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Fiscal Council recommendation:

Fiscal policy must take swift actions to limit the fiscal implications of population aging

Population aging is one of the key challenges of Slovenian fiscal policy. This is a long-term problem, which, however, calls for an immediate response. Without quick action on aging-related expenditure, the conditions for achieving the medium and long-term stability of public finances will be tightened, as it will be necessary to establish a significantly higher structural surplus of public finances to ensure long-term debt sustainability of the general government. The current structural deficit at around 1-1.5% of GDP and the general government debt of around 80% of GDP represent a weak starting point for facing the existing and anticipated burdens of aging.

Medium-term objective of fiscal policy (MTO) is the cornerstone of the preventive arm within the framework of the Stability and Growth Pact, guiding the functioning of fiscal policy. The MTO is defined as the structural balance, i.e. the general government balance, adjusted for cyclical movement without the effects of one-off measures. The MTO must be defined so as to ensure¹: (i) a safe distance from the balance of 3% of GDP (the reserve is provided by taking into account the so-called "minimum benchmark" set by the EC once yearly), (ii) sustainability or rapid achievement of the long-term sustainability of public finances (above all, taking into account the level of debt and aging-related costs), and (iii) in line with (i) and (ii) the manoeuvre margin for budgetary policy, in particular in terms of government investments².

The government must determine the value of the medium-term objective of its fiscal policy in its annual Stability Programme. The MTO is thus country-specific, and the European Commission checks its compliance with the MTO based on the MTO calculated at least every three years³. The triannual frequency of the MTO calculation relates to the publication of the Ageing Report⁴ (prepared by the European Commission), which, on the basis of current legislation and long-term demographic projections, sets predicted changes in the cost of population aging in each country.

¹ Regulation EC 1466/97.

² Regulation EC1466/97 also provides that the euro area Member States and the ERM2 are required to set the MTO at a level of at least 1% of GDP. Countries that are parties to the Stability, Coordination and Governance Agreement in the EMU have made additional commitments to achieve the MTO at least at 0.5% of GDP, except in cases where general government debt is significantly below 60% of GDP and where long-term risks to the sustainability of public finances are low.

³ The only exceptions are countries that carry out structural reforms with a significant impact on the sustainability of public finances. In these cases, MTO is recalculated also before the expiry of the three-year period.

⁴ The next Ageing Report will be published in 2018. At that time, the European Commission will also set new MTOs for individual EU Member States.

The lowest MTO that can be selected by a state is defined as the most favourable value of the following three components:

$$MTO^{min} = \max (MTO^{ILD}, MTO^{MB}, MTO^{EA,ERM2})^5, \text{ where}$$

$$MTO^{ILD} = Balance_{debt\ stabilizing} + \alpha * Ageing\ Costs + Effort_{debt\ reduction}.$$

Balance_{debt stabilizing} in the equation for MTO^{ILD} (ILD: Implicit Liabilities and Debt) refers to the budget balance that allows debt stabilisation at the level of 60% of GDP, and is determined by the coefficient of 0.6 and average nominal GDP growth by 2060⁶. The contribution of aging costs, which is expressed as a discounted value of an increase in the cost of aging, over an infinitely long period, is determined by the coefficient $\alpha = 0,33$. The effort to reduce debt is determined by the term $0.024 * debt-1.24$. MTO^{MB} (minimum benchmark) is determined on the basis of the fluctuation of the economic activity in the past and the sensitivity of the balance to such fluctuations⁷ has a value of -1% or -0.5% of GDP.

Sensitivity analysis shows that the medium-term objective of fiscal policy in Slovenia is most dependent on long-term economic activity as well as on aging costs. On the basis of the currently known values of the parameters that determine the MTO in Slovenia, we simulated the effects of changes to individual parameters on the value of MTO⁸. In the simulations we assumed a deterioration in individual parameters, as the Ministry of Finance warned in the government materials⁹. The greatest MTO increase would occur in the event of reduced long-term economic growth, although population aging also has a relatively high impact on the value of MTO. These findings indicate the need for action in both areas – especially since there could be simultaneous adverse effects from both factors – to ensure the long-term stability of public finances. It should also be considered that economic policy has a more immediate direct impact on the costs of population aging by defining institutional arrangements for social security systems than on ensuring long-term economic growth.

Table: The results of the simulations of changed parameter effects on the MTO values

| | deviation from the baseline scenario | |
|--|--------------------------------------|------------|
| | MTO value (% BDP) | (p.p. BDP) |
| baseline scenario | 0.25 | |
| change in long-term GDP growth (-1 p.p.) | 1.00 | 0.75 |
| debt change (+10 p.p. GDP) | 0.50 | 0.25 |
| aging cost change (+1 p.p. BDP) | 0.75 | 0.50 |

Source: FS calculations.

⁵ The value of MTO based on this formula is rounded to the most favourable one quarter of a percent.

⁶ Calculated within the framework of the Ageing Report.

⁷ The value of this component is published annually by the European Commission in the publication “Vade Mecum on the Stability and Growth Pact”.

⁸ According to the Fiscal Council calculations, the value of MTO in Slovenia currently stands at 0.25% of GDP, while in the budget documents the balanced structural balance is specified as the medium-term objective. Inconsistency with the rules of the Stability and Growth Pact has also been highlighted by the European Commission in its regular estimates of budget plans. Nevertheless, the current deviation of 0.25 percentage points does not have much weight in the orientation of the fiscal policy due to the uncertainty of the structural balance estimates.

⁹ Government materials “The importance of limiting the growth of the population aging costs for fiscal consolidation in the following years (10300-7 / 2017/1)” mentions, for example, the method and level of pension adjustment with inflation as a measure for which model estimates show that it has the fastest and most significant effect on the cost of pension expenditures in relation to GDP.

The consequence of the increased medium-term objective of fiscal policy would be a more restrictive fiscal policy. Based on the updated long-term demographic projections, the exact MTO value could be determined only in 2018. Since the calculation of the long-term costs associated with aging also include the current values of the parameters of the social security systems, it is necessary to take measures that will prevent the excessive increase of these costs in the long run. In the opposite case the demands for fiscal policy restrictions will become more stringent. **In the period up to achieving the MTO this would entail additional structural efforts, and afterwards the maintenance of the structural surplus at a higher level than the currently envisaged levelled position or a slight surplus of the structural balance¹⁰.** An additional limitation of fiscal policy over a longer period can, among other things, also have a deterrent effect not only on the short-term but even to a greater extent on long-term economic activity.

¹⁰ With a 0.25 p.p. increase in the MTO, it would be necessary to ensure structural measures of EUR 100 million per year (considering the current level of GDP).