Large and Unknown Implicit Liabilities: Policy Implications for the Eurozone

Charles Wyplosz

Graduate Institute of International Economics and CEPR

Workshop on “Fiscal Policy in EMU: New Issues and Challenges”

Brussels, 12 November 2004

Limited policy responses to contingent liabilities

- Why?
  - Too bad for future generations
  - Tough intragenerational transfers
  - New and analytically complex problem, no road map
  - Clash with Stability and Growth Pact
- An attempt at clarification
  - No new results or data

Ageing: How big a problem?

- Pensions
- Health care
- Other implicit liabilities

Pensions: reasonably well understood

- Demography

Estimated Dependency Ratio (Europe)

Source	Definition[a]	Now (year)	Mid-21st century (year)
US Census Bureau	$P^{\geq 65}/P^{20\text{ to }64}$	27 (2000)	57 (2050)
Gokhale and Raffelhüschen (2000)[b]	$P^{\geq 60}/P^{20\text{ to }59}$	37 (1995)	69 (2055)
Economic Policy Committee (2001)	$P^{\geq 65}/P^{15\text{ to }64}$	24 (2000)	49 (2050)

Notes: (a) $P^{\geq 65}$ indicates the size of the population 65 years old and older.
(b) Active population-weighted average of national measures.

Pensions: reasonably well understood

- Demography
- Implications for spending

Estimated Budgetary Impact of Pensions in the EU[a]
(% of GDP)

	Budget balance	Peak year for budget	Debt	Peak year for debt
Turner et al. (1998)	-4	2040-50	40	2050
Gokhale and Raffelhüschen (2000)[b]	-4.3	n.a.		2055
Economic Policy Committee (2001)	-3.2	2040		2040

Notes: (a) Assuming unchanged benefits.
(b) GDP-weighted average of national impacts.

Health care: surprisingly small

- Longer life time but healthier elderly

Estimated Budgetary Impact of Health Care in the EU
(% of GDP)

	Budget balance	Peak year
Turner et al. (1998)	-3	2040-50
Economic Policy Committee (2001)	-2.2 to -2.7	n.a.

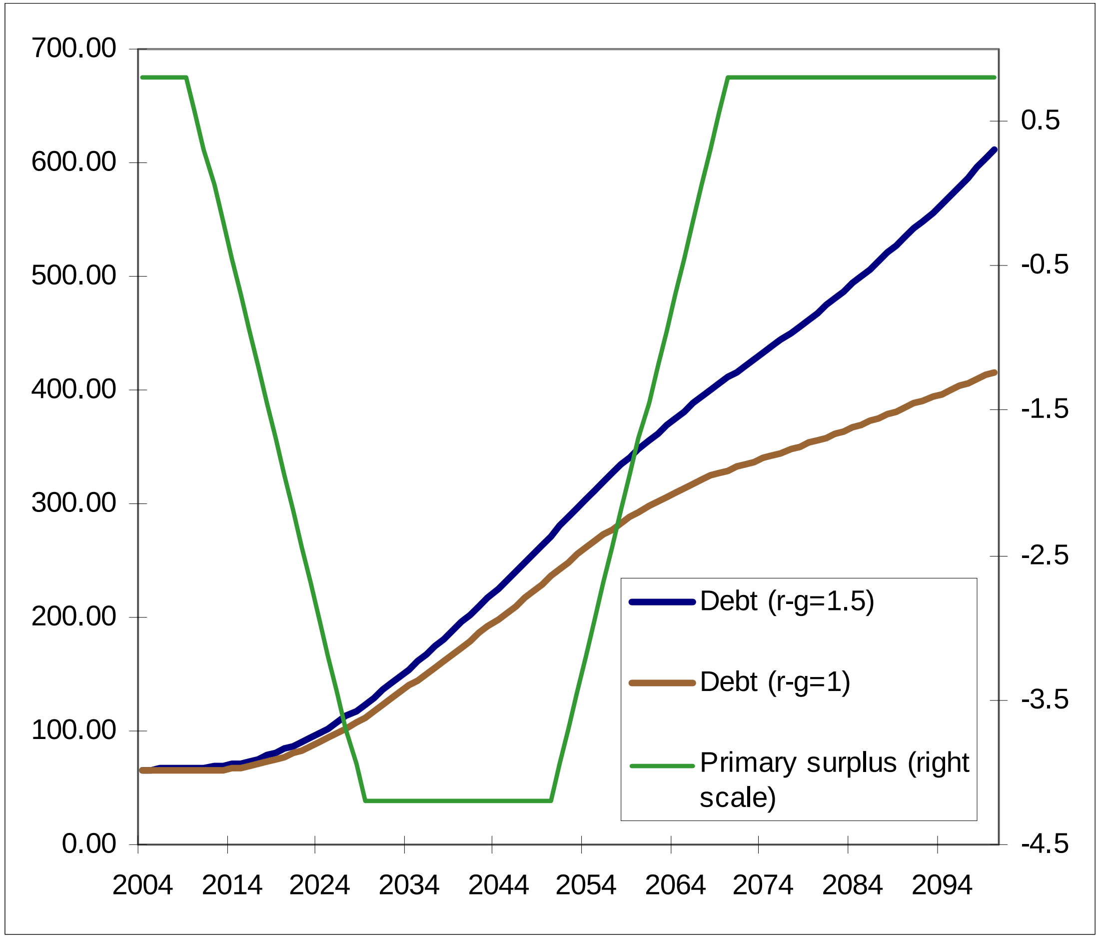
Health care: surprisingly small

- Longer life time but healthier elderly
- But large uncertainties
  - Growing costs anyway
  - Home care
- Could be much higher

Other liabilities

- A long potential list
  - Unemployment benefits
  - Subsidies
  - Recurrent public investments
- Considerable uncertainty
- Even fully-funded pensions

Theory: explosive debt processes

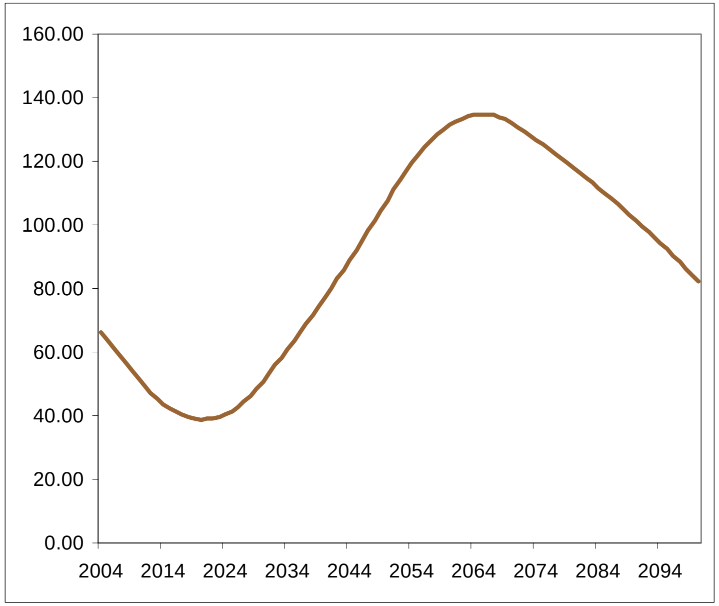


Theory: explosive debt processes

- Very sensitive to assumptions
- Non stationarity of debts
- Easier to stabilize debt if early reaction
- Size of shock of limited importance
- Debt buildup unavoidable

Theory: explosive debt processes

- Very sensitive to assumptions
- Non stationarity of debts
- Easier to stabilize debt if early reaction
- Size of shock of limited importance
- Debt buildup unavoidable
    - Absorb half of cost in 2004



Generational accounting perspective

- Assume intertemporal constraint
  - Either tax increases, including default
    - No difference between explicit taxes and forced saving
    - Some incentive aspects ignored
  - Or reduced transfers
- Important issue: impact on capital accumulation and output

The Ricardian equivalence benchmark

- Irrespective of solution, private sector saves if not taxed: same consumption
  - Either debt buildup financed by savings
  - Or future pension cuts compensated by savings
- No intergenerational issue with altruism

Limits of Ricardian equivalence

- Well known objections and mixed empirical validation
- Will saving means more capital?
  - Rejected by studies
- An important issue: the poor can't save
  - An implicit liability
  - An intragenerational issue

Uncertainty

- Limited uncertainty for the ageing problem
  - Precautionary saving, both private and public
  - Means a transfer to future generation is estimates are unbiased
- Other large but unknown liabilities
  - Precautionary saving again
  - But poor will not save: implicit liability
- A “catastrophe fund”?
  - No use when debts are large

Policy implications: the role of private savings

- Will savings do it all?
  - Yes in a fully Ricardian world
  - But:
    - World is not Ricardian
    - Externalities and moral hazard
- Yet, private savings is first best
  - Need to set expectations right: done (?)
  - But intragenerational issue left hanging
    - Savings as an externality
    - Large moral hazard
    - Limited time inconsistency problem

Limits of the saving solution

- Funds play an insurance role
  - Collective uncertainty: asset returns
  - Individual uncertainty: life time
  - Both remain irrespective of whether defined benefits or defined contributions
    - Moral hazard
- Must be some forced saving
  - Same as taxes; question of tax base (Income? Flat?)
  - The three-pillar system

The Stability Pact and the ECB

- Ignores implicit liabilities and the unavoidable debt buildup
- Re-think the debt vs. annual deficit debate
- Encourage bond-financed pension funds
- The transition to higher saving
  - Possible contractionary effects
    - Allow for deficits
  - Lower interest rates and outflows
    - The ECB should recognize a good cause

The immigration solution

- Not “the” solution, but part of it
- The welfare magnet danger
  - Basic human rights vs. limiting illegal immigration
  - Time to re-think current approaches