Large and Unknown Implicit Liabilities: Policy Implications for the Eurozone

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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

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

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\textsuperscript{a}({\% of GDP})

<table>
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<tr>
<th>Source</th>
<th>Budget balance</th>
<th>Peak year for budget</th>
<th>Debt</th>
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<td>Turner et al. (1998)</td>
<td>-4</td>
<td>2040-50</td>
<td>40</td>
<td>2050</td>
</tr>
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<td>Gokhale and Raffelhüschen (2000)\textsuperscript{b}</td>
<td>-4.3</td>
<td>n.a.</td>
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<td>2055</td>
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<td>Economic Policy Committee (2001)</td>
<td>-3.2</td>
<td>2040</td>
<td></td>
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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)

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<td>n.a.</td>
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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
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- 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
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- 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