THE BIG CHILL

The STAGGERING SCALE of the GOVERNMENT DEBT ICEBERG

A new IEA study warns that many major governments are on course for fiscal calamity.

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We are all aware of the level of government debt.

However, governments do not produce sufficiently forward-looking accounting measures – ones that transparently reveal the extent to which a government's future financial commitments cannot be met by future receipts.

We are therefore generally in the dark about the true extent of government indebtedness under current fiscal policies.

As populations age, the tax base is likely to grow more slowly. At the same time, in all developed countries, government social security and healthcare spending will rise more rapidly because of promises that have been made to today's older and middle-aged generations.

No funds have been set aside to meet these future commitments and, in any meaningful economic sense, they represent government liabilities and a form of indebtedness.

This article presents the main findings of the recent IEA Research Monograph – *The Government Debt Iceberg* by Dr. Jagadeesh Gokhale, senior fellow at the Cato Institute in Washington D.C.

Like an iceberg, that part of the government's indebtedness that is visible, the explicit debt, is only a small proportion of the total.

To extend the metaphor further, by failing to consider timely revisions to current fiscal policies, many governments are heading for the iceberg, seemingly unaware of the calamity they are facing.

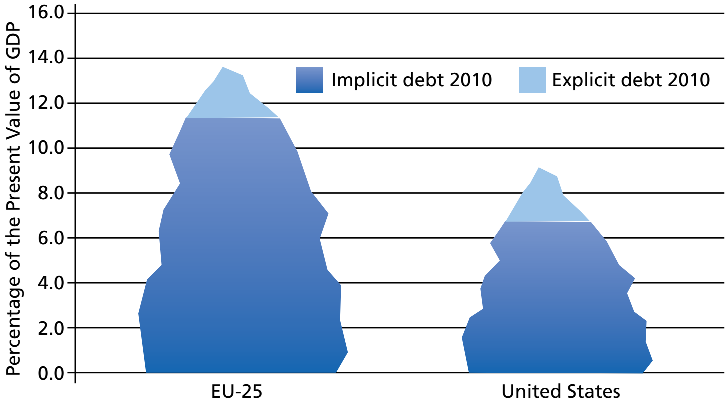
Short-term debt crises in the US and EU

The nominal value of outstanding explicit government debt is easily measured and reported. It is this debt that, for example, amounts to around 80 per cent of national income in the UK.

However, other government commitments – such as those to pay future pensions and provide healthcare – may be even more certain and predictable than the government's explicit debt.

Different forms of future spending commitments have different levels of certainty attached to them, but government promises to pay future pensions to public sector workers, for example, are probably even more difficult to renege on than commitments to repay explicit government debt. The unfunded portions of these commitments are not included in national debt measures.

Figure 1: Indebtedness icebergs in the European Union and the United States. Explicit and implicit debt as a percentage of the present value of GDP*



* Fiscal imbalance is represented by the peaks and not the areas of the icebergs

The partial US government shut-down and the delay in congressional approval of a debt-limit increase until the very last minute has cast a bright spotlight on the processes and constraints lawmakers must navigate to achieve even temporarily acceptable outcomes in an era of rising debt.

TOTAL US GOVERNMENT DEBT IS AROUND 100 PER CENT OF NATIONAL INCOME

The temporary resumption of US federal operations and small increase in the US federal debt limit provides a limited window for budget policy negotiations between lawmakers with starkly different policy preferences.

However, the focus has been very much on short-term crisis management and the level of debt that has accumulated as a result of past policy decisions. That debt is, itself, enormous: total US government debt is around 100 per cent of national income.

The short-term situation in Europe is not too different from that in the US, though the longer-term outlook is even more problematic, as we shall see.

In the euro zone, monetary union enabled governments to borrow at low interest rates – which less competitive nations did in excess.

In some euro zone countries, such as Spain and Ireland, governments bailed out banks, as happened also in the UK.

The recession that followed the financial crisis then led to revenue implosions and explicit debt levels increased rapidly. EU nations have witnessed sovereign debt levels surge from 60 per cent of national income during the mid-2000s to 85 per cent today.

The iceberg beneath the surface

Traditional national debt measures are backward looking. They show the extent to which governments have not been able to meet spending commitments from taxation historically. Additionally, traditional debt measures constitute only the tip of the debt iceberg.

Any proper approach to accounting also measures future commitments that would not be covered by future receipts: that is how insurance companies, for example, account.

A proper economic measure of government indebtedness measures the extent to which all future spending plans cannot be financed by current taxation plans – the sum of explicit debt (inherited from the past) and future excess spending commitments is known as the fiscal imbalance. It shows the effect of today's spending and tax policies that, if continued, will determine the evolution of explicit debt in the future.

The upward march of explicit debt will continue under today's policies as ageing baby-boomers in both the US and the EU are due to be paid retirement and health care benefits at a time when the growth of government receipts is likely to remain slow or plateau.

Policies may be changed in the future. However, policy changes should be judged according to their impact on the size of the fiscal imbalance and not simply according to their impact on the current government debt.

For example, in some EU countries, private pension funds have been nationalised to reduce the national debt, but the citizens who owned those funds have been given promises of future government pensions instead. The current national debt is reduced but the long-term future sustainability of government finances is not improved.

The fiscal imbalance shows by just how much policy has to change in order for the government to balance the books in the long term. Any policy changes to bring government finances back to a sustainable position are likely to affect younger and future generations negatively, because they will, in all likelihood, have to either pay more taxes or have their benefits curtailed below their expectations.

Changing policy course, dealing with long-term indebtedness and getting government finances on a sustainable long-term footing will not be easy.

Sustained and large prospective fiscal imbalances usually arise from rapid projected growth in social protection expenditures because of ongoing demographic shifts.

The beneficiaries of such programmes usually enjoy considerable security in their benefits. The benefits are usually strongly entrenched – either supported by difficult-to-reverse court judgments, constitutional guarantees or protected by large and influential political interest groups. Such benefit obligations are also frequently protected against erosion through inflation.

That may make prospective obligations on account of such programmes just as inviolable as payment obligations on government bonds.

Item	Included in explicit debt figures	Included in implicit government debt
Accumulated government debt	Yes	Yes
Future pensions promised to public sector workers	No	Yes
Future state pensions in social security schemes	No	Yes
Future healthcare costs for an ageing population	No	Yes
Future spending on defence, education etc. that cannot be financed at current tax rates	No	Yes

The complete indebtedness measure

The extent of public indebtedness and policy choices available to resolve it will largely determine the future economic environments in the EU and the United States.

Key questions concern whether those policies and resulting economic conditions will remain conducive to advancing living standards through sustained output growth, or whether the long-term austerity required to resolve fiscal imbalances will perpetuate economic stagnation.

Moreover, decomposing such forward-looking fiscal imbalance metrics can help in assessing how future policy changes would affect different generations – young and middle-aged workers versus retired generations.

How large are the indebtedness icebergs for the EU and the United States? *Figure 1* shows the results for EU-25 nations (as a whole) and the United States.

For the EU as a whole, the total fiscal imbalance equals 13.5 per cent of the present value of future projected GDP. The explicit debt is 2.1 percentage points of future GDP (this is roughly 85 per cent of the current year's GDP mentioned above). The implicit debt relating to future spending commitments not financed by current tax plans is 11.4 per cent of the present value of GDP (over five times the explicit debt).

The United States' federal fiscal imbalance is 9.0 per cent, of which 2.2 per cent of the present value of GDP represents the explicit debt.

It is immediately noticeable that, although the EU and the US have similar ratios of explicit debt, the EU has a much larger ratio of implicit debt.

The higher EU implicit debt arises partly as a result of demography and partly as a result of policy decisions.

EU expenditures on social protection programmes are around 30 per cent of GDP compared with 15 per cent in the US. It is social protection spending which is especially prone to increasing as populations age.

This problem is then compounded by more rapid population ageing in the EU. EU countries will have smaller worker-to-retiree population ratios in the future.

That ratio is currently just above 5.0 in the US and about 3.5 in the EU. By 2040 the ratio is projected to be about 3.1 in the US and 1.8 in the EU.

A relatively lower and declining worker-to-population ratio also contributes towards higher implicit debt in the EU compared with the United States.

Policy options in the short and long terms

Recently, weaker EU nations have responded to rising explicit debt levels by imposing unpopular but unavoidable austerity policies while continuing to spend money on crucial government functions through bailouts from international agencies and stronger EU countries.

But the long-term fiscal picture examined in this monograph shows that even the economically stronger

THE US IS SAILING TOWARDS THE FISCAL ICEBERG WITHOUT CHANGING COURSE, ALONG WITH THE UK AND OTHER EU COUNTRIES

EU nations such as Germany, Finland and the Netherlands, must deal with the long-term fiscal imbalance problems arising from pensions, healthcare and other social protection commitments.

The US fiscal imbalance mainly arises from its social security and Medicare programmes which support retiree consumption and health care expenditures.

Much of US policy reform will have to focus on bringing the finances of these programmes back into balance – something which will be a huge challenge given that most Americans have not saved to fund their own old age consumption and healthcare but, rather, rely on the taxes to be paid by future generations.

Closing the fiscal imbalance from the tax side would involve doubling federal taxes, from today into the indefinite future, or cutting all federal spending by over one third.

Resolving the fiscal imbalance in EU nations so that all spending could be financed by taxation would require, on average, an increase of 23.2 percentage points in the consumption tax rate – assuming that such a rise is feasible.

Alternatively, the fiscal imbalance could be closed by reducing health and social protection expenditure by about one half.

In the UK, total spending would have to be cut by more than one quarter or health and social protection expenditure by around one half compared with the level implied by current policy, to avoid tax increases if all spending is to be met from tax revenue in the long run.

Download *The Government Debt Iceberg* for free at: ***www.iea.org.uk***

EU NATIONS HAVE WITNESSED SOVEREIGN DEBT LEVELS SURGE FROM 60 PER CENT OF NATIONAL INCOME DURING THE MID-2000S TO 85 PER CENT TODAY

Interestingly, the United States' spending sequestration adopted during early 2013 left major social safety net expenditures untouched. This is despite the fact that these areas have grown hugely in the last few years.

Similarly, the fiscal consolidation package in the UK has tended to spare pensions, health and other social protection programmes whilst cutting judicial, community and local government expenditures.

This policy is expected to improve private investment and economic growth prospects as market confidence in national budget sustainability improves. However, as far as the long-term budget position is concerned, both the US and UK are focusing on the wrong areas.

Unfortunately, we are unlikely to grow our way out of these problems. Many of the projected expenditures could increase if there is economic growth because the commitments are linked to wage growth, and most are protected against inflation during retirement.

Indeed, if countries do not address their fiscal imbalances now, the size of the necessary adjustment will increase over time, undermining investor confidence and reducing growth potential.

Instead, appropriate and timely structural changes to bring public finances into balance would be likely to spur economic growth.

Conclusion

The long-term fiscal problems faced by most developed countries are much greater than is implied by government debt figures. It is possible that, in some countries, necessary reforms will be undertaken. However, things look grim in the US and most of the EU.

Given the differences in their preferences and the political and economic constraints they face in achieving fiscal policies that are acceptable to a bipartisan majority of lawmakers – even during the short-term – it remains quite unlikely that US national fiscal policies will soon be placed on a long-term sustainable course. The US is sailing towards the fiscal iceberg without changing course, along with the UK and other EU countries.

It is fair to say that, in some countries, measures have been planned which will ease the situation. The UK is raising the state pension age for example. However, it is being raised so slowly that life expectation at retirement will be longer at the end of that process than at the beginning.

These measures are inadequate, and little is being done to ensure that individuals save for and fund future pension and healthcare costs so that these growing costs are not borne by a shrinking tax base.

For current students, the long-term fiscal position of governments is one of the crucial issues for their generation. If today's fiscal course is continued for much longer, their expectations are likely to be disappointed – either in terms of higher future tax rates or in terms of reduced future benefits that will be provided by government.

Those larger fiscal burdens will be likely to increase tax-avoidance efforts on the part of mobile productive factors – capital and skilled workers. As the IEA Research Monograph by Dr. Gokhale clarifies, the quicker governments change policy, the more painlessly the situation will be resolved.

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