The Treasury

Budget 2024 Information Release

September 2024

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Treasury Report: Vote Health Budget 2024 Settings

Date:	13 December 2023	Report No:	T2023/2003
		File Number:	SH-8-1

Action sought

	Action sought	Deadline
Hon Nicola Willis **Minister of Finance**	**Agree** to discuss the Vote Health Budget 2024 settings with the Minister of Health **Refer** this report to the Minister of Health	20 December 2023

Contact for telephone discussion (if required)

Name	Position		Telephone	1st Contact
Jill Caughey	Principal Advisor, Health	[39]	[35]	
Jess Hewat	Manager, Health			✓

Minister's Office actions (if required)

Return the signed report to Treasury.

Refer this report to the Minister of Health.

Note any feedback on the quality of the report	

Enclosure:

Treasury Report: Vote Health Budget 2024 Settings

This report follows Treasury's recent fiscal strategy and Budget 2024 advice. Vote Health spending is a significant and growing pressure on future budget allowances and poses a considerable affordability challenge to the Crown in the short, medium and longer term. As noted in our recent fiscal strategy advice, returning to surplus through a steadily improving Operating Balance Before Gains and Losses (OBEGAL) trajectory is important to support medium-term fiscal sustainability and macroeconomic stability.

Decisions on health funding need to be considered as part of a broader set of Budget and fiscal strategy choices, including difficult decisions about the coverage of the health system, spending choices in other Votes and options to raise revenue. The key fiscal challenge in health is how to manage spending growth sustainably while at the same time supporting equity and quality in outcomes.

This report provides you with detail and advice on two separate settings for Budget 2024 for Vote Health:

- The top-down and bottom-up forecasts that will inform Treasury's advice on Health New Zealand | Te Whatu Ora's cost pressures and reprioritisation options in Budget 2024.

- Our advice on the approach to budgeting for Vote Health, which involves a mix of annual and multi-year funding at Budget 2024.

A two-year funding settlement covering all operating and capital funding was provided in Budget 2022 as a transitional arrangement. This report covers the benefits, costs and risks of different approaches to budgeting for Vote Health (annual and multi-year). On balance Treasury recommends providing a three-year funding arrangement for health operating cost pressures only. Alongside better top-down and bottom-up forecasts of health expenditure, this will provide a better three year picture of Health New Zealand operating costs than we have had before, including on efficiencies and reprioritisation choices. It will also support decisions to improve the fiscal sustainability and value of Health New Zealand spending, as well as improve cost control. As such, it starts to operationalise the savings strategy discussed in T2023/1996 in a Health New Zealand context.

We are providing this report to you now because:

- We understand you have asked for more detail on what makes up the health cost pressure funding line publicly disclosed in recent Economic and Fiscal Updates.

- Decisions from you and the Minister of Health ahead of Christmas on your preferred approach to budgeting for health (annual vs multi-year) would enable officials to work on detailed design advice (for example, the approach to reprioritisation for Health New Zealand) in January, improving the utility of our advice to you during the Budget 2024 process in February / March.

- Referring this report to the Minister of Health (as we recommend) will ensure that you both have the same information early on about the Budget 2024 design choices and implications for Vote Health.

Health New Zealand is preparing budgets to fit within Budget 2024 planning parameters developed by the Treasury and the Ministry of Health in early 2023

Treasury's advice on health cost pressures in Budget 2024 for Health New Zealand[1] will be informed by both top-down and bottom-up forecasts of health spending including:

- A top-down funding model that was used to set the cost pressure planning parameters disclosed in the 2023 Budget and Pre-Election Economic and Fiscal Updates (BEFU and PREFU) and subsequently included in your fiscal plan. The planning parameters factor in demographic and inflation (including wage inflation) costs over the three-year period and include much larger efficiency expectations compared to historical Treasury or OECD projections of health expenditure.[2]

  The assumptions underpinning the top-down planning parameters mean that Health New Zealand is likely to need a mixture of management controls, efficiency / productivity savings and service changes ('reprioritisation') to manage within the planning parameters. While back-office efficiencies will be one part of this, the size of back-office spending, the level of efficiencies already built into 2023/24 budgets and the need to align future efficiencies with future phases of Health New Zealand's operating model roll-out will limit scale and pace of these.

- Bottom-up forecasting of health system activity, costs, efficiencies, and actions over the next three years as part developing the three-year costed 2024 New Zealand Health Plan. Bottom-up cost, efficiency and activity forecast information from Health New Zealand (and Te Aka Whai Ora) is due ahead of Christmas, including the New Zealand Health Plan financial annex templates issued by Treasury. The bottom-up forecasts have been informed by analytical inputs including agency-led baseline reviews that cover ~40% of Health New Zealand's spending.

The bottom-up information from Health New Zealand will also include detail on reprioritisation scenarios, which require Health New Zealand to set out what kinds of policy changes would be needed to allow the health cost pressures to be funded at a lower level than the top-down planning parameters. Given the level of efficiencies already built into the top-down planning parameters, this will likely require choices such as further service changes and rationing of services or increasing user-pays.

Further advice on health cost pressures, including assessing the bottom-up cost, efficiency and activity forecast, and reprioritisation options, will be provided to you early next year.

Decisions are needed about what aspects of funding at Budget 2024 should be annual vs multi-year

We recommend you discuss Vote Health Budget 2024 settings with the Minister of Health and take a decision on the approach to Budget 2024 funding (multi-year vs annual).

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[1] Decisions about funding for the Māori Health Authority | Te Aka Whai Ora will be subject to the timing and nature of its disestablishment process. We will advise you on this in due course. In this briefing we predominately focus on Health New Zealand. Te Aka Whai Ora has been covered by the same top-down and bottom-up cost pressure process as Health New Zealand, including completing financial annex templates, which will provide financial information to support decisions once detailed policy choices have been taken.

[2] The efficiency expectations are approximately three times that assumed in the OECD's "enhanced productivity" health expenditure projections for New Zealand.

Budgets are standardly set annually, and our advice is that this is retained for capital investment and new initiative funding in Vote Health for the time being. We recommend that cost pressure funding is provided on a multi-year basis. In summary, our advice is:

- ❌ Do not progress multi-year funding for new operating initiatives in Budgets 2024 to 2026
- ❌ Do not progress multi-year funding for capital investment in Budgets 2024 to 2026
- ✅ Progress multi-year funding for health operating cost pressures in Budgets 2024 to 2026 (with additional controls and protections).

Health New Zealand's systems and capability are still maturing and the entity is unlikely to meet a series of preconditions established by the previous Government to access a multi-year funding arrangement covering all funding. However, we want Health New Zealand to grow its capability in medium-term planning and budgeting and maximise incentives for cost control. We think multi-year cost pressure funding at Budget 2024 is the best option to support this. While this would mean that Vote Health is treated differently than most other Votes, and reduce fiscal flexibility in a time of fiscal consolidation, on balance we think that relative to other options multi-year cost pressure funding is preferable:

- A number of reviews have identified the lack of predictability in health funding as an inhibitor to effective long-term planning. This includes a forthcoming paper from the OECD that notes the importance of multi-year funding in providing incentives for effective forward planning, efficiency, the optimal allocation of resources, and supporting better quality inputs into the budget process.[3]
- A three-year funding package for cost pressures from Budget 2024 would provide a firm budget constraint for the New Zealand Health Plan, making it easier to hold Health New Zealand accountable for sticking to its budget and delivering on the Plan, including forecast efficiencies. Under the Pae Ora (Healthy Futures) Act 2022 (the Pae Ora Act), the New Zealand Health Plan must have effect from 1 July 2024, cover three years of activity and be fully costed. Compared to its predecessor system, the accountability settings, particularly the New Zealand Health Plan and associated financial information, helps set clear performance expectations and support incentives for financial control and delivery.
- In practice, unless Ministers want to make significant service or access reductions in health over the next three years, there is little risk in committing to meeting cost pressures upfront. The top-down and bottom-up approach to forecasting Health New Zealand cost pressures in Budget 2024 provides a good picture of the cost of running the health system and forecast volumes, productivity, efficiencies and reprioritisation options.
- Annual Budget arrangements in health, particularly annual arrangements without an early signal of cost pressure funding, tend to result in short-term purchasing and commissioning decisions that are often more expensive. These arrangements also result in a lot of analytical and planning capacity in agencies being focused on annual budget decisions, at the expense of more valuable analysis of baseline costs and opportunities.

Alternative options to multi-year cost pressure funding at Budget 2024

The main alternative to our recommended approach is returning to annual funding and delaying a decision on multi-year funding until Budget 2025. The key circumstance where we recommend deferring a decision on multi-year funding by one or two years is if Ministers wanted

[3] OECD, *Medium-term Budgeting for Health: going beyond the annual focus of the budget* (draft paper to be published in 2024)

to consider options for significant service and access reductions in health for affordability or other reasons.

Recommended Action

We recommend that you:

a **agree** to discuss the Vote Health Budget 2024 settings (multi-year vs annual) with the Minister of Health

Agree/disagree.

b **refer** this report to the Minister of Health.

Refer/not referred.

Jess Hewat
Manager, Health

Hon Nicola Willis
Minister of Finance

Purpose of Report

1. This report follows Treasury's recent fiscal strategy and Budget 2024 advice. Vote Health spending is a significant and growing pressure on future budget allowances and poses a considerable affordability challenge to the Crown in the short, medium and longer term. This report provides you with detail and advice on two separate settings for Budget 2024 for Vote Health:

   - The top-down and bottom-up forecasts that will inform Treasury's advice on Health New Zealand | Te Whatu Ora's cost pressures and reprioritisation options in Budget 2024. This includes the top-down cost pressure "planning parameters" publicly disclosed in recent Economic and Fiscal Updates, which set out an indicative funding track for Health New Zealand for the next three years.

   - Our advice on the approach to budgeting for Vote Health, which involves a mix of annual and multi-year funding at Budget 2024.

2. A two year funding settlement covering all operating and capital funding was provided in Budget 2022 as a transitional arrangement. This report covers the benefits, costs and risks of different approaches to budgeting for Vote Health (annual and multi-year). On balance, Treasury recommends providing a three year funding arrangement for health operating cost pressures only. Alongside better top-down and bottom-up forecasts of health expenditure, this will provide a better three year picture of Health New Zealand operating costs than we have had before, including on efficiencies and reprioritisation choices. It will also support decisions to improve the fiscal sustainability and value of Health New Zealand spending, as well as improve cost control. As such, it starts to operationalise the savings strategy discussed in T2023/1996 in a Health New Zealand context.

3. We recommend you discuss the Vote Health Budget 2024 settings with the Minister of Health. Decisions from you and the Minister of Health before Christmas on your preferred approach to budgeting for health (annual vs multi-year) would enable officials to work on detailed design advice (for example, the approach to reprioritisation for Health New Zealand) through January. This will improve the concreteness, and therefore the utility to you, of our advice during the Budget 2024 process in February / March.

The health system poses a significant affordability challenge for the Crown

Overview of Vote Health

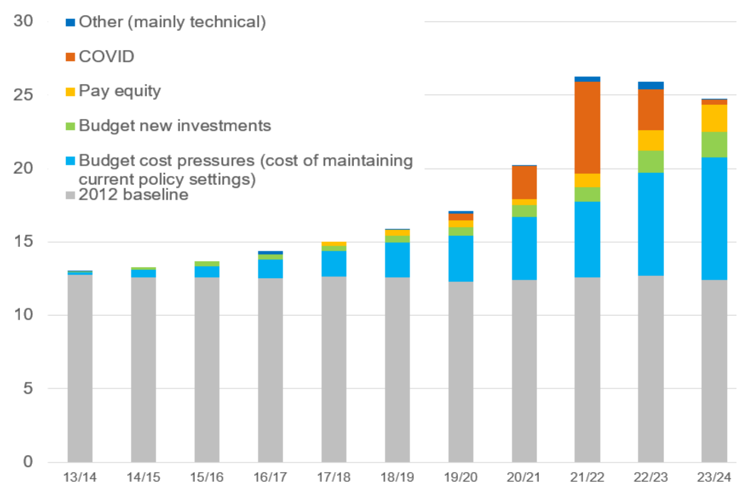
4. Vote Health operating spending is $24.7bn in 2023/24. It has grown ~5.6% pa from 2009/10 to 2023/24.[4] New Zealand's spending on health (as a percentage of GDP) is in line with the OECD average.

5. Vote Health has grown significantly recently in nominal terms (refer to Chart 1 overleaf). The bulk of this reflects demographic and price growth. Additional drivers include pay equity, cumulative service expansions (e.g. mental health and cancer screening), higher staffing levels as agreed in employment negotiations, an expansion of pharmaceutical purchasing, and COVID-19 (which had high temporary costs, and lower ongoing costs likely hidden in the base).

[4] Excludes Disability Support Services and COVID-19 appropriations.

6. Alongside significant recent growth in expenditure, productivity growth has slowed; we are paying more for inputs and/or delivering fewer outputs for a fixed quantity of inputs. This is consistent with trends in other developed countries. No single cause exists for this change but contributors are likely to include the ongoing impacts of COVID-19, inefficiencies in the hospital system generated by access issues in the primary and community sector, the fact that people in hospital are on average sicker and in need of more care, and safe staffing requirements. Health New Zealand are introducing productivity metrics in its reporting from December 2023 and we expect the New Zealand Health Plan (covering 2024/25 to 2026/27) and associated financial annexes to provide information on forecast volumes and productivity improvements.

Chart 1: Total Vote Health operating expenditure (2013/14 – 2023/24, $bn)



*This chart shows cumulative increases since Budget 2013 for each year. I.e. the 2023/24 bar represents **all changes to the baseline** since Budget 2013. This chart is based on data pulled from multiple sources to provide an overall picture of key drivers of health spending in recent years. It has not been subjected to detailed QA.*

Difficult trade-offs and choices, including on health spending, will be required both to deliver on your short-term fiscal strategy objectives and address medium-term fiscal sustainability

7. As noted in our recent fiscal strategy advice, returning to surplus through a steadily improving Operating Balance Before Gains and Losses (OBEGAL) trajectory is important to support medium-term fiscal sustainability and macroeconomic stability. Achieving this whilst delivering your Government policy commitments within highly constrained Budget allowances will require difficult decisions. It will require a deliberate and structured programme of reprioritisation, savings, new spending restraint, and revenue raising measures over successive Budgets (refer T2023/1992).

8. Vote Health accounts for about 15% of annual spending through appropriations and will be a significant and growing pressure on future budget allowances. Treasury's long term fiscal model projects health spending to growth from ~7% of GDP today to ~10% of GDP by 2061, consistent with international experience.[5]

9. Whilst efficiency and productivity improvements will make a modest contribution to fiscal sustainability in health, they will not be sufficient to fundamentally bend the health cost curve in order to address long-term affordability challenges.[6] Even in a more efficient system, underlying drivers of expenditure will remain including: population growth, ageing, income and technology driven demand and relatively low productivity growth in health.

[5] This is Core Crown health spending (including ACC), not just Vote Health spending.
[6] See for example, OECD, *Health Spending Projections to 2030* (2019), New Zealand Treasury, *Health Projections and Policy Options* (July 2013)

10. Improving medium-term fiscal sustainability in health therefore needs to be considered as part of a broader set of Budget and fiscal strategy choices, including difficult decisions about the coverage of the health system, spending choices in other Votes and options to raise revenue. The key fiscal challenge in health is how to manage spending growth sustainably while at the same time supporting equity and quality in outcomes.

Health New Zealand is preparing budgets to fit within Budget 2024 planning parameters developed by Treasury and the Ministry of Health in early 2023

11. Treasury's advice on health cost pressures and reprioritisation in Budget 2024 for Health New Zealand[7] will be informed by both a top-down funding model and bottom-up planning and budgeting by Health New Zealand as part developing the 2024 New Zealand Health Plan (covering 2024/25 to 2026/27), along with a consideration of what is required to achieve the Government's fiscal strategy. Together this will provide a better three year picture of Health New Zealand operating costs than we have had before, including on efficiencies and reprioritisation choices.

Top-down modelling has delivered cost pressure planning parameters that represent the minimum cost of maintaining current policy settings, having factored in efficiency gains

12. Budgetary planning parameters for cost pressures only were issued to Health New Zealand (and Te Aka Whai Ora) in March 2023 based on a top-down funding model. These were published in BEFU 2023, PREFU 2023 and will be published in HYEFU 2023. You have also included them in your Fiscal Plan.

13. The planning parameters only cover Health New Zealand and Te Aka Whai Ora cost pressures (not capital or new-initiative funding). The parameters do not cover Pharmac (approximately 5.5% of Vote Health). Health New Zealand and Te Aka Whai Ora represent 91% and 2.6% of Vote Health operating spending respectively.

14. The table overleaf summarises the key assumptions underpinning the planning parameters. These assumptions were informed by international and domestic literature and modelling and were tested with subject matter experts from the Ministry of Health and Treasury. This included a New Zealand Institute of Economic Research literature review on health productivity and efficiency.

15. The annual increases reflected in the planning parameters are largely driven by inflation (including wage bargaining) and staffing increases to meet demographic demand. Other cost drivers in health do exist, which are commonly referred to in health economics literature as the "residual". The residual includes things like:

    - Additional costs driven by technology or process enhancements and innovations. Unlike in other industries, technological and process innovations in the health sector have generally been observed as cost escalating rather than cost containing. This is because technologies and process innovations often result in an expansion of people who receive care, e.g. through improved diagnostics or via wider application of treatments.

    - Rising prevalence of chronic health conditions (over and above the impact of demographic change).

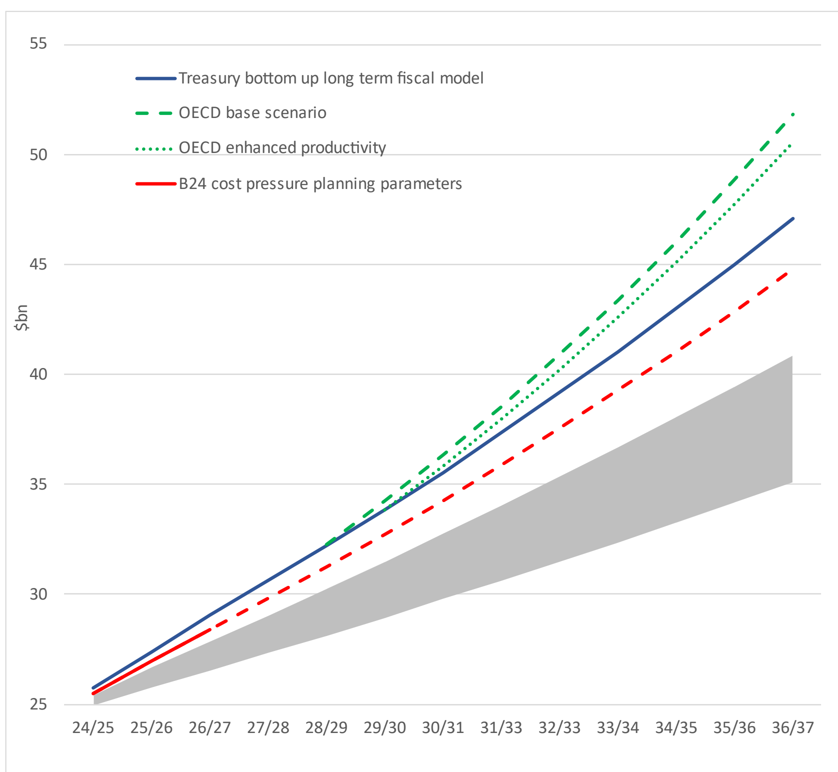
[7] Decisions about funding for the Māori Health Authority | Te Aka Whai Ora will be subject to the timing and nature of its disestablishment process. We will advise you on this in due course. In this briefing we predominately focus on Health New Zealand.

16. The assumptions underpinning the planning parameters are deliberately cautious (i.e. on the low end of the credible range of assumptions considered). As the table below shows, we are assuming that over the next three years these other cost drivers will be fully offset by gains in efficiency and productivity at Health New Zealand. Domestic and international literature suggests that this assumption is ambitious. However, we want Health New Zealand to have strong incentives to seek out and implement innovations that will improve efficiency and value for money. Having said that, for this reason:

- We consider the planning parameters represent the minimum funding level required to maintain current policy settings. They assume large savings compared to historical Treasury or OECD projections of health expenditure (see table below and chart overleaf).
- We do not think it will be possible to accommodate service changes (e.g. expanding breast cancer screening) within the planning parameters without reprioritising funding away from existing services. Historical experience with district health boards suggests that any such reprioritisation needs to be agreed upfront on the basis of a clear implementation plan, otherwise the promised savings may not eventuate and deficits (or unexpected declines in service delivery) can result.

[38]

Chart 2: Comparison of Budget 2024 planning parameters to OECD and historical Treasury health expenditure projections



The grey wedge shows health cost pressures at 29-44% of Budget allowances, reflecting Vote Health's historical share between Budget 2013 and Budget 2023 (for both cost pressures and new investments). It uses Budget allowances from your Fiscal Plan. This grey wedge is lower than the budget planning parameters due to a combination of Budget allowance settings and demographic change.

Health New Zealand is building a three-year bottom-up cost and activity forecast (as required for the New Zealand Health Plan) that it will adjust to fit within the top-down planning parameters

17. Alongside the top-down health planning parameters, Health New Zealand (and Te Aka Whai Ora) is developing and refining a detailed bottom-up forecast of health system activity, costs and actions over the next three years. This is a key part of developing the three-year costed New Zealand Health Plan covering 2024/25 to 2026/27 as required by the Pae Ora Act.[8]

18. The Health New Zealand cost and activity forecast is informed by analytical inputs that collectively provide a much more detailed and nuanced picture of cost pressures than the top-down model. This includes in-depth agency led baseline reviews that cover ~40% of Health New Zealand's spending. The combination of these baseline reviews and a single financial system are providing Health New Zealand visibility of variation in costs and cost structures that can be addressed over time. These baseline reviews, along with the other analytical work underpinning the New Zealand Health Plan, will provide useful insights into baselines and performance to input into Treasury's proposed savings and performance plans.

19. As expected, given the assumptions in the top-down planning parameters, early indications from Health New Zealand are that its bottom-up model indicates higher annual costs than forecast in the top-down model. Health New Zealand is likely to need to manage cost growth in the order of [33] of baselines to stay within the parameters, via a mix of management controls, efficiency / productivity savings and service changes ('reprioritisation').

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[8] Under the current legislation Health New Zealand and Te Aka Whai Ora are responsible for developing the New Zealand Health Plan. Te Aka Whai Ora is also developing a bottom-up forecast of its services and costs as part of developing the New Zealand Health Plan, noting that most of its baseline is contracts with Māori providers previously held by district health boards.

20. Whilst some of the reduction in cost growth will come from back office efficiencies, there are limitations on the scale and pace of these, given the size of back office spending, the level of efficiencies already built into 2023/24 budgets and the need to align future efficiencies with future phases of Health New Zealand's operating model roll out. This means that managing within the parameters will require constraint on wage and FTE growth, as well as some service changes that reprioritise lower value frontline services to higher value services.

21. Bottom-up cost and activity forecast information from Health New Zealand (and Te Aka Whai Ora) is due ahead of Christmas, including completing New Zealand Health Plan financial annex templates issued by Treasury earlier this year. The annexes will include detail of the choices required to manage within the planning parameters, including forecast efficiencies and service changes ('reprioritisation').

Health New Zealand will be providing information on reprioritisation options prior to Christmas as part of its existing Budget 2024 work

22. Health New Zealand (and Te Aka Whai Ora) need to set out reprioritisation options as part of its New Zealand Health Plan financial annex templates that are due with Treasury ahead of Christmas. These require Health New Zealand to set out what kinds of policy changes would allow the planning parameters to be reduced by [33] and [38] Given the level of efficiencies already built into the top-down planning parameters, this will require choices such as further rationing services or increasing user-pays.

23. [33]

24. This information on Health New Zealand reprioritisation options could be used to inform decisions through Budget 2024 on reprioritisation targets for Health New Zealand (as recently proposed in Treasury's baseline reduction advice – refer T2023/1996). Alongside the three year bottom up cost, activity and efficiency forecasts, it starts to operationalise the savings strategy discussed in Treasury's recent advice in a Health New Zealand context (refer T2023/1996).

Decisions are needed about what aspects of Vote Health funding at Budget 2024 should be annual vs multi-year

25. Standard practice across most Votes is to decide funding for the following year (and outyears) annually at each year's Budget. This allows Ministers to make decisions about investments based on the newest possible information, compare value for money across all possible investments at one time, and maintain flexibility to respond to changing economic conditions.

26. On Treasury's advice the previous Government agreed to shift to a multi-year funding approach in health. This included a two-year transitional arrangement in Budget 2022 and a three-year arrangement from Budget 2024 (subject to improvements in planning and financial control). Treasury's advice in 2021 was that the benefits of providing greater funding certainty to support planning outweighed any downsides from reduced fiscal

[9] The scenarios are called "affordability scenarios" in the financial annex templates. [33] and [38]

flexibility, noting that any reduction in fiscal flexibility was limited in practice. This section sets out Treasury's advice on what the budgeting approach for Vote Health should be in Budget 2024. It considers the relative benefits, costs and risks of different approaches to budgeting for Vote Health (annual and multi-year).

27. **We propose that annual Budget funding be retained for all new initiative funding** in Vote Health, **and for all capital investment** for the time being. Our view is that decision-makers currently lack the necessary information to make three-year funding commitments for capital and new initiatives. Transitioning to multi-year funding for these parts of the system would risk:

- getting the level of funding wrong;
- prioritising the wrong investments from a value and deliverability perspective; and
- not adequately understanding reprioritisation decisions in the case of new operating investments.

28. We recommend reconsidering the readiness and case for multi-year funding for new initiatives and capital at Budget 2027 once information and capability is more mature. There are some early signs of progress in capital planning. An initial draft of the Health New Zealand's ten year Infrastructure Investment Plan is starting to bring together a prioritised national picture of investments, as well as considering options and implications of changes to models of care for the future capital pipeline.

29. Retaining an annual arrangement for new operating and capital investments would also give Ministers more flexibility to consider and announce new health and capital initiatives as part of the next three Budgets.

30. **We propose that a multi-year commitment be made at Budget 2024 for cost pressure funding only**. The rationale for this is set out in the following section, along with a discussion of the main risks and benefits. A fuller options assessment is provided in Annex A.

We want the system to grow its capability in multi-year planning and maximise incentives for cost control and we think multi-year cost-pressure funding will support this

31. We want the health system to engage in better medium-term planning and budgeting, giving relatively more attention to intended expenditure and activity 24+ months out than is currently the case. This is important in getting better allocative decisions, longer-term higher-value contracts and partnerships, "invest to save" approaches to healthcare delivery, and better-quality inputs into the Budget process. This approach enables the system to make more headway on problems that need sustained attention over multiple years e.g. changing models of care to improve efficiency and equity.

32. The Pae Ora Act requires Health New Zealand (and Te Aka Whai Ora) to develop a three-year New Zealand Health Plan to take effect from 1 July 2024. This will be an important driver of medium-term thinking and planning in the new system.

33. Our view is that **providing a multi-year funding package of cost pressure funding only at Budget 2024 will further support Health New Zealand to shift to a multi-year planning mindset and maximise incentives for cost control**. While this would mean that Vote Health is treated differently than most other Votes, and reduces fiscal flexibility in a time of fiscal consolidation, on balance we think that relative to other options multi-year cost pressure funding is preferable:

- A number of reviews have identified the lack of predictability in Budget funding for health as an inhibitor to effective long-term planning, and as being associated with poor use of resources.[10]

- A multi-year funding package for cost pressures from Budget 2024 would align the planning horizon of the New Zealand Health Plan with funding decisions for services. It would provide a firm budget constraint for the New Zealand Health Plan, making it easier to hold Health New Zealand accountable for sticking to its budget and delivering on the Plan. Compared to its predecessor system, the accountability settings, particularly the New Zealand Health Plan and associated financial information, helps set clear performance expectations whilst setting incentives for financial control and delivery.

- Annual Budget arrangements in health, particularly annual arrangements without an early signal of cost pressure funding, tend to result in short-term purchasing and commissioning decisions that are often more expensive. These arrangements also result in a lot of analytical and planning capacity in agencies (including the Treasury) being focused on marginal spending decisions, at the expense of more valuable analysis of baseline costs and opportunities.

- Unless Ministers want to make significant service or access reductions in health (i.e. real reductions in funding and services, having already factored in productivity improvements and netted off all savings and reprioritisation efforts) in the next three years, there is little risk in committing to meeting cost pressures upfront. The top-down and bottom-up approach to advising on Health New Zealand cost pressures in Budget 2024 provides a good picture of the cost of running the health system and forecast activities. Ministers will still have options to mandate the reprioritisation of funding within the three-year period to accommodate policy change.

- A multi-year funding package does not mean a multi-year appropriation (which would allow health entities to choose for themselves how to phase expenditure over a multi-year period). In our proposed approach, all funding would still be provided, and accounted for, annually via appropriations; and would be charged against annual Budget allowances. The key difference is that Health New Zealand would know at Budget 2024 what cost pressure funding it will receive through to the end of 2026/27, rather than finding out one year at a time. Funding set aside for 2025/26 and 2026/27 could not be brought forward to 2024/25.

Alternative options to multi-year cost pressure funding at Budget 2024

34. As part of our options assessment (see Annex A), **we considered returning to annual funding and delaying a decision on multi-year cost pressure funding until Budget 2025.** Whilst a year's delay would provide additional time to scrutinise the detail of Health New Zealand's 2025/26 and 2026/27 planning and budgeting, for the reasons set out in the previous paragraph, it is unlikely to change Treasury's advice on the total cost pressure quantum needed and it risks creating uncertainty and deferring the benefits of multi-year funding by a year.

35. The key circumstance where we would recommend deferring a decision on multi-year funding by one or two years is if Ministers wanted to consider options for significant service and access reductions in health for affordability or other reasons. In that case, an annual or two-year cost pressure budget in Budget 2024 would enable time for policy work and implementation planning; and provide flexibility to reduce cost pressure funding in 2026/27 relative to the existing planning parameters.

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[10] For example, OECD, *Medium-term Budgeting for Health: going beyond the annual focus of the budget* (draft paper to be published in 2024), *Health and Disability System Review* (2020), Ministry of Health, Treasury and DPMC Working Group, *Future Funding of Health and Disability Services in New Zealand* (2002).

36. If your preference is to delay a decision on multi-year funding until Budget 2024 or return to annual funding, we can provide further advice on design options.

37. The diagram below contrasts a multi-year arrangement with an annual arrangement. The key difference between the two arrangements is the timing of when decisions are taken. In a multi-year arrangement cost pressure decisions for 2024/25 to 2026/27 are taken in Budget 2024, whereas in an annual arrangement cost pressure decisions get taken Budget by Budget.

Chart 3: Comparison of multi-year and annual funding arrangements

Multi-year funding arrangement **Annual funding arrangement**

Over the past two years, building conditions into Budget arrangements has been useful in improving the quality of Health New Zealand's planning and budgeting

Budget 2022

38. When the previous Ministers agreed a two-year Vote Health funding package for 2022/23 and 2023/24, they decided to hold cost-pressure funding in contingency for release only when Health New Zealand had met a series of conditions (primarily focussed on providing additional information about intended delivery and expenditure). The process of agreeing the drawdown of cost pressure funding gave Ministers and their monitoring agencies access to much better information than might otherwise have been available.

Budget 2024

39. In early 2023, Ministers agreed the following five preconditions for Health New Zealand to access multi-year funding for all new funding (cost pressures and new investments) from Budget 2024:

Table 2: Preconditions for shifting to multi-year health funding from Budget 2024

<table>
<tr><th>System accountability settings</th><th>Capability</th></tr>
<tr><td>A. The Government Policy Statement (GPS) meets minimum standards and provides expectations that are sufficient to guide the development of the NZHP.</td><td rowspan="4">E. The health system demonstrates capability to manage a full three-year funding settlement in the transition period to July 2024. Evidence includes:

i. The system is forecast to be in financial balance at June 2024.

ii. Funding streams are being managed in a way that reflects the appropriation and output class structure.

iii. Reporting and monitoring provides an improved picture of performance and risk and is used to inform decisions.

iv. Information to support drawdown of the cost pressure contingencies agreed at Budget 2022 meets requirements.

v. Establishment of critical financial and planning capabilities and systems.

vi. Effective working arrangements between entities.</td></tr>
<tr><td>B. The New Zealand Health Plan is a fully costed spending plan that responds to the GPS and provides Ministers with a coherent representation of planned activity.</td></tr>
<tr><td>C. Processes and plans are in place to respond to performance and financial risks during the multi-year period.</td></tr>
<tr><td>D. There are clear and commonly understood governance structures and financial delegations that enable funding to be allocated in line with the GPS and the NZHP.</td></tr>
</table>

40. These preconditions were predicated on the assumption that Health New Zealand would be starting from a relatively tidy starting position in terms of its financial and data systems, and would have about 18 months to make significant improvements from this position.

41. In reality, Health New Zealand inherited a lot of complex financial and data systems from district health boards that were not fit for purpose and has spent significant effort getting things in shape to enable joined-up planning and reporting. It has also taken longer than we had hoped for Health New Zealand to establish its operating model and make key appointments.

42. Consequently, Health New Zealand is some way behind where we had envisaged it would be in terms of maturity in planning, budgeting and implementation. It has however, made a lot of visible progress recently. Through the development of the New Zealand Health Plan we are getting increasingly robust and coherent forecasts of health system activities, costs and actions over the next three years. Health New Zealand also achieved a break-even position for 2022/23, and so far, is on track to do so for 2023/24. In the context of two decades of near continuous fiscal deficits in the health sector, this has been a significant achievement, and has been accompanied by an improved culture of financial control.

43. Noting the above, it seems unlikely that Health New Zealand will fully meet the preconditions. The question then is whether given where we are now the risks of shifting to multi-year funding for cost pressures outweigh the benefits outlined at paragraphs 31 to 33.

We think the risks of shifting to multi-year funding for cost pressures can be managed

44. The main risks of shifting to multi-year funding for cost pressures before Health New Zealand has fully met the above preconditions are:

    - Capability risk: System settings or practices at Health New Zealand will be inadequate to identify or manage risks or issues that arise in the next three years.

    - Cultural risk: Health New Zealand will come to view Ministerial or Treasury conditions as negotiable.

45. On the capability risk: this is a valid concern, given many performance reporting and management practices across the system are immature. However, we do not think that annual Budget funding meaningfully mitigates this risk. It may even exacerbate it through tying up managerial attention with annual Budget processes rather than more valuable analysis of baseline costs and opportunities. Whether a single-year or multi-year approach is chosen, all funds will still be allocated and accounted for on an annual basis, and monitoring and reporting practices will be largely the same in both models.

46. On the cultural risk: again, this is a valid concern. To mitigate this risk in terms of Ministerial conditions, you can clearly communicate to Health New Zealand that any decision you make about multi-year funding will be based on your judgement about the best option available to you without reference to past Ministerial decisions. From a Treasury perspective, there are a range of tools that can be used to maintain Health New Zealand's incentives to meet Budget and public finance requirements. Examples include using contingency drawdown processes to get more detailed financial and delivery information (such as those used for Health New Zealand post Budget 2022 as discussed above in paragraph 38), and intervention levers under the Crown Entities Act 2004 to provide more targeted Ministerial direction, protections and accountabilities where capability is still maturing.

47. As noted earlier, the available evidence seems to suggest that providing some multi-year funding certainty plays an important role in supporting the building of multi-year planning and budgeting capability. A forthcoming paper from the OECD notes the importance of multi-year funding in providing incentives for effective forward planning, efficiency, and the optimal allocation of resources (refer footnote 3). If we wait until Health New Zealand is fully capable of realising every benefit of multi-year funding, there is a risk this arrangement is repeatedly delayed, particularly as having some multi-year funding certainty (even if just for cost pressures) will in itself provide incentives and further opportunities to improve capability.

Whatever you decide, we recommend building in controls and protections focused on risk identification and management

48. Given that Health New Zealand is still developing its maturity, including in performance reporting and management practices, we think some additional controls and protections will be needed to understand and manage risk. Such controls and protections will be needed irrespective of whether Health New Zealand receives annual or multi-year cost pressure funding at Budget 2024 because annual Budget funding will not address or mitigate underpinning gaps in capability or maturity.

49. We will work with health entities to provide further advice on additional controls and protections as part of our Budget 2024 Vote Health advice early next year. The design of these levers need to be proportionate to the risk involved. By way of illustration, these could include a mix of:

- Additional information requirements e.g. the use of contingencies for cost pressures to get more detailed ex ante visibility over forecast budgets and delivery, as well as reporting requirements to support improvements in performance information.
- An agreed capability build between now and Budget 2027 with clear milestones and consequences for not meeting milestones. Health New Zealand already has some existing plans that could be used as foundational blocks for this e.g. its financial reporting roadmap, and hospital and specialist services purchasing system work. Depending on Health New Zealand's progress in other areas over the next few months, there is also the option to use legislative 'intervention' tools in areas of significant concern to manage risks. This could include reviewing options to improve financial expertise on the Board and information flows between entities.

Next steps

50. We recommend you discuss Vote Health Budget 2024 settings with the Minister of Health and officials and take a decision on the approach to Budget 2024 operating cost pressure funding (multi-year vs annual).

51. We will provide you with more detailed advice on Budget 2024 for Vote Health early next year. This will include:

- information on health cost pressures, including the implications of the bottom-up cost, efficiency and activity forecasts, and reprioritisation options, from Health New Zealand; and
- the controls and protections we recommend you build into any arrangement to better understand risk and manage risks.

52. A decision from you and the Minister of Health prior to Christmas on your preferred approach to cost pressure funding would improve the concreteness, and therefore utility to you, of this advice.

Annex A: Assessment of Vote Health Operating Budgeting arrangements

Option	Certainty	Flexibility	Vision for reform	Financial Sustainability	Global prioritisation	Transparency
Option 1: **Annual Budget**	Annual health spending only confirmed 2.5 months prior to start of financial year (unless early signal given). Marginal spend is important for planning.	Flexibility to add new health initiatives each year. In practice flexibility on cost pressures is limited given requires changes to policy settings.	Funding & planning cycles are not aligned. Does not support building medium-term strategic planning capability and culture. Providing single year Government Budget likely means you only get one year of detailed internal Health NZ budget.	In theory annual budget supports sustainability. But absence of early signal on "top-down funding track/constraint" may mean costs end up higher than would otherwise have been. Poor incentives for medium term strategic investment, e.g. 'invest to save'.	Main benefit is the ability to prioritise across new investments.	Focus on marginal spend limits the ability to scrutinise the baseline. Future funding for health not transparent.
Option 2: **Multi-year Budget certainty for cost pressures only** (a range of design choices within this) ***(Treasury preferred option)***	Improves certainty for the health sector re core cost pressure funding. Also improves certainty for the Crown.	Flexibility to add new health initiatives each year. Limits flexibility to reconsider health policy settings to reduce costs, but in practice policy and design work mean reductions would be implemented in next arrangement.	Funding and planning cycles partially aligned, which supports building medium-term strategic planning, capability and culture. Will enable us to get a 3-year detailed internal Health NZ budget.	Provides better incentives for efficiency & cost control. A credible forward funding path makes it easier to hold health entities accountable for sticking to their budget and delivering on NZHP (3-year horizon).	Annual universal prioritisation of new initiatives promotes consistency.	Allows for increased baseline scrutiny e.g. via 3-year spending plan, via budget conditions built in to access budget funding. Future health cost pressure spending clearly communicated in forecasts. Basis for cost pressure growth is transparent.
Option 3: **Multi-year Budget certainty for cost pressures <u>AND</u> new investments** (a range of design choices within this)	Improves fiscal certainty for the health sector. Also improves certainty for the Crown.	Limits flexibility to add new health initiatives each year, although design choices support some flexibility. In practice flexibility on health cost pressures is limited.	Funding and planning cycles are aligned, which supports building medium-term strategic planning, capability and culture. Will enable us to get a 3-year detailed internal Health NZ budget. If we don't have good information on new investments, this could result in suboptimal decisions.	Provides better incentives for efficiency & cost control. A credible forward funding path helps hold health entities accountable for sticking to their budget and delivering on NZHP (3-year horizon). If new investments are not well developed, there is a risk to costings & delivery.	Locks in any new initiative funding for health so can't trade-off new investment choices on an annual basis.	Allows for increased baseline scrutiny e.g. via 3-year spending plan, via budget conditions built in to access budget funding. Future health spending clearly communicated in forecasts. Basis for growth is transparent.
Option 4: **Defer shift to multi-year funding until B25**	Creates uncertainty for the health sector.	Provides additional time to scrutinise Year 2 and Year 3 costs (although unlikely to change Tsy advice on quantum)	Funding and planning cycles not aligned. Defers benefits of multi-year funding certainty. Single year Government Budget likely means you only get one year of detailed internal Health NZ budget.	Absence of early signal on "top-down funding track/constraint" may mean costs end up higher. Poor incentives for medium-term strategic investment, e.g. 'invest to save'.	Main benefit is ability to prioritise across new investment and savings in B24 and B25.	Less transparency of medium-term planning and budgeting. Future funding for health not transparent.

Key

- Some negative impact
- Ambiguous impact
- Some positive impact
- Larger positive impact