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# Honorable States?

## The Sustainability of European Public Finances in Times of Crisis

The public debt crisis continues to dog Europe as 2012 draws to a close. Political resistance to austerity measures and public sector reforms, fragility in the banking sector, and economic contraction continue to bedevil the so-called European "problem countries", thereby endangering the prospect of a rapid resolution of public budget imbalances. At the same time, doubts have flourished in the so-called "donor countries" as to whether the ongoing rescue strategy, with its ever-greater financial guarantees and fiscal transfers, presents the right way forward for Europe.

The uncertainty in Europe necessitates a thorough and realistic assessment of the long-term fiscal prospects of public budgets throughout Europe. The Market Economy Foundation (Stiftung Marktwirtschaft), in cooperation with the Research Centre for Generational Contracts (Forschungszentrum Generationenverträge) at the University of Freiburg, has undertaken a new and expanded analysis of public fiscal perspectives in 27 EU member states, Switzerland, and the United States.

### 1. Official Debt Calculations: Only Half of the Story

Public debt is ordinarily discussed in terms of the current budget deficit, which must be funded with new debt obligations, and the outstanding debt, which represents the debt that a government has accumulated from past borrowing. The debt and deficit limits of the Maastricht Criteria and the Stability and Growth Pact reflect this approach to public debt analysis, which focuses primarily on the past and present behaviour of governments. These fiscal limits, however, suffer from two key shortcomings, which have become even more conspicuous in light of the ongoing sovereign debt crisis in Europe.

First, the debt and deficit limits in the Maastricht Criteria and Stability and Growth Pact lacked binding force, allowing many countries to regularly violate without sanction the three percent deficit limit and the sixty percent debt limit. While this disregard for the rules was not the only reason for the outbreak of the current sovereign debt crisis – indeed, badly affected countries such as Spain and Ireland had fulfilled the Maastricht Criteria prior to the outbreak of the crisis – this much is clear: were European countries to have had a stronger fiscal position at the onset of the crisis, governments would have been in a much better position to manage the fiscal challenges that have beleaguered them over the course of the past years. Moving forward, it is crucial that limits on public debt and deficits are made binding, so that they are resistant to political considerations.

Second, the traditional way of calculating government debt almost entirely excludes future revenues and obligations from consideration. At best, national and state governments look only a few years ahead planning for the medium term. Even when such considerations are incorporated into financial planning, the economic and deficit assumptions tend to reflect rather wishful thinking. In general, official fiscal planning tends to ignore consideration of future revenues and expenditures, even when their underlying trends are foreseeable and calculable today.

### 2. An Honest Consideration of Public Debt: Facing the Future

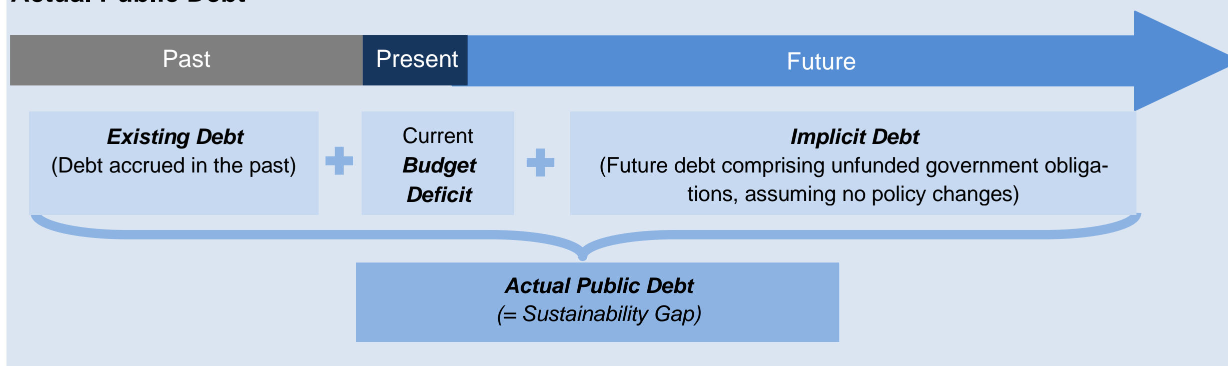
Taking the future into account reveals some troublesome developments. Demographic changes, namely a rapid ageing of the population, will significantly increase pressure on age-related public expenditures, such as retirement benefits, pensions, and health care. At the same time, the proportion of people of working age, on whom society depends to provide the taxes and contributions to social insurance schemes, will decline, creating a scissor-like divergence in public revenue and expenditure over the coming decades.

The source of the impending gap between government revenue and expenditure lies in the present and must be addressed today: every year, in addition to their current expenditures, governments accrue legally-binding obligations that must be paid in the future, such as pension benefits and health care services. Most countries, however, fail to make adequate provision for these future obligations, which are generally designed in a way that ignores future demographic trends and their implications for revenues and expenditures. This imbalance – the gap between future government revenues and expenditures – is called the implicit government debt.

The implicit public debt must be taken as seriously as the explicit public debt because it almost inevitably leads to increased taxes and social security contributions or a reduction in public benefits in the future. The third alternative – gradually allowing implicit debts to become explicit debts – is not an option if a country seeks to avoid risking national bankruptcy.

***A realistic look at the actual level of public debt requires that the implicit debt of the future be added to the explicit debt of the past. The sum is called the "sustainability gap."***

**Actual Public Debt**




### 3. The Actual Level of Public Debt in the EU-27

The results of the "actual public debt" calculation – calculated by adding the explicit and implicit liabilities of each of the EU-27 member states – is presented in the "Sustainability Ranking" below.

**Primary Findings:**

- For the vast majority of countries studied, the size of **the implicit debt dwarves the size of explicit debt**. The traditional, backward-looking debt calculation provides a picture that is too optimistic.
- Additionally, the "actual debt" analysis demonstrates that **the level of explicit public debt does not predict the level of implicit public debt**. For example, Luxembourg, which has been called a "fiscal model" for other countries, ranks second-to-last in the sustainability ranking due to its high implicit debt, which is driven by its excessively generous pension system. At the other end of the spectrum, Italy (with a high level of explicit debt) is the "winner" of the sustainability ranking because it runs a significant primary surplus and expects only a small rise in age-dependent expenditures as a proportion of GDP.
- **Germany does fairly well in the ranking** – an accomplishment not unrelated to its past pension reforms. The country enjoys a favourable initial fiscal position; Germany has a primary surplus of 2.3% of GDP**. In order to close the sustainability gap of 136% of GDP, Germany must enact a permanent fiscal consolidation amounting to 2.9% of GDP. This means that public expenditures must be permanently reduced – or revenues increased – by €75 billion.**
- Given its highly precarious initial fiscal position, it is alarming that Greece must make up a sustainability gap of 900% of GDP under the scenario examined. However, the **situation is not entirely hopeless for Greece, as alternative scenarios produce more favourable results**. If Greece succeeds to realize the structural primary surpluses forecasted by the European Commission and is able to push through (pension) reforms, as assumed in the European Commission's 2012 Ageing Report, Greece will put itself on a sustainable fiscal path and reduce its sustainability gap to zero. Under these circumstances, Greece could even count itself among the leaders of the Sustainabilty Ranking. **However, such a scenario requires a favourable macroeconomic environment that would stimulate the Greek economy, commitment to long-term reform in Greece, and considerable patience from Greece's European partners.**
- The latter will be tested by the development of Greece's explicit debt. Even in the most optimistic (and sustainable) scenario, Greece's explicit debt will climb until 2015 before a slow consolidation process shows itself. **The Troika's intended target of reducing explicit Greek debt to under 120% of GDP by 2020 is unrealistic, even taking the additional measures recently agreed upon into account.**

- Outside of the borders of the European Union, the analysis shows both positive and negative signs. **Swiss explicit debt (35% of GDP) and implicit debt add up to a sustainability gap of 141% of GDP**, approximately as high as the German gap. Much more dramatic are the results for the United States. **With a sustainability gap of over 1300% of GDP (the United States' explicit debt is 104% of GDP), the United States do as poorly in the ranking as the lowest performing European countries,** though with more potential for consolidation on the revenue side and, according to experience, more economic dynamics.

**EU Sustainability Ranking** (Realistic Scenario, Base Year 2011)

| | in % of GDP | Implicit Debt | Explicit Debt | Sustainability Gap |
|---|---|---|---|---|
| 1 | Italy | -123 | 121 | -2 |
| 2 | Latvia | -42 | 43 | 0 |
| 3 | Estonia | 75 | 6 | 81 |
| 4 | Poland | 74 | 52 | 126 |
| 5 | Germany | 55 | 81 | 136 |
| 6 | Bulgaria | 160 | 16 | 176 |
| 7 | Sweden | 138 | 39 | 177 |
| 8 | Portugal | 73 | 108 | 181 |
| 9 | Hungary | 109 | 81 | 190 |
| 10 | Romania | 234 | 33 | 267 |
| 11 | Lithuania | 264 | 38 | 303 |
| 12 | Austria | 242 | 72 | 315 |
| 13 | Malta | 253 | 71 | 324 |
| 14 | Czech Republic | 379 | 39 | 418 |
| 15 | France | 356 | 86 | 442 |
| 16 | Denmark | 396 | 47 | 442 |
| 17 | Finland | 420 | 49 | 469 |
| 18 | Slovak Republic | 506 | 43 | 549 |
| 19 | Netherlands | 499 | 65 | 565 |
| 20 | United Kingdom | 550 | 88 | 639 |
| 21 | Belgium | 558 | 98 | 655 |
| 22 | Slovenia | 620 | 47 | 667 |
| 23 | Cyprus | 764 | 71 | 835 |
| 24 | Spain | 735 | 69 | 805 |
| 25 | Greece | 720 | 171 | 891 |
| 26 | Luxembourg | 1209 | 18 | 1228 |
| 27 | Ireland | 1271 | 106 | 1378 |

The calculations (depicting the realistic scenario) start from the actual economic and fiscal position in 2012. The data for future GDP-growth as well as for the long-run change in age-dependent expenditure, with the exception of spending on pensions, is taken from European Commission's 2012 Ageing Report. For the development of pension expenditures in each country, an average of the rates described in the European Commission's 2009 and 2012 Ageing Reports is used, if 2012 Report predicts a smaller increase than the 2009 Report. Otherwise, future pension expenditures are projected according to the 2012 Report. For the years following 2060 – the last year for which data are predicted by the Ageing Report – the proportion of public expenditures on age-related items is held constant.

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