There is no such thing as implicit government debt

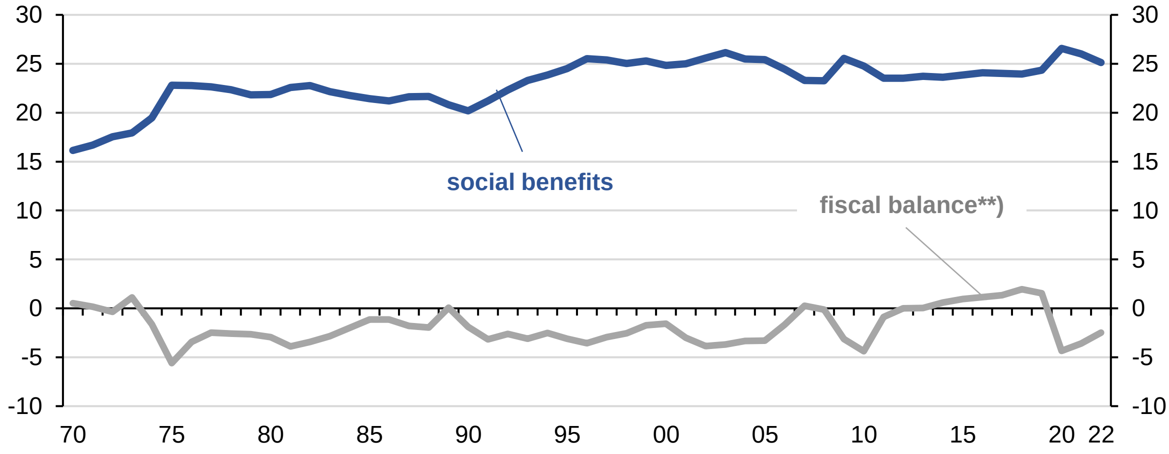
Armissan, September 6, 2023 | *Dieter Wermuth*

A few days ago, Professor Bernd Raffelhüschen and his research assistants at the Universität Freiburg have published a study about the future of Germany's social security system, called "Reputable government? The generation balance (between young and old). Update 2023. Reform ideas for a fair health and nursing care insurance." The authors claim "to have created an instrument for the projection of long-term developments of public finance and their distributional effects."

The main response in the media has been that government debt is considerably larger than those 66 percent of nominal GDP calculated on the basis of the so-called Maastricht criteria of the European Monetary Union. The true number is a shocking 448 percent – rather than 66. Raffelhüschen calls the sum of explicit and implicit debt the sustainability gap, ie, the claims of present and future generations against the state. "Today, non-visible debt accounts for more than 85% of the state's total debt." Dorothea Siems of the Springer Group's daily Die WELT draws the conclusion that "the German government's fiscal policies are increasingly irresponsible."

general government social spending and fiscal balance*)

% of nominal GDP



*) in accordance with ESA 2010, until 1990 West Germany (ESA 1995) - **) the 1995 budget balance is adjusted for wealth transfers in conjunction with the closing of the Treuhandanstalt

source: Bundesbank; own calculation, design & research: Uwe Richter

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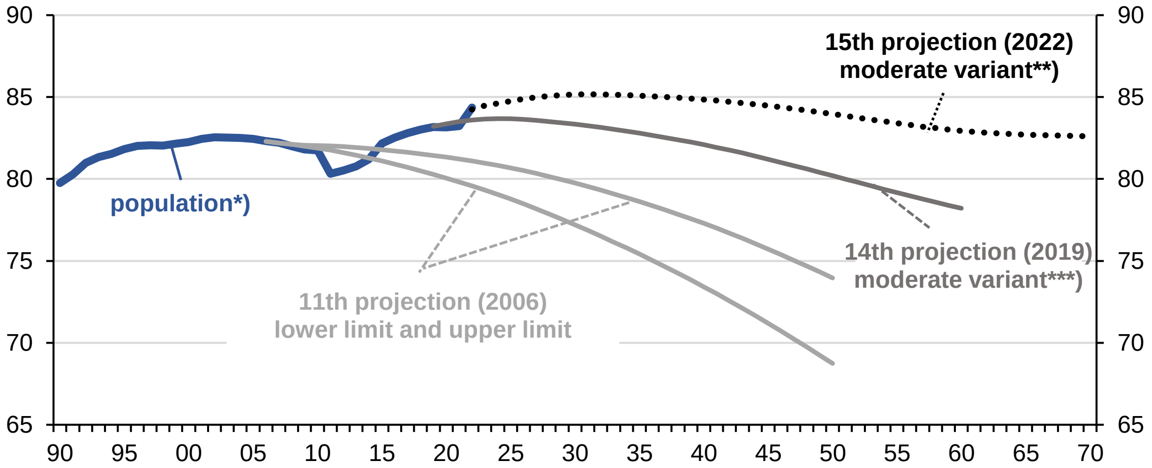
Seriously? So far, the government has no problem servicing its debt. After re-unification in 1990 social spending had jumped steeply to 25.5% of GDP (1996) but has since stabilized around this level and was 25.1% in 2022. Does not look very irresponsible.

But I find it irresponsible to define future government spending as implicit debt. As long as the state is able to reduce its debt service, ie, to cut social benefits or to increase citizens' taxes and fees, it is extremely unlikely that it will default. In its present form the financing of the social security system is very different from genuine government debt – which is based on an explicit and usually non-revocable contract between the issuer and the buyers of the debt (bonds and similar instruments). The terms of the contract cannot be changed retroactively, except by default or restructuring.

population projections for Germany

millions



*) end of year, since 2011 based on Zensus 2011 – **) average net immigration of 290,000 persons per year – ***) average net immigration of 221,000 persons per year

source: Statistisches Bundesamt; design & research: Uwe Richter ©UR

There is, of course, the risk that one day the young may not be able or willing to finance a comfortable standard of living for the old. The number of old people who need support is rising rapidly. But there is also no lack of possible solutions: adjusting the retirement age, financial and structural incentives to increase labor market participation rates of women and old people, raising productivity growth and, most importantly, targeted immigration. It should be possible to invite and integrate something like half a million immigrants per year. This would be just a little more than half a percent of the present population and reverse any trend toward population decline and a rising old-age ratio. Any problems faced by the social security system would simply disappear.

No reason to panic. For many foreigners Germany is an attractive country, rich and safe, where they would like to settle. Instead of worrying about unsustainable implicit government debt and proposing regressive countermeasures such as higher patients' contributions to medical bills, elimination of refunds for dentistry expenses, or higher insurance premia, academic analysts, most of them civil servants themselves, should focus on how to bring about the necessary structural changes.

Two concluding remarks: the news from Freiburg – that the situation of government budgets is not only worse than expected but almost catastrophic – has been totally ignored by capital markets. The yield on long-term bonds remained unchanged at about 2½% and thus well below inflation. It is also worth noting that the analysts have used a real long-term rate of 3% to calculate the present value of future social security deficits. This is an arbitrary number which is not in synch with real government bond yields observed in recent decades. If a rate of, say, 1% rather than 3% were used, the implied deficit would rise to more than 1,000 percent of GDP. What would happen to the perceived solidity of government finances? Probably nothing. In other words: the study is actually pretty irrelevant.

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