THE TREASURY
Kaitohutohu Kaupapa Rawa

Long-term Fiscal Outlook: A View from the Treasury

Speech delivered by Gabriel Makhlouf, Treasury Deputy Chief Executive

Conference on Retirement Income Policy and Intergenerational Equity

Day 2 – Fiscal Perspectives Session Thursday 22 July 2010

Thank you, Diana, for your opening remarks and for your introduction.

For those of you that I have not yet had the opportunity to meet, my name is Gabriel Makhlouf and I moved to New Zealand earlier this year from the U.K. to take up one of the two Deputy Chief Executive roles at the Treasury.

Can I first congratulate you Diana and the Office of the Retirement Commissioner, together with the Institute of Policy Studies, for bringing together such a distinguished line-up of speakers?

The scope of the inter-related issues being tackled over this two-day conference is impressive. It is a pleasure to be here on behalf of the Treasury to deliver the address for this the *Fiscal Perspectives Session* of the conference.

I believe that we all carry a responsibility to share our research and insights to assist New Zealanders to make evidence-based choices on how to manage the challenges arising out of population ageing in a manner that is fair between generations and in a way that is most likely to enhance the economy's performance.

The Treasury, which is the Crown's advisor on how to maintain macroeconomic and fiscal stability and on how to enhance the economy's performance over time, has a special responsibility in this regard.

Structure of presentation

The Treasury's perspective on retirement income policy and inter-generational equity must invariably take into account the projections for the Crown's finances while also assessing the impact of Government retirement income policy on people's well-being and on the performance of the economy.

My talk today is in two parts.

The first is a summary of what we know about demographic change and the challenge it poses to the Crown's finances, to economic performance and to people's incomes.

The second part addresses the issue of how New Zealand's outlook compares internationally and what other governments are doing to put their long-term finances onto a sustainable footing.

I have been assisted in thinking about these issues by the research over recent weeks by Treasury analysts who have gone back and had a look at our 2009 Long-term Fiscal Statement and asked how the outlook outlined in that report might have looked had it been prepared with more up-to-date information than was available at that time.

What they found was that had the Statement been prepared with the benefit of using the materially stronger economic and fiscal starting point of Budget 2010, and with the benefit also of incorporating policy decisions adopted in that budget, then the level of Crown debt at the end of the 40-year projection period would be lower.

The substantive conclusion of their research, however, is that the underlying reality remains unchanged from the perspective of the Crown's finances.

And the underlying reality is that the Crown's finances are not sustainable into the long-term on the basis of projecting forward historic trends in spending.

As we said when we published our 2009 Long-term Fiscal Statement, New Zealanders need to do some significant things differently in the years ahead from what they have become accustomed to. Some serious trade-offs will be required to maintain the Crown's finances in order.

Part 1

What we know about New Zealand's ageing population

So what do we reliably *know* about New Zealand's ageing population and what does it mean for the future performance of our economy?

Well, for starters we know that New Zealand has been experiencing a shift in the structure of its population from the time of its establishment, and certainly since the collection of reliable data from the final decades of the 1800s.

Like the rest of the developed world, New Zealand is well into a process of transition from a high fertility/high mortality state to a low fertility/low mortality state.

The median age began rising in the late 19th century and that process continued apace through the 20th century with a temporary reversal during the Post World War II Baby Boom. No matter what angle you choose to examine the data from, all the indications are that this multi-century phenomenon will accelerate over the next few years.

By 2060, we expect that there will be four people aged 65 years and over for every 10 New Zealanders of working age, between 15 and 64: That ratio compares with a ratio of two to 10 today.

If you combine the pre-working age population (those under 15) together with the those aged 65 and over, then in 50 years' time demographers expect that the ratio of these traditionally non-working age people will stand seven to every ten working-age New Zealanders – that is a 7 to 10 ratio compared with a ratio of 5 to 10 today.

Whereas two-thirds of the population today is of working age, by 2060 demographers expect that fewer than six out of ten will be aged 15 to 64.

What these trends mean for future economic performance

What will these profound changes in demographics most likely mean for our future economic performance and is the Treasury confident that there is a clear link between these demographic trends and our likely future economic performance and incomes?

Well, one area where there is strong consensus among economists is that the ageing of the population will in time reduce our labour force participation rate which in turn will act to moderate economic output.

New Zealand has a high labour force participation rate, meaning that a relatively high proportion of New Zealanders aged 15 and over is either in paid employment or actively seeking paid employment, as a ratio to the working age population.

New Zealand's labour force participation rate is projected to continue to hover around high levels of 68% in the middle of this decade before easing down to around 63% by 2060 and, yes, the projection does take into account the fact that we anticipate more individuals to continue working later in their lives than has been the case in the past.

It is just that not enough individuals are anticipated to do so to prevent a decline in the overall labour force participation rate.

If we assume, perhaps optimistically, that those older workers undertake paid employment at around the same number of hours as the average of the current workforce, that still won't be enough to prevent New Zealand's trend real economic growth rate from easing back from an average of 3% per annum over the next three years, to a bit under 2% from the mid-2020s.

Is that significant?

It certainly is in terms of the degree to which the future economy will be able to fund essential social services.

The rise in the ratio of elderly to the working age population will act as a drag on the economy's potential growth rate.

Over time, our economy will be constrained by a lower "non-inflationary" speed limit than we are currently constrained by and this will coincide with a period when the call on the Crown's resources to fund social services and entitlements will be rising because the ratio of dependents will be rising relative to those of working age.

What it means for the Crown's accounts

But what does this all mean for the Crown's finances?

Well, there is very little controversy about the broad outline of what this all means for the finances of the Government of New Zealand.

What it means is that the current settings for government spending and revenue projected on the basis of historic growth patterns are not sustainable over the longer term.

To help illustrate this reality, consider just one area of Crown spending: the universal New Zealand Superannuation entitlement for residents aged 65 years and over.

At the moment, around 13% of total core Crown spending, excluding the interest costs on servicing the outstanding stock of Crown debt, goes to pay for New Zealand Superannuation. Assuming current policy settings are maintained, the 2009 Statement projected these costs to consume around 22% of Crown spending by 2050.

To look at it from another perspective, at present the level of central government spending on NZ Superannuation is equal to about 4.4% of the national income in a year. The 2009 Statement projected public spending on the universal pension rising to consume around 8 per cent of national income by 2050.

Moreover, at present, the value of public spending on health services is around 7% of GDP. Taking account of projected wage and other cost pressures, the ageing population, and the tendency for governments to continue to provide new services as they become available, then history suggests that if things were to be left to play out consistent with past trends then central government health spending could expand to over 10% of GDP by 2050.

Today, around 25% of the government's annual operating spending goes on social services, including health and New Zealand Superannuation, to the 13% of the population aged 65 and over. Those ratios are projected to rise dramatically by mid-

century, reaching as high as 40% of the central government's annual operating spending for a group that, by 2050, will constitute around 25% of the population.

Those are significant figures and they raise important questions, including about inter-generational equity. But I should add that those questions are already being posed. Recent OECD data indicate that New Zealand compares very favourably in efforts to combat poverty among the elderly, but that our poverty rate among children is higher than the OECD average. Efforts to improve our relative record with regard to childhood poverty will obviously need to be balanced against all the other competing calls on the Crown's resources in the years ahead. It is all about choices and deciding what's important.

Part 2

Challenge to Crown accounts consistent with situation overseas

The Treasury produced its first ever long-term fiscal statement in 2006 in the middle of a world-wide economic boom. The 2009 Statement, on the other hand, was prepared near the trough of the biggest global economic downturn since the 1930s.

In spite of the two statements being prepared with dramatically different starting fiscal positions, and in an environment of significantly different economic conditions, the essential conclusion of both is the same: the Crown's fiscal settings are unsustainable over the long term because the projections for net debt in both reports are for a consistent, uninterrupted upward trajectory.

Projections are not forecasts. Forecasts try to work out what will happen; they are an attempt to portray a precise picture at any particular point in the future. Projections, on the other hand, are based on long-run trends. They are an exercise in projecting historic spending and revenue patterns, as these interact with changes in population. In this case they start from the end of the Treasury's formal four-year forecast period and, as such, they help us to understand whether the Crown's finances are sustainable or not over the long term.

So long as any government's debt projections are persistently sloping upwards at the end of the projection period, then that means the fiscal position is not sustainable under current policy settings for the long haul.

That is a conclusion that challenges governments across the developed world.

To address these challenges, governments are looking at a whole range of options related to public spending and taxation and one of these is pension reform.

For societies that have historically maintained financial incentives to reward early retirement, for example, steps are being taken to reduce those incentives.

A number of governments are to reduce the generosity of pension entitlements of their public sector workers.

And a number of the high-performing OECD countries are in the process of progressively raising, or have announced they will raise, their pension entitlement ages

to 67 or 68 years. This list includes the United States, Australia and the United Kingdom.

They have looked at similar changes in their populations to those we are experiencing. In 1938, for example, when NZ introduced a universal pension, a 65-year-old could expect to live to 78 on average. By 1977, when today's NZ Superannuation was essentially created (but with a take-up age of 60), a 65-year-old would live on average until 80. That life expectancy has now reached 85 and will rise to 89 for a 65-year-old in 2060.

In recent months, fiscal packages, dominated by cuts to government spending and supplemented with some measures to increase tax bases, have been rolled out in a number of the major European countries - packages adopted with a view to ensuring public finances are put onto a more sustainable footing for the *long haul,* while shoring up market confidence in sovereign debt markets in the *here and now*.

It is some comfort that New Zealand's public sector accounts are in a healthier starting position than many other OECD governments due in part to our strong integration with the buoyant economies of Asia and the fact that we went into the 2008-2009 global economic downturn with the Crown carrying low debt levels.

But New Zealand's relatively benign starting position is just that, a benign starting position.

Projections to mid-century, which it is important to emphasise – and I'm repeating this to make it absolutely clear – are not forecasts but an exercise in projecting historic spending and revenue patterns forward from the end of the Treasury's formal forecast period, consistently show that the Crown would be spending more on programmes than it would be taking in as revenue, a process that were it allowed to proceed would quickly overwhelm our relatively benign starting position.

Our problem in the long term is the same as other countries' and that is that our government's debt curve is projected to be on an upward trend at the end of the projection period, when what we require is for a levelling off or a decline.

Potential responses to fiscal pressures arising from an ageing population

It isn't the end of the world – but it is a warning signal for us to prepare for action.

And in preparing for action, our 2009 Statement looked at a few ways of potentially squaring the fiscal circle, to provide some ideas to encourage informed public debate and also to help make the challenges we are facing more concrete.

Acting on these would require difficult choices and trade-offs to be made with alternative courses of action potentially affecting different generations differently.

As an example, the 2009 Statement illustrated a potential solution involving only changes to taxation. Under the 2010 update, with the tax changes announced in the Budget, raising tax a little at first, but more assertively through time so that the tax-to-GDP ratio is eventually lifted by a little over 2 percentage points, would likely be enough to put a halt to projections for net debt to indefinitely track higher.

Such a move would amount to an across-the-board personal tax rise of 3.5 percentage points. Or, alternatively, the same amount of revenue could be raised with GST alone by lifting the GST rate by 4.2 percentage points. But a very strong reason for not going down that route is that significantly higher taxes would further lower the economy's speed limit.

More attractive solutions lie in enhancing our economic growth, which in turn will provide higher living standards to all New Zealanders. With higher incomes, people will be better positioned to cover some of the costs of services they currently receive from the public purse. They will also be able to afford to pay more tax to ensure that those unable to participate in the workforce are still adequately cared for by the State.

The Treasury has an ongoing role to provide broad policy advice on how to raise our economy's performance. In terms of productivity this includes means of achieving stronger labour productivity growth than we have historically managed, including that of our public sector, as well as raising the productivity of our industries and export sector.

Improving labour force participation is another method of boosting growth. Our labour force participation is quite high in the prime age groups, by international standards, but drops off as people approach 65 and then falls rapidly in the "65 and above" age groups. These older age groups are going to become an increasingly larger proportion of the population over the next 40 years, so encouraging their participation in the labour force, even if on a part-time basis, will be a key factor in achieving stronger economic outcomes for the nation over this time.

Treasury's *2009 Long-term Fiscal Statement* assumed that NZ's annual net migration rate could average around 0.2% of the resident population over the projection period. While the merits of higher immigration need to be debated in full before proceeding with any policy change that might permanently lift this figure, ongoing higher immigration would mitigate, to some extent, the ageing profile of our future population. If migrants possessed skills that meant they could quickly assimilate into our labour force, and match if not surpass average productivity levels, this could be another means of improving our overall economic performance.

But, as we also said in 2009, higher economic growth is not the sole solution to addressing our future fiscal pressures. While lifting economic growth, we also need to slow our spending growth to ensure we live within our means and do not burden future generations of New Zealanders with higher levels of debt they need to finance.

Putting stronger starting assumptions into the 2009 projections

As I said, our projections are based on a large number of working assumptions.

We are required to use our best professional judgement about what assumptions are fair and reasonable to feed into the model, with the starting position of the economy and the Crown's finances having a significant impact on final numbers in any given projection period.

As I indicated earlier, Treasury analysts recently went back and had a look at our 2009 Statement and asked how the long-term outlook outlined in that report might look had the Statement been prepared with the benefit of using the materially stronger economic and fiscal starting point of Budget 2010, and with the benefit also of incorporating policy

decisions in that budget together with recent updates by Statistics New Zealand of its population and labour force projections.

Our analysts conclude that were the Treasury to go through the full process of producing another Long-term Fiscal Statement today, incorporating all of this new information, then it would show the Crown's net debt level at the end of the projection period standing well below the 223% level projected in the 2009 report.

Their estimate is that net debt in a revised 2009 Statement would stand close to the 2006 Statement projection for net debt of just above 100% of GDP in 2050 and rising – that is a level of net public debt similar to what Greece is experiencing at present.

The salient point is that the Treasury's 40-year-ahead projections outlined an unsustainable picture in our 2006 report, an unsustainable picture in our 2009 report and we are confident that were we to present another formal Statement to Parliament today then the long-term outlook would again be unsustainable with net Crown debt by mid-century standing above 100% of GDP and, critically, trending higher beyond that date.

Conclusion

Let me draw the threads together.

The question I wanted to have a clear answer to before fronting up here today is whether there are any difficult issues that need to be faced up to in New Zealand, and which it is the professional duty of the Treasury to highlight.

The answer is that New Zealanders are in the same boat as every other developed economy on the questions that need to be addressed in the context of the long-term finances of government.

The hard questions confronting us are the same ones in front of all developed societies: how best to adjust to put government finances onto a sustainable footing over the long term.

A projection for net debt of around 100% of GDP may be a less unnerving headline than a projection for over 200% of GDP, but what matters is not individual numbers but the direction of the Crown's debt position. If the direction is upwards and deficits are set to continue, then it is only a matter of time until a 100% net debt position spirals out to a 200% ratio to GDP.

The Treasury's work in this area since 2006 consistently informs us that, if you project historic trends in spending into the future, then the projections for the Crown's debt curve is headed upwards, meaning that growing debt financing costs ensures that net debt will continue to grow at an accelerating rate.

A key role for the Treasury is to highlight the benefits of taking prudent action earlier rather than later to turn that long-term outlook around – to get the projections for the shape of the debt curve to be headed lower, not higher, as this century progresses.

I know that a number of the addresses at this conference will look in depth at the pros and cons of some of the large array of options available to future governments in the retirement income area.

The pros and cons, for example, of raising the age of eligibility to universal superannuation; the pros and cons around various options to change the rules around the indexation of the taxpayer-funded pension; the pros and cons around options to return to means testing of New Zealand Superannuation; the pros and cons of an expanded role for KiwiSaver-like products in providing retirement income.

As we said last year, the largest single driver of the fiscal position is the policy choices governments make. Governments have the capacity to manage the fiscal position over time. It will involve change and choices. The principles we advocated last year still apply: make early change, keep debt under control, focus on outcomes and growth, encourage workforce participation, keep spending under control and focus on public sector productivity.

To conclude, for the Treasury, a key challenge over the next few years is to ensure that we produce robust analysis on the most economically and socially enhancing ways to correct the Crown's long-term fiscal outlook.

We have no doubt that adjustments will be required in the years ahead to get the long-term fiscal projections onto a sustainable footing.

Decisions on how to meet the fiscal challenge will need to take into account the implications for different groups within society – children, young working families and the retired, amongst others. And as the Treasury stressed at the time of the publication of our 2009 Statement, there is no single "silver bullet" available.

Protecting the fiscal position of the Crown is in the common interest, and meeting the challenge will require adjustments, changes in behaviour and changes in expectations from many New Zealanders.