The Treasury

Budget 2018 Information Release

Release Document August 2018

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[40]	not in scope	
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Treasury Report: Options for Baseline Re-prioritisation: Budget 2018 and beyond

Date:	10 November 2017	**Report No:**	T2017/2410
		File Number:	BM-2-1-2018

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Discuss** with Hon David Clark and officials. **Agree** to talk to officials about how you would like to proceed.	10.30 am, Monday 13 November
Associate Minister of Finance (Hon Dr David Clark)	**Discuss** with the Minister of Finance and officials.	10.30 am, Monday 13 November

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Robert Barton	Senior Analyst, Budget & Financial Design	[39] (wk)	N/A (mob)	✓
John Marney	Team Leader, Budget & Financial Design	[39] (wk)	N/A (mob)	

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

Please **ensure** Ministers see this report before their meeting with Treasury at 10.30 am on Monday**.**

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Options for Baseline Re-prioritisation: Budget 2018 and beyond

Executive Summary

The Government will face mounting spending pressures beyond Budget 2018. It has an opportunity in its early life to establish a process for freeing up lower priority spending to provide headroom for subsequent Budgets. While this will be difficult, it will become more challenging as Ministers become associated with existing spending and programmes. Our initial scan of the major spending sectors has shown that a ‘bottom up’ spending review is unlikely to generate significant savings, especially in the current fiscal climate. This report therefore outlines options for initiating baseline reviews with the objective of reprioritising spending towards the priorities of the new Government, and for ensuring that increased funding is spent on the intended improvements to outcomes.

Recommended Action

We recommend that you:

a. **note** the need to provide fiscal headroom for future budgets to address spending pressures beyond Budget 2018;

b. **note** this process will work best if Ministers and chief executives have a clear objective to achieve in identifying baseline spending available for reprioritisation;

c. **agree** to discuss this report and how you would like to proceed with Treasury officials.

Agree/disagree	*Agree/disagree*
Hon Grant Robertson	Hon David Clark

d. **note** that your approach to reprioritisation should be signalled in your paper to Cabinet on the Budget 2018 Strategy.

John Marney
Team Leader, Budget & Financial Design

Hon Grant Robertson
Minister of Finance

Hon David Clark
Associate Minister of Finance

Treasury Report: Options for Baseline Re-prioritisation: Budget 2018 and beyond

Purpose of Report

1. This report outlines options for the Government to review and re-prioritise existing baseline spending in order to:

    a. help manage the risks and pressures that exist for Budget 2018 and to provide some headroom beyond 2018;

    b. meet manifesto commitments outlined in your Fiscal Plan and party agreements, and ensure that the Government is only funding effective programmes aligned with its priorities; and

    c. remain consistent with your Budget Responsibility Rules.

2. We think there is a window of opportunity in the early life of this Government to reprioritise existing spending, including freeing up savings for new priorities and higher value policies, which will close as Ministers become more closely associated with existing spending and programmes. We also observe that setting an ambitious target upfront leaves room for softening subsequently, while toughening up an initial target is very difficult.

Context

3. Although your immediate attention is focussed on the 100 day plan and Budget 2018, it is useful to think about the medium term fiscal horizon over three years, with decisions made now affecting the headroom in years 2 and 3. While the 100 day plan and Fiscal Plan can be accommodated within the revised fiscal parameters for Budget 2018, the Government will still face significant spending pressures in 2018 and beyond. These arise from several sources and will require careful managing:

    a. Wage pressures are likely to increase resulting from public sector unions claiming “catch up” increases, possible gender equity claims, and from general labour market supply constraints;

    b. Wage bargaining will also be influenced by general inflationary pressures;

    c. Some current spending commitments are only partially funded;

    d. Demands for discretionary spending in budgets after 2018 are likely to rise;

    e. There are risks that manifesto baseline increases (e.g. Health and Education) do not deliver the sought service improvements as funding gets diverted into wages and other costs.

4. We understand that you have already alerted your Cabinet colleagues of the need to find fiscal headroom in Budget 2018 and beyond. It will therefore be important to maintain focus on budget discipline, value-for-money, re-prioritisation where possible, and on effective results. The aim should be to identify lower value spending which can be re-directed to higher value policies. It will require an analysis of the quality of both existing and potential spending. There are several established tools available, including cost benefit analysis, which are useful in identifying value for money and comparing the relative benefits of different policies.

5. Reprioritised funds can be identified from a number of sources:

   a. From the cancellation of programmes introduced by the former Government which the new Government wishes to discontinue;

   b. From policies and programmes which evidence shows are ineffective at achieving the intended objectives;

   c. From internal agency inefficiencies, including misallocation of funding to unnecessary activities poorly related to the policy objective.

Overall approach

6. Several approaches to baseline reprioritisation have been used in the past:

   a. *A centralised line-by-line review looking at what spending did not align with Government priorities*: This approach is time consuming with high transaction costs and in the past has not generated significant savings. A more effective measure has been to curtail future increases by reducing the spending allowances.

   b. *Departmental chief executives put forward their own savings options:* Results have been variable, but generally are unlikely to yield much. In the current climate, given the surplus environment we are currently in, it is challenging to create a narrative for this approach.

   c. *Rebalance spending across departments:* This approach would look at the spending levels across different sectors and identify areas where expenditure could be reduced by applying a top-down adjustment.

   d. *Apply a X% haircut to baselines (with some sectors exempted):* This is another form of top-down adjustment, and can be an effective option. Key practical questions include the size of haircut and which sectors it applies to. It can create anomalies, but has the merit of readily achieving the Government's fiscal goal, at least in the immediate term, provided savings can actually be extracted.

7. We have undertaken an initial scan of major sector Votes and identified some possible opportunities for reprioritisation (see following section). Departmental chief executives and Ministers will be better placed to undertake bottom-up analysis of their own baselines to identify specific savings options. We think however a bottom-up approach is unlikely to yield significant reprioritisation on its own, particularly in the current circumstances (forecast surpluses and significant new spending already announced).

Sectoral Scan

8. As noted above, Treasury officials have undertaken an initial scan across the major sectoral Votes. The overall conclusion we have drawn from this sector scan is that, absent difficult choices around changing policy settings, there are only modest specific savings available for reprioritisation. (It is difficult to quantify these, but they are likely to be less than $250 million per year).

9. Health. Although Vote Health will receive significant increases in its operating funding under this Government, this will be against a background of rising volumes and other cost pressures which are not currently reflected in baselines. Unless there is a continued drive for a more cost-effective system, there is a risk that the new funding will simply be absorbed without delivering improved health outcomes. There is scope to improve the configuration of services and the targeting of resources to high-need populations, although demand for new health technology and interventions is probably unlimited.

10. In delivering on the Government's commitments to increase health funding, new and existing interventions should be carefully evaluated in terms of affordability and value for money. We recommend therefore that you request detailed advice from the Minister of Health about sector cost pressures, to justify funding allocated to these from within the signalled funding track. This will help to ensure that as much new funding as possible is dedicated to new or improved services. (Indeed, we have already suggested establishing a health working group to take a deeper look at health system issues and achieve greater gains from health funding increases).

11. Education. Spending in Vote Education is dominated by three key policy settings: ECE subsidies, schools operational funding, and teacher salaries. Our initial assessment of the Labour Manifesto, as well as agreements with NZ First and the Green Party, does not immediately identify areas where savings will be realised. This includes policies on Partnership Schools, where costs will be attached to exiting this policy. The Ministry of Education is currently undertaking an expenditure review across the vote, following the formation of the new Government, and they have identified some small potential savings. However, we would not expect significant savings as spending in Vote Education is largely driven by the interaction of the number of students and funding formulae (e.g. teacher:learner ratios).

12. There is scope for freeing up some general savings from reviewing the policy settings underpinning these funding formulae, as well as scope to consider whether operating and capital savings could be generated through enhancing efficiency in the school property network. However, further work is needed to identify the scale of potential savings and it would take time to realise them. They would also involve trade-offs and require considerable engagement with the sector. As for Health, we think there is merit in continuing to scrutinise cost pressure bids from this sector, despite headline funding growth having been already signalled in your fiscal plan.

13. Social Development. There will be some minor savings available from within the Ministry of Social Development from policy changes and potentially from changes to its security arrangements for its Work and Income premises. To achieve meaningful reprioritisation however will require a review of major welfare and benefit policy settings.

14. Justice. Savings within the justice sector will be very difficult to achieve in the context of the currently increasing prison population. The Department of Corrections currently faces an imminent prison capacity shortfall that could require investment of up to [37] million in capital over the forecast period, with significant associated operating expenditure. Changes that arrest or reduce the growth in the prison population could mitigate some of the cost pressures the sector is facing, but are unlikely to be immediately translatable into savings, particularly over the short term. However, we think this is a promising area for policy reform with potential fiscal savings in the form of avoided costs over the medium to long term.

15. While the justice sector in general is unlikely to be a source of savings in the short term, particular pockets of funding could be reprioritised. In particular, the Justice Sector Fund could be an opportunity for savings. The Justice Sector Fund is a notional fund comprised of the annual underspends from the sector's agencies. The fund was originally set up to help agencies live within baselines, but over time has evolved into a source for pilots and short-term initiatives and now excludes cost pressure bids. There is now scope to reallocate this fund (currently approximately $23 million over three years).

16. Defence. The funding track for the 2016 Defence White Paper ($20 billion in capital and $130 million average annual operating increases to 2030) is indicative only and remains to be confirmed and appropriated via successive business cases and budgets.

17. The Labour-New Zealand First coalition agreement has indicated a review of Defence procurement and there may be some savings to be realised from this. However, significant savings are most likely only to come from a revisiting of the White Paper, and are more likely to be in the form of lower future spending growth rather than actual cuts. If Ministers want to review the total amount of defence funding, they could consider in the first instance revisiting the options for Defence Force structure and capability presented in the 2013 Defence Midpoint Rebalancing Review, which underpins the White Paper. However, any substantial changes to the current indicative funding track and capability profile may require Ministers to scale back the level of ambition and/or timing for New Zealand defence policy and could mean that the NZDF would contribute progressively less to New Zealand's goals abroad.

18. Economic Development. There is some scope for reprioritisation as a consequence of changes in policy direction. For instance, the current $8.5 million for Regional Growth Initiatives could be rolled into the new Government's Provincial Growth Fund, and the $952 million over five years for research and development should be scaled back with the introduction of the Government's intended tax concessions (although this may ultimately end up being no better than fiscally neutral). There are grant schemes which could be reviewed with potential savings in excess of $100 million (eg. there is limited evidence of net economic benefits to New Zealand from the NZ Screen Production Grant fund of $80 million per year).

Comment

19. From the above scan, the following key themes can be discerned:

    a. In the welfare and justice sectors, significant reprioritisation will require changes to policy settings and programmes;

    b. For defence, the choices relate to the scale of purchases and their phasing of the capital;

    c. In the education sector, reprioritisation relates to the alignment of programmes to those of the new Government;

    d. In the health sector, ensuring that there are the intended gains from health funding increases will require particular scrutiny.

20. This section outlines three broad options for approaching baseline reprioritisation. None avoid difficult choices, and none can guarantee achieving the desired level of freed up spending. However, setting an ambitious target upfront leaves room for softening subsequently, while toughening up an initial target is very difficult. Under any option, a key objective would be to create additional headroom within the allowances, increasing your spending options in future Budgets. To that end, we do not recommend making commitments at this stage to reward individual sectors or Ministers for offering up savings as part of this process.

21. We have attached as annexes tables showing the increases (nominal and real) in the various sectors' baselines over the past decade, and which in part shows the limits to fixed nominal baselines.

Option 1

22. The first option is to target, for example, a 2% reduction to most baselines, with possibly the smaller Votes, together with Health and Education, being excluded. It is clear from past experience that baseline reviews work best when there are clear objectives set by Ministers (including a broad fiscal target for reprioritised funding) and that chief executives respond best when their own Ministers are supportive.

23. Given that you have already signalled spending growth tracks for Health and Education in your Fiscal Plan, you may prefer not to apply a 2% savings target to these Votes. In place of this, we would recommend that you require the Ministers of Health and Education to provide a detailed breakdown of marginal spending growth between new initiatives and cost pressures, supported by analysis of cost drivers. This will help maintain budget disciplines in these sectors, and maximise the scope for new initiatives within these sectors, without compromising your manifesto commitments.

24. Even for agencies within scope, some aspects of the baseline would not be suitable for a targeted reduction. This includes technical accounting items, appropriations authorised by permanent legislative authority, and appropriations covered by cost-recovery arrangements. If you were attracted to this option, we would need to undertake further work to identify which parts of individual baselines it should be applied to, in consultation with agencies. A 2% reduction[1] applied to all operating baselines except Education and Health would likely raise less than $500 million per year; we would need to undertake more detailed analysis to identify a more precise figure.

Option 2

25. The second option is to adopt a more targeted approach. While it focuses on aligning funding to the new Government's policy priorities, in some respects it is not that different to the fiscal management techniques which have been in force for several years.

    a. Individual Ministers would request their departments to provide line-by-line reviews of their spending, and work with their chief executives in identifying low(er) priority spending. In particular, they should realign baseline spending with the new Government's priorities within existing sectors. While this may help to refocus spending within existing baselines, it is unlikely to return meaningful savings to Finance Ministers. It will however help give your Ministerial colleagues

[1] Applied to departmental and some non-departmental spending, excluding transfer payments.

ownership of the responsibility of examining the quality of spending in their portfolios.

b. In addition, those agencies making cost pressures bids would be required in the first instance to identify reprioritisation options which could help fund the bids, including changes to policy settings. In principle, under fixed nominal baselines, this should happen already, but in practice it has often been difficult to engage agencies in substantive discussions about realistic trade-offs. To give the process more bite, we would therefore recommend relevant chief executives to report either to Finance Ministers or Cabinet committee, and specifically to consider changes to policy settings. Raising the discussion to this level may add greater focus to those reviews and the policy choices available to Ministers.

Option 3

26. Finally, Ministers could consider the balance of spending between sectors it has identified as priorities for increased investment and those sectors on which it has to date been silent – with targets for baseline reductions in some areas. Some rebalancing might be possible in Budget 2018 (or at least signalled) and Ministers could commission a review of the overall spending balance between sectors, with a view that over time (this may take two to three years) the emphasis of spending might be rebalanced between the sectors. One advantage of this approach is that it could take a sectoral, rather than an agency, focus but retain the discipline of overall spending targets for some sectors.

27. This option incorporates many of the elements of the previous options but develops them further by taking a higher level top down approach. As it is unlikely to deliver many gains in the short term, it will require ongoing pressure on agencies and their Ministers to continue reviewing the alignment of programmes well into 2018/19.

Process and timing

28. Under all options, thought will need to be given to how Finance Ministers would like to oversee and manage the process.

29. As mentioned earlier, the future spending pressures you will be facing will accumulate over time, meaning you will be looking for some headroom in time for Budgets 2019 and 2020. If you require savings to baselines in Budget 2018, option 1 is the most likely option to achieve that. Otherwise, if you are prepared to wait for savings and reprioritisation to occur over the course of more than one Budget, then any of the options could be adopted.

30. All options will need close Ministerial and official involvement if they are to succeed in generating significant reprioritisation. In the current absence of an expenditure Cabinet committee, you may therefore want to consider establishing a special Ministerial committee, chaired by either the Minister of Finance or the Prime Minister, and including key Finance and senior Ministers. This could be advised by an officials committee, consisting of senior central agency officials plus possibly a deputy chief executive or two, and supported by the Treasury.

Other areas for reform

31. As all the options are essentially top down approaches, they are likely to elicit a degree of resistance from agencies. A particular disadvantage of a targeted baseline reduction is that agencies retreat into themselves, taking a solely agency-centric view to the detriment of the sector-wide interest. There is also a risk that agencies deprioritise discretionary spending, even if it is effective, in order to meet fixed costs and absorb increased cost pressures.

32. Existing Budget processes – particularly fixed nominal baselines and annual allowances – have been effective at controlling spending growth during the aftermath of the global financial crisis. Maintaining fiscal discipline in a surplus and low-debt environment may be more difficult. There may also be opportunities for other improvements in the Budget process, to facilitate cross-agency collaboration and encourage a long-term focus while maintaining fiscal discipline, amongst other things. We are undertaking some work looking at options to redesign the Budget process over the medium term, which will involve taking a broader view of how systems encourage efficient delivery of successful outcomes. This work is still at an early stage.

Next Steps

33. We recommend signalling your preferred approach to reprioritisation and savings in your Budget Strategy paper for Cabinet. We can provide you with detailed advice on process and baselines subsequent to that, depending which approach you prefer.

34. We recommend you discuss this report and how you would like to proceed with Treasury officials at your earliest convenience. In particular, we would like your steer on the following questions:

    a. Timing: Is your focus primarily on finding savings as part of Budget 18, or are you prepared to wait for savings to emerge over a longer time frame?

    b. Are you comfortable with setting a target for savings? Would 2% be too soft or too tough?

    c. Which sectors do you see as candidates for rebalancing spending between?

    d. How do you want to manage those sectors getting increases (to ensure that funding is spent on the Government's priorities)?

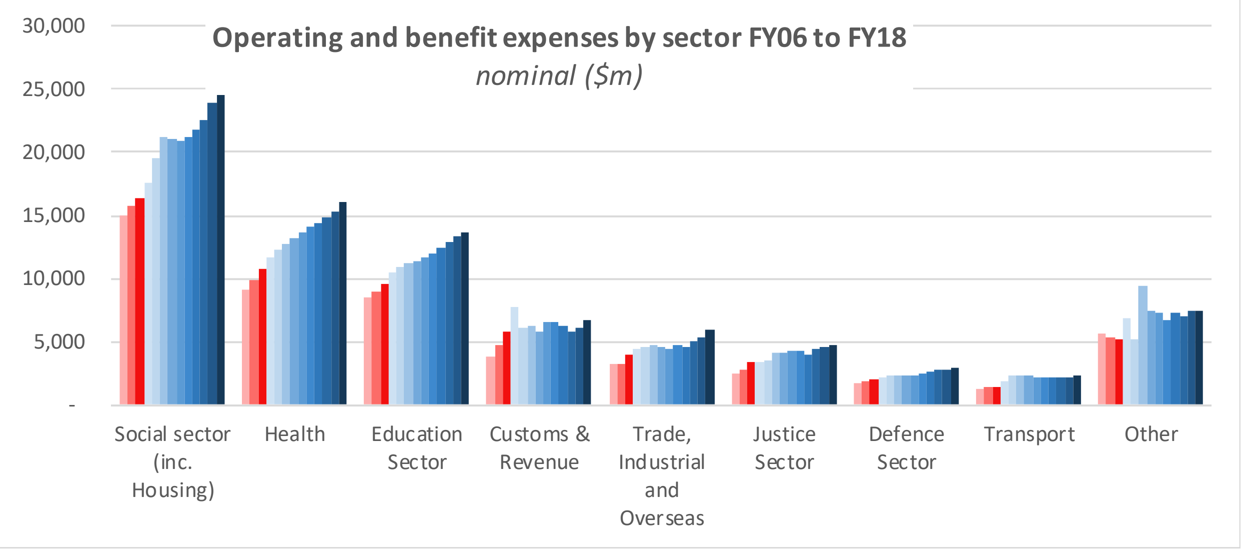
    e. How do you want to involve your Ministerial colleagues?

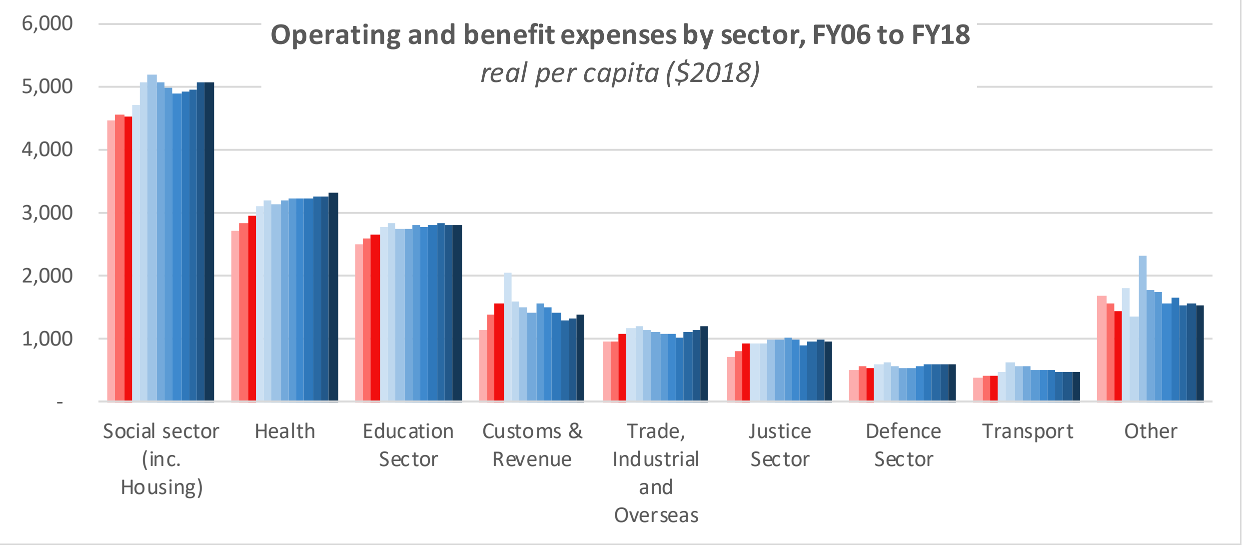
ANNEX: HISTORICAL VOTE INFORMATION (EXCLUDES CAPITAL)

Operating and benefit expenses by sector (departmental and non-departmental operating, output and borrowing expenses, benefits and related expenses)

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	AAGR
Nominal ($m)														**2006-18**
Social sector (inc. Housing)	15,073	15,809	16,413	17,611	19,513	21,216	21,028	20,904	21,230	21,814	22,580	23,908	24,715	4.3%
Health	9,100	9,858	10,772	11,621	12,348	12,797	13,252	13,607	14,050	14,345	14,793	15,363	16,109	4.9%
Education Sector	8,440	8,944	9,591	10,423	10,941	11,182	11,389	11,737	11,987	12,430	12,916	13,282	13,599	4.1%
Customs & Revenue	3,865	4,739	5,724	7,682	6,098	6,185	5,834	6,554	6,500	6,208	5,810	6,167	6,708	5.7%
Trade, Industrial and Overseas	3,227	3,276	3,939	4,390	4,576	4,699	4,554	4,502	4,696	4,586	4,984	5,360	5,897	5.3%
Justice Sector	2,460	2,769	3,405	3,428	3,543	4,061	4,079	4,273	4,329	3,930	4,386	4,608	4,708	5.9%
Defence Sector	1,727	1,907	1,962	2,194	2,355	2,315	2,255	2,311	2,500	2,594	2,737	2,814	2,933	4.6%
Transport	1,267	1,422	1,470	1,805	2,379	2,270	2,300	2,119	2,214	2,222	2,116	2,184	2,257	5.5%
Other	5,713	5,378	5,238	6,798	5,194	9,476	7,412	7,311	6,738	7,278	6,952	7,393	7,403	4.9%
Per capita, real terms ($2018)														
Social sector (inc. Housing)	4,474	4,557	4,510	4,703	5,069	5,195	5,073	4,970	4,893	4,913	4,959	5,064	5,081	1.1%
Health	2,701	2,842	2,960	3,103	3,208	3,133	3,197	3,235	3,238	3,231	3,249	3,254	3,311	1.7%
Education Sector	2,505	2,578	2,636	2,783	2,842	2,738	2,747	2,790	2,763	2,799	2,837	2,813	2,795	0.9%
Customs & Revenue	1,147	1,366	1,573	2,051	1,584	1,514	1,407	1,558	1,498	1,398	1,276	1,306	1,379	2.5%
Trade, Industrial and Overseas	958	944	1,083	1,172	1,189	1,151	1,099	1,070	1,082	1,033	1,095	1,135	1,212	2.1%
Justice Sector	730	798	936	915	920	994	984	1,016	998	885	963	976	968	2.6%
Defence Sector	512	550	539	586	612	567	544	549	576	584	601	596	603	1.5%
Transport	376	410	404	482	618	556	555	504	510	500	465	463	464	2.3%
Other	1,696	1,550	1,439	1,815	1,349	2,320	1,788	1,738	1,553	1,639	1,527	1,566	1,522	1.6%

Notes. Votes have been grouped for ease of presentation and because the Vote structure has changed over time. Social Sector is mainly Social Development, MVCOT and Housing, but also includes a range of smaller Votes. Education Sector includes the Tertiary sector and ERO, as well as Vote Education. Justice Sector includes Corrections, Justice, Courts, Police, and some others. Trade, Industrial and Overseas includes Business, Science and Innovation, Labour Market, Primary Industries, Foreign Affairs and Trade and Development Assistance.


Operating and benefit expenses by sector FY06 to FY18
nominal ($m)
30,000
25,000
20,000
15,000
10,000
5,000
-
Social sector (inc. Housing)
Health
Education Sector
Customs & Revenue
Trade, Industrial and Overseas
Justice Sector
Defence Sector
Transport
Other


Operating and benefit expenses by sector, FY06 to FY18
real per capita ($2018)
6,000
5,000
4,000
3,000
2,000
1,000
-
Social sector (inc. Housing)
Health
Education Sector
Customs & Revenue
Trade, Industrial and Overseas
Justice Sector
Defence Sector
Transport
Other