THE IMPORTANCE OF MAINTAINING LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

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Abstract

This paper seeks to emphasize the significance of preserving long-term fiscal sustainability by continuing measures for economic recovery, boosting economic growth, and upholding a new framework for sustainable development. This approach aims to eliminate economic vulnerabilities and secure a decent standard of living. The main objectives for creating and consolidating public finances aim at improving the quality of public spending by improving budget planning, implementing reforms in the labor, pension, and SME support sectors, prioritizing sectoral policies, ensuring real competition between proposed projects for funding, and supporting performance by using the best practices at the European level and avoiding wastage of public funds. The paper analyzes the degree of fiscal consolidation achieved, contributing to reducing inflation, interest rates, the trade deficit, and the current account deficit of the balance of payments, as well as the stability of the leu exchange rate, taking into account the fragility of the domestic and external environment, the budgetary effort required for the new pension system law, and the implementation of reforms from the PNRR, which must be completed by 2026. Considering the issues mentioned above, Romania has set several objectives to ensure the sustainability of the gross financing needs, such as reducing the budget deficit by supporting and adapting the business environment to the challenges posed by economic crises, simplifying taxation, and improving legislation to address tax evasion, to create the conditions for healthy and sustainable economic growth.

Keywords: economic recovery; labor and pension reforms; demographic trends; sustainability indicator; long-term expenses

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1. Introduction

The paper highlights the role and importance of long-term sustainability of public finances based on a series of determining factors, such as: the initial budgetary position, the cost of population aging and demographic trends, or the quality and destinations of public spending. This is analyzed in detail once every three years, both in the Fiscal Sustainability Report and in the Population Aging Report. The long-term sustainability of public finances in Romania is significantly influenced by ad-hoc, consistent increases in the pension point value, but the measures taken in 2021 aimed to reduce short-term risks. In the first quarter of 2024, the Population Aging Report 2024 is scheduled to be published, based on projections made in the winter of 2023, including the provisions of the new pension law. Romania's assessment is significantly influenced by changes in pension legislation. The new law adopted in 2023 provides for the same indexation formula (100% of the inflation rate plus 50% of the real average gross salary increase in the previous year). If any of the indicators mentioned above are negative, only the positive value will be considered (this provision remains unchanged from previous legislation). Therefore, the pension point will increase from January 1, 2024, from 1,785 lei to 2,032 lei.

According to the Population Aging Report 2024, there is a reduction in pension spending compared to previous evaluations. The projections for this report were made in the winter of 2023, considering the new pension law. These indicate, in the long term, a decrease in the share of total pension spending, from 8.5% of GDP in 2022 to 7.1% of GDP by the end of the forecast period (2070). The new legislative changes provided for in the National Recovery and Resilience Plan (PNRR) aim to ensure both fairness for pensioners and the long-term sustainability of public finances, considering the objective of medium-term fiscal adjustment.

The pension reform was managed by the Ministry of Labor and Social Justice and it envisages changing the formula for calculating pensions, applying the pension indexation rule, and adopting mechanisms against ad-hoc indexation, significantly reducing the possibilities for early retirement, alongside introducing incentives to extend working life, voluntary increase of the standard retirement age to 70 years, in line with life expectancy growth, as well as equalizing the retirement age for men and women at 65 years by 2035[1]. Additionally, the reform included in the PNRR aimed to revise special pensions in accordance with the contributory principle, increase the adequacy of minimum pensions, especially for those below the poverty

[1] The Public Debt Sustainability Report published in February 2021 estimates a trajectory of rapid debt growth, reaching a level of over 100% of GDP by the year 2030.

threshold, and increase contributions to the Second Pillar of pensions. In this regard, the Government approved, in mid-March 2022, an increase in the contribution to the Second Pillar by 1pp, to 4.75%, starting from January 1, 2024.

Projections regarding long-term pension expenditures will be revised following the entry into force of the new legislative changes provided for in the National Recovery and Resilience Plan (NRRP), which aim to ensure both fairness for pensioners and the long-term sustainability of public finances, considering the objective context of medium-term fiscal adjustment. Beyond legislative changes, expenses related to population aging are projected to increase, with their dynamics being influenced in Romania by a pronounced change in the age pyramid.

The situation differs from that in other EU countries, although two-thirds of the member states estimate, for the horizon year of 2070, a more pronounced increase in the share of GDP-related expenditures on population aging compared to previous estimates. The general effort among member states continues to focus on adjustments and reforms in pension, health, and social assistance sectors. Demographic changes will alter Romania's population structure, with implications for pension expenditures and even labor market.

The magnitude and speed of population aging depend on future trends in life expectancy, fertility, and migration. In the perspective of the coming years, the public pension system will have fewer resources compared to expenditures, putting pressure on the budget balance and long-term sustainability, as the ratio between people aged over 65 and those in working age (15-64 years) will increase.

According to a Eurostat study, Romania's population is projected to decrease from 19.04 million in 2022 to 15.02 million by 2070[1]. The old-age dependency ratio, which measures the proportion of elderly persons (aged 65 and over) to the working-age population (aged 20 to 64), is expected to rise significantly from 33.5% in 2022 to 55.8% in 2070. This increase is attributed to a peak in 2056 when many will reach retirement age and due to the increasing life expectancy.

According to a Eurostat study, Romania's population is expected to continue to decline, from 19.04 million in 2022 to 15.02 million in 2070. The old-age dependency ratio, which is the proportion of elderly persons (aged 65 and over) to the working-age population (aged 20 to 64), is estimated to increase from 33.5% in 2022 to 55.8%

[1] https://ec.europa.eu/eurostat/web/population-demography.

in 2070, with a peak in 2056 of those reaching retirement age in the next decade, as well as due to increasing life expectancy.

In the next period, life expectancy at birth is projected to increase by 12.4 years for men, from 70.9 years (in 2022) to 83.3 (in 2070), and by 9.9 years for women, from 78.6 years (in 2022) to 88.5 (in 2070), almost according to a study by Eurostat. Life expectancy at age 65 is projected to continuously increase in the period 2022-2070, from 14.2 to 22 years for men and from 18.1 to 25.4 years for women, representing an increase of +7.8 years and +7.3 years, respectively.

Population survival rates improve over time for both men and women, and the net migration flow is expected to decrease until 2040, after which it will turn to net inflows, on an upward trend until 2070, when it will reach 28.2 thousand people[1].

Measures aimed at ensuring smart and sustainable growth include supporting private investments and consolidating the sustainability of public finances through significant reforms in tax administration, fiscal management, and the public pension system.

Reforming the pension system aims to ensure an adequate level of pension for low-income individuals while maintaining the sustainability of the public pension system in the medium and long term. At the same time, tax administration reform envisaged under Component 8 (Tax Reform and Pension System Reform) aims to ensure a higher degree of tax debt collection and tax compliance, strengthening the relationship between tax administration and taxpayers, including through improved transparency, mainly through tax administration digitalization and gradual withdrawal of existing tax incentives.

2. Long-term Sustainability of Public Finances

Romania has taken a series of measures to mitigate the social impact and the impact on employment generated by the crisis caused by the COVID-19 pandemic, aiming to reduce the number of people exposed to the risk of poverty or social exclusion by 2027. The Social Inclusion and Poverty Reduction Strategy 2022-2027 is one of the conditions imposed by the European Commission in the "New Cohesion Policy", with Romania aiming to reduce by at least 7%, compared to 2020, the number of people exposed to the risk of poverty or social exclusion by 2027. The strategic

[1] The National Strategy for Social Inclusion and Poverty Reduction for the period 2022-2027 was approved by Government Decision No. 440/2022.

objectives aim to ensure a decent standard of living for all and to combat transitional situations of resource poverty so that they do not become structural problems of poverty and social exclusion.

In the field of social assistance, improvement of the system is envisaged through the reforms adopted and the implementation of the minimum income scheme (MIS) reform as assumed within the National Recovery and Resilience Plan. The reforms mainly aim to improve labor market activation mechanisms for vulnerable individuals, grant benefits to economically vulnerable people, reduce the risk of energy poverty through the implementation of social protection measures for vulnerable consumers, and increase the incomes of the poorest households by supporting families with children and encouraging childbirth.

In Romania's case, the long-term sustainability of public finances will be influenced by the implementation of reforms regarding the revision of the fiscal framework and the pension system, included in the National Recovery and Resilience Plan (NRRP). This will be assessed this year on the occasion of the country sheet related to the 2024 Population Aging Report, conducted at the European Union level. In recent years, assessments of Romania's long-term fiscal sustainability have been significantly influenced by ad-hoc, consistent increases in the pension point value.

Reforms under the National Recovery and Resilience Plan (NRRP) involve legislative changes aimed at eliminating inequities in the system and reducing expenses to promote the long-term sustainability of public finances. These include changes to the pension calculation formula, the introduction of a new pension indexing rule in line with maintaining the share of pension spending in GDP, and mechanisms against ad-hoc indexing, significant reduction of early retirement options, along with incentives for extending professional life, voluntary increase of the standard retirement age to 70 years, in line with life expectancy growth, and equalization of the retirement age for men and women at 65 years by 2035.

Table 1. Demographic Indicators

	2022	2023	2030	2050	2070	2090	2100
Fertility Rate	1.81	1.80	1.80	1.78	1.77	1.77	1.77
Total Population (mil), including	19.04	19.03	18.22	16.44	15.04	14.57	14.61
Men	9.24	9.23	8.86	8.11	7.54	7.38	7.40
Women	9.80	9.80	9.36	8.33	7.50	7.20	7.21
Life Expectancy at Birth							
Men	70.9	71.4	73.7	79.0	83.3	86.9	88.4
Women	78.6	79.0	80.9	85.0	88.5	91.3	92.5
Life Expectancy at Age 65							
Men	14.2	14.6	16.0	19.2	22.0	24.4	25.4
Women	18.1	18.4	19.7	22.7	25.4	27.7	28.7

Source: Eurostat – EUROPOP 2023

Beyond the structural changes in the pension system, the dynamics of aging-related expenditures will be influenced, in the long term, by demographic trends. Demographic projections by Eurostat for Romania (Europop2023) indicate a significant decrease in the population by 4 million people by 2070, compared to 2022. However, it is worth noting that the decrease is considerably lower than the previous estimate from 2019, when the change for the period 2019–2070 was forecasted at 5.7 million people. Additionally, in the long term, by the year 2100, a significant change in the age pyramid is expected, with recent projections indicating an intensification of the population aging process compared to previous projections (Europop 2019), in the context of increasing life expectancy.

Demographic changes will alter the population structure of Romania and will have implications for the dynamics of the labor market and pension expenditures. In this context, pressure on the public pension system will increase, as it will have reduced resources compared to expenditures, which will put pressure on the budget balance and the long-term sustainability of public finances. The magnitude and speed of population aging depend on future trends in life expectancy, fertility, and migration. The aging process will bring changes in the demographic structure and modify the ratio between the population of retirement age and the working-age population, with implications for the labor market and the pension system.

In the long term, the evolution of the pension system in Romania will be influenced by demographic prospects given by the evolution of the birth rate and the natural aging process of the population, in the context of increasing life expectancy. According to Eurostat projections for the horizon of 2070, life expectancy at birth increases by over 12 years for men and by 9 years for women. The estimated advance for the horizon of 2100 is significantly higher (17.5 years for men and 13.9 years for women). Life expectancy at age 65 is also projected to increase, by 7.8 years for men and by 7.3 years for women.

3. Long-term Fiscal-Budgetary Challenges

These challenges are assessed using indicator S2, which measures the long-term sustainability gap by showing the initial and permanent fiscal-budgetary adjustments needed to stabilize the debt-to-GDP ratio over an indefinite period, including the costs of population aging[1].

This set of indicators is utilized in the Commission's assessment of EU countries' budget plans within the context of the Stability and Growth Pact. These indicators enable the evaluation of the extent of necessary policy adjustments, whether currently or in the future, and the type of adjustments required, such as fiscal-budgetary, structural, or a combination of both. It is essential to analyze how to address the medium and long-term sustainability challenge, which is conducted in two stages:

- Acknowledging the presence of a considerable fiscal-budgetary sustainability issue.
- Identifying the specifics of this issue to formulate effective policy solutions. This involves analyzing the current, relative, and projected levels of deficits and debts, along with future strains from aging-related expenditures in the EU, particularly pension costs, as highlighted in the service forecasts[2].

The S2 sustainability indicator measures the extent of current and future budgetary imbalances and the resulting pressure on public finances. Higher S2 values indicate a greater risk to fiscal-budgetary sustainability, necessitating more substantial budgetary adjustments. An S2 value above 6 signifies a high risk, while a value below 2 indicates a low risk. Historically, there have been periods of significant

[1] However, it is possible that the adjustment envisaged by indicator S2 may lead to stabilizing the debt at relatively high levels.

[2] See the assessment made by the European Commission regarding the stability and convergence programs - the working documents of the Commission's services prepared by DG ECFIN at the address: https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/eu-economic-governance-monitoring-prevention-correction/stability-and-growth-pact

improvement in the fiscal-budgetary position (primary balance) of up to 2 percentage points of GDP. However, sustained improvements of 6 percentage points or more are rare. When high population aging costs create a significant sustainability gap, policy adjustments must include structural reforms to limit long-term aging-related spending.

The results obtained for the sustainability indicator S2 or for the sustainability gap can be broken down into two parts:

- Initial budgetary position (level of debt and initial structural primary balance): Some EU countries currently have deficits that are too high relative to their debt levels and long-term growth potential, which suggests a risk of escalating debt even without factoring in the impact of population aging;
- The "cost of population aging" refers to the present value of changes in long-term spending due to an aging population. Significant differences exist between EU countries in this respect: some face much larger spending increases than others, driven mainly by demographic trends and the characteristics of their pension systems, as well as healthcare and long-term care expenditures. In some countries, fiscal sustainability challenges are primarily influenced by pension spending trends, while in others, healthcare and long-term care trends play a larger role. Various policy measures can be considered, including fiscal consolidation and structural reforms aimed at reducing long-term budgetary costs associated with population aging.

4. Conclusion

In conclusion, the government's budgetary position is the primary element of sustainability indicators and should remain unaffected by temporary factors. Therefore, adjustments must be made to account for the economic cycle's impact on the overall budget balance and the effects of specific measures. A key initial step for any country in tackling fiscal sustainability challenges is to adhere strictly to EU fiscal rules and the Stability and Growth Pact. Expanding the tax base also helps ensure robust budgetary positions.

Fiscal sustainability refers to the government's capacity to cover its current expenses and maintain its tax and related policies in the long term without risking insolvency or failing to meet its debt and expenditure commitments. The recent crisis has underscored the importance of fiscal sustainability.

When assessing fiscal sustainability, it is crucial to consider both current and potential public debt levels. High public debt can threaten fiscal sustainability, regardless of long-term spending related to population aging. Countries with high debt levels are more susceptible to economic downturns and interest rate fluctuations.

Lastly, addressing inappropriate fiscal behaviors will enhance revenue collection efficiency for the consolidated general budget.

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