HM TREASURY

Assessing long-term fiscal sustainability

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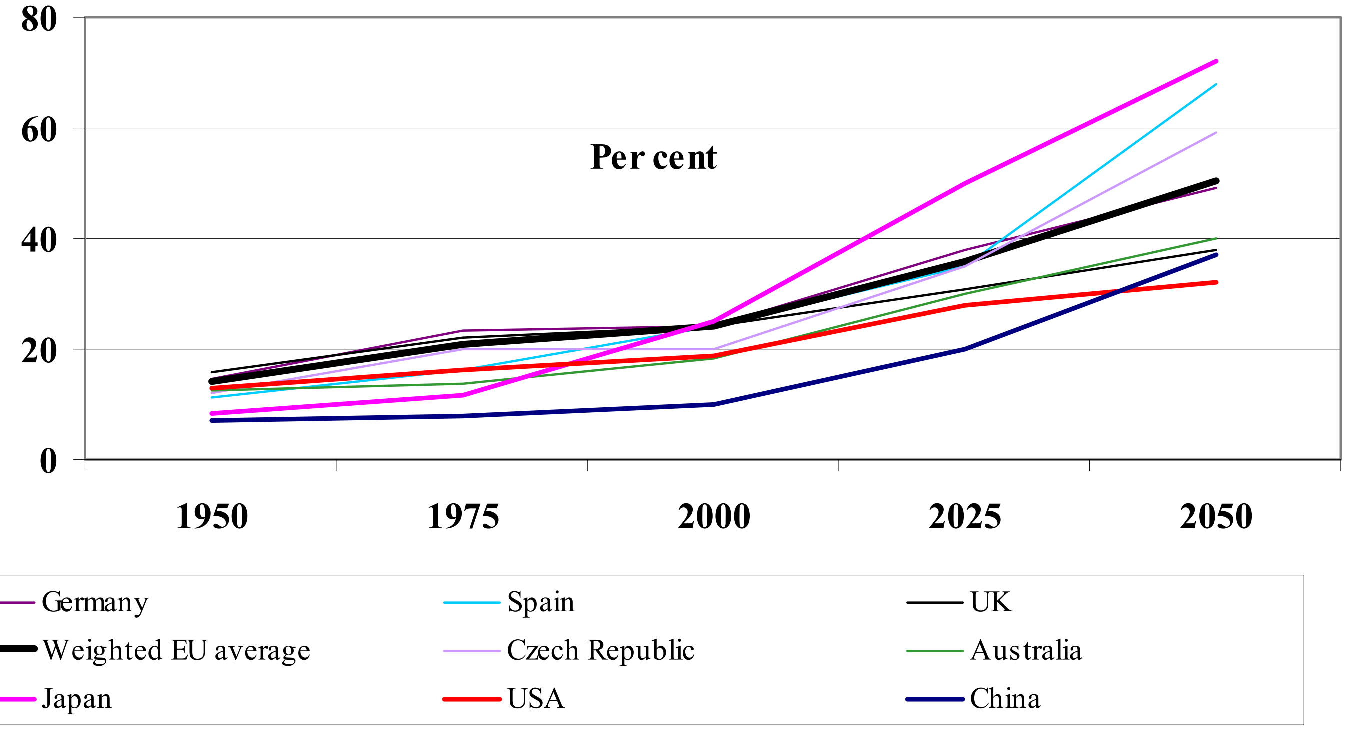
Overall context

- EU member states face rapidly ageing populations
  - more older people due to increased longevity
  - working-age populations projected to fall and age
  - fertility rates below replacement rates
- Trend similar in other developed countries
- EU countries have highly developed welfare states

Old-age dependency ratios



Source: UN, World Population Prospects 2002.

Why should finance ministries care?

- Long-term trends could affect long-term sustainability of public finances
- Trends might have distributional effect
- Governments need to know about the future

Legal requirements in the UK

- Government introduced *Code for Fiscal Stability* in 1998, which requires
  - government to state its fiscal objectives and rules for fiscal policy
  - publication of illustrative long-term fiscal projections, covering at least ten years

UK fiscal objectives

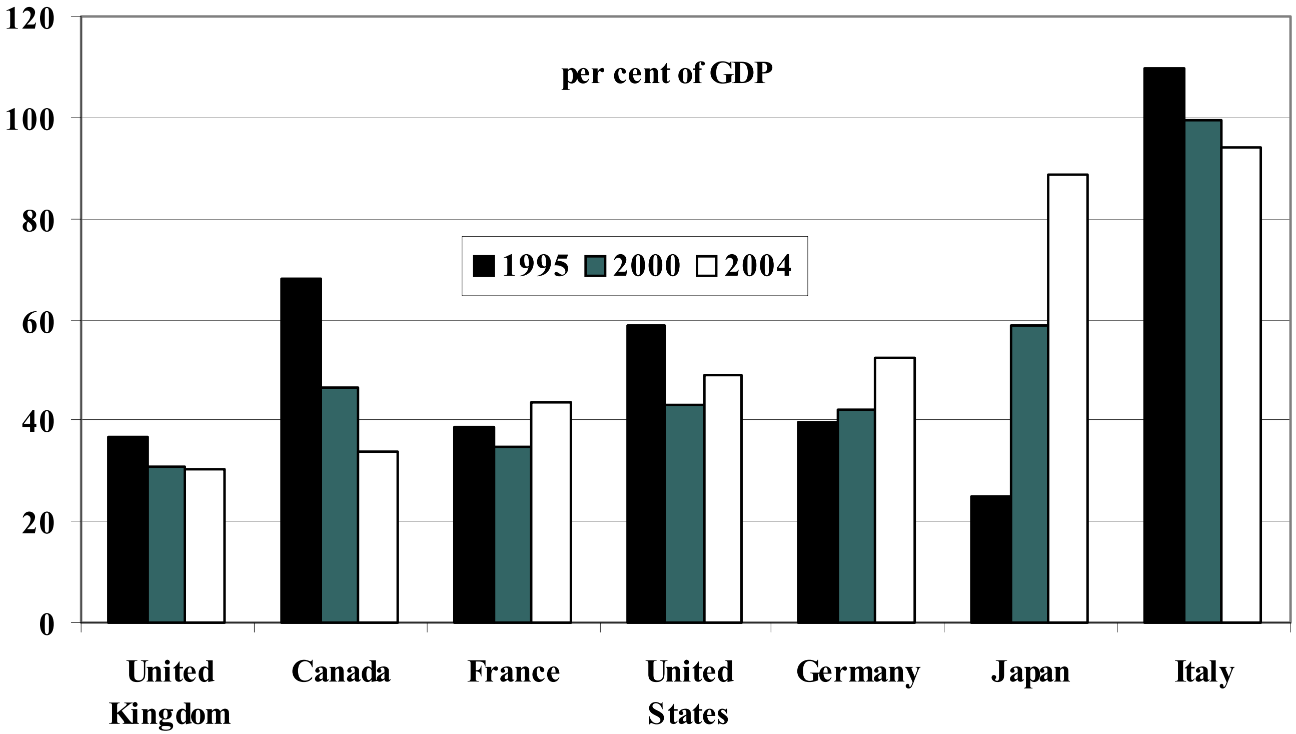
Short term	Medium term	Long term
Support monetary policy Allow automatic stabilisers to smooth economy	Ensure sustainable public finances Ensure spending, tax impacts fairly within & between generations	Ensure sustainable public finances Ensure spending, tax impacts fairly within & between generations Promote long-term economic growth

time

UK starting position

- Fiscal rules
  - meet golden rule (borrow only to invest) over the economic cycle
  - sustainable investment rule: public sector net debt as a proportion of GDP at a stable & prudent level
- Public finances
  - relatively low net (and gross) debt to GDP ratio
- Demography
  - population ageing less rapidly than in most other EU countries

Net debt to GDP ratios in G7

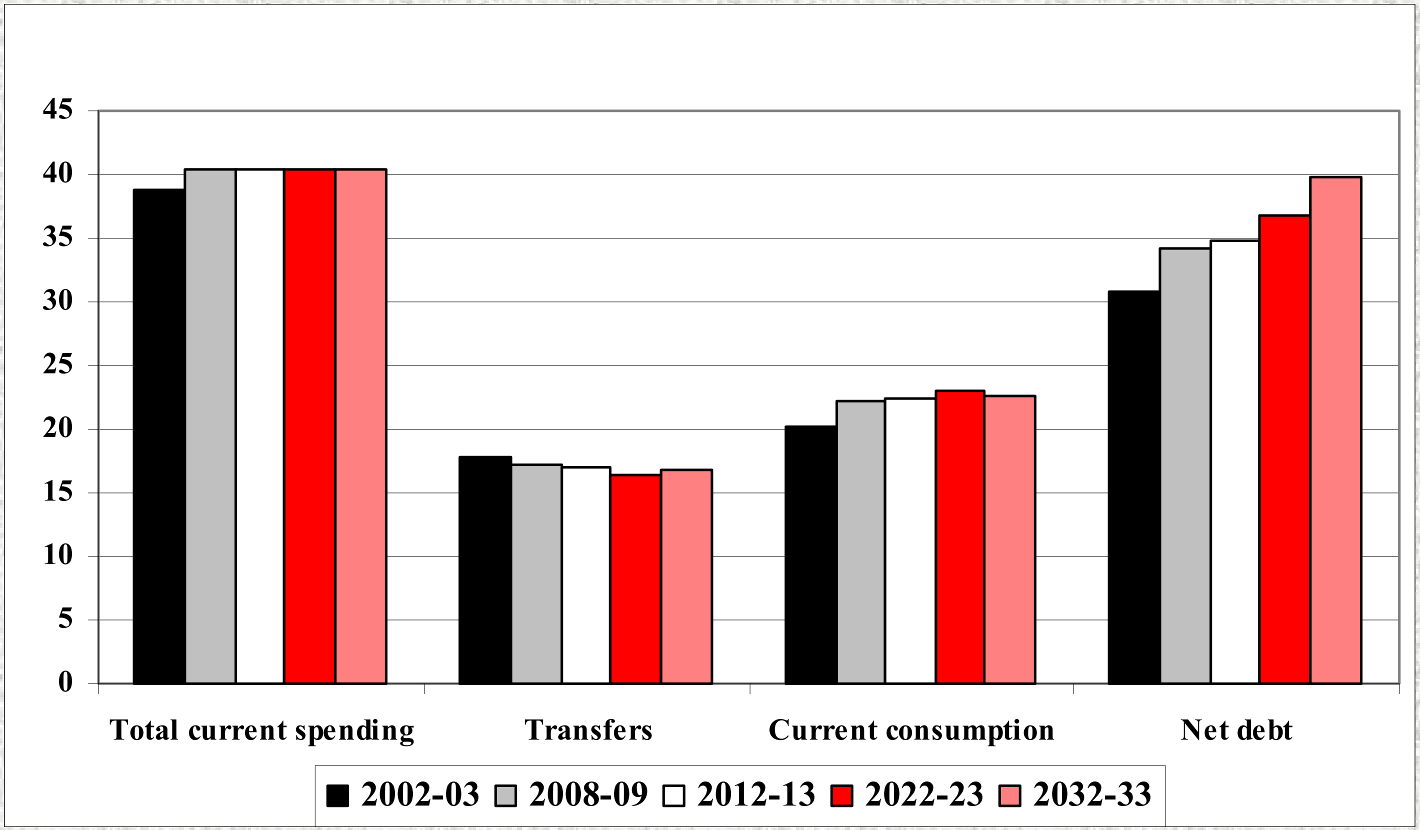


Source: OECD Economic Outlook June 2003.

Illustrative long-term projections

- Published in Budget document
- Based on medium-term forecast
- Simple top-down projections show
  - net debt as a share of GDP
  - potential growth rate of current consumption

Illustrative long-term projections (per cent of GDP)



Long-term public finance report

- Motivation
  - provide comprehensive picture of the sustainability of the public finances
  - provide indication of generational fairness
  - generate better information for policy makers
  - stimulate public debate on key issues affecting all
- Report focuses on demographic changes but not, for example, global warming

Long-term public finance report (cont.)

- Report based on comprehensive set of revenue and spending projections. Used for:
  - bottom up projections,
  - intertemporal budget gap,
  - fiscal gap, and
  - generational accounting

Long-term public finance report (cont.)

- First report concluded
  - UK public finances sustainable and in relatively strong position
  - generational accounting suggests high degree of inter-generational fairness

What difference does it make?

- Presents the bigger picture in which policy decisions have to be made
- Coherent approach to assessing long-term policy issues, useful for other departments
- Addresses important issues, which are often considered not to be “urgent”
- Encourages other countries to be more transparent about future challenges

Some thoughts on domestic work

- Technical expertise had to be built up internally, working closely with outside academics
- Coordinating input from other ministries time consuming
- Colleagues and policy makers often not used to these time horizons
- Presentation key – target audience?

International comparisons

- Similar work is done in other countries, e.g.:
  - Australia’s inter-generational report
  - New Zealand’s long-term projections
  - EU countries submit long-term projections to European Commission as part of Stability and Convergence Programmes
  - United States Congressional Budget Office produces long-term projections
  - different degrees of comprehensiveness

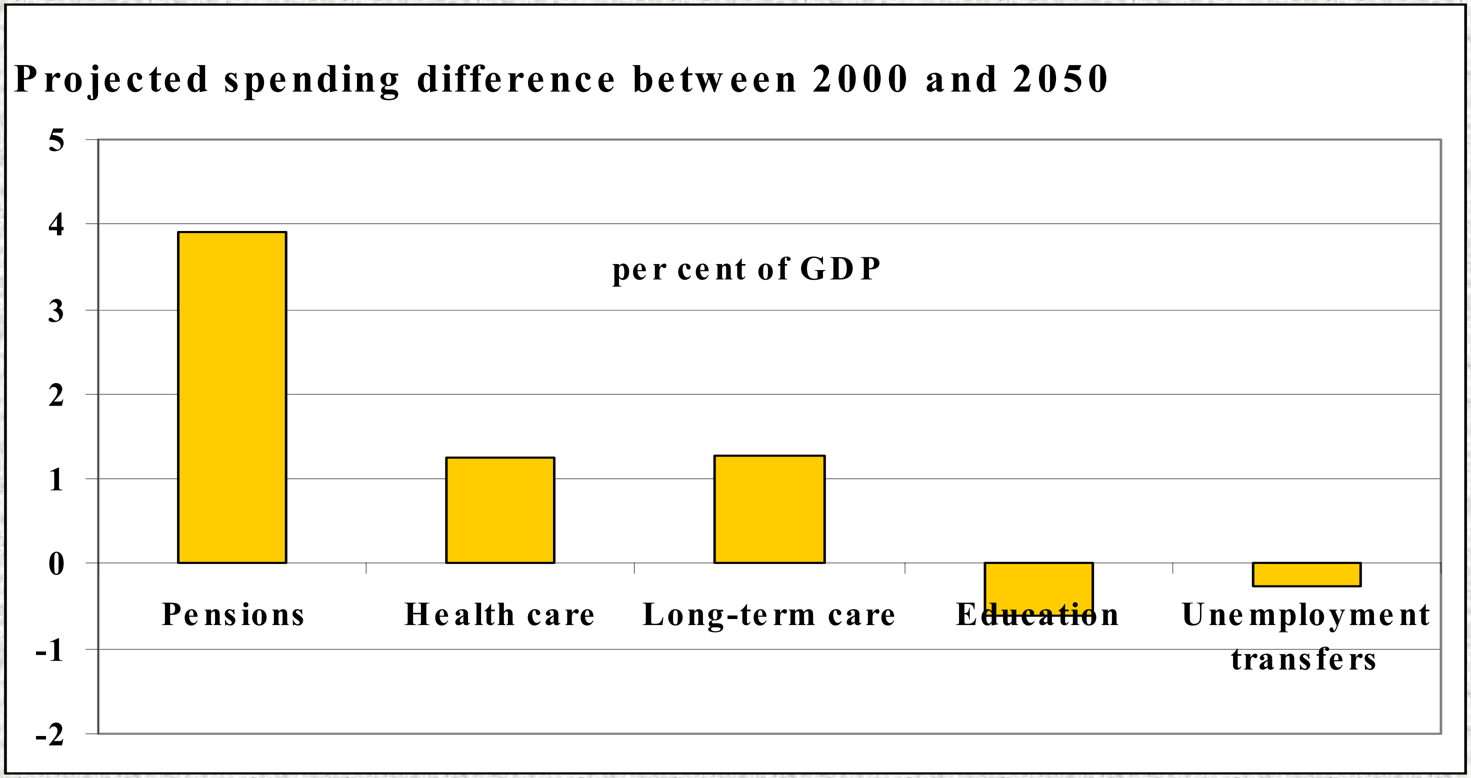
Working Group on Ageing

- Mandate from European Finance Ministers to assess budgetary impact of ageing in EU countries
- Work started in 2000, first comprehensive report now finished
- Main “value added” is that countries used commonly agreed assumptions and methodology
- Projections cover public pensions, health and long-term care, education, unemployment benefits but not global warming

Working Group on Ageing

- Age-related spending projected to increase by between 3 and 7 per cent of GDP in most countries
- Main drivers: pensions and health spending
- Despite fewer young people, education spending unlikely to offset projected increases elsewhere
- Budgetary imbalances projected to arise in many EU countries over next 30 to 40 years

EU spending projections



Unweighted EU average, calculated using projections from participating member states.
Source: EPC Working Group on Ageing 2003.

What difference does it make?

- Pension and health system reforms now top of policy agenda in many EU countries
- Working group provides technical background to policy discussion on EU and national level
- Finance ministers keen to monitor progress
  - mandate to update and refine projections by 2005 (including new EU countries)

Some thoughts on int'l work

- Interesting experience to work on these issues with other countries and exchange expertise
- Issues complex & differ from country to country
- Agreeing on assumptions, methodology and presentation not easy
- How can future projections be improved, e.g. non-demographic drivers of health spending
- EU at leading edge of analysis, possibly ahead of many other organisations countries

Where next?

- Analyse impact of ageing on productivity and more generally trend growth?
- How to control health spending growth?
- Use comprehensive projections to predict future demand for capital stock & inform investment plans?
- Presentation style: who is reading it, academics, general public etc?
- Suggestions?

References

UK

Illustrative long-term fiscal projections

http://www.hm-treasury.gov.uk/budget/bud_bud03/budget_report/bud_bud03_repannexa.cfm

Long-term public finance report

http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr02/assoc_docs/prebud_pbr02_adsustain.cfm

European Commission's Economic Policy Committee

http://europa.eu.int/comm/economy_finance/epc/epc_reports_en.htm