# COMMENTS ON SESSION 1: PUBLIC EXPENDITURE TRENDS

*Ricardo Martner*[*]

Let me start expressing my gratitude to Mr. Daniele Franco and the staff of the Banca d'Italia for inviting me to offer these comments. This is my third visit to the Perugia workshops, and I am still impressed with the quality of the works presented and of the discussion. The kindness of our hosts also deserves a mention.

The main trends of the public expenditure composition in OECD countries are described in the papers by Wierts and Heller and by Hauner. In the European Union, a significant rise of total expenditure as a percentage of GDP took place until the Nineties, mainly explained by the establishment of the welfare state: income support, health, education and public pensions (Wierts). The weight of the general government in the economy of the European Union has been rather stable in recent years, clocking in on average at 50 points of GDP. In the rest of the OECD (Australia, Canada, Japan, the U.S.), this indicator is much lower, and social protection is at least 6 points below the average (Heller and Hauner).

The papers of this session are concerned with the future, with only one certainty: ageing population in industrialized countries is a big challenge for public finances, as recent OECD and IMF reports have shown. It is worth mentioning that the average length of retirement (the difference between life expectancy and the effective age of retirement) went from 5 years in 1960 to 18.2 in 2000 (Lefèbvre, Perelman, Pestieau and Vidal).

But uncertainty remains, even in demographic variables, as Heller and Hauner point out. Recently, for example, some experts predicted a decrease in life expectancy in the U.S., due to bad nutrition habits. Certainly, the long-term projections for public finance concerning pensions and health do not consider this assumption. Even if life expectancy continues to rise, as it is plausible, one should expect an endogenous increase of the effective age of retirement in the long term, as Lefèbvre and colleagues conclude in their estimation of a regression panel that the effective age of retirement is positively correlated with income and negatively with longevity.

Uncertainty on economic variables is not minor. For instance, the $\beta$-factor (the interest rate/growth differential, in percentage points), used as benchmark to define debt dynamics by Comley and McKissack, fluctuates on average between 2.6 for Finland (not to mention the terrible 9.3 differential of Turkey) and –4.1 for Ireland. Moreover, in countries like Italy, this differential jumped from –17 to 8 points during the 1970-2005 period. Even if this factor tends to be more stable in recent years in OECD countries, any deviation in long-term projections completely

[*] Economic Commission for Latin America and the Caribbean, United Nations, Santiago, Chile.

alters debt dynamic and hence the appreciation of debt sustainability when taking into account ageing populations.

Despite these uncertainties, it is a fact that reforms have to be undertaken. First, in this competitive world, the generosity of pension systems in the European Union is somewhat striking. In that sense, the Lefèbvre and colleagues' paper seems rather pessimistic: the resistance to reforms prevents to converge to the optimal frontier, defined as the best practices that relate the effective age of retirement to economic conditions. In that sense, the comparison between effective and optimal age of retirement is very interesting, as it shows that inefficiencies have grown in seven out of the fifteen countries of the sample, when comparing the Seventies with the Nineties.

But the authors also show that in other seven countries the difference has diminished, as the effective age of retirement is endogenous to income and life expectancy. Hence, if GDP per capita is ever growing in the future, the pressure of social protection in overall public financing should lower, and if life expectancy continues to rise, in the long term the age of retirement should also increase. Endogeneising the effective age of retirement could play a key role in public expenditures projections: to me this is the substantial contribution of the paper.

Second, pre-funding strategies are crucial to manage the future pressure of pensions and health expenditures. Comley and MacKissack classify OECD countries in tough, mild pre-funders and others, depending on the initial levels of debt stocks, taxes and the projection of public finance flows. Many of the pre-funding countries succeeded to generate primary surpluses (Belgium being the polar case) over a long period of time, improving their liability position. These countries have a better starting point than others to deal with ageing populations. Even if it is difficult to make this division between countries, as the criteria are always unsatisfactory, the authors show that pre-funding is a good and perhaps unavoidable strategy for developed countries, even if the question of intergenerational equity remains an open one.

I myself come from a pre-funding emerging country (Chile) that has made pre-payments of debt since the Nineties, achieving an 11 per cent debt burden in 2004 from more than 50 per cent in 1990. In this case, the strategy has to be assessed considering other factors, as the level of poverty or income distribution. Unfortunately, many Latin American countries went from indebtness to recent huge primary surpluses, without establishing the welfare state along the way.

Third, the composition of public expenditures also matters. In the Finnish case, as the paper of Kinnunen and Tuovinen illustrates, between 2005 and 2050 virtually all the rise in health (+0.9), pensions (+4.4) and care for the elderly (+1.0) is compensated by the decrease in children (–0.9), education (–1.4) and expenditure on assets (–1.9), so that the overall expenditure will stabilize at 51 points of GDP. In this kind of projections, the β-factor is critical, since – in the long term – a well behaved relation between growth and interest rates amplify the fiscal room to increase primary expenditures.

Heller and Hauner also point out that the non-age related expenditures do not remain constant over long periods. To be optimistic, there are potential savings in general public services and economic affairs. And institutional reform may help, as emphasized by Wierts, to redirect public expenditure towards growth-enhancing items. The ability to reallocate public expenditure is crucial, and it is much easier within an MTE framework.

The ageing society is undoubtedly challenging for public finances, but not necessarily alarming, if we believe in a better future.