Implications of the European financial crisis for fiscal policy and public financing of the health and social sectors

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April 17, 2013
Principal conclusions (1)

• The financial crisis in Europe has indeed had adverse effects on the fiscal position in general, and in particular on health and social spending

• For most countries, fiscal austerity is here to stay

• The advisability of short-term fiscal austerity in the face of weak growth is not unanimously shared, though the need for medium term fiscal consolidation is accepted.
Principal conclusions (2)

• For many European countries, the financial crisis, with its reverberations in Europe, has added to the pressures that will constrain health and social spending in coming years and decades.

• Rising debt levels, threats to fiscal sustainability, and the pressures for fiscal austerity have already reduced spending on health and other social sectors in many European countries. No let up in budgetary restraint can be easily anticipated.
Principal conclusions (3)

• For some countries, the impetus for such medium-term consolidation arises NOT from the effects of the crisis but from deeper rooted structural challenges, namely population aging and inflexibly dated and excessively generous social insurance schemes.
Ramifications of the European financial crisis created pressures for significant tightening of fiscal policy

**Channels of Influence**

- The crisis led to large fiscal deficits in 1\textsuperscript{st} and 2\textsuperscript{nd} years, resulting in significant increase in public debt
  - In part, through the impact of automatic stabilizers
  - In part, from discretionary Keynesian fiscal stimuli
  - In some countries, public debt further augmented by need to recapitalize the banking sector as a result of weak financial sector
  - Debt to GDP ratio also rise with fall in real growth level and rate

- For many countries, public debt reached levels perceived as “unsustainable,” in terms of
  - Potential for eventual fiscal default, with potential effects on risk premia in sovereign borrowing
  - Yielding loss of future flexibility in fiscal policy
  - Enhanced vulnerability in the case of another crisis
Gross Debt to GDP ratios have sharply risen since 2008 and significantly above 60% sustainable threshold (as a percent of GDP)
Ramifications of the European financial crisis created pressures for significant tightening of fiscal policy

Channels of Influence

• In some countries, the fiscal deficit became excessive and there was a snowballing of debt, with rise in risk premium on borrowing
  – Principally in southern tier countries, has led to strong fiscal austerity measures, often in context of IMF/EU programs

• With the end of the immediate financial crisis, the risks associated with high debt and prospects of fiscal sustainability led to significant cutbacks in fiscal position, with significantly reduced structural fiscal balance, particularly in 2011 but as early as in 2010
Cyclically adjusted fiscal deficits cut sharply after 2009 (as a percent of GDP)
Effects on Health and Social Spending to date

- Statistical data on public spending on health only exists through 2010 (Eurostat, OECD, WHO)
- In some countries, reduced nominal spending occurred as early as 2008-2009 (e.g., Estonia, Hungary, Ireland)
- In all other European countries, rate of increase of health spending dramatically fell relative to 2007-2009
Health systems in times of global economic crisis: an update of the situation in the WHO European Region
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Effects on Health and Social Spending to date

- Cutbacks also felt in other social sectors
- Pension reform measures enacted in many countries, with
  - Tightened eligibility for early retirement
  - Pushing back of age for pension eligibility
  - Reduction in pension indexation rates
- Unemployment benefits began to be curtailed as well
- Increased use of targeting measures to restrain social sector spending to poorest households
For most countries, fiscal austerity regimes will continue in the future (1)

- In euro-zone countries, lack of exchange rate as policy instrument necessitates use of fiscal policy as means of restoring current account viability
  - Underlies motivation for EU strengthening of Stability and Growth Pact fiscal surveillance provisions
  - Underlies continuing motivation for a “fiscal union”
  - Has enhanced continuing EU-wide pressures for fiscal austerity once immediate crisis had passed
For most countries, fiscal austerity regimes will continue in the future (2)

- For some countries, a significant front-loading of deficit reduction measures have already been put in place following the end of the immediate financial crisis, in part a result of EU-IMF lending programmes
  - For these countries, while amount of future fiscal deficit reduction will fall, pressures for continued austerity remain

- Estimates suggest euro area structural deficit narrowed by 1½% of GDP in 2012, with further cutbacks of 1/2% of GDP anticipated in 2013 and over 2014-2017. Cutback in hard-hit periphery countries were even larger in 2012-2013, averaging 3½ % of GDP
For most countries, fiscal austerity regimes will continue in the future (3)

- “Fiscal gap” calculations suggest the need for further primary balance reductions, either up front or over time, underlying the pressure for continued austerity.

- High overall tax ratios in European countries put all the pressure for fiscal austerity on the need for spending cutbacks.
  - The pressure will be on spending categories that have low “multiplier effects,” in order to lessen adverse growth effects, given the continued slow growth environment
  - Recognition of the need to promote spending that fosters growth potential
Projections for decline in cyclically adjusted deficits 2011-2014 (as a percent of GDP)
Perspectives on the advisability of fiscal austerity

- Principal divergence of views relate to advisability of significant fiscal austerity in the short-term environment of low growth or recession.
- No disagreement prevails among leading international macroeconomic institutions on the need for medium- to long-term fiscal consolidation, based on studies of fiscal sustainability.
- For the short-term, IMF and OECD both emphasize that where there is sufficient fiscal space, it is important to allow automatic stabilizers to function and thus to allow nominal fiscal deficits to rise in a low growth environment.
- They argue that fiscal policy measures need to be tight principally in countries experiencing market pressures on the risk premium associated with sovereign borrowing.
- Their concern is to avoid aggravation of weak growth environment (associated with weak private sector demand) by also reducing public sector’s contribution to aggregate demand. Too much fiscal restraint in such situations can be counterproductive to objective of restoring fiscal sustainability.
For some countries, other factors—aging, deficient social insurance schemes, and cost pressures in health—constitute an additional impetus for the need for fiscal consolidation

- Source of “fiscal gap” arises not only from the financial crisis effects but also from the combined effect of an aging population and the structural character of the social insurance system.

- EU 2012 Aging Report highlights the divergent national fiscal implications of the aging of the population in the context of current social insurance systems
  - Pressures for increased pension, health, and long-term care spending

- Many countries have proved slow in addressing structural weaknesses in pension arrangements (age of retirement, excessive indexation arrangements, lack of claw back in taxation of pensions of high income pensioners). Pension challenges particularly acute in Luxembourg, Belgium, and Netherlands.

- Health sector spending pressures also originating from excess cost growth pressures associated with technological change. Health cost pressures seen as particularly challenging in Switzerland and the Czech Republic (recent OECD studies)

- Long-term care spending pressures link with aging as higher share of very elderly associated with higher probability of need for long term caring arrangements
How much consolidation is needed: fiscal gap results
Immediate rise in the underlying primary balance needed
to bring gross financial liabilities to 50% of GDP in 2050

Source: Merola and Sutherland (2012) OECD Economics Working Paper 934 (as percent of GDP)
Obvious challenge: How to optimally cut spending in the health and social sectors?

- Policy alternatives are far more obvious in the pensions sector

- They would involve pushing back retirement ages, reduced indexation of pensions, extending wage averaging period for determining pension benefits, taxation of higher income pensioner benefits, and reduced generosity of benefit schemes
Obvious challenge: How to optimally cut spending in the health and social sectors?

• In health sector, policy alternatives are much more difficult to formulate. May include
  – Limits on availability of new, unproven technologies that may have only marginal additional gain relative to previous technologies
  – Pushing for the adoption of high efficiency best practices seen in other countries or regions
  – The use of generics and national buying scheme for pharmaceuticals
  – An increase in cost sharing, particularly if progressivity considerations used
  – Restraint in cutting spending on preventive practices which may have higher long-term return than spending on acute medicine

• One may also see increased use of targeting in the payment of social transfer benefits