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## *Fiscal Consolidation and Implications of Social Spending for Long-Term Fiscal Sustainability*

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# Fiscal Consolidation and Implications of Social Spending for Long-Term Fiscal Sustainability[1]

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During the economic and financial crisis fiscal positions across OECD countries deteriorated sharply. Many countries have already started fiscal consolidations but additional consolidation will be required. Moreover, additional challenges to the sustainability of fiscal balances are posed by population ageing and additional spending requirements on health and pensions, which by European Commission and the OECD projections will drive up public spending in almost all OECD countries over the horizon 2012-2050.

On average in the OECD, public pension spending is projected to increase from 8.4% of GDP in 2010 to 11.4% in 2050. Spending on health care is already one of the largest public spending items, accounting for more than 15% of general government spending on average in the OECD in 2007. Pressures from spending on long-term care are expected to grow in the future. Most OECD countries currently allocate between about 1 and 1.5% of GDP to long-term care, but they could at least double by 2050. These developments, combined with a post-crisis growth slowdown, will put increasing pressure on fiscal sustainability.

In a recent paper published in the *Review of Economics and Institutions*, Merola and Sutherland (2013) gauge the scale of fiscal consolidation that will be needed to ensure long-term sustainability by 2050 in the OECD countries. The fiscal consolidation effort is measured in terms of fiscal gap, which indicates the size of fiscal consolidation requirements necessary to achieve a certain debt-to-GDP target (e.g. pre-crisis debt-to-GDP ratio, 75%, 50% and 25%) by 2050. When assessing the fiscal consolidation effort, this paper also gauges the budget pressures posed by future growth in health and pension spending.

The main results are the following.

[1] Merola, R. and D. Sutherland (2013), "Fiscal consolidation and the implications of social spending for long-term fiscal sustainability", Review of Economics and Institutions, Vol. 4(3). http://www.rei.unipg.it/rei/article/view/100

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First, even without considering challenges posed by aging population, considerable differences across countries emerge. A number of countries (e.g. Switzerland, Korea, Luxembourg and Sweden) do not face any tightening requirements to meet the 50% debt-to-GDP ratio target. Some European countries have targeted a reduction in the overall fiscal deficit to 3% of GDP over the next few years. In some of these countries, ambitious cuts in public expenditure (e.g. the Slovak Republic), higher taxes (e.g. Spain), a mix of the two (e.g. Ireland) or robust growth (e.g. Poland) have supported fiscal consolidation. Therefore, the fiscal tightening required to meet the 50% debt ratio target is more moderate than might be expected.

Second, when the projected increase in health spending is phased in, fiscal consolidation becomes more difficult across all countries except Sweden. The Swedish exception is largely due to several institutional reforms started in late 1990s. In other countries increases in long-term care add pressures on long-run financial sustainability, particularly for Switzerland, the Czech Republic, Canada, New Zealand and Japan, where the projected increase in health and long-term health spending exceeds 1.5% of GDP. In Ireland long-term care spending will add approximately an additional percentage point of GDP to the fiscal gap.

Third, increases in public pension spending will put additional pressures on public finance. In some countries, the increase in pension spending over the next 40 years does not represent a major challenge, either because the population is "greying" at a slow pace (e.g. Denmark) or because pension spending is expected to increase moderately (e.g. in Germany, France, the United Kingdom, the United States and Japan). On the contrary, the rise in consolidation requirements is far more pronounced in those countries where the predicted increase in pension spending as a share of GDP is large (e.g. Hungary, Switzerland, Finland, the Netherlands, Belgium, Ireland, Korea and Luxemburg). In Greece and Spain, reforms of the pension system in 2010 addressed the pressure emanating from demographics developments and increasing pension spending. In Finland, while ageing increasingly weighs on the public finances, considerable financial assets have been built up to support future pension spending.

Fourth, against the background of rising health and pension spending, policy reforms to entitlement programmes become particularly important to mitigate budget pressures. For example, reforms aimed at delaying pension receipt (e.g. delaying the statutory retirement age together with increased penalties for early retirement) can not only slow the growth of outlays, but can also boost the labour force participation of elderly workers. Long-run simulations in Merola and Sutherland show that the impact of delaying retirement by 5 years can be can be quite substantial especially in those countries where pension spending makes consolidation more challenging (e.g. Belgium, Luxembourg and the Netherlands). In Ireland, the fiscal programme focused on pension reform and the need to increase retirement age as one of the main priorities to address long-term

spending pressures in the pension system. However, there is potential to further reform pensions. As recommended in the recent *OECD Review of the Irish Pension System,* Ireland should consider a structural change in the state pension scheme (moving to either a universal basic pension or a means-tested basic pension) complemented with either mandatory or auto-enrolment with opt-out in private pension schemes.

In addition, reforms to health and long-term care spending could also ease some of the pressure on budgets. Generally, the most effective reforms in the health system include those that strengthen and broaden the role of market mechanisms, improve health service efficiency in the provision of primary care, reduce waiting lists and introduce more competition in the pharmaceutical sector. In Ireland, health reforms are necessary to improve access to primary care and ensure that the financing system is based on incentives that are aligned to fairness and efficiency.