COMMENTS ON SESSION 4
ENVIRONMENTAL ISSUES AND SUSTAINABILITY REPORTING IN THE POLICY DEBATE

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The papers approach the issue of sustainability reporting from different angles. The paper by Eych and the paper by Kastrop and Velleuer analyse the experience with sustainability reporting in the United Kingdom and in Germany, respectively. The paper by Biraschi *et al.* does not deal with sustainability reporting in Italy as such but presents a sensitivity analysis of the long-term sustainability of Italian public finances following the commonly agreed EU methodology.

These being policy papers, I will focus on the sustainability issues that are recognised as salient for policy purposes in each of them. Before doing this, I would like to make a couple of more general observations, which I believe have a bearing on the issues highlighted by each paper.

The first observation is that while the normative background against which the Italian and the German experiences should be read is provided by the EU fiscal framework, in the case of the United Kingdom the normative background is strictly national. Specifically, for the Germany and Italy the relevant reference is the so-called preventive arm of the Stability and Growth Pact and the medium-term budgetary objectives that it prescribes for the general government balances, the sustainability rationale of which has been made explicit by the 2005 reform. For the United Kingdom, as explained in the paper, the reference is provided by the Code for Fiscal Stability and its implementing rules, namely, the "golden rule" for the public sector balance and the "sustainable investment rule" for the public sector debt.

The second observation is that the three countries, while all facing challenges to the long-term sustainability of public finances as reflected by the "medium-risk" classification in the assessment of the European Commission, present clearly different situations when it comes to the underlying determinants. Specifically, and in terms of the three components entering the calculation of the "sustainability gap":[1] Italy has a very high public debt and (owing to successive pensions reforms) a relatively low projected cost of ageing; the primary balance shows a structural surplus, which is however not yet sufficient to stabilise the debt; in Germany and the United Kingdom the projected cost of ageing is broadly in line with the European average, owing in the former to a recent pension reform and in the latter to relatively ungenerous public pension provisions; outstanding debt remains relatively low in the United Kingdom while is close to the EU

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[1] The sustainability gap is defined in relation to the primary in the starting period balance that would satisfy the intertemporal budget constraint of the government for the projected increase in age-realted expenditure:

$$S2 = rD_{t_0} - PB_{t_0} - r\sum_{t=t_0+1}^{\infty}\frac{\Delta PB_t}{(1+r)^{t-t_0}}$$

where D is the debt ratio, PB is the structural primary balance, $1+r$ is the interest-growth rate differential, *i.e.*:

$$1+r = \frac{1+i}{1+g}$$

where i and g are the nominal interest rate and the nominal GDP growth rate, respectively. For a derivation, see European Commission (2006).

average in Germany; the United Kingdom however is currently running a structural deficit on the primary balance while Germany has a surplus.

Changes in public debt reflecting the accumulation of deficits and surpluses tend to be gradual; by contrast, the structural balance, although adjusted for one-offs and the cycle, can exhibit large changes from one year to another; finally the cost of ageing is a projection conditional on a number of macroeconomic and policy assumptions, any significant departure from which would entail very different realisations. These differences may help explain why sustainability reporting in the United Kingdom seems concerned more with playing down than raising concerns about the future of public finances at least when compared with similar exercises carried out in Germany and Italy. Specifically, the paper by Eich does not seem to consider the achievement of a primary surplus sufficiently high to bridge the sustainability gap evidence by current projections as a serious issue for fiscal policy. As recognised in the paper, this conclusion is influenced by taking the planned and not the actual budgetary position as the starting point for running long-term projections. While it is true that the starting position is key to the results of sustainability calculations and is subject to considerable risks, it is also true the risks run both ways and even the best laid medium-term plans can be carried off course by economic and political developments, as confirmed by the recent experience of the United Kingdom itself.

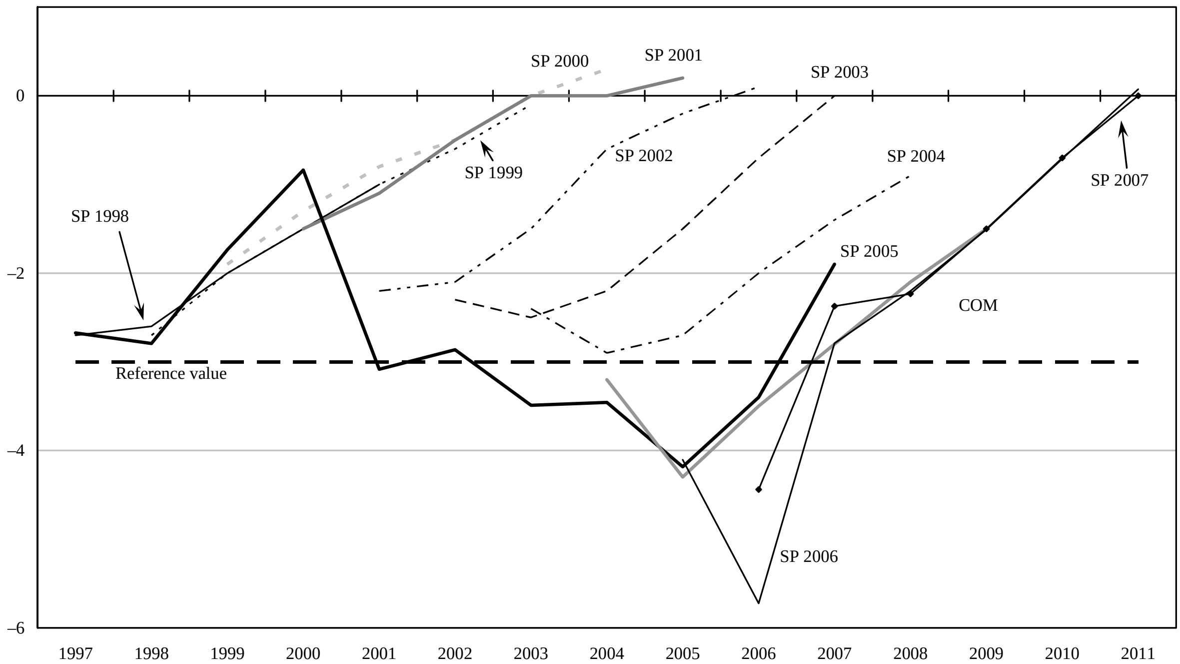
Beyond these medium-term developments, the most obvious risk, at least in the case of the United Kingdom, is that the projections of age-related expenditure, and in particular those for public pensions, may turn out to be optimistic: according to the projections reported in the European Commission's 2006 *Sustainability Report*, which are produced by national government themselves based on commonly agreed macroeconomic an demographic assumptions, the benefit ratio (defined as the average public pension relative to the average wage per worker) is set to decline by 22 per cent between 2005 and 2050 from levels that are already the lowest among the EU-15 countries. The 2008 *Long-term Public Finance Report* referred to in the paper projects a somewhat larger increase in age-related spending reflecting the effects of the 2007 pension reform, itself a reflection of the realised likely inadequacy of existing overall (*i.e.*, private and public) pension arrangements.

The paper also highlights the greater emphasis accorded in the latest sustainability reporting to the so-called top-down approach to sustainability, where the future evolution of spending and revenue is subject to a set of high-level constraints, which in the case of the United Kingdom are derived from the domestic fiscal rules. While recognising that it can have its uses, I would caution against drawing strong policy conclusions from the top-down approach. For example, in the case of the United Kingdom, the government has reason to conclude that it is well-placed to sustain current expenditure ratios in the future while respecting its deficit and debt rules. Indeed, as the debt ratio is currently in the vicinity of the ceiling set by the "sustainable investment rule", respecting the deficit *and* the debt rule demands that the expenditure ratio be constrained to its currently planned levels, at least if the government does not plan a permanent increase in taxation. But the difficulty in meeting the rules lies all in the gap between the currently planned and no-policy-change evolution of expenditure, which tells us by how much expenditure in other areas will have to be cut if one wants to ensure adequate pensions in the future.

The main message from the analysis of the sustainability of Italian public finances presented in the paper by Biraschi *et al.* is that the achievement and maintenance of a high primary surplus, as foreseen by the medium-term budgetary plans of the government in compliance with the Stability and Growth Pact, is critical to making public finances robust to demographic and productivity shocks. To see why this is the case, it is sufficient to recall the determinants of public finances sustainability as described above: in the case of Italy the debt is so high that the primary surplus required to set it on a rapidly declining path as required by the Pact, if maintained over time, would also be more than sufficient to "pre-fund" future age-related expenditure, which have been significantly curtailed by successive pension reforms. While undisputable on its own terms, this conclusion also contains three important policy caveats. First, achieving and sustaining a level of the primary surplus as high as planned (of the order of 5 per cent of GDP) is politically very difficult. The track record of the Italian government is not encouraging: as shown in Fig. 1, the history of Italian stability programmes is one of successive postponements of the achievement of the medium-term objective of a balanced budget.

Figure 1

Italy: Projections Versus Outcomes for the Government Balance in Successive Stability Programmes
(percent of GDP)



Source: European Commission services' (COM) and Italian stability programmes (SP).

Second, note that a high-primary surplus may be even more difficult to maintain when the debt is reduced to lower levels as the corresponding overall balance, which is the most visible budgetary aggregate and the one typically used by government for budgetary planning , would have to move from balance to a surplus, reflecting the reduction in interest payments. If by contrast primary surpluses were allowed to shrink in line with reduced interest payments, the sustainability calculations presented in the paper, which assume that the changes in the primary balance over time would reflect changes in age-related expenditure, would no loner be valid.

Last but not least, the counterpart of the relatively limited projected increase in age-related expenditure in Italy is a progressive reduction in the generosity of the public pension system, with the benefit ratio (as defined above) declining by around 30 per cent between 2005 and 2050. This raises the issue which the authors call "social sustainability" and I would rather call "political sustainability", in line with the reasoning presented in Galasso and Profeta (2004): in a PAYG system, ageing reduces the rate of return workers can expect from the system at any given age, but as past contributions to the system are a sunk cost for the individuals, the rate of return that enters their calculation – and their voting decisions – increases with age (and is infinite for those already retired): with the age of the media voter increasing over the same period from 45 to 56 years, is a large reduction in pension benefits politically sustainable or will voters opt instead for increasing taxes, even at the cost of further slowing down the economy?

That maintaining public finances sustainability demands a consistent consolidation effort is also one of the key messages of the paper by Kastrop and Velleuer. I find it notable that the "qualitative results" of the sustainability reporting include an explicit call for consolidation to be directed above all towards the expenditure side and accompanied by an improvement in quality of public finances, and in particular the efficiency of public expenditure. In so doing the authors implicitly recognise the limitations of the partial equilibrium approach used in the projections of age-related expenditure: the paper by Cournède and Gonand in this volume provides persuasive quantitative evidence that cuts in non-growth-enhancing spending items can deliver a significant growth bonus relative to a tax-based consolidation strategy. This is also a reason for arguing, as the authors seem to do, against a medium-term budgetary objective implying a full "frontloading" of the cost of ageing, even in a situation, such as that of Germany, where the reforms already enacted in the pension system leave little room for further reduction in projected age-related expenditure. However, I would argue that a significant degree of frontloading is necessary if one wants to make sense of the aim of incorporating implicit liabilities in budgetary policy as foreseen by the reform of the Stability and Growth Pact.

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