



LOOKING TO THE FUTURE

New Zealand's long-term fiscal challenges

Consultation on the scope of the Treasury's
combined Statement on the long-term fiscal
position and Long-term insights briefing



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We're looking for your input on the topics we're proposing to cover in our 2021 report on New Zealand's long-term fiscal challenges.

Background

The Treasury is the Government's lead economic and financial advisor, and steward of the public finance management and regulatory systems. A key part of the Treasury's stewardship role is taking a long-term view, thinking about the impacts of the trends, risks and opportunities we see today – and the decisions taken or not taken – on the future.

At least every four years the Treasury produces a Statement on the long-term fiscal position of the Government, looking at least 40 years into the future. We do this to inform commentary and discussion on significant long-term potential impacts on the Government's finances, and to help decision-makers assess policy options that might be considered in these areas.

This year, this report will incorporate our first Long-term insights briefing to the Minister of Finance, looking at the medium to long-term trends, risks and opportunities to New Zealand through the Treasury's core fiscal stewardship lens.

Combining these reports gives us the opportunity to analyse key trends and their potential long-term fiscal impacts directly alongside a range of policy options available to address them.

The 2021 Statement will focus on the Government's long-term fiscal position and policy options available to address the long-term fiscal challenges, risks and opportunities.

New Zealand's strong public health response and focus on protecting jobs and supporting livelihoods have helped us come through the first stages of the current pandemic in good shape compared to the rest of the world.

However, COVID-19 has had an unprecedented impact on the economy and the Government's fiscal position, and there is still considerable uncertainty about its future effects – as well as the effects of long-term trends like population ageing and climate change.

Where possible, our report will incorporate the impacts of COVID-19 on key economic variables such as interest rates, labour productivity, migration and trend growth. Other macroeconomic developments – especially declining interest rates – precede COVID-19 and have implications for long-term fiscal sustainability. We also intend to canvass these long-run developments and their implications in more detail.

The uncertainty around the impact of COVID-19 has seen us use scenarios and sensitivity analysis in much of our economic forecasting, and we intend to do the same in this report.

We believe that focusing on these issues in the analysis of our 2021 report is the best contribution the Treasury can make in our first Long-term insights briefing. The long-term fiscal challenges that New Zealand faces affect us and future generations, so we need to make sure that New Zealand considers and is ready for the future.



What do you think?

We're seeking your feedback on how to approach the proposed topics outlined in this document, and we welcome your written submission.

We are particularly interested in:

- Your reflections on the proposed topics
- Your views on how these topics can best be assessed.

Please email your written submission to:

LTFSfeedback@treasury.govt.nz

Alternatively, you can post your submission to:
LTFS Consultation
The Treasury
PO Box 3724
Wellington 6140

Consultation closes on 26 March 2021.

The Treasury's 2021 Statement on the Long-term Fiscal Position will be published before the end of September 2021.

In addition to consulting on the subject matter of the report, we will also be consulting on a draft of the report in mid-2021 and publishing background material on our website from now until the report is released.

Visit our website for further details and updates on this consultation process:

treasury.govt.nz/2021LTFS

Incorporating diverse views on wellbeing

The impacts of demographic trends are likely to vary across New Zealand's communities, reflecting their different geographic locations, economic dependencies and ethnic makeup.

In preparing for this work, we have interviewed a number of Māori and Pacific leaders and subject-matter experts, with the aim of increasing our understanding of different communities' perspectives.

We will incorporate these insights, apply a living standards approach and draw on te ao Māori perspectives and He Ara Waiora, a tikanga-based wellbeing framework in the 2021 Statement.

Other stewardship products

The 2021 Statement is part of a suite of Treasury stewardship reports and products.

Your feedback on the 2021 Statement may also help inform development of our:

- **Living Standards Framework (LSF):** We are currently refreshing the LSF to better reflect te ao Māori and Pacific community knowledge systems, values and culture, as well as child wellbeing, with the intention of releasing a refreshed framework and wellbeing indicators by the end of 2021. This work will inform the future indicators that we use to prepare the inaugural Wellbeing Report. There will be an opportunity to provide submissions on additional indicators as part of the LSF refresh.
- **Investment Statement:** Investment Statements describe and state the value of significant Government assets and liabilities, how those have changed over time, and how they are forecast to change. The next Investment Statement is planned by 2022.
- **Wellbeing Report:** The Treasury's first report on the state of current and future wellbeing in New Zealand will be prepared in 2022.



Impacts on the long-term fiscal position

We propose that the 2021 Statement focus on the following dimensions of New Zealand’s long-term fiscal position:

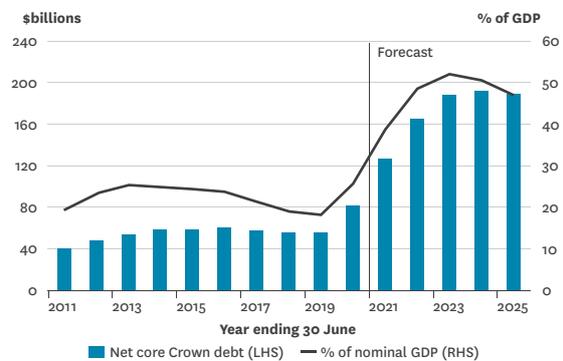
- New Zealand’s current fiscal position and the ongoing effects of COVID-19
- Why a strong fiscal position supports living standards
- New Zealand’s long-term fiscal position
- Demographic trends and the economic impacts of an ageing population
- The impact of unanticipated shocks on the fiscal position
- Other factors that will affect the fiscal position.

The following pages provide more detail on each of these topics.

New Zealand’s current fiscal position

At the end of 2019 the Government was in a strong fiscal position. Net core Crown debt was 19.0% of GDP. This enabled the Government to respond strongly to the COVID-19 pandemic in order to support living standards. Since then, New Zealand’s debt position has shifted significantly. The 2020 Half Year Economic and Fiscal Update (HYEFU) forecast net debt to reach 46.9% of GDP in 2024/25 (see Figure 1).

Figure 1: Net core Crown debt



Source: The Treasury

As illustrated by the ongoing COVID-19 pandemic, a prudent level of debt provides governments with space for fiscal responses to one-off shocks such as natural disasters, disease outbreaks or economic downturns.

Prudent levels of debt also give governments scope to make investments to support and improve future living standards.

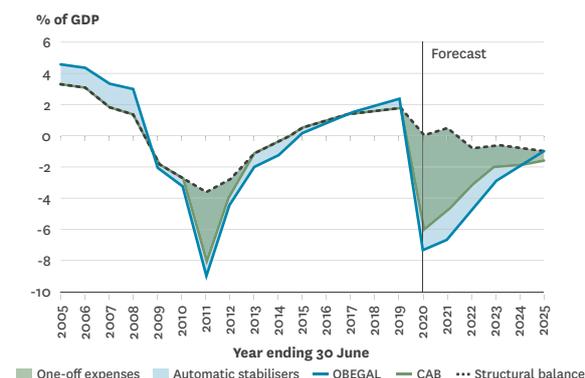
The 2021 Statement will present New Zealand’s fiscal position in more detail, including the effects of COVID-19 on the fiscal position, why a strong fiscal position supports living standards, and the costs and benefits of New Zealand’s current level of debt.



New Zealand's long-term fiscal position

Even after excluding spending on temporary COVID-19 measures and accounting for the economic cycle, HYEFU forecast a structural deficit of 1.1% of GDP (see Figure 2), with expenses exceeding revenue at the end of the forecast period. Since then, economic data, particularly from the labour market, indicates that the economy has recovered faster than forecast at HYEFU, which could improve the fiscal position.

Figure 2: OBEGAL, the cyclically-adjusted balance (CAB) and structural balance



Source: The Treasury

However, the macroeconomic outlook remains uncertain and deficits may persist in the near term, which could lead to increasing levels of net debt.

The 2021 Statement will present projections for the long-term fiscal position over the next 40 years. This will include expenditure in key areas such as health and New Zealand Superannuation (NZ Super) expenditure. The Statement will present possible paths for government expenses, revenue and net debt, along with other key fiscal variables such as net worth.

The Treasury is currently reviewing the appropriateness of the Government's key fiscal indicators, such as net core Crown debt and operating balance before gains and losses (OBEGAL). We are working towards providing the Government with advice from this review, for consideration ahead of Budget 2021. The outcome of this review may affect the presentation of the headline debt and operating expenses in the 2021 Statement.

Demographic change

The structure of New Zealand's population is set to change dramatically over the next 40 years. New Zealanders aged 65+ are projected to account for more than 25.9% of the total population by 2060, compared to 15.6% in 2020.

The 2021 Statement will analyse the key factors affecting both the level and structure of New Zealand's future population. This will also include how these factors differ by population group and region.

Understanding the potential economic impacts of an ageing population is an important part of the long-term fiscal sustainability challenge, given that tax revenue is closely linked to economic growth and because government expenditure varies by age group.

The 2021 Statement will consider the main ways an ageing population can affect the economy and the long-term fiscal position.

Unanticipated shocks

Unanticipated shocks such as COVID-19, natural disasters and economic downturns add to fiscal pressures. This occurs through a combination of automatic and discretionary spending to contain the impacts of the shock, as well as the possibility of falling tax revenues due to lower incomes, profits and consumption.

Over the long term, it is important to ensure that New Zealand's public finances retain adequate buffers to cope with these unexpected negative shocks. Being able to respond adequately to adverse events is important to ensure individual living standards are resilient, and to help smooth out the macroeconomic impact over time and across different communities.

The 2021 Statement will analyse the impact of a single shock in isolation, as well as a sequence of shocks, on the economy.



Other factors that will affect the fiscal position

It is not possible to analyse all of the factors that will impact New Zealand's long-term fiscal position. Some factors will eventuate that we are not aware of, like the COVID-19 pandemic; then there are other factors we are aware of, but are not yet able to include detailed modelling due to high levels of uncertainty around magnitude and timing, such as climate change.

The 2021 Statement will consider some of the factors not modelled that could impact the long-run position. In particular, drawing on internal and publicly available analysis, the 2021 Statement will discuss the impact that climate change may have on the long-term fiscal position and living standards.

Extending the analytical approach

As in previous Statements, the Long-term Fiscal Model (LTFM) will be used to present a 'historical trends' long-term fiscal projection scenario, which assumes that expenditure and revenue follow historical trends and legislative settings remain unchanged.

New analysis underpinned by a general-equilibrium approach, using the New Zealand Dynamic Fiscal Model (NZDFM), will be used to present an 'alternative' long-term fiscal projection, given policy and behavioural responses within the model. The analysis will show how governments could accommodate higher levels of expenditure by adjusting tax rates, while also ensuring government debt remains sustainable. The analysis will also show the possible effects on the economy, such as higher interest rates from higher debt levels leading to lower investment.

While there are limitations to both approaches, they are complementary and allow us to carry out a more complete analysis of how the fiscal pressures emerging over the next 40 years may affect New Zealand under a variety of alternative assumptions and scenarios.

Where possible, the 2021 Statement will incorporate the impacts of COVID-19 on key economic variables such as interest rates, labour productivity, migration and trend growth.



Options to improve New Zealand's long-term fiscal position

We propose that the 2021 Statement focus on the following to improve New Zealand's long-term fiscal position:

- Options to increase tax revenue
- Different paths for total government and health expenditure
- Options to change New Zealand Superannuation settings
- The relationship between economic growth and the long-term fiscal position, in particular the impact of productivity growth and labour market participation
- Implications of long-term economic trends such as declining interest rates
- Strengthening New Zealand's fiscal framework.

The following pages provide more detail on each of these topics.

Even after excluding temporary COVID-19 spending and accounting for the economic cycle, the Treasury is currently forecasting many years of deficits. There is considerable uncertainty around these fiscal forecasts and therefore uncertainty about the starting point for longer-term fiscal projections.

Projected changes in key spending areas such as health and NZ Super are more certain, and indicate ongoing fiscal pressures.

Tax revenue

The 'historical trends' long-term fiscal projection scenario will hold tax revenue as a percentage of GDP constant. While this assumption is based on historical trends, the Government has choices about the level of tax revenue it collects. For example, a government may decide to tax more in order to fund spending pressures in particular areas. The Government has many different options to increase tax revenue, each with its own costs and benefits.

The 2021 Statement will explore, at a high level, specific options that would increase tax revenue, such as increasing personal income tax rates. This will be in addition to the scenarios presented in the NZDFM, which will present analysis on how average business, labour and consumption tax rates would need to respond in order for net debt to stabilise.

This analysis will illustrate the possible flow-on impacts to the economy (such as labour supply and business investment) from changes to these tax rates.

Another reason why the projected level of tax revenue may differ from the future level of tax revenue is that structural changes to the economy also change the nature of the tax bases from which the Government draws revenue. This in turn could require a policy response in the future.

The 2021 Statement will explore some of the tax sustainability challenges generated by factors which include increasingly internationally-mobile labour and business income, and changing shares of capital and labour income.



Government expenditure

The 'historical trends' scenario will illustrate one possible path for government expenditure, based on historical trends and existing legislative settings. However, as with tax revenue, the Government has choices about the level of government expenditure on health, NZ Super and other items.

There are also large uncertainties around the projections of key areas of government spending, particularly health, so it is important to understand the sensitivity of the fiscal projections to a range of possible spending scenarios.

The 2021 Statement will examine the impact on the long-term fiscal position and key economic variables of the following scenarios:

- Spending on government services (non-transfer spending) is managed to within current levels as a percentage of GDP, but spending on transfers is allowed to grow.
- Transfer spending (including NZ Super) is managed to within current levels as a percentage of GDP, but spending on government services such as health is allowed to grow.

Given the importance of health spending on the long-term fiscal position, the 2021 Statement will present alternative, aggregate levels of health expenditure and discuss the trade-offs required to reach this level of spending.

Due to New Zealand's ageing population and current legislative settings, NZ Super expenditure will grow significantly over the next 40 years.

The 2021 Statement will present options for adjusting NZ Super, and the impact of this on the long-term fiscal position, such as raising the age of eligibility or changing the relationship with average wages.

Economic growth

The 2021 Statement will consider the relationship between economic growth and the long-run fiscal position, in particular the impact of productivity and labour supply (two key drivers of economic growth) on the long-run fiscal position.

For example, higher productivity growth generally improves living standards as it results in higher incomes. But higher productivity is not expected to close the projected gap between revenue and expenses. Although productivity growth is expected to raise additional revenue, productivity growth also flows through to expenses in a number of ways.

Implications of long-term economic trends

Macroeconomic developments over the last decade – especially declining interest rates and the implications for monetary policy – have created new analysis and debate about the role of fiscal policy. This manifests itself in both shorter-term stabilisation policy and the analysis of long-term fiscal sustainability. These are long-term challenges that will be considered over the next 5-10 years.

Additionally, large one-off events like the COVID-19 pandemic can have lasting effects on labour market attachment and economic performance.

The 2021 Statement will canvass these macroeconomic challenges in more detail, along with the immediate issues that help us better understand them, and the potential policy solutions.



New Zealand's fiscal framework

The Public Finance Act (PFA) is the legislative core of New Zealand's fiscal policy framework, which specifies how each Government should manage its finances. The public finance system includes the PFA and the wider, non-legislative systems in place across the public sector that give effect to the Government's fiscal strategy.

The 2021 Statement will consider the fiscal sustainability implications of modernising New Zealand's public finance system.

The Government is seeking to modernise the public finance system, with the aim to improve ministerial decision-making and strategic alignment, and support medium-term planning and joined-up working, with a strong focus on the value for money delivered by all government spending, and greater consistency with te ao Māori.

While modernisation could affect expenditure management, it would not change the nature or magnitude of the significant expenditure policy choices and trade-offs. Nonetheless, greater clarity and better information on what is intended and achieved with public spending may support higher living standards and promote better spending decisions overall. It could also enable better fiscal decision-making and collaboration by taking a longer-term view and supporting cooperation across ministers and agencies.



Legislative requirements of the Long-term insights briefing and the Statement on the long-term fiscal position

The legislative requirements of the Long-term insights briefing and the Statement on the long-term fiscal position are set out in the Public Service Act 2020 and Public Finance Act 1989 respectively.

These can be found at the links below.

Long-term insights briefings:

Public Service Act 2020

<https://www.legislation.govt.nz/act/public/2020/0040/latest/LMS106159.html>

Sch 6 cl 8 Long-term insights briefings and Sch 6 cl 9 Public consultation

Statement on the long-term fiscal position:

Public Finance Act 1989

<https://www.legislation.govt.nz/act/public/1989/0044/latest/DLM160809.html>

S26N Statement on long-term fiscal position and S26NAAA Extension of time limit for 2020 statement: COVID-19



