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The Importance of Maintaining Long-Term Sustainability of Public Finances

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Abstract: This paper aims highlighting the importance of maintaining long-term sustainability of public finances through the continuation of measures for economic recovery, accelerating economic growth, and maintaining and supporting a new framework for sustainable development that leads to the elimination of vulnerabilities in the economy and ensures 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, taking into account 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 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.

[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.

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, taking into account 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 expected to continue to decline, from 19.04 million in 2022 to 15.02 million in 2070[1]. 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% 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[2].

Measures aimed at ensuring smart and sustainable growth include supporting private investments and consolidating the sustainability of public finances through

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

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

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 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 NRRP involve legislative changes aimed at ensuring, on the one hand, the elimination of inequities in the system, and, on the other hand, a reduction in expenses, to promote 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: this indicator of the long-term sustainability gap shows the initial and permanent fiscal-budgetary adjustment needed to stabilize the debt-to-GDP ratio over an indefinite period, including the costs of population aging[1].

This set of indicators is used within the Commission's assessment of EU countries' budget plans in the context of the Stability and Growth Pact. These indicators allow the evaluation of the extent to which significant policy adjustment is needed currently or in the future, as well as the type of adjustment required (fiscal-budgetary, structural, or a combination of both). It is necessary to analyze how the medium and long-term sustainability challenge should be addressed. This analysis is carried out in two stages:

- Confirming the existence of a significant fiscal-budgetary sustainability challenge.
- Determining the nature of the challenge in order to develop appropriate policies to remedy the situation. This is done by examining the relative, current, and potential levels of deficit and debt, as well as future pressures on aging-related spending in the EU, especially pension expenditures, included in the forecasts of services[2].

The sustainability indicator S2 quantifies the magnitude of current and future budgetary imbalances and, implicitly, the pressure on public finances. The higher the values of sustainability indicator S2, the greater the risk to fiscal-budgetary sustainability and, consequently, the necessary budgetary adjustment. If S2 is above 6, the risk is high; if it is below 2, the risk is low. In the past, there have been several periods of lasting improvement in the fiscal-budgetary position (primary balance) of

[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

up to 2 percentage points of GDP. However, there have been very few periods of sustained improvements totaling 6 percentage points or more. In cases where the high costs of population aging result in a significant sustainability gap, policy adjustments must necessarily include structural reforms aimed at limiting long-term spending related to population aging.

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 too high a deficit relative to their level of debt and long-term growth potential, which would imply an "explosive" debt even without considering the impact of population aging;

- "Cost of population aging", i.e., the present value of the variation in long-term spending related to population aging. There are also large differences between EU countries in this regard: some countries face much larger increases in spending than others, mainly due to demographic developments and the characteristics of their pension systems, but also due to other categories of spending, such as healthcare and long-term care. In some countries, the challenge of fiscal-budgetary sustainability is mainly affected by pension spending trends, while in others it is mainly affected by trends in healthcare and long-term care spending. Multiple policy measures are possible, including fiscal-budgetary consolidation and/or structural reforms, especially those aimed at reducing long-term budgetary costs related to population aging.

4. Conclusion

As a final point, I believe that the government's budgetary position is the first key element of sustainability indicators and should not be influenced by temporary factors. Therefore, it is necessary to make an adjustment to reflect the impact of the economic cycle on the overall budget balance and the impact of any specific measures. For any country, a first step in addressing fiscal-budgetary sustainability challenges is to fully adhere to EU fiscal-budgetary rules and the Stability and Growth Pact. Measures to broaden the tax base also contribute to ensuring solid budgetary positions.

Public finance sustainability, also known as fiscal-budgetary sustainability, is the government's ability to cover its current expenses and sustain its tax policies and other related policies in the long term, without jeopardizing its solvency or risking being unable to repay some of its debts or fulfill some of its promised expenses. The recent crisis has demonstrated how important fiscal-budgetary sustainability is.

When evaluating fiscal-budgetary sustainability, due attention must be paid to the current and potential level of public debt. Therefore, a high level of public debt can endanger fiscal-budgetary sustainability, regardless of long-term spending related to population aging. Countries with high debts are more vulnerable to economic recessions and interest rate shocks.

To conclude, investigating inappropriate fiscal behaviors will certainly bring increased efficiency in terms of revenue collection for the consolidated general budget.

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