STIFTUNG Marktwirtschaft

Honourable states? EU Sustainability Index 2016
– Key results –

1. The EU – a club of debtors?

The perspective on the European sovereign debt crisis has shifted a bit. High sovereign debts seem to have lost their intimidating factor; at least their political acceptance has risen (again). The crisis thus becomes – at least partly - the fiscal "norm". Otherwise, it is difficult to interpret the extremely sluggish reform negotiations with Greece, the reluctant progress of reforms there and in some other European countries, as well as the accepted pan-European dependence on a very expansive monetary policy with low interest rates.

Optimists may argue that a certain consolidation process has taken place in more recent years. In fact, budget deficits far above the 3% threshold of the European Stability and Growth Pact, as observed in many European countries between 2009 and 2014, are a thing of the past. And some countries (like Germany, for example) even achieve a slight budget surplus. However, a significant European-wide reduction in sovereign debt is still far off. The public budget deficit in the EU was 2.4% of GDP in 2015, and in its autumn forecast, the European Commission expects a slightly lower budget deficit of 2.0% of GDP in 2016. With a real economic growth forecast of just under 2 % projected for 2016, the high explicit debt ratio of just under 90 % of GDP among EU member states is likely to remain constant. However, a courageous movement toward the 60 per cent threshold of the Stability and Growth Pact should be the order of the day.

This is even more the case, since the majority of the states are faced with considerable fiscal challenges due to demographic ageing. In order to quantify these at least approximately, the Stiftung Marktwirtschaft (Market Economy Foundation), in cooperation with the Research Centre for Generational Contracts of the University of Freiburg, analysed the long-term prospects of the public budgets of the EU Member States.

EU Sustainability Ranking 2016 *(base year 2015)*

Rank	*in % of GDP*	Explicit Debt	+ Implicit Debt	= Sustainability Gap 2016	Sustainability Gap 2015
1	Croatia	87	-48	39	144
1	Estonia	10	29	39	63
3	Latvia	36	17	53	95
4	Denmark	40	22	62	298
5	Italy	132	-25	107	57
6	Bulgaria	26	83	109	209
7	Hungary	75	60	135	102
8	Portugal	129	18	147	109
9	Germany	71	90	161	149
10	Poland	51	128	179	190
11	Sweden	44	155	199	273
12	Austria	86	163	249	221
13	Czech Republic	40	214	254	386
14	France	96	170	266	291
15	Lithuania	43	229	272	279
16	Slovak Republic	52	259	311	320
17	Greece	177	154	331	392
18	Malta	64	273	337	404
19	Netherlands	65	291	356	390
20	Romania	38	343	381	263
21	United Kingdom	89	301	390	498
22	Finland	64	368	432	455
23	Cyprus	108	350	458	391
24	Slovenia	83	466	549	545
25	Belgium	106	497	603	579
26	Spain	100	665	765	592
27	Ireland	79	709	788	1171
28	Luxembourg	22	803	825	984
ø	EU28	87	169	256	266

Change to 2015: decreasing debts (green); unchanged debts (yellow); Increasing debts (red)

Deviations in the total sum (sustainability gap) may derive from rounding.

The starting point for the calculations is the economic and fiscal starting position of 2016 according to the autumn forecast of the EU Commission. The data for future (potential) GDP-growth is taken from the European Commission's Ageing Report 2015. A development according to the AR 2015 is assumed for the age-dependent expenditure, with an exception regarding pension expenditure. A weighted average according to AR 2009, AR 2012 and AR 2015 is assumed for the development of pension expenditure, provided that the pension expenditure increase according to AR 2015 is smaller than the average increase according to AR 2009 and 2012. Starting in the year 2060 (maximum projection period of the ageing reports), the percentage of age-dependent expenditure on GDP is assumed to be constant.

Sources: European Commission, Eurostat. Calculations: Research Centre for Generational Contracts.

The peculiarity of this European debt comparison is that, in addition to the officially stated explicit debts, it considers the implicit sovereign debts that are not yet directly visible. The latter mainly result from future primary deficits in the public sector (i.e. budget deficits without accounting for interest expenditure), which are to be expected if the current fiscal policy continues unchanged and at the same time the effects of demographic change increasingly impact public budgets.

2. The inadequacy of traditional, historically based debt criteria

Public debt is commonly discussed either in terms of the current budget deficit, which has to be covered by additional borrowing, or the outstanding debt, which represents government debt accumulated in the past. The debt and deficit limits of the European Stability and Growth Pact (Maastricht Criteria) reflect this approach to public debt analysis, which focuses primarily on the past and the present behaviour of governments. However, two major shortcomings of these fiscal ceilings must be diagnosed – especially in light of the still unresolved sovereign debt crisis.

First, they lack sufficient political accountability. As a result, the 3 per cent deficit criterion was repeatedly and the 60 per cent debt criterion was continuously violated by many states without this behaviour being sanctioned. Even though these rule violations were only one of several reasons for the ongoing sovereign debt crisis, there can be little doubt that a better initial fiscal position would have made it much easier to manage the crisis in many countries – both, in terms of margins for economic policy counter-measures and a faster return to monetary policy "normality". Moreover, the decade-long careless management of constantly growing sovereign debt and the tendency of the policy to push uncomfortable consolidation measures into the future, even in the case of a booming economy, make every new edition of a debt-financed growth policy a fiscally risky undertaking. The rather lax handling of the debt criteria of the Stability and Growth Pact in the recent past, raises considerable questions as to whether the institutional status quo is capable of actually making debt limits "politically solid".

Secondly, the traditional view on sovereign debt almost completely masks future developments. At best, (as in Germany, for example) the medium-term financial planning of the national and the state governments will take only a few years into consideration. Furthermore, the economic forecasts as well as the projected public deficits, in which it is based, tend to reflect rather wishful thinking. However, long-term developments affecting public budgets remain outside the scope of official budgetary planning, even if their basic tendencies are already foreseeable today.

3. Honestly calculated sovereign debt – taking the future into account

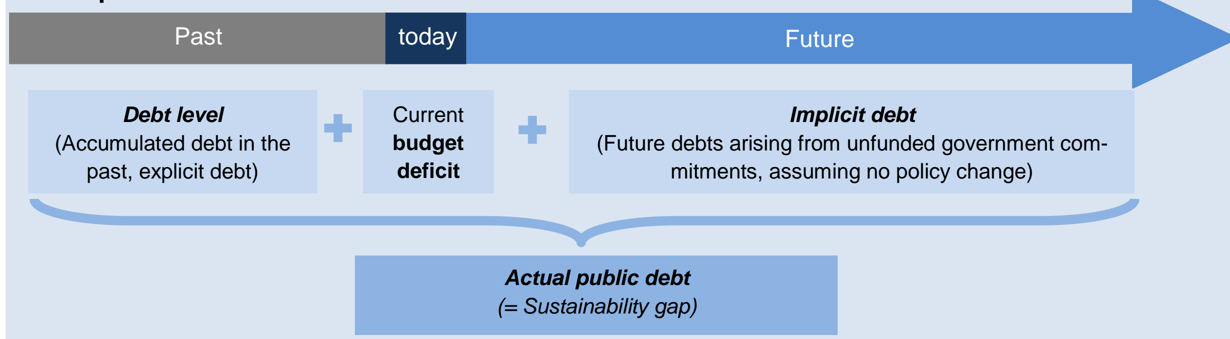
Taking the future into account reveals some troublesome developments. Demographic change, in particular, not only leads to a considerable pressure on age-related public expenditures, such as pensions, health care or long-term care. At the same time, it also reduces the proportion of working age people, who bear the majority of social insurance contributions and taxes. As a consequence, there is danger of a growing divergence of (age-dependent) public expenditure and public revenues.

The cause of this imminent gap between future government revenue and expenditure lies in the present and must also be addressed in the here and now: Each year, the state, in addition to its current expenditures, enters into considerable legally binding commitments for the future (for example, in the form of pension commitments or "promised" healthcare services), which will only be budgeted years later. However, most countries do not provide for these commitments, nor are the commitments adequately designed to take future demographic trends into account an to keep government revenues and expenditures balanced over time. The extent that future government expenditures are not covered by future government revenues is called implicit debt. This should be taken as seriously as explicit debt because it either leads to an increase in taxes and social contributions or a reduction of government benefits in future years. The third alternative, that future deficits are simply financed by means of new visible debts, i.e. that implicit debts gradually become explicit debts, is limited by the existing distortions on the financial markets from the sovereign debts and thus not an option, if a country seeks to avoid the risk of national bankruptcy. However, since tax rates and social security contributions cannot be increased significantly without negatively affecting economic growth, and since it will be politically difficult to implement actual expenditure reductions in the future, reforms must begin in the present. Policymakers should "eradicate" the implicit debt as quickly as possible and retract financially irresponsible “promises” for the future, so that people can plan under realistic assumptions – for example with regard to their old-age pensions.

Components of the sustainability gap

A realistic look at the actual level of public debt requires that the implicit debt of the future be added to the visibly explicit debt of the past. The sum is often referred to as "fiscal sustainability gap".

Actual public debt



4. The actual level of public debt in Europe - The EU Sustainability Ranking 2016

Adding-up the explicit and implicit debts for each individual EU Member State results in the above-mentioned EU sustainability ranking (see table on page 1).

Key results:

- The updated European sustainability ranking shows a slight improvement in the overall debt situation in 2016. On a European average, the sum of explicit and implicit debt – the so-called sustainability gap – has declined by 10 percentage points to 256 per cent of GDP. Looking at the Member States, a reduction in the sustainability gap can be observed in 16 of the 28 EU members. In three Member States, total debt remained roughly the same, while in nine countries, including Germany, it rose. The main driving factors of this development are changes in the current primary balances (budget balances without consideration of interest payments).

- Against the background of the fact that the European sustainability gap is still a good two-and-a-half times the annual economic output, its slight improvement must not be taken as an excuse to lower consolidation efforts. On the contrary: Since no single country has sustainable public finances, further structural reforms and consolidation measures are the order of the day throughout Europe. This is particularly true for the 17 Member States, whose total debt exceeds the 200 per cent mark in relation to GDP.

- In 22 of the 28 EU Member States, implicit debts exceed officially identified explicit debts – and in some cases very significantly. However, the implicit debts, which are not yet directly visible, are rarely the topic of public and political discussions. This is not only alarming due to a lack of transparency, but also makes rational political decisions more difficult, as the state of public finances appears to be more optimistic than it really is.

- Croatia, Estonia, Latvia and Denmark are the leaders of the sustainability ranking. They are facing very small implicit debts, or in the case of Croatia, actually have implicit assets. On the one hand, this is due to a comparatively strong fiscal starting point. In its autumn forecast, the European Commission expects that all four countries will achieve a primary surplus in 2016. On the other hand, a very moderate future development of their age-related expenditures is projected for all four top performers: In particular, pension expenditures are growing at a slower pace than GDP, which means that the share of GDP will decline in all four countries by the year 2060.

- Germany has again fallen in the ranking, with a slight increase in the sustainability gap, and has a total debt of 161 per cent of GDP or EUR 4.9 trillion.

- As in the previous year, Ireland and Luxembourg are at the bottom of the sustainability ranking. In the case of Ireland, however, the calculation methodology used in conjunction with a high Irish growth assumption for the period from 2055 onwards, leads to a certain "exaggeration” of the sustainability problem compared to the other countries. On the other hand, Luxembourg's sustainability gap results mainly from an overly generous pension system, which cannot be financed in the long term at the same rate.

- Compared to the explicit debt, the distinctly positive performance of Portugal and especially Italy is largely based on radical pension-reforms, which will show their full effect not until future decades. However, if these reforms were to be withdrawn in the coming years and decades, this would lead to a significant increase in the implicit debt in these countries. The same applies to the case where the primary surplus, which is assumed for 2016 and future years, is too optimistic.

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