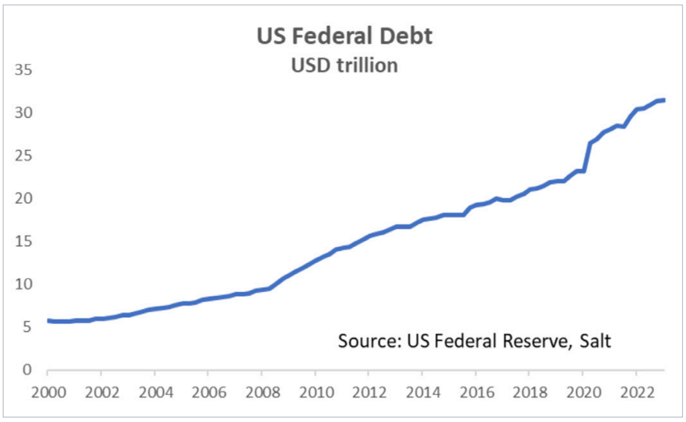
Fiscal sustainability needs hard choices

Relief that the US Congress managed to navigate its way through the latest debt ceiling crisis without too much drama ignores the bigger problem.

As part of the deal, the debt ceiling has been suspended until the end of 2024 in exchange for spending cuts and other restraints. Its relatively smooth passage through congress has prevented a catastrophic default by the US Government.

However, the agreement only makes a small dent in the much bigger problem of US long-term fiscal sustainability. In May, the CBO released its latest long-term US fiscal projections showing that on a "no policy change" basis, US Federal debt, which currently sits at USD31 trillion or 118% of GDP, will reach 195% of GDP by 2053 and will still be on a rising trajectory.



The United States is not the only country in the world with fiscal sustainability issues. Debt levels are generally high and rising in most western liberal democracies and are often matched with high and rising private sector (household and corporate) debt ratios.

Fiscal sustainability is being further challenged by ever-increasing calls on Governments to meet an ever-rising list of challenges including meeting Net-Zero 2050 decarbonisation commitments, closing infrastructure deficits and building back stronger when existing infrastructure fails during extreme weather events, and closing inequality gaps.

Furthermore, this pressure is coming while ageing populations are already threatening the quality of healthcare provision and challenging commitments to pension entitlements. Higher interest rates are also raising debt servicing costs.

The challenge for politicians is to meet these challenges within the constraints of maintaining prudent levels of debt and a globally competitive, growth enhancing tax system, not to mention frequent calls for tax cuts.

Making this all fit into an affordable, coherent, and sensible long-term fiscal plan is becoming increasingly difficult. Former UK Prime Minister Liz Truss found this out to her detriment. Financial markets will take a dim view of fiscal plans that simply don't add up.

Across the English Channel, President Macron of France has suffered the ignominy of rioting in the street against his plan to raise the pension age. It's tough making the hard calls.

Some countries are facing into these challenges from a better starting point. Germany is the poster child of fiscal responsibility in the eurozone, a position borne of a desire not to repeat the hyper-inflation that beset the country after the first World War. But it is also borne of necessity. Fiscal responsibility in Germany acts as the counterbalance to fiscal largesse elsewhere in the region that may yet test the structural integrity of the Euro.

Here in New Zealand, we often finish any fiscal commentary by stating that our fiscal position stands out as a beacon of fiscal prudence to the rest of the world. Some commentators have recently argued that perhaps we should be a little more lenient on our definition of prudent debt as we face into the rising challenges on the public purse.

We disagree. We are a small, open economy and must maintain a set of fiscal ratios that remain the envy of the world if we are to continue to attract the capital flows required to fund persistent current account deficits. Rating agencies made just this point following the release of Budget 2023.

And of course, rating agencies don't just look at one part of a country's indebtedness. While we have low public debt, our private sector debt ratios are worryingly high.

Even within that debt constraint it's important that we maintain a buffer to deal with unexpected events. We have used that buffer three times in the last dozen years in responding to the Canterbury earthquakes, Covid, and now the rebuilding of communities following Cyclone Gabrielle. All those responses would have been different without a strong fiscal starting point.

So, despite our better debt position, the fiscal challenges ahead and constraints are just as great for us as they are for countries that have already higher debt ratios.

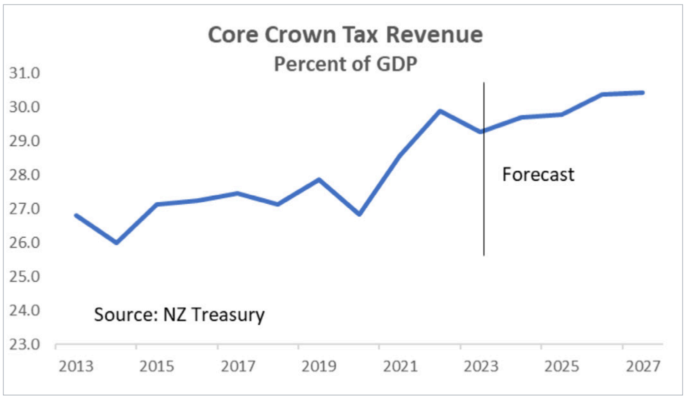
We are seeing that already in the various party policy positions. National wants to cut taxes and will raise the age of entitlement to New Zealand Superannuation (NZS), albeit from 2037. Labour has committed to current NZS entitlements and has no plans to cut taxes. The Greens want to reduce taxes for low-income earners and will pay for it by a wealth tax.

Agree or disagree with any of these positions, you can see the point. Politicians are already acknowledging the policy trade-offs required. If you want something new, you must work out how you're going to pay for it.

The NZ Treasury's regular four-yearly Statement on the long-term fiscal position of the Government regularly highlights the unsustainability of current spending and revenue plans. The Treasury is always at pains to highlight these are just projections rather than forecasts as a lot can change in 40 years, but nevertheless highlight that net debt is on an unsustainable trajectory if nothing changes.

Fortunately, the mathematics of fiscal policy is easy to grasp. If debt is on an unsustainable path, there are two options: collect more tax revenue or spend less. More tax revenue can come in three forms: raise existing tax rates, find new things to tax, or grow the economy faster.

However, our tax settings are already on an unsustainable path, threatening incentives to work and invest. Budget 2023 show our tax take is already rising as a percentage of GDP. From a recent low of 26.0% in 2014, this ratio rises to 30.4% in 2027.



Fiscal drag has seen wage and salary earners on below average incomes moving into higher tax brackets that should be the preserve of people on higher incomes. Adjusting the tax bracket thresholds and mandating regular inflation adjustments to those brackets is essential on fairness grounds but will result in a significant loss of revenue.

If we want to take the "grow the economy faster" track, we are going to have to fix our poor track record on productivity. Unfortunately, there's no silver bullet here and it will take time. Raising productivity means getting a whole lot of things right in education, skills development, innovation, technological adaption, and yes, tax policy, where in an economic growth discussion, less is generally more.

So, by process of elimination we come to reducing the ubiquitous wasteful expenditure. But this too is hard work and will require significant value judgments and hard choices.

We are in better fiscal shape than many, but we are also facing into significant constraints. Hard choices are going to have to be made, and soon.

The days of forgivingly-low interest rates have passed, and the willingness of investors to keep financing those governments who lack credible plans to fix their fiscal problems can diminish, leading to even higher debt servicing costs as bond yields become inflated by rising country risk premia.

That was the lesson learned by many emerging markets since the 1990s, and it should not be lost on developed economies, particularly those like New Zealand, which depend on offshore capital investment flows. It is crucial to avoid the vicious circle of higher government debt being issued and rolled over at ever-higher interest yields, as that can become a potent threat to both investment returns and to the provision of public services.