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Fiscal sustainability with population ageing
(Frank Eich)

- **The main challenge facing the next British government will be to bring the public finances back on a sustainable footing. It is not so much the level of debt that is the main worry but the size of the deficit, which at 12 per cent of GDP is one of the largest in the developed world.**
- **Supporting the economic recovery, calming the financial markets and ensuring long-term fiscal sustainability requires a fine balancing act. The Labour Government passed the Fiscal Responsibility Act to achieve this. Based on the legal requirements set out in the Act, official projections show net debt to peak in 2014-15 before falling again towards 70 per cent of GDP by end decade. To achieve this, the Treasury assumes that public sector net borrowing will fall from the current 12 per cent of GDP to 1.3 per cent by end decade.**
- **Ambitious as these plans appear to be, they might actually not be sufficient to ensure the long-term sustainability of the public finances. Age-related spending is projected to increase by around 4 per cent of GDP between now and mid century. It could be more if occupational pensions failed to play the important role they have done in the past. Accommodating these additional pressures within the tougher fiscal position would require deep cuts in non-age related spending such as defence, law and order or infrastructure or matching tax increases. A decision to deficit finance this spending would lead to a rapid increase in the debt to GDP ratio again from the late 2020s onwards, putting the UK's public finances yet again on an unsustainable path.**

Undoubtedly the main domestic challenge facing the next British government post May general election will be to bring the public finances back on a sustainable footing. It is not so much the level of debt that is the main worry – it is similar to that in many other developed countries - but the size of the deficit. Though the 2009-10 government deficit turned out to be slightly smaller than previously feared at 12 per cent of GDP, it was nonetheless one of the largest in the developed world. To put that into some perspective, the entire income tax take – by far the biggest part of government receipts - is around 12 per cent. It is also around twice the size of the government's education budget or its spending on state pensions.

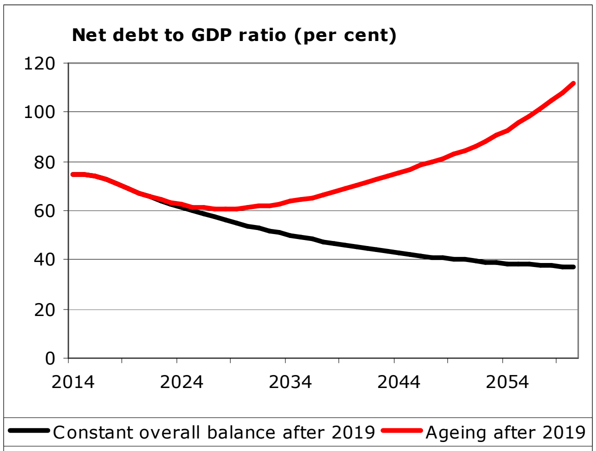
Much of the recent discussion has been on the speed of fiscal consolidation, with some urging for a rapid reduction in the deficit to stabilise the economy while others believe that this approach could jeopardise the fragile economic recovery. Admittedly, supporting the economic recovery, calming the financial markets and ensuring long-term fiscal sustainability requires a fine balancing act. The Labour Government believes it has found the right answer to this challenge by passing the Fiscal Responsibility Act into law, which sets a ceiling for public sector net borrowing in 2013-14 and requires debt to fall in 2015-16.

Official illustrative projections published in *Budget 2010 Securing the recovery* show net debt to peak in 2014-15 before falling again towards 70 per cent of GDP by the end of the decade. To achieve this turn-around in fortunes the Treasury assumes that public sector net borrowing will fall from the current 12 per cent of GDP to below 2 per cent by 2016-17 and then converge towards 1.3 per cent as the government intends to borrow only to invest by the end of the decade. To turn these assumptions into actual outcomes will require the tremendous effort of reducing the deficit on the current budget from nearly 8½ per cent of GDP now to zero within this time span. The government hopes that strong economic growth over that period will help along the way.

Ambitious as these plans appear to be, they might actually not be sufficient to ensure the long-term sustainability of the public finances. The government's latest Long-term public finance report, published alongside the 2009 Pre-Budget Report in December, projects government spending to increase by 2¼ per cent of GDP due to demographic changes between 2019 and 2029, and by another 1¼ per cent by 2040. By mid century age-related government spending on education, pensions or health is projected to be around 27 per cent of GDP compared with around 23 per cent now. The increase would be even higher if state pension spending rose in line with that projected in many other EU countries. That it does not depends to a large degree on the assumption that occupational pensions will continue to play an important role in ensuring pensioner incomes in the future. The rapid decline of defined-benefit pension in the private sector puts into question the credibility of this assumption.

To ensure the long-term sustainability of the public finances, these substantial additional spending pressures would need to be accommodated within the tougher spending plans set out by the government. This would be an astonishing achievement for any government in the future and would require deep cuts in non-age related spending such as defence, law and order or infrastructure. Alternatively a future government could raise taxes to match the projected increase in spending.

Assuming that future governments decide to deficit finance this additional spending in the longer term, then the debt to GDP ratio would start rising again by the late 2020s – the period when the final wave of the large baby boom cohorts leaves the labour market and starts relying more on government transfers in the shape of pensions or health and long-term care. By the mid 2040s the debt burden in relation to the size of the economy would then be again where it is nowadays. Future governments and taxpayers will probably look back and wonder why so little effort was made to strengthen occupational pensions and why the recent long period of solid economic growth when the baby boomers were in their prime in the labour market was not used more effectively to prepare for the financial consequences of the ageing population.



Source: Author's own calculations based on official information.