COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 12.10.2006
COM(2006) 574 final

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT

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{SEC(2006) 1247}

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1. LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES AND BUDGETARY SURVEILLANCE AT THE EU LEVEL

In the coming decades, the size and age-structure of Europe's population will undergo dramatic changes due to low fertility rates, continuous increases in life expectancy and the retirement of the baby-boom generation. Ageing populations will pose major economic, budgetary and social challenges. It is expected to have a significant impact on growth and lead to significant pressures to increase public spending[1]. This will make it difficult for Member States to maintain sound and sustainable public finances in the long-term. This is of particular importance in Economic and Monetary Union, as high deficits and rising debt in some countries leading to unsustainable public finances might have an adverse impact on macro-economic conditions for other EMU countries. Therefore, ensuring fiscal sustainability requires time-consistent policies, which involves addressing budgetary imbalances before the budgetary impact of ageing sets in.

Successive European Councils have recognised the need to address the implications of ageing populations at European level. In particular, the Stockholm European Council decided in March 2001 that *'the Council should regularly review the long-term sustainability of public finance, including the expected strains caused by the demographic changes ahead'*. In the renewed EU Sustainable Development Strategy, the June 2006 European Council stressed the important challenge to public finance of an ageing population and proposed continued EU support to the efforts by Member States to modernise social protection systems and ensure their sustainability. Following the indications of the European Council, the Commission and the Council now examine the long-term sustainability of public finance as part of the regular multilateral budgetary surveillance, reflecting the increased emphasis on the link between medium-term budgetary strategies and long-term fiscal sustainability issues.

Indeed, the ECOFIN Council stressed in its report of 20 March 2005 on the reform of the Stability and Growth Pact (SGP) that in the surveillance of budgetary positions, sufficient attention should be given to debt and sustainability so as to safeguard the sustainability of public finances in the long run, and that the link between long-term sustainability concerns and medium-term budgetary planning needs to be strengthened.

In 2003, the ECOFIN Council gave a mandate to the Economic Policy Committee to present a new set of age-related public expenditure projections based on a new population projection provided by Eurostat and agreed assumptions on key economic variables for all 25 Member

[1] See Economic Policy Committee and European Commission (DG ECFIN), (2006), 'The impact of ageing on public expenditure: projections for the EU-25 Member States on pensions, health-care, long-term care, education and unemployment transfers (2004-2050)', European Economy, Special Reports No 1, 2006.

States covering pensions, health care, long-term care, education and unemployment transfers[2]. These projections were completed in February 2006 and were prepared together by the Commission (DG ECFIN) and the Member States within the Ageing Working Group of the Economic Policy Committee (EPC). They provide a comparable, transparent and robust basis for assessing the budgetary implications of demographic change and the sustainability of public finances across Member States.

The report, including the projections, was endorsed by the ECOFIN Council of 14 February 2006 as the basis for assessing the sustainability of public finances in the context of the SGP. The Council also considered this report as an input in ongoing debates on the modernisation of welfare systems and extending working lives as a follow-up to the Hampton Court Summit of October 2005, the Lisbon strategy, the renewed EU Sustainable Development Strategy and the Open Method of Coordination on pensions. Moreover, in its conclusions, the Council invited the Commission to undertake a comprehensive assessment of the sustainability of public finances in the Member States by the end of 2006. The report attached to this Communication responds to this invitation.

2. THE EU APPROACH TO ASSESS THE LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

The assessment of long-term sustainability of public finances is part of the regular EU budgetary surveillance. It is based on the long-term age-related government expenditure projections and on the budgetary strategies presented in the Stability and Convergence Programmes. In this context, consistency between short to medium-term budgetary targets and long-term sustainability is at the core of the analysis.

The issue of long-term sustainability is a multi-faceted one. It involves avoiding imposing an excessive burden on future generations and ensuring the country's capacity to appropriately adjust budgetary policy in the medium and long run. In order to analyse whether, based on current policies and in view of the significant budgetary challenge posed by ageing populations, the government finances are on a sustainable path or not, a long-term perspective of government commitments is necessary. For this purpose, the results of the common long-term age-related expenditure projections under current policies and the current budgetary position are the key inputs to the analysis of the sustainability of public finances.

The new projections provide a comparable, transparent and robust basis for assessing the budgetary implications of demographic change and the sustainability of public finances across Member States. Overall, the projections show that the EU faces a significant budgetary challenge posed by population ageing. Most of the projected increase in public spending will be on pensions and, to a lesser degree, in health care and long-term care. The potential offsetting savings in terms of projected public spending on education and unemployment benefits are likely to be limited[3]. In the EU age-related expenditure is projected to increase by about 4% of GDP up to 2050, although this hides very different developments in the Member

2 The long-term budgetary projections are made on a 'no-policy change' basis and do not include the effects of additional policies that could strengthen e.g. economic growth and have a beneficial impact on the budgetary projections.

3 The projected budgetary savings on education expenditure are made on current policies. In line with the Lisbon commitments to build a knowledge-based economy, such savings could be reallocated to educational areas which yield high socio-economic and fiscal returns, in line with the conclusions of the Spring 2006 European Council.

States; ranging from an increase of 7% of GDP or more in ES, IE, LU, PT, CY, CZ, HU and SI to a decrease as a share of GDP in EE, LV and PL[4].

Based on the projected expenditure trends, deficit and debt levels are projected over the long-term. Debt sustainability is derived from the *intertemporal budget constraint*. It imposes that current total liabilities of the government, i.e. the current public debt and the discounted value of future expenditure including the budgetary impact of ageing populations, should be covered by the discounted value of future government revenue. If current policies ensure that the intertemporal budget constraint is respected, current policies are sustainable.

The assessment of long-term sustainability of public finances goes beyond answering the question whether current policies are sustainable or not. An estimation of the size of the budgetary imbalances is also needed to understand the challenge that policy-makers face. This is provided by *sustainability gap indicators* that measure the size of a required permanent budgetary adjustment (e.g. a constant reduction of non age-related public expenditure as a share of GDP or a constant increase in public revenue as a share of GDP) that enables respect of the government's inter-temporal budget constraint, thus ensuring sustainable public finances. The sustainability indicators are decomposed into: (i) the impact of the initial budgetary position; and (ii) the long-term budgetary impact of ageing.

The sustainability indicators provide a firm basis to identify the size and the main source of risks to public finance sustainability in the EU Member States. To reach an overall assessment of the sustainability of public finances, other factors are taken into account, which allow a better qualification of the assessment with regard to where the main risks are likely to stem from. This includes factors relating to both short- and medium-term developments and to long-term budgetary trends:

- *the current stock of government debt* is arguably the most important factor since: (i) high-debt countries are more sensitive to short/medium term shocks to economic growth and to interest rates changes; (ii) a high level of debt may lead to a higher interest rate than assumed in the projections and increase further the risks to public finance sustainability; and (iii) high-debt countries need to maintain large primary surpluses for a prolonged period of time in order to reduce the level of debt, which may prove difficult to sustain in view of other competing budgetary pressures;
- *the medium-term objectives (MTOs) and short-term budgetary developments* provide information on the direction of fiscal policies. A scenario is run in which it is assumed for all countries that the medium-term objective is reached in 2010. It does not mean that the Commission expects all Member States to attain the MTO in 2010; some have already attained it while other might not reach it by 2010. It serves to illustrate to what extent, in most cases, budgetary consolidation can contribute to reduce risks to public finance sustainability. Moreover, the latest Commission services forecasts provide the expected short-term budgetary developments on a no-policy change basis, highlighting whether there are risks attached to the Member States' budgetary plans in the short-term;
- *sensitivity tests* provide information on the robustness of the results with respect to changes to key parameters. For example, the resilience of the pension schemes to external shocks is

[4] No pension projections were available for Greece in the new common projections exercise and the rise in age-related expenditure is therefore underestimated. Pension expenditure in Greece was projected to rise between 2005 and 2050 by 12.4% of GDP in the 2001 common projections exercise and by 10.2% in the 2002 update of the Greek stability programme.

not the same in the different countries. Moreover, there is some uncertainty regarding the size of the sustainability challenge in the EU and different assumptions concerning the main drivers of expenditure can have a large impact. Government expenditure may increase faster than implied by demographic change alone in the future. In the past, other factors such as increased provision and quality of public services have also contributed to the rising expenditure trends, e.g. on health-care;

- *if average pensions become much smaller relative to average income than today* different types of budgetary pressures could arise in the future. This could be the case if e.g. insufficient pensions increased the risk of poverty for older people and translated into higher public social expenditure, or if private pensions turned out to be lower than expected so that the government might have to compensate for this shortfall. A decrease in the relative level of pensions may therefore imply different risks to public finances unless measures are in place that enable appropriate retirement incomes for future pensioners;

- *changes in government revenue as a share of GDP over the long-term* have an impact on future budgetary developments. For example, if pension contributions are exempted from taxation while pension disbursements are subject to taxation, taxes on pensions as a share of GDP may increase over the long-term if countries have accumulated large assets in funded pension schemes and the schemes have not yet matured;

- a *high current tax ratio* leaves more limited room of manoeuvre for using tax increases to finance additional public expenditure as compared to a lower tax ratio.

However, when considering these factors, a cautious approach is called for, as they are not necessarily quantifiable; moreover, comprehensive information may not be available.

In order to indicate the relative importance of the risks to the long-term sustainability of public finances, a three level categorisation is used, introduced by the Commission and the Council in the 2005/06 round of assessment of the stability and convergence programmes: low / medium / high risk. This classification recognises that an ageing population represents a budgetary challenge over the long-term for all countries, i.e. low risk does not mean no risk. In some cases, even low risk countries still face a non-negligible sustainability gap. These countries need to address the challenge of an ageing society by additional reforms and/or by improving their budgetary situation. Indeed, there is some uncertainty regarding the future projected expenditure developments; if age-related expenditure is also influenced by factors other than demographic change, which have been observed in the past, ensuring fiscal sustainability might prove even more challenging. At the same time the classification provides a clear distinction of the degree of risk EU Member States might face with regard to public finance sustainability. This, together with the analysis of the main sources of risks, is important in terms of identifying the appropriate policy response.

3. OVERALL ASSESSMENT OF THE RISKS TO THE LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES IN THE EU

The EU faces a considerable challenge in view of ageing populations over the coming decades. There is a major impact of ageing on public expenditure over the long-term, influenced notably by a significant increase in pension expenditure. In order to tackle this budgetary challenge the EU needs to implement structural reform measures so as to curb the long-term expenditure trends and to raise potential growth, e.g. by raising employment rates or the effective retirement age. In addition, pursuing budgetary consolidation is required to create room for fiscal manoeuvre before the budgetary impact of ageing takes hold. In the absence of reform measures and budgetary consolidation, the analysis reveals that a considerable sustainability gap of about 3½% of GDP, i.e. the gap between the structural budgetary position in 2005 and a sustainable position, emerges in both the EU and the euro area.

Unless measures are taken to fill this gap, the government debt/GDP ratio is projected to remain above 60% over the coming decades for the EU as a whole and towards 2020, it is projected to start rising considerably, reaching almost 200% of GDP in 2050.

Reconciling the long-term policy challenge with the medium-term budgetary policy formulation process was an important element in the reform of the Stability and Growth Pact in 2005. As a part of the new SGP, medium-term budgetary objectives (MTOs) that reflect country-specific characteristics, the debt/GDP ratio and the growth potential, were introduced.

A large majority of countries still have budget deficits above their MTOs and plan consolidating their public finances over the next few years. In order to illustrate the impact of a medium-term improvement of the budgetary position on long-term sustainability, an alternative scenario was analysed in which all the Member States are assumed to be at their MTO in 2010. Under this assumption, the sustainability gaps in the EU and in the euro area would be about 1½% of GDP. Regarding the implications for debt in the euro area, if the MTOs are attained in 2010, the debt/GDP ratio is projected to be about 80% of GDP in 2050, compared with close to 200% of GDP if the 2005 budgetary position remained unchanged. For the EU as a whole, the debt/GDP ratio is projected to be below the 60% of GDP reference value until the early 2040s.

The long-term budgetary challenge posed by ageing populations can thus be reduced, in fact more than halved, if Member States attain their MTOs in 2010 compared with the budgetary situation in 2005. This clearly illustrates that fiscal consolidation over the medium-term can contribute very significantly to reducing the fiscal sustainability challenge in the EU and the euro area. However, it is not sufficient to fully cater for it. Unless the underlying developments entailed by ageing are tackled, the debt/GDP ratio would still be on an upward trend in most countries by 2050.

Ensuring fiscal sustainability over the long-term would require additional budgetary consolidation in particular in the absence of further reform measures that would curb the significant increases in age-related expenditure over the long-term to various degrees in the Member States. Several Member States have reformed their pension systems in recent years, in particular in DE, FR and AT and also with earlier reforms e.g. IT and SE, which shows that a determined implementation of in many cases difficult reform measures have reduced the projected increase in pension expenditure. However, the projected expenditure increases are still significant in the EU. Moreover, to secure the lasting success of significant pension reforms, they should go together with a prolongation of working lives enabling a higher accumulation of pension rights and thus have a positive impact on the level of pensions relative to wages in the future; achieving this might however require other structural reforms.

Assessment for the EU Member States

While the budgetary impact of ageing populations is a concern for all the EU Member States, the EU aggregates mask considerable variety. There is a large variation across the EU in the degree of risks and where they mainly come from. Overall, among the 25 Member States of the EU *six countries* are assessed to be at *high risk*, *ten* at *medium risk* and *nine* at *low risk*, which overall confirms the assessments of the stability and convergence programmes carried out in the early months of 2006. The main characteristics of the sustainability challenges they face can be summarized as follows:

- *High risk countries*

The high risk group of countries (CZ, EL, CY, HU, PT and SI) is characterised by a very significant rise in age-related expenditure over the long-term, underlining that measures aimed at curbing them will prove strictly necessary. Moreover, CZ, EL, CY, HU and PT have large deficits and in some cases also a high level of debt, in particular in Greece. Budgetary consolidation is as well necessary and urgent in order for these countries to reduce risks to public finance sustainability.

- *Medium risk countries*

The intermediate group of countries (BE, DE, ES, FR, IE, IT, LU, MT, SK and UK) consists of countries with very different characteristics but a relatively clear-cut distinction appears between: (i) countries with a significant cost of ageing and where measures might be needed to curb these costs, but which currently have relatively strong budgetary positions (ES, IE, LU); and (ii) countries that need to consolidate, though to different degrees, their public finances over the medium-term but for which the costs of ageing are less of a concern, usually as a result of reforms made to their pension systems (SK, IT, DE, FR, UK and MT); within this group the situation of Italy should be highlighted, where a rapid budgetary consolidation is required to ensure a steady reduction of the currently very high level of debt. Belgium shares some characteristics of both sub-groups; maintaining a strong budget balance is necessary so as to reduce the very high level of debt as well as to offset the high increase in age-related expenditure, being above the EU average. However, even if it is maintained for a long period of time, the current high primary surplus is not sufficient to fully cover the relatively high cost of ageing populations over the long-term. Measures aiming at curbing the projected increases in pension expenditure would undoubtedly contribute to reduce the risks to sustainability.

- *Low risk countries*

The low risk countries (DK, EE, LV, LT, NL, AT, PL, FI and SE) have in general come furthest in coping with ageing, which result from a strong budgetary position (running large surpluses, reducing debt and/or accumulating assets) and/or comprehensive pension reforms, sometimes including a shift towards private pension schemes. This does not mean that in these countries there are no risks regarding the long-term sustainability of public finances. In fact, their situation relies on the successful implementation of the far-reaching reforms, which have reduced significantly the long-term budgetary impact of ageing (EE, LV, LT, AT, PL and SE) and on maintaining the budgetary position or in some cases on strengthening it. Other countries with a relatively high projected cost of ageing, notably on pensions, may also need to consider structural reforms aimed at modifying the projected long-term budgetary trends at some point, should the current strong budgetary position not be maintained over the long-term (DK, NL and FI), although the overall adjustment required would be of a lesser degree than for medium and high risk countries.

4. ENSURING SUSTAINABLE PUBLIC FINANCES: A BROAD POLICY CHALLENGE FOR THE EU

The analysis reveals that coping with the budgetary impact of ageing is a key policy challenge in the EU. It confirms that the three-pronged strategy to cope with the economic and budgetary challenge posed by ageing populations decided by the Stockholm European Council in 2001 is appropriate and needs to be pursued, i.e. reducing debt at a fast pace, raising employment rates and productivity, and reforming pension, health care and long-term care systems.

First, Member States need to achieve more rapidly and sustain sound underlying budgetary positions so as to run down public debt at a fast pace before the full impact of ageing unfolds. Indeed, the sustainability analysis shows that consolidating the public finances towards the MTOs and sustaining such a position will significantly contribute to alleviating part of the long-term budgetary costs of ageing in the EU and will prevent a rapid and strong rise of the debt/GDP ratio. Moreover, sound public finances are a prerequisite for low interest rates and high and stable economic growth which would in turn contribute to improve the sustainability of public finances.

Second, there is a need to raise employment rates, especially amongst women and older workers, and appropriate steps should be envisaged to raise labour supply and labour utilisation. The analysis in the report shows that if employment rates increased more than projected it would considerably contribute to fiscal sustainability. Indeed, in many countries, substantial benefits could be reaped by reducing structural unemployment further. Successfully implementing such policy measures and enhance productivity, in line with the goals of the Lisbon strategy, would furthermore raise potential GDP growth rates, improve future living standards, provide more room for budgetary reallocation in the future. In addition, the common long-term projections show that there could be some limited budgetary savings stemming from a projected reduction in education expenditure on account of ageing populations. However, in view of the need to enhance productivity in the future, Member States could consider using those savings for modernising their education systems, including the development of life long learning, investing to raise educational attainment levels and improving the functioning of the educational systems, in line with the Lisbon commitments to build a knowledge-based economy and society.

Third, Member States need to consider appropriate reforms of pension, health-care and long-term care systems to ensure that they are financially viable in the face of ageing while at the same time securing core policy goals of adequacy and access. Recent pension reforms in about half of the EU-15 Member States and in several new Member States have reduced the budgetary impact of ageing and are helping to raise the effective retirement age. Indeed, the analysis shows that recent pension reforms, e.g. in Germany, France and Austria, as earlier reforms, such as in Italy and Sweden, have contributed significantly to improve the sustainability of public finances. Moreover, raising employment is unequivocally welfare enhancing; it strengthens the financial sustainability of pension systems, delays the start of expenditure rises, increases contributions to pension schemes, and can generate additional budgetary savings. Moreover, raising employment rates, notably of older workers, is of prime importance for countries where a significant decrease in the benefit ratio, i.e. average pensions over GDP per worker, is projected, as it reduces the risk of possibly inadequate pensions in the future. In recent pension reforms, some Member States have introduced a link between life expectancy at retirement and pension benefits and these measures appear to achieve a better sharing of demographic risk. This provides an important incentive for extending working lives. Furthermore, the sustainability analysis shows that considerable budgetary savings on health-care expenditure may be realised if the projected increase in life expectancy over the long-term is accompanied by an increase in healthy life years and an improvement in the health status. Putting in place measures that improve the health status of the populations can thus contribute to easing the cost of ageing and improve the sustainability of public finances.

In addition to rigorously implementing the consolidation of the public finances over the medium-term towards the MTOs and/or maintaining such a budgetary position so as to reduce sustainability risks, a determined effort is required to improve the functioning of the EU economies and to adapt the public systems to be better able to cope with the significant challenges ahead. The policies behind this three-pronged strategy are an integral part of the Lisbon strategy insofar as raising employment rates and running sound macro- and micro-economic policies are conducive to economic growth and prosperity. The appropriate combination of policies in these three areas will depend on the main reasons behind the sustainability challenge and the policy priorities that the Member States have set for themselves.

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