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24 June 2024

Failure to Address Fiscal Sustainability is Unsustainable

As we were building our diversified portfolios three years ago and assessing the big structural themes these new portfolios would have to perform under, fiscal sustainability was one of the most obvious. That's because it was the primary constraint on, or problem exacerbated, by several of the other themes. These included ageing populations, climate change, fixing inequality and even rising geo-political tensions as a more fragmented and hostile world resulted in higher defence spending.

Furthermore, while the solutions to the problem of fiscal sustainability are quite clear and obvious they are either hard to achieve, such as generating higher productivity-led economic growth, or deeply unpopular and therefore challenging for politicians seeking re-election to implement, such as generating higher revenue and/or cutting expenditure.

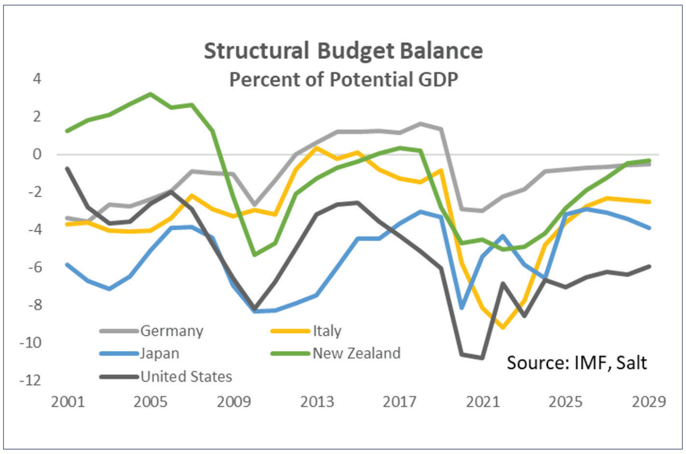
This note looks at the key factors contributing to fiscal UN-sustainability, and the options for addressing the problem.

It's structural!!

How do you know when looking at any country's fiscal accounts whether there is a problem? A deficit could just be the result of the stage of the cycle the economy is in. Give it a few more months or years and that economy could be generating a fiscal surplus.

Enter the concept of the structural budget balance. The structural budget balance refers to a measure of a government's fiscal position that adjusts the nominal budget balance to account for the cyclical effects of the economy and one-off temporary measures. In effect it provides an estimate of what the government's budget balance would be under "normal" economic conditions, assuming that the economy is operating at its potential output level.

The chart below plots the structural budget balance of several countries going back 20-years, along with forecasts out to 2029. The data for all countries comes from the International Monetary Fund (IMF), so the balance for each country is calculated on a consistent basis, making comparisons between countries possible.



In most cases these countries have a history of running structural budget deficits, New Zealand and Germany being the exceptions in certain periods; New Zealand in the period before the Global Financial Crisis and New Zealand and Germany in the period between the GFC and the start of the pandemic. Into the forecast period, all countries are expected to retain structural deficits of varying degrees.

Fiscal sustainability increasingly challenging

Fiscal sustainability in the world's older developed economies faces several major challenges:

Aging Populations:

- **Increased Pension Costs:** As the population ages, the proportion of retirees compared to working-age individuals (the dependency ratio) increases, leading to higher pension liabilities.
- **Healthcare Costs:** Older populations require more healthcare services, which increases public expenditure on health.
- **Reduced Workforce:** A smaller working-age population as a proportion of the total population can lead to slower economic growth and reduced tax revenues.

Public Debt Levels:

- **High Debt-to-GDP Ratios:** Many developed economies have accumulated significant public debt, which limits fiscal flexibility.
- **Debt Servicing Costs:** As interest rates rise, the cost of servicing existing debt increases, putting additional pressure on public finances.

Economic Growth:

- **Stagnation Risks:** Slow or stagnant economic growth can exacerbate fiscal challenges by reducing tax revenues and increasing the relative burden of debt.
- **Productivity Challenges:** Ensuring productivity growth in the face of demographic changes and technological transitions is critical, but hard work.

Social Welfare Systems:

- **Sustainability of Social Programs:** Maintaining social programs becomes increasingly difficult with fewer contributors and more beneficiaries.
- **Inequality and Social Cohesion:** Growing inequality can strain social cohesion and increase demand for redistributive policies, adding to fiscal pressures.

Political Constraints:

- **Policy Gridlock:** Political divisions and short-termism can hinder the implementation of necessary but potentially unpopular fiscal reforms.
- **Populism and Anti-Austerity Sentiments:** Rising populism and resistance to austerity measures can limit governments' ability to address fiscal imbalances.
- **Rising geo-political tensions:** Increased tensions and conflicts (Asia-Pacific strategic tension, Russia-Ukraine, Israel-Hamas) are leading to higher defence budgets.

Climate Change and Environmental Policies:

- **Investment Needs:** Significant investment is required to mitigate and adapt to climate change at a time when public finances are already strained.
- **Economic Impact:** Climate-related events, such as extreme weather, and the transition to a green economy can have profound economic impacts, affecting fiscal stability.

Technological Change:

- **Disruption and Adaptation Costs:** Rapid technological advancements such as Artificial Intelligence can disrupt labour markets and require significant public investment in education, training, and infrastructure.
- **Taxation Challenges:** Digitalisation and the global nature of technology companies pose challenges to traditional tax systems.

Options to address structural budget deficits

Addressing these increased challenges requires a combination of policy measures aimed at improving the underlying fiscal position of a government.

Expenditure Reforms:

- **Reduce Public Spending:** Implementing cuts in non-essential government expenditures, reducing subsidies, and streamlining public sector operations.
- **Improve Efficiency:** Enhancing the efficiency of public services and investment to ensure better value for money.
- **Reform Entitlement Programs:** Modifying pension systems, healthcare, and social welfare programs to ensure long-term sustainability.

Revenue Reforms:

- **Increase Tax Revenue:** Raising taxes, broadening the tax base, and eliminating tax loopholes to enhance revenue collection.
- **Tax Reform:** Implementing a more efficient and equitable tax system, possibly by shifting towards consumption taxes or environmental taxes.
- **Strengthen Tax Enforcement:** Enhancing tax administration and compliance to reduce tax evasion and avoidance.

Economic Growth Policies:

- **Stimulate Economic Growth:** Implementing policies to boost productivity-led economic growth, such as investing in infrastructure, education, and research and development.

- **Labour Market Reforms:** Encouraging higher labour force participation, particularly amongst women, and improving labour market flexibility.
- **Support Innovation and Productivity:** Fostering an environment that supports innovation, entrepreneurship, and productivity improvements.

Fiscal Management:

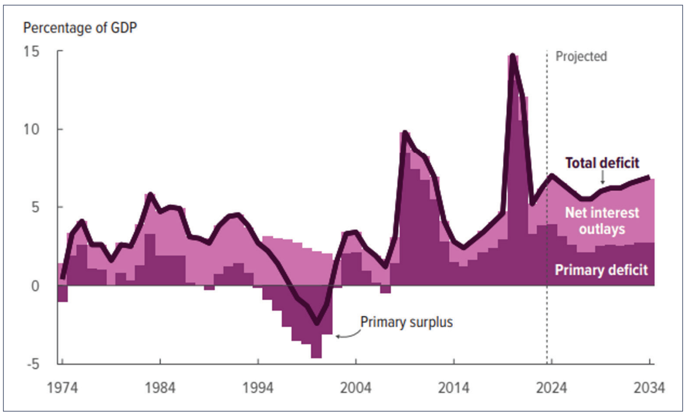
- **Strengthen Fiscal Institutions:** Enhancing the role of independent fiscal institutions to provide objective analysis and oversight of fiscal policy.
- **Medium-Term Budget Frameworks:** Adopting medium-term budgetary frameworks to improve fiscal planning and discipline.
- **Fiscal Rules:** Implementing fiscal rules and frameworks that ensure sustainable debt levels and prevent future structural deficits. These rules can take a number of forms, each with their own issues including the Debt Ceiling cap in the US and the Stability and Growth Pact (SGP) in the European Union.

Effective implementation of these policies requires careful consideration of their economic and social impacts, political feasibility, and timing. Additionally, a balanced approach that combines expenditure controls, revenue enhancements, and growth-promoting measures is often necessary to address a structural budget deficit sustainably.

The only thing bipartisan in the United States is the problem

Latest projections for the US budget deficit and federal debt were released by the Congressional Budget Office (CBO) this week. Those forecasts show a marked deterioration from those produced just a few months ago in February.

The deficit is forecast at $1.9 trillion (6.7% of GDP) this fiscal year and to average 6.3% of GDP over the next 10 years. Federal debt is expected to hit $50.7 trillion (122% of GDP) in 2034, revised up from $48.3 trillion (116% of GDP) in the February forecasts. In a longer term set of projections last updated in 2023, the CBO projects US federal debt to reach 192% of GDP by 2053.



If it wasn't already a problem these latest projections and the scale of the deterioration over just a few months should bring a fresh focus on the financial health of the United States in this year's Presidential election.

To be fair, the fiscal situation has deteriorated under both Biden (spending) and Trump (spending and tax cuts). Trump's 2017 tax cuts added nearly $1.9 trillion to the existing debt, according to Committee for a Responsible Federal Budget. Trump has proposed extending those cuts which would add $5 trillion to Federal debt by 2034 according to the CBO. Biden wants to keep the lower tax rates for people who earn less than $400,000, and provide new social spending funded by the portion that is allowed to expire.

Congress suspended the debt ceiling limit in 2023, but that agreement will expire next year, setting up a likely acrimonious confrontation between the two parties over federal spending and tax.

Why the US can't just keep borrowing

Theoretically, there is no absolute limit to how much money the U.S. government can borrow because it can always issue more debt if there are willing buyers for its Treasury bond securities. However, there are several practical and legal constraints that affect the government's borrowing capacity:

- **Debt Ceiling:** The U.S. has a statutory debt ceiling, which is a cap set by Congress on the amount of debt the federal government can incur. When the government reaches this limit, it cannot issue any more debt until the ceiling is raised or suspended by Congress. The debt ceiling has been a contentious political issue, leading to periodic standoffs and negotiations.
- **Market Demand:** The government's ability to borrow heavily depends on the demand for its debt securities. Investors, both domestic and international, must be willing to buy U.S. Treasury bonds. If confidence in the U.S. government's creditworthiness declines, demand for its debt could drop, raising borrowing costs or limiting borrowing capacity. China has been one of the largest foreign holders of US Treasury securities, yet they sold a record amount of Treasury and US agency bonds (US$53.3 billion) in the first quarter of 2024. This is being explained as building a more diversified pool of reserves but comes at a time of heightened trade and geo-political tensions.
- **Economic Constraints:** High levels of borrowing can lead to higher interest rates as the government competes with the private sector for funds. Rising interest costs can strain the federal budget and crowd out other government spending. Excessive borrowing and spending can fuel inflation, eroding the value of money and potentially leading to economic instability. The Federal Reserve may counteract this by raising

interest rates, which could slow economic growth. While there is no strict upper threshold, a high debt-to-GDP ratio can signal to investors that the government might struggle to service its debt. This ratio is closely watched by credit rating agencies, which can downgrade U.S. debt, making borrowing more expensive.

- Political Constraints: The political environment significantly influences borrowing limits. Political parties may have differing views on acceptable levels of debt and deficits. Political impasses, such as those over the debt ceiling, can create uncertainty and risk defaults on government obligations. When S&P downgraded the US long-term credit rating from AAA to AA+ in 2011 they cited political polarisation after a bitter and acrimonious debt ceiling squabble in Washington.
- International Confidence: As the issuer of the world's primary reserve currency, the U.S. benefits from strong international demand for its debt. However, global confidence is not limitless. Factors such as political instability, fiscal mismanagement, or severe economic downturns could undermine confidence and reduce the ability to borrow.

So, while there is no strict upper limit to how much the U.S. government can borrow, practical constraints like the statutory debt ceiling, market demand, economic impacts, political considerations, and international confidence play crucial roles in determining borrowing capacity. Exceeding these practical limits could lead to significant economic and financial challenges.

Europe's Stability and Growth Pact

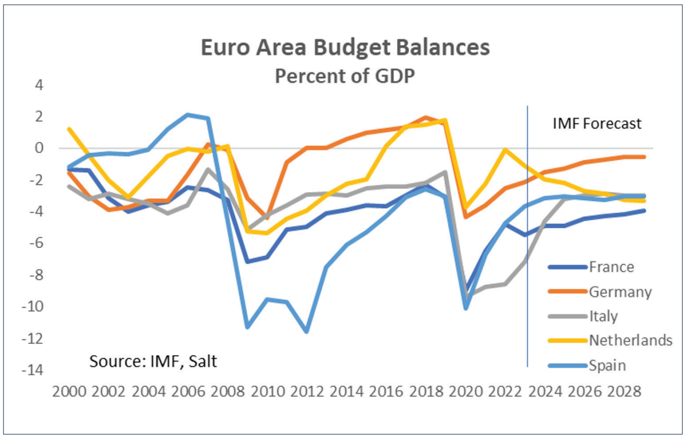
The Stability and Growth Pact (SGP) is a set of rules designed to ensure fiscal discipline within the European Union. It mandates that member states maintain budget deficits below 3% of GDP and public debt under 60% of GDP.

The SGP aims to prevent excessive government borrowing and ensure economic stability. However, it faces criticism for being too rigid, hindering countries' ability to implement counter-cyclical policies during economic downturns.

We take a more negative view in the sense that the rules are flouted by many governments and that the enforcement mechanisms lack teeth. At best, enforcement is inconsistent. There is friction between a prudent "northern bloc", often led by Germany and the Netherlands, and a "southern bloc" where France often supports Italy and others in seeking more flexible application of the rules.

The SGP was put on hold at the start of the COVID-19 pandemic to allow governments to increase spending during the crisis. What followed at the end of last year was an agreement that allowed more gradual and tailored spending cuts for countries exceeding the SGP's mandates. Several eurozone countries, including France and Italy, have deficits above the 3% threshold.

Attempts by President Macron to address the fiscal situation have been strongly contested by protests and have arguably led to a loss in centrist political support and to the rise of the right-wing populist parties that has now triggered a snap election for the French Parliament.



Fiscal laxity is never a good thing but particularly in Europe. It was unsustainable fiscal settings that unleashed the Euro zone debt crisis in the early 2010s that nearly saw the demise of the common currency. A lack of a common fiscal policy remains one of the biggest risks to the Euro's survival.

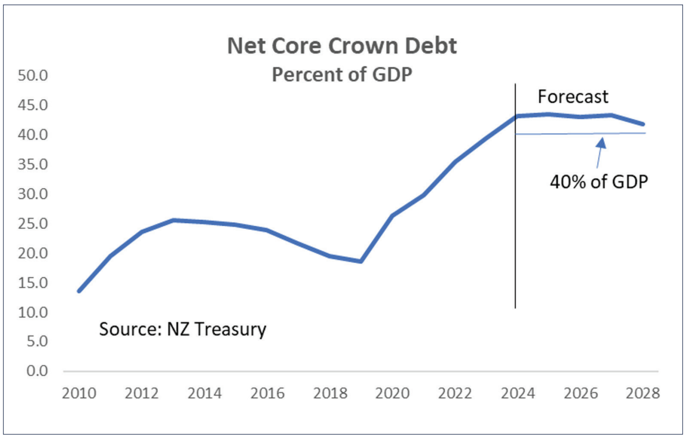
New Zealand needs to be better than everyone else

Here in New Zealand our fiscal framework is sound, and our key fiscal ratios are in relatively good shape. While that's good, there is no other option. We are a small open economy that also has a propensity to run Balance of Payments deficits, requiring funding from external savers while the rating agencies keep a close eye on developments.

The basis of our framework is the Public Finance Act (1989), later strengthened with the Fiscal Responsibility Act (1994). The FRA requires the New Zealand Government to set its own long-term fiscal objectives consistent with the principles of responsible fiscal management.

Since the FRA was introduced, our fiscal policy anchor or rule has been a target for public debt, expressed as a percentage of GDP. This has had various incarnations since it was introduced with the new Coalition Government adopting a net core Crown debt limit of 40% of GDP.

Budget 2024 demonstrated the constraints on fiscal policy. Debt is already above the Government's own self-imposed limit of 40% of GDP and is projected to remain so over the forecast horizon. Furthermore, a fiscal buffer needs to be restored so that we can cope with the next fiscal crisis.



Tax cuts were a cornerstone of the National Party's election campaign and were therefore a priority in the Coalition Government's first Budget. These tax cuts were only possible by an across-the-board reduction in core government spending. The allocation for new initiatives was set at $2.4 billion per annum, wafer-thin given the growing pressures on government spending.

Going forward, in the absence of sources of additional revenue or stronger economic growth, new initiatives will have to funded by ongoing cutting or reprioritisation of existing spending. In our view, this will need to become more strategic in nature and needs Ministers to focus on the core role and outcomes required in each of their ministry's, cutting anything that isn't deemed critical.

Hard choices will need to be made and priorities determined. This will require a change in the fiscal conversations we are having. For example, the perennial debate about the affordability of New Zealand Superannuation (NZS) needs to shift from a conversation about the affordability of NZS in isolation to one of whether current NZS arrangements are a higher or lower priority than faster adaptation to climate change or reducing child poverty.

As we strive to meet the challenges of fiscal sustainability in New Zealand, we will require a mix of stronger growth, cutting/reprioritising current expenditure, and new revenue measures. A failure of any one of these will simply put more responsibility on the others.

Implications of not fixing the problem

Ongoing structural deficits in major developed economies are already and will continue to have implications for interest rates, inflation, currencies, credit ratings, investor confidence, and economic growth generally.

- Interest Rates: Persistent deficits require governments to borrow more, increasing the supply of government bonds. Persistent structural deficits might lead to a loss of investor confidence in the government's fiscal management. To continue to attract investors, yields on these bonds may need to rise.
- Monetary Policy: Central banks will adjust monetary policy settings to counteract the inflationary pressures or economic distortions caused by high and ongoing deficits. This is in fact one of the reasons we expect neutral interest rates to be higher in the period ahead.
- Exchange Rates: Higher deficits can lead to a depreciation of a country's currency as investors might perceive the country to be less financially stable.
- Credit Ratings: Ratings agencies may downgrade a country's sovereign credit rating if deficits are seen as unsustainable, increasing borrowing costs and potentially leading to a loss of investor confidence.
- Private Investment: Higher government borrowing can crowd out private investment by increasing interest rates, making it more expensive for businesses to borrow and invest. Ongoing deficits might create uncertainty about future fiscal policies, such as potential tax increases or spending cuts, influencing investment decisions.

The bottom line is that structural deficits need to be addressed. While there are no easy answers, a head in the sand approach will just make the problem bigger, and more disruptive to solve when action becomes urgent.