THE TREASURY
Kaitohutohu Kaupapa Rawa

Affording Our Future

Speech Notes

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Embargoed until 2pm

Thursday 11 July 2013

Good afternoon.

Thank-you for coming to cover an issue of strong public interest, particularly for younger people who have a stake in what our country will be like in the middle of this century and beyond.

You are here because *Affording Our Future*, the Treasury's *2013 Statement on the Long-Term Fiscal Position*, has now been presented to Parliament. The *Statement* updates our 2009 analysis of the Crown's long-term financial position.

This four-yearly update, which fulfils a reporting requirement in the Public Finance Act, represents the culmination of over a year of research, academic peer-review and feedback involving a large number of analysts and specialists across the public service.

I am happy to report that the technical assumptions and conclusions in *Affording Our Future* have been informed by a far greater degree of independent and external scrutiny than was attempted in earlier long-term fiscal statements.

The *2013 Statement* is in two parts, and is supported by around 40 research papers.

Part 1 defines what we mean when we talk about *prudent fiscal management* and why it is so important to affording our future. It provides a stock-take of governments' record in managing the Crown accounts in recent decades. It also outlines the potential scale of the fiscal challenge ahead relative to what we, as a society, have become accustomed to expecting from our governments in terms of services and entitlements.

Part 2 sketches some illustrative policy options future governments might consider as they meet the long-term challenge.

Key modelling assumptions

Annex 1 in the *Statement* consists of seven chapters that examine the potential drivers of costs in the major portfolio areas of government activity over the next four decades. Please take the time to study the modelling assumptions that underpin our projections in these chapters closely. Modelling assumptions are referenced throughout the *Statement*, and the rationale for individual component assumptions are examined in more detail in the technical background papers supporting the *Statement.* These are available as stand-alone documents on our website and are in your information packs today. The assumptions and conclusions in the research papers are integral to understanding the overall conclusions of the *2013 Statement.*

It is important that no one here misinterprets these projections to be forecasts.

And as those of you who have been reporting on our regular public updates on this project over the past 18 months know, there are no "crisis" headlines to be had when reporting on a set of half-a-century-ahead projections.

What you have is much better than that.

You have at your disposal a rich set of analysis for using to delve into many areas of critical interest to New Zealanders – insights into the ongoing affordability of publicly-funded education, welfare, superannuation, health and other essential services and entitlements as well as the competitiveness of our tax system.

I do hope to see on-going news stories in the months ahead arising out of the materials before you.

What's the story?

There is no crisis. But that doesn't mean there isn't an important story underlying the conclusions of the hundreds of pages of research which inform the *2013 Statement*.

The story is that if we were to permit Crown spending behaviour to revert to historic patterns after we return to surplus in 2014/15, then:

- If we do not increase taxes, expenses will soon outstrip revenue, leading to persistent deficits;
- We will need to make policy adjustments, either to spending areas or to revenue, or a mixture of both;

The sooner we start giving serious consideration on how those policy adjustments will be designed and implemented, the better. That is because making early, incremental and less socially-disruptive policy responses will diminish the risk of needing to make sharper, more disruptive and potentially less equitable adjustments later on.

Delaying adjustment, by adopting a path along the lines of the *resume historic cost growth scenario* (of permitting expenses to revert to their historic rates of growth from 2015/16), would make the fiscal challenge harder – progressively harder the longer we delay.

The Treasury has modelled some examples of the types and scale of policy adjustments that future governments may need to consider.

What's driving this?

A key driver of the outlook is, of course, the ageing process that is profoundly affecting societies the world over.

It isn't mysterious why some state-funded entitlements, put in place when our population was much younger, should become more and more costly for the Crown to maintain over time as our median age rises resulting in more and more people in older age groups, both in absolute terms and as a ratio to the total population.

The biggest contributors to New Zealand's ageing population are our past low fertility and falling mortality rates which are expected to continue. Population ageing is not a new trend – New Zealand's population was gradually ageing during most of the last century.

The number of people aged 65 years and over, for example, has doubled since 1980 and currently stands at 635,000. It is projected that this age group will double in size again by 2040, most likely numbering around 1,270,000 in that year. By 2060, it may number 1,530,000.

But the fiscal pressures we are starting to face are only partly the result of demographic change. Cost pressures in public healthcare also drive the challenging overall outlook and that is because of anticipated increasing demand for healthcare services, new technologies, and the rising costs to pay for salaries. Healthcare is a more complex area of Crown activity than retirement income policy, and healthcare costs are more complex to contain, also.

Statistics, probabilities and how to deal with uncertainty

Some things are important to stress in order to diminish the risk of misunderstanding. One thing that it is vitally important to be clear about is that there are different degrees of uncertainty around the various assumptions that go into putting together a full set of half-a-century-ahead financial projections.

When it comes to population ageing, there is a high degree of certainty around the parameters of our projected future population structure and the parameters of the anticipated effects this will have on Crown' finances if policy settings remain static.

There is obviously less certainty, in contrast, around some of the other key components that feed into long-term fiscal projections.

But it is fair to assume New Zealanders' general expectations for what the government should provide to them by way of health services, for example, will rise as the economy grows, even as it is not possible to say precisely how strong that expectation will be.

Societies across the developed world are readjusting their expectations of what is realistic, practical and desirable. Some developed governments are reducing spending levels, transferring more of the costs of paying for some services to individuals than in the past and New Zealanders are not immune from the step-change in people's expectations.

In our long-term projections, we use history as a *guide* – but it is just that. It is a guide to capturing the potential scale of future pressures based on what we've experienced in the past.

Long term projections' utility is as a working tool to capture reasonable parameters of the potential scale and sources of emerging cost pressures based on what we know of history and as these interact with what can be reasonably anticipated in the future.

No one in the public should ever think of the Treasury's projections as a set of forecasts of what we think will happen in the decades ahead.

In fact, the only thing I can say with certainty today is that the central projections in this *Statement* ***will not unfold for long*** because New Zealanders and their governments won't permit the future to unfold in an unsustainable way for long before they take corrective action by adjusting policy settings.

How this relates to the Government's Fiscal Strategy

As I stressed at the outset, this is a Treasury document. It is not a Government report, but a report *to Government* and *to Parliament*.

In New Zealand, the government of the day publishes its short-to-medium term *Fiscal Strategy Report (FSR)* alongside the annual Budget. The *FSR* includes a set of medium-term projections that go out 15 years – a decade beyond the Treasury's formal forecast period.

The current *FSR* published in May, for example, outlines what the current government's strategy is to place future generations in a much better position to meet the fiscal challenge.

The strategy aims to ensure the level of net Crown debt is no higher than 20% by 2020 achieved through efficiency improvements and maintaining strict control on the rate of growth in core expenses in each budget over the next six years – consistent with recent budgets.

The *Statement* before you shows where net Crown debt ***could otherwise stand*** by 2020 in the absence of the government's fiscal strategy - at over 27% of GDP.

That is the ratio of debt-to-GDP that could reasonably be anticipated by that year if historic rates of growth in Crown expenses were permitted to progressively re-assert themselves starting in the first full fiscal year of the next Parliamentary term, or from the 2015/16 financial year. This assumes no change to existing tax and legislative settings while factoring in the other key ingredients – demographic change, productivity growth, inflation, and so on.

The difference between what debt would look like in 2020 under the two scenarios captures well why governments have been serious about adopting prudent short-to-medium term fiscal strategies over the past two decades to protect New Zealanders.

Long-Term Fiscal Statements do not provide policy advice. In common with Treasury's *Economic and Fiscal Updates*, that is not their statutory function.

But the Treasury's consistent advice to governments over many years has emphasized the importance of robust medium-term fiscal strategies involving firm management of operating and capital budgets as part of an integrated approach to strengthening the Crown's balance sheet.

History has taught New Zealanders a hard lesson that as a small, open economy with a high reliance on commodity exports we are sensitive to changes in international commodity prices and are vulnerable to periodic financial shocks and natural disasters.

I think it would be fair to say that New Zealanders expect their governments to commit to prudent fiscal strategies and that is certainly the experience in this country over the past two decades.

Prudent fiscal management has permitted our society to withstand some very big shocks beyond the control of any government, while simultaneously assisting to better position the Crown ahead of fiscal challenges on the horizon.

It is my intention that this *Statement* inform an evidence-based discussion that we need to have as we meet the long-term fiscal challenges ahead of us.

Examples of what could be done

To assist that process, the *2013 Statement* includes a section with illustrations of potential policy adjustments that could be adopted in the future.

These have been selected to help people think through some of the relevant implications for the various dimensions of living standards that would flow from progressing them.

Some of the illustrative options focus on the Crown expenses side of things, looking at a set of additional measures that could be adopted to constrain governments' ongoing costs; there are also options looking at what difference adjusting the tax-to-GDP ratio would make to the outlook for Crown finances over the long term.

One way of thinking about the size of the long-term policy changes that need to happen is by comparing the spending path that the *Resume Historic Cost Growth* scenario implies, and the spending path that would be necessary to achieve net government debt at 20% of GDP as a long-term average, assuming we do not collect more tax.

A graph is used in *Affording Our Future – Figure 6* - which shows two "*what if*" spending paths:

- A blue *"Spending path that maintains 20% net debt*" line, which tracks the average spending path that would allow us to maintain net government debt at an average of 20% of GDP from 2020, assuming our tax take remains constant at 29% of GDP; and

- An orange *"Spending path under 'Resume Historic Cost Growth' scenario*" line, which tracks the average spending path that we would see if expense areas grow at the rates we have seen historically, also taking into account current legislative settings and demographic changes, consistent with the projections in Table 1.

The lines track *primary* expenditure – they don't include debt-financing costs.

For the blue *'spending path that maintains 20% net debt'*, debt-financing costs would be fairly minimal. But for the orange *'spending path under Resume Historic Cost Growth scenario'*, debt-financing costs would increase over time, assuming no revenue adjustments, eventually becoming quite significant.

The examples in Part 2 of *Affording Our Future* illustrate how you could either reduce the rate of growth in expenses (bringing the orange line down) or increase the amount of revenue the Crown receives (pushing the blue line higher) – in other words, the graphs illustrate how different options would act to bring the orange and blues lines closer together as they will need to be.

One purpose of having these options in the *Statement* is to make it clear that no single policy action would, in itself, "fix" the emerging misalignment expenses and revenue – what will be needed is a mix of policy adjustments.

And as is made clear in the *Statement*, none of the options represent policy recommendations by the Treasury – they are, as I have said, intended to be illustrative of the fiscal implications of different types of options as well as to assist people to think through the implications of any course of action.

Based on the work that we have done to prepare our *2013 Statement*, Treasury's assessment is that policy adjustments will be required to safeguard the sustainability of future governments' finances.

I will be talking to audiences on these issues through to 2017

In the period ahead of our next *Long-Term Statement* – due by July 2017 - I hope to speak to audiences about the pros and cons of the different types of policy adjustments that will be needed in the decades ahead.

For this process to be successful, this is a conversation that all of us have a role to participate in – it is after all a conversation about our country's future.

It will be an informed discussion, if it honestly discusses the implications, or the trade-offs, if you like, between choosing different policy options in the decade ahead.

- How fair would an option be between young and old, between generations?
- What risks would an option pose to the quality of essential services that New Zealanders value?
- What would the risks be to New Zealanders' access to health care of adopting various potential policy options?
- What are implications for how our economy might perform, and its relative competitiveness?

There are many other critical questions that I am sure you all agree need to be transparently addressed. Journalists and media organisations have important roles to play in ensuring that conversation focuses on the issues of substance.

I now want to open the floor to any questions that you may have of me or my colleagues.

Up the front with me today are Treasury Deputy Secretary Bill Moran and Deputy Treasury Secretary and Chief Economist, Girol Karacaoglu.

END