Is our pension system viable?

Rafael Doménech

The persistent Social Security deficit and the continuous tapping of the Reserve Fund, which has dropped 62% from the 66.8 billion of 2011, has spurred another intense debate about the viability of Spain's pension system.

Let me start by saying that our pension system is viable, but we need to keep making major changes to it. First, we need to sustain our recovery so we can cut the deficit. With an unemployment rate of 20%, the system's revenues are way below those generated in a normal cycle. Second, we must eliminate the current structural deficit, which will not disappear with a recovery without additional reforms. After factoring uncertainties into the calculation, we believe a reasonable estimate of the structural deficit in 2015 would be 11 billion. Third, it is vital that long-term revenues and expenditure grow at the same pace, so that the structural deficit doesn't rise again. This is the biggest challenge.

Current forecast indicate that the number of pensions will rise from 9.4 million in 2015 to 15.0 in 2050, with annual growth rates increasing from the current 1.2% to 1.8% in 2035, and then grow by less than 1% as of 2045. Furthermore, the new pensions are usually higher than those leaving the system. In the last few years, this effect has led spending to rise by around 1.6%, nearly double the average productivity growth of the last two decades (0.85%). If we assume that this effect will gradually fall to 0.8%, the annual increase in spending in real terms would stand at over 2.5% up to 2040.

As the pension system's revenues grow over the long term at the same pace as GDP, it would be necessary for its real growth to stand at over 2.5% in order to finance the increase in spending over the next few decades. Obviously, the best solution would include structural reforms that boost employment and productivity. But what would happen if GDP growth doesn't reach 2.5%? In that case, we would basically have to options: ensure revenues outpace GDP until they equal spending or reduce spending growth to GDP. Either of these is perfectly in line with the Pension Revaluation Index approved in 2013.

Cutting pension spending growth would not prevent improvements in minimum pension payments or the purchasing power of the average pension. However, by cutting spending growth at a slower pace than average wage growth to keep the deficit from growing, the generosity of the system, measured by the average pensions in relation to average wages (or benefit ratio), would diminish progressively. According to the 2015 Ageing Report from the European Commission, Spain's benefit ratio (65.4%) in 2013 was the second highest in the EU and 23 points above the average of the eight most advanced countries (42.4%). The problem is that maintaining the benefit ratio is even more challenging than ensuring the system's sustainability. Unless the number of people paying into the system grows at the same rate as the number of pensioners, reaching the unlikely figure of 27 million contributors in 2050, the only option is to cut the benefit ratio or increase taxes.

Closing the gap between pension revenue and spending through taxes, while maintaining the benefit ratio, would be a very tough pill to swallow for taxpayers as it would be necessary to keep raising the rate on the taxes earmarked for pensions. Apart from the distorting effects on growth and employment, this alternative would require the transfer of ever greater income from the active population to pensioners, increasing the burden for future generations and reducing the amount paid into the system.

In short, the dilemma is evident: either we must maintain the current generosity of the system through higher taxes on future generations or gradually converge toward more sustainable generosity, as we have seen in more advanced European countries whose populations have aged before ours, thereby avoiding an intergenerational imbalance and learning from them how to modernize our welfare system. All this should lead us to converge as soon as possible with a distribution system based on transparency and incentives in notional accounts (individual). Additionally, the more progress made in reforms that boost employment and productivity, the more manageable the dilemma will be. Spanish society must be aware how difficult it is to ensure decent and sustainable pensions, as well as the implications derived from choosing certain solutions over others when there is no such thing as a free meal.