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What We Need is a Forward-Looking Fiscal Policy Strategy

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With each month, budget deficit estimates seem to grow. The gap between US government revenue and expenditure now looks to be about 2 per cent of gross domestic product next year. And in Europe, a number of countries are poised to breach the limits set by the growth and stability pact. As concern mounts, the question is what to do about all of this.

There are several options. We can continue to muddle along, trying to find short-term fixes, or we can face the fact that the real problem is not current deficits but unfunded future fiscal burdens. Doing something about these will require creating a broad fiscal framework. Early attempts have misfired but it is important that we redouble our efforts now.

Today's fiscal policy crisis is a clear consequence of the way in which the discussion is framed. By focusing attention on cash flow deficits and accumulated government debt, policymakers have substituted promises that fall due later for current expenditure. Government guarantees made today that fall due on someone else's watch benefit the current political leaders at the expense of future leaders.

This problem is not dissimilar to the monetary policy problem we faced several decades ago. Recall that monetary policy easing brings higher growth and employment before it raises inflation. That short-sightedness brought us the high inflation decades. The solution then was new monetary policy strategies such as inflation targeting, which force central bankers to take the long view. My hope is that we can transfer these lessons to fiscal policy.

Modern governments are primarily engaged in three activities. They provide for protection of the population through a combination of external military and internal security programmes. They are pension funds that support virtually all citizens in their old age. And they are health insurance companies, paying for the medical care of part if not all of the population. And it is the pension and health-care programmes that create fiscal problems.

What is to be done? Following the monetary policy analogy, we need to implement a strategy that forces politicians to take the long view and, instead of focusing on current deficits, focus on a measure of the long-term sustainability of the trajectory of government spending.

The first step is to move away from cash flow accounting and compute a different set of numbers. One is to estimate the net present value of unfunded government obligations over the expected lifetime of someone born today - say, 75 years. The US Treasury computes this every year and it is currently about twice gross domestic product, plus or minus $1,000bn (£640bn). Two-thirds of this is related to healthcare and the rest to the retirement system. Meeting that bill would either raise debt from 30 to 250 per cent of GDP, or force a doubling of federal taxes. In Europe and Japan, the bill is even higher.

So what is the solution? We need a fiscal policy strategy to mirror monetary policy frameworks such as inflation targeting. Most important, we need to stop looking backwards and start looking forwards. The spirit behind the growth and stability pact and the now defunct US Budget Enforcement Act - with their clear limits to deficits and debt - is right but they are clearly misguided in detail. Yes, we need to achieve budget discipline that ties fiscal policymakers' hands, just as a price stability objective ties the hands of monetary policymakers. But we cannot do it by focusing on common deficit and debt measures. Instead, we have to move to things such as the net present value of unfunded liabilities, or the trajectory of tax rates needed to finance future obligations that are already on the

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books.

There would be clear advantages to changing our mindset. A forward- looking fiscal policy strategy ensuring a sustainable long-run budget path all but eliminates pressure to resort to inflationary finance. And, since long-term interest rates depend less on current deficits than on what financial markets' perceptions of the future path of government borrowing are, a forward-looking strategy that manages this path will reduce these borrowing rates at the same time as it makes resources available for private investment. Such a policy is unequivocally pro-growth.

To get things started, here is a proposal for the US. We should restrict federal government revenues to the 40-year average of 19 per cent of GDP and estimated public debt 75 years from now should not rise above 50 per cent of GDP. All current and future tax or spending proposals should be evaluated relative to this objective.