Pensions

Pensions, employment and contributivity

Expansión (Spain)

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Distributive pension systems such as Spain's are based on an implied inter-generational contract between workers and pensioners. A contract which in addition to being sustainable in the long term and providing adequate pensions, must also be balanced and efficient. Without sustainability, adequacy cannot be assured. Without inter-generational balance and efficiency, the sustainability and adequacy of pensions may be endangered.

Favourable demographic and economic conditions mean there is no need to worry about these matters. On the contrary, when employment is growing faster than the number of pensioners and productivity by more than the average pension, it is easy to maintain a defined benefit system with high replacement rates (pension to final salary) and benefit rates (average pension to average salary). If income exceeds expenditure for years it is difficult not to fall into the temptation of increasing the generosity of the system with pensions well in excess of those contributed to throughout working life, as has been the case in Spain. Since 1995 the benefit rate has increase by 20 percentage points, to 64.2% of the average wage in 2016, the third highest rate in the EU and nearly 20 pp above the European average (European Commission, 2018).

The problem arises when this pyramid scheme starts to look shaky because the demographics are no longer favourable and growth in productivity is below that of the average pension, as in Spain's case. Following an intense economic crisis, and despite bigger inflows in 2017 than in 2008 with a million fewer contributors, the growing expenditure on pensions has opened up a huge deficit, equivalent to a thousand euros a year per contributor. The retirement of the baby boomers and the notable increase in life expectancy from age 65 (19.4 years for men and 23.6 years for women, increasing at the rate of more than one year every ten years) will continue to exert increasing pressure on expenditure.

All the demographic projections (INE, Eurostat and AIReF) indicate that the dependency ratio will double in thirty years. According to the projections of the European Commission (2018), maintaining the pension system unchanged would require revenues equivalent to 6.3 percentage points of GDP per year at this time horizon. This is equivalent to 115% of VAT revenues in 2017, 95% of personal income tax revenues or 4.000 euros per year per contributor. This enormous tax cost would jeopardise growth in employment, innovation and productivity and would burden workers and other taxpayers with all the future demographic and economic risks in an attempt to safeguard benefits. A strategy that in some European countries has proven counter-productive, leading to fiscal crisis and smaller pensions. To put the cost of this high-risk strategy into perspective, one need only refer to the current debate on the increase in the maximum contribution bases and contributions by the self-employed, by an amount representing barely two or three tenths of a percentage point of GDP.

The best solution is to keep increasing the retirement age and transition to defined contribution systems, as other countries have done. With automatic and very gradual mechanisms for adjusting initial pensions the system is protect from any scenario and greater balance on the distribution of efforts between and within generations is assured. The countries that have done it best have gradually implemented distributive systems with individual notional accounts in which pensions can be adjusted in line with inflation. Social contributions are seen as a form of saving, not as a tax, favouring growth in employment and productivity. All this leads in the long term to a balanced redistribution between generations and to bigger pensions, although the replacement and benefit rates are lower as a result of the decline in the ratio of contributors to pensioners. As well as being contributive, the system is progressive. When the contributive pension is less than the minimum pension it is topped up with financing from sufficiently wide taxation (personal income tax or VAT) and detailed transparently so as to showcase the solidarity existing.

In short, to improve such a basic pillar of the welfare state as the pensions system it is necessary to seek an equitable balance in the distribution of income among pensioners, workers and taxpayers, both current and future. The design, contributivity and efficiency of the pensions system affects investment, employment, the capture of talent, wages and economic growth, so in the final analysis it also contributes to creating more wealth with which to improve both the standard of living of future pensioners and that of society as a whole at the same time.

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