

The sustainability of public finances in the context of population ageing

W. Melyn
L. Van Meensel
S. Van Parys

Introduction

In almost every country in the world, populations are growing considerably older, a development known as ageing. That process is farthest advanced in the industrialised countries. Belgium, too, is experiencing population ageing, and that will continue in the coming decades owing to expansion of the older population and a temporary decline in the population of working age.

These demographic developments have a huge impact on society. For instance, economic growth slows down owing to the temporary reduction in the population of working age. In addition, there is a strong upward pressure on public expenditure relating to pensions, health care and care of the elderly as a result of the steep rise in the number of pensioners. This demographic change therefore brings serious social and economic challenges, including in the sphere of public finances.

This article will endeavour to explain these challenges and investigate how the government can respond, including via an appropriate fiscal policy, an economic policy that encourages growth, and reforms in the sphere of pensions and health care, in order to maintain sound public finances.

The article begins with an overview of the main demographic developments. Section 2 deals with the economic and budgetary impact of ageing. Section 3 explains what is meant by sustainable public finances and how that concept can be put into practice. Finally, section 4 addresses the way in which the Belgian government can respond to

the challenges of ageing. The article ends with a summary of the main conclusions.

1. Demographic developments

At global level, there are two dominant demographic trends. While the population continues to expand in most regions of the world, the population is ageing at a rapid pace, although there are variations between regions and countries. These trends are expected to persist in the coming decades.

The demographic developments in Belgium will be analysed below. The data used for that purpose come from the latest population forecasts for Belgium for the period 2015-2060, as published in March 2016 by the Federal Planning Bureau and the Directorate General for Statistics of FPS Economy. Reliable population forecasts are important to obtain an idea of the challenges that lie ahead. Here, specific attention focuses on the changing age pyramid, as that determines the budgetary, economic and social challenges confronting the policy-makers.

1.1 Determinants of population patterns and structure

Three factors determine population patterns and structure: life expectancy, the average number of children per woman, and net migration. We shall examine them in succession.

1.1.1 Life expectancy

In the past few decades, there has been a significant rise in life expectancy at birth in Belgium: between 1960 and 2015 it increased from 67.6 to 78.6 years for men, and from 73.6 to 83.5 years for women. That increased life expectancy is due primarily to the fact that, particularly since the first half of the 20th century, advances in medical science have meant that more children survive infancy and reach adulthood. At the same time, as a result of improvements in diet and medical progress, more and more people are living to a greater age.

In the coming decades, life expectancy at birth is likely to increase further. According to most forecasts, that increase will be slightly smaller in the future than it has been in past decades. On the basis of the latest predictions, life expectancy at birth in Belgium will rise to 86.5 years for men and 88.7 years for women in 2060. The gender gap will therefore diminish.

1.1.2 Average number of children per woman

Since the end of the post-war baby boom that lasted until the second half of the 1960s, when women in Belgium had an average of 2.7 children each, the average number of children per woman has declined sharply overall. Nowadays, the number is around 1.7.

Apart from the end of the temporary surge that followed World War II, that trend is due to a number of factors: birth control options increased, the average age at which couples get married or set up home together has risen, and women are having children later. These factors partly reflect socio-economic trends, such as the rising level of education for women and their increased participation in the labour market.

According to the latest population forecasts, the average number of children per woman is set to rise gradually in the coming years to 1.9 in 2035, and is expected to become almost stable thereafter. This means that fertility will remain at a relatively low level in historical terms, and below the natural replacement rate of 2.1.

1.1.3 Net migration

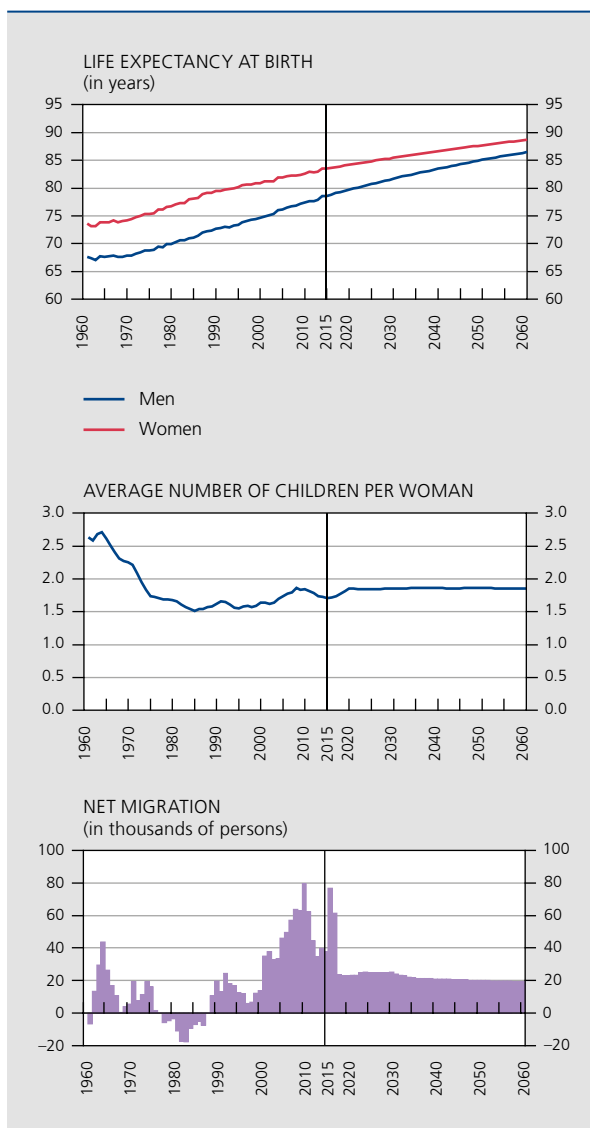
The third and final factor determining the change in the total population and its age structure is net migration, which is equal to the difference between the number of immigrants and the number of emigrants.

In Belgium, annual net migration increased from around 15 000 persons at the beginning of the 2000s to more than 65 000 during the period 2008-2011. It then subsided for a time, before recently reverting to the level prevailing before the financial and economic crisis. According to the latest population forecasts, net migration is expected to fall to between 20 000 and 25 000 persons per annum. That represents roughly 0.2 % of the Belgian population.

1.2 Population forecasts reveal the impact of ageing

The change in the population can be expressed as the sum of the natural balance (the number of births minus

CHART 1 DETERMINANTS OF POPULATION PATTERNS AND STRUCTURE IN BELGIUM



Sources: Federal Planning Bureau, FPS Economy – DGS, NBB.

the number of deaths), net migration and a practically negligible statistical adjustment. The figures for Belgium over the period 1995-2005 illustrate that. Over those ten years, the population grew by an average of 53 800 persons per year. That is attributable to a natural increase of 15 000 persons per year and net migration of 37 200 persons. On average, the statistical adjustment concerns 1 600 persons per year. The projections indicate that, up to 2060, the population will expand by an annual average of 40 000 persons: 16 000 as a result of natural increase and 24 000 via net migration. These figures show that during those periods net migration is the principal factor behind the overall population growth in Belgium.

A breakdown of the overall population figures by age group reveals the changes in the age structure of the population. In the future, that structure will change significantly, with major economic and budgetary implications.

When analysing the age structure, it is usual to distinguish between the population of working age and other population groups, namely the younger and older categories. For the purposes of this article, the population of working age was taken as equivalent to the age group ranging from 18 to 66 years. The age of 67 years was chosen as the criterion because that will be the statutory retirement age in Belgium from 2030. The Study Committee on Ageing uses the same approach in its 2016 report.

According to the latest population forecasts, the expansion of the population of working age will slow down

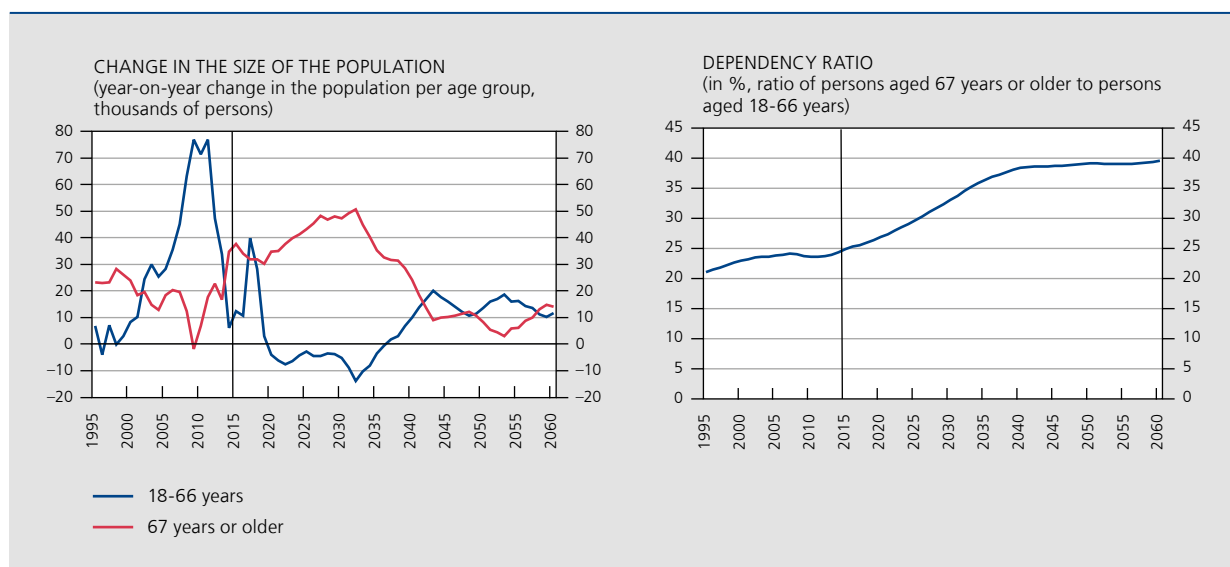
sharply between 2010 and 2036, actually becoming negative from 2020. It will become positive again from 2037 until the end of the projection period in 2060. Over the period 2015-2060 as a whole, the population of working age is set to grow by around 300 000 persons. Expressed as a ratio of the total population, that age group will decline almost continuously from around 64 % in 2015 to 57.2 % in 2060.

In contrast, during the period 2015-2060, the group aged 67 years or older will expand steadily by a total of almost 1.2 million persons. Expressed as a ratio of the total population, the share of this age group will increase almost continuously from 15.9 % in 2015 to 22.6 % in 2060⁽¹⁾.

These two developments form the basis of population ageing. That is generally summarised in the form of the dependency ratio of older persons, which will be defined here as the ratio between the number of persons aged 67 years or more and the number of persons in the 18-66 age group. For Belgium, that ratio increased from 21.1 % to 24.9 % between 1995 and 2015, and – according to the population forecasts – will continue rising to almost 40 % in 2060. In other words, this means that in 1995 there were roughly 5 actives per pensioner, and that is expected to fall to just 2.5 by 2060.

(1) The share of the young age group (0-17 years) is expected to stay fairly constant over the whole projection period at around 20 % of the total population.

CHART 2 SHARP RISE IN THE DEPENDENCY RATIO, DUE MAINLY TO AN INCREASE IN THE ELDERLY POPULATION



Sources: Federal Planning Bureau, FPS Economy – DGS, NBB.

In Belgium, there are wide regional variations in the demographic picture. Regional data show that population ageing is primarily evident in the Flemish Region and to a lesser extent in the Walloon Region. In contrast, in the Brussels Capital Region, the population of working age continues to expand faster than the population of pensionable age throughout the period. That is due to the younger age structure of the Brussels population (more children and persons of working age, particularly in the 20-40 years age group) and to the stronger growth of the population of working age in Brussels.

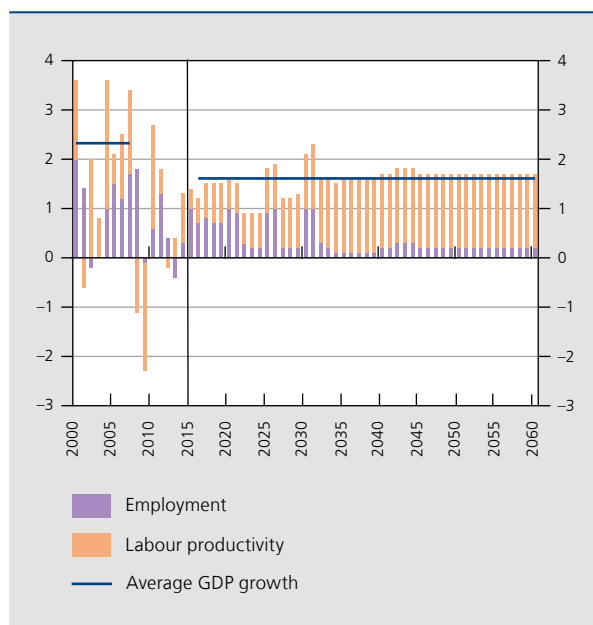
2. Economic and budgetary implications of ageing

Population ageing can be described as a demographic success story. However, it presents the government with a number of challenges concerning care of the ageing population and the associated sustainability of the Belgian social model.

2.1 Economic implications

The movement in the population of working age described above has significant implications for the economy's growth potential. According to the reference

CHART 3 ECONOMIC ACTIVITY
(percentage changes compared to the previous year)



Source : Study Committee on Ageing (SCA).

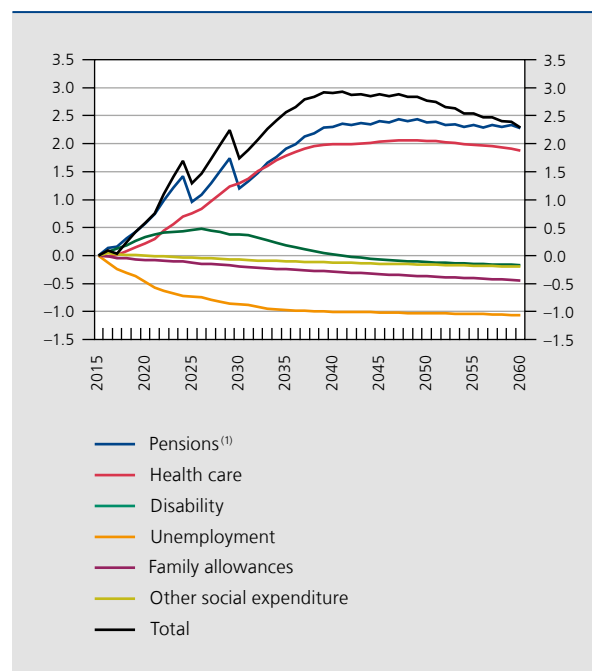
scenario in the 2016 report of the Study Committee on Ageing, employment growth will diminish compared to the period preceding the financial and economic crisis, and from 2032 will average only around 0.2 % per year. The annual rise in labour productivity is expected to pick up gradually from 0.4 % in 2015 to 1.5 % from 2035, and will thus become the main – and almost the only – engine of economic growth. Consequently, potential economic growth will average 1.6 % in the period 2016-2060, compared to an average of 2.3 % in the period prior to the financial and economic crisis (2000-2007).

The pattern is likely to be similar in most other European countries. There, too, increased labour productivity will become the main factor driving economic growth.

2.2 Budgetary implications

Population ageing will bring increased costs for the government in the decades ahead. The main reason is that more people will be entitled to a pension and the costs of health care will increase, partly because of the larger proportion of older people. Moreover, that is a

CHART 4 BUDGETARY COSTS OF AGEING
(change in social benefits in percentage points of GDP compared to 2015)



Source : SCA.

(1) The increase in expenditure on pensions by 2060 (2.3 percentage points of GDP) can be broken down as follows: 1.5 percentage points for the employee scheme, 0.2 percentage point for the self-employed scheme, and 0.5 percentage point for public sector pensions.

problem confronting all European countries, albeit to varying degrees. The differences are due in part to divergences between pension systems.

In Belgium, it is the Study Committee on Ageing (SCA) that estimates the budgetary costs of ageing, defined as the change in social benefits as a percentage of GDP.

The impact of population ageing on public finances is estimated on the basis of projections of social benefits, as demographic changes have a significant effect on that expenditure. Various demographic, socio-economic, macroeconomic and social policy assumptions are applied here. The modelling is based on an unchanged regulatory framework, after inclusion of the reforms already approved, particularly those concerning pensions. Measures not yet clearly defined at the time of publication of the report by the Study Committee on Ageing are disregarded.

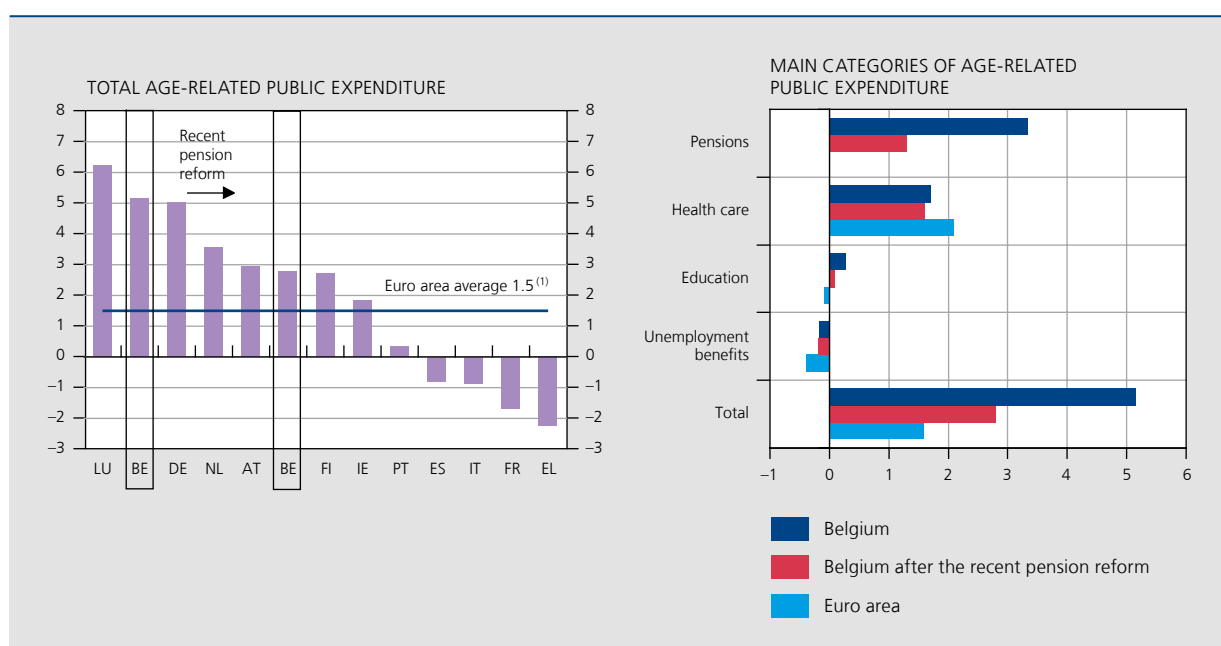
According to the latest estimates by the Study Committee on Ageing dating from July 2016, demographic changes will cause social benefits to increase further in the long term, compared to 2015. For instance, according to the reference scenario, total social benefits will increase from 25.3% of GDP in 2015 to 27.6% in 2060, after having reached a maximum of 28.2% during the period 2039-2047.

The budgetary cost of ageing will therefore peak at 2.9 percentage points during that period, then gradually decline to 2.3 percentage points in 2060. Expenditure on pensions and health care will rise during 2015-2060 by 2.3 and 1.9 percentage points of GDP respectively. All other expenditure together will fall by 1.9 percentage points of GDP. That mainly concerns expenditure on unemployment benefits (-1.1 percentage point of GDP) and family allowances (-0.4 percentage point of GDP). That fall occurs because fixed benefits are only partly adjusted in line with prosperity, but also because there are fewer claimants entitled to unemployment benefits.

It must be remembered that, if these forecasts are to become reality, it is necessary to pursue an active policy of supporting productivity growth and increasing labour market participation. Moreover, these estimates are purely indicative, since they are very susceptible to changes in the assumptions adopted. Estimates based on a different assumption concerning the annual rise in productivity are discussed in section 4.2.

Estimates of the budgetary impact of ageing are also produced at European level. For that purpose, the European Commission and the Member States together draw up long-term projections in the Economic Policy Committee's Working Group on Ageing Populations. The first projections

CHART 5 INTERNATIONAL COMPARISON OF THE EXPECTED CHANGE IN AGE-RELATED PUBLIC EXPENDITURE
(changes in percentage points of GDP over the period 2013-2060)



Sources: EC, NBB.

(1) The average is 1.4 if the recent Belgian pension reform is taken into account.

of this technical working group, founded in 1999, date from 2001 and covered only expenditure on pensions and health care. In 2003, those data were supplemented with projections for expenditure on education and unemployment benefits. These projections show that almost all EU Member States will face a substantial rise in age-related public expenditure. The methodology used by the European Commission here is not entirely comparable to that of the Study Committee on Ageing.

A comparison of the first twelve member countries of the euro area on the basis of the figures in the 2015 edition of the European Commission's Ageing Report shows that age-related expenditure in the euro area as a whole will rise by 1.5 percentage points of GDP over the period 2013-2060. However, that euro area average conceals wide variations between the Member States. At one end of the spectrum, there is a group of countries comprising Luxembourg, Belgium (before the pension reform) and Germany where the expected increase in ageing costs comes to 5 percentage points of GDP or more⁽¹⁾. At the other extreme is a group of countries comprising Spain, Italy, France and Greece where age-related government expenditure is set to decline during 2013-2060. The main reason for the fall expected in those countries is that reforms which are already in place reduce public expenditure relating to pensions during the projection period.

Belgium is among the countries where the budgetary costs of ageing are above average, even taking account of the downward impact of the 2015 pension reform. That is mainly because the expected increase in pension expenditure in Belgium is considerably higher than the euro area average.

3. What are sustainable public finances?

3.1 Theoretical concept of sustainable public finances

The sustainability of public finances is not a clear-cut concept. Nonetheless, it is intuitively obvious that sustainable public finances must imply that the government can avoid defaulting on the public debt and is therefore solvent.

A generally accepted definition of sustainable public debt in the long term is the situation in which a government can meet its current debt obligations on the basis of future primary surpluses (i.e. budget surpluses excluding interest charges). In formal terms, it means that the intertemporal budget constraint must be met, i.e. the value of the current debt must equal the discounted value of future primary surpluses. Here it is assumed that the current contractual obligations relating to the debt are fulfilled, so that there is no default or delayed payment, and that the debt is not monetised by the monetary authorities in the form of inflation. If the current debt exceeds the discounted value of the future primary surpluses expected in a constant policy scenario, then additional consolidation measures are essential to ensure the sustainability of public finances. Since there is a limit on the future primary surpluses that can be achieved – e.g. because there is a limit on the tax burden that an economy can bear, or austerity fatigue may ultimately set in – the intertemporal budget constraint implies an upper limit to the debt ratio; beyond that limit the government becomes insolvent.

The intertemporal budget constraint does not mean that a country with public debts must always maintain a primary budget surplus in order to remain solvent. Deficits and an increase in the debt may even be desirable at certain times. However, in the long term, they must be offset by surpluses.

Although government solvency needs to be considered from a long-term perspective, short-term developments may have an impact, especially as regards the liquidity of the public debt. A large proportion of that debt is renewed each year, so the financial markets must always comprise counterparties willing to (re)finance the debt, otherwise the government may face liquidity problems. In certain periods, as during the recent sovereign debt crisis that affected certain euro area countries in particular, the financial markets may lose confidence in the government of a country, making it very expensive, or even impossible, to raise finance. Although financial market sentiment does not always accurately reflect the fundamentals of the public finances in question, a lack of access to finance in the short term may threaten solvency. The broad analysis of the sustainability of public finances must therefore also take account of factors that influence the sustainability of the debt in the short term, such as liquidity.

(1) In the original Ageing Report 2015, the European Commission did not take account of the impact of the 2015 pension reform. However, at the end of 2015, it published an adjusted estimate of the ageing costs for Belgium, which does take account of that pension reform. In this estimate, the costs for Belgium were adjusted from 5.2 to 2.8 percentage points of GDP. As a result of this adjustment for Belgium, ageing costs for the euro area will fall from 1.5 to 1.4 percentage points of GDP.

3.2 Indicators of the sustainability of public finances

To calculate the current value of future budget balances in order to see whether or not a country needs to take consolidation measures in order to meet the intertemporal budget constraint, it is necessary to consider numerous assumptions, e.g. concerning the future macroeconomic environment, the movement in public revenue and expenditure with no change of policy, interest rates, etc. On the basis of such assumptions, the European Commission calculates two sustainability indicators – known as S1 and S2 – which determine the degree to which the primary balance needs to improve in the future in order to maintain the debt at a certain level. Account is also taken of the expected budgetary costs of ageing. For Belgium, the downward impact of the 2015 pension reform was taken into account.

3.2.1 The S2 sustainability indicator

The European Commission's S2 sustainability indicator closely fits the intertemporal budget constraint. It indicates for each country the change in the structural

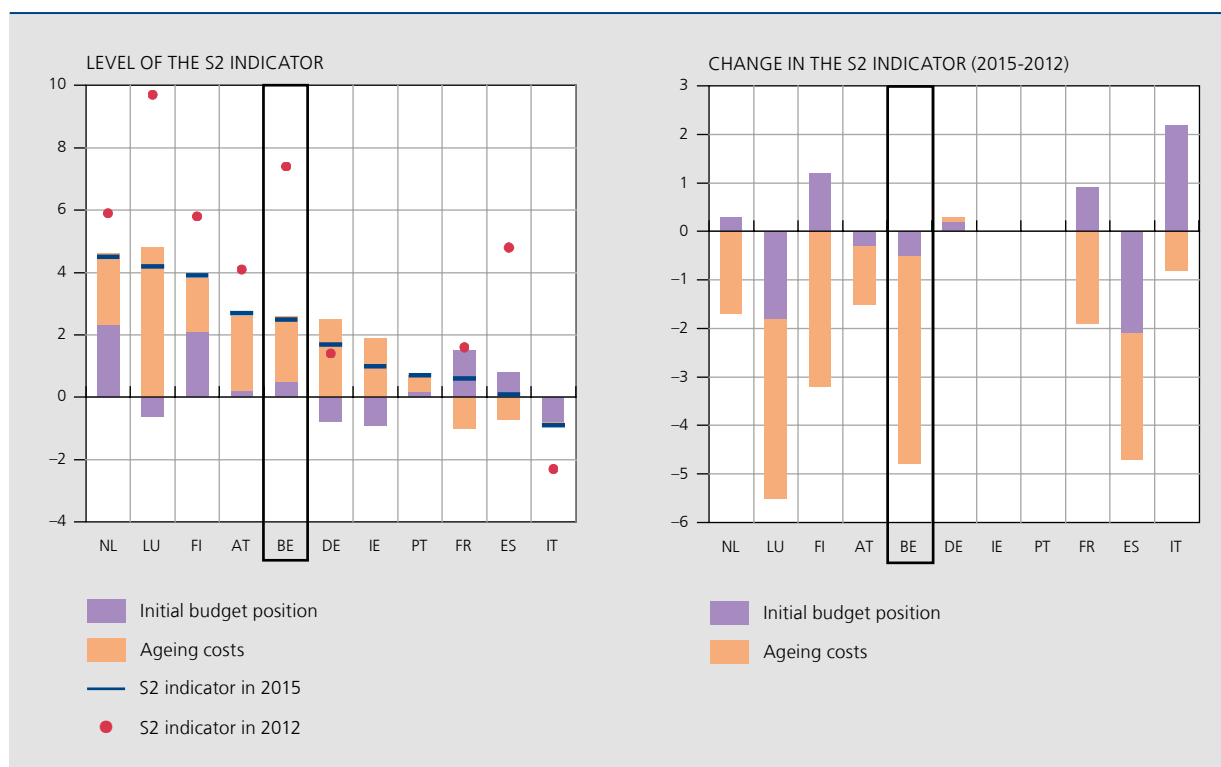
primary balance⁽¹⁾ necessary to stabilise the debt ratio in the long term, taking account of the costs of ageing. If a country achieves that structural adjustment immediately, it satisfies the intertemporal budget constraint.

With the S2 indicator, the European Commission therefore gives an indication of the budget adjustment that a country must achieve in order to ensure the long-term sustainability of its public finances. A positive S2 indicator means that – with no change of policy and taking account of ageing-related costs – the future primary surpluses are insufficient to repay the current public debt. An S2 indicator of 2.5% of GDP, as in Belgium's case, indicates that the structural primary balance would always have to be 2.5% of GDP higher than the current structural primary balance in order to stabilise the debt ratio in the long term.

A positive S2 indicator does not necessarily mean that the public finances are unsustainable, but that consolidation efforts must be made to ensure their sustainability.

(1) In other words, the balance adjusted for one-off factors and the influence of the business cycle.

CHART 6 S2 INDICATOR: ADJUSTMENT OF THE STRUCTURAL PRIMARY BALANCE REQUIRED TO MEET THE INTERTEMPORAL BUDGET CONSTRAINT
(in % of GDP)



Source: EC.

The value of the S2 indicator should be seen as a reference point and not necessarily as a policy recommendation. For instance, a consolidation effort equivalent to the S2 may be undesirable in the short term. It should also be noted that the S2 indicator does not concern the required level of the debt ratio, but is aimed merely at stabilising that ratio. Consequently, the S2 indicator should be interpreted with due caution, especially in countries with a high debt ratio.

The S2 indicator can be divided into two components, namely the budget adjustment necessary in view of the initial budget position, and the budget adjustment necessary as a result of the expected ageing-related costs. The first component indicates the difference between the structural primary balance needed to stabilise the current debt ratio and the current structural primary balance, assuming that the current balance always remains the same. The second component shows the additional budget adjustment needed in view of the expected future costs relating to ageing, which will cause the current structural primary balance to deteriorate rather than remain constant if there is no change of policy. That component therefore corresponds to the current (discounted) value of future ageing-related costs.

For Belgium, the first component comes to 0.5 % of GDP, and the second to 2.1 % of GDP. That means that, leaving aside the ageing-related costs, the structural balance has to improve by 0.5 % of GDP in order to stabilise the debt ratio in the long term. An additional improvement in the structural balance of 2.1 % of GDP is needed to cover the costs of ageing.

Belgium is in the middle of the ranking when compared with the other original euro area members. In most countries, including Belgium, ageing costs are the main threat to the sustainability of public finances. Italy has a surprisingly low or even negative score, despite having the highest debt ratio of all the countries considered. The reason is that Italy's initial budget balance contributes to a small reduction in the debt. Furthermore, the costs relating to population ageing are not expected to increase there.

Comparison of the S2 indicators for 2012 and those for 2015 reveals that the long-term sustainability of public finances has improved in almost all countries except for Italy⁽¹⁾. Belgium is among the countries with the biggest reduction. Compared to 2012, the required structural primary effort has declined by 4.8 % of GDP. That is attributable mainly to more favourable expectations concerning ageing-related costs, which are in turn due partly to the structural reforms undertaken by the governments

since 2012 – particularly in regard to labour market policy and pensions, in order to curb the expected expenditure and support growth – and partly to a revision of the population assumptions. The improvement in the structural primary budget balance between 2012 and 2015 is also a factor.

3.2.2 The S1 sustainability indicator

The European Commission's S1 sustainability indicator shows the required level of the cumulative change in the structural primary balance over 5 years to arrive at a debt ratio of 60 % of GDP by 2030, that being the maximum debt ratio stipulated by the Treaty on the Functioning of the European Union.

Unlike the S2 indicator, the S1 indicator therefore does not require stabilisation of the debt ratio, but convergence towards 60 % of GDP. A higher initial debt position therefore means that a greater effort is required. As in the S2 indicator, the S1 indicator takes account of the expected costs of ageing, but the period to which the S1 indicator relates ends in 2030⁽²⁾.

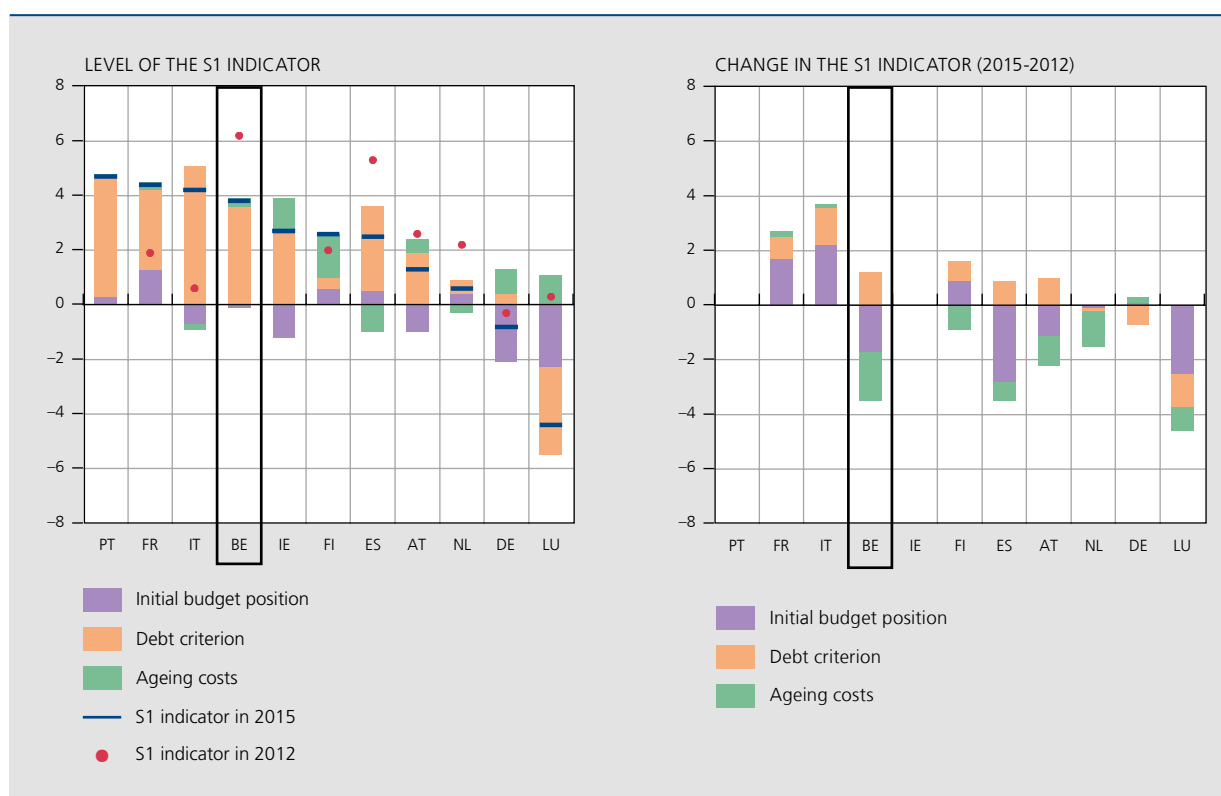
The S1 indicator can also be divided into various components. The first component – the “initial budget position” – indicates the amount by which the structural primary balance must change in order to stabilise the debt ratio, assuming that this balance is maintained until 2030. The second component – “ageing costs” – measures the additional change that must be made to the structural primary balance in order to stabilise the debt ratio, taking account of the ageing costs. The third component – the “debt criterion” – measures the further adjustment of the structural primary balance needed to reduce the public debt to 60 % of GDP in 2030.

To cut the debt ratio to 60 % of GDP by 2030, Belgium needs to improve its structural primary balance by 3.8 % of GDP over five years. By far the largest part of that, namely 3.6 percentage points, is due to Belgium's high level of debt, amounting to 106.7 % of GDP when the indicators were calculated. In view of the shorter time horizon of this indicator, the impact of the ageing costs is considerably less than in the case of the S2 indicator.

(1) The European Commission only publishes the S2 indicator every 3 years, namely in the Fiscal Sustainability Report. The latest report dates from the beginning of 2016 (*Fiscal Sustainability Report 2015*), and the previous one from the end of 2012.

(2) Finally, in the calculation of the adjustment to be made, the S1 indicator takes account of a 5-year adjustment period, whereas the S2 assumes immediate adjustment of the structural balance.

CHART 7 S1 INDICATOR: REQUIRED CHANGE IN THE STRUCTURAL PRIMARY BALANCE IN ORDER TO ACHIEVE A DEBT RATIO OF 60% OF GDP BY 2030
(in % of GDP)



Source: EC.

In comparison with the other original euro area members, Belgium has a less favourable S1 score owing to its high level of debt. Italy, with debt amounting to more than 130% of GDP, would have to make a major effort to bring its debt down to the required level. Conversely, Luxembourg – which has one of the worst S2 scores – gets a favourable medium-term score on account of its low debt ratio in the region of 20% of GDP. It therefore makes sense to consider the two sustainability indicators together and take account of their various components.

4. How can the government respond to the challenge of ageing?

It is clear from the above analysis that the challenge of population ageing should be a priority on the political agenda. To ensure the sustainability of public finances in the long term in the context of ageing, a three-pronged strategy was devised at European level, and forms the common theme of this section. The strategy involves consolidation of public finances, an active policy to boost

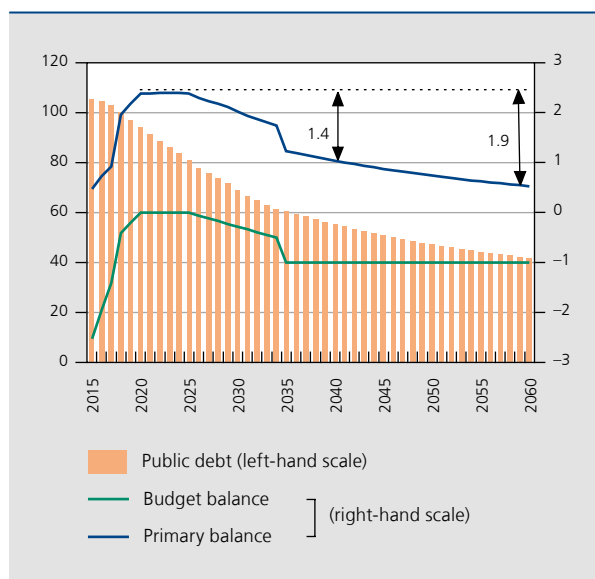
potential GDP, and a limit on ageing-related expenditure. This section presents these three aspects in more detail, with particular attention to the situation in Belgium.

4.1 Fiscal strategy

The government has to bring about and maintain sound budgetary positions as well as reducing the public debt. That is necessary, among other things, to create the scope needed to cover the costs of ageing. To do that it has to adopt additional consolidation measures in order to achieve a structural balance in the medium term. This consolidation must be based primarily on selective expenditure cuts. In addition, an effort must be made to ensure that taxes are properly collected, while use can be made of the scope in some revenues.

Although the government has managed, by dint of structural measures, to achieve a substantial reduction in the expected costs of ageing, those costs nevertheless remain considerable. Combined with the high public debt, far exceeding the Maastricht Treaty criterion of 60% of GDP,

CHART 8 THE STABILITY PROGRAMME BUDGET PATH PERMITS PARTIAL PRE-FINANCING OF THE AGEING COSTS⁽¹⁾
(in % of GDP)



Sources: SCA, NAI, NBB.

(1) On the basis of the macroeconomic assumptions of the SCA reference scenario and the assumption that the implicit interest rate on the public debt will rise to 3.75 % in 2035 and then remain stable at that level.

and the budget deficit which still stood at 2.5 % of GDP in 2015, that continues to raise concern over the sustainability of Belgian public finances.

By adhering to the European fiscal framework, Belgium would be able to ensure the sustainability of its public finances. If that condition were met, there would be scope in the budget to cover the costs of ageing, because the accelerated debt reduction would bring down the interest charges, and use could be made of the budget balance.

That prospect is borne out by the results of a simulation exercise concerning the long-term trend in public finances. The exercise assumes that a structurally balanced budget will be achieved in 2018, in line with the April 2016 stability programme target, and will be maintained until 2025. The general government budget balance would tend towards a deficit of 0.5 % of GDP after 2025. Once the debt ratio falls below 60 % of GDP, the deficit rises to 1 % of GDP. This picture is totally consistent with the European fiscal framework, which specifies that the budget deficit must not exceed 0.5 % of GDP in the medium term but may rise to 1 % of GDP in countries where the debt ratio is below 60 % of GDP and where the risks to the long-term sustainability of public finances are low. This exercise also uses the growth assumptions adopted by the Study Committee on

Ageing. According to that scenario, labour productivity will increase by an average of 1.3 % per annum over the period 2016-2060, while employment will expand by 0.3 %, so that the growth of economic activity averages 1.6 % per annum.

According to this simulation exercise, the primary balance comes to 2.4 % of GDP in 2020, after which it gradually subsides to 1 % in 2040, and then 0.5 % of GDP in 2060. The permitted deterioration in the primary surplus amounting to 1.4 % of GDP between 2020 and 2040 corresponds to just under half of the expected impact of the ageing costs during that period. By 2060, the reduction in the primary surplus would release scope corresponding broadly to the expected costs of ageing. The debt would fall below 60 % of GDP by about 2035.

To continue being able to fund social benefits and other expenditure in the future without an excessive increase in the tax burden, it is therefore advisable, in accordance with the rules of the European fiscal framework, to improve the budget position in order to achieve a structural balance.

4.2 Strategy for sustainable growth

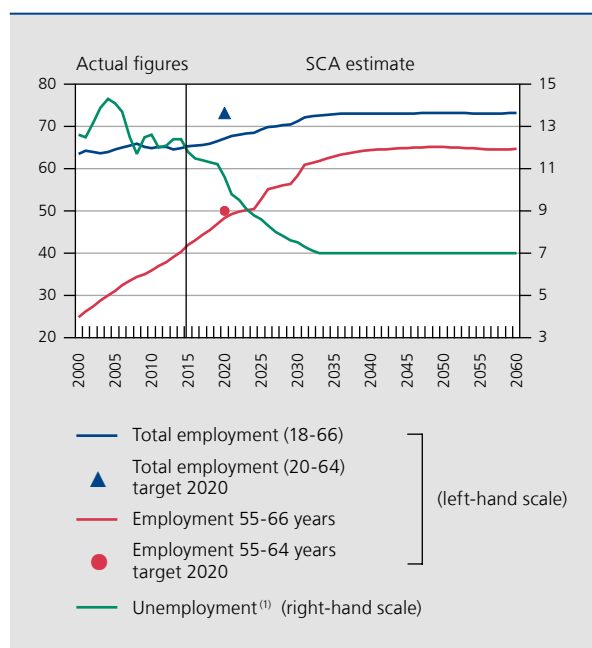
It is also necessary to pursue an active policy designed to boost potential GDP. The main scope here exists in regard to the promotion of employment, since Belgium has a relatively low employment rate compared with other countries. Moreover, labour productivity needs to be supported. Although private initiatives are the main source of increased productivity, the government can make a significant contribution by creating favourable framework conditions via targeted public investment and expenditure on research and development, by encouraging more efficient market functioning, entrepreneurship and creativity, and by making institutions more efficient, etc. The degree of funding future public expenditure including the costs of ageing in fact depends very largely on economic growth in the years ahead.

Economic growth is derived from two components, namely expansion of employment and increased labour productivity. It is therefore vital to support both components as far as possible via an active government policy.

4.2.1 Employment

Belgium still has very substantial scope for increasing employment. In 2015, the employment rate of persons aged between 20 and 64 years in Belgium was 67.2 %, whereas the target according to the Europe 2020 strategy for growth and employment is 73.2 %. For persons aged between 55 and 64 years, the Belgian

CHART 9 A FAVOURABLE TREND IN EMPLOYMENT REQUIRES AN ACTIVE LABOUR MARKET POLICY
(in % of the corresponding population)



Source: SCA.
(1) This concerns the administrative definition of the unemployment rate.

employment rate was 44.7 % in 2015, compared to a target of 50 % by 2020.

In its reference scenario, the Study Committee on Ageing assumes a steady expansion of employment from 2015 to 2035. During the period 2015-2060, the employment rate is projected to rise by 7.9 percentage points, from 65.3 to 73.2 % (for the 18-66 age group). First, the activity rate is

forecast to rise by 4.6 percentage points, i.e. a larger proportion of the population of working age will be available for the labour market, either in work or as job-seekers. The increase applies mainly to persons aged from 55 to 66 years, as a result of the pension reform and the rising participation of women in the labour market. Second, a larger proportion of the labour force is expected to be in work, as the unemployment rate is projected to decline in the long term from 11.8 % to 7 %⁽¹⁾.

The above assumptions take account of the measures approved up to mid-2016 concerning pension and labour market reforms, such as the adjustment of the system of insertion allowances, tightening of the conditions for access to the system of unemployment with employer top-up⁽²⁾, more stringent requirements concerning availability for the labour market, stricter controls over access to time credit and career breaks, etc. Employment policy must continue to aim at maximum job creation in the future, too. Particular attention should focus on rectifying the extremely low employment rate of certain risk groups which have difficulty in entering the labour market.

Despite an improvement compared to the figure for 2000, the employment rate of persons aged over 55 years in Belgium is 9.1 percentage points below the euro area average, and much lower than in Germany and the Netherlands. However, the successive reforms since 2011, which included tightening of the conditions of access to early retirement, have not yet been fully effective. The status of an older unemployed person not seeking work was also changed: with effect from 2015, new unemployed

(1) The unemployment rate is calculated on the basis of the administrative concept and not the survey concept normally used for international comparisons.
(2) These used to be "pre-pensions".

TABLE 1 EMPLOYMENT RATE OF RISK GROUPS
(in % of the corresponding population aged from 20 to 64 years, unless otherwise stated; 2015)

	Belgium	<i>p.m.</i> Belgium, change since 2000 (1)	Germany	France	Netherlands	Euro area
Total	67.2	+1.8	78.3	69.5	76.6	69.3
20-29 years	57.1	-7.6	71.8	60.8	75.7	59.1
55-64 years	44.7	+17.9	67.0	48.8	62.2	53.8
Non-EU nationals	44.3	<i>n.</i>	57.1	45.6	50.5	56.0
Low-skilled	45.8	-4.2	59.3	50.6	60.0	52.7

Source: EC.
(1) Percentage points.

persons are obliged to look for work until they reach the age of 65 years.

In addition, the labour market participation of young persons and the low-skilled has fallen in Belgium over the past 15 years. However, the decline in the employment of young people is due partly to a larger percentage of students and the extension of the period of study. Belgium is the European country with the lowest employment rate for non-European nationals, and the gap between that group's employment rate and that of Belgian nationals is much wider than the European average. Each of these groups therefore merits special attention, particularly in the form of training and measures to combat discrimination. It is also important to ensure that asylum-seekers are integrated into the labour market. That population has a number of strengths: in particular, it could offset population ageing to some extent. While 21% of the Belgian population is aged between 18 and 34 years, around half of the asylum-seekers are in that age group.

4.2.2 Productivity

The second component of economic growth, the increase in labour productivity, is also essential for creating the economic basis to finance the costs of ageing.

According to the reference scenario of the Study Committee on Ageing, productivity growth will rise steadily year by year, from 0.5% in 2021 to 1.5% in

2035, and then remain constant. Over the period as a whole, productivity growth averages 1.2% per annum, a rate that roughly corresponds to the average increase in productivity from 2000 to 2007, but is relatively high considering recent observations. The Ageing Working Group assumes year-on-year growth of 1.5% in the long term.

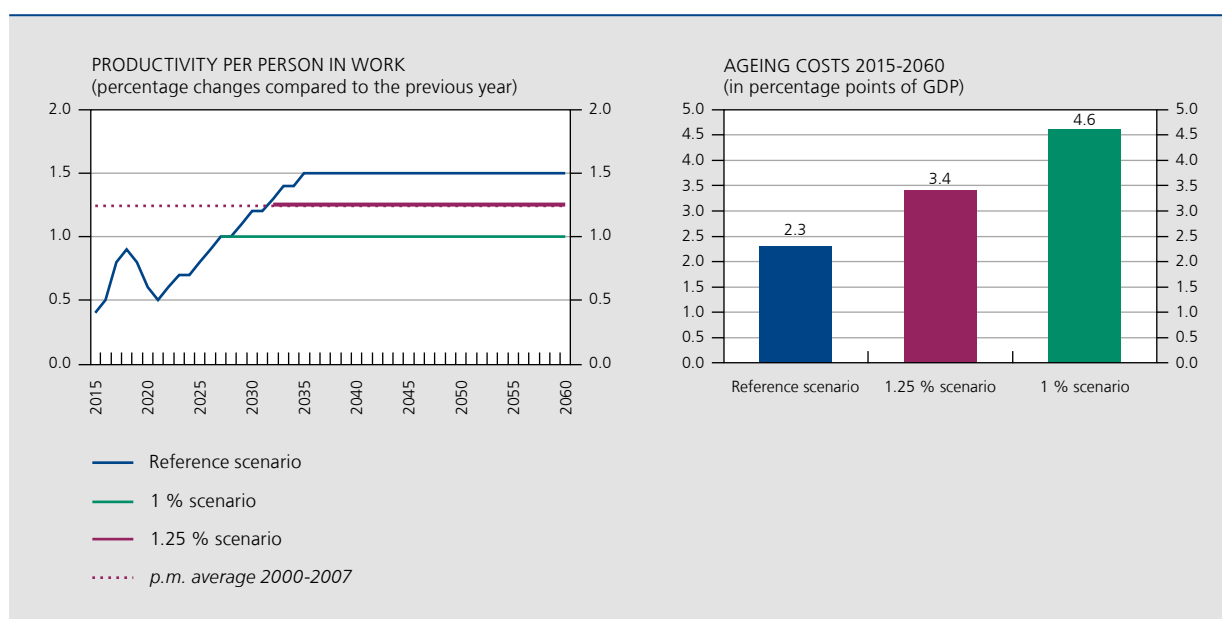
Two alternative scenarios with lower productivity growth in the long term, namely annual growth of 1.25% and 1% respectively, demonstrate that increased productivity is crucial to contain the costs of ageing. The average year-on-year growth of activity between 2015 and 2060 would be 0.15% lower in the 1.25% productivity scenario, and 0.32% lower in the 1% scenario. The budgetary costs of ageing would be respectively 1.1 and 2.3 percentage points of GDP higher than in the reference scenario.

It is therefore extremely important to support the growth of labour productivity, hence the need for the government to invest sufficiently in infrastructure, research and development, and education, and to create an attractive environment for private initiatives and entrepreneurship.

4.3 Limiting ageing-related expenditure

Finally, the three-pronged strategy requires maintaining control over the rise in expenditure on pensions and health care in order to safeguard the affordability of social protection in the long term.

CHART 10 INCREASED LABOUR PRODUCTIVITY IS VITAL TO CONTAIN THE COSTS OF AGEING



Source : SCA.

4.3.1 Pension expenditure

When it took office in October 2014, the federal government announced measures to extend the reform of the pension system. Those measures aimed essentially to keep employees in work for longer. That would reduce the spending on pensions, increase employment and support economic activity, bringing down the budgetary costs of ageing.

The most notable measures concerned increasing the statutory retirement age, further tightening the conditions for early retirement, and abolishing the pension bonus, which was a financial incentive intended to encourage employees reaching the end of their career to continue working for longer. In addition, the government expressed its intention to bring the pension system for civil service staff more into line with private sector schemes. Apart from these reforms, when the government took office it also announced the creation of a National Pension Committee. This advisory committee prepares a number of structural reforms and systematically monitors the financial and social sustainability of the pension schemes. It is supported by the pensions Knowledge Centre and by an Academic Council. Those institutions were established in the spring of 2015.

Some important pension reform measures were already taken in 2015. For instance, the statutory retirement age is being increased from 65 to 66 years in 2025 and to 67 years in 2030. On reaching that age, people are allowed to take their pension without having to fulfil any career conditions. The conditions for access to early retirement were also tightened further. At the end of 2011, the previous federal government had decided to raise the stipulated minimum age for that from 60 to 62 years, and to increase the length of service from 35 to 40 years. The current federal government decided to raise the minimum age to 62.5 years in 2017 and 63 years in 2018. The career condition will be further increased to 41 years in 2017 and 42 years from 2019. However, there are exceptions in regard to very long careers. Furthermore, the number of persons entitled to a survivor's pension is being limited by gradually raising the minimum age applicable, namely from 45 years to 50 years in 2025 and 55 years in 2030. Finally, the pension bonus system was abolished with effect from 1 January 2015; from then on, the only bonus rights will be those built up before the announcement that the system was being abolished. These reforms apply to the three principal pension systems, namely the public sector scheme, the scheme for employees and the scheme for the self-employed.

In addition, a number of adjustments to public sector pensions were approved. A key change in this

system concerned the so-called "diploma bonus" whereby years spent studying are taken into account in calculating the length of the career; this is being phased out between 2016 and 2030.

Following on from the measures adopted by the previous government, the conditions for granting unemployment benefits with an employer top-up, i.e. what used to be "pre-pensions", were also tightened up. Two important changes were made here. First, the minimum age for eligibility for this scheme was increased, and next, these unemployed persons must in the future be registered as job-seekers who are available for the labour market. Nevertheless, there are exceptions, e.g. in the case of arduous occupations, long careers and serious medical problems. In regard to the supplementary occupational pension, the federal government decided that in future it will be impossible to draw that pension before the person concerned actually takes (early) retirement. Moreover, with effect from 1 January 2016, new pension plans may no longer expire before the age of 65 years.

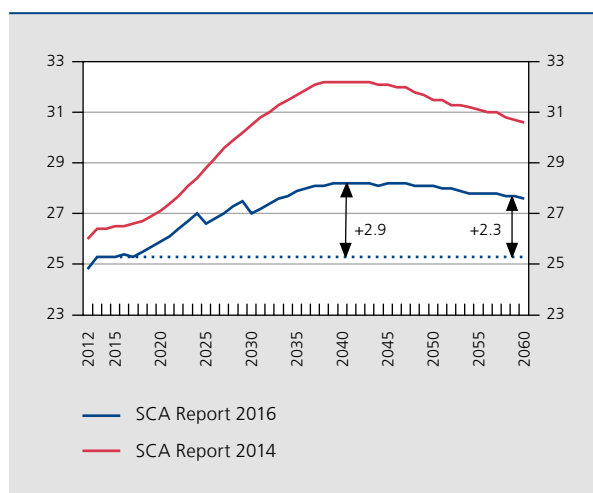
In its 2015 report, the Study Committee on Ageing examined how the principal measures in the recent pension reform affected the labour market, economic activity and ageing costs. In the process, the reference scenario used at that time was compared with a scenario excluding those measures.

The results show that, in the long term (by 2060), the reforms will reduce by 395 000 units altogether the number entitled to a retirement pension and the number of non-job-seeking unemployed with an employer top-up. As a corollary to that, the non-retired population – i.e. the labour force and inactives – will increase to the same extent. The expansion of the labour force will bring a 5.6% increase in employment. As a result of the reforms, the total employment rate will be 3.9 percentage points higher and the employment rate for persons aged between 55 and 66 years will actually rise by 16.4 percentage points. GDP will also increase by 5.6% since it is assumed that productivity growth remains unchanged.

The reforms should bring ageing costs down by 2.1 percentage points of GDP, of which 1.5 percentage points can be attributed to lower pension expenditure and 0.6 percentage point concerns other social benefits. The fall in social expenditure is due to three factors: the decline in the number of pensioners and non-job-seeking unemployed with an employer top-up, abolition of the pension bonus, and the upward revision of economic growth.

Despite this favourable effect of the pension reform on ageing costs, social benefits will continue to rise steeply

CHART 11 SOCIAL BENEFITS BEFORE AND AFTER THE RECENT PENSION REFORM
(in % of GDP)



Source: SCA.

in the future, namely by 2.3 percentage points of GDP in the period 2015-2060, as stated in section 2.2.

In 2016, the government took a number of steps to make further adjustments to the pension system. They included the harmonisation of the diploma bonus for calculating pensions under the three pension systems, the phasing out of the preferential *'tantièmes'* and the revaluation coefficients in the civil service pension scheme, introduction of a mixed pension in the public sector (contract agent/civil servant), abolition of a number of special pension schemes, and reform of disability pensions for civil servants. However, the details of the implementation of these proposals have not yet been defined and are still under discussion between the various parties concerned.

In the coming years, further radical reforms to the various pension schemes are to be expected. The National Pension Committee was instructed to prepare a range of reforms. It has to examine how the strenuousness of the job can be taken into account in pension entitlements, and investigate the possibility of including a part-time pension and introducing a points system for pensions. In regard to this last aspect, the federal government has expressed the intention to reach agreement on such a system by the end of its term in office so that it can be introduced by no later than 2030. Other reforms which have been announced concern reform of the pension institutions and strengthening of the link between the work done and the amount of the pension. Measures have also been announced concerning reinforcement of the second pension pillar.

In view of the longer working life resulting from the pension reform, the average amount of the pension will be higher than in a scenario without the reform. That together with the greater participation of women in the labour market will reduce the risk of poverty among pensioners. Similarly, inequality among pensioners will diminish. The pension reform measures which have already been introduced would therefore not only lower the budgetary costs of ageing, they would also improve the social sustainability of pensions.

4.3.2 Health care expenditure

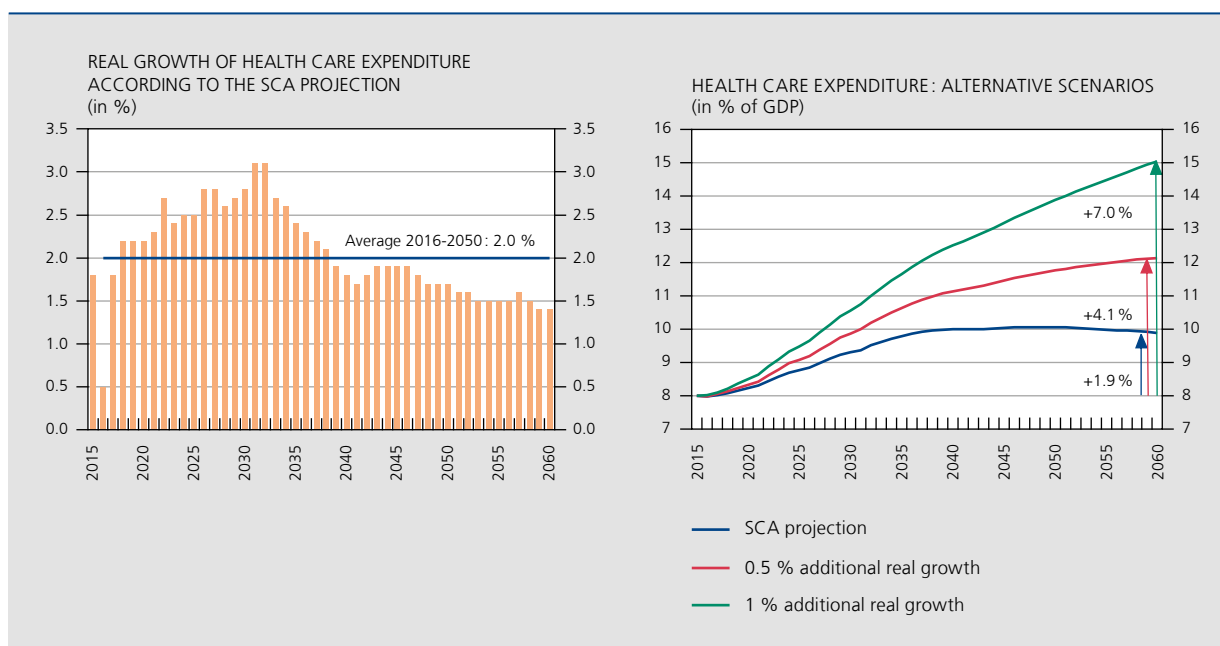
In the coming decades, public health care expenditure will be influenced by the needs inherent in the growing number of elderly persons, as that will lead to increased demand for health care. In addition, specific facilities will be required for the diagnosis and treatment of certain disorders and diseases associated with that age group. However, ageing is only one factor driving up expenditure on health care, because that spending is also being propelled by increased prosperity and the rising cost of treatment, attributable partly to rapid technological progress.

Public spending on health care increased from 5.9 % of GDP in 2000 to 8 % in 2015. According to the forecasts of the Study Committee on Ageing, that expenditure will continue climbing to reach 9.9 % of GDP in 2060, so that this spending category will contribute 1.9 percentage points to the costs of ageing.

The average annual real increase in health care expenditure is expected to gradually accelerate from around 1.8 % in 2015 to around 2.5 % in 2025. In subsequent years, that growth rate will continue edging upwards to 3.1 % in 2031 and 2032. During that period, the number of persons aged between 75 and 84 years will increase steeply, and the proportion of the population aged between 65 and 74 years will reach a peak. After that the growth rate will diminish to around 1.4 % by the end of the projection period.

In the period 2016-2060, the average real growth rate of health care expenditure will come to 2 %, while activity growth is expected to average 1.6 % during that period. However, if health care expenditure were to increase faster than expected, there is a risk that ageing costs would be substantially higher. This can be clearly demonstrated using two simulation exercises. Those exercises presuppose that annual expenditure growth is respectively 0.5 and 1 percentage point higher. That would mean average real expenditure growth during the projection period of 2.5 % and 3 % respectively. In the first exercise, health care expenditure would contribute

CHART 12 PUBLIC EXPENDITURE ON HEALTH CARE



Sources: SCA, NBB.

4.1 percentage points of GDP to the cost of ageing, whereas in the second exercise that figure would increase to no less than 7 percentage points of GDP. This simulation clearly shows that it is essential to maintain strict control over the growth of health care expenditure.

Conclusion

In the coming decades, Belgium's public finances like those of most European countries, will be confronted by the effects of population ageing. For instance, between 2015 and 2060, the social benefits paid by the government in Belgium will rise by 2.3 percentage points of GDP.

The recent pension reform has curbed the expected increase in pension expenditure, but the costs of ageing are still high by European standards. There is also a risk that the costs have been underestimated, for example if the rise in labour productivity is weaker than the assumed figure forming the basis of the reference scenario of the Study Committee on Ageing.

Population ageing therefore remains a vital policy challenge for Belgium. To meet that challenge, further work is needed on a coherent strategy comprising a three-pronged policy covering targeted budgetary, economic and social aspects.

First, the budgetary policy must include a consolidation programme aimed at achieving a structurally balanced budget in the medium term. It should consist mainly of a selective reduction in expenditure. Efforts must also be made to ensure that taxes are properly collected, and use can be made of margins in some revenues.

In addition, the economic policy should aim to stimulate growth by boosting potential GDP. To that end, every effort must be made to drive up the employment rate, particularly that of a number of risk groups, via an active employment policy. There is also a need to increase productivity, e.g. by stimulating investment, research and development, and more efficient market functioning.

Finally, the increase in expenditure on pensions and health care must be kept under control. That is important to ensure the sustainability of public finances and the affordability of social protection in the long term.

Bibliography

- Balassone F., J. Cunha, G. Langenus, B. Manzke, J. Pavot, D. Prammer and P. Tommasino (2009), *Fiscal sustainability and policy implications for the euro area*, NBB Working Paper 155.
- Bisciari P., D. Dury, B. Eugène and L. Van Meensel (2009), "Pension system reforms in the EU15 countries", NBB, *Economic Review*, December, 21-45.
- Burggraeve K. and C. Piton (2016), "The economic consequences of the flow of refugees into Belgium", NBB, *Economic Review*, June, 43-61.
- Clements B., K. Dybczak, V. Gaspar, S. Gupta and M. Soto (2015), *The Fiscal Consequences of Shrinking Populations*, IMF Staff Discussion Note 15/21.
- Dury D. and L. Van Meensel (2007), "The sustainability of public finances in the context of population ageing", NBB, *Economic Review*, September, 81-95.
- EC (2012), *Fiscal Sustainability Report 2012*, European Economy 8.
- EC (2014), *The 2015 Ageing Report: Underlying Assumptions and Projection Methodologies*, European Economy 8.
- EC (2014), *Assessing Public Debt Sustainability in EU Member States: A Guide*, Occasional Papers 200, September.
- EC (2015), *The 2015 Ageing Report: Economic and budgetary projections for the 28 EU Member States (2013-2060)*, European Economy 3, May.
- EC (2015), *2015 Pension Reform in Belgium*.
- EC (2016), *Fiscal Sustainability Report 2015*, Institutional Paper 018, January.
- EC (2016), *Joint Report on Health Care and Long-Term Care Systems & Fiscal Sustainability*, Institutional Paper 037, October.
- ECB (2012), "Analysing government debt sustainability in the euro area", *Monthly Bulletin*, April, 55-70.
- Escolano J. (2010), *A practical guide to public debt dynamics, fiscal sustainability, and cyclical adjustment of budgetary aggregates*, Technical notes and manuals, IMF, Fiscal Affairs Department.
- Fasquelle N., S. Weemaes and P. Willemé (2010), "De gezondheidszorguitgaven: determinanten en projecties", Documentatieblad van de Federale Overheidsdienst financiën, 1st quarter.
- Federal Planning Bureau, FPS Economy – Directorate General of Statistics (2016), *Perspectives démographiques 2015-2060 – Population, ménages et quotients de mortalité prospectifs*, March.
- High Council of Finance, *Opinions*.
- Langenus G. (2006), *Fiscal sustainability indicators and policy design in the face of ageing*, NBB, Working Paper 102, October.
- Melyn W., L. Van Meensel and S. Van Parys (2015), "European governance framework for public finances: presentation and evaluation", NBB, *Economic Review*, September, 73-99.
- OECD (2015), *Ageing: debate the issues*, OECD Insights.

Reinhard N. and J.-E. Sturm (2008), *Sustainability of public debt*, CESifo seminar series, The MIT Press.

Study Committee on Ageing, *Report 2016 and preceding years*.

United Nations (2015), *World Population Ageing Report*.

United Nations (2015), *World Population Prospects, Key Findings and Advance Tables*.

Van Ewijk C., N. Draper, H. ter Rele and E. Westerhout in cooperation with J. Donders (2006), *Ageing and the Sustainability of Dutch Public Finances*, CPB Netherlands Bureau for Economic Policy Analysis.

Willemé P. (2014), *Structurele determinanten van de publieke gezondheidszorguitgaven*, Working Paper 06-14, September.