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THE COSTS OF DEMOGRAPHIC AND ECONOMIC CRISES - CHALLENGES TO PENSION SYSTEMS REFORM

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ABSTRACT: *As the economic and financial crisis accelerates worldwide, covering the expenses driven by an aging population is a challenge both now and in the future for the pension systems. Thus it is necessary to adopt sustainable reforms to cushon the expected impact of these crises on the budget. In general, the strongest pressure occurs on pay-as-you-go (PAYG) pension systems. It is also essential that the reforms on pension systems should be accompanied by anti-crisis policies concerning the financial sector, the labour market and public finances.*

KEY WORDS: *demographic crisis; reforming the pension system; pension costs; anti-crisis policy; private pension funds.*

JEL CLASSIFICATION: *E62; H55*.

The acceleration of the aging process is a major phenomenon worldwide. Europe and Japan face this situation in particular. It is estimated that Europe has already reached a critical stage, the European Union member states being forced to cope with these demographic challenges both short and long term.

It has been anticipated that pensions, including disability pensions, early retirement or surviving relative will grow larger in the future rising on average by around 3% of GDP by 2050 in comparison to the present level. However, this average does not fully illustrate the large differences which are expected among countries.

The dynamics of capital accumulation and the sustainability of the pension system depend largely on the openness of the economy. The European economies are not isolated from each other nor of the world. Therefore, even slight differences in their pension schemes, coupled with a severe aging population will inevitably increase the financial flows between these countries and will bring modifications regarding the accumulation of the fixed capital. Thus the nature of the financial environment will

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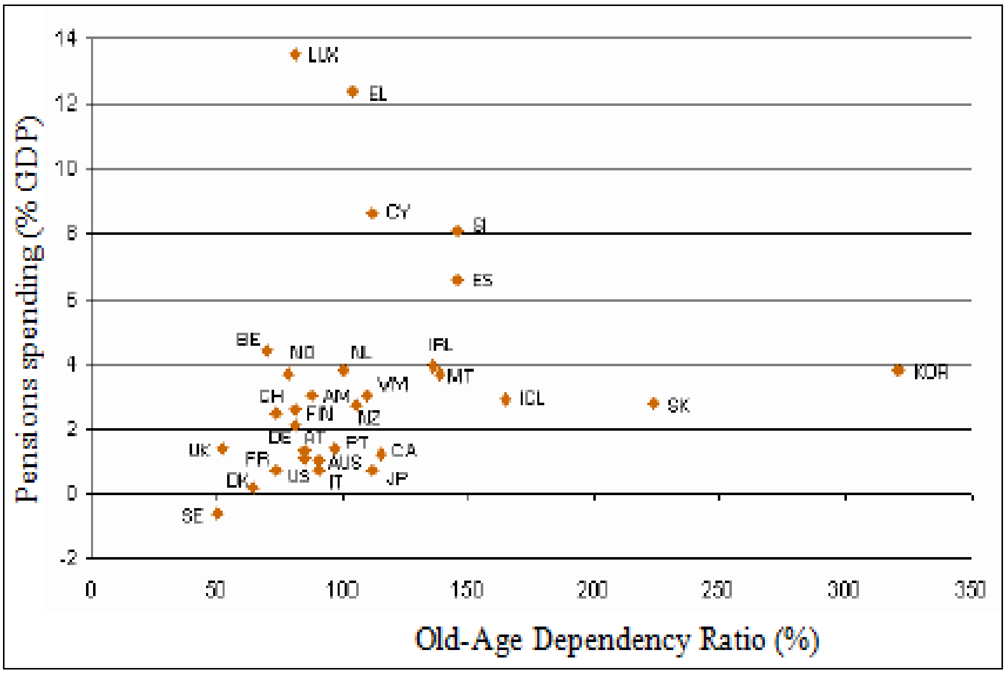
play a crucial role for the European economies in the process of adapting to these phenomena and implementing their reforms (Chojnicki & Magnani, 2000, p.66).

The charts below show the correlation between pensions spending and old-age dependency ratios (the number of over 65s compared to the population aged 15-64) both in advanced sovereigns as in emerging sovereigns. Naturally, the higher the old-age dependency ratios get, the larger becomes the pensions spending. Anyway this is not a rule, because the expected increase in budgetary spending for pensions can be cushioned by implementing sustainable reforms (http://www2.standardandpoors.com/ spf /pdf/mediaglobal_aging_100710.pdf).



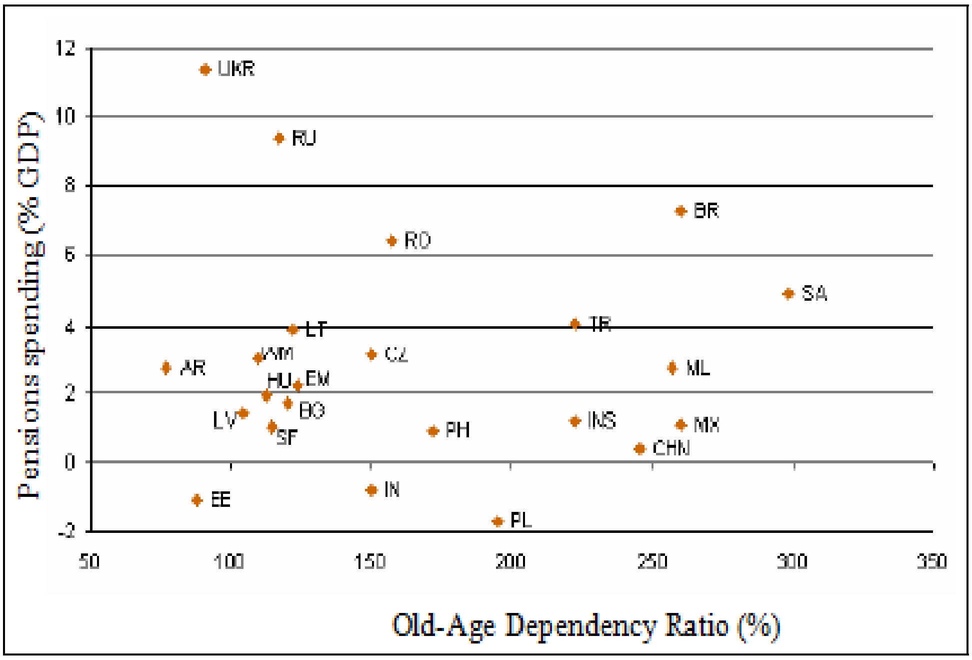
Source: European Comission, International Monetary Fund, Standard &Poor's 2010

Figure 1. Advanced countries: Pensions spending and Old-Age Dependency Ratios (2010-2050)

Untill 2050 the Old-Age Dependency Ratios are believed to double both in advanced states as in emerging states. Although, there are some sensitive resposes in Europe, especially Eastern Europe, Latin America and Asia. The greatest pressure on budgetary spending relative to aging is noticeable in states where there are still reforms pending on pensions systems, mostly PAYG(pay-as-you-go) pension systems. In these conditions, in states such as Luxembourg, an increase of more than 13 % of GDP by 2050 is anticipated.

Under the rapid changes in their demographic structure, Spain and Slovenia are also implementing reforms to their PAYG, this involving changing the formula of pension indexation, increasing the legal retirement age and so on. Fortunately, in countries where the demographic structure seems to be very poor, past systemic reforms have cushioned the expected increases in pensions, for example Slovakia and Korea.

The emerging states seem to hold, on average, a relative better position due to their present conditions of development and to a lower coverage of pension systems. Unlike the advanced economies where the median pension spending to GDP is at about 9.2% the emerging states, excepting few, present a lower percentage 6.4%.



Source: European Comission, International Monetary Fund, Standard &Poor's 2010

Figure 2. Emerging countries: Pensions spending and Old-Age Dependency Ratios (2010-2050)

Pension spending will face nevertheless many threats and uncertainties in the near future. Taking into consideration employment and old-age dependency ratios on long term, the projections for pensions in emerging countries apart from the ones in the European Union stand on constant coverage ratios of pensioners to the persons above 65 years. However, the advanced economies seem to suffer a faster deterioration of the old-age dependency ratio. We have to mention that these long-term projections stand on the supposition that there will be no change of the policy cover and adequacy.

There are also expected significant changes in their social structures as these states develop. During the last half of the 20th century, the government welfare spending has grown faster than GDP as a stage of this development process. Taking this into consideration these projections seem to be optimistic. This is the case of Poland, Estonia and India were expecting a fall in pension seems to be very optimistic and not politically sustainable if the replacement rates decrease significantly because this situation will lead to an increase of poverty risk for the older. Hungary has taken a radical measure by nationalizing the Pillar II pension systems.

On the other hand, higher increases in pensions spending are expected in countries such as Romania, Russia and Brazil and Ukraine because of their pension systems which are not reformed. Romania, for example is facing this situation under the terms of the programs with IMF/EU.

On medium and long term, the risks associated to the increase of the expenditure related to the older population, in the context of an accelerated aging phenomenon while a decrease of the active population, can be significantly reduced implementing fiscal consolidation measures (http://ec.europa.eu/europe2020/pdf/nrp/cp_romania_ro.pdf).

The current economic and financial crisis has worsened and amplified the effects of severe demographic tendencies. According to the European Commission estimation, the impact of aging phenomenon on public finances in Europe, will make the effects of social and economic crisis seem very small compared to the costs associated with this phenomenon. In addition, the public pension systems in Europe seem to be more and more unsustainable as there is a dreasting need for adopting combined measures, for their swift reform, for improving public finances, fiscal consolidation and for the stabilization of the perspectives regarding the economic growth. The recovery from the economic crisis proves to be slow and the main challenge for the EU is the sustainability of its spending. We recall that reducing the public debt is one of the main lessons that should be learned from the economic crisis.

Unlike the current economic and financial crisis, the demographic crisis is a centenarian phenomenon whose effects will not disappear even after 2050. It is also necessary that the measures to reform the pension systems should be accompanied by anti-crisis policies regarding the financial sector, the labour market and thus public finances. During the last decade the demographic aging in Europe was much faster than the initial estimates of the European authorities and more and more countries have shown a greater concern for increasing the share of private pensions to supplement the income from public pension systems.

Thus, during the last decade, there have been consistent reforms in public pension systems that reduced the generosity of state pensions. The EU member states changed their approach and outlook on retirement and passed from individual pension systems (pay-as-you-go) to multi-systems, thus leading to the appearance (in Central and Eastern Europe) and development (in Western Europe) of private pension systems.

In order to cope with the increasing costs of these crises it is also necessary to reform the Stability and Growth Pact and to include in the analysis of European public finances, the costs of private pension systems, Pillar II type. The orientation of the pact towards objectives and criteria in the short term, has led some states to go back to some reforms of their pension system and to affect the development of private pension systems (Beetsma & Oksanen, 2007).

The effects of the financial crisis were strongly felt in the stability of public pension systems which encouraged the improvement of private pension schemes in Europe. The fact that many countries delay or postpone the reform of public pension systems and prefer to increase their public debt in order to maintain the current public pension systems that prove to be unsustainable will lead to serious long-term repercussions in Europe. It is estimated that in the context of birth rate fall, aging and population reduction in EU there will be an increase in public spending on average 10.2% of GDP (in 2010) to 12.5% in 2060. Taking into consideration also the fact that until 2060 there will be a doubling of the old-age dependency ratio the survival of public pension systems under these conditions will become almost impossible.

In the public pension sector, the current financial and economic crisis led to an increase in cost/income ratio by percentages ranging on average between 5% and 15% and this ratio is expected to double by the doubling of the dependency ratio due to aging population. Despite their greater need, reforms in this area are difficult to implement.

Thus, increasing the retirement age, reducing state pension indexation as the development of private pension systems is a priority to modernize the European pensions. Given the increased role of private pension funds in the world, there is also a greater need for an increased regulation of financial markets to assure their transparency and sustainability. At the national level it is also necessary to ensure a fair and proportionate legislation of private pensions but by avoiding double regulation.

Taking into consideration the significant increase in spending on social protection during the recent years (pensions, unemployment benefits, minimum pension and social services), the Romanian government has committed to a substantial reform of the public pension system in order to improve its sustainability. So there has been considered increasing the number of contributors to pension system by adding new categories of taxpayers and integrating special schemes, raising the retirement age and restricting early retirement and disability pensions as limiting the benefits by a gradual transition to pensions indexation the with the inflation rate and establishing the pension exclusively according to the paid contributions.

The main measures provided for in Law no. 263/2010 on public pension reform in Romania aims to (Law no. 263/2010 of 16 December 2010 regarding the unitary system of public pensions):

- Introduce a new pension indexation formula since 2012
- By 2020, the pension point will annually increase by 100% of the inflation rate plus 50% of real growth of average gross salary in the previous year. If one of the indicators is negative, the positive one is used.
- Since 2021, the pension point will annually increase by 100% of the inflation rate plus 45% of the real growth of average gross salary in the previous year. The percentage of real growth of average gross salary is gradually decreasing by 5% per year;
- increase women's retirement age gradually to 63 by 2030;
- include certain categories of taxpayers who have not previously contributed (army, police, etc.);
- reduce early retirement and restrict the disability pensions;
- increase the contribution base by including new categories(liberal professions).

Thus, for Romania, the share of total expenditure on pensions in GDP is expected to increase to about 11% of GDP at the end of the forecast range. Pillar 2 will have a growing share of total expenditure on pensions since 2050, reaching a share of 1.7% of GDP in 2060 (Table 1).

Table 1. The long-term forecast of pension expenditure

					% in PIB
	2011	**2030**	**2040**	**2050**	**2060**
Social insurance(included retired farmers) of which:	9,0%	10,8%	11,3%	11,5%	10,8%
Pillar 1	8,8%	10%	11,3%	11,5%	10,8%
Pillar 2		0,1%	0,5%	1,5%	1,7%

Source: MFP

In conclusion, Europe's demographic decline is drastic and the process of population aging is accelerating even more. Moreover, the economic power of developed countries is declining. The aging population will trigger a decline in labour productivity, taking into consideration the fact that labour productivity decreases as you age. In addition, the volume of savings is decreasing and therefore there are fewer available funds for investment and consumption.

In these conditions, the developed countries are forced to allocate an increasing proportion of GDP for the older generation. I think it is impossible to achieve sustainable macroeconomic policies (regarding the costs, the budget revenues at national level the costs of banking market and the big retail market operators) without analyzing and acting on demographic variables. The impact of this demographic crisis on pensions will be devastating. The Member States will face enormous pressure to face the needs of an aging population.

The dynamics of capital accumulation and the sustainability of the pension system depend largely on the openness of the economy. The European economies are not isolated from each other nor of the world. Therefore, even slight differences in their pension schemes, coupled with a severe aging population will inevitably increase the financial flows between these countries and will bring modifications regarding the accumulation of the fixed capital. Thus the nature of the financial environment will play a crucial role for the European economies in the process of adapting to these phenomena and implementing their reforms. So, an increased regulation of the financial markets is also a necessity.

I consider that the aging population was one of the key factors in the origin of the economic and financial crisis. Until 2050 the Old-Age Dependency Ratios are believed to double both in advanced states as in emerging states. Although, there are some sensitive responses in Europe, especially Eastern Europe, Latin America and Asia. In the future, Europe will be dominated by a population of over 55 years and life expectancy continues to increase. Fertility will remain low in Europe and the dependency ratio will double by 2060. We must not forget that young people can not bear these costs for too much time. So it is necessary for the state to support the young workforce in order to boost the economy. In addition to increasing the number of jobs we must primarily pursue an increase in work productivity.

I believe that to deal with this situation we should consider the changes in the consumption habits for all ages and to give more importance to cover the essential costs for a decent life. It seems that population decline is a greater danger to the world economy than the current recession. So it is necessary to develop and implement regulatory strategies to support pensions on long-term.

The greatest pressure on budgetary spending relative to aging is noticeable in states where there are still reforms pending on pensions systems, mostly PAYG (pay-as-you-go) pension systems. The main problems that we face in the private pension reform concern: the tax systems that can support them, raising the retirement age as well as regulations on occupational pensions. I think that in this context we need to give a special importance to the supervision and coordination of pension policies across Europe.

We have seen that under the debt crisis, the EU Member States had to substantially reduce expenses to balance budget deficits but avoided to reduce pensions. This is a challenge to the fiscal credibility of the European governments. Hungary has applied an additional nationalization of occupational pensions, Slovakia continues as before to finance its system, Poland has reduced the payments triggering a wave of criticism. In the Czech Republic the government is working on a reform of the pension system.

Romania aims to increase the number of contributors to the pension system, to rise the retirement age and to restrict early retirement and disability pensions and the integration of special regimes. But the cost of these reforms is surprisingly large. Moreover, the European Union has not undertaken a reform of the Stability and Growth Pact in order to adapt it to the reform of pension systems and countries with reformed systems face many difficulties to comply with its regulations.

Unlike the current economic and financial crisis, the demographic crisis is a centenarian phenomenon whose effects will not disappear even after 2050. However there are many other risks to be faced in the future.

Therefore it is also necessary to implement anti-crisis and economic measures for a sustainable growth in order to face the costs of the current demographic crisis and those of the financial and economic crisis. The fact that many countries delay or postpone the reform of public pension systems and prefer to increase their public debt in order to maintain the current public pension systems that prove to be unsustainable will lead to serious long-term repercussions in Europe.

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