Fiscal Futures: The Role of Long-Term Budget Projections

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Countries Around The World Are Facing Long-Term Fiscal Challenges

- Pension, health care, & other services expected by ageing (& sometimes smaller) populations
- The risks imposed by climate change & natural disasters
- The costs of contingent liabilities inherent in government programs such as:
  - Loan guarantees
  - Insurance for pensions and bank deposits
  - Insurance for low probability/high consequence events
  - Public-private partnerships
- The need to replace ageing infrastructure
Old Age Dependency Ratios
Solutions Are Not Simple

• Some say that there are simple solutions:
  – Eliminating waste;
  – Introducing automatic cuts;
  – Increasing taxes on the rich; and/or
  – “Growing” out of the problem.

• But the problems of addressing these challenges are too big for any “simple” solution.

• In addition, most countries have accumulated substantial debt and are currently running substantial deficits.

• And the deficits by themselves will get bigger unless the forces fueling them on the spending side are addressed.

• Legitimate pressures exist to ensure that the impact of decisions made by current generations are not overburdening, denying future generations the services provided by government today.
The First Priority is Economic Growth, But…

• A major problem is that higher spending and tax cuts will make big budget deficits even bigger, without necessarily assessing the long-term fiscal impact.

• And without an explicit commitment and an explicit plan to make institutional budget reforms, the fiscal futures for many countries will be grim even after the economy has exited from the current crisis.
Institutional Budget Reforms Can Help

- Link stimulus programs to long-term programmatic reforms using performance information.
- Change the fiscal rules under which countries operate in order to promote fiscal sustainability.
- Most importantly, and the focus of this presentation, incorporate assessments of the long-term consequences of political actions into budget systems.
Incorporate Assessments of Long-Term Consequences

• Almost all budget processes are very short sighted.
  – They do not force consideration of the long-term consequences of political decisions.
  – They don’t inform anyone—especially not the public—of such consequences.

• But some countries have changed their budget systems to make sure that the long-term consequences of current fiscal actions are assessed.
Long-Term Fiscal Projections: Definition

• A time period of more than 10 years
  – Medium-term forecasts focus on fiscal stability, but not necessarily on sustainability.
  – A number of countries prepare medium-term fiscal frameworks of 8-10 years: Denmark, Sweden, US.

• Coverage of the entire budget, not just specific budgetary funds
  – A number of countries prepare actuarial projections of pension funds: Australia, Canada, Japan, Korea, Sweden, UK.
Questions Addressed by the OECD Study*

1. How have various nations reformed their budget systems & decision-making institutions to help them cope more effectively with the long-term fiscal challenges they face?

2. What evidence is there about the effectiveness of specific reforms in managing the political incentives that have led to a projected mismatch between obligations and revenues?

3. To what extent and in what ways are these experiences relevant to other nations?

The Ability to Address These Questions Is Crude

• Few countries have reformed their budget systems to incorporate long-term information, and those that have only made changes relatively recently.

• Long-term budgetary outcomes, and the fiscal measures underlying them, are themselves very long term.

• There is a need to control a vast amount of other, frequently more important, factors.

• Despite the difficulty, an assessment -- even if only a crude one -- can help steer policymakers towards those system changes that are likely to be valuable to the improvement of their fiscal futures.
Why Make Long-Term Projections

• Sustainability: long-term projections are needed to help determine whether current government actions impede fiscal sustainability.

• Intergenerational efficiency: failure to address long-term fiscal risks early on may force future governments to adopt policies whose costs to the population living at the time will far exceed those borne by taxpayers today.

• Intergenerational fairness: governments may miss an opportunity to consider a structured approach where present policies can facilitate the achievement of long-term fiscal policy outcomes that are both sustainable & fair.

• Intergenerational effectiveness: failure to address long-term fiscal risks may weaken the ability of governments to respond to other, less predictable problems.
Dimensions of Fiscal Sustainability

• **Solvency**
  – The capacity of governments to finance existing and probable future liabilities/obligations.

• **Growth**
  – The capacity of government to sustain economic growth over an extended period.

• **Fairness**
  – The capacity of government to provide net financial benefits to future generations that are not less than the net benefits provided to current generations.

• **Stable Taxes**
  – The capacity of government to finance future obligations without increasing the tax burden.
How To Make Long-Term Projections

- Demographic Assumptions
- Economic Assumptions
- Current Laws
- Time Horizon
- Sources of Uncertainty
Demographic Assumptions

• Fertility Rates
• Net Immigration
• Life Expectancy
Economic Assumptions

• Labor market participation
  – Age and gender
  – Cultural factors
  – Future income, including pensions

• Productivity

• The next 25 years the same as the last 25 years?
Current Laws: Revenues

• Taxes
• Sales of Natural Resources
Current Laws: Spending

- Discretionary programs
- Mandatory programs
- One-time spending
- Contingency spending
- Interest
Time Horizon

- Generational equity implies at least one generation: 25 years
- Natural resource availability may imply a different horizon
- Demographics matter
- The differences between making medium-term projections and long-term ones
Sources of Uncertainty

- Fertility and life expectancy
- Productivity
- Labor market participation rates
- Pension reforms
- Health care costs
- Interest rates
- The importance of sensitivity analyses
A Fiscal Future Report: Example I Australia’s Intergenerational Report (IGR)

- Charter of Budget Honesty requires 40-year projections every 5 years, presented to parliament & publicly released.
- Projections based on Commonwealth government current policies in “Mid-year Economic and Fiscal Outlook”, adjusted for major policy decisions.
- Fiscal indicators used:
  - Government spending per capita
  - Primary balance & net government debt
  - Adjusted primary balance
- Comparisons of government spending per capita & primary balance to previous projection are included.
- Sensitivity analysis for demographic & macro assumptions are included as an annex, but not for non-demographic-driven components of different spending categories.
Australia’s Projections of Primary Balance
A Fiscal Future Report: Example II, The Sustainability of Dutch Public Finances

- Fiscal projections of general government until 2100, updated on an ad hoc basis, prepared by the independent CPB, publicly released.
- Current policies based on the most recent budget, factoring in several policy reforms.
- Assumptions:
  - Constant tax rates
  - Spending indexed to either wage or GDP growth
  - Unchanged composition of the economy
- Fiscal indicators include:
  - Projected primary budget balance & debt
  - Sustainability gap
  - Lifetime net tax benefits by population cohort
- Comparison & decomposition to the 2000 projection of the sustainability gap.
- Sensitivity analysis for demographic & economic assumptions on the required primary surplus & sustainability gap.
Potential Dutch Policy
Reactions

• Raise indirect taxes or personal income taxes in 2006
• Delay reductions in government material consumption in 2040 rather than 2006
• Abolish tax privileges on pensions
• Raise the statutory retirement age by two years using a one year step in 2015 and 2025.
A Fiscal Future Report: Example III
New Zealand’s Long-Term Fiscal Position

• Presents bottom-up long-term fiscal projections:
  – Government spending by category
  – Primary operating balance
  – Net debt

• Sensitivity analysis is done only on expenditures, presenting impact on primary balance and debt.

• Presents top-down long-term fiscal projections assuming:
  – Gross debt at 20% of GDP; and,
  – With policy options to slow health spending growth or cap “other” operating expenditures.

• Past/current policy actions not discussed in report.
NZ’s Long-Term Fiscal Position, 2006: Necessary Changes to Health Spending to Achieve Gross Debt Target

Figure 11.8: Health spending slowed to limit debt to 20% of GDP

Source: The Treasury
A Fiscal Future Report: Example IV

Germany’s Report on Sustainability of Public Finance

• Presents bottom-up long-term fiscal projections:
  – Government spending as % GDP
  – Net debt
  – EU Sustainability Gap assuming: Debt/GDP ratio continuously balanced between 2011-50, & infinitely balanced

• Not a baseline projection but a range (“corridor”) factoring in sensitivity analysis

• Sensitivity analysis for revenue and health spending

• Estimated impact of policy simulations for retrospective and prospective changes include
  – Long-term care insurance
  – Civil service pension reform
Range of Germany’s Sustainability Gap Under Different Policy Simulations, 2008

Sustainability gap: the necessary increase in primary net borrowing
- S1, old: debt/GDP ratio if budget continuously balanced, 2011-50;
- S1, new: debt/GDP ratio reaches 60% GDP by 2050;
- S2: Intertemporal budget restriction is met.

S2 policy simulations
- Status-quo: includes pension reforms, but not latest changes in long-term care, insurance/civil service pensions
- Retrospective scenario: excluding pension reforms of 2004 (sustainability factor) & 2007 (raising the retirement age to 67)
- Prospective scenario: assumes latest changes in the field of long-term care, insurance/civil service pensions
Some Findings

• Detail varies significantly across countries.
• Some countries prepare rolling projections; others updates with the same end-year.
• Some countries present sensitivity analysis of projected fiscal position; others as an annex; & others as alternative policy scenarios.
• Discussions comparing assumptions, changes in methodology & fiscal position with previous reports are done only in Australia & the UK.
• Projections focus on fiscal risks associated with ageing populations, but not on climate change, globalization.
• Germany prepares fiscal futures reports based on independent economic research institute’s projections.
Recommendation I: Strengthen Explicit Disclosures

• Incorporate comparisons with past government assessments to highlight trends in sustainability.
• Include sensitivity analysis of demographic, macro- and micro-economic, and other assumptions to illustrate exposure to risks.
• Clearly present changes in the methodology and key assumptions to provide a means of assurance and credibility of their quality.
Recommendation II: Link Projections to Budget

- Prepare them on an annual basis to eliminate discretion over when projections are produced.
- Use them to illustrate the fiscal consequences of reforms or policy options—if not in the report, then when initiatives are proposed.
- Tie them to other budget practices & procedures (fiscal rules & triggers) to build action around assessments of sustainability.
Answers to the Study’s Questions

1. How have various nations reformed their budget systems and decision-making institutions to help them cope more effectively with the long-term fiscal challenges they face?
   - In many different ways: see the examples and the Study’s Overview.

2. What evidence is there about the effectiveness of specific reforms in managing the political incentives that have led to a projected mismatch between obligations and revenues?
   - Some, but it is too soon to tell, and it is difficult to determine a direct linkage between reforms, incentives, and outcomes.

3. To what extent and in what ways are these experiences relevant to other nations?
   - There may be important lessons from the experiences of the countries who have tried to use long-term information:
     - Some countries have improved their fiscal futures.
     - Combining long-term assessments with better use of performance information and changes in fiscal rules, including the use of triggers, may be very valuable.
Conclusion

The expanding use of fiscal projections in countries with very different governmental and budgetary systems supports that these recommendations should be relevant to a broad range of OECD and non-OECD countries alike.