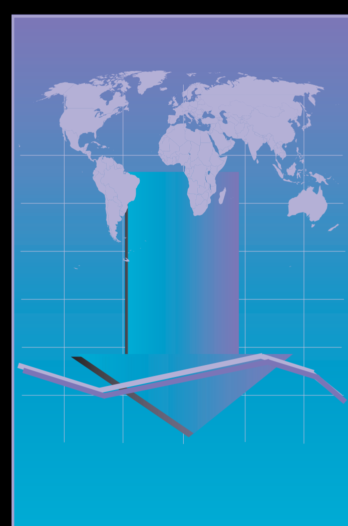
ECONOMIC ISSUES 3

Confronting Budget Deficits



INTERNATIONAL MONETARY FUND

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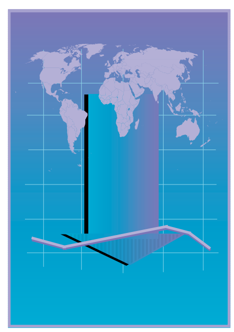

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Preface

The Economic Issues series was inaugurated in September 1996. Its aim is to make some of the economic research being produced in the International Monetary Fund on topical issues accessible to a broad readership of nonspecialists. The raw material of the series is drawn mainly from IMF Working Papers, technical papers produced by Fund staff members and visiting scholars, as well as from policy-related research papers. This material is refined for the general readership by editing and partial redrafting.

The following paper, prepared by Rozlyn Coleman, draws on material originally contained in IMF Working Paper 95/128, "Long-Term Tendencies in Budget Deficits and Debt," by Paul R. Masson and Michael Mussa. Readers interested in the original Working Paper may purchase a copy from IMF Publication Services.

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Confronting Budget Deficits

Political leaders have so frequently cried wolf over budgetary spending that voters are skeptical about talk of budgetary crises. This is unfortunate, since deficits should arouse genuine concern, particularly as their size in some industrial countries is daunting. Yet, the absolute size of deficits is not their most alarming aspect. In fact, most countries now run much smaller deficits (as a ratio of GDP) than they did during wartime. Rather, the persistence of budgetary shortfalls during a long period of peace, when governments traditionally pay off debts and save for the future, should set the alarm bells ringing. Furthermore, projected increases in the cost of government programs, as populations age and economic growth lags, give cause for further concern.

Government budget deficits (the excess of spending over revenue) in industrial countries have been growing as a percent of GDP for the past 20 years. Large deficits emerged after the oil crisis in the mid-1970s and widened dramatically after 1980, largely the result of government overspending rather than meager tax receipts. Government expenditures in industrial countries rose from 28 percent of GDP in 1960 to 50 percent in 1994. These deficits have sharply increased the public debt (the accumulated burden of yearly budget deficits), which jumped to 70 percent of GDP in 1995 from 40 percent in 1980, weakening government finances and draining resources from the economy. Aging populations and sluggish economic growth add urgency to this worrisome trend.

Governments now have little choice but to restructure their spending programs.

History Lesson

During the nineteenth and early twentieth centuries, fiscal deficits and surpluses were small in the major industrial countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), and a chart of fiscal balances would show a fairly stable trend line. World War I (1914–18) altered the picture radically, as its participants emptied national treasuries and borrowed against the future in a desperate struggle to survive. The interwar period saw a return to "normalcy" that brought the huge deficits contracted during the war down to manageable size in nearly all countries. World War II (1939–45) and the immediate postwar years repeated the fiscal experience of World War I and the interwar period—immense deficits in all countries followed by surprisingly satisfactory progress toward fiscal balance. Nevertheless, a disturbing trend began in the 1960s and gained seemingly irresistible momentum by the 1970s. The normal peacetime condition of near fiscal balance gave way in almost every industrial country to large and obdurate fiscal deficits.

Why Persistent Deficits?

These unsustainable deficits deeply concern policymakers. Five of the above seven nations have run deficits in each of the past eight years, despite satisfactory economic growth over the period. As for the two exceptions, Japan has run deficits in each of the past three years, and the United Kingdom in each of the past six years. Most economists agree that commitment to social welfare programs, demographic trends, and fundamental macroeconomic shifts are the main causes of the deterioration of fiscal positions across the industrial world and that each of these factors needs to be addressed for budgetary balance to be achieved.

Entitlements

Before World War I, few governments extended social welfare benefits for unemployment, social security, or health care even to their neediest citizens. Historians debate the moment at which this changed. Some suggest that the generation that endured the horrors of World War I rejected the Victorian values of self-discipline and self-reliance and demanded a safety net. Others maintain that the Great Depression elicited a reconsideration of government's role in the economic life of the country, forcing governments to social action. Still others suggest that the activism of governments during World War II in providing health care, pensions, and other assistance to the members of the armed forces changed perceptions of the social responsibility of government. Whatever the starting point, clearly a profound shift occurred in political philosophy between the start of World War I and the end of World War II. In response, governments, especially in Europe, established generous pension, national health care, family and child welfare programs, an extensive system of public education, and long-term unemployment insurance.

These programs have sent government spending skyrocketing. By the mid-1960s, spending was up in all industrial countries. In Canada, France, Italy, and Japan, it climbed by 8–11 percentage points during 1975–93, while in the United States insurance trust expenditures (Social Security and Medicare) rose to 22 percent of general expenditures in 1992. As a percent of total spending, U.S. public welfare spending, a category broader than insurance trust spending, nearly tripled during the period. Table 1 shows the increases in social welfare spending for the United States, whose social welfare programs are among the least extensive among the

Table 1. U.S. Government Expenditures, Selected Years, 1902–92

	Total in Billions of of Dollars	Percent of Total						
		Defense and International Relations	Education	Welfare	Health	Interest on Debt	Insurance Trust Expenditure	Other
1902	1.66	10	16	2	4	1	—	67
1942	45.58	58	6	3	2	3	2	26
1975	560.1	17	17	7	4	6	19	29
1992	2,487.9	13	14	8	5	10	22	28

Source: U.S. Department of Commerce (1975, 1987, 1994).

industrial countries, during the twentieth century. With the exception of interest payments on the national debt, no other category of U.S. spending has increased more than social welfare programs.

Demographic Shifts

In industrial countries, government transfers for social security and subsidized health care have come to be viewed as entitlements, immune to political attack. This hands-off status cannot last much longer, however. Current demographic trends imply that by 2010 people aged 60 and older will constitute 23 percent of the population of Organization for Economic Cooperation and Development countries (the world's richest industrial countries), up from 18 percent in 1990. Without reform, these systems will go bankrupt early in the next century.

What is the problem with an aging population? When national social security systems were established, their funding was calculated on much shorter life spans. People paid into social security systems based on the calculation that they would live only a few years after retirement. They were led to believe that these systems were straightforward pension plans: you are entitled to each payment you receive during retirement because you contributed to the plan during your working life. In reality, however, most public pensions are structured as pay-as-you-go systems, meaning that benefits are funded from current taxes and not from payments made by present recipients during their working lives. Longer life expectancies suggest that taxes must rise (rather dramatically in some countries) to pay for pensions for retirees, whose retirement is expected to last much longer than that of previous generations.

Other considerations render the arithmetic all the more inexorable. First, declining birthrates in industrial countries since the early 1960s mean that fewer people will be working relative to the retired population. Second, policies designed to put young people to work have provided incentives for older workers to retire early, although research suggests that such policies rarely reduce unemployment among the young. Third, the cost of health care—used disproportionately by the elderly—has been rising rapidly.

Macroeconomic Shifts

The 1950s and 1960s were unusually sanguine decades in the industrial world. Unemployment and inflation were low; economic growth was robust. Incomes were rising faster than inflation so that a consumer could buy more. At the same time, optimism about the government's ability to solve social problems was buoyant. Social welfare programs, many of which were broadened at this time, assumed rather too hopefully that the robust tax revenue and low inflation of the era would continue indefinitely. As a result, government budgets were set on trajectories that were unsustainable and vulnerable to economic downturns.

In the late 1960s and early 1970s, economic growth began a secular decline because of fundamental macroeconomic shifts: slower growth in productivity, volatile inflation, rising health care costs, and increasing structural unemployment. Together these factors have driven government revenues well below targets projected during the boom years.

Productivity Slowdown

Long-term economic growth—continuous increase in the total value of a nation's goods and services—depends primarily on productivity growth, that is, that each worker produce more each year than he did in the previous year. Productivity-led growth lends resiliency to national economies, since output grows not through longer hours spent at the job but through *better and more effective* hours. (Growth achieved simply through pushing existing capital and labor to work longer and harder creates inflation, which erodes the nominal value of the goods and services produced.) New drill presses on the factory floor, faster computers, better communications, and improved distribution of goods raise productivity by making workers more efficient.

For reasons still debated, productivity growth began to fall in the early 1970s. Explanations for the slowdown include the end of a long-term economic cycle, the oil price shocks starting in 1973, and government policies undermining incentives for private companies to invest in productivity gains. Whatever the cause, sluggish productivity growth is a likely cause of lower growth rates after 1973. Although productivity growth has picked up slightly in the past few years, the improvements have been small and have not yet translated into visibly higher growth rates.

Inflation and Debt

The oil embargo of 1973 wreaked havoc on an unprepared and oil-dependent industrial world. Huge price jumps and the attendant economic instability remain powerful memories for those who lived through the oil crisis. What is less well remembered, however, is that those price hikes occurred during a period of steadily rising prices, which contrasted with the long-term price stability traditional in the industrial world.

While inflation is painful for consumers, those in debt usually welcome it because inflation makes existing debt (if it has a fixed interest rate) cheaper to service and repay. This sounds like unambiguous good news for governments, who are always deeply in debt, since a surge in inflation could float their problems away. Nevertheless, only *unanticipated* inflation reduces debt, since creditors negotiate the terms of each loan with a keen eye for *anticipated* inflation to ensure a reasonable real rate of return on their money. When inflation is volatile, creditors lose money and become wary about future lending, either demanding higher interest rates to cover the added risk of inflation surprises or choosing not to lend at all. Because continued liquidity in the credit markets is vital to economic growth, governments cannot raise interest rates for any length of time without disrupting financial markets.

The real growth rate also affects the accumulation of government debt. If an economy grows more slowly than the real interest rate, the national debt grows faster than the government's ability to pay it back. Disturbingly, such a dynamic has taken hold in the industrial world, where real interest rates have generally exceeded real growth rates since the early 1980s, an indicator of how urgent the deficit problem has become. Inflation also raises payments for indexed benefits, since their levels are by definition tied to inflation. If inflation rises unexpectedly, the government will pay out larger sums for welfare, unemployment, social security, and food and housing assistance. Such unexpected expenditures will increase deficit spending. Finally, inflation in an industry such as health care can put severe strain on the government budget.

Structural Unemployment

Employment fluctuates, generally rising and falling with corporate earnings. At the trough, businesses cut back on production and often lay off workers. The resulting short-term unemployment hurts government budgets by increasing the demand for unemployment claims, social welfare payments, food assistance, and other benefits designed to cushion the fall. Short-term unemployment also temporarily reduces income tax revenue. Conversely, at the peak of the economic cycle, businesses run at full capacity and hire (or rehire) as many workers as they can use. Government finances recover accordingly.

Even during peak years, the unemployment rate never reaches zero. Its lowest resting spot is called the natural rate of unemployment, and historically it has fluctuated between 2 and 5 percent of the labor force in industrial countries. (Those who remain unemployed, despite strong demand for labor, generally do so because their job search involves a major career change.) Recently, however, the rate has lingered well above the historical natural rate in all industrial countries, except Japan and the United States, suggesting that the unemployed have been taking longer to find a new job or have dropped out of the labor force entirely. This phenomenon is known as structural unemployment.

There are two standard economic explanations for structural unemployment. First, social welfare programs have eroded the incentive to find a new job quickly. The unemployed, at least in the short term, are not desperate and may even enjoy their new-found leisure. In Europe, for example, where unemployment is higher than in the United States, unemployment assistance lasts for many months and pays a large percentage of the worker's last salary so that the life style of the unemployed is not immediately affected. Moreover, most European countries offer national health insurance, so that this vital benefit is not linked to employment and is not a cause of concern. Assistance with housing and food also reduces the enthusiasm with which the unemployed may approach their job search.

Second, employers may be hiring fewer workers. Higher minimum wages, unionization, and mandated employer contributions to benefit plans, by raising the cost of hiring a worker, dampen the demand for labor. In addition, employers increasingly demand sophisticated technical skills. They need workers who can handle complex machinery, manage computer technology, and interact with clients. As mental acuity has replaced physical strength, less educated workers cannot compete in today's workplace and so join the ranks of the structurally unemployed.

A final explanation of structural unemployment has to do with the psychological effects of government programs on individual behavior. Some observers now believe that the growth of social welfare programs in the 1960s and 1970s stimulated a decline in the stigma attached to long-term unemployment and government dependency. As a result, social welfare programs have become self-perpetuating. If that has indeed happened, the economy is in danger of being saddled with a permanently higher level of unemployment.

Table 2. Government Debt as a Percent of GDP, 1980–94

	1980	1985	1990	1994
Belgium	81.6	112.6	128.4	136.0
Canada	44.3	64.7	73.1	95.6
France	20.8	31.0	35.4	48.4
Germany[1]	31.8	41.7	43.4	49.8
Greece	24.2	50.6	73.9	114.1
Italy	57.8	82.3	102.1	129.0
Japan	52.0	68.7	69.8	83.3
Netherlands	46.6	71.5	78.8	79.4
Norway	52.2	40.7	39.2	50.1
Spain	17.5	45.1	45.1	62.8
United Kingdom	49.6	52.7	34.4	46.0
United States	43.6	51.5	59.9	68.9

[1]Data refer to western Germany through 1990, united Germany thereafter.

Debt Cloud on the Horizon

The problem is not that governments occasionally engage in deficit spending during economic recessions or times of national emergency but that they do so continuously. The result has been to increase public debt to worrisome levels. Consider France's debt-to-GDP ratio. In 1985, France carried a debt equal to 32 percent of its GDP; by 1994, the debt had reached 48 percent—a 50 percent increase over nine years. France's economy grew more slowly during this period, so that the country's debt burden is growing faster than its ability to pay it off. Table 2 presents the debt ratios of a number of industrial countries.

Given demographic trends, the industrial world faces an increasingly uphill battle against debt accumulation. By 2010, most pay-as-you-go public pension plans are predicted to come under severe strain, and the demographic peak is not expected until a few decades after that. By 2050, given current trends, nearly one in three people in the industrial world will be 60 or older. For the United States, social security liabilities in 2010 are projected to reach 167 percent of its gross domestic product, while future contributions and current assets are estimated at 136 percent of GDP, leaving a gap of 31 percent that must be met by higher taxes or lower benefits. Most other industrial countries must navigate even more treacherous fiscal straits. If one adds to these difficulties health care benefits paid to the elderly, the prospect becomes downright bleak. Ultimately the taxes needed to support current government commitments will fall on tomorrow's taxpayers. Consequently, some observers fear that intergenerational conflict may be on the horizon.

Deficit Reduction

Most industrial nations recognize the need to reduce deficits, but as yet few have addressed the problem comprehensively. Most have engaged in piecemeal policymaking to mitigate the most pressing deficit problems. Although these measures do provide some relief, more drastic action is needed. The major policy options available to the industrial countries are described below.

Economic Growth

Governments have many reasons to wish for higher economic growth, not least because growth eases government finances through higher revenues and lower transfer payments. Although governments cannot fully control their economies, they can pursue policies to enhance growth prospects and to reduce the vagaries of the economic cycle. Usually these policies reduce such rigidities as excessive regulation and complicated tax structures and improve the environment for business investment and trade. In these ways, governments ensure that private business and commerce will respond vigorously to upturns in the economy and that government coffers will reap the reward.

Two countries particularly hard hit by recession are undertaking a growth approach. Japan's fiscal position eroded badly during 1992–95, but Japanese officials have reason to expect that the present recovery will alleviate budgetary pressure and compensate partly for those bad years. In addition, they hope that economic performance will shore up some continuing weakness in the financial markets arising from bad loans. Canada, too, is looking toward an economic recovery to help with deficit reduction. Other countries have also been working to improve the competitiveness of their economies so that they may maximize economic upswings.

Spending Cuts

Most electorates find cutting spending more tolerable than increasing taxes. Spending cuts, while painful, can be strategically aimed at unpopular programs (e.g., welfare in the United States) or be spread across diverse constituencies to impose minimal hardship on voters. Other cuts may have sufficient, if not enthusiastic, support to make them feasible, such as reducing unemployment insurance payments, the defense budget, and government bureaucracies, or contracting with private companies for services previously performed by the government.

The United States has undertaken several attempts at reducing government expenditures. The Gramm-Rudman-Hollings Act of 1985 forced across-the-board cuts at the federal level, but the government backed away from full implementation of this legislation because of economic contractions in the late 1980s and early 1990s. A 1993 attempt at deficit reduction, which included spending cuts that fortuitously coincided with an upturn in tax revenue, met with greater success. In Europe, because the Maastricht treaty requires budget stability among its members before monetary union can be reached, most European government budgets are now attempting some fiscal consolidation.

Tax Increases

Cutting expenditures has its limits; increasing taxes is another option. Although tax increases are politically and even economically risky, some countries will need to raise tax rates to cover the projected costs of social security and national health care in the twentyfirst century. Tax design and the timing of an increase are complicated, and many redistributive issues need to be addressed during a policy shift.

Raising taxes is not impossible. Germany has recently done so successfully. To facilitate the absorption of the former German Democratic Republic, the German government imposed a solidarity tax of 7 $^{1}/_{2}$ percent. This tax helped the country to contain its deficit, which had risen sharply after 1990 but then leveled off when the new tax revenues began to flow in. Other countries have raised taxes in limited ways, but none is seriously debating significant tax increases at this time.

Pension Reform

As mentioned earlier, aging populations are placing increasing pressure on public pension systems. To diminish the cost of these systems, governments can shrink the pool of beneficiaries either by raising the retirement age or by reducing benefits. Most countries are modifying their social security systems in response to demographic projections.

In France, the government recently increased the years of public service needed to qualify for a full government pension and lengthened the salary period upon which those benefits are calculated. The U.K. government has chosen a slightly different tack—introducing incentives that would move people out of public pensions schemes and into private ones—in an effort to reduce government obligations. Germany, Canada, Italy, Japan, and the United States are debating these and other measures.

Health Care Reform

The same demographics forcing changes in social security are pressing for health care reform as well, since the elderly need more medical care than the young. Furthermore, health care costs have been rising drastically. These two factors have governments looking for ways to bring down costs and to regulate the procedures doctors perform.

In France, the government has negotiated with health care providers in an effort to establish acceptable and affordable treatment of patients, while at the same time increasing patient copayments for these services. In the United States, health care reform was prominent during the first two years of the Clinton Administration and although no legislation resulted from it, some incentives are being introduced to move Medicaid and Medicare patients into managed care.

Creditor Confidence

Some governments—notably Italy and Canada—now pay high interest charges on their government debt because of creditor uncertainty about fiscal policies. This hearkens back to the need for governments to control inflation, and these two governments have tried to improve creditor confidence by demonstrating spending restraint and low-inflation policies.

Legal Measures

The United States has attempted to contain deficit spending by such legal means as balanced-budget legislation and a much contested constitutional amendment to eliminate deficit spending. These initiatives are controversial since they limit legislative policy options, making it difficult to change spending priorities even when the need is compelling. Most analysts are concerned that legal restraints might introduce excessive rigidity in government fiscal policy.

Developing Countries

Budgetary issues in developing countries differ from those in industrial countries. Usually smaller and structurally different, developing economies may set other goals from those of industrial nations, focusing, for example, to a greater degree on building infra-

Table 3. Government Finances of Developing Countries, 1993

(In percent of GDP)

Region	Revenue	Expenditure	Balance
Africa	21.9	31.3	–9.3
Asia	15.4	17.8	–2.4
Four newly industrialized Asian economies	18.3	17.6	0.7
Middle East and Europe	29.3	36.3	–6.7
Western Hemisphere	17.3	17.4	–0.1
Countries in transition	24.6	31.4	–6.8

structure, creating an industrial base, and encouraging new business formation. Their populations are younger and less skilled, and they have limited access to capital. Fiscal policy in developing countries faces unique challenges. Budgets are smaller, personal incomes are lower, and tax collection is often erratic. Much employment occurs outside the formal economy, making transactions difficult to tax. Financial markets in developing countries are often inefficient, making it hard for governments to finance their deficits.

In keeping with lower government revenues, most developing countries have lower public expenditures than industrial countries, with developing countries in Asia and the western hemisphere spending the least and those in Africa, the Middle East, and eastern Europe the most (see Table 3). Yet, the majority of developing countries run deficits, with the occasional exception of the middle-income countries—those with higher per capita incomes.

Fortunately for their fiscal prospects, developing countries do not spend as much on social welfare programs (pensions, health care, and unemployment insurance) as industrial countries do. Private saving often takes the place of government support in this regard. Younger populations put less spending pressure on governments, and in many countries extended family networks traditionally care for the elderly. Nevertheless, governments still need to adjust their budgets to the inevitable aging of their populations, although they have more lead time than the industrial world. This extra time may help developing countries design more sustainable public pension and welfare programs than those in place in the industrial world.

The example of Chile is particularly interesting in this regard. A 1980 reform switched the public pension system from an unfunded, defined-benefit plan to a funded, defined-contribution plan. Participation in the plan was made mandatory for the employed and optional for the self-employed. Although strong economic growth is partly responsible, the system now has a large portfolio of assets. Related policies have achieved low government deficits. Chile is trying to build financial security for the old through a public system that aims at reducing poverty and at raising voluntary savings.

Choices

Large and persistent deficits push up interest rates, reduce investment, and create a burden of indebtedness that is difficult for governments and taxpayers to bear. Further, deficits interfere with the effective functioning of markets at home and abroad. Most important, they compromise the living standards of current and future generations.

The causes of these deficit problems, although complex, have been carefully analyzed. Governments of industrial countries have entered into a costly covenant with their citizens by offering generous assistance to the poor, unemployed, disabled, and elderly, and the increased spending has sent debt ratios soaring throughout the industrial world for the past two decades. As populations age and productivity grows slowly, these debts are forcing decisions upon national governments. Most economists agree that measures to reduce government spending are imperative, particularly through restructuring entitlement programs that have grown beyond sustainable limits. The choices are difficult, but must be addressed soon to buy time for changes to be made gradually, reducing the harm done to those dependent on government transfers and allowing all to adjust to possible new taxes and to the prospect of lower benefits. Further skirting of the deficit issue is irresponsible.

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