Pension / Regional Analysis Spain

The quest for balance in the Spanish pension system

Vozpópuli (Spain)

Rafael Doménech

After more than two years of negotiations, the Toledo Pact Commission has ended the legislative period without reaching an agreement on the reforms needed to guarantee the balance, sustainability and adequacy in the Spanish pension system. With a deficit that surpassed 18.937 billion euro in 2018 (around 150 euro per pension per month), the lack of agreement on a fundamental pillar of the welfare state comes as bad news. It would also have been equally undesirable to reach a pact without finding solutions to overcome demographic and economic challenges in the medium and long term that will only increase the already-high deficit as the baby-boomer generation retires.

The diagnosis of the system's current problems is well known. Since the start of the 2008 financial crisis, pension spending has increased by 4% on average annually, whilst earnings have stagnated–or even decreased–as a result of a 17% fall in employment. The economic recovery, that began in 2013, enabled a year-end revenue for 2018 that was 9% above that of 2008, which can be attributed to increases in both the tax base and salaries, although the number of workers contributing to the system in December 2018 (19,024,465) was still 2.4% lower than the highest number recorded, which was reached in July 2007. Pension spending has accelerated further in recent months against this backdrop. In addition to a 1.1% increase in the number of pensions and a 1.6% increase in the average pension as a result of the substitution effect–pensions of new pensioners are usually higher than those who pass away–pension revaluation has placed them above inflation for the average pension. In February of this year, spending increased by 7.2% compared to the same month of the previous year, which is the largest year-on-year increase in the last decade.

Generally speaking, the objective is to increase pensions with the CPI. However, to ensure that they are sustainable it is necessary to adopt compensatory measures to reduce spending growth compared to growth in earnings. This balance is essential for a pay-as-you-go system that funds contributory pensions with tax revenues. As shown in the Agenda for Change, potential real GDP growth between 1.5% and 2% is not sufficient to compensate for a 2.7% increase in spending given the increase to the average pension (as a result of the substitution effect) and the number of pensions.

How can the balance in the pension system be ensured? The balance between earnings and expenditure implies that the average pension on the average salary (or benefit ratio) must be equal to the total earnings from salaries in the economy multiplied by the ratio of contributors per pension. In December 2018, the number of pensions totalled 9,695,870, meaning there were almost two taxpayers per pension. The number of pensions will increase gradually between now and 2050. Given the expected mortality rates, we will need to fund around 15 million pensions. Therefore, in order to maintain the current pension system (i.e., with the current deficit), fiscal pressure and the average pension on the current average salary, we would need the number of workers contributing to the system to exceed 29 million and grow by more than three million per decade.

No forecasts–not even the most optimistic–foresee such growth of the working-age population unless the retirement age increases to maintain the ratio between contributors and pensions. That said, this solution is very demanding, particularly taking into account that life expectancy at 65 increases by more than 16 months every 10 years, and that the average retirement age has been going up at a rate of 6 months per decade. To give an idea of what this solution would entail, the OECD has calculated that, to maintain the ratio of workers to pensioners, the retirement age would need to go up by more than 11 years by 2050. As such, everything done to increase employment, active population and the retirement age forms part of the solution, but it will not be enough without additional measures.

Increasing fiscal pressure is an inefficient and unrealistic alternative, given the high level at which social contributions start and the magnitude of the fiscal effort that it would require. All projections (Fedea, the European Commission and the AIReF) indicate that, without compensatory measures, the deficit in the pension system will increase by several GDP percentage points in the coming decades. According to the projections of the European Commission (2018), keeping the pension system as is without any changes would require the contribution of annual earnings equivalent to 6.3 GDP percentage points in the coming decades. This equates to 115% of the VAT collected in 2017, 95% of Spanish personal income tax or 4000 euro per year per worker, meaning that they will bear all future demographic and economic risks. It is hard to imagine this huge tax cost and the lower contributiveness of the system not having a negative impact on growth in terms of employment and productivity, investment and innovation, and, therefore, on pensions in the long term. In the midst of the digital revolution, this cost means that the promises of increasing the fiscal pressure by that much are hard to believe. It is most likely that a future fiscal crisis will force a drastic adjustment of the average pension, as has been the case in other European countries.

The third alternative is to reduce spending by gradually decreasing the benefit ratio to the same level as other countries in the European Union. Since 1995, the benefit ratio has increased by 20 percentage points to 64.2% of the average salary in 2016, the third highest rate in the EU and almost 20 percentage points above the European average, according to the European Commission. Why is the benefit rate so high? The pensions of new retirees are much higher than the contributions made during their careers. Even with the 2011 reform in full swing, the actuarial deficit would be 28 cents per euro for the new average pension.

As the Forum of Experts of the BBVA Institute of Pensions and other experts groups have been advocating for many years, the solution needs to be implemented as soon as possible, gradually and ahead of time, with a pay-as-you-go system based on individual (notional) accounts in which new pensions enter the system without deficit. Calculating the initial pension based on what has been contributed during workers’ careers, and taking into account the demographic and economic projections during the expected lifetime of the new pensioner following their retirement, would ensure that pensions could increase with inflation maintaining their purchasing power. Social contributions would be perceived as savings rather than as a tax, helping to create more productive employment. Annual information about pensions rights accumulated by each worker would also enable it to be seen by how much a pension increases for each year that retirement is postponed. For current pensions, the balance will need to be sought between revaluations below inflation, except for minimum pensions (which must increase by at least as much as the CPI), and additional tax revenues will be necessary. These measures should, however, be temporary until the system is in equilibrium.

As Nobel laureate Peter Diamond said, a better goal than seeking radical reform is trying to improve the highly satisfactory current structure. But immobility is not an option either, as well as promising unsustainable pensions in the future when faced with demographic, economic and social changes. We hope that in the next term, the Toledo Pact Commission reaches a broad consensus on a gradual, equitable, efficient and comprehensive solution, similar to that in other European countries such as Sweden, which guarantees the sustainability and adequacy of pensions in a balanced way between pensioners, workers and current and future taxpayers.

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ENQUIRIES TO:
BBVA Research: Calle Azul, 4 Edificio La Vela, Floors 4 & 5 28050 Madrid, Spain
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 25
bbvaresearch@bbva.com www.bbvaresearch.com