"Does New Zealand need lower public debt levels?"

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Until the global financial crisis (GFC) in 2008, New Zealanders as a whole were highly indebted to overseas lenders but most of that debt was owed by the private sector.

The government, with gross debt under 20% of GDP in 2008, had been one of the most prudent OECD governments in recent times when it came to spending more than the revenues it earned. The crisis changed all that. Ballooning budget deficits and GDP stagnation more than doubled our debt-to-GDP ratio to nearly 40% within just four years.

It is these sorts of rapid increases in government debt, together with initially elevated levels, that triggered the recent fiscal crises we have witnessed in several European countries and the US.

Can New Zealand avoid the kinds of crises that Britain, the US and the Euro zone are now experiencing because our public debt started so low? Or are we also vulnerable to a fall in lender confidence now that our debt levels have risen?

I would argue that, as a result of the GFC and its aftermath, taxpayers and financial markets are finally waking up to the fact that persistent government deficits are simply unsustainable. And long-term public debt levels previously regarded as benign, even those in New Zealand, are no longer sensible, meaning that there may no longer be such a thing as a 'safe' government debt level anymore. The longer-term consequences of this are substantial. Either the future track of public spending will have to be permanently curtailed compared to the past, or taxes will need to be permanently higher, or both.

Until the GFC, economists concerned with government debt generally worried about governments competing in financial markets for funds driving up interest rates and so crowding out valuable private sector investment. They could do so, in part, because much government debt was perceived as 'low risk' compared to almost all private sector alternatives and hence very attractive to many investors. (It is no coincidence that the term 'risk-free interest rate' is associated with the rate paid on 10 year government bonds).

In many ways the early 1980s crisis in New Zealand, that included an unsustainable build-up of public debt levels following massive debt-funded public investment, can be seen as New Zealand's very own 'GFC moment'. The foreign and public debt fall-out that helped shape the subsequent radical policy reforms created a lasting memory here of the severely adverse effects high levels of government indebtedness can bring. As a result, over the last 30 years or so, New Zealand has bucked the advanced economy trend of generally increasing public debt levels, by trending down instead.

So why have those other countries expanded their debt levels – even before the GFC? And are there any lessons for us?

Two features characterise much of the public debt expansion on OECD countries in the last 50 years. The first has been a desire to intervene during recessionary episodes to smooth out some of the worst effects of these shocks. Attempts to keep unemployment lower and output higher than it otherwise would be: such as unemployment benefits paid for from public deficits.

If it is effective – and that is subject to much debate – most economists would argue this is a 'good think'. Steady income levels are generally preferred to volatile ones. However, it has proved much easier to raise so-called 'temporary' spending and deficits during recessions than it was to reverse the process – and run surpluses – in more normal times.

As a result each new recession has tended to bring newly elevated public debt that never returns to its old, pre-recession level. A stairway to crisis, one might say!

The second feature is a steadily increased willingness on the part of governments and voters to spend more through the government budget, especially on transfers like pensions for the elderly and social welfare payments.

At the same time numerous factors, including globalisation, have made it harder for governments to raise tax revenues from their citizens and businesses. But with interest rates on government borrowing falling, then remaining low, for much of the post-1990 period, debt-funding those spending imperatives was feasible and seemed okay.

There must be a suspicion that Eurozone politicians have still not learned the obvious lessons from these uncomfortable fiscal facts – incurring public debt prudently implies repaying it as quickly as possible if persistent funding problems are not to arise.

And the lessons for New Zealand? We have just experienced two big unexpected shocks to our budget deficits: the GFC-induced recession and the Canterbury earthquake recovery costs (plus the newly highlighted fiscal consequences of improved earthquake protection across the country).

These events have unquestionably demonstrated how palatable public debt levels can quickly become unpalatable! This doesn't necessarily mean that they are not worth incurring. But it does mean that a longer-term target of budget surpluses on average is essential, and probably lower public debt levels than we thought prudent in the past.