Government Debt Is Not a Free Lunch

December 6, 2019

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With borrowing costs at multi-decade lows, governments seemingly can take on much more debt without any great concern about long-term consequences. But the real risks and costs of higher public borrowing may be hidden.

AMBRIDGE – With interest rates on government debt at multi-decade lows, a number of leading economists have argued that almost every advanced economy can allow debt to drift up toward Japanese levels (over 150% of GDP even by the most conservative measure) without any great concern about long-term consequences. Advocates of much higher debt might be right, but they tend to downplay or ignore everything that can go wrong.

First and foremost, the new view of debt understates the risks to other claimants on public tax revenues – such as pensioners, who might be thought of as junior debt holders in the twenty-first-century welfare state. After all, most social-security systems are debt-like in the sense that the government takes money from you now, and promises to pay it back with interest when you are old. And for governments, this “junior” debt is massive relative to the “senior” market debt that sits atop it.

Indeed, governments in OECD countries are currently paying out an average of 8% of GDP in old-age pensions, and a staggering 16% in the case of Italy and Greece Actuarially, future taxes earmarked for paying pensions swamp future taxes earmarked for paying debt by a significant multiple, although many governments have been trying to adjust pensions downward gradually, as Europe did during the financial crisis, and Mexico and Brazil have done under duress more recently. Unfortunately, slow growth and aging populations mean much remains to be done.

Thus, even if it seems that governments can take on much more debt without having to pay significantly higher market interest, the real risks and costs may be hidden. Economists Alan Auerbach and Laurence Kotlikoff made a similar point in an influential series of papers back in the 1990s.

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