EN

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels,
COM(2009) 545/3

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Long-term sustainability of public finances for a recovering economy

{SEC(2009) 1354}

EN EN

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Long-term sustainability of public finances for a recovering economy

1. INTRODUCTION

1. This Communication and its companion Report (*Sustainability Report 2009*) assess the sustainability of public finances in the EU Member States. It is an update of the communication and report of 2006[1], following the request of the ECOFIN Council of November 2006[2], which asked the Commission to prepare a new sustainability report when new common age-related expenditure projections become available in 2009. The Communication 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.

2. The report takes into account the context of the financial and economic crisis and its impact on public finances at the moment when the first signs of stabilisation become apparent. As long as the recovery is not sustained and the discretionary measures deployed by governments are not withdrawn, the effect of the crisis on public finances cannot be fully determined. However, given the large impact of the crisis on public debt, this communication provides a timely input at a stage where, in line with the European Council position: 'fiscal policies must progressively be reoriented towards sustainability' and 'exit strategies need to be designed now and implemented in a coordinated manner as soon as the recovery takes hold, taking into account the specific situation of individual countries'[3].

3. The regular assessment of fiscal sustainability is in line with the reformed Stability and Growth Pact (SGP), according to which long-term issues should get a prominent role in surveillance. Recently, Member States have agreed detailed principles on the revision of the medium-term budgetary objectives (MTO) in order to ensure that the Member States' budgetary strategies reflect real medium-term needs, by taking account not just of debt levels but also implicit liabilities, notably costs related to ageing populations, in particular projected healthcare and pension expenditure.

2. AN ACUTE CHALLENGE AFTER THE CRISIS

4. **The European economy is showing signs of entering a phase of recovery after a deep crisis.** Thanks to effective and substantive policy action since autumn 2008,

[1] 'Long-Term Sustainability of Public Finances in the EU,' *European Economy*, 4/2006 and Commission communication - COM(2006) 574, 12.10.2006.

[2] Council Conclusions on 'The Sustainability of Public Finances,' 7 November 2006.

[3] Informal meeting of EU heads of State or Government, 'Agreed language for the Pittsburgh G-20 summit', Brussels 17 September 2009.

coordinated in the context of the EERP[4], a financial meltdown and a generalised loss of confidence has been avoided. However, uncertainty remains high, and there are still risks of negative feedback loops between the financial sector and the real economy. Given the output losses in previous quarters, economic activity is set to shrink by 4 percent this year, while growth in 2010 will be slim.

5. **Fiscal policymaking has been successfully targeted to the need and urgency of pulling the economy out of the recession.** Discretionary fiscal stimulus and unfettered automatic stabilisers have provided a cushion to economic activity and contributed to the recent signs of improvement, but have led to a substantial deterioration in government accounts. From a deficit of 0.8 percent of GDP in 2007 – the best result for thirty 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. Moreover, exceptionally large contingent liabilities may translate into actual costs over the coming years, although some costs in support of the banking sector may be recouped.

6. **The sustainability of public finances in a longer-term perspective must not be ignored.** Though the debt and deficit increases are by themselves quite impressive, the projected impact on public finances of ageing populations is anticipated to dwarf the effect of the crisis many times over. The fiscal costs of the crisis and of projected demographic development compound each other and make fiscal sustainability an acute challenge. 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.

3. How to Assess Long-Term Sustainability of Public Finances

7. **Sustainability relates to the ability of a government to assume the financial burden of its debt in the future. There is no defined upper limit to sustainable debt levels.** Limits to sustainability differ across countries and time. The capacity to run high debts depends *inter alia* on the degree of development of financial markets, perceived risks, and trust in the capacity of a government to implement structural reforms and consolidate deficits. It also depends on the degree of global risk aversion and investments alternative to government bonds. However, countries with high debt ratios – as well as large external imbalances or contingent liabilities – are particularly exposed to market turbulences, such as changes in interest rates and spreads during times of evolving economic perspectives.

8. **A one-off increase in the stock of government debt need not put sustainability at risk.** Fiscal expansion in a crisis context is not detrimental for sustainability as long as the measures adopted by governments are temporary and phased out when the recovery is secure. Concerns arise from the structural nature of high deficits, and because, without an adequate structural reform strategy, the crisis may have a durable impact on output and potential growth, which overlaps with the secular

[4] 'European Economic Recovery Plan,' communication from the Communication to the European Council - COM(2008) 800, 26.112008.

slowdown in GDP growth and the rise in expenditure on account of the demographic trends.

9. **Fiscal policy is not sustainable if it implies an excessive accumulation of government debt over time** – now or in the foreseeable future – and ever-increasing debt service. Sustainability requires the avoidance of an excessive increase in government liabilities – a burden on future generations – while ensuring the government's capacity to deliver the necessary public services, including the necessary safety net in times of hardship, and ability to adjust policy in response to new challenges.

10. In order to analyse whether, based on current policies, government finances are sustainable, a long-term perspective is thus necessary. The assessment is based on long-term projections[5] of government expenditure, revenue and deficit that take into account expenditure drivers such as demographics and debt accumulation. To quantify the sustainability risks of the Member States' public finances, the established concept of sustainability gap is used. This indicator measures by how much tax or spending would need to be adjusted, *now and in a lasting manner*, to ensure that the government debt remains within manageable limits over the projection horizon. However, a complete assessment also requires the consideration of a series of other indicators, such as the current debt, contingent liabilities, the stock of government-owned assets, the tax burden, the projected evolution of average pensions and the performance of private funded pension schemes, the developments in the sustainability gaps in case no action is taken, as well as the possible reinforcement of social protection in some countries.

11. An increase in debt ratios in the coming decades is avoidable, and policy measures can and should be taken to escape a trend of increasing debt. The long-term scenarios – under unchanged policies, therefore not including measures that governments may be considering but that have not yet been adopted – in the companion report show a relentless increase in debt ratio over the coming decades. These scenarios allow an assessment of the risks Member States are confronted with, but they are not inevitable. Unchanged policy scenarios are state-of-the-art for long-term sustainability assessments, but they are not realistic forecasts in any country. Those scenarios are useful to illustrate the size of the policy action that is necessary to ensure sustainable public finances, and show the outcome if no action was taken. This approach, already used in the Sustainability Report of 2006, was endorsed by the ECOFIN Council of November 2006, which concluded that such a report should be the basis for the assessments of long-term sustainability in the context of annual stability and convergence programmes.

12. The assessment of the long-term sustainability of fiscal policy is now a well established part of budgetary surveillance in the EU. However, **in a context of crisis and recovery, the sustainability assessment is undertaken under larger than usual uncertainty**. On the one hand, it is difficult to correctly judge the initial structural fiscal position in 2009. This is related to the uncertainty on the potential output and the output gap, but also on the way that tax revenue has been affected by

---

[5] '2009 Ageing Report,' joint report of the Commission and the EPC, *European Economy*, 2, and Commission communication 'Dealing with the Impact of an Ageing Population in the EU' - COM(2009) 180, 21.42009.

the crisis, as well as on the durable or temporary nature of the support measures adopted by governments. In so far as the temporary measures taken in the context of the crisis have not be fully filtered out of structural deficits, the sustainability risk may have been overestimated. On the other hand, if growth-enhancing reforms are not adopted, the crisis may have a protracted impact on the way our economies will grow over the next decade; in this case, the baseline sustainability indicators in the companion report would underestimate risks.

4. ASSESSMENT OF SUSTAINABILITY BY COUNTRY

13. The long-term sustainability of the public finances and the budgetary impact of ageing populations 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. This variation results from: (i) differences in their initial budgetary positions in 2009 for general government, including the debt level and the structural deficit; (ii) differences in the financing and scope of social protection systems (iii) differences in potential growth that result from their relative levels of development and the projected demographic developments.

14. On the basis of the quantitative sustainability indicators[6], the sensitivity analysis of the underlying assumptions and additional factors, such as debt, government assets and pension projections, an overall assessment of the long-term risks to public finance sustainability the different Member States might face is reached[7]. Based on this methodology and following the approach developed in the 2006 Communication, and as presented in that communication and endorsed in the ECOFIN Council conclusions of November 2006, Member States are classified into categories depending on the degree of long-term risks they faced and where these risks mainly come from. In its conclusions the Council also considered that the categorisation used in the sustainability report provides an important tool to assess the sustainability challenges that Member States are facing.

15. **Bulgaria, Denmark, Estonia, Finland and Sweden** have relatively stronger budgetary positions and have undertaken comprehensive pension reforms in recent years. Though the crisis is leading to a deterioration in government balances and a substantial increase in government debt ratios of each of these countries, their structural fiscal positions remain sounder than in most other EU countries and present, therefore, a low long-term risk. In Bulgaria, Denmark, Estonia and Sweden, the increase in age-related expenditure over the next decades is projected to be well below the EU average. In Finland, the projected increase in expenditure is substantial and the fiscal cost of the crisis has been large. However, the large stock of financial assets in the social security portfolio provides a cushion to absorb a deterioration in government accounts.

---

[6] Sustainability indicators assume age-related expenditure (pensions, healthcare, long-term care, unemployment and education) will evolve in line with demographic projections, and the constancy of the ratio-to-GDP of revenue and other primary expenditure.

[7] The companion report contains a detailed explanation of the methodology used and of the different alternative scenarios.

16. **Belgium, Germany, France, Italy, Hungary, Luxembourg, Austria, Poland and Portugal** are countries with very different characteristics in relation to their initial budgetary position and age-related expenditure. Belgium, Germany and Austria are projected to bear costs of ageing close to, or above, the EU average, but their initial budgetary positions are relatively sound, provided that the crisis-related deterioration in government accounts does not become structural. Though medium-term consolidation will improve the sustainability indicators, reforms to address rising age-related costs will be indispensable. For Belgium, the debt ratio – which is returning to above 100 percent of GDP – constitutes a burden and a specific risk. The projected increase in the age-related expenditure in Luxembourg is the highest of the whole EU; however, this risk is cushioned by the currently low debt and large government-owned financial assets.

17. For France, Italy, Hungary, Poland and Portugal, the long-term costs of ageing are not projected to be particularly high. However, their initial budgetary positions imply that fiscal policy is unsustainable even without considering any increase in age-related expenditure. In all these countries, the crisis and the support to recovery are leading to a very fast increase in debt ratios, quickly offsetting the consolidation gains achieved in recent years. For Poland, projections indicate a fall in age-related expenditure over the long term because of the shift of pension provision to funded schemes; however, the projected reduction in expenditure is also related to a large cut in benefit ratios. This may raise issues of pension adequacy and increase old-age poverty. For France, ambitious fiscal consolidation, once the recovery is firmer, is indispensable and will constitute a major step to improve sustainability. In Portugal, a recent pension reform have done much to improve sustainability; however, the structural budgetary position remains largely unbalanced. In the case of Italy, fast fiscal consolidation once the recovery takes hold is indispensable to ensure a steady reduction in the very high debt ratio[8]. The low sustainability gap of Hungary results from pension reform and recent fiscal consolidation; however, the correction in structural imbalances in recent years needs to be pursued further in order to reduce debt. In general, for this group of countries the long-term sustainability risk is medium.

18. The sustainability gaps of **Czech Republic, Cyprus, Ireland, Greece, Spain, Latvia, Lithuania, Malta, the Netherlands, Romania, Slovenia, Slovakia and the United Kingdom**are all above 6 percent of GDP; over double that level in Ireland, Greece, Spain, Slovenia and the United Kingdom. In nearly all of these countries, the sustainability gaps are the result of a very large projected increase in age-related expenditure, compounded in most cases by large initial imbalances, and hence they are exposed to a higher long-term risk. This indicates that closing their gaps will require both ambitious consolidation programmes that reduce debts and deficits in the coming years, and profound reforms of social protection. This is particularly the case for Greece, which faces the second highest increase in age-related expenditure of the entire EU, while its very high debt ratio adds to the concerns on sustainability. The possible continuing effects of the crisis on the budgetary position and on medium-term growth are a serious concern for most of the high risk countries – in particular, Ireland, Greece, Latvia, Spain and United Kingdom – for whom avoiding

---

8 This is projected to be above 116 percent of GDP at the end of 2010 – the highest ratio since the creation of the euro.

a very fast increase in debt ratios is a policy challenge already in a medium-term perspective.

19. **In many countries, there has been a deterioration in sustainability in comparison with previous assessments.** Compared with the 2006 situation, the sustainability gaps are larger in most countries and ten of them (Ireland, Spain, Latvia, Lithuania, Malta, the Netherlands, Austria, Poland, Slovakia and the United Kingdom) are now in a higher risk category. In the case of the countries most hit by the crisis, the deterioration in sustainability gaps is particularly severe. However, thanks to consolidation and pension reform, Hungary and Portugal have shifted from the higher to the medium-risk group of countries.

5. SUSTAINABILITY OF PUBLIC FINANCES FOR A RECOVERING ECONOMY: POLICY CHALLENGES

20. The crisis-related deterioration in public finances and the projected increase in expenditure due to demographic change both constitute major policy challenges. Given the current budgetary situation, the projected changes in population structure and the long-term scenarios for economic growth, the government debts of many countries will experience significant increases. Though interest rates are currently low, soaring government bond issuance will put upward pressure on rates as the economies emerge from crisis and crowd out investment. 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, identified in Member States' stability and convergence programmes, should be implemented in a decisive manner as soon as conditions allow it, to avoid a more severe correction at a later stage.

21. High debt ratios in the past have often been corrected by fast economic growth. With demographic developments negatively affecting potential growth, the importance of productivity-enhancing reforms will further increase. **The reduction in debt ratios will have to come from a combination of fiscal consolidation and structural reforms to support potential growth.**

22. **A fast and unsustainable increase in government debt in the coming decades can be avoided.** 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. Yet, the macroeconomic situation created by the crisis has changed the context, the way such a strategy may be applied, the relative weight of its components and the urgency of its implementation. 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.

23. The first element of the sustainability-oriented strategy refers to the need to reduce debt, by reaching and sustaining sound underlying budgetary balances. In the decade prior to the crisis, ambitious consolidation was successfully implemented in several countries. The Member States that reached their MTOs in line with the SGP

managed to reduce their debt ratios substantially and improved their sustainability indicators. This provided them with a new-found leeway to implement a counter-cyclical expansionary policy when the crisis came into full force in the second half of 2008.

24. Simply overcoming the ongoing economic and financial crisis without fiscal consolidation in a determined manner will not suffice to bring government debts to a sustainable 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. A consolidation effort of 0.5 percent of GDP per year until the Member States' MTOs are reached[9] will only stabilise the debt ratio at around 100 percent of GDP if growth takes time to return to the pre-crisis trend. Thus, although fiscal support must be maintained until recovery is secured, fiscal policies must progressively be reoriented towards sustainability.

25. 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[10]. The appropriate withdrawal of public-sector support measures for the financial sector must reconcile the need to safeguard financial stability with the medium-term goal of returning the sector viability and competitive market functioning, and protecting taxpayers' interests in line with state aid policy.

26. **The second leg of the strategy concerns increasing employment rates.** Structural reforms, in particular aiming at improving the functioning of labour markets, have contributed to raising employment rates among older workers and women, and to increase growth potential. The increase in employment rates prior to the crisis was an important step towards sustainability, by counteracting some of the effect that a reduction in the working age population would have on growth. At the current time, 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. There is a broad consensus on a set of European principles[11] to mitigate the impact of the crisis, shape a lasting recovery and contribute to potential growth in a longer perspective: it is important to prioritise measures aimed at reducing the costs of adjustment and speeding up transitions in the labour market. **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. In euro-area countries, labour-market policies should also facilitate structural adjustment, in particular with regard to addressing significant divergences in external competiveness, through their impact on unit labour costs.

---

9 That is the benchmark consolidation rhythm in the SGP.

10 Guarantees to bonds or loans issued by banks, special purpose vehicles ('bad banks') and other entities.

11 'Driving European Recovery,' Commission Communication for the Spring European Council - COM(2009) 114, 4.3.2009.

27. A key lesson of financial crisis in the past is the likely negative impact on potential growth and the need for structural adjustment, reallocations and innovation to counter it. Structural reforms thus have a crucial role to play in an overall strategy designed to return economies to sustainable growth and fiscal paths. While being tailored to the specific circumstance in each country, reform agendas to bolster potential growth should include, not only the above-mentioned measures to improve the labour markets and increase participation rates, but also a full exploitation of the Single Market; reforms to improve 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.

28. **Reforms to social protection systems – the third element of the strategy – are necessary.** For many Member States, the primary surpluses that would be required to reduce debt and ensure a full pre-funding of ageing-related cost are unrealistically large. Those primary surpluses are well above the historical levels ever recorded in EU countries, and would have to be sustained for very long.

29. **The main policy lever to ensure sustainability is through reform of pension and healthcare systems.** In relation to pensions, several reforming avenues are possible and have been implemented or are being contemplated by several countries. These range from, changes in the rules on the accumulation of pension rights, establishing a better link between contributions paid during working life and pensions, increasing statutory retirement age, tightening eligibility requirements and removing incentives to early retirement. 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.** On top of savings to government expenditure in a medium- to long-term horizon, an increase in the statutory and effective retirement ages contributes to increase the working population and stem the deceleration in potential output. Moreover, the extension in working life and the respective accumulation of pension rights will have a favourable impact on pensioners' income.

30. **The projected long-term increase in healthcare spending is large and constitutes on its own a risk to sustainability.** Given the complex and hardly predictable mechanisms of progress in medical technology, which have accounted for a considerable share of expenditure growth, the projections may even underestimate future spending. Moreover, for some countries, a need to improve the quantity and quality of health services and to widen the coverage of formal long-term care provided to elderly may add further pressure on public finances. 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.

31. **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). .

6. CONCLUSION

32. The available long-term projections show that, in the absence of an ambitious effort to consolidate government accounts and structural reforms, there would be unbearable increases in debt interest and pension expenditure, as well as on healthcare and long-term care during the coming decades. **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.**

33. **Successful fiscal expansion to counter recession and longer-term fiscal sustainability are not incompatible.** Fiscal measures to increase confidence and support demand are only successful if they are perceived by the markets and public opinion as temporary and consistent with long-term sustainability. Otherwise, if economic agents expect a durable widening of debt, fiscal support will lose its effectiveness and can become counterproductive, in particular when the crisis climax has been overcome and one enters a phase of recovery.

34. Past experiences show that, by illustrating the need and urgency of structural reforms, crises constitute a window of opportunity that governments can use to make decisive breakthroughs in structural reforms. 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.

35. It is in the context of the sustainability challenge and the need to support the nascent recovery that the Commission has recommended the correction of imbalances in those countries that are currently in a situation of excessive deficit. It is also in this

perspective that Member States should set out ambitious and realistic targets in their stability and convergence programmes. These are expected to give a specific attention to sustainability-oriented strategies.