The long-term sustainability of public finances

The Covid-19 pandemic has come at considerable cost to Sweden, including for public finances. In the report's base scenario, both the government's net financial position and Maastricht debt as a share of GDP are nevertheless around the same in 2050 as they were before the pandemic. Public finances are therefore considered to be long-term sustainable. Much of the recovery in public finances will, however, take place in the near term as the economy rebounds. The base scenario assumes that the population grows healthier and works to a greater age. In an alternative scenario where this does not happen, public finances are not found to be long-term sustainable.

The NIER assesses the long-term sustainability of Sweden's public finances annually at the government's request. The aim is to detect potential imbalances at an early stage so that fiscal policy can be adjusted before problems arise. There is no universal definition of fiscal sustainability. The NIER defines long-term sustainable public finances as where the government sector's net financial position as a share of GDP does not trend down, and the government sector's consolidated gross debt (Maastricht debt) as a share of GDP does not trend up, provided that the former is not excessively low and the latter not excessively high in the first place.

The Covid-19 pandemic and the action taken to support the economy mean that government net lending will be deep in negative territory in both 2020 and 2021. As a result, Maastricht debt increased as a share of GDP in 2020 and is expected to rise further in 2021. Net lending is then expected to recover as the economy rebounds, approaching zero in 2023. Maastricht debt as a share of GDP will drop back in the coming years towards pre-pandemic levels. More critical for long-term fiscal sustainability, however, are the demographic changes expected in the coming decades, with a growing share of elderly people in the population. For example, the demographic dependency ratio, which compares the number of young and elderly in the population with the number of people of working age, is projected to climb from 0.75 today to 0.85 in 2050.[1]

[1] The demographic dependency ratio shows the number of people in the population under the age of 20 and over the age of 64 relative to the number of people aged 20-64.

SUSTAINABLE PUBLIC FINANCES IN THE BASE SCENARIO

In the base scenario presented in the first chapter of the report, we assume that increased life expectancy results in more healthy years for the elderly and so longer participation in the labour market, which is in keeping with the aims of the pension reform.[2] In this year's sustainability calculations, we have made new assumptions about developments in labour force participation in the long term.[3] The review has resulted in a higher participation rate than assumed in last year's report, leading to higher GDP and so higher tax revenue.

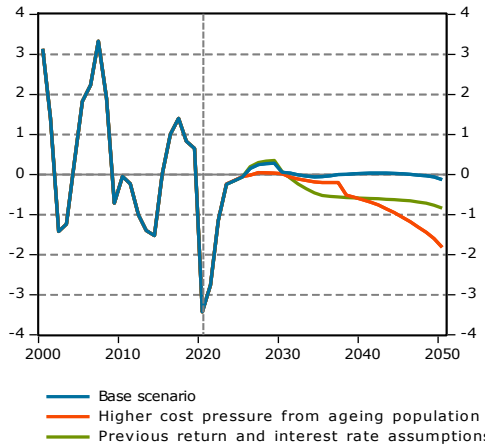
As in previous reports, one starting point for the calculations is an unchanged public sector commitment. By our definition, this means that government consumption grows in step with demographic developments plus an increase in the standard of welfare services in line with the historical pattern. We also assume unchanged replacement rates in the transfer systems, and tax rules unchanged from those for 2021.

In the base scenario, primary net lending recovers from its low level in 2020 to around –1 per cent of GDP in 2023. It then remains around this level through to 2050. Since the government sector is in a net wealth position, net financial returns help give net lending of around 0 per cent of GDP during the same period (see Diagram 1). Ahead of this year's calculations, we reviewed the assumptions behind long-term interest rates on government debt and long-term returns on financial assets. These assumptions result in a higher total return on financial assets, which better reflects the historical pattern. This review means that the government sector's net capital income does not deteriorate with an unchanged net financial position, and neither does net lending. The net financial position and Maastricht debt are therefore relatively stable as a share of GDP and remain around current levels through to 2050 (see Diagram 2 and Diagram 3). The conclusion is therefore that public finances can be considered long-term sustainable.

Our calculations continue beyond the period reported on here and run right through to 2100. On this horizon too, the net financial position and Maastricht debt are relatively stable as a share of GDP. The uncertainty inherent in such long-term projections does, however, require them to be interpreted with caution.

Diagram 1 General government net lending

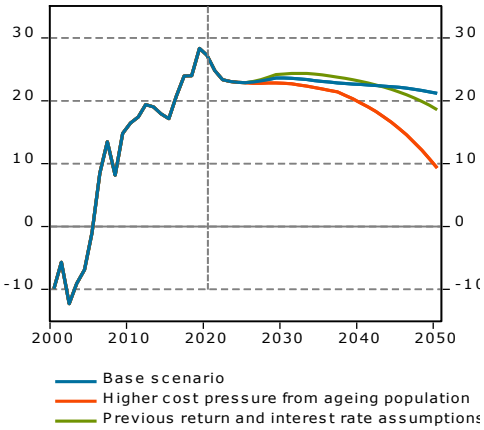
Per cent of GDP



Source: Statistics Sweden and NIER.

Diagram 2 General government net financial position

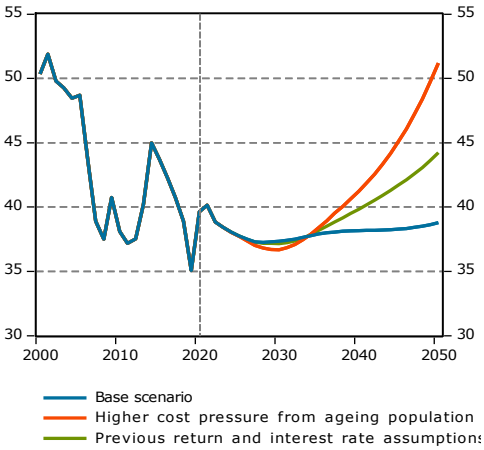
Per cent of GDP



Source: Statistics Sweden and NIER.

Diagram 3 Maastricht debt

Per cent of GDP



Source: Statistics Sweden and NIER.

[2] See Ministry of Health and Social Affairs memorandum "The Pension Group's agreement on long-term raised and secure pensions", 2018, and article "Sustainable pensions: Improved basic protection for pensioners and a gradual increase in retirement age", 2019.

[3] The assumptions have been revised to reflect rule changes decided or proposed that are expected to raise the retirement age in the general pension system.

LESS FAVOURABLE OUTCOME IN ALTERNATIVE SCENARIOS

The second chapter of the report presents a number of alternative scenarios. These show how public finances would perform under different assumptions to those used in the base scenario. One such scenario assumes that the population does not grow healthier over time, and that people do not therefore work to a greater age. The path for public finances is then considerably less favourable. Net lending falls towards –2 per cent of GDP in 2050, and Maastricht debt trends up to just over 50 per cent of GDP (see Diagram 1 and Diagram 3). For public finances to be long-term sustainable, therefore, it is important to ensure that the population does grow healthier over time so that a longer life also means a longer working life.

In another scenario, we look at how public finances would perform under the assumptions used in last year's report for interest rates and returns. Applying these assumptions, the net financial position is slightly more than 2 percentage points lower in 2050, and Maastricht debt slightly more than 5 percentage points higher, than in the base scenario (see Diagram 2 and Diagram 3). These assumptions have a greater impact in the longer term, however. Public finances deteriorate after 2050, and both the net financial position and Maastricht debt reach levels that cannot be considered long-term sustainable.