The Treasury

Budget 2015 Information Release

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Office of the Minister of Finance

Chair
CABINET

BUDGET 2015 AND BEYOND: STRATEGY AND PROCESS

Proposal

1. This paper seeks agreement to the overall strategy and process for Budget 2015, delivering our economic, fiscal and social objectives through improved public sector performance, and new innovative processes.

Executive Summary

2. The Government has successfully managed to achieve all four of our key priorities in the face of economic and fiscal challenges over the last six years, including a domestic recession, the global financial crisis and the Canterbury earthquakes.

3. Unlike many other countries, we did not slash services and raise taxes. Instead, we focused on improving public sector productivity, a strategy that has let us steer the public finances back into surplus.

4. Disciplined fiscal management has yielded significant results over the past six years. This strategy, which I can confirm we will continue for Budget 2015, has required tough decisions to be made but has allowed us to increase allowances for Budget 2015 to $1.5 billion per annum.

5. The return to surplus and increased allowances are not a signal to relax efforts and return to pre-2008 levels of funding without accountability for delivering improved outcomes. There will be new funding available, but not a lot, and only where we can provide evidence that we really understand a problem or opportunity and will have an impact.

6. Solving difficult social problems by attacking their root causes will make Government spending more sustainable in the future. Budget 2015 will continue to build on improving public sector performance with increased expectations that any new funding is evidence based. Budget 2015 will also introduce a focus on a few areas where there are vulnerable or at risk groups, who can cost a lot and could be better helped.

7. This will be the third year that departments will be developing four-year plans (4YPs). These plans are critical for setting out how we can get better value from the

$70 billion currently spent through the state services and how departments intend to improve the lives of New Zealanders.

8. This year we will look to strengthen chief executive ownership of 4YPs and their implementation by making them primarily departmental documents. Supporting this, any new initiative bids will be collected separately from 4YPs, as this approach reinforces the focus of 4YPs on how chief executives will deliver within existing baselines while providing flexibility for when new bids need to be submitted post-election.

9. Consistent with this, we expect agencies to continue to commit to all-of-government initiatives that are already underway. We have set ourselves an ambitious plan for all-of-government activity, which requires agencies to work together to better the system. If we continue to break down these silos and continue to build on the progress we have made we will be able to better improve New Zealander's lives.

Looking back – our past achievements

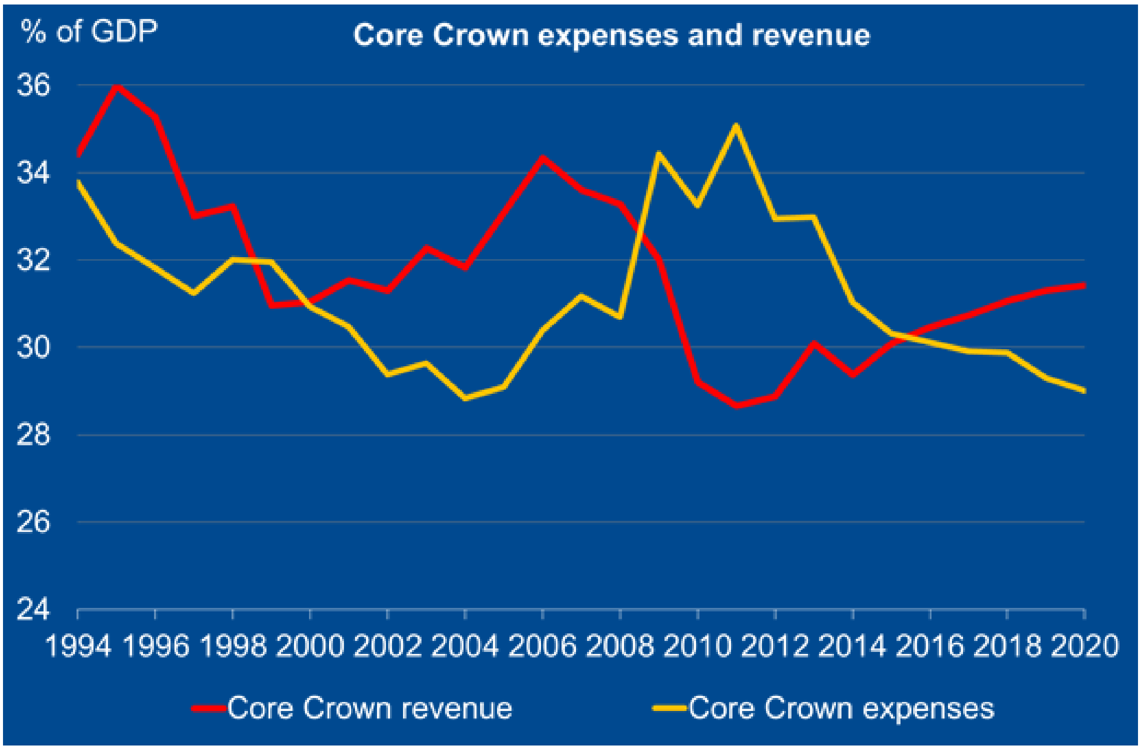
10. Since coming into office in 2008, the Government has encountered severe economic and fiscal challenges, including a domestic recession, the global financial crisis and the Canterbury earthquakes.

11. Like other governments, we have had to adjust fiscal policy in response to the downturn as falling tax revenue put strain on the public finances and forced a build-up in debt. But unlike other developed countries we did not slash and burn services and raise taxes. Instead, our response to the downturn was measured and well signalled, and we concentrated on the most direct influence we have over New Zealand's economic and fiscal performance: public sector productivity.

12. At around one-quarter of the economy, we realised that a better performing public sector would reduce fiscal deficits and improve broader economic performance. We took the time to think through the problems in each sector and worked out the changes that needed to be made. During our first term we capped the public sector headcount, reprioritised spending towards front-line services, and extracted a sizeable efficiency dividend out of the public sector. In our second term, our Better Public Services (BPS) programme started to deliver measurable results and introduction of the Welfare investment approach demonstrated a marked improvement for investment decisions. Now, we are starting to consider how we build on these and other achievements, and the focus provided by the BPS results and Business Growth Agenda will continue to improve the effectiveness of all public spending.

13. Budget 2014 displayed a remarkable turnaround in the Crown's fiscal outlook and presented a surplus in 2014/15. This supported the notion that departments are starting to understand their cost drivers better, and some are showing signs they are arresting old patterns of ever-increasing expenses for little obvious gain. The priority given to managing the Government's finances means there has been limited new operating spending each year. As a result, Budget 2014 forecast Core Crown expenses to drop below 31 per cent of GDP in 2014/15, down from 35 per cent just three years ago – and then remain well under that level. This turn-around has been achieved while Kiwis Count scores have shown improvements over the same period in New Zealanders' satisfaction with public services.

Figure 1: Core Crown expenses and revenue



14. Over the past six years, we have learned that the state sector can deliver better public services for less when it has a clear direction and knows the results it needs to deliver. In the short-term, once results are identified, funding can be directed at what is important and away from what is less crucial.

Current achievements

Continued focus on public sector performance and results...

15. We have set the public service ten challenging results to achieve, and the Better Public Services programme continues to make measurable progress toward solving difficult social problems. For example, we are making good progress with an increase in the number of 18 year olds achieving NCEA Level 2 as well as continuing to reduce long-term welfare dependency. Looking forward, the challenge is to lock in, then accelerate these gains and continue improving the lives of New Zealanders. A public sector that is performing efficiently and effectively will not only do this, but also let us pay down debt and prepare for future shocks.

16. Budget 2015 will build on our past success. Agencies will need to provide options that can credibly improve performance in the short-term to deliver longer-term, downstream benefits. An integral part of improving performance is evaluating the impact of past policy so the Government can work out why current policy is not working or achieving the anticipated results.

17. Agencies that are performing at a high-level, managing service delivery risk and delivering effective public services will have a better sense of the choices available. They are more likely to be able to manage their costs over the medium-term, achieve

measurable progress towards results, and let Ministers make informed choices about policy direction and funding levels in those sectors.

...as we move to managing a growing economy rather than recovering from a recession...

18. The economy has strengthened significantly over 2013 and into this year, with growth in real GDP of 3.8% in the 12 months to March 2014. This is the fastest pace of growth since mid-2007 and the fourth-equal highest growth rate in the OECD over this period. The expansion has also become more broad-based, flowing through to higher employment and rising real wages. As the economy has strengthened, interest rates have begun to rise to more normal levels and the exchange rate has remained elevated.

...allowing for a prudent increase in operating allowances...

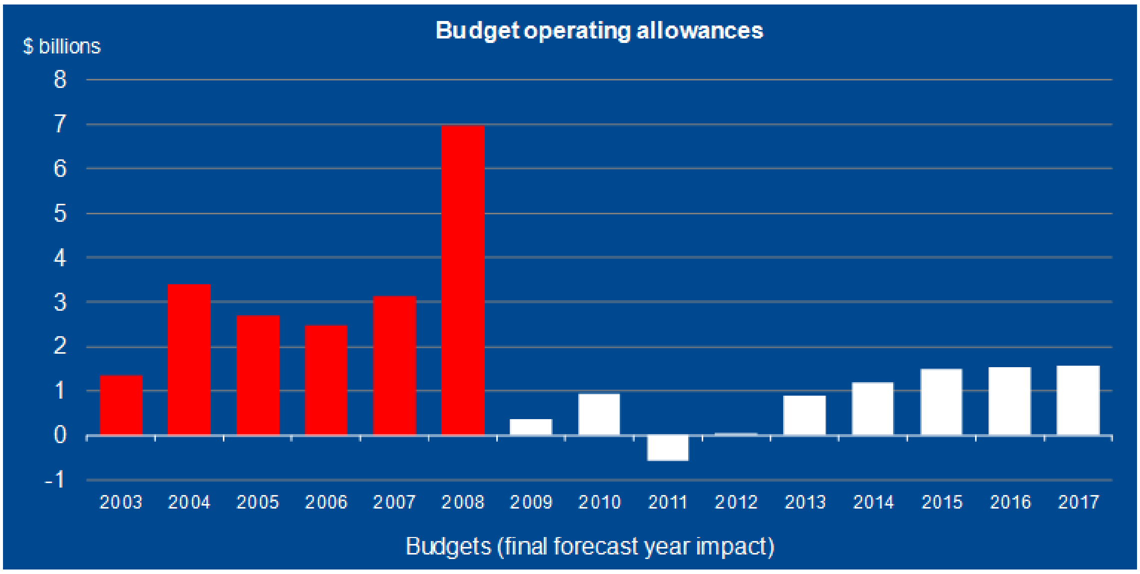
19. With this economic outlook I can confirm that we will continue to follow the fiscal strategy outlined in Budget 2014.

20. One of the key considerations that we took into account when setting future operating allowances in Budget 2014 was taking pressure off interest rates. The Treasury advised that increasing allowances to $1.5 billion per annum was around the upper limit for increased spending (or revenue initiatives) before they begin to materially affect interest rates or impact on the Government's objective of reducing net debt to 20% of GDP by 2020.

21. We therefore decided to lift the operating allowance for Budget 2015 to $1.5 billion per annum (growing at 2% each Budget), to provide the Government with future options around investment in public services and/or modest tax reductions. Allowances averaging around $1.5 billion per Budget remain well below those adopted in the mid-2000s and provided that they do average around $1.5 billion, there could be room to move some of the allowance between Budgets.

22. We were able to raise future allowances because of an improved fiscal position. This position has turned around significantly over our term of Government, with the operating balance before gains and losses moving from a deficit of $18.4 billion in 2010/11 to a small surplus in 2014/15 being delivered in Budget 2014. Beyond the 2014/15 surplus, net core Crown debt in dollar terms is expected to decline from 2017/18 and, as a share of GDP, is expected to fall to 20.0% by 2020 in line with our objective as noted above.

Figure 2: Budget operating allowances



23. However, there are a number of risks to the economic and fiscal position that we need to be aware of, highlighted by the recent decline in dairy prices and the shortfall of tax revenue compared to forecast in the 2014 Budget Update. The Treasury will incorporate new developments into the Pre-election Economic and Fiscal Update due for release on 19 August 2014.

Budget 2015 Approach – Evidence-based solutions

24. The return to surplus and increased allowances are not a signal to relax efforts and return to pre-2008 levels of funding without accountability for delivering improved outcomes. There will be new funding available, but not a lot, and only where agencies can provide evidence that they really understand a problem or opportunity and will have an impact. This increased burden of proof will apply to applications for new funding, and to accounting for existing activity before any new funding is accessed.

25. In Budget 2014 the Treasury used a capital investment panel to provide external expert opinion on capital proposals. The robustness of this process and the challenge it provided was useful to both agencies and Budget Ministers. The Treasury will continue this approach and be looking to expand this scrutiny to more expenditure proposals. This approach will include higher expectations on up-front evidence for a proposal, and day one understanding of how a programme, project, service line or intervention's success will be monitored.

26. There are cost pressures to be considered but we are not prepared to fund wage or other price increases without a clear understanding of how service quality and productivity advancement is also being addressed. The investor confidence approach will be carried over from Budget 2014 for service lines (hospitals, prisons, schools) and votes where the focus will remain on demonstrating improving efficiency and effectiveness and achieving results.

27. It is important that a collaborative approach across, and outside, government is taken to achieve objectives. Few agencies can achieve key social, economic or environmental goals without actively engaging with other ideas in central and local government, or with academics, external providers, businesses or citizens.

28. Agencies must show how they intend to work together in order to deliver results, improve their effectiveness, and shift their resources accordingly. They also need to show how they are better targeting efforts and improving services for citizens and business. Information is essential to this. Improvements are underway, but more progress on information sharing and use is needed to focus efforts and make more informed decisions on where to invest.

29. This evidence-based and solution focused approach has been well signalled, building on past Budget expectations, and the trust we have placed on Chief Executives to manage their business while improving service quality and effectiveness. Agencies should now:

a. have a sound understanding of their cost drivers and balance sheets;

b. be able to articulate and demonstrate that they have "investor confidence" i.e. what is already being done to focus on results, manage current expenditure and future pressures, including efficiency savings (e.g. BASS measures) and contribution to bettering the system through contribution to cross government initiatives (e.g. uptake of ICT common capabilities);

c. be able to provide advice that helps us form a view on the best way to invest the next marginal dollar, and reinvest lesser quality spending.

30. A well-directed and focussed public sector will let us not only deliver the economic and social benefits New Zealanders demand, but also position ourselves to potentially signal tax cuts, repay Government debt faster in the future and make real and demonstrable changes for New Zealanders.

Strengthen the focus on solutions that work for "at risk" groups...

31. When we look at the whole life of an individual, we know that effective, early interventions can present much better outcomes (for the individual) reducing the likelihood of engagement with the justice system or benefit dependence. To achieve this we need to look at solving difficult social (and other) problems by attacking and focussing on their root causes which will improve outcomes. This approach will often require working across traditional agency service lines, but promises better returns on investment for the taxpayer.

32. There are a number of good initiatives underway such as the continued focus on the result areas. Innovations like the Whanau Ora Commissioning agencies, Social Sector Trials and the Children's Teams are primarily localised solutions that help families' access better services and support. The Welfare investment approach allows us to use data to better prioritise efforts. However, there are still questions about the depth of change outside focus initiatives. Although we often 'know their names', most families or individuals are still likely to be double or triple handled as they are passed along the pipeline with limited data sharing.

33. Budget 2015 will introduce a focus on a few areas where there are vulnerable or at risk groups, who could be better helped. Directly targeting these groups will enable us to demonstrate and measure the impact we are having as well as apply lessons across a broader range of groups. The initial groups I want to investigate further are: vulnerable children; at risk youth; and families associated with gang members.

34. The children and youth groups selected are representative of important transition points in life where poor outcomes can have poor long-term consequences. We know that children who enter CYFs care or who do not achieve NCEA Level 2 are more likely to have contact with the justice system (3/4 of young offenders are known to MSD and are more likely to reoffend) or longer-term benefit dependence (62% of 30-39 year olds currently receiving benefits first went on as young people). We also know that gang affiliation correlates with poor outcomes for both gang members and family members. For example, five out of nine child deaths in New Zealand between 2009 and 2012 involved stepfathers with gang connections. Further groups may be identified in the future.

35. An initial collation was undertaken to pull together the information we have on these groups in terms of characteristics, risk factors and future outcomes. Common characteristics of these groups, usually related to the family environment include sole parents, violence, benefit dependency, poverty, alcohol and drug abuse, inadequate housing, over representation of Māori, poor social and economic outcomes and teen pregnancy. Through anecdotal evidence we know that the same people are reflected in all three groups.

36. I have asked officials to focus thinking on population groups where the scope to make a difference to outcomes is high *and* there is also scope to reduce long-term fiscal costs. Focus should also be increased at the 'hard end' of these groups – as a way to complement the results approach. Officials have observed that results are tending towards the easier-to-reach gains, sometimes leaving those with the most complex and pressing needs outstanding.

37. This exercise has confirmed that for the most vulnerable we do (or should) literally know their names. I have directed Treasury, working with the Social Sector Forum agencies, to come back to social and justice sector Ministers with a genuinely new approach for identifying solutions for these groups in Budget 2015 and beyond. I expect this process to look at people tailored solutions based on local circumstances; include an appropriate level of tension from external challenge around new ideas and current approaches; recognise and challenge the effectiveness of existing spending and delivery mechanisms; involve clients, communities and providers in ideas sourcing, not run a closed door process; and be expandable to include additional focus areas in the future.

38. To incentivise innovation and thinking differently about old problems, there would be a small amount of associated funding available, where agencies, Non-Government Organisations (NGOs) and/or external providers can identify promising new ideas and approaches.

Four-Year Plans will demonstrate agencies understand their business

Lifting the ambition of Four-Year Plans to lift Living Standards...

39. This will be the third year that departments will be developing 4YPs. These plans are critical for setting out how we can get better value from the $70 billion currently spent through the state services and how departments intend to improve New Zealanders' living standards – whether through:

a. more effective and innovative provision of services such as health and education, and/or

b. improved regulatory regimes such as those governing resource management and work force, and/or

c. being more efficient in how they operate.

40. Over this time we have strengthened expectations on chief executives to focus on improving their collective impact on citizens and businesses. At the same time, support and tools available to deliver on these expectations have been strengthened, such as the support provided by the property, procurement and ICT functional leaders and greater ability for chief executives to delegate functions or powers.

41. 4YPs are the key strategic planning document, which provides an integrated view of a department's medium-term strategy to be delivered within existing baselines. And in doing so, set out how these expectations on chief executives will be met and where the various tools and processes are being used.

...this will be aided by changes to the Four-Year Plan process...

42. While the intent of 4YPs has not changed, I propose to change the 4YP process this year to reinforce their key strategic role, to:

a. strengthen their ownership by chief executives;

b. provide greater flexibility to accommodate the needs of a government post-election; and

c. focus more on what agencies will do to contribute to wider result areas and priorities, and how they will work with others to achieve these collective outcomes.

43. I propose greater chief executive ownership of 4YPs by making them primarily departmental documents, with Ministers setting the government priorities that the plan intends to achieve. Greater chief executive ownership:

a. is critical for driving departmental activity and holding chief executives to account for addressing how they will use their resources to deliver on these priorities, as opposed to only revealing the challenges; and

b. enables the performance expectations and assessments of chief executives to be more strongly aligned to the 4YP and its implementation.

...and with bids for new budget funding submitted separately from 4YPs

44. I also propose that bids for new budget funding are submitted separately from 4YPs. Ministers will have a critical role in challenging chief executives through the 4YP process to demonstrate the strategic shifts and key actions they will take to deliver on the government's collective priorities, not just those of the department, within existing baselines. These collective priorities include the results approach as well as other initiatives such as the Functional Leader strategies for property, procurement and ICT

agreed to by Cabinet to improve the efficiency and effectiveness of the state sector. Separately collecting new budget bids also provides flexibility for when these bids are to be submitted and what these bids should contain.

45. This year there may be limited time post-election for engaging with Ministers and finalising incoming government priorities before the focus turns to budget initiatives and implementing election manifestos. Accordingly, this year the draft 4YPs to be delivered in November are expected to be more akin to a 'state-of-play' 4YP for an incoming Minister and government.

46. The 4YPs will be finalised post-budget decisions, following ongoing engagement with Ministers to ensure the plans are consistent with the incoming government's policies and performance expectations of the department.

47. Once finalised, the strategic intentions at the front-end of the final 4YP can then be presented to the House, effectively replacing the need to produce and present a separate 'Statement of Intent'. I wish to reinforce the role of the 4YP as the department's key strategic document by aligning and decluttering strategic report documents.

Plans need to reflect all-of-government as well as individual agencies' needs

48. I expect agencies to continue to commit to all-of-government initiatives that are already underway. In particular, we have set ourselves an ambitious blueprint for government ICT initiatives, which requires agencies to be part of building the 'common capabilities' across government to keep New Zealand's public services at the forefront of technological developments.

49. This sort of cross-government work is likely to require agencies to contribute funding and help provide information to the Government Chief Information Officer (GCIO) and Treasury that Ministers need to finalise decisions on how to fund All-of-Government ICT common capabilities in Budget 2015.

50. The ICT funding may include central funding, contributions from departments or a combination of both. I have asked GCIO and Treasury to consult and clarify with departments the fiscal impact of migrating to common capabilities, identifying where benefits lie and what funding options make sense. As part of this, I am expecting departments to assess overall fiscal costs and savings of migrating to common capabilities and include these in 4YPs, including any contributions to GCIO.

Consultation

51. This paper was prepared by the Treasury. The State Services Commission was consulted (on the Four-Year Plan section) and the Department of the Prime Minister and Cabinet was informed.

Recommended Action

I recommend that Cabinet:

a **note** since coming into office in 2008, the Government has encountered severe economic and fiscal challenges, and has responded to these through a measured programme of improving public sector performance;

b **note** that the Government's books have turned around significantly over the last six years resulting in Budget 2014 delivering a small surplus in 2014/15;

c **note** that progress has come from defining results, directing agencies to achieve them and reprioritising resources accordingly;

d **note** that better public service performance is helping achieve the Government's social objectives and deliver considerable fiscal savings as social results are achieved;

e **note** that we move to managing a growing economy rather than recovering from a recession;

f **note** that the operating allowance for Budget 2015 was lifted to $1.5 billon per annum;

g **agree** the continuation of the fiscal strategy outlined in Budget 2014;

h **agree** that Budget 2015 will focus on targeting vulnerable groups of people and improving public sector performance;

Four-Year Plans

i **note** that the purpose of four-year plans remains unchanged, which is to provide an integrated view of a department's medium-term strategy to be delivered within existing baselines;

j **note** proposed changes to four-year plans are designed to reinforce their key strategic role, to strengthen their ownership by chief executives, and provide greater flexibility to accommodate the needs of a government post-election;

k **agree** to strengthen chief executive ownership of four-year plans and their implementation by making them primarily departmental documents, with Ministers being satisfied the plans are consistent with the government's policies and performance expectations of the department;

l **agree** that new initiative bids will be collected separately from four-year plans, as this approach reinforces the focus of four-year plans on how chief executives will deliver within existing baselines while providing flexibility for when new bids need to be submitted post-election;

m **agree** that draft four-year plans will be provided in November to the incoming Minister, with the plans being finalised post-budget decisions;

n **note** that sustainable funding for the all-of-government ICT common capabilities programme led by the GCIO will be considered as part of Budget 2015;

o **note** that I have asked the Treasury and GCIO to consult with agencies on the recommendation n in the later part of 2014.

Hon Bill English
Minister of Finance

Date: