Government debt is not a free lunch

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 **writes Kenneth Rogoff**

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Downplaying the risks

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.

Slow growth and aging populations mean much remains to be done

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 ageing 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.

No guarantees that interest rates will fall

Second, and perhaps even more critically, the current complacency regarding much higher debt implicitly assumes that the next crisis will look just like the last one in 2008 when interest rates on government debt collapsed. But history suggests that this is a dangerous assumption. For example, the next wave of crises could easily stem from a sudden realization that climate change is accelerating much faster than previously thought, requiring governments simultaneously to stall the capitalist engine and spend vast sums on preventive measures and remediation, not to mention dealing with climate refugees. And the next global conflagration could be a cyberwar, with unknown ramifications for growth and interest rates.

Big shifts in policy can backfire owing to big shifts in expectations

Moreover, aggressive experimentation with much higher debt might cause a corresponding shift in market sentiment – an example of the Nobel laureate economist Robert Lucas's critique that big shifts in policy can backfire owing to big shifts in expectations. And, frankly, any realistic assessment of current global economic risks must acknowledge that the world's most important economy is in state of political paralysis, with impulsive decision-making leaving it ill-equipped to deal with an outside-the-box crisis should one arise.

The bottom line is that there is no guarantee that interest rates will fall in the next global crisis.

Balancing risk and cost

None of the preceding arguments undermine the strong case for investing now in high-return infrastructure projects (including in education) that more than pay for themselves in the long run. As long as governments adhere to sound debt-management criteria, balancing risk and cost when choosing maturities, today's ultra-low interest rates offer great opportunities.

Debt is not a magic shortcut for giving to the poor without taking from the rich

But the broader claim that issuing government debt has become a veritable free lunch, similar to government profits from currency issuance, has been dangerously overblown. If the aim of government policy is to reduce inequality, the only sustainable long-term solution involves raising taxes on high earners; debt is not a magic shortcut for giving to the poor without taking from the rich.

True, in many advanced economies, current real (inflation-adjusted) interest rates on government debt are below the real rate of economic growth. Presumably, therefore, governments can take on much more debt without ever having to raise taxes. After all, as long as income is growing faster than the stock of public debt, simple arithmetic shows that the ratio of debt to GDP (income) will fall over time.

Not quite so simple

Yet, things are not quite so simple. Interest rates are ultra-low in part because global investors are starved of "safe" assets that will still payout in the event of a sharp downturn or economic catastrophe. But can governments, in fact, provide that insurance for free if there is a risk that interest rates will rise in the next major systemic crisis? A recent International Monetary Fund study of 55 countries over the last 200 years showed that although economic growth exceeded interest rates on government debt almost half the time, this was not a good predictor of whether the surveyed countries were safe from interest-rate spikes in a crisis.

How sure can investors be that they will come first in line in the next crisis?

Last but not least, how sure can investors be that they will come first in line in the next crisis, as they did in 2008? Will the United States government again put Wall Street before Main Street and honour debts to China ahead of obligations to pensioners?

Modern economies have many important uses for debt. But it is never a risk-free option for governments, which is why it should be taken on and managed wisely, even when rock-bottom borrowing costs prevail.

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