Long-run fiscal challenges dwarf COVID's fiscal legacy

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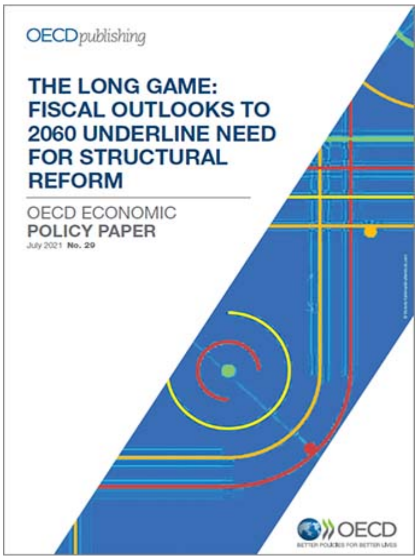


The decline in economic activity associated with caution, lockdowns and other restrictions in response to the COVID-19 pandemic brought government revenue down substantially in 2020 across the OECD. Governments have appropriately responded with a range of temporary programmes to support workers and businesses, simultaneously raising expenditure. Consequently, fiscal positions have deteriorated sharply and gross government debt in the OECD is projected to be around 20-25 percentage points of GDP higher in 2022 than it would have been absent the pandemic.

The immediate fiscal challenge for governments is to continue to target fiscal support towards sectors hardest hit by the COVID-19 shock and, as the pandemic ebbs, to phase out temporary programmes gradually along with the restrictions that limit doing business in these sectors. In the longer run, however, the direct fiscal impact of the pandemic pales in comparison to additional fiscal pressures stemming from secular trends, such as population ageing and the rising relative price of services.

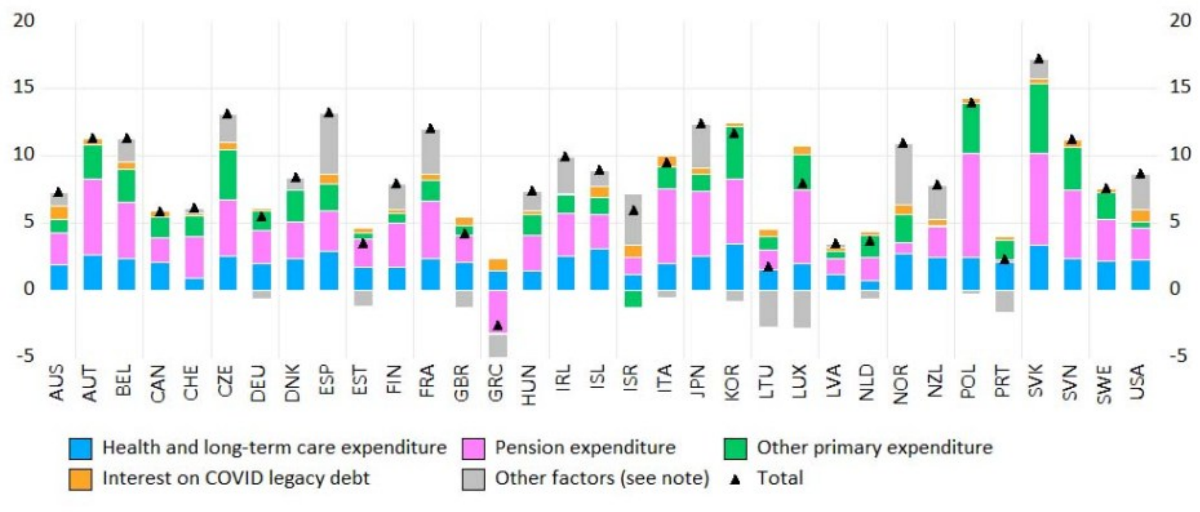
In the latest long-run projections from the OECD Economics Department, these fiscal pressures are assessed using stylised projections that take secular trends, such as demographics, into account. The idea is not to obtain precise forecasts, but rather rough orders of magnitude to size up the fiscal challenge ahead. Under a 'business-as-usual' hypothesis, in which no major reforms to government programmes are undertaken:

- Public health and long-term care expenditure is projected to increase by 2.2 percentage points of GDP in the median country between 2021 and 2060 (see figure). These projections are based on a pre-pandemic health and long-term care spending baseline, so any permanent increase in health spending in response to experience with COVID-19 (for instance to build more spare capacity in intensive care units or raise pay levels for workers in public care homes) would come in addition.
- Public pension expenditure is projected to increase by 2.8 percentage points of GDP in the median country between 2021 and 2060, but cross-country variability is much higher than in the case of health expenditure projections. Countries that have legislated increases in statutory retirement ages, and especially those that have linked future increases to gains in life expectancy – such as Estonia, the Netherlands and Portugal – tend to have lower projected increases in public pension expenditure, whereas countries with particularly unfavourable demographics – such as Japan, Korea and Poland – tend to have higher projected spending increases.
- Other primary expenditures are projected to rise by 1½ percentage points of GDP in the median country between 2021 and 2060. And this figure excludes important sources of expenditure pressure, such as climate change adaptation.
- In contrast to the fiscal pressures from the secular

trends discussed above, the additional debt service on the increase in public debt due to the COVID-19 pandemic – here approximated by the increase in gross government debt between 2019 and 2022 – adds only about ½ percentage point of GDP to long-run fiscal pressure in the median country. Emergency fiscal transfers during the COVID period contribute little to long-run fiscal pressure because they are temporary. Their permanent component is the flow of interest payments on the associated stock of additional debt, assuming that it is permanently rolled over, which is the case here because of the assumption that the government debt-to-GDP ratio is stabilised at its 2022 level.

Potential future fiscal pressure to keep public debt ratio at current level in the baseline scenario

Change in fiscal pressure between 2021 and 2060, % pts of potential GDP



Note: The chart shows how the ratio of structural primary revenue to GDP must evolve between 2021 and 2060 to keep the gross debt-to-GDP ratio stable near its current value over the projection period (which also implies a stable net debt-to-GDP ratio given the assumption that government financial assets remain stable as a share of GDP). The underlying projected growth rates, interest rates, etc., are from the baseline

long-term scenario presented in Guillemette and Turner (2021). Expenditure on temporary support programmes related to the COVID-19 pandemic is assumed to taper off quickly. The necessary change in structural primary revenue is decomposed into specific spending categories. The component 'Interest on COVID legacy debt" approximates the permanent increase in interest payments due to the COVID-related increase in public debt between 2019 and 2022. The component 'Other factors' captures anything that affects debt dynamics other than the explicit expenditure components (it mostly reflects the correction of any disequilibrium between the initial structural primary balance and the one that would stabilise the debt ratio).
Except in Greece, where a massive fiscal consolidation effort has already taken place since the Great Recession, all OECD governments would need to undertake fiscal consolidation in this scenario, which is premised on the idea that fiscal authorities would seek to stabilise public debt ratios at projected 2022 levels by adjusting structural primary revenue from 2023 onward. The median country would need to increase structural primary revenue by nearly 8 percentage points of GDP between 2021 and 2060, but the effort would exceed 10 percentage points in 11 countries. These results do not imply that taxes will, or even should, rise in the future. The fiscal pressure indicator is simply a metric serving to quantify and illustrate the fiscal challenge facing OECD governments. Raising taxes is only one of many possible avenues to meet this challenge.

If financing conditions remain favourable, as assumed in the baseline scenario, countries with relatively low initial public debt ratios could finance some of the projected increases in expenditure with debt. With higher public debt would come risks, however. For this reasons, absorbing future fiscal pressure with additional borrowing is a strategy that could postpone, but probably not avoid, the need for policy reforms.

Another avenue would be reforming health and pension systems to increase efficiency and prevent expenditure from rising as much as projected in this stylised exercise. In addition, structural reforms that raise employment rates are associated with substantial fiscal dividends. In the context of slowing global population growth and even declining population in many countries, labour market reforms that would raise employment and encourage longer working lives appear particularly desirable. In addition to reducing fiscal pressure, such reforms align well with the goal of helping women and disadvantaged groups gain employment. As the report demonstrates, combining labour market policy reforms with increases in average effective retirement ages could *halve* the projected increase in fiscal pressure in the median OECD country through 2060 (of nearly 8 percentage points of GDP).

Reference

Guillemette, Y. and D. Turner (2021), “The long game: Fiscal outlooks to 2060 underline need for structural reform”, *OECD Economic Policy Papers*, No. 29, OECD Publishing, Paris, https://doi.org/10.1787/a112307e-en.