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August 2022

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[41] 18(c)(i) - that the making available of the information requested would be contrary to the provisions of a specified enactment

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TE TAI ŌHANGA
THE TREASURY

DEPARTMENT OF THE PRIME MINISTER AND CABINET
TE TARI O TE PIRIMIA ME TE KOMITI MATUA

MINISTRY OF HEALTH
MANATŪ HAUORA

Joint Report: Health Reform – A Multi-Year Approach to Health Funding

Date:	30 July 2021	**Treasury Report No:**	T2021/1579
		Health Report No:	HR20211656
		DPMC Report No:	DPMC-2021/22-40
		Treasury File Number:	SH-1-6-14

Action sought

	Action sought	**Deadline**
Minister of Finance (Hon Grant Robertson) Minister of Health (Hon Andrew Little)	**Agree** to the recommendations in this report. **Refer** this report to the Prime Minister and the Associate Ministers of Health (Hon Peeni Henare, Hon Dr Ayesha Verrall, Hon Aupito William Sio)	Ahead of a joint Ministers meeting to discuss these proposals the Joint Ministers meeting on 9 August 2021.

Contact for telephone discussion

Name	**Position**	**Telephone**		**1st Contact**
Niki Lomax	Senior Analyst, Health and ACC, Treasury	[39]	[35]	✓
Jess Hewat	Manager, Health and ACC, The Treasury			
Stephen McKernan	Director, Health Transition Unit, DPMC	-	[23]	
Dr Ashley Bloomfield	Director-General of Health Ministry of Health	-		

Minister's Office actions

Return the signed report to Treasury.

Refer a copy of this report to the Prime Minister and the Associate Ministers of Health (Hon Peeni Henare, Hon Dr Ayesha Verrall, and Hon Aupito William Sio)

Note any feedback on the quality of the report

Enclosure: Annex: Options for implementing a multi-year approach to health funding

Joint Report: Health Reform – A Multi-Year Approach to Health Funding

Executive Summary

A fundamental reset of budget management settings for the health sector is recommended to better manage spending growth sustainably while at the same time ensuring consistency, quality, and equity in health outcomes. The current fiscal management settings for health – fixed nominal baselines with new funding allocated through the annual Budget process – have proven ineffective at controlling expenditure growth and addressing the affordability challenge in health.

Affordability and financial sustainability can better be achieved if the health system is provided with a medium-term funding commitment that decision-makers can fairly be expected to plan to and manage within. This will also support better strategic planning and investment to achieve the ambitions of reform, such as shifts in models of care and improved equity. This means moving away from fixed nominal baselines and the current annual Budget process and instead agreeing up front, and reflecting in the Government's fiscal strategy, a multi-year funding path for Vote Health.

We recommend implementing this new multi-year funding arrangement from Budget 2024 in order to allow time for broader system settings designed to support better planning and financial control to be embedded in the new system. This includes appropriate governance and accountability arrangements, internal Health New Zealand delegations and controls, strengthened performance analytics and monitoring functions, clinical engagement with planning processes, a clear plan for managing the health workforce including an employment relations strategy, and the completion of the first full New Zealand Health Plan (NZHP).

The **multi-year funding arrangement at Budget 2024** would comprise:

a a **three-year funding commitment** that provides a credible and strongly enforced upper limit on health spending covering all cost pressures and new investments in health over a three-year period; and

b a **medium-term funding track** from year four onwards to support health sector planning, and to shape investment prioritisation decisions whose impacts fall beyond the three-year funding commitment.

This approach would mean that there would be one health budget every three years. This will change the role of Cabinet and Ministers in the Budget process – limiting the opportunity for taking decisions on health funding to once during the parliamentary term. Slowing down the Budget cycle and shifting focus away from incremental marginal investments would increase the capacity of officials to focus analytical effort on tackling significant issues and cost drivers in the health system.

Core to this proposal is the three-year funding commitment being treated as a hard upper limit. The internal controls and incentives in the system (in particular the approach to employment relations) must be designed to support Ministers to hold the line of each three-year funding commitment. There should be a very high bar for adjustments or addendums, with exceptions reserved for genuinely unforeseeable one-off shocks such as a disease outbreak or a Whakaari/White Island type event.

The proposed future settings for the health system are well aligned with the Public Finance System Modernisation (PFSM) reform proposals which also recommend a shift towards multi-year planning and funding cycles. The key difference with these proposals is the inclusion of an ongoing medium-term funding track for health beyond the three-year funding commitment period.

The ongoing medium term funding track is needed to enable the health sector to undertake meaningful medium-term planning and make strategic investments that take time to deliver savings. An agreed funding track that credibly supports forward-planning and reflects the reality of health sector cost pressures is critical for Ministers to legitimately hold Health New Zealand accountable for keeping to its budget.

To support the sector through the forthcoming transition period we propose a transitional funding package at Budget 2022 that: rebases the sector on Day One with no deficits and enough funding to stay deficit-free through the reform period; provides enough medium-term certainty for Health New Zealand and the Māori Health Authority to work with the sector on a credible first full NZHP; and is sufficiently flexible to allow for the realities of a complex transition process.

We recommend that the transitional funding package at Budget 2022 should rebase the health system, providing two Budget's worth of funding upfront for cost pressures and any new initiatives, with an expectation that no additional funding should be sought at Budget 2023. This will require a substantial uplift in health spending and is likely to consume the majority of current operating allowances over the forecast period. Ministers will have choices about how to manage and communicate these near-term costs, but limited ability to reduce them.

We recommend that Ministers should factor health reform costs in setting their Budget 2022 strategy and the setting of allowances across the forecast period.

Ministers will receive further advice over coming months from the Treasury, the Ministry of Health and the Transition Unit with further detail on elements of these proposals and the broader funding settings.

Recommended Action

We recommend that you:

a **note** that in April 2021 Cabinet agreed to establish a funding framework for health that provides greater budget certainty for the health system and the Crown, and directed officials to provide further advice on funding and fiscal management settings for health ahead of Budget 2022, including options for a multi-year settlement (CAB-21-MIN-0092 refers)

b **note** that Cabinet have agreed that the core components of a new accountability framework for health will be a Government Policy Statement (GPS) that sets requirements and expectations for the health system over a multi-year period, and a New Zealand Health Plan (NZHP) that responds to the strategic priorities in the GPS and provides a detailed health service plan (SWC-21-MIN-0107 refers)

Multi-year funding arrangement from Budget 2024

c **agree** to establish a multi-year funding arrangement for Vote Health from Budget 2024 (at the earliest), to align with the delivery of the first full NZHP

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

d **agree** that the multi-year funding arrangement will comprise:

i. a three-year funding commitment that provides a credible and strongly enforced upper limit on health spending covering all cost pressures and new investments in health over a three-year period.

ii. a medium-term funding track from year four onwards to support health sector planning and drive investment prioritisation decisions with impacts beyond the three-year funding commitment.

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

e **agree** that the first multi-year funding arrangement should only be implemented once Ministers have confidence that adequate system settings to support improved planning and financial control will be in place (including, but not limited to, the first full NZHP and accompanying employment relations and workforce strategy)

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

f **agree** that the GPS should set the funding parameters within which the NZHP will be delivered

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

g **agree** that the multi-year funding arrangement should apply to all the health sector entities covered by the NZHP, with an option to extend the arrangement to all of Vote Health including the Ministry of Health (to be agreed ahead of Budget 2024)

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

h **agree** that the funding track will be the basis on which each future NZHP is developed and will in due course be confirmed as the new three-year funding commitment for the health sector unless a strong case can be made for further investment

Agree/disagree	*Agree/disagree*
Minister of Finance	**Minister of Health**

i **note** that that the approach set out above is consistent with the direction of the Public Finance System Modernisation (PFSM) reforms, which also proposes multi-year planning and funding, with the key difference being the ongoing medium-term funding track

Transitional funding package at Budget 2022

j **agree** to provide a transitional funding package at Budget 2022 that supports the health sector through to Budget 2024, providing funding certainty for the health sector for a two-year period

Agree/disagree **Minister of Finance**	*Agree/disagree* **Minister of Health**

k **agree** that the health system should be provided with sufficient medium-term funding certainty at Budget 2022 for the sector to start work on the first full NZHP

Agree/disagree **Minister of Finance**	*Agree/disagree* **Minister of Health**

l **agree** that at establishment, Health New Zealand should be provided with funding sufficient to meet its expected costs and should not be forecasting a deficit position on Day One

Agree/disagree **Minister of Finance**	*Agree/disagree* **Minister of Health**

m **note** that this will require a significant uplift in ongoing operating funding to rebase the health system in Budget 2022, and that there may be material, unexpected costs that emerge through the transition period

n **note** that the health system rebase will need to be carefully communicated to the sector and you will receive further advice on this and any requirements and expectations that will be provided to the Heath New Zealand Board alongside this funding

o **note** that health cost pressures and the cost of reform will require significant investment and this should be explicitly factored in to the Government's fiscal strategy

p **agree** that officials should prepare a Cabinet paper based on the recommendations in this report

Agree/disagree **Minister of Finance**	*Agree/disagree* **Minister of Health**

q **note** that you will receive further advice on the issues set out in this report, including:

i. detailed advice on likely costs for a Budget 2022 transitional funding package (in September)

ii. further advice on the health system rebase, including quantum, an approach to communication and any conditions or requirements that should be provided alongside the funding (alongside the advice on a Budget 2022 transitional package)

iii. advice on capital funding settings, including options for providing a longer-term funding track for capital (in September)

iv. advice on a formula to underpin the ongoing operating funding track, including an approach to providing an indicative funding signal at Budget 2022 (in early 2022), and

v. advice on the internal budget management rules to support the sector to manage within the funding commitment (in advance of Budget 2024).

r **refer** this briefing to the Prime Minister and Associate Ministers of Health (Hon Peeni Henare, Hon Dr Ayesha Verrall, and Hon Aupito William Sio).

Refer/not referred.
Minister of Finance

Jess Hewat
Manager
Health and ACC
The Treasury

Stephen McKernan
Director
Transition Unit
Department of the Prime Minister and Cabinet

Dr Ashley Bloomfield
Director-General of Health
Ministry of Health

Hon Grant Robertson
Minister of Finance

Hon Andrew Little
Minister of Health

Joint Report: Health Reform – A Multi-Year Approach to Health Funding

Purpose of report

1. This report, prepared jointly by the Treasury, the Ministry of Health and the Health Transition Unit at the Department of the Prime Minister and Cabinet (DPMC), seeks your agreement to a set of proposals for reforming the fiscal management settings for Vote Health. These proposals have been designed to support the ambitions of reform (improved strategic planning and financial sustainability) and to address the affordability challenges in health.

2. Specifically we seek your agreement to:

   a a **multi-year funding approach** to be implemented from Budget 2024, and

   b a **transitional funding package** to be implemented at Budget 2022.

3. This paper should be read alongside a forthcoming paper from the Health Transition Unit on funding settings for the health sector entities (DPMC-2021/22-45). We recommend that these two papers form the basis of a paper from joint Ministers to Cabinet in September that seeks agreement to the overarching funding frameworks for a reformed health system.

4. The proposals below relate predominately to operating funding for health, with an expectation that capital and operating settings should align as much as possible. You will receive further advice in September on capital investment system settings for the health sector, which we recommend should form the basis of a subsequent Cabinet paper in October.

Background

5. In April 2021 Cabinet agreed to establish a funding framework for health that provides greater budget certainty for the health system and the Crown. Cabinet directed officials to provide further advice on funding and fiscal management settings for health ahead of Budget 2022, including options for a multi-year settlement (CAB-21-MIN-0092 refers).

6. This was in response to the Health and Disability System Review (HDSR) that identified the lack of predictability in baseline funding for health as an inhibitor to effective long-term planning.

7. Greater budget certainty through a multi-year funding approach will support a proposed multi-year accountability framework for the health system. Cabinet has agreed the core components of this framework (SWC-21-MIN-0107 refers):

   a A Government Policy Statement (GPS) that sets requirements and expectations for the health system over a multi-year period. The GPS will be issued by the Minister of Health and specify national priorities for outcomes and services, which will set the basis for monitoring and reporting on progress. Subject to decisions on a multi-year funding approach, it is envisaged that the GPS will also confirm the total funding available for the system over the same timeframe.

b A New Zealand Health Plan (NZHP) that responds to and translates the strategic direction, priorities, outcomes and policy requirements in the GPS into concrete, funded plans for health services and health system capacity. The NZHP will be jointly produced by Health New Zealand and the Māori Health Authority and signed off by the Minister of Health. The NZHP will cover the full publicly-funded health system and include all health Crown Entities (e.g. PHARMAC, New Zealand Blood and Organ Service, Health Quality and Safety Commission) and other public sector health organisations to align all entities in a common direction and integrate delivery.

8. It is envisaged that the two documents will be refined in parallel so that they reflect shared priorities and requirements and align with the same budget process.

Current settings and the case for change

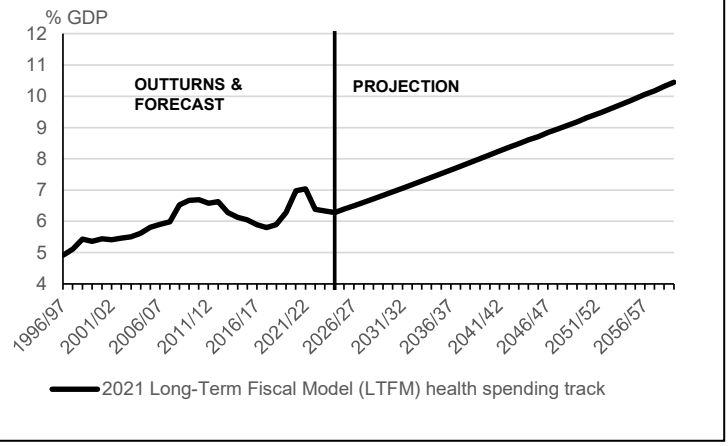
9. The shift to multi-year planning is an opportunity to redesign budget management settings to better align planning and funding cycles, improve financial sustainability, control, and transparency in the health system.

The health system poses a significant affordability challenge for the Crown.

10. The Treasury's long-term fiscal model projects New Zealand's health spending based on historical trends to reach 10.5% of GDP by 2060, consistent with international experience.

11. Even in a reformed system, health spending will continue to increase given the underlying drivers of expenditure (demographic change, income effect, labour costs, technological change, and socioeconomic drivers). The key fiscal challenge in health is how to manage spending growth sustainably while at the same time ensuring consistency, quality, and equity in health outcomes.

Chart 1: 2021 Long term fiscal model – health expenditure track (Core Crown health expenditure to GDP)



Budget allowances have proven ineffective at controlling expenditure growth in health.

12. Vote Health currently has a fixed nominal baseline with no automatic adjustments for inflationary, demographic or demand pressures.[1] Increases for District Health Boards (DHBs) and Ministry-managed health services are sought via the annual Budget process to fund cost pressures and provide for any new services or investments. All requests for new funding are prioritised and traded off against spending requests from other portfolios and funded from the operating and capital allowances.

13. In theory the allowance framework and fixed nominal baselines enable the Crown to control cost growth by applying a high degree of scrutiny to all funding increases. In practice these levers have proved ineffective at containing costs in the health sector. By the time Budget decisions are taken most costs for the following financial year are already fixed and it is challenging for DHBs to change course or generate savings. Limiting new funding provided to the health system (in order to help manage overall pressures on allowances) is not in itself sufficient to limit health system spending, unless accompanied by policy choices that meaningfully constrain costs.

14. The allowance framework is intended to optimise decision-making across all government spending through the annual Budget process. However, this process is undermined in health by the practice of providing DHBs with cash injections to manage their deficit position and ensure they can continue to meet basic operational costs. [34]

    This process has created regional inequities by undermining the Population-Based Funding Formula (PBFF).

Late Budget decisions and year-to-year variances impede strategic planning processes in DHBs.

15. DHB Annual Plans were intended as a critical tool for holding Boards to account for their performance, but in practice they have not been credible funding plans or effective accountability levers. While Vote Health reliably receives additional funding at every Budget, key decision-makers and planners in the system usually do not know the size of the increase for the forthcoming financial year until about six weeks before the year begins. In these six weeks DHBs are expected to revise and agree their Annual Plans with the Minister of Health for the forthcoming year.

16. This misalignment of funding and planning cycles, and unpredictability of future funding, means that it has become normal practice for Annual Plans not to be submitted or signed off until part-way through the financial year, if at all. This undermines the Ministry's ability to act as effective system monitor.

17. The timing and short horizon of funding decisions also leads decision-makers to focus on marginal savings initiatives and quick wins rather than structural issues (such as models of care) that require an 'invest to save' approach over multiple years. DHBs can generally assume that they will receive a similar amount of funding uplift to the year prior, but invest to save programmes are often funded from the marginal annual increases DHBs receive – which is the area of greatest budget uncertainty.

[1] Under the current fiscal management approach automatic adjusters are only applied to areas of government spending that are deemed to be legislative entitlements or obligations – such as welfare benefits, New Zealand Superannuation, and some spending in Vote Education and Vote Labour Market (ACC).

A multi-year approach from Budget 2024

We recommend a fundamental reset of budget management settings for the health sector, with a medium-term funding track at the heart of the new system.

18. We think affordability can better be achieved if the health system is provided with a medium-term funding commitment that decision-makers can fairly be expected to plan to and manage within. We think this will also support better strategic planning and investment to achieve the ambitions of reform, such as shifts in models of care and improved equity.

19. This means shifting away from fixed nominal baselines and the current annual Budget process and instead agreeing up front, and reflecting in the Government's fiscal strategy, a multi-year funding path for Vote Health.

20. This **multi-year funding arrangement** would comprise:

    a **a three-year funding commitment** that provides a credible and strongly enforced upper limit on health spending covering all cost pressures and new investments in health over a three-year period; and

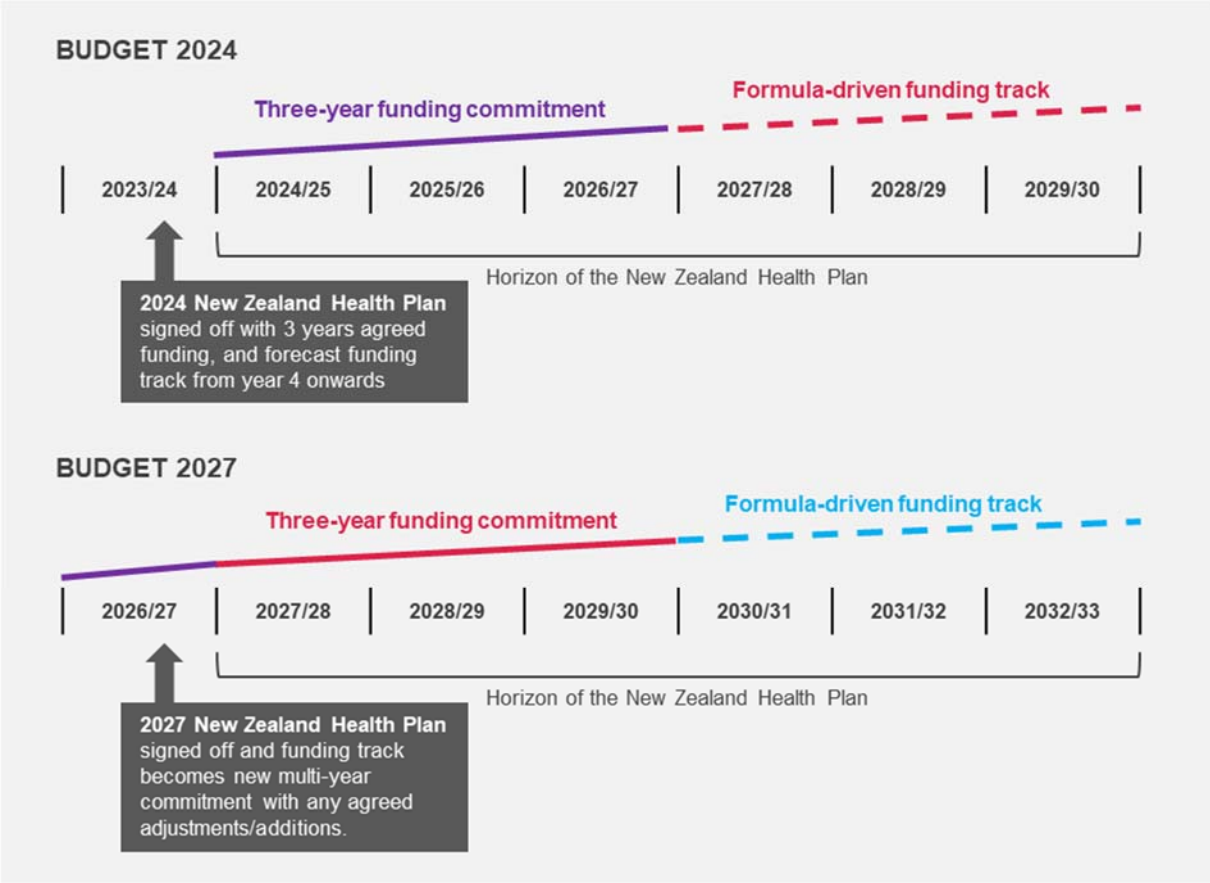
    b **a medium-term funding track** from year four onwards to support health sector planning, and to shape investment prioritisation decisions whose impacts fall beyond the three-year funding commitment.

21. This approach should be nested within broader system settings designed to support better planning and financial control. This includes appropriate governance and accountability arrangements, internal Health New Zealand delegations and controls, strengthened performance analytics and monitoring functions, clinical engagement with planning processes, a clear plan for managing the health workforce including an employment relations strategy, and the completion of the first full NZHP.

22. You have received advice about proposed governance and accountability arrangements via a recent Cabinet paper on legislative arrangements [SWC-21-MIN-0107 refers]. Further advice is coming to you on the initial options and proposals for legislating intervention powers and monitoring arrangements for the new entities.

23. We recommend that the multi-year funding approach should be contingent on all these settings being in place, which we expect at the earliest would be Budget 2024. Ministers would have an option to delay implementation (e.g. to Budget 2025) if these prerequisites were not in place. Ensuring these prerequisites are in place will support an improved planning culture in the sector and provide necessary assurance that a three-year funding commitment could be adhered to.

The figure below illustrates how this would work in practice.



24. The first three-year funding commitment would be agreed at Budget 2024 alongside the first full NZHP and would apply to the years 2024/25 to 2026/27. In part, the function of the NZHP would be to act as a detailed spending plan for these three years, and outline indicative spending for the following three years based on the formula-driven funding track.

25. During the first three-year period, work would begin on the 2027 NZHP, using the formula-driven funding track from 2027/28 onwards as the basis for planning. If Health New Zealand and the Māori Health Authority considered that additional funding above the funding track was required to meet health system cost pressures and deliver the Government's priorities, they could submit initiatives for consideration through Budget 2027. At Budget 2027 Cabinet would agree the funding commitment for the next three years based on the existing funding track plus any agreed adjustments to the next three-year funding commitment.

26. While in theory Ministers could agree a new multi-year funding commitment that was lower than the indicative funding track, in practice we expect that the track will become a minimum funding path from which the next multi-year funding commitment and NZHP will be negotiated. The track will need to be conservative enough to retain investment choices for Ministers, but sufficiently credible to allow sector to run an effective planning process.

27. **This approach means that, in effect, there would be one health budget every three years.** Most funding would continue to be appropriated by Parliament on an annual basis, and announcements relating to policy changes or the roll out of new programmes funded from within the three-year commitment could be made at any time. But no new funding would be allocated for the Health sector on two out of three annual Budget Days.

28. This will change the role of Cabinet and the Minister of Finance in the Budget process – limiting the opportunity for taking decisions on health funding to once during the parliamentary term. The Minister of Health would continue to take significant policy decisions to Cabinet throughout the three-year period, as appropriate, but decisions should be funded within the multi-year funding commitment.

29. A key benefit of slowing down the cycle of Budget decisions, is that it should take the focus away from annual assessments of dozens of small initiatives and give Ministers and officials more time to properly analyse and tackle significant issues and cost drivers in the health system.

The multi-year funding approach should cover all health sector entities covered by the NZHP – with scope to expand coverage later if desired.

30. We propose that the multi-year funding arrangement and the NZHP should, at minimum, cover: Health New Zealand; the Māori Health Authority; PHARMAC; the New Zealand Blood and Organ Service; the Health Quality and Safety Commission and any other entity in scope of the NZHP – in order that the funding and planning processes be aligned. We recommend seeking Cabinet agreement to this minimum coverage in September 2021 to ensure that Health New Zealand and the Māori Health Authority have clarity, before their establishment on 1 July 2022, about the funding arrangements and planning scope they will be working to as they develop the first full NZHP.

31. It is not necessary that the NZHP and the multi-year funding arrangement have the same scope. Ministers may wish to extend the scope of the funding arrangement (though not the NZHP) to include the Ministry of Health. This would be consistent with the Public Finance System Modernisation (PFSM) proposals – in effect treating all of Vote Health as a single “cluster”. We will provide further advice on this ahead of Budget 2024, including on the coverage of a longer-term funding track.

32. The funding arrangement or health “cluster” could also be extended to cover Disability Support Services, currently funded through Vote Health. This will depend on the outcome of the Disability System Machinery of Government work programme due to report to Ministers in September 2021.

We will provide further advice on the funding track for operating and capital funding.

33. As noted, a medium-term funding track for operating funding is needed to give the sector confidence to undertake meaningful medium-term planning and make strategic investments that take time to deliver savings, such as changing models of care. It will also provide Parliament and the public with a more transparent picture of health system funding and costs over time.

34. We propose that the operating funding track be formula-driven, factoring in weighted key drivers of health costs (wages, price, demographic change, technology) [33]

35. The ability of the system to benchmark against globally accepted standards for efficient providers, and move toward those benchmarks is supported by an integrated system that can allocate funding more effectively. This could result in efficiency dividends growing over time, acknowledging that it could take several years of investment for the reformed system to start to generate the significant efficiencies of which it is expected to be capable.

36. It will be important for its credibility that the formula is developed with advice from external expertise, including clinicians. Reflecting the importance of the funding track for both the health and public finance systems, we recommend that the Minister of Finance and the Minister of Health should be jointly delegated power to set the initial formula, with any substantive changes in the future to be agreed by Cabinet. The Ministry of Health and the Treasury should jointly develop the process for designing this formula and be jointly responsible for providing advice to Ministers. You will receive further advice on this ahead of Budget 2022.

37. A capital funding track is needed to enable the planning of a prioritised pipeline of projects with adequate lead-in time and to ensure alignment where capital decisions have operating impacts. A formula-based approach is less likely to be appropriate for capital than for operating funding. You will receive further advice on a proposed approach for multi-year capital funding in September.

Core to this proposal is the three-year commitment being treated as a hard upper limit.

38. As noted at paragraph 21, the internal controls and incentives in the system (in particular the approach to employment relations) must be designed to support Ministers to hold the line of each three-year funding commitment. Health-specific budget management rules may also be required, e.g. allowing funding to move between years or programmes to manage costs, and building in indexation to new programmes. Further advice on this will be provided ahead of Budget 2024, taking into account any new settings that are required to support implementation of PFSM.

39. The three-year funding commitment would include a provision for new investment, as well as a provision to manage risks and uncertainties (e.g. in relation to wage bargaining). We see value in establishing a budget management rule that any unforeseen costs beyond these risk buffers be funded in the first instance from the provision for new investment, to strongly incentivise Ministers and Health New Zealand to manage unplanned costs. The Treasury will provide further advice on the design of any specific budget management rules ahead of Budget 2024, including alignment with the PFSM clusters.

40. We recommend that Ministers agree upfront a very high bar for adjustments or addendums to the three-year funding commitment. Exceptions should be reserved for genuinely unforeseeable one-off shocks such as a disease outbreak or a Whakaari/White Island type event. We expect that principles for what is deemed genuinely unforeseeable will evolve overtime as precedents are established, but initially any requests would to be treated on a case-by-case basis.

The case for the proposed multi-year approach

The inherent challenges in the system mean no risk-free policy solution is available. We believe that a multi-year approach will deliver important benefits….

41. Even with a strong planning process and appropriate incentives, the three-year funding commitment and funding track will face continuous upward pressure from the health system. Domestic and international experience has shown that holding the line on cost control in the health sector is difficult. Priorities change mid-cycle, consumer expectations increase as health technologies improve, and wage settlements can bring significant unforeseen costs. As the largest employer in New Zealand, Health New Zealand will face significant pressure from unions; these dynamics will be challenging for the system to manage.

42. Furthermore, we know that financial management relies on good culture and practice in governance, planning and accountability. This has been historically variable in the health system, though the reforms are focused on substantially improving it.

43. There are also significant unfunded inequities in the current system. Reform, especially in the establishment of the Māori Health Authority, will rightly create further pressure to address these inequities. Addressing these inequalities has real benefit to the economy. Enhanced and effective investment in health can increase the duration of healthy life. This allows for longer productive attachment to the workforce, has the potential to increase taxation revenue, and can reduce the trajectory of the net health cost burden over time.

44. Given these cost pressures and drivers, it will be challenging to ensure that the funding formula adequately manages the tension between the sector's need for a credible funding path for planning purposes and the affordability challenge. While marginal increases above a forecast funding track should be expected, the track should not be seen as a starting position from which *significant* additional increases can be negotiated.

45. An agreed funding track that credibly supports forward-planning and reflects the reality of health sector cost pressures is critical for Ministers to legitimately hold Health New Zealand accountable for keeping to its budget and to mitigate the above risks. An unrealistic budget or a short planning horizon would give Health New Zealand a standing excuse for failing to adequately manage its finances. The funding track will to sit alongside a broader set of strengthened accountability and financial control arrangements.

… and is preferable to the available alternatives (including the status quo).

46. In preparing this advice, we assessed our recommended approach against the status quo as well as other multi-year funding options and variations of the recommended approach (refer to the Annex for an overview of other options considered). We assessed all these alternatives as presenting an inferior balance of risks and benefits. This view was tested across agencies and (in confidence) with external experts, all of whom endorsed our assessment.[2]

A transitional funding package at Budget 2022

47. The sector will undergo a transition period from its legal establishment on 1 July 2022 to the start of the first three-year funding arrangement from 1 July 2024. During this time, the sector will need to focus on change management, implementation, and getting all the necessary prerequisites in place ahead of Budget 2024.

48. To support the sector through this transition period we propose a transitional funding approach that:

    a establishes the sector on Day One with no deficits and enough funding to stay deficit-free through the reform period;

    b provides enough medium-term certainty for Health New Zealand and the Māori Health Authority to work with the sector on a credible first full NZHP; and

    c is sufficiently flexible to allow for the realities of a complex transition process.

Rebasing the system in Budget 2022 will emphasise from the outset that deficits will no longer be a normal feature of the system.

49. A health system rebase – a significant ongoing funding uplift – is needed to redress historic underfunding and set a clear and reasonable expectation that the system will henceforth operate within allocated funding while continuing to provide the current level of health services. Service reductions in the short term would be harmful to the success of the reform programme.

50. We recommend that this rebase occur at the establishment of Health New Zealand in 2022, however an argument could be made for waiting until the broader system settings are embedded before providing such a significant investment. On balance, we consider that deferring the rebase risks establishing an unhelpful precedent. When DHBs were established in 2001 they were established in deficit. A rebase in 2004 was insufficient to put them on a sustainable financial footing and the "deficit culture" has continued ever since. A rebase in Budget 2022 will also signal the Government's commitment to reform and should be provided alongside renewed expectations for financial management and system performance culture going forward.

[2] These proposals were tested with a 'Challenge Panel' comprising senior officials from across the Treasury, Ministry of Health, Transition Unit; the policy director leading the Reform of Vocational Education; and an experienced DHB Crown Monitor.

51. The rebase does not represent a new cost to the system; rather, it is a more transparent way of showing what we have already spent or know we will need to spend. A significant portion of the cost will be offset by the forecast DHB deficit position in the fiscal forecasts. The 2021 Budget Economic and Fiscal Update included a combined DHB deficit position of $600 million per annum, meaning that if a $700-800 million per annum uplift were provided, the net impact would be approximately $100-200 million per annum.

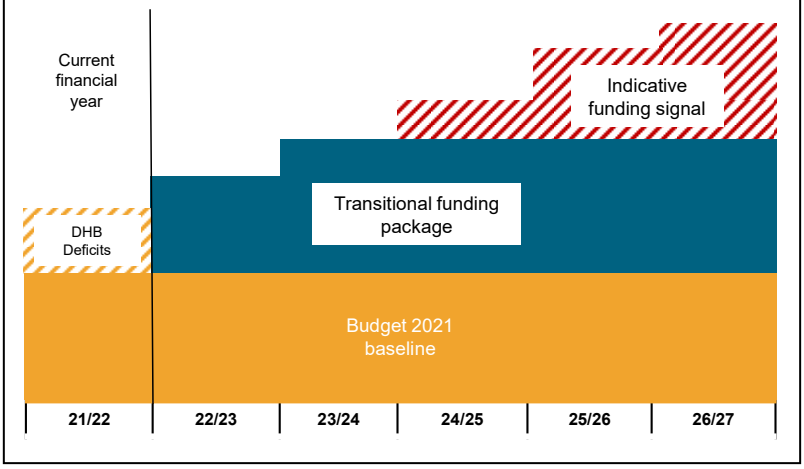
52. DHB deficits have largely emerged in their provider arm (which are predominantly hospital services) and so this will be where the funding needs to go first. We would expect to see a shift overtime towards investment in primary and community care in line with the ambition of reform. Similarly, we would expect that funding would shift over time to address regional inequities that have emerged over time – we would recommend Ministers set expectations for this upfront with the new Health New Zealand Board.

53. Ministers will have choices about when and how the rebase is communicated to the sector and what conditions to attach to it, for example any additional obligations the Health New Zealand Board is expected to meet during the transition period. Officials will provide further advice on this as part of the development of an interim GPS and first Letters of Expectation for the new Boards.

Funding certainty through the transition period will help keep the system's focus on managing the change.

54. To provide this certainty, we recommend that the Budget 2022 transitional funding package include a cost pressure adjustment alongside the rebase. This adjustment would meet volume and price pressures and any other known, or emerging cost pressures through to Budget 2024 – effectively providing two Budgets' worth of funding agreed upfront (with the expectation that no additional funding would be provided at Budget 2023).

Chart 2: Transitional funding package at Budget 2022



55. This will require several billion dollars' worth of investment and will exceed the current operating allowances set aside for Budget 2022 and 2023.

56. The Minister of Health has indicated that he would like to make additional investments through Budget 2022 to support core ambitions of reform, e.g. investments in primary care, improving equity and access, investment in digital assets. We recommend these initiatives be considered alongside other new spending initiatives at Budget 2022. As with cost pressures, we recommend agreeing two Budgets' worth of funding of new initiatives upfront, with the expectation of no further funding at Budget 2023.

57. [33]

58.

59.

System and fiscal strategy implications

The proposed multi-year funding approach for health is consistent with the direction of the PFSM proposals.

60. The proposed future settings for the health system are well aligned with the PFSM reform proposals and the shift towards multi-year planning and funding cycles, with the first two clusters being piloted through Budget 2022 (T2021/1269 refers). Health reform provides a valuable opportunity to advance this work programme.

61. The key difference between the health proposal and the broader PFSM proposals is the inclusion of an ongoing medium-term funding track beyond the three-year funding commitment period. This may create a precedent for other spending areas – particularly in the social sector where similar arguments can be made for supporting longer-term funding certainty. These issues will be considered as part of the PFSM work programme.

Multi-year funding presents a challenge for the current allowances framework that will need to be resolved.

62. Ministers will have choices about fiscal management in the context of multi-year funding arrangements. Decisions on the future settings are not required now and should be consistent with the approach that is agreed for the PFSM clusters. You will receive further advice on the application of the fiscal management approach in Budget 2022 – the reform of health funding settings and PFSM cluster pilots will provide key pieces of context for that advice.

Health cost pressures and the cost of reform will require significant investment. This should be explicitly factored in to the Government's fiscal strategy.

63. Health reform will not generate cost-savings in the short term – rather, the intention of these reforms is to help bend the medium-term cost curve. Health is likely to consume the majority of current operating allowances over the forecast period. Ministers will have choices about how to manage and communicate these near-term costs, but limited ability to reduce them. We therefore recommend that Ministers should consider health reform costs in setting their Budget 2022 strategy, factoring the costs into the setting of allowances across the forecast period.

64. As noted, you will receive advice on the detail of the transitional funding package from the Ministry of Health, supported by the Transition Unit, in September. This will be in time to inform fiscal and Budget strategy advice for the 2022 Budget Policy Statement in December, with a final package being confirmed in Budget 2022.

Next steps

65. The Ministers of Finance and Health will have an opportunity to discuss this report at the Joint Ministers meeting on 9 August. Subject to your feedback on the proposals, we will prepare a Cabinet paper that seeks agreement to both the multi-year funding approach and the broader funding settings that will be the subject of a forthcoming paper from the Transition Unit and the Ministry of Health (DPMC-2021/22-45).

66. Ministers will receive further advice over coming months from the Treasury, the Ministry of Health and the Transition Unit on a number of issues related to these proposals and the broader funding settings, including:

    a detailed advice on likely costs of a Budget 2022 transitional funding package (in September);

    b further advice on the health system rebase, including quantum, an approach to communication and any conditions or requirements that should be provided alongside the funding (alongside the advice on a Budget 2022 transitional package);

    c advice on capital funding settings, including options for providing a longer-term funding track for capital (in September, ahead of a planned Cabinet paper in October);

    d advice on a formula to underpin the ongoing operating funding track, including an approach to providing an indicative funding signal at Budget 2022 (in early 2022); and

    e advice on the internal budget management rules to support the sector manage within the funding commitment (in advance of Budget 2024).

67. The Minister of Finance can expect an initial piece of advice from the Treasury on a fiscal management approach for Budget 2022 in August.

Ministry of Health comment

68. The Ministry of Health fully supports the principle of having a multi-year funding approach, as a mechanism for enabling longer term planning and giving Health New Zealand the flexibility to meet Ministers' expectations. However, the Ministry is concerned about establishing an ex ante three year allocation, given uncertainty about likely future pressures and demands, and emerging priorities. [33]

69. We are giving further thought to how we might forecast expenditure and reasonable new pressures, particularly in the early years of the evolution of the new operating model. The complexity is increased by the information asymmetry in the new model, something that is a standard problem in regulated industries, since we are setting up a large organisation that will have the best information about its cost-pressures.

70. As noted in the paper, there is no guarantee that a multi-year funding track will on its own solve the deficits by forcing efficient allocation decisions within a fixed budget. Achieving fiscal discipline will require additional, complementary governance and accountability arrangements as well as changes in expectations and behaviour. The Ministry will work with Treasury and the Transition Unit to design these arrangements and put in place safeguards, starting from the two year budget proposal for Budget 2022.

Annex: Options for implementing a multi-year approach to health funding

Option	Status quo	Recommended multi-year funding approach	Public Finance System Modernisation approach	Indexed funding for health	Indexed cost pressure funding + annual increases
Description	Fixed nominal baseline, with funding increases for both cost pressures and new initiatives agreed annually through the Budget process.	Three-year funding commitment and ongoing medium-term funding track from year four onwards. (Refer to paragraphs 17-38.)	Three-year funding commitment only. No ongoing medium-term funding track agreed beyond year three.	Indexed funding path as a cap on total health funding – in effect, treating health spending like a benefit expense.	Indexed funding path for cost pressures only, with annual adjustments for new initiatives.
Summary of option assessment	(Refer to paragraphs 8-16.)	• Provides medium-term funding path against which the sector can be held to account. • More transparent than the status quo; future health spending would be publicly communicated. (Refer to paragraphs 39-44.)	• Would align with approach applied to Justice and Natural Resources clusters in Budget 2022. • Limits ability of Health New Zealand and Māori Health Authority to prepare credible draft NZHP. • Compared to recommended approach, less amenable to medium-term invest to save programmes to contain cost growth.	• Provides a medium-term funding path and transparency of some cost pressures, but is not practical. • It would not account for ordinary/reasonable variances in demand, or the impact of wage settlements – which are often lumpy. This may undermine sustainability and credibility of the funding path.	• Provides medium-term path, but does not integrate consideration of cost pressures or new initiatives. Retention of annual Budget process undermines funding certainty. • Higher risk of 'cost ratchetting' if formula only applies to cost pressures with new initiatives to be agreed on top. • Retains Minister of Finance's and Cabinet's annual role in health Budget process