THE TREASURY
Kaitohutohu Kaupapa Rawa

New Zealand's fiscal policy choices – the big picture

John Whitehead, Secretary to the Treasury

13 December 2007

It's great to see you all today. And I hope you'll join me for a Christmas drink and mince pies in half an hour or so.

Fiscal policy might not seem the most festive topic – but choices about government revenue and spending are important. I hate to sound like a Grinch, but we shouldn't be fooled into focusing just on a few large numbers that have come through the books in the past.

Fiscal policy needs to be made as part of a forward looking, integrated, and coherent fiscal strategy. Several strategies are possible, and there are choices to be made.

But we can't afford as a nation to be lackadaisical about these important decisions – or the underlying trade-offs. The choices we make now may continue to affect us in significant ways for a considerable period ahead.

They are decisions that should be openly debated – and I think it's part of Treasury's role to inform that debate.

Hardly a week goes by when you don't hear someone say: *'Why don't they just spend this huge surplus?'*

Just the other day there was a news story on TV about the difficulty of finding high school teachers, and a principal said: *'Why don't they spend the surplus and pay teachers more?'*

Many reasonable New Zealanders wonder why the government doesn't just spend the surplus on more roads, or on lowering taxes, or in any of the hundreds of other ways we could spend money.

Their questions are fair. Lots of choices are possible – and reasonable.

I'm talking to you today because the Treasury has an interest in making the interaction between choices transparent. We want to be explicit about the tradeoffs behind each of the various options.

Without sunlight on the true choices available, policy decisions can seem capricious and the credibility of ultimate decisions can suffer.

Without sunlight helping people see the pros and cons that surround the options, policy decisions can come as a shock. That can cause costly policy swings, and discourage people from making long-term or far-reaching investment.

I want New Zealanders to be fully aware of the true costs and trade-offs.

The fiscal policy trade-offs Treasury is concerned with fall within three areas:

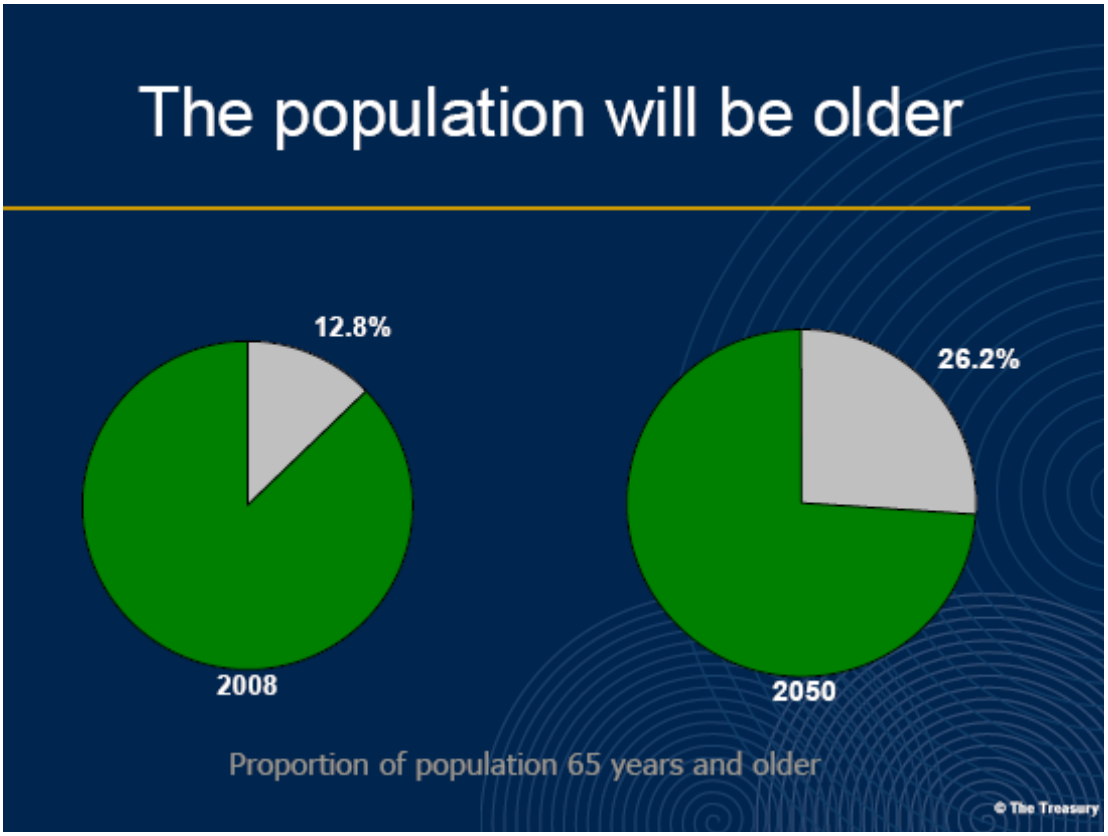
- First, the sustainability of policy – that is, our ability to keep doing what we choose to do as time passes.
- Second, structure –the choices about how we raise money, and how we spend it. We want to seek the best value for money and the best contribution to government objectives, especially growing our economy.
- And the third area is the extent to which policy supports economic stability. We want to ensure fiscal policy isn't a source of economic shocks, and doesn't make the tides of the economic cycle ebb and flow more than they need to.

Many different fiscal strategies are possible, and I'm not here to offer my own particular preference about which is most desirable. But I will seek to outline what the Treasury sees as characteristics of a coherent and credible strategy.

Choices will be made by the government of the day and the choices will be vigorously debated.

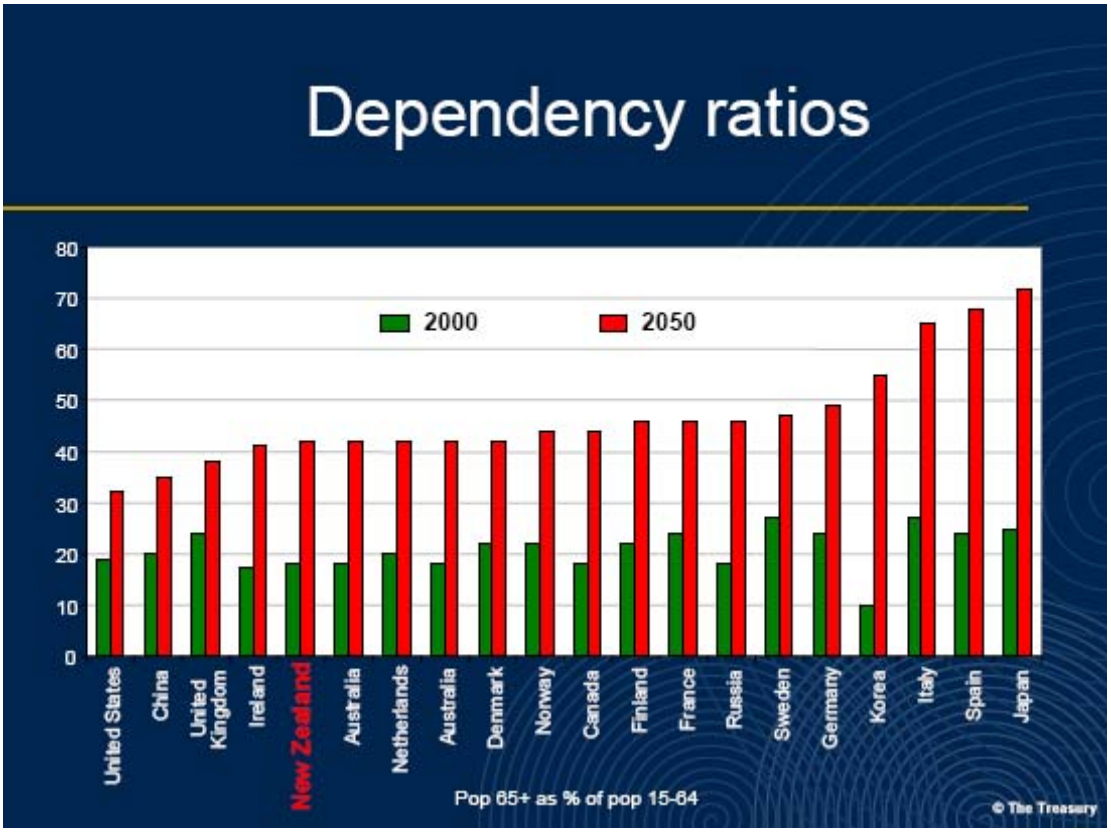
But there are facts surrounding those choices that can't be escaped.

For example, when we think about the long-term sustainability of policy, we need to confront demographic changes.



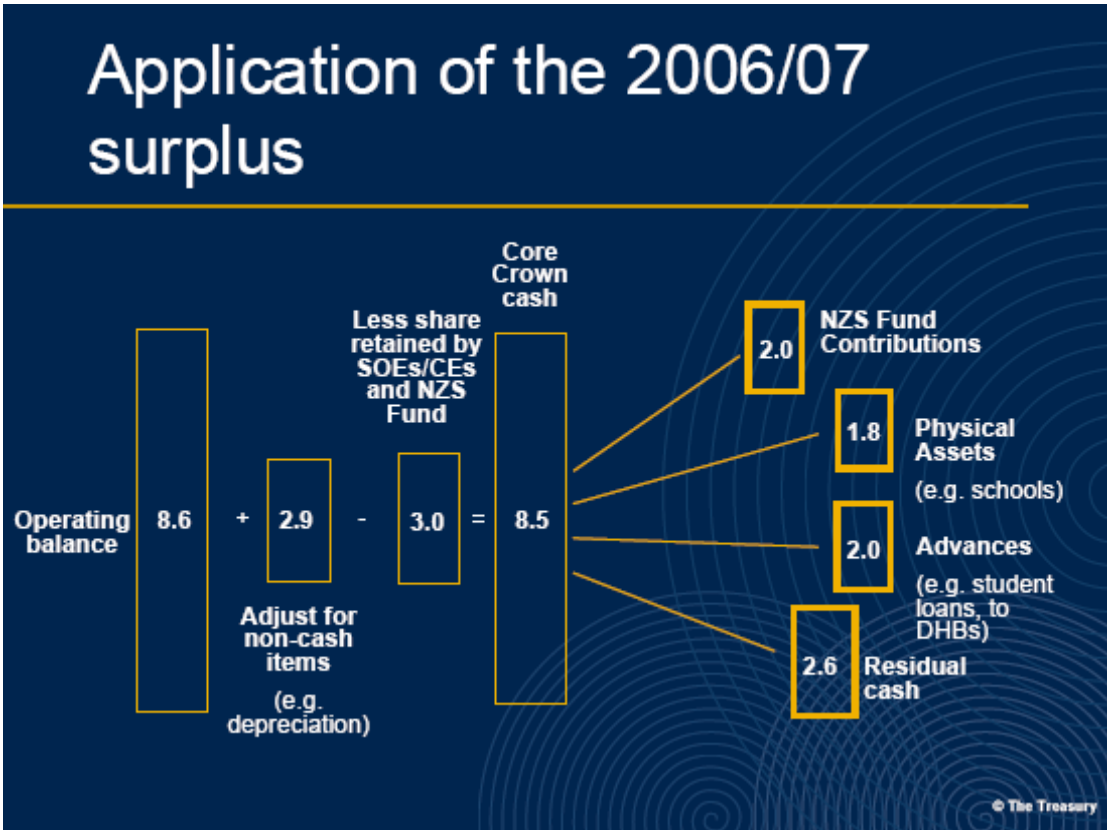
Our population is getting older. As the slide behind me shows, over the next 40 years or so we're going to see a New Zealand that looks different from how it looks today. Fewer strollers and more walking frames. More retirement centres than parenting centres.

And the shift in average age of the population will be permanent. Eventually, the changing make-up of our population will mean significant increases in government spending if current policies continue.



We are better placed than many countries. We have made changes that have strengthened our fiscal position, and our population ages more slowly than some countries.

Still, when assessing the sustainability of fiscal policy, headlines about the size of this year's surplus – while interesting – don't actually tell us that much.



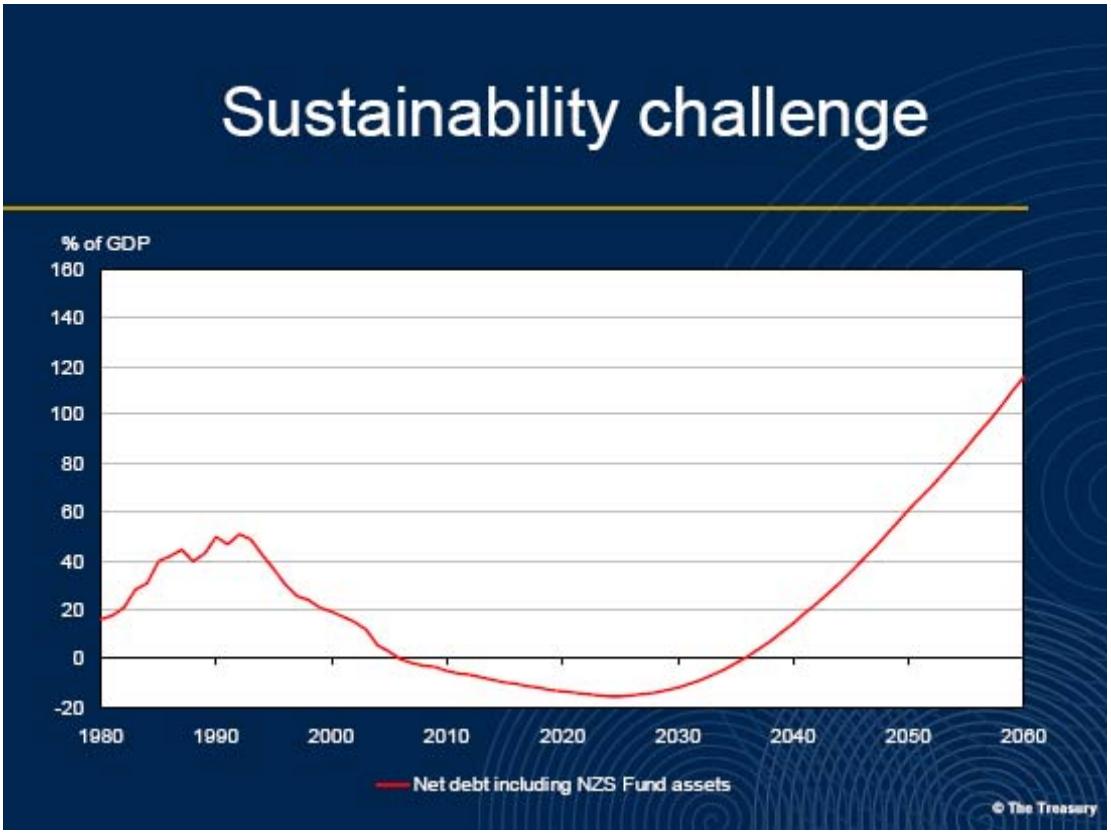
For a start, a substantial share of the surplus is already committed – to the New Zealand Super Fund, to student loans, and to building schools and hospitals. As the slide behind me shows, the operating surplus isn't a big pile of cash stashed away in a big vault below this building.

What's more important are the projections of the operating balance and net asset position looking out 5, 10, 20 years - or even longer.

As we discussed in the first Statement of New Zealand's Long-term Fiscal Position last year, population changes mean that, over the longer-term, we simply can't keep doing what we are doing now.

This is not a problem we can solve solely by lifting growth. Faster economic growth is unlikely to address the built-in growth of spending on both health and New Zealand Superannuation.

If our economy grows faster and our incomes grow, we demand better health care - we want the latest technologies and the latest medicines. Likewise, Superannuation payments rise to keep a constant relationship with average wages.



Trying to meet those demands with the existing ratio of tax-to-GDP eventually implies ever increasing levels of debt.

I might not need a forklift to illustrate the point, but beyond 2060 government debt would reach levels that are not realistic.

And negative impacts on the economy would show up long before that happened.

We could take the ostrich approach and hope the problem goes away. There is always a chance that it might.

But it's better to think about the options the way a household might look at the bills it knows are coming – the roof will need replacing, there are likely to be big dental bills, and we need to put aside a bit for retirement.

If you know all these demands are coming, do you just hope for a Big Wednesday win?

More likely, you begin to adjust your lifestyle where you can, so that the demands can be met as they fall due.

It's prudent to prepare for the scenarios we think are most likely, even though forecasting those scenarios isn't an exact science.

Policy is always made before all the facts are in. By the time all the facts are known with certainty, we are not forecasting - we are reporting history.

It is possible to delay making choices until the problem is closer. Waiting for more information is always an option.

But that option is not without costs. The longer we wait, the larger and more difficult the policy changes required. It's better for the long term performance of the economy and for the credibility of policy choices to make changes smoothly.

The changes necessary to avoid explosive increases in debt are these:

- We can reduce the cost of future spending to the level of tax we raise.
- Or we can increase the tax take as a proportion of GDP to pay for our spending.

There are no soft options. Ultimately the persistent and growing gap between revenues and expenses projected from around 2030 will need to be corrected.

The trade-offs are not easy. For example, the share of our economy that goes towards health could double over the next fifty years. The implications of trying to pay for that are enormous.

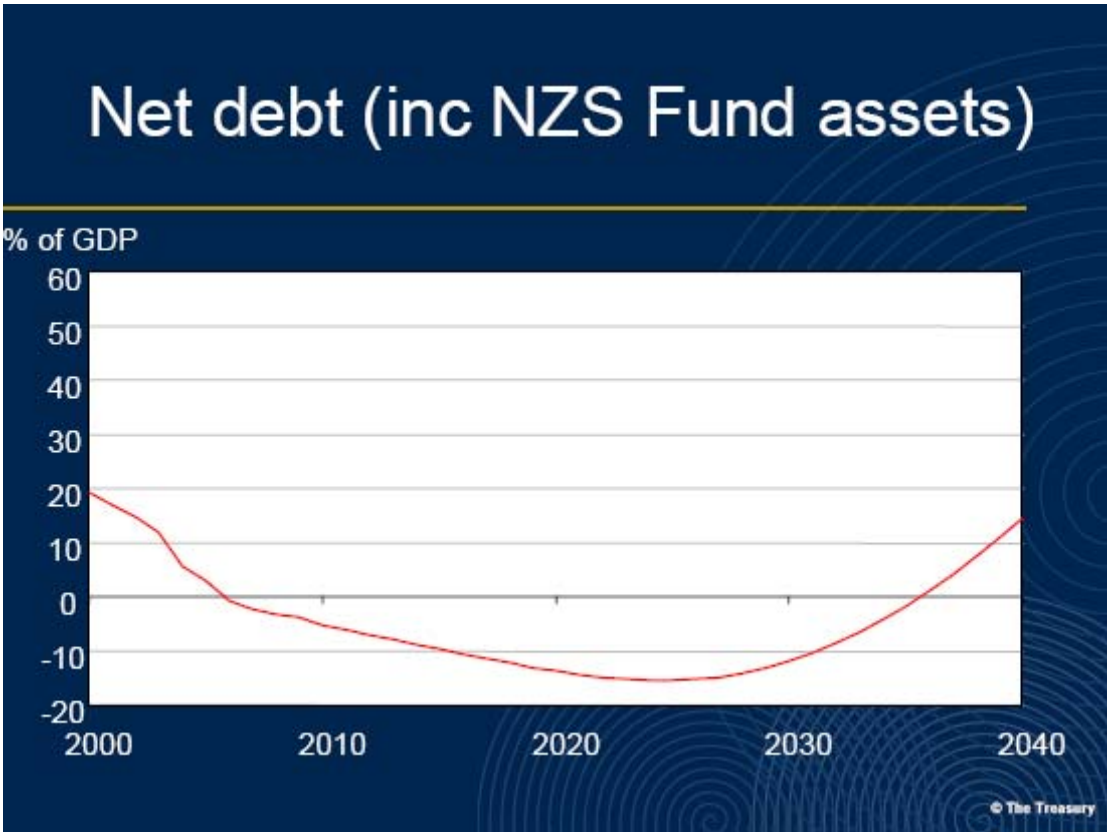
The challenge is to make changes to the spending pathway and still meet reasonable expectations about the services that will be available.

We face similar cost pressures with superannuation. A number of countries overseas have decided now how policy will adjust over time to respond to those pressures. For example, some Nordic countries have begun linking eligibility to state pensions to life expectancy, raising the entitlement age as their populations live longer.

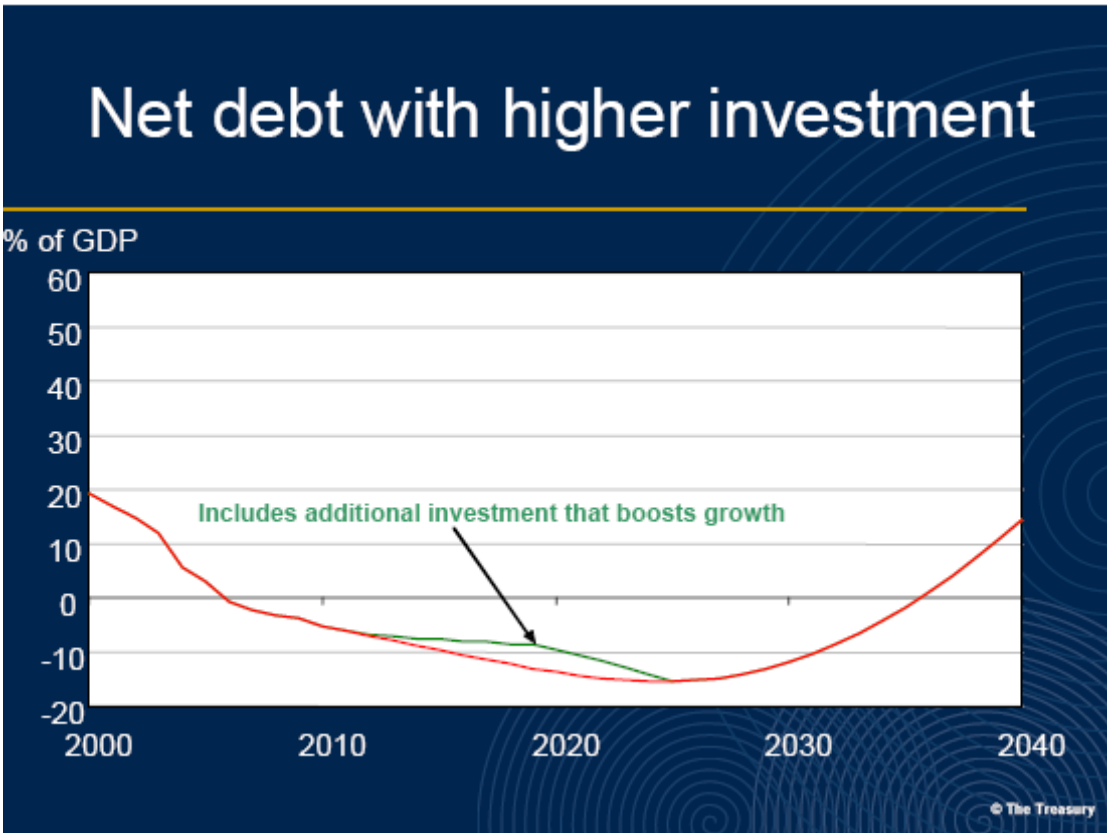
Here in New Zealand we have brought forward some of the burden of who will pay for some of these future costs. Today's generation is saving through the New Zealand Superannuation Fund. This sees the government's net debt as a share of GDP decline over the next two decades to the extent that the government is building up financial assets. The Fund will meet about a third of the increased cost of pensions in the future.

However, the other two thirds of the increase still need to be dealt with, either through the taxes paid by future generations at the time, spending less in other areas like education or defence, or by adjustments to pension costs. And as I said earlier – higher growth, alone, is no cure, because pensions are pegged to average wages.

Making informed choices requires us to tease out the interactions and trade-offs and to recognize what is actually happening. Prefunding essentially shifts taxes through time so that future taxpayers do not meet all of the pension cost increase. In contrast, raising debt shifts taxes from current to future generations. Prefunding will see net financial assets rise as a share of GDP. Increasing debt to fund physical assets can at a first glance seem at odds with this strategy. Whether it is depends in part on the type of government investment and its rate of return relative to the cost of borrowing.

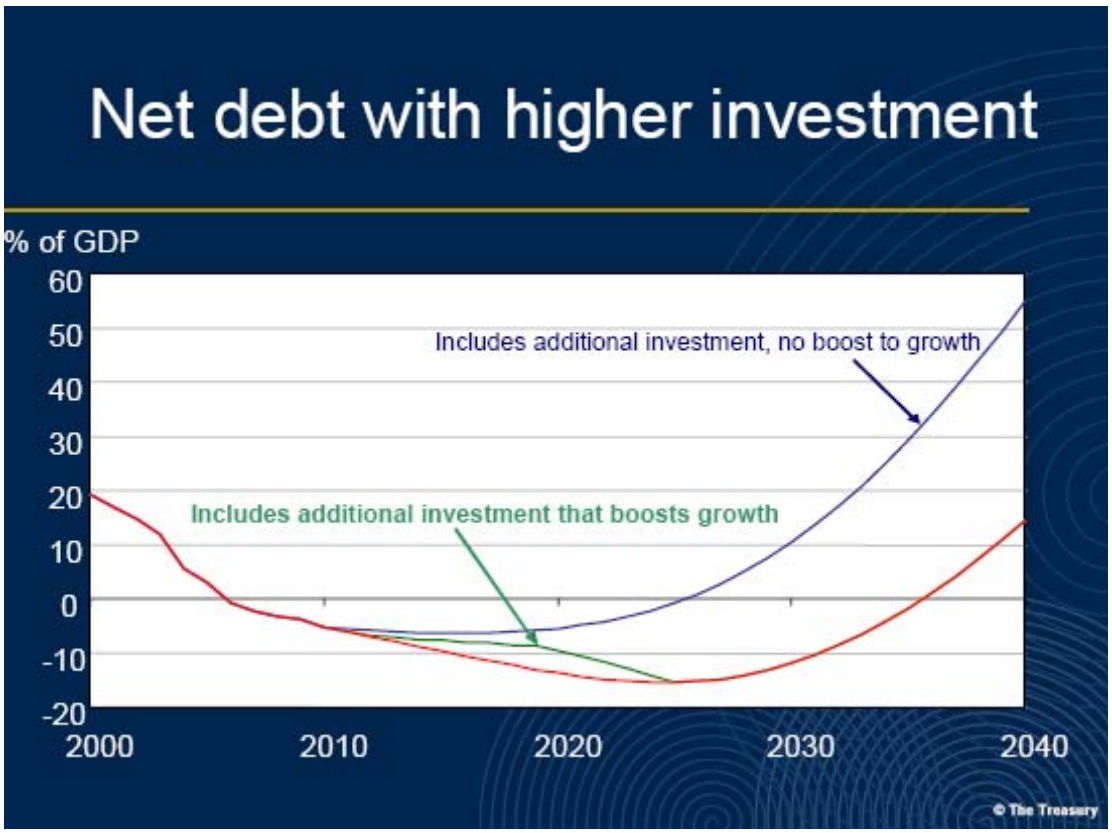


When you borrow to invest in physical assets, you reduce your overall net financial assets. That might be a good idea if you invest in assets that make you better off by producing a return.



For example, if we borrow for investment that sufficiently speeds up economic growth then the long-term path of net financial assets to GDP and the 'effective' debt burden may be unchanged. This is shown by the green line in this graph. Of course, whether any particular investment has this effect is case-specific.

The government might also use debt to finance assets that don't directly help our economy to grow – like hospitals or prisons. We might choose to use debt to pay for these long-lasting assets to spread the costs over generations. There is a valid question over how much of tomorrow's assets should be paid for today.



But when we pay for these kinds of assets with debt there is a permanent reduction in our net financial assets. The blue line on the graph shows this – net debt goes up.

Large government investment programmes that do not achieve a financial rate of return at least equal to the cost of borrowing increase debt levels – and so lower the level of service or lift the level of tax that we can expect in future.

Reasonable people can reach different conclusions about the appropriate amount of prefunding and borrowing for government investment. Either way, these decisions require our best judgment about the appropriate level of debt.

There is, of course, a limit to how much debt you can take on. There is no particular level of debt that is right for all countries, because circumstances differ.

The Treasury's view is that an appropriate government debt-to-GDP ratio in New Zealand is at the low end in comparison with other countries.

A low government debt-to-GDP ratio gives us a buffer against unexpected shocks. It's like having money in the bank in case we hit a stumble like severe drought or global recession that pushes the economy into recession, or an even more extreme event like a foot and mouth outbreak, a pandemic, or some other disaster. New Zealand is more exposed to a number of these risks than many countries. Our ability to withstand these shocks is influenced by our size, the ability of our economy to adjust, and the overall level of debt we hold.

Sound public finances also have a role to play in mitigating the risks associated with persistent current account deficits and the internationally very high level of net external liabilities incurred by the New Zealand private sector. As the Reserve Bank noted last week, the government's very low debt position has played a significant role in reducing borrowing costs right across the economy and supporting higher trend growth.

So far, I've discussed the importance of assessing the sustainability of fiscal policy decisions. We know that as the population ages, today's policy settings will be unaffordable. And debt levels must be considered alongside the extent of pre-funding in the Super Fund.

Another measure of fiscal policy is structure – what we spend, and how, matters.

There is a limit to how much of the future costs we face we want to carry now, and when we think about what contribution to make now, we need to ensure we don't impose excessive costs today that inhibit economic growth or detract from other government objectives.

Governments have many objectives – economic, social, and environmental. As a Treasury, we have an interest is supporting the government to achieve its goals in a way which maximizes New Zealand's growth potential.

Growth is important because it's the principal means to raising New Zealanders' living standards. While it doesn't solve all problems, structuring policies in ways favourable to growth will give us greater choices in the future fiscal challenges we face.

One way is to ensure that public services are delivered in the most efficient and effective way - that is, there is quality spending, and we stretch each dollar as far as we can.

Better quality spending means that tax burdens can be lower.

Better quality spending can produce a stronger economy.

And so better quality spending can help us meet some of the demands we face in future.

The way the government uses its resources, and how it raises revenue, have a significant impact on overall economic performance.

If we choose policies that don't facilitate growth, then we reduce our capability to meet future demands.

To put it the other way round, if we want to be best positioned to meet the demands we face in future, we can ask whether fiscal policy will encourage growth.

Will it make more skilled workers available?

Will it increase investment?

Will it lift productivity?

These aren't the government's only objectives. But they are a valid lens through which to assess the merits of different fiscal policy choices.

As well as the long term sustainability and composition of fiscal policy, the third area I want to discuss is how fiscal policy can affect growth by supporting a stable economy.

The government's role in the economy is such that large changes in spending and tax from year to year can make a difference to demand and supply pressures, especially in an economy already with decades-low unemployment.

It's important for governments to avoid causing shocks to the economy that put monetary policy under undue pressure. This point has come into focus in the current debate around the level of the surplus.

When the economy endures prolonged cycles of boom and bust, trend growth is slower. People are less confident in their spending and investment decisions. And policy loses credibility.

But we also know from bitter experience that governments are not very good at pulling policy levers to smooth out the ups and downs of the economy. The Reserve Bank's operation of monetary policy was made independent for precisely this reason.

There is wide-spread acceptance that when the economy enters a downturn it is appropriate to allow some fall in the surplus as tax revenues slow and unemployment spending increases.

In contrast, when the economy is in an upswing the surplus rises as taxes grow and unemployment falls.

These changes happen without a discrete policy change and reflect the operation of the so-called 'automatic fiscal stabilizers'.

However, the use of more active discretionary fiscal policy for smoothing out the economic cycle is a more fraught tool. It was used in the 1970s with a startlingly poor effect.

Nonetheless, the interaction with monetary policy is something we need to take into account when we consider substantial changes in fiscal policy.

Having said that, it seems sometimes like there's never a good time to increase spending or to cut taxes.

When things are going well we worry about whether more spending or tax cuts will add to inflation and push interest rates up.

And during downturns we worry about whether changes are affordable.

I began by saying that we hear someone every week asking, 'why can't we just spend that $8 billion surplus?'. 'Why can't we use at least some of it to pay teachers more, or to build more roads, or to cut taxes?'.

Some level of surplus will need to be long-lasting as long as we pre-fund some proportion of the future cost of superannuation or build up financial assets for other future needs.

However, over recent years the government's surpluses have been higher than they needed to be to meet the level of prefunding the government has set out in its fiscal strategy.

Part of this is because Treasury's forecasting hasn't been perfect. And it's no consolation to Ministers that we compare favourably with other forecasters here and overseas. We don't take this issue lightly – and work is underway in several areas to improve our forecasting performance.

The Treasury's view is that choices about the future size of the surplus should be made according to a long-term fiscal strategy – a strategy that takes into account the future squeeze. That settles on a stable medium-term surplus. That encourages value for money in achieving the government's objectives and is growth enhancing.

Concern about monetary policy is relevant, but it's only one factor for governments to take into account. There will be times when some short term pain is worth the gains from changing fiscal policy.

In other words, in some circumstances, it might be worth risking interest rates or the exchange rate being higher for longer if the medium term benefits to economic performance outweigh the costs.

Still, in moving to a lower surplus, there are ways to reduce the pressure on monetary policy – to ensure fiscal policy does not accentuate cyclical highs and lows.

We could spread the transition from larger to smaller fiscal surpluses over time. Smaller ongoing adjustments to revenue and expenditure may reduce the need for monetary policy to respond aggressively.

We could look for policies that will contribute to higher sustainable growth. More labour supply and increased productivity will reduce inflation pressures eventually, as well as put New Zealand on a higher growth path.

And we could signal in advance how we would react to fiscal surprises.

Considerations of sustainability, structure and stability show us that whichever fiscal policy options are preferred – whether it's a lower surplus, more debt, tax cuts or spending changes – all carry trade-offs.

US politician Daniel Patrick Moynihan once said: 'we are all entitled to our own opinions, but we are not entitled to our own facts.'

In our own situation, we can all have our view about the best balance between competing demands.

But we can't escape the inevitable consequences of any particular choice.

We can't escape that there is a looming fiscal squeeze in the longer-term, which makes current policy settings unaffordable in the long run.

We can't escape that money spent on a hospital or teachers' salaries or prisons or roads can't then be spent on something else.

And we can't escape the trade-offs involved in timing the transition to a lower, stable medium-term fiscal position when the economy is operating at full capacity.

Whichever fiscal strategy is chosen, the Treasury's view is that it must take account of these realities.

We should choose a strategy that focuses on the future path of spending and taxes, operating balance and net financial assets – not just last year's surplus.

A strategy that is explicit about the interaction of government debt and the New Zealand Superannuation Fund.

And a strategy that is transparent about the trade-offs that will inevitably be faced.

When someone says 'spend the surplus', my response is 'ok, how will you respond to the looming demographic squeeze?'

When someone says, 'why don't we carry more debt', I ask, 'ok, who will pay for the spending demands of a changing population?'

When someone says we should spend out money on 'x', I ask what else the money might be spent on and what balance is appropriate between paying for services today and meeting demands in the future.

So what might characteristics of a coherent strategy look like?

It would see ongoing operating surpluses, but at levels lower than we've seen in recent years. And the adjustment would be spread over several years.

It would see the changes in spending and taxes which get us to a lower surplus contribute effectively to the government's objectives, and in particular support growth.

It would see ongoing efforts to improve value for money in the public sector.

It would see government net financial assets as a share of GDP continuing to rise over the next few decades.

And it would see us start to debate the sorts of changes we need to make to address the growth in spending as our population ages and get richer.

But this is only one scenario. A number of changes, or combinations of changes, are possible.

The point is that those decisions should be made and debated in the context of an integrated, coherent strategy. This will make it easier for people to make the long term decisions needed to deliver higher living standards.

ENDS