The Treasury

Budget 2016 Information Release

Release Document July 2016

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[s18(c)(i)]	that the making available of the information requested would be contrary to the provisions of a specified enactment	
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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Managing Baselines: Cabinet paper

Date:	24 November 2015	**Report No:**	T2015/2647
		File Number:	BM-2-1-2016

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Bill English)	**Sign** and **submit** the enclosed Cabinet paper.	10am Thursday, 26 November 2014

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
John Marney	Principal Advisor	04 917 6151 (wk)		✓
Ben McBride	Manager, Health	04 917 6184 (wk)	021-869-450 (wk) [23]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Submit the enclosed Cabinet paper, once signed.

Note any feedback on the quality of the report

Enclosure: Yes

Treasury Report: Managing Baselines: Cabinet paper

1. Please find herewith a Cabinet paper about managing baselines in Budget 17. This is due for discussion at SEC on Wednesday, 2 December (the deadline for submission is 10am on Thursday, 26 November).

2. As discussed earlier this week, we have removed the section dealing with the fiscal management approach. (Note that an outline of the paper previously circulated to HEDSJ Ministers did refer to this section.) The paper now covers historical expenditure trends, cost pressures identified by agencies, and choices and trade-offs.

3. The paper includes a short discussion on Crown entitles, with a specific recommendation about better integrating ACC into the overall process for Budget 17.

Recommended Action

We recommend that you **sign** the Cabinet paper and **send** it to SEC.

Yes / No
Minister of Finance

Ben McBride
Manager, Health

Hon Bill English
Minister of Finance

Office of the Minister of Finance

Chair
CABINET COMMITTEE ON STATE SECTOR REFORM AND EXPENDITURE

MANAGING BASELINES IN BUDGET 16

Purpose

1. This paper provides contextual information, ahead of Budget 16, about baselines and cost pressures in different sectors. It also discusses, at a high level, the sorts of choices and policy trade-offs that may be needed to manage cost pressures within the Government's fiscal strategy whilst also leaving some headroom for new initiatives.

Executive Summary

2. Annual growth of both Crown operating and benefit expenses has fallen significantly since 2008-09. This is a reflection of the Government's fiscal strategy, based on careful and responsible management of public spending and a focus on returning to surplus and then reducing net debt. This approach to fiscal management will continue in Budget 16.

3. Agencies were asked to identify their cost pressures as part of the four-year plan process. Identified pressures already exceed available funding for Budget 16, and it is likely that pressures in out-years will increase over time. The identification of cost pressures will in most case not translate into new funding unless a compelling case is made. This will be tested through the Budget process in the usual way. In their four-year plans, agencies should be considering the extent to which existing settings and new policies influence cost pressures within Votes, and how to manage these, so that these choices can be weighed against other difficult savings options and prioritisation decisions.

4. The analysis outlined in this paper excludes most Crown entities, which are not required to submit four-year plans. I will consider whether it would be useful for Finance Ministers to have greater visibility of Crown entity cost pressures in future and, if so, how best to approach this. Funding adjustments by the accident compensation corporation (ACC) can impact directly on the Budget operating allowance, so as a first step I would like to better integrate ACC into the overall process for Budget 17. This would include ACC reporting on its cost pressures and non-earners' account funding proposals being considered as part of the Budget process. I propose that officials report back to me and the Minister for ACC with advice about how this will work.

Background

5. The paper aims to provide greater clarity about baselines and cost pressures across Government. Specifically, it:

   - describes recent expenditure trends for the Crown as a whole and for different sectors;

- draws together information about cost pressures that agencies have submitted for their four-year plans; and
- discusses how operational and policy settings affect baselines in particular sectors.

6. Agencies have been asked to adopt a more consistent approach in reporting cost pressures as part of the current four-year plan process. As in previous years, however, this will not translate into new Budget funding in most cases and pressures will need to continue to managed within baselines.

Crown entities

7. Crown entities are not required to submit four-year plans, so the analysis in this paper largely excludes them. Baselines and pressures for DHBs (and one or two smaller entities) are included. There may be scope to improve consistency in how cost pressure for Crown entities are reported. It may also be useful for Finance Ministers to have greater visibility of these pressures, particularly in relation to entities with significant operating expenses or a material impact on the balance sheet. I will consider this further in due course.

8. As a first step, I propose to look at how ACC can be better integrated into the overall process for Budget 17. There are particular reasons to focus on ACC first, including its size and its impact on the balance sheet and fiscal targets. ACC is funded from a combination of levies and general taxation. In recent years, given the focus on OBEGAL, funding for the Crown-funded non-earners' account (for people outside the paid workforce, who are not funded through levies) has not counted against the operating allowance, but it does affect net debt. Funding requests from ACC in respect of the non-earners' account are not assessed alongside other Budget bids, so Ministers cannot readily compare ACC cost pressures with those in other sectors to inform their funding decisions. Nor can Ministers readily influence discretionary spending or encourage cost control through their funding decisions because the ACC budget is set through a separate process that does not have Cabinet oversight, and ACC always has enough money to meet its short-term costs.

9. I therefore recommend that officials report back to myself and the Minister for ACC about how we can better integrate ACC into the overall process for Budget 17. This would include ACC reporting on its cost pressures and the consideration of proposals with funding implications for the non-earners account.

Recent expenditure trends

10. This section of the report summarises historical expenditure trends. Figure 1 shows Crown operating and benefit expenses over the period 2003/4 to 2014/15. Annual growth rates for both categories of expenditure are shown in figure 2. Capital expenditure is not shown.

    - Benefit expenditure is made up of welfare benefits, NZ superannuation, tax credits and similar payments, which are mostly (although not exclusively) administered by the Ministry of Social Development and Inland Revenue. These are income transfers representing statutory entitlements, where payments are demand-driven and not directly controlled by Ministers or their agencies. Benefit expenditure increased by over 40% between 2003/04 and 2008/09, mainly due to tax credit reforms under the previous government and the cost of NZ superannuation. The growth has since slowed considerably, with total growth of less than 12% from 2009/10 to 2014/15.

- Operating expenditure, broadly speaking, represents the running costs of Government which is subject to more direct management control. It includes the operating costs of schools, district health boards, and third-party service providers. Operating costs for Vote Finance are show separately in figure 1 (and excluded from figure 2) because of the presence of significant one-off non-departmental expenses in 2008/09 and 2010/11 associated with the Deposits Guarantee Scheme put in place since the global financial crisis. From 2003/04 to 2008/09, operating expenditure (excluding Vote Finance) increased from $25 billion to almost $41 billion, an average of about $3.1 billion a year. Since 2008/09, the rate of growth has slowed significantly, to around $1.1 billion per year. Negative growth in 2011/12 and 2012/13 was attributable to a number of factors, including lower spending by the social sector and CERA.

Figure 1. Crown operating and benefit expenses ($bn)

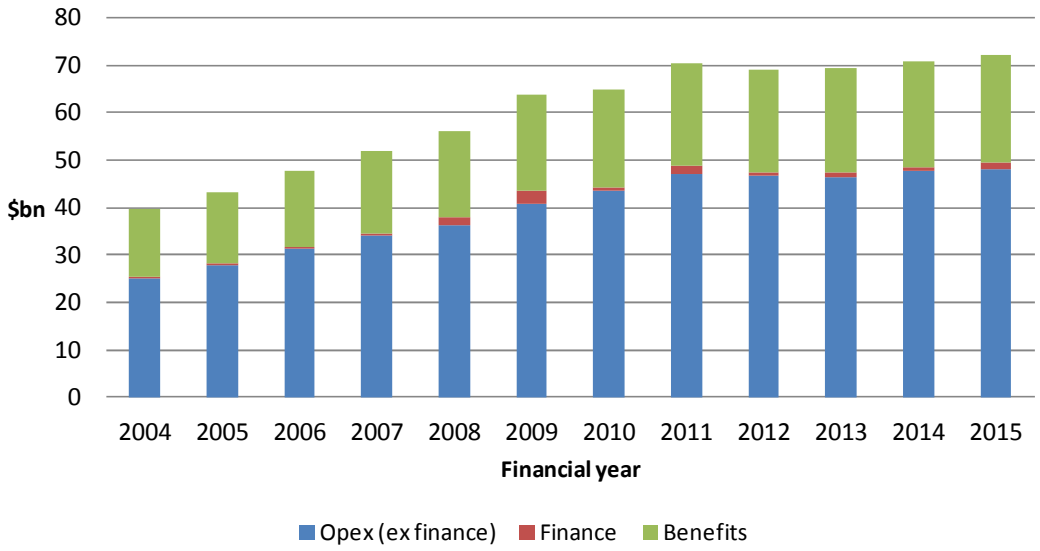
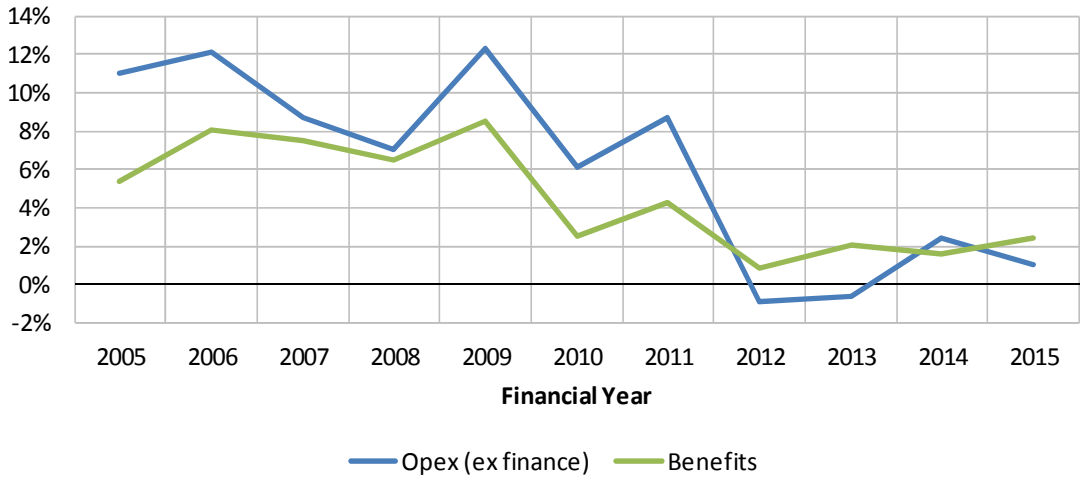


Figure 2. Crown operating (excluding Finance) and benefit expenses, % change



11. Figure 3 shows the level of operating spending in selected sectors over the same timeframe. (Benefit expenditure is not shown.) Operating expenses in the health and education sector has continued to increased steadily, although the expenditure curve in both sectors bent in 2009/10 The one-off spikes in Vote Finance in 2008/09 and 2010/11 are visible in the "other" category. Spending by MSD and other social sector agencies rose during the period from 2009/10 to 2011/12 as a result of earthquake-related initiatives which have since reduced. Spending by CERA also rose and fell over a similar timeframe. Justice sector expenses fell in 2014/15, partly because the cost of Treaty settlements was lower in that year.

12. Figure 4 shows the percentage increase in operating expenditure over three three-year periods up to 2014/15. This shows the overall restraint in spending growth under this Government, and the relative increases for different sectors. (Vote Finance is excluded from this analysis because of its large fluctuations.)

Figure 3. Operating expenses by sector ($bn)

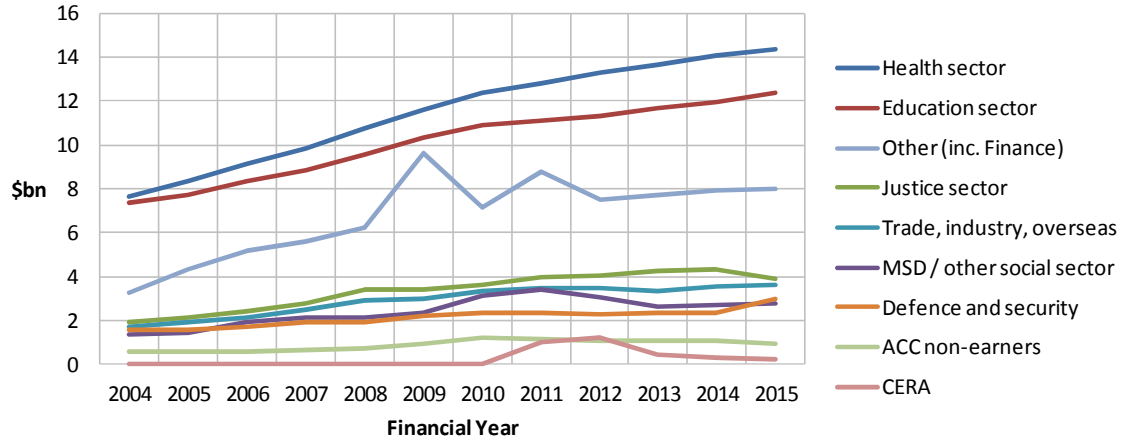
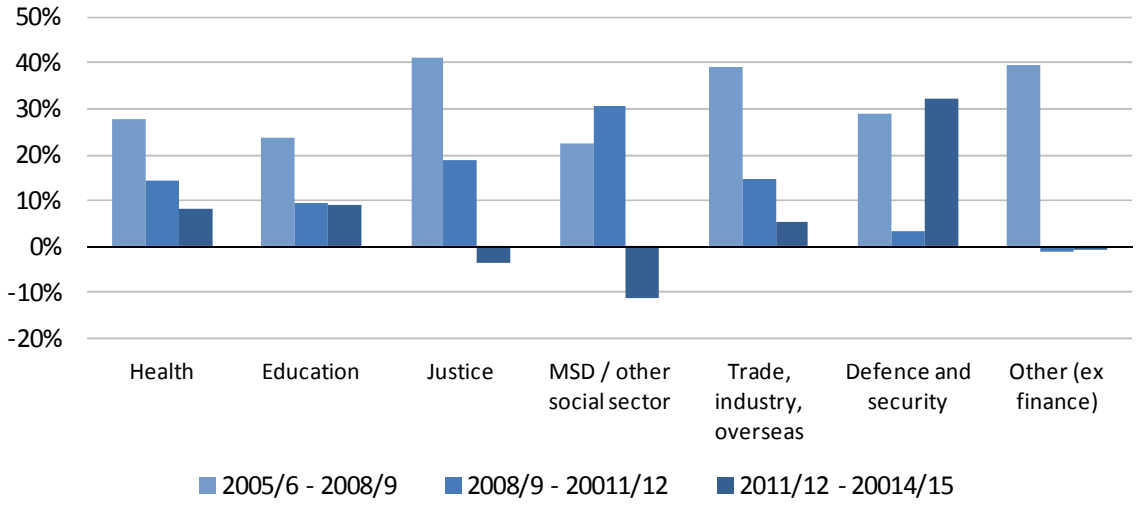


Figure 4. Operating expense by sector (excludes Finance), % change



Cost pressure information in four-year plans

13. This section summarises information about operational cost pressures provided by agencies as part of the four-year plan process. The aim is to provide contextual information and inform Budget discussions about priorities and trade-offs. Identification of cost pressures will in most case not translate into new funding unless a compelling case is made. This will be tested through the Budget process in the usual way.

14. Note that the following analysis largely reflects how agencies have presented their cost pressures in their four-year plan submissions. The Treasury has not yet tested the robustness of the underlying assumptions. In some instances, individual agencies may have categorised similar cost pressures differently.

15. The analysis excludes any costs to the Crown from on-going negotiations with the care and support workforce. It also excludes expenditure on welfare benefits and NZ superannuation, given that MSD does not actively manage this expenditure from year to year (other than through long-term liability management under the investment

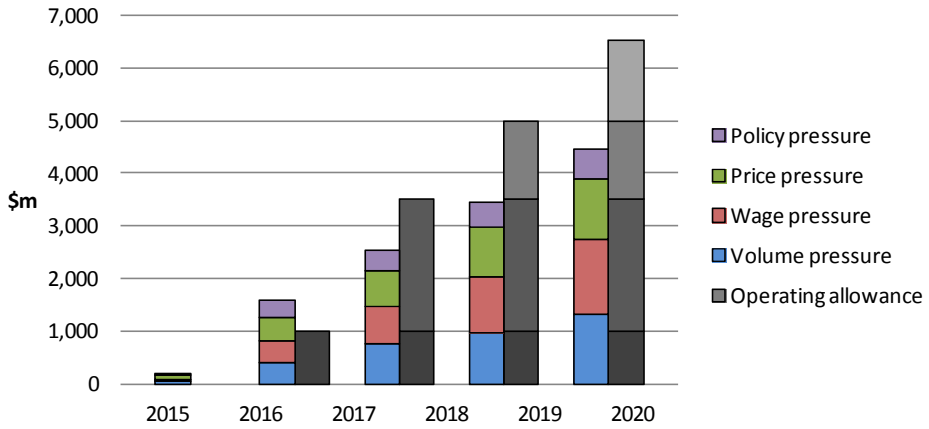
approach). The cost of ECE subsidies and other forecast expenditure in Vote Education is included.

The overall picture

16. Figure 5 breaks down future cost pressures by demand, wages, price and policy and compares these to funding available through the operating allowance for Budget 16. This provides a summary of the level and type of operating cost pressures facing the Government over the next few years, relative to the amount of new funding. Identified pressures exceed the allowance for Budget 16 by a considerable margin.

17. As noted above, distinctions between the different categories of cost pressure will to some extent reflect agencies' judgements, including whether to look through third-party providers for the purposes of calculating wage and price pressures. The policy category is intended to capture costs arising from previous decisions or legislative changes and should not include in-principle policy decisions by Cabinet subject to funding or any new initiatives.

Figure 5: Net operating cost pressures (less contingencies) and allowances



18. Figure 6 shows overall cost pressures by sector alongside existing baselines. For completeness, future pressures that will be met from contingencies made in previous Budgets are also shown, to give a sense of the gross pressures affecting different areas of Government (this is mainly relevant to Vote Education, although there is also a small contingency from Budget 15 for Police wage costs). Nominal pressures are obviously influenced by the size of the relevant baseline and are largest for the biggest sectors (Health and Education). Figure 7 provides a breakdown of how pressures are distributed within sectors in 2016/17. Annex A provides a more complete picture.

Figure 6: Net and gross operating cost pressure and baselines, by sector and year (FY15 to FY20)

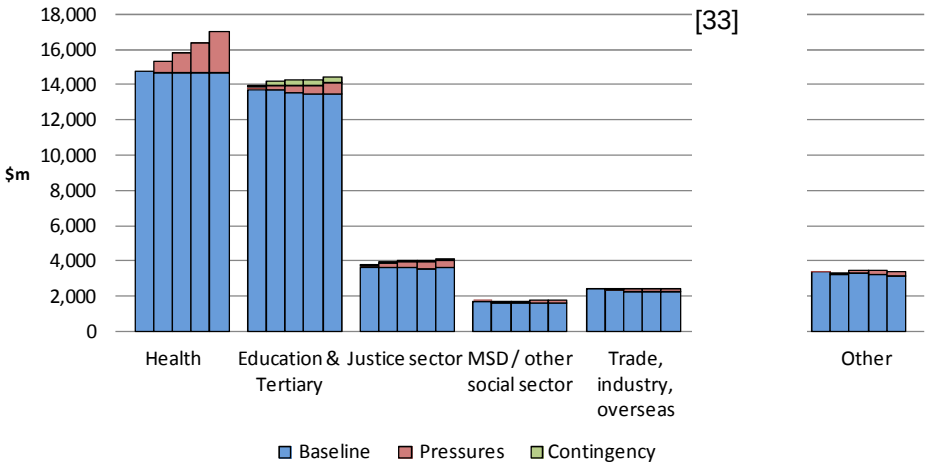
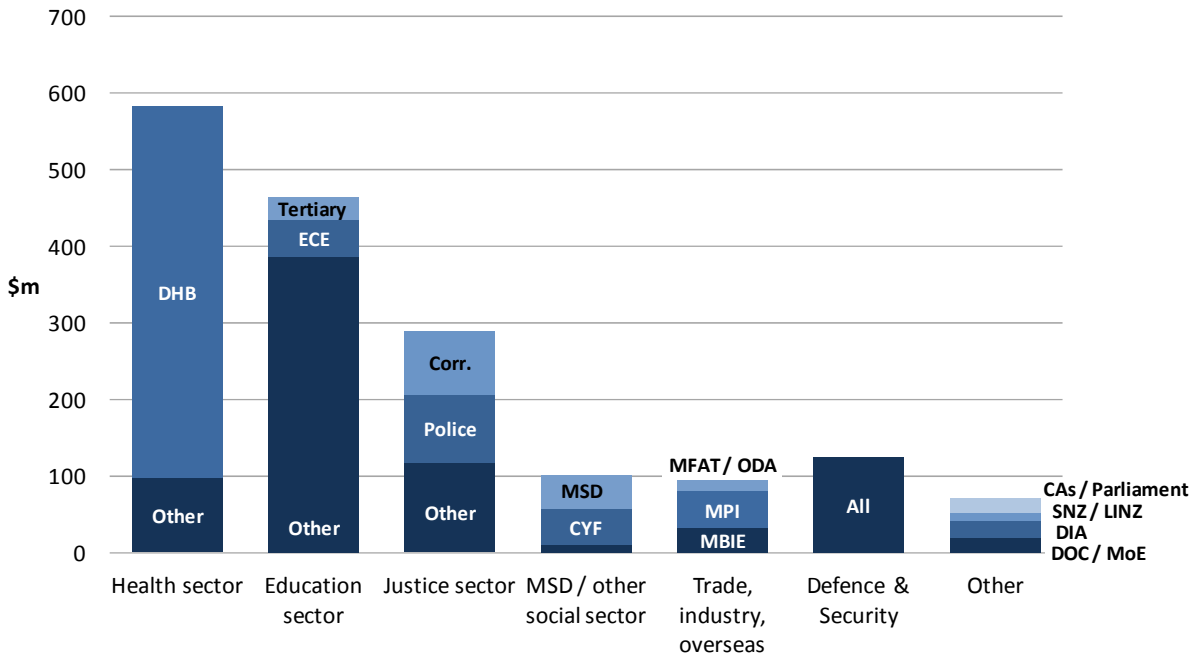


Figure 7: Gross operating cost pressures by Vote, 2016/17



19. Figure 8 shows pressures as a percentage of existing baselines and gives a better indication of the relative pressures faced by individual sectors. The Justice sector faces the most significant overall pressures over the short- to medium-term (11% of existing baselines by 2017/18). These include, in particular, volume and price pressures for the Ministry of Justice, wage pressures for Police, and a range of policy pressures for the Department of Corrections alongside wage and price inflation. The Ministry of Social Development reports significant short-term pressures (7% of baseline in 2016/17), mainly from increased security and direct costs for CYF.

20. [33]

[33]

21. Figures 9 and 10 provide more detailed information about the types of pressures reported by different sectors, in nominal terms (figure 5) and as a percentage of their total pressures (figure 6). Wage pressures are a common theme across all sectors. In addition

- Vote Health faces significant volume pressure in all years, reflecting the combination of fixed nominal baselines and a population that is both ageing and increasing in size, which increases the demand for services. Vote Education does not have fixed nominal baselines but still faces volume pressures due to expansionary capital pressures (more students, more schools) on operating funding (capital charge and depreciation). For some other sectors, these may be shown as price pressures.
- Price pressures in the education sector are notable. Excluding the contingency for the teachers' collective agreement, these are driven primarily by operating costs relating to infrastructure, including capital charge and depreciation.
- Price pressures are the largest single category affecting the "trade, industry and overseas" sector comprising MBIE (departmental expenditure), Vote Primary Industries and Food Safety, and Votes Foreign Affairs and Trade and Official Development Assistance. All agencies within this category face some price pressures from general inflation and higher capital charges from expected investment, as well as some specific factors. Policy pressures are, however, more significant for Vote Primary Industries and Food Safety (6% of baseline in 2017/18), due to a combination of factors including as-yet unfunded commitments on climate change research and existing practice in relation to Bovine TB which has historically been funded for fixed periods.
- Policy-driven cost pressures are in fact quite pronounced across a number of sectors and represent 18% of all identified pressures in 2016/17 and 13% of pressures over the four years from 2016/17 to 2019/20.

Figure 9: Gross operating cost pressures by sector, type and year (FY15 to FY20): $million

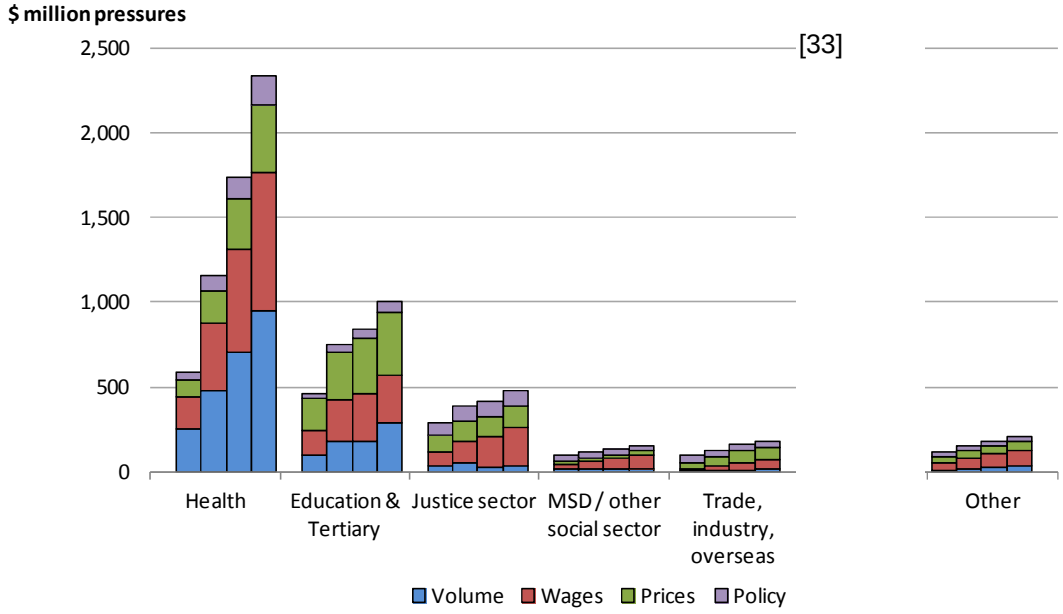
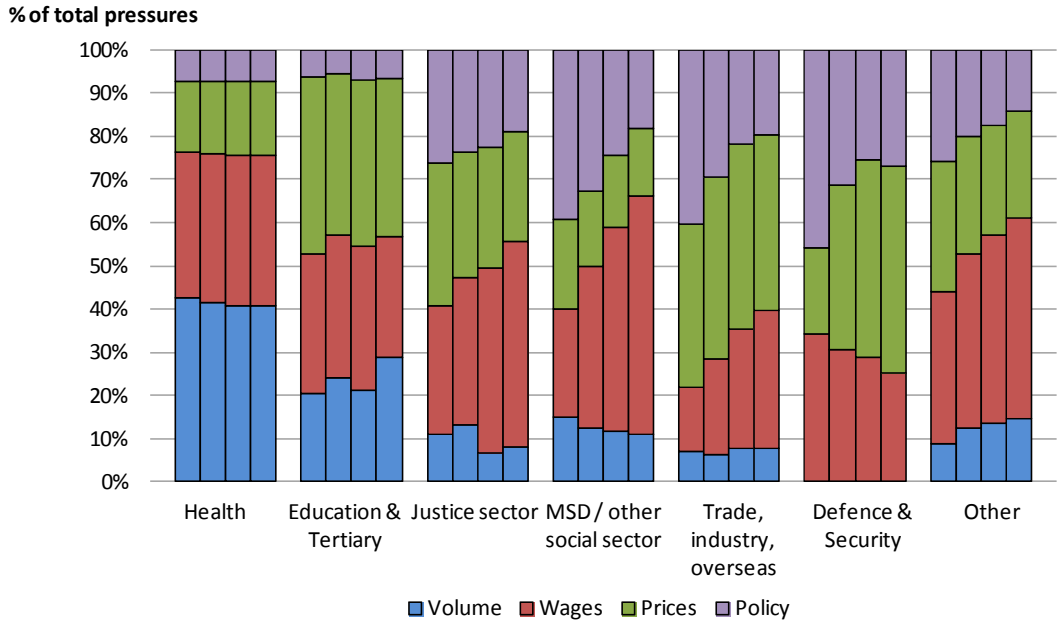


Figure 10: Gross operating cost pressures by sector, type and year (FY15 to FY20): % of total pressure



Choices and trade offs

22. All categories of cost pressure – including volume, wage and price pressures – depend to some extent on policy choices made by Ministers, including decisions to maintain existing settlings. Creating headroom within the fiscal strategy for spending on new initiatives while also maintaining appropriate levels of funding for essential services and Government priorities will require some difficult trade-offs over the next few years. As noted earlier, identified cost pressures already exceed available funding for Budget 16, and it is likely that new pressures will emerge, adding to the pressure on the operating allowance in out-years.

23. Having fixed nominal baselines as the starting point for most Votes imposes an implicit efficiency requirement on government agencies. This is an appropriate discipline which will continue. Inevitably, however, some pressures require funding, and collectively these reduce Cabinet's discretion with regard to new policy. There are also limits to the costs that departments can reasonably be asked to absorb without compromising service quality and/or increasing risks that may in some instances rebound with adverse impacts and increased fiscal costs. It is therefore important that we think carefully before imposing additional unfunded obligations on agencies. We should also consider the extent to which existing settings and policy choices influence cost pressures within Votes, and weigh those against other difficult savings options and prioritisation decisions. There may be opportunities for agencies to manage pressures through service changes, or by stopping things that are not effective.

24. Some points to consider for the larger Votes are as follows:

25. Health. Although Vote Health has continued to receive significant annual increases in its operating funding under this Government, this has been against a background of rising volumes and other cost pressures which are not reflected in baselines. It is not necessary to consider significant changes to the existing health policy framework in order to continue the drive for a more cost-effective system. [33]

    Demand for new health technology and interventions is probably unlimited. New and existing interventions should be carefully evaluated in terms of affordability and value for money relative to other social investments before commitments are made. There

are also opportunities for the health sector to work with other social sector agencies to deliver improved returns within existing funding.

26. Education. Early childhood education is one area of cost growth. This reflects existing policy settings and could be managed by shifting incentives on supply of particular service types and reducing or targeting subsidies and eligibility. Other cost drivers in the education system include operational expenditure related to new school growth and workforce mix. Schools receive about a quarter of their funding as a capped grant for operating costs (adjusted annually). Holding down the operating grant would require schools to absorb operating cost pressures. Minsters could also consider changing the formula or components that determine this operational funding stream.

27. Social development. The Ministry of Social Development's simplification programme will have significant impacts on the service delivery model of Work and Income, Students and Seniors, [33]

MSD offices and sites will cost about [33] The increased security presence at next year. [33]

28. For Child, Youth and Family (CYF) the main drivers of cost are the number of investigations, the number of children in care and the mix and intensity of services provided. These are influenced by a range of factors, including legislative settings, practice guidelines and social trends. CYF is looking at options to manage its cost pressures. [33]

Again, this is an area where we should consider the contribution that other sectors can make toward managing cost pressures for CYF and improving outcomes for their clients.

29. Ministry of Justice. The Ministry undertook a significant expenditure review in the last year, which identified scope for savings, although these will not be sufficient to offset its cost pressures. [33]

The Christchurch Justice and Emergency Services Precinct represents a significant cost pressure, owing to the decision to construct this building without funding all operating costs. [34]

30. Police. Despite falling overall crime rates, Police face increased demand for services such as responding to domestic disputes, mental health incidents and attempted suicides. They also face increasing input costs, in particular wage increases flowing from the negotiation of collective employment agreements. Their ability to manage their demand and input cost pressures is constrained by a government commitment to sworn officer numbers, public resistance to rationalising their national property footprint, and an industrial relations environment that includes complex collective agreements and final offer arbitration. [33]

[33]

[33]

31. Corrections. Despite the falling crime rate, the prison population (muster) is at an all time high and continues to trend above forecast. The Department also faces wage increases relating to collective agreements. Its ability to manage these pressures is constrained by legislative settings (which influence the prison muster), the dual objectives of public safety and its BPS commitment of reducing reoffending by 25%, and a high proportion of baseline funding (80%) being allocated for workforce and asset ownership costs. [31, 33]

[31, 33]

32. Defence. In 2013, Cabinet approved the Defence Midpoint Rebalancing Review (DMRR) indicative funding track as the basis for the NZDF's long-term planning. The funding track is indicative only and remains subject to Budget funding decisions each year. [33]

[33] There is a built-in inflation assumption for CPI and military specific inflation. The DMRR follows on from a savings and redistribution programme making over $200 million of ongoing savings. It also implies reduced funding for support functions and cost pressure that NZDF must manage [33]

[33]

Consultation

33. Departments and agencies that provided information about cost pressures have been consulted on the contents of this paper. The Department of the Prime Minster and Cabinet and the State Services Commission have been informed.

Financial Implications

34. This paper does not have any direct financial implications.

Human Rights

35. The proposals in this paper are consistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Legislative Implications

36. There are no legislative implications.

Regulatory Impact Analysis

37. This paper has no implications for regulatory requirements on businesses or individuals, so a regulatory impact statement has not been prepared.

Publicity

38. No publicity is proposed.

Recommendations

39. I recommend that Cabinet:

    1. **note** that growth in Crown operating and benefit expenses has slowed since 2008-09, reflecting the Government's fiscal strategy.

    2. **note** that agencies were asked to identify their cost pressures as part of the four-year plan process.

    3. **note** that Crown entities are not required to submit four-year plans and that I will consider whether it would be useful for Finance Ministers to have greater visibility of Crown entity cost pressures in future and, if so, how best to approach this.

    4. **note** that cost pressures for the accident compensation corporation (ACC) are of particular relevance to Budget discussions because of ACC's size and its impact on the balance sheet and fiscal targets.

    5. **direct** officials to report back to the Minister of Finance and the Minister for ACC with advice about how ACC can be better integrated into the overall process for Budget 17, including ACC reporting on its cost pressures and non-earners' account funding proposals being considered as part of the Budget process.

       Yes / No

    6. **note** that operating cost pressures identified by agencies exceed available funding for Budget 16.

    7. **note** that the identification of cost pressures will, in most cases, not translate into new Budget funding unless a compelling case is made.

    8. **note** that agencies should be considering the extent to which existing settings and policy choices influence cost pressures so that these can be weighed against other difficult savings options and prioritisation decisions.

Hon Bill English
Minister of Finance

Date:

ANNEX A: BASELINE AND COST PRESSURES BY VOTE

	2015/16 baseline
Health Sector	
Vote Health (incl. DHBs)	14,765
Education Sector	
Education	10,770
Tertiary	2,949
ERO	19
Justice Sector	
Ministry of Justice	822
Police	1,546
Corrections	1,274
SFO	10
MSD / other social sector	
MSD	1,454
Maori Development	249
Pacific Island Affairs	6
Women	5
Trade, industry, overseas	
MBIE	638
Primary Ind. & Food Safety	774
Foreign Affairs / ODA dept	484
ODA non-dept	559
Defence & Security	
Ministry of Defence	16
Security Services	143
Other	
IRD	765
Customs	164
Environment	351
Dept of Conservation	356
Internal Affairs	394
Culture & Heritage	496
Statistics NZ	109
Land Information NZ	218
Transport	141
Crown Law	64
Treasury	85
SSC	29
DPMC	47
Parliamentary Counsel	21
Office of Clerk	20
Parliamentary Service	112

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