ANZ Research

NZ Insight: The intergenerational divide

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Contact

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The intergenerational divide

Bottom line

- Macroeconomic policy has responded vigorously to this crisis, and that response is well justified.
- However, COVID-19's legacy of increased public debt and even less affordable housing will be carried disproportionately by younger people.
- This is adding to what was already a rough deal for younger people, who will be left picking up the tab of climate change and an ageing population.
- Policy makers have a significant mountain to climb if they want to address the widening intergenerational divide. We certainly don't have all the answers, but progress can't start without discussion. One thing's for sure, there's no point looking to the RBNZ for a quick fix. This is a structural problem that stretches well beyond the reach of the RBNZ's cyclical policy tools and mandate.
- A perfect demographic storm means the pressure on policy makers is only poised to intensify from here. Big policy changes are likely to happen eventually.

A significant shock, policy response, and long-run challenges

The COVID-19 shock is truly a 'once in a generation' event (touch wood). And the macro policy response (ie the response from both the Government and the Reserve Bank) has been appropriately swift and substantial. It has cushioned the blow, even if it is unable to offset and even out the impacts entirely.

But what about the longer-run implications? While necessary, this policy response, in the context of tight housing supply, is leaving in its wake a housing market that is even more difficult to enter for first-home buyers, along with a growing public sector debt burden that will need to be at least partially consolidated through some combination of higher taxes and less government services than otherwise at some point in the future.

Politicians certainly have their work cut out, but they are the only ones who have the tools available to address these issues over the long run. These are structural issues that cyclical policy tools (chiefly monetary policy) are not equipped to address. The trajectory we're on, as well as New Zealand's demographic profile, suggests policy makers are going to become more and more attuned to these issues over time as voter concerns evolve.

'Damage control' policies have limited the economic fallout…

Although the data is impacted by volatility, the economy has been a lot more resilient to the current crisis than economists initially expected. It remains unclear how much of the positive vibe in the recent data will translate into real, on-the-ground economic activity in a sustained way, but it's clear that the monetary and fiscal policy response has been very effective at limiting the initial hit to economic activity.

That's great news because it means the transition through the recovery (ie once virus risks are contained, and borders reopened) will be a lot easier than otherwise.

The initial macro-policy response has been trying to lean against the turn in the business cycle by limiting the hit to incomes, expenditure and production.

For monetary policy, this means making sure credit is flowing smoothly, debt-servicing costs are kept low, and businesses and households have confidence to spend and invest. And the RBNZ has done just that! However, the vigorous response of the housing market has also exposed decades of inadequate policy action from the Government in addressing New Zealand housing supply problems.

For fiscal policy, damage control has meant ensuring that policies limit the income hit, keep people connected to the labour market as far as possible, boost confidence, and stimulate the economy through the recovery – all the while keeping COVID-19 at bay. And to date, the fiscal response has been powerful, essentially paying, through the wage subsidy, for a significant portion of the lost production brought about by lockdowns – at the cost of a lot of government debt.

In addition to the above, fiscal policy has a longer-run role to play by focusing stimulus on bolstering the productive capacity of the economy through investment in key infrastructure and training, addressing regulatory bottlenecks (such as RMA reform), and incentivising businesses to invest. If successful, this part of the policy response could really limit the burden the policy response is currently putting on the younger generation.

…but there will be longer-term scars

Although policy has provided a cushion, that's not to say there won't be some permanent scarring brought about by this crisis. A significant amount of damage for some sectors of the economy is unavoidable. Challenges lie ahead, and some colossal forces are pushing and pulling at the economy right now as the lost summer of tourism goes up against strong housing momentum. It's still not clear where the dust will settle, let alone exactly how virus and vaccine developments will evolve from here, although recent news flow is encouraging.

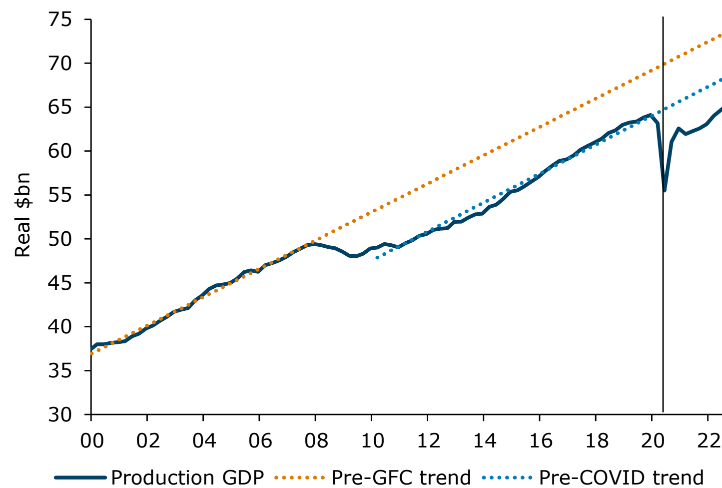
Unfortunately, we think some of the lost GDP is gone for good – the question is how much. Lockdowns, a closed border, the very sharp and synchronised shock among our trading partners, and the turn in the business cycle more broadly will do that. Here's how:

- International tourism will never completely make up for lost ground. Once borders eventually reopen, New Zealand is unlikely to play host to twice as many tourists as before. There simply isn't capacity for that! Further, while there will certainly be some pent-up demand, foreign incomes are likely to be weaker and that's likely to weigh on highly discretionary spending (such as international holidays). And that's before we consider the possibility of lingering health concerns associated with travel, and possible barriers to travel, such as testing and proof of inoculation, and potentially long delays in rebuilding air capacity. Indeed, it's possible that New Zealand may never be as well serviced by international airlines again. Many other services industries face similar issues – it's hard to make up for lost time when many foregone services (eg haircuts) don't get consumed at an increased rate on the other side.
- Reduced business investment (typically a significant underperformer during a crisis and very weak currently) has put New Zealand's capital stock on a lower-than-otherwise path. That means, in short, that we can't make as much stuff. Sure, it's possible that investment comes back with a vengeance. But not while the outlook is still uncertain, as it is expected to be for a while, and it's hard to see it making up for lost ground. All else equal, a smaller capital stock implies a lower productive capacity, weaker economic activity, and lower incomes than otherwise.

- Further, this shock has hit different sectors of the economy very unevenly. That's exacerbating skill shortages to which the closed border is also contributing, creating a real growth constraint for those firms that are seeing stronger demand and looking to expand. This, plus New Zealand's relatively highly regulated labour market, could see the unemployment rate come down only slowly, also leading to a more sluggish recovery than otherwise.

All up, once we've navigated the lockdown noise in the data, we expect trend GDP is likely to settle below its pre-COVID trajectory, just as it did following the Global Financial Crisis (figure 1), with it taking even longer for the labour market to return to normal.

Figure 1. GDP



Source: Stats NZ, ANZ Research

The swift and significant macro-policy response has been justified. It has reduced job losses, paved the way for higher-than-otherwise aggregate incomes, and therefore a larger tax base, providing more resource for the current and future governments to tackle issues like homelessness and child poverty.

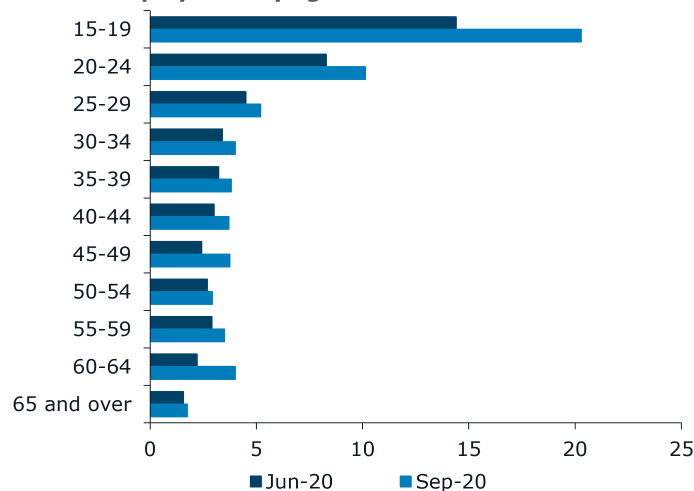
But there's no such thing as a free lunch. We will have to bear the costs of the response, and this will be disproportionally borne by younger people. And as we discuss in the next section, things on the intergenerational front were looking pretty unfair already.

Challenges lie ahead for younger people, in particular

Intergenerational inequality is running away on us. There is a wide range of factors contributing to this unfortunate development and all of them suggest things are only going to get worse, unless something is done about it.

- **Labour market conditions** are rough for those just starting out, with the recent rise in the unemployment rate much more acute at the younger end of the spectrum (figure 2). We'd expect this underperformance to continue throughout the recovery, as businesses will have more experienced candidates available to choose from. Minimum wage rises will assist those who have a secure job, but will unfortunately exacerbate the hurdles that new entrants to the labour market face. The Flexi-wage subsidy will help, but may not make much difference to marginalised workers, such as youth, if there is still a decent amount of spare capacity in the labour market.

Figure 2. Unemployment by age bracket



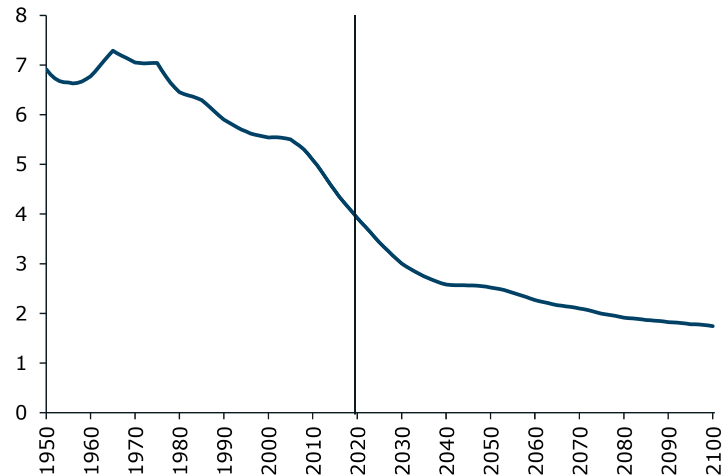
Source: Statistics NZ

- **Housing** is unaffordable for many, and the problem is getting worse rapidly. The primary issue is that New Zealand has failed to build enough houses to meet demand, leading to house prices that are eye-wateringly high relative to incomes. A secular decline in interest rates over recent decades has helped keep a lid on debt-servicing costs relative to incomes, but scraping together an initial deposit is becoming ever more challenging. Statistics NZ have recently reported that "homeownership rates have fallen for all age groups since the early 1990s, but especially for those in their 20s and 30s" and that overall, home ownership is at its lowest in almost 70 years. We estimate that since the late 1990s, home ownership costs have increased from about 35% of household incomes to around 45%, and the time taken to save for a deposit (assuming one is saving 10% of pre-tax income) has grown from 8 to almost 15 years – and is only getting longer.

- The **ageing population** represents another burden on younger people. New Zealand's Pay As You Go[1] superannuation system and demographics mean tax-payers today are paying a larger superannuation bill than those who are currently retired (or close to it) ever did. The ratio of those of working age (15-64) to those 65 or older has declined steadily over time (figure 3) from around 7:1 40 years ago to a little under 4 today; in 20 years it's projected to be closer to 2.5 to 1. This trend is not fair on younger people, implying more debt, a reduction in government services, or higher taxes. Introducing a Save As You Go (SAYGO) system (such as KiwiSaver and the NZ Super Fund) is a great way to future-proof the system, but current settings aren't aggressive enough to make the problem go away. Further, the transition to a SAYGO system isn't necessarily fair if you're asking younger income earners to pay for the generation ahead and also save more for their own retirement at the same time. There's no quick fix.

[1] NZ super is a 'pay as you go' system. In practice it means that taxes on activity and incomes today provide the revenue to make super payments to current retirees. This compares to a 'save as you go' system, where a generation saves for its own retirement. The difference between the two matters a lot when generation sizes are different.

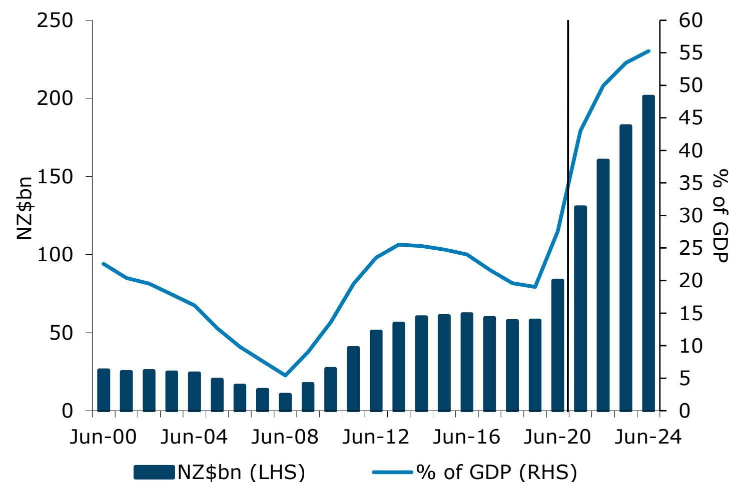
Figure 3. Ratio of 15-64 year olds (working age) to 65+



Source: Macrobond, ANZ Research

- **Climate change** is bringing costs with it as rising sea levels and coastal erosion damage infrastructure and dwellings – and the tax-payer will inevitably be lumped with a lot of it. More extreme weather conditions (eg droughts and flooding) will hinder agricultural production and therefore returns. The costs of transitioning to a greener economy via increased regulation will also erode bottom lines, production and incomes, though it will present some opportunities too. On the whole, the economy is likely to be smaller than otherwise. That's not to say it's a step in the wrong direction, but the costs are real and choices lie ahead regarding who's going to wear them.
- The fiscal response to COVID-19 was justified, but **public sector debt** has exploded in response (figure 4). The good news is that the starting point was low, and interest rates are also low, and that's providing some breathing room. Nonetheless, fiscal consolidation will be needed to bolster the fiscal war chest for the next inevitable crisis. Higher taxes or reduced government services than otherwise are in store – a discussion needs to be had about what this looks like, and the sooner the better.

Figure 4. Core Crown net debt



Source: The Treasury (Pre-election Update forecasts)

The response

Politicians are under pressure to address these issues, some more urgently than others. Books have been written on these topics, and unfortunately we don't have any silver bullets to suggest. But there are certainly some key themes that policy needs to focus on.

For **housing**, the long-term solution is to build more houses. The simple fact is if New Zealand's housing supply was more responsive to demand, and more building had taken place in the past, the market would be less susceptible to these bouts of rapid house price inflation. This is a structural issue, not a cyclical one, and central and local government are the policymakers with the tools to address this, not the Reserve Bank. Government can bolster supply by reducing red tape, freeing up more land for development, encouraging intensification, helping local councils fund required infrastructure, and incentivising investment and training to lift the productive capacity of the construction industry. There are also ways to limit speculative demand, such as tax changes – though price impacts tend to be of the one-off variety. It's all easier said than done, of course, and not a quick fix. But looking forward, assessing the Government policy response is pretty straightforward. Does it help increase supply more than it adds to demand? If the answer is no, then the policy is not addressing the fundamental issue.

Sustainable income growth will need to be a real focus as part of the long-term housing strategy, but also as a way to limit the costs associated with the eventual fiscal consolidation. Limiting the initial hit to incomes via the wage subsidy means a stronger-than-otherwise starting point, and that's definitely going to help over the years ahead. But it's done and dusted now, and the Government needs to pivot to policies that will boost the productive capacity of the economy. New Zealand's low-wage problem is essentially a low labour productivity problem. Increased spending on infrastructure (including for residential development) is the obvious go-to here – and absolutely needs to happen. But politicians must not overlook private sector incentives when it comes to investing and taking the right kind of risks that will also influence the economy's productive capacity. Recent changes to depreciation settings should encourage some additional investment, but more encouragement is needed. Addressing capacity issues with productivity-boosting capital investment rather than simply importing cheap labour as a go-to solution would help housing affordability too. A good hard look at immigration settings to ensure they are income-supportive over the long run is warranted.

A broadening of the tax system will happen eventually. The top 2% of income earners are in for a higher tax bill from 1 April 2021, but that's just a higher rate on the same people already paying tax. Further, the top 2% of income earners are not necessarily the top 2% when it comes to wealth. Broadening the tax system such as via capital gains, wealth or inheritance taxes, are real possibilities over the longer run. Indeed, if income earners end up doing the heavy lifting of fiscal consolidation while houses remains unattainable to them – even to those earning an average wage – then surely it's just a matter of time before the tax system is changed to make it fairer for them. The political appetite obviously isn't there right now, but the debate won't go away.

Increased scrutiny of government spending is likely to become a key part of the fiscal consolidation in the years ahead too. Budget processes focus on allocating additional spending based on priorities. But often the spending that's already baked into the fiscal outlook doesn't get the attention it should; not all of it is achieving the desired result or is an efficient use of tax-payer dollars. Fees-free tertiary study is a great example. It's very expensive and doesn't seem to have had much impact on enrolments. Yes, it helps younger people, but it's helping younger people who are more likely to earn an above-average income anyway, thanks to their qualifications. It would be a different story if it led to higher enrolments, perhaps, but interest-free loans are already subsidising higher future income earners.

We urgently need to take a good hard look at **superannuation settings** to make them fairer. It's more complicated than just increasing the eligibility age and/or means testing. Different groups tend to experience different life expectancy rates,

meaning a higher eligibility age might not be fair in some cases. Also, the incentives to hide wealth in a means-testing environment can make the system complicated and less efficient. And we're certainly not advocating that old age pensioners who are just getting by as it is should have to tighten their belts even further. But the fact remains that young people are being short changed, and some recipients of NZ Super don't need it. And the slower we go on reform, the bigger the mess.

The pressure to do more is only going to intensify

The longer New Zealand stays on its current path, the louder the voices of those adversely affected will get. There's a significant cohort of 20-29 year olds who currently account for a little less than 20% of the voting population. But fast forward 30 years or so, and this cohort, together with eligible voters younger than them, is projected to account for more than 60% of the voting population (figures 5 and 6).[2]

Figure 5. NZ demographics 2020

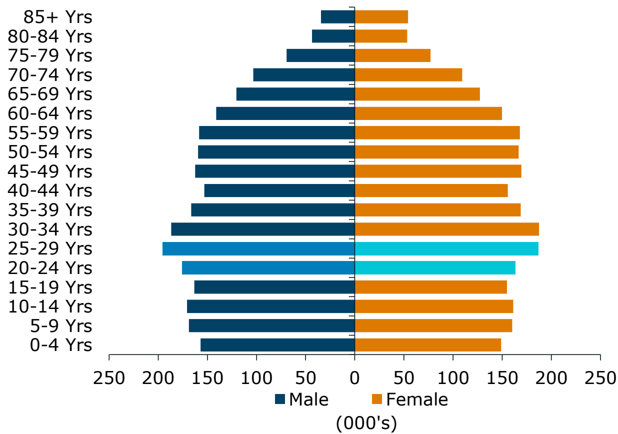
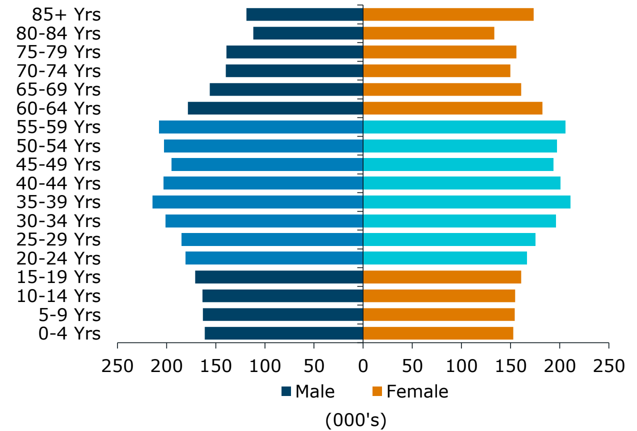


Figure 6. NZ demographics projection to 2048



Source: Statistics NZ, ANZ Research

Of course voter preferences tend to change with age as one's own financial interests do! By 2050 these 20-29 year olds will be 50-59. This cohort will have (hopefully) paid enough taxes and/or foregone enough government services such that New Zealand's Government debt position is at a "prudent" level. But will they be close enough to their own retirement that they won't want to change superannuation eligibility settings too much? Will they own three houses and fight a capital gains tax tooth and nail? One thing's for sure - over coming years if they don't, in aggregate, make the steady progression that their forebears did into home ownership and asset accumulation – and that's looking pretty unlikely at this point – their views on appropriate tax policy are going to be different too. And they'll vote accordingly, though it may be a slow evolution rather than a wave of radical change.

The fact is, the multi-decade housing boom (ie decades of housing supply failures) has massively enriched the older half of the population at millennials' expense. Population ageing and a pay-as-you-go system means young people are being asked to support an outsized cohort of non-earners. Millennials are on the hook for the costs of climate change mitigation. And now they're being hit with the bill for the COVID-19 rescue as well. But in time those same young people will account for the lion's share of voters and their roar will be heard loud and clear. Politicians beware; 30- and 40-somethings, get saving. Things are going to change – eventually.

[2] Stats NZ national population estimates, 50th percentile.

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