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Assessing the long-term sustainability and inter-generational fairness of government policies

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- **Gross debt is backward-looking and excludes important liabilities, making it an imperfect tool to assess state of public finances. However, it is commonly used around the world, facilitating comparability, and easy to measure precisely.**
- **Other measures can include wider range of liabilities and assets. UK net worth, which includes public infrastructure, stood at £320bn in 2008.**
- **Some liabilities are almost certain, others less so, yet others are based on meeting expectations rather than legal contracts, making it difficult to calculate the government's total liabilities.**
- **Generational accounting assumes current government policies and individual behaviours to remain unchanged forever, and assesses the impact of demographic change on long-term public spending and revenue.**
- **Generational accounting is useful "what if" exercise, which can alert policy makers of challenges ahead. Governments and individuals can and do change policies and behaviours accordingly to avoid undesirable outcomes.**
- **Illustrative accounts for the UK show that the 2008 policy settings were fiscally unsustainable and inter-generationally unfair. Emergency Budget should help to restore long-term sustainability but generational imbalances remain.**

Earlier this week the Office for National Statistics (ONS) and the National Institute of Economic and Social Research (NIESR) presented their latest thinking on the wider measures of public sector debt and how to gauge the fairness of government policy across the generations. The audience consisted of government officials and academics, though unsurprisingly the media were also out in force.

The main objective of the joint work is to increase the transparency of government statistics, in particular those to do with public sector (net) liabilities, and to develop tools to better assess the long-term sustainability of the public finances and the degree of fairness of government policies across the generations. Coming out of the deepest recession in living memory, it is certainly an opportune time to revisit these issues.

Joe Grice, the ONS's Chief Economist, argued that a broader approach than that currently used would help to assess better the true state of the public sector finances. The current approach, which follows international standards, and is based on the rather narrow and backward-looking concept of gross debt, only captures liabilities accumulated up to now; the related concept of net debt deducts the government's liquid financial assets. Public-sector net debt stood at £900bn in early 2010. The current approach excludes many important other liabilities the government might face; equally though, it misses all non-financial assets the government holds, most notably physical infrastructure. The wider concept of net worth, published by the ONS annually in its Blue Book, takes account of these assets. At the end of 2008 the government's net worth position was positive at £320bn.

The concepts can be widened further; for example by including future liabilities arising from past decisions. Some of these will be as good as certain as they are based on legal contracts such as public sector pensions, PFI projects or nuclear decommissioning, others might be less certain as they will be contingent on particular developments (e.g. guaranteeing private sector borrowing). Future liabilities might also arise from social/moral commitments the Government might have entered; social security pensions are a prime example for this. These distinctions matter so that a value of £4trn, which can be calculated by adding all liabilities together - regardless of their legal status or whether they are likely or unlikely to materialise – is likely to show a distorted picture.

While a government might feel morally and socially obliged to pay the Basic State Pension in the future, there are in fact no legal contracts with individuals forcing it to do so. Governments can and do change what they are happy to pay and under what conditions depending on circumstances; the recent changes to the indexation rules or announced increases in the State Pension Age are just two examples. But perhaps there is no legal contract necessary for government to honour its promise: the threat of making itself unpopular with the electorate and losing the next election will in many cases suffice.

If this is true for state pensions, then this is also probably true for other spending areas such as health and long-term care. An even wider assessment of the public finances could thus include all future government spending, which citizens might expect – based on current policies - to benefit from in the future. To balance this, such an assessment should then also include all the taxes citizens might expect to pay in the future. Based on this concept, how do the public finances look like?

This is exactly the question Martin Weale of NIESR and Professor James Sefton (Imperial College) tried to address in the second presentation. Using an approach called generational accounting and assuming that current spending and tax policies (and individual behaviours) would remain unchanged forever, Weale and Sefton projected all government spending and revenue into the future. With the population ageing rapidly, they project the share of pension and health spending in GDP to rise strongly over the coming decades. Taking account of the existing debt stock, they then calculate by how much taxes would have to increase to ensure that the government would remain solvent forever. Their illustrative projections show that the fiscal position in 2008 (their base year) was unsustainable and that the fiscal position would have to be tightened by around 10 per cent of GDP to ensure long-term solvency. This figure is not too far away from the plans of the new Government. But even this tightening is not sufficient to make future generations equally well off. The projections show that someone born today would get a better deal out of the welfare state than someone born in, say, 10 or 20 years' time. Even more tightening would be required to achieve inter-generational fairness. The projections suggest that the UK's public finances are in their current state neither sustainable nor inter-generationally fair. While the former merely confirms what we knew already, the latter adds an important dimension to the debate.

The point of the exercise is not to show that we are all doomed but that policy action and most likely changes in individual behaviours (for example remaining in the labour market for longer where possible) are required to achieve sustainable outcomes in the long term. This is what the new Government intends to do now. Reducing the fiscal gap now should also go some way towards making outcomes fairer for future generations. What the exercise cannot do though is to inform the Government on any short-term policy challenges, including the appropriate speed of fiscal consolidation. This is clearly a limitation and for that other models are required. A model, which could be used to analyse short- and long-term issues, would be a powerful tool to have for government. Watch this space.