Foreword

Peter Heller emphasizes one overriding theme in this important new book: *think ahead* in managing public sector budgets. One might suppose such a message to be superfluous. After all, do we really need reminding that our actions today affect our choices tomorrow, whether in our personal decisions or in our collective decisions regarding a national budget? Yet Heller is thoroughly persuasive in demonstrating that current fiscal practices around the world fall far short of the necessary intertemporal logic and rigor. He goes far to explain why that is so, and why thinking ahead in fiscal affairs is much harder than it looks. Even more important, he shows how governments can improve their fiscal policymaking by adopting new tools for intertemporal analysis and budget implementation. The lessons are so powerful, indeed, that they would do much to transform the practices of Heller's own institution, the International Monetary Fund, in its role of helping countries escape the trap of extreme poverty.

The intertemporal constraints on fiscal policy can be summarized by a government's long-term budget constraint. In one version of this measure, the discounted present value of government spending on goods and services starting today and continuing until the distant future cannot exceed the discounted value of government revenue less the current stock of net government debt to the public. If the government commits to a new program involving increased spending today and in the future, it must pay for that by making offsetting cuts in other areas of spending today or in the future, or by increasing the net present value of its revenue, perhaps through tax rate increases. If these choices are not planned sensibly, a government may well someday find itself resorting in desperation to inflationary financing, which is a tax on holders of the national money, collected without explicit public approval as the government "borrows" from the central bank. Or the government might be pushed into abrupt cuts in future programs or even to a default on its debt servicing, with all of the painful consequences likely to ensue from the collapse of the government's financial credit and credibility. Similarly, if a government accumulates debt in the short term by running budget deficits, it will eventually have to service that debt by increased revenue in the future or by offsetting cuts in the discounted value of its spending. Debt financing may postpone hard choices, but it does not eliminate them.

Heller stresses the complexities that arise naturally from these long-term considerations. Government spending is typically set in programmatic terms, not in fixed dollar amounts determined in advance over several years. The annual flows attached to long-term programs are then appropriated in annual budgets. A government may be committed to providing a certain amount of health coverage without knowing precisely the future demands for health services as the population ages or as health care risks and costs change. A government may be committed to providing a given level of retirement security yet lack a clear sense of the changing age distribution of the workforce and the timing of retirement decisions. Or a government may be committed to a program of income support, for example the purchase of farm outputs at a predetermined price, without knowing how fluctuations in the weather, world market prices, and myriad other factors will affect crop yields and the supply of outputs to government purchase programs. In short, outlays associated with long-term government programs are likely to be highly uncertain. The time path of revenue associated with a given tax system is at least as complex.

The complexities multiply when we set the short-term electoral cycle alongside the long-term fiscal constraints and uncertainties. Politicians notoriously support short-run tax cuts or spending increases for the electoral boost that they offer, without giving their constituents much insight into the longer-term implications. Hard choices are pushed off until after the election, at which point a new election is on the horizon. And it is hard enough for the general public to get a rough sense of the budget at any given moment in time, much less to be able to factor in the consequences of today's budgetary decisions for the distant future.

Heller's book is particularly powerful in reminding us of some of the key drivers of longer-term change in the world economy today—from population dynamics, to climate change, to geopolitical shocks such as global terrorism—and how systematic thinking about those forces can intelligently be incorporated into budgetary debate, planning, and implementation. He reviews in detail how various governments around the world have begun to grapple with the forecasting uncertainties and the politics of intertemporal budgetary planning. And he asks the right questions. How can the public become informed of the relevant long-term trade-offs, so that these can be considered in a democratic manner? What are the best summary statistics with which to convey that information? How useful are novel tools such as generational accounts, which measure the long-term income transfers between generations? And what kinds of institutional constraints (budget rules, reporting rules, or other procedures) are best at limiting the manipulation of long-term budgets for the sake of short-term electoral considerations?

Three issues jump to mind that cry out for Heller's approach. The first is the increasingly erratic performance of U.S. fiscal policy. In just three years—as a result of massive tax cuts, unexpected shortfalls in tax revenue, the bursting of a financial bubble, and the aftermath of September 11—the U.S. budget has gone from projections of unending and massive surpluses to projections of massive deficits for years to come. The overall swings are mind-boggling. In January 2001, just as President George W. Bush was coming into office, the U.S. Congressional Budget Office projected a cumulative "on-budget" surplus (that is, excluding Social Security) of $3,122 billion over 2002–11. By March 2003 the 10-year forecast had shifted to a cumulative on-budget *deficit* of $1,678 billion. Thus in just two years we have seen an astounding, indeed unprecedented, swing of nearly $5 trillion! The projected deficits might indeed be much larger under some plausible assumptions about future policies. One feels, strongly, that the U.S. public has not been fully informed about the implications of the federal government's budget choices in recent years. How are the cumulative deficits to be handled in the future? Will cuts in popular programs be necessary? Will taxes have to be raised again? The issues have hardly yet been joined in public debate, and the multiyear tax cuts have been peddled as short-run stimulus measures.

A second and pervasive fiscal phenomenon is the strain on retirement and health financing as a result of population aging. Most countries rely on pay-as-you-go financing for some or all of their public pension and health systems. As populations age, the ratio of beneficiaries of social support to contributors will rise markedly, putting huge strains on the public financing of these programs. Indeed, the strains are already in evidence. One recent study of the United States, discussed by Heller, suggests that the net difference between government commitments and revenue (net of public debt) is on the order of $44 trillion, suggesting that massive spending cuts or tax increases will be required in the future. The bulk of the shortfall revolves around the costs of pensions and, especially, health care. Although Heller is right to underscore the uncertainties of such calculations, there is no doubt that a first-order fiscal adjustment lies ahead, yet the broad public is mostly unaware of this. The situation in many of the countries of Europe, with generous yet partly or wholly unfunded retirement and health systems, is comparable or even worse.

The third area crying out for Heller's approach is the work of the IMF and the World Bank in the poorest countries, as those countries strive to meet the Millennium Development Goals of poverty reduction. Heller's approach would call upon both institutions to take a much more detailed look at the medium- and long-term fiscal implications of ambitious programs of poverty reduction. The world has committed to helping the poorest countries escape the trap of extreme poverty. That will require massive public investments in roads, energy systems, water treatment facilities, health systems, and education—investments far exceeding any currently being undertaken (thus helping explain why many countries are still mired in extreme poverty). Indeed, the investments required will far exceed the capacity of these governments to finance them out of national revenue. A greatly increased transfer of fiscal resources from the richest countries to the poorest is needed, much closer to the internationally accepted and lauded target of 0.7 percent of donor GNP each year in development aid (the current level is roughly 0.22 percent).

Heller's approach would urge the IMF and the World Bank to prepare fiscal scenarios in line with these required increases. In doing so, these institutions would gain much more clarity about the need to finance such transfers in the form of grants as opposed to loans, and about the need to support much deeper cuts in existing debt. The longer-term implications of bold poverty reduction programs are obscured by the typical three-year framework in which such programs are discussed, and by the lack of recognition so far by many of the richest countries of the need for greatly increased transfers to the poorest. Yet that recognition is likely to come, and Heller's admonitions for long-term planning will then be exactly what is needed.

In short, this is a book to be read, and then to be applied. Thinking ahead is a first and critical step to building a sounder economic future.

Jeffrey D. Sachs
Director
Earth Institute of Columbia University
New York City
August 2, 2003