Box 8

THE EUROPEAN COMMISSION'S 2009 SUSTAINABILITY REPORT

In October the European Commission published its 2009 Sustainability Report, which assesses the sustainability of public finances in the EU27 over the period 2008-60.[1] This report updates the Commission's first Sustainability Report published in 2006.[2] Its assessment of sustainability risks is based on a wide range of indicators covering, inter alia, sustainability gaps and government debt ratios. The respective calculations draw upon the new long-term projections of age-related government expenditure[3] released in April this year, as well as the Commission's spring 2009 economic forecast. This box summarises the methodology underlying the assessment of sustainability risks and presents the main results of the report.

Methodology for measuring sustainability risks

The Commission's approach to assessing risks to fiscal sustainability combines a quantitative analysis of governments' fiscal positions with qualitative assessments of additional sources of possible fiscal pressures. The quantitative analysis derives from governments' intertemporal budget constraint, i.e. the notion that any current and future government debt will need to be repaid by future budget surpluses.[4] The Commission's approach results in the S2 indicator, which measures the amount of fiscal adjustment (i.e. increase in tax revenues or reduction in public expenditure) necessary to achieve a sustainable fiscal position. This indicator captures, in particular, two sources of possible shortfalls in the intertemporal budget constraint: i) the gap between the current fiscal balance and the fiscal balance required to stabilise the debt-to-GDP ratio; and ii) the additional gap related to projected increases in age-related government expenditure until 2060.[5] The Commission's approach is based on primary balances, i.e. excluding interest expenditure, and accounts for the impact of the business cycle by using structural (i.e. cyclically adjusted) primary balances.

The fact that the calculation of the sustainability indicators for 2009 is based on the spring estimates for structural primary balances leads to a degree of uncertainty in the results. In view of the financial crisis and the economic downturn, uncertainty over the level and growth rate of potential output (and thus over structural fiscal balances) is particularly high at present. The very long projection horizon adds to the uncertainty surrounding the assessment.

The report also accounts for qualitative factors in the overall assessment of risks to the sustainability of public finances in the EU27. These include, inter alia, the projected change in the structural primary balance from 2008 to 2010, the level of the government debt ratio in 2009 and the tax-to-GDP ratio, as well as the benefit ratio. The tax ratio captures the fact that countries with an already high tax ratio may be restricted in improving the sustainability of their public finances, as their ability to raise tax rates further may be limited for political reasons.

1 See Sustainability Report 2009, *European Economy 9/2009*, European Commission, Brussels, 2009.
2 See the box entitled "Long-term fiscal sustainability in the euro area" in the December 2006 issue of the Monthly Bulletin.
3 See the box entitled "The 2009 Ageing Report: updated projections for age-related public expenditure" in the June 2009 issue of the Monthly Bulletin. Projections of age-related expenditure comprise pensions, health care, long-term care, unemployment benefits and education.
4 For details on the assessment of sustainability, see N. Giammarioli, C. Nickel, P. Rother and J.-P. Vidal, "Assessing fiscal soundness: theory and practice", *Occasional Paper Series*, No 56, ECB, Frankfurt am Main, 2007.
5 For an overview of the models underlying the pension projections, see Economic Policy Committee (AWG) and the Directorate General for Economic and Financial Affairs, "Pension schemes and pension projections for the EU27 Member States – 2008-2060", Volume 1, *Occasional Paper Series*, No 56, European Commission, Brussels, 2009.

Accounting for the size of the benefit ratio is supposed to capture the fact that countries with a low benefit ratio (compared with average incomes in the economy) may be restricted in reforming their social systems through further reductions in benefit levels.

Significant increase in risks to the sustainability of public finances in the euro area

The results of grouping the euro area countries into risk categories show that half of the 16 euro area countries are assessed as high risk in terms of the sustainability of their public finances, namely Ireland, Greece, Spain, Cyprus, Malta, the Netherlands, Slovenia and Slovakia (see table below). Belgium, Germany, France, Italy, Luxembourg, Austria and Portugal are assessed as medium risk, while Finland is the only euro area country that is assessed as low risk. Compared with the 2006 Sustainability Report, mainly owing to the deterioration in their

Overall sustainability risk assessment and main underlying factors considered

	Sustainability gap indicator (S2)				Selected qualitative indicators for assessing additional sources of fiscal pressures	Overall sustainability risk assessment	
	Required adjustment of structural primary balance to:		Total	Overall risk assessment according to the S2 indicator			*memo:*
	stabilise debt ratio given initial budgetary position	address long-term change in primary balance due to ageing					
	(1)	(2)	(3) = (1) + (2)			2009	*2006*
Belgium	0.6	4.8	5.3	medium	tax ratio (-)	**medium**	*medium*
Germany	0.9	3.3	4.2	medium	change in structural primary balance (-)	**medium**	*medium*
Ireland	8.3	6.7	15.0	high	change in structural primary balance (-)	**high**	*medium*
Greece	2.6	11.5	14.1	high		**high**	*high*
Spain	6.1	5.7	11.8	high	change in structural primary balance (-)	**high**	*medium*
France	3.8	1.8	5.6	medium		**medium**	*medium*
Italy	-0.1	1.5	1.4	low	very high debt ratio (-) tax ratio (-)	**medium**	*medium*
Cyprus	0.5	8.3	8.8	high	change in structural primary balance (-)	**high**	*high*
Luxembourg	-0.4	12.9	12.5	high	very low debt ratio (+)	**medium**	*medium*
Malta	1.4	5.7	7.0	high		**high**	*medium*
Netherlands	1.9	5.0	6.9	high	change in structural primary balance (-)	**high**	*low*
Austria	1.6	3.1	4.7	medium	benefit ratio (-)	**medium**	*low*
Portugal	3.7	1.9	5.5	medium	benefit ratio (-)	**medium**	*high*
Slovenia	3.9	8.3	12.2	high	change in structural primary balance (-)	**high**	*high*
Slovakia	4.5	2.9	7.4	high		**high**	*medium*
Finland	-0.5	4.5	4.0	medium	low debt ratio (+), change in structural primary balance (-)	**low**	*low*

Source: European Commission.
Notes: As regards qualitative indicators, the change in the structural primary balance refers to the period 2008-10. The list of qualitative indicators reviewed in the table is not exhaustive; the assessment of the debt ratio in 2009 is included only when it contributes to explaining differences in the risk assessment according to the S2 indicator and the overall sustainability risk assessment. (-) factor tends to increase risk to long-term fiscal sustainability, while (+) factor tends to reduce it.

current budgetary positions, Ireland, Spain, Malta, the Netherlands, Austria and Slovakia have been grouped into a higher risk category.

As indicated in the table, the underlying quantitative determinants of the identified sustainability gaps, i.e. the gaps arising from the initial budgetary position and from the projected rise in ageing costs, differ significantly across the euro area countries. The table also shows that to stabilise the debt ratio, the current structural primary balance may require a large adjustment, amounting to more than 8 percentage points of GDP. In turn, the adjustment of the structural primary balance needed to address projected increases in age-related expenditure may reach almost 13 percentage points of GDP.

Strong need for structural reform and fiscal consolidation

The report provides an essential and balanced assessment of sustainability risks in the EU27, which are described as being so significant that "debt sustainability should get a very prominent and explicit role in the surveillance procedures" under the Stability and Growth Pact. Although the results are subject to a large degree of uncertainty and do not account for planned consolidation measures, they provide evidence of rapidly rising risks to the sustainability of public finances. In particular, owing to the financial crisis and the economic downturn, the starting positions of all countries have already worsened considerably. The assessment does not explicitly account for the increase in the size of countries' contingent liabilities associated with the stabilisation of the banking system during the current crisis, meaning that it may underestimate the size of the challenges to sustainability.

In November the ECOFIN Council issued its conclusions on the 2009 Sustainability Report. Acknowledging the "larger than usual uncertainty" surrounding structural budgetary positions and long-term budgetary projections, it concluded that the crisis-related deterioration in public finances "added substantially to sustainability challenges". The Council therefore called for these challenges to be addressed through a determined implementation of the three-pronged strategy agreed at the 2001 European Council in Stockholm, consisting of: (i) deficit and debt reduction; (ii) increasing employment rates; and (iii) reforming social protection systems.

The findings of the Sustainability Report should be taken as a wake-up call concerning the severity of the challenges to fiscal sustainability. They highlight the urgent need to design and communicate ambitious fiscal exit and consolidation strategies in order to return to sound fiscal positions.