

1.2 Debt without penalties?

Will low interest rates mean more money for the government? There is plenty to wish for, but money does not grow on trees. Zero debt is not the best debt, but borrowing is only successful if lenders believe that you will be able to repay your debt. The government — that lives forever — can achieve more in this respect than ordinary citizens, but here too the financial scope is not unlimited. Before the capital markets close down tight, high debts take their toll. Although academic scholars do not agree on the exact level at which growth will start to stall, sky-high debt ultimately leads to higher risk premiums in interest rates and to lower preparedness to invest. In addition, it is also wise for the government to create a buffer in the event of a downturn, to avoid having to cut spending if the economic situation changes; and to be able to carry out financial rescue operations in times of acute crisis. Moreover, if the various generations are to be treated equally, population ageing also needs to be taken into account; what today appears to be easy to finance can become rather difficult once more people become ready to 'enjoy' health care and state pensions than there are younger people paying taxes to provide the required revenues. Within the EU, fiscal rules have been made which all parties should adhere to, and one must, of course, set a good example. These are all well-known considerations and constraints to keep public finances healthy, but they originate from other times.¹ What happens when we go back to our times — the era of unprecedented low interest rates?

In a much quoted speech, Blanchard suggested that the welfare costs of high debt could be more manageable now that interest rates are low.² A well-known accounting law teaches us that a public debt does not explode as long as the interest rate is lower than economic growth (and the primary deficit is small enough to ignore it); if you postpone the interest payments, the debt will increase by less than the growth in GDP. And, according to Blanchard, interest rates had recently fallen below the growth rate in the United States and that was historically the rule rather than the exception.³ The risk of crowding out private investment may therefore be smaller than expected for some countries; with a boost now, prosperity may be able to reach a higher level in the future. And as monetary policy reaches its limits and many countries struggle to bring public finances back to pre-crisis levels, additional scope to stabilise the economy is very welcome. And there is more room for productive investments. A disruptive and refreshing new perspective.

As always, the facts are nuanced and rapid conclusions are risky; countries are not all the same, and one year is not like another, nor is the primary deficit always negligible. A simple data analysis for the years 1961–2017 shows that Blanchard's seductive idea for Europe cannot be applied in a straightforward manner.⁴ For example, the average difference between interest rate increases for the 22 largest OECD countries in this period was not negative, but positive: 0.2%. The average for the EU Member States was 0.9%, but for the Netherlands -0.6% (and -0.8% for the period 1951–2017).⁵ Looking beyond the averages, one can see that in about half of the years between 1961 and 2017 the difference is negative. Observations with a negative difference between interest rates and growth represent 49.7% of the sample (Figure 1.7, on the left).⁶ In 51% of the years 1961–2017, there is a negative difference in the Netherlands (66% for the years 1951–2017), but for a country like Germany this percentage is much lower. In addition, the sign of the interest rates and growth

¹ Suyker, W., 2016, Opties voor begrotingsbeleid [options for budget policy], CPB Policy Brief 2016/02 ([link](#)).

² Blanchard, O., 2019, Public debt and low interest rates, *American Economic Review*, vol. 109(4): 1197–1229 ([link](#)).

³ For his calculations, Blanchard uses ten-year interest rate, corrected for tax revenues from paid interest rates; Blanchard subtracts this from the interest rate. This increases the frequency of negative interest rate-growth differences.

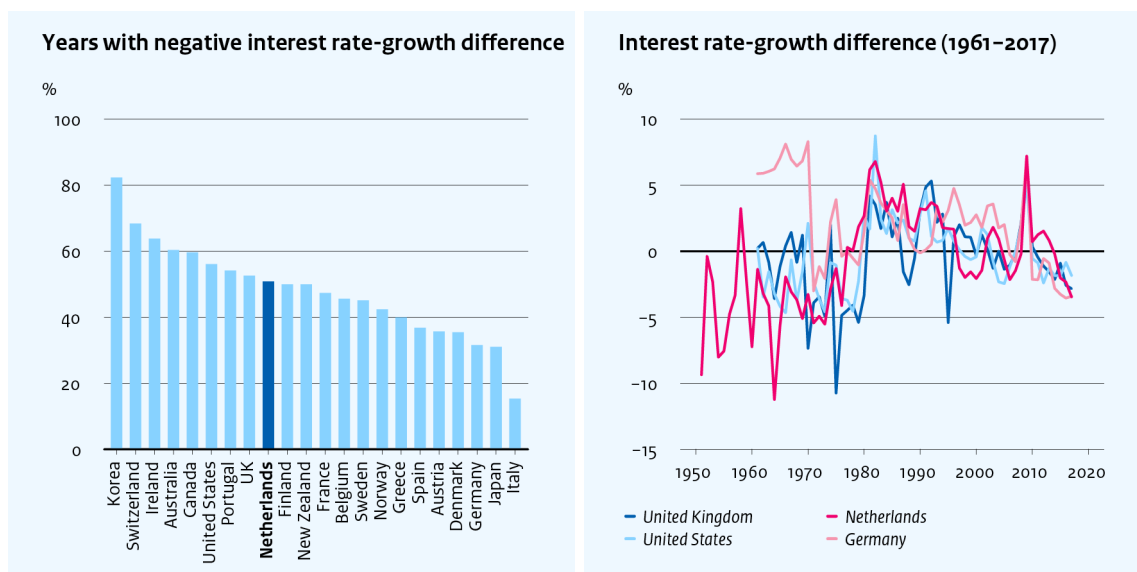
⁴ Data availability for multiple countries is leading for choices made over the period 1961–2017.

⁵ OECD research from the 1990s concludes that the interest rate-growth difference is probably positive for the medium term and long term, see Blanchard, O., J.C. Chouraqui, R. Hagemann and N. Sartor, 1990, The Sustainability of Fiscal Policy: New Answers to an Old Question, *Economic Studies* 15 ([link](#)). New empirical analysis already leans more towards a possibly negative interest rate-growth difference, but does not rule out a positive difference for the long term, see Barret, P., 2018, Interest-growth differentials and debt limits in advanced economies, IMF Working Paper WP/18/82 ([link](#)).

⁶ This analysis is in line with results from Wyplosz, see Wyplosz, C., 2019, Olivier in wonderland, VoxEU ([link](#)).

differential over time fluctuated, considerably (see Figure 1.7, on the right), with alternating periods of positive and negative scores.⁷ In addition to the relationship between interest rates and growth, the other debt increases (the primary balance) are also relevant for the dynamics of debt.⁸ Although debts decrease more often (67.8% of the time) than increase if the difference between interest rates and growth is negative, this is certainly not always the case. If the balance is positive, debts increase more often (68.0% of the time). Figure 1.8 on the left compares the estimated primary balance with the estimated public debt for 2019. For a large number of countries, we see a significant primary deficit in combination with a high level of public debt, which indicates that these countries are not immediately ready to be more relaxed about taking on additional debt.

Figure 1.1 Share of years with negative interest rate-growth differential, and that for the Netherlands, Germany, United Kingdom, United States, 1961–2017



NB: r is the 10-year interest rate.
Source: World Bank, OECD ([link](#)).

If you engage in additional spending or tax cuts in years with negative interest rate-growth differential, then pro-cyclical policy is not inconceivable. Figure 1.8 on the right shows the estimated output gap against the estimated difference for 2019. For most countries, we see that the current negative difference is accompanied by a positive output gap.⁹ That suggests that spending a large amount of money now could have a procyclical effect. But there is, of course, no need or obligation to implement this policy on an annual basis. In fact, estimating the economic situation is difficult, implementation takes time.¹⁰ In other words, good reasons for medium-term policies with automatic stabilisers rather than active budget policies.

Traditionally, the Netherlands has opted for a structural focus, with a view to the future. Debt is entered into for a longer period of time. This does not mean looking blindly at today's figures, but thinking about

⁷ For example, the interest rate–growth difference in the 1980–2017 period came to 1.3% for the Netherlands.

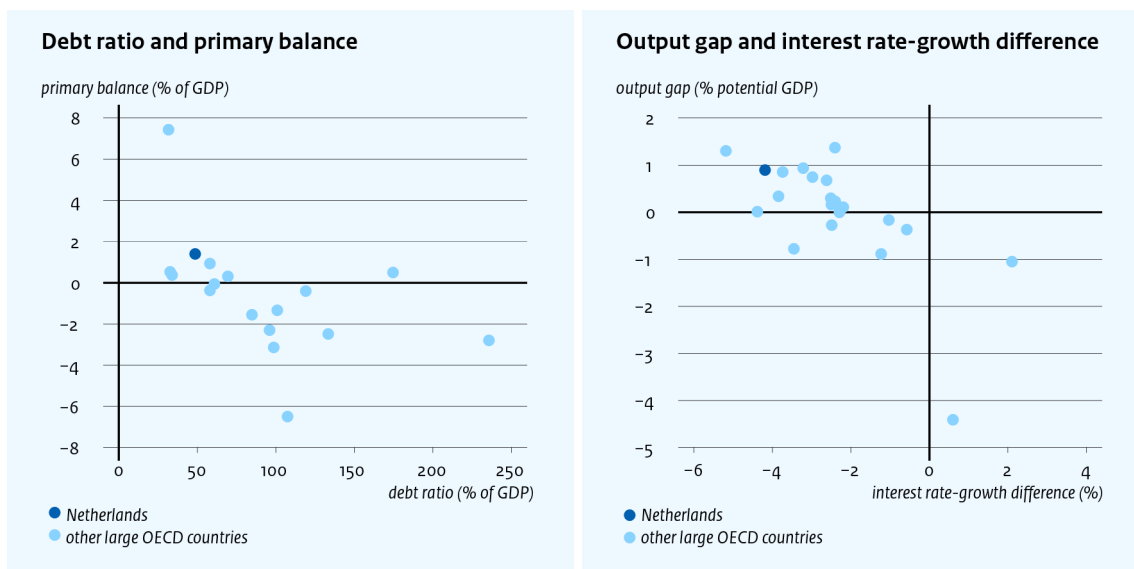
⁸ Source: World Bank, OECD. Wyplosz, C, 2019, Olivier in wonderland, VoxEU ([link](#)) contains a similar table. Cochrane, J, 2019, The value of government debt, NBER Working Paper 26090 ([link](#)) shows that part of the variation in debt ratio is ex ante linked with the variation in the discount rate. It does not find a connection ex post.

⁹ The ECB has a similar analysis, see Checherita-Westphal, Interest rate-growth differential and government debt dynamics, ECB Economic Bulletin, Issue 2/2019 ([link](#)).

¹⁰ See Hers, J. and W. Suyker, 2014, Structural balance: a love at first sight turned sour, CPB Policy Brief 2014/07 ([link](#)).

what the world may look like in the long term and what that would mean in terms of the here and now. Projections are difficult, especially when it comes to the future, but we are not completely naive.¹¹

Figure 1.2 Relationship between debt ratio and primary balance in 2019 (left) and interest rate growth differential and output gap in 2019 (right)



Source: IMF World Economic Outlook database, OECD, AMECO ([link](#)).

For example, we know that the Netherlands is ageing and that this is putting pressure on the primary balance and the debt. The ageing of the population is already making itself felt and the size of this cohort of the population can be predicted relatively well. Provisions such as pensions and care offer the prospect of a dignified old age, but they do have to be paid for. The ratio between active and inactive citizens is becoming more unfavourable for this purpose. Looking only at interest rates and growth figures presents a short-sighted picture.

A prudent outlook also takes into account the systematic risk in an economy and therefore uses a risk-weighted discount rate.¹² For example, the tax base is not a stable factor, but rather depends on the economy, the capital markets and the mobility of the tax base. The economy is growing thanks to education, innovation, risk-taking and entrepreneurship — typical activities that involve uncertainty and ups and downs. Some of the future taxes in the Netherlands also depend on the return on pension capital. Pensions are only taxed with income tax when they are being paid out, and VAT and excise duties are levied when this income is consumed. CPB's calculations related to ageing explicitly take these uncertainties into account by using a higher discount rate for future budget flows than that of the risk-free interest rate. The risk-weighted discount rate is also decreasing, but for now remains higher than the growth rate.¹³ Only glancing at the risk-free interest rate would mean you would be skirting around the problem of the uncertain future.

¹¹ This quote is attributed to many people, yet the person who coined the phrase remains unknown ([link](#)).

¹² Working group on discount rates 2015 ([link](#)).

¹³ The ageing study will include an update of the relevant risk-weighted discount rate and growth rate. The discount rate is determined by the wealth and debt of Dutch households, see the methodology of the Working Group on Discount Rate, 2015, ([link](#)). Based on the estimated yields by the Commission Parameters, 2019, ([link](#)) and other current data suggest a risk-weighted discount rate larger than the growth rate.

So, what would be the solution? Subtle facts do not lend themselves to drawing dazzling conclusions.

Finding the right viewpoint is difficult. The ageing calculations at the time of the Coalition Agreement showed a certain deficit and there is no reason for optimism with respect to the December update.¹⁴ A lower discount rate may make it easier to find a project with a positive cost-benefit analysis (CBA).¹⁵ Unfortunately, a lower discount rate also means it is more difficult to make public finances sustainable, as the return on the piggy bank for later (for the costs related to ageing) will be lower. And an investment that increases the productivity of the economy leads to larger financial resources in the future, but also, counterintuitively, to a deterioration of sustainability.¹⁶ Many public expenditures are linked to growth or wages, resulting in higher productivity leading to more public spending, higher health care costs, higher wages and higher indexation of the state pension. Passing this larger financial resource on to a growing population cohort of elderly people is therefore more expensive.

At the same time, the current nominal interest rate is low or even negative, partly due to low risk premiums on government bonds, and the markets think that this will continue to be the case for some time to come. The reputation of the budget hawk is paying off. The Dutch debt (49.3% of GDP this year and 47.6% next year) is relatively low, whether you look at EU regulations or the desired buffer in case of crisis. Irrespective of whether analyses show that the Netherlands is more sensitive to shocks than an average economy, we can handle it.¹⁷ Internationally as well, for years, the Netherlands has had a substantial surplus on its current account. The European fiscal rules contain arrangements for financing the transition costs in the event of a structural reform. Opting for incidental budget entries means the primary balance will not be subject to a structural burden.¹⁸ And if these temporary plans are funded via long-term financing, the current interest rate can be fixed for a considerable period of time. A deviation from the Musgrave criterion of equal arrangements for future generations — the standard in the calculation on ageing — is ultimately a political choice, in certain forms (productivity, environment) perhaps less vulnerable to generational debate than in others.

A route of temporary impulses is not without risk. Capital markets do not believe in fairy tales, and voters are not fooled: there is no such thing as free money. There are risks involved in investing, and this applies to the government as well as to the business community. In addition, the government can often only partially turn the proceeds of profitable public investments into ready cash for the budget. Furthermore, nothing is as permanent as a temporary measure. The United States has many temporary tax reductions that are continued indefinitely, and the Netherlands is not lily white on this point either.¹⁹ The problem of perpetual temporariness is, of course, less acute in the case of measures that have an intrinsic end. Certain parts of the energy and climate transition may meet these requirements. Experience has also shown that the distinction between intensification and investment — at first so clearly visible — fades over time. Fiscal rules and funds may offer protection against this type of temptations, but the more sophisticated the rules, the more difficult compliance appears to be. The road to hell is paved with good intentions 😊.

¹⁴ See CPB, 2019, *AOW variant en Arbeidsaanbod*, CPB Communication, 5 June 2019 ([link](#)). This states: 'From the presented partial effects no conclusion can be drawn about the size and direction of the adjustment of the sustainable balance later this year. It is expected that certain other developments, such as in health care, will have an opposite and possibly larger impact of the sustainable balance.' The positive effects indicated in the partial analysis have since largely been implemented.

¹⁵ The discount rate is weighted against the capital shares of the relevant portfolio and, therefore, is not identical for CBAs or studies on population ageing.

¹⁶ See CPB, 2014, *Minder zorg om vergrijzing* [Fewer worries about population ageing], CPB Book 12 ([link](#)). Particularly, see Section 5.2.2.

¹⁷ See the Budget Memorandum 2019, Appendix 18, *Schokproef overheidsfinanciën 2019* [shock-proof public financing] ([link](#)).

¹⁸ And hardly the long term sustainability of public finances..

¹⁹ The temporary IOW has been extended multiple times, the reduction in health insurance subsidy postponed each time. The temporary lowering of VAT for labour-intensive services has become structural.