

Box 4

FISCAL CHALLENGES FROM POPULATION AGEING: NEW EVIDENCE FOR THE EURO AREA

Ensuring the long-term sustainability of public finances in the euro area and its member countries is a prerequisite for the smooth functioning of EMU. The sovereign debt crisis has shown the negative effects that large fiscal imbalances in some member countries can have on the economic and financial stability of the monetary union as a whole. In this respect, an important lesson from the crisis is the need for each country to maintain sound public finances and thus foster the stability of EMU as a whole.

Looking ahead, the demographic ageing process represents a major challenge to long-term fiscal sustainability. Demographic ageing is projected to lead to a significantly higher old-age dependency ratio, defined as the ratio between the population aged 65 and above and the working age population (i.e. people aged 20-64). For the euro area, based on the 2010 Eurostat population projection, the old-age dependency ratio is projected to roughly double from 30.1% in 2010 to 58.4% in 2060, which will place a significant burden on the pension and healthcare systems of euro area countries. Against this backdrop, addressing the challenges related to population ageing must remain high on the policy agenda of both national and European policy-makers. The objective should be for all countries to restore budgetary room for manoeuvre, rein in ageing-related spending and strengthen potential output growth, thereby safeguarding the long-term sustainability of public finances.

New ageing-related expenditure projections up to 2060 were published in the 2012 Ageing Report, prepared by the European Commission and the EU Economic Policy Committee.¹ This box summarises the main findings of the report and the challenges for economic growth and fiscal sustainability stemming from population ageing.

The evolution of ageing-related expenditure over the period 2010-60

For the period 2010-60, the 2012 Ageing Report projects an increase in strictly ageing-related public expenditure (i.e. expenditure on pensions, health care, long-term care and education) of 4.5 percentage points of GDP in the euro area as a whole.²

1 See “The 2012 Ageing Report – Economic and budgetary projections for the 27 EU Member States (2010-2060)”, European Commission and Economic Policy Committee, *European Economy*, 2/2012, May 2012.

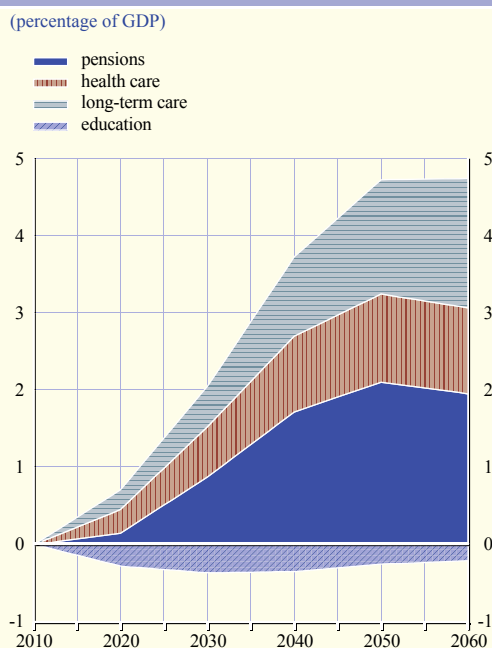
2 This refers to the reference scenario. In a risk scenario based on more prudent assumptions regarding health care and long-term care, the increase would amount to 5.3 percentage points of GDP.

Chart A shows the evolution over the projection horizon of the change in strictly ageing-related spending and its sub-components for the euro area in the reference scenario. Overall, until 2020 a relatively modest increase is projected, whereas the dynamics worsen significantly between 2020 and 2050. The chart reveals interesting patterns in the trend of different sub-components. Pension expenditures remain the main driver of increases in spending over the projection horizon, though their increase is steeper over the period 2020-40, becomes flatter afterwards and starts declining towards the end of the projection horizon; healthcare spending follows a similar trend. By contrast, the increase in long-term care spending is relatively negligible until 2030 and becomes much steeper afterwards, thus partially offsetting the slowdown in pension and healthcare spending from 2040 onwards. Education expenditures are projected to be on a downward path by 2040 and to start increasing gradually thereafter.

Over the projection horizon 2010-60, in the euro area, pensions are projected to increase by 2.0 percentage points of GDP, while healthcare spending is projected to increase by 1.1 percentage points of GDP and long-term care spending by 1.7 percentage points. By contrast, spending on education is expected to decrease slightly, by 0.2 percentage point of GDP, for the euro area as a whole.

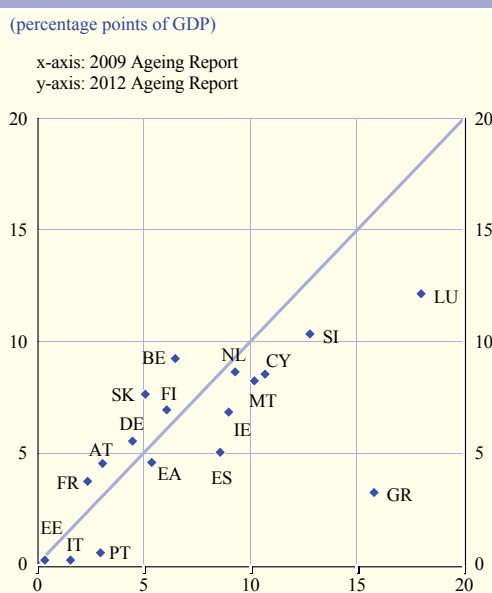
Compared with the 2009 exercise, the 2012 projection exercise points to a slightly lower increase in strictly ageing-related spending over the projection horizon (4.5 percentage points of GDP compared with 5.4 percentage points; see Chart B). Among the euro area countries, Luxembourg remains the country with the largest projected increase in ageing-related spending. Greece stands out as the country where the outlook for ageing-related expenditure has improved the most compared with the 2009 exercise. In Italy and Portugal, ageing-related spending pressures are expected to decline, owing to pension reforms.

Chart A Projected increase in pension, healthcare, long-term care and education expenditures in the euro area over the period 2010-60



Sources: 2012 Ageing Report and ECB calculations.

Chart B Projected change in strictly ageing-related expenditure over the period 2010-60 under the reference scenario



Sources: 2009 and 2012 Ageing Reports.
Notes: Projections for unemployment-related expenditures have been subtracted from the 2009 total ageing cost estimates so as to arrive at a measure of strictly ageing-related costs which can be compared with the 2012 exercise.

Improvements are also projected for Spain, Cyprus, Ireland, Malta and Slovenia. By contrast, six euro area countries (including Germany and France) show a deterioration in the outlook for ageing-related expenditure compared with the 2009 exercise, with Belgium and Slovakia seeing the strongest deterioration.

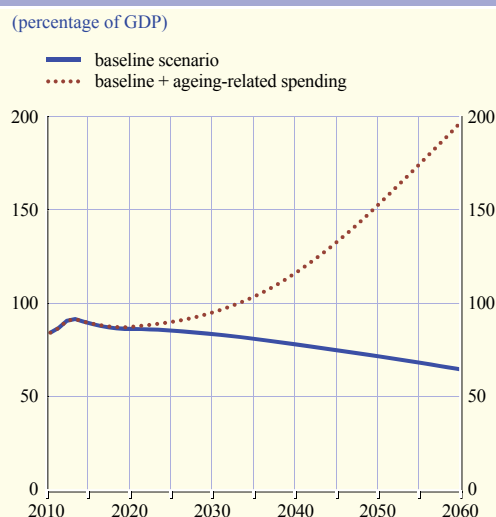
Differences between the two projection exercises can be ascribed to a number of factors and vary from country to country. Although the macroeconomic assumptions of the 2012 Ageing Report are more pessimistic than the previous ones, reflecting to a large extent the impact of the economic and financial crisis, the overall outlook for ageing-related spending has improved compared with the 2009 exercise. For a number of countries, this is due to the inclusion in the projections of the pension reforms implemented since the finalisation of the 2009 exercise, which have contributed to a sizeable reduction in the budgetary impact of ageing.

Challenges to fiscal sustainability and options for reform

The budgetary pressures arising from demographic ageing have been a cause for concern for a long time.³ Although the reforms undertaken since the finalisation of the 2009 Ageing Report have started to pay off in some countries, the need for timely and comprehensive policy reform remains high in several countries. Risks to long-term fiscal sustainability remain elevated, first, because the liabilities related to demographic ageing will require a substantial increase in government spending and, second, because most countries are in a much weaker fiscal position, with high debt-to-GDP ratios following the financial crisis.

Looking at the budgetary pressures arising from ageing-related costs from a long-term perspective, Chart C shows the results of a conventional debt sustainability analysis for the euro area aggregate for the period 2010-60 under a baseline scenario and a so-called ageing scenario, which includes the impact of the strictly ageing-related costs as projected in the reference scenario of the 2012 Ageing Report. The baseline scenario is based on the European Commission's spring 2012 forecast until 2013. The structural primary balance is assumed to remain constant from 2014 onwards. The ageing scenario is identical to the baseline scenario except for the structural primary balance which reflects the Commission projections until 2013, whereas from 2013 onwards it increases according to the projected increase in strictly ageing-related spending, using 2013 as a reference year. Chart C shows

Chart C Long-term debt scenarios for the euro area aggregate for the period 2010-60



Sources: European Commission's spring 2012 forecast until 2013 and ECB calculations.

³ Demographic ageing has been the subject of a relatively large number of ECB Monthly Bulletin articles, including: "Population ageing and fiscal policy in the euro area" (July 2000); "The need for comprehensive reforms to cope with population ageing" (April 2003); "Demographic change in the euro area: projections and consequences" (October 2006); "Challenges to fiscal sustainability in the euro area" (February 2007); "Entitlements of households under government pension schemes in the euro area – results on the basis of the new system of national accounts" (January 2010); and "Ensuring fiscal sustainability in the euro area" (April 2011).

that the euro area debt ratio will start deviating from a sustainable path around 2020, if the fiscal imbalances related to demographic ageing are left unaddressed.⁴

Looking ahead, reform efforts to address the sustainability challenges related to population ageing should focus on some key priority areas. As regards pension systems, reforms should continue in the direction of adjusting the key parameters to the changing demographic environment. Many of the existing schemes are based on the pay-as-you-go principle, which is financially viable as long as the number of contributors significantly exceeds the number of beneficiaries. In such schemes, the worsening of the dependency ratio calls for higher contributions during the productive age and/or lower benefits in the retirement phase, if other parameters are left unchanged. A preferable, and more equitable, solution is an automatic built-in adjustment of the main parameters such as the statutory retirement age, which can be regularly modified on the basis of updated projections of life expectancy and other demographic developments. This would allow the ratio between contributors and beneficiaries and the ratio between contributions and pensions to be kept at affordable and acceptable levels, both from a financial and social point of view. Such a mechanism would also help citizens to form adequate expectations about the level of future pensions, thereby allowing them to take informed decisions on spending and saving throughout their lifetimes.

Another important aspect for the financial viability of existing pension systems is the accumulation of sufficient pension assets to enable the (partial) funding of pension liabilities. This is a long process which requires clear rules and the disclosure of adequate information to citizens about their pension benefit prospects. However, it should be noted that the financial and sovereign debt crisis, and the associated volatility in financial markets, have had a negative impact on the profitability of pension funds, with clear repercussions for the future sustainability of pension liabilities. Moreover, some Member States have started to draw from the accumulated pension reserves earlier than planned and often for reasons not related to the financing of pension liabilities. These initiatives carry considerable risks, as they represent a reversal of pension reforms previously undertaken which, if not corrected in due time, risks jeopardising the sustainability of public finances.

While the importance of reforming pension schemes is widely known and accepted, the need for reform of public health and long-term care systems has so far received less attention in the public debate. Government spending on health and long-term care has increased sharply in the last decade in many countries, largely on the back of rising costs related to technological progress in medicine, but also on account of insufficient monitoring of expenditures. This trend is expected to become more pronounced in the coming years and points to a clear need to improve the cost efficiency of health and long-term care systems. Although reforming these systems inevitably involves complex choices, key reform areas which should be addressed by governments without delay include, for example, improving existing cost-sharing systems so as to encourage the effective use of healthcare services and increasing hospital efficiency.⁵

Determined structural reform in the above-mentioned areas is important to address market concerns regarding fiscal sustainability. In addition to reducing future government obligations,

⁴ For more details on the structure of the debt sustainability analysis presented in this box and for a comprehensive discussion about the tool utilised therein, see the article entitled "Analysing government debt sustainability in the euro area", Monthly Bulletin, ECB, April 2012.

⁵ For more details on policy recommendations, see the "Joint Report on Health Systems", European Commission and Economic Policy Committee, *Occasional Papers*, No 74, December 2010.

structural reforms must strengthen long-term potential output growth, thus putting countries with fiscal sustainability problems back on a sustainable path. Indeed, the projected population ageing (and the associated reduction in the labour force) would, according to the 2012 Ageing Report, imply – without further reforms – a fall in the potential GDP growth rate (from close to 2% in 2000 to 1.6% in 2020 and further to 1.4% in 2060) in the euro area. Pension reforms, as well as an improved functioning of labour markets and increased productivity, are thus needed to offset the effects of an ageing society on potential growth.