December 2014

Honorable States? EU Sustainability Ranking 2014 – Key Results –

Europe is still suffering from its overwhelming debt burden. Consequently – six years after the onset of the financial crisis – numerous European Member States controversially discuss what would be the most promising fiscal policy. On the one hand, it is argued, that the twofold strategy of strict consolidation and structural reforms must be continued, in order to break the trend of ever higher debt levels. On the other hand, there are proposals to pause the process of structural reforms. Instead, additional debt-financed government expenditures should provide the necessary impulses for increased economic activity and higher economic growth, even if there is the risk, that the already high debt-levels continue to rise. The supporters of this idea disregard the experience of past decades and count on self-financing effects which are supposed to occur through stronger economic growth and – as a result – higher tax revenues.

But how bad does the debt problem of the European Union present itself at the moment? And how did the situation change since last year? In order to answer these questions, the Stiftung Marktwirtschaft (Market Economy Foundation) in cooperation with the Forschungszentrum Generationenverträge (Research Centre for Generational Contracts) at the University of Freiburg has analysed the long-term perspectives of the public budgets of the EU Member States. The distinctive feature of this analysis is that not only the officially reported debt is taken into account, but also the implicit public debt. The implicit debt essentially results from future budget deficits which can be expected to arise if the fiscal status quo is continued without any modification although the demographic change will heavily influence government revenues and expenditures in the coming decades.

EU Sustainability Ranking* 2014 (Base Year 2013)

	in % of GDP	Explicit Debt +	Implicit Debt =	Sustainability Gap	Change to the Sustainability Ranking 2013
1	Latvia	38	17	55	Constant debt
2	Italy	128	-23	105	Increase of debt
3	Estonia	10	115	125	Increase of debt
4	Portugal	128	3	131	Reduction of debt
5	Germany	77	81	157	Constant debt
6	Hungary	77	95	173	Constant debt
7	Poland	56	150	206	Reduction of debt
8	Lithuania	39	212	251	Reduction of debt
9	Austria	81	173	254	Constant debt
10	Denmark	45	255	300	Constant debt
11	Romania	38	265	303	Constant debt
12	Bulgaria	18	305	323	Increase of debt
13	Czech Republic	46	306	352	Reduction of debt
14	Malta	70	282	352	Reduction of debt
15	Sweden	39	327	365	Increase of debt
16	Slovak Republic	55	411	465	Increase of debt
17	France	92	388	480	Increase of debt
18	Netherlands	69	432	501	Reduction of debt
19	Finland	56	456	512	Increase of debt
20	Greece	175	356	531	Reduction of debt
21	Slovenia	70	507	577	Reduction of debt
22	United Kingdom	87	509	596	Reduction of debt
23	Spain	92	526	618	Reduction of debt
24	Belgium	105	574	678	Increase of debt
25	Cyprus	102	592	694	Reduction of debt
26	Ireland	123	752	875	Reduction of debt
27	Luxembourg	24	1020	1043	Reduction of debt
ø	EU27	87	254	341	Constant debt

Legend: Reduction of debt / Constant debt / Increase of debt

Differences in summation (sustainability gap) are possible due to rounding errors.

The calculations start from the actual economic and fiscal position in 2014 (Autumn 2014 European Economic Forecast by the European Commission). The data for future GDP-growth – starting with the level in 2014 – is taken from European Commission's 2012 Ageing Report. With the exception of spendings on pensions the same is true for the age-related expenditures. 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 the 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 age-related expenditures to GDP is held constant.

* Due to missing data, Croatia, EU Member State since 1 July 2013, is not yet included in the calculations.

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

1. The inadequacy of the traditional criteria of the Stability and Growth Pact

Public debt is commonly discussed either in terms of the current budget deficit, which must be funded with new debt obligations, or the outstanding debt, which represents the debt that a government has accumulated from past borrowing. The debt and deficit limits of the Stability and Growth Pact (Maastricht Criteria) 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 Stability and Growth Pact have lacked binding force, allowing many countries to regularly violate the three percent deficit limit and the sixty percent debt limit without any sanction. While this disregard of the rules was not the only reason for the outbreak of the current sovereign debt crisis – indeed, strongly 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. A rampant use and careless handling of public debt in past decades as well as the tendency of politicians to postpone unpleasant consolidation steps – even during economic booms – clearly indicate, that a revival of debt-financed growth-policy would be a risky and rarely rewarding approach. On the contrary, for the future 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 expenditures from consideration. At best, national and state governments – like in the case of Germany – look only a few years ahead just planning for the medium term. Even when such considerations are incorporated into financial planning, the economic forecasts as well as the projected public deficits tend to reflect rather wishful thinking. In general, official fiscal planning tends to ignore long-term changes of future revenues and expenditures, even when their underlying trends are foreseeable and calculable today.

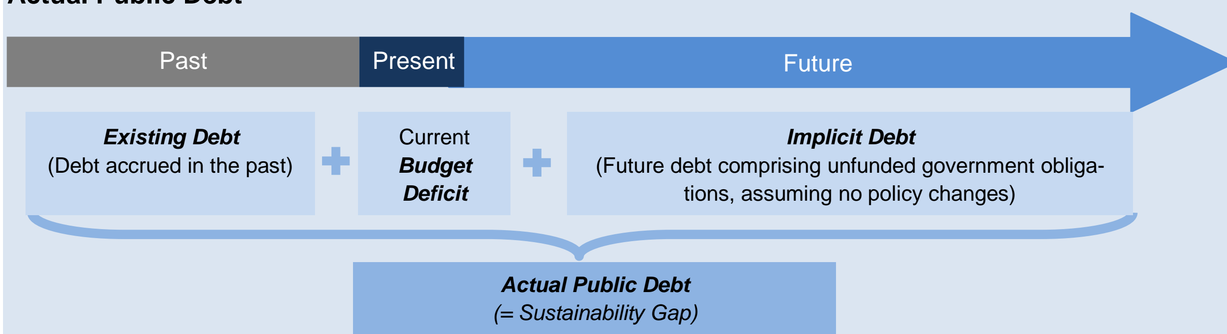
2. An Honest Consideration of Public Debt: Facing the Future

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, health care and long-term care. At the same time, the proportion of the working-age population, on whom society depends to provide (a large share of) the taxes and contributions to social insurance schemes, will decline, creating a growing divergence in public revenue and expenditure over the coming decades.

The source of the impending gap between future 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 promises, 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.

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



The implicit public debt must be taken as seriously as the explicit public debt because it almost inevitably leads either to higher taxes and social security contributions or a reduction in public benefits in the future. The third alternative – gradually allowing implicit debt to become explicit debt – is not an option if a country seeks to avoid risking national bankruptcy. Since tax rates and social security contributions cannot be raised significantly without endangering economic growth and since it will be politically difficult to implement actual expenditure cuts in the future, reforms need to begin here and now. Policymakers should implement the necessary reforms as quickly as possible to erase the implicit debt. Unsound financial promises of the state must be withdrawn, so that people can plan under realistic assumptions – for example with regard to their old-age pensions.

3. The Actual Level of Public Debt in Europe – The EU Sustainability Ranking 2014

The results of the "actual public debt" calculation – calculated by adding the explicit and implicit liabilities of each of the EU-27 Member States – are presented in the "EU Sustainability Ranking" (see Box on page 1).

Key Findings:

- The updated **EU Sustainability Ranking 2014** shows a silver lining. Numerous European states have made some progress consolidating their public budgets: In 2014, 13 out of the 27 examined EU Member States managed to decrease **the sum of their explicit and implicit public debt – the so-called sustainability gap**. Six Member States were at least able to keep the sustainability gap constant. This development has been driven by lower primary deficits, i.e. budget balances disregarding interest payments.
- However, the **consolidation improvements**, which have been achieved, **are rather small compared to the large sustainability gaps.** Therefore, it is far too early to recommend turning away from the consolidation course. So far, despite the progress made, not a single country has managed to achieve fully sustainable public finances. The total indebtedness of 21 Member States exceeds the 200 percent mark in relation to their GDP**. In these countries, the implicit debt excels the explicit debt significantly. The EU average sustainability gap is still 341 percent of the GDP** (compared to 349 percent of the GDP in 2013) – more than three times the annual economic output of the EU. Therefore, further structural reforms and consolidation efforts across Europe are highly recommendable.
- As in the previous year, **Latvia** has the lowest overall level of public debt and is the **front-runner** of the Sustainability Ranking 2014. Italy continues to be in second place even though its sustainability gap has grown. Luxembourg and Ireland have swapped positions and continue to be at the bottom end of the table. The different results for Italy and Luxembourg illustrate that the **level of explicit public debt does not allow for conclusions about the level of implicit public debt** or about the total sustainability gap. Luxembourg's large sustainability gap derives primarily from its pension system which is too generous and will turn out to be unaffordable in the long run. Italy, on the other hand, will only have to face a minimal increase of the age-related expenses in relation to GDP until 2060. Combined with a sizeable primary surplus this even creates a small, implicit wealth for Italy – the only one across the EU.
- While **Germany's** sustainability gap of 157 percent of its GDP (respectively 4.4 billion €) remaines almost unchanged it falls back on the 5th place behind Portugal. The latter has managed to reduce its implicit debt almost entirely.
- The fact that particularly the countries placed at the bottom end of the table have managed to reduce their public indebtedness confirms last year's insight that **consolidation succeeds first and foremost under great economic pressure**. Among the big Member States, on the other hand, well-placed Italy and middle-ranking France have rather gone backwards than forward.