

# Notat

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## Conference on Economic Consequences of Ageing in the EU

### Speaking note, Finance Minister Claus Hjort Frederiksen

First, I would like to thank the European Commission in Denmark for taking the initiative to organize this conference. And for inviting me to speak on this important topic – the economic consequences of ageing.

Beyond the immediate challenges of the global financial crisis, the consequences of ageing are probably the key economic challenge that European countries will have to face over the next decades. And the way in which we deal with the financial crisis now must not weaken our basis for dealing with these longer-term challenges.

I will touch on three issues in my comments. First, the shaping of the Danish strategy to cope with ageing. Second, some implications of the financial crisis. And third, fiscal and structural policy requirements.

*Denmark already focuses on long-term challenges*

In Denmark, we have a long tradition for planning fiscal policy in a medium- and long-term framework taking ageing into account. Previously, the 2005-plan and the 2010-plan – and today the 2015-plan.

In the 2010-plan from 2001, it was a key goal to prepare for ageing through public savings and higher employment – by running healthy fiscal surpluses and reducing public debt. These ambitious goals have largely been met. Net public debt has now been eliminated.

The strategy took a new turn with the Welfare Agreement in 2006. This extensive Agreement covered retirement reform, education, labour market policies and more.

With the reform, the challenges are now dealt with more directly at the root, since longer lives will now imply longer working lives. This also meant that the need for pre-saving was reduced.

The welfare reform has been a decisive step to ensure fiscal sustainability in Denmark. The reform is backed by 5 parties in Parliament, representing close to 90% of the popular vote.

Fiscal sustainability is also the cornerstone of the 2015-plan which we released in August 2007. In the 2015-plan, we included a number of new policy priorities, including:

- ambitious targets for energy and climate policies
- a Quality Fund for investments in public hospitals and schools and so on
- continuation of the tax freeze. And more.

The plan also sets targets for structural reforms to increase labour supply and thereby secure sustainable public finances. Such reforms will also help to underpin growth potential.

When we issued the plan in 2007, the requirement was to implement structural reforms to strengthen public finances by 0.8 percent of GDP – or 14 billion Danish kroner.

This requirement was essentially unchanged in the 2008 update of the plan. The update included structural reforms agreed last year, but also effects of the financial crisis on the near-term budget outlook and on pension wealth.

Since the 2008 update, we have agreed on a tax reform, which is fully financed. The reform lowers marginal tax rates on labour and strengthens incentives to save.

The dynamic effects of the reform are projected to strengthen public finances and thus delivers about 40 percent of the reform requirement in the 2015-plan (of 14 billion kroner). So we are heading in the right direction.

But we also have to be aware that the financial crisis – and the worsening of the fiscal balance and prospects over the short-term – can also affect longer-term challenges. The crisis will – if anything – increase the need for structural reform.

An updated 2015-plan will be submitted to the EU Commission in our next convergence programme in November. The update will include changes to the economic outlook caused by the worsened financial crisis, and the many decisions that have been taken since last year to contain the crisis.

*Political advantages (and disadvantages) of medium-term plans*

Now you may ask yourself, why I – as a politician – am so keen on a plan which in some ways ties our hands and forces us to think far beyond the next election. But those are precisely the reasons why I – as a Finance Minister – am a strong supporter of such plans.

First, the continuous focus on longer-term challenges and fiscal sustainability has been helpful in promoting reforms in Denmark.

We have managed to agree on far-reaching reforms, even in recent years of large fiscal surpluses and high employment. In particular with the Welfare reform. But also with continuous adjustments of labour market and tax policies.

Second, the plans have been helpful in promoting fiscal discipline within the framework of the tax freeze.

Our medium term framework has been key to maintain solid structural surpluses these last few years in the face of very large actual surpluses. This sound starting position means that we have larger room for manoeuvre than many other countries to dampen the financial crisis.

*Preparing for ageing has been a long process in Denmark*

In terms of what other countries might learn from Danish experience, let me point out that adjusting policies to the challenge of ageing has been a long process. Beginning with the extension of labour market pensions during the 1980s, and continuing with a long series of labour market and tax reforms. Efforts to establish and then maintain sound public finances have continued to this day.

This long process of gradual reform also shows that we will face some very hard and long-lasting challenges, if we allow the financial crisis to undermine fiscal sustainability. The process of adjusting policies in order to cope with large deficits is hard for any government and – more important – for the citizens in our countries. And it is a key objective to prevent that such needs become too large.

The recent agreement in the EU on Medium-Term Objectives – based on current debt and a fraction of the long-term increase in age-related spending – marks progress in dealing with Europe's sustainability challenge. Implementing this agreement in the upcoming stability and convergence programmes and assessments will be an important step forward.

The work should proceed. We should improve methods – including on the calculation of structural balances – and hopefully one day all EU Member States will incorporate the

full cost of ageing in their budgetary objectives. Denmark will continue to support the work.

*The Danish strategy vis-à-vis ageing*

Let me now say a few more words on the strategy that we are pursuing in Denmark to meet the challenges of ageing.

The basic principle underlying the Welfare reform is that when we live longer and in better health, it is also natural that we work longer. The early retirement age and the public pension age will be raised by 2 years, beginning from 2019. If lifetime continues to increase, the age thresholds in the pension system will be adjusted accordingly.

Meeting the challenge through longer working lives has several advantages. It raises labour supply and thus allows higher growth and higher living standards than alternative strategies. The alternatives to longer working lives are essentially higher taxes or less public spending.

The principle that age thresholds for early retirement and public pension shall follow increases in longevity also implies that our welfare system becomes much more robust in terms of future changes in longevity, which are hard to foresee.

*Denmark cannot avoid fall-out from global crisis*

I would also like to use this occasion to comment on the possibility of avoiding negative effects from the global crisis on output, employment and public finances in Denmark.

Let's be clear: Denmark cannot avoid being affected by the decline in demand and confidence among our trading partners. And we cannot – realistically – prevent an increase in unemployment although we have very expansionary monetary and fiscal policies in place.

Due to our sound starting point with healthy public finances, we can dampen the impact. And that's what we do with the very large easing of fiscal policy planned for 2009 and 2010.

*We have taken major steps to counter the financial crisis*

Within the framework of sustainable policies, the Danish government has taken many steps to dampen the impact of the crisis. In these efforts, we have been guided by two key principles:

- First, measures to support demand should be temporary, and not weaken public finances permanently. They should be consistent with the longer-term goals in the 2015-plan.
- Second, measures should improve economic structures and underpin longer-term growth, not the opposite.

In this vein, we have shifted forward public investments to 2009 and 2010. We have given people the opportunity to withdraw their Special Pension savings now, and many Danes are doing so. This measure improves public finances in the short run, at a very low long-term cost.

We have agreed a tax reform, which lowers taxes significantly from 2010 and is fully financed over the long-term. The reform helps to boost demand next year, but let me stress again that the tax reform strengthens long-term sustainability and strengthens the fiscal balance in 2015.

Also in other countries it is important that measures taken during the crisis are temporary – and that they, as far as possible, strengthen long-term prospects rather than weaken them.

Many countries with large deficits will face a big task in restoring fiscal health, and this task is compounded by ageing.

There is a risk that too many temporary measures will add up, and make it harder to restore healthy finances afterwards.

A credible medium-term strategy for budget consolidation, once the time is right, can provide benefits already now. It can help to underpin confidence and ensure that interest rates do not increase due to a lack of fiscal credibility. And in the Danish case, it can reduce vulnerability if financial tensions and pressures on our fixed exchange rate policy should re-emerge.

*What we mustn't do during the crisis*

Sensible policies during the crisis also means that we have to avoid the policy mistakes of the past.

During past crises, there was a belief in many European countries that higher unemployment could be avoided or cured by reducing labour supply. Danish politicians thought so too in some cases.

We now know better. A combination of worsening fiscal balances and “unsound” structural policies would be a poisonous cocktail implying lower employment and a more permanent weakening of public finances.

If we can avoid committing these mistakes again, at least the long-term challenges will not have increased due to bad policies during the crisis.

At the EU level the “European Economic Recovery Plan” should be followed by a Fiscal Recovery Plan – a coordinated strategy of consolidation and reforms that strengthens sustainability in line with the Stability and Growth Pact.

The easing of fiscal policies in 2009 – equal to around 1 per cent of GDP on average in the EU – has not been, and should not be, a ‘one-size-fits-all’ expansion. Member States

have different policies reflecting their different room for manoeuvre. Accordingly, they should implement consolidation policies reflecting their different challenges going forward.

*Timing of the Ageing Report*

The 2009 Ageing Report comes at a time where there is a particular need for communicating the longer term challenges, stressing the need for sound policies, and finding credible ways to ensure sustainability.

If this need is not met, we run the risk of losing the confidence of markets and reducing our room for manoeuvre.

Some might say that the timing of the report is not good – that we have to focus only on solving the financial crisis. I would say that it is even more important to have the report now, because we need to ensure that the financial crisis does not turn into a crisis for public finances.

In the extreme, EU countries face a choice between an orderly adjustment of public finances in line with a well-devised and credible long-term plan. Or more disorderly adjustments prompted by possible losses of market confidence. To avoid the risk of the latter, we should therefore proceed with the credible strategy as soon as possible.

*Concluding remarks*

Finally, I hope that this report will receive the attention it deserves around Europe. It should become a key reference point in discussions about the challenges of ageing.

So congratulations once again to the European Commission and thank you for this important report.

Thank you.