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How to stop governments going bust

INVESTORS have good reason to worry about states defaulting on their loans: Argentina and Russia provide chastening recent reminders. But both were dysfunctional economies with troubled political pasts. Surely, there is no need to worry about the indebtedness of the governments of stable, advanced countries?

Maybe not, but take a look all the same at the table below. Most countries' explicit net debt—issued as bonds and traded every day in financial markets—is at manageable levels, relative to GDP. However, embodied in current tax and expenditure policies are a lot of obligations for which governments have not yet had to make explicit provision. This implicit liability arises mainly from future increases in spending on pensions and health care. Include it, and total debt vaults to levels last seen (for explicit debt) in wartime. Governments often fall into bad habits when their debts are so high, usually by resorting to the printing press and using inflation to cut the real value of their liabilities.

Credit-rating agencies are alerting their clients to the danger. Standard & Poor's gave warning last year that many European governments will be relegated to the second division of borrowers if they do not tackle spending commitments that are set to soar as populations age. So far, however, investors do not appear to be charging higher risk premiums on explicit debt—the sanction that would most concentrate the minds of finance ministers.

Yet the long-term budgetary risks are real and looming ever closer, says Peter Heller, deputy director of fiscal affairs at the International Monetary Fund, in a thought-provoking new book^{*}. These risks arise not only from the effects of an ageing population on pension and health-care bills, but also potentially from medical technology, global warming, security and globalisation. Irrespective of ageing, advances in medical technology are likely to push up public spending on health care: the more medical science and public

health services can provide, the more people will want. Climate change may increase the incidence of floods, storms and droughts—"extreme weather events"—after which governments often step in as insurers of last resort. Some governments are already under pressure to spend more on defence: the "peace dividend" made possible by the end of the cold war is exhausted. And globalisation may limit governments' ability to exploit their national tax bases as both capital and labour become increasingly footloose.

There may be some pleasant surprises to set against this catalogue of doom. Rising productivity ought to mean that future generations are richer and will be able to afford bigger tax bills, especially if the world economy enjoys the sort of productivity growth that America has experienced in recent years. Europeans could start to have more children, who would prop up their onerous pay-as-you-go pension systems.



Mr Heller accepts that there are huge uncertainties; after all, fiscal forecasts a year ahead, let alone a decade or more, are often wildly wrong. But he thinks that the balance of risks lies on the downside. Worse, risks may hit the public finances at the same time; for example, governments in Europe could find their outlays ballooning from weather-related damage as well as population ageing. As for appealing to the generosity of future richer generations, he is properly dubious about governments' ability to squeeze more tax out of their citizens. Higher tax rates might merely mean a bigger shadow economy, or an abandonment of over-taxed work in favour of untaxed leisure.

Plan, plan and plan again

So what is to be done? First, governments must look much farther ahead than they do

now. An increasing number of western countries are planning their public finances on a basis of three to five years, but this is nowhere near enough, argues Mr Heller. They need to incorporate a long-range perspective (of at least 25 years and preferably more) into their budgets. Second, these projections should be vetted by independent agencies such as America's Congressional Budget Office, because of governments' tendency to see the silver lining and not the cloud.

Such long-range forecasts would alert both politicians and the general public to the need for pre-emptive action to avoid a future fiscal crunch. One way forward would then be to run budget surpluses over the next few years in order to create borrowing room in the more distant future. But Mr Heller cautions against pinning too much hope on this approach. It has been tried before. In the late 1990s, America's Social Security surpluses were supposedly in a "lockbox"—which was prised open the moment the rest of the federal budget swung into deficit. Similarly, Norway's supposedly separate rainy-day fund, financed from oil and gas revenues, was raided in 2001 to meet immediate budgetary pressures.

If governments are to avoid going bust, politicians will have to grasp the nettle. They must cut back on the over-generous promises they have made to their citizens, above all in pensions and health care. And they must do so sooner rather than later. Delay means that future generations of pensioners will find themselves short-changed through an abrupt cut in benefits. Given due warning, they could take steps to protect their incomes in retirement.

Politically, this is not much easier than promising to lock away surpluses. Even so, recent pension reforms by European governments are a small step in the right direction. But how much better it would be if governments published comprehensive long-range fiscal projections, scrutinised by independent bodies and open to public debate. Unless governments are forced to be honest about their predicament, it will be hard to stop them going bust.

* "Who Will Pay? Coping with Aging Societies, Climate Change, and Other Long-Term Fiscal Challenges": www.imf.org/external/pubs/nft/2003/www/index.htm

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