The Treasury

Mini-Budget 2023 Information Release

May 2024

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TE TAI ŌHANGA
THE TREASURY

Treasury Report: Implementing the fiscal strategy

Date:	27 November 2023	**Report No:**	T2023/1987
		File Number:	

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Nicola Willis)		30 November 2023

Contact for Telephone Discussion (if required)

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Minister of Finance's Office Actions (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure:

Executive Summary

Your Government has outlined an ambitious 100-day plan and wider policy programme, which your fiscal strategy must ensure can be funded. However, government finances will be under sustained pressure this term – requiring difficult choices to deliver your policy priorities while achieving your fiscal strategy.[1] This represents a significant enough challenge that you should think of it as an ongoing goal to be pursued, rather than something which can be achieved through a single set of decisions.

A structured programme of work is required to ensure fiscal sustainability (the fiscal sustainability programme). We recommend the fiscal sustainability programme focus on two interrelated objectives:

- Creating sufficient fiscal headroom to fund your manifesto and achieve the fiscal strategy.
- Orienting government to prioritise the fiscal discipline necessary to operate in a tight fiscal environment and embed a culture of continuously improving value for money.

Where possible the fiscal sustainability programme should support the wider shift to address long-standing challenges in the public finance system. This includes moving from a system focused on managing marginal expenditure to one focused on dealing with the underlying drivers of spending, better balancing the achievement of short-term goals with addressing long-term challenges, more actively managing the balance sheet, and supporting collaborative approaches between agencies to address complex, cross sectoral issues.

Historic and overseas experience suggests this will be challenging. Creating fiscal headroom, in particular, consistently proves harder, takes longer, and rarely achieves as much as initially anticipated. Success will require a clear strategy with three main components:

- Promoting the fiscal sustainability programme as a key Government priority, with a focus on collective ownership through Cabinet leadership, and a culture of fiscal discipline and driving value for money in the public sector.
- Identifying concrete measures to constrain new spending, reduce expenditure, and increase revenue, and implementing the right mix to reach a sustainable endpoint.
- Balancing taking decisive action early with the need to sequence change, reinforce fiscal discipline, and enhance value for money across the course of the term.

Promoting the fiscal sustainability programme as a key Government priority

Cabinet will need to collectively own the fiscal sustainability programme for it to be effective. Ownership can be established by publicly committing to fiscal sustainability as one of a few key priorities then demonstrating that priority through action. The Speech from the Throne, Budget Policy Statement and a Mini Budget that aligns with your fiscal strategy offer early opportunities to demonstrate this priority publicly.

Within the public sector, the priority placed on achieving the fiscal strategy can be reinforced through existing accountability mechanisms. This includes incorporating expectations of fiscal discipline and value for money in documents such as the Prime Minister's letter of expectations to Ministers and the Enduring Letter of Expectations to Crown entities.

[1] In *Initial Decisions for your Fiscal Strategy* we recommended a fiscal strategy aimed at supporting a sustainable balance sheet and fiscal position through returning OBEGAL to surplus in 2026/27 at the latest, and maintaining ongoing surpluses beyond 2026/27 – [33]

Changes to institutional settings will be needed to ensure the fiscal sustainability programme is governed well and Ministers and agencies prioritise the discipline necessary to operate in a tight fiscal climate. Establishing a Cabinet Expenditure Control committee to steer the fiscal programme would send a clear signal to the public service and your colleagues of the priority that senior Ministers intend to place on achieving the fiscal strategy.

However, current Cabinet processes risk policy decisions being taken without costs being considered, and while Cabinet sets expectations for financial and regulatory analysis, these are not always done – or done well. We suggest confirming recent changes to improve decision-making for managing the Government's investment portfolio and agreeing funding between Budgets, and further work to develop options for stricter requirements – including costing, value for money, and delivery assurance requirements such as those used in Australia and the UK.

Measures to constrain new spending, reduce expenditure, and increase revenue

Creating sufficient fiscal headroom to fund your manifesto and the return to surplus will require departing from existing policy settings. Potential options to achieve this include:

- Decreasing expenditure including through centrally directed savings exercises (e.g., identifying specific policies and programmes to stop or scale back, imposing top-down reductions to agency baselines).
- Constraining new spending through sequencing manifesto commitments across multiple Budgets and applying the Fiscal Management Approach (e.g., reducing allowances to force trade-offs, requiring agencies to reprioritise within existing baselines and minimising commitments made to fund initiatives between Budgets).
- Increasing revenue through structural reform of the tax system, policy changes to increase revenue, or letting fiscal drag continue to increase revenue raised through personal income tax.

Active management of the balance sheet can be used to create fiscal headroom and contribute to achieving the fiscal strategy. For example, review of ownership rationales can allow for capital recycling, reducing net capital expenditure, while improving the performance of assets and liabilities can have benefits for the fiscal outlook. We can provide advice on active balance sheet management if requested.

It is likely that the use of all these levers will be necessary in some form. The trade-off between them is complex, because the costs and benefits of exercising each differ – meaning robust value for money analysis is critical to inform them. Decreasing expenditure and constraining new spending risk a decline in service quality and/or negative impacts on living standards. Increasing revenue likewise has trade-offs for living standards, including potentially negative impacts on economic performance. All choices involve political judgments for you and your Cabinet colleagues around fairness and equity.

We recommend you initially focus on taking specific policy choices to reduce expenditure and increase revenue, complemented by an initial baseline exercise to reduce departments' baselines. This will enable the rapid creation of fiscal headroom necessary to deliver a fiscally neutral (or positive) Mini Budget and demonstrate a fiscal track consistent with the fiscal strategy at Budget 2024. After Budget 2024 we recommend you shift to using savings and performance plans, with spending reviews, to maintain and create fiscal headroom and drive an increased focus for the public sector on value for money of expenditure. This would support you to stay on track to deliver your manifesto while achieving the fiscal strategy.

Fiscal risks may pose a challenge to your fiscal strategy. You may wish to take action to mitigate the effects these could have on the track to return to surplus. Some of the most significant fiscal risks that can be managed by Ministers include public sector pay pressures, growing demand for public services, the size of the Government's capital investment programme, and funding pressures generated by policy reviews. Choices to manage these risks largely involve challenging policy choices to prevent costs in the short- and long-term.

Balancing taking decisive action early with the need to sequence change

The fiscal sustainability programme will need to balance taking decisive action early with the importance of sequencing change across the term.

In the short-term, your focus will need to be on actions that:

- Free up headroom to fully fund 100-day priorities and get the return to surplus on track in a way that is easy to implement, while mitigating the risk that decisions create fiscal risks later in the forecast period.
- Send a strong signal that the fiscal sustainability programme is a priority for your Government and communicate your expectations that Ministers and the public sector should operate in accordance with its objectives across the course of the term.
- Establish the right governance for the programme, to ensure the decisions you take flow through to implementation and agencies remain focused on results.

In the medium-term, your focus can shift to actions that:

- Are not possible in the tight timeframe available, or where the need for further work is identified as part of short-term work.
- Embed a culture of continuously improving value for money through visibility and scrutiny of baseline expenditure and holding decision-makers accountable for performance, implemented through changes to institutional settings.
- Mitigate fiscal risks that may otherwise defer the return to surplus.

These short- and medium-term imperatives can be balanced by progressing the programme in three phases. Figure 1 highlights key actions we propose you consider for each phase:

Figure 1: Fiscal programme phases and key actions (summary)

Phase 1
HYEFU 2023
Budget 2024

Actions to consider for this phase include:

- Sending a clear signal regarding your commitment to fiscal sustainability by running Mini Budget that is *at least* fiscally neutral.
- Setting a strategy for Budget 2024 that operates within allowances consistent with your fiscal strategy.
- Creating fiscal headroom with targeted policy savings and a reduction in agency funding implemented through an initial baseline exercise as part of Budget 2024.
- Using the initial baseline exercise to gather information from agencies on a range of issues that Ministers will want to consider in identifying savings and setting future expenditure plans (e.g., historic expenditure and cost trends).
- Establishing a Cabinet Expenditure Control (CEC) committee to steer the fiscal sustainability programme, supported by a senior officials group.
- Publicly committing to the fiscal sustainability programme and its objectives through publications such as the Budget Policy Statement and reinforcing this commitment through existing public sector accountability mechanisms.

Figure 1 continued.

Phase 2
Over 2024/25
Budget 2025

Actions to consider for this phase include:

- Requiring all agencies to produce savings and performance plans, setting expectations for how they will deliver priorities, secure savings, and manage within baselines.
- Initiating rolling savings and performance reviews by agencies reporting to CEC, to drive value for money and ensure accountability for savings and performance plans.
- Initiating Treasury-led reviews into areas of significant expenditure and fiscal risk.
- Further improvements to institutional settings, with a particular focus on the quality of advice that informs Cabinet decision-making.

Phase 3
Ongoing

Ensuring that change from earlier phases is sufficiently embedded, so that the public finance system will continue to drive value for money and create fiscal headroom.

While this programme aims to ensure your manifesto can be implemented and your fiscal strategy delivered, economic conditions will have a significant impact on its success. The actions outlined above are necessary for success but may not prove sufficient. Maintaining contingency options to quickly create fiscal headroom will continue to be necessary.

We recommend your immediate focus be on the actions associated with phase one, where decisions are time sensitive. Your decisions on these areas are sought in the slides *Budget 2024 and Mini Budget: Critical Early Decisions*. You may wish to read those slides alongside this report and its companion paper *Initial Decisions for your Fiscal Strategy* (TR 2023/1992).

We can provide more detailed advice on areas highlighted in this briefing, including a savings strategy, active balance sheet management, and institutional changes to support fiscal sustainability.

Recommended Action

We recommend that you:

a **note** government finances will be under sustained pressure this term, requiring difficult choices to deliver your policy priorities while achieving the fiscal strategy proposed in *Initial Decisions for your Fiscal Strategy*;

Noted.

b **agree** to initiate a programme of work to implement the fiscal strategy and ensure fiscal sustainability;

Agree/disagree.

c **agree** the programme's objectives will be to:

- create sufficient fiscal headroom to fund your manifesto and achieve the fiscal strategy; and
- orient government to prioritise the fiscal discipline necessary to operate in a tight fiscal environment and embed a culture of continuously improving value for money;

Agree/disagree.

d **agree** the programme will be:

- governed by the Cabinet Expenditure Committee (if established);
- publicly announced as part of the Speech from the Throne, Mini Budget, or Budget Policy Statement;

Agree/disagree.

e **note** Cabinet arrangements and the content of the Speech from the Throne are decisions for the Prime Minister;

Noted.

f **agree** to take the points above to the Prime Minister for discussion;

Agree/disagree.

g **indicate** if you wish the Treasury to provide further advice on institutional changes to support fiscal sustainability, with a focus on the quality of advice that informs Cabinet decision-making;

Yes/no.

h **note** international evidence is that creating fiscal headroom on the scale required to deliver your policy priorities while achieving the fiscal strategy is best done over the course of several years and focused on structural reforms to expenditure and revenue policy settings (using spending reviews and targeted policy reviews to do so);

Noted.

i **agree** to progress the programme in three phases to balance international practice for creating fiscal headroom with the strict timeframes necessary to fund a Mini Budget and demonstrate a path to surplus at Budget 2024;

Agree/disagree.

j **note** the Treasury will provide more detailed advice on savings strategy to decrease expenditure in *Approach to Savings*;

Noted.

k **indicate** if you wish the Treasury to provide advice on active balance sheet management to support your fiscal strategy;

Yes/no.

l **Discuss** with officials your preferred mix of levers to create fiscal headroom, including decreasing expenditure, constraining spending, and increasing revenue.

Yes/no.

Struan Little
Deputy Secretary, Budget and Public Services

Hon Nicola Willis
Minister of Finance

_____/_____/_______

Treasury Report: Implementing the fiscal strategy

Purpose of Report

1. This report proposes a structured programme of work to implement your fiscal strategy across the course of the term, balancing short- and longer-term considerations. It focuses on questions of strategy and aligning machinery of government, with detailed advice on each of the programme components proposed to follow in light of your initial decisions.

Section A: Implementing the fiscal strategy via the fiscal programme

1. Your Government has outlined an ambitious 100-day plan and wider policy programme, which your fiscal strategy must ensure can be funded. However, government finances will be under sustained pressure this term – requiring difficult choices to deliver your manifesto while achieving your fiscal strategy.
2. The Pre-election Economic and Fiscal Update (PREFU) highlighted the challenge posed by lower-than-expected revenue and substantial anticipated cost pressures, noting this would require significant trade-offs to manage if the previous Government's fiscal strategy was to be achieved. Poorer economic conditions than forecast, specific fiscal risks crystallising, unanticipated cost pressures, unavoidable demand for new initiatives – any of these factors materialising would turn the forecast 2026/27 OBEGAL surplus into a deficit.
3. The fiscal position has further deteriorated since PREFU, putting the already narrow path to achieve that fiscal strategy in jeopardy. In *Initial Decisions for your Fiscal Strategy* we recommend you target a return to surplus in 2026/27 at the latest, noting that fiscal and macroeconomic conditions suggest that an earlier surplus would be desirable if feasible (TR 2023/1992 refers). How feasible that is will depend on the choices you are comfortable making to implement your fiscal strategy.
4. The difficulty of achieving a return to surplus is sharpened by the need to create additional fiscal headroom to deliver on your manifesto and coalition agreement priorities, without deferring responding to critical challenges to long-term fiscal sustainability such as climate and demographic change. These long-term challenges informed our recommendation to calibrate your fiscal strategy to further increase surpluses beyond 2026/27, [33]
5. Implementing the fiscal strategy will require creating significant fiscal headroom over the forecast period. Doing so in a way that manages the balance sheet well and enables operating surpluses to be sustained represents a significant enough challenge that you should think of it as an ongoing goal to be pursued across the course of this term and beyond, rather than something which can be achieved through a single set of decisions.
6. A structured programme of work is required to ensure fiscal sustainability (the fiscal sustainability programme). We recommend the fiscal sustainability programme focus on two interrelated objectives:
    a. Creating sufficient fiscal headroom to fund your manifesto and the return to surplus.

b. Orienting government to prioritise the fiscal discipline necessary to operate in a tight fiscal environment and embed a culture of continuously improving value for money.

7. Historic and overseas experience suggests this will be challenging. Creating fiscal headroom, in particular consistently, proves harder, takes longer, and rarely achieves as much as initially anticipated. Success will require a clear strategy with three main components:

   a. Promoting the fiscal sustainability programme as a key Government priority, with a focus on collective ownership through Cabinet leadership and a culture of fiscal discipline, implemented through institutional settings.

   b. Identifying concrete measures to reduce expenditure, constrain new spending, and increase revenue, and implementing the right mix to reach a sustainable endpoint.

   c. Balancing taking decisive action early with the need to sequence change, reinforce fiscal discipline, and enhance value for money (VFM) across the course of the term.

Section B: Promoting the fiscal sustainability programme as a Government priority

2. New Zealand and overseas experience has been that collective ownership by leadership is critical to achieving fiscal sustainability.[2] Responsibility for proposing the Government's fiscal strategy sits with the Minister of Finance, supported by the Treasury. This clarity can lead to you and the Treasury being seen as solely responsible for achieving the fiscal strategy, with other Ministers and their agencies exclusively focused on delivering the Government's policy priorities. In a period of fiscal restraint, that would be problematic as tough choices will be required of all Ministers.

3. Cabinet will need to collectively own the fiscal sustainability programme. To achieve this we recommend Cabinet agrees the programme's critical architecture, the Government publicly commits to it as one of a few key priorities, and changes are made to institutional settings to ensure Ministers and agencies prioritise the discipline to operate in a tight fiscal climate.

Providing Cabinet mandate for the fiscal sustainability programme

4. The fiscal sustainability programme will require an all-of-government approach. This is necessary because our devolved public management system means the decisions that need to be made do not all sit with Ministers. Cabinet can influence these decisions through setting a clear direction, requiring savings, efficient operations and better performance information from agencies, and ensuring its own decisions consistently reinforce this message over time.

5. We recommend Cabinet mandates the fiscal sustainability programme - including agreeing:

   a **Objectives** - These should clearly signal to the public service and your colleagues the priority the Government intends to place on identifying a credible path to surplus and delivering on it. In the absence of such messages there are few incentives to adhere to fiscal discipline, and many to strain against it. Responding to the issues of the day has an urgency that means fiscal sustainability risks being seen as a problem for tomorrow.

[2] Bose, D. et. al. (2016), "Returning to surplus: New Zealand's post-GFC fiscal consolidation experience" Treasury working paper 16/05; Balasundharam, V. et.al., "Fiscal consolidation: Taking stock of success factors, impact, and design" International Monetary Fund working paper 23/63.

Example objectives for your consideration are:

i Creating sufficient fiscal headroom to fund your manifesto and the return to surplus.

ii Orienting government to prioritise the fiscal discipline necessary to operate in a tight fiscal environment and embed a culture of continuously improving VFM.

b **Governance** - The sustained focus required across government to implement the fiscal sustainability programme points to establishing a Cabinet Expenditure Control committee (CEC) and a senior officials group to support it. Using such a committee to steer the programme would ensure Cabinet oversight of where and how savings will be made and regular consideration of whether you are on track to achieve your fiscal strategy, key risks to doing so, and actions to mitigate risks.

If you agree with this option we suggest you raise it with the Prime Minister for early consideration, as decisions about Cabinet arrangements sit with him and the window for such choices tends to be narrow.

c **Work programme** - The programme will need to balance taking decisive action early with the importance of sequencing change across the term. This can be done by progressing the programme in three phases, outlined in more detail in **Section D**.

Committing to the fiscal sustainability programme as one of a few key priorities

6. Success will require treating the fiscal sustainability programme as one of the Government's key priorities, supported by a commitment from senior Ministers to prioritise the steps necessary to achieve fiscal sustainability in the face of inevitable pressures to delay or defer them. Publicly stating that your fiscal strategy relies on the fiscal sustainability programme, and outlining how you intend to go about it over the course of the term will give the programme status equal to other significant political commitments – and support an approach focused on transparency and accountability.

7. Early opportunities to publicly commit to the programme as a priority include:

a **Speech from the Throne** - The Speech is used to highlight the Government's policy and legislative proposals on the principal issues of the day. If you wish to reference the Government's intention to undertake the fiscal sustainability programme and its objectives in the Speech, you may wish to discuss this with the Prime Minister.

b **Mini Budget** - In *Budget 2024 and Mini Budget: Critical Early Decisions* Treasury recommended that any Mini Budget you agree before Budget 2024 is *at least* fiscally neutral. Taking significant savings and/or revenue raising decisions to ensure that this is the case would send a strong early signal that the programme is a priority.

c **Budget Policy Statement** (BPS) - The Public Finance Act 1989 requires the BPS to articulate the Government's strategic priorities and wellbeing objectives that will guide your Budget decisions, as well as your fiscal strategy as expressed through short-term intentions and long-term objectives. If you wish to make signalling the fiscal programme a core aspect of the Budget 2024 BPS, an early indication of that would enable us to better target our more detailed advice on Budget 2024.

8. This commitment can then be reinforced within the public sector through existing vertical accountability mechanisms. Documents such as the Prime Minister's letters of expectations to Ministers, the Public Service Commissioner's letters of expectations to Chief Executives, and the Enduring Letter of Expectations to Crown entities provide a channel to set

expectations for achieving fiscal sustainability, exercising discipline in a fiscally constrained environment, and ensuring decision-making is subject to robust VFM analysis. You could complement these measures by writing to your colleagues, providing a draft letter for them to reinforce expectations with their Chief Executives.

Changes to institutional settings

9. Changes will be required to ensure the institutions of government are set up to actively manage the process of creating fiscal headroom, support you to stay on track for return to surplus, and ensure new and existing expenditure represents VFM. While the annual Budget is the key public-facing tool to implement the changes necessary to create fiscal headroom, the fiscal sustainability programme necessitates a year-round focus across the multitude of government decisions through the course of the term.

10. This requires ensuring the settings are in place that allow Cabinet to govern well and make decisions on the basis of high quality and robust policy advice. Such advice should be clear on the fiscal impact of proposals, consider the impact and compliance costs for individuals and business (not just the cost to the Government), and reflect a clear implementation plan and assurance processes to ensure delivery.

11. Current processes risk policy decisions being taken without costs being considered, and while Cabinet sets expectations for financial and regulatory analysis, these are not always done – or done well. Decisions are often taken in isolation from their wider impact (whether on the fiscal strategy, the investment pipeline, or the legislative programme), poor costings lead to gold plated programmes if too high or future cost pressures if too low, and business cases are too long and often do not contain the information required to make a decision.

12. This focus on high quality and robust advice does not just apply to policy proposals seeking new funding – it is also essential for proposals seeking reprioritisation or savings to ensure VFM, and for regulatory proposals. The effects of poor analysis can be felt immediately (e.g., when a lack of consultation means unnecessary costs are imposed on businesses) or years later (e.g., regulatory failure).

13. Improvements have been made but more is required. For example, in August 2023 Cabinet approved changes to the investment management system – including requiring the Treasury to report quarterly on the overall investment portfolio, introducing initial investment assessments to ensure Cabinet oversight earlier in the process, and requiring Gateway reviews to be shared with Cabinet as part of business case approvals. These changes provide a strong basis from which Cabinet will be able to actively prioritise and sequence the investment pipeline and manage risk. However, they do not address underlying issues with the business case and assurance process. More fundamental changes are needed.

14. We can provide more detailed advice on institutional changes to improve advice informing Cabinet decisions. At a high level we suggest:

    a Confirming recent changes to improve decision-making for managing the Government's investment portfolio and agreeing funding between Budgets.

    b Initial actions focused on promoting collective ownership of the fiscal programme's objectives and actions by establishing CEC and a senior officials group to support it, publicly committing to the programme and reinforcing this though public sector accountability mechanisms as above, and enforcing existing requirements (e.g., accurate costings, an expectation that proposals will be funded from baselines, regulatory impact analysis, and clear articulation of any implementation challenges). CEC could also have a role in decisions with financial implications. Options range from maintaining oversight of upcoming decisions by policy committees, through to all decisions with financial implications requiring approval from CEC.

c Medium-term actions focused on setting revised and new expectations for Ministers and the public service on what is required for policy proposals, including stricter processes on joint Minister delegations, greater expectations on the financial implications and VFM considerations for Cabinet papers and on evaluation of initiatives that are approved, and reviews of the business case and assurance processes to support better investment decisions.

d Longer-term actions focused on areas which require system change to implement. Potential actions include a gatekeeping role for Treasury to certify costings included in policy proposals, requiring agency chief executives to certify value for money and implementation considerations, and enabling uncontested proposals to progress without substantive Cabinet discussion to free up space to focus on complex areas

Section C: Measures to reduce expenditure, constrain new spending, and increase revenue

15. Creating sufficient fiscal headroom to fund your manifesto and the return to surplus will require departing from existing policy settings. Potential options to achieve this include reducing expenditure through centrally directed savings exercises, constraining new spending by sequencing manifesto commitments across multiple Budgets and applying the Fiscal Management Approach, and increasing revenue through policy changes or letting fiscal drag continue to increase revenue raised through personal income tax.

16. The extent to which you intend to emphasise expenditure reduction, spending restraint, or revenue increase to achieve fiscal sustainability is a critical choice that should be made early. The trade-off between these three levers is complex, because the costs and benefits of each differ. Spending restraint and reducing expenditure risk a decline in service quality and/or negative impacts on living standards. Increasing revenue likewise has trade-offs for living standards, including potentially negative impacts on economic performance. All choices involve judgements for you and your Cabinet colleagues to make around fairness and equity.

17. The Crown owns $537 billion of assets and owes $345 billion of liabilities and is subject to a number of contingent and implicit risks. In addition to the expenditure and revenue levers above, more active management of the balance sheet can support your fiscal strategy. For example, review of ownership rationales can allow for capital recycling, reducing net capital expenditure. Improving performance of assets and liabilities (e.g., increasing the return on commercial assets, the financial sustainability of Crown entities, or generating efficiencies in balance sheet management practices) can have benefits for the fiscal outlook. Making conscious choices about the risk the Crown accepts can reduce the volatility of forecast outcomes. We can provide advice on active balance sheet management if requested.

Reducing expenditure

18. Expenditure reduction can be pursued in a variety of ways, as reflected in the different approaches successive governments have taken to controlling expenditure. These include:

a **Stopping or reducing programmes** – Identifying specific policies and programmes to end or scale back. This can also include shifting the cost of the service from the Government to other actors (e.g. via introducing user-pays). Policies can be identified centrally or by agencies, but significant policy decisions are made by Cabinet.

b **Top-down baseline reductions** – Permanent reductions in agency baselines are agreed centrally then implemented by agencies. A variant on this is to specify areas where savings are to be made, such as staffing caps or spend on consultants.

c **Detailed baseline scrutiny** – Identifying areas of expenditure to undertake detailed scrutiny of, focused on VFM and efficiency of operating models. The areas of focus can be agencies, programmes, or processes. Internationally this process of conducting in-depth assessments of existing expenditure to identify opportunities to reduce or redirect spending is referred to as a 'spending review'.

19. Spending reviews are widely considered best practice for creating fiscal headroom to fund new priorities, address emerging cost pressures, and improve the fiscal position.[3] They can be designed to incorporate elements of all the approaches above – we propose several types of spending review as part of the fiscal sustainability programme, summarised in Figure 2 below. Spending reviews are most effective at securing savings when a clear target is agreed in advance.

Figure 2: Types of spending review proposed for the fiscal programme

Initial baseline exercise	An exercise that forms the basis of Budget 2024 and enables trade-offs to be made through a single process. As part of this, each Chief Executive undertakes a review of their expenditure to implement their baseline reduction by: • Identifying savings and revenue generating options to reach targets. • Quickly reprioritising expenditure to align spending with Government priorities (manifesto commitments, programmes to stop). • Highlighting how cost pressures would be managed within baselines. Assessed by Treasury and provided to Budget Ministers to inform package development. Complemented by a Treasury-led process to review the capital investment pipeline to identify savings and better match market capacity.
Savings and performance plans and reviews	Rolling reviews by agencies, reporting to CEC, about their savings and performance plans, focused on driving value for money and performance: • Scrutiny of allocated funding, what was delivered with that, its impact, and what might be done to achieve more at less cost (at the aggregate level). • Surface options for Ministers to reprioritise between agencies in a decentralised system. • Feed into the next Budget's process, and revisions to the agency's savings and performance plan.
Thematic reviews	One-off reviews led by the Treasury and relevant agency focused on specific areas of significant spending or fiscal risk, aiming to surface saving options, develop solutions to cross-cutting fiscal issues (e.g., risks posed by the Crown entity funding models) and improve efficiency of spending.
Ad hoc reviews	One-off short, sharp exercises led by the Treasury to quickly scrutinise value for money of programmes you are concerned about. These may lead to the further, more detailed reviews outlined above.

Spending restraint

20. A focus on spending restraint aims to slow the growth of expenditure, which otherwise tends to increase year to year by default as the costs of existing programmes are driven upwards by a combination of demographic and inflationary pressures, and public demand for

[3] Tryggvadottir, Á. (2022), "OECD Best Practices for Spending Reviews", *OECD Journal on Budgeting*, vol. 22/1; Doherty, L., and Sayegh, A. (2022), "How to Design and Institutionalize Spending Reviews", *IMF How To Notes*, 2022 (004), A001.

improved service or new programmes. Spending restraint can be pursued through application of the Fiscal Management Approach (the FMA).

21. The FMA is a set of budgeting practices that have been used by successive Governments to give effect to fiscal strategy since the 1990s. Its key components are fixed nominal baselines to hold agency funding steady, allowances to manage new spending, and the annual Budget process to allocate funding across competing priorities. Collectively these rules aim to be flexible enough to respond to changing economic context and fiscal strategy, incentivise agencies to default to managing within their baselines, and use political judgment to resolve trade-offs between what will allow fiscal targets to be met, existing services to be adequately funded, and policy priorities that require new initiatives implemented.

22. You can use the FMA to implement spending restraint by reducing Budget allowances, then managing demands for new spending within them. This has historically proven an effective way to constrain spending in a tight fiscal environment.[4] However managing within tighter allowances will require the Government to:

   a Carefully sequence funding manifesto and coalition commitments across multiple Budgets, potentially deferring some commitments beyond this term.

   b Require agencies to reprioritise existing funding to meet cost pressures, rather than funding them through the Budget. Cost pressures could be kept out of the Budget process entirely, however our experience is that in the absence of policy change this will often only defer funding to a year or two later; that is, the cost pressures are temporarily hidden, not removed. At its worst this could lead to savings unwinding later in the forecast period, as Ministers judge those cost pressures unavoidable.

   c Minimise funding commitments made between Budgets, including avoiding all but the most critical pre-commitments, so the Budget process can be used to ensure scarce funds are allocated to initiatives which represent the highest VFM.

23. The primary risk of leaning heavily on constrained allowances to exercise spending restraint is that most expenditure growth happens outside allowances. Until recently around 70% of growth in expenditure was through allowances, but since 2019/20 that has been closer to 50%. This trend is partly due to increased use of funds (e.g. the Climate Emergency Response Fund, COVID Response and Recovery Fund), but more to growth in forecast spending – mostly made up of non-departmental or benefit related expenses. Constraining such expenditure will be reliant on firm adherence to fiscal management rules, and consideration of policy changes to slow expenditure growth (e.g., changes to legislation).

Increasing revenue

24. Structural reform of the tax system is the most effective way to ensure it is flexible and capable of raising additional revenue sustainably. However, significant reform takes time so would not immediately create fiscal headroom. Such reform would need to recognise that while raising revenue is the primary purpose of the tax system, its distributional and economic objectives are also important. Leaning heavily into raising revenue to enable fiscal sustainability risks coming at the expense of other objectives.

25. Since 2010, fiscal drag (inflation or income growth shifting income into higher tax brackets) has played an important role in enabling successive governments to use the tax system to meet their revenue objectives. This has placed increased pressure on the tax system’s other objectives. If you wish to offset or end fiscal drag, through adjustment of personal

[4] Bose, D. et. al.

income tax rates and thresholds, the fiscal headroom which needs to be created will further increase.

26. Our best advice is to begin structural reform to address historic issues in the tax system and balance its objectives. The core aspects of such a package would be looking at mechanisms to manage the difference in rates between personal and company tax and introducing a capital gains tax.

27. If your judgment about the need for structural reform differs from ours, other tax reform could create significant fiscal headroom by emphasising raising revenue:

   a Progressively through a GST package of rates increase and rebate, deemed return tax on rental property, or inheritance tax. A net wealth tax or increasing the top personal tax rate could meet distributional objectives but comes with greater economic and integrity costs.

   b Based on different distributional judgments through a land tax or increased personal tax rates. These options have significantly different distributional outcomes, and assessing them requires value judgements.

28. If you wish to place less emphasis on revenue increases to achieve longer-term fiscal sustainability, then smaller impact options could be used to address fiscal pressures in upcoming Budgets. Such options are more likely to involve trading off coherence, compliance costs, administrative costs and integrity and fairness of the tax system.

29. We can provide more detail on those proposals, including choices to place additional weight on the tax system's objective of improving economic performance.

Recommended combination of levers to create fiscal headroom

30. Creating the headroom required to implement the fiscal strategy will prove a significant challenge. Over the course of the term we expect you will need to use all the levers outlined above – i.e., take decisions that increase revenue, restrain new spending, and reduce expenditure.

31. International evidence is that creating fiscal headroom on this scale is best done over the course of several years and focused on structural reforms to expenditure and revenue policy settings (using spending reviews and targeted policy reviews to do so).[5] This eases the otherwise sharp trade-offs between consolidation, equity, and economic growth objectives. Across the board expenditure reductions need to be carefully designed, as savings in dissimilar programmes do not have the same consequences, tend to add to long-term costs (e.g., by postponing maintenance), and often reverse savings over time.[6]

32. Our advice on creating fiscal headroom to implement the fiscal strategy is informed by this international evidence and past New Zealand experience – as well as the strict timeframes associated with funding a Mini Budget, demonstrating a path to surplus at Budget 2024, and delivering on the fiscal strategy. We propose you create fiscal headroom:

   a First by taking specific policy choices to reduce expenditure and increase revenue, complemented by an initial baseline exercise to implement a baseline reduction. These measures would focus on delivering a fiscally neutral Mini Budget and demonstrating a fiscal track consistent with the fiscal strategy at Budget 2024.

   b Then shifting following Budget 2024 to using Savings and Performance Plans, and associated reviews, to maintain and create fiscal headroom and drive increased focus on

[5] Balasundharam, V. et.al.,

[6] Daniel J. et.al. (2006) "Fiscal Adjustment for Stability and Growth", *IMF Pamphlet Series*, No. 55.

VFM of expenditure. These measures would focus on supporting you to stay on track to deliver your manifesto while achieving the fiscal strategy.

33. While the early process to create fiscal headroom will need to be centralised and highly directive in order to meet the tight timeframes associated with Budget decisions, over time it will be desirable to shift to a more decentralised model with agencies and their Ministers reporting to the CEC. This is important both to ensure collective ownership of the choices taken to create fiscal headroom, and to place the onus on agencies to front up to Cabinet with choices. Savings and Performance Plans, and associated reviews, will need to be used to manage the fact that agencies will have to operate within baselines this term – placing greater weight on reprioritisation efforts to fund cost pressures than in recent years.

34. Initial choices to implement this approach are outlined in *Budget 2024 and Mini Budget: Critical Early Decisions*. We will provide more detailed advice in light of those decisions, including on the Initial Baseline Exercise and Savings and Performance Plans

Section D: Balancing taking action early with the need to sequence change

35. The fiscal sustainability programme will need to balance taking decisive action early with the importance of sequencing change across the term. While above we emphasised thinking of fiscal sustainability as an ongoing goal to be pursued through a structured programme across the term, that programme needs to account for the time-critical nature of decisions to enable a Mini Budget and Budget 2024.

36. In the short-term, your focus will need to be on actions that:

    a Free up headroom to fund 100-day priorities and get the return to surplus on track in a way that is easy to implement, while mitigating the risk that decisions create fiscal risks later in the forecast period.

    b Send a strong signal that the fiscal sustainability programme is a priority for your Government and communicate your expectations that Ministers and the public sector should operate in accordance with its objectives across the course of the term.

    c Establish the right governance for the programme, to ensure the decisions you take flow through to implementation and agencies remain focused on results.

37. In the medium-term, your focus can shift to actions that:

    a Are not possible in the tight timeframes available, or where the need for further work is identified as part of short-term work.

    b Embed a culture of continuously improving VFM through visibility and scrutiny of baseline expenditure and holding decision-makers accountable for performance.

    c Mitigate fiscal risks which may otherwise defer the return to surplus.

38. These short- and medium-term imperatives can be balanced by progressing the programme in three phases. Figure 3 below outlines these proposed phases, and highlights key actions for each phase. Across all phases it will be important to maintain tight control over new spending and reinforcing fiscal discipline. This includes through managing within announced allowances and holding decision-makers accountable for performance.

39. Figure 4 below shows how these phases could map across the course of this term.

Figure 3: Fiscal programme phases and key actions (detailed)

Phase 1
HYEFU 2023
Budget 2024

This phase provides for swift decision-making, with a focus on creating immediate fiscal headroom:

- Establish the critical architecture for the fiscal programme. This includes Cabinet agreement to the programme, its objectives and approach, governance arrangements, and key elements of the work programme to deliver it.
- Fund a package of a few key priorities and implement them through a Mini Budget. The combination of speed and certainty required to ensure this Mini Budget is fiscally neutral means it will need to be tightly scoped, focused on making the policy decisions needed to realise the savings and revenue required to pay for time critical priorities that cannot wait until Budget 2024.
- Agree the approach to Budget 2024, including (if you wish) an Initial Baseline Exercise to manage the trade-offs between priority manifesto commitments, managing critical cost pressures, and expectations for agencies to identify and return savings. It will be important to consider the capital investment portfolio alongside operating expenditure, as capital decisions have operating implications.
- Set allowances (alongside any early decisions in a mini-Budget) consistent with meeting your fiscal and Budget objectives and deciding whether you wish to manage more types of spending within allowances (e.g., incorporating funds that are managed outside allowances).

Phase 2
Over 2024/25
Budget 2025

This phase comprises actions intended to maintain the focus on creating headroom from the initial phase, but shifting the emphasis to greater visibility and scrutiny of expenditure to ensure resources are aligned to delivering the Government's priories:

- Requiring all agencies to prepare and maintain Savings and Performance Plans, documents that pull together information about their priorities, performance, expenditure, and future funding needs. These would improve centralised information about value for money, and surface options for reprioritisation and choices to manage cost pressures within existing funding.
- A series of thematic reviews targeting areas of particular fiscal risk. Such reviews may need to be more focused on identifying savings until the fiscal outlook improves, when they could shift more to improving performance.
- Beginning CEC reviews of agency Savings and Performance Plans, including any associated performance targets and using them to inform Budget 2025.
- Further changes to institutional settings, with a particular focus on the quality of advice that informs Cabinet decision-making. This could include, for example, taking a stricter view of what constitutes financial implications and linking these to the impact on the fiscal strategy, and a review of the rules governing delegated financial decision-making set out in Cabinet Office Circular CO (18) 2.
- Progressing savings and/or revenue raising options identified as part of phase one which have a longer lead-in time (e.g., which require changes to legislation), and considering whether further centralised savings exercises are necessary.

Phase 3
Ongoing

This phase is focused on ensuring change is embedded. It entails:

- Embedding spending reviews as a core part of the public finance system. This includes initiating further thematic reviews as required and rolling reviews of Savings and Performance Plans for the remaining agencies which have yet to undergo a detailed review, before beginning the second round of reviews.
- Introducing changes to institutional settings which require significant changes to systems. This could include, for example, the costing and value for money assurance requirements used overseas outlined above.

Figure 4: Fiscal programme – phasing across the 2023-2026 term