

Jonathan Boston and
Rebecca Prebble

The Role and Importance of Long-Term Fiscal Planning

Many countries now require the regular publication of long-term fiscal projections, looking at the potential long-term costs of government spending programmes (see Anderson and Sheppard, 2009). In New Zealand, section 26N of the Public Finance Act 1989 (as amended in 2004) requires the Treasury to publish a Statement on the Long-Term Fiscal Position at least every four years. Under the act, such statements must look out at least 40 years.¹ Their contents are the responsibility of the secretary to the Treasury (rather than the minister of finance), and the Treasury is required to use ‘its best professional judgments’ in assessing the fiscal outlook and potential risks.

Jonathan Boston is a Professor of Public Policy at Victoria University of Wellington. Rebecca Prebble is a Senior Analyst at the New Zealand Treasury and worked on the Treasury’s 2013 Statement on the Long-Term Fiscal Position. The views, opinions, findings, and conclusions or recommendations expressed in this article are strictly those of the authors and do not necessarily reflect the views of any organisation, including the New Zealand Treasury.

It is also obliged under the act to ensure that ‘all significant assumptions underlying any projections’ are included in the statement. Aside from these parameters, the act is silent on the matters to be covered, giving the Treasury considerable flexibility over the process employed to produce such documents, including the nature and extent of any consultation with external experts, the wider policy community and interested stakeholders. Since the requirement for such statements was introduced in 2004 the Treasury has published three reports. The most recent of these – *Affording Our Future* – was released in July 2013. Against this backdrop, this article considers:

- the nature of long-term fiscal planning;
- why long-term fiscal planning is important;
- why a legislative requirement for such planning is desirable;
- whether long-term fiscal planning actually achieves its goals;
- some of the uncertainties involved in long-term fiscal planning; and
- the potential for long-term planning in areas beyond fiscal ones.

What is long-term fiscal planning?

This article uses the expression 'long-term fiscal planning' as a general term to refer to the Statements on the Long-Term Fiscal Position that the New Zealand Treasury publishes as well as similar reporting requirements in other jurisdictions. 'Planning' is a word that can mean different things in different contexts, of course. Perhaps most commonly, it tends to imply a clearly sought outcome along with steps to get there. However, we use 'planning' in a looser sense here. Hence, long-term fiscal planning includes projecting what the future might hold given a number of reasonable assumptions; it is not restricted to mapping out what steps

provide guidance on projected trends in aggregate levels of public expenditure.

The Treasury also includes assumptions about revenue, assuming a relatively constant revenue stream (as a share of GDP), based on average historic tax takes relative to GDP. The combination of 'no policy change' scenarios on both the spending and revenue side give a sense of whether, and the extent to which, current policy settings on either the spending or revenue side (or both) may need to change in the future to avoid a funding gap.

In New Zealand there is no explicit requirement for the government to respond to the Treasury's regular Statements on

fiscal management that governments should, when formulating fiscal strategy, 'consider its likely impacts on present and future generations'. The aim of the new principle is to ensure that governments consider the long-term implications of their fiscal policies and explain those implications.

Why is long-term fiscal planning important?

Long-term fiscal planning often reveals that the long-term costs of some government spending programmes are quite different – often more expensive³ – from their short-term costs. A programme that might have been relatively cheap when it was introduced can have features that mean its costs increase over time. A programme that becomes more expensive in the future implies that other spending areas will need to be squeezed or more revenue will need to be raised if the programme is to continue. Increasing revenue or squeezing other spending areas might not reflect the preferences of the electorate. In that case, changes will be necessary to alter the long-term trajectory of the programme at issue.

In a sense, simply the fact that changes to a programme will eventually be necessary is not a reason for long-term planning. After all, changes can be made when they become necessary and not before. But often the kinds of policy changes necessary will require some lead time to give people time to plan for possible new arrangements. In addition, a government that acknowledges that changes will be needed sends a signal to lenders, households, and firms that it can be trusted to address fiscal pressures appropriately, giving people confidence in that government's future solvency. And changes that are planned well in advance and follow an informed public debate tend to be less disruptive – and less prone to reversal later – than sudden changes.

The desirability of long-term planning is particularly clear in the case of state pensions. The Treasury's 2013 Statement on the Long-Term Fiscal Position projects that if current policy settings remain the same, the government will go from spending just over 4% of GDP on New Zealand Superannuation in 2010 to about 8% of GDP in 2060.⁴ It does not

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might be necessary to reach a particular outcome.

Long-term fiscal planning attempts to get a sense of possible future demands on government resources. It involves looking at current spending programmes and assessing their potential future costs. The methodology for the New Zealand Treasury's production of regular Statements on the Long-Term Fiscal Position involves assuming that current legislative and policy settings will remain the same and that historic per capita growth rates in different spending areas (both operating and capital) will continue. These assumptions are combined with other assumptions about likely future demand for different government spending areas in the future. Factors like the performance of the economy and the age structure of the population affect that future demand. Together, these assumptions give a picture of how different spending areas might grow or shrink in the future if current policy settings do not change. Additionally, they

the Long-Term Fiscal Position. In practice, however, governments do tend to respond in some fashion. For example, Bill English, the current minister of finance, released a press statement in response to the Treasury's 2013 statement (English, 2013). More formally, it has become practice for the Fiscal Strategy Report, the government's primary document for communicating the details of its fiscal strategy,² to contain a section addressing long-term fiscal pressures as described in the most recent Statement on the Long-Term Fiscal Position. These sections help readers marry the outlook for the next 40+ years with the more medium-term focus of Fiscal Strategy Reports.

As noted above, alluding to the Treasury's long-term fiscal projections in Fiscal Strategy Reports is not mandatory. But a recent addition to the fiscal responsibility principles in part 2 of the Public Finance Act ought to reinforce the practice. The Public Finance (Fiscal Responsibility) Amendment Act 2013 introduced a new principle of responsible

necessarily follow that we should expect to see policy changes – after all, many OECD countries already spend more than 8% of GDP on state pensions.⁵ But assuming that changes to New Zealand Superannuation policy were deemed to be desirable, governments should introduce reforms slowly and after an informed public debate.⁶ People rely on having a more or less certain stream of income when they decide to stop working and make decisions about how much to save over the course of their working lives based on that reliance. Any changes to New Zealand Superannuation, therefore, would need to be signalled well in advance of actually coming into effect. Long-term fiscal planning also allows time to build consensus around what kinds of changes are best, leading to less likelihood of policy reversals.

In relation to public health care, the other main area in which the Treasury's long-term fiscal projections show significant pressures,⁷ the benefits of early warning are less cut and dried. Even if we decide as a society that the increases in public health care spending the Treasury projects are undesirable, it is not immediately obvious what we might do to avoid them. There are some possibilities, like increasing the use of patient co-payments and limiting the coverage of the public system, as well as trying to find more efficiencies, but the fiscal impacts of these options are difficult to quantify.⁸ And the impacts that such changes might have on any one individual's circumstances are impossible to know in advance. Having said that, an understanding of what the public health system is likely to look like in the future could well affect people's short-term decisions, such as whether to buy health insurance.

While their role of helping individuals plan for the future is more limited, projections for future health care spending serve the important task of putting current and future governments on notice that policy changes will be necessary if they do not want to see public health care spending growing significantly as a share of the economy. Of course, some governments may see proportionately higher health care

expenditure as desirable, at least relative to the alternatives. But in that case they will need to make trade-offs elsewhere, either by accepting higher taxes or by reprioritising within the existing fiscal pool. If the public is reasonably well-informed about long-term fiscal pressures, it ought to be easier to judge and debate what sorts of trade-offs might accord best with society's preferences.

Why is a legislative requirement for long-term fiscal planning considered desirable?

While New Zealand's requirement for the

future. Governments can then come under pressure to say what they intend to do about these rising costs – an issue that governments might prefer to avoid.

A legislative requirement to carry out long-term fiscal planning on a regular basis both makes sure that work happens even when there are more immediately pressing issues and also removes the temptation to prevent publication for reasons of political convenience. Accordingly, it provides for greater certainty and is likely to increase the overall quality of public debate.

A core assumption underpinning long-term fiscal planning is that if the facts about possible future trajectories are known, people will make short-term decisions that ought to lead to better long-term outcomes.

regular production of a Statement on the Long-Term Fiscal Position was introduced in a 2004 amendment to the Public Finance Act, the New Zealand Treasury has in fact had a model capable of producing long-term fiscal projections since well before 2004, and from time to time either the Treasury or the government has published such projections (for example, Janssen, 2002). A legislative requirement is useful, however, for making sure that long-term fiscal planning actually happens. Politics and policy analysis are often taken up with urgent issues, leaving little time or resources for long-term thinking. Despite the usefulness and importance of long-term planning, time and resource constraints can mean that it will not necessarily happen.

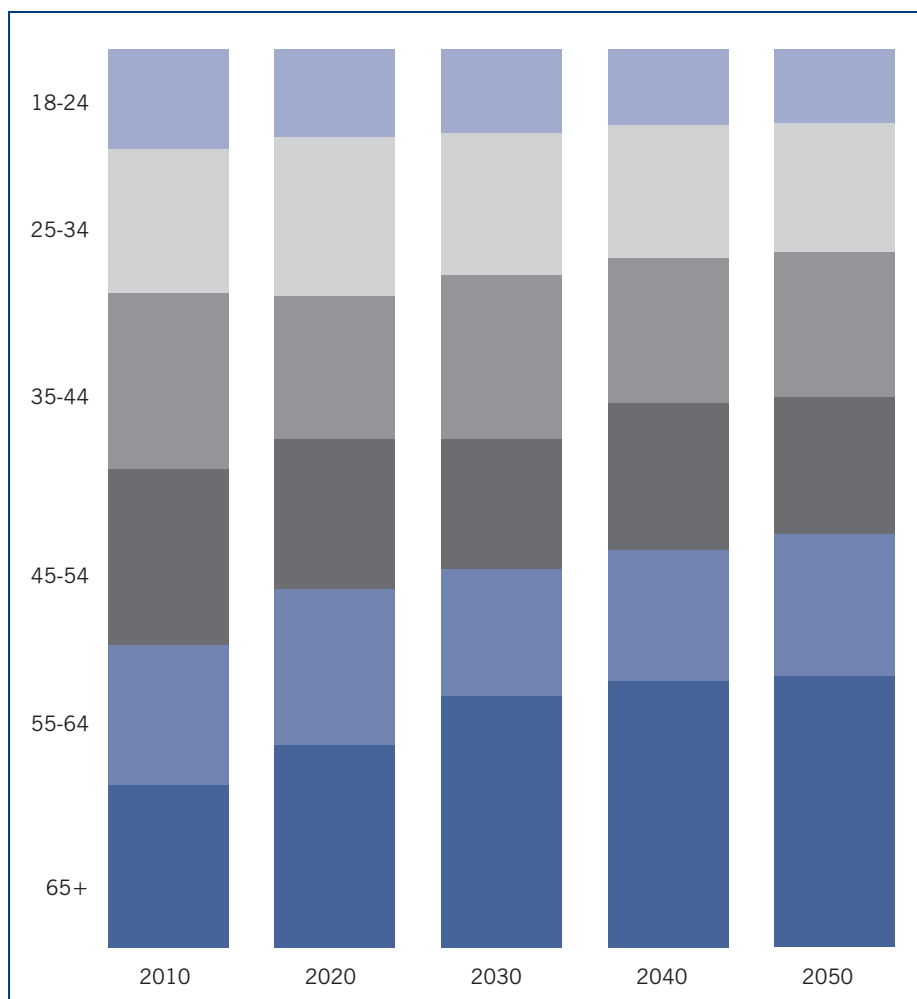
Furthermore, governments might have incentives to avoid confronting the issues that long-term planning uncovers. In the context of long-term fiscal planning, often the planning process reveals that certain government spending areas are likely to become more expensive in the

Does long-term fiscal planning work?

A core assumption underpinning long-term fiscal planning is that if the facts about possible future trajectories are known, people will make short-term decisions that ought to lead to better long-term outcomes. But this rationale encounters some practical problems and is open to a number of objections. The most significant problem is that the people responsible for making short-term decisions are often not those who will eventually experience the long-term outcomes of those decisions, e.g. 20–40 years later. Taking the interests of people in the future into account often involves some cost to voters now. Even with better information, voters do not necessarily have incentives to support measures that they perceive to be against their own interests.

This problem has been described as a political asymmetry – an imbalance of political power between political actors.⁹ There are different kinds of political asymmetry. For instance, a voting

Figure 1: Projected New Zealand elector count by age group (% of total)



Source: Treasury (2013), using data from Nolan et al (2012)

asymmetry is essentially the fact that young people and people not yet born cannot vote, so their views are not directly taken into account in a democracy, yet such people will be directly affected in various ways by the choices of those who are currently able to vote and make decisions on public policy matters. In many situations a cost-benefit asymmetry may also be in evidence – namely, the fact that the costs and benefits of different policies may fall on different groups (and/or over different time periods).¹⁰ Together, these asymmetries have obvious implications for long-term fiscal policy. Superannuation policy is a particularly good example. In New Zealand, current superannuation payments to those aged 65 and over are funded by the current cohort of taxpayers: that is, the people who receive superannuation payments are by and large a different group of people from the group who pays for them. (There is some overlap, of course,

as many over-65s pay significant amounts of tax.) And any adjustments to New Zealand Superannuation realistically (if not legally) have to be made well in advance, meaning that a cohort of people must vote to reduce what will eventually be their own entitlements, without necessarily any offsetting personal gain. The projected age profile of voters in New Zealand out to 2050 (see Figure 1) gives little comfort in this regard. Simon Upton’s and Michael Cullen’s contributions to this issue of *Policy Quarterly* also make this point.

The case of New Zealand Superannuation can be extended to long-term fiscal planning more generally. ‘Doing something’ about long-term fiscal pressures might involve asking a group of voters to accept some cost – perhaps not a huge cost, but still one that people will notice – for a future gain which may largely be enjoyed by others. We can draw an analogy with climate change mitigation

policies: initiatives to reduce the likely magnitude and impacts of human-induced climate change tend to require sacrifices on the part of current voters, with the benefits (in the form of reducing ecological damage and lower adaptation costs) being felt by future generations. In such contexts there is legitimate room for scepticism about the extent to which just providing information can be effective. Indeed, with respect to climate change, the international evidence thus far is that very few governments have been willing to impose significant short- to medium-term costs – via some kind of market-based instrument (e.g. an emissions tax or an emissions trading scheme) – on current voters in order to reduce greenhouse gas emissions.

However, in the area of long-term fiscal planning, the problems of political asymmetry might be over-stated. The time horizon over which countries carry out long-term fiscal planning is actually not that long: it is 40 years in New Zealand, and most other countries take comparable time periods. Many of the people who will bear the cost of any short-sighted decisions made in the near term are already both alive and voting. The current cohort of people aged 18–30 is aware of long-term fiscal issues and is making its views felt: Susie Kriebler and Finn O’Dwyer-Cunliffe’s article in this *Policy Quarterly* issue is an example. Even voters who are unlikely to be significant taxpayers in 40 years’ time still have reasons to care about those who will be large taxpayers in future decades. Voting now for policies that, for example, imply much higher taxes for future taxpayers is risky. Future taxpayers are likely to have many options other than living in New Zealand, so there is no guarantee that such people will stay and keep paying taxes they perceive to be unfair. A New Zealand that loses a chunk of its workforce will be unable to maintain high transfer payments, regardless of whether a large proportion of the electorate would vote for them. Thus, even a very narrow-minded voter who cares only about what he or she personally pays to and receives from the government should consider the impacts the policies they favour might have on others.

Furthermore, the picture of a narrow-minded voter who cares only about what he or she personally pays to, and receives from, the government is, in our view, an overly pessimistic representation of most people. Most people care about people other than themselves – they care about their children and grandchildren, for example. There are also many instances in history of societies making decisions that seem to go against the short-term interests of most people in those societies. Colin James, in his paper to the Affording Our Future conference, gave the examples of the abolition of the slave trade, and the British Reform Act of 1832 widening the franchise (James, 2012). The point is that with enough information, people can and do make what seems to them to be the right decision even when it appears to be contrary to their own interests.

That is essentially the rationale behind the publication of long-term fiscal planning documents. Simply providing information does not force anyone to do anything about what the information reveals. But providing information gives people the opportunity to consider what problems are on the horizon, what policy options are available to address these problems, and what the long-term impact of their choices could be.

Is long-term fiscal planning accurate enough to be useful?

Long-term fiscal planning can be criticised on the basis that the time horizons it involves – four decades in New Zealand's case – are too long for it to produce any useful information. After all, consider how many unexpected things have happened over the last 40 years, and how much they have changed the course of our lives. Given the inherent unknowability of the future, can long-term fiscal planning really say anything useful about what might happen over the next 40 years?

This critique, however, misunderstands the purpose of long-term fiscal planning. Such planning does not attempt to predict the future, but rather aims to show the likely long-term fiscal implications if current trends continue. The fact that policy settings might change, so that those projections do not eventuate, is explicitly taken into account.

In fact, to some extent that is the whole point of such planning.

Having said that, in the process of projecting the potential future fiscal impacts of current policies, long-term fiscal planners need to make some *predictions* about what might happen in the future.¹¹ In the case of the potential future path of spending on public health care and New Zealand Superannuation, modellers need to incorporate predictions about factors that affect demand for that spending. Here is one place where uncertainty creeps in.

The difficulties in projecting future public health care spending are a specific example of a more general difficulty: that is, there are many things that might affect future demand for spending, whether on education, welfare, law and order or other areas, that we simply cannot predict. Thus the Treasury's projections have significant uncertainty bands around them.

Should we be better at long-term planning in areas beyond the fiscal?

Most of the arguments in favour of long-term fiscal planning apply equally well to

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Projecting future demand for New Zealand Superannuation, assuming current policy settings, is relatively mechanical: it is driven by the number of people aged 65 and over in each year between now and 2053 (although the Treasury's projections actually go out to 2060). All of the people who will be 65 or over between now and 2053 are already alive. Certainly, some of those people will die before the end of that period, and we do not know exactly how many, but we have a pretty good idea of the general range.

Projecting the future costs of public health care involves more uncertainty. The Treasury's projections of the possible fiscal path of public health care rely heavily on the rate at which spending on public health care has grown in the past. The future might be quite different from the past. Technological changes might make it easier to treat more people more cheaply; alternatively, some new forms of health treatment might be very expensive, and/or medical conditions such as obesity may become more common across the population, thus generating significant additional demand for health services.

long-term planning in general. We might not be very good at predicting the future accurately, but by thinking about what it might bring we give ourselves options. But whereas long-term fiscal planning in New Zealand is relatively well-established with the legislative requirement for the Treasury to produce Statements on the Long-Term Fiscal Position, long-term planning in other areas is more piecemeal.

Two areas where better long-term planning might be useful in New Zealand are social trends and environmental trends. Neither kind of long-term planning would be exactly like long-term fiscal planning, but they could be beneficial all the same. Long-term social planning might look at current social trends and their likely future impact, assessing how the future role of the government might need to change in order to respond to them. Long-term environmental planning could look at a range of possible long-term environmental outcomes, some of which might depend on actions we take now. Long-term thinking in these areas is admittedly challenging, and risks being wrong, but it is possible. The OECD, for example, recently published

its *Environmental Outlook to 2050*, which looks at key social, demographic and economic trends and what these are likely to mean for the natural environment (OECD, 2011).

It is arguable that recent changes to the State Sector Act 1988 nudge government departments towards taking a more long-term view. Departmental chief executives are now responsible for 'the stewardship of a department ... including its long-term sustainability, organisational health, capability, and capacity to offer free and frank advice to successive governments' (section 32(1)(d)). 'Stewardship' is defined as 'active planning and management of medium- and long-term interests, along with associated advice' (section 2). The introduction of the notion of 'stewardship' recognises that while government departments must act primarily in accordance with the wishes of the government of the day, they also have broader responsibilities to the country more generally, both now and in the future. Making sure that they are ready to address the issues of tomorrow as well as today is part of that broader role.

Giving effect to these new stewardship requirements will probably require changes to current practice. As Iain Rennie, the state services commissioner, has pointed out, departments are 'very good at responding to the demands of ministers and the here and now' but

'much less good at thinking about the long term and the various dimensions of that' (Rennie, 2013). Thinking about long-term issues does not necessarily require formal or regular reporting, but examples from other countries or multinational organisations can give some guidance about how to give effect to a stewardship culture.¹²

Conclusion

Looking at long-term fiscal issues is a well-established practice in New Zealand. Long-term fiscal planning gives us warning about what kind of spending pressures might be on the horizon and what we might do about them. Admittedly, 'doing something' about future spending pressures must confront a political asymmetry problem, as the people making the decisions are not necessarily the same as those who will feel the effects of those decisions. But there is reason to hope that long-term fiscal planning can still be effective. An emerging opportunity for New Zealand will be incorporating the broad techniques employed for long-term fiscal planning into thinking about the future more generally.

1 The expression 'long-term' can have a number of different meanings. Forty years makes sense in the context of the Statement on the Long-Term Fiscal Position, being a long enough time period to get a sense of potential future costs of different programmes, but not so long as to make any projections meaningless. Even within the Public Finance Act, 'long-term' has different definitions, reflecting different purposes. For example, section 26J requires governments to set out their 'long-term fiscal objectives' in the annual Fiscal Strategy Report, where 'long-term' means at least ten years.

- 2 The government publishes a Fiscal Strategy Report along with each Budget. Fiscal Strategy Reports are required by section 26J of the Public Finance Act 1989.
- 3 It is not the case that all spending programmes become more expensive over time, however. For example, as discussed in Paul Sherrell's contribution to this issue of *Policy Quarterly*, current projections show expenditure in the justice sector declining as a share of GDP if current trends continue.
- 4 This number is simply gross New Zealand Superannuation payments; it does not include KiwiSaver contributions from the government and does not net off the tax people pay on New Zealand Superannuation payments.
- 5 For example, the Euro area average was around 10% of GDP in 2010 (Upton, 2012).
- 6 Nicola Kirkup's contribution to this *Policy Quarterly* issue describes and assesses some potential changes to pension policy.
- 7 Treasury's 2013 Statement on the Long-Term Fiscal Position projects public health care spending to grow from 6.8% of GDP in 2010 to 10.8% (approximately) in 2060.
- 8 Mays et al., 2013, in this *Policy Quarterly* issue, elaborate on the difficulties of predicting the actual impacts of 'cost saving' public health care measures. For example, increasing the use of co-payments could discourage people from seeking certain kinds of care, meaning that they need more expensive care later as their health deteriorates.
- 9 The concept of political asymmetry is explained in Boston and Lempp (2011).
- 10 The voting and cost-benefit asymmetries are two of four democratic asymmetries identified by Wolf (1987). The other two are the interest group asymmetry and the accounting asymmetry.
- 11 A 'prediction' or 'forecast' is the forecaster's best guess about what will probably happen over a particular time period. While forecasters are aware that reality will probably be somewhat different from their forecasts, and maybe wildly different, a forecast is still intended to be a prediction of what will actually happen, given what we know now. In contrast, a projection merely states what *would* happen if certain assumptions turn out to be true. A projection need not bear any close resemblance to what actually unfolds and it is not a criticism of a projection that it turned out to be 'wrong' (whereas a forecast could be criticised on that basis).
- 12 The controller and auditor-general currently has a work programme that involves helping the public sector plan for New Zealand's future needs, with particular reference to a changing demographic structure but also taking into account other ways in which the future might be different from the present. So far the auditor-general has produced three reports as part of this work programme: *Commentary on Affording Our Future: Statement on the Long-Term Fiscal Position, Public Sector Financial Sustainability and Matters arising from the 2012-2022 Local Authority Long-Term Plans*. These reports are available at www.oag.govt.nz. Further publications are planned for 2013.

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