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The Spanish labour market and the sustainability of the pension system

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Introduction

The main challenges of the Spanish public pension system reflects two excellent facts:

1. People are living longer, due to the increase in life expectancy beyond 65.
   Life expectancy beyond 65y increases by 16 months every 10 years (3.2h per day)
2. The *baby boom* generation will start to retire at the beginning of the next decade and will do so with expectations of a longer life than their European counterparts (approximately two years longer)

Introduction

- The Sustainability Factor and the Annual Growth Factor (FS and IRP in their Spanish acronyms, Law 23/2013) has ensured the sustainability of the public pension system
- With this reform all options are possible (increasing the structural revenues of the system, parametric reforms, etc.) except one: paying pensions by running a structural deficit
- Once the sustainability has been guaranteed, the debate can focus on the adequacy (benefit ratio) and efficiency of the system, which depend on a large extent on the efficiency of the labour market

Introduction

- In order to meet the adequacy objective, the system has to be sustainable. In other case, it cannot guarantee appropriate and adequate pensions …

  … and would generate uncertainties that would have a negative impact on investment, employment, growth and well-being

- Adequacy objective. Art. 50 of the Spanish constitution: the State will guarantee, by means of appropriate and periodically upgraded pensions, adequate financial resources for its citizens during their old age

Introduction

- Pensions will gain purchasing power if the real growth in revenues is higher than the increase in the number of pensions (1.4% in 2015) plus the substitution effect (1.6%)
- The average pension (that of the representative pensioner, which changes over time) will gain purchasing power if the real growth in Social Security revenues is more than the growth in the number of pensions
- Debate on the adequacy of the system: what will happen to the benefit ratio (average pension to average wage)?
- The objective of this presentation is to show that in the next decades, job creation is the most urgent, important and demanding challenge in order to ensure the pension system as we know

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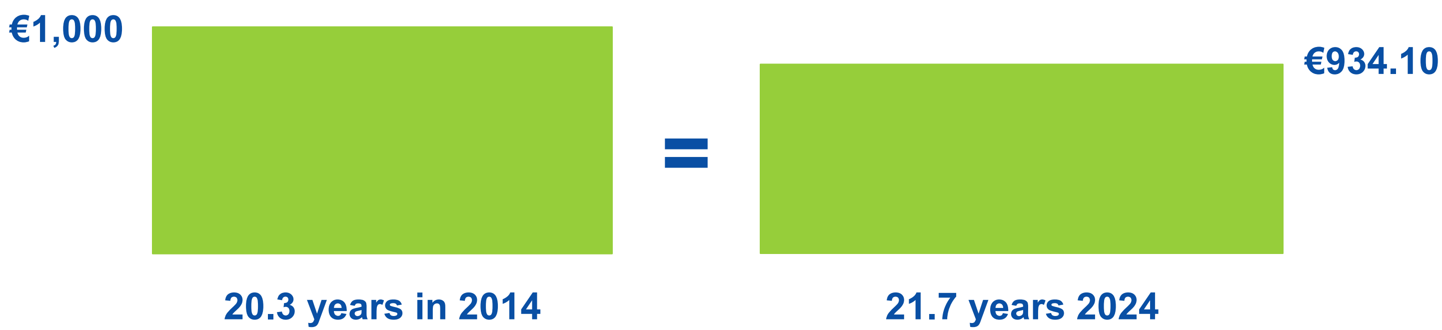
The Sustainability Factor and IRP

Law 23/2013 has guaranteed the budgetary sustainability of the public pension system (Doménech and Pérez-Díaz, 2013):

1. Sustainability Factor (FS in its Spanish acronym): only comes into play in the calculation of the initial pension, and moderates it by the increase in life expectancy vs. a base year

2. Annual Growth Factor (IRP in its Spanish acronym): determines the balanced annual growth in pensions, in accordance with the revenues available to the public pension system in the medium term

The Sustainability Factor

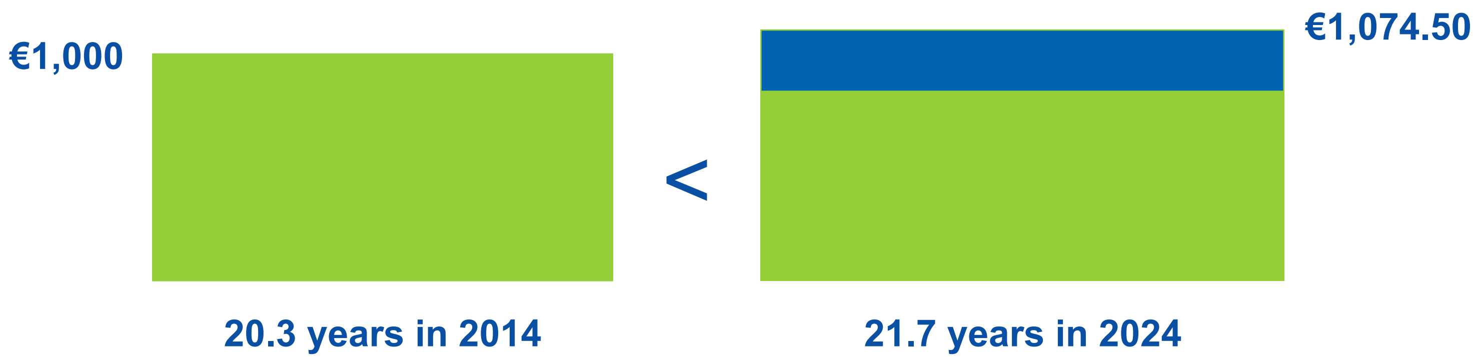


Note: assuming equal lengths of working lives

- The sustainability factor multiplies the initial pension to give equal treatment to individuals who, having made the same contributions, are going to receive a pension for a different number of years due to their different life expectancies, …

  … and adjusts the initial pension product for life expectancy

The Sustainability Factor



Note: assuming real growth of the regulatory base equal to half the average growth between 2001 and 2013 (1.41%)

- The sustainability factor does not imply smaller initial pensions, but modulates its growth
- Thanks to economic growth, longer working lives and higher contribution rates will give rise to larger initial pensions and to an increase in pension purchasing power

The Annual Growth Factor (IRP)

- Its objective is to balance the budget between the revenues and expenses of the pension system, corrected for the economic cycle

Pension expenses = Revenues of the pension system

- An unfunded or Pay-As-You-Go system can only share out available resources
- The IRP allows all options except one: it cannot pay pensions running a recurrent or structural deficit

The Annual Growth Factor (IRP)

- If the system is balanced, it will continue to be so when:

IRP + Growth in the number of pensions + Substitution effect (joiners/leavers) = Inflation + Real growth in revenues

Note: all variables are adjusted by the economic cycle

- As all variables are corrected by the economic cycle, pensions are not sensitive to recessions or affected by temporary factors

The Annual Growth Factor (IRP)

- **Given its definition, the IRP increases or decreases in line with inflation**

IRP = Inflation + Real growth in revenues - Growth in the number of pensions - Substitution effect (joiners/ leavers)

Note: all variables are adjusted by the economic cycle

- **The pensioners do not gain or lose purchasing power depending on whether inflation is higher or lower …**

  … this happens when the real growth in revenues is higher or lower than the increase in pension spending due to demographics and the substitution effect

The Annual Growth Factor (IRP)

- **What if the system is structurally unbalanced?**

IRP = Inflation + Real growth in revenues - Growth in the number of pensions - Substitution effect (joiners/leavers) - Correction of the deficit

NB: all variables are adjusted by the economic cycle

- Every year, a quarter of the structural deficit is corrected in percentage terms vs. the total expenses of the system, with a minimum (0.25%) and maximum (inflation +0.5%) revaluation

- Once the sustainability of the system has been guaranteed, the debate can focus on the adequacy and efficiency of the system

Adequacy and efficiency in a sustainable system

- As the revenues of the Social Security represent a relatively stable percentage of total wage income, the benefit ratio depends on the employment (Social Security affiliates) to pensioners ratio:

$$\frac{\text{Average pension}}{\text{Average wage}} = \frac{\text{Employment}}{\text{\# Pensioners}} \times \frac{\text{Social Security contributions}}{\text{Total wage incomes}}$$

- As the number of pensions is expected to rise from 9 to 15 million in 2050, to maintain the replacement rate the number of affiliates would have to rise from 17.3 to 27 million

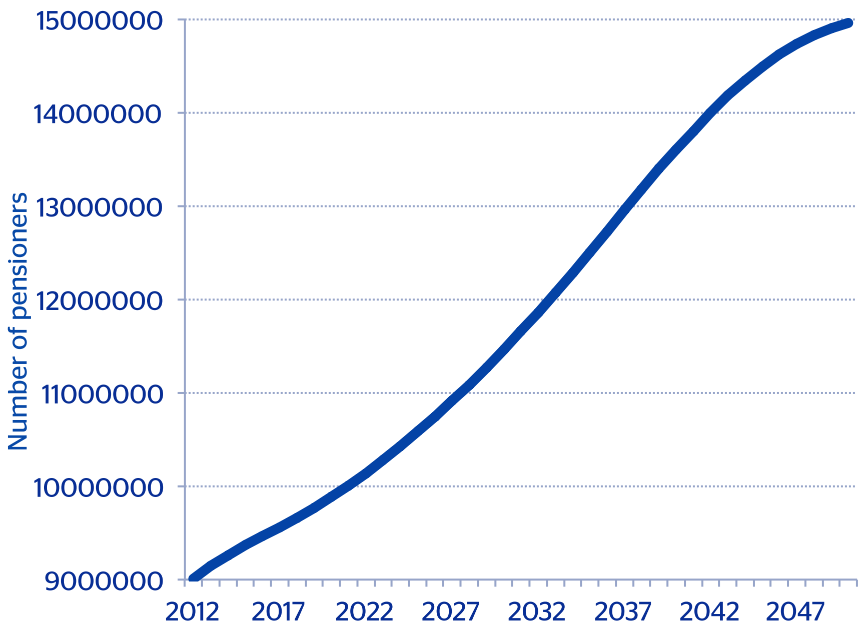
- Unemployment would have to fall to 6% to allow affiliations to rise to above 20.6 million, assuming no increase in the working-age population

Adequacy and efficiency in a sustainable system

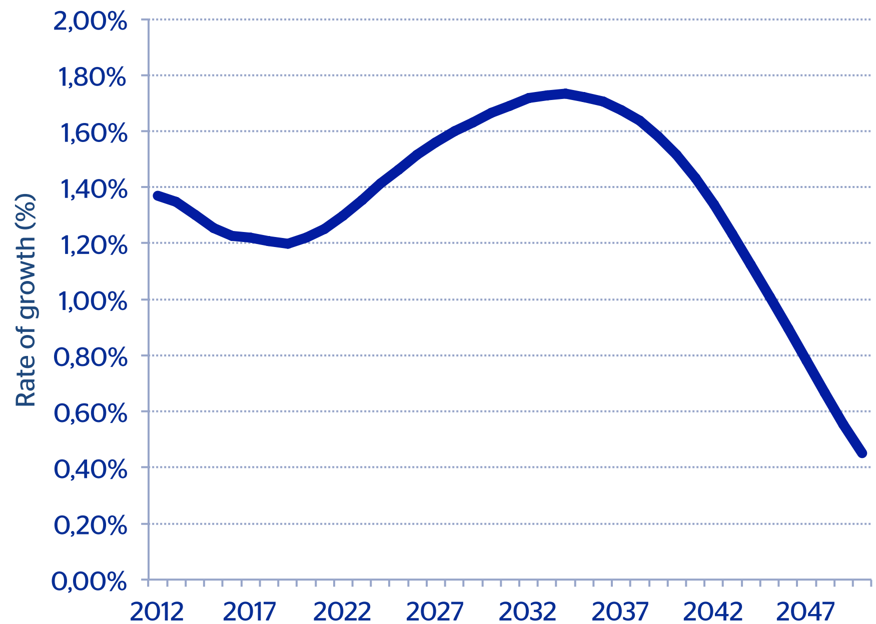
- Although the theoretical replacement rate (initial pension over final wage) is around 80%, in practice the average pension represents little more than 50% of the average wage (51.1% as of 2012)
- Both the theoretical and effective replacement rates are amongst the highest in Europe (Doménech, 2014)
- For adequacy not to be affected by aging, employment has to grow at a similar rate as the number of pensions

Adequacy and efficiency in a sustainable system

Projection of the number of pensions from 2013 to 2050
Source: MEYSS (2013)



Average rate of growth in the number of pensions
Source: MEYSS (2013)



More and better jobs to improve pensions adequacy

Given the expected increase in the average number of pensions, Spanish society can choose between combinations of the following alternatives:

1. Accept the reduction in the average public pension as a percentage of the average wage and compensate for this with more resources from private savings

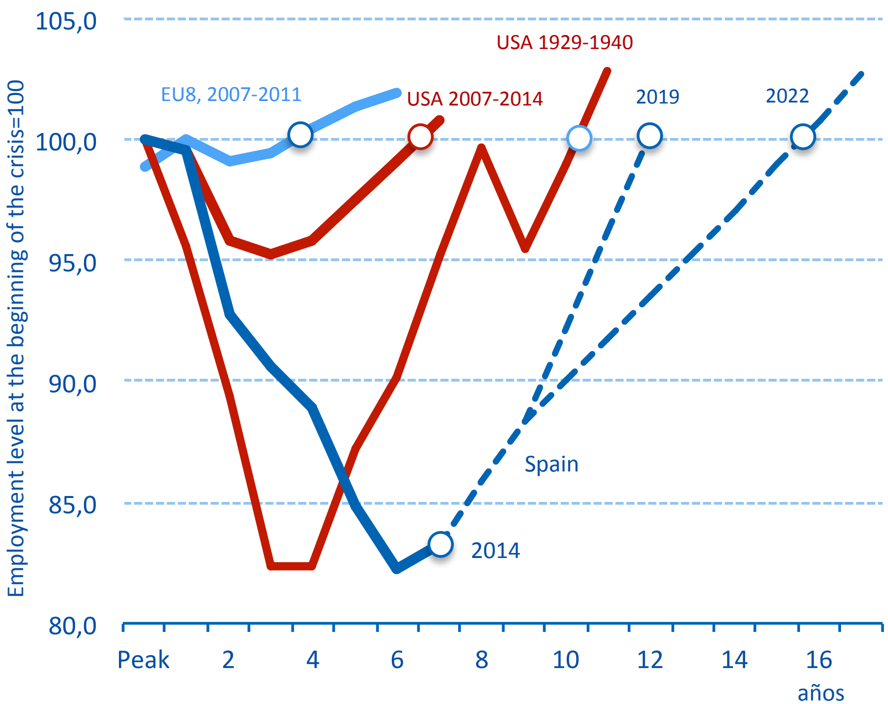
2. Increase the resources of the public pension system: higher taxes or less public expenditure in other areas

3. Implement structural **reforms** which **reduce the unemployment rate, and increase active population and wages** (higher productivity)

More and better jobs to improve pensions adequacy

Employment

Source: Andrés and Doménech (2015)



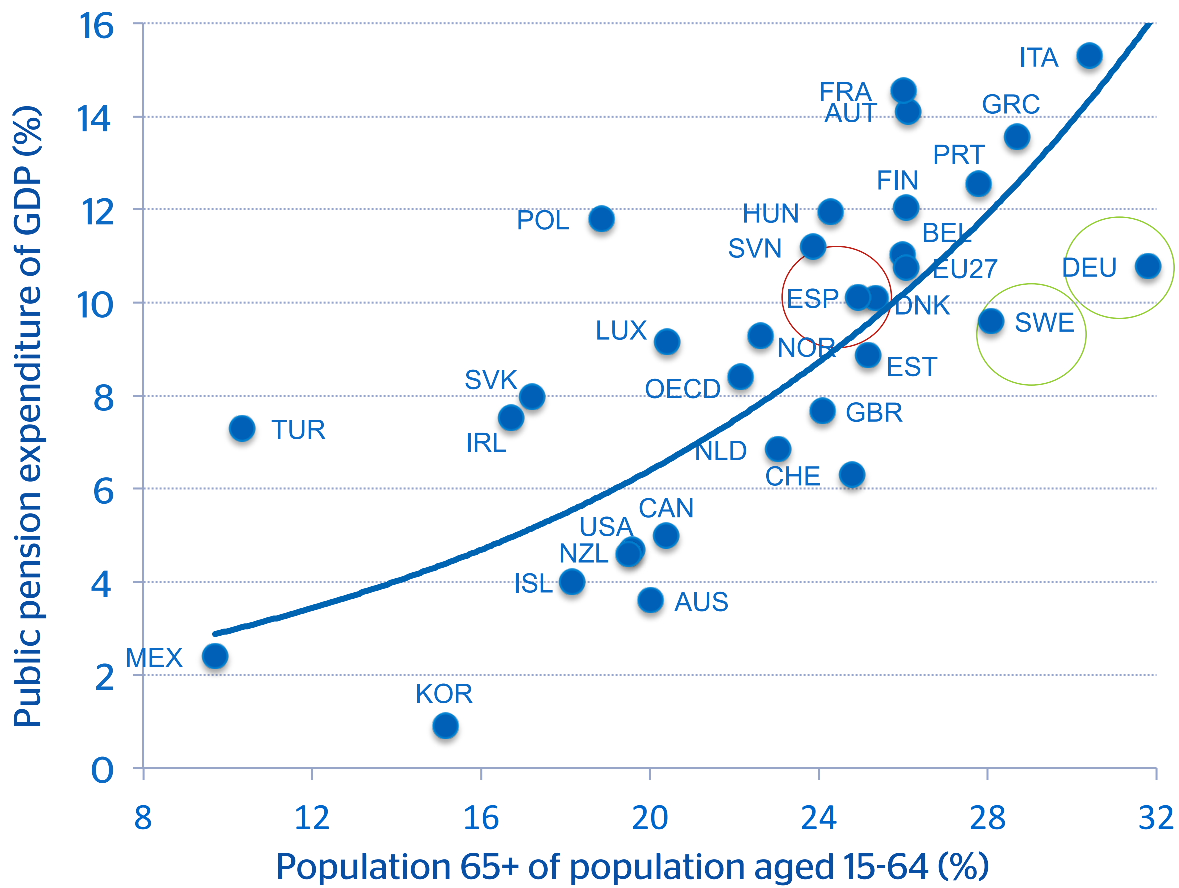
Although a employment growth rate of 1.4% will be enough to maintain the average pension/average wage …

… that growth is not enough to take employment back to its 2007 level in a reasonable number of years

In the next 10 years, the challenge of creating jobs and reducing the unemployment rate is more demanding than pensions adequacy

More and better jobs to improve pensions adequacy

Spending on public pensions over GDP and the dependence ratio, 2010
Source: OCDE (2011)



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Main problems of Spanish the labour market

1. High structural unemployment rate (14-18%)
2. Very volatile cyclical unemployment (±8pp)
3. Very volatile entry and exit flows
4. High long-term unemployment rate (>12pp)
5. Adjustment via jobs (quantities) rather than wages (prices)
6. Little adjustment through the number of hours worked per employee
7. Excessively high temporary employment rate
8. Very low rate of part-time employment, with a negative correlation with U
9. High rate of youth unemployment, which doubles the aggregate unemployment rate
10. Uneven regional unemployment (negative correlation between U and productivity)

The causes of an inefficient labour market

1. Inefficient collective bargaining (wages and firm productivity)
2. Rigid wage structure and indexation to inflation
3. Duality between permanent vs. temporary workers, and the perception of legal uncertainty
4. A tax structure which is unfavourable to employment
5. *Mismatch* between human capital and inadequate and/or inefficient active policies
6. Generous albeit inefficient passive policies
7. Other inefficiencies in the economy (regulations, product market competition, institutions, etc.)

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1. A modern hiring process: more permanent jobs (1)

- Complement the reduction in the number of contracts with a drastic modernisation of the severance payment system (BBVA Research, 2014)
- Reduce firing costs of permanent contracts towards those of countries with lower temporary employment rates, and increase legal certainty: comply with simpler rules
- A new permanent contract for new hires, more attractive for both companies and workers than the short-term contracts, with:
    1. A severance payment that increases with tenure up to 12 days per year worked
    2. A second component similar to the Austrian system: deferred salary of 8 days per year worked, paid into an individual account managed by the Social Security (also for temporary contracts)

1. A modern hiring process: more permanent jobs (2)

- Firing costs of permanent contracts should be lower:

  1. To make it more attractive

  2. To penalise, in relative terms, firms with higher temporary employment rates

  3. Job stability compensates the lower initial compensation

- More stability and higher wages: given the 15% wage premium of permanent jobs, if temporary employment rate falls to the same level of other European countries, expected wages of new employees would be higher than at present

- The young would be the principal beneficiaries of this reform

2. Collective bargaining, wage flexibility and taxation (1)

- Collective bargaining at the firm level: more internal flexibility within companies, adjustments through wages and working hours rather than jobs
- Wages should reflect differences in productivity between firms
- *Opt-in* vs. *opt-out*
- Mixed system: collective bargaining adapted to firms (e.g., wages), within a context of national sector agreements in other items
- This mixed system would foster a more cooperative collective bargaining, institutionalising the agreements at the firm level (part of the German miracle)

2. Collective bargaining, wage flexibility and taxation (2)

- Wage flexibility: causality from productivity to wages rather than the other way (reducing employment)
- Given the high current unemployment rate, greater flexibility would lead to a downward adjustment of the average wage
- The decrease in the aggregate real wage does not mean that the wages of all workers decrease, but the average wage due to a composition effect
- The fall in the average real wage will have expansionary effects given that employment rises by more than the decrease in the real wage (Andrés & Doménech, 2013): the elasticity of employment to wages is close to 1.5

  ➔ There will be an increase in GDP, private consumption, and public revenues, and a reduction in unemployment benefits expenditures and public deficit

2. Collective bargaining, wage flexibility and taxation (3)

- Fiscal devaluation (Boscá et al, 2013), tuning tax rates to reduce labour costs
- Reduction of social security contributions (reduces production costs) offset by an increase in indirect taxation (a rise in consumer goods prices)
- Compared to other countries, Spain has a lot of fiscal space for reducing social security contributions and raising indirect taxes
- Effects: raising indirect rates by 2pp and bringing down social security contributions by 2.3pp would boost employment by 200,000 jobs and GDP by 0.7%

3. More and better active policies

- Ensure that implementation of the Youth Guarantee scheme is successful, extending it to all unemployed workers with the necessary adjustments
- Improve the functioning of the public employment services and enhance public-private partnerships through private intermediation
- Extending partnership with the private sector on training, both general and better adjusted to firms demands
- Continuous and rigorous evaluation of results
- Temporary incentives to hiring, conditional upon training, of workers whose productivity is below the minimum wage level
- More resources for active policies via a better-funded European Social Fund and conditional upon positive evaluations of their results

4. Greater effectiveness of passive policies

- Efficient design: generous but incentivising job search and reducing fraud
- Effective integration of active and passive policies, putting the accent on the conditional nature of benefits as one of their key criteria
- All-in-one solution: integrating unemployment benefit into individual accounts like the Austrian system
- Additional benefits when individual accounts run out via a means-tested and conditional welfare allowances
- Partial solution (without individual benefit accounts) requires bringing in the experience of Nordic countries:

  1. ALMP to increases the employability of unemployed
  2. Proper definition of "suitable job offers"

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Conclusions

- The Sustainability Factor and the Annual Growth Factor guarantee the sustainability of the public pension system
- All options are possible except one: paying pensions by running a structural deficit, which would violate the fiscal sustainability principles in the Spanish Constitution
- Medium and long-term equilibrium between revenues and expenditure is guaranteed for a public pension system which should be under permanent adjustments to ensure its objectives:

  1. suitable and adequate pensions,
  2. fairness among generations
  3. long-term sustainability

Conclusions

- For adequacy not to be affected by aging, employment must grow at the same rate than the number of pensions
- Although in the next decade an employment growth rate of around 1.4% would be enough to maintain the average pension to average wage ratio …

  … this growth rate is not enough for employment to return to the 2007 level in a reasonable number of years …

  … which calls for an employment growth rate as high as possible

Conclusions

- The 2012 labour reform (Cardoso et al, 2013) and other policies have proved positive …

  … but they need further additional measures (Andrés & Doménech, 2015)

- The most pressing and important challenge is reducing the structural employment rate to the levels in neighbouring countries

- An unemployment rate of 6% would maintain the current proportion of Social Security affiliates to pensioners up to the end of the next decade without an increase in the labour force

- Once the labour market problems have been sorted out, increases in the labour force will become necessary to sustain a growing number of pensioners

- But an efficient labour market is essential to increasing the labour force and attracting talented human capital

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