THE IMPACT OF THE ECONOMIC AND FINANCIAL CRISIS ON PENSION SYSTEMS IN THE EUROPEAN UNION*

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Abstract: This article aims to highlight the impact of the financial crisis on national pension systems in the European Union and to identify the necessary measures for the reform of pension systems in order to ensure their financial sustainability on long term. The financial crisis has affected all pension systems worldwide and the ongoing global recession is affecting the anti-crisis measures taken by governments to limit the negative effects of the impact of this crisis on the national pension systems. Having to face these two events which follow each other rapidly, most of the world's governments react erratically and in different ways.

JEL classification: G01, G23

Key words: economic and financial crisis, pension system reform, pension costs, anti-crisis policies

1. INTRODUCTION

Due to the intensification of the global economic and financial crisis covering pension expenditures is a real challenge both now and in the future. In order to maintain the pension system at an adequate level most countries in the EU support costs of over 10% of GDP. Through worldwide studies, World Bank warns policymakers not to take short-term tax changes because they will have to face a negative and long term impact on the financial sustainability of pension systems.

Among the objectives that policy makers should consider to ensure the financial sustainability of pension systems are: protecting the purchasing power of pensioners, gradually increasing the retirement age and the conviction of employed persons to contribute to private pension systems which is actually the key for the moment and for the long-term sustainability of pension systems.

On a general approach to the pension systems, currently existing in the world, there can be identified two main systems: a system that ensures a minimum pension through PAYG system and another representing an additional minimum pension consisting of a private pension contribution of the insured. An important characteristic of the system PAYG is the pension indexation, which allows the pension system to take account of inflation, the second feature is why the PAYG system allows a transfer of resources from the rich to the poor, meaning a horizontal redistribution of resources.

Among the disadvantages of the PAYG system, are: its vulnerability to the aging process of population world widely, the reduction of the active population and the

* **Acknowledgement**:"This work was partially supported by the strategic grant POSDRU/CPP107/DMI1.5/S/78421, Project ID 78421 (2010), co-financed by the European Social Fund – Investing in People, within the Sectoral Operational Programme Human resources Development 2007 - 2013"

macroeconomic issues that countries with economies in transition mainly confront.

The financial crisis has deeply unbalanced the pension systems leading to a reduction in revenue and to an increase or maintenance in spending. Besides the effects of this crisis if we take into account the impact of the demographic crisis, we will face amplification on long term. Therefore, even slight differences in the operation of pension schemes in the European Union, coupled with an increasing aging population will inevitably increase the financial flows between Member States and will bring changes in terms of fixed capital formation. Thus the nature of the financial environment will play a crucial role for the economic adaptation to this phenomenon and for the implementation of the reform measures[15].

For the PAYG public pension systems, the slowing of the real economy has worsened the fiscal pressures on finances and contributions. The crisis highlighted the need to strike a balance between PAYG systems and the fully funded systems.

There are relevant differences in the evolution of public pension expenditure among the EU member states which range from a decline of -2.8 percentage points of GDP (Poland), to a growth of 15.2 percentage points of GDP (Luxembourg).

We will see a major increase in spending on pensions in countries such as Belgium, Greece, Estonia, Cyprus, Luxembourg, Malta, Romania, Slovenia and Ireland with a level of about 5 percentage points or more (over 10 p.p in Greece, Luxembourg and Cyprus, although in most countries they started from a low level due to the maturity of pension systems. In countries such as Bulgaria, the Czech Republic, Germany, Lithuania, Netherlands, Slovakia, Finland and the UK will see an increase of 2 percentage points and 5 percentage points of GDP. Estonia, France, Italy, Latvia, Austria, Poland and Hungary will register a moderate growth due to reforms that have been implemented in their pension systems[16]. The chart below outlines in a comprehensive manner the scale of the challenges for the pension systems among the Member States of the EU. It shows the projected evolution of pension expenditure as a measure of sustainability and the changes in the benefit ratio, as a measure of adequacy in the future.

Further efforts are thus required to indicate the relative merits of different pension models. In these circumstances, the Member States of the European Union chose to accept an increase in deficits for pension systems in order to allow them to play the role of automatic stabilizer. To meet these rising costs it is also necessary to reform the Stability and Growth Pact which should include in the analysis of public finances at the EU level also 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 of their reforms on pension systems and to affect the development of private pension systems[17].

In Romania, the current situation of the pension fund is dramatic. Over a long period of time this mechanism has worsened the economic decline and the social disaster The pension system in Romania has undergone several reforms over time in order to improve its sustainability.

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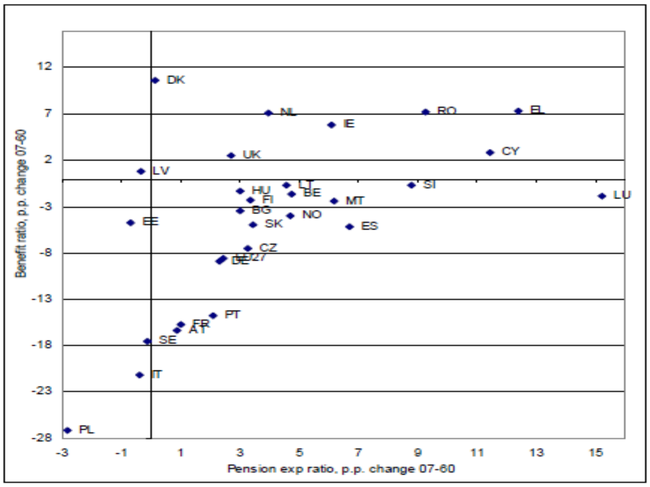
[15] Xavier Chojnicki & Riccardo Magnani - Vieillissement, retraites et ouverture financiere en Europe: des réformes encore insuffisantes, Économie internationale 113 (2008), p. 66,2008.

[16] Progress and key challenges in the delivery of adequate and sustainable pensions in Europe – European Economy, Occasional Papers 71/ November 2010, p.55.

[17] Roel Beetsma and Heikki Oksanen - Pension Systems, Ageing and the Stability and Growth Pact, European Economy, Economic Papers, Number 289, October 2007.

Out of 10 million people, active population, only 5.8 million contribute to the pension system, the reform having as purpose the creation of an equitable redistribution and creating a closer link between the contributions made and the benefits received.



Source: Commission services, 2009 Ageing Report.

Figure 1. Pension policy challenges - pension expenditure and benefit ratio

It is also necessary to consider two important global trends: the decreasing rates of fertility and the medical developments which are leading to a prolongation of life.

Therefore increasingly fewer workers support more and more retirees. Thus the public pension system failure will occur as a result of the increase of the retirement age and of the taxes on wages. The effects of the demographic decline on the public pension system in Romania are very large. This system works as a redistributive PAYG: the social contributions are collected from employees and are immediately paid as pensions. In the context of the current demographic problems, fewer employees, more retirees, this system cannot work for too long.

It is though recommended to pass from systems that generally include a single level to multi-level systems[18].

A solution to this problem is the development of private pension systems and their connection to the free market. There are two directions which can be followed in order to achieve this goal: either by a sudden and complete renunciation to the public pension system, either through a gradual transition, keeping the system as a pillar. The method proposed by the World Bank, aims to reform the public pension PAYG, by transforming it into a major private one and by the formation of the three pillars. But to do this we need: a good capacity of implementation, an adequate financial sector and good macroeconomic policies.

The observed trend at the European level is to give greater importance to private complementary prefinanced schemes, which are often defined contribution schemes. Our country has adopted a system of pillars according to the model proposed by the World Bank.

According to Law 411/2004 as amended, the contributions to the private pension system (pillar 2) should increase by 0.5% per year from 2% in 2008 to 6% of gross income of participants in 2016, the remaining 3,5% continuing to fund state

[18]http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52010DC0365:EN:NOT

pensions. But as a result of the measures taken by the Government of Romania, this increase did not take place. As other social reforms, the reforming of the pension system in Romania takes place in agreement with the IMF and World Bank. In the last three years we have seen a doubling of spending on pensions, and an increase in GDP with only 28%.

After the unleash of the economic-crisis, countries with PAYG pension systems returned to their previous contributions and gave up reducing the contributions to pension funds. These projects of reducing contributions to pension funds were considered in order to encourage the increase in number of the employees by reducing the cost of labor. Other anti-crisis measures took into account the reduction of the contributions to Pillar 2 and their increase in the first pillar, this is the case of Romania, Hungary and Slovakia, the latter allowing citizens to opt for a single pillar.

Although the effects of the financial crisis are strongly felt in pension systems, the real crisis will occur as a result of the aging process and demographic movements. It is therefore necessary to establish a plan in order to combat the effects of these long-term phenomena.

5. CONCLUSIONS

In the last decade, there has been a considerable progress regarding the pension reform at the EU level. Despite the significant differences between these systems, the Member States take measures in order to adapt to the changes in demographics, which tend to increase over the next decade. But to counter these phenomena is a real challenge. According to the latest Eurostat estimates, the size of the active population will decrease from 2012. A potential growth will be based less on an increase in labor supply and more on measures to increase labor productivity. This will have economic and budgetary consequences on long-term.

In addition to these perspectives, the economic and financial crisis led to a deterioration of public finances and to a sharp increase in public deficits and debt levels, which clearly affects the public spending programs on social protection. In addition, we are witnessing a reduction of investments in private pension funds and an increased uncertainty regarding the extent to which they will be recovered.

Therefore we need a careful review of pension policies in order to provide a sustainable and adequate retirement income. This is a call to implement policies based on interconnections between employment, social protection systems, financial market policies and labor migration policies if we want to ensure sustainable pensions.

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