The Treasury

Budget 2017 Information Release

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[40]	Not in scope	

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THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Budget 2017 - Initial Budget Initiatives and Business-As-Usual Pressures

Date:	21 December 2016	**Report No:**	T2016/2530
		File Number:	BM-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Steven Joyce)	**Note** the high level analysis on Track 2 Budget initiatives and business-as-usual pressures presented in this report. **Note** the Treasury will provide further advice and analysis on this in the new year. **Refer** a copy of the report to the Associate Ministers of Finance and the Prime Minister.	10 January 2017

Contact for Telephone Discussion (if required)

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

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Yes

Treasury Report: Budget 2017 - Initial Budget Initiatives and Business-As-Usual Pressures

Executive Summary

The purpose of this report is to provide an initial update on cost pressures received as part of Departments' Four Year Plans and Track 2 Budget 2017 initiatives received by the Treasury on Wednesday 14 December.

The report does not include detailed analysis or recommendations on specific initiatives. The information received by the Treasury will be further analysed and used to help inform decisions through the Budget process.

The reference to cost pressures and business-as-usual pressures in this report is analogous. The term 'cost pressures' has been used as part of the Four Year Plans, however for Budget initiatives the term 'business-as-usual' better reflects the nature of the costs.

The tables below provides a summary of the high level information received on cost pressures and Budget initiatives.

Cost pressures identified in Four Year Plans (2017/18)	
Gross cost pressures	$3.4 billion
Strategic responses from departments (including pressures already funded in baselines)	$1.6 billion
Net cost pressures	$1.8 billion

Budget Initiatives (business-as-usual pressures and new initiatives)	
Average operating initiatives per annum (Track 1)*	[33]
Average operating initiatives per annum (Track 2)**	$2.7 billion
Total capital cost over forecast period	$7.0 billion

* These costs are indicative only and final initiatives are due on 31 January.

**Around $1.2 billion of this relates to business-as-usual pressures.

Cost Pressures identified in Four Year Plans

The Four Year Plans were introduced to encourage Departments to adopt a strategic, medium term approach to their planning. As part of the process Departments are also required to provide cost pressure information with their plans, detailing their anticipated costs, split by personnel and non-personnel pressures, with a further break-down by driver (be it price, volume, wages or other drivers).

Gross operating cost pressures are expected to be $3.4 billion in 2017/18 rising to $8.4 billion by 2020/21. The most significant cost pressures are faced by the Health and Education sectors driven by demographic changes and wage price increases.

Taking into consideration Departments strategic responses to manage cost pressures, there remains a funding gap of $1.8 billion in 2017/18 rising to $4.2 billion by 2020/21. The most common strategic response identified by departments is reprioritisation of existing baselines.

It is likely the funding gap (or net pressure) identified will eventuate into future Budget initiatives, which would leave limited room for new initiatives in the future.

Not all net cost pressures identified in 2017/18 will translate into Budget initiatives. A good example of this is ACC cost pressures where only a third is being sought through the Budget process.

Track 2 Budget Initiatives

Around 280 initiatives have been submitted so far for Track 2 with an average operating cost per annum of $2.7 billion and a total capital cost of $7.0 billion over the forecast period. Around half of the costs of operating initiatives relate to business as usual pressures which broadly aligns with the net cost pressure information (excluding ACC) for 2017/18 received through department's Four Year Plans.

[33]

Final Track 1 initiatives are due from departments on 31 January.

The *2017 Budget Policy Statement* published earlier this month confirmed that the operating allowance will remain at $1.5 billion and the capital allowance will increase from $900 million to $3.0 billion in Budget 2017 and to $2.0 billion in future Budgets.

The total cost of initiatives submitted so far show that both the operating and capital allowances are heavily oversubscribed. This is exacerbated by the number of precommitments that have already been approved against the allowances. As part of the decision-making process, the Treasury will provide advice on the choices and trade-offs available to manage within the remaining operating and capital allowances excluding any precommitments ($1.2 billion and $1.4 billion, respectively).

Our initial analysis of Budget initiatives suggest that there are minimal bids received to date in relation to the Kaikōura earthquakes. There are likely to be both urgent funding proposals which will require consideration by Recovery Ministers, and proposals for Budget 2017 which relate to earthquake recovery and response.

Fiscal costs following the Kaikōura earthquakes are likely to put additional pressures on Budget 2017 allowances. The fiscal forecasts in HYEFU included an impact of a net $1 billion, but decisions and new information about costs is likely to revise this number higher ahead of Budget 2017.

In addition the above mentioned Budget initiatives exclude any potential income tax and family assistance changes.

Recommended Action

We recommend that you:

a **note** that $3.4 billion of gross operating cost pressures have been identified in departments Four Year Plans for 2017/18;

b **note** that departments are required to provide information on strategic responses to manage these cost pressures, following which a funding gap of $1.8 billion remains in 2017/18;

c **note** that there is a correlation between the size of the funding gap identified through Four Year Plans and the cost pressure initiatives submitted through Track 2 of the Budget process, however not all net pressures from Four Year Plans are expected to translate into Budget initiatives;

d **note** that around 280 Track 2 initiatives have been submitted so far with an average operating cost per annum of $2.7 billion and a total capital cost of $7 billion across the forecast period;

e **note** that final Track 1 initiatives will be due on 31 January 2017 [33]

f **note** that the operating and capital allowances for Budget 2017 have been confirmed through the *Budget Policy Statement* and are heavily oversubscribed in comparison to the fiscal cost of initiatives that have been submitted so far;

g **note** that the Treasury will provide further analysis and advice on these initiatives in the new year as part of the Budget decision-making phase, including any choices and trade-offs required to manage within the remaining allowances; and

h **refer** this report to the Associate Ministers of Finance and the Prime Minister.

Refer/not refer

Kamlesh Patel
Team Leader, Budget Coordination

Steven Joyce
Minister of Finance

Treasury Report: Budget 2017 - Initial Budget Initiatives and Business-As-Usual Pressures

Purpose of Report

1. The purpose of this report is to provide an initial update on operating cost pressure information received as part of Departments' Four Year Plans and Budget 2017 initiatives received by the Treasury on Wednesday 14 December.

2. The Treasury will be analysing the cost pressure information and Budget 2017 initiatives received in more detail in the New Year to help inform budget decisions. In the meantime, this report offers an indication of:

   a the level of Departments' anticipated cost pressures and what is driving those pressures;

   b what Departments are planning to do to manage those pressures;

   c the extent to which further work or funding will be required (at a future time) to cover any gap;

   d overview of Budget 2017 initiatives;

   e breakdown of Track 2 initiatives by sector and high level components of initiatives;

   f potential implications of the Kaikōura earthquakes.

Cost Pressure Information From Departments' Four Year Plans

Background

3. Departments are required to complete a four year plan (4YP) each year. The 4YP process was introduced to encourage Departments to adopt a strategic, medium-term approach to their planning.

4. Departments are also required to provide cost pressure information with their plans, detailing their anticipated costs, split by personnel and non-personnel pressures, with a further break-down by driver (be it price, volume or other drivers).

5. Where a Department's level of cost pressures exceeds its level of strategic responses (i.e. the measures the Department has planned to manage its pressures), we expect Departments will either identify further strategic responses at a future time, or will submit a budget bid.

6. For the purposes of this report:

   a "**Gross cost pressures**" are the entire cost pressures anticipated by Departments, regardless of whether those pressures have already been funded (through recent baseline increases), or whether Departments have identified strategic responses to manage the pressures.

   b "**Unfunded cost pressures**" are the gross cost pressures, less the portion of pressures that have already been funded (in baselines).

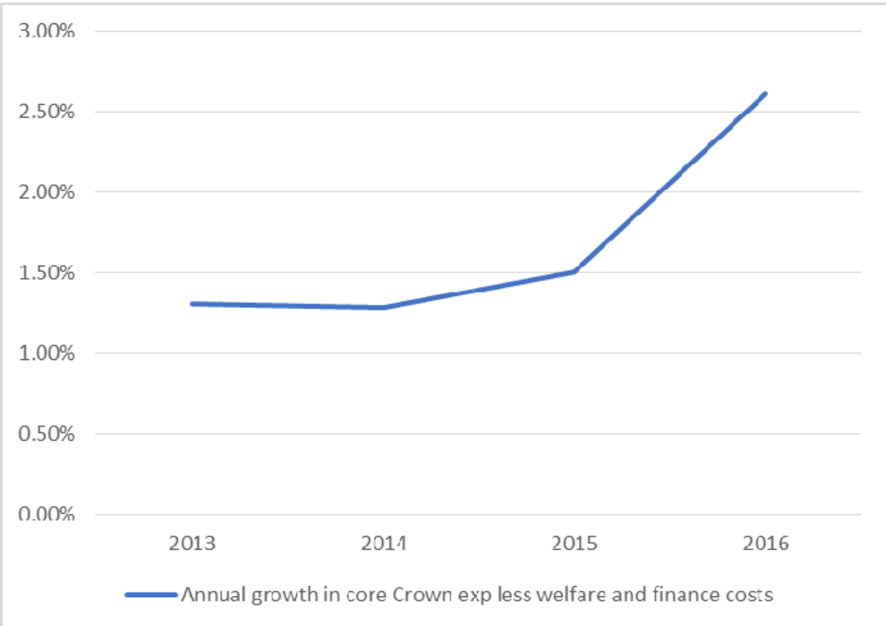
c "**Strategic responses**": are the measures Departments intend to take to manage their cost pressures within existing baselines. For example, finding efficiencies, reprioritising resources or making changes to operating models. A budget bid is not considered a strategic response on the basis that Ministers may choose to decline a bid.

d "**Net pressures**" are the residual, unfunded cost pressures left after strategic responses have been deducted. Also referred to as the "gap" in the plan.

Scope

7. The information in this section covers all Departments' operating expenditure (departmental and non-departmental[1]), excluding welfare benefits, NZ superannuation payments and finance costs. At an aggregated level this represents around $46 billion of core Crown expenses for the year ended 30 June 2016 (total core Crown expenses were $73.9 billion) and broadly speaking represents the running costs of the Government which is subject to more direct management control. Figure 1 shows the annual growth in core Crown expenses excluding welfare benefits, NZ superannuation payments and finance costs.

Figure 1 – Annual growth in core crown expenses excluding welfare benefits, NZ superannuation payments and finance costs



8. All Departments were required to submit a 4YP. However, six Departments (out of a total of 37) did not submit their templates on time: DIA, LINZ, MoT, NZ Police, SSC and TPK. While their cost pressure information is missing from this initial analysis, we have included comments about the likely financial contents of their plans in Appendix A.

9. The most significant of these omissions is NZ Police. NZ Police is yet to submit a final 4YP that includes financial information, but is seeking significant funding through Budget 2017 for its "Policing 2020" proposal, which Ministers have been considering recently.

[1] This includes Crown Entity activity, to the extent Crown Entities receive non-departmental funding from the Crown. For example, cost pressures for ACC's non-earners' claims (i.e. claims of people outside the paid workforce) are captured because they are funded from general taxation, not levies).

Limitations

10. There are a number of limitations with this initial analysis:

    a We asked Departments to submit their cost pressure information using a standard template. The template could not cover all scenarios, so Departments had to use judgement, meaning there are likely to be some inconsistencies in how they have presented their information. However, Treasury has made adjustments to the numbers submitted by Health, Education and Corrections, to better reflect the contents of their 4YPs. We will be checking other data in the New Year and making changes where appropriate.

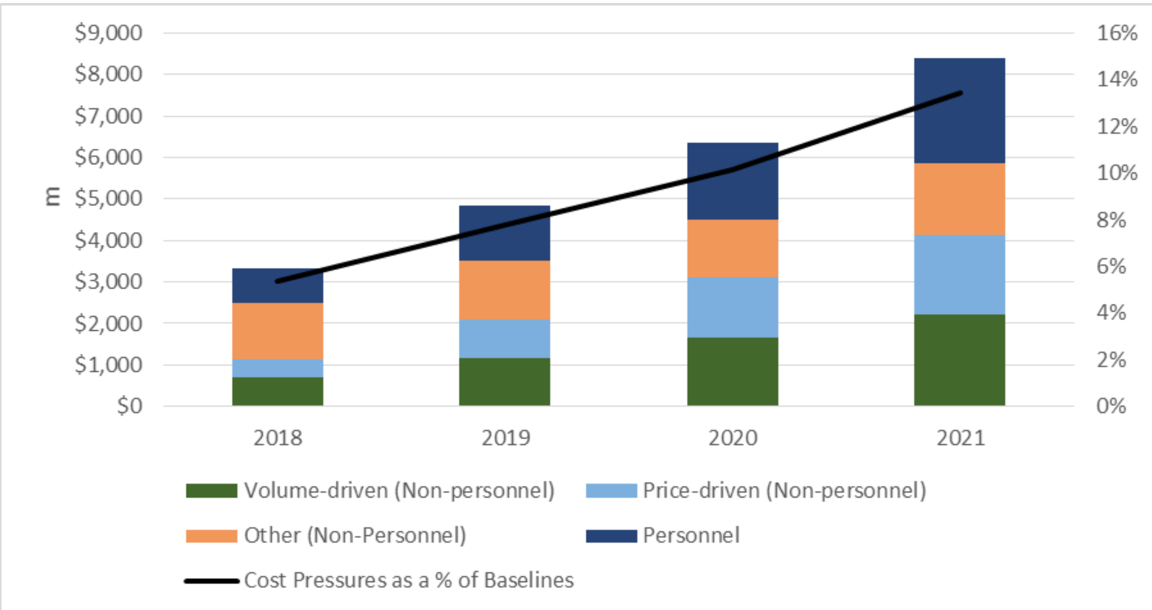
    b Departments were instructed to outline in their 4YPs the implications of their identified strategic responses on the achievement of their strategic intentions. In some cases, the proposed responses will not be palatable to Ministers and, therefore, the responses will not be implemented. In this situation, we can expect net pressures to increase and budget bids will be more likely to emerge as a result. Treasury will be interrogating the nature of departments' strategic responses as we review their 4YPs.

11. Due to the timing of the 4YP process, the cost pressures in this analysis <u>exclude</u> the consequences of the earthquakes in November. The potential impact of the Kaikoura earthquakes is discussed further in paragraphs 38-44.

<u>Level of Departments' Anticipated Cost Pressures and Drivers</u>

12. Figure 2 shows gross cost pressures are expected to rise from \$3.4 billion in 2017/18 to \$8.4 billion through the 4YP period (2017/18 to 2020/21).

Figure 2 – Cost pressures by driver and as a percentage of Budget 2016 baselines



13. Given cost pressures are expressed on a cumulative basis and that baselines are relatively fixed, cost pressures as a percentage of baselines rise from 5.4% in 2018 to 13.4% in 2021. Gross cost pressures for the 4YP period total \$22.9 billion (excluding cost pressures relating to the omitted six Departments).

14. The largest pressures in dollar terms come from the Health and Education sectors, driven primarily by demographic changes and wage price increases.

15. Health faces significant volume pressures ($3.4 billion over the forecast period) resulting from an increasing and ageing population. Health's wage pressures (from bargaining and remuneration increases) are also significant [38] over the forecast period). [33]

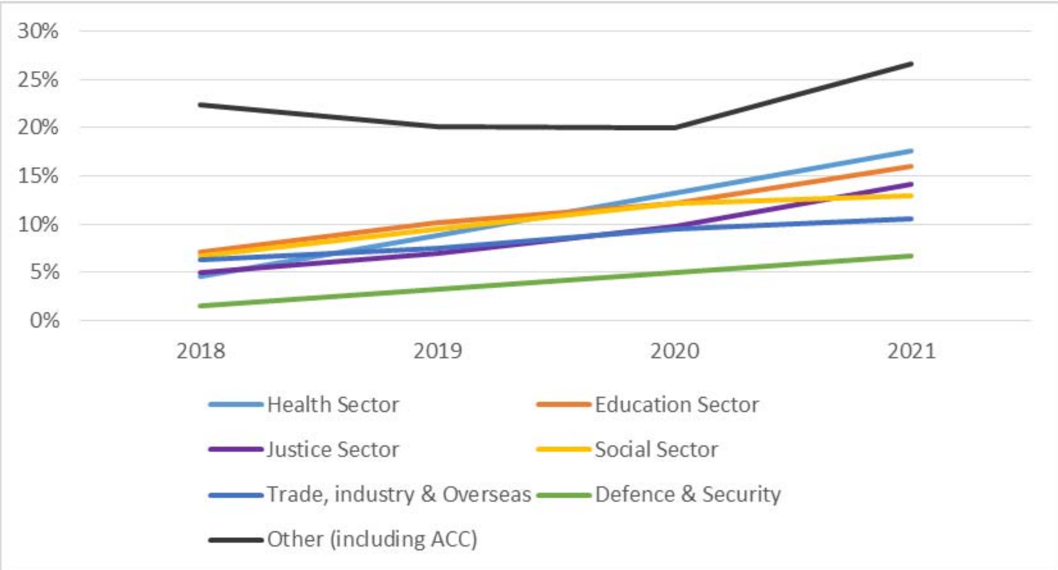
16. Volume pressures are also significant for the Education and Justice Sectors ($2.4 billion and $0.6 billion respectively).

17. For the remaining sectors, price changes are more prevalent. The Defence and Security Sector is anticipating significant cost pressures from changes in the price of non-personnel inputs ($2.3 billion over the forecast period, with 69% of these costs being depreciation and capital charge) and wage increases ($1.5 billion).

18. We will be looking into the large amount of costs in the "other" category of cost drivers in the New Year.

19. Figure 3 shows most sectors anticipate gross cost pressures to be greater than 10% of current baselines by 2021, ACC's cost pressures are the largest as a % of baselines (51% for the 2017/18 year).

Figure 3 – Cost pressures as a % of Baselines



20. ACC reports gross cost pressures of $672m in 2017/18, 51% of baseline. However, these pressures result largely from how (and when) ACC's funding requirements are assessed. As at June 2016, when ACC estimated its cost pressures:

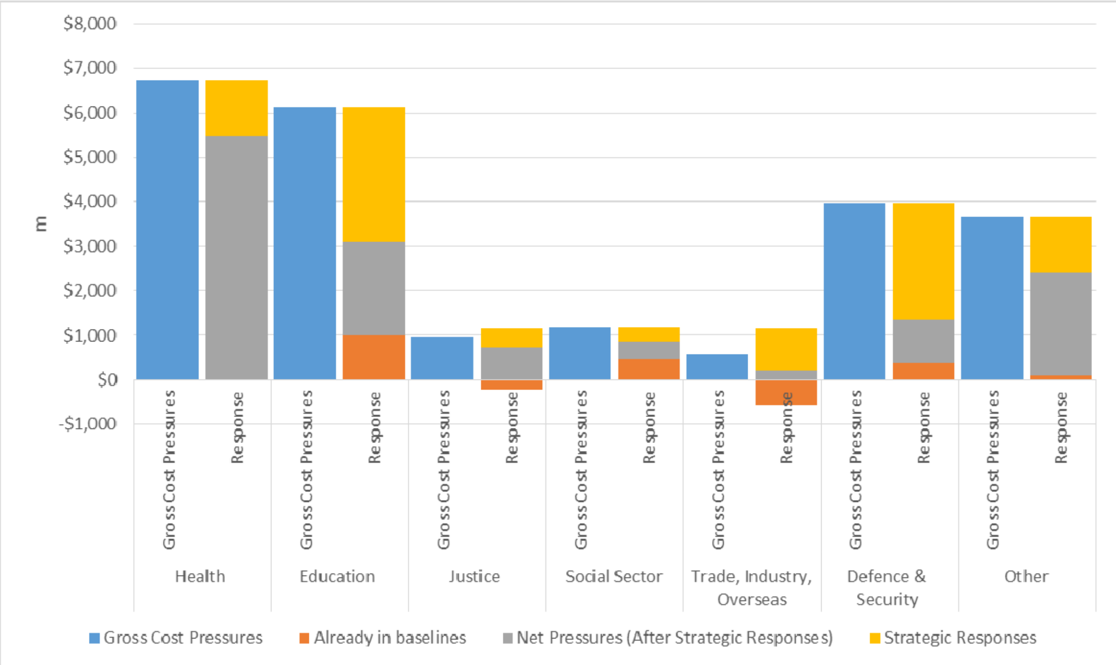
- the present value of ACC's outstanding claims liability had been pushed up by very low discount rates. ACC works on a fully-funded basis, so its pressures are based on an estimate of the lifetime cost (discounted to present value) of all the claims it expects to get in the coming year. Discount rates are now bouncing back (note they will keep fluctuating over time).

- ACC expected its non-earners' claims to be under-funded overall in 2017/18. ACC's cost pressures therefore include a large upward adjustment to increase the funding position.

Departments Response to Cost Pressures

21. Departments have identified strategic responses of $9.5 billion to partly manage pressures over the 4YP period. However, this leaves $12.2 billion ($1.8 billion in the 2017/18 year) of cost pressures yet to be managed.

Figure 4 – How Departments (by sector) are responding to identified gross cost pressures

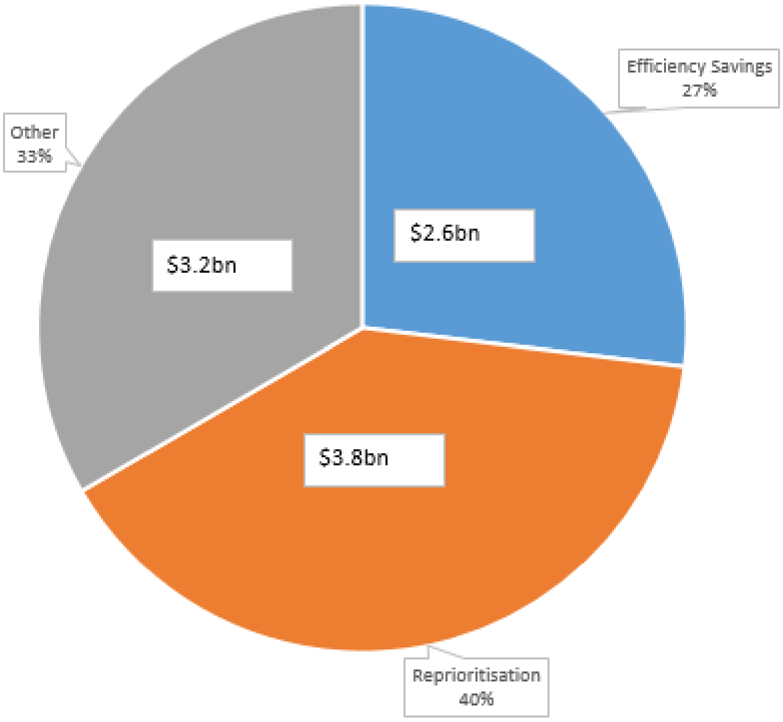


22. The orange-coloured areas in the graph show the proportion of cost pressures that have already been built into agency baselines and therefore require no further response from the agency. A negative figure arises from the situation where an agency has a baseline that decreases in 2017/18. Departments were asked to explain how they were responding to this decrease in funding.

23. The grey-coloured areas in the graph represent the net pressures that are yet to be managed. We expect Departments will either identify further strategic responses at a future time, or that they will submit a budget bid to respond to the cost pressure.

24. In some cases, Departments have funding reviews or other internal processes underway that aim to present options for managing cost pressures. However, where the outcomes of these reviews are still unknown they have not been factored into the numbers above.

How Departments intend to respond to gross cost pressures

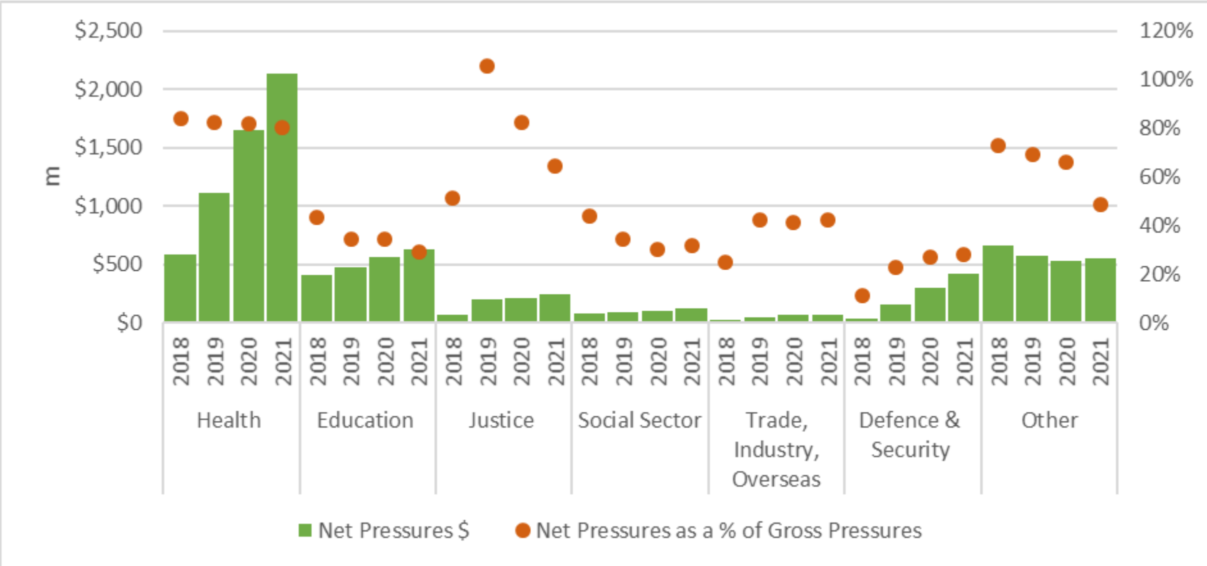


25. Reprioritisation is the most commonly identified response (40% of the value of the identified responses - $3.8 billion). Through the 4YP process, Departments were asked to identify their lowest value activities and specify which of these activities they would stop or reduce in order to fund higher value activities. The funding freed up through this process was to be shown as a strategic response – “Reprioritisation”. Further work will be done in the new year to dig deeper into the evidence of prioritisation identified in 4YPs. In addition, Departments are indicating that they intend to find more efficient ways of operating to make savings of $2.6 billion.

The Funding Gap

26. All sectors are showing unmanaged cost pressures over the forecast period. Health and Education show the largest gaps, Justice Sector faces the most significant gap relative to gross pressures. Figure 5 shows the “gap” in sectors’ plans (i.e. their net pressures (after strategic responses) which they do not yet have a plan to manage). The dollar value of the net pressures are shown, as well as the net pressures as a % of gross pressures. This percentage gives an idea of the extent to which Departments cost pressures remain unmanaged. A small percentage means that the Department has indicated they have a plan in place to manage the majority of their identified cost pressures. A large percentage indicates that they only have responses to a small portion of their cost pressures.

Figure 5 – The “gap” in plans

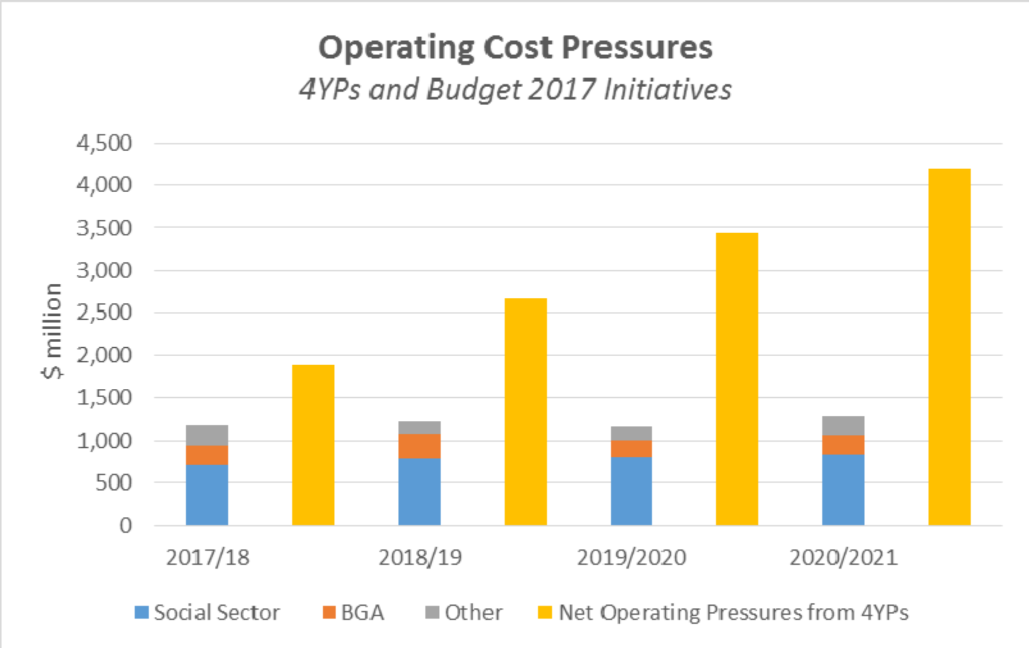


27. It is expected that a portion of these net pressures will become funding requests through the budget process but not necessarily the whole amount. This is particularly true for the pressures identified in the out years where the agency still has time to formulate a response.

28. Figure 6 compares business-as-usual pressures submitted as Budget initiatives through Track 2 (discussed further in the next section of this report) with the net pressures outlined in department’s 4YPs. We don’t expect all net pressures to translate into Budget initiatives which helps to explain the difference seen below. The total net pressures for the 2017/18 year include $672 million for ACC non-earners account, [33] . If we exclude the ACC non-earners account, cost pressures identified through the 4YP for the 2017/18 year broadly align with business-as-usual pressures submitted as Budget initiatives.

29. The 4YP cost pressure information reflects compounded pressures out to 2020/21, while the business-as-usual pressures submitted as Budget initiatives will focus on more immediate pressures identified by agencies from 2017/18. This explains the large variances between budget initiatives and net pressures seen in the out years in figure 6. It is worth noting the Government has set aside future Budget allowances, which could be used to manage some of the funding gap if these pressures eventuate.

Figure 6 – Business-as-usual pressures submitted as Budget initiatives compared to the net pressures outlined in department's 4YPs



30. Information received through the 4YPs reflect operating cost pressures only and figure 6 above does not include capital initiatives. The Budget initiatives submitted in Budget 2017 outline a total of $7 billion investment opportunities. Through the Budget process, the Treasury and the Investment Panel will provide further advice to Investment Ministers and Budget Ministers on the relative value propositions, scaling and deferral options and package up options which provide options for balanced investment.

31. The capital pipeline, provided routinely to Investment Ministers, outlines that the $7 billion requested is only part of the $17 billion of known capital pressures (see Appendix C). These include significant outyear implications for Transport and Defence. Financial impacts from the Kaikoura earthquake are still being determined, thus the nature and scale of some of the investments in the above chart may change.

Budget Initiatives – Track 1 and 2

Overview of Budget Initiatives

32. Budget initiatives for Track 2 were submitted by agencies on Wednesday 14 December. The submission date for Track 1 initiatives is 31 January 2017 and reflects the higher expectations associated with initiatives in this track. Indicative Track 1 initiatives were submitted to Treasury for review by the Social Investment Panel in November, with the purpose of providing early assistance to agencies in developing these initiatives [T2016/2356 refers].

33. Following the Track 1 November Checkpoint, Portfolio Ministers were asked to submit letters to the Minister of Finance indicating the initiatives they wish to submit through both Track 1 and Track 2.

    a **<u>Track 1:</u>** [33]

    Initiatives cover key social spending areas including Social Development, Social Housing, Education, Health, Justice and Vulnerable Children. The fiscal costs are indicative only and subject to change. The Treasury will provide further information and advice on these initiatives following final submission in January.

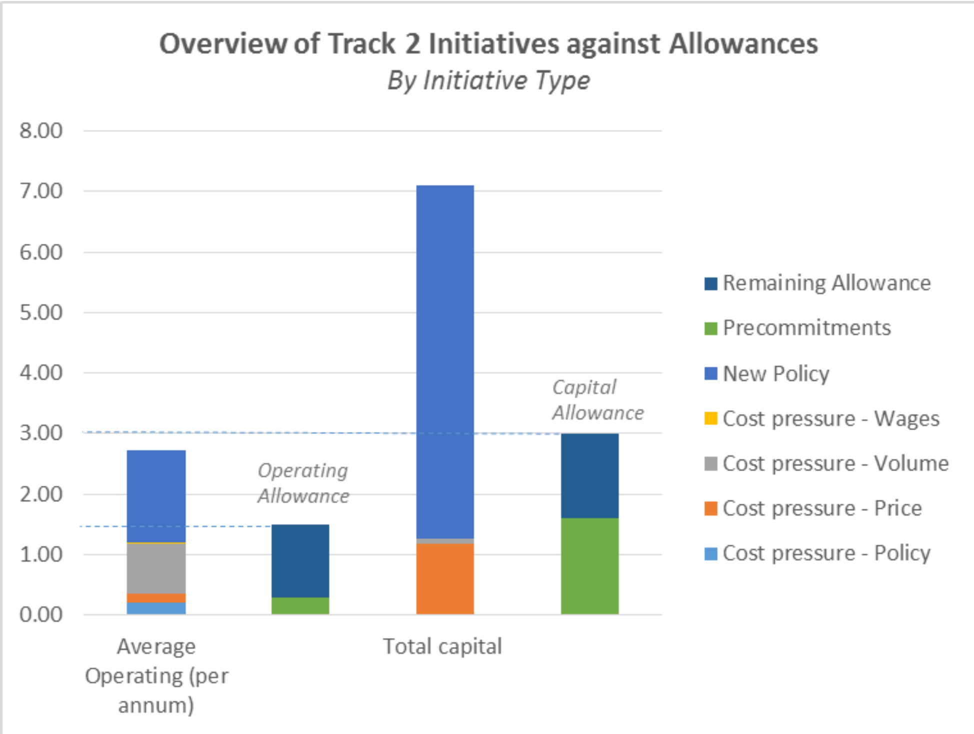
    b **<u>Track 2:</u> A total of 280 initiatives have been submitted for Track 2 with an average operating cost per annum of $2.7 billion and a total capital cost of $7.0 billion over the forecast period**. This reflects initiatives lodged on Wednesday 14 December and does not include all initiatives that we expect may be submitted related to the Kaikōura earthquakes. The Treasury has not yet completed an assessment of the initiatives and therefore the information presented in this report provides a high-level analysis only.

34. Track 2 initiatives cover the established budget streams (BGA, Social Sector, Other and Capital) and include both business-as-usual pressures and new policy initiatives.

35. Figure 7 below provides a breakdown of operating and capital costs by initiative type. Nearly half of the total operating cost per annum reflects business-as-usual pressures in the operating space. This is in comparison to capital which is predominately made up of new policy initiatives, with only 18% percent of the fiscal cost reflecting business-as-usual pressures.

36. The graph below also compares the total operating and capital cost of initiatives against the allowances stated in the Budget Policy Statement ($1.5 billion for operating and $3.0 billion for capital). As shown, there have already been a number of precommitments against these allowances reducing the amount available to be allocated for new initiatives and any business-as-usual pressures.

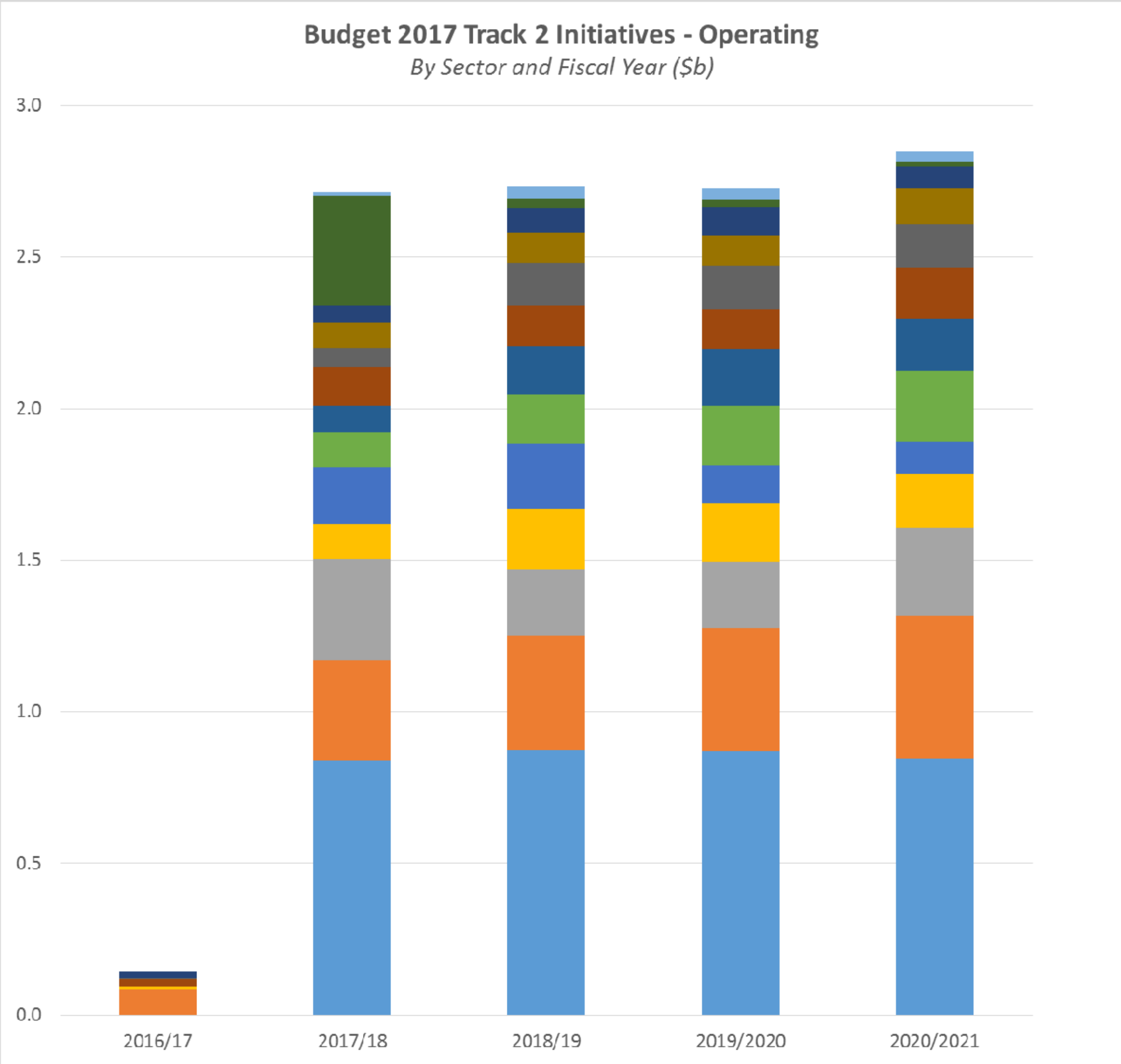
Figure 7 – Overview of Track 2 initiatives against allowances



<u>Breakdown of Track 2 initiatives by sector and high level components of initiatives</u>

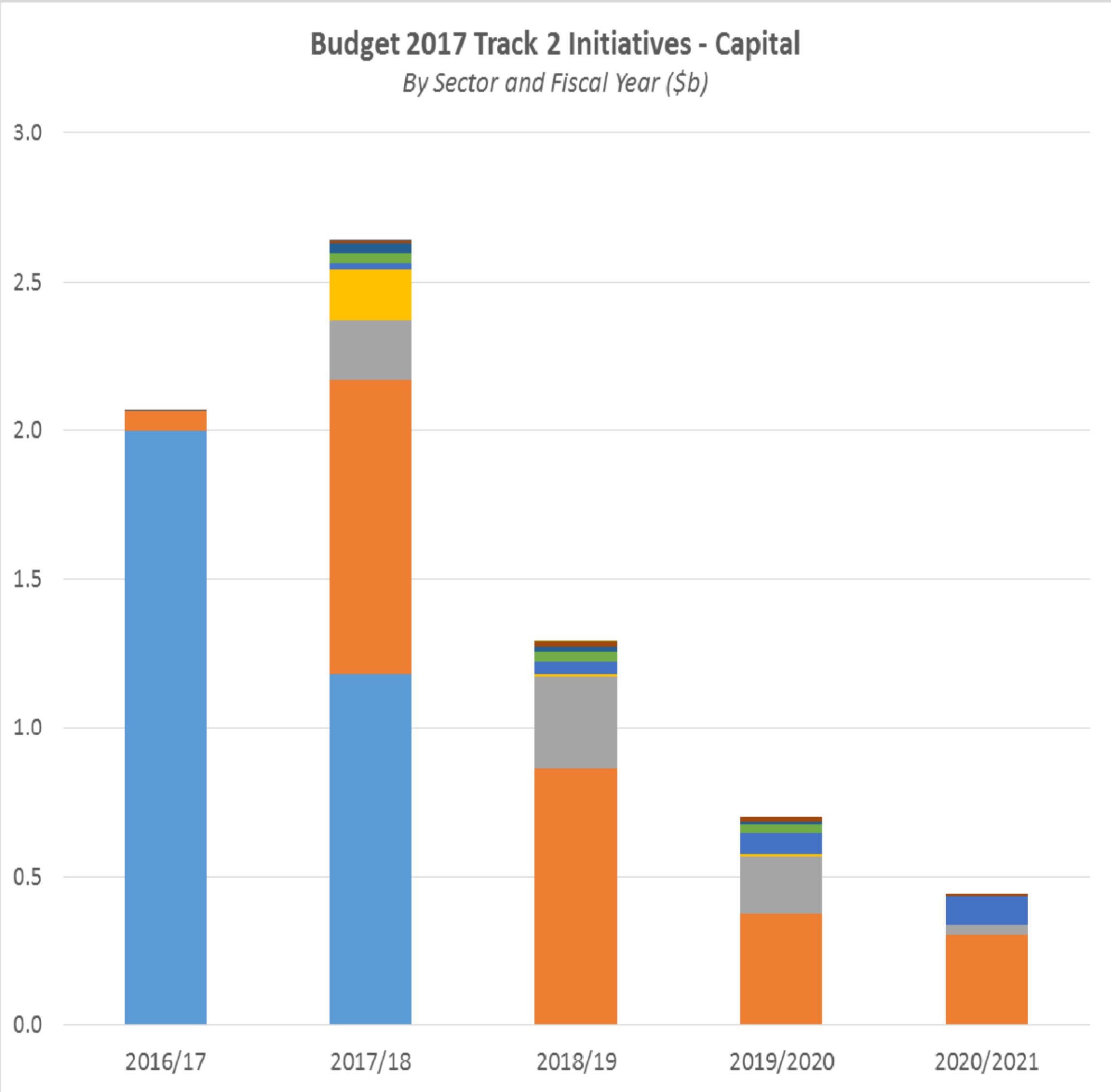
37. Figure 8 and 9 below provides a breakdown of Track 2 initiatives by sector across both operating and capital. The significant initiatives for each sector are also highlighted in the adjacent tables.

Figure 8 – Budget 2017 Track 2 Initiatives - Operating



SECTOR	***SIGNIFICANT COMPONENTS***
Health	DHB cost pressures, disability support [33] primary care services and PHARMAC.
Education	Demand driven forecast changes, school property programme.
Parliamentary Service, Internal Affairs, Finance, Arts, Culture and Heritage	ACC support for non-earners, student loan compliance, RealMe.
Vulnerable Children	Transition costs and service delivery changes.
Foreign Affairs, International Education, Bio-Security and Trade	Tourism growth initiative, bio-security 2025, Dubai expo, primary sector exports.
Science and Innovation	R&D growth grants, endeavour fund.
Labour Market and Tertiary Education	Tuition subsidy increases.
Justice Sector	Managing increasing prisoner and serious crime volumes. Justice pipeline cost pressures.
Defence	Defence White Paper.
Social Development	Cost pressures, social investment, critical IT systems, disability support.
Conservation, Primary Industries, Lands, Environment	Climate change, fisheries, regional irrigation support, battle for our birds.
Transport, Building and Housing	Housing infrastructure fund, three waters, urban development.
Maori Development	Maori land service programme.

Figure 9 – Budget 2017 Track 2 Initiatives - Capital



SECTOR	SIGNIFICANT COMPONENTS
Defence	Defence White Paper contingent capital funding
Transport, Building and Housing	Wellington metro upgrades, rail freight (KiwiRail), [33]
Education	Education school property programme.
Conservation, Primary Industries, Lands, Environment	Investment in irrigation schemes in certain regions [37]
Parliamentary Service, Internal Affairs, Finance, Arts, Culture and Heritage	Parliamentary accommodation strategy, preserving the nation's memory.
Social Development	Critical IT Systems.
Maori Development	Maori land service programme.
Foreign Affairs, International Education, Bio-Security and Trade	Tourism growth initiative, establishing NZ High Commissions in selected countries.

Potential implications of the Kaikōura earthquakes

38. Treasury's preliminary estimates from HYEFU of the fiscal impact of the earthquakes was around $2 to $3 billion as at 21 November. There remains a significant level of uncertainty around these estimates. The HYEFU also included an incremental net cost of $1 billion to fund earthquake response and recovery (e.g. after reprioritisation and insurance proceeds), although this did not represent a funding envelope.

39. In the wake of the 14 November earthquake, Ministers have approved funding for a number of proposals relating to response and recovery. There are likely to be both urgent funding proposals which will require consideration by Ministers, and proposals for Budget 2017 which relate to earthquake recovery and response.

Transport Implications

40. On Monday 5 December, Cabinet agreed to rebuild and improve State Highway 1 and the main trunk rail line along the current coastal route, with improvements for safety and resilience of the route, at an estimated cost in the range of $1.4 billion to $2.0 billion (CAB-16-MIN-0675 refers). The Crown contribution to the State Highway 1 reinstatement will be confirmed as part of the Budget 2017 process.

41. In order to continue with the required works for the SH1 reinstatement project, [38]

Earthquake Commission Implications

42. EQC can model the projected claims liabilities associated with a given earthquake scenario. The median projected modelled loss arising from the Kaikōura earthquake is $390 million, however this estimate is sensitive to changes in assumptions which could result in increased costs overtime. The Kaikōura event is expected to exhaust the Natural Disaster Fund (NDF). The Treasury have outlined options to fund the asset deficiency in T2016/2487.

Kaikōura Local Government and Infrastructure

43. The central government contribution towards restoring Kaikōura's core local infrastructure, including the 'three waters', remains uncertain. Initial Treasury estimates put the Crown contribution towards Kaikōura damage to core assets at $100 million, to be met from new funding. This figure will change once the actual damage on the ground is assessed and the cost sharing arrangement with Kaikōura District Council is agreed early next year.[2]

[2] The existing civil defence funding framework prescribes that central government funds all emergency restoration work, but then central and local government split the costs of permanent repairs 60/40 respectively. [25]

Emerging Earthquake Initiatives for Budget 2017

44. There do not appear to be many earthquake related initiatives received as part of the submissions made on 14 December. We expect to see some bids emerging, in particular cost pressures to cover possible increases in insurance premiums and potential new expenditure around Wellington resilience.

Next Steps

45. The Treasury has issued instructions to agencies based on an indicative Budget date of **Thursday 25 May 2017**. We propose to discuss this date with you ahead of a potential announcement at the Finance and Expenditure Committee on **8 February 2017**.

46. Based on this indicate Budget date, the following dates would be considered to achieve key decisions:

- Monday, 10 April – Cabinet considers the Technical Budget package.
- Monday, 24 April – Cabinet considers the Significant Budget package.

47. These would be supported by Budget Ministers' meetings on the following dates:

- Tuesday, 14 February – Budget Ministers' meeting #1.
- Tuesday, 21 March – Budget Ministers' meeting #2.
- Tuesday, 4 April – Budget Ministers' meeting #3.
- Tuesday, 11 April – Budget Ministers' meeting #4.

48. Other dates that the Treasury will manage to support Budget advice being provided to Ministers include:

- The BGA Expert Review process will occur on Wednesday, 25 January.
- The Capital Investment Panel will meet between 27 February – 3 March
- The Social Investment Panel will meet on Monday 27 – Tuesday 28 February.