

## Treasury Report: Budget 2010 for Education

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<b>Date:</b>	13 November 2009	<b>Report No:</b>	T2009/2489
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### Action Sought

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	Action Sought	Deadline
Minister of Finance (Hon Bill English)	<p><b>Discuss</b> the contents of this report at your catch up with the Secretary of the Treasury on Tuesday 17 November</p> <p><b>Agree in principle</b> to no longer having forecast changes in Vote Education;</p> <p><b>Agree</b> to discuss the rules around what is a forecast change with the Minister of Education; and</p> <p><b>Refer</b> this report to the Minister of Education.</p>	Tuesday 17 November

### Contact for Telephone Discussion (if required)

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Name	Position	Telephone	1st Contact
Stephen Glover	Manager, Children and their Families	9176123 (wk)	<i>[deleted – privacy]</i> ✓
<i>[deleted – privacy]</i>	Analyst, Children and their Families	<i>[deleted – privacy]</i>	<i>[deleted – privacy]</i>

### Minister of Finance's Office Actions (if required)

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If agreed, refer this report to the Minister of Education.  
Discuss the rules around what is a forecast change with the Minister of Education.

**Enclosure: No**

## **Treasury Report: Budget 2010 for Education**

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### **Executive Summary**

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This report is structured in two parts:

- **Part One:** provides some initial advice on the relative ease of managing new education spending within \$250 million in Budget 2010 (see pages 5-10).
- **Part Two:** provides advice on the current Vote Education Budget Management rules, and seeks your in principle agreement to no longer having forecast changes in Vote Education. "Forecast changes" occur where funding is automatically increased (or decreased) in baseline updates for certain changes in volume, price and standards. In the past these changes have not had an impact on the operating allowance (see pages 11-15).

#### **PART ONE: Managing education within lower funding increases than the past**

We are aware of education pressures totalling almost [deleted – confidentiality of advice]. This is significantly higher than education's indicative allocation of \$250 million. We consider that there are choices open to Ministers, in terms of reprioritisation and not funding pressures, to manage Vote Education within \$250 million. Achieving this will be challenging and require reductions in existing entitlements and/or service levels, and limited funding for new policies.

\$261 million of the pressures have come through the 2009/10 October Baseline Update for items that have historically been forecast changes. In the second part of the report we recommend that these no longer be forecast changes and so thereby count against the budget allocation. Allowing all of these items to continue to go through as forecast changes effectively increases education's allocation to \$511 million in outyears, and thereby reduces the extent of reprioritisation required.

*[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*

#### **PART TWO: What should count against the education allocation ... reviewing the rules around what is a forecast change in Vote Education**

Vote Education has historically had a number of price, volume and standard pressures, funded through forecast rounds, without affecting Budget allocations. These changes are large in nominal terms, averaging \$125 million over each of the last six years. This report recommends that these no longer be forecast changes, and instead count against the Budget allocation.

Removing forecast changes in Vote Education would bring the treatment of new spending in Vote Education into line with its treatment in other Votes. This has a number of benefits, including:

- putting transparent policy choices in front of Ministers – currently increased costs arising from forecast changes aren't traded off against other pressures that arise through the Budget process. At baseline updates, Ministers aren't given advice on options to manage down forecast changes, or options to fund increased costs;
- incentivising the Ministry of Education and Minister of Education to ensure that operational changes or processes don't add to cost; and
- incentivising accurate costings of policy.

If it is not possible to manage education OBU 2009/10 forecast changes and other Budget 2010 pressures within \$250 million, this should be considered as part of the broader Budget process, rather than allowing items to continue to be forecast changes. The Minister of Education has an opportunity to seek more funding for education on 30 November as part of the baseline review process.

### Next steps

We recommend that you meet with the Minister of Education to agree upon a new set of budget management rules for Vote Education. We can provide you with further advice to support this discussion.

The Minister of Education will report back prior to Christmas on how education will be managed within \$250 million as part of the baseline review process. If education cannot be managed within \$250 million the Minister of Education will be required to report back by 30 November setting out why. We can provide you with further advice on the baseline review, including the management of education pressures once it is completed.

### Recommended Action

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We recommend that you:

#### **PART ONE: Managing education within lower funding increases than the past**

- note** that Treasury considers that it is possible to manage all new education spending (including items that have traditionally been forecast changes) within \$250 million;
- note** that managing all new education spending within \$250 million will require reductions in existing entitlements and/or service levels, and limited funding for new policies;
- note** that allowing some forecast changes in Vote Education reduces the extent of reprioritisation required to manage education within \$250 million, but effectively increases education's allocation;
- [information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*

**PART TWO: What should count against the education allocation ... reviewing the rules around what is a forecast change in Vote Education**

e **agree in principle** to no longer having forecast changes in Vote Education;

*Agree/disagree.*

f **note** that if it is not possible to manage education OBU 2009/10 forecast changes and other Budget 2010 pressures within \$250 million, this should be considered as part of the broader budget process, rather than allowing items to continue to be forecast changes;

g **agree** to discuss the rules around what is a forecast change with the Minister of Education; and

*Agree/disagree.*

h **refer** this report to the Minister of Education.

*Agree/disagree.*

Stephen Glover  
**Manager, Children and their Families  
for Secretary to the Treasury**

Hon Bill English  
**Minister of Finance**

### PART ONE: Managing education within lower funding increases than the past

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#### **Budgets 2010 and beyond should contribute to increases in skill levels, or at least not undermine skill levels**

1. Improving the level of skills in the economy is an important driver of economic growth. At the same time, in order to meet the government's fiscal objectives these increases in skill levels needs to be achieved within much lower funding increases than in the past.
2. From a skills point of view we consider that the following things matter, so we should prioritise spending that delivers upon these objectives in an efficient and effective manner:
  - ECE: encouraging participation, particularly by Maori, Pasifika, and children from lower socio-economic communities. Encouraging universal part-time access for over 2s is important for establishing early foundations, as is maintaining parental connections with the labour market.
  - Schooling: raising achievement levels overall, including increasing the proportion of school leavers with NCEA levels 2 and 3 and reducing the wide variation in outcomes from schooling.
  - Tertiary: maintaining access, but prioritising funding towards young people completing higher level qualifications. This group is likely to achieve the greatest labour market return.
3. It is not necessary to spend large amount of new money to lift achievement. For example, in the schooling sector, international comparisons show little if any relationship between per-student expenditure and the overall quality of schooling and student achievement. This does not mean that money is irrelevant, but the amount of funding seems to matter less than the quality of the system into which it is channelled.<sup>1</sup>
4. Over the short to medium term we consider there is room for reprioritisation within education. However, the way this is done is critical. We need to be careful that changes don't compromise student achievement and the future skills and productivity of New Zealand's workforce. As such we suggest looking at changes that:
  - improve the productivity of the education system by using limited funding more efficiently to achieve the same or better results, and/or
  - shifting the balance between public and private funding to better reflect public and private benefits (involves shifting costs from Government to users in the ECE and tertiary sectors).

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<sup>1</sup> Hanushek, Eric A. and Ludger Wößman (2007) *"The Role of Education Quality in Economic Growth"* World Bank Policy Research Working Paper No. 4122, February [http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2007/01/29/000016406\\_20070129113447/Rend ered/PDF/wps4122.pdf](http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2007/01/29/000016406_20070129113447/Rend ered/PDF/wps4122.pdf); Hanushek, Eric A, Dean Jamison, Eliot Jamison and Ludger Wößman (2008) *"Education and Economic Growth"* Education Next, Spring 2008 p. 62. <[http://media.hoover.org/documents/ednext\\_20082\\_62.pdf](http://media.hoover.org/documents/ednext_20082_62.pdf)

## **Education pressures in Budget 2010 are significant**

5. The graph below sets out the pressures that we are aware of. Together they total almost [deleted – confidentiality of advice]. This is significantly higher than the \$250 million indicative allocation that Cabinet has agreed for Vote Education in Budget 2010 (refer CAB Min (09) 39/23). We have categorised these pressures based on the degree of discretion Ministers have over them.
6. We have included pressures that have historically been forecast driven, because as discussed in the second section of this report, we think these should count against education's allocation. These pressures total at least \$260 million in outyears.

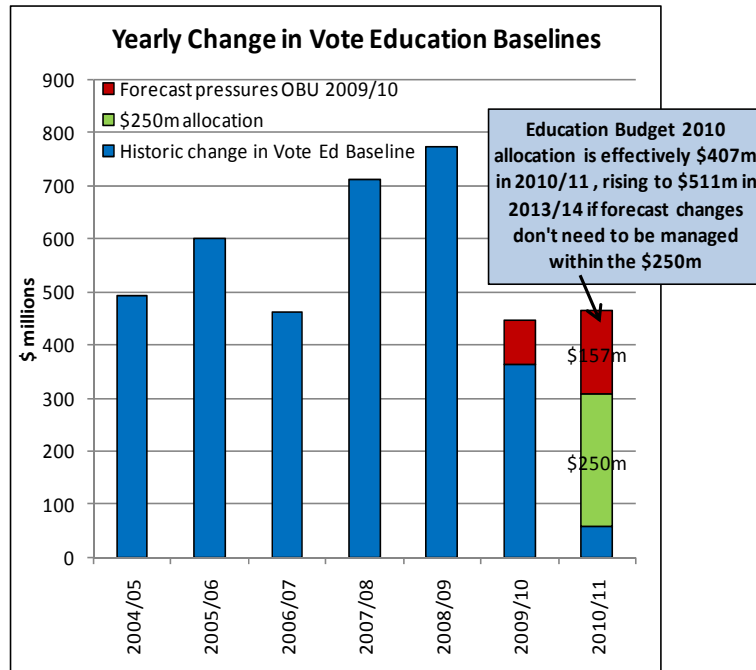
*[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

7. On top of the pressures set out above, \$50 million is required in outyears to realise the savings agreed to in Budget 2009 from staffing entitlements.

## **The relative ease of managing within \$250m, depends on whether the OBU 2009/10 forecast changes count against the education allocation**

8. The extent of reprioritisation required for education to manage within \$250 million depends on the extent to which items that have historically been forecast changes count against the \$250 million. As discussed in Part Two of this report, our advice is that items that have historically been forecast changes should now count against the allocation (refer pages 11-15).
  - Not requiring the costs of any of the OBU 2009/10 forecast changes to be managed within the \$250 million would mean that a moderate level of cost pressures could be met [deleted – negotiate without prejudice], without the need for any reprioritisation providing no new initiatives were funded (e.g. Youth Guarantee, ECE adult/child ratio reductions, national education network).
  - Funding new initiatives would require either reprioritisation or meeting a smaller range of cost pressures.

9. OBU 2009/10 forecast changes are \$261 million in outyears. Funding these, as well as the moderate level of cost pressures discussed above from the \$250 million, will require one or two large areas of reprioritisation, or several smaller areas. Such reprioritisation will mean reductions in existing entitlements and/or service levels. Pursuing new initiatives would add to the level of reprioritisation required.



*[information deleted in order to enable the Crown to negotiate without disadvantage prejudice]*

10. *[information deleted in order to enable the Crown to negotiate without disadvantage prejudice]*

11. *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*

12. *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*

**There are some significant financial risks in education in Budget 2010**

13. There are two significant financial risks that may arise quite late in the Budget process, or during the 2010/11 year:

- *[information deleted in order to enable the Crown to negotiate without disadvantage or prejudice]*
  
- *Unforeseen further pressures for items that have traditionally been forecast driven.* While the assumptions around the Ministry's forecasts appear more realistic than in the past, this still represents a significant risk. Traditionally education would be able to receive additional funding for forecast items through the March Baseline Update. Changes have averaged \$30 million over the last ten years (roughly a third of the size of October Baseline Update Changes), but have been higher in the last three years.

14. If these pressures are significant enough it may necessitate sudden reprioritisation within Vote Education or other Government spending, or alternatively, take up most of the Government's between budget spending contingency.

**There are a number of opportunities for reprioritisation BUT these all involve reductions in entitlements and/or service levels**

15. While, we consider that there is sufficient scope for reprioritisation in education to manage **all** education pressures, virtually all options will affect the consumers of the education service by either reducing standards or by increasing the amount they pay for the service.



16. We advise thinking about reprioritisation in the following order of priority:

1. *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*
  
2. *Reduce standards where there is insufficient evidence of cost effective increases in outcomes.* There are examples of this in *[deleted confidentiality of advice]*:
  - in ECE there is a funding incentive to have more registered teachers, and this incentive applies up to a 100% level. There is no evidence that this level of qualifications is necessary for quality outcomes so we recommend reducing the extent to which qualifications are incentivised through the funding system.
  - *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*
  
3. *Shift costs from Government to users of services where there is evidence that the Government's investment is not cost effective.* *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*. It could either involve:
  - *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*
  - reducing the *level* of subsidised entitlements. For example, tertiary tuition subsidies could be reduced, and fees allowed to rise. The current public/private split is approximately 80/20 (including the implicit subsidy through the student loan scheme). Increasing the proportion of tuition costs paid by students would more closely recognise the significant private benefit from tertiary education.

There may be some very limited scope to shift costs in the schooling sector *[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]*

## Early engagement by Ministers on proposed reprioritisation will be useful

17. One of the keys to managing education to \$250 million is ensuring early on that Ministers are comfortable with the reprioritisation that the Minister of Education is proposing. If there are “no go” areas for Ministers, it would be useful if these could be signalled to agencies. The education baseline review which is due at the end of December or November (depending on whether additional funding is being sought) will present the main trade-offs that Ministers will be asked to make in Budget 2010 in order to manage new education spending within \$250 million.

## There are also significant education capital pressures

18. We are aware of education capital pressures totalling up to [deleted – confidentiality of advice]. The phasing and scalability of these pressures is not clear at this point. These will need to be considered alongside capital pressures in other areas.

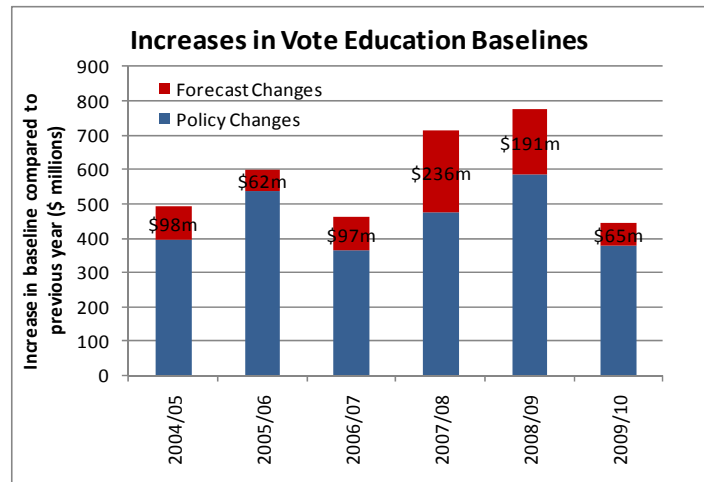
<b>Capital pressures in order of priority - [deleted – confidentiality of advice] (outyear costs)</b>
<p><b>1. Pressures which must be funded unless change policy settings – [deleted – confidentiality of advice]</b></p> <ul style="list-style-type: none"><li>• School property – <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i>. Note that to meet \$500m manifesto commitment \$65.5m required.</li></ul> <p><b>2. [deleted – confidentiality of advice]</b></p> <ul style="list-style-type: none"><li>• School property – possible that \$70m required to repair “leaky buildings” over next two years. <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i>.</li></ul> <p><b>3. Discretionary pressures – [deleted – confidentiality of advice]</b></p> <ul style="list-style-type: none"><li>• Broadband – <i>[information deleted in order to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials]</i>. \$116m is required to deliver on the \$150m “earmarked” for broadband in schools as part of the manifesto commitment. Operating costs of a National Education Network included in the graph on page 6.</li><li>• <i>[information deleted in maintain the effective conduct of public affairs through the free and frank expression of opinions]</i></li></ul>

## Next steps

19. The Minister of Education is required to undertake a detailed examination of the Vote Education baseline which is to be submitted to Budget Ministers. The deadline for this is 21 December 2009 if no additional funding beyond the \$250 million is required, but 30 November 2009 if additional funding is sought. This review will demonstrate how pressures facing Vote Education will be handled within the funding available to Vote Education. If they cannot be managed, it will demonstrate why they cannot be managed (refer CAB Min (09) 39/23). We can provide you with advice on the Ministry’s baseline review, including the management of pressures, once it is completed.

## PART TWO: What should count against the education allocation .... reviewing the rules around what is a forecast change in Vote Education

**Vote Education has received significant funding outside budget through forecast changes - average \$125 million per year since 2004/05**



20. Most of education expenditure is “demand driven” spending – baselines are adjusted automatically for changes in volume and for some changes in price and standards. The cost of these changes has generally been borne by “the centre” outside the annual budget allocation.

21. What is a forecast change in Vote Education has developed as a matter of historical practice. This has resulted in inconsistencies in treatment of changes with other Votes, and even within Vote Education. The sorts of things that are currently considered to be forecast changes include changes in:

- quantity: e.g. increase in number of pupils attending primary and secondary schools, increase in number of children attending ECE, increase in number of students requiring school transport;
- standards: e.g. higher levels of registered teachers in ECE, changing composition of schooling workforce;
- price: e.g. increase in school transport costs, increase in schools’ heat, light and water costs;
- operational policy changes: e.g. change in way students are counted means that staffing costs will be higher in 2009/10; and
- costing errors: e.g. we understand that an undercosting of the 2007 primary teachers’ collective will cost ~\$46 million in outyears.

22. The Ministry of Education’s forecasts for the 2009 October Baseline Update sought \$149 million for participation changes, \$50 million for price changes, \$16 million for standard changes and \$46 million for undercostings (outyear costs).

23. Treasury has been directed to review the budget management rules for Vote Education and report to the Minister of Finance with recommendations for changes in practice in time for these to be implemented for the October Baseline Update (refer CAB Min (09) 13/8(20)). This report seeks in principle agreement to a new set of budget management rules for Vote Education.

24. We will consider the rules around forecast changes for student support costs in tertiary education (funded through Votes Social Development and Vote Revenue) as part of the tertiary work programme. Historically some changes to student support costs have not counted against budget allocations. For example, the student loan costs from an increase in fee maxima are funded as a forecast change. In principle, we believe these types of changes, as well as the student support costs of over-enrolments, should count against the budget allocation.

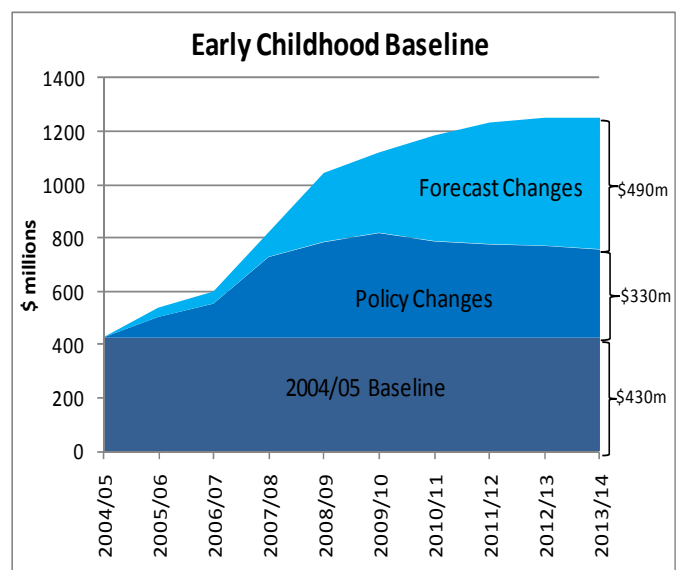
## We need to rethink whether education should automatically receive additional funding if certain expenses increase

25. Although less than 2% of the Vote Education baseline, forecast changes are large in nominal terms. The average change over the last 6 years would take up half of the proposed education allocation.
26. In thinking about what should be a forecast change, it is useful to bear in mind three main objectives:
- **transparency** – putting transparent policy choices in front of Ministers, including continuing with current policy settings at greater cost vs changing policy settings to reduce costs;
  - **incentives** – maximising incentives for operational efficiencies and accurate costings; and
  - **consistency** – ensuring consistency between treatment of new spending with other Votes, and within Vote Education.

### Transparency

27. Currently increased costs arising from forecast changes aren't traded off against other pressures that arise through the Budget process. At baseline updates Ministers aren't given advice on options for managing down costs, or options to fund increased costs.

28. Currently where costs of a new policy end up being significantly higher than forecast, Ministers don't get an opportunity to make an explicit decision about whether to spend more, or whether to change the policy to live within the original costing. The graph to the right shows that forecast changes in ECE have been much larger than policy changes since the introduction of a new ECE funding system which rewards higher levels of qualification, and 20 Hours ECE. A more recent example is making correspondence school programmes free for alternative education providers – this has ended up costing at least three times the Budget 2009 bid.



29. Less scrutiny is given to means of funding forecast changes than for budget proposals. For example, higher roll growth in ECE could be funded by reductions in ECE entitlements. This sort of funding option is more likely to come up in the context of Budget discussions, than a baseline update.

30. Removing forecast changes would mean that Vote Education would get to keep any positive gains from “forecasts” for which it had to bear the risk. While in theory this could reduce some of the transparency around spending, in reality we don’t consider that this is likely to be an issue. Positive gains are likely to be small or non-existent in the case of price and standards changes. Quantity changes are more difficult to predict, but we are unlikely to see any positive gains over the next couple of decades (unless we make policy changes which change behaviour):
- In **ECE** current projections suggest we will see a reduction in the number of children under 5 for a few years beginning in 2013 (before they increase again). Historical trends suggest that any decrease in absolute numbers will be more than offset by an increase in average hours of attendance.
  - In **schooling** student numbers are expected to rise until 2024. After this point they are projected to decrease; however this decrease will be offset to some extent by students progressing into the more expensive upper secondary school years (and more generally, rising unit costs to maintain service delivery).
31. As with other Votes we would expect education to be able to manage other education pressures from any “spare” funding if quantity changes mean that there are positive gains in the future. In any event, any proposal to redirect positive gains to other education policy priorities will require Cabinet approval if it represents a significant policy change.

### ***Incentives***

32. Entitlement driven funding isn’t always the most efficient or effective way of delivering something. Allowing forecast changes for all entitlement funding creates an incentive for funding to be designed in this way, so that when price, quantity or standard pressures emerge additional funding is automatically obtained through baseline updates. For example, schools’ are automatically compensated for their actual heat light and water costs and increases in cost are sought as a forecast change. Schools have no incentive to minimise their costs – between 2005 and 2008 costs increased by over 52% but electricity costs (as measured in the CPI) only increased by 23%. The Ministry is preparing advice for Budget 2010 on how heat, light and water entitlements might be changed to a formula driven approach.
33. Entitlement driven funding also doesn’t place strong incentives on agencies to ensure operational changes or processes don’t add to costs. For example, in the 2009 school year there are approximately 350 teachers more than can be explained by student numbers and composition. The cost of this is just over \$20 million. It is possible that operational factors may have contributed to this. One such factor is likely to be a decision to use ENROL in 2009 for the purposes of determining staffing entitlements. ENROL counts a student’s year of schooling differently than in the past – essentially schools determine the year of a student under the ENROL system. The Ministry is planning to revert to the previous system for the 2010 school year.
34. Nor does the current system incentivise accurate costings. Funding for undercostings of policy are able to be sought through baseline updates. For example, \$46 million is sought in the OBU for what would seem to be an undercosting of the impact of the 2007 primary teachers’ collective settlement. The Ministry of Education has put in place reviews to improve the robustness of their policy costing, rate setting and forecasting processes. Of course, moving to an approach where there are no forecast changes may actually incentivise over-costings of policies. A low budget allocation will mitigate this risk. Ministers could also require greater transparency over the actual cost of new policies, versus what funding was set aside initially for them.

## Consistency

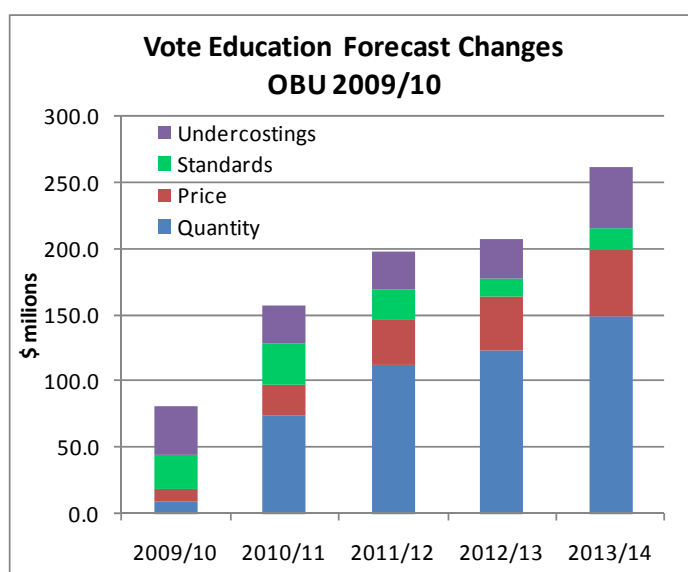
35. No other Vote has such a large number of forecast changes for changes which are not legislated dollar entitlements. In Vote Health all demographic, cost and other pressures are considered through the Budget process. One of the key differences between health and education, is that education tends to have specific dollar funding entitlements (usually contained in funding handbooks). However, there is a genuine choice about whether to deliver funding in this manner, and whether to maintain current levels of entitlements. As such there doesn't appear to be a compelling reason for treating education any differently from health.

### In conclusion ... forecast changes should count

36. Our advice is that no items of Vote Education spending should be forecast changes in the October Baseline Update or beyond. They should count against the budget allocation. Bringing all education forecast changes inside the allocation will promote transparent policy choices, efficiency gains, accurate costings and consistency with the treatment of new spending in other Votes.

### Practical implementation

37. For increased costs in outyears there is more scope to adjust policy settings to manage costs down. If additional costs arise during the course of a particular year, there is unlikely to be scope to adjust policy settings so it is likely that funding would need to be obtained from the between budget spending contingency. If the changes were significant enough it could take up a large proportion, or even more than, the entire between budget spending contingency.
38. In practice removing all forecast changes from Vote Education would mean the following for the OBU 2009/10 changes:
- 2009/10 year – the \$81.6 million sought would count against the between Budget spending contingency. As the contingency currently stands, funding these changes from the between Budget contingency would increase the deficit over the forecast period from \$79 million to \$161 million, but would not affect the \$106 million per annum remaining in the contingency in outyears
  - 2010/11 year & beyond – the \$823 million sought across the forecast period would count against the education allocation.



39. Counting all OBU 2009/10 changes against the education allocation would mean that \$11 million would need to be found in outyears to keep within a \$250 million allocation. This is before any other cost pressures or new policies could be funded. As indicated in the first part of this report we think it is possible to manage all education costs within \$250 million, but it would require reductions in entitlements and/or service levels, and limited funding for new policies.
40. Preliminary indications suggest that Vote Health is facing a similar scale and nature of pressures as Vote Education in Budget 2010. This suggests that treating Vote Education in the same way as Vote Health is not unfair in terms of the scale of pressures that will need to be managed.

### **A transitioned approach is possible**

41. If it is not possible to manage education OBU 2009/10 forecast changes and other Budget 2010 pressures within \$250 million, this should be considered as part of the broader Budget process, rather than allowing items to continue to be forecast changes. The Minister of Education has an opportunity to seek more funding for education on 30 November as part of the baseline review process. Nevertheless, there are options to allow forecast changes in OBU 2009/10 for some items. Changes in volume seem the most obvious candidates, e.g.:
  - schooling salaries and operations (excluding the correspondence school): \$10.4 million in 2009/10 rising to \$56.1 million in 2013/14. We would advise excluding the correspondence school because there may be options for changing policy to manage these costs; and
  - ECE subsidies: \$5.6 million in 2010/11, rising to \$83.2 million in 2013/14.
42. Allowing the two volume adjustments above to go through as forecast changes in OBU 2009/10 would mean that only half of the Vote Education forecast changes had to be managed within the education allocation.

### **Next steps**

43. We recommend that you meet with Minister Tolley to agree upon a new set of budget management rules for education. We can provide you with further advice to support any discussion.