ARTICLES

CHALLENGES TO FISCAL SUSTAINABILITY IN THE EURO AREA

Fiscal sustainability is a prerequisite for stability, growth and cohesion in a monetary union. Fiscal policies need to guarantee the sustainability of public finances through sound deficit and debt positions that are underpinned by solid growth prospects and viable social security systems. Over and beyond that, fiscal policies should also minimise further sustainability risks that arise from their links to domestic and external imbalances. The provisions of the revised Stability and Growth Pact support a comprehensive approach to fiscal sustainability within the EU fiscal framework. In the light of these considerations, a rigorous implementation of the revised Pact is of crucial importance, particularly with regard to the excessive deficit procedure and more determined progress with fiscal consolidation and reform.

1 INTRODUCTION

Fiscal sustainability is a precondition for stability and growth. The perception that public finances are on an unsustainable path would create uncertainty in the economy and lead agents to take into account in their decisions the consequences of a persistent deterioration of public finances, i.e. either major policy reversals or disruptive market reactions. Moreover, increased uncertainty could lead to a tendency towards shorter-term contracts, and could lower welfare, as risk-averse agents would spend more resources on hedging against uncertainty.

Such concerns are even more relevant in a monetary union. In this environment, national policy-makers may be inclined to run larger fiscal deficits as market signals via the national exchange rate are eliminated and those from interest rate risk premia may be muted. An unsustainable fiscal situation increases the risk of national policy positions being geared more and more towards short-term domestic objectives that may diverge from – or even run counter to – the common goals of the monetary union. For example, countries with increasing fiscal problems could be in favour of a loose implementation of the EU's fiscal rules, which could, over time, erode public confidence in the conduct of sound economic policies. Moreover, national policy objectives could conflict with those of the central bank as regards the need to preserve price stability, thereby undermining cohesion. The institutional framework of EMU set out in the Treaty establishing the European Community (the "Treaty"), in particular the independence of the central bank (Article 108 of the Treaty) and the no-bail-out clause (Article 103 of the Treaty), ensures that unsound fiscal policies in one country do not undermine the stability of the union.[1] In addition to these provisions, prudence calls for a close monitoring of sustainability-related developments in Member States, so that emerging risks can be addressed in a timely manner.

The analysis of fiscal sustainability needs to consider the possible links between fiscal policies and both domestic and external imbalances, in addition to the standard parameters, i.e. fiscal balances and public debt, as well as GDP growth and interest rates. Domestic imbalances, as evidenced by large asset price swings and boom-bust cycles in output growth, for instance, can increase the risk of fiscal policies (inadvertently) becoming pro-cyclical, and the correction of such imbalances can imply additional fiscal pressures. In addition, external imbalances – which also reflect domestic imbalances – can undermine growth and fiscal sustainability by triggering corrections in household and corporate sector behaviour.

The EU framework for policy coordination takes account of the need for an institutional mechanism to counteract the risks to fiscal sustainability in EMU. With regard to economic policies, the Broad Economic Policy Guidelines represent the overarching policy instrument for the coordination of the general orientation of

1 See the article entitled "The relationship between monetary policy and fiscal policies in the euro area" in the February 2003 issue of the Monthly Bulletin.

policies, as well as of specific policy recommendations. In the fiscal area, the framework of the Stability and Growth Pact, which combines the requirement of fiscal discipline with incentives for structural reforms, facilitates a comprehensive approach to sound economic and fiscal policies. Nevertheless, challenges remain and it is now essential to ensure that the Pact is implemented in a rigorous and consistent manner.

This article considers the challenges to fiscal sustainability that arise from conventional determinants, as well as those that result from the link between fiscal policies and domestic and external imbalances. Section 2 discusses fiscal sustainability in general, also covering the implications of imbalances. Section 3 deals with experience in the euro area and in individual countries with regard to key variables. Section 4 focuses on policy measures to ensure fiscal sustainability and Section 5 elaborates on how the revised Pact contributes to the implementation of sustainability-oriented policies. The final section concludes and presents an overview of current policy requirements in the euro area.[2]

2 FISCAL SUSTAINABILITY

THE NOTION AND DETERMINANTS OF FISCAL SUSTAINABILITY

Fiscal sustainability is generally defined as a government's ability to service its debt obligations over time. In technical terms, sustainability requires that the current policies of the government satisfy the intertemporal budget constraint, namely the need for the discounted present value of future primary balances (i.e. the budget balance excluding interest payments) to be equal to the outstanding stock of debt (see the box below). Consequently, a positive differential between the average interest rate and economic growth means that, all other things being equal, the higher the level of outstanding debt, the larger the future primary surpluses necessary to ensure fiscal sustainability.

2 The data in this article refer to the euro area excluding Slovenia.

Box

THE THEORETICAL FRAMEWORK OF FISCAL SUSTAINABILITY

The purpose of this box is to present the formal conditions for the sustainability of public finances. Key components, as shown below, are the stock of debt, the primary balance, the interest rate and economic growth. This formal discussion confirms the importance of low debt and deficits, stable monetary conditions and high growth, as detailed from a more policy-oriented perspective in this article.

The theoretical analysis of fiscal sustainability starts from the government's budget constraint in a single given period. The change in government's nominal debt (B) from one period to another ($B_t - B_{t-1}$) is indicated by the interest payments on outstanding government debt from the previous period ($r_t B_{t-1}$) minus the primary budget balance (D_t), where r is the average nominal interest rate and the primary balance equals government revenue minus non-interest expenditure, so that:

$$B_t - B_{t-1} = r_t B_{t-1} - D_t \qquad [1]$$

In an economy in which nominal GDP (Y) rises at a rate of g_t (i.e. where $Y_t = (1+g_t)Y_{t-1}$), the government's budget constraint [1] can be expressed by dividing its elements by nominal GDP:

$$b_t = \frac{1+r}{1+g} b_{t-1} - d_t \,, \qquad [2]$$

where $b_t = \frac{B_t}{Y_t}$ and $d_t = \frac{D_t}{Y_t}$, while both the nominal interest rate and the growth rate of nominal GDP are assumed to remain constant over time.

Equation [2] shows that the evolution of the debt-to-GDP ratio depends on three factors, namely the primary budget balance ratio (d_t), the legacy of past fiscal policies that resulted in debt financing (b_{t-1}) and the ratio between the nominal interest rate and nominal GDP growth $\left(\frac{1+r}{1+g}\right)$. If the nominal interest rate is higher than the growth rate of nominal GDP, a primary budget surplus is needed to maintain the government debt ratio at its current level.

This finding can be extended for longer time horizons. By re-arranging equation [2] and substituting b_t forward up to year T–1, it is possible to derive the government's intertemporal budget constraint from the year 0 to the year T:

$$b_{-1} = \frac{1+g}{1+r} d_0 + \ldots + \left(\frac{1+g}{1+r}\right)^{T+1} d_T + \left(\frac{1+g}{1+r}\right)^{T+1} b_T \qquad [3]$$

Over the infinite horizon, equation [3] yields:

$$b_{-1} = \sum_{i=0}^{+\infty} \left(\frac{1+g}{1+r}\right)^{i+1} d_i + \lim_{T \to +\infty} \left(\frac{1+g}{1+r}\right)^{T+1} b_T \,. \qquad [4]$$

The stock of debt inherited from the previous period must equal the discounted sum of future primary balances plus the discounted value of debt in the final period. Applying the so-called no-Ponzi condition, public debt in the infinite future can be assumed to be zero. This is because rational agents will only hold public debt if they can expect such debt to be redeemed by the government at least in the very long term. Thus, fiscal sustainability can be defined as follows:

$$b_{-1} = \sum_{i=0}^{+\infty} \left(\frac{1+g}{1+r}\right)^{i+1} d_i \,. \qquad [5]$$

This equation indicates that a given fiscal policy is sustainable if the present discounted value of primary budget surpluses is equal to the current level of public debt. In other words, where public sector debt exists, the government will have to run primary budget surpluses in the future if public finances are to be sustainable.

For practical purposes, however, this concept of fiscal sustainability has a number of shortcomings. Most notably, the theoretical infinite-horizon concept would allow very high levels of public debt at a given point in time, the sole requirement being that primary surpluses in the future be large enough to cover them. Similarly, this concept would also permit very large primary deficits in the short run, as long as they were followed by primary surpluses

in the more distant future. Uncertainty regarding economic and policy developments in the very long term calls for adjustments to the theoretical concept for practical purposes.

To address the aforementioned problems, the time frame for practical sustainability analyses is generally limited to a finite horizon of, say, 20 or 50 years, for instance. Fiscal sustainability is then assumed to be ensured as long as the debt-to-GDP ratio remains below a given threshold. Thus, using the current debt level as a starting point, a typical analysis of fiscal sustainability would project the development of the debt ratio over the relevant period, applying assumptions regarding interest rates and GDP growth rates, as well as the primary surplus. If the projected debt ratio exceeds a certain threshold, it would be deemed to be increasingly unsustainable and policy changes would be considered necessary.

The importance of the growth rate of the economy stems from the fact that debt sustainability is measured relative to output, as a proxy of the tax base of future revenues. Stronger growth contributes to a more rapid reduction of the value of the debt stock relative to output. For example, this is reflected in the fiscal reference values of the Maastricht Treaty: with nominal GDP growth of 5% (3% real growth, plus 2% inflation), fiscal deficits of 3% of GDP would stabilise the debt ratio at 60% of GDP. In particular, if the debt ratio were to be above that level at the outset, a deficit of 3% of GDP would give rise to a declining debt ratio, bringing it down to the reference value over time. At a debt level of 60% of GDP, the impact of a fiscal deficit in the order of 3% of GDP on the debt ratio would just offset the decline in the debt ratio that results from nominal GDP growth, leaving the debt ratio constant.

By contrast, with nominal GDP growth of 3% – which may be a more realistic projection for some euro area countries in the medium term – the beneficial impact of nominal growth on the debt ratio is much smaller. An unchanged average deficit of 3% would therefore result in the debt ratio approaching 100% of GDP over time, which is far less safe than the Maastricht reference value.

The concept of public debt used for sustainability analysis needs to be comprehensive. The theoretical approach is based on net public debt, i.e. outstanding gross liabilities minus government assets. In practice, however, most public assets are very difficult to value, as there is no liquid market for a large proportion of those assets and as price estimates are uncertain.

In terms of size, the impact of implicit government obligations is, for most countries, of equal or even greater importance. Essentially, a realistic projection of government obligations needs not only to cover the level of outstanding explicit government debt, which is usually in the form of debt contracts such as bond issues or bank credits. It also needs to include future obligations which the government will, in all probability, have to honour under current policies, even if such obligations are not supported by legally enforceable contracts.

The most prominent of those implicit liabilities arise from public pay-as-you-go pension schemes in an environment of demographic ageing. Such systems involve a government promise to pay pensions to current contributors, with those pensions, in turn, covered by the contributions of future generations. While such promises are, to a large extent, not strictly enforceable in a legal sense, the system is built on current contributors' trust in the fact that they will receive an old-age pension financed by future generations. Thus, a government will generally not renege completely on its obligations.

Reflecting this commitment, the statistical recording of implicit pension liabilities in a supplementary table is one of the major issues under consideration in the current review of the 1993 System of National Accounts. The backward-looking approach focuses on the recording of pension claims accumulated in the

past and requires the solution of methodological and technical questions regarding the quantification of accrued liabilities. A similar situation can be seen in the area of expenditure on health and long-term care. The hypothesis underlying projections for these outlays is that current policies will remain unchanged, even if there is no explicit government obligation to guarantee the current levels of medical and social services in the future.

ADDITIONAL SOURCES OF RISK TO FISCAL SUSTAINABILITY

The analysis of fiscal sustainability needs to take the links between fiscal policies and domestic and external imbalances into account. First, inappropriate fiscal policies can contribute to the emergence or accumulation of domestic and external imbalances, the correction of which can, in turn, undermine fiscal sustainability. Second, in an environment of slow growth and low investor and consumer confidence, an unsound fiscal position can undermine economic sentiment further, and can thus contribute to a perpetuation of low growth and fiscal imbalances.

As regards the link between fiscal policies and the accumulation of imbalances, fiscal policy-makers face the problem of identifying the cyclical state of the economy in real time. The identification of a period of boom (or bust) requires not only timely estimates of current economic growth, but also an accurate estimate of the rate of trend growth. As the trend growth rate may vary over time, it is difficult to estimate it with any certainty in real time.

In particular, it was often argued in past boom phases that the strong growth observed at the time did not reflect cyclical developments, but rather an upward shift in the trend growth rate. Assuming that a neutral fiscal policy refers to a balanced budget when output growth is at trend, in the case of higher trend growth, a balanced budget in cyclically adjusted terms would be consistent with a lower actual fiscal balance. In the case of unchanged trend growth, however, such a lower actual balance would imply an expansionary fiscal stance. Thus, fiscal policies would actually contribute to the overheating of the economy reflected in domestic or external imbalances. Moreover, in periods of strong demand and asset price growth, certain tax revenues (e.g. property, turnover and capital gains taxes) tend to be growing exceptionally fast, i.e. their elasticity with regard to their specific tax base may change pro-cyclically. Rising fiscal revenues, in turn, allow stronger public expenditure growth, which may boost demand and wage growth without showing up in worsening fiscal balance-to-GDP ratios in the upswing phase of the cycle.

Overall, expansionary fiscal policies in boom times may contribute to the emergence and persistence of real economic imbalances. As a consequence, the fiscal position at the end of a boom tends to be weaker than might be assessed on the basis of constant tax elasticities, and there is thus less room for manoeuvre to deal with the implications of a downturn without jeopardising fiscal sustainability.

Turning to the impact of fiscal policies in an environment of subdued growth, the slow growth performance and unsound fiscal positions may reinforce each other in a vicious circle. An environment of low growth, which could be a consequence of a preceding unsustainable boom period, weakens fiscal sustainability, in particular when fiscal imbalances are large to start with. On the external side, if the correction of accumulated external imbalances requires gains in price competitiveness, this may generally entail lower inflation (compared with competitors) as well as slow wage and domestic demand growth if nominal exchange rate changes are ruled out. But these developments also tend to weaken fiscal balances, as revenues decline, while expenditure on unemployment and other social security transfers could rise. Moreover, an adjustment of domestic asset prices in a downturn is likely to trigger capital losses or negative wealth effects, leading to further adverse surprises on the revenue side, such that

Selected fiscal and macroeconomic indicators

	Public debt (as a percentage of GDP)	Fiscal deficit (as a percentage of GDP)	Cumulative change in the consumer price index (in percentages relative to the euro area)	Cumulative change in unit labour costs (whole economy) (in percentages relative to the euro area)	Cumulative current account balance[1] (as a percentage of GDP)
	2006	2006	1999-2006	1999-2006	1999-2006
Belgium[2]	89.4	-0.2	-0.4	-0.2	27.4
Germany	67.8	-2.3	-4.4	-9.7	10.7
Ireland	25.8	1.2	11.5	13.0	-6.2
Greece[3]	104.8	-2.6	9.7	12.3	-45.4
Spain	39.7	1.5	9.0	9.9	-28.2
France	64.7	-2.7	-1.9	2.3	3.0
Italy	107.2	-4.7	2.3	9.2	-5.6
Luxembourg[2]	7.4	-1.5	5.3	11.1	56.7
Netherlands	50.5	0.0	3.7	5.9	37.5
Austria	62.1	-1.3	-2.8	-6.9	-1.6
Portugal	67.4	-4.6	7.7	16.5	-55.8
Finland	38.8	2.9	-3.9	-1.8	44.1
Euro area	69.5	-2.0			-0.4

Sources: ECB and European Commission (Public debt and fiscal deficit, Autumn 2006 forecast. Cumulative change in unit labour costs, AMECO, full-time equivalent).
1) For 2006, up to the third quarter.
2) Data for the cumulative current account balance refer to the period from 2002 to 2006 (third quarter).
3) Data for the cumulative change in unit labour costs need to be interpreted cautiously. Alternative estimates by the Bank of Greece suggest a cumulative change of 19.5% relative to the euro area.

the fiscal balance tends to deteriorate more than would be expected on the basis of adverse demand effects alone. At the same time, the public debt ratio will tend to rise, as the denominator in the ratio will grow more slowly than before.

Overall, the combined effects of larger deficits and weaker growth may give rise to a substantial worsening in fiscal sustainability when domestic or external imbalances unravel. The greater the imbalances, the larger are the potential implications for sustainability via these channels.

At the same time, an unsound fiscal position will tend to undermine economic confidence. When faced with large fiscal imbalances, consumers may prefer to raise that part of their current income that is devoted to precautionary savings, rather than the part they consume. Similarly, enterprises may opt to put off investment decisions in view of uncertainty over eventual tax increases. As a consequence, unsound fiscal positions and low growth reinforce each other, perpetuating the slump and undermining fiscal sustainability further.

As a consequence of the above, a comprehensive assessment of fiscal sustainability needs to take account of the linkages between fiscal positions and macroeconomic developments, so that it can flag emerging risks in a timely manner. For fiscal policy-makers, the above considerations highlight the need for prudent policies, in particular in boom phases.

3 EXPERIENCE IN EMU VARIES FROM COUNTRY TO COUNTRY

Looking at medium-term fiscal developments in the euro area, fiscal sustainability has shown no permanent improvement since the inception of EMU. The average debt ratio is only marginally lower than in 1998 and, indeed, a three-year upward movement therein has only been reversed in 2006 (see the table above, as well as Chart 1). More than half the euro area countries report debt ratios above

the reference value of 60% laid down in the Maastricht Treaty. Two of the countries currently in excessive deficit (Greece and Italy) have very high debt ratios. The average debt level of all countries in excessive deficit (the two aforementioned countries plus Germany and Portugal) has risen rapidly since 2001. This has more than offset the decline in the average debt ratio of those countries that are not running excessive deficits.

The data also show that debt developments are driven mainly by persistently large fiscal deficits and slow growth (see Chart 2); only for a few countries have significant deficit-debt adjustments been recorded.[3] After 1998 the average euro area fiscal deficit initially declined, continuing a trend that had started during the preparations for EMU. However, fiscal balances did not improve sufficiently during this period, which was marked by a relatively favourable economic environment. After 2000 many countries experienced a worsening of their fiscal imbalances. While this was partly due to the deterioration in the economic environment, an easing of the fiscal policy stance in a number of countries also contributed to the rising euro area deficit ratio in 2001 and 2002.

The development of the fiscal deficits in countries in excessive deficit resembles that of the euro area average, albeit at a higher level. Given their insufficiently sound budgetary positions in 2000, at the end of the previous period of strong growth, these countries experienced very high deficit ratios after that date. The modest improvement observed in the average deficit ratio since 2004 has not sufficed to reverse the increase in the average debt ratio for these countries.

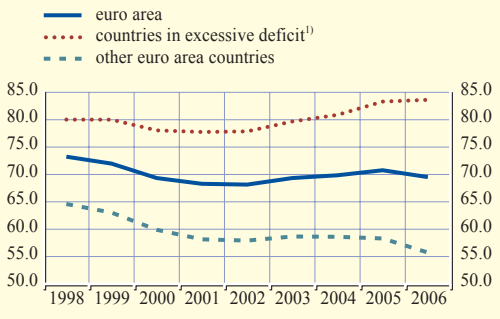
In addition to the explicit debt burden, projected implicit future liabilities that are due to demographic ageing are substantial. Taking a comprehensive forward-looking approach, the ratio of ageing-related expenditure to GDP (net of some offsetting effects from lower projected expenditure on education and unemployment) is projected by the European Commission and the Economic Policy Committee (EPC) to rise by 5 percentage points, or more, in half the euro area countries by 2050 (see Chart 3).[4] The largest increase is projected for Portugal, namely 9.7 percentage points. For Greece, for

3 See the article entitled "EMU and the conduct of fiscal policies" in the January 2004 issue of the Monthly Bulletin.

4 See also A. Maddaloni, A. Mussa, P. Rother, M. Ward-Warmedinger and T. Westermann, "Macroeconomic implications of demographic developments in the euro area", ECB Occasional Paper No 51, August 2006.

Chart 1 Public debt

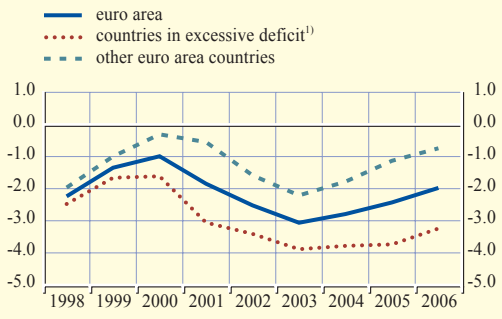
(as a percentage of GDP)



Source: European Commission.
1) Countries in excessive deficit as of February 2007.

Chart 2 Fiscal balances

(as a percentage of GDP)



Source: European Commission.
Note: The fiscal balance data exclude UMTS receipts.
1) Countries in excessive deficit as of February 2007.

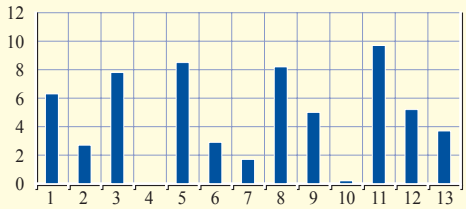
which most recent data are not yet available, projections in the previous study undertaken by the EPC also point towards a very heavy ageing-induced burden. For the euro area average, the projected increase is close to 4 percentage points. It should also be noted that these projections may even turn out to be optimistic, as they are based on favourable assumptions regarding labour productivity. In addition, not all factors that have driven expenditure in the past were included in the projections for expenditure on health and long-term care.

Turning to possible pressures on fiscal sustainability that result from boom-bust episodes, there have not as yet been many empirical assessments of the fiscal costs of such adjustments. However, looking at the period since the late 1980s, a number of studies have shown that the adjustment of domestic, external and asset price disequilibria has, in a number of industrialised countries, resulted in both major deteriorations in fiscal balances and significant bailout costs in the corporate and banking sectors.[5] These countries experienced increases in the debt ratio that ranged from 10 to 50 percentage points in the 1990s. They included economies which experienced sharp downturns and exchange rate devaluations, but in some cases also drawn-out adjustment periods without significant devaluations. Moreover, at the end of the stock market boom in 2000, the mis-estimation of trend growth, coupled with the fact that positive revenue surprises were mistakenly perceived to be permanent, also led to important mis-judgements of the true fiscal position in a number of countries.

With regard to further potential imbalances, persistent inflation differentials have been recorded within the euro area. Two of the countries in excessive deficit (Greece and Portugal) and two countries with sound fiscal positions (Spain and Ireland) have recorded the largest increases in the consumer price index relative to the euro area average (see the table). While temporary differences in inflation rates, in themselves, are not necessarily a problem for a monetary union, as they can contribute to a convergence of price levels across countries, they may contribute over time to the emergence of external imbalances.[6]

Chart 3 Burden of ageing-induced expenditure between 2004 and 2050

(change as a percentage of GDP)



1 Belgium
2 Germany
3 Ireland
4 Greece
5 Spain
6 France
7 Italy
8 Luxembourg
9 Netherlands
10 Austria
11 Portugal
12 Finland
13 Euro area

Source: "The impact of ageing on public expenditure: projections for the EU25 Member States on pension, health care, long-term care, education and unemployment transfers (2004-2050)", Economic Policy Committee and European Commission, 2006.
Note: Data for Greece are not available.

Unit labour costs have developed along divergent lines since the inception of EMU. While differences in the development of this indicator in EMU may, as in the case of inflation, reflect equilibrating effects, they may also point to emerging imbalances. Changes in the unit labour costs in two of the countries in excessive deficit (Greece and Portugal), together with Spain, account for some of the largest cumulative increases relative to the euro area average (see the table). These three countries also had the largest cumulative current account deficits over the period from 1999 to 2006, which ranged between around 28% and 56% of 2006 GDP.[7] The increases in unit labour costs were also very high in Italy.

5 F. Eschenbach and L. Schuknecht, "Deficits and Asset Prices", *Economic Policy*, July 2004, pp. 315-346, and "The Fiscal Costs of Financial Instability Revisited", ECB Working Paper No 191, November 2002.

6 See also the article entitled "Monetary policy and inflation differentials in a heterogeneous currency area" in the May 2005 issue of the Monthly Bulletin for a more detailed analysis.

7 See the article entitled "Competitiveness and the export performance of the euro area" in the July 2006 issue of the Monthly Bulletin for complementary analysis.

In summary, the experience gained in euro area countries indicates a number of risks to fiscal sustainability. The average debt ratio in the euro area remains high, with considerable cross-country dispersion, and debt ratios have been rising in a number of countries, reflecting persistently large fiscal deficits. Projections for fiscal policies in the coming years suggest an only slow and moderate improvement in fiscal balances. In addition, the projections of the European Commission and the EPC point to substantial ageing-related fiscal pressures in several countries unless decisive consolidation and reform measures are implemented swiftly. Potential fiscal burdens that arise from the correction of accumulated internal and external imbalances may represent additional risks to long-term fiscal sustainability for some countries.

4 WHAT CAN FISCAL POLICIES DO TO ENSURE SUSTAINABILITY?

Fiscal policies have an impact on all the variables determining fiscal sustainability that were discussed above. Budget deficits translate immediately into increases in the level of debt, and thus constitute a major risk to sustainability. Moreover, the design of social security and health care arrangements drives the accumulation of implicit liabilities. Over and beyond these direct effects, fiscal policies are also an important factor for medium and long-term growth and can have a major impact on the emergence and correction of internal and external imbalances.

DEFICIT AND DEBT

Starting with deficit and debt developments, attaining and maintaining sound fiscal positions (as regards both the fiscal balance and public debt) is particularly important in a monetary union. The risks posed by fiscal indiscipline have long been acknowledged. National policy-makers tend to act within short time frames that are influenced by the electoral timetable. This generates a tendency towards larger fiscal deficits, as the associated burdens of a higher debt ratio become visible only over time. The deficit bias of national policies is more pronounced in a monetary union, as immediate market reactions to a country's errant policies are subdued. There is no nominal exchange rate to serve as an indicator of the market's assessment of an individual country's macroeconomic prospects, and a possible interest rate risk premium may be compressed if markets assume that country risk is reduced by membership in a currency union.

In order to keep the accumulation of implicit liabilities contained, pension and health care systems need to be designed in a way that makes them robust in terms of the impact of demographic ageing through the reform of existing public systems and greater reliance on private savings in funded pillars.[8]

GROWTH

For long-term fiscal sustainability, the impact of fiscal policies on trend growth is of key importance. Even small differences in long-term growth rates can have major implications for fiscal sustainability on account of the length of the time horizon involved. In the same vein, given both the size of the public sector in the euro area and the involvement of the public sector in all important economic relationships, the potential for growth-friendly fiscal policies is large.[9]

Starting with the overall macroeconomic environment, fiscal soundness as discussed above strengthens public confidence in economic stability, reduces economic uncertainty and facilitates long-term economic relationships that contribute to economic efficiency. In addition, the size of government matters. The larger its size, the higher is the

8 For more details, see the article entitled "Demographic changes in the euro area – projections and consequences" in the October 2006 issue of the Monthly Bulletin.

9 For more details, see the articles entitled "Fiscal policies and economic growth" and "The importance of public expenditure reform for economic growth and stability" in the August 2001 and April 2006 issues of the Monthly Bulletin respectively.

level of taxation, and thus the greater is the impact of tax distortions. Consequently, governments can contribute to long-term growth by limiting the size of the government sector and reducing the importance of tax distortions.

The harmful effects of fiscally induced distortions are particularly visible in the labour market. On the demand side, a large tax wedge on labour raises total labour costs and reduces demand for labour. The combined effect of unemployment benefits and labour taxation can also act as a significant disincentive in respect of the labour supply. The loss of benefits and the need to pay taxes and social security contributions can make it unattractive for unemployed workers to re-enter employment. Similar disincentives apply with regard to the decision to retire if pension entitlements increase only marginally for years worked beyond the minimum retirement age.

The composition of public expenditure provides governments with a further channel through which to support long-term growth. From a macroeconomic perspective, public expenditure for productive purposes, such as investment or education, is more likely to strengthen growth than expenditure for redistributive purposes. Nevertheless, even productive expenditure does not necessarily contribute to growth. First, its financing gives rise to additional distortions, which then need to be compensated for. Second, such expenditure needs to be managed efficiently, i.e. such that the minimum amount of financing is used for any given purpose. In productive as well as redistributive spending, raising expenditure efficiency can make an important contribution to reducing the negative growth effects of government expenditure.

IMBALANCES

Fiscal policies should also confront the risks to fiscal sustainability that arise from internal and external imbalances. As noted above, a primary concern for fiscal policies must be, at the very least, to refrain from contributing to an overheating of the economy. Thus, in periods of boom, governments must take particular care to ensure that their policies do not – perhaps inadvertently – create additional demand pressures, which may lead to economic overheating.

Fiscal prudence is particularly warranted in a number of areas. Given the importance of public sector employment in euro area economies, public sector wage developments can have a significant impact on overall wage behaviour. Strong rises in public sector wages, even when reflecting a favourable fiscal situation, may lead to wage pressures in the private sector. Similarly, increases in the number of public sector employees may aggravate labour market shortages, also leading to upward wage dynamics. In addition, in the area of social security, there is a risk of the coverage and size of benefits being raised during good times, implying government obligations that will be difficult to reverse in bad times. This also points to the need for governments to preserve fiscal flexibility, i.e. the ability to adjust the budget swiftly in response to changes in the economic environment. Finally, fiscal policies can have a major impact on developments in the real estate sector. Tax provisions have the potential to give further impetus to a domestic real estate boom. The deductibility of mortgage interest from taxable income, for example, lowers real after-tax interest rates for residential investment, and can thus contribute to overheating. The composition of the tax burden (i.e. taxes on consumption versus income/labour taxes) can also affect the composition of demand and, therefore, the national savings-investment balance.

NEED FOR A COMPREHENSIVE APPROACH INTEGRATING FISCAL PRUDENCE AND STRUCTURAL REFORMS

As discussed in Section 2, adjusting the economy in response to imbalances generates additional risks to fiscal sustainability. To reduce these risks, policies need to follow a comprehensive approach to fiscal reform. In addition to a prudent stance, fiscal and structural

policies should be consistent with the flexible adjustment of prices and wages, as well as with the sectoral and geographical reallocation of labour and capital. Reforms in this direction will increase potential output and foster economic activity in the euro area, as well as help to prepare for future challenges, including demographic change, and exploit the opportunities created by technological progress and globalisation.

Fiscal structural reform as part of a comprehensive growth-friendly reform programme can address many issues simultaneously and create important spill-over effects. For example, a well-designed pension reform, including the development of a privately funded pension pillar, can reduce the implicit pension debt by lowering future public pension obligations. In addition, such a reform can reduce the incentives for early retirement: since the pension from the funded pillar depends only on the individual's accrued capital, every additional year in employment raises the pension benefits accordingly. Furthermore, such a pension reform allows contributions to the pay-as-you-go system to be lowered, which reduces the perceived tax wedge on labour and creates incentives for the labour supply. Positive incentive effects can also be strengthened by linking contributions to the pay-as-you-go pension system more closely to the benefits they generate, e.g. in the form of a so-called notional defined contribution system.[10] However, fiscal reforms need to be embedded in a comprehensive reform strategy. Notably, as far as older workers are concerned, increased incentives for the supply of labour will only result in higher levels of employment and growth if labour markets are flexible enough to absorb the additional supply.

5 CURRENT CHALLENGES FOR FISCAL SUSTAINABILITY UNDER THE REVISED STABILITY AND GROWTH PACT

The institutional framework set out in the Treaty for economic and fiscal policies establishes incentives for fiscal and structural policies to contribute to fiscal sustainability. Central to the monitoring and surveillance of fiscal policies is the Stability and Growth Pact. In 2005 the Pact was revised in a manner intended to place a greater focus on the sustainability of public finances.[11]

FISCAL SUSTAINABILITY UNDER THE REVISED PACT

Compliance with the requirement laid down in the Pact that budgets be "close to balance or in surplus" over the medium term should ensure that fiscal policies are sustainable, while also providing sufficient scope for the operation of automatic stabilisers over the cycle. The fulfilment of this medium-term objective would normally lead to a convergence of debt ratios at levels well below the reference value of 60% of GDP.

In reflection of the growing relevance for fiscal policies of considerations such as population ageing in recent years, however, analysis of the sustainability of public finances has broadened and become more embedded in the EU fiscal framework. Indeed, one of the objectives behind last year's revision of the Pact was to introduce a stronger focus on debt and sustainability. This is reflected in several ways.

Starting with the preventive arm, medium-term budgetary objectives (MTOs) now more explicitly reflect the goal of long-term fiscal sustainability. Member States' MTOs vary, depending on their respective debt-to-GDP ratios and estimated potential GDP growth (two key determinants of sustainability). As soon as an appropriate methodology has been agreed, it is intended to take implicit liabilities that stem from population ageing directly into account in the setting of MTOs. Countries that have not

10 See also the article entitled "Demographic change in the euro area: projections and consequences" in the October 2006 issue of the Monthly Bulletin.

11 See the article entitled "The reform of the Stability and Growth Pact" in the August 2005 issue of the Monthly Bulletin for details.

yet attained their MTOs are required to take steps to do so. As a benchmark, euro area countries and countries that participate in ERM II are to strive to improve their structural budget balances by 0.5% of GDP each year until their MTOs have been met. Furthermore, major structural reforms with a verifiable impact on long-term sustainability may be taken into account when assessing a temporary deviation from the MTOs, or the adjustment path chosen to reach them. In this regard, special attention is paid to pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. Finally, and perhaps of the greatest relevance for the prevention of domestic and external imbalances, the preventive arm's revised provisions suggest a higher adjustment effort in good times, while the continued requirement to maintain a sound budgetary position places a limit on pro-cyclical policies.

Under the corrective arm of the Pact, reports by the European Commission on the existence of an excessive deficit consider (among the "other relevant factors") the respective country's situation as regards the sustainability of the level of its debt. In addition, the short-term fiscal costs of multi-pillar pension reforms can, under certain circumstances, be taken into account for decisions on whether or not an excessive deficit exists.

To facilitate the continuous monitoring of fiscal sustainability, in particular with regard to demographic ageing, countries have agreed to outline their policies in their annual stability programmes. The basis for the assessment of sustainability by the Commission and the Ecofin Council are the projections produced by the Working Group on Ageing under the auspices of the Economic Policy Committee. In its examination of countries' stability programmes, as in the case of its own Sustainability Report, the European Commission also provides an assessment of long-term fiscal sustainability, drawing on projections of ageing-induced fiscal burdens and its own qualitative considerations.

CHALLENGES FOR THE IMPLEMENTATION OF THE REVISED STABILITY AND GROWTH PACT

While the revision of the Pact has introduced new provisions that could help to promote fiscal sustainability, the challenge now is to put these into effect through a rigorous and consistent implementation of the revised framework. Experience thus far has been mixed in this respect and major challenges still lie ahead. There have been some positive developments since the reform of the Pact. Both actual and planned recourse to temporary measures, which may improve deficits in the short run, but have little or no impact on sustainability in the long run, have declined.

Looking ahead, the MTOs set by Member States broadly comply with the requirements of the reformed Pact. However, planned progress towards MTOs has generally been modest among those Member States with budgetary imbalances. Moreover, concerns about macroeconomic disequilibria are not translating into more ambitious fiscal consolidation and reform. Several countries that are currently in excessive deficit have set a very late target date by which they intend to reach their respective MTOs, or have not provided such a date at all, which raises questions regarding the role of these objectives from a medium-term perspective. Furthermore, planned fiscal adjustment is generally back-loaded, with most countries projected to have undertaken little or no consolidation in 2006 and, instead, focusing consolidation efforts on the later years of the programme horizon. Finally, the measures needed to ensure such consolidation are often not specified, or do not appear fully credible in the light of past experience.

The European Commission's autumn 2006 economic forecasts pointed towards improving fiscal balances in the euro area in the period from 2006 to 2008. However, the projected development of structural budget balances indicates shortfalls in terms of structural consolidation in many Member States unless further policy measures are taken. In the context

of the economic expansion projected for many countries, this suggests that there is a significant risk of Member States failing to take advantage of "good times" in order to achieve sound budgetary positions and appropriately address sustainability risks.

In the context of the revised corrective arm of the Pact, a number of countries have received extended deadlines for the correction of their excessive deficits. In particular, extended deadlines have been granted to Germany, Italy and Portugal, while Greece had already received an extension of the deadline for correcting its excessive deficit in February 2005 (i.e. prior to the reform of the Pact). This notwithstanding, Italy and Portugal are both at risk, according to the Commission's forecasts, of failing to comply with their commitments under the excessive deficit procedure unless further consolidation measures are implemented. Any delay in correcting excessive deficits in a sustainable manner can contribute to a perceived weakening of fiscal sustainability. Therefore, it is essential that, should the risks to these countries' compliance with commitments materialise, the appropriate steps be set in motion under the countries' excessive deficit procedures.

6 CONCLUSION AND POLICY OUTLOOK

The analysis of fiscal sustainability has traditionally focused on fiscal deficits, debt, output growth and interest rates. With regard to government obligations, this article has reiterated that government deficits and public debt – coupled with substantial implicit fiscal liabilities that reflect ageing-induced fiscal burdens – are large for the euro area as a whole and that the current and projected imbalances imply very substantial risks to sustainability in some countries. Furthermore, a comprehensive approach to fiscal sustainability needs to take into account the links between fiscal policies and domestic and external imbalances. A number of euro area countries, including some with very high deficit and debt ratios, have experienced large increases both in the domestic price level relative to that of the euro area and in relative unit labour costs, and have accumulated a large stock of external liabilities through current account deficits.

Fiscal policies need to ensure sustainability, paying due attention to a number of determinants. Low deficit and debt ratios limit the burden of future debt servicing, while preserving scope for the operation of automatic stabilisers. Viable social security systems, implying that the fiscal burdens resulting from population ageing are contained, boost expectations of sustainability. Growth-friendly policies facilitate the task of maintaining sustainability. But there is also the additional challenge of how to minimise fiscal risks stemming from internal and external imbalances. To this end, governments must be careful, especially in boom periods, to ensure that their policies do not contribute to an overheating of the economy, a loss of competitiveness and rising external indebtedness. Fiscal reforms that reduce tax distortions and contribute to the efficient allocation of resources, in particular in the labour markets, strengthen growth and give the economy greater flexibility to react to shocks, thereby helping to prevent imbalances and facilitate required adjustment.

In the context of the revised Pact, the 2007 budgets and the stability programmes of end-2006, these findings have important policy implications. It is essential that fiscal strategies address fiscal sustainability concerns in a comprehensive manner. In particular in countries with economic and fiscal imbalances, it is of the utmost importance to seize the opportunity presented by good times to make rapid progress along the path towards sound fiscal positions. In keeping with the intentions behind the reform of the Pact, namely the enhancement of the sustainability and quality of fiscal policies in the EU, Member States' fiscal strategies should take appropriate account of the broader challenges to fiscal sustainability that stem from the macroeconomic environment, such as those related to asset price booms and

shifts in cost and price competitiveness. In some countries, both the scale of the required fiscal adjustment and more general sustainability concerns call for more ambitious and comprehensive fiscal consolidation and reform strategies than are currently envisaged.