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PRESS RELEASE

Fiscal sustainability and policy implications for the euro area

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Population ageing poses important challenges for policymakers in the coming decades. Increasing outlays for pension, health and elderly care systems will weigh on government budgets while economic growth is projected to decline due to the gradually decreasing population of working age. At the Stockholm European Council in 2001 a three-pronged strategy was formulated to deal with those challenges. It consists of structural reforms to pension and care systems, measures to increase employment and economic growth and fiscal consolidation. In this paper we focus on the latter element and we examine the issue of fiscal sustainability in euro area countries, i.e. the extent to which current fiscal policies can be continued or will have to be adjusted.

We first carry out a critical assessment of the widely-used estimates of the budgetary impact of population ageing by the European Policy Committee's Working Group on Population Ageing. According to this Working Group's most recent estimates ageing would worsen budget balances by around 4.3% of GDP in the 2010-2050 period in the eleven countries that initially formed the euro area in 1999. However, such long-term projections are obviously surrounded with significant uncertainties. Using plausible alternative estimates for key parameters in the Working Group's projections, largely based upon sensitivity analyses carried out by this Working Group, we find that ageing costs in the 2010-2050 period may be 1 percentage point higher.

Against this background, we look at a range of fiscal sustainability indicators and calculate sustainability gaps taking into account the modified ageing costs. We find that, of all the countries considered in this paper, public finances currently only appear to be sustainable in Finland. All other countries will have to adjust their fiscal policies sooner or later. The exact size of the sustainability gaps differs according to the indicator chosen but the ranking of the countries is more robust. The required adjustment effort is much smaller for countries that have recently implemented important structural reforms to their pension systems such as Germany, Austria and Italy.

Sustainability indicators such as the ones considered in this paper typically measure the size of an 'early' adjustment effort to restore fiscal sustainability. In many cases, this early adjustment effort would imply very important consolidation measures in the coming years. In this paper we propose to analyse the appropriateness of such a budgetary strategy on the basis of an intergenerational equity criterion. The method that is used to make this criterion operational is close to a classical generational accounting approach but differs from it in a number of specific aspects. By attributing government revenue and primary expenditure to different age cohorts, we calculate a 'net tax burden' for different generations. We then compare the evolution of this net tax burden for two different budgetary strategies, an early adjustment effort aimed at restoring fiscal sustainability in the coming years already and a more gradual fiscal adjustment spread over the 2010-2050 period. We show for three euro area countries - Belgium, Germany and France - that the earlier fiscal adjustment effort leads to a somewhat flatter profile for the net tax burden across age cohorts: the burden is higher for younger and future generations but the increase is generally less steep than under the more gradual adjustment effort. Hence, an earlier fiscal adjustment, i.e. 'pre-funding' (a large part of) the ageing costs via fiscal consolidation in the coming years can in our view be considered more equitable.

Our calculations of the fiscal burden across age cohorts are partly based upon a number of simplifying assumptions (e.g. with respect to the age profiles for specific government revenue and expenditure items). However, sensitivity analysis shows that the main result - a pre-funding approach is more equitable than a gradual fiscal adjustment - is quite robust to changes in these assumptions.

While the paper does not provide any insights on which policy mix, e.g. structural reforms vs. budgetary pre-funding, is the optimal response to population ageing, its main conclusion seems relevant against the background of the developments in the EU fiscal rules. The ECOFIN Council has indeed recently indicated that long-term fiscal sustainability, notably the future impact of ageing, is to be better taken into account in the definition of the medium-term objectives for fiscal policy introduced in the context of the revised stability and growth pact. In this connection, concerns for intergenerational equity could play a role and could be made operational along the lines suggested here. If our tentative conclusions were confirmed and if no further cost-cutting reforms to pension and care systems are implemented, an upward revision of the medium-term objectives to significant surpluses may then be warranted for many EU Member States.