal objectives.

### **Executive Summary**

3. Budget 2005 is our sixth Budget and last in our second term of Government. Through our first two terms of Government we have built a reputation of being a prudent fiscal manager. We have gained this reputation through being a Government that has advanced significant policy in the short and medium term while at the same time being fiscally responsible over the longer term. We have advanced our policy programme while implementing our fiscal strategy – running operating surpluses sufficient to meet our contributions to the New Zealand Superannuation Fund and cover other capital spending while also reducing Crown debt to prudent levels. This will position future governments to manage the future demographic costs that New Zealand will face.
4. However this fiscal strategy policy is under significant pressure given current growth rates in government spending and expected economic and fiscal forecasts.
5. The macro economy has developed broadly in line with expectations at the time of the *December Update* (though the macroeconomic and fiscal forecasts have not yet been finalised). Treasury expects that any revisions to the fiscal forecasts, while perhaps favourable over the short-term, are likely to be small and less than the extent of positive changes over recent years. If this is confirmed then our most critical influence on our ability to meet our fiscal objectives will be the pace of growth in government spending.

6. The current growth in government spending is unsustainable if we are to remain on track to meet our fiscal objectives. To rectify this we need two critical mind shifts. The first is that recent growth rates across all government sectors (in particular Health and Education) are unsustainable and expectations need to be revised. The second is that it is going to be increasingly imperative that a portion of future spending proposals will need to be met from within existing baselines.

7. Budget 2005, our second biggest nominal Budget in history, builds on significant funding promised in Budget 2004 and has a total fiscal impact of \$2.2 billion operating in 2005/06 rising to \$2.9 billion in 2008/09. Areas that receive a significant portion of operating funding include Health, Education, Justice, Defence and Social Development. In addition we have been able to advance a savings package to encourage savings for retirement, home ownership and tertiary education. We have also advanced a significant business package which is partially funded by recycling the carbon charge revenue.

8. Budget 2005 also advances key capital investments (at levels higher than initially budgeted for). These include further capital funding for the Defence Force, additional funding for Housing acquisitions and modernisation and significant funding to the transport sector.

9. This paper is split into two sections. The first section covers the economic and fiscal context that the 2005 Budget spending package is set against. The second section sets out the details of the 2005 Budget package – the overall size of the package and the policies that the package advances.

***Putting money aside to meet future age-related costs while managing debt-to-GDP at prudent levels remains the cornerstone of the Government's fiscal strategy...***

10. In our first two terms of Government we have progressed the Government's key economic and social priorities. We have made large investments in health and education and in our people via the Working for Families package. We have been rebuilding key economic infrastructure in areas such as roading, railways and electricity. At the same time we have steadily moved toward our long term fiscal objectives. As a result we have gained a reputation as being a responsible and prudent economic and fiscal manager.

11. These are not ends in themselves. New Zealand, like other developed countries, faces substantially increased costs in the future due to the growing proportion of our population who will be elderly with the associated increase in health and pension costs. We are making our statutory contributions to the New Zealand Superannuation Fund (NZSF), pre-funding a significant portion of likely future age-related fiscal costs. We are supporting this by our debt-to-GDP objective. Low debt levels provide space for future age-related spending. It also allows time to assess the impact of demographic and other changes and formulate policy changes if that is what is needed.

12. We have made impressive progress on reducing our level of debt. Since we have been in office we have presided over the level of gross sovereign-issued debt falling from 35% of GDP in 1999 to around 23% now. In the Fiscal Strategy Report last year, to further recognise the importance of keeping debt at low levels and its role as a tool for fiscal management, we set ourselves a new target of reducing debt to below 20% of GDP by 2015.

13. Having said this, we should not lose sight of other fiscal indicators and therefore, ahead of the 2006 Fiscal Strategy Report, I intend to review the suite of indicators to ensure we do not lose sight of our overall fiscal strategy of pre-funding (both of building financial assets and paying back debt).

14. We have been assisted in our progress toward our fiscal objectives by favourable economic conditions that have reduced government spending in areas like welfare and finance costs and supported revenue collection. Our economic management has helped deliver these conditions and our fiscal management has been part of this by minimising a key source of economic volatility and by providing a stable environment for businesses and households to plan and invest.

15. We have assessed much of the improvement in fiscal outturns over recent years as being long lasting and therefore available to progress our policy priorities. This was reflected in Budget 2004 and our Budget Policy Statement (BPS) plans for Budget 2005. Following these Budgets we look to have used up the fiscal headroom we have consciously built up over our first two terms. While further positive surprises to the fiscal position cannot be ruled out over the short term, Treasury advise that these are likely to be smaller than those seen over the last few years. It would be imprudent to base our fiscal plans on a flow of continuing positive surprises. This emphasises the need to carefully manage our spending and revenue plans over coming years. Managing back the rate of increase we have seen in government spending over recent years is the key lever we have, but it is also the key challenge.

***The economic growth outlook indicates that the economy is increasingly coming up against constraints...***

16. The macro economy has developed broadly in line with expectations at the time of the December Economic and Fiscal Update (DEFU). Consistent with DEFU, real GDP growth is still growing at a solid pace, underpinned by household spending consumption, business investment growth and a rebound in export of primary goods. Employment growth has been strong, with unemployment now at low levels. Looking forward, Treasury still expects growth to ease back. Declining net migration, a cooling housing market, and the lagged effects of higher interest rates and the exchange rate, together with a projected decline in the terms of trade, are seen to be the main drivers.

17. The pace and sustained nature of recent growth is placing increasing pressure on available capacity. Spare resources are scarce, including in the labour market. One positive by-product of this is the strong increase in business investment we have seen that should support future productivity growth. However, we are also seeing increased inflation pressure, particularly in the construction sector, and increased imports. Annual CPI inflation is expected to rise to the top of the target band of 1-3 percent and remain there for some time. An outlook of continued capacity constraints and only a moderate slowdown over the coming year prompted the Reserve Bank to lift interest rates by 25 basis points on 10 March and further increases were not ruled out. The annual current account deficit has increased relative to DEFU forecasts, rising to 5.8% in September 2004 from 4.8% in June 2004. The prospects are that this deficit will increase further.

18. Macroeconomic and fiscal forecasts have not yet been updated for the *Budget Update*. Treasury's current view is that any revisions to the fiscal forecasts, while perhaps favourable over 2004/05 and maybe 2005/06, are likely to be small and less

than the extent of positive changes over recent years. If this is confirmed when the updated forecasts are available in mid-April the main driver of the *Budget Update* relative to the *December Update* will be the impact of the higher 2005 Budget package and outyear allowances for new operating and capital initiatives.

***Growth in Government spending is unsustainable if we are to remain on track to meet our fiscal objectives, and significant reprioritisation will be important in the future...***

19. The most critical influence on our ability to meet our fiscal objectives, while still funding new priorities, is the pace of growth in government spending. Within this, our success at meeting our objectives is driven by a) the amount of new government spending (i.e. increases to baselines) and b) our ability to meet future spending initiatives through reprioritisation (i.e. funding within existing baselines). While not currently anticipated, further positive “shocks” to the fiscal position would provide additional headroom and further policy options.

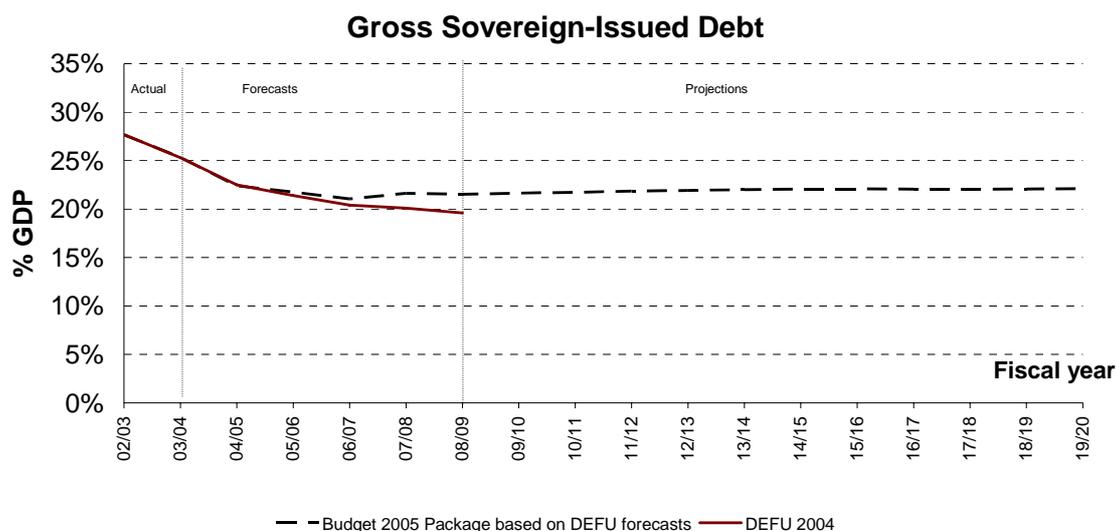
20. In our first term of Government we delivered Budgets that committed approximately \$1 billion per annum of new net operating funding per Budget. In our second term, Budget 2003 committed \$2.7 billion of new net operating funding and Budget 2004 committed \$3.8 billion of funding<sup>1</sup>. These Budget increases were a conscious decision to deliver bigger Budgets to advance our priorities and were on the back of sound fiscal management and strong economic growth which widened the fiscal headroom. The size of Budget 2004 was set knowing that the fiscal position of that year would enable us to fund our flagship Working for Families package. However, when delivering Budget 2004, we recognised that due to the substantial increase that the Budget made in the level of Government expenditure, in order to continue to meet our debt objective future Budgets would need to be significantly smaller.

21. In December we set aside \$2.1 billion (rising to \$2.4 billion in 2008/09) for spending in Budget 2005. This was an increase on what we had planned for Budget 2005 in the Fiscal Strategy Report 2004, though the increase was on the back of an improved economic outlook and additional fiscal headroom. In addition to this increase, the Budget Policy Statement 2005 also stated that we may have scope for further spending above these levels in the short-term but that this additional spending should not be stimulatory and should at least be fiscally neutral over the long term.

22. Budget 2005 has exceeded the provisions we set aside in December, though the increase has in part been directed towards implementing a savings package that is not expected to be stimulatory. Also contributing to the increase is the introduction of a business package that has had more upfront costs than originally anticipated and has required more ongoing funding than is available through the planned recycle of the carbon charge. The chart below shows the impact of Budget 2005 on the Government’s debt objective (based on the December forecasts). This shows that, on the basis of the December forecasts, the level of Budget 2005 is not consistent with our long-term debt objective to pass through 20 percent by 2015.

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<sup>1</sup> These figures represent the final outyear impact of the Budgets as this is the ongoing baseline cost of each Budget once all policies are implemented.



23. [Information withheld under section 9(2)(g)(i) of the Official Information Act 1982]. If we cannot keep future budgets to lower levels, we will not be on track to achieve our long-term fiscal objectives. In addition, to the extent that we overspend now, in the absence of positive fiscal forecasting changes, we reduce our policy and spending options in the future. Finally, we run the risk of increasing inflation pressures which could result in further upward pressure on interest and exchange rates at a time when some parts of the productive sector are already under considerable pressure. This increases the risk that when the economy does slow down it will be deeper, meaning it will have a larger impact on all New Zealanders.

24. To avoid such consequences, we need to apply our remaining lever – the size of government spending. Firstly we need to commit to deliver a Budget next year that is within the spending intentions we have previously set for ourselves. To achieve this we need two critical mind shifts. The first mind shift is that recent spending growth rates across all government sectors are unsustainable. The second is that it is going to become increasingly imperative that a portion of future spending proposals will need to be met from within existing baselines.

25. In terms of unsustainable growth rates, this is particularly true for Health and Education which have received a combined additional \$1.8 billion by 2008/09 in Budget 2005. Such levels of funding growth are incompatible with moving into an environment where Budgets are committing around the \$2 billion mark of new funding for new initiatives.

26. We have been concerned about growth rates in these sectors for some time and therefore as part of the bilateral process we have agreed to begin some work to look at the long term funding sustainability around Health and Education (particularly Tertiary Education). The box below sets out the scope for these pieces of work.

[Information withheld under section 9(2)(f)(iv) of the Official Information Act 1982]

27. The success of these reviews will be critical to manage future Budgets at forecast levels. I propose we consider strengthening these reviews by setting a growth objective to manage outyear expenditure (e.g. ensuring Health and Tertiary expenditure growth rates are no greater than the growth rate of nominal GDP). I am seeking further advice on whether a target objective could be extended beyond the Tertiary sector into the entire Education sector, though such a target would need to be formulated within the context of the current policy settings in this area. What is clear is that addressing the growth rates in these two sectors alone will be insufficient. We must revise our expectations, on an ongoing basis, across all sectors.

28. Adding to the challenge of managing to lower Budgets is the level of agreed decisions we have already taken against future Budgets. For instance, against the \$2.1 billion set aside for Budget 2006, we have already taken decisions on approximately \$700 million of this. These decisions relate to the Health funding package, the Defence funding package, Education (Student Component Funding) and our commitments around Official Development Assistance.

29. In terms of the second mind shift (meeting a portion of new spending from existing baselines), it is timely to do more work in this area considering we have now been in Government for two terms and we have implemented a large amount of policy change. It is time to consolidate on what we have done and test the effectiveness of the increase spending we have implemented. Experience of a few Ministers who have attempted to reprioritise in the past has shown that there can be a two to three year lag between identifying areas of spending to move out of, before the funding is actually freed up for new priorities. This means that work needs to begin now to identify low priority spending across various areas. The Managing for Outcomes (MFO) approach is designed to help Ministers and departments plan their desired outcomes over the medium to long term, including prioritising activities and evaluating effectiveness of interventions. I shall come back to you with further thinking on how to take such work forward.

30. To also help reduce additional pressure on Budget 2006 I will be again seeking Cabinet's agreement to keep between-Budget policy decisions with a fiscal impact to a minimum, relating to urgent issues that cannot be deferred to Budget 2006 (consistent with CO (02) 17). I expect those Ministers, who managed Budget 2005 allocations, to manage all their between-Budget spending pressures from the contingencies they were required to set aside. For those areas outside the sector related contingencies, I have set aside a modest general contingency. I intend to continue the focus I gave the general contingency after Budget 2004 and, before signing off the paper to Cabinet, I will be looking for clear evidence that the initiative *cannot be funded through reprioritisation* of baselines **and cannot be deferred** to the next Budget. Again, I will be asking Treasury to assist me on this matter.

**These strategies may be insufficient for the Government to still demonstrate that we are on target to meet our fiscal objectives**

31. Even if we were to commit to restrict future spending to levels we have previously set for ourselves, we face the possibility that our Budget Economic and Fiscal Update will show that we are not on track to meet our fiscal targets. I intend to wait to see the final forecasts rather than suggest changes to Budget 2005 now. But if Budget 2005 looks unsustainable from a fiscal and macroeconomic perspective, we should be prepared to consider options to manage Budget 2005 back. Budget Ministers have discussed a set of management strategies on which areas should be managed back. The attached Annex presents an agreed set of strategies that we may need to adopt.

32. I intend to report back to the Cabinet Policy Committee on 13 April, having sought Cabinet's agreement for POL to have power to act, for final decisions on Budget 2005, including adopting some or all of the management strategies if the fiscal forecasts suggest we will not be on track to meet our long term fiscal objectives.

33. Above was the fiscal and economic context that the 2005 Budget is set in. What follows is information about Budget 2005 itself – the size of it, the themes of expenditure and the priorities it will progress.

**Budget 2005 Advances Significant Progress on Policy**

34. Budget 2005, our second biggest nominal Budget in history, builds on significant funding promised in Budget 2004 and has a total fiscal impact of \$2.2 billion operating in 2005/06 rising to \$2.9 billion in 2008/09. In addition, this Budget injects a further \$2.1 billion of capital over the next five years. These are set out in the tables below.

**Table 1 – Summary of Operating Impact since Budget Strategy**

(\$ million) GST incl.	2004/05	2005/06	2006/07	2007/08	2008/09 and outyears
Health	167	1086	1084	1147	1191
Education	23	381	652	669	653
Justice	78	149	179	218	228
Defence and Security	2	97	110	143	152
Social Development and Housing	1	78	101	112	110
Sustainability Package	24	46	37	35	31
Resource Management Act/ Coastal Marine Area		20	20	20	20
Arts and Heritage	0	22	20	20	18
GIF <sup>1</sup>	2	118	98	102	95
Other	69	237	319	307	314
2005 Between Budget Spending		150	150	100	100
Forecast Risk	(62)	(76)	(62)	(77)	(81)
Thin Capitalisation changes		(240)	(360)	(360)	(360)
Remaining Budget 2004 Other contingency	(47)	(101)	(127)	(144)	(144)
<b>Subtotal</b>	<b>257</b>	<b>1968</b>	<b>2221</b>	<b>2291</b>	<b>2326</b>
Additional Spending:					
Business Package (net)		226	226	103	55
Timing delay in tax revenue/receipts <sup>2</sup>				760	
Savings Package	0	33	132	286	163
Provision for Specific Fiscal Risk				100	400
<b>Total 2005 Budget Package</b>	<b>257</b>	<b>2227</b>	<b>2579</b>	<b>3540</b>	<b>2945</b>
<b>Budget Strategy</b>	<b>439</b>	<b>2100</b>	<b>2180</b>	<b>2365</b>	<b>2435</b>
<b>Underspend/(Overspend)</b>	<b>182</b>	<b>(127)</b>	<b>(399)</b>	<b>(1,175)</b>	<b>(510)</b>

1. This figure is higher than the Budget Strategy figure as there are a number of contingency initiatives from Budget 2004 that are yet to receive funding.

2. This is due to a delay of provisional tax revenue/receipts from June 2008 to July 2008 as a result of the provisional tax simplification measures in the Business Package. Effectively there is a delay in timing by 51 days but it impacts on the operating balance as it crosses financial years and therefore there is an impact on the presented level of the operating balance and gross debt as at 30 June 2008.

**Table 2 – Summary of Capital Impact since Budget Strategy**

(\$ million) GST incl.	2004/05	2005/06	2006/07	2007/08	2008/09 and outyears
Health	0	24	0	0	0
Education	3	5	0	0	0
Justice	53	183	102	-9	10
Defence and Security	47	511	31	23	32
Social Development and Housing	0	93	76	65	66
Sustainability Package	-30	41	2	0	8
Resource Management Act/ Coastal Marine Area	0	2	0	0	0
Arts and Heritage	4	4	7	1	1
GIF	0	1	2	1	1
Other	97	254	56	56	49
Contingency		200			
<b>Total 2005 Budget Package</b>	<b>174</b>	<b>1318</b>	<b>274</b>	<b>137</b>	<b>166</b>
<b>Provisions at Budget Strategy</b>	<b>156</b>	<b>741</b>	<b>941</b>	<b>414</b>	<b>550</b>
<b>Underspend/(Overspend)</b>	<b>(18)</b>	<b>(577)</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>

35. The package makes significant progress of Government priorities – some of which are outlined below.

**Summary of Budget 2005 Policy Initiatives in Key Sectors**

<b>Policy Area</b>	<b>Key Initiatives</b>
<i>Encouraging savings</i>	<p>Cabinet will be considering a savings package at the same time as the Budget package. The savings package includes:</p> <ul style="list-style-type: none"> <li>• A Work Based Savings Scheme – whereby individuals make contributions from their wages and salary with the money channelled through the existing IRD processes to invest in long term privately provided savings funds. The funds would be principally for retirement, but would allow for a withdrawal for first home ownership;</li> <li>• A Tertiary Education Savings Scheme – the package provides an option for helping families to save for their children's tertiary education. The design details of this part of the package have yet to be finalised as the Government is in the process of seeking formal expressions of interest in a contestable (single or multiple provider) tertiary savings scheme(s);</li> <li>• Home ownership assistance – a package of initiatives aimed at assisting families and low income New Zealanders into their first home. The package includes an expansion of the Mortgage Insurance Scheme (MIS) to enable first home buyers to access commercial finance with low deposit levels, home ownership education and a deposit subsidy that is linked to participation in the Work Based Savings Scheme.</li> </ul>
<i>Supporting business</i>	<p>The business tax package includes:</p> <ul style="list-style-type: none"> <li>• changes to the taxation of financial intermediaries that improve the tax treatment of savings;</li> <li>• changes designed to improve the efficiency of business investment, comprising depreciation rate changes and an increase to the threshold for expensing low value assets together with extending depreciation loading to second hand assets;</li> <li>• simplifications to fringe benefit tax, primarily in respect of motor vehicles;</li> <li>• reducing compliance costs by alignment of provisional tax and GST payment dates and providing businesses with the ability to pay provisional tax on the basis of GST sales; and</li> <li>• a temporary exemption for tax on foreign sourced income for new migrants and returning New Zealanders.</li> </ul>
<i>Supporting economic growth</i>	<p>The Growth and Innovation package includes:</p> <ul style="list-style-type: none"> <li>• ensuring an increase in the supply of industry training opportunities - boosting funding for industry training, modern apprenticeships, and work place numeracy and literacy programmes;</li> <li>• ensuring New Zealand has the capability to negotiate and effectively implement its existing programme of bilateral trade agreements. Resourcing programmes which will assist New Zealand firms and institutions to take advantage of the opportunities created for greater market access and to deepen our relationships with our trading partners;</li> <li>• Delivering on programmes to ensure that New Zealander and New Zealand business can take advantages of the</li> </ul>

	<p>opportunities provided by ICT. Delivering on the Government's role in Digital Strategy, with a focus on content, capability and infrastructure;</p> <ul style="list-style-type: none"> <li>• A commitment to extending and streamlining existing support for research and development through the Technology for Business Growth programme. In addition, it will assist New Zealand businesses to establish deeper relationships with researchers in CRIs and TEIs, and facilitate their access to world-class technology specialists;</li> <li>• funding that will increase the capability of the public science system to deliver greater benefit to New Zealand businesses through the creation of additional research consortia and a higher level of direct funding to CRIs to allow them to develop capability;</li> <li>• A boost to the promotion of New Zealand as a tourist destination.</li> </ul>
<p><i>Protecting New Zealand's Environment and Heritage</i></p>	<p>The Sustainability package includes significant funding to work towards:</p> <ul style="list-style-type: none"> <li>• achieving climate change outcomes through a range of initiatives to reduce emissions and improve energy efficiency;</li> <li>• protecting New Zealand's health, natural environment and primary industries by improving detection of, and response to, biosecurity threats;</li> <li>• ensuring the sustainable utilisation of our fisheries resources through targeting poaching and black market activities and improving engagement with the recreational sector;</li> <li>• enhancing New Zealanders' enjoyment of our natural resources through improved land access; and</li> <li>• promoting sustainable business practices through reducing the production and impact of waste and encouraging recycling</li> </ul>
<p><i>Advancing social policies</i></p>	<p>The <b>Health sector</b> package includes:</p> <ul style="list-style-type: none"> <li>• funding the wage settlement package for nurses;</li> <li>• price increases in the Disability Support and Aged Care sectors;</li> <li>• beginning implementation of the removal of asset testing for Aged Care residential services;</li> <li>• funding the costs of the Holidays Act;</li> <li>• price increases to meet inflationary and demographic pressures across the sector;</li> <li>• speeding up the roll-out of the Primary Healthcare Strategy;</li> <li>• increasing the number of cataract procedures;</li> <li>• cancer strategy;</li> <li>• implementing a national Travel and Accommodation Policy, for those who incur high travel costs because of distance from treatment centres or frequency of visits.</li> </ul> <p>The <b>Education</b> package includes:</p> <ul style="list-style-type: none"> <li>• an expansion of the funding and regulatory system for Early Childhood Education introduced in Budget 2004;</li> <li>• further investment in quality teaching, and additional resources for schools;</li> <li>• funding to increase tertiary student component subsidies in 2006;</li> <li>• a number of initiatives to strengthen the use of Information and Communication Technology in education;</li> <li>• a significant expansion of the Performance-based research</li> </ul>

	<p>fund to support excellent research;</p> <ul style="list-style-type: none"> <li>continued support for international education through the addition of three extra offshore education counsellors;</li> <li>a package of Student Support initiatives including the introduction of an abatement rate for students who work while receiving an allowance.</li> </ul>
	<p><b>The Justice sector package includes:</b></p> <ul style="list-style-type: none"> <li>increased capacity through new prisons and Court Houses, extra judges and extra police;</li> <li>enhanced capability in MOJ's Courts and policy areas, following the baseline review;</li> <li>provision for more access to legal aid by adjusting eligibility thresholds;</li> <li>early intervention initiatives in Police and Justice.</li> </ul>
<i>Further investment in public sector capability</i>	<p>We continue to invest in building and maintaining the capability of the State Sector. Aside from the sectors mentioned above we are:</p> <ul style="list-style-type: none"> <li>meeting significant pay settlements or existing cost pressures in Conservation, Labour, Revenue, Parliamentary Services and Customs;</li> <li>expanding and enhancing public service capability in Statistics NZ, Revenue, MCDEM, DIA, Transport and MFAT;</li> <li>meeting the costs from the agencies significantly affected by increased SSRSS take-up due to the successful implementation of the scheme, and the costs of the Holidays Act changes.</li> </ul>

### *Capital investment*

36. Budget 2005 advances many key capital investments, over and above the key sectors outlined in the table above (which include both operating and capital spending components). Such areas include:

- further investment in defence capital spending. We are committing \$410 million of capital – the next instalment of the \$1 billion capital commitment we previously made. We are also committing a further \$209m of capital funding from 2007/08;
- further investment in the housing sector (an additional \$250m over the next four years) to fund acquisitions, modernisation of existing stock, and continuation of key housing programmes;
- further investment in the transport sector. Budget 2005 provides an appropriation for a loan to Transit of \$158 million to part fund the Albany to Puhoi Urban rapid Transit northern motorway extension (ALPURT B2).

37. In the *2004 December Economic and Fiscal Update* we increased the capital provisions by \$750 million in 2005/06 and a further \$750 million in 2006/07. The level of capital committed in Budget 2005, for the 2004/05 and 2005/06 fiscal years, exceeds the capital provisions by approximately \$500 million. This is a significant sum beyond what we agreed in the Budget Strategy. We have been consistently overspending our capital provisions and I am currently assessing whether the level of provisions we allow for capital is adequate. I am aware of further pressures on capital (particularly around Education) and I therefore propose setting aside a further \$200 million in 2005/06 for these pressures.

## **Key results in priority areas**

38. The 2005 Budget Strategy paper agreed that Vote Ministers in priority areas (health, education, law and order, defence, social development and GIF) should report back to Cabinet before final budget decisions are taken on what results are being sought from spending in their votes and how the achievements of those results will be determined [CAB Min (04) 40/3A refers]. These are outlined in Annex Two.

## **Progressive and United Future Party Initiatives**

39. Where possible I have taken into consideration initiatives submitted by Ministers for the Progressive and United Future Parties.

## **Legislative Implications**

40. The detailed financial recommendations tabled in Cabinet will feed through to the production of the Appropriation (2005/06 Estimates) Bill and the Appropriation (2004/05 Supplementary Estimates) Bill.

## **Public Finance Act/GST Implications**

41. The Public Finance Amendment Act 2004 contains a number of technical changes that affect the 2005 Budget package. In particular appropriations sought for the 2005 Main Estimates are now presented GST exclusive. To date, all allocations, contingencies and 2005 Budget initiatives have been presented GST inclusive.

42. As part of the transition to GST exclusive recommendations I ask you to note:

- 2005 Budget allocations and initiatives will be presented as GST exclusive in all Budget documents. In most cases the quoted initiatives will be lower than the financial recommendations because of this.
- That the 2005/06 sectoral contingencies and Between Budget Spending will have the GST removed.

## **Publicity**

43. Budget day is 19 May 2005. The Office of the Minister of Finance coordinates all communications relating to the 2005 Budget, including requests for early announcements. The Minister of Finance's written approval is required for any early announcements.

## **Consultation**

44. This package reflects discussions between Finance Ministers and Vote Ministers at budget bilateral meetings. The package has also been endorsed by Budget Ministers.

45. Departments were consulted for the bilateral meetings and on the detailed financial recommendations to give effect to the 2005 Budget initiatives.

## **Recommendations**

46. I recommend that Cabinet:

## 2005 Budget Package

1. agree to a 2005 Budget package with the following fiscal impact:

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<b>Underspend/(Overspend)</b>	<b>182</b>	<b>(127)</b>	<b>(399)</b>	<b>(1,175)</b>	<b>(510)</b>

1. This figure is higher than the Budget Strategy figure as there are a number of contingency initiatives from Budget 2004 that are yet to receive funding.

2. This is due to a delay of provisional tax revenue/receipts from June 2008 to July 2008 as a result of the provisional tax simplification measures in the Business Package. Effectively there is a delay in timing by 51 days but it impacts on the operating balance as it crosses financial years and therefore there is an impact on the presented level of the operating balance and gross debt as at 30 June 2008.

## Summary of Capital Impact since Budget Strategy

(\$ million) GST incl.	2004/05	2005/06	2006/07	2007/08	2008/09 and outyears
Health	0	24	0	0	0
Education	3	5	0	0	0
Justice	53	183	102	-9	10
Defence and Security	47	511	31	23	32
Social Development and Housing	0	93	76	65	66
Sustainability Package	-30	41	2	0	8
Resource Management Act/ Coastal Marine Area	0	2	0	0	0
Arts and Heritage	4	4	7	1	1
GIF	0	1	2	1	1
Other	97	254	56	56	49
Contingency		200			
<b>Total 2005 Budget Package</b>	<b>174</b>	<b>1318</b>	<b>274</b>	<b>137</b>	<b>166</b>
<b>Provisions at Budget Strategy</b>	<b>156</b>	<b>741</b>	<b>941</b>	<b>414</b>	<b>550</b>
<b>Underspend/(Overspend)</b>	<b>(18)</b>	<b>(577)</b>	<b>N/A</b>	<b>N/A</b>	<b>N/A</b>

2. **note** that the package is consistent with the Budget priorities signalled in the 2005 *Budget Policy Statement*;
3. **note** that current costings for the savings package included in the above table exceed the provisional savings allocation as outlined in the Savings paper being considered by Cabinet concurrently which seeks to delegate finalisation of the savings allocation to the Minister of Finance, Minister of Housing and Minister of Education, in consultation with the Prime Minister following receipt of the Budget forecasts;
4. **agree** to the detailed initiatives for the 2005 Budget as outlined in Annex Three;
5. **agree** to set aside a further \$200 million in capital spending for 2005/06 and retain the current capital provisions for 2006/07 onwards;

### Managing to Lower Budgets

6. **note** that in order to remain on target to meet our long-term fiscal objectives, future Budgets need to be significantly smaller than Budgets 2004 and 2005;
7. **agree** that in order to deliver a Budget next year that is significantly smaller than Budget 2005;
  - i. this will require reductions in spending growth rates across all the Government sectors but in particular Health and Education;
  - ii. increase our attention to explore reprioritisation within existing spending rather than growing portfolios;
  - iii. manage between-Budget spending in sector-related allocations to the contingency levels set during Budget 2005;
  - iv. manage between-Budget spending against the general contingency to urgent issues that **cannot** be funded through reprioritisation of baselines **and** cannot be deferred to Budget 2006 (consistent with CO (02) 17);

8. **note** that to demonstrate we are still meeting our fiscal targets we may need to adopt some or all of the Budget Minister agreed strategies, to manage back the Budget 2005 package, as set out in Annex 1;
9. **note** I intend to report back to Cabinet Policy Committee on 13 April, having sought Cabinet's agreement for POL to have power to act, for final decisions on the Budget 2005, including adopting some or all of the management strategies if the fiscal forecasts suggest we will not be on track to meet our long term fiscal targets;

#### **Finalising and Announcing the Budget Package**

10. **authorise** the Minister of Finance to finalise, along with Vote Ministers, any technical adjustments to baselines to ensure accuracy while finalising the 2004/05 Supplementary Estimates, the 2005/06 Estimates and the final forecasts;
11. **note** that the Office of the Minister of Finance will coordinate all Budget communications, and that written approval from the Minister of Finance is required for announcements ahead of Budget day (19 May 2005).

**Hon Dr Michael Cullen**  
Minister of Finance

## **Annex 1 – Options around the 2005 Budget Package**

On 21 March Budget Ministers met to discuss a set of management strategies that could be adopted if the Budget Economic and Fiscal Update indicates that we are not on target to meet our fiscal objectives. An agreed set of strategies, that may need to be adopted, are set out below.

- Deferral of capital initiatives. These relate to both deferral on existing projects and Budget 2005 initiatives. Key areas are Health, Education and Transport.
- Reduction in 2005 Budget operating spending. Key areas here are:
  - Managing back allocations that are oversubscribed. These include Health, Social Development and Housing and Defence and “Other”;
  - Reductions in the Education allocation. Although this allocation is balanced, there are opportunities to manage this back.
- Reduce indicative forecasts for future Budgets. Budgets 2006, 2007 and 2008 are included in the fiscal forecasts at \$2.1b, \$2.2b and \$2.25b respectively.

## **Annex 2 – Key results in priority areas**

Vote Ministers in priority areas (health, education, law and order, defence, social development and GIF) are required to report back to Cabinet before final budget decisions are taken on what results are being sought from spending in their votes and how the achievements of those results will be determined [CAB Min (04) 40/3A refers].

### **Health**

The package of bids presented by the Minister has been developed to ensure alignment with the health priorities for New Zealand in accordance with the:

- Key Government Goals: in particular to restore trust in Government and provide strong social services and to reduce inequalities in health, education, employment and housing;
- Societal outcome of Healthy New Zealanders;
- System outcome of a fair and functional health and disability support system;
- Ministry outcome of ensuring the system works for all New Zealanders.

Budget 2005 will enable the continued roll-out of a number of key government policies including the removal of asset testing, the primary health care strategy and the orthopaedics initiative. The majority of expenditure in the package is however increasing the level of government investment in current policy settings rather than introducing new initiatives or expanding service provision. Funding is allocated to maintain the real level of services per capita (FFT and demographic allocations), increases in the real price paid for services (Industrial settlements and DSS) or cost increases in existing initiatives such as the Primary care strategy and the deinstitutionalisation of the Kimberly centre.

These initiatives increase the price the government is paying for services. They are intended to improve the sustainability and capability of the sector to deliver services rather than to achieve immediate improvements in health outcomes.

### **Education**

The package of bids presented by the Minister of Education has been developed to ensure alignment with the Education Priorities for New Zealand, as expressed through each of the sector strategies.

In the early childhood education sector the initiatives are closely tied to raising participation (through additional funding for the discretionary grants scheme), implementing the regulatory and funding changes approved last year, and funding improvements in quality through the sustainability adjustment, and through investment in information technology professional development.

In the schooling sector, priorities are aligned with the developing Schooling Strategy. There is additional professional development support through supplementary learning support and assessment exemplars for students with special learning needs. The largest components are the already agreed wage settlements with the New Zealand Educational Institute and the Post-Primary Teachers Association, and increases to the government's investment to maintain the real value of resourcing to schools.

The tertiary component of the package aligns with the change messages of the Tertiary Strategy. The Ministry of Education intends this to be achieved through strategic funding initiatives to generate greater alignment with national goals and stronger linkages with business and other stakeholders. The largest elements of the tertiary package are various forms of increases to tertiary education institutions including blanket increases to student component funding rates, and an expansion of the Performance-based research fund. There is also a range of student support initiatives to increase responsiveness to the needs of, and wider support for, learners.

The majority of expenditure in this package is increasing the level of government investment in current policy settings, rather than introducing new initiatives. This increase results largely from raising the price that government pays for services in the education sector), instead of altering the mix or quantity of services government purchases. Initiatives that are examples of such price increases are the adjustment to school operational funding, the recent wage settlement with teachers, increases to student component funding rates in the tertiary sector, and increases in the per hour subsidy for early childhood education. These price increases include both indexation funding to maintain the value of government spending in real terms as the unit cost of resources used in the education sector increases; and real funding increases where the unit price paid is increasing faster than inflation, with the aim of increasing quality and productivity in the sector.

## **Justice**

Justice Sector Budget initiatives were organised into five themes.

The initiatives under the Early Intervention/Youth Justice theme increase funding for Police Youth Services and implement the Family Court Parent Information Programmes (PIPs). The additional Police Youth Services investment provides for an additional 20 sworn Youth Aid officers who will help meet the demand arising from an increased youth population. The impact of this will be monitored through existing performance measures. There will also be six further Youth Development Teams which will focus on youth at risk in order to break the cycle of offending. The impact of these teams will be formally evaluated. The PIPs will educate separating parents on how to minimise negative effects on their children, including youth offending. This initiative will be evaluated.

The major proposals associated with the Access to Courts and Legal Services theme are the Ministry of Justice Baseline Review and the Legal Aid Eligibility Review. The Baseline Review addresses growing delays in case disposal, infrastructure deterioration, policy capability, information technology, and overall workloads. The Ministers of Justice, Finance and State Services Commission will approve performance and evaluation measures as part of the implementation plan. The Legal Aid Eligibility Review will increase access to legal aid for those on low incomes who currently cannot realistically afford legal representation. The number of legal aid grants are forecast to increase from 60,000 to 85,000 per year. The impact of this proposal will be monitored through the quarterly reporting of the Legal Services Agency.

The Prison Capacity theme continues the building programme deferred from Budget 2004. After each new prison facility is brought into operation, the Department of Corrections will evaluate its performance, including systems and services, management, control, and containment.

The Resettlement and Reintegration of Prisoners theme comprises one initiative which will provide better support and accommodation for inmates re-entering the community, namely 13 additional re-integration workers in prisons and 62 additional places in community residential centres or supported accommodation. This will be monitored to ensure that delivery standards are met by the provider, the right people are receiving the services, and other short term objectives are being met. Longer term, the Department of Corrections will evaluate the contribution that reintegration services make towards rehabilitation.

The final Justice Sector theme is Police Frontline Capacity. There are two initiatives here. The first provides increased baseline funding because of increased charges for accommodation, fuel, ESR services, etc. The second provides for 80 additional sworn staff, improved technology, and other equipment. Sixty of the additional staff will be deployed in areas where there is greatest demand, and the remaining 20 will be assigned to policing organised crime. The impact of this initiative will be monitored through existing performance measures, such as response times to emergency calls.

## **Defence**

In December 2003, the Ministers of Defence, Finance and State Services commissioned an assessment of the resource requirements of the New Zealand Defence Force (NZDF) to undertake the roles and tasks set out in the Government's statements of defence policy and to implement the Long-Term Development Plan (LTDP). The review concluded that the NZDF's capacity and capability in some areas was below the requirements of defence policy.

In response to the review, the Ministers of Finance and Defence proposed a 10-year Defence Funding Package (DFP) to develop military and organisational capability to a level that will ensure the Government's defence goals are met on a sustainable basis. The DFP has been agreed-in-principle by Cabinet [CAB Min (05) 5/2 refers].

The DFP will support a staged recovery of NZDF military capability over a ten-year period. This will increase progressively the level of forces that can be committed to operations and the period over which they can be committed alone or concurrently.

Implementation of the DFP also includes improved organisational capability within the NZDF and the Ministry of Defence to help support improved decision-making processes. Specifically, the NZDF and the Ministry of Defence will work together to put in place an improved corporate planning and performance management regime to support priority setting and resource allocation decisions.

The NZDF and the Ministry of Defence will report back to joint Ministers (Defence, Finance and State Services) in June and November 2005 on the key planning and performance management requirements and how Defence will put the necessary structures and systems in place. On completion of the organisational capability recovery, the improved systems and processes will have been fully integrated into the Defence organisations' mainstream processes.

At year five of the DFP (FY2009/10) there will be a review of the adequacy of the changes made and a report will be made to joint Ministers. This review will measure the effectiveness of the DFP in supporting development of Defence's military and corporate capability.

## **Social Development and Housing**

### *What the Package Would Achieve*

The Social Development and Housing package provides support for a number of new and existing initiatives that underpin priority areas for the government including:

- a. Children, families and communities with a key focus being a suite of early intervention initiatives for vulnerable children aimed at identifying and alleviating problems that might arise in the early years of a child's life and impact on their wellbeing in the future;
- b. Social assistance with a focus on moving beneficiaries back into work and supporting the participation of women in the labour market;
- c. Increasing capacity to accommodate people in State Housing; enhancing connections with third sector housing providers; maintaining healthy housing and community renewal programmes and increasing the number of households that can enter home ownership; and
- d. Capability enhancements across key social development/housing agencies including substantial funding to maintain the capability and capacity of the Department of Child, Youth and Family Services; establishing the new Department of Building and Housing and enhancing the policy capability of the Housing New Zealand Corporation.

The Social Development & Housing package is designed to achieve a balance between the foundations to develop initiatives that are intended to improve medium-to-long-term social outcomes through, for example, the Early Intervention Package and funding urgent capability and capacity requirements for social development agencies such as CYF. The SD & H package is also designed to make more immediate impacts on labour market outcomes for priority groups. This includes women (ie funding initiatives that allow improved access to child-care, and investigate barriers to labour market participation) as well as targeting the long-term unemployed and improving services for sickness/invalid beneficiaries.

The inclusion of housing as part of the wider social development allocation has also enabled a more complete assessment of social priorities to be undertaken. For Budget 2005 it has been determined that enhancements to the existing Mortgage Insurance Scheme will make home ownership more affordable for people who currently could not afford their own home. Home ownership is one of the key drivers behind improved social development outcomes and the contribution of this package will complement the savings package that is also being developed by the government.

### *Commitment to taking forward work on the measurement of value for money*

Various mechanisms will be used to monitor progress of the initiatives in this package, including formative and outcome evaluations of specific programmes, and monitoring of performance via reporting against the Statement of Intent of the relevant agency. This includes improved agency performance targets where significant investment in capability and capacity has been made.

A key theme across the allocation is improving the ability of agencies to respond to new information gained through evaluation and research on the effectiveness of programmes. Evaluation results will be used to ensure resources are allocated in the most efficient way possible. This is currently demonstrated by the government's

approach to social assistance where investment is intended to improve social and economic outcomes as well as deliver savings for the Crown for reallocation in other priority areas.

### **Growth and Innovation**

The Budget 2005 GIF allocation supports the government's growth and innovation goals. Overall, the spending from the allocation is expected to contribute to sustainable increases in productivity and economic growth through enhanced innovation by way of:

- Increasing competitive advantage;
- Enabling more innovative companies, enterprises, and New Zealanders to take their ideas to the world;
- Intensifying knowledge development, transfer and utilisation;
- Championing collaboration through encouraging networks and partnerships; and
- Further celebrating business and entrepreneurial success.

More specifically, the initiatives comprising the GIF Budget package are expected to:

- Boost human capital and skills availability through expanding the Modern Apprenticeships and Industry Training programmes, delivering foundation learning through industry training organisations, enabling better provision of information on the employment outcomes of tertiary education, and increasing the supply of Fulbright researchers.
- Grow firms with technological capability and know-how and gain maximum leverage from general purpose technologies such as ICT. The package contributes by enhancing support for business research and development, expanding the Technology for Industry Fellowships (TIF) programme, enabling businesses to access digital information to enhance capability and lift productivity, and developing regional and community ICT-related initiatives.
- Closer and more effective relationships between New Zealand and other countries. Ensuring a 'NZ-Inc' approach to trade agreements by integrating trade strategy, trade promotion and business development. This includes additional funding for public service to improve the ability to negotiate and implement trade agreements. It also aims to assist New Zealand firms to take advantage of gains in trade access and profile. Other objectives are to facilitate offshore connections in particular sectors of the economy and international relationships. This includes an expansion in the International Investment Opportunities Fund (IIOF), establishing additional off-shore education counsellor positions, boosting New Zealand's tourism promotion, and furthering the Seriously Asia project.
- More effective networks and better cooperation among firms, public institutions and partnerships with sectors. Adopting the Danish Technological Institute's Technology Partnership Programme and increasing the number of Research Consortia are aimed at strengthening these relationships and networks.

- Increase the effectiveness and capability of economic development and commerce-related Crown Entity activities and agencies. The ultimate outcome is to ensure a competitive and well-regulated economy. This includes boosting the capacity of the Commerce Commission, Securities Commission, and Takeovers Panel, The package also aims to increase resources for MED to provide policy advice on SME, infrastructure, and Auckland issues.

Evaluation and monitoring of the Growth and Innovation Framework includes high-level focus on indicators, programme evaluations, and agency evaluations. Key components include:

- Economic Development Indicators Report 2005.
- Evaluation of NZTE programmes – evaluation activity in 2005 will focus on the Growth Service Outputs (around one third of NZTE activity).
- Growth through Innovation: Progress Report to Ministers.

### **Annex 3 – detailed list of all initiatives for the 2005 Budget**

This list is correct as at 31 March 2005. There may be instances where Cabinet will be considering some papers that are listed here as contingency items or agreed initiatives between 31 March 2005 and 11 April 2005 (inclusive)