

In order for pensions to work, we need radical reform

Many young Spaniards believe their pensions will never see the light of day. Here's my reform proposal.



May 9, 2024

By [Javier Díaz Giménez](#)

Soon there won't be enough workers to pay for the increasing number of retirees. As people

live longer and birth rates drop, there will be a deficit in the Spanish pay-as-you-go pension system if the government continues to provide Spain's generous retirement benefits — *and* keep up with inflation.

But, as worrisome as the prospect looks, Spain is unlikely to stop paying pensions anytime soon — voters simply won't allow it. Much like in the rest of Europe, a majority of Spanish voters are over 50 years old. Since this group of voters is also the most concerned about pensions, they will continue to vote for politicians who prioritize pensions.

So how can the pension system continue to be sustainable? The short answer is that it won't.

To continue paying the promised pensions, other social services may suffer instead. There could be cuts to healthcare, education or road maintenance. Alternatively, the government could impose higher taxes — be they payroll taxes or personal income taxes — reduce pension rights or increase the retirement age. But, as [the 2023 protests in France](#) demonstrated, the repercussions when politicians tread on citizens' pensions are severe.

What we need, then, is a radical reform of the current pension system.

Universal pensions for all

The first step is to make the pension system universal. In other words, we need to ensure that *every worker* pays into the system — no exceptions. Just think about it this way: In contributive pension systems, pensions are nothing more than deferred wages; in other words, they are compulsory savings that will eventually be used in retirement. In pay-as-you-go pension schemes, everybody must participate in order for the scheme to work.

But that's not what is currently happening. There are around 1.8 million *mutualistas* who legally choose not to pay into social security and who take out private insurance and pension plans instead. This option is only available to certain professionals, like public sector employees or agricultural workers. And while they're still a minority, their lack of participation could take a toll on public pensions by keeping much-needed funds from entering the system. Around 5 million self-employed workers have a similar leeway in choosing their pension contributions.

Going the private route could also be a big risk to the retirees themselves. These insurance companies and financial institutions simply cannot guarantee sufficient annuity — that is, a livable wage until the day we die — especially now that people are living longer. Since the

1950s, the amount of time we spend in retirement has gone from 10 to more than 20 years, while the retirement age has remained almost unchanged. This means that more funds are needed to sustain us during that time. It's unrealistic for a bank to promise a regular income to *every single retiree* without going bankrupt. What happens if a person lives to 100 but their savings run out when they turn 85?

The problem — and the reason we have an increasing number of *mutualistas* — is that distrust in the public pension system is growing. These doubts are somewhat warranted because of the large and growing social security deficits. But it's imperative that we continue to trust in our public pensions — otherwise, the scheme will fall apart. A viable pension system must create incentives for workers to contribute; people should be more than willing to pay payroll taxes because they're confident it's the best way to guarantee their welfare in the future.

And so far, there's no reason *not* to trust. The Spanish government has, as of today, paid every single pension promised to every taxpayer who contributed their part. Its track record is exemplary. The fear about what the future may bring is understandable, but there is no reason to lose hope — after all, algorithms and machines will increasingly contribute to the system to generate the value needed to pay our pensions.

A mixed pension system

The other major aspect of my reform proposal is to reorganize the pension system into a mix of pay-as-you-go and funded components.

Right now, Spain's public pensions rely almost entirely on a pay-as-you-go system. That means that current workers' tax contributions are pooled together to pay for the benefits of the current retirees. Pay-as-you-go pension systems rely on local funds — it works well as long as the local economy does well.

But it's also vulnerable to demographic changes, economic conditions and public policies. This is where the more-retirees-than-workers issue comes into play: How can the government pay every pension if there are not enough workers to contribute to the system? Moreover, if Spain is hit by an economic crisis like the 2008 global financial crash or the COVID-19 pandemic, the unemployment rate skyrockets and puts extra strain on social welfare programs.

Funded systems are less reliant on local factors. Funds can be invested in fully diversified

portfolios — global stocks, bonds, exchange traded funds (ETFs), mutual funds — to generate returns over time. It allows taxpayers to have savings to pull from when they retire and, in a mixed pension system, these funds can be used to supplement the pay-as-you-go pensions.

But a funded system has its own downsides: It carries investment risks and lacks solidarity. The value of the retirement savings accounts can fluctuate with market conditions and require constant oversight so that people can ensure their investments meet their long-term financial goals.

This may sound similar to the private insurance companies, but the key difference is that funded pension systems are supervised by public authorities. While banks can go bankrupt and fail to provide the money they promised, government entities can reinsure the private fund managers and continue to distribute funds. In other words, they can make sure that the retirees are not left empty-handed.



Javier Díaz-Giménez

Professor in the Economics Department at IESE and holder of the [Cobas A.M. Chair for Savings and Pensions](#).

www.iese.edu/insight