



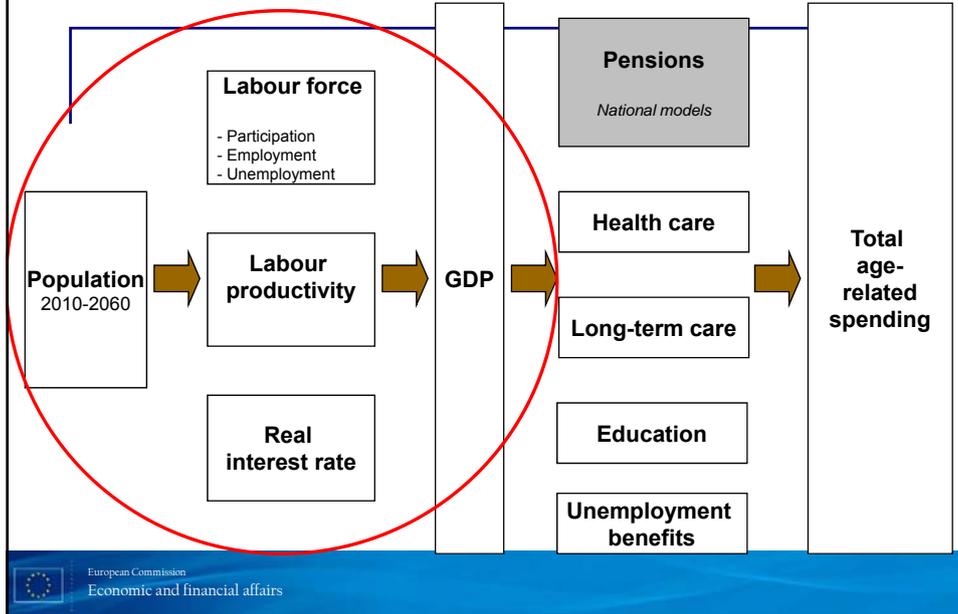
Long-term sustainability of public finances and economic consequences of ageing populations in the EU

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European Commission
Directorate General for Economic and Financial Affairs
Long-run fiscal sustainability – key drivers and how to assess them?
12 December 2011, Oslo, Norway

Outline

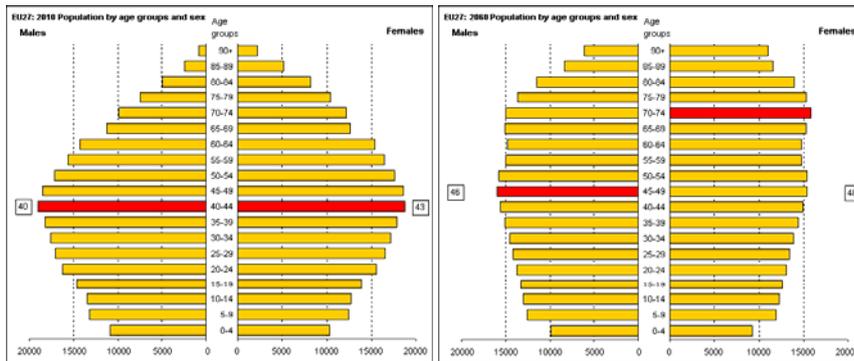
- Demographic prospects
- Economic impact of ageing populations
- Implications for pensions
- Overall budgetary effects of ageing populations
- Policy challenges/reform options

Overview of EC-EPC projection exercise (2012 AR)

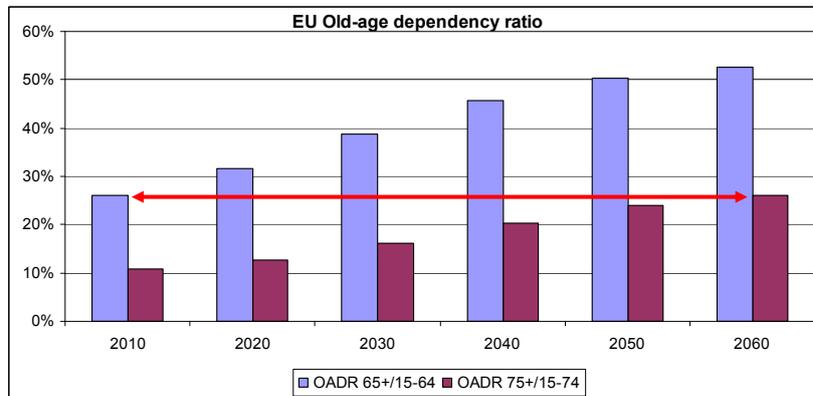


Population projections: EUROPOP2010

European Union



Old-age dependency ratios: there a need to re-think what 'old' is



Participation rate projections: the cohort approach

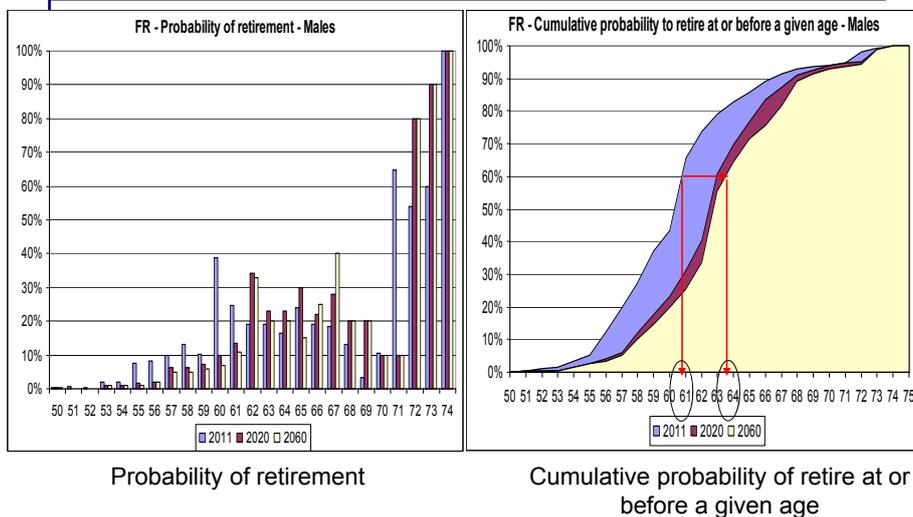
The cohort approach:

participation rates are projected for
each single year of age and gender

Two Main Features of the Methodology :

- 1) Use of entry rates and exit rates:
2001-2010 average kept constant
over the period of projections
- 2) Incorporate the impact of pension reforms

Impact of recent pension reforms



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From participation rates to employment

➤ Employment rate (15-64) for the EU27:

from 64.1% in 2010 to 68.9% in 2060

(EA: 64.2% to 69%)

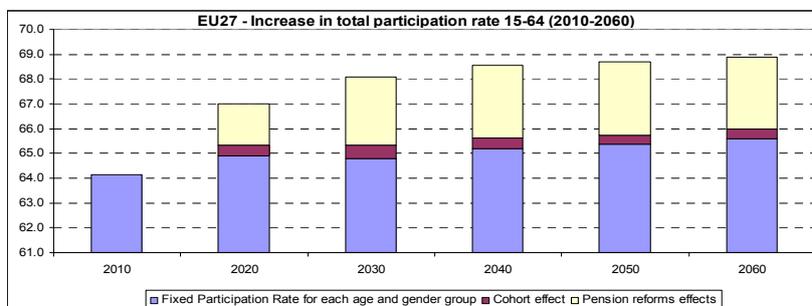
mainly due to:

- women's employment: from 58.2% to 64.7%

(EA: 58% to 65%)

- older workers (aged 55-64): from 46.3% to 62.7%

(EA: 47% to 64%)



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Productivity

Δ labour productivity : 1.5 % by 2060

■ Δ TFP assumptions is key :

- convergence to 1.0% for all

- "Leader group" of countries (GDP per capita 2010 above EU27 AVG) converge by 2025
- "Follower group" of countries (GDP per capita 2010 below EU27 AVG) converge according to the distance to the EU27 average in 2010.

+

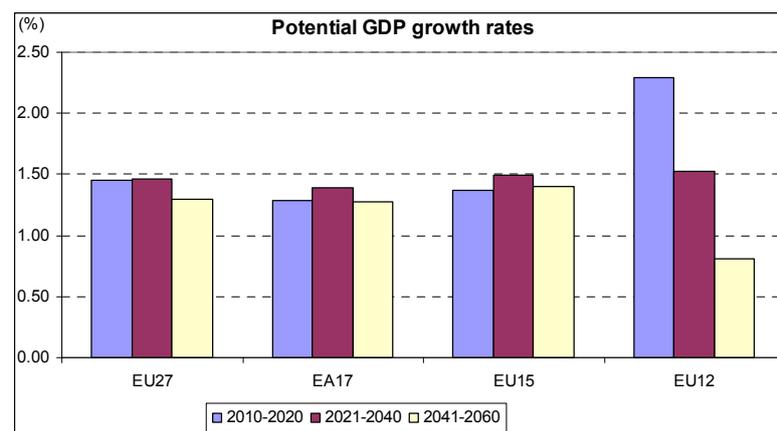
■ Contr. from capital deepening: 0.5% in 2060

$$= (1 - \alpha) \Delta K/L \text{ or } \Delta TFP(1 - \alpha) / \alpha \quad (\alpha = \text{labour share} = 0.65)$$

- **Transition rule:** Linear convergence to constant capital/labour in the period 2016-2020

- **long run capital rule:** Δ capital stock = Δ E + labour augmenting technical progress (or TFP/ α), thus capital/labour ratio in efficiency units constant from 2021.

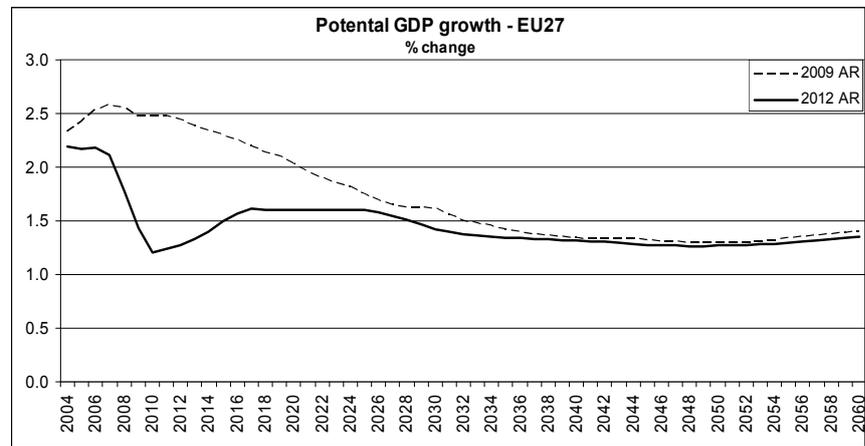
Potential growth rates decline due to shrinking working age populations



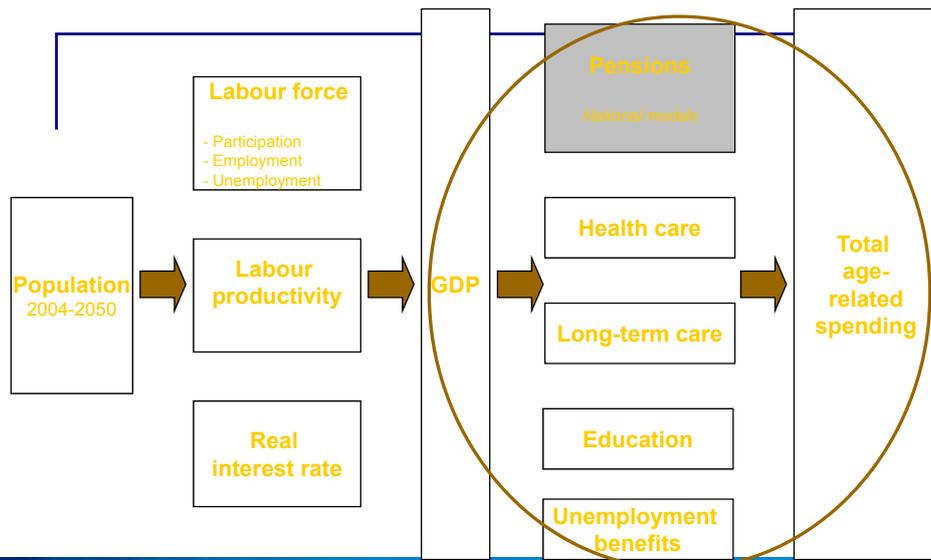
Potential growth rates decline

due to shrinking working age populations

Productivity (+1.5 %) becomes the dominant source of growth



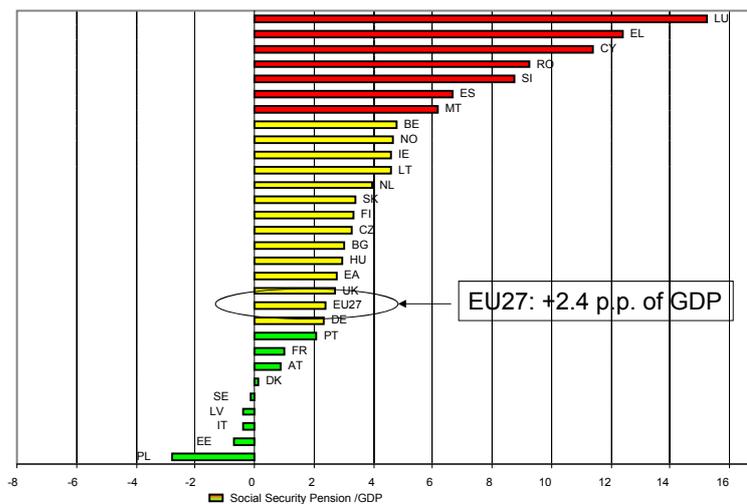
Age-related expenditure projections 2009 AR



Pension reform process

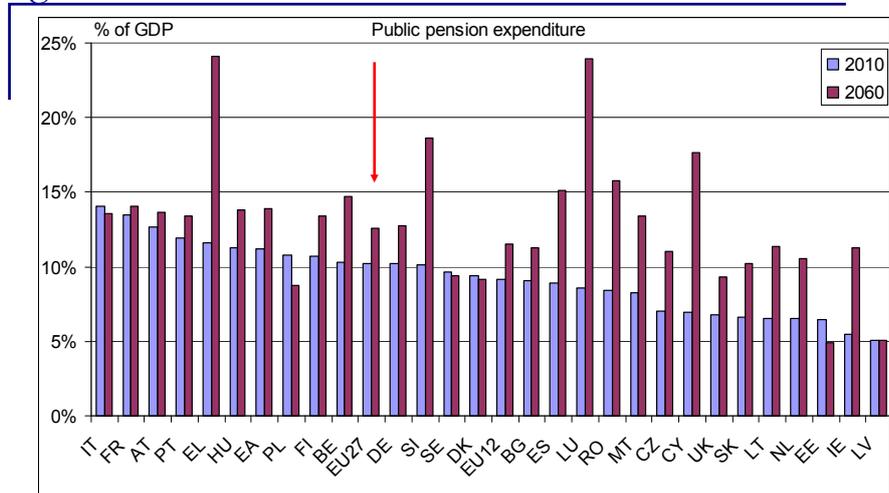
- **Large number of pension reforms over the last decade motivated by population ageing, and rising awareness of this challenge, supported at EU level by coordination processes**
- **Wide range of reforms measures adapted:**
 - Eligibility criteria (age, available schemes)
 - Generosity (contributory periods, indexation, sustainability factors)
 - Incentive effects (hard and soft)
 - Additional pillars introduced (often with incentives)

Projected changes in public pension expenditure (2007-2060 in percentage points) - 2009 AR



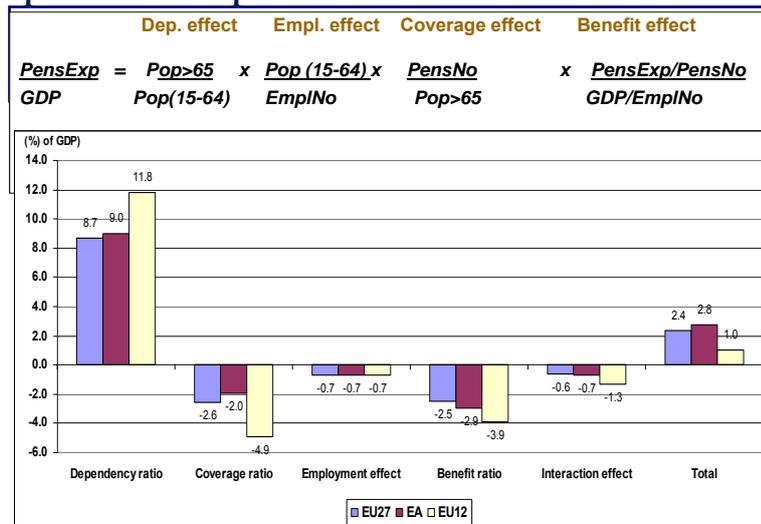
Public pension expenditure

Large variation in the EU - 2009 AR



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Decomposition of the increase in pension expenditure



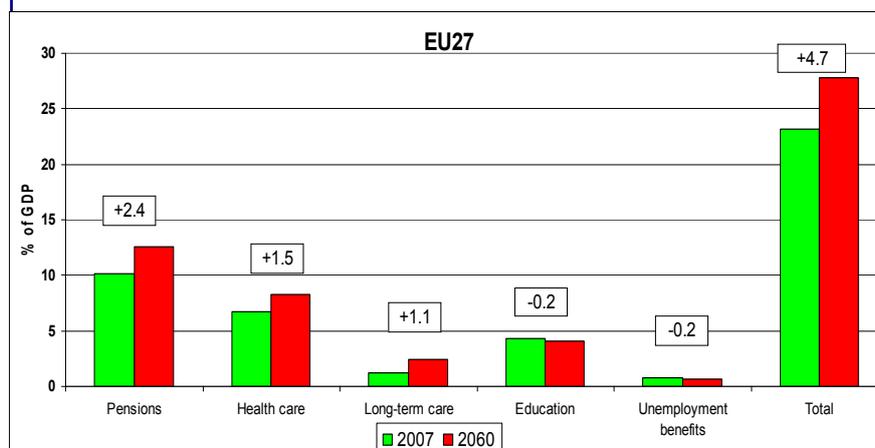
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Ageing or retirement problem ? Adult life spent in retirement EU27

	Men		Women	
	2010	2060	2010	2060
Employment rate of older workers (55-64)	54.5	66.0	38.6	59.5
Average entry age	21.6	21.6	23.6	23.6
Average exit age	62.5	64.3	61.7	63.8
Life expectancy at the time of withdrawal	18.9	22.7	22.7	26.0
% of adult life spent in retirement	31.7	34.7	37.4	39.3
Requested exit postponement in years (to keep % life spent in retirement constant)		2.0		1.3

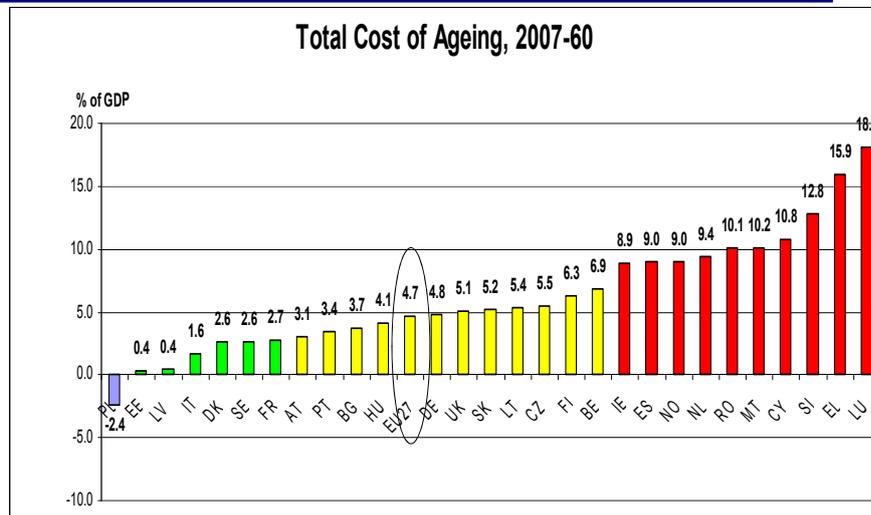
The Cost of Ageing, EU27, components

(change in percentage points) 2009 AR

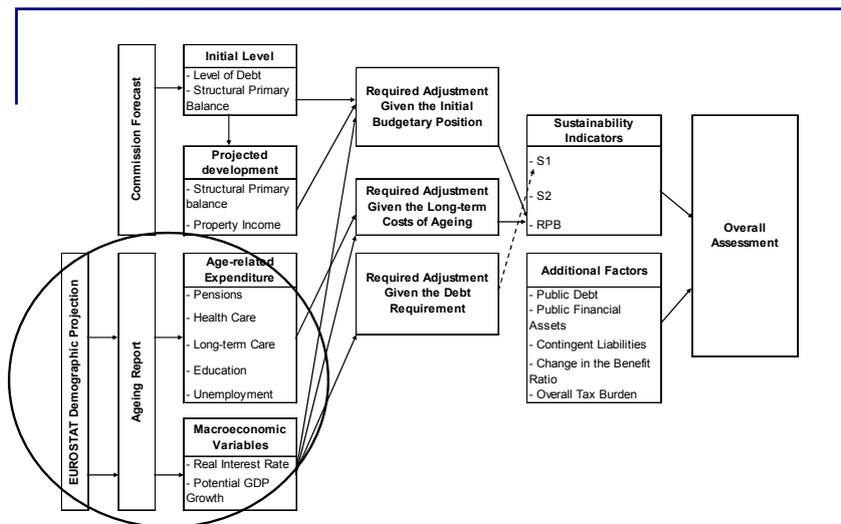


The Cost of Ageing, variety in the EU

(change in percentage points)



Assessment of the long-term sustainability of public finances



Fiscal sustainability: Sustainability indicators

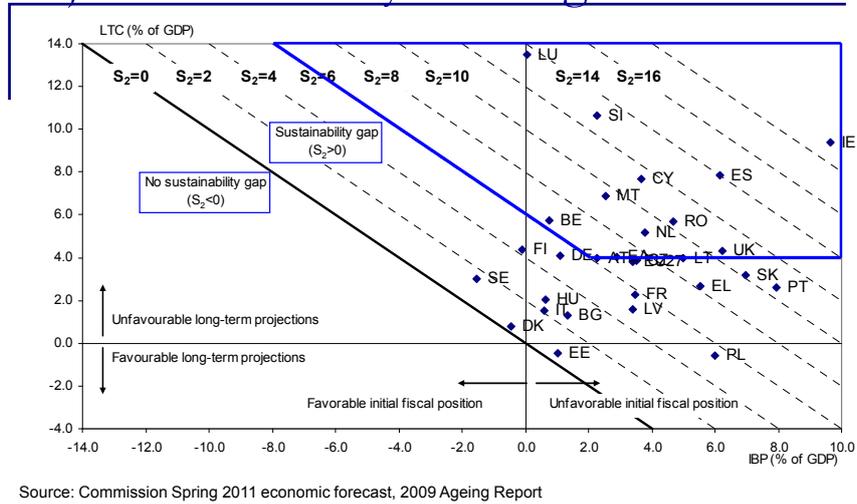
- The assessment of public finance sustainability is **integral part of the SGP**, annual updates of the situation
- Sustainability gap indicators are used at European level.
- They provide a measure of the size of a permanent budgetary adjustment (e.g. a constant reduction (increase) of public expenditure (revenues) as a share of GDP that enables to meet one of the following conditions:
 - reaching a target of 60% of GDP for the Maastricht debt in 2050, **the S1 indicator**;
 - fulfilling the inter-temporal budget constraint over an infinite horizon, **the S2 indicator**.

Fiscal sustainability: Decomposing the sustainability indicators

	Required adjustment given the initial budgetary position (IBP)		Required adjustment to reach debt to GDP ratio of 60% in 2060 (DR)		Required adjustment due to long-term changes in the primary balance (LTC)
S1=	Gap to the debt-stabilising (structural) primary balance	+	Additional adjustment required to reach a debt target of 60% of GDP in 2060	+	Additional adjustment required to finance the increase in public expenditure due to ageing up to 2060
S2=	Gap to the debt-stabilising (structural) primary balance	+	0	+	Additional adjustment required to finance the increase in public expenditure due to ageing over an infinite horizon

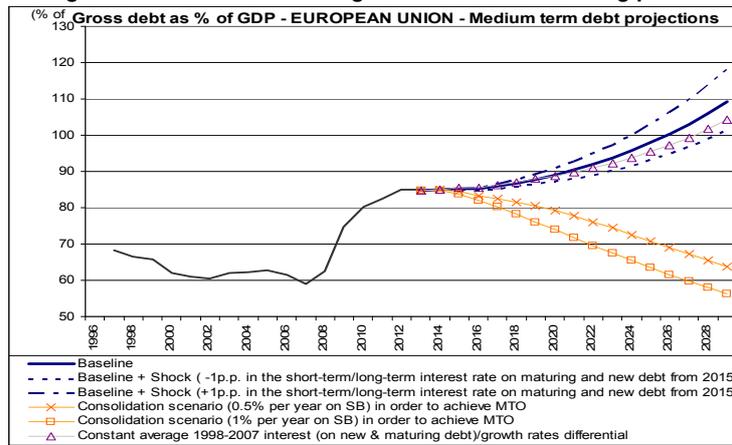
$$S_2 = rD_{t_0} - PB_{t_0} - r \sum_{t=t_0+1}^{\infty} \frac{\Delta PB_t}{(1+r)^{t-t_0}}$$

The sustainability gap decomposed – major sustainability challenges in the EU



Medium-term debt projections under alternative assumptions – EU

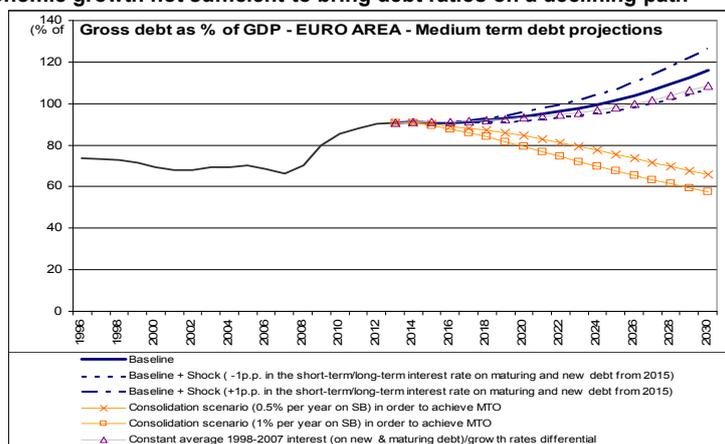
Daunting fiscal challenge: unsustainable debt trends show that a recovery in economic growth not sufficient to bring debt ratios on a declining path



Source: Commission Autumn 2011 economic forecast, 2012 Ageing Report, 2009 Ageing Report

Medium-term debt projections under alternative assumptions – euro area

Daunting fiscal challenge: unsustainable debt trends show that a recovery in economic growth not sufficient to bring debt ratios on a declining path

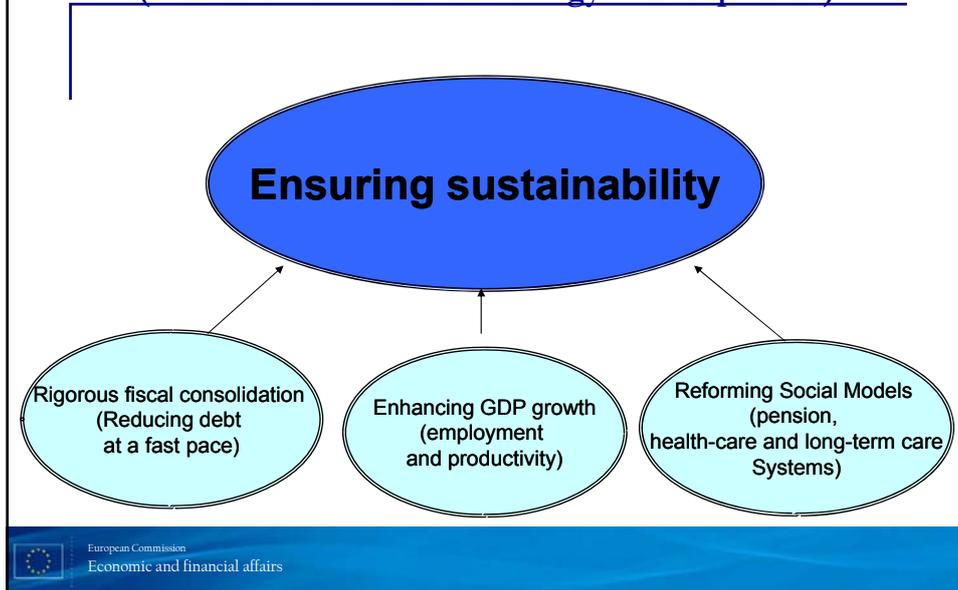


Source: Commission Spring 2011 economic forecast, 2009 Ageing Report

Policy challenges/reform options

- **Urgent need for fiscal consolidation at this important juncture**
- **The sooner measures to improve fiscal sustainability are identified and implemented with determination the better**
- **Any delay will imply a more severe correction at a later stage**
- ***On pension policies*, the EU is facing a retirement challenge and not an ageing challenge, stemming from European social models of yesterday not being apt for tomorrow, affecting expectations and behaviour of the population**

Policy conclusions and recommendations
a three-pronged strategy required in the EU
(...from 2001 Stockholm strategy to Europe 2020)



Reforming pensions systems

recommendations in the Annual Growth Survey - AGS2011 and 2012

The AGS 2011 marks the start of a new cycle of economic governance in the EU and the first European semester of economic policy coordination

- Fiscal consolidation should be supported by reform of pension systems, making them more sustainable
- Member States that have not already done so should **increase the retirement age and link it with life expectancy**
- Member States should **reduce early retirement schemes** as a priority, and use targeted **incentives to employ older workers** and promote lifelong learning
- Member States should **support the development of complementary private savings** to enhance retirement incomes
- In view of demographic change, Member States should **avoid adopting measures related to their pension systems which undermine the long term sustainability** of their public finances.

The 2009 AR and SR reports can be found at DG ECFINs website:

http://ec.europa.eu/economy_finance/publications/publication_summary13784_en.htm

http://ec.europa.eu/economy_finance/publications/publication_summary16273_en.htm

Thank you for your attention