



# SageBush public finance resources

## Managing cost increases

SageBush's public finance resources support public sector leaders to understand and manage financial challenges.

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# Context: Managing costs in the public sector is difficult

Managing cost increases in the public sector is difficult because the key levers used in other sectors – increasing revenue by increasing prices and reducing services – are generally not available. Revenue is fixed, and any increases must be agreed by Cabinet. Reducing services is often resisted by ministers, officials and the public. Agencies are therefore expected to meet cost increases from within existing baselines.

It is therefore not surprising that budget bids are often the default response from agencies trying to manage cost increases. However, this approach is rarely successful due to other funding priorities and is unlikely to be supported unless other options have been thoroughly explored. Agencies also risk damaging their credibility by pushing for budget bids without exploring other options. The more often they respond in this way, the less likely they are to be supported when they really do need new funding.

This paper provides a high-level framework to help public sector agencies manage cost increases. It is intended to assist agencies to identify a range of options to address their funding issues.

## Step 1: Size the problem

The first step is to confirm whether there is a problem and how big it is. To do this, cost forecasts should be developed over a medium to long time horizon.<sup>1</sup> This will help to determine whether cost increases are a short-term issue or a more systemic problem. The forecasts should be critiqued and confirmed within the agency.

Forecast costs should be compared to available funding (appropriations). This will show whether the agency is facing a funding shortfall and how big it is. Increased costs do not necessarily mean an agency has a problem if it has an existing funding surplus or if revenue is increasing by a similar amount.

## Step 2: Understand the causes

Next, the causes of funding shortfalls need to be understood in order to determine the appropriate response. Funding shortfalls should be grouped according to how costs are generated and where the decision-making authority lies.

There are four general groupings:

- **Agency decisions** – costs may have increased due to internal agency decisions. These decisions are usually about increasing the level or nature of support activities or changes to business processes. Agencies are accountable for managing cost increases resulting from internal decisions.
- **Demand for services** – costs may have increased due to changes in demand for services. Agencies may need to consider requesting additional Crown funding and/or increasing fees (with corresponding appropriation changes) to reflect changes in demand.
- **Unavoidable costs** – costs may have increased due to factors outside the control of the agency or government. These might include inflation, pay increases, contractual commitments or increased supplier costs. Agencies are expected to manage these costs within existing baselines.
- **Government decisions** – costs and/or funding may have increased due to government decisions, typically to provide new services or to extend existing services. If there is no new funding or existing funding is insufficient, an agency must take steps to reduce costs to meet the government's requirements.

<sup>1</sup> The time horizon should align with the 4-year plan or other long-term planning documents such as the strategic financial plan (10 years).

## Step 3: Identify options

The third step is to identify options to manage the forecast funding shortfalls. There are six general approaches:

### Reduce costs

1. **Prioritise** – existing activities and services should be reviewed and prioritised to identify low-value activities. Costs can be reduced by cutting back or stopping low-value activities.
2. **Realise efficiencies** – costs can be reduced by improving productivity through technological, process and/or service delivery changes.
3. **Change services** – costs can also be reduced by changing the nature, range or level of services delivered. This may lead to a reduction in activities or services provided and may require ministerial approval.

### Increase funding

4. **Increase revenue** – agencies may consider increasing revenue to meet volume-driven cost increases. If the activity is Crown funded, the agency may need to request an increase in Crown revenue. If the activity is fee funded, revenue should adjust with volumes, but fee changes may be necessary.
5. **Adjust appropriations** – there are a number of options to adjust appropriations to meet cost increases including transferring underspends, fiscally neutral transfers and linking appropriations to volumes.
6. **New funding** – the last resort should be to request new funding. This can be done through a Cabinet paper seeking policy decisions or through the annual budget process.

Of course, some of these approaches will be appropriate for some funding shortfalls but not others. Options therefore need to be considered in the context of the cause of the cost increases. An example of how this might work is illustrated in the following table:

		Causes				
		Agency decisions	Demand for services	Unavoidable costs	Government decisions	
Options	Reduce costs	Prioritise	✓	✓	✓	
		Realise efficiencies	✓	✓	✓	
		Change services			✓	
	Increase funding	Increase fees		✓		
		Adjust appropriations			✓	✓
		New funding		✓	✓	✓

The nature of each option and how it would be applied should be worked through with agency staff. This process will result in a long list of options with descriptions of how they would work and expected impacts.

## Step 4: Assess options

The long list of options should be assessed against criteria such as:

- achievability – how difficult will it be to implement?
- impact on delivery of outputs – what will be the impact on the quantity, quality or scope of services?
- impact on business – what will be the impact on business operations?
- ability to meet funding shortfall – are the potential cost savings and/or funding increases sufficient to meet the funding shortfall?
- risk of adverse impacts – what are the potential risks and are they manageable?

The assessment process will result in a short list that should be analysed in more depth – in particular, the impact on achievement of organisational goals. Business groups should be consulted and the preferred option (or suite of options if they are to be implemented jointly) agreed.

## Step 5: Approval of preferred option

A paper should be prepared for the leadership team requesting approval to implement the preferred option.

The paper should outline forecast costs, expenditure and revenue appropriations and resulting funding shortfalls. It should then set out the identification and assessment of options, leading to the preferred option.

It will need to clearly identify any impacts on services and achievement of organisational goals. Significant changes to outputs, deliverables or the agency's strategy may require discussion with key stakeholders such as the responsible minister, Treasury, State Services Commission and/or other interested agencies.

The leadership team will need to make a decision on the preferred option and allocate responsibility for implementation. Project plans will then need to be developed, resources allocated and teams established with clear deliverables and timeframes.

## Postscript: Terminology matters

To encourage agencies to resolve funding issues internally rather than seeking more funding, we need to change the terminology used to describe financial issues. For example, the term 'cost pressure' has been deliberately avoided in this paper.

'Cost pressure' is often used broadly to describe any activity that is unfunded, whether these activities are driven by ministerial directions or requirements, unavoidable costs or proposed new initiatives. This makes prioritising activities more complicated than it needs to be, heightens the sense of urgency and potentially disempowers the agency by creating the perception that a budget bid is the only way that it can manage cost increases. We therefore advise agencies to refer to 'funding shortfalls' rather than 'cost pressures'.

Please contact us  
if you would like to talk  
about specific challenges  
your agency is facing.



**Ben Bush** 021 208 5432  
ben.bush@sagebush.co.nz

**Brian Sage** 027 223 0541  
brian.sage@sagebush.co.nz

