Filling the Sustainability Gap in the EU after the Crisis

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Most countries in the European Union are facing a structural deterioration of their public budget as a result of the financial and economic crisis. The European Commission (2009) projects an average structural deficit for 2010 of 4.7% for the euro area and a corresponding figure of 5.5% for the entire EU. [2] Actual deficits are generally higher due to the negative output gaps. Greece, Ireland, Portugal, Spain and the UK all feature double digit deficit figures. Further, virtually all EU countries are on exploding debt paths if policies do not change. By 2060, Greece, Latvia and Ireland would all have debt ratios of over 800% of GDP, a number that in reality would of course never be reached as those countries would be forced into default long before reaching those levels. While sustainability gaps were already positive before the current crisis, the crisis has magnified them further.

In this paper, based on the European Commission's (2009) Sustainability Report we present the sustainability gap for different EU countries and discuss the future development of the various age-related spending categories. In particular, we distinguish spending on pensions, healthcare including long-term care and unemployment benefits/education.

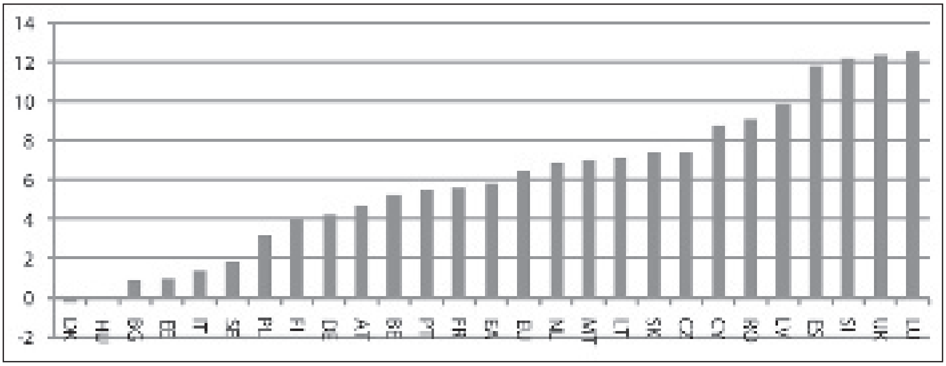
The sustainability gap in EU countries

Based on the EU Sustainability Report, Figure 1 plots the so-called S2 indicator for all EU countries. This indicator of the sustainability gap shows the adjustment to the current structural primary balance needed to fulfill the infinite-horizon inter-temporal budget constraint. The required adjustment also takes account of the additional spending as a result of population ageing. The indicator is based on existing policies.

1. See also Beetsma, R. and R. Gradus (2010). The sustainability gap in the EU with special attention to the Netherlands, *CESifo DICE report*, 8 (2), 69-74.

2. European Commission (2009). Sustainability Report, *European Economy*, No. 9, p 38.

Figure 1: sustainability gap in EU-countries



Source: European Commission (2009, p. 35)

According to the sustainability indicator, 25 of the 27 EU Member States display a sustainability gap. Only Denmark and Hungary appear to be sustainable already. Around a fifth of the countries need a 4% GDP adjustment or less, roughly half of them need a GDP adjustment of between 4 and 8% and about a quarter of them require an even larger adjustment. The most extreme cases are the United Kingdom with a sustainability gap of 12.4% points and Luxembourg with a gap of 12.5% points. Hence, most countries need to put in place drastic policy changes to offset their sustainability gaps.

The composition of the sustainability gap

For most countries total age-related public spending is an important component of the sustainability gap. Total age-related public spending for the EU-27 is projected to increase by 4.6% points over the period 2010-2060 (Table 1). Of this total, 2.7% points are accounted for by an increase in public pensions and 2.5% points by both an increase in healthcare spending and an increase in long-term care spending.[3] In other words, public pensions account for only half of the rise in age-related spending, although they usually receive most of the attention in the discussions about ageing costs. Indeed, in many countries retirement ages are gradually being increased. For example, in the UK the normal pension age is scheduled to rise from 65 to 68 by 2044 and in Germany from 65 to 67 by 2031. In the Netherlands, the Rutte-I cabinet proposed to raise the age at which people become eligible for a public pension from 65 to 66 in 2020. Social partners, employers' representatives and the trade unions, have agreed to link further increases in the public pension retirement age to the development of life expectancy. However, public pensions are the governments' domain and at the moment it is not clear whether the new cabinet will be prepared to take over this agreement. Healthcare

3. Using EU average data based on European Commission (2006) and taking into account the presence of other age-related spending, Beetsma and Oksanen (2008) show that a transition from a pay-as-you-you go public pension system to a funded, actuarially neutral system would require a budget surplus of 1.6 percent of GDP over the next two generations. The surplus is needed to convert implicit debt in the form of accumulated pension rights to the workers into (explicit) public debt (see Beetsma, R. and H. Oksanen (2008). Pensions under ageing populations and the EU Stability and Growth Pact, *CESifo Economic Studies*, 54 (4), 563-592 and for data see European Commission (2006). The Long-term Sustainability of Public Finances in the European Union, *European Economy*, No. 4).

accounts for the other half of the rise in age-related spending. A small reduction by 0.2% points is obtained through lower spending on unemployment benefits. However, those EU-wide averages hide substantial disparity across the countries. The most extreme cases are Greece with an expected rise in age-related public spending by 16% points and Luxembourg with an increase by 18.2% points (see Table 1).

Table 1
Increase in age-related spending in percent of GDP over period 2010-2060

	Pensions Spending		Healthcare*		Unemployment and Education		Total	
	2010	Δ 2060	2010	Δ 2060	2010	Δ 2060	2010	Δ 2060
Belgium	10.3	4.5	9.2	2.4	7.3	-0.3	26.8	6.6
Bulgaria	9.1	2.2	5	0.8	3.0	0.2	17.1	3.2
Czech Republic	7.1	4.0	6.6	2.4	3.3	0.0	17.0	6.3
Denmark	9.4	-0.2	7.8	2.4	8.0	0.1	25.2	2.2
Germany	10.2	2.5	8.6	3	4.6	-0.4	23.3	5.1
Ireland	6.4	-1.6	5.2	1.2	3.2	0.3	14.6	-0.1
Estonia	5.5	5.9	6.8	3	5.3	-0.2	17.5	8.7
Greece	11.6	12.5	6.6	3.4	3.6	0.1	21.9	16
Spain	8.9	6.2	6.3	2.3	4.8	-0.2	20.0	8.3
France	13.5	0.6	9.7	1.8	5.8	-0.2	29.0	2.2
Italy	14	-0.4	7.6	2.2	4.3	-0.2	26.0	1.6
Cyprus	6.9	10.8	2.8	0.6	5.8	-0.6	15.5	10.7
Latvia	5.1	0.0	3.9	1	3.3	0.3	12.3	1.3
Lithuania	6.5	4.9	5.1	1.6	3.5	-0.4	15.1	6.0
Luxembourg	8.6	15.3	7.3	3.1	4.0	-0.3	19.9	18.2
Hungary	11.3	2.6	6.1	1.7	4.5	-0.3	21.8	4.0
Malta	8.3	5.1	5.9	4.7	5.0	-0.7	19.2	9.2
Netherlands	6.5	4.0	8.4	5.5	5.6	-0.2	20.5	9.4
Austria	12.7	1.0	7.9	2.6	5.2	-0.2	25.7	3.3
Poland	10.8	-2.1	4.5	1.3	3.6	-0.6	19.1	-1.1
Portugal	11.9	1.5	7.4	1.9	5.6	-0.4	24.9	2.9
Romania	8.4	7.4	3.6	1.3	2.7	-0.2	14.7	8.5
Slovenia	10.1	8.5	8	3.4	5.1	0.7	23.1	12.7
Slovakia	6.6	3.6	5.4	2.5	2.9	-0.6	14.9	5.5
Finland	10.7	2.6	7.5	3.3	6.4	0.0	24.7	5.9
Sweden	9.6	-0.2	10.8	2.9	6.6	0.0	27.1	2.7
UK	6.7	2.5	8.4	2.3	4.0	0.0	19.2	4.8
EU 27	10.2	2.3	8.2	2.6	4.9	-0.2	23.2	4.6

*Source: European Commission (2009, p. 29); *) including long-term care*

Of course, these calculations are subject to substantial uncertainty, partly because the underlying assumptions may fail to hold in the long run. The EC Sustainability Report assumes that wages rise in line with the growth of labor productivity. Together with the growth of productivity, changes in the number of people employed determine economic growth. As a result of a declining labour supply, GDP growth is forecast to average 1.3% per year by 2040. The EU projects public spending per cohort to increase in line with wages and thus labour productivity. Spending in the healthcare sector may well rise faster, however, as labour productivity in this sector is likely to increase at a slower pace than in the rest of the economy, thereby putting upward pressure on wage costs (the so-called "Baumol effect"). At the same time, technological innovations may boost spending in the cure sector. Both effects will cause healthcare spending to rise faster than projected by the EU[4].

Long-term care accounts for an important part of the rise in health-care related spending. Spending on long-term care will rise exponentially for the very old[5]. It is well-known that in all EU Member States the share of the population that is 80 years or older is growing faster than any other segment of the population.

The estimation of the structural primary balance is subject to substantial uncertainty, especially at the current moment after an unprecedented crisis and with so much doubt about the future of the economy. Therefore, the assessment in the Sustainability Report of the sustainability risks for the EU Member States is useful. According to the Report, Bulgaria, Denmark, Estonia, Finland and Sweden have done most to cope with ageing[6]. There is an intermediate group of countries (Belgium, Germany, France, Italy, Luxembourg, Hungary, Austria, Poland and Portugal) in terms of the projected increase in age-related spending and there is a large group of countries (Czech Republic, Ireland, Greece, Spain, Cyprus, Latvia, Lithuania, Malta, the Netherlands, Romania, Slovenia and United Kingdom) for which a very significant rise in age-related spending is predicted. Greece and Ireland are positioned worst in this regard.

What options are there to close the sustainability gap?

Countries are free to select their own policies to close their sustainability gap. One possibility is to raise taxes. Among the consolidation measures Greece presented in January last year there is a crackdown on tax fraud. However, given that taxes are already high in most European countries and that the incidence of tax fraud is less serious in most countries than in Greece further increases in tax burdens are undesirable as they will negatively impact economies through reduced work incentives.[7] Substantial reductions in public spending and, in particular, social spending will be necessary, especially for Greece[8]. Of course, reductions in public spending may in the short-run have negative demand effects but will in the longer-run crowd in private consumption and investment by limiting the tax burden. Commitment to substantial spending cuts will also send a positive signal to the financial markets. After all, lack of confidence in the resolve on the part of the Greek government has driven up interest rates on its public debt to such high

4. Asselt, E.J. van, L. Bovenberg, R. Gradus and A. Klink (2010). *Health care in ageing European society with special attention to the Netherlands*, CES: Brussels.

5. OECD (2005), Long-term care for older people, Paris.

6. European Commission (2009). Sustainability Report, *European Economy*, No. 9, p. 88-89.

7. For a discussion of the Dutch tax system and its incentives see (R. Gradus (2010). Flat but fair: a proposal for a socially conscious flat rate tax in the Netherlands, *Intertax*, Vol. 38, pp. 601-610.)

8. Gros, D. (2010). What Greece now needs to do, *European Voice*, April 28, http://www.europeanvoice.com/article/2010/04/what-greece-now-needs-to-do/67798.aspx

levels that other euro area members and the IMF had to come to its rescue. Sustainability gaps in Southern Europe can, and probably need, to be reduced through increases in labour market participation, which should be partly achieved through increases in the retirement age and measures that stimulate economic growth. In addition, Southern Europe as a whole has suffered from a loss in competitiveness since joining the euro area. Labour market institutions are badly in need of reform, while an internal devaluation, through wage cuts, might be inevitable to restore competitiveness relative to other European countries, in particular Germany. Also in many instances product markets are in need of reform. One of the best-known examples concerns the proposed abolition of the system of permits for truck drivers in Greece, which only recently led to strikes and blockades.

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European governments are confronted with substantial sustainability gaps. Those gaps are not new. However, for many countries they have become larger as a result of the economic and financial crisis. The crisis has led to higher structural deficits and rising public debt ratios causing substantial turbulence on the financial markets, while, in fact, public debt should have been on the decline in anticipation of rising age-related spending. Obviously, substantial policy adjustments are needed in most countries to fill their growing sustainability gaps and avoid that too large a share of the bill is shifted to future generations. We put forward a number of options to avoid an increase in the tax burden. These suggestions primarily aim at achieving sustainability through structurally higher economic growth and labour force participation. Obviously, other choices are possible. However, it is important that they remain consistent with achieving sustainability and allow future generations to continue to profit from essential public services without having to pay substantially higher taxes.