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Mounting Medical Care Spending Could Be Harmful To The G-20's Credit Health

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Steadily rising health care spending will pull heavily on public purse strings in the coming decades. If governments do not change their social protection systems, they will likely become unsustainable, in Standard & Poor's Ratings Services' view.

Population aging will lead to profound changes in economic growth prospects for countries around the world, we believe, as governments work to build budgets to face ever greater age-related spending needs. Governments' main policy actions so far have consisted of increasing pension outlays. We believe that getting a firmer grip on rising health care spending is at least equally important.

Overview

- We generally expect population aging, together with medical advances, will continue to push up spending on health care, already one of the costliest budget items for many governments.
- Advanced G-20 economies in Europe, in particular, have only narrow room for maneuver in managing health care spending, compared with emerging economies, where demographics and economic growth are still slightly more favorable.
- Nondemographic factors, such as technology and treatment coverage are a significant driver of health care costs.
- Mounting health care spending, if not managed through policy initiatives, would hurt G-20 sovereign creditworthiness, based on our scenario analysis for the 2010-2050 period.

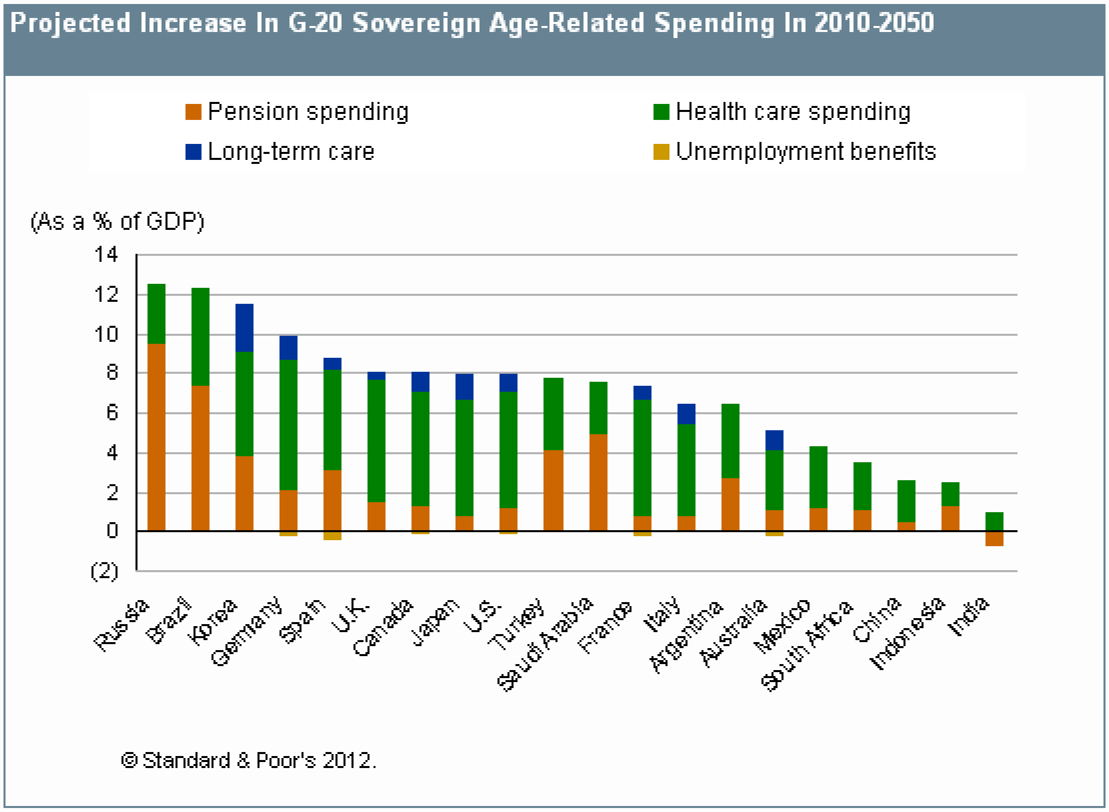
Most G-20 advanced economies simultaneously face significant changes in their policymaking across the board, which we believe leaves them with limited leeway to act on health care spending. In contrast, most G-20 emerging economies may have more flexibility to consider their policy options. However, because nondemographic factors are the main impetus behind future rises in health care spending, we believe that efforts to tackle mounting health care spending and to make changes to social protection systems will be especially relevant in advanced economies' policymaking in the coming decades, in underpinning the long-term sustainability of government finances.

(For related Standard & Poor's research on the impact of demographic-related spending pressures on sovereign creditworthiness, see "Global Aging 2010: An Irreversible Truth," published Oct. 7, 2010.)

Most G-20 Emerging Economies May Have A Slight Edge Over Advanced Economies In Managing Rising Health Care Costs

We think governments' fiscal burdens will increase significantly, with the highest deterioration in public finances in 2010-2050 likely to occur in Europe and in other advanced G-20 economies, such as Japan and the U.S. These countries already have what we view as high existing social protection and rapidly worsening demographic profiles (see chart 1).

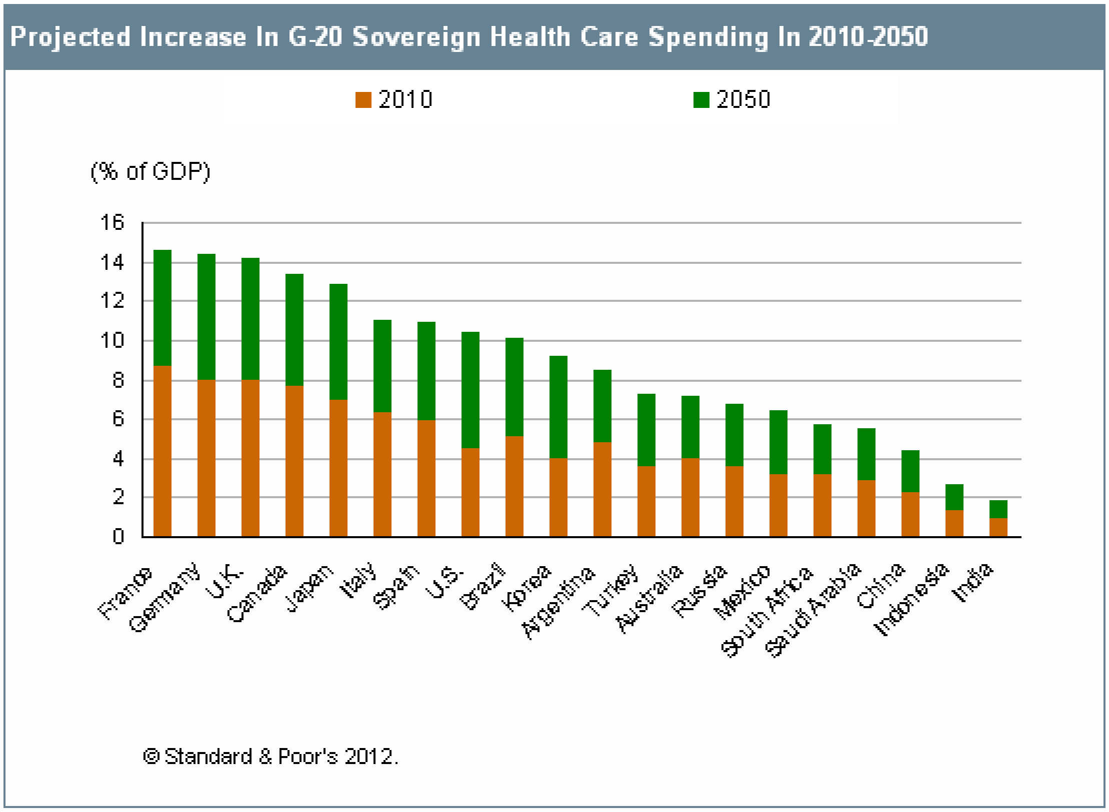
Chart 1



While pensions look set to remain the biggest expense item in the budgets of advanced G-20 economies, health care will likely be the fastest growing expenditure in the coming decades. Without policy changes, health care spending in a number of advanced economies, such as Germany, the U.S., the U.K., and France, will increase by around 6% of GDP by 2050. We project that health care costs for a typical advanced economy will stand at 11.1% of GDP by 2050, up from 6.3% of GDP in 2010(see chart 2).

We think some G-20 emerging economies may have a small advantage over their advanced counterparts when it comes to managing rising health care expenses. Emerging market sovereigns, especially in Southeast Asia, still have more favorable demographic dynamics and economic growth. Consequently, these governments may have more time to consider their policy options, although they must also find a way to design programs that are fiscally sustainable as their populations continue to age. Already, our analysis suggests that the need in some emerging market sovereigns to address demographically-driven budgetary challenges is hardly less pressing than in some advanced economies.

Chart 2



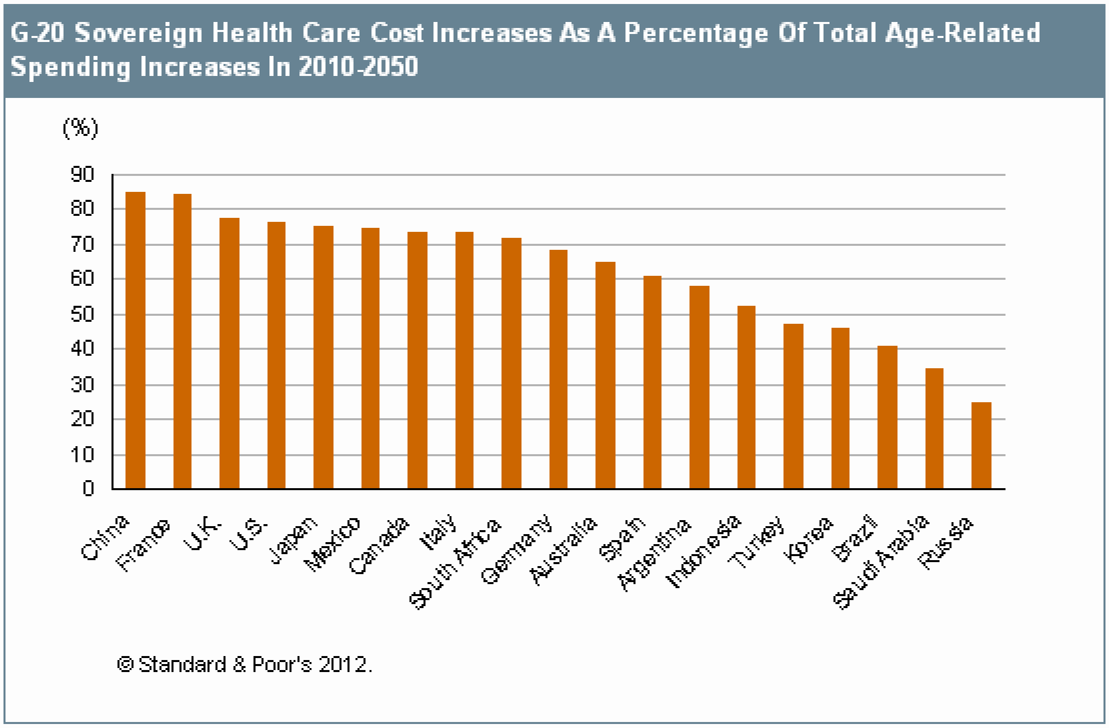
Nondemographic Factors Are The Major Contributor To Increases In Health Care Spending

In addition to the demographic shift behind the swell in the number of users of health care services, nondemographic factors such as the costs of evolving technology and treatment coverage are fueling the rise in health care expense. A 2010 study by the International Monetary Fund indicates that, unlike with rising pension costs, two-thirds of the projected increase in health care spending is due to nondemographic factors. The projected high increase in health care spending, compared with that of pensions, also reflects the incorporation of pension reforms into pension projections and the lack of reform efforts in health care so far.

In addition, we believe that the dominance of nondemographic factors in projected health care spending may contribute to a slower pace of reforms in this area. In our opinion, these nondemographic factors carry lower long-term visibility on budgetary challenges for policymakers than the generally rather predictable parameters of other social outlays, such as long-term care and unemployment benefits.

The projected growth in health care cost increases as a percentage of the total increase in age-related spending in the coming decades illustrates the challenging upward trends in health care spending. Health care spending represents the majority of the total increase in age-related spending in more than half of the G-20 advanced economies (see chart 3). It exceeds 60% in a large number of countries, including France, the U.K., the U.S., Japan, Canada, Italy, and others. To us this is yet another indicator that, in general, policymakers have focused more on other areas of age-related spending--particularly pensions--at the expense of health care costs, to improve the long-term sustainability of social protection systems.

Chart 3



Age-Related Spending Increases Will Have Adverse Effects On G-20 Sovereigns' Creditworthiness Without A Policy Change

Without additional policy measures, the projected increases in age-related spending will represent a large burden for public finances and will weigh on sovereign creditworthiness. Under our hypothetical no-policy-change scenario for 2010-2050, we assume G-20 governments will refrain from adjusting their fiscal stance or any policies on age-related spending. In other words, the governments will take no additional steps to manage age-related spending, except for borrowing for budget shortfalls. We foresee gradually increasing total government expenditure and burgeoning budget deficits as age-related outlays creep upward and interest costs rise on the back of growing national debt. In this scenario, most G-20 advanced economies will likely face ballooning government debt, while several emerging economies post far lower comparative debt ratios by 2050, owing to less of a squeeze on budgets from population aging (see table 1).

Table 1

Simulated G-20 Net Government Debt In 2010-2050 Under Standard & Poor's No-Policy-Change Scenario

	Ranking in 2050	Net debt in 2030 (mil. €)	Net debt in 2050 (mil. €)
Japan	1	314	729
Russia	2	142	585
U.S.	3	209	472
U.K.	4	178	401

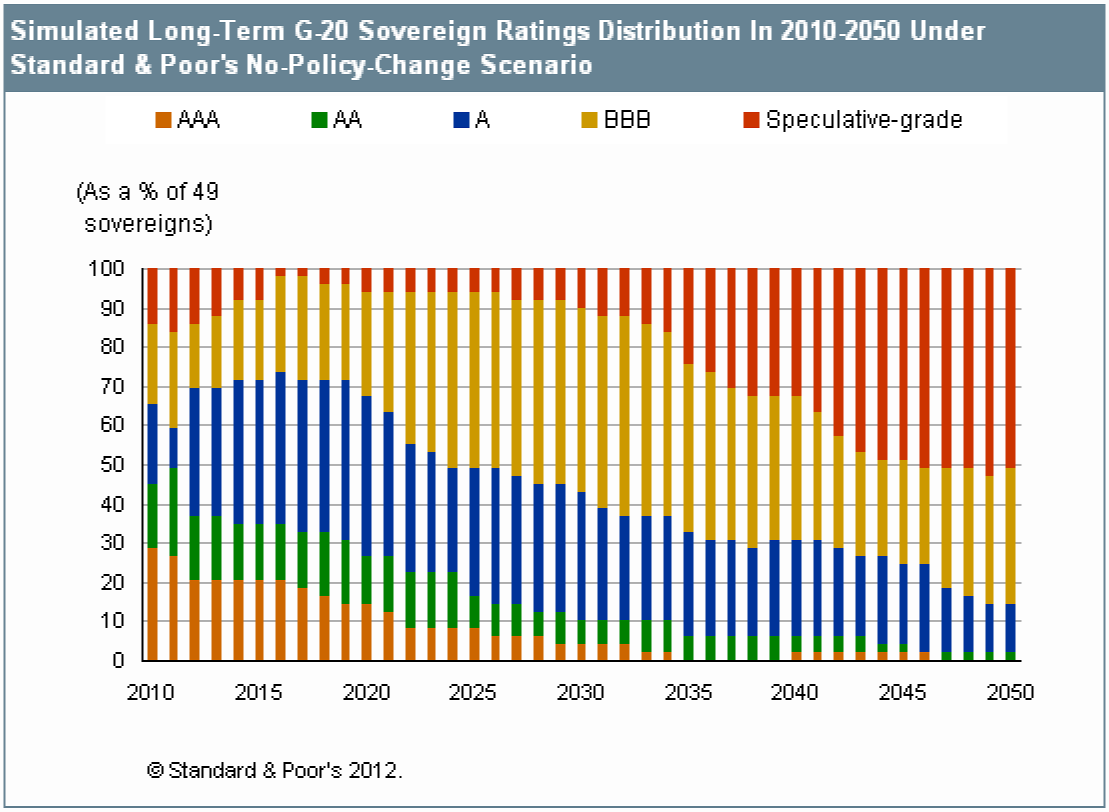
Table 1

Simulated G-20 Net Government Debt In 2010-2050 Under Standard & Poor's No-Policy-Change Scenario (cont.)			
Spain	5	139	388
France	6	164	367
Germany	7	127	340
Italy	8	135	277
Mexico	9	59	144
Korea	10	7	139
Turkey	11	39	119
South Africa	12	58	119
Canada	13	32	115
Argentina	14	34	110
Brazil	15	12	107
China	16	31	83
Australia	17	12	73
India	18	63	67
Indonesia	19	16	34
Saudi Arabia	20	(83.2)	(40.2)

Source: Standard & Poor's.

Under our no-policy change scenario, we have simulated hypothetical sovereign rating trends. Based on our view of mounting public debt, we see collective deterioration in the hypothetical sovereign ratings in our sample (see chart 5). To discern a broader trend, we added 29 other world economies to the G-20 group. Our simulation shows that downgrades would start in 2015 and would include a number of highly rated sovereigns. Although the downward drift is impressive by any standards, equally noteworthy is that the change in our hypothetical ratings would not be linear over time. Ratings in general would weaken somewhat in the second part of this decade, while at the same time the number of sovereigns with speculative-grade ratings would decrease until 2020. The projected downward transition in sovereign ratings would then dominate along our entire rating scale beyond 2020, when the full budgetary impact of population aging kicks in.

Chart 4



Our Alternative Scenarios Show Potentially Stronger Fiscal Performances And Rating Trends

In order to assess the impact of future trends on governments' fiscal performance and hypothetical sovereign rating trends, we have simulated two alternatives to our no-policy-change scenario.

Scenario I: Age-related spending reforms without health care reform

In this scenario we assume that governments enact legislation to fully contain future increases in age-related spending over the 2010-2050 projection period, illustrating the benefits of reform measures. However, they do not tackle health care spending. As such, the scenario captures in isolation the effects of no health care reform.

Compared with the no-policy-change scenario, we see the following potential outcome: Overall sovereign debt will be lower, but sovereigns with relatively high current government deficits and higher projected increases in health care spending will see their debt burdens grow faster than those of their peers with more balanced budget positions or lower health care spending increases, despite efforts to eliminate future increases in other age-related spending.

The relatively small differences in the debt ratios that we calculate in the no-policy-change and first alternative scenario for a number of countries confirm the importance of health care cost growth versus total age-related spending in France, Japan, the U.S., and the U.K., for example (see table 2).

Table 2

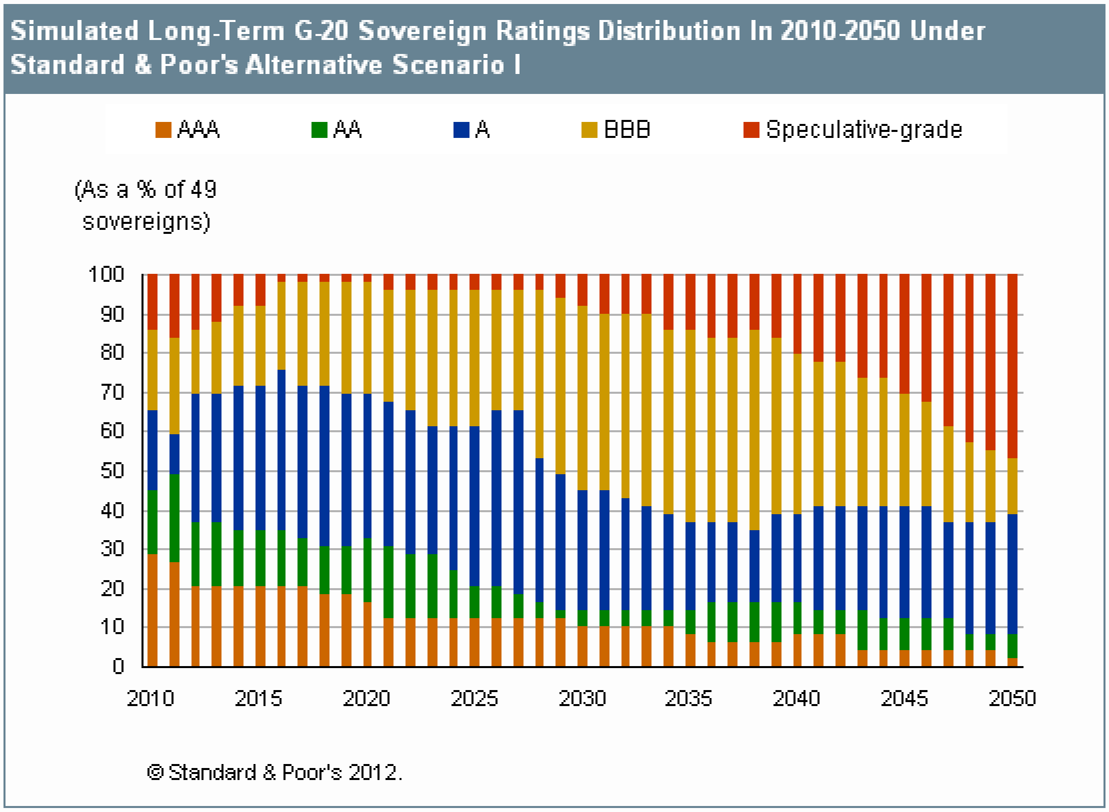
Simulated G-20 Net Government Debt In 2010-2050 Under Standard & Poor's Alternative Scenario I

	Ranking in 2050	Net debt in 2030 (mil. €)	Net debt in 2050 (mil. €)
Japan	1	309	698
U.S.	2	196	418
Russia	3	106	396
U.K.	4	170	360
France	5	170	359
Spain	6	129	324
Germany	7	117	270
Italy	8	128	228
South Africa	9	53	99
Mexico	10	43	95
Argentina	11	33	78
China	12	29	75
India	13	59	70
Canada	14	13	51
Australia	15	8	41
Turkey	16	16	36
Indonesia	17	12	18
Brazil	18	5	14
Korea	19	(-17)	(-1)
Saudi Arabia	20	(-83)	(-49)

Source: Standard & Poor's.

Looking at our hypothetical sovereign ratings under this alternative scenario, versus the levels in the no-policy-change scenario, the large budgetary impact of projected health care spending increases relative to total age-related outlays The collective deterioration in the hypothetical ratings on the sovereigns in our sample is only slightly less severe than under our no-policy-change scenario (see chart 5). In our view, this means that even if the governments enact legislation to fully prevent other age-related outlays from growing in the 2010-2050 period, the probable increase in projected healthcare costs alone is so substantial that the impact of these reform efforts would not be enough to meaningfully reverse the resulting credit deterioration.

Chart 5



Alternative scenario II: Balanced budget and age-related spending reforms without health care reform

We assume in this scenario that governments enact legislation to fully contain future increases in age-related spending over the 2010-2050 projection period and balance their budgets by 2016, while initiating no health care reforms. This scenario balances the effect of no health care reform with budgetary consolidation and structural reforms of other age-related costs. The improvement in hypothetical net debt compared with the levels in our two previous scenarios is particularly marked in countries that currently have large general government imbalances, such as the U.S. or the U.K. (see table 3). For governments currently generating surpluses, like Saudi Arabia, this scenario is equivalent to a loosening of fiscal policy and therefore has a negative budgetary impact. Based on this scenario, we believe budgetary consolidation of currently large deficits and simultaneous implementation of age-related spending reforms could offset future increases in health care costs.

Table 3

Simulated G-20 Net Government Debt In 2010-2050 Under Standard & Poor's Alternative Scenario II

	Ranking in 2050	Net debt in 2030 (mil. €)	Net debt in 2050 (mil. €)
Saudi Arabia	1	89	428
Japan	2	111	138
Germany	3	58	110
Korea	4	15	92
France	5	61	87
Canada	6	27	84
U.S.	7	50	70

Table 3

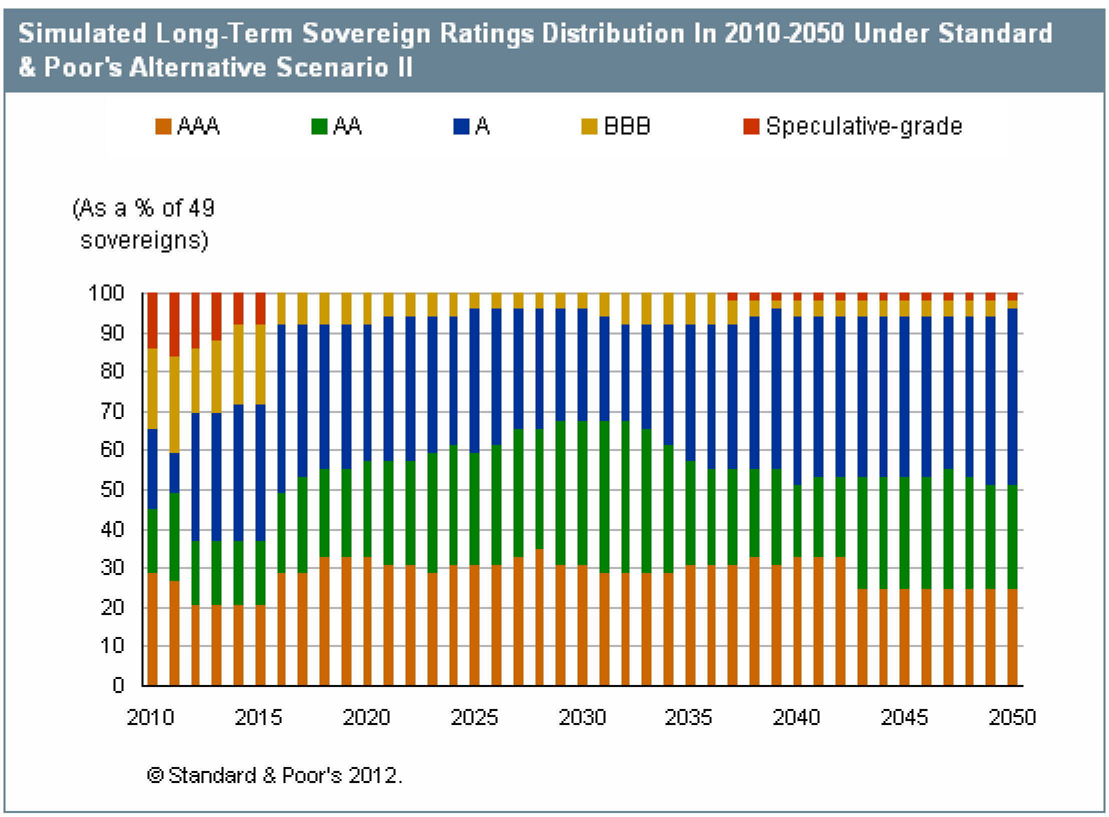
Simulated G-20 Net Government Debt In 2010-2050 Under Standard & Poor's Alternative Scenario II (cont.)

U.K.	8	46	60
Spain	9	36	58
Italy	10	63	50
Australia	11	9	41
Argentina	12	12	32
Mexico	13	13	26
China	13	8	26
Brazil	15	10	23
Indonesia	16	4	2
Turkey	17	0	0
South Africa	18	5	(5)
India	19	1	(23)
Russia	20	(69)	(51)

Source: Standard & Poor's.

The results of this scenario also point to overall stabilization of our hypothetical sovereign ratings, albeit with some weakening as the percentage of ratings in the lower investment-grade categories increases (see chart 6).

Chart 6



What Remedy Against Escalating Health Care Spending?

Given the magnitude of health care costs and the country-specific set-up of health care systems, we believe there is no one-size-fits-all solution to curb future spending increases. Health care spending reforms so far have included measures on both the supply and demand sides:

- Streamlining health care system, through broader use of technology, containing costs of medical prescriptions, and discouraging abuses of the system;
- Changing the balance between public and private sector financing and provision of services; and
- Reducing the scope and generosity of coverage.

As market pressures push policymakers to embrace budgetary consolidation, governments are implementing health care system reforms such as those listed just above. This is particularly true in Europe, where the ongoing sovereign debt crisis and emphasis on government spending restraint are also pulling the attention of governments. Health care reforms in Europe have strained relationships between governments and their electorates and are severely testing social cohesion.

However, there are benefits to continuous and early implementation of health care reforms. If governments change the scope of public health care provision soon enough, it could help spread the burden of adjustment across generations of taxpayers and voters. Moreover, as the demographic profile of electorates ages further in the coming years, the political climate for reforming pension and health care spending may become even more difficult than it is now.

Implementing structural reforms that concern social protection systems is never easy. However, the alternative could present even greater obstacles.

Related Criteria And Research

- Global Aging 2010: An Irreversible Truth, Oct. 7, 2010
- Global Aging 2010: An Irreversible Truth--Methodological And Data Supplement, Oct. 7, 2010
- From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies, Washington D.C., International Monetary Fund, Fiscal Affairs, Department, April 30, 2010 (http://www.imf.org/external/np/pp/eng/2010/043010a.pdf)

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