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

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

Support monetary policy
Allow automatic stabilisers to smooth economy

Ensure sustainable public finances
Ensure spending, tax impacts fairly within & between generations

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Ensure spending, tax impacts fairly within & between generations
Promote long-term economic growth

Short term
Medium term
Long term
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

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

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
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
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Long-term public finance report
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European Commission’s Economic Policy Committee
http://europa.eu.int/comm/economy_finance/epc/epc_reports_en.htm