General Discussion: Long-Term Tendencies in Budget Deficits and Debt

Chairman: Gordon Thiessen

Mr. Thiessen: Thank you very much, Kumi. We're now open for questions.

Mr. Bruno: I like the paper a lot and find nothing in it to argue with. On the part dealing with industrial countries, I'd like to add a comment. I'd like to add something to the contrast made between the developing countries and the developed countries, which may be of some relevance to the way we look at industrial countries. And it links up with discussions we will have tomorrow. In the paper, the contrast is made in terms of size of social expenditure, which is much smaller, and the ability of these countries to learn from bad experience in industrial countries. Also there is mention of the lesson that we can learn from a country like Chile. In that context, I think it is important to make another contrast; namely, in developing countries there were large deficits. There still are large deficits, as the paper records. But it is important to note that in many countries, large deficits have been reduced very quickly. One of the reasons may be that the composition of finance is different. In industrial countries, it is mainly domestic debt finance. In developing countries where capital markets are underdeveloped, that option is much less. So you have to resort either to external debt or to the printing press. That, of course, can be sustained as long as the external creditors are willing to sustain it. But once it ends, it comes down in a big crash. A hard landing is very painful and unpleasant. But it may also have a quality side; namely, you can have a clean slate and change things.

I am very doubtful as to whether Chile would have adopted this beautiful scheme that we're all very proud of, if it hadn't gone through that kind of crisis. Is that recommended for industrial countries?

Mr. Thiessen: Do you want to comment on that?

Mr. Shigehara: I hope not.

Mr. Thiessen: Okay, other questions?

Mr. Makin: Thank you. This is for Mr. Shigehara, who has very nicely outlined for us the impact of the interest rate/growth rate differential on debt-to-GDP dynamics. I wonder if the OECD, or perhaps the IMF, has done any simulations on prospective debt-to-GDP ratios in a large industrial country like Japan, where deflation may actually be in the offing?

Mr. Shigehara: That's an issue I think we're going to discuss in the forthcoming meetings within the OECD. I think a very interesting issue relates to deflation, which could become an important factor influencing the debt dynamics in Japan.

Mr. Thiessen: One back there...

Mr. Dugger: Following on the question earlier about the conditions that you need in order to address a profoundly serious fiscal problem: I was struck by the absence of attention to political conditions in the listing of causes of long-term fiscal imbalances. I was impressed by some work in Europe by Tabellini and some others. It may be that just as a profession we tend to shy away from these kinds of things, but their work seemed to indicate fairly clearly that where you have political fragmentation, deficit problems become more acute. It's probably the consequence of political leaders feeling insecure and needing to promise more than ever before. We had a similar kind of fragmentation beginning in the United States in the 1970s. One of the evidences of that was a very, very rapid development of a subcommittee system in the U.S. Congress. This followed right after Kevin Phillips' observations in the late 1960s about the changing political and economic philosophies in the United States. And the question is just—Is this a worthwhile avenue for inquiry?

Mr. Masson: I'm aware of that work, and I think it is worthwhile to pursue. But we tried to identify common factors across a range of countries. So I think that one has to go to other explanations to explain what has happened across all industrial countries. I mean, it wasn't just a particular episode of political fragmentation. So I would say it is worth pursuing, but we didn't think that was the major point in our work.

Mr. Thiessen: I must say, Paul, I was wondering why you didn't give more emphasis to inflation than you did. It seems to me that you can tell a story. You talk about the increased pressure for social spending, and yet you go through the early postwar period without any of that leading to increased deficits. And then all of a sudden in the 1970s, this spending leads to deficits. I must say, and perhaps it's a central banker's bias, I am inclined to look to inflation where suddenly you have gains for the government sector. You know, all of a sudden you've got revenue gains when inflation picks up; you've got the decline in the effective value of the debt; you've got essentially reductions in real interest payments. At the same time, inflation probably contributes to the productivity slowdown. So now you've got a brief period where governments are doing very well; they've got a lot of revenue; there is an inclination to spend; and, as you were suggesting, once the spending occurs it becomes an entitlement and you can't get it down. Subsequently, people adjust to inflation and governments no longer benefit. I must say that's the story when I look at the Canadian data. It seems to fit particularly well, for the federal government at least. How do you react to that?

Mr. Mussa: Sounds like a central banker to me. I think there is an important element of truth in that, but we need to be a little careful. When we look at the United States, it's not only the inflation phenomenon, but defense spending fell from 10 percent of GDP in the 1950s and 1960s to about 5 percent of GDP over the course of the 1970s. And that allowed room for social spending to expand without taxes being raised. Also, without indexing of the tax system, there is a tendency for tax revenue to rise in the presence of both inflation and real growth. Again, as Alan suggested in his opening remarks, because of the effects of inflation and high real growth, the political system didn't need to confront the harsh reality of raising taxes to finance growing public benefits. I think that made it politically easier to get the job done. I think inflation did play a role in that regard. It helped to bring down the level of the debt with a lower level of taxation that would otherwise have been needed for that purpose. Indeed, one could argue dramatically lower. If the old rules had been followed, you would have deflated. That's what happened after the Civil War in the United States, the Napoleonic wars, and so forth. Deflation would have made the cost of buying down the debt substantially greater. Instead they did the reverse, and that opened the fiscal room for social benefit programs that otherwise would have been politically much more difficult to put in place. It would have required even higher levels of taxation. But where we are now in many industrial countries is that the level of taxation has reached the point where very many people say, as Roberto Duran said, "No mas." We don't want any more taxes. And reaching that limit is, I think, an important part of the explanation of why we've had deficits in recent years. The opportunity to do it on the cheap because of inflation, or because defense spending was falling, or what have you, is no longer there. There isn't the popular support or political will to raise taxes to finance the increases in social spending that keep occurring.

Mr. Thiessen: Okay. Time for another question.

Mr. Feldstein: I liked the paper and this is really a comment more than a question. In the paper you make the point that transfers rose because people have retired earlier than they did when the social security program began. Health care costs have risen more rapidly since these programs have been put in place. Unemployment rates—particularly in Europe—have gone up dramatically. Now, I think it's important to emphasize that these were not just unfortunate coincidences. They were a result of the structure of those programs. When you make retirement cheap and when you have high replacement rates, people are going to retire. When you make health care costs free to the consumer at the time of care, the demand for health care will go up, and similarly for unemployment. And so, when we think about why this happened and what can be done about it, the structural redesign of these programs becomes very important.

Mr. Thiessen: Thank you. Probably time for one more. I'm sorry to cut off the discussion so early. Jacob.

Mr. Frenkel: I have three brief comments. First, concerning Michael Mussa's remark that one of the reasons for the growth of government spending reflects the growing demand among electorates for growing government spending: I guess that's right. But it really reflects the failure of governments to convince the electorate that higher government spending means higher taxes. And I am sure that there is no growing popular demand for higher taxes. Second, concerning the role of inflation, I think Michael is right by noting that when inflation has been higher, there has been a capacity to wipe out the debt, but this capacity has probably been reduced now. But connecting with the discussion of tomorrow, I would note that if inflation is extremely high—which we did not see in the industrial countries but we did see in, for example, my own country—then the capacity of the government to borrow in an unindexed fashion also disappears; and the government ends up having to borrow completely indexed debt. That, of course, with this mechanism, eliminates the capacity of inflation to erode the debt. And, finally, we want to get back to Mr. Shigehara, who noted that one of the reasons for the growing deficits is the greater capacity of government to borrow abroad rather than borrow domestically. I am not sure what the implication of it is. I can guess. I assume it is not preventing governments from borrowing abroad, but rather making sure that the information is timely, that the statistics are available, and that all the lessons from Mexico are learned.

Mr. Thiessen: Does anybody want to comment on that?

Mr. Mussa: Yes. In response to Jacob's first comment, I think it is very important to note that, to quite a substantial extent, the increase in government spending on social programs has been matched by increases in government revenue. I think there is an important lesson for developing countries of what is likely to happen as their real income levels rise. The public does demand a high level of social spending. One can, as Marty Feldstein suggests, redesign and re-structure some of those programs to diminish their harmful incentive effects. But the notion of government-sponsored health care for the aged is here to stay and enjoys very broad support of the electorate; and, by and large, people are prepared to pay for it through the increases in taxation that have occurred since the beginning of the century. So governments are in the social spending business in a big way and they're going to remain so. It's the capacity to reduce the growth of those programs, which offers the hope of resolving the budget deficit problem. But we are not going back to where we were in 1900.