

English Summary

The current Faroese fiscal policy is unsustainable. Given the growing elderly population, it will not be possible to maintain the current welfare service level in the future without reforms. A balance must be struck where rising life expectancy is not merely synonymous with more years as a pensioner, but also more active years on the labour market.

Fiscal policy sustainability, or lack thereof, is illustrated with a figure termed the fiscal policy sustainability indicator (the indicator from hereon). A negative indicator means that public expenditure exceeds future public revenues. The indicator illustrates the percentage of annual GDP shortfall if current welfare levels are to be maintained.

The indicator is -9% of GDP as calculated using the population forecasts issued by Statistics Faroe Islands (SFI from hereon). This population forecast is based on historical statistics. Due to a financial crisis in the 1990s the Faroe Islands experienced a large-scale emigration in the 1990s and it effects the population forecast to predict an annual net emigration.

Historically there have been major fluctuations in immigration and emigration in the Faroe Islands. A sensitivity analysis was therefore carried out applying an annual net emigration of 0 and not minus 50. In this case the sustainability indicator is -8% of GDP.

This more optimistic net emigration is, however, not sufficient to solve the fiscal policy sustainability issue. Both results reveal that the current fiscal policy is unsustainable and that reforms are required. The results of -9% and -8% of GDP yield a deficit of roughly 2 billion DKK at 2022 GDP levels recurring every year if no steps are taken to improve fiscal policy sustainability.

In 2015 the Faroe Islands Economic Council carried out a sustainability analysis, which yielded a sustainability indicator of -5% of GDP. The forecast was calculated up to 2051. The new model has an infinite time frame. In the new model approximately half of the results date from the period after 2062.

The model used to calculate the sustainability indicator is based on current welfare services, provisions and public revenues, and it forecasts public expenditure and revenues according to changing demographic figures. The rising life expectancy alters the population age structure over time leading to a growing proportion of older people as compared to people of working age.

For the purpose of forecasting public revenues and expenditures statistics relating to economic factors that impact the development of the Faroese economy have been used. In addition, conditions have been established for how population figures change, when people leave the labour market, expected labour market participation in the future, and the extent to which the population will require public services. The baseline year is 2018, however, legislative changes adopted since 2018, which impact fiscal sustainability, have been included in the calculations.

Originally the model was developed by the Danish Research Institute for Economic Analysis and Modelling, DREAM, for the Greenlandic economy, but it has been adapted to Faroese conditions and is using Faroese statistics. There are several uncertainties linked to the conditions set for the calculations and these uncertainties increase the further ahead we look. For example, the calculation period is

infinite, and it is likely that several conditions will change in the future. Another condition applied is that the population remains constant after 2062 due to the finite time frame of the population forecast.

The exact figure of the indicator may vary according to the conditions and the exact figure should therefore be used with caution, however, the conclusion is unambiguous. The current fiscal policy is not sustainable and it is vital that reforms and initiatives are rolled out immediately in order to promote sustainability in the Faroese economy.

Factors that reduce public expenditure or raise revenue improve fiscal sustainability. Increasing the pension age improves fiscal sustainability, both because public expenditure on pension payments is reduced and because public revenues increase when people stay longer on the labour market. The pension reform that entered into force in 2018 only raises the pension age by six months by 2024 and then again in 2031. However, the legislation allows for a life expectancy indexation of the pension age, which means that it is possible to adapt the years on the labour market to the average life expectancy of the population.

Demographic trends over the next 40 years show a rise in the number of people who will be needed to be taken care of compared to the number of people in the work force. This is because we live longer. The Faroese government has managed the pension system since 1988, since then the average life expectancy of pensioners has risen by 4 years and is at present 19 years, without any corresponding increase in the retirement age. This means that the financial responsibility of the working force to pay for welfare services has become harder and it will only get worse.

If the retirement age does not increase in line with life expectancy, it will lead to greater imbalance in the ratio between rising pension expenditures and proportionally lower tax revenues from income tax during the working life. It is therefore necessary to set the retirement age, so that rising life expectancy is not exclusively intended for extra years as a pensioner, but also more active years in the labour force. The basic principle could therefore be to allow for the retirement age to increase, as long as is advisable, and it follows a process of political review. Initially, however, in order to achieve fiscal sustainability it is necessary to accelerate the balance between years spent in the labour force versus years spent as a pensioner. If, in future, the rise in life expectancy proves to taper off, then the retirement age should be revised as set out in the basic principle.

A. Result based on Statistics Faroe Islands population forecast

The baseline scenario for the fiscal policy sustainability calculation is based on the population forecasts issued by SFI and the adopted retirement age. In the model this means that the retirement age rises by six months in 2025 and in 2030. In addition, three alternative scenarios have been calculated: the first applies a retirement age that rises by six months every five years throughout the forecasting period; the second lets the retirement age rise by a whole year every five years starting in 2035; and the third scenario lets expenditure on elderly care fall by 20% over the next 40 years, cf. to table 1.1.

A. Indicator, basic scenario and impact of political initiatives		Table 1.1
Indicator, basic scenario	- 9%	- 9%
A1. Retirement age rises by ½ year every 5 years	+ 5pp	
A2. Retirement age rises by 1 year every 5 years (from 2035)		+ 8pp
A3. Elderly care expenditure per person cut by 20% over 40 years	+ 1pp	+ 1pp
Indicator including political initiatives	- 3%	0%

Today the retirement age is 67 years and there are approximately 4 persons of working age for every pensioner in the Faroe Islands. In the baseline scenario the retirement age will be 68 by 2062 and the forecast average life expectancy as a pensioner will reach 22 years as mentioned. This implies that there will be only 2 persons of working age for every pensioner in the Faroe Islands by 2062. The baseline scenario yields a sustainability indicator of -9%.

A1. If the retirement age rises by six months every five years throughout the forecasting period, the retirement age will reach 71 by 2062 and the forecast average life expectancy as a pensioner will be 19 years, as it is today. In addition, there will be about 3 persons of working age for every pensioner in the Faroe Islands. This will improve the indicator by 5 percentage points.

A2. If the pension age rises by one year every five years throughout the forecasting period starting in 2035, the pension age will reach 74 by 2062 and the forecast average life expectancy as a pensioner will be 17 years. In addition, there will be 4 persons of working age for every pensioner in the Faroe Islands, as there is today. This improves the indicator by 8 percentage points.

A3. A cut in expenditure on elderly care by 20% over 40 years will improve the indicator by about 1 percentage point. Taking steps to improve efficiency in the sector for elderly care can significantly contribute to addressing the sustainability challenge.

B. Sensitivity analysis, result based on the adapted demographic forecast

The sensitivity analysis, which applies a net annual emigration of 0, yields an indicator of -8%, cf. table 1.2. If the retirement age rises by six months every five years throughout the forecasting period the indicator improves by 4 percentage points (B1), whereas a rise in retirement age of one year every five years commencing in 2035 yields an improvement of 7 percentage points (B2). Cutting expenditure on elderly care by 20% results in a 1 percentage point improvement (B3).

B. Indicator, sensitivity analysis and impact of political initiatives		Table 1.2
Indicator, sensitivity analysis (net migration 0)	- 8%	- 8%
B1. Retirement age rises by ½ year every 5 years	+ 4pp	
B2. Retirement age rises by 1 year every 5 years (from 2035)		+ 7pp
B3. Elderly care expenditure per person cut by 20% over 40 years	+ 1pp	+ 1pp
Indicator including political initiatives	- 3%	+ 0%

Recommendations

These results demonstrate that the most effective step to addressing the fiscal policy sustainability challenge is to raise pension age by one whole year every five years starting in 2035. The results of -9% in the baseline scenario and -8% in the sensitivity analysis (net emigration 0), yield an annual deficit of approximately DKK 2 billion in 2022 figures, if no steps are taken to improve fiscal sustainability. Reforms are therefore required so that today's generation does not leave unpaid bills to future generations.

The Faroe Islands Economic Council recommends:

Recommendations



Raising the retirement age

The political system should promote intergenerational solidarity by raising the retirement age so that the increase in life expectancy is not merely synonymous with extra years as a pensioner, but also that a proportion of the extra years gained are spent actively on the labour market.



Improving efficiency in elderly care

For elderly care the political system should make public sector operations more efficient, so that the growth in total expenditure on elderly care per person falls.



Initiate fiscal policy regulations

The political system should launch a fiscal framework on state and municipality level in order to curb the growth in public expenditure.



Curbing emigration

The political system should implement initiatives that promote immigration and reduces emigration from the Faroe Islands, particularly of the youth.