Pension reforms: why they fail and how to make them viable

The problems with pensions are understood — we just don’t want to face them. Here are tips for viable reform.



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Europe’s aging population is an age-old problem. So, too, is the growing imbalance in public

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pension systems. Without far-reaching reforms, the pressure on public finances will continue to grow.

This is the conclusion of a research project in which Julian Diaz-Saavedra (University of Granada) and I analyzed how to design pension system reform that is sustainable, equitable and politically viable. We designed it for Spain, but the conclusions can be extrapolated to other European countries.

For decades, I have been warning that the optimal time to have carried out this reform in Spain was 1980. Over recent decades, we have enjoyed what demographers call the "demographic dividend": a period in which the working population grew faster than the retired population, and we weren't yet feeling the pressure of our own baby boom. That window of opportunity — when we could have pushed through progressive reforms without high social costs — was wasted. We've been living on an income that is fast running out.

The silver wave

Over the next two decades, the last cohort of Spain's baby boom will reach retirement age and claim their pensions.

14.1
million Spanish workers
The number of baby boomers that are due to retire.

At no time has Spain stopped paying pensions, and I see no reason why that should change now. But this apparent tranquility comes at a huge price: the absorption of resources that could instead finance functioning trains, daycare centers or affordable housing.

Why it is imperative to reform the pension system

The long-term demographic trends are clear: baby boomers are retiring (in Spain, this generation was born in the late 1950s through to the mid-1970s, later than other Western

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countries), the birth rate is falling and life expectancy continues to grow longer.

Therefore, the dependency ratio — the ratio of contributors to retirees — will decline significantly over the next two decades. As a result, there is no choice but to enact profound reforms to public pension systems.

An effective way to strengthen the system is to introduce automatic adjustment mechanisms: rules that adapt pensions to demographic and economic developments.

These mechanisms — such as revaluation formulas linked to how long retirement is expected to last — and the financial sustainability of the system reduce the need to adopt a constant series of arbitrary reforms. They can make the system more predictable and more credible.

But pension sustainability also depends on the overall design of the system. For example, when only part of a worker's career is taken into account when calculating their pension, or when pension rights are calculated based on regulatory bases rather than actual contributions, some workers are arbitrarily favored (usually those with higher education and higher incomes) while others are disadvantaged, increasing both retirement pension expenditure and inequality.

That's why we insist that a pay-as-you-go system is not a financial product. It has the virtues and defects of intergenerational solidarity and offers a spectacular gift to the first generations. The accounting for this pay-as-you-go system must be "dynastic": each generation supports the next, and that chain cannot be broken.

How to tackle viable pension reform

Pension reform isn't just about getting the technicalities right. At heart, it is a political challenge.

People who stand to lose out from reforms naturally oppose them, leading to social tensions and often policy reversals. These political U-turns are not isolated phenomena: in recent years we have seen them in Spain and also in Poland, Germany, Croatia and the Netherlands.

For a reform to be politically viable, it needs to be more than just technically sound. It must compensate the groups most affected, at least temporarily.

In Spain, where the system's deficit already exceeds 4% of GDP, we have put forward a plan that combines sustainability, equity and political stability. This plan includes the following

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measures:

- Introduce a sustainability factor that adjusts the initial pension according to life expectancy at retirement.
- Apply an automatic adjustment rule that links pension revaluation to the financial balance of the system, rather than to the consumer price index.
- Extend the pension calculation period to cover the entire working life, improving equity between workers with upward and downward career trajectories.
- Scrap the cap on contributions but keep the maximum pension the same, so that higher earners pay more into the system without getting bigger pensions in return.
- Offer a one-time compensation for those who are disadvantaged by the reform, delivered in the form of liquid assets and financed through public debt. This transitional component seeks to facilitate a fair transition and avoid the social rejection that often causes pension reforms to fail.

Two “zero-cost” measures that change everything

In addition to these measures, we propose two “zero-cost” reforms with enormous structural impact:

1. Separate common contingencies. Retirement, widowhood and minimum supplements — some $162 billion in 2024 — should continue to be paid for by Social Security; the rest (disability, maternity, accidents or the minimum living wage) should be financed through the general state budget. This simple separation would put an end to debates about “improper expenses.”

2. Capitalize on the Intergenerational Equity Mechanism (MEI). The MEI, as it exists today, is a scam: it does not generate pension rights, because the pension is calculated based on the regulatory base and the number of years contributed, not on the actual amount contributed. Instead of investing that 1% in public debt — the worst possible investment — we should capitalize it in individually managed plans, administered by Social Security, similar to the Swedish “Pension Premium.” This model would create around 20 million savers and investors and, in the long term, allow us to evolve toward a 50% pay-as-you-go/50% capitalization system.

We must also finance the system with an eye to the future: machines and robots will have to

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pay for pensions. Social Security contributions should be gradually transferred from payroll to corporate tax. If we do not make this substitution, the massive automation of human employment will lead us to a society with unmanageable unemployment rates.

Good reforms also build trust

The many simulations we conducted show that well-designed reform has multiple benefits. It not only improves the financial sustainability of the system by reducing future pension expenditure, but it also encourages private savings and promotes longer working lives.

By limiting the deficits, the reform avoids the need for substantial tax increases to finance them.

The net benefits for future generations are substantial, even after accounting for the cost of the public debt issued in compensation.

There’s also a key feature: if the reform is announced far enough in advance, the cost of the transition is lower, as families have more leeway to adjust their consumption, savings and retirement choices.

A pan-European issue

According to our estimates, at least 16 European countries will experience a significant increase in their pension expenditure as a share of GDP in the coming decades.

Luxembourg tops the list, with a projected increase of more than 8 percentage points.

However, many countries have yet to adopt the automatic adjustment mechanisms needed to balance their pension systems. Some countries, including Austria, Belgium, Bulgaria, Hungary, Ireland, Malta and Slovenia, have not implemented a single one of these reforms.

Others have taken baby steps and adopted one. Finland has implemented two.

All of these countries will need to adjust their pension systems if they wish to avoid growing deficits and ensure future sustainability.

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Implications for policymakers and managers

For public officials, the most pertinent message is that reforms can't just be about economic efficiency; they must also seek social consensus.

Introducing automatic adjustment mechanisms is necessary but not enough. Intelligent policies need to be designed that compensate the people affected, explain new measures clearly and anticipate public pushback.

For managers, in a context of less generous public pensions, there are two main implications:

- Be prepared for an environment in which responsibility for retirement savings will increasingly be individual or shared with the company.
- Look for opportunities: Supplementary pension plans can become a strategic tool for attracting, retaining and nurturing senior talent in an aging workforce.

In short, public pension systems in Europe need profound and urgent reform. But for these reforms to work, they must be fair, credible and sustainable.

MORE INFO: "Public pension reforms: financial and political sustainability" by Javier Diaz-Gimenez and Julian Diaz-Saavedra appears in the *European Economic Review* (2025).

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