From Financial Crises to Fiscal Consolidation in Emerging and Advanced European Economies:

Achieving sustainable social expenditures and maintaining social cohesion in the context of demographic change

Report to the Council of Europe

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Contents

Abbreviations and Acronyms

ADL	Activities of Daily Living
ALMM	Active Labour Market Measures
BEPG	Broad Economic Policy Guidelines
BOP	Balance of Payments
CIT	Corporation Income Tax
CIS	Commonwealth of Independent States
COE	Council of Europe
DPL	Development Policy Loan
EBRD	European Bank for Reconstruction and Development
EMU	European Monetary Union
ENP	European Neighbourhood Partnership
ERM	European Exchange Rate Mechanism
ESF	European Social Fund
ESSN	Emergency Social Safety Net
EU	European Union
FCL	Flexible Credit Line
FDI	Foreign Direct Investment
FYROM	Former Yugoslav Republic Macedonia
GDP	Gross National Product
GEO-ICT	Geographical Information Communications Technology
GFS	Government Financial Statistics
GMI	Guaranteed Minimum Income
IBP	Initial Budgetary Position
IMF	International Monetary Fund
LTC	Long Term Changes
MTEF	Medium Term Expenditure Framework
NPGS	National Public Goods and Services
NUTS	Nomenclature of Territorial Units for Statistics
OECD	Organisation for Economic Cooperation and Development
OOP	Out-of-Pocket
PAYGO	Pay-As-You-Go
PER	Public Expenditure Review
PETS	Public Expenditure Tracking Survey
PIT	Personal Income Tax
RPGS	Regional Public Goods and Services
SGP	Stability and Growth Pact
SHI	Social Health Insurance
STW	Short Term Working
UK	United Kingdom
US	United States
WEO	World Economic Outlook

PREAMBLE

Introduction and Overview:

Introduction:

Coping with the social impacts of the financial and economic crises and longer term demographic trends in advanced and emerging European economies[1] are the two themes covered in this report. The themes are couched in the following inter-related questions:

- How did the transmission channels of the crises affect advanced and emerging economies in Europe?
- What are the constraining or enabling factors that shaped responses to the crises in advanced and emerging European economies?
- What types of social policy measures were adopted in response to the crises in emerging and advanced European economies?
- What are the challenges from the crises for fiscal sustainability, and what are the exacerbating effects of ageing related expenditures on fiscal sustainability?
- What are the likely impacts and implications for achieving fiscal sustainability and managing ageing related expenditures for central and sub-national governments?

These questions are addressed in the analysis presented in this report, which has been prepared for consideration by the conference of ministers responsible for local government in the follow-up session of the 16th Session of the Ministerial Conference in Strasbourg in October 2010. This report, which builds on the social report presented to the conference of ministers in 2009, has been prepared by Laurie Joshua, in collaboration with the team convened by LGI [the Local Government and Public Service Reform Initiative] and the Council of Europe, as part of their established policy and practice collaboration. The report has been greatly assisted by observers in 26 countries who supplied data and offered insights into the financial, social and demographic issues posed by the financial and economic crises and the implications for both national and sub-national governments. Where necessary supplementary data sources have been used to illustrate the wider significance of particular social issues and the social policy implications that decision-makers need to consider and address.

It should be noted that in this report, where the experience of one or more advanced or emerging European economies is highlighted, this is either because the national observers

[1] The delineation of member states of the Council of Europe [CoE] into Advanced and Emerging economies accords with IMF World Economic Outlook [WEO] classification criteria: (1) per capita income level, (2) export diversification - so oil exporters that have high per capita GDP do not make the advanced classification because around 70 per cent of their exports are based on oil, and (3) degree of integration into the global financial system. Based on these criteria **Advanced economies** in Europe include: Austria, Belgium, Czech Republic, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Norway, Portugal, Slovak Republic, Slovenia, Spain, Sweden, and the United Kingdom [16 of which are members of the Euro zone]; while **Emerging economies** in Europe include: Albania, Armenia, Bosnia Herzegovina, Bulgaria, Croatia, Estonia, Georgia, Hungary, Latvia, Lithuania, Macedonia [FYROM] Poland, Romania, Russian Federation, Serbia, and Ukraine [7 of which are EU member states, and 5 are EU candidate and pre-accession countries].

from these countries have emphasised a particular point [which is captured in the text boxes] or because the author thinks they represent a good illustration of the issue under discussion. Consequently, the fact that a particular economy is mentioned does not necessarily mean that the point being made does not apply to others.

Overview

The transmission channels of the financial and economic crisis from advanced to emerging economies in Europe had a significant impact on the abilities of national and sub-national authorities to adopt measures to mitigate the worst effects of the economic downturn. However policy measures taken to maintain consumption, reduce job losses, and provide essential public services in the face of reduced revenues and increased demand have resulted in the worsening of government debt and deficits in both advanced and emerging European economies. Most governments in advanced European economies have, or are planning to, embark on measures that allow stimulus spending to expire and refocus efforts on fiscal consolidation; while a significant number of emerging European economies [alongside Iceland and later Greece] - that reverted to the International Financial Institutions and others for financial support – embarked on fiscal consolidation at much earlier stage in the crises cycle. The challenge for governments in both groups of economies is how to achieve fiscal consolidation, while at the same time preserving the objectives of active, fair and socially cohesive societies in the context of ageing populations.

Though debt and deficit increases – resulting from the crisis – are by themselves significant, the impact of ageing populations on public finances in both advanced and emerging economies is expected to dwarf the effect of the crises in the longer term. This is because the fiscal costs of the crisis and projected demographic developments have compounding effects and make fiscal sustainability an acute challenge.

Significant challenges therefore lie ahead at both national and sub-national levels with regard to ageing related expenditures – particularly with regard to pensions, health care, long term care, education and unemployment benefits and social assistance. Moreover, population dynamics – tied to migration and natural changes – has significant implications for revenue raising, revenue sharing, and for fiscal equalisation at sub-national levels of government in both advanced and emerging European economies. The fiscal impact of ageing populations is, in turn, determined by the following characteristics: (i) the extent to which financial and administrative responsibilities in different domains of social policy are *tilted* towards either central or sub-national government; (ii) positive or negative population growth; (iii) the pace at which the share of the population of over 65's increases, (iv) the rate of increase in old age dependency ratios; (v) the proportion of older old [aged over 80] as proportion of the population and levels of physical and mental frailty (vi) the demand for ageing related benefits and services, and (vii) the impact of ageing on revenues in the wake of a decline in the working age population.

Policy responses to fiscal consolidation and the exacerbating effects of ageing populations need to be tailored to the specific conditions of individual economies and to particular sub-national localities. But ultimately decisions – including the application of social and technological innovations to improve efficiencies - will need to strike the delicate balance between current recovery strategies and future sustainability of public finances across various social policy domains such as pensions, health, and long term care. Clear and bold social policy choices will be required from national and sub-national governments in both advanced and emerging European economies to devise credible strategies to reduce public debt, but without compromising on the important aspects of current and future welfare systems – particularly those designed to maintain social cohesion and protect future generations. This is especially pressing in economies where the demographic shift will take place sooner and also more rapidly. The population ageing challenge is multifaceted, having repercussions on the labour market, economic growth potential and public finances. The appropriate policy choices in advanced and emerging European economies will have to be custom designed, in view of the fact that the setup of public services, social protection systems, labour markets and the structure of economies show large variations. The main features of future policy choices to counter the effects of the financial and economic crises and the exacerbating effects of population ageing will need to focus on:

- Strategies that are extensive and long-lasting – including measures that address future pension expenditures in the public sector [local and central government], actions to postpone retirement, and measures to increase the productivity and efficiency of ageing related services.

- Measures for reducing the rise in government expenditure given that the prospects of an ever-increasing debt would pose an obstacle to a sustained and long lasting recovery from the present crisis, and the achievement of balanced economic growth. Sustainability - related to the ability of a government to assume the financial burden of debt both currently - could be achieved via (i) increases in revenues, (ii) cuts in expenditure or (iii) structural reforms in policy domains such as social assistance, pensions, and long term care in order to decelerate projected increases in age related expenditures. Introducing such reforms will need to be based on medium term objectives, take into account implicit liabilities due to ageing.

- The role of sub-national economies in the public sector. In economies where sub-national governments play a relatively large role in the public sector – particularly in relation of the provision of key social policy domains, like healthcare and long term care, and where general public sector employment trends and wage bills account for a large proportion of expenditures – the evolution of both staff numbers and wages will be a significant determinant of public expenditure pressures. Higher employment in public services will, therefore, need to be not only a concern from the fiscal standpoint, but also from the perspective of crowding out employment in other sectors of the economy under conditions where labour supply is declining. Measures to improve efficiencies and to yield economies of scale through mergers of sub-national government units, the introduction of technological change, social re-organisation of service delivery, and greater use of private and not-for profit sectors may help, but in the face of permanent financial pressures these measures will need to be complemented with fundamental structural reforms that take into account entitlement and eligibility criteria. Indeed, if, in the face of longer term fiscal strain productivity reforms at the sub-national level fail, the strains of raising revenues and meeting expenditure demands could undermine central government tax policies, and transfer risk to other sectors of the economy.

- Standardised models and methods for conducting policy analysis linked to the fiscal effects of ageing need to be expanded. These models and methods are presently only available for advanced and emerging economies within the European Union. The deployment of standardised methods for assessing the fiscal effects and sustainability of ageing related expenditures should be explored with governments in the accession candidate, pre-accession candidate and European Neighbourhood Partnership economies. The extension of the methodology would help identify options for fiscal consolidation, for managing ageing related expenditures, and for mitigating the risk of cross-border spillovers.

The next few years will undoubtedly be a crucial time as national and sub-national governments search for measures in the shape of proactive economic policies which not only strengthen their recovery from the crisis, but also help steer clear of the dangers of insolvency. Balancing the needs of youth and older people, both current and future, warrants a fresh focus on fiscal policies and future social policy imperatives – including arrangements for inter-governmental fiscal relations that govern revenues and expenditures.

Section 1

Financial and Economic Crises in Advanced and Emerging Economies and Variations in Fiscal Capacities to Respond:

The financial crisis that hit the global economy in mid-2007 is without precedent in post- war economic history. The crisis begun with the puncturing - in early-mid 2007 - of the real estate bubble in the United States [US], the United Kingdom [UK], Ireland, Spain and Iceland. As a result, a huge amount of speculative funds shifted to the primary commodities market [food, fuel and metals] where prices had – over a two year period – started increasing gradually[2]. The food-energy bubble came to an end in July/August 2008[3] and coincided with the number of mortgage defaults and house foreclosures growing out of control and started to affect US and UK banks which had issued risky subprime mortgages. Over-leveraging positions rendered financial institutions extremely vulnerable to corrections in asset markets because the mortgage banks sold their low-grade mortgages backed by houses to international merchant banks – such as Lehman Brothers – which, in turn, issued a huge amount of bonds guaranteed by the houses financed by mortgages. The sudden loss of confidence and the rise of counterpart risk triggered by Lehman's bankruptcy led to the so-called "sudden stop" in financial markets in advanced European Union [EU] countries[4] because many European banks had bought such bonds and were therefore affected by the sharp decline in their value when the number of mortgage defaults rose and a growing number of foreclosed houses were put on the market by the banks, with the effect of further depressing prices. The lack of an initial "sudden stop" in capital flows to the emerging European economies was part of a general decoupling of emerging economy finance from the crisis in the advanced European economies in early-mid 2007[5].

The two crises affecting advanced European economies – the 'financial' crisis' and the ensuring 'real' economy crisis – in 2007 and 2008 begun to severely impact emerging European economies during 2009 [see Table 1 for year over year percentage change in Gross Domestic Product (GDP) growth] – although in the Baltic states the crises was felt at the onset in 2007, and in Hungary the impact emerged in November 2008 on the back of pre-existing financial difficulties - evidenced by a skyrocketing budget deficit of 9.3 per cent and a high debt level of 66 per cent of GDP - before the onset of the global crises. Aside from Poland, all emerging European economies entered a period of contraction that was in most cases more severe than the average in advanced European economies. The variation in cross-border transmission was due to the extent to which different emerging European economies were inter-connected with the financial system itself and also by the extent to which they were integrated with supply chains in European and global product markets. The increasing international integration of emerging European economies over the past decade, which enabled these economies to benefit from growth also, ironically, provided channels for the transmission of shocks via real and financial channels with the severely hit advanced European economies i.e., through the flows of trade, investment, finance and remittances[6].

[2] FAO [2008]

[3] Food and fuel prices rose sharply in many countries in 2007 and through the first three quarters of 2008. As the global financial crises worsened, food and energy prices abated worldwide. Increased agriculture production - following soaring food prices and higher returns to agriculture activity - led to a bountiful harvest in 2008 and helped to ease global commodity shortages.

[4] Blanchard [2009], EC [2009]

[5] This phenomenon is sometimes attributed to the fact that the crisis originated in US mortgage and other asset markets – to which emerging market countries were not directly exposed.

[6] Emerging economies within the EU and economies in South Eastern Europe were more highly integrated with economic developments in the Western Europe; while countries in the Commonwealth of Independent States

Table 1: Changes in GDP Growth [%] 2007-2010

Countries	GDP Growth Year Over Year Percentage Change			
Advanced Economies	**2007**	**2008**	**2009**	**2010***
Austria	3.5	2.0	-3.6	1.3
Belgium	2.9	1.0	-3.1	1.3
Czech Republic	6.1	2.5	-4.2	1.6
Denmark	1.7	-0.9	-.4.9	1.6
Finland	4.9	1.2	-7.8	1.4
France	2.3	0.4	-2.2	1.3
Germany	2.5	1.3	-5.0	1.2
Greece	4.5	2.0	-2.0	-3.0
Iceland	6.0	1.0	-8.5	-3.0
Ireland	6.0	-3.0	-7.1	-0.9
Italy	2.3	0.4	-2.2	1.3
Slovakia	10.6	6.2	-4.7	2.7
Spain	3.6	0.9	-3.6	-0.4
Netherlands	3.6	2.0	-4.0	1.3
Sweden	2.5	-0.2	-4.9	1.8
United Kingdom	2.6	0.5	-4.9	1.2
Emerging Economies				
Albania	6.0	7.5	2.8	1.4
Bulgaria	6.2	6.0	-5.0	0.0
Croatia	5.5	2.4	-5.8	0.3
Estonia	7.2	-3.6	-14.1	-0.4
Hungary	1.0	0.6	-6.3	0.0
Latvia	10.0	-4.6	-18.0	-3.5
Lithuania	9.8	2.8	-15.0	-0.6
Macedonia [FYROM]	5.9	4.9	-0.7	1.3
Poland	6.8	5.0	1.7	2.7
Romania	6.3	7.3	-7.1	0.8
Russia	8.1	5.6	-7.9	3.7
Ukraine	7.9	2.1	-15.1	4.0

*Forecast
Source: WEO IMF [2010], EBRD [2010]

Prior vulnerabilities had a critical role in determining the ability of emerging European economies to use government spending to mitigate the micro transmission of shocks to households. Indeed, the ability of policy measures - in the face of external shocks - to mitigate the transmission to households was constrained by initial conditions in terms of fiscal space[7], exchange rate arrangements, and inflationary outlook. For a significant number of emerging European economies the ability to use government spending to address adverse economic shocks was generally constrained in the presence of large and hard to finance current account deficits which were exacerbated by a marked slowdown in revenue growth[8]. Shocks to households and the vulnerability of households to poverty in emerging

[CIS] were affected via second-round impact shocks linked to trade and remittance flows with the Russian Federation which begun to witness a real GDP contraction in 2009.

[7] Fiscal space refers to the government's ability to increase expenditure or reduce taxes without impairing the sustainability of its fiscal position.

[8] For example, between 2008-2010 growth in general government revenues was -2.8 per cent in Bulgaria, -3.2 per cent in Croatia, -2.1 per cent in Hungary, -3.5 per cent in the Russian Federation, and -3.9 per cent Ukraine

European economies, varied according to their exposure to (i) risks such as household indebtedness[9] and interest rate rises and opportunities for hedging; (ii) food and fuel price rises depending on the share of imported food and fuel in local consumption, (iii) the extent to which households were net producers or net consumers of food and the food share of total household consumption, and (iv) reliance on remittances. Rising levels of indebtedness reflected the benefits of financial sector development – which allowed households to smooth their consumption – but in the down turn indebtedness, particularly when denominated in foreign currencies, created the risk that households were unable to meet their consumption needs.

The worst decreases in GDP growth occurred in the emerging European economies of Latvia, Lithuania and Estonia which - due the small size of their domestic economies and their level of exposure to foreign banks - were extremely vulnerable to the crisis. This was partly a result of the fact that the preceding boom had created large imbalances in their economies and was causing them to overheat. For the majority of emerging European economies their vulnerabilities were accentuated by the fact that foreign-owned banks moved in and liberalised lending, often in foreign currency, to publics largely unaccustomed to credit – especially first-time homebuyers[10]. It is notable that Poland introduced special regulations to limit the volume of mortgages in foreign currency which slowed their growth, and households were not as exposed to mortgages denominated in foreign currency as much as in other emerging European economies.

At the macro level there were three main pathways through which the crisis was transmitted from advanced to emerging economies in Europe: (a) fall in exports, both because of a decline in their volumes[11] and – especially for exporters of commodities [such as gas, oil, metals cotton etc] – because of a sharp fall in their international prices[12]; and (b) decline in Foreign Direct Investment [FDI], given that emerging European economies had become a major recipient of FDI and the vicinity of the EU market[13]; and (c) a fall in remittances – over 10 per cent of GDP in Albania and 5 per cent in Romania and Bulgaria came from migrant remittances in 2007. With many migrant workers employed in the sectors hardest hit by the recession [such as household work, construction and agriculture], receipts of remittances in emerging European economies increased by only 5 per cent in 2008, compared with 21 per cent the previous year[14]. Figure 1 below describes in diagrammatic form the macro pathways

[9] In the emerging economies of Central Europe, as well as Ukraine and parts of South Eastern Europe, mortgage and household loans have – since 2002 - accounted for a much larger rise in household liabilities. Across all emerging markets, however, mortgage debt increased both in per capita terms and relative to disposable income.

[10] When household debt is denominated in foreign currencies or indexed to foreign currencies exchange rate depreciations can leave households un-hedged and subject to higher debt payments, and higher default and delinquency rates – particularly in contexts where unemployment rates have risen – which can have second round implications for the health of financial sector balance sheets.

[11] In the emerging economies of Central and Eastern Europe merchandise trade rose between 1998-2007 from 70 per cent to 107 per cent with the Euro zone as the main destination

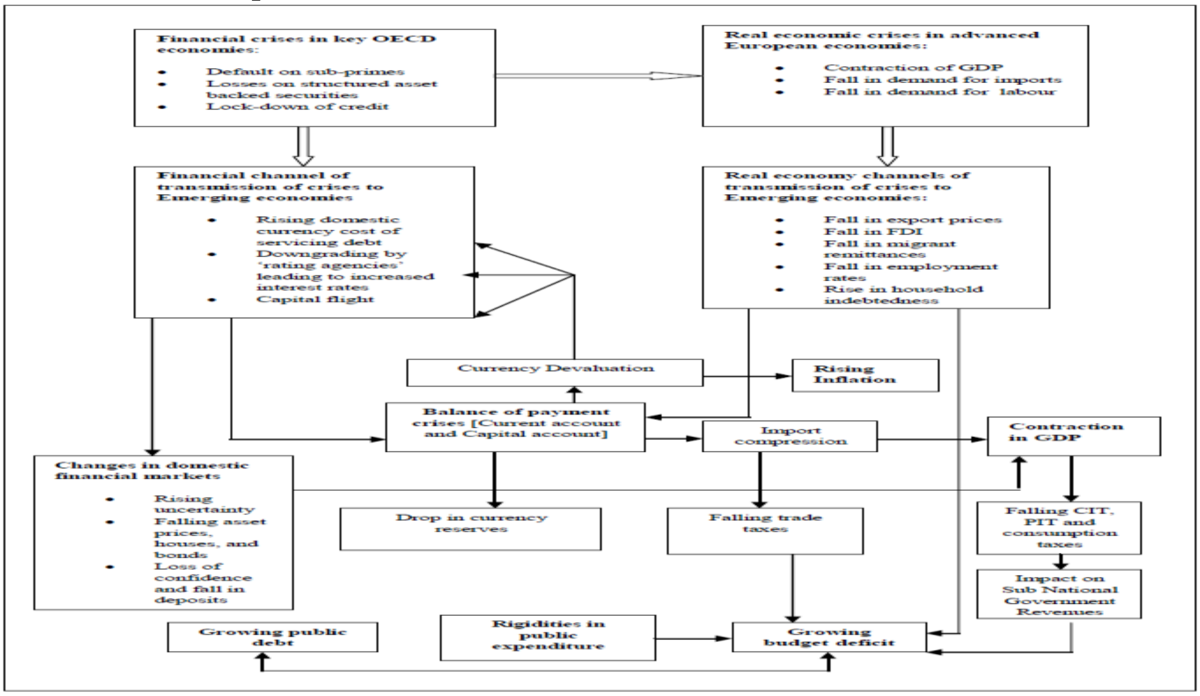
[12] For example, at the end of January 2009 the IMF composite commodity price index [2005=100] had fallen to 102 from a peak of 219 in July 2008 and from a pre-food-fuel bubble of 133 in June 2007.

[13] Central European and the Baltic economies, for example, received a total of US$263 billion in FDI over 1989-2007, even the less attractive South Eastern Europe region received US$116 billion during the same period, and European Neighbourhood Partnership [ENP] economies received US120 billion – EBRD [2009]

[14] CIS countries also suffered a decline in remittances – which is major source of revenue for low-income economies in the region. In 2007, international remittance receipts were the equivalent of 46 per cent of GDP in Tajikistan, 28 per cent of Kyrgyz Republic, and 34 per cent in Moldova

of transmission of the crises from advanced European economies to emerging economies in Europe[15].

Figure 1: Macro Transmission Channels of the Crises from Advanced to Emerging Economies in Europe:



Source: Joshua [2010a]

The severity of the financial crises and its impact on the real economy called for unconventional policy reactions. With monetary policy constrained by a zero bound limit in late 2008, advanced European economies responded to the crisis by launching fiscal stimulus packages composed of tax cuts, increases in transfers to people on low incomes, employment measures, infrastructure spending, transfers to business, and additional spending on education and health[16]. Several emerging economies in Asia and the Middle East also implemented substantial packages to support the demand side of the domestic and global economy[17]. Combining all national efforts, the world fiscal stimulus, according to the ILO [2009], amounted to approximately US$ 2 trillion or equivalently 1.4 per cent of world GDP, which was below the IMF's recommendation of 2 per cent of world GDP[18].

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[15] The figure is stylised and abstracts from several important elements – it is simplified and ignores second-round effects and the consequences of multiple shocks, and does not explicitly show how the social effects are distributed or the implications for local self government revenues and expenditures and the delivery of public services.

[16] The main argument used by policymakers in favour of fiscal stimulus measures was that the efficiency of monetary policy transmission channel had been reduced due to frictions in the credit market. Many central banks could not cut interest rates further as the "zero bound" for interest rates had been reached, and it was uncertain whether the quantitative measures which they adopted would suffice to counter the slump in economic activity. Fiscal policy was, therefore, regarded as a supplement to dampen the effects of the downturn.

[17] The front runner in relative terms was China, whose US$586 billion stimulus accounted for about 13 per cent of Chinese GDP followed by Saudi Arabia, Malaysia. However, the United States, whose "*American Recovery and Reinvestment Act of 2009*" was the largest package in absolute terms [US$787 billion]. Most European countries stimulus package ranged between 0.3 per cent in Italy and 1.3 per cent in the United Kingdom, which were substantially lower than the sample average of 2.8 per cent. The exception was Germany, whose two fiscal packages amounted to 3.1 per cent of German GDP.

[18] Blanchard [2008]

In advanced European economies two factors determined the size of the fiscal stimulus: differences in the necessity for stimulus and fiscal space. In emerging European economies, and well as in Greece and Iceland, the collapse of trade and capital flows put an end to growth trajectories and created external financing gaps which required large front-loaded financial assistance packages which were provided by the International Monetary Fund [IMF]. A number of these packages, designed to cushion the impact of the collapse and to smooth policy adjustments, were developed in close cooperation with Balance of Payment [BoP] support from the European Union [EU] and with EU member states inside and outside Economic and Monetary Union [EMU][19] zone, and with the World Bank, who provided Development Policy Loans [DPLs] and Public Expenditure Reviews [PERs] – See Table 2 for an overview of financial assistance measures supported by the IMF and the World Bank in a selection of advanced and emerging European economies. IMF supported measures focused on smoothing current adjustments, and mitigating liquidity pressures; while World Bank measures focused on reducing rigidities in public expenditures, including unwinding public sector wage bills and entitlement growth of the pre-crises period – imposed by laws and regulations - and measures for improving efficiency and protecting expenditures to support labour and social protection, education and health[20]. In some cases – such as in Latvia and Hungary – the participation of the World Bank in rescue plans entailed re-engagement in counties from which it 'graduated'.

Table 2: Financial Assistance by the IMF and World Bank [in US$] 2008-2010

Country	IMF	World Bank
Serbia	4.5 billion	150 million
Romania	17 billion	422.9 million
Poland	20.6 billion [Flexible Credit Line][21]	1.3 billion
Bosnia Herzegovina	1.6 billion	111.0 million
Iceland	2.1 billion	-
Latvia	2.35 billion	1.6 billion
Greece	30 billion	-
Ukraine	16.9 billion	.0.5 billion
Hungary	15.7 billion	1.4 billion

Source: IMF 2010, Joshua [2010a]

For emerging European economies, which turned to the IMF and the World Bank for financial support, the policy options for fiscal consolidation were - to varying degrees - also shaped by exchange rate regimes: (i) EU member states such as Hungary, Latvia, and Poland which are in the European Exchange Rate Mechanism [ERM11] had attendant requirements to maintain a peg to the Euro within a fixed band; (ii) for EU candidate and accession countries – such as Macedonia [FYROM] and Serbia – they were expected to demonstrate

[19] BoP support is permitted Under Article 119 of the Treaty Establishing the European Union for member states not yet part of the Economic and Monetary Union [EMU] of the EU, and under Article143 for members of EMU.

[20] Although spending in these policy areas might not harbour starker inefficiencies than other items, they do account for large segments of government spending, and so were a natural part of expenditure-based fiscal consolidation.

[21] The Flexible Credit Line [FCL] is a renewable credit line**,** which at the country's discretion can initially be for either a six-month period, or a 12-month period with a review of eligibility after six months. If a country decides to draw on the credit line, repayment takes place over a 3¼ to 5 year period. The FCL is designed to meet the increased demand for crisis-prevention and crisis-mitigation lending from countries with robust policy frameworks and strong track records in economic performance.

compliance with the EU's Broad Economic Policy Guidelines [BEPG] – including real and nominal convergence, joining ERM 11, and elimination of import duties on goods coming from the EU; while other countries - such as Ukraine – were not disciplined by the requirements expected of counties in the ERM 11 mechanism or by EU accession requirements. While a fixed exchange rate appeared advantageous during the pre-crises boom, the downturn that followed also intensified as a result. Thus for countries in groups (i) and (ii) IMF and World Bank programmes had to support countries' own choices of exchange rate regimes which had important policy implications for fiscal tightening, the likelihood of protracted recession, and the prospects of recovery. While some common trends exist among the policy measures adopted by the IMF and the World Bank in emerging European economies, it is noteworthy that pro-cyclical expenditure cuts have on average been higher in economies where the initial primary deficit was large, and as a result, their overall fiscal adjustments have been more significant with attendant impact on sub-national government budgets.

In advanced European economies countercyclical measures were adopted in 2008 and 2009 – see Table 3 below for the timing and distribution of stimulus packages - and the measures were more heterogeneous in both their composition and timing, showing no clear preference for early or late stimuli. Only Ireland, Spain and the UK implemented measures that took effect in 2008.

Table 3: Timing and Distribution of Stimulus Packages in Advanced European Economies

Country	2008	2009	2010	Country	2008	2009	2010
Austria	0	79	21	Luxembourg	0	65	35
Belgium	0	51	49	Netherlands	0	49	51
Czech Rep	0	56	44	Poland	0	70	30
Denmark	0	33	67	Portugal	0	100	0
Finland	0	47	53	Slovakia	0	41	59
France	0	68	32	Spain	32	44	24
Germany	0	48	52	Sweden	0	43	57
Ireland	6	39	55	United Kingdom	11	85	4
Italy	0	15	85				

Source: OECD, 2009

The share of tax cuts in stimulus packages declined significantly from the first wave to the second in many advanced EU economies – with countries like Germany and Spain clearly favouring tax cuts over direct spending in their 2008 packages,[22] but subsequently turning to more expenditure loaded plans in 2009. The timing of stimulus measures was linked to the size of the output gap that each country faced, and in the UK by the loss of sizeable tax revenues from the financial sector. The majority of advanced European economies implemented their stimulus measures in 2009 and 2010[23].

Section 2:

[22] Prasad and Sorkin [2009]

[23] Advanced economies in Asia and Oceania also focused their fiscal expansions in 2009, and in the US most of the fiscal impulses only became effective in 2010.

Social Policy Measures Adopted in Response to the Financial and Economic Crises in Emerging and Advanced European Economies

Fiscal stimulus packages that contributed to the rise in government debt and deficit have generally been regarded as a necessary means of stimulating the economy to bring countries out of recession. However, stimulus measures, even when well designed entail substantial costs and harbour risks to future financial stability including the exacerbating effects of age related expenditures [see Section 3 below]. Thus stimulus measures must met three basic requirements to ensure they are fiscally sustainable: they must be temporary, timely and targeted. Timely measures, once triggered, stimulate new spending quickly and so kick-in almost immediately. Targeted measures are usually aimed at individuals[24] who will spend the new resources they receive, and the temporary nature of stimulus measures must expire once the economy improves. These three features are crucial for maintaining the fiscal sustainability of public finances over the medium term if economies are to avoid being stuck with permanent, deficit-increasing tax cuts or spending increases that fuel debt and increase the deficit which have spill over into other economies.

For emerging European economies the measures adopted by governments – with IMF and World Bank support - for unwinding economic imbalances and meeting the simultaneous challenges posed by fiscal consolidation required redirecting social spending to produce more efficient and equitable social policies across labour and social protection – including social assistance and pensions – health, long term care, and education. Thus the need to restore conditions for future growth meant that measures adopted had to: (i) prioritise and be selective; (ii) strike a balance between issues that had been neglected during the growth years or where public expenditures had grown faster than GDP – such as the size of the wage bill; and (iii) ensure that safeguards were introduced to protect essential services to vulnerable populations; and (iv) devise short term [temporary] measures that struck a balance with permanent measures to address long term challenges. Hence for emerging European countries [and also for Greece and Iceland] the crisis opened-up opportunities for expenditure adjustments and to undertake reforms aimed at bringing about the achievement of structural changes. Thus in emerging European economies the challenge entailed the triangulation of short term fiscal consolidation, safeguarding essential social policy expenditures, setting the framework for the restoration of growth over the medium term and making that growth more sustainable.

<u>Measures Adopted in Emerging European Economies</u>:

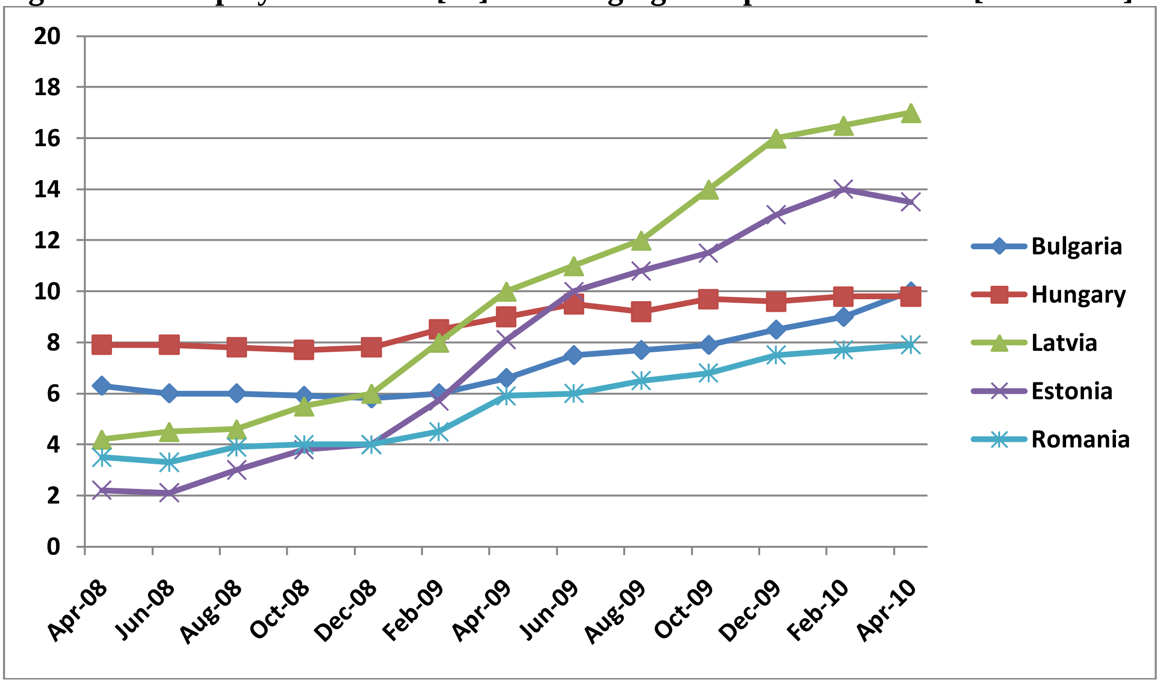
Safeguarding social policy expenditures posed numerous challenges not least the variation in emerging European economies pre-crises starting points. The section below provides illustrations of temporary and permanent measures that were adopted across key domains of social policy in emerging European economies:

Labour:

[24] A stimulus measure aimed at high income individuals, for example, is less effective as they are more likely to save a large share of any increase in disposable income. Thus targeting measures on people with low disposable incomes is more effective due to their propensity to spend rather than save.

Two major labour market characteristics influenced the scope of the impact of the crisis on the job market in particular emerging European countries. First, as a rule, economies with a better employment situation - such as Estonia and Latvia[25] - suffered most from the crisis, although many emerging European economies experienced labour market situations characterised by a lack of demand for labour[26] - see Figure 2 for overview of unemployment trends in a range of emerging European economies.

Figure 2: Unemployment Rates [%] in Emerging European Economies [2008-2010]



Source: authors calculations based on EBRD data [2010]

Under conditions of weak demand for labour, employment interventions usually have only limited levels of success or the programmes and their unit costs per beneficiary are too high to have a meaningful impact. However, a number of emerging European economies responded to the global economic crisis by providing additional resources for labour policies, and discretionary policy measures to cushion the negative effects of the crisis on workers and low-income households – including youth and women[27]. Bulgaria, Estonia, and Latvia, for example, also drew on European Social Fund [ESF] resources to bolster local efforts. Spending on unemployment benefits increased automatically as job losses mounted, and many governments moved to scale-up resources for active labour market measures [ALMMs]. However, constraints on public finances associated with the crisis limited the scale and scope of labour market interventions. Measures introduced [see Box 1 for country level observations by country level correspondents] can be grouped into four main types of policy interventions: (a) policies to create new jobs, (b) policies to protect existing jobs, (c)

[25] For example, employment rates in Estonia [70 per cent] and Latvia [69 per cent] were close to the EU Lisbon strategy employment targets; while in EU accession candidate economies employments rates were much lower – for example, 37 per cent in Macedonia [FYROM]

[26] In addition to the rising number of unemployed, many emerging economies in Europe witnessed significant increases in the number of 'discouraged workers' who are available and willing to work but did not seek employment, mainly because they believed there were no jobs available to them

[27] Unemployed youth and women represent groups of jobseekers that are particularly vulnerable in the labour market. Even in times of positive economic growth, youth unemployment rates are two to three times that of adults in many countries. An economic downturn diminishes the labour market prospects of less-qualified youth and women and increases their vulnerability to long-term unemployment.

policies to enhance employability of workers and job seekers through ALMMs, and (d) policies to provide additional income support. Interventions to directly create jobs were controversial since they can have significant costs and uncertain benefits, especially beyond the short term[28].

Box 1: Labour Market Measures – Country Level Observations

Bulgaria: The government adopted new and revised ALMMs, expanded public works, amended labour and employment legislation to introduce reduced work hours, and introduced wage subsidies to cover remuneration losses resulting from shorter hours, and adjusted unemployment benefit liability

Poland: The government amended the labour code to stabilise employment by allowing employers to adjust labour input by adjusting work hours rather than employment levels, and improving ALMMs – including training apprenticeships for school leavers, wage subsidies, public works and business start-ups, and assessing cost options for various government schemes – including "technical leave", impact of increases in minimum wage, addressing low labour participation rates, and reducing the tax wedge on disability contributions.

Social Assistance:

Emerging European economies devote an average of 1.7 percent of GDP to social assistance programmes and another 8.3 percent for pensions and other forms of social insurance. Most systems operate a mix of programmes, usually in the form of cash transfers, with an emphasis on family allowances [child allowances, maternity allowances, birth grants, etc.], social pensions, heating and housing allowances, and targeted anti-poverty 'last-resort' programmes. In many emerging European economies, the programmes within the social protection system are multiple and fragmented, leading to duplication of benefits[29]. Coverage of the poor by social assistance is not always correlated with fiscal effort as benefits are not usually targeted effectively. Often, less than 40 percent of the poor are covered and in some economies less than a third of those in the poorest quintile are covered[30]. Targeting of overall social assistance is impressive in a few cases – for example in Serbia, Romania, Armenia, and Lithuania. Given that there are close links between poverty and the labour market, social assistance benefits were of critical importance for the long-term unemployed, as unemployment benefits in emerging European countries usually have stricter time limitations compared with advanced European economies. Once insurance benefits are exhausted, beneficiaries become eligible to apply for social assistance. In economies such as Bulgaria, Estonia, Latvia, Lithuania, Poland and Romania[31] - guaranteed minimum income [GMI] programmes[32] provide social assistance payments of last resort to the poorest households, and are increasingly tied to encouraging attachment to the labour market, and in some cases are attached to tax credit and exemption from co-payments for health etc. Prior to the crises GMI programmes in emerging European economies covered between 1 and 4 percent of the total population and comprised 0.1 to 0.5 percent of GDP. In the context of the crisis governments focused on efforts to make significant reforms [see Box 2 for country level observations reported by correspondents] by consolidating programmes, refocusing design and eligibility criteria, developing and applying targeting tools, improving

[28] Large-scale direct job creation programme can be justified in times of economic downturn when aggregate demand is depressed and there are few vacancies
[29] *op. cit.* Joshua [2010a]
[30] *ibid*
[31] In Romania, for example, more than 80 percent of the benefits of the GMI programme accrue to the poorest quintile of households
32 Minimum income benefits are targeted means-tested benefits which are paid monthly, or on a one-off emergency basis, to poor households.

implementation arrangements, strengthening oversight, monitoring and evaluation, improving the focus on children, and reinforcing links between social assistance and ALMMs.

Box 2: Social Assistance – Country Level Observations

Romania: The government increased the GMI eligibility threshold by 15 per cent; maintained indexation of benefits to inflation, ensured 100 per cent funding of the GMI from the State budget, and conducted a public expenditure tracking survey [PETs] of social assistance benefits and GMI, and maintained universal child allowances for children up to 2 years of age, and for disabled children up to 3 years age.

Latvia: The government established the Emergency Social Safety Net [ESSN] which incorporated amendments to the law on Social Assistance and Social Services to increase the GMI for adults and children and the identification of funding to compensate providers of public transportation services to disabled people, children of pre-school age, and orphans.

Serbia: The government took measures to reverse the decline in allocations of material support for low income households and child allowances, increasing the coverage and improved the design of the most efficient and well-targeted social assistance programmes while progressively limiting spending on selected less efficiently targeted programmes, and adjusted equivalence scales for children to bring them in line with the EU Social Charter that was ratified by the Government in September 2009, and improved crises monitoring through a system of social indicators for tracking the demand for social assistance

Macedonia [FYROM]: The government took measures to protect social assistance from fiscal spending cuts and increased expenditures, undertook legislative reforms for improving targeting, improved means testing, reduced inclusion and exclusion errors, reduced programme fragmentation, improved information management systems, and improved delivery of conditional cash transfers to improve access to education for marginalised groups.

Pensions

The financial crisis had a significant impact on pensions systems in emerging European economies**.** Pensions systems in these economies have different configurations[33] with most having a three pillar system: a non-contributory [zero] pillar which is tax financed at a flat rate on the basis of age and residence rather than contributions, a pay-as-you-go [PAYGO] first pillar where contributions are paid by employers and current workers; and sometimes a second pillar – where contributions are kept in individual savings accounts - and a third pillar – where individuals can save additional voluntary contributions. The financial crises affected each component of the pension system differently. Thus as output fell and the tax base shrunk financing for the zero pillar also shrank; as unemployment rose, the revenues from workers and employers to finance the first pillar also shrunk; and the valuation of financial assets held in the second and third pillars also fell – combined with fewer contributions due to rising unemployment. These outcomes – in the absence of real GDP growth – had significant short, medium and long–term impacts. In the short to medium term the zero and first pillars placed additional pressures on public deficit levels; for the second and third pillars the drastic fall in asset values had a significant impact on the future pensions of workers currently contributing to these schemes. The impact of the financial crises on the pension systems in emerging European economies was compounded by two factors: (i) high pension dependency ratios [the ratio of beneficiaries to contributors] in relation to population dependency ratios [the ratio of individuals above 64 years of age to those in the working age population]; (ii) the rates of return earned by second pillar pensions had been modest relative to income growth during the preceding period of economic growth.

In the context of abrupt shocks to the fiscal position of pension systems, emerging European economies, some of which had even more generous pension provisions than advanced European economies, were forced into implementing policy changes across the pillars.

[33] See: Independent Evaluation Group [2006]; and Holzmann, MacKellar and Rapansek [2009]

Ukraine, one of the more rapidly ageing emerging European economies, spends 15.4 percent of its GDP on pensions, Serbia around 13 per cent, Poland around 12 per cent, while Bulgaria, Estonia and Latvia spend less than 8 per cent of GDP. There have been five important parameters that countries – [see Box 3 below for country level illustrations] – used to revise in their pension regimes in the context of implementing specific crises related reforms. First was the retirement age for men and women, which continues to be lower than the 65 years prevailing in some of the advanced European economies. Second was indexing pensions post-retirement to inflation rather than wages, to maintain their purchasing power, rather than to wage growth. Third, reduction in contributions rates in the second pillar. Fourth, vulnerabilities of the second pillar pension[34] systems due to regulatory limits and barriers to the increased effectiveness of investment by pension funds. Fifth, reducing the temptation to transfer second pillar contributions to the first pillar - which increases future liabilities in the second pillar.

Box 3: Pensions - Country Level Observations

Poland: The government enacted the Law on Bridging Pensions which reduced the number of people eligible for early retirement while safeguarding the base level of pensions for those affected by change and improvements in fiscal sustainability.

Hungary: By the time the financial crises hit Hungary the government had had started to address imbalances in the pension system. During the crises the government abolished the 13th pension payment, established new indexation rules that tied pension indexation to GDP growth which protects the purchasing power of pensioners and prevented the gap between wage and pension growth from increasing drastically, and regulatory and institutional improvement of the second pillar pension and developed plans for hedging against inflation risks of indexed liabilities.

Serbia: When the crises hit Serbia the government had taken measures to contain pension expenditures under a Precautionary Stand-By Arrangement [SBA] with the IMF by implementing a nominal pension freeze and inflation only indexation to reduce aggregate pension spending. The government also embarked on developing a new pension reform strategy to address medium term sustainability which focused on options for reducing pension benefit for early retirement and eliminating a 45 year limit on years of service; pro-rating minimum pensions for those whose contributions is for fewer than 35 years; moving towards equalisation of retirement ages for men and women; and indexing pensions for post-retirement, and new proposals for farmers pensions

Romania: The government took measures to index first pillar pensions increases to inflation instead of wages and to gradually equalise retirement ages between men and women.

Social Care Services:

Specific measures to reform or improve social care service – including long term care for the ageing population – did not feature significantly in the crises reform programmes of emerging European economies. However, in Serbia measures were introduced to improve financial formulas for the allocation of central government earmarked grants for expanding the provision of community based social services, for reinforcing incentives to diversify provision away from residential care, and for extending financial support for the provision of social care services in poor and small municipalities[35]; in Croatia measures were introduced to strengthen the existing framework of service delivery partnerships between central and

[34] The highest percentage of participating in the second pillar is in Estonia [38.5 per cent], and the lowest in Lithuania [17.6 per cent]. The highest ratio of fund assets to gross domestic product is in Poland [10.9 per cent], and the lowest in Latvia [1.2 per cent]. The economies with the largest second-pillar pension funds registered at the end of 2006 were Hungary [18] and Poland [15]; those with the fewest were Croatia [4] and Estonia [5]. The greatest percentage pension contribution paid to second pillar funds is in Slovakia [9 per cent], and the lowest in Latvia [4 per cent].

[35] Joshua [2010b]

sub-national governments and non-profit actors, and Poland, with World Bank support, undertook a review of social care service – including long term care services for the elderly[36]

Education:

Prior to the financial crises a number of emerging European economies [e.g., Moldova] were spending more than the average of advanced European economies, on the other hand a number of countries – such as Armenia - were spending much less than the average of advanced European economies. The variation in spending took place against the back drop of falling fertility rates – which reflects a steep downward trend in the population aged 0-7[37] and in school aged populations[38]. The result was small class sizes – for example average class sizes in Poland and Serbia are 20 and 17 respectively, compared with 22 in France and Germany. The efficiency and effectiveness of education spending varies considerably among countries. This variation is reflected in educational outcomes [whether enrolment rates, average years of schooling, or learning scores] than would be expected given the levels of per capita income or public spending on education, while other economies have worse outcomes than would be expected - which indicates that quality assurance remains a challenge across emerging European economies. The financial crises brought added urgency to government education choices, and governments [see Box 4 for country level observations] focused on a range of measures for improving efficiency and effectiveness – including pre-school financing, wage bill and salary adjustments, school management systems, and expanding tertiary education through the expansion of student loans and subsidies.

Box 4: Education: Country Level Observations

Bulgaria: The government stepped up efforts to increase access, improve quality and optimise the school network, introduce unified standards, increase the delegation of school budgets to municipal schools and kindergartens, and expand pre-school provision.

Poland: The government expanded compulsory access to pre-school education for 5 year old children, consolidated the school network, raised the entry level salaries for teachers, and took steps to improved quality and outcomes through the reform of vocational education.

Armenia: The government addressed declines in public funding for education and focused on measures for improving quality assurance, and expanded a state-backed loan scheme for improving access to the poor, identified measures for expanding pre-school education, and improved arrangements for public-private partnerships to support improvements in innovation.

Health

Many emerging European economies made significant progress in health care reforms over the last 10 years and increased spending levels – as a proportion of GDP – during the preceding period of growth. The increased levels of spending enabled the delivery of primary health care to undergo major improvements, the introduction of measures to regulate medical practices, improve the quality of care, and improve mechanisms for demand

[36] World Bank [2010]

[37] Countries with the largest fall in such numbers include Bulgaria, Estonia, Georgia, Latvia, Moldova and Romania.

[38] The fall in school-age population is expected to continue over the next few years – with the largest declines predicted in Belarus, Georgia, Lithuania, Moldova and Poland.

management[39]. At the same time, a substantial unfinished agenda remained, which was exacerbated by the crises, particularly with regard to (i) the health care financing[40], (ii) the ability of households to pay for private health care, or to make co-payments to public or social health insurance [SHI] schemes, (iii) the dominant use of hospital based care and extended stays in inpatient facilities accompanied by excessive, and expensive to maintain, hospital infrastructure; (iv) the emerging priority of cost-effective interventions for non-communicable diseases; and (v) the high costs of pharmaceuticals which represents the largest component of out-of-pocket [OOP] spending for most people. The situation was exacerbated as real government spending on health care declined due to reduced revenues from the general government budget, falls in contributions, and wages freezes on payroll funded Social Health Insurance. Overall, population ageing combined with technological and relative price developments were also creating strong upward pressures on future spending.

To address the indirect impact of the crises, governments in emerging European economies have focused on cutting budgets for health care providers, increasing cost sharing, reducing or cutting back on planned expansion of coverage of medicines and mobility aids, reducing supply by increasing the waiting times for treatment – many of which will have unintended impacts on health related hardships and financial burdens on families already affected by the economic slowdown. Broadly speaking the actions taken in emerging European economies can be divided into two broad classes: (i) policies, mainly of a budgetary or regulatory nature, aimed at restraining inputs and costs, and (ii) shifting the financing of health care to the private sector or devolving responsibilities to sub-national government[41] in the form of higher cost-sharing.

Overall, the crisis had systemic impacts on health finance which meant services needed to be provided in more efficient ways. This was particularly acute where the enlarged pool of vulnerable groups who required subsidising from the general budget increased in the wake of fewer contributors to SHI and falling or reduced tax revenues. Governments [see Box 5 for country level observations on health reforms] have focused on a range of measures for improving efficiency and effectiveness – including expanding family medicine models, reducing or formalising OOP expenses that can have catastrophic impacts on households and individuals, reducing informal payments, targeting services on the poor and vulnerable – including child and maternal services, and selected cuts in public resource allocation by reducing excessive use of in-patent care services.

[39] countries have often increased cost-sharing to avoid excessive demand, reformed compensation systems for providers so as to boost productivity and some have raised competition at the provider level and/or at the level of insurers

[40] Governments in emerging European countries initially mainly relied on macro-type controls on resources and budgets. Subsequently, they are progressively turning towards incentive-based reforms, with the objective of steering both demand and supply and improving micro-efficiency

[41] Romania, for example, took the step of initiating plans to devolve the management of regional hospital services to sub-national government under the rubric of its wider plans for administrative decentralisation. The plans are linked to the reduction of bed numbers, the establishment of hospital boards, and establishing a system for classifying hospitals.

Box 7: Health - Country Level Observations

Armenia: The government focused on reducing OOP expenses, introduced official copayments and fee waivers that have sought to protect the poor and vulnerable, increases rates of hospital service reimbursement, improved GP and primary health care services, and strengthen health management systems

Bulgaria: The government focused on controlling hospital spending [which accounts for 56 per cent of the National Health Insurance Fund], unifying the methods of payment for hospitals, improving contracting arrangements between hospitals and regional insurance funds, reduced supply induced demand, refined pharmaceutical policy and strengthened the framework for cross-referencing drug prices with advanced European economies.

Latvia: The government focussed on increasing hospital efficiency – including reductions in the number of beds – and developing hospital business plans, expanding the network of community nurses to support GPs, reduction in reimbursement rates to providers, increases in patient co-payments to reduce the use in services while exempting immunisation and maternity care services, reduced co-payments for children under the age of 18, and reduced salaries and staff numbers at Ministry and subordinate agencies., and helped municipalities maintain subsidies to poor households.

Serbia: The government embarked on the reduction of hospital bed occupancy, shifted away from input-based financing which encouraged inefficiency in the use of resources and introduced measures to strengthen incentives to improve service volumes and quality, and shifted towards a capitation based payment system in which physicians are to be paid according to the number of patients in their rosters

Overview of Measures in Emerging European Economies

The financial crisis forced governments in emerging European economies to cut expenditures. The downward trend in the economy and the dwindling of international credit required reductions in spending even if deficits were macro-economically sustainable. In the short-term, the options open to emerging European economies were limited – particularly in the context of diverse transmission channels and secondary effects - and have in some cases required across-the-board cuts in major economic categories of social spending. But cuts in themselves are not long term solutions. Over time, they lead to a continuing deterioration of services and, in and of themselves, do not address structural inefficiencies. Emerging European economies have therefore started had to focus on more fundamental reforms, even if the payoff, in fiscal terms, is not immediate. The measures adopted to cope with the crisis have different fiscal impacts over different time horizons and have differing degrees of impact on the efficiency of essential areas of public expenditure. In some cases, such as changes in pension systems, the timing and scale of the fiscal impacts can be determined with some accuracy. In other cases – such as ALMMs, social assistance benefits, social care, education and health – it has been less easy to be accurate.

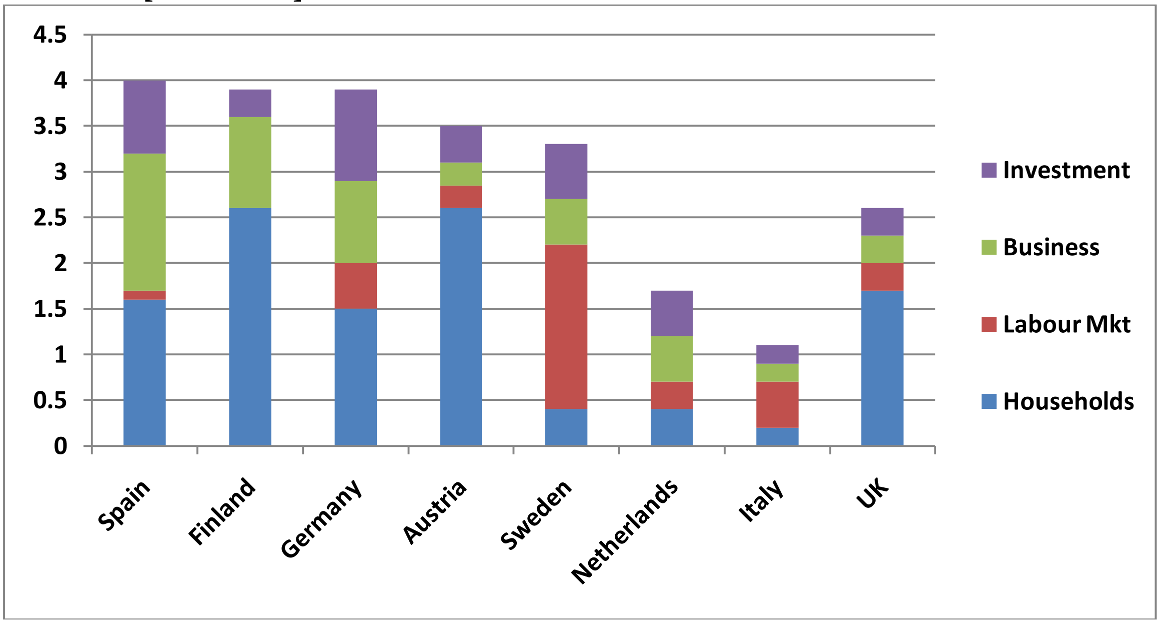
Looking ahead, significant challenges remain for fiscal consolidation and for structural reforms in labor, social protection, education and health. Despite some early signs of stabilisation current account deficits still need to adjust in some cases, and the balance sheet problems of banks, companies, local governments, and households may yet intensify in the process. For the majority of emerging European economies, the crises wiped out most of the steady gains in poverty reduction and employment growth[42] achieved over the last decade. The return to sustainable growth in these economies is hinged to domestic policy reforms, but also - to a significant extent - dependent on the implementation and coordination of policies in the advanced European economies.

Measures Adopted in Advanced European Economies

[42] After the 1998 Russian crisis through to 2006, over 50 million people moved out of poverty in Central and Eastern Europe. Poverty fell throughout all the sub-regions of Eastern Europe, with the middle-income countries of the Commonwealth of Independent States [CIS] experiencing the largest declines in poverty – see World Bank [2010]

In contrast to emerging European economies policy interventions in advanced European economies initially took the form of strong countercyclical policy interventions that focused on employment measures and expansion of social protection systems [e.g., social assistance, tax credits, tax exemptions, and housing support[43]] which acted as automatic stabilisers[44] to mitigate the social consequences of the crises. Expansion of education infrastructure – particularly early-years provision and vocational training for young people – to promote and protect the formation of human capital also featured. Less emphasis was immediately placed on measures that focused on health[45] or reforms [parametric and structural] to pension schemes. For the advanced European countries their policy responses varied in size and emphasis – combining measures aimed at households, businesses, labour market programmes, and increased investment expenditure – see Figure 3 for an overview of the composition of recovery measures in advanced European countries.

Figure 3: Composition of Recovery Measures [% of GDP] in Advanced European Countries [2009-2010]



Source: European Commission [2009c]

In advanced European economies, the impact of the crises on employment varied greatly – for example unemployment rates increased significantly in Ireland, Spain, Denmark and Slovakia, but remained relatively stable in Germany, Luxembourg and the Netherlands [see Figure 4 below]. The characteristics of unemployment, in forms similar to emerging European economies, revealed that particular categories of workers were hard hit by the crises – particularly the young and those holding temporary contracts. The take up rates of

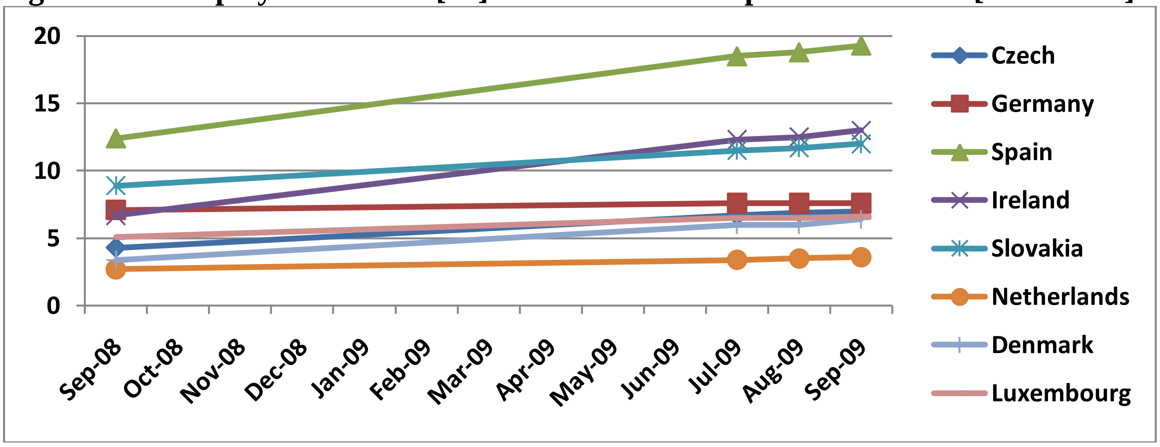
[43] Measures to protect householders was linked to household indebtedness, the growing number of non-performing housing loans recorded [e.g., Iceland], and increases in home repossessions particularly in Denmark, Spain, Greece, Ireland, the Netherlands and the UK

[44] Countries with in which automatic stabilisers – to boost growth, absorb shocks, and forestall a negative downward spiral - are larger [such as social assistance and unemployment insurance] require smaller discretionary stimulus. Thus fiscal; expansion in a particular country should be larger if multipliers are lower – see Baunsgaard and Symansky [2009] for a review of the role of automatic stabilisers.

[45] The exception was Germany which as part of its stimulus measures expanded employment in the hospital sector, and the reduction of wage-based contributions to social health insurance.

benefits also increased – although the number of claims on social assistance [i.e., last resort schemes] was dependent on how early the crisis hit, and on the coverage and duration of unemployment schemes. The advanced European economies with the largest number of unemployment claimants between 2008 and 2009 were Ireland and Austria; while pressure on last resort schemes increased significantly in Denmark, Czech Republic, and Slovakia[46] and are expected to increase in both Iceland and Greece. As the length and depth of the crises became more pronounced, and employment growth came to a standstill in 2009, advanced European countries begun to turn attention to questions of budgetary discipline for public finances in general and social protection in particular – including pensions, health care, and long term care. The section below provides illustrations of temporary and permanent measures that were adopted across key social policy domains in advanced European economies.

Figure 4: Unemployment Rates [%] in Advanced European Economies [2008-2009]



Source: Eurostat – LFS [2009]

Labour:

By the end of 2009 all advanced European economies had taken a mixture of measures to preserve employment – though the measures adopted built on existing policies rather than the introduction of completely new measures – emphasis was placed on short term working [STW][47], youth unemployment, reductions in employer social insurance contributions to reduce the tax wedge of labour, and the expansion of job training[48]. Box 8 below provides illustrations of the types of labour market measures that were undertaken in particular economies.

Box 8 Labour Market Measures – Country Level Observations

Czech Republic: the government introduced lower social insurance contributions for enterprises and for the self employed, skills training for workers in companies affected by the crises, and expanded vocational training for young people.

Spain: the government introduced two specific State wide funds valued at €11 billion to stimulate investment and employment, reductions in social security contributions, expanded of vocational skills training, and expanded public works.

Germany – the government introduced measures for the significant expansion of Short Term Working [STW] to avoid redundancies, and expanded vocational and skills training

Austria – the government expanded public works for long term unemployed, expanded STW, increased wage subsidies, and expanded ALMMs for young people

Ireland: the government established the Labour Market Activation Fund worth €20 million as part of Budget which is expected to provide at least 6,500 education and training places; also an additional 500 Community Employment training places – which helps long term unemployed return to work - bringing the total number of places available to 23,300

attached to achieving fiscal sustainability over the medium term.

Social Protection Measures [Social Insurance, Social Assistance, Tax Credit/Allowances and Exemptions]

Advanced European economies devoted considerable proportions of their stimulus measures to social protection – including increases to minimum wages, extending the coverage/duration of unemployment benefits, and expanding tax rebates, tax credits and tax exemptions for low income groups. Most of these schemes were composed of blend of temporary [e.g., increase in job seekers allowance in Ireland] and permanent measures [e.g. extension of unemployment insurance to young people ending a fixed term labour contact in France], and, in a trend similar to emerging European economies, reforms to social assistance were more closely aligned to ALMMs. Ireland was one of the few countries that actually reduced the scope of existing social protection measures, while Greece – whose social protection system comprised of allowances, exemptions and privileges had largely been geared to supporting those in work rather than reducing poverty – embarked on system wide reform to better align its social protection system with EU norms and standards[49]. Box 9 below provides illustrations of measures adopted by particular advanced European economies**.**

Box 9 Social Protection – Country Level Observations

France: disability and old age minimum benefits were increased by 25 percent, one-off bonus payments to GMI beneficiaries, enhanced allowances for people with disabilities, increased eligibility for social insurance coverage to young people,

Ireland: increase of €515 million for social welfare payments –including pensions, but cuts in early child care supplement and its replacement with 1 year of free pre-school provision, and increase in job seekers allowance but linked to increase in the number of required previously paid social insurance contributions from 52 to104 – thus making eligibility to the jobseekers allowance more stringent.

Spain: tax credits were expanded to cover 16 million individuals, increase in minimum pensions, reduction in income tax for people on low incomes, removal of waiting periods for accessing unemployment benefits, and expansion of rights to unemployment benefits to self employed persons

Greece: measures were taken by the government to mitigate the impact of the financial and economic crisis on the most vulnerable groups including the decision to shield people with low wages and pensions from the impact of wage and pension cuts. The elimination of the 13th and 14th pensions was compensated, for those receiving less than €2500 a month, by introducing a new flat bonus of €800 a year. Largest annual overruns in the budget have consistently come from the social security funds, and the EU will be undertaking a full overview of all social security and social assistance programmes.

[49] See IMF [2010] and EC [2010c]

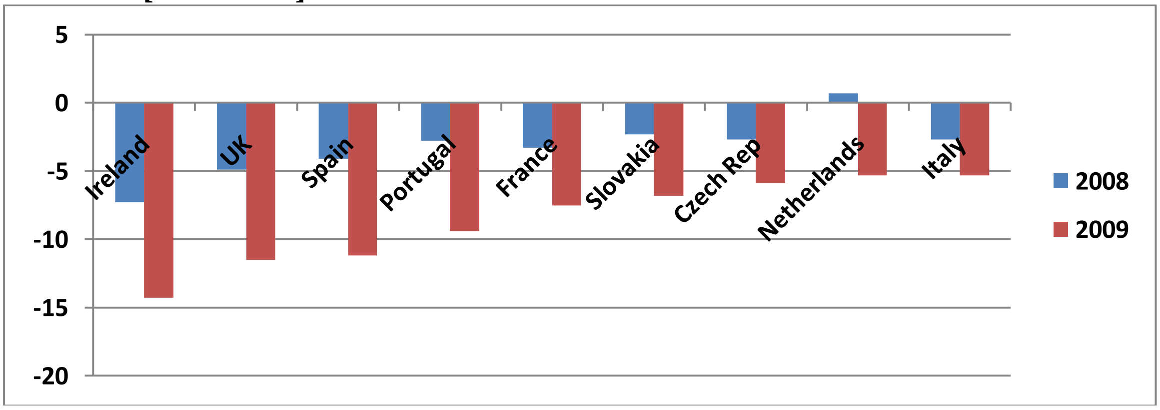
Social Care:

Unlike emerging European countries, a number of advanced European counties addressed long term care as part of their crises measures. Austria increased long term care allowances to enable older people to stay in their homes; Germany made provision to expand employment in the provision of long term care by creating 20,000 additional jobs in the sector; Iceland, under the rubric of fiscal consolidation, embarked on measures for the expansion of long term care as part of a wider job creation programme; in the UK [England and Wales] the government initiated a review on the future funding for long term care services[50]; and in Finland measures were taken to expand the approach adopted in Kainnu region[51] for the integration of health and long term care services for the elderly.

Overview of Measures in Advanced European Economies

Measures introduced to support the most vulnerable and facilitate their reintegration into the labour market represented more than 50 per cent of all recovery measures undertaken in the advanced European economies. Most of the measures aimed to support household purchasing power were, however, temporary with clear end dates or budget thresholds. In the effort to avert the risks of a perverse spiral between output losses, worsening balance sheets, rising credit risks, rising levels of job insecurity and adverse effects on spending behaviour, the fiscal position deteriorated [see Figure 5 below for an overview of the growth in government deficits] in most of the advanced European economies.

Figure 5: Size of Government Fiscal Deficits in 2008 and 2009 in Advanced European Countries [% of GDP]



Source: Eurostat [2010]

As the deterioration in economic growth lessens and the fiscal space for stimulus diminishes the urgency attached to addressing structural problems, in both advanced and emerging European economies, has become more pronounced. Within this new environment the pecuniary and non-pecuniary consequences[52] of the recession in advanced and emerging

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[50] The review initiated by the new UK government that was elected in 2010 precedes earlier reviews initiated by the previous administration.

[51] The Kiannu region is sparsely populated but rapidly ageing. In the early 2000s the authorities adopted measures to integrate ageing-related factors into regional development plans – these plans were elaborated under the rubric of the "Ageing Report" commissioned by the Finnish Prime Minister's Office in 2009

[52] Including, the balance between paid work with caring and family responsibilities towards care for older people and care for children - all of which necessitate a mix of income maintenance and care services that require new *institutional complementarities* – see Cerami and Stubbs [2009] – that take into account structural changes in labour markets, gender roles, and family and household composition.

European economies are likely to endure beyond the recession period, and sharper trade-offs will be required at a time when the options for growth-enhancing policies have become narrower – particularly for countries with large fiscal deficits and/or significant structural rigidities.

Labour markets in both advanced and emerging European economies face the risk of hysteresis[53] and the emergence of new forms of unemployment which could have negative impacts on potential output. This and other upheavals are not solely confined to the effects of the current financial situation, but are related to more profound structural changes that urgently need to be considered – including (i) options for increased targeting of social assistance, (ii) new thresholds for tax allowances and tax credits, (iii) revisions to existing marginal tax rates[54] for those transiting from welfare into work in order to minimise the risk of "benefit traps" that make it financially unprofitable for people to move into employment because their benefits exceed expected future earnings, and (iv) parametric changes to existing pension regimes [such as raising the statutory retirement age, reducing benefits, or increasing contribution rates] without significantly increasing the tax wedge on labour costs; and (v) devising sustainable mechanisms for funding long term care.

In addition, the income of social security schemes has fallen considerably as direct result of the crises. This reduction was due essentially to a decline in social contributions and income from investment, and a fall in public subsidies and in subsidies between schemes[55]. The fall in income and reserves has been compounded by the considerable rise in social protection expenditures due to the increased demand in unemployment benefits, housing benefits and social assistance. Consequently, many insurance-based social protection programmes are likely to face considerable financial problems which may have been compounded by the reduction in social contributions granted to enterprises. While measures such as additional benefits or freezing envisaged increases in contribution rates may have increased the disposable income of individuals or facilitated the financial situation of enterprises, such measures also put at risk the sustainability of social security systems. These risks are accentuated by increases in ageing related expenditures which are more latent and covert, and will exert significant additional demands on future public budgets. In all events, fiscal stability measures are being forced back on the national policy agendas of advanced European economies, and strategies have sought to reduce, albeit cautiously, both public spending and debt levels which – in some respects - have mirrored measures that were confronted earlier in emerging European economies.

Section 3:

[53] Hysteresis refers to a permanent loss of human capital due to long term unemployment in the event of a protracted slow down i.e., the hysteresis effect.

[54] Marginal tax rates on work can be a significant disincentive for enabling the transit from receipt of welfare and into work. For example, in the UK marginal tax rates can be as high as 97 per cent thus making people worse-off in work than they would be if they remained in receipt of social welfare benefits.

[55] In certain cases, such as the National Pensions Reserve Fund in Ireland and the Retirees Reserve Fund in France, losses amounted to as much as five years income from investments and nearly 25 per cent of the net value of their assets – see Flùckiger [2010]

The Challenges Confronting Fiscal Sustainability and the Exacerbating Effects of Age Related Expenditures

The concept of fiscal sustainability concerns the long-term ability of governments to meet the financial obligations linked to their current debts and future obligations – a sustainable[56] position involves a debt level that does not entail interest payments so large that they cannot be paid and prevents the government servicing the costs of its debt through revenues. In both advanced and emerging European economies the effects of population ageing exacerbate fiscal sustainability. This is because the fiscal costs of the crisis and projected demographic developments compound each other and make fiscal sustainability an acute challenge. The level of public debt and deficit is an important measure of assessing the sustainability of public finances: a high government deficit over several years leads to the accumulation of public debt, and if debt becomes sufficiently large governments have to consolidate expenditures and/or raise taxes.

Policy shifts towards fiscal consolidation have been driven by: (i) a dramatic increase in gross debt-to-GDP ratios between 2007 and 2011 [see Table 5 below] on the back of fiscal stimulus measures, (ii) the deteriorating budget positions due to reductions in consolidated government revenues and expenditures, and (iii) the need for a balance between temporary stimulus measures [with sunset clauses] and permanent stimulus measures with a durable impact on budget balances[57]. With the approaching expiry of countercyclical measures in most advanced European economies, and a tentative recovery seemingly underway, attention has turned to: (a) structural measures for addressing the legacy the recession has left for the public finances particularly the size of government deficits; and (b) to fiscal adjustment [including further measures for pension reform and increasing and equalising the retirement age for men and women, improving the targeting of social protection measures, strengthening labour market activation, and spending on health and long-term care in the context of demographic ageing] and strengthening fiscal discipline at both national and sub-national levels in a context where the public finances of many economies have already become, or are at least at risk of becoming, unsustainable.

[56] The common definition of debt sustainability goes beyond the absence of a *de jure* sovereign default. Consequently, public debt sustainability refers to a sovereign country's ability to service debt without large adjustments to public revenue and/or expenditure and without increasing public-debt-to- GDP ratios. Hence, debt sustainability refers to both a country's ability and willingness to repay its debt. Under the EU Stability and Growth Pact [SGP] advanced and emerging EU member states are required to meet the maximum 60 per cent ratio of public debt to GDP, and a maximum public deficit of 3 per cent of GDP - unless these ratios are judged to be close to being satisfied and are falling at a sufficiently fast rate towards their ceilings.

[57] Effective fiscal stimulus requires, in addition to being timely and well targeted, that tax and spending changes must be temporary and not increase long-run budget deficits – see Elmendorf and Furman [2008].

Table 5: Changes in Government Debt Ratio's in a Cross Section of Advanced and Emerging European Economies:

	Gross Debt Ratio					% Change in Debt Ratio
Country	**2007**	**2008**	**2009**	**2010**	**2011***	**2007-2011**
Advanced Economies						
Belgium	84.2	89.8	96.7	99.0	100.9	16.7
Germany	65.0	66.0	73.2	78.8	81.6	16.5
Ireland	25.0	43.6	64.0	77.3	87.3	62.3
Greece	95.7	99.2	115.1	124.9	133.9	38.2
Spain	36.2	39.7	53.2	64.9	72.5	36.3
France	63.8	67.5	77.6	83.6	88.6	24.8
Italy	103.5	106.1	115.8	118.2	118.9	15.5
Luxembourg	6.7	13.7	14.5	19.0	23.6	16.9
Netherlands	45.5	58.2	60.9	66.3	69.6	24.1
Austria	59.5	62.6	66.5	70.2	72.9	13.1
Portugal	63.6	66.3	76.8	85.8	91.1	27.5
Slovenia	23.4	22.6	35.9	41.6	45.4	22.0
Finland	35.2	34.2	44.0	50.5	54.9	19.7
Slovakia	29.3	27.7	35.7	40.8	44.0	14.7
Czech Republic	29.0	30.0	35.4	39.8	43.5	14.6
Denmark	27.4	34.2	41.6	46.0	49.5	22.1
Sweden	40.8	38.3	42.3	42.6	42.1	1.3
United Kingdom	44.7	52.0	68.1	79.1	86.9	42.2
Emerging Economies						
Bulgaria	18.2	14.1	14.8	17.4	18.8	0.6
Estonia	3.8	4.6	7.2	9.6	12.4	8.6
Latvia	9.0	19.5	36.1	48.5	57.3	48.3
Lithuania	16.9	15.6	29.3	38.6	45.4	28.5
Hungary	65.9	72.9	78.3	78.9	77.8	11.9
Poland	45.0	47.2	51.0	53.9	59.3	14.3
Romania	12.6	13.3	23.7	30.5	35.8	23.3

*Forecast
Source: based on ECFIN 2010 Spring Economic Forecast

The need to reduce government fiscal deficits and debt levels is more acute in the advanced European economies, where reversing the debt build-up will be a daunting fiscal challenge. The fiscal outlook for emerging European countries is significantly stronger and debt ratios are projected to return to pre-crises levels by 2013[58]. In designing fiscal exit strategies policy makers in advanced European economies have had to face a key choice – whether government debt should be stabilised at higher post crises levels or whether it should be brought down to more prudent levels. However, simply stabilising debt ratios at post crises levels is unlikely to be insufficient given the increase in the number of advanced European economies with debt ratios near or above 100 percent – which may lead to sizable increase in real interest rates which would slow potential growth and harm the poor and vulnerable[59].

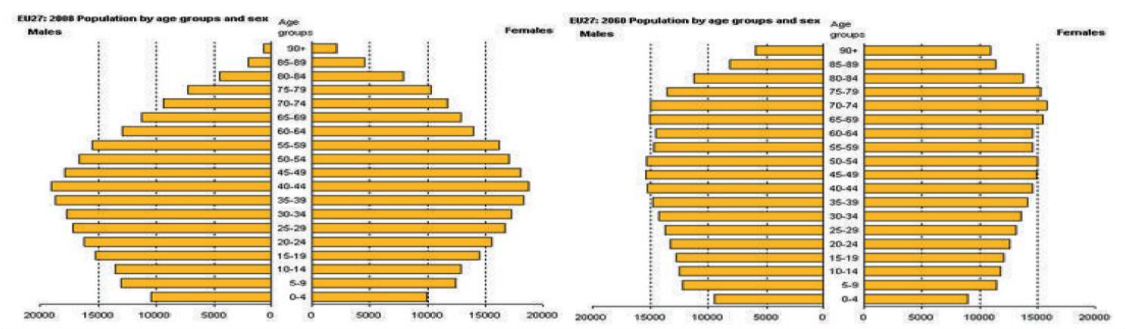
Spending related to ageing exacerbates fiscal sustainability because of longevity gains combined with falling fertility rates which lead to shrinking working age populations. Essentially the three main factors that are driving the ageing of both advanced and emerging European economies can be identified as: (i) ageing of the baby-boom generation [1945-65] as they reach 65+ in 2010 and beyond; (ii) much lower fertility since the baby boom

[58] IMF [2010b]
[59] For example, Italy which had the highest debt ratio prior to the crisis has experienced slow growth for at least the past two decades and hindered the ability of the government to respond to the current crisis.

phenomenon; and (iii) rising life expectancy at older ages [a critical factor that is likely to continue]. Lower numbers of economically active people leads to lower economic growth and lower tax revenues, while a higher number of retired people entail additional public provision of age-related transfers and services. These factors will have an adverse impact on employment and economic growth in both advanced and emerging European economies[60]. Ageing has not occurred in isolation and has emerged in the context of increasing flows in human and economic capital across national boundaries at regional and global levels. Thus while an appreciation of the dynamics of human and capital flows is essential to address the challenges of ageing societies, it is also necessary to understand the dynamics of ageing as a complement to human and capital flows. Hence the ageing of populations in advanced and emerging European economies is influenced by population dynamics beyond the region[61], and many governments have as yet to come up with a clear and convincing perspective on possible solutions to tackle these issues.

Though the debt and deficit increases – resulting from the crisis - are by themselves significant, projected impact on public finances of ageing populations[62] is anticipated to dwarf the effect of the crisis many times over - particularly in advanced European economies where estimates[63] suggest that the net present value of future spending increases due to ageing will be more than ten times as large as the fiscal costs of the crises. The scale of the transformation that will result from ageing in EU states is depicted in Figure 6 below, and illustrates that the base of the population pyramid – comprised of children aged less than18 years - is expected to become smaller between 2008 and 2060 due to below-replacement fertility rates – with the emerging economies of Hungary Latvia, Bulgaria, Lithuania, Poland and Romania witnessing declines of greater than 25 per cent in the number of children, while at the same time witnessing growth of over 150 per cent in the number of older old [i.e., over 80s] – a feature that is also projected in a significant number of advanced European economies including Ireland, Italy, Slovakia, Spain, Greece and Portugal. As a consequence, the shape of the age distribution will gradually change from a ‘pyramid’ to a ‘block’.

Figure 6: Ageing Profiles: Advanced and Emerging Economies in the EU [2008-2060]



Source: Eurostat [2010]

Significant challenges therefore lie ahead with ageing-related spending, especially with regard to:

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[60] Particularly in Italy, Poland, Hungary, Bulgaria, Russia, Ukraine and Romania which are also confronted with population decline

[61] For example, while it took advanced European countries some 120 years to go from young to mature population, maturity being achieved in 2000, such a shift in the proportion of young and old will have occurred in Asia in less than 25 years – see Harper [2010]

[62] IMF [2010c]

[63] IMF [2009]

Pension expenditures: which increases with an older population, and consist of old age pensions and survivors' pensions, early retirement funding, various disability benefits and other items of public expenditure that provide support for those unable to work. The extent to which such expenditure increases depends on both the degree of ageing – the number of retirees and the average length in retirement, which is directly linked with longevity – but also very significantly on the retirement age and the structure of the pension and support systems in place. Pension systems typically constitute a significant portion of the public budget, but their structures vary widely, in terms of their generosity and their dynamic properties. In the absence of changes to policy, public pension expenditure is projected to increase significantly due to the demographic trends with more people retiring and spending more years in retirement due to the increase in longevity.

Health Care: is affected by the age structure of the population and the way total health-related costs are split between governments, user contributions [through legitimate out of pocket expenses], and private insurance bodies. However, the link between age and the cost of healthcare is much less linear than for pensions. Although the consumption of healthcare services by the elderly is substantially larger than that by prime-age adults, an increase in life expectancy is typically also accompanied by an increase in the average number of healthy years and so healthcare costs need not increase in a linear fashion. Analysis of past trends in healthcare expenditure suggests that technological developments – i.e., new and better treatments[64]– are responsible for a significant part of overall costs growth, which may result in a significant increase in spending which is not fully captured in projections. However, technological advancement may also have positive effects on reducing costs of medical treatments through efficiency gains [faster and better treatments]. Overall there is large uncertainty as to which factor will dominate in the future.

Long Term Care[65]: relates to the costs associated with helping people carry out activities of daily living [ADL]. These costs are expected to increase with an ageing population. The increase depends, as with the healthcare expenditure, on the 'quality' of ageing, but also crucially on the range and type of support available for individuals less able to look after themselves. There is large variation between advanced and emerging European economies in terms of their reliance on informal care [usually provided by family members] which might be difficult to maintain going forward given the sheer numbers and their geographical/spatial distribution, changes in gender roles, and by pressures in the labour market. The growth in numbers of the older old [aged 80+] will constitute the fastest growing age class of the population in the future and is likely to account for a significant rise in expenditures on long term care.

Education: expenditure on education, as a share of GDP, tends to fall as the population ages, as young people make up a smaller share of the population. This requires radical shifts in the ways education services [pre-school, primary, secondary, post secondary and adult education services] are managed and delivered. However, public expenditure on education is only partly determined by demographics. So while a decrease in public education

[64] New and better treatments are also one of the reasons that explain increases in longevity over the last decades.
[65] Long-term care brings together a range of services for people who depend on ongoing help for an extended period of time with the activities of daily living. This can be due to chronic illness, physical or mental disability or as part of care at the end of life. These services include help with everyday activities of housekeeping, transport, self-management and social activities but have frequently a focus on more intensive personal care such as bathing, dressing, getting in and out of bed or chair, moving around and using the bathroom

expenditure ratios may result solely from changes in the demographic composition [i.e., fewer children in the future] other factors – such as policy ambitions to increase attainment, or increase levels of enrolment in higher education – also affect education spending and may dominate over savings that demographic changes can offer.

Unemployment benefits and social assistance: are also expected to put relatively less pressure on government balances, as the higher dependency ratio is likely to result in lower levels of unemployment amongst labour market participants. However, there are likely to be trade-offs with expenditures on incentives to participate in the labour market for working age individuals – particularly with regard to addressing youth unemployment, reducing child poverty rates, and providing in-work tax credits.

In advanced European economies where coverage by these systems is more extensive, the share of the elderly population is often larger and spending is high, the primary objective will be to stabilise expenditures. In contrast, in the emerging European economies, which generally have lower expenditures due to less extensive coverage, the challenge is to expand coverage of services provided by these systems, but in a manner that does not generate imbalances. According to the EU's Ageing Report 2009[66] - ageing related expenditures – and old age dependency ratios - are expected to increase in emerging European economies due to large increases in life expectancy at birth, for both males and females in Estonia, Latvia, Lithuania, Hungary, Poland, Bulgaria and Romania. Overall, elderly people are projected to account for an increasing share of the population due to continued gains in life expectancy in both advanced and emerging European economies which will have a significant effect on ageing related costs - Table 6 below provides an overview of projected increases in total ageing related expenditures – based on current policies - for pensions[67], health, long-term care, unemployment and social assistance benefits and education between 2010 and 2060 in advanced and emerging European economies.

Table 6 Increase in Ageing-related Expenditures 2010-2060 [% of GDP]

Countries	Total Ageing Related Expenditures 2010 [% GDP]	% of Total GDP Increase Linked to Pension Expenditures 2010-2060	Total % Change in Ageing Related Expenditures 2010-2060
Advanced Economies			
Belgium	**26.8**	**4.3**	**6.6**
Czech Republic	**25.2**	**4.0**	**6.3**
Spain	**20.0**	**6.2**	**8.3**
Italy	**26.0**	**-0.4**	**1.6**
Sweden	**27.1**	**-0.2**	**2.7**
Denmark	**25.2**	**-0.2**	**2.2**
UK	**19.2**	**2.5**	**4.8**
Emerging Economies			
Bulgaria	**17.1**	**2.2**	**3.2**
Latvia	**12.3**	**0.0**	**1.3**
Lithuania	**15.1**	**4.9**	**6.0**
Hungary	**21.8**	**2.6**	**4.0**
Romania	**14.7**	**7.4**	**8.5**
Poland	**19.1**	**-2.1**	**-1.1**

Source: EC 2009c

[66] EC [2008]

[67] Pension expenditures are singled out because of their overall proportion, as a percentage of GDP, in ageing related expenditures

In order to assess the sustainability challenges faced by both advanced and emerging European economies, an indicator – the so called S2 indicator - has been devised by the European Commission[68] that quantifies the gap that must be closed to ensure that all public obligations can be financed in the future[69]. The S2 indicator[70] is based on analysis of two components, the *Initial Budgetary Position* [IBP], which is in deficit in many countries due to economic downturn, includes gross government debt and the structure of the primary balance[71]; and *Long Term Changes* [LTC] of the future related to expenditures on pensions, health care, long term care, education, and social security benefits. The greater the value of the indictor, the greater the adjustment required to restore sustainability of public finances[72].

The value of the sustainability gap for both advanced and emerging economies in the EU is 6.5 per cent – which represents the permanent adjustment required to make public finances sustainable. Decomposed results [see Figures 7 and 8 below] show that for both groups of economies the IBP is responsible for 3.3 per cent of the S2 gap – which signifies that, even without taking account of the costs of ageing countries will need to tighten their fiscal stance [in terms of the structural primary balance] by 3.3 per cent of GDP to achieve fiscal sustainability. The LTC is responsible for 3.2 per cent of the S2 gap, meaning that the projected increases in ageing related costs also have significant impact.

Among emerging European economies Latvia and Romania have sustainability gaps significantly above 6.5 per cent of GDP – which puts them at risk. Latvia has the highest S2 [9.9 per cent] and a disproportionately high level of IBP compared to LTC. For Romania, the impact of the LTC and IBP is almost equal, and the LTC gap is the result of very large projected increases in age-related expenditure based on the absence of major reforms. Lithuania shows a moderate level of the S2 gap, while Bulgaria – which has low debt and deficit levels – has low sustainability gaps as does Estonia. Poland has an S2 level of 3.2 per cent, but a higher level of IBP, and its LTC is negative [-1.2 per cent] which counteracts the higher IBP. The lower LTC is due to the fact that Poland has made significant advances in pension reform which reduce its long term ageing costs – see Figure 7 below for an overview of Sustainability Gap indicator S2 and its two components – Initial Budgetary Position [IBP] and Long Term Changes [LTC] in emerging European economies.

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68 EC [2009c]

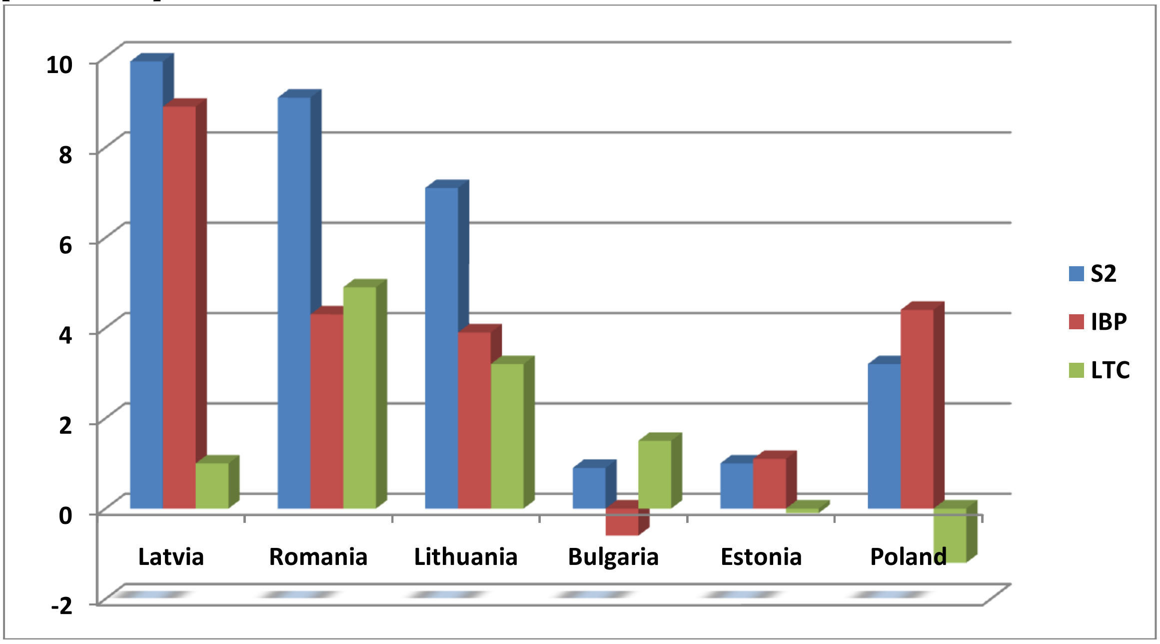
69 The Indicator has been developed for advanced and emerging economies within the EU-27 and does not cover EU accession candidate and pre-accession candidate countries, nor does it cover emerging economies in the CIS.

70 The S2 Indicator does not advance arguments about how adjustments should take place which can occur as a result of increases in government revenues, reductions in spending or structural reforms.

71 The primary balance is government net borrowing or net lending excluding interest payments on consolidated government liabilities. The *structural primary balance* is the cyclically adjusted balance netted out for any temporary effects.

72 The sustainability gap results incorporate the initial impact of the crises on IBP, but the LTC rely on employment and GDP growth assumptions of the pre-crises period.

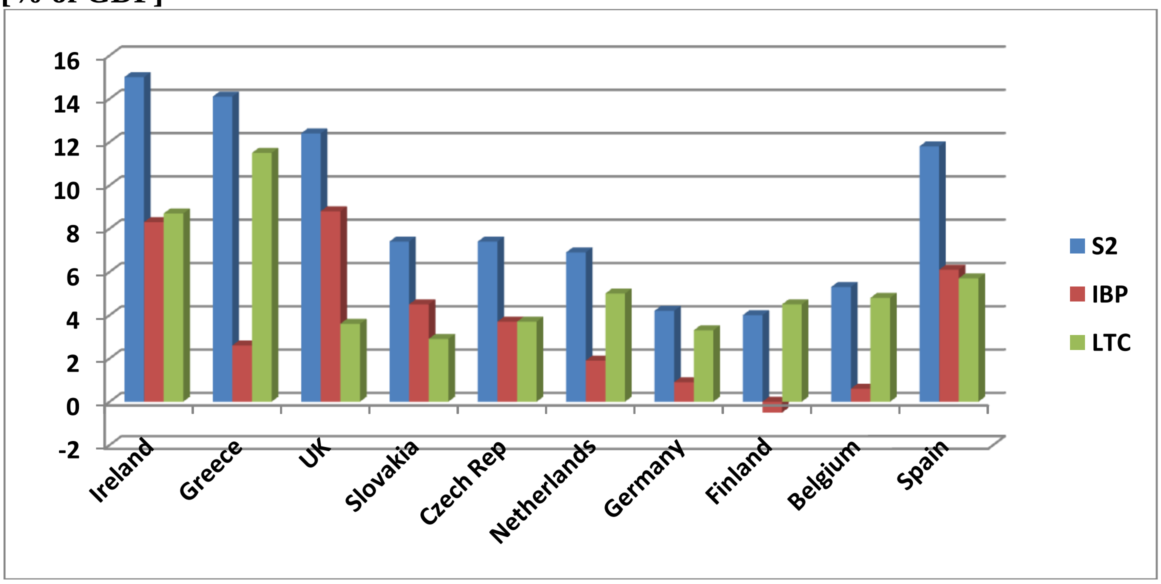
Figure 7: S2 Indicator of Fiscal Sustainability Levels in Emerging European Economies [% of GDP]



Source: calculations based on Sustainability Report 2009

Among advanced European Economies, Ireland Greece, the United Kingdom and Spain have sustainability gaps higher than 10 per cent of GDP with the Czech Republic, the Netherlands, and Slovakia not far behind. Among these economies the contribution of LTC is particularly high in Greece; and the contribution of IBP is large in the United Kingdom and Slovakia; the LTC is also high in the Netherland, in Germany, Finland and Belgium the contribution of LTC is particularly large – see Figure 8 below for an overview of the Sustainability Gap indicator S2 and its two components – IBP and LTC - in advanced European economies.

Figure 8: S2 Indicator of Fiscal Sustainability Levels in Advanced European Economies [% of GDP]



Source: calculations based on Sustainability Report 2009

There is a large variation in the degree of risks that emerging and advanced European economies face and the origins of the risks. Overall a significant number of countries have large sustainability gaps. However, it is worth noting that economies with different characteristics can overall face a similar degree of risks to fiscal sustainability. For example, the projected cost of ageing can be high while the budgetary position is relatively sound. By contrast, an economy can have projected costs of ageing which actually improves its long-term sustainability, while sustainability difficulties arise mainly from the weak budgetary position. Indeed the priorities in the two cases are different; in the former case reforms to social policy systems that would curb the increase in ageing–related expenditure are needed, while in the latter case consolidation efforts are more likely to be appropriate. In other instances both age-related expenditures and fiscal consolidation often need to be addressed simultaneously. There is clearly increasing recognition that the challenges and opportunities presented by demographic ageing require a new strategic focus. In most advanced and emerging European economies, it is possible to identify a combination of national government policy strategies, programmes or plans to address ageing issues, and a wide range of local-level projects, often undertaken by sub-national authorities and the not-for-profit sector. Much less common is regional-level action taking a strategic sub-national approach to demographic ageing and providing a territorial framework for local initiatives. Policy makers at national and sub-national levels in both advanced and emerging European economies therefore need to calibrate fiscal consolidation and structural reform efforts in a manner that takes account of these differences while at the same time aiming to preserve the objectives of active, fair and socially cohesive societies[73].

[73] Council of Europe [2008]

Section 4:

Impacts and Policy Implications for Sub-National Government Responsibilities

Competencies for different types of social policy spending are distributed unequally across levels of government. This is because some spending programmes are regulated by national legislation, resulting in uniform standards of distribution and uniform eligibility criteria – for example, pension policies are usually regulated at the national level. The contribution rate, the pension formula, the level of benefits and the retirement age are examples of policy parameters that are the same for the whole population in any given polity[74]. In some advanced and emerging economies [e.g., the UK[75], Ireland and Ukraine] funding sources and eligibility criteria for the main social assistance programmes [including guaranteed minimum income schemes] are the prerogative of central government. Likewise, in all advanced and emerging countries tax allowances, various tax credits to those in work, and social insurance based schemes contribution rates and eligibility thresholds are set by national governments. These types of social policy programmes can be classified as *national public goods and services* [NPGS] which entail large sunk costs and need a large number of participating individuals in order to function.

In contrast, responsibilities for other social policy domains [such as education services, residual social assistance schemes, some health services, and social care services] are localised further down the ladder of levels of government and there is a greater variety in terms of quality and general levels of spending which reflect the regional characteristics of demand and supply – i.e., they are *regional public goods and services* [RPGS]. RPGS can, therefore be defined as those spending programmes where the spending authority lies with sub-national levels of government [i.e., local or regional]. In reality of course, almost every social policy spending programme entails some degree of interdependence between central and sub-national government. Therefore in defining NPGS and RPGS, the decisive characteristic is whether a certain type of spending is more *tilted* towards the local and regional level or the national level. The provision of social policy related NPGS and RPGS across both advanced and emerging European economies varies: some countries strive for uniform standards, whereas others allow greater variety and more autonomy at lower levels of government.

A common approach for comparing and assessing sub-national spending power - defined as the extent of control sub-national governments exert over the budget – is the sub-national share of government expenditure, as provided in Government Finance Statistics [GFS] generated by the IMF. However, sub-national government spending in social policy is strongly influenced by upper level government regulation which reduces sub-national government discretion over various budget items. Analysis of sub national government spending power in key social policy domains – for example, by Dexia[76] - based on simple

[74] It should be noted that pension regimes in both advanced and emerging economies retain different social insurance institutions, depending on occupation [e.g., national civil servants, local government employees etc]. Nevertheless, even if policy parameters vary slightly across different occupations, the rules are set at the national level so that there are uniform for all persons in a given occupation. There is usually no leeway for different settings of policy parameters across different sub-national territorial units.

[75] In England for example, council tax benefits and housing benefits are administered by local government but are funded through central government earmarked grants.

[76] Dexia [2008]

expenditure shares can therefore be misleading[77]. Indeed, spending power indicators[78]show relatively low sub-national spending autonomy[79]. Spending power indicators also appear to show that sub national governments have relatively little power and autonomy, especially if compared to the commonly used sub-national expenditure share, and simple expenditure shares tend to give an inappropriate picture of sub-national spending autonomy. In the majority of advanced and emerging European economies it is the central government that plays the major role in social policy domains which fluctuate counter-cyclically – e.g., unemployment benefits; while sub-national governments often have more significant roles in less-cyclically-prone domains like education, long term social care services; and, in some economies – such as Sweden, France and Spain – they have shared responsibilities for residual social assistance schemes which people become eligible for after exhausting their unemployment benefits[80].

However, even where social assistance schemes are tilted towards toward the RPGS model the financial crisis has meant that central governments in advanced European economies have had to step in to meet increased demand [see examples from Sweden, Finland and Spain below], and in some emerging European countries [such as Latvia] social assistance expenditures, administered from local government revenues, have been budget capped in an attempt to control expenditures alongside the tightening of targeting mechanisms, and the introduction of refined eligibility criteria. In other countries, such as Romania, the GMI scheme reverted from being a shared responsibility with sub-national government to a programme fully funded by central government.

Pre-existing fiscal multi-level government arrangements for the fiscal, administrative and regulatory provision of NPGS and RPGS had a significant impact on the levels of differentiation, range and type of response adopted by sub-national governments towards the social policy during the crisis. Some economies [such as Ukraine] allowed sub-national government deficits to widen and by building up large wage arrears, while other economies [such as Finland and Sweden where social policy responsibilities – for example in health, social assistance and social care- are tilted towards local government] opted to ease spending limits on local government deficits and borrowing and responded to the crisis with procyclical spending cuts, tax base broadening and even - in the case of Finland, France, Slovak Republic, Sweden, and the UK - tax rate increases, while other economies such as Austria, Belgium, Germany, Portugal, Spain and Switzerland responded with countercyclical tax rate cuts, increased investment spending[81] and increased levels of grant transfers – see box 10 below for an overview of correspondents accounts of the type of measures adopted at the sub-national level to support social policy.

Thus sub-national governments cannot be ignored in the context of national efforts for fiscal consolidation and structural reforms of social policy – particularly when population ageing

[77] No internationally comparable indicators of spending power for the various domains of social policy are currently available, and would require detailed analysis of each policy area for which sub-national governments spend money. Data would have to be retrieved in a manner that would require knowledge of the institutional and regulatory background of each policy area such as pensions, health, education, social assistance, social care, and housing.

[78] Charbit and Michalun [2009]

[79] Federal countries tend to grant more spending power than unitary countries, and sub national government spending power tends to be higher in federal than in unitary countries in most policy areas.

[80] Blöchlinger, Charbit, Campos, and Vammalle [2010]

[81]The differences in response at the sub-national level mainly reflected legal constraints on local deficits and borrowing.

profiles are spatially differentiated at sub-national levels. Overall the distinction between NPGS and RPGS - and the attributes of policy autonomy, budget autonomy, input autonomy, and output autonomy – became blurred by the crises due to the requirement for greater coordination between central and sub-national governments brought about by the collapse in revenues [e.g., personal income tax (PIT), corporation income tax (CIT), and other taxes such as housing and building permits] and spending increases. The ageing of societies, and the dispersion/concentration of particular ageing cohort's in particular sub-national government territories, is also likely to have significant implications for economies [such as Sweden, Finland and Spain] where revenue sharing [such as PIT] has traditionally been an important component of local revenues and where responsibilities for health, social care etc are tilted towards the RPGS model of provision.

Box 10 – Variations in the Titling of NPGS and RPGS and Crisis Responses

Sweden – local municipalities and county councils are responsible for social care [children, disabled and elderly], ALMMs, and health care services. To cushion the effect of the crisis, the government made additional resources [€1 billion] in temporary support on top of around €750 million allocated in the 2009 budget.

Finland – the government provided additional government aid of €28.6 billion a proportion of which was allocated to sub-national government to cover the costs of social care, employment measures and health care services. The allocation to sub-national government was designed to compensate for the loss of lower level tax revenues. Around €30 million of the additional resources was ring-fenced for sparsely populated municipalities.

Spain: the government allocated an additional €6 billion to sub-national governments to specifically support employment measures at the regional level through a new Fund for Employment and Local Sustainability, and an additional €5 billion was allocated to regional governments through the Local Investment Fund to support social care services, education, health etc.

Ukraine: social protection benefits are highly centralised and financed through deconcentrated transfers and therefore does not directly affect sub-national budgets. Residential social care services are financed indirectly by central government, while community-based social care services are the responsibility of municipalities. On-going efforts to reform the funding of both residential and community based social services have not been influenced by the crisis. However, centralised efforts were made to introduce the monetisation of in-kind transfers [privileges] and to improve the verification of eligibility of social assistance benefits

UK: the previous government introduced a number of social policy measures including one-off welfare payments for various vulnerable groups valued at around €900 million, and introduced a Future jobs Fund [FJF] valued at around €800 million. Sub-national governments and for-profit and non-profit providers could bid for FJF funds. The government also provided financial help and support to help local authorities improve the take-up of tax credits. However, none of these measures had a direct affect on sub-national government revenues due to the centralised nature of the welfare system. The FJF was cancelled following the elections in 2010

Population dynamics – linked to migration and natural change alongside an ageing population – will have significant implications on established patterns of raising revenues, on revenue sharing arrangements, and on methods for fiscal equalisation at sub-national levels of government in both advanced and emerging European economies. The fiscal impact of an ageing population has both aggregate and localised attributes which are interwoven with the following factors: (i) positive or negative population growth; (ii) the projected rates at which the share of the population of over 65's will increase, (ii) the rate of increase in the old age dependency ratio; (iii) the proportion of older old aged [i.e., over 80s] and their rates of physical and mental frailty (iv) the demand for ageing related benefits and services, and (v) the impact of ageing on revenues in the wake of a declining rates of participation in the labour market. Recent projections[82] in a selection of advanced and emerging European economies are highlighted in Table 7 below. The table also highlights regions[83] where the number of over 65s as a share of the total population, and old age dependency ratios, are projected to increase most significantly between 2010 and 2030.

[82] *op. cit.* Eurostat [2008]

[83] Regions are based on the Nomenclature of Territorial Units for Statistics [NUTS] 2/2006 which divides territories in EU member states into 271 regions. NUTS2 level data is compiled using the standard demographic cohort-component model.

Table 7: Ageing and Population Dynamics in a Selection of Advanced and Emerging European Economies and their Sub-National Territories [2010-2030]:

Territory	Sub-National Territories [Regions]	Share of total Population aged 65 or over [%]		Old age dependency ratio [%]	
		2010	2030	2010	2030
Advanced Economies					
Czech Republic		**15.4**	**22.9**	**21.8**	**35.7**
	Střední Morava	15.7	24.3	22.3	38.3
	Moravskoslezsko	15.0	24.2	21.1	38.2
Germany		**20.6**	**27.6**	**31.2**	**46.2**
	Chemnitz	25.9	37.3	40.9	70.2
	Sachsen-Anhalt	24.2	36.0	37.0	66.1
Netherlands		**15.3**	**24.1**	**22.8**	**40.0**
	Drenthe	17.8	28.0	27.5	49.6
	Zeeland	18.5	29.2	28.7	51.7
Finland		**17.1**	**25.5**	**25.7**	**43.9**
	Itä-Suomi	20.3	31.9	31.3	59.9
	Länsi-Suomi	18.4	26.1	28.2	45.6
Portugal		**17.8**	**23.3**	**26.6**	**36.6**
	Alentejo	22.9	25.4	36.0	40.7
	Algarve	18.8	23.2	28.8	37.3
Emerging Economies					
Bulgaria		**17.5**	**23.3**	**25.3**	**36.3**
	Severozapaden	21.4	28.1	32.7	47.5
	Severen tsentralen	18.7	24.9	27.1	39.4
Hungary		**16.6**	**22.0**	**24.2**	**34.1**
	Dél-Dunántúl	17.0	24.3	24.8	38.6
	Dél-Alföld	15.2	23.8	25.7	37.6
Poland		**13.6**	**23.0**	**19.0**	**36.0**
	Świętokrzyskie	14.9	25.4	21.2	40.8
	Łódzkie	14.9	25.0	21.0	39.8
Romania		**14.9**	**20.3**	**21.3**	**30.3**
	Sud-Vest Oltenia	16.4	21.5	23.8	32.4
	Sud Est	14.9	20.8	21.2	31.4

Source: Eurostat [2010] based on EUROPOP 2008

The financial and economic crises, together with the need for fiscal consolidation and the impact of demographic ageing, has brought into sharp relief the need for both top-down direction, and a renewed focus on multilevel governance frameworks which narrow or close social policy "gaps" between levels of government via the adoption of tools and processes for vertical and horizontal cooperation at local levels. In both advanced and emerging European economies measures for improving spatial infrastructure decision support systems[84] have – in the wake of crises - been implemented. For example, Geographical Information Communication Technologies [Geo-ICT][85] are being scaled-up to contribute to the efficiency and effectiveness of the organisation of government; to layer, map, plan, coordinate and integrate physical and social infrastructure at national and sub-national levels in the context of fiscal consolidation and reduced human resources[86]; to facilitate mechanisms for drawing together the public sector, social enterprises/not for profits, and the private sector; and for improving consultation with, and the participation of, local citizens. In addition, in the UK [England], measures have been taken - in the wake of cuts amounting to GBP 1.16 billion in

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[84] Some of these measures have been driven by the EU-wide INSPIRE spatial infrastructure initiative which was launched in 2007 – see - http://inspire.jrc.ec.europa.eu/index.cfm/newsid/10061

[85] Geo-ICT includes Geographic Information Systems [GIS], Land Information Systems [LIS], Spatial Decision Support Systems [SDSS], Spatial Data Infrastructures [SDI] and other geographic information and communication technologies.

[86] Navara [2010]; Rix, Fast, and Masser [2010]

central government grants to local authorities – to assess and draw on lessons from an initiative entitled "Total Place"[87] which addresses whole systems of governance across 13 pilot local government sites[88].

While localised initiatives – linked to Geo-ICT and organisational change – can be useful to generating improvements in efficiency, the need for top-down direction is likely to remain of paramount importance. The rationale for this partly stems from the fact that spending cuts, and tax rises, will need to be set within a national medium term expenditure framework [MTEF] that incorporates sub-national governments, and, also, from the fact that sub-national governments cannot effectively implement social policy reforms – that fully take into account the fiscal, social and spatial effects of ageing populations- without working closely with national governments. A renewed focus on multilevel governance, therefore, needs to recognise that sub-national governmental authority to act in key domains of social policy – such as social care services and long term care for the elderly – has to "nest" with financial, legal and institutional frameworks at higher scales.

The emphasis on the horizontal dimension of multilevel governance provides opportunities for learning, information transmission and cooperation between cities or regions and national governments, including local jurisdictions in the same area. A closely connected reason has to do with externalities because economic and social policy measures adopted in one economy – as highlighted by the crisis – strongly depends on appropriate interventions in other economies. Serious failure to address structural reforms in social policy can spill over to other territories and place-based responses, or policies that at least take account of conditions in "places", are increasingly likely to yield dividends in the light of differentials in the characteristics of ageing populations and the effects of ageing on local labour markets, inequality and poverty, and fiscal sustainability.

Moreover, horizontal governance opens-up the scope for business, research and social enterprises to influence policy dialogue processes, and also to explore options for consolidating previously separately managed services though information technology and as part of efforts to reduce overhead costs and minimise duplications of effort. The horizontal dimension of multilevel governance can also help improve coordination across national line ministries for the implementation of cross-cutting programmes that take account of the way NPGS and RPGS are bundled - such as the inter-linked domains of employment, pensions, health, and long term care.

[87] Leadership Centre for Local Government [2010], HM Treasury [2010]

[88] "Total Place" focuses on how much public money [central and local] is spent within a given local government area, and then explores the finances in detail on a particular theme, such as drug and alcohol abuse, care for older people, children's services etc and proceeds to look at innovative ways for cost effective ways of organising and delivering the service. The initiative has, for example, identified that only 5 pence in every GBP 1 spent is actually controlled by elected representatives of local government, and that in local government areas over 100 separate agencies are responsible for spending decisions – see: http://www.hm-treasury.gov.uk/psr_total_place.htm

Section 5:

Concluding Observations:

There is no doubt that the crisis is leaving a legacy of profound challenges to fiscal sustainability that both advanced and emerging European economies face. Some are immediate, such as deciding when and how to exit crisis support measures. At the same time, unevenness in the pace of recovery within and between advanced and emerging European economies, and the prospect of unwinding fiscal imbalances in the context of meeting the future demands of ageing societies represent a significant risk. Moreover, the impact of policy reforms that have to be taken now on the future for pension, health and long term care systems and measures for improving labour market participation and social protection are less well defined. The effects of actions taken now on future fiscal and social policy challenges need to be re-evaluated as part of macroeconomic policy frameworks that have been developed in response to the crisis. In other words, the magnitude of the anti-crises fiscal measures of the last two years can serve to bring into high relief the profound fiscal challenges for both central and sub-national governance that was previously [in the pre-crises period] mainly seen as a prospective one.

The moment for real engagement with these issues cannot be avoided. National, regional and local policy-makers need to be aware of the impacts of decisions on fiscal policy issues upon social policy systems and structures and the need to control spending growth while at the same time minimising the risk of social and political stress. Policy responses, including innovative use of Geo-ICTs, will need to be tailored to the specific conditions of individual national and sub-national economies, but ultimately decisions will need to strike a delicate balance between current recovery strategies and future sustainability of public finances across various social policy domains. Clear and bold social policy choices [see below] will be required from national governments in both advanced and emerging European economies, to devise credible strategies to reduce public debt, but without compromising on the important aspects of current and future welfare systems – particularly those designed to protect future generations and the promotion of active, fair and socially cohesive societies. The temptation to sacrifice some element of future benefits to purchase popularity with current generations, and/or to continue to implement stimulus spending strategies for a recovery from current crisis, is ever present, and will need to be resisted in the absence of demonstration of actual need.

The appropriate policy choices in advanced and emerging European economies will - in view of the fact that the setup for public services, social protection systems, labour markets and the structure of economies show large variations - have to be custom designed. The main features of future of policy choices to counter the effects of the financial and economic crises and the exacerbating effects of population ageing will nevertheless need to consider the following:

- Strategies will need to be extensive, flexible and long-lasting – including measures that address future pension expenditures in the public sector [local and central government], actions to postpone retirement, and measures to increase the productivity and efficiency of ageing related services.

- Measures for reducing the rise in government expenditure - given that the prospects of an ever-increasing debt would pose an obstacle to a sustained and long lasting recovery from the present crisis, and the achievement of balanced economic growth. Sustainability - related to the ability of a government to assume the financial burden of debt both currently - could be achieved via (i) increases in revenues, (ii) cuts in expenditure or (iii) structural reforms in social policy domains such as social assistance, pensions, and long term care in order to decelerate projected increases in age related expenditures. Introducing such reforms will need to be based on medium term objectives and take into account implicit liabilities due to ageing.

- The role of sub-national governments in key social policy domains. In economies where sub-national governments play a relatively large role in the public sector – particularly in relation of the provision of key public services, like healthcare and long term care, and where general public sector employment trends and wage bills account for a large proportion of expenditures – the evolution of both staff numbers and wages will be a significant determinant of public expenditure pressures. Higher employment in public services will, therefore, need to be not only a concern from the fiscal standpoint, but also from the perspective of crowding out employment in other sectors of the economy under conditions where labour supply is declining. Measures to improve efficiencies and to yield economies of scale through mergers of sub-national government units, the introduction of technological change, social re-organisation of service delivery, and greater use of private and not-for profit sectors may help, but in the face of permanent financial pressures these measures will need to be complemented with fundamental structural reforms. Indeed, if, in the face of longer term fiscal strain productivity reforms at the sub-national level fail, the strains of raising revenues and meeting expenditure demands could undermine central government tax policies, and transfer risk to other sectors of the economy.

- Expanding the standardisation of models and methods for assessing the fiscal effects of ageing on public expenditures. Models and methods for conducting policy analysis to assess the fiscal effects of ageing are presently only available for advanced and emerging economies within the EU. The deployment of standardised methods for assessing the fiscal effects and sustainability of ageing related expenditures should be explored with governments in the accession candidate, pre-accession candidate and ENP partner countries. The extension of the methodology would be help identify options for fiscal consolidation, for managing ageing related expenditures, and for mitigating the risk of cross-border spillovers.

The next few years will undoubtedly be a crucial time as national and sub-national governments search for measures in the shape of proactive economic policies which not only strengthen their recovery from the crisis, but also help steer clear of the dangers of national insolvency. Balancing the needs of youth and older people, both current and future, warrants a fresh focus on current fiscal policies and future social policy imperatives – including arrangements governing inter-governmental fiscal relations for revenue raising and expenditure. Fiscal solutions to the current crisis need to ensure that the avoidance of current fiscal catastrophes does not simply lay the groundwork for future, perhaps bigger, social crises. Achieving this balance will require not only the political will to make tough policy decisions, but also the ability to persuade citizens in both advanced and emerging European economies that the public interest requires some current sacrifice to ensure future stability in key areas of social policy.

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