Pensions and inflation: there are no free solutions

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In recent weeks, we have learned of certain initiatives to repeal the reform of the 2013 pensions system, its revaluation mechanism and the sustainability factor (which kicks in from 2019), as well as others to raise pensions by 1.2% in 2017, with a revision clause if inflation outstrips this figure. There is no doubting that this is a well-intentioned short-term proposal, yet this is not what the debate is about. The key issue is what costs these proposals entail.

The first cost is that repealing the 2013 reform once again threatens the sustainability of the public pension system. The system needs ongoing measures to improve how it functions, its efficiency and how fair it is. That said, all of this depends on ensuring its financial sustainability, which is an absolutely essential precondition. One cannot guarantee the social adequacy or sustainability of a pay-out system where revenues do not match expenditure in the medium and long term.

The 2013 reform brought in two mechanisms. The first of these was the sustainability factor. Prior to the 2011 reform, for every euro in contributions, 1.44 euros of pension was provided, where both sums are valued in today's money. In the years leading up to the crisis, this imbalance could be paid for thanks to the fact that the growth of employment outstripped that of the number of pensions. The situation was like a Ponzi or pyramid scheme. When the 2011 reform becomes fully effective in 2027, forecasts suggest that the shortfall will be reduced from 44 to 28 cents per euro of contributions. The sustainability factor of 2013 will prevent the deficit from growing with longer life expectancy. To do away with this deficit, a pay-out system must be implemented as soon as possible which is based on notional defined contribution accounts, with ring-fenced minimum pensions that guarantee sufficiency, fairness and solidarity. The second mechanism introduced in 2013 was the Pensions Revaluation Index (PRI), which fine-tunes the annual update adjustment according to price growth, while also factoring in growth in real revenue and the number of pensions as well as that of the replacement effect (new pensions tend to amount to more than those leaving the system). It furthermore includes a correction of the existing trend deficit. When such corrections detract from price growth, the PRI ensures that pensions rise by at least 0.25%, such as in 2017. The PRI is designed to be sufficiency-neutral, given that it can be applied by increasing system revenues or paring down expenditure growth. It moreover provides useful information on the financial health of the system. And ensuring sustainability is the best guarantee to ensure today's young people their future pensions.

Since the PRI allows pensions to rise as inflation does if additional revenues are provided, the second cost is a strictly financial one: How much resources should be provided in 2017 and in the following years for the PRI to provide a 1.2% rise this year? For this to happen, the PRI firstly requires that the current trend deficit be removed (some 11 billion euros) and secondly that we take stock of the fact that a 1.2% rise in 2017 is consolidated in the expenditure in the following years. In other words this means applying the PRI by calculating the revenues needed in 2017 and in the following five years so that pensions can rise 1.2% this year, without resorting to the shortcut of maintaining or increasing the current deficit. Calculations using the current forecasts up to 2022 suggest that in 2017 alone we would need to contribute 13 billion euros just to start with and an average of a little over 14 billion a year up to 2022. This annual amount represents roughly one tenth of Social Security system revenue or of the sum collected in indirect taxation, and 12% of what is collected by way of direct taxes. Hiking taxes is a legitimate policy option, but public opinion must know at what cost: it is not a measure without a price. And ex-post the hike would be bigger owing to the negative effects of greater fiscal pressure on economic activity. A more affordable option is to limit how the minimum pension rises with core inflation and even with average productivity growth.

In short the debate is about how to spread out the adjustments between generations and within each of them fairly, efficiently and transparently while keeping the system balanced using measures that boost employment and productivity. And if adjustments also call for some sort of increase in fiscal pressure, the cost of this cannot be concealed, which will mainly fall on current and future workers. On the youth of today, who will pay more for less: their pensions will have greater purchasing power but they will be less generous than those of the present in relation to the average wage prevailing at any time.