

The Budgetary Challenges Facing the EU

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Introduction

In my presentation, I would like to bring you up to date with the work carried out by the Economic Policy Committee. Our activities have increased substantially over the past three years, nearly on account of the recognition that sound and sustainable public finances are crucial for the long-term success of Economic and Monetary Union.

I would like to summarize briefly our work on 2 questions:

- What are the main budgetary challenges?
- What are the reform challenges of public systems?

And finally, I would like to illustrate the strategy in the Belgian case.

I. Main budgetary challenges

The EPC has been active mainly in 3 areas directly linked to the assessment of the sustainability of public finances in the long term, namely our efforts to produce comparable long-term projections for public spending on pensions, health and long-term care for the elderly, our efforts to define sustainability indicators and, finally, and to try to establish the framework or a strategy allowing society to cope with the problem of ageing and to fully benefit from a longer life expectancy.

A. Methodology



Methodology	
Demographic projection	Eurostat
✓ Distribution of population among social categories: labour force, pensioners, etc	National projections
✓ Macroeconomic scenario: wages, employment, contributions	Working Group on Ageing and Commission
✓ Pensions projections	National projections
✓ Health care and long term care projections	Working Group on Ageing and Commission
✓ Other items (education, child allowances,...)	Working Group on Ageing and Commission
✓ Public account projection: primary surplus, deficit and debt	Working Group on Ageing and Commission
✓ Public finances sustainability indicators	Working Group on Ageing and Commission

[Slide 1]

1. Director of the Belgian Federal Planning Bureau and Chairman of the Economic Policy Committee Working Group on Ageing Population. I would like to thank Heinz Scherrer, secretary of the Working group and official of the Commission for his help to prepare this presentation.

Let me first turn to long-term projections on public spending on pensions, health and long-term care for the elderly. These projections, prepared in cooperation with the Commission services in November 2001, not only covered old-age pensions, but also most income transfers to persons aged over 55, including early retirement pensions, disability and survivors pensions and other transfers to the elderly. The health care projections covered acute hospital care and medical services, as well as long-term care.

The projections were made using the models of national authorities, but on the basis of a common demographic projection and agreed assumptions on key macroeconomic parameters.

In those fields that are mainly in the domain of subsidiarity, this is one of the main advantages of this division of labour.

If no policy changes occur, the demographic projection will then entail a regular decrease of employment and a progressive slowdown of growth. Moreover, the expenditures on some of the main functions of the social security system will increase, putting at risk the sustainability of public finances.

Growth accounting

Average annual growth rates	'80 – '90	2000-2050
- Productivity	1.7	1.7
Total factor productivity	1.0	1.0
Capital deepening	0.7	0.7
- Employment	0.4	-0.2
GDP growth	2.2	1.6

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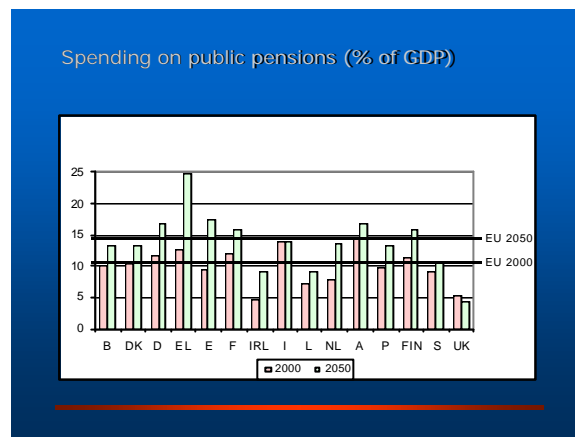
Demographics, however, do not represent the whole picture. What matters more for growth and for pension systems is the balance between economically active people in employment and the inactive people who must be supported. The negative impact of demographic developments can partially be offset if more people of working age participate in the labour market and if unemployment rates are lower. This was a major assumption of the projections.

The participation rates of women will continue their upward path. The last measured gender gap for the employment rate in the Union still amounted to nearly 18 percentage points. Of course, this average conceals large intra-Union differences, their gender gap ranging from less than 5 percentage points in the Scandinavian countries up to 30 percentage points in the Mediterranean countries. Moreover, already enacted reforms will succeed in reversing the trend towards lower effective retirement ages and in decreasing unemployment. As a result, the number of people employed is projected to decline by only 10 million people, even though the working-age population will decline by 40 million people. This implies that whereas the old-age dependency ratio (elderly as a percentage of working age population) will double in coming decades, the so-called old age economic dependency ratio (number of old age people per person employed) will only increase by 50 %. In 2050, there will be one person aged over 55 for 1 person employed.

As can be seen from the table, the average GDP growth would be 1.6% instead of 1.3% which would be the outcome if the employment rate does not increase. This average is half a percentage less, though, than the average growth over the past 30 years.

I should state, however, that these increases in employment rates are realistic but should not be taken for granted. In some countries, policy action may be needed to actually realise the assumed increases in employment levels¹.

B. Big spending increases on pensions in most countries



[slide 3]

Overall, the results indicate that spending on public pensions will increase by between 3 and 5%-points of GDP in most Member States between 2000 and 2050. There are, however, very large differences in the timing and scale of changes across countries. The largest increases in pension spending of 8 and 12%-points of GDP have been projected for Spain and Greece respectively.

(Now, various countries have new projections based on national demographic projections. These do not change significantly the results, except for Spain where the arrival of many immigrants could reduce the impact of ageing on pension by more than 3 % of GDP).

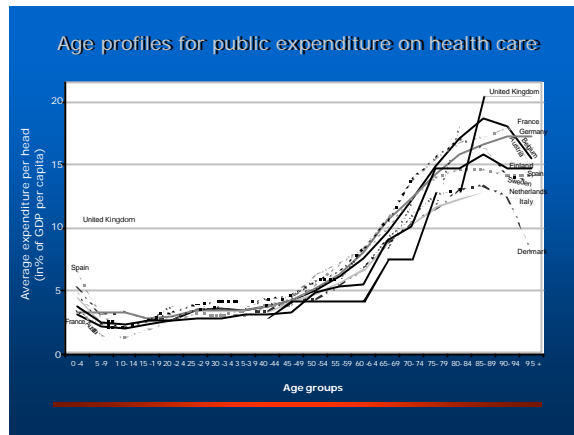
Results draw very much on 2 points: the employment projection and the reduction of the average replacement ratio incorporated in the national projection.

C. Projections for health and long-term care

In addition to public spending on pensions, spending on health care and long-term care in most countries is projected to rise by some 2 to 3%-points of GDP by 2050.

It is obvious that the impact of ageing on pension expenditure is largely uncertain. In the case of health care, the uncertainty is even larger.

1. For example, higher female participation rates may partly depend on more resources being devoted to child-care facilities. Also, achieving an increase in the effective retirement age, which would mean reversing a long historical trend, may require reform of pension systems disability and unemployment schemes so that they provide better incentives to older workers to remain in the labour force.



[Slide 4]

At first sight, ageing and health care expenditures appear highly related. The pattern of average expenditures across age groups follows a well-defined pattern across countries. In particular, expenditures per head increase with age, and are particularly high for the oldest age groups.

The age-profiles for expenditures per head on long-term care show a similarly distinct pattern across Member States. There is little expenditure before old age, and then rapidly increasing levels of expenditure at higher ages. Increases in the more traditional sectors of health care are relatively limited in most Member States. On the other hand, increases in spending on long-term care could be dramatic in several Member States where public services of this kind are already well developed.

Projected change in public spending (% of GDP)			
	Health care	Long term Care	Total
B	1.5	0.8	2.4
DK	1.1	2.5	3.5
D	2.1		
EL	1.7		
E	1.7		
F	1.9	0.6	2.5
IRL	2.3	0.2	2.5
I	1.7	0.4	2.1
NL	1.3	2.5	3.8
A	2.0	1.1	3.1
P	1.3		
FIN	1.8	2.1	3.9
S	1.2	2.1	3.3
UK	1.4	1.0	2.5
EU	1.7	1.0	2.7

[Slide 5]

However, other factors also come into play and should be taken into account in the future, for instance:

- the profile could move to the right if it is related to the life expectancy
- in recent decades demand as well as supply factors have prevailed like access and technology.

II. Reform challenges of public systems

A. Three-pronged strategy

When considering the specificity of the health care and the pension systems and the variety of the challenges, a strategy can be developed along three policy dimensions on which the Member States can put different weights according to their room for manoeuvre (this is the so called three-pronged strategy adopted by the Stockholm European Summit).

- Firstly, increase the employment rate, especially for older workers. Raising the effective retirement age can lead to a double dividend: increase in employment and growth and reduction of pension expenditures.
- Secondly, reduce public debt and, accordingly, the interest burden in order to progressively have some room for manoeuvre in the budget. This financial recommendation is also consistent with promoting savings and investment and thus productivity. Public savings is important since the ageing of population can have adverse effects on private savings.
- Thirdly, reform the pension systems, especially through parametric reforms.

B. Parametric reforms

Let us begin with pension reforms. It is very difficult to draw general conclusions from the analysis of the pensions system of the member states because they are so different.

There is now a large consensus for accepting that the first pillar PAYGO system is perhaps not the best performing system, but for various reasons, it is better to continue with a structure of three pillars (diversification of risks, sacrificed generation...). That is why in many member states the pension reforms have concentrated on the parameters of the system. Each system has a set of parameters that can be controlled and can have relatively important impacts on the expenditures. For illustrative purposes, the EPC produced a number of additional projections on three selected options for parametric reforms:

Illustrative impact of certain parametric reforms
(share of GDP in 2050)

	Half a percentage point change in the indexation of pensions	Raising the effective retirement age by one year	Reducing benefits in line with increase in life expectancy
<i>Flat-rate systems</i>			
DK	2.7	-1.0	-1.7
IRL	1.6	-0.4	-
NL	2.7	-1.1	-
UK	0.6	-0.2	-0.5
<i>Earnings-related systems</i>			
A	1.0	-	-
B	0.5	-	-
FIN	0.9	-0.6	-1.5
F	-	-0.9	-
D	-	-0.7	-1.6
I	1.2	-0.1	-0.4
P	2.0	-0.34	-1.9
E	1.9	-	-

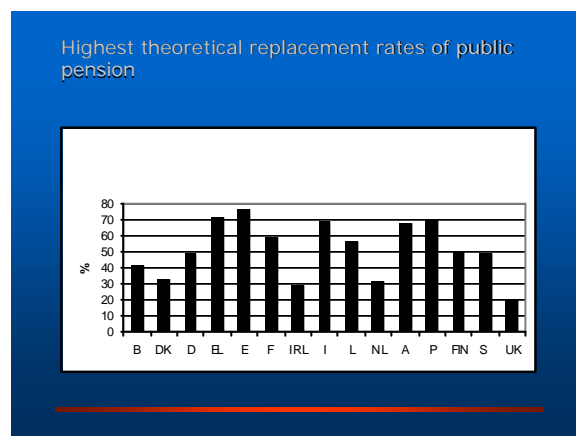
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- the first simulation assessed the spending impact of a change in the indexation of pensions by half a percentage point per year. Actually, in

many countries the indexation is higher than a simple indexation to prices. In earnings-related systems, such a reduction could, on average, absorb 0.5 to 2 percentage points of the expected increase in pension expenditure by 2050, which is one third of the increase. In flat-rate systems, the impact would be much larger, but would involve a trade-off with regard to the relative living standard of pensioners.

- the second simulation examined the spending effect of an increase in the effective retirement age by one year. Roughly speaking, if workers were to work one additional year before retiring, public pension expenditure would be reduced by 0.6 to 1 percent of GDP over the period to 2050, which corresponds to 10-30% of its expected increase.
- the third simulation looked at the spending effect of an adjustment of the benefits to the expected increase in life expectancy (for instance by implementing an actuarial neutrality for each cohort like in the Swedish and the Italian reform). The projections suggest that approximately half of the expected increase in pension expenditure is the result of the increased life expectancy. Such a measure could thus reduce the expected increase in pension expenditure by 0.4-1.9 percentage points compared to the baseline in 2050.

Reforms of pension systems, and especially parametric reforms such as shifting indexation to prices instead of wages, will in many cases reduce the average benefit ratio. The room for manoeuvre here again is not the same in all the Member States. We can assume that this room depends on the level of income replacement in the different pension systems, which is difficult to capture. It is a function of parameters such as the statutory replacement rate, the number of years necessary for a full career, the indexation rules, etc.



[Slide 7]

On the graph, you can see a comparison of the relative replacement rates of public pensions, calculated on the basis of a synthetic indicator for a hypothetical individual with a full career (retirement age 65, remaining life expectancy: 17 and contributions over full career as defined in the national system). It shows that several Member States could pursue reforms aimed at containing average pension benefits, without endangering the general adequacy of old-age provision within their systems. But this is far from being the case in other countries.

C. Increase the employment rate

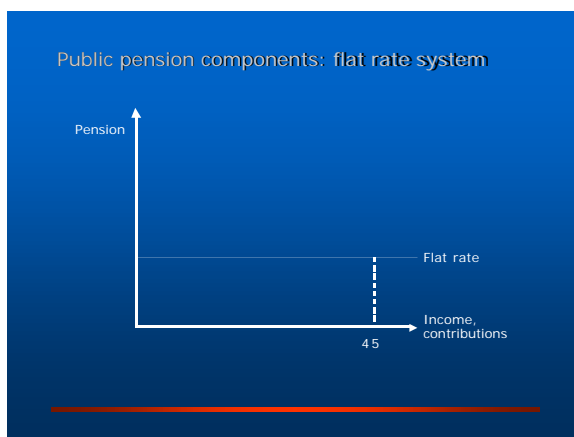
This leads me to the second prong of the strategy, namely the employment rate.

Clearly most countries need to raise – and could raise - the employment rate of older workers and the effective retirement age. But, as you can see from the graph, the difference with the EU-target or the room for manoeuvre is very different among the EU countries.



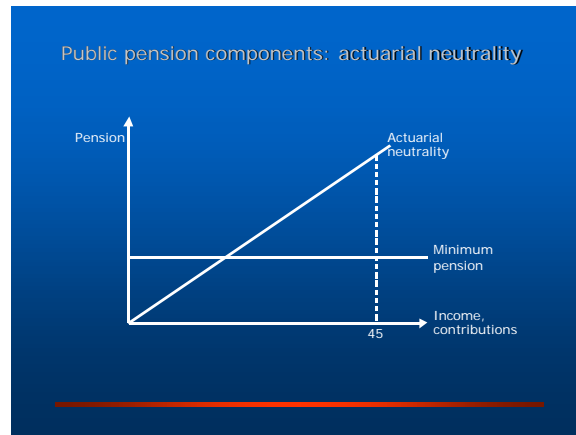
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In many Member States, the pension system and other transfers such as early retirement, disability, or unemployment benefits do not provide sufficient incentives for older workers to remain active on the labour market. The EPC considers that, apart from removing barriers for female participation, reforms of these systems should mainly aim at reducing disincentives (for workers and for firms) to remain on the labour market. In particular, in the end this means to strengthen the actuarial neutrality of the retirement system. The following graphs characterize the main features of the pension system. On the vertical axis of the graph, I have put the level of discounted pension and on the horizontal the discounted contributions paid during the working life of the individual or his discounted wages.



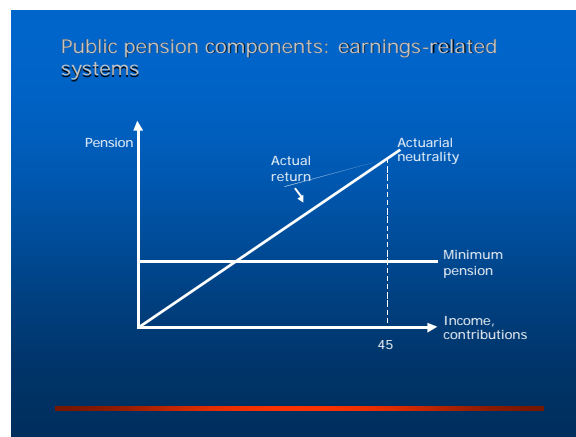
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The first type of system is a flat rate system: the pension does not depend on income. On top of that, the individual will contribute to a private scheme which gives, in principle, an actuarially neutral pension.



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The second type is the earnings-related pension system. Generally this type is either a minimum or a benefit defined pension related to the average wage of the last 5, 15, 35, 40 or 45 years. Do these systems present an actuarial neutrality?¹ In a PAYGO earnings-related system, in theory, the rate of return to be considered is the average rate of increase of the wage rate.

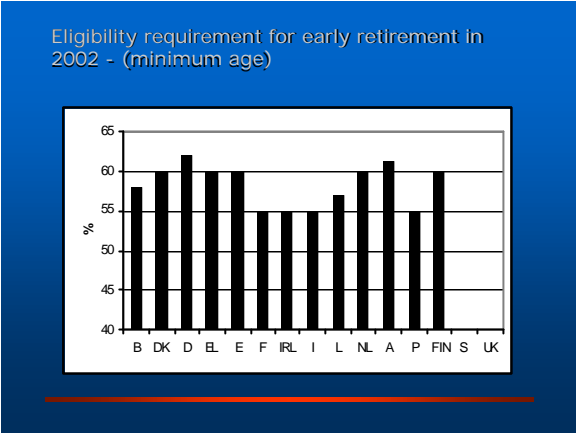


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In a second report of the EPC of July 2002, we have tried to compute the implicit rate of return of the public pensions taking into account the main parameters of each system². For an individual with a full career (in many cases 45 years) the actual rate of return is higher than the actuarial PAYGO rate of return only in GR, SP and A. When a return is computed for the present lower average length of a career, this rate is above the PAYGO actuarial rate in all countries. Moreover, the difference is increasing with life expectancy. The conclusion is that the priority is not to change the system (of early retirement and retirement) for a full career but to adjust it towards an actuarial neutrality across all possible ages of retirement³.

1. When considering a reform of this type of system, a tradeoff should be made between "adequacy" and "sustainability". There is a definition and a set of indicators to measure the risk of unsustainability, as far as adequacy is concerned, this is not the case. The problematic part of the definition is not providing access and a minimum pension for everyone, but what about the maintenance of "an adequate living standard". The only criterion or benchmark that I see here is the actuarial neutrality of the system.
2. The rate of return is 'theoretical' since it does not take into account all the characteristics of each system.

In addition, the minimum age of early retirement condition should be raised since it has a close correlation with the employment rate. since it has a close correlation with the employment rate.



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D. Increased funding will be required

In the following table, I have ranked the EU countries according to the relative level of the replacement rate and the employment rates of older workers. As you can see, in some countries, where the benefits in the 1st pillar are low and the employment rate is high, the room for manoeuvre can be very narrow.

		Benefits		
		Low	Medium	High
Employment	Low	B	F, L, A	I
	Medium	IRL, NL	D, FIN	EL, E
	High	DK, UK	S	P

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In such cases, and I would say at least partially in most cases, more funding or financing means are required. How can this be done? During the last decades we have understood that increasing the contribution rates or the non-wage labour cost is not a good solution for employment. Another strategy is to increase public saving now in order to finance the cost of ageing later. Most Member States consider a surplus rule, entailing a continuous reduction of interest burden of the public debt, as an important mechanism by which they can counterbalance future spending requirements resulting from ageing. In their National Report on pensions, several

3. Moreover, disability and unemployment benefits for older workers and other systems should be designed in such a way as to restrict alternative or backdoor routes into early retirement.

Member States underline their commitment to sound public finances as a basic element of the strategy to cope with ageing. This is especially the case for B, DK, FIN, NL and SW. Most of those countries have now reached a structural surplus. In addition, these commitments have often been underscored by establishing reserve funds.

For most of these countries, the sustainability indicators developed by the EPC show that the risk of unsustainability is low.

At the opposite, as Klaus Regling has shown us this morning, the other countries present a pattern of evolution of the debt ratio that is unsustainable. According to the indicators in only 5 or 6 countries the debt ratio is projected to remain below 60% in 2050. For most of them this ratio will increase beyond the 60% threshold. This has severe policy implication. It implies either to reform pensions or to fill the so-called “tax gap” by increasing urgently the structural primary surplus.

III. The three-pronged strategy: the Belgian case

I would like to illustrate the three-pronged strategy by the Belgian case.

	2000-2030	2000-2050
Budgetary cost of ageing		
Pensions	2.5	3.2
Health care	2.2	3.3
Unemployment and early retirement	-0.8	-1.0
Child allowances (and other social items)	-0.8	-1.0
	<hr/>	<hr/>
	3.1	4.5
Other policies (tax reform)	1.4	1.4
Total	<hr/>	<hr/>
	4.5	5.9
Interest burden	<hr/>	<hr/>
	-5.5	-6.0

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In the following table, all the expenditure items related to ageing have been identified and consolidated, some of them are increasing, others are decreasing. A global management of these items has been institutionalized. I have also identified the tax reform that will be achieved during the next five years. The result is an extra cost of 4.5 percent of GDP between 2000 and 2030 and 5.9 percent of GDP between 2000 and 2050. If the government maintains a budget surplus of 0.7 percent of GDP during the next 30 years, the implied reduction of the interest burden would be respectively 5.5 percent and 6 percent of GDP¹.

This strategy derives from the Belgian context:

Low replacement rates;

A high public debt ratio;

A low employment rate, especially for people between 50 and 64, and a very high productivity level.

In this context, the reform of the pension system is concentrated on the various early

1. The relatively favourable situation of Belgium is mainly due to the high primary surplus in 2000 necessary to achieve the “close to balance” rule of the Stability and Growth Pact.

retirement schemes. The priority is put on the employment rate and the reduction of the public debt. The strategy is to achieve a structural surplus that will feed into a reserve fund devoted to future pension expenditures which is called "Silver fund".

A monitoring process has been put in place by law. A group of experts form the so-called "Comité d'étude sur le vieillissement" which has been set up with the technical assistance of the Federal Planning Bureau. It is responsible for the projections and the indicators published every year in April. Every year, the Government delivers to the Parliament a paper called "The Silver note". The Silver note indicates, in particular, the amount of money paid into the Silver fund. The Silver note is also the basis of the sustainability section of the Stability programme.

According to a survey of the Working Group on Ageing, a similar monitoring process is being introduced in several countries.

IV. Conclusions

I would like to draw five main conclusions from the EPC exercise.

First, ageing populations will lead to substantial pressures for increased public spending in coming decades. In many Member States, further reforms notably of pension and early retirement schemes is inevitable. The most appropriate route seems to be to increase the actuarial fairness of the system across ages of retirement. A possible ingredient is, in several countries, to change the indexation rule of pensions.

Second, the very big differences between Member States as regards the budgetary impact of ageing populations show that the design of pension systems matters. Countries can learn valuable lessons from successful reforms elsewhere, and the EU has a key role to play in this regard. This is precisely the aim of the so-called open method of coordination in the field of pension and health care. The Swedish reform seems to be a "best practice".

Third, raising employment rates is a critical element in strategies required to meet the budgetary cost of ageing. It is important not to be complacent, and to assume that higher employment, especially of older workers, will occur automatically or that it will somehow fully resolve the budgetary challenge. On the contrary, an ill-functioning labour market like in the 80's, could have a very detrimental effect on public finances.

Fourth, the work on the budgetary implications of ageing populations needs to be complemented with work on the social implications, and in particular on the so-called "adequacy" of retirement income provision.

Lastly, more work needs to be done to improve the quality and comparability of our indicators¹, especially if a financing gap indicator is to be used in the assessment of the Stability programme.

By linking long-term sustainability to the assessment of the stability programmes, the European Council has agreed that the future impact of ageing is a matter of concern in the debate on the present budgetary situation. Indeed, reforms in this field take time. Between now and 2010, there is a small window of opportunity where the

1. In particular, in 2004/2005, at the request of the Ecofin Council, the WGA will provide the next round of updated projections on the budgetary challenges of ageing populations. This exercise will be based on a new consistent demographic projection. A common methodology should be designed to split the population into different social groups: employment, pensioners, etc. We should also review the health care expenditure projection taking into account other factors than the demographic structure of the population.

strategy has to be put in place. My conviction is that, even with reforms, each country will have also to set ambitious fiscal objectives consistent with the long-term sustainability constraints.

As you can see, ladies and gentlemen, we are really making progress at the European level on the sustainability issue. The problem is posed, a strategy has been defined and a coordination process has been established. But a lot is yet to be done, especially in defining and spreading good practices leading to politically acceptable reforms.

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