Long-term sustainability of public finances for a recovering economy

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PURPOSE: to examine the long-term sustainability of public finances for a recovering economy.

CONTENT:

This Communication and its companion Report (Sustainability Report 2009) assess the sustainability of public finances in the EU Member States. It is issued in the context of the reflection on strategies to exit from the economic and financial crisis and on the convergent and coordinated framework for the reform of Europe's economies at the core of the strategy for Europe 2020.

An acute challenge after the crisis: the communication notes that thanks to effective and substantive policy action since autumn 2008, coordinated in the context of the European Economic Recovery Programme (EERP), a financial meltdown and a generalised loss of confidence has been avoided. However, **even if there are some signs of the green shoots of recovery in the European economy, uncertainty remains high**: economic activity is set to shrink by 4 percent this year, while growth in 2010 will be slim.

Discretionary budgetary stimulus measures have provided a cushion to economic activity but have also resulted in **a substantial deterioration in government accounts**. From a deficit of 0.8 percent of GDP in 2007 – the best result for 30 years – the government deficits in the EU are forecast to average 6 percent of GDP in 2009 and around 7 percent in 2010. In the three years to 2010, the gross debt ratio for the EU as a whole is increasing by more than 20 points. The available projections show that, in the absence of ambitious efforts to implement structural reforms and consolidate government accounts, there would be very large increases in expenditure on debt interest and public pensions, as well as on healthcare and long-term care during the coming decades.

Assessment of sustainability by country: the long-term sustainability of the public finances is a **concern for all EU Member States**. However, there are **large variations** across the Member States in terms of the degree of long-term risk that they are exposed to and the sources of that risk. There are serious sustainability gaps for most countries as a result of the economic crisis, and several countries (Ireland, Spain, Latvia, Lithuania, Malta, the Netherlands, Austria, Poland, Slovakia and the United Kingdom) now find themselves in the long-term high-risk category. The deterioration in sustainability gaps is especially severe in those countries most seriously affected by the crisis. However, thanks to consolidation and pension reform, Hungary and Portugal have shifted from the higher to the medium-risk group of countries.

Policy challenges: the crisis-related deterioration in public finances and the projected increase in expenditure due to demographic change both constitute major policy challenges. Public finances, including social protection systems, have cushioned the economic and social impact of the crisis. Notwithstanding the need to keep supporting the economy and avoid choking an emerging recovery, **measures to improve fiscal sustainability should be implemented in a decisive manner** as soon as conditions allow it, to avoid a more severe correction at a later stage. **The reduction in debt ratios will have to come from a combination of fiscal consolidation and structural reforms to support potential growth.**

The **strategy** to prepare for the economic implications of the demographic changes has been in place since the 2001 European Council of Stockholm. This strategy includes (i) deficit and debt reduction, (ii)

increases in employment rates and (iii) reforms of social protection systems. It has shown its validity and remains applicable. While, prior to the crisis, the three prongs of the strategy were options from which countries could choose, each of these pillars is now indispensable for most EU countries.

1) Reduce debt: simply overcoming the ongoing economic and financial crisis without fiscal consolidation in a determined manner will not suffice to **bring government debts to asustainable path**. Projections based on a scenario of growth returning to the long-term path of before the crisis show that without consolidation, the gross debt-to-GDP ratio for the EU as a whole could reach 100 percent as early as 2014, and keep on increasing. Thus, although fiscal support must be maintained until recovery is secured, fiscal policies must progressively be reoriented towards sustainability. A fast reduction in the debt ratio will also depend on an orderly disposal of assets accumulated in support of the financial sector, and an effective management of contingent liabilities.

2) Increase employment rates: where employment is contracting and unemployment is rising, there is a **need to avoid cyclical unemployment becoming entrenched**, an increase in long-term unemployment and a reduction in participation rates. **Policies should be in synergy with the social goals of supporting the income of the most disadvantaged citizens, which in itself will assist stimulating aggregate demand.** Short-term policies to address the crisis should not run counter to long-term reform strategies, including the implementation of the flexicurity principles under the Lisbon Strategy. In particular, Member States should refrain from using policies such as early retirement schemes in order to mitigate the impact of higher unemployment and industrial restructuring. Reforms must also focus on improving the functioning of the EU's knowledge triangle of education, R&D and innovation, which contribute to technological developments and productivity growth, and efforts in relation to green technologies.

3) Reform social protection systems: the main policy lever to ensure sustainability is through reform of pension and healthcare systems.

- ***Pensions:*** several reforming avenues are possible and have been implemented or are being contemplated by several countries. In several countries, future pensioners have been encouraged to top-up their public pensions with their own savings and funded old-age income. Yet, developments in financial markets during the crisis have illustrated the risks associated with the shifting of a large share of pension provision to privately-managed funded schemes, and has reduced the political and social support to implement reforms that leave a large proportion of pensions subject to market fluctuations. The Commission will continue to work with the Council and the Member States to identify lessons for the design of funded schemes and target beneficiaries in order to secure adequate and sustainable private pension provision. Each country will have to identify the reforms that better fits its own characteristics and social preferences and consensus will be desirable to implement them. **Increases in the effective retirement age** that reflect gains in longevity are being contemplated in several Member States and merit wider consideration.
- ***Healthcare***: the projected long-term increase in healthcare spending is large and constitutes on its own a risk to sustainability. Given its multidimensional nature, a **reform of healthcare** needs to consider several complex issues, on ways to make health system more efficient; on the resources allocated to preventive and curative medicine; on responding to the challenge of maintaining an appropriate healthcare workforce; on the balance of financing between patients, public and private insurers; the degree of competition among providers of care; on the effective assessment and management of technology aiming at fostering efficiency and ensuring high-quality services while rationalising costs; or ethical issues like access to expensive treatments.
- ***Quality of public finances***: as public resources are scarce, **an increase in the quality of public finances is indispensable.** Modernising public services and reducing non-productive expenditure helps stemming the debt increases, frees resources to invest in growth-boosting areas such as education, research and innovation, and other policy objectives (social, environmental, health) and strengthens incentives for raising the productive capacity of the economy. Fiscal consolidation through raising additional revenue should take account of incentive effects, efficiency and

competitiveness, be focused on those measures with the least distortionary effects, in particular on labour participation and capital accumulation, while contributing to meeting other goals (*e.g.* green taxes).

In conclusion, the Commission considers that **rising government expenditure and prospects of an ever-increasing debt would be an obstacle to a sustained and long-lasting recovery** and balanced economic growth.

Fiscal exit strategies aiming at achieving ambitious and realistic medium-term objectives need to be designed now, and implemented in a coordinated manner as soon as recovery takes hold, taking into account the specific situations of individual countries. To support the required reforms and enhance the credibility of fiscal adjustment – which inevitably stretches over a number of years – Member States may also need to develop further their own stability-enhancing institutional arrangements. In the Stability and Growth Pact context, debt sustainability should get a very prominent and explicit role in surveillance procedures.