Budget time-bomb ticks towards 2000

A budget time bomb is ticking and there is no sign that any political party is really prepared to tackle the problem. This will not explode in the next Parliament, but unless it is tackled soon it will go off early next century, with damaging consequences.

While the Government hints at tax cuts this November and Labour promises to spend more on key areas they are only telling half the story. If this or any future Government does not reduce its spending, tax increases are inevitable.

This is not a problem isolated to the UK. In fact, Britain is in a far better position than most other industrialised countries where governments are also struggling with rising debt levels. Similar anti-inflationary policies have been pursued in most industrialised countries since the late seventies. Central to this has been a desire to reduce budget deficits, as Governments have sought fiscal consolidation

Despite this desire, the debt problem has continued to mount. Government debt to GDP ratios have risen in all industrialised countries. For the 20 major economies in the Organisation of Economic Co-operation and Development (OECD) the overall ratio of gross public debt rose from 39.7% of GDP in 1979 to a massive 72.4% by last year. And it is still rising.

There are two main reasons for this global trend: rising pensions and increasing health care costs. In the UK, social security costs about £90 billion a year, which is 40% of total public expenditure and is equivalent to £15 per working person per day. Economic policies have compounded the budget problem in many countries, as weak demand has led to persistently high unemployment, particularly throughout Europe.

Rapidly ageing populations point to the problem getting worse. Even though Britain has the slowest ageing population amongst the G7 countries, the proportion of people aged over 65 will rise from 15.4% in 2000 to 18.2% in 2020. By then there will be about 2.5 workers for each pensioner, compared with 3.3 today and 5 just after the War when the welfare system was established. In addition to ageing populations the high numbers in full-time education will impose an immense burden on the small number of tax paying workers.

Most governments are trying to tackle high debt levels because of their economic impact, but the social consequences cannot be overlooked. Will the small number of tax paying workers be willing or able to shoulder the burden of pensioners and, if they won't or can't, what will be the consequences for the old or the needy? Already the linking of pensions to prices rather than to earnings has reduced future government liabilities but it could trigger increased hardship for the needy.

The academic literature into this area reaches four main economic conclusions: government deficits are already excessive and will become unsustainable, threatening a financial breakdown as governments try to service increased debt burdens; the solution is to cut spending, not raise taxes; reforms need to be transparent, decisive and equitable; large and growing fiscal imbalances will harm economic performance by imposing unacceptable burdens on future generations.

While governments should seek medium-term fiscal consolidation this should not rule out the scope for demand management when appropriate. If an economy is weak, tackling budget deficits by cutting spending or raising taxes can be pro-cyclical, reinforcing the weakness of the economy, keeping unemployment high. Ironically this is happening now in Europe, reinforcing the need for interest rates to remain low.

What can be done to tackle this problem?

First, the ideal solution is stronger economic growth. Above trend growth would reduce the cyclical component of deficits, boosting taxes and lowering transfer payments. Of course, an economy needs to have a sufficient output gap and spare resources to ensure that any such above trend growth does not trigger an inflation problem. Although the UK's growth prospects are good, it will not be able to grow strongly enough to close the budget gap. More needs to be done.

Secondly, direct government action is required. This can take different formats such as curbing government spending, raising taxes or reducing the welfare and pension burden by raising retirement age or encouraging people to undertake their own private health and pension provisions.

But even a committed government may find it hard to cut benefits, particularly as people now regard them as entitlements. Governments which try to cut benefits may not get re-elected. Similarly, politicians are reluctant to raise taxes. A recent OECD analysis of 15 episodes of fiscal consolidation in different countries found that in two-thirds, the emphasis was on spending cutbacks. Initially it was government investment that was cut, then government consumption with social benefits largely untouched.

This leaves privatising government services and pensions as an area that could become an increasing attractive aspect of government policy. Whichever way one looks at this, it is not good for immediate economic growth: spending cuts or tax increases curb demand, whilst squeezing pensions will push private savings up.

Thirdly, if growth is not strong enough or if government direct action is lacking this leaves the third option, which is either for governments to default or inflate their debt away. Clearly this is not a policy objective, but it is a sign of what could happen if there is no serious attempt to defuse the future budget problem.

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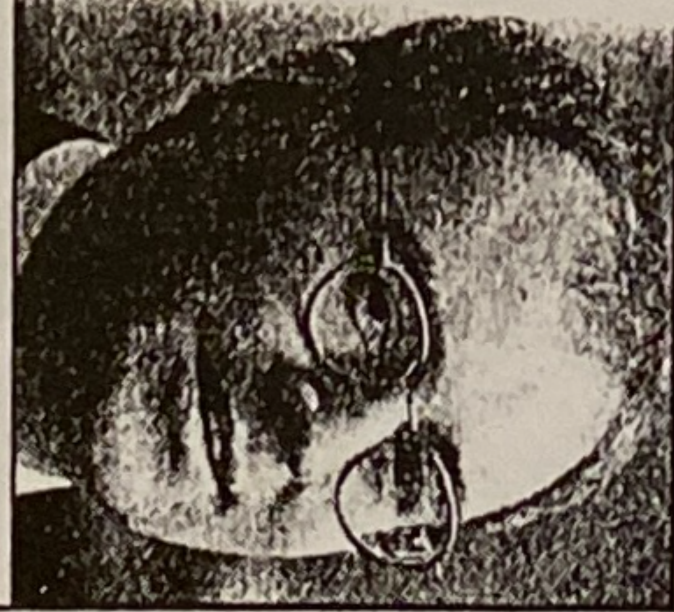
A printing error in last week's column. Service sector employment has not fallen during the last year. It should have read, "Manufacturing employment has fallen this year, whilst the service sector continues to grow healthily, creating jobs. Thus the unemployment rate has fallen steadily to 7.7%."



The Government needs to tackle fiscal problems before tax increases become inevitable, argues **Gerard Lyons**

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