



Quick Guide to Affording Our Future

STATEMENT ON NEW ZEALAND'S
LONG-TERM FISCAL POSITION
July 2013



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Quick Guide

The Public Finance Act 1989 requires that the Treasury prepare a Statement on New Zealand’s Long-Term Fiscal Position at least every four years. The Statement must relate to a period of at least 40 consecutive financial years, and be accompanied by a statement of all significant assumptions underlying any projections it includes.

Affording Our Future, the Treasury’s 2013 Statement on the Long-Term Fiscal Position, was tabled in Parliament on 11 July 2013. This Quick Guide sets out some key messages from that Statement.

➤ AFFORDING OUR FUTURE WILL REQUIRE ADJUSTMENTS

Population ageing, rising demand for certain services, and increasing prices of those services mean that some things the Government provides will become more expensive in the future – indeed, this process has already started. These cost pressures create a fiscal challenge.

This Quick Guide gives an idea of the size of the fiscal challenge and illustrates some options for addressing it. We project a “what if” scenario that shows how government expenses might grow from the 2015/16 fiscal year if they were to revert to their average historic rates of growth per recipient (different periods of history are relevant for different expense categories), taking into account demographic and other key economic variables, and assuming no change to current legislative policy settings. We call this scenario “Resume Historic Cost Growth”.

This scenario is different to the Government’s fiscal strategy, which involves firm control of expenditure growth.

Two areas of government spending are projected to grow significantly in the “Resume Historic Cost Growth” scenario:

- Government spending on healthcare is projected to grow from 6.8% of gross domestic product (GDP) in 2010 to 10.8% in 2060, an increase of 4 percentage points.
- Spending on NZ Super is projected to grow from 4.3% of GDP in 2010 to 7.9% in 2060, an increase of 3.6 percentage points.



Our full projections under the “Resume Historic Cost Growth” scenario are set out in Table 1. We assume that we collect tax revenue equal to 29% of GDP over most of the projection period. This percentage is roughly consistent with our tax take in recent history, but of course different governments may wish to collect more or less tax in the future. One consequence of holding tax revenue constant as expenses increase, however, is that from the mid-2020s revenues become insufficient to cover expenses. Accordingly, governments must borrow to make up the difference. Table 1 reflects the cost of this borrowing in the line “Debt-financing costs”, which shows these costs increasing over time. The bottom line “Net government debt” also increases as a consequence.

Table 1: Treasury projections for government expenses, revenue and debt as % of nominal GDP under the “Resume Historic Cost Growth” scenario¹

% of nominal GDP	2010	2020	2030	2040	2050	2060
Healthcare	6.8	6.8	7.7	8.9	9.9	10.8
NZ Super	4.3	5.1	6.4	7.1	7.2	7.9
Education	6.1	5.3	5.2	5.2	5.1	5.2
Law and order	1.7	1.4	1.4	1.4	1.4	1.4
Welfare (excluding NZ Super)	6.7	4.8	4.4	4.2	4.0	3.8
Other	6.5	5.6	5.7	5.8	5.9	6.1
Debt-financing costs	1.2	1.8	2.5	4.2	7.1	11.7
Total government expenses	33.4	30.8	33.4	36.9	40.6	46.8
Tax revenue	26.5	28.9	29.0	29.0	29.0	29.0
Other revenue	3.2	3.0	3.2	3.2	3.3	3.6
Total government revenue	29.7	31.9	32.2	32.2	32.3	32.6
Expenses less revenue	3.6	-1.1	1.2	4.6	8.3	14.3
Net government debt	13.9	27.4	37.1	67.2	118.9	198.3

The projections in this table are of course very sensitive to our assumptions. But changing our assumptions within realistic bounds makes little difference to the overall message: some major expense categories are growing.

¹ In this Quick Guide, for “net government debt” we use “net core Crown debt”, for “government expenses” we use “core Crown expenses”, and for “government revenue” we use “core Crown revenue”. All these terms are defined in the *Financial Statements of the Government of New Zealand*. “Core Crown” means the Crown, departments, Offices of Parliament, the NZ Super Fund and the Reserve Bank of New Zealand. It does not include Crown entities, State-owned Enterprises, or local government.



➤ SO WE FACE A LONG-TERM FISCAL CHALLENGE

Clearly, spending needs to be constrained relative to the “Resume Historic Cost Growth” scenario – or taxes need to be increased – if we are to maintain a prudent level of government debt in the future.

Making adjustments earlier will avoid rising interest payments that grow rapidly the longer we delay making policy changes. Waiting until debt is high before making changes means that adjustments will need to be larger and take longer.

The Government has signalled that it will adopt a more constrained – and prudent – medium-term fiscal path than our “Resume Historic Cost Growth” scenario shows.²

The Government’s fiscal strategy is one way of reaching a prudent level of debt over the medium term. It is not the only way, and other governments might make different choices. But a prudent medium-term fiscal strategy puts future governments in a stronger fiscal position and gives them a wider range of choices.



² In its 2013 *Fiscal Strategy Report*, the Government committed to bringing net government debt to a level no higher than 20% of GDP by 2020. Reaching this goal will mean following a tighter medium-term fiscal path than the “Resume Historic Cost Growth” scenario shows.



> MEETING THE CHALLENGE

One way of thinking about the size of the policy changes that need to happen is by comparing the spending path that the “Resume Historic Cost Growth” scenario implies and the spending path that would be necessary to achieve net government debt at 20% of GDP as a long-term average, assuming we do not collect more tax.³

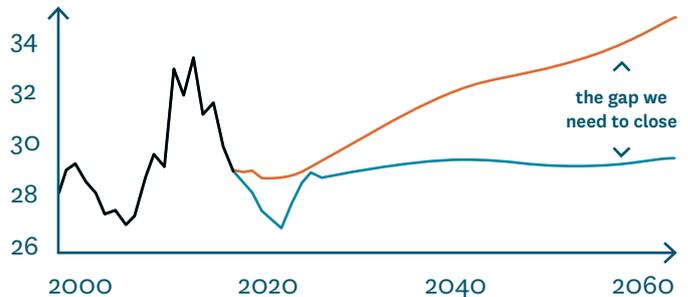
Figure 1 shows two “what if” spending paths:

- **The blue “Spending path that maintains 20% net debt” line,** which tracks the average spending path that would allow us to maintain net government debt at an average of 20% of GDP from 2020, assuming our tax take remains constant at 29% of GDP, and
- **The orange “Spending path under ‘Resume Historic Cost Growth’ scenario” line,** which tracks the average spending path that we would see if expense areas grow at the rates we have seen historically, also taking into account current legislative settings and demographic changes, as shown in Table 1.

Both of these lines track “primary” expenditure. That is, they do not include debt-financing costs.

Figure 1 Two government spending paths – an illustration of the gap we need to close

Government spending as % GDP, excluding debt-financing costs



In what follows, we set out some options for partially closing this long-term gap. We use Figure 1 as a base graph to show the fiscal impact of different tax increase and spending growth reduction options.

³ The selection of the 20% net government debt average over time measure is not intended to represent a Treasury recommendation. Rather, it is a benchmark level that is within the range of debt levels that past governments have considered “prudent”. While we have recommended that net government debt be reduced to 20% of GDP or below by 2020, we have not made any recommendations about prudent debt levels beyond that date.



Option: Index personal income tax thresholds to price inflation, but not to real wage growth

The projections in our “Resume Historic Cost Growth” scenario hold tax revenue constant at 29% of GDP. But holding tax revenue constant requires some assumptions about how governments will respond to people’s pay rising over time through the combined effect of price inflation and real wage growth. As that happens, they move into higher tax brackets and accordingly pay more tax.

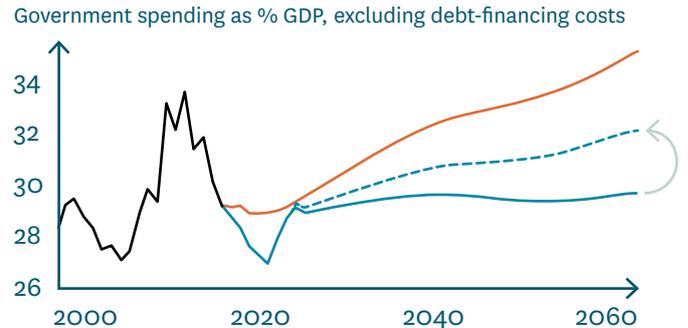
Since in New Zealand there is no automatic adjustment for this, governments must adjust tax thresholds periodically if they wish to compensate for this effect. Our projections that hold tax revenue constant at 29% of GDP implicitly assume that this periodic adjustment happens.

New Zealand could introduce legislation that would automatically adjust income tax thresholds to compensate for price inflation (although not for real wage growth). The effect would be that on average over time governments would collect more tax revenue relative to a situation where they periodically adjust tax thresholds to compensate for both price inflation and real wage growth.

> FISCAL IMPLICATIONS

Figure 2 shows that if we index personal income tax thresholds to price inflation (and make no other adjustments), we could spend more and still maintain net government debt at 20% of GDP on average over time.

Figure 2 Three government spending paths – the impact of inflation indexing tax thresholds



The difference inflation indexed thresholds makes to the spending path necessary to maintain net debt at 20%



> BROADER LIVING STANDARDS IMPLICATIONS

Indexing personal income tax thresholds to price inflation but not adjusting for real wage growth might be seen by some as an acceptable change, as people would become liable to pay more tax only as they become richer.

There are equity considerations though, as this approach would make our system less progressive (relative to a system that adjusts for the effects of both price inflation and real wage growth). Also this approach would probably have negative economic growth impacts.

Figure 3 The Treasury’s Living Standards Pentagon





Option: Increase the GST rate to 17.5%

> FISCAL IMPLICATIONS

Figure 4 shows the difference increasing the GST rate from 15% to 17.5% from the 2017/18 fiscal year could make to the Government's long-term fiscal position. The impacts are fairly modest, but a higher GST rate means that we could have higher spending and still maintain net government debt at 20% of GDP on average over time.

A GST rate of 17.5% would increase our tax take by around 1 percentage point of GDP, bringing our total tax take to around 30% of GDP.

> BROADER LIVING STANDARDS IMPLICATIONS

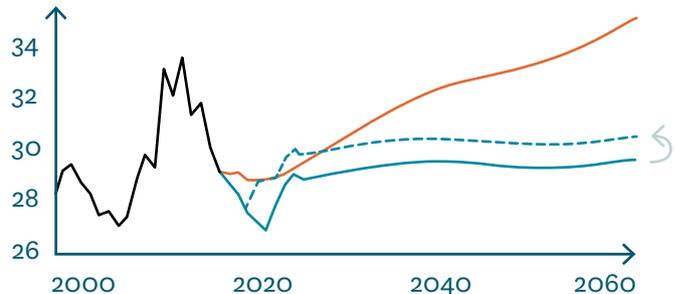
A GST rise would have fewer efficiency implications than some other revenue-raising options, but even so GST is still essentially a tax on labour so we would expect any economic growth effects to be negative rather than positive.

In terms of equity, the costs of a GST increase would be distributed proportionately across different income groups, at least if measured on a lifetime basis.

A GST increase could give rise to calls for exemptions. It could also prompt people to buy more goods from overseas, decreasing revenue and also potentially damaging the local retail industry.

Figure 4 Three government spending paths – the impact of a 17.5% GST rate

Government spending as % GDP, excluding debt-financing costs



The difference GST at 17.5% makes to the spending path necessary to maintain net debt at 20% of GDP.



Option: Reduce projected rate of growth in public healthcare spending

Our “Resume Historic Cost Growth” scenario projects spending on public healthcare to increase from 6.8% of GDP in 2010 to more like 10.8% in 2060.

> FISCAL IMPLICATIONS

Figure 5 shows how much difference public healthcare spending growing only half as much, reaching 9% of GDP in 2060 rather than 10.8%, would make to the long-term fiscal position.

> BROADER LIVING STANDARDS IMPLICATIONS

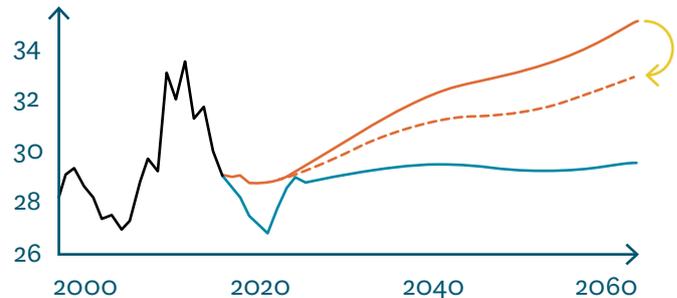
Adopting a lower public healthcare spending growth track might involve trade-offs in terms of equity and – potentially – our social infrastructure.

These trade-offs arise because it may be hard to reduce the growth in public healthcare spending significantly in a way that doesn’t increase the gap between what is medically possible and what is publicly funded, meaning that those who have the means to purchase some treatments (either outright or through insurance) will do so. Other people may not be able to access those treatments.

Whether a lower public healthcare growth track is desirable ultimately depends on what New Zealanders want from the health system relative to other government services.

Figure 5 Three government spending paths – the impact of lower growth in healthcare spending

Government spending as % GDP, excluding debt-financing costs



↪ The difference lower health spending growth makes to the “Resume Historic Cost Growth” scenario.



Option: Raise the age of eligibility for NZ Super to 67 and index payments to price inflation rather than wages

Two features of our current NZ Super settings are the age of eligibility at 65 and the indexation of the value of payments so that they retain their relativity with average wages. We could adjust both of these settings, so that:

- the age of eligibility is raised by six months each year, starting in the 2019/20 fiscal year, so after four years 67 would be the age of eligibility for everyone, and
- the annual growth in NZ Super payments is indexed to price inflation, rather than wage growth, again from the 2019/20 fiscal year.⁴

> FISCAL IMPLICATIONS

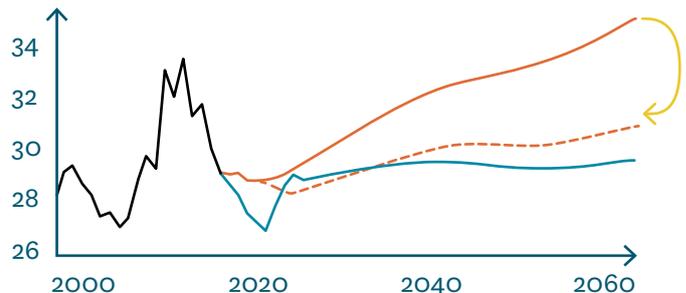
Figure 6 shows that these changes would bring about a significant improvement in the government’s long-term fiscal position (although it is possible that the fiscal impacts may be overstated, as these changes could mean that more people need to receive other welfare benefits of different kinds).

4 This would represent a fiscal saving because wages tend to grow faster than prices.

Note that raising the age of eligibility to 67 but making no changes to the way in which the value of NZ Super payments grows over time makes a much less significant difference to the fiscal position. In Figure 6, around three-quarters of the “work” is done by the indexing of growth in NZ Super payments to inflation.

Figure 6 Three government spending paths – the impact of raising the age of eligibility for NZ Super to 67 and indexing growth in payments to price inflation

Government spending as % GDP, excluding debt-financing costs



The difference raising the age plus inflation indexing makes to the “Resume Historic Cost Growth” scenario.



➤ BROADER LIVING STANDARDS IMPLICATIONS

The impacts of this option would fall mainly on people whose sole or primary source of income is NZ Super, raising equity concerns. And it is possible that some people might regard these changes as challenges to New Zealand's social infrastructure. However, KiwiSaver might make a difference to how different people feel these impacts.

Economic growth impacts are hard to predict, but any impacts seem likely to be positive, by encouraging people to work for longer and to save more.