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PRESS RELEASE

Fiscal sustainability indicators and policy design in the face of ageing

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As awareness is growing about the potentially large impact of population ageing on government budgets, fiscal assessments increasingly focus on the sustainability of public finances. While the intuition behind this concept is clear - sustainable policies are those that can be continued indefinitely - different theoretical benchmarks and a wide range of operational definitions and empirical tests are proposed in the literature.

As far as the theoretical benchmarks are concerned, most specifications would imply that an ever-growing public debt ratio is unsustainable. With respect to the operational definitions and empirical tests, one can distinguish between backward-looking and forward-looking approaches. The former have in common that they try to test econometrically whether the development of fiscal variables in a given period in the past suggests that policies have been affected by the government budget constraint. While these tests provide valuable insights concerning the way in which fiscal policy was designed in the past, regime changes can never be excluded and the assessment of the current sustainability of public finances typically requires a forward-looking approach. In this latter case, fiscal sustainability is assessed by analysing the development of public finances in the coming decades taking into account an estimate of the budgetary impact of ageing on the basis of a number of macroeconomic and demographic assumptions. The results of these studies are presented in the form of long-term budgetary projections, synthetic indicators measuring the fiscal effort needed to restore sustainability and, in the case of generational accounting, indicators of the generational imbalance.

For the EU countries the budgetary impact of population ageing is estimated by the Ageing Working Group attached to the Economic Policy Committee. In addition, the European Commission routinely assesses the sustainability of public finances, inter alia on the basis of two synthetic indicators - S1 and S2 - based upon the aforementioned estimates of the ageing costs and the requirement of a 60 p.c. of GDP debt ratio by 2050 and compliance with the government's intertemporal budget constraint respectively.

In this paper the sustainability of public finances in euro area countries is assessed on the basis of the most recent projections of the Ageing Working Group and two alternative synthetic indicators for gauging fiscal sustainability are proposed. They quantify the fiscal effort that would be needed in order to fully pre-fund the budgetary costs of ageing and generate a debt-stabilising budget balance or a balanced budget by 2050.

It is shown that public finances seem to be unsustainable in nearly all euro area countries. This implies that, given the present demographic and macroeconomic outlook, fiscal adjustments will be needed to deal with population ageing. As measured by the sustainability gaps calculated in this paper, the magnitude of these adjustments varies greatly across euro area countries. Implementing the required adjustment in the coming years before ageing-related expenditure starts to rise significantly, i.e. pre-funding the ageing costs, would require significant consolidation measures and lead to the reimbursement of public debt and the creation of net government financial assets in a number of countries.

This raises the question whether such a policy would actually be appropriate or to what extent medium-term objectives for fiscal policy should already take into account the estimated ageing costs, an issue which is important in the context of the reformed Stability and Growth Pact. The ECOFIN Council has considered that these medium-term objectives should not only depend on government debt and potential growth but also on the size of the implicit liabilities related to ageing.

In this paper it is stressed that different budgetary strategies, i.e. different degrees of pre-funding, have different implications for the fiscal burden of subsequent generations of workers. This is illustrated for Belgium, Italy and Spain. This analysis shows that, while full pre-funding may require a relatively important fiscal effort in the coming years, it generally implies a more even distribution of the fiscal burden across generations than a more gradual adjustment strategy. More specifically, gradualism comes at a cost: postponing the required adjustment only increases the fiscal burden for future generations. Against this background, some pre-funding of ageing costs seems appropriate and for some governments this might imply targeting budgetary surpluses rather than balanced budgets or small deficits in the medium term.