Time is ticking away to solve long-term fiscal challenges posed by aging societies, climate change, and other problems

Who Will Pay?

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ACROSS the world, a number of current and emerging problems pose new dangers for industrial and developing countries alike. The convergence of these problems will create significant social, political, and economic challenges to governments already stretched by new threats from international terrorism and other risks. This combination of challenges includes the following:

Demographic changes. Longer life expectancy and lower fertility rates will boost the proportion of elderly in many industrial countries and some emerging markets (see Chart 1, page 38)—in some cases, even as total population shrinks. In many developing countries, however, youth populations will explode and, in some, HIV/AIDS will continue to cut lives short and retard economic growth.

Climate changes. Global warming will trigger higher temperatures, new precipitation patterns, a rising sea level, and more frequent extreme weather events—hitting the economies of the tropics, southern Africa, and some island states especially hard. Scientists are fairly sure that the concentration of greenhouse gases already present in the atmosphere will warm the earth's surface about 1.9–5.8 degrees centigrade (roughly 3–10 degrees Fahrenheit) over the next century. The only uncertainty is how quickly climate change will occur, how it will manifest itself in different regions, and whether human intervention can moderate the extent of global warming during the next century.

Economic changes. The growing interconnectedness of the global economy means that shocks, positive stimuli, and technological advances will be transmitted more rapidly across national borders. As capital becomes more mobile, it will be harder for governments to tax it, shifting tax burdens increasingly to labor. And disparities in global incomes will worsen, heightening the risk of political instability, especially if high youth unemployment persists.

Security changes. Global security will be threatened by the risk of bioterrorism, proliferation of weapons of mass destruction, the competition for water and energy supplies, and even health scares, as illustrated by SARS.

Technological changes. The ongoing technological revolution—in biogenetics, information and communications, new materials, and cognitive science—will stimulate higher productivity, creating opportunities for better health and longer lives but also intensifying pressures for higher health spending.

The unfolding of these trends will, of course, have far-reaching implications for societies. But surprisingly little research has been done on the fiscal consequences. Governments will need to respond to growing demands for social services, heightened security needs, and unanticipated shocks. And fiscal risks will be amplified by the fact that most governments have precommitted resources to meet generous social insurance packages. Indeed, industrial country outlays will need to rise sharply simply to fulfill promises made to aging populations (see Chart 2, page 38).

Should these fiscal risks be a source for concern, given the enormous uncertainties in long-run forecasts? With continued real growth, won't economies be richer, enabling future generations to pay higher taxes without a decline in living standards? Shouldn't the poorest countries focus on maximizing growth, rather than take actions that would benefit only future generations? While these are valid questions, a forthcoming comprehensive fiscal study suggests that policymakers would be well advised to begin grappling *now* with future fiscal risks.

Being shortsighted

Few governments now take account of long-term risks. Even where government policies have given rise to accumulating commitments—for example, in the social insurance sphere—most budgets give little guidance on future liabilities. The potential costs of fiscal guarantees, contingent liabilities, and more implicit commitments are rarely reflected in budgets. Thus, measures of debt significantly understate a government's total obligations.

Moreover, while budgets increasingly encompass a medium-term framework of three to five years, few countries provide long-term scenarios—the exceptions being Australia, the United Kingdom, and, to a more limited extent, the United States (see box on page 39). Most countries' sustainability analyses focus on their ability to service current debt and anticipated future deficits and may not draw on available actuarial assessments of pension schemes. Projections of broader fiscal aggregates lack credibility, because they are based on unchanged policy assumptions, current laws, or constant shares of revenues and expenditure in output. Budget processes also lack mechanisms to foster debate on policy commitments or guarantees whose fiscal consequences emerge only over the long term; rarely are legislatures required to ration or limit such policies.

Two approaches currently dominate how governments tackle unsustainable policy frameworks. The first is an aggregative approach—drawing on fiscal rules or discretionary policies. Some governments have sought to run fiscal surpluses or at least maintain a fiscal balance over the business cycle—for example, the European Union's Stability and Growth Pact—with the hope that reduced public debt will free up resources to finance age-related spending. Indeed, if debt is repaid and assets are accumulated, governments may effectively earn investment income to prefund future budgetary obligations.

The second approach focuses on the sources of fiscal pressure. In some countries, specific spending programs have been modified to reduce a government's future spending obligations. Easing the pension burden, for example, might involve delaying the retirement age, holding pension benefits constant in real terms (rather than linking them to real wage growth), or reducing benefits in response to increased longevity. France, Germany, Italy, Sweden, and the United Kingdom have taken steps in this direction. For medical care, countries could cut back on eligibility, quality, or quantity of care; make people wait longer for service; or require higher copayments.

What are the principal obstacles to taking a long-term approach? One is uncertainty. Consider how difficult it is to predict 5 years into the future, let alone 25 or 50. Modest changes in assumptions on some key demographic variables can significantly alter projections of future fiscal burdens. For example, higher fertility rates can lead to significant increases in the size of the labor force. But such uncertainty only underscores the need for greater attention to risk management and for analytic techniques that clarify the likelihood and consequences of favorable and unfavorable scenarios. The harder question is whether and how to formulate policies that incorporate potential risks.

A second obstacle is the reluctance of politicians and societies to confront long-term risk factors. Only today's votes matter, even though many voters will be affected in the future by current policies. Politicians find it difficult to ask for immediate sacrifices—especially since it is hard to assure voters that sacrifices today will result in better tomorrows—and are tempted to make promises whose costs will be borne by future generations. A succession of fiscal surpluses may lull voters and politicians into complacency and relaxed fiscal discipline. Since few governments issue bonds with maturities exceeding 15–20 years, capital markets rarely impose an independent counterdiscipline to countries whose policies are unsustainable over the longer term.

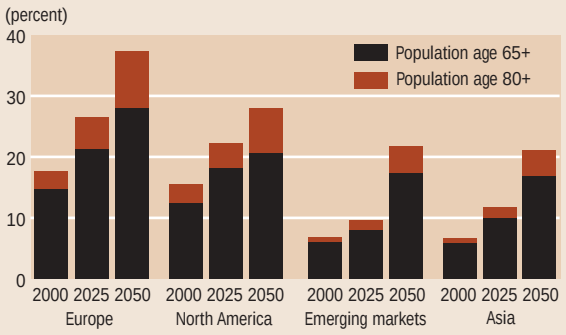
A third obstacle is the complexity of economic interactions. In an interconnected world, the macroeconomic environment is affected both by many countries undergoing similar structural trends and by the policies that countries adopt in response. For example, if many industrial countries increase savings because of aging populations, global interest rates may decline, requiring even higher savings to meet future income requirements.

A final obstacle is that governments may find it difficult to anticipate the behavior of individuals in the face of long-

Chart 1

Getting older

The shares of the elderly in total populations around the globe are rising.

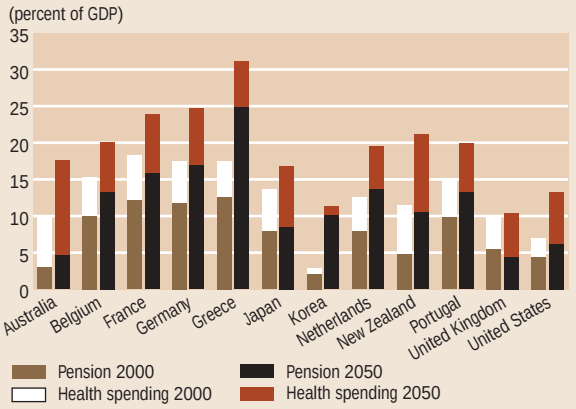


Source: United Nations Population Division, 2003, *World Population Prospects: The 2002 Revision* (New York).

Chart 2

Mounting tab

Aging populations in industrial countries will sharply boost pension and health outlays.



Sources: OECD, 2001, "Fiscal Implications of Aging: Projections of Age-Related Spending," *OECD Economic Outlook 2001*, Vol. 69, No. 1 (Paris); European Commission, Economic Policy Committee, 2001, "Budgetary Challenges Posed by Ageing Populations: the impact on public spending on pensions, health and long-term care for the elderly and possible indicators of the long-term sustainability of public finances," EPC/ECFIN/655/01 (Brussels).

term risks. For example, actions taken to reduce fiscal deficits may be offset by higher private sector spending. At a minimum, authorities need to ensure that the state's financial sustainability is not compromised.

Approaches to reform

So what can governments do differently? Tackling long-term issues requires a multipronged approach. The essential elements include building the long term into economic and fiscal analyses; integrating a long-term perspective into budget processes and institutions; tightening the overall fiscal position over time; downscaling policy commitments early, in a well-telegraphed manner; paying greater attention to risk-management issues; and enhancing policy coordination among countries.

Governments should periodically provide a comprehensive review of the principal structural risks their countries face over the long term—demographic, economic, geopolitical, climatic, natural resource, and security—and undertake an assessment of their *combined* potential fiscal consequences. Long-term projections and sustainability calculations should be supplemented by analyses that can gauge the magnitude and *probability* of risks. Policymakers can then evaluate how much risk is associated with alternative options. Quantitative multicountry general equilibrium analyses can shed light on changes in the global environment, in terms of growth and interest rates.

Governments should improve budget information flows. Accrual accounting techniques can provide cost estimates on the stock of outstanding policy commitments (such as already accrued social insurance benefits of the labor force, the operations and maintenance needs of a government's infrastructure, or prospective government insurance benefit payments in response to insured risks) and the potential obligations associated with contingent guarantees. These techniques can also be used to assess the fiscal consequences of policy actions—such as a change in the eligibility age for a retirement pension—that have little immediate effect on the budget in cash terms but potentially large effects on future budget outlays. More problematic is taking stock of outlays that may arise from what might be termed a government's "implicit commitments"—that is, obligations either inherent in the role of government or based on precedents.

Assessments of a government's potential liabilities are best provided in supplements to the formal budget document and should be recognized as highly uncertain. With such transparency, a government would provide far greater clarity on its prospective fiscal liabilities and its obligations to individuals and society at large. Correspondingly, households would be better informed about the financial burdens that they may have to meet through their own savings.

Governments should overhaul the budget process to better capture long-term risks. This means ensuring that governments undertake the aforementioned analyses and disclose the size of their commitments and exposure to alternative risks. It also means promoting a public debate on their approach to long-term risks. Perhaps an independent budget scorekeeper should be charged with assessing such risks, with the government required to respond in budget debates. Alternatively, the legislature's budget deliberation process might set limits (as recently proposed by the U.S. General Accounting Office) on the creation of future fiscal commitments that exceed a given threshold. Fiscal rules may also help overcome political economy incentives to ignore long-term risks, particularly if they use accrual accounting techniques that take account of long-term effects. And the role of independent fiscal sustainability assessments carried out by multilateral agencies and regional peer group entities, such as the IMF, the OECD, and the European Commission, should be enhanced.

What principles should guide a government if its long-term fiscal position appears significantly at risk, either because of existing commitments or because of future structural risk factors?

Peering into the crystal ball

In 2002, two countries produced long-term fiscal assessments. Australia's *Intergenerational Report* assessed the long-term sustainability of current government policies over 40 years. The goal was to ensure that policy decisions take account of their financial effects on future generations, so that they "do not face an unmanageable bill for government services provided to the current generation." Alternative scenarios focused on demographic trends and rates of growth of health care costs. The United Kingdom's first annual *Long-Term Public Finance Report* provided a "comprehensive analysis of long-term economic and demographic developments and their likely impact on the public finances." The report adds to existing supplementary analyses to the U.K. budget, such as generational accounting estimates and long-term actuarial analyses of the government's pension funds.

The reports of the United Kingdom and Australia, in particular, are path breaking. But they remain deficient to the extent that the range of risks addressed remains fairly narrow. Environmental issues receive little attention and, for many categories of expenditure, future shares of spending in GDP are simply held constant.

Ensure adequate fiscal leeway. Policymakers should leave enough room to use fiscal policy to achieve macroeconomic objectives. For example, if the debt load is excessive, it will be difficult to cut taxes or increase expenditures. Having leeway also ensures that a government can resort to fiscal tools to respond to unanticipated shocks or unexpected developments—such as higher life expectancies and thus higher pension costs—without abruptly reneging on outstanding policy commitments.

Recognize political economy considerations. Medium-term fiscal consolidation—that is, reducing or eliminating the public sector's debts relative to GDP—is central to any long-run strategy. However, an aggregative strategy, particularly if it implies accumulating substantial assets (relative to GDP), is unlikely to succeed, because such surpluses or asset balances are a tempting target for politicians. Equally, it may be unrealistic for a government to presume it will be able to raise taxes to finance future expenditure obligations if the tax share significantly surpasses what is politically feasible.

Adopt micro-level reforms that reduce outstanding policy commitments. Changes in policy program parameters that affect the future path of expenditure commitments may be critical. Policymakers also need to implement reforms with a long phase-in period to facilitate private sector adjustment to reduced government commitments. Regulatory policy reforms may be necessary to shift coverage of some risks to the private sector, or to limit private sector actions that expose a government to fiscal risks.

Consider policy programs that build in flexibility to outstanding policy risks. Recent Swedish and Italian pension reforms are illustrative, as they allow the government to adjust pension benefits periodically in response to changes in life expectancy or interest rates.

Use risk management for sectoral policies. Regulatory and tax/expenditure policies should explicitly consider and delineate the extent of a government's involvement in the case of adverse circumstances and minimize its exposure to losses in the event of such outcomes For example, land-use restrictions or urban settlement policies can reduce the likelihood of damage losses in high-risk coastal areas and reduce the prospect of the government's being forced to pay relief costs. Preventive policies that reduce the likelihood of adverse outcomes can also be important (for example, mitigation policies with respect to climate change and adaptation policies to promote climate-sensitive technologies). Governments should fund research efforts to narrow uncertainty on the likelihood of risky outcomes, particularly if the alternative policy choice would be to undertake immediate costly and irreversible investment outlays.

Coordinate policy at the international level. Some fiscal risks emerge from factors outside the control of a country. Global coordination, whether in terms of mitigation policies for climate change, approaches to migration policy, or financial mechanisms to address financial market failure, may help.

In closing, it is tempting to reduce the problem of long-term fiscal sustainability to the challenges facing aging industrial countries that have overpromised generous social benefits. But the reality is that *all* countries need to take stock of the multiple risks to which they are exposed over the long term and ensure that governments have the fiscal capacity to tackle them. Although the menu of options might suggest a reduced role for governments, the goal is to ensure that governments can deliver on their long-term commitments, continue to provide public goods and welfare assistance, avoid imposing politically damaging and economically disadvantageous tax burdens, and have the fiscal latitude to respond effectively to unanticipated risks. ■

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