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Future-Proofing the EU Budget:

A Pension System for Our Common Future

Abstract

After decades of prosperity, the European Union is currently facing a hard challenge, as its ageing population, low birth rates, and reliance on pay-as-you-go (PAYG) pension systems threaten the sustainability of public finances as well as long-term competitiveness. This policy paper argues that a transition to funded pension systems across EU member states is essential for future-proofing the European budget. Drawing on recent Eurostat data, comparative analysis, and previous policy research, we demonstrate how the current model undermines fiscal sustainability and hinders economic growth. We further highlight the benefits of capitalised systems and offer concrete policy recommendations for a more resilient and investment-friendly pension model in the EU.



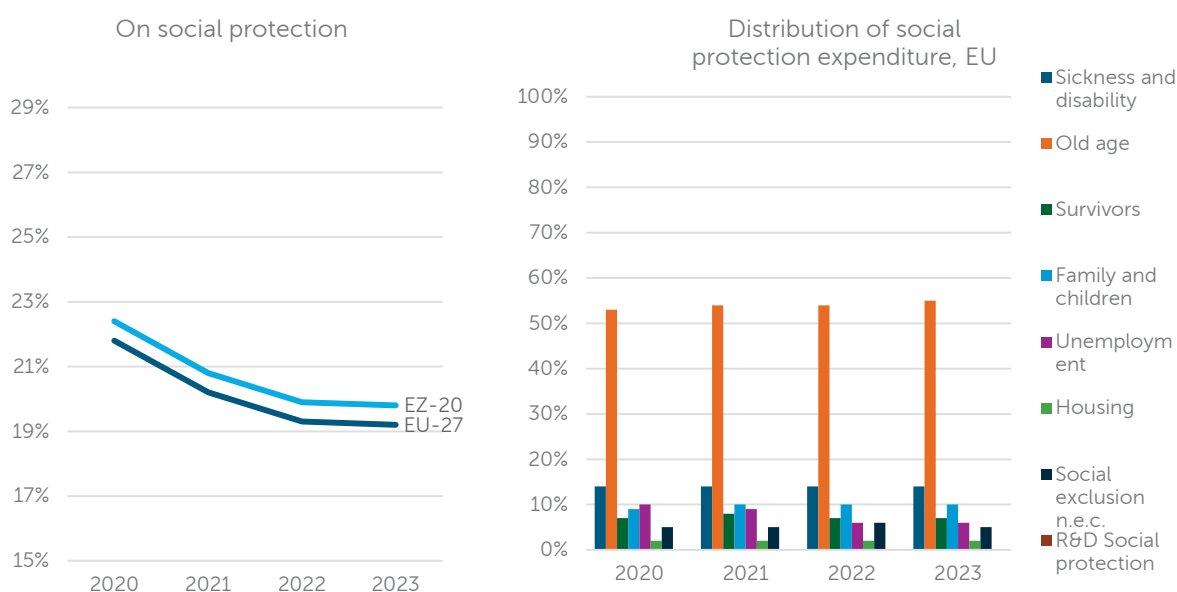
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Introduction: Why Europe's Pensions Need Rethinking

Pension expenditure represents one of the largest components of social protection in the European Union. As Figure 1 shows, both the EU-27 and the Eurozone allocate approximately 20% of GDP to social protection, with pensions accounting for more than 75% of that share. This prioritisation of pensions over other social safety net policies creates structural imbalances, particularly in countries with ageing populations and slow growth.

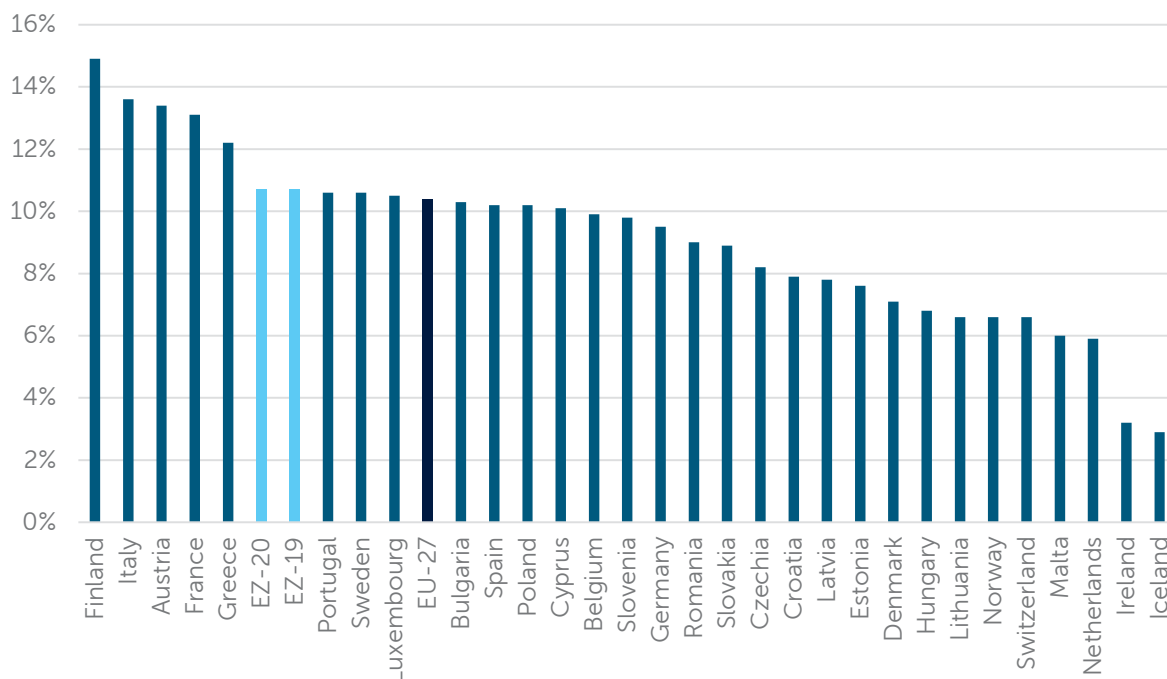
Figure 1. General government expenditure (as % of GDP)



Source: Eurostat (n.d.), *General government expenditure by function (COFOG) [gov_10a_exp] [Custom table]* (European Commission), https://ec.europa.eu/eurostat/databrowser/view/gov_10a_exp__custom_15941477/bookmark/table?lang=en&bookmarkId=1bc01903-74cf-4197-9570-9e64a5b8f35a.

Moreover, the distribution of pension expenses varies greatly among member states. Countries like Greece, Italy, Austria, and France spend between 12% and 15% of GDP for pensions, while countries such as the Netherlands, Ireland, and Iceland, allocate less than 6% (Figure 2). This variation suggests that the architecture of national pension systems – mainly, whether they are predominantly PAYG or funded – has significant implications for fiscal pressure.

Figure 2. General government expenditure (as % of GDP) on old age pensions by country, 2023

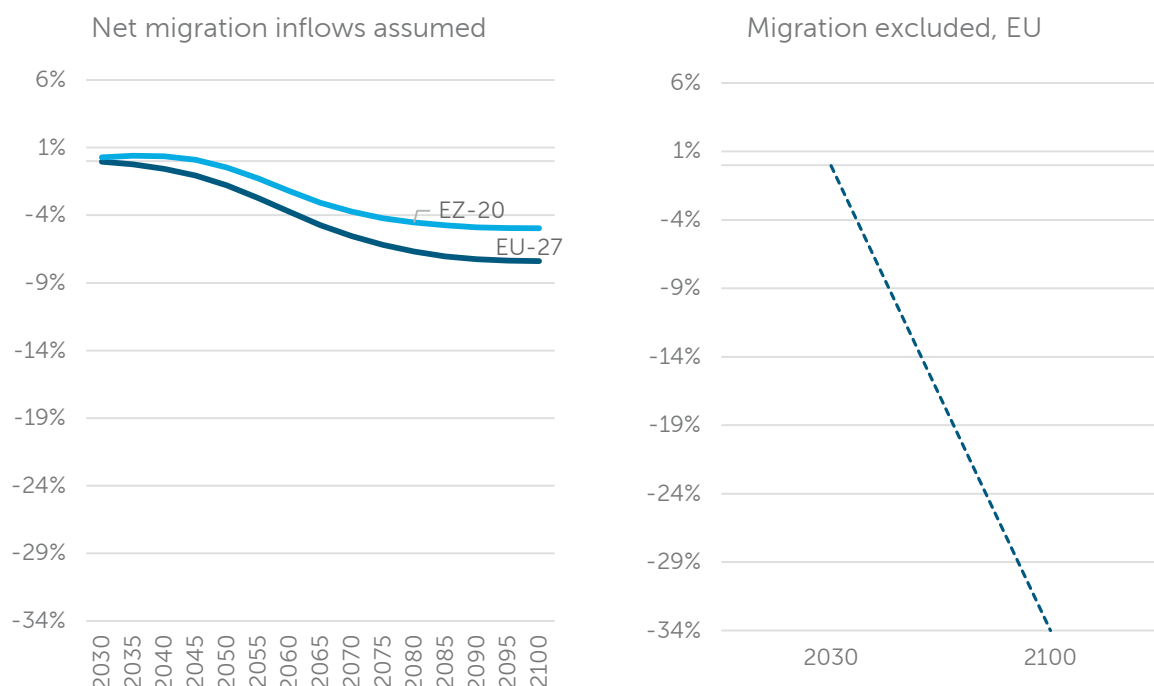


Source: Eurostat. (n.d.). *General government expenditure by function (COFOG) [gov_10a_exp]* [Dataset]. European Commission. https://ec.europa.eu/eurostat/databrowser/view/gov_10a_exp/default/table?lang=en

Demographic trends worsen the problem. By 2060 the population of the EU-27 is projected to decline by more than 4 percentage points compared to 2025, and by almost 8 percentage points by 2100 (Figure 3). This projection models integrate historical migration patterns, assuming that countries will maintain their average net migration from the past two decades. In the scenario where migration is excluded, the population will fall to 295 million people from 447 million today, a percentage change close to -34%.¹ These trends for labour force participation strongly undermine the viability of European pension systems.

¹ A. Clark (2025), 'Europe's Population Crisis: See How Your Country Compares – Visualised', *The Guardian*, 18 February, <https://www.theguardian.com/world/ng-interactive/2025/feb/18/europes-population-crisis-see-how-your-country-compares-visualised>.

Figure 3. Projection of future European population, compared to the 2025 population



Source: Eurostat. (n.d.). Population projections at national level (2019-based) [proj_19np] [Dataset]. European Commission. https://ec.europa.eu/eurostat/databrowser/view/proj_19np/default/table?lang=en. Clark, *Europe's Population Crisis*.

This paper argues that Europe needs a structural shift: from unsustainable PAYG systems to hybrid or fully funded pension models, a transition that will enhance fiscal sustainability, stimulate economic growth, and increase financial security for future generations.

This reform becomes even more urgent as labour mobility keeps rising across EU member states. In 2022, approximately 13.5 million EU citizens of working age lived in an EU country different from their nationality. This represents a 35% increase compared to 2012.² As more Europeans live and work in multiple EU countries, the need to resolve the limitations of national PAYG systems becomes more pressing. A pension model that combines capitalization and portability can better address the needs of a mobile workforce, reduce administrative complexity, and improve pension prospects for these cross-border workers. EU can thus enhance its fiscal sustainability, stimulate economic growth, and increase financial security for future generations.

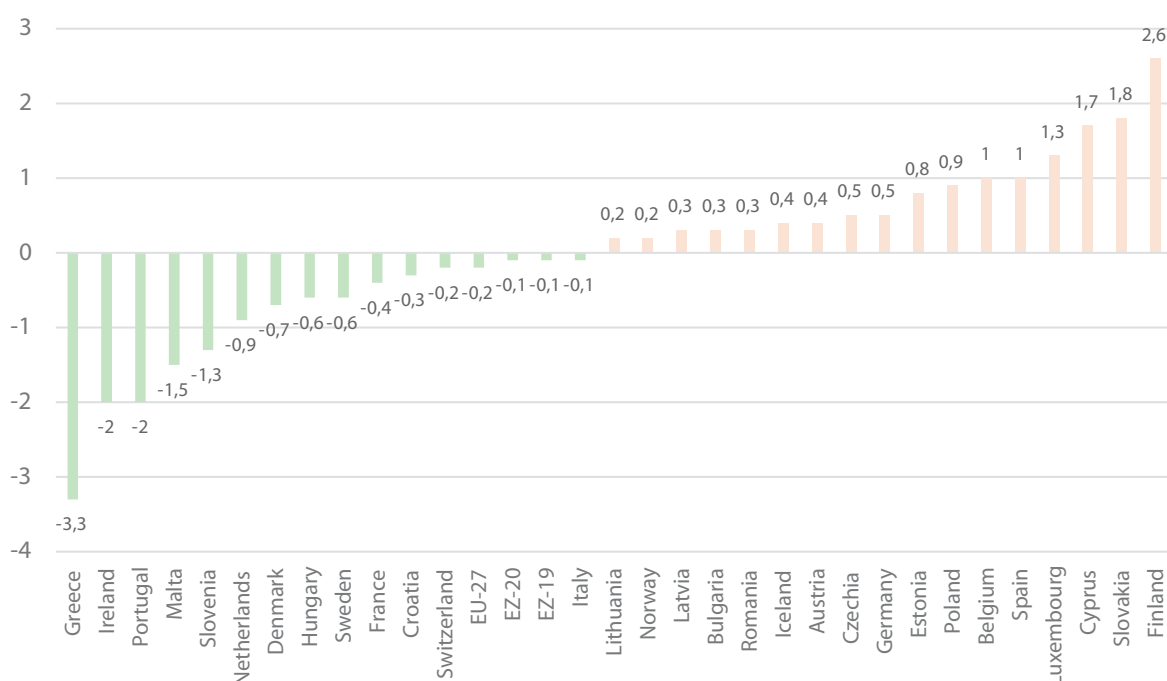
² C. Philippe, C. Saravakos, F. Gross, L. Bogdanov, N. Marques, P. Ganey, and R. Ďurana (2025), *Reviving Europe's Competitive Edge* (EPICENTER), <https://www.epicenternetwork.eu/publications/reviving-europes-competitive-edge/>.

Current Pension Systems are not Sustainable

Europe's PAYG systems were designed in an era of growing populations and expanding wage bases. Under such systems, current workers fund the pensions of current retirees through social contributions. While sustainable during the post-war economic and demographic boom, the model is now faltering.

Figure 4 shows the percentage points change in pension expenditure expressed as a percentage of GDP from 2014 to 2023. Countries like Greece, Portugal, and Ireland have implemented reforms that lowered this burden, while pension expenses have risen in countries like Finland and Cyprus. However, most EU members continue to face pressure on their pension spending as their populations keep aging.

Figure 4. General government expenditure (as % of GDP) on old age pensions by country, percentage points change from 2014 to 2023

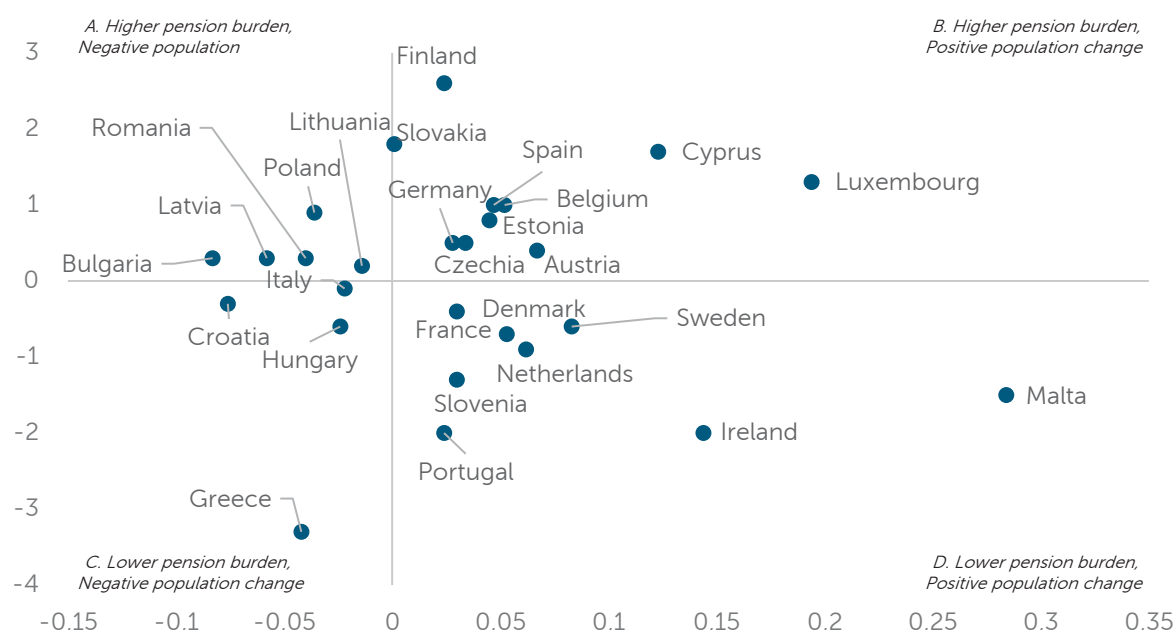


Source: Eurostat. (n.d.). *General government expenditure by function (COFOG) [gov_10a_exp]* [Dataset]. European Commission. https://ec.europa.eu/eurostat/databrowser/view/gov_10a_exp/default/table?lang=en

The demographic challenge is especially evident in the interaction between population change and pension expenditure. When both pension spending and population changes are considered together, the problem becomes more evident. Figure 5 shows the percentage changes on pensions expenditure and population change (with net migration assumed) in EU countries for the last decade. Countries in *Top left quartile (A)* have experienced both a higher old age pensions burden and a negative population change since 2014, namely, they are the ones failed to address both factors. Countries in *Top right quartile (B)* also experienced

a higher pension burden, but at least saw their population increase. Countries in *Bottom left quartile (C)* saw their population decrease, however, they managed to reduce the old age pensions government expenditure. Countries in *Bottom right quartile (D)* saw both their population increase, and they managed old age pensions government expenditure decrease during this period. It is no coincidence that the last group of countries are the ones with the most developed funded pension system schemes. Countries with robust funded systems like Iceland and the Netherlands have managed to reduce their pension expenditure relative to GDP, experiencing a positive demographic trend.

Figure 5. General government expenditure (as % of GDP) on old age pensions and population change (in percentage points) during the period 2014-2023.



Source: Eurostat. (n.d.). General government expenditure by function (COFOG) [gov_10a_exp] [Dataset]. European Commission. https://ec.europa.eu/eurostat/databrowser/view/gov_10a_exp/default/table?lang=en. Eurostat. (n.d.). Population projections at national level (2019-based) [proj_19np] [Dataset]. European Commission. https://ec.europa.eu/eurostat/databrowser/view/proj_19np/default/table?lang=en

The PAYG model also does not adequately cope with economic volatility and structural changes in the labour market. With rising job insecurity, informal work, and delayed labour market entry for young people, contribution gaps become more frequent and harder to close. This increases the risk of poverty among future retirees and creates political pressure for ad hoc fiscal interventions.

More broadly, the EU underperforms compared to the OECD in the development of pension funds. On average, capitalised pension wealth accounts for only 29% of GDP in the EU, compared to 84% in the OECD. This gap translates into an estimated opportunity cost of around €350 billion per year, or 2.4% of EU GDP, in foregone long-term investment returns.³

³ European Commission (2023), *2023 Annual Report on Intra-EU Labour Mobility*, Directorate-General for Employment, Social Affairs and Inclusion (Luxembourg: Publications Office of the European Union), <https://ec.europa.eu/social/BlobServlet?docId=27068&langId=en>.

This trend will further worsen unless structural reform is undertaken. The ratio of contributors to beneficiaries will continue to fall due to the diminishing working-age population and longer life expectancies. This will require either unsustainable tax increases or reductions in benefits. Both alternatives are politically costly and economically harmful.

The Role of the EU: Policies to Support Pension Capitalisation

The EU has recognised the need to address this challenge by bolstering funded pension systems. Among the relevant initiatives undertaken are the Pan-European Personal Pension Product (PEPP) and the IORP II Directive. The PEPP was designed with the aim of offering a portable, transparent, and cost-efficient pension scheme to citizens across member states, but its implementation has since faced considerable challenges. As of 2023, participation remains negligible as fiscal incentives and provider engagement are not sufficient. If implemented, PEPP will allow savers to transfer their pension rights across borders and to choose among different investment options, but the administrative burdens and the absence of tax harmonisation across the EU have hindered uptake.

Also, the IORP II Directive aims to enhance the governance and cross-border compatible implementation of occupational pension funds as well as strengthen trust in funded schemes, by imposing stricter rules on risk management, transparency, and member communication. However, only a tiny fraction of pension assets in the EU are under cross-border schemes. To address these limitations, the European Commission, under its Sustainable Investment Strategy, has proposed a review of these two frameworks, as well as the promotion of auto-enrolment mechanisms, simplified product offerings, and comprehensive pension tracking tools.

Despite these efforts, progress remains slow. This highlights the need for more effective action at the EU level, including better coordinated policies, stronger financial incentives, and more regulatory flexibility. These are essential to create a favourable environment for member states to shift towards capitalised models.

What Are Funded Pension Systems and Why They Matter

Funded pension systems operate on the principle of individual capitalisation. Each worker contributes to a personal or collective fund that is invested over time to generate returns. Upon retirement, benefits are drawn from the accumulated capital rather than from current tax revenues.

This model differs fundamentally from the PAYG approach. A funded system, ensures both personal freedom and efficiency, as it emphasizes individual ownership, market-based returns, and reduced reliance on intergenerational fiscal transfers, as well as, as well as the that the contributions create tangible savings and investment that are insulated from demographic pressures. The pension becomes not a fiscal transfer but a financial asset that creates more wealth based on personal freedom and choice.

The key advantages of such systems include:

- **Wealth creation:** Contributions are invested in the real economy, fostering growth and innovation.
- **Intergenerational fairness:** Each age cohort finances its own retirement, reducing dependency on future taxpayers.
- **Resilience to demographic shifts:** Funded systems are less sensitive to changes in workers-to-retirees ratios.
- **Transparency and ownership:** Individuals have clearer rights and a better understanding of their future benefits.

Countries like Denmark, the Netherlands, and Iceland show how well-regulated and diversified pension funds can ensure income for pensioners and boost national savings and levels of investment. In contrast, countries that rely too much on PAYG schemes face growing implicit liabilities within a constrained fiscal space.⁴

In practice, funded systems can be organised as either individual defined-contribution accounts, or as collective funds with shared risk. In both cases, the capitalisation of these contributions introduces a long-term investment prospect that can help stabilise financial markets and enhance economic resilience.

How Capitalised Pensions Can Boost Europe's Fiscal and Economic Outlook

The benefits of capitalisation extend well beyond pension adequacy. As documented empirical research shows,⁵ countries that adopted funded schemes have seen:

- Higher GDP growth due to increased domestic investment.
- Lower public debt levels, since pension obligations are partially self-financed.
- Improved labour competitiveness, as payroll tax burdens are reduced.

A shift toward a capitalised pension system would also align with broader EU priorities such as the capital market union, financial inclusion, and financing of innovation. Pension funds can act as long-term institutional investors, and thus support investments in fields such as green infrastructure, tech development,

⁴ Denmark, the Netherlands, and Iceland consistently rank among the top global pension systems, according to the Mercer CFA Institute Global Pension Index 2024. As Anderson (2019) notes, in Denmark and the Netherlands capital-funded pension schemes are successful because they can generate secure income for participants, while managing investment risk and aligning interests of plan participants with investment management.

⁵ European Commission (2023), *2023 Annual Report on Intra-EU Labour Mobility*, Directorate-General for Employment, Social Affairs and Inclusion (Luxembourg: Publications Office of the European Union), <https://ec.europa.eu/social/BlobServlet?docId=270688&langId=en>. M. Xafa (2017), *European Capital Markets Union Post-Brexit*, CIGI Papers No. 140 (Centre for International Governance Innovation), August. N. Marques (2023), *Le manque-à-gagner lié au sous-développement de l'épargne retraite* (Paris–Bruxelles: Institut économique Molinari), p. 24.

and startups across the Union.

Capitalised pension savings can also help deepen capital markets and reduce reliance on bank lending by channelling household savings into productive investment to fuel innovation and generate higher returns for both savers and societies at large.

However, transition costs and Maastricht Treaty constraints pose challenges. Moving from PAYG to funded systems involves a temporary duplication of financing needs — covering both current retirees and future pensions. Unfortunately, the Maastricht criterion on gross debt-to-GDP does not account for implicit liabilities, making such transitions appear fiscally imprudent under current rules. This must change.

A typical case highlighting this challenge is Greece. In the last few years, Greece has taken significant steps toward establishing a funded second-pillar pension system. However, the country faces hard fiscal constraints due to its high debt-to-GDP ratio, which makes the financing of this transition particularly difficult without external support. The Greek example showcases a broader problem that many southern European countries face: without EU-level adjustments to the current fiscal criteria or the help of dedicated support mechanisms, efficient reform may remain unattainable. Therefore, the revision of the Maastricht framework to reflect future savings and implicit liabilities is not just a technical necessity but a political prerequisite for enabling member states to invest in their long-term sustainability.

In addition, public understanding and trust in funded systems must be cultivated. Policymakers should focus on financial education, ensure proper regulation of fund managers, and provide mechanisms for portability and risk-sharing across employment transitions.

Conclusions and Policy Recommendations

Europe needs to effectively address the structural weaknesses of its pension systems. Given the current demographic trends, inaction will only widen the fiscal gap and undermine economic dynamism. A forward-looking EU budget must therefore integrate pension reform as a core component of fiscal resilience.

We propose the following policy actions :

- Amend the Maastricht debt criterion to account for implicit pension liabilities and thus remove a major disincentive to reform.
- Encourage member states to develop or expand funded pension pillars, using best practices from countries like Denmark and the Netherlands.
- Promote the use of individual investment accounts for supplementary pensions, particularly among younger workers.
- Abolish state monopolies on second-pillar pensions, fostering competition

and innovation in pension fund management.

- Channel pension savings into productive investments, aligned with the EU Green Deal and Digital Strategy.
- Enhance financial literacy and transparency to build trust in funded systems and encourage long-term participation.
- Support EU-wide pension mobility and harmonisation, allowing workers to carry rights and savings across borders.

Europe's future prosperity depends both on fiscal prudence and on structural foresight. Reforming pension systems is no longer a technical debate, but a political and moral imperative.

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