New Zealand's Long-term Fiscal Statement Challenges and Choices

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Introduction

Thank you for coming here. I'm going to first talk about what this document sets out to achieve – and what it is, and is not. Then I will quickly run through some of the key findings and numbers, and make some concluding comments.

This Statement is about New Zealand's long-term fiscal outlook – the government's spending and revenue – and what drives it. It is also about the country's future and the big issues the public and government are going to have to think about if we want to maintain or improve our living standards and public services.

That's because the government plays a large part in our lives. We drive on publicly built roads, we pay tax to the government, nearly all of us use publicly funded education and health institutions and services, and a lot of people receive income from the government. All of those things make a difference to the lives of New Zealanders. This document is about how we pay for them.

It includes, as it is required to do, projections 40 years into the future. I want to make it clear that these aren't forecasts, they are projections. Forecasts try to work out what will happen and include our best estimates about different variables. Projections are generally based on long-run trends and are very dependent on the assumptions made. The Statement brings together information about the current state of the world, and what has happened, and then projects forward to describe what could happen from here.

In fact, I'd go further and say we know that our projections won't come true – we won't see debt at over 220%, we won't see middle NZ on the top tax rate. Governments are going to make decisions and change policies; and people are going to do different things. This document is to create discussion about which policy decisions by government might best make a difference to the future fiscal situation and to show the possible impact of different choices, actions, or inaction. Behind the numbers and models we recognise that this Statement is about people: both future and present generations.

This is Treasury's document. Governments make policy decisions and what is set out here is not government policy. Nor is it policy advice. It sets out options and the consequences of various decisions; because dealing with fiscal issues is all about making choices. Finally, this isn't an economic blueprint. Driving productivity and growth is critically important, but this document is tasked with reporting on the long-term fiscal outlook. And it is important to note that because of the link between growth and government spending, we can't just grow our way out of the fiscal problem. Growth helps, but it doesn't fix the problem alone.

Just as with households, no matter how much you earn, you can get into trouble if you spend too much. Too much government spending inevitably means higher debt or higher taxes. As a nation, we're going to have to make some choices about what we want.

Demographics

Demographic change means reports like these are being produced around the world. New Zealand is facing a permanent change from a younger to older population as people live longer and have smaller families. The baby boomers do not cause this trend, but we do speed it up. As this graph shows, that pick-up in the number of people turning 65 happens from now over the next 20 years.

The first baby boomers will receive New Zealand Superannuation from 2011 and the numbers of new superannuitants will peak in the late 2020s.

By 2050, the total population is projected to have grown by 25%, while the number of people aged over 65 is projected to have increased 150%. By mid-century, the number of people 85 and older will have grown by about 400% – from 64,000 now to 330,000. That highlights the major change in life expectancy. Over the past 55 years life expectancy at birth has increased by about two years every decade. Although this rate is projected to slow, a person turning 65 in 2050 would still expect to live an additional 24 years, 4.4 years more on average than a 65 year-old in 2008.

Population ageing is important fiscally as 25% of government spending is currently on the 12% of the population aged over 65 and this will grow.

Population ageing is also likely to cause a slowdown in economic growth because of the shift to a relatively smaller working-age population.

You have probably noticed, however, that demographics, while important, are not the sole or major focus of the statement.

What Has Changed/Key Findings

Factors other than demographics have changed the fiscal outlook since the first of these Statements was produced in 2006. In 2006, as this graph shows, net public debt was projected to reach over 100% of GDP in 2050. Now, if government spending returns to historic patterns, net public debt could reach more than 220% of GDP midway through the century.

The major change between 2006 and 2009 is that the government's budget is already in deficit - by $5.9 billion in the Crown Financial Statements.

Around half of the difference between the 2006 and 2009 projection is due to the lower revenue and increased expenses associated with the recession and the resultant downward revision to economic growth and tax revenues over the next few years. The remainder is due to increased costs in existing programmes and changes to government policy over the past three years.

Models

There are two main ways we examine the fiscal outlook. The first is by taking what's called a "bottom-up" approach - essentially we look at what would happen if we keep doing what we've done before. The "historic trends" scenario we use does just this. It projects forward on the basis of spending patterns of the last 20 years, including things like demographic change going forward. An important thing to note with both main scenarios we use is that the starting point is the Budget forecasts.

In the historic trends scenario this means we project historical spending patterns starting again at the end of the forecast period in 2014. This explains why the debt projections are different from those in the Budget forecasts, and why in this scenario, as this graph shows, we remain in deficit – and ultimately run huge deficits – until 2050.

This scenario emphasises the impact of spending on debt. This graph, of the primary balance – the balance between spending and revenue – and the operating balance, which includes debt servicing costs, illustrates this starkly. Debt builds debt and, debt financing costs use a larger and larger share of income. In 2050, debt servicing would be around $110 billion annually.

Of course, another way the projected increase in spending could be addressed is by increasing taxes. Raising taxes has its costs, however, and ideally any extra revenue would be raised through base-broadening and more immobile taxes rather than increasing income taxes. As the Statement discusses, taxes can have a negative impact on growth, and the way in which they motivate or discourage people to work is particularly important long-term.

Another way we have looked at things in this Statement is to look at a representative "basket" of public services that are provided to taxpayers. What these lines show is the change in purchasing power per person for superannuation (the blue line), benefits (the red line) and then all other public services provided to people – the per person spend on health, defence, education etc (the green line). In the historic trends scenario payments to superannuitants in 2050 are 66% higher than in 2013 because of the way NZ Super is indexed to wages; the purchasing power of benefits is unchanged because they are inflation adjusted; and the basket of other services per person is 34% higher – reflecting historic spending trends.

Sustainable Debt

The second main scenario we use recognises that governments will want to manage debt – and it takes the Government's Fiscal Strategy Report goal of net public debt at 20% of GDP as the desired level. So the "sustainable debt" works from a top down basis of setting this debt target and then looking at what would have to change to achieve that.

The major difference between this scenario and the historic trends one is that the much smaller increase in government spending each year – the operating allowance of $1.1 billion plus 2% for inflation each year that was set in the 2009 Budget – continues not just for the forecast period but though until 2023.

Using the basket to illustrate the effects, the superannuation and benefits lines do not move because we assume they continue to be indexed in the same way – and the way Budgets work, adjustments to these payments are not included as part of new spending.

So the adjustment in spending occurs in all of the other areas. As you can see, after an initial 10% decline in the level of services, by 2050 they are 2% higher per person than in 2013. The gradual rise is because after 2023, lower debt means we project the operating allowance increasing to $2 billion a year (and increasing with inflation).

The key thing to take away from these graphs is that dealing with budget imbalances means spending less, taxing more, or borrowing. The long-term fiscal problem is "solved" if governments have budget surpluses over time.

But achieving a sustainable level of debt – or any particular spending or tax level – is not simply a matter of drawing a line on a graph. In this case what it shows is that living with the $1.1 billion operating allowance over the next 15 years means reducing some public goods and services.

Options and Choices

Now, I'm not going to talk you through the whole document. I've tried to help you to understand the approach we've taken, and you have time to look at the individual sections.

What they show is that the largest single driver of the fiscal position is the policy choices governments make - which means that governments have the capacity to manage the fiscal situation over time. It's not easy: it will involve change and choice.

But we have suggested a few principles that would help.

Make early change. Policy reforms will become harder and the changes required more severe as each year passes. Making early incremental policy change reduces the risk around the quality of decision-making and gives people time to adjust.

Keep debt under control. If current policies lead to increasing debt, future generations will find it difficult to set their own spending priorities or to meet unforeseen challenges. High levels of public debt increase the cost to everyone through higher interest rates, debt servicing and taxes, and ultimately could limit the ability of governments to set the policy they want.

Focus on outcomes. We need to focus on what works and what doesn't and it's important for the public to think about what it wants overall - for example, about having healthier people rather than high numbers of doctors visits – instead of measuring a government's commitment to policy by spending levels. The media (you) has a big role in lifting this level of debate.

Focus on growth. Growth means the country and individuals will be wealthier and there will be a larger tax base. Fiscal policies should also consider the impact on growth – this is particularly relevant in terms of the overall level of government spending, and tax policy. But growth alone doesn't solve the fiscal problem; that requires a fiscal response.

Encourage workforce participation. Demographic shifts mean all developed countries will be competing for labour and skills. We need policies that encourage New Zealanders to stay here, or to return after their OE, and to work if they can. Particularly important will be policies that allow older people to maintain paid work.

Keep spending under control and focus on public sector productivity. Focussing on value for money and efficiency across all areas of government spending will provide a win-win. This means getting the most out of the existing $64 billion of total government expenditure each year and very carefully evaluating the quality of new spending proposals. The reality of government is that it is easier not to introduce a new programme than to remove an existing one. And to give the greatest possible flexibility of response, all policies should be examined.

Conclusion

I hope this Statement generates discussion and debate. I acknowledge some of that may be people reacting to the information in it.

So there are a couple of comments I'd like to finish with. The projections on this document are based on steady growth. Like everyone else, we'd like to be surprised by things turning out better.

But look at what's happened since 2006. The first statement said we had time - about 25 years from then, until around 2030 - before the government's accounts might move into deficit.

Three years later, and we are facing that future now. We are in deficit, and deficits are forecast to last for a few years yet. A lot of the headroom we had, financially and just as importantly in time, has disappeared. Our experience of the last 12 months – the global financial crisis and the worldwide and domestic recession – has reminded us that economic shocks do and will occur. Economic growth, increasing government revenue and operating surpluses cannot be taken for granted.

And looking at those issues differently, and over the long-term is important. As a country, we have tended to look at policies and government commitment to them in terms of the levels of spending attached. Increasingly, we have realised that there can also be a cost – there's an acceptance that high debt is to be avoided.

It would be good if this Statement also brought into focus that as a country we need to also think about the value of government spending. There's a joke along the lines of 'an economist knows the price of everything and the value of nothing'. Although this is a fiscal statement, it is about the things that we value and the tradeoffs between them and as a nation – economists and politicians included – we need to make choices about the priority we put on things going forward.

What results do we really want; and comparatively, what are the most important things? And then what does spending on those things mean for debt or taxes? If we can get the same results for less money, that's positive. The debate needs to focus on both sides of the equation: what can we afford? And how can we get the outcomes we most want out of what we're prepared to spend?

The choices we make as a country about what the government provides, and how, are critical. The decisions made now determine not only the services currently provided and how they are paid for, but will shape New Zealand's future and either expand, or limit the choices of future generations.

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