Box 7

THE 2009 AGEING REPORT: UPDATED PROJECTIONS FOR AGE-RELATED PUBLIC EXPENDITURE

In April, the 2009 Ageing Report, prepared by the European Commission and the EU Economic Policy Committee's Ageing Working Group, was published.[1] Taking account of the latest demographic outlook published by Eurostat in 2008, the report contains an update of the 2006 projections for age-related public expenditure in the 27 EU Member States for 2007-60. This box briefly surveys and assesses the projection results, which are based on a "no policy change" scenario, focusing on the euro area countries.

Significant increase in total age-related public expenditure until 2060

The table below summarises the projection outcome for total age-related public spending for the euro area countries as a percentage of GDP over the period 2007-60, covering public expenditure on pensions, healthcare, long-term care, unemployment benefits and education. For the euro area as a whole, total age-related public spending-to-GDP is projected to rise by 5.2 percentage points over the projection horizon. This increase in the ratio reflects, to a large extent, a rise in pension expenditure and, to a lesser extent, rises in spending on health and long-term care, while expenditure on unemployment benefits and education are projected to marginally decline. According to these projections, the change in total age-related spending ratios over 2007-60 is projected to be very different across the euro area countries, ranging from increases of 18 percentage points in Luxembourg and 15.9 percentage points in Greece to 1.6 percentage points in Italy. The projections show that the largest share of age-related public spending is related to pensions, which is nevertheless projected to develop very heterogeneously across countries. All euro area Member States are projected to experience a rise in their healthcare expenditure ratio, with the strongest increase seen in Malta (3.3 percentage points) and the smallest in Cyprus (0.6 percentage point). Public spending on long-term care is projected to rise in all euro area countries, apart from in Cyprus, where it is

1 See European Commission and Economic Policy Committee (2009) "The 2009 Ageing Report: Economic and budgetary projections for the EU-27 Member States (2008-2060)", European Economy 2/2009, Brussels.

Age-related public expenditure-to-GDP, 2007-60

(in % of GDP; changes in percentage points)

	Pensions		Healthcare		Long-term care		Unemployment benefits		Education		Total
	Level 2007	Change 2007-60	Level 2007	Change 2007-60	Level 2007	Change 2007-60	Level 2007	Change 2007-60	Level 2007	Change 2007-60	Change 2007-60
Belgium	10.0	4.8	7.6	1.2	1.5	1.4	1.9	-0.4	5.5	0.0	6.9
Germany	10.4	2.3	7.4	1.8	0.9	1.4	0.9	-0.3	3.9	-0.4	4.8
Ireland	5.2	6.1	5.8	1.8	0.8	1.3	0.8	0.1	4.5	-0.3	8.9
Greece	11.7	12.4	5.0	1.4	1.4	2.2	0.3	-0.1	3.7	0.0	15.9
Spain	8.4	6.7	5.5	1.6	0.5	0.9	1.3	-0.4	3.5	0.1	9.0
France	13.0	1.0	8.1	1.2	1.4	0.8	1.2	-0.3	4.7	0.0	2.7
Italy	14.0	-0.4	5.9	1.1	1.7	1.3	0.4	0.0	4.1	-0.3	1.6
Cyprus	6.3	11.4	2.7	0.6	0.0	0.0	0.3	-0.1	6.1	-1.2	10.8
Luxembourg	8.7	15.2	5.8	1.2	1.4	2.0	0.4	0.0	3.8	-0.5	18.0
Malta	7.2	6.2	4.7	3.3	1.0	1.6	0.4	0.0	5.0	-1.0	10.2
Netherlands	6.6	4.0	4.8	1.0	3.4	4.7	1.1	-0.1	4.6	-0.2	9.4
Austria	12.8	0.9	6.5	1.5	1.3	1.2	0.7	0.0	4.8	-0.5	3.1
Portugal	11.4	2.1	7.2	1.9	0.1	0.1	1.2	-0.4	4.6	-0.3	3.4
Slovenia	9.9	8.8	6.6	1.9	1.1	1.8	0.2	0.0	5.1	0.4	12.8
Slovakia	6.8	3.4	5.0	2.3	0.2	0.4	0.1	-0.1	3.1	-0.8	5.2
Finland	10.0	3.3	5.5	1.0	1.8	2.6	1.2	-0.2	5.7	-0.3	6.3
Euro area	11.1	2.8	6.7	1.4	1.3	1.4	1.0	-0.2	4.2	-0.2	5.2

Source: The 2009 Ageing Report.

projected to remain unchanged. Finally, for the majority of euro area countries, public spending ratios for education and unemployment benefits are projected to decline slightly or remain unchanged.

Compared with the last projection exercise finalised in 2006, for 12 euro area Member States, public expenditure on pensions is projected to rise more strongly than previously anticipated. By contrast, downward revisions of projection results have been made for four euro area Member States. The reasons for these changes differ across countries, ranging from changes in the underlying demographic outlook and macroeconomic assumptions to structural reforms impacting on age-related public expenditure. For Greece, no projections for pension expenditure were available in 2006.

The severe economic downturn could raise the age-related budgetary costs even further

The macroeconomic scenario underlying the ageing cost projections was finalised in 2008 and thus does not incorporate the impact of the recent economic downturn. To account for the potential impact of the severe economic downturn on ageing costs, two types of negative shocks were considered. First, temporary negative shocks were simulated in two alternative scenarios: a "rebound recovery" and a "lost decade" scenario. These scenarios entail two different assumptions regarding the duration of the temporary shock. The rather optimistic "rebound recovery" assumes that the European economy will rebound soon and will have returned to the pre-crisis level of GDP by 2020. The "lost decade" scenario assumes that it could take until 2020 to get back to the real growth rates (but not the GDP level) set in the baseline scenario. Second, in the worst case scenario, a permanent (negative) shock to the growth potential of the EU economies is simulated.[2] This assumes that the current downturn will lead to a permanently

2 The baseline scenario assumes that the annual average potential GDP growth rate in the euro area will fall from 2.1% in the period 2007-20, to 1.7% in the period 2021-30 and to 1.3% in the period 2041-60, owing mainly to the adverse impact of demographic developments.

higher unemployment rate and a permanently lower labour productivity growth rate compared with the baseline. Compared with the baseline scenario, in the "rebound" scenario, there would be no significant additional impact on total age-related costs. However, according to the "lost decade" scenario, total age-related costs for the euro area Member States are projected to rise by an additional 0.9 percentage point of GDP over 2007-60. In turn, according to the "permanent (negative) shock scenario", this rises further to 1.8 percentage points. Thus, the scenarios show that accounting for the economic downturn might raise projections for the increase in age-related budgetary costs over 2007-60 by as much as 15-35%.

Strong need for structural reforms and fiscal consolidation

The 2009 Ageing Report provides, in a unique way, comparable information particularly on the 27 Members States' pension systems, highlighting the urgency for structural reforms in the areas of pension and healthcare systems. This notwithstanding, there are reasons to consider that the baseline projections for age-related public spending provided in the 2009 Ageing Report underestimate the actual costs stemming from population ageing. First, health care cost projections in the baseline scenario assume an income elasticity of only 1.1, which, according to empirical evidence, may understate the impact of rising demand for cost-intensive technological improvements in the future. Second, projections for public spending on long-term care may underestimate the impact of a shift from informal to formal care, particularly in many new EU Member States that currently provide only a limited amount of formal long-term care. Third, as noted above, accounting for the economic downturn might increase the baseline projections for age-related budgetary costs substantially, because, inter alia, potential growth could be lower than assumed in the projections.

An underestimation of the ageing-induced fiscal costs is problematic for two reasons. First, it understates the risks to fiscal sustainability and thus the need for structural reforms and fiscal consolidation. Second, it is problematic, because in the framework of the Stability and Growth Pact, these projections have gained rising importance, as they will feed into the determination of countries' medium-term-budgetary objectives (MTOs), which would then tend to be insufficiently demanding.

Given the large and increasing risks to fiscal sustainability in a number of euro area countries at the current juncture, it is necessary that countries set sufficiently demanding MTOs and adopt a credible path to sound fiscal positions. At the same time, implementing the three-pronged strategy, decided by the Stockholm European Council in 2001 to cope with the economic and budgetary challenges posed by ageing populations, has become ever more pressing, which includes: (i) reducing government debt at a fast pace; (ii) raising employment rates and productivity; and (iii) reforming pensions, healthcare and long-term care systems.