- Like to thank the Treasury for inviting me to make a contribution. After 13 years' absence from any involvement in public life it has been a welcome challenge to reimerse myself in issues with which I used to be familiar.
- The paper I have contributed is entitled *Long term Fiscal Risks – NZ's Case in the Context of OECD Countries*. The cross country comparisons compiled in the paper were pulled together by James Beard of the NZ Treasury and Michelle Harding (formerly from the Treasury) – both currently based in Paris. I am indebted to them for their help.
- It is a long paper and I am not going to trawl through all the comparisons – there is not time and in any case most of them have come out in the papers that have been presented to the conference. Instead I'd like to focus on the main theme of the paper which is about seeing this fiscal review as an exercise in managing a wide range of risks under conditions of significant uncertainty; and how, from a political point of view, one might seek to stop the need for fiscal prudence sliding off the radar screen.
- Sir Michael's paper makes many wise observations about the political economy of the issue that I share. He is also much better qualified to talk about the details of retirement income. But I think it would be useful for this conference to finish on wider angle perspective. The issues we are dealing with are broader than retirement income; and they are subject to pervasive uncertainties that really can do with some underlining.
- The issue of retirement income places the demographic transition we're undergoing in sharp relief. The fact that the trajectory of ageing can be so precisely quantified – and the impacts modelled – lends a misleading sense of certainty to this whole debate. The phenomenon is painted as inexorable, quantifiable and manageable.
- In one sense it is. But we should also reflect on how unfamiliar the future might be. The world has never experienced ageing on the scale we're about to live through. This is what it means for the old-age support ratio in OECD countries [slide 1]. And this is what that ageing means fiscally in a variety of countries [slide 2].

- But it is not just a developed country phenomenon. China will shortly start to age - before ever having fully developed. And that ageing will occur in the most urban world we have ever experienced – from 30% urban, 70% rural in 1950 we will by 2050 have exactly reversed those proportions. And, absent political or biological disaster (and those cannot be discounted) it will also be the most mobile world ever, raising profound claims about identity.
- We all know this. But we don't really understand what it will entail. Which is why I feel instinctively nervous about telling people that we can engineer particular outcomes.

- Geo-political, social and environmental trends mean that the world in which future taxes and dividends are struck will differ significantly from the context in which current entitlements have been established. While we can describe the plausible direction of a number of these trends, the risks around them are not sensibly quantifiable. That doesn't mean they can be ignored.

Take the physical environment. A much larger economy will place increasing pressure on the planet's capacity to absorb waste and supply vital ecosystem services. The baseline case (with no policy change) for the *OECD Environmental Outlook to 2050* (OECD 2012d) projects the global economy to almost quadruple by 2050 from $75 trillion to $300 trillion. The OECD's share of the global economy will decline from a little over half global GDP (54%) to less than a third (31%). Needless to say NZ becomes an even more vanishingly small element of a much less familiar geo-political world.

No country will be immune from the global environmental pressures of such a world whose impacts will be transmitted directly (as in the case of climate change) or indirectly (through declining environmental quality affecting global supply chains). The *Outlook*'s baseline case

projects that the world is on course for a 3-6 degree increase in global average temperature by the end of the century (2-3 degrees by 2050), a 55% increase in demand for water (with 40% of the world's population living in areas of severe water stress by 2050), a further 10% decline in biodiversity by 2050 and more than double the number of premature deaths from airborne pollution (particulate matter and ground level ozone). In some cases (notably airborne pollution) the ageing profile of OECD populations will place them at particular risk.

As an open economy, New Zealand can expect to feel the consequences of rising resource scarcity and environmental damage through trade linkages and directly experience the local consequences of globally-induced climate change. Depending on the severity of environmental pressures, New Zealand could become an increasingly desirable destination for migrants as well as benefit from demand for the biological output of its resource base in a world needing more food.

The global scale of potential climate change has reinforced the impression that environmental change is the most likely source of catastrophic risk. This may not be so. For a carefully measured assessment of the relative orders of magnitude that can reasonably be attached to known risks, Smil (2008) is essential reading. On the basis of a rigorous assessment of the known statistical level of exposure to risk of fatality caused by large scale catastrophic events, Smil identifies only one risk emanating from the natural world – a viral pandemic – to which a high probability of mortalities in the region of 10^5 can be attached within the next fifty years. He ascribes a similar level of probability to a mega-war (defined as a 'potentially massive armed confrontation').

Conflict is not good for smoothly advancing prosperity. To those inclined to dismiss such risks, Smil counsels pondering on the ubiquity throughout history of irrationality, the drive for power and

dominance and how as a species we might respond to unpleasant social and environmental develoments:–

> Doing that might lead one to conclude that despite many localized problems, the second half of the twentieth century was an exceptionally stable and an unusually benign period in global terms, and that the probabilities of more painful events will greatly increase during the next 50 years."[1]

Then there are natural hazards. New Zealand's vulnerability to seismic and volcanic events is well known. I barely need to mention it in this city or after the Christchurch earthquakes.

Natural disasters have the potential to impose economic shocks that knock New Zealand's growth prospects and thereby undermine the government's ability to raise tax revenue. Prudentially, New Zealand's geological endowment requires the Government to run its finances on the basis that it will have to face recurrent fiscal burdens in the same way countries like the Netherlands face water management expenditures or other countries face significant defence expenditures for geo-political reasons. A similar reasoning applies to New Zealand's relatively high exposure to biological risk given the biological base of the economy.

While not a 'natural' disaster in the same sense, anthropogenic climate change poses unknown but potentially significant economic risks within the horizon under consideration. Significant climate change is already locked in and global emissions trajectories suggest that the chances of holding average global temperature increases to 2 degrees are fast dwindling. The global community faces a choice in the next decade of either acquiescing in significant climatic disruption or costly adjustment because of the failure to take comprehensive measures over the last twenty years.

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[1] Smil (2006), page 250-1

Like many countries, New Zealand's stated acknowledgment of the risks is not matched by actions that can significantly reduce those risks. While the costs of placing economies at a competitive disadvantage from acting unilaterally are prominently advertised, the costs of a collective failure to act are discounted. This is a long-run challenge that will not go away and the costs that will be encountered either adapting to the consequences or trying to limit their extent are likely to weigh on future growth. This places a further question mark over future growth scenarios based on benign assumptions about the physical world.

One other class of risk to smoothly advancing prosperity deserves comment – financial crises. The financial sector is capable of delivering shocks with every bit as much impact as natural disasters. Such shocks can swiftly impose constraints on a government's fiscal position for many years.

Economic crises are not rare events. A recent study estimates that since 1970 there have been a total of 147 banking crisis, 218 currency crises and 66 sovereign debt crises. As the world is now well aware, this is not just an emerging markets phenomenon. Thirty one of the 34 current OECD members have experienced at least one systemic banking crisis since 1970 and 32 have experienced at least one of a banking, currency or sovereign debt crisis over that period.

Against this backdrop New Zealand is fortunate not to have been among those having experienced a banking crisis although this may be as much a consequence of prudent Australian regulation governing our largely Australian-owned banking sector. Serial failures by other New Zealand financial intermediaries over the last thirty years have destroyed a significant share of private savings which suggests that New Zealand has lacked important management skills and has failed to regulate appropriately. There is no room for complacency.

One specific source of economic vulnerability for New Zealand is its external indebtedness position and the risk of a 'sudden stop' in capital inflows if foreigners turn-off New Zealand as an investment destination.

Encouraged by New Zealand's economic performance and prospects, sound institutions and policy settings, foreign investors have been willing to fund New Zealand's sustained current account deficit. This has seen the net international investment position expand to a net liability of over 70% of GDP Good management and a bi-partisan track record of taking unpalatable political decisions when required has shielded New Zealand from greater investor scepticism. However, investor sentiment cannot be assumed to be unshakeable. A significant and sustained negative reappraisal of NZ's risk profile could see GDP and employment fall as activity contracts and the fiscal position deteriorate. Only our institutions (like this process we're engaged in) and political probity keep those prospects at bay.

New Zealand policy makers are not alone in pondering what long run trends mean for fiscal sustainability. The demography of OECD countries coupled with the rapidly increasing economic weight of emerging economies means they are beginning to face competition for capital, resources and skills from a much less advantageous position than they have been accustomed to.

What distinguishes New Zealand from many OECD countries is the fact that this enquiry is not taking place in response to an immediate fiscal or economic crisis but as part of an institutionalised process of periodic review. This, combined with the relative intimacy of New Zealand society and its less polarized political landscape, should enable a more measured trimming of the fiscal sails in advance of acute challenges arising.

Whether or not this happens is, of course, another matter. New Zealand's relative security has led to long periods of policy immobilism which, nevertheless, seem able to be surmounted when a crisis threatens. The crisis of the 1980s led to a remarkable policy response and the expenditure of a large amount of political capital (in terms of trust in political institutions). Rebuilding that trust has been a slow, hard-won business.

The temptation now is to consolidate rather than take action. But the future is less accommodating than it was thirty years ago. New Zealand was one of the first OECD economies to promote a radical break with the post-war mixed economy consensus. While all OECD countries faced difficulties in the aftermath of the oil shocks of the 1970s, the crisis of public finances New Zealand faced was exceptional. Structural reform to promote growth played into a global economic outlook that, while difficult, was not plagued by the synchronized resort to austerity measures currently being experienced. There was room for a small open economy to exploit growth opportunities in a global market place that was expanding as trade barriers fell. Difficult structural adjustments could be pursued in a less demanding global climate. Many of New Zealand's OECD partners still had relatively strong national balance sheets

In addition, a demographic 'window' was opening in which the demand for spending on the school age cohort was moderating without any immediate increase in the population of retirees. Reversing an exceptionally low age of pension entitlement also managed to defer the worsening of the old-age dependency ratio by seven or eight years.

That window has now closed. New Zealand faces the need to keep public debt levels under control and ensure that sound policy supports continued access to global capital markets by New

Zealand businesses against the backdrop of the worst global economic recession in two generations and worsening demographic trends.

Retirement income has been a particular lightning rod. Because the decision to pay pensions out of taxes relies on expenditure decisions that will be voted by elected officials far in the future, no-one can say with certainty how a future parliament will regard any inter-generational bargain purportedly made on its behalf decades before its own election. Encouragement of savings provides a way for people to spread the risks by relying not just on future taxpayers but on returns from privately invested capital. But again this is not without risk. Thirty or forty years from now as savers set out to call in their annuities they will, with retirees around the world, find themselves in competition with relatively fewer workers whose bargaining position will be stronger and the owners of industry whose views about dividend payments may not match those of pension fund managers.

A more numerous retired population might be expected to seek to secure the election of a Parliament that broadly represents its interests. But elections are an extremely imperfect mechanism for securing particular preferences. In deciding on the level and incidence of taxation, politicians are at the centre of a contest between the (partially overlapping) interests of the owners of capital (seeking dividends), workers (seeking remuneration) and voters. The outcome of the particular forces at work in some future economic and political setting is simply unknowable. All one can say is that for today's working age population to assume that rising claims on taxpayers will be met in the future on the basis of current sentiment would be very risky.

The most cautious way to minimize these risks would be through a phased increase in the age of eligibility to match increasing life expectancy. A more ambitious approach would, in addition,

consider an element of targeting. It might even seek to progressively establish a somewhat lower level of payment in relation to prevailing wages. Communicating the desirability of savings is an essential element of any such rebalancing of taxpayer risks although I do not support compulsion and I worry about the practicalities of targeting.

But retirement income is only one driver of the emerging fiscal pressures and it would be unfortunate if the medium term fiscal review became all about retirement income. It is the wider bundle of services that needs to be considered and the resilience of the economy – and the tax system - to meet the claims that are likely to be made of elected officials. Taking a wider view would lead one to focus as much concern on the apparently inexorable increase in foreign claims on output (through accumulating balance of payments deficits) as particular government expenditure trends. As net borrowers, New Zealanders face the real possibility that not only governments may not deliver the social dividends they hope for but access to the capital needed to generate new streams of income may be significantly limited.

An optimistic forward-looking scenario would see global demographic trends as ultimately playing into New Zealand's hands. A world with two billion more inhabitants within little more than a generation and widespread demand for more food on the part of a growing global middle class can only play to New Zealand's strengths as a food producer. In that case the rents from increasingly scarce soil and water might be sufficient to sustain rising living standards for the foreseeable future. The interesting political economy question is whether food producers should be allowed to keep the full benefit of those rents. The case for taxing the rents that soil, water and other resources provide cannot be ignored in a world where capital and labour are so mobile and resources potentially more scarce.

To this optimistic outlook might be added New Zealand's geo-political proximity to the region where the largest growth prospects are clustered – China and East Asia. It seems reasonably safe to assume an on-going rise in Chinese influence in both economic and security spheres. But how far that influence will extend – and with what consequences for a tiny trading country like New Zealand – is impossible to say. China faces a multitude of long-term challenges that place a question mark over the inevitability of its ascent: an extraordinarily aberrant gender ratio, serious environmental ills, the increasing inequality of economic rewards, and its weak soft-power appeal."[2]

These risks and uncertainties, provide a compelling rationale for placing public finances on a more resilient basis. This review is well timed. NZ is neither so rich (like Norway) that it isn't under pressure nor so fragile that it is forced to take precipitate action. Many OECD countries are being forced to take steps that are inevitably ad hoc and brutal. New Zealand has for the moment the opportunity to act pre-emptively on its own terms rather than in response to external pressures. That relatively benign position will not last. The opportunity should be grasped so that change is not precipitate and citizens and taxpayers can adjust their circumstances with time to spare.

If that is to happen we have to turn a deaf ear to some apparently 'easy' solutions.
Over the years, a variety of 'painless' remedies have been offered as alternatives to either curbing expenditure or raising taxes (or both) to generate the surpluses needed to reduce the stock of debt. The most seductive is to advocate higher rates of growth that will lift all boats including government revenues. There are two problems with this approach. In the first place, there is no historic track record of the New Zealand economy sustaining a rate of growth higher than 2%. But even if such a growth rate were achieved there is no way of ensuring that a

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[2] Smil (2006), p 249.

significant share of higher tax revenues could be devoted to debt retirement. Growth brings with it rising expectations and ensuing distributional claims.

An alternative remedy often advocated is a much more aggressive inward migration policy. There is a belief that a much larger population would underwrite higher productivity. To the extent that we could count on large numbers of (younger) skilled migrants of working age, a more productive workforce might seem a plausible outcome. But again, there are no guarantees. New Zealand cannot assume that it will be able to attract the people it thinks it wants - we have had 25,000 or more net migrants in only four of the past 60 years. It does not occupy a global cross-roads – it cannot position itself as some sort of global emporium. Many other economies can offer higher densities of intellectual capital and more exciting opportunities.

Human capital is for me the Achilles heel of New Zealand's future ability to stay afloat. Currently we're managing to cover the outward migration of skills with a matching inflow. [slide 3]. Very simply, if the human capital pipeline were disrupted, all bets are off.

But even if we could significantly out-compete other countries for human capital, it is not a sustainable answer. Migrants cannot be held at arm's length from the matrix of expectations and services that drive public expenditure. Migrants will demand health and education services like everyone else. They will also age. A larger more vibrant population would very likely contribute to productivity growth but whether it would be sufficient to reverse the public debt trajectory is another matter.

So how do we make progress from here?

The political conditions for making progress will be optimized if the factual boundaries of the policy debate can be broadly agreed and internalized. These cannot encompass strongly normative considerations. A very large element of public policy debate is about the distributional consequences of policy change. This is as true of debates over regulatory reform and property rights as it is of taxing and spending decisions. Those debates are evergreen. But it should be possible to agree that any solution set cannot ignore certain facts.

Elected officials could make a constructive contribution to New Zealand's future by accepting that policy options are constrained by the following propositions:

- First: without policy change, demographic momentum will drive the current fiscal imbalance even further from balance with a consequent build-up in the stock of public debt.

- Second: recourse to policies designed to enhance productivity, however desirable, cannot alone be relied upon to close the spending gap.

- Third: there are sufficient risks – nationally and globally – to assert that the climate for fiscal consolidation in the future is unlikely to be more benign

- Fourth: recent events confirm that sovereign borrowers enjoy no special immunity from the requirement of everyone to live within their means and that low debt levels are essential if governments are to retain the 'firepower' necessary to respond to costly, unforeseen disjunctive events.

- Fifth: expenditure control and tax increases – in whatever proportions – are the only certain ways of generating the surpluses needed to bring the stock of debt down to a level at which that sovereign 'fire power' can be protected.

- Six: returning to fiscal balance and reducing debt is best done outside of a crisis context and that agreement on a trajectory and timetable need not preclude a vigorous debate about how to stay on that trajectory.

- Seven: given that policy changes are likely to hold spending and taxing consequences that differ across generations, being able to communicate a clear long-term trajectory is not only more economically efficient; it is also fairer to be transparent rather than leave the future permanently veiled in uncertainty.

If a multi-party consensus around 'boundaries' of this type could be agreed, New Zealanders could then turn their minds to the range of policy alternatives on offer from political parties, confident that their long term security, if not guaranteed, was at least being argued within responsible bounds.

But what are the chances of agreement on 'boundaries' today being respected in debate tomorrow? It is here that some institutional innovation might be useful. The current exercise led by the Treasury has been both sophisticated in its reach and ecumenical in its invited participation. But it has, inevitably, engaged a policy-literate elite and the Treasury, which serves the government of the day, cannot be on permanent referee duties. For that reason it might be worth conferring the 'guardianship' of the debate to an independent entity that can comment directly on the consistency of policy settings with the agreed need to keep debt and expenditure on sustainable tracks.

That need not be an expensive or cumbersome business. The Treasury could, through an amendment to the Public Finance Act, be charged with annually assessing the trajectory of policies currently in place against pre-agreed criteria for fiscal sustainability. That analysis could be made available to an independent 'Fiscal Sustainability Committee' whose job it would be to provide a public commentary on the compatibility of policy settings with desired long run outcomes.

The terms of appointment, tenure and public outreach of such a Committee to secure its independence and authority is beyond the scope of this paper. Colin James' paper canvasses a range of institutional possibilities. New Zealand's record as a public policy innovator gives some confidence that new approaches could be found given the will. That said, politicians have been jealous about infringements on the exercise of executive power. The fact that New Zealand remains a unicameral system with far fewer moving parts than most democracies is evidence for this. The control of fiscal policy lies at the heart of executive power in New Zealand and going beyond formal scrutiny to some form of limitation or review would indeed be novel.

Let me conclude by saying that the current exercise provides more than enough evidence that prudence demands credible and durable responses to the fiscal consequences of demographic, financial and geo-political trends. We don't need more papers on the dynamics that compel this conclusion. We need sustained attention to the conditions that will permit our political institutions to deliver those responses.