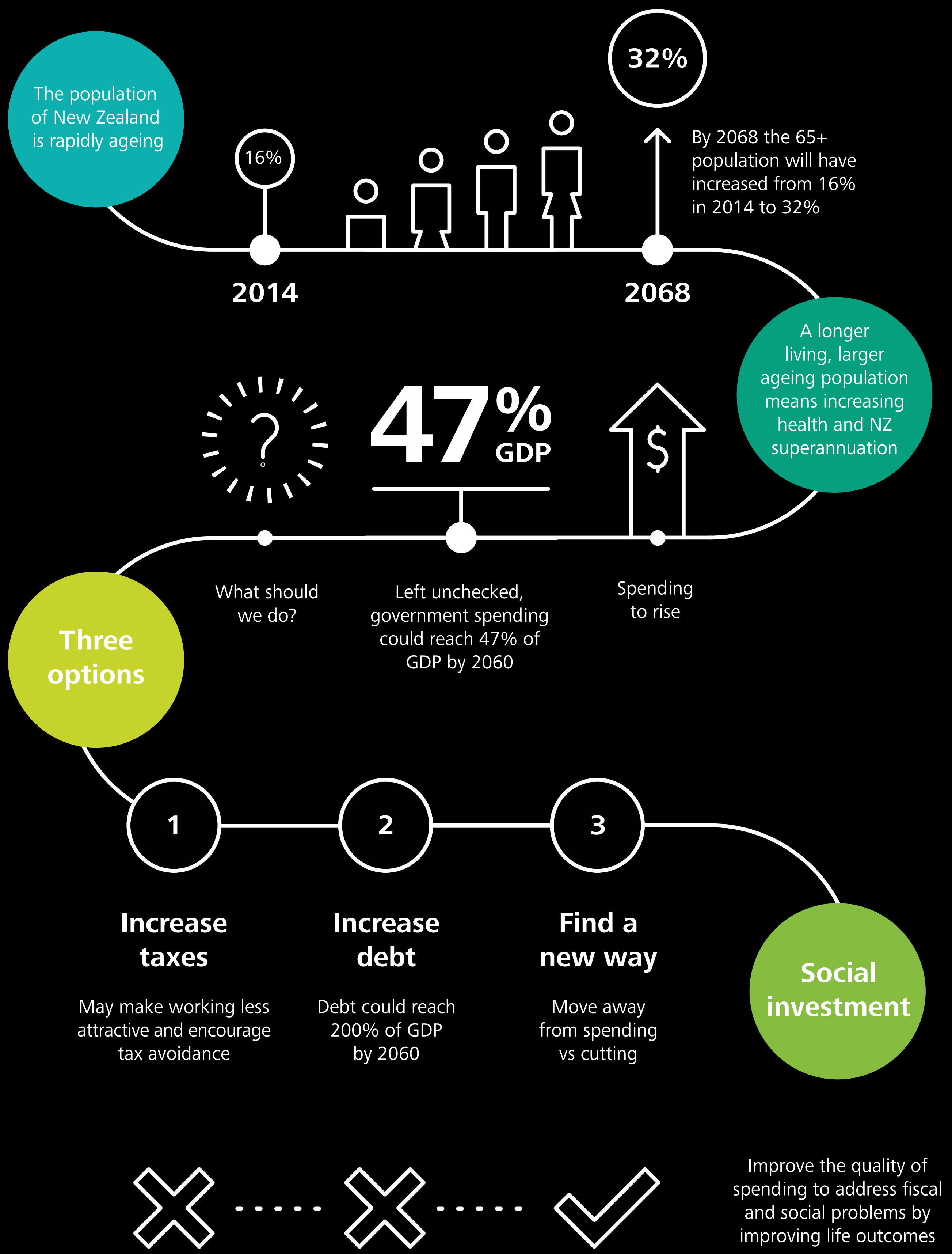
Why social investment?



Crown finances

The government's books are in solid shape

Most governments in the developed world would welcome a set of accounts like those of New Zealand. Despite imposing austerity measures, many other OECD governments are burdened with significant debt, yet are nowhere near returning to a scenario where their revenue exceeds their expenses. As a consequence, many government balance sheets are loaded with rising debt and high debt servicing costs.

In contrast, the New Zealand government's books are in good shape for now. The post-global financial crisis (GFC) target of returning to operating surplus was achieved in June 2015, the first surplus in seven years.

This operating surplus was achieved through a combination of restrained fiscal spending, reforms that improved outcomes from public sector spending and a post-GFC economic recovery that resulted in higher tax revenue. In contrast, the majority of OECD governments are still in deficit, including Australia, the US, the UK, France and Japan.

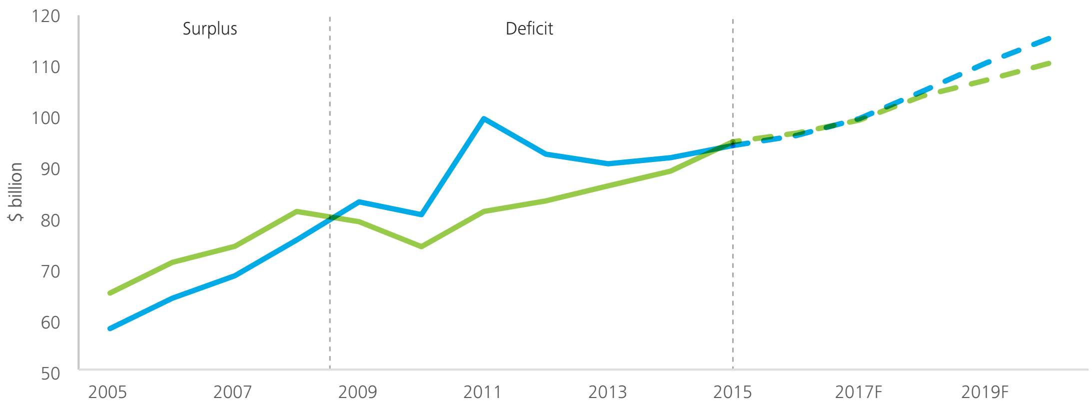
This is an admirable outcome given the events of the past five years

In addition to the GFC, New Zealand also faced the economic, social and fiscal costs of the Canterbury earthquakes between 2010 and 2011, with net costs to the Crown reaching $12.9 billion (21.3% of net debt) in June 2015, and a severe drought in 2012/13.

Despite these challenges, government revenue has grown at a compound annual growth rate (CAGR) of 4.0% over the past five years, as a result of increasing tax revenue boosted by rising employment, wages, labour force participation and net positive migration.

Economic growth has been solid, driven largely by the ongoing Canterbury rebuild and strong population growth. The recent dairy price downturn has been partially offset by a booming tourism sector, strong non-dairy primary exports, and a healthy services sector. Looking beyond the current business cycle, however, New Zealand continues to lag behind other countries with respect to productivity rates. Low private sector investment in research and development and infrastructure deficits could also be expected to constrain the rate of economic growth and tax revenue.

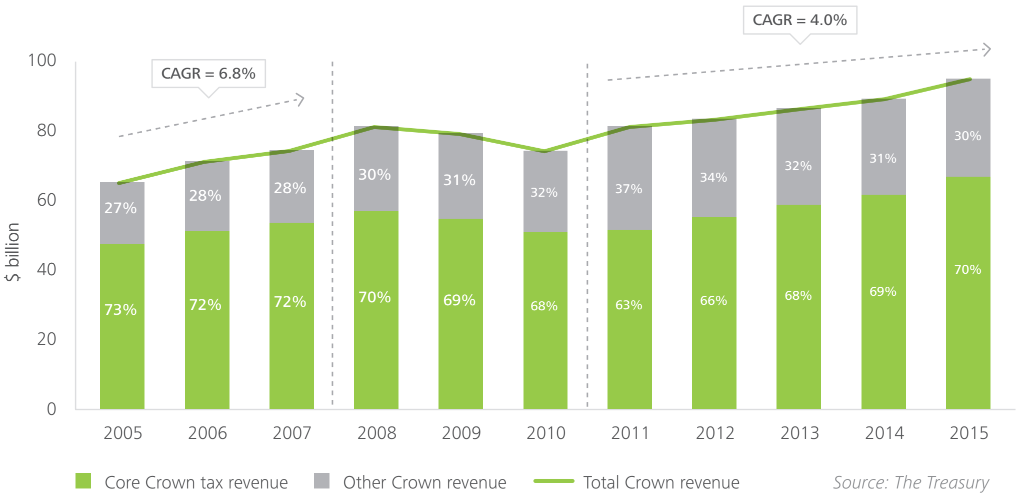
Total Crown revenue and expenses FY2005 – 2019



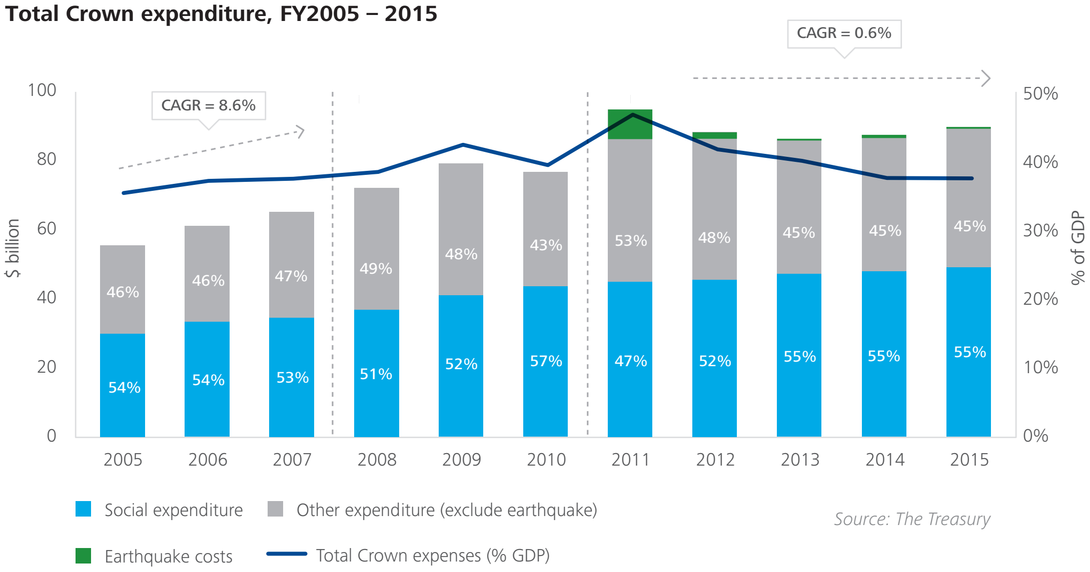
Source: The Treasury

New Zealand has a broad-based, low rate progressive tax system with tax revenue raised predominantly through individual income tax and goods and services tax (GST). The 2009 tax review, which raised GST while reducing personal and corporate tax rates, was intended to result in a tax system more focused on consumption and less on income. Since 2012, tax revenue has increased by 21% and is slowly returning to pre-GFC levels as a percentage of total revenue. Annual economic growth has remained at around 2.5% over this period.

Total Crown revenue FY2005 – 2015



Total Crown expenditure, FY2005 – 2015



Total expenditure increased consistently year on year between 2005 and 2009, with the step change increase in 2011-12 (largely a result of the Canterbury earthquakes) taking average spending from $71.7 billion pre-earthquakes to $93.8 billion post. This level of expenditure is expected to continue over the foreseeable future as the Earthquake Commission (EQC) liabilities and other earthquake recovery related expenses are paid out.

However, since 2012-13 government spending has increased by a relatively modest CAGR of 0.6% compared to a pre-GFC CAGR of 8.6%. Growth since 2012, has been mainly driven by increases in social expenditure such as social welfare, education, and health, with CAGRs of 2.3%, 3.4% and 2.1% respectively, partially offset with a drop in other expenditure (excluding finance costs) averaging 1.0% per year over the same period.

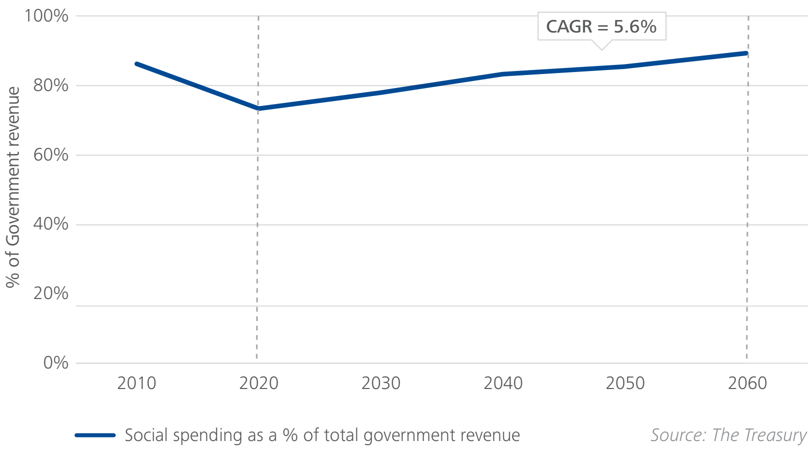
It is projected that between 2020 and 2060 social spending may increase by a CAGR of 5.6% in comparison with a government revenue CAGR of 0.5% over the same period if there are no major changes to the way the government spends.

Social expenditure includes a range of areas:

- Welfare and social services
- Justice
- Health
- Education
- Other services, such as social housing

While social spending is forecast to increase, the current government has remained committed to maintaining an environment of constrained overall expenditure and has chosen to make reductions in other spending areas such as back-office expenses and limiting Crown entities, expenditure (e.g. Education New Zealand and the Tertiary Education Commision).

Social spending as a % of total government revenue



Source: The Treasury

With a surplus achieved, the focus now turns to reducing debt

Having achieved a surplus, the current government's attention is now being directed towards trimming debt as a share of gross domestic product (GDP). In the 2015 Budget, the government announced one of its fiscal priorities, and a measure of fiscal success, is to reduce net core Crown debt.

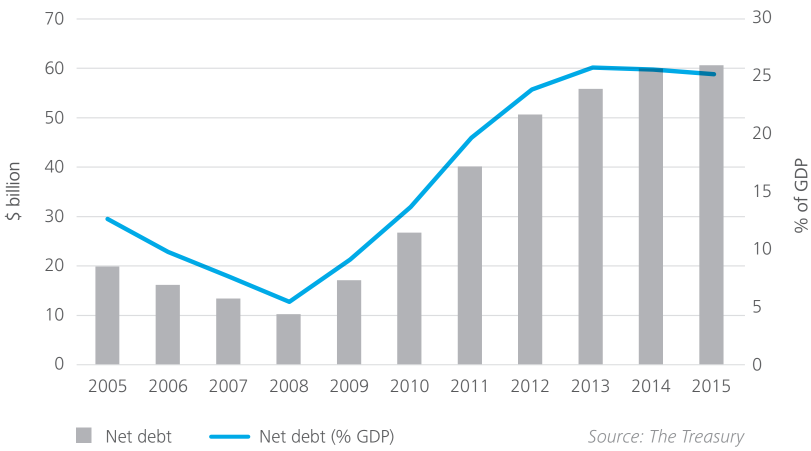
Net debt is around $61 billion, or 25% of GDP, having risen rapidly over the past seven years from a low of 5.5% of GDP in 2008, largely due to increasing social expenditure and fiscal stimulus infrastructure spending as the GFC took full force.

New Zealand's gross debt ratio is 35% of GDP. While New Zealand's debt to GDP ratios have risen quite significantly relative to the past, using the OECD's measure of gross debt-to-GDP to compare across OECD countries puts our debt levels into perspective. Countries such as the UK, France, Canada and the US have gross debt ratios in the range of 80-120% of GDP, making New Zealand's current gross debt ratio of 35% of GDP enviable.

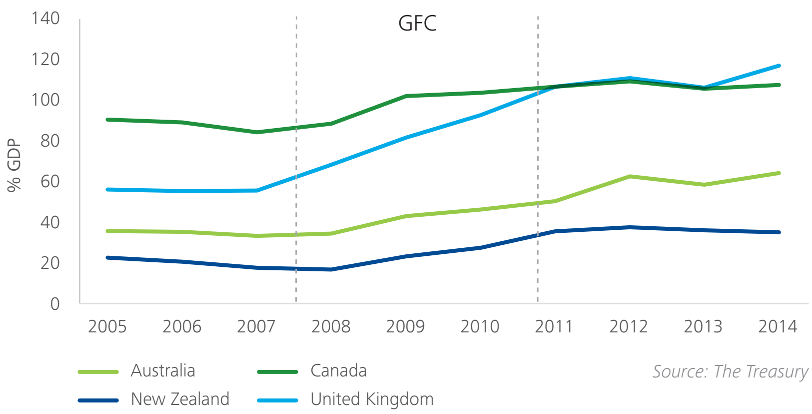
Reducing debt is important, particularly for New Zealand as a trade exposed nation, because high net debt to GDP ratios can expose the government to risk when unexpected negative global shocks hit the economy. High levels of debt can lead to high debt servicing costs, especially when global interest rates lift from their current lows. These servicing costs could displace productive government spending on education, health and other beneficial areas.

For these reasons, the government aims to reduce net debt from its current 25% of GDP to around 20% by 2020 and between 0% and 20% in the medium term. When the economic and social effects stemming from an ageing population are also taken into account, the importance of managing net debt becomes even more crucial.

Net core Crown debt 2005 – 2015



Central government debt as a % of GDP across the OECD countries 2015 – 2014



The ageing population threatens a cost and debt explosion

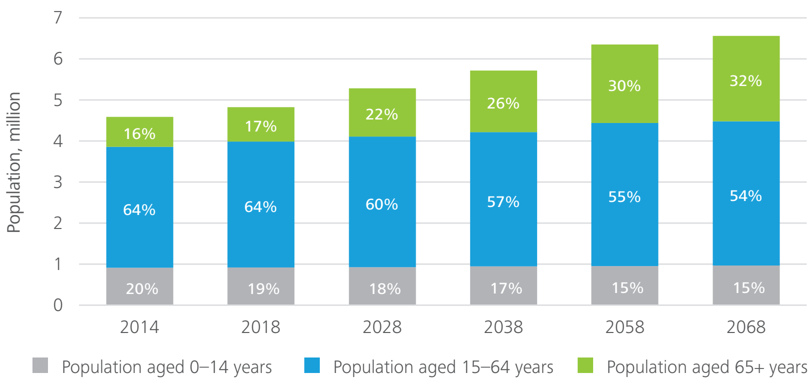
The population of New Zealand is ageing rapidly. By 2038 the 65+ age bracket population is projected to nearly double to 1.3 million, accounting for over a quarter (26%) of New Zealand's population (up from 16% in 2014). This trend is projected to continue, reaching 32% of the total population by 2068.

The number of people aged 65+ years per 100 people aged 15-64 years (the dependency ratio) is set to increase from 22 in 2014 to 39 in 2038, rising to 48 by 2068. With relatively fewer people in the working population, the income tax base will shrink, meaning there is less government revenue to support increasing expenditure on areas such as superannuation and healthcare.

New Zealand's ageing population puts the government's finances under significant pressure. Treasury's Long-Term Fiscal Model (LTFM) shows potential long term paths of government expenditure from the Treasury's fiscal projections. The 2013 LTFM projection shows that if current spending and taxation patterns are maintained, the ageing population would push net debt up to almost 200% of New Zealand's GDP by 2053. This is clearly untenable.

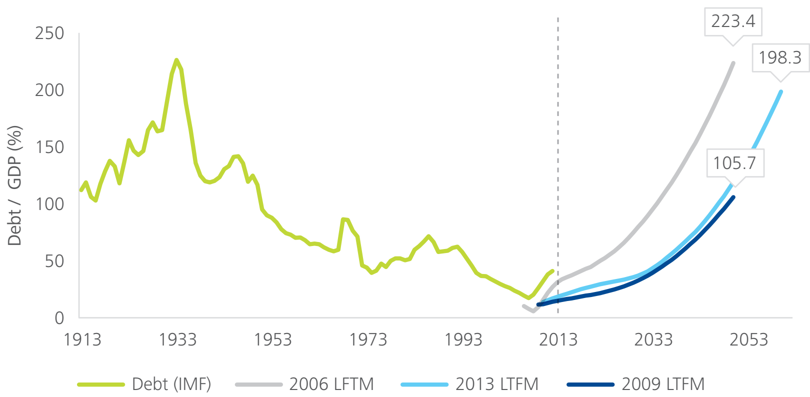
By 2038 the 65+ population is projected to nearly double to 1.3 million

Age bracket population projections 2014 – 2068



Source: Statistics New Zealand

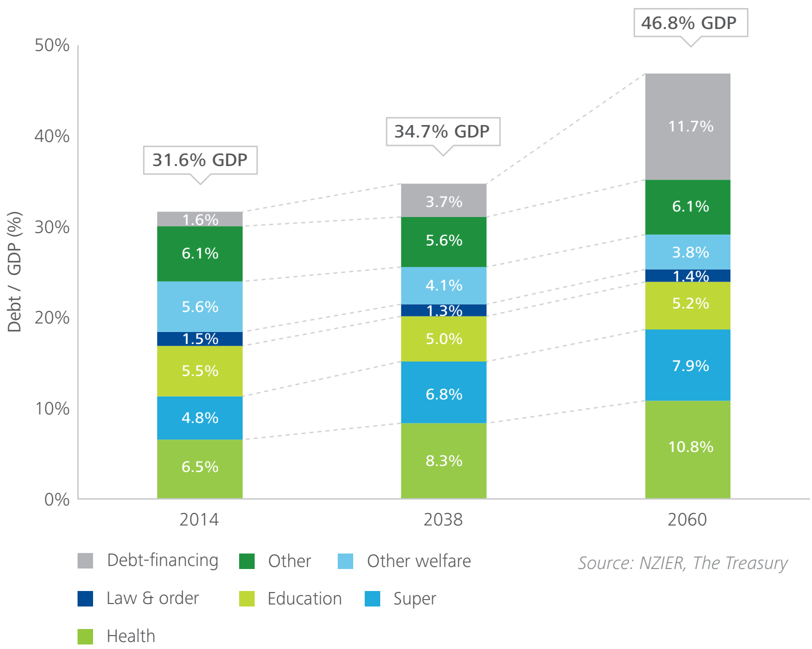
Three potential government spending paths



Source: NZIER "Fighting Fit"

Under The Treasury's 2013 modelling scenario, government spending would rise significantly, from 32% of GDP in FY14 to 35% of GDP in 2038, and to 47% by 2060. The biggest contributors to this increased spending profile are healthcare costs due to an ageing popluation, NZ superannuation payments and debt servicing costs, (as shown below).

The cost of ageing on key government expenditure items



Source: NZIER, The Treasury

It is noted that although New Zealand's social costs and, in particular, superannuation spend, are projected to increase substantially by 2060, in the context of other OECD countries, this is relatively low for both current and forecast periods. The Treasury's estimate of superannuation costs for New Zealand in 2014 was less than 5% of GDP. The average pension costs for OECD countries one year later was 9.3%.

This relationship appears to be similar when comparing forecasts of pension costs between New Zealand and OECD countries. The Treasury has forecast NZ Super costs to reach 7.9% by 2060. Although a shorter time period, forecast average pension expense for OECD countries is estimated at 11.7% in 2050. The New Zealand forecast is 3.8% lower despite being forecast out ten years later.

This suggests that even though New Zealand pension costs are expected to increase substantially between now and 2060, these forecast pension costs are still relatively lower than that of their OECD counterparts.

If current spending and tax patterns were maintained, government spending would rise to 47% of GDP

Tax more, spend less or take on more debt?

It is not feasible to let debt as a percentage of GDP rise to extreme levels. Doing so would place an intolerable burden on future generations to repay the debt, and the risk associated with the New Zealand economy would depress the currency and push up borrowing costs.

So what is the government to do? It has limited options:

1. It can lift income or corporate tax rates or widen the tax base – for example – through a capital gains or land tax. Yet lifting the tax rate can make working less attractive and can encourage tax avoidance and other undesirable behaviour. If New Zealand wants to remain attractive to foreign investors, it can't afford to let its tax rates get too far out of line with other similar countries e.g. Germany, Canada, Australia, UK and the US.

2. It can take on more debt. But as already discussed, this seems an unsustainable long term fiscal strategy.

3. It can seek to limit future spending growth by making changes to the outlays it can control, in particular, spending with no productive benefit.

Improving the quality of the government's social spending is a priority

Over the next four decades, the pressure on government resources will require a change in the approach to public spending. The priorities of the current government, which include responsibly managing the government's finances and delivering better public services within tight fiscal constraints, reflect a desire to improve the quality of expenditure.

This is where social investment comes in