COMMENTS ON SESSION 3: FISCAL SUSTAINABILITY

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The papers of this session provide excellent insights into the "state of the art" on fiscal sustainability. Most angles of the literature are either covered in survey or original elements in these contributions, as mapped in the survey table below.

Issue	Contributions
1) **Measurement issues**	Franco, Marino and Zotteri, Gokhale and Smetters
2) **Backward-looking assessments**	
Empirical studies (stationarity of debt, cointegration of revenue and expenditure, primary balance reaction to public debt)	Survey in Langenus
Fiscal structural reform and growth	Cournede, Giorno, Hoeller and van den Noord
3) **Forward looking studies**	
Debt, implicit liabilities/spending forecasts in partical equilibrium	Celasun, Debrun and Ostry; Oliveira Martins; Gokhale and Smetters
Sustainability gap and synthetic indicators	Langenus
General equilibrium/supply side effects	Cournede, Giorno, Hoeller and van den Noord
Generational accounting	Surveys in Langenus; Giammarioli, Nickel, Rother and Vidal
Combination generational accounting and general equilibrium	Draper, ter Rele, Westerhout
4) **Financability of debt**	Giammarioli, Nickel, Rother and Vidal
5) **Implications for rules**	Franco, Marino and Zotteri

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What have we learnt in this session?

The paper by *Langenus* surveys the existing literature that analyses sustainability from a backward- and forward-looking perspective. It also provides synthetic indicators of fiscal sustainability which could complement those already compiled by the Commission. Another very useful contribution of his paper is the simulation of adjustment today versus its delay to the intermediate and distant future. He finds that pre-funding of ageing costs would be less economically costly and more intergenerationally fair.

The paper by *Giammarioli, Nickel, Rother and Vidal* also combines a literature survey with an original and highly relevant discussion on the short term financeability of public debt. Analysts of fiscal sustainability typically focus on the non-sustainability (explosiveness) of the supply of government debt and tend to neglect the demand side. However, as the authors point out, if confidence in sustainability is lost, demand for government bonds and willingness to lend (at least at long maturities) may already decline much before debt explodes. Shortening maturities and declining confidence reinforces the short term vulnerability of governments to investors being unwilling to finance further debt.

Franco, Marino and Zotteri point to some important issues with regard to the measurement of expenditure projections and estimates of the amount of pension liabilities. Concerns about comparability of expenditure projections, homogeneity in methods and (in-)completeness of current pension liabilities as compared to total future liabilities suggest to use these indicators only in a complementary manner to the deficit and debt indicators. Measurement problems related to social security projections are also addressed by *Gokhale and Smetters* with particular reference to the US case.

Oliveira Martins, de la Maisonneuve and Bjørnerud provide projections of health expenditure over the coming decades. This study is finds that health spending will rise much more strongly than predicted by the EPC's Working Group on Ageing due to less favourable and likely more realistic assumptions.

Van den Noord and Cournède and *Giorno and Höller* discuss (amongst others) the complementarity of fiscal reform and monetary easing in monetary union. While the authors are falling short of proposing certain policy actions, their argumentation should nevertheless not be misunderstood as a reason for the explicit coordination of fiscal and monetary policies or for up-front interest rate cuts in anticipation of fiscal reform.

The study by *Debrun, Celasun and Ostry* suggests a very interesting approach of measuring risks to fiscal sustainability with the help of fan-charts. The only shortcoming of their approach is perhaps the use of estimated policy reaction functions on the basis of panel analysis. Alternatively, one could perhaps compare fan charts that are based on historical policy responses in the respective countries with alternative reaction functions that reflect different reform paths.

Finally, the paper by *Draper, ter Rele and Westerhout* combines generational accounting with general equilibrium modelling to examine all in one model the sustainability and time path of deficit and debt, the distributional effects on different generations and the supply side effects of different reforms in the Dutch economy.

What do we know and what do we not know?

Judging from the existing literature and what can be learnt from these contributions, we seem to know quite a bit about past government behaviour, about pension systems and their likely costs in coming decades under certain assumptions, about the possible interaction between the fiscal costs of ageing and the real economy and about the distributional effects of current systems and different reform scenarios.

We seem to know much less about health and long term care and how to reform them successfully. We still know with too little precision how economic agents would respond to reforms and how the optimal mix of private and public old age insurance would look like.

Perhaps we know even less about financial vulnerability and risks to the demand side for government bonds in industrialised countries in general and in EMU in particular. The common currency has introduced significant stabilising elements into debt demand, for example, by creating a deep and liquid market for euro area debt, or by making all countries debt eligible for investment portfolios of institutional investors. Pension regulations have resulted in increased and stable demand for government debt to better match the maturity of assets and liabilities of growing pension funds. But on the other hand, domestic debt markets are now less "rigged" as national investors are no longer forced to buy their government's debt and international holders of government bonds can exit markets at very short notice. The conditions under which there may be major deteriorations in the financeability of debt of euro area countries or even "runs" as we currently only know them from the experience of emerging markets may be worth exploring further.

What society in the future?

There is another angle to fiscal sustainability and population aging which we tend to forget when bickering over sustainability gaps, general equilibrium effects or reaction functions. Social security reform is about risk sharing between the private and the public sector and the life we will live as old people. With reform, there will be more risk with individuals. But chances are that higher income, better incentives to save and maintain one's human capital implies that we will be relatively well able to cope with it as members of rich societies.

Without reform, there will be around 100 pensioners for 100 workers in many countries. A Bulgarian colleague of ours told me that this is already the case in his home country. The world has not come to an end there. And it is also not very likely to come to an end in unreformed Western welfare states. But public pensions will be low to maintain government solvency and this will also require that much of the risk of longevity will be shifted to individuals (even though perhaps a bit later than with reforms). Health services will perhaps remain universal but they are likely to be poor to remain affordable. This also implies that much of the risk of having to pay for good quality service in case of serious illness will again be with the individual.

Does it then not matter whether to reform or not? The main difference I see is that unaffordable, degenerate welfare states will not only have to shift part of the risk to the private sector but they will do this in an environment of high taxes, low employment, low growth and, therefore, a generally much poorer ability for private agents to cope with risk. There will also be less private charity to mitigate risk. There may also be more intergenerational fighting and less cohesive and peaceful societies. Fiscal sustainability, social security reform, rebalanced risk sharing will not be about equity versus efficiency, it will be about equity with or without efficiency, cohesion and prosperity. This is ironic because it is today's nanny states that claim that they are better for cohesion and the poor.

In conclusion, we know a lot more about sustainability of public finances than only a few years ago. But we still do not know well when public finances are sustainable, especially as regards the small probability of drastic events on the demand side of public debt. And we have not really thought about what not reforming would mean for our future societies. There is a good side to this. It will keep us fiscal economists in demand for many years to come.