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The Welfare State Debt Wave Is The One To Worry About

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Rishi Sunak is rightly worried about Boris Johnson's spiralling spending commitments.

Covid-19 brought unprecedented peacetime borrowing. The Office for Budget Responsibility (OBR) forecast that public net debt would jump from £1.8 trillion in 2019 to £2.6 trillion by 2022 – that's from 84pc to 109pc of GDP. It was hoped, though, that as emergency spending stopped and tax revenue flowed again after lockdown, borrowing would plunge, with the Chancellor just needing to be wary of the interest rate risk associated with servicing a debt burden elevated by this one-off crisis.

Permanent new spending is a whole different story. But, in truth, even Boris's habit of green-lighting new funds risks masking a greater public finance threat on the horizon. Just as 90pc of an iceberg lies below the water line, huge contingent liabilities undergird the UK's observable, accumulated debt. It's this coming tidal wave of welfare state spending – the health, social care and pensions promises made to an ageing population – that represents the biggest fiscal challenge of our time.

Every year, the OBR reports the Government finances are on an unsustainable trajectory absent major policy change. Health spending is projected to grow from 7.9pc of GDP to 14.8pc in 50 years' time. State pension spending would rise from 4.8pc of GDP to 6.9pc, and spending on adult social care from 1.2 to 2.2pc of GDP. Without crippling tax hikes, borrowing and debt interest costs would surge, with net debt rising to well over 400pc of GDP.

Nobody is saying this will be allowed to materialise. But these scenarios show how the welfare state bakes in huge fiscal risks as the population ages. Sadly, today's politicians often make these longer term pressures worse. The Government continually provides projection-busting NHS spending settlements, lifting the debt baseline. A growing cohort in Westminster demands taxpayers shoulder more of the future social care burden. Conservative pledges to lower net migration, meanwhile, shrink the working age tax base.

Obviously, the primary problem here is demographic change combined with the pay-as-you-go nature of the NHS and state pension. When a large working-age population of taxpayers finances spending for a relatively small elderly cohort, things work fine. But we test that model to the limit when the ratio of working age people (18-64 year olds) to those 85 and over is projected to plummet from 25-to-1 in 2018 to just 14-to-1 over two decades.

That's not to say today's politicians are inheritees of 1940s' Labour's sins. Our MPs continually compound the problem. The triple lock says that the state pension should rise by the higher of earnings, prices, or 2.5pc every year. Introduced in 2011, it has been described by the OBR as an "upward ratchet", given it guarantees that state pension spending rises against GDP. Yet even after shock after shock hits, it remains sacrosanct.

A "brainwave" of the Liberal Democrats, introduced by the Coalition, and now supported by all, the triple lock already costs £7.9bn per year more than if the state pension had tracked earnings since its inception. Even before Covid-19, its net costs were forecast to rise another £3.2bn per year by 2024.

It's not just the triple lock, though. There are other unjustifiable pensioner benefits. And no politician seems interested in how highly sensitive spending on health and social care is to productivity growth within those industries. In fact, the Conservatives under first Theresa May and now Johnson have seemingly given up on public service reform. Chucking money at them is seen as synonymous with improvement.

Add to this the two "once in a generation" crises we've seen over a decade, along with rising debt levels and slowing growth, and you see how irresponsible it is to ignore this slow-motion demographic fiscal crash. In 2011, the OBR projected public net debt on unchanged policies would hit 107pc of GDP by 2060. Now, they project 336pc for that year.

For some, the answer to all this is obvious: raise taxes. But aggressive revenue proposals won't close the fiscal gap, because tax increases lower the deficit level but not the growth of the deficit induced by ageing. What's more, substantially higher taxes would lower GDP, exacerbating the problem. Nor can you inflate this debt away. The state pension is inflation-protected, after all, and the NHS promises to provide actual costly services and treatments.

That's why, even prior to this recent spendthrift period, the OBR said there needed to be a "decade-on-decade" fiscal tightening of 2.9pc of GDP to stop ever-rising debt. Without eliminating many other government functions, protecting the welfare states requires taxes to jump significantly. Otherwise the OBR says public borrowing except debt interest would rise to 12.7pc of GDP in 50 years. Yet taxes are already headed to their highest post-war level in the coming years.

Might this all blow over? Perhaps we will get extremely lucky. Maybe an unforeseen tech revolution in healthcare will bail us out. But budgeting for a productivity boom in a traditionally slow productivity growth, labour-intensive sector seems imprudent. If anything, some other assumptions from the OBR look overly optimistic.

That only leaves very uncomfortable reforms of age-related welfare going far beyond linking the state pension age to longevity. Abolishing the triple lock, cutting other pensioner benefits, introducing copays for certain NHS services, reforms to encourage productivity in the NHS and social care, more immigration, and greater pre-funding of pensions will probably all be proposed in time.

These reforms would be politically toxic. But pushing them off just worsens the adjustment required. Politicians sometimes talk about the need for long-term thinking. To live up to that, they should worry less about the one-off Covid debts or today's spend-happy PM, and more about the drivers of this looming fiscal time bomb.

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