Box 8

LONG-TERM FISCAL SUSTAINABILITY IN THE EURO AREA

The European Commission has recently published its first sustainability report.[1] It presents an assessment of the sustainability of public finances based on the new common projections on age-related costs[2], the current budgetary situation and a number of additional factors which could impact on future public finances. A sustainability assessment is regularly made in the framework of the annual examination of the countries' stability and convergence programmes and, in addition, the Commission will periodically publish a comprehensive report when new ageing-related projections are available.

The Commission's assessment of sustainability is based on two main quantitative indicators ("sustainability gaps"), which take into account the current deficit and debt situation and the projected change in age-related spending from 2005 to 2050 on pensions, health care and long-term care (see table). The so-called S1 indicator shows by how much tax revenue would need to be increased or public expenditure to be cut to finance the costs of population ageing and reach a public debt ratio of 60% of GDP in 2050. The so-called S2 indicator is slightly more ambitious and represents the required tax revenue increase or expenditure cuts that would finance the costs of population ageing and be sufficient to pay back all public debt at some distant point in the future (in technical terms, the S2 indicator indicates what budgetary improvement is needed to equate the present discounted value of future primary balances to the current stock of gross debt). The report also presents a series of sensitivity tests which show that increasing life expectancy or demand for health care could further increase the sustainability gap.

On top of these quantitative indicators, the Commission takes account of a wide range of other "qualitative factors" so as to derive an overall risk classification of low, medium or high sustainability risk for all EU countries. In particular, it draws attention to the current level of debt, the effects of structural reforms, the reliability of the projections figures, the robustness of sustainability indicators to sensitivity tests and the level of the current tax burden (as high levels may limit the ability of countries to cope with additional fiscal challenges in the future). Risks surrounding the adequacy of pensions are also considered, as insufficient pension provisions may bear fiscal risks in the future. Government contingent liabilities (e.g. from government guarantees that may be called on) may in principle be accounted for but are currently not considered in the absence of sufficient data.

1 "The long-term sustainability of public finances in the European Union" report by the European Commission (2006).
2 "The impact of ageing on public expenditure" report by the EPC/Commission (2006).

The report finds that most euro area countries are subject to moderate or high sustainability risks and significant consolidation efforts will be needed to cope with high public debt and the fiscal costs of population ageing. For the euro area as a whole, the required permanent improvement in the fiscal position (either from a rise in tax or a reduction in expenditures) needed to ensure sustainability amounts to 3.5% of GDP. The attainment of deficit targets in the 2005-06 stability programmes will not be sufficient in most of euro area countries. This highlights the need for most euro area countries to pursue vigorously the three-pronged strategy of reducing debt, raising employment and productivity, and reforming pension and health care systems, as promoted by the Lisbon agenda.

Sustainability gaps

(as a percentage of GDP)

Country	Change in age-related expenditures	Sustainability gap, S1 [1)]	Sustainability gap, S2 [2)]	Risk categorisation
Belgium	6.6	0.4	1.8	medium
Germany	4.0	3.5	4.4	medium
Greece [3)]	1.4	3.2	3.0	high
Spain	8.9	0.2	3.2	medium
France	3.2	3.2	4.0	medium
Ireland	7.8	-0.8	2.9	medium
Italy	2.3	3.4	3.1	medium
Luxembourg	8.4	4.6	9.5	medium
Netherlands	5.2	-0.2	1.3	low
Austria	1.1	0.1	0.3	low
Portugal	9.7	7.9	10.5	high
Finland	5.0	-3.3	-0.9	low
Euro area	**4.4**	**2.3**	**3.5**	

Source: European Commission report entitled "The long-term sustainability of public finances in the European Union" (2006).
1) The sustainability gap based on the S1 indicator is the difference between the constant tax ratio as a share of GDP required to reach a debt ratio in 2050 of 60% of GDP and the current tax ratio to GDP.
2) The sustainability gap based on the S2 indicator is the difference between the constant tax ratio as a share of GDP that would equate the present discounted value of future primary balances to the current stock of gross debt, and the current tax ratio to GDP.
3) For Greece, pension projections are not available, leading to a significant underestimation of the rise in age-related expenditures there. Previous calculations showed an increase of about 10% of GDP in these expenditures.