Saving the Spanish pension system

A deficit exists in the Spanish pension system, which will only get worse unless deep structural reforms are made soon.

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Since 2010, the Spanish social security system has paid out more than has been paid in. This is not just a problem of recent economic circumstances. The deficit is structural, and will continue to rise, due to declining birth rates and low levels of immigration.

In 2010, for every person over the age of 65 or potential beneficiary of a retirement pension, there were 3.6 potential contributors between the ages of 16 and 64. If current demographic trends continue, that ratio will be 2.5 in 2030 and 1.6 in 2050.

To continue to fund its pensions, Spain will need 26.5 million immigrants over the next 40 years, or roughly 665,000 per year. But only 70,000 immigrants arrived in 2010.

These are some of the considerations of a new study on Spanish pensions prepared by IESE professors Antonio Argandoña and Javier Díaz-Giménez, together with Julián Díaz-Saavedra, of the University of Granada, and Beltrán Álvarez.

A vulnerable system

A comparative analysis with other OECD and G20 nations reveals that the Spanish pension system is less contributory than that of many other countries. This makes it more vulnerable to demographic and economic shifts.

In addition, the role of capitalized savings is much less significant in Spain than in most other eurozone countries.

These features of the Spanish pension system pose the following problems:

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- *It generates uncertainty*. Workers do not know when they will retire or the amount of public pension benefits they will receive.
- *It lacks transparency.* To generate the accounting illusion that the contribution paid by the worker is very small, the employer has to cover three-quarters of it, which encourages the underground economy.
- *It is arbitrary and barely contributory*. A worker who has paid the maximum contribution from the age of 16 to 49 (i.e., 34 years) is not entitled to receive a pension. Another who has worked for one more year and paid the minimum contribution during the first 20 years and the maximum over the past 15 years is entitled to earn the maximum pension.
- *It is not universal.* There are many exceptions.

Contribute for 40 years, retire at 68

Over the past 25 years, the Spanish pension system has been reformed four times, most recently in 2011. Although recent modifications have substantially improved sustainability, they are insufficient.

The authors consider it essential to reduce the application periods described in the latest reform. The minimum contribution period to receive a pension should immediately be raised to 40 years, and the retirement age should be extended to 68.

But such measures will not be sufficient to restore a budget balance unless deep structural reforms are adopted to shift from the current "benefit distribution" system to a "defined contribution" system.

Under the first system, the State determines the amount of pension benefits and adjusts the contributions as required.

Under the other system, contributions are set, and the pensions are adapted to them. As such, the contributions made by workers during their working lives are taken into account, so that each euro that is contributed generates one euro in pension rights.

Learning from international practices

In countries with best practices, employee contributions go into a virtual account, which contains the total amount paid by each contributor, along with the fictitious yields that are

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generated throughout his or her working life.

The final amount is converted into an annuity at retirement. Thus, workers are always informed of the amount of their pension rights, and can plan their retirements with no surprises. They also understand that their contributions are actually deferred wages that they will receive at retirement.

Another difference is in the amount of minimum pension benefits, which in Spain is equivalent to 27 percent of average earnings, while in the eurozone it amounts to 25 percent. The minimum amount should be relatively low and only given to those who really need it, regardless of their pension contribution.

In most of the countries studied, workers are expected to supplement their future state pensions with another savings plan, either through the company they work for, or through another private entity, in order to guarantee some income in the event that they live longer than expected.

But little is done to stimulate such capitalized savings for old age in Spain, where the total volume represents 8 percent of GDP, compared with 98 percent in the United Kingdom, 90 percent in Switzerland and 53 percent in Ireland.

Proposals for achieving sustainability

The authors believe the most suitable option for achieving sustainability is to adopt a mixed mechanism between distribution and capitalization, which is similar to Sweden's, where capitalization is virtually mandatory.

This would tap into the advantages of the two systems — mainly, the lower cost of the distribution system in the event of increased longevity, and the possibility offered by capitalization systems to diversify sources of income in retirement.

Targeted minimum pensions that depend on the income and assets of the recipients should be applied, with the aim of ensuring a minimum income that is independent of pension contributions.

The transition to a new design should minimize the personal costs to pensioners and workers, while also respecting their rights.

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