BBVA | Research

Pensions and private savings

Diario Expansión (Spain)

Rafael Doménech

19 Feb 2018

In the last few weeks, the debate on private savings as an instrument to supplement public pensions has again intensified. Although this has always been a topic for discussion and analysis, the recent cause was the royal decree that will enable the amount saved in pension plans to be redeemed after 10 years.

Wisely, but with greater or lesser success, previous Spanish governments have encouraged private savings for old age, which is a common practice in advanced countries for three reasons.

Firstly, in free market economies, private savings form an essential component of national savings and it would be an attack on individual freedom if individual decisions regarding the income that people would like to receive in in their old age were made more difficult. The criticism that incentives for private retirement savings seek to privatise the public pension system does not make sense. It is sufficient to design a good pay-as-you-go system and, at the same time, encourage saving in supplementary capitalisation systems, allowing them to be under public or private management, as is the case in Sweden, for example.

Secondly, the experience of other countries and the opinion of Spanish taxpayers show us that it is unreasonable to expect that, for the majority of citizens, the only income during retirement will be a public pension. With the latest data available from the European Commission, in the EU as a whole the average retirement pension in 2013 was 45.5% of the average salary. In Spain, the replacement ratio was 65.4%, the second highest in the EU. Since wages determine the basis for Social Security contributions and the public pension system is pay-as-you-go (spending on pensions is funded by revenue streams), balancing the budget in the long-term will result in an unavoidable dilemma. To meet the increase in the number of pensions from the current 9.5 million to the 15 million forecast for 2050 without changing the current system, the number of contributors would need to rise from the almost 18.5 million people currently registered to just over 27 million. This is highly unlikely to occur, given the expected demographic trends. What cannot be covered by more employment can only be made up for by more taxes (i.e., lower disposable income for future generations) or by less growth in pensions in comparison to wages. Given taxpayers' reservations regarding the tax increases that would be required, the probable decrease in the replacement ratio would be compensated for if everyone were to put away more savings during their working lives, so as to supplement their pension during retirement.

Thirdly, if, to date, putting away savings for old age has been insufficient at the aggregate level, the increase in life expectancy and the demographic trends will exacerbate this problem in the future. For years now, studies (for example, the work of David Laibson) have demonstrated individual preferences for immediate gratification, with increased consumption in the present and postponing decisions on savings for old age. This is why Richard Thaler, a Nobel Prize winner in Economics for his work on behavioural economics, has for many years defended the idea of motivating workers with small "pushes" so that they automatically join retirement savings plans. Unlike Spain, some countries have already set up such plans, which helps explain why the amount of accumulated savings in private pension plans in 2016 was 50% of GDP on average in OECD countries, compared to 14% in Spain.

The recent reform enabling the redemption of pension plans after 10 years may be a small "push", encouraging saving for old age, even though it also makes it easier to use the accumulated savings before retirement to bring an immediate reward and again postpone the decision to save to the future. Even if the net balance ends up being positive, much remains to be done. Other advanced economies have been more ambitious and have been teaching us the way forward for years.

As Sweden and other European countries have done, the contributory nature and transparency of the system must be improved by introducing individual (notional) pay-as-you-go accounts as soon as possible, which take people's entire working lives into account. The system's progressive nature must also be ensured by means of minimum pensions with protected purchasing power, to guarantee an adequate amount for those who have not contributed or saved what is necessary. In addition, as in those other countries, there is a need to introduce capitalisation accounts with automatic membership, with contributions from both employees and the companies for which they work throughout their working lives, regardless of whether the management of these accounts is public or private.

The more ambitious we are with these reforms, the better the service provided by the public pension system as a fundamental pillar of the Welfare State.