Spain's social security system: Recent reform and existing challenges

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Spain's social security system faces structural and cyclical related challenges. The recent 2011 reform addresses some of the major shortcomings of the system, but will likely be insufficient to ensure long-term sustainability.

The Spanish social security system is comprised of a pay-as-you-go public scheme, together with a supplementary private one. Reliance on private pension plans in Spain remains limited primarily due to the high retirement salary workers receive, together with the limited development of employment pension schemes. The public system faces challenges due to structural issues such as demographic constraints, as well as cyclical issues arising from the economic crisis. The main areas of the 2011 reform attempt to address some of the issues facing the current system. However, given the costly transition from a pay-as-you-go to a capitalized system of notional accounts, this is not an option in the current economic crisis and additional measures will likely be needed.

Introduction

The social welfare system includes all those features aimed at protecting workers' income from the following risks and unforeseen events associated with an employee's situation: Death, disability, illness, retirement and unemployment.

In Spain, we can distinguish between the public social security system, mainly based on Social Security benefits, and the supplementary private pension scheme, of a voluntary nature, comprised of all forms of private savings intended to cover the above events, through various products such as pension funds, savings insurance, life insurance, health insurance, or long-term care.

Public pension system

Spain's public retirement-income scheme is a pay-as-you-go system. Every year, revenues from social security contributions of employers and employees together with transfers from the State budget (general taxes) are used to pay benefits for that year. The system does not reserve capitalization funds for the payment of pensions in the future.

In the Spanish public pension scheme there are two different performance levels:

- Non-contributory or social assistance level, financed by general taxes, under the control

[1] A.F.I –Analistas Financieros Internacionales, S.A.

Table 1
Spanish social security system

Public Social Security System	Supplementary private pension scheme	
First Pillar	Second Pillar	Third Pillar
Basic level		
Non-contributory benefits. Of a universal nature. Financed through taxes and made up of non-contributory benefits, health care, family benefits and social services	Employee pension plans and collective insurance	Individual and associate pension plans
Contributory and professional level		
Mandatory for employees and self-employed. Financed through contributions assumed by the company and the employee and involves perception of annuities of retirement, permanent or temporary disability, maternity, death and subsistence.		Individual insurance

of social security and managed by the Autonomous Regions. This is a basic level which seeks to ensure minimum benefits to those citizens who lack financial resources or have very low income levels (less than 5,007.8 euros per year). All citizens are eligible, even if they have never contributed or have not contributed for a sufficient amount of time (nowadays 15 years) to reach contributory level benefits. The objective is to avoid situations of extreme poverty among retirees.

- Contributory level: Provides pension benefits based on years and contributions quoted by workers throughout their working lives. To access these pension benefits workers must meet the following requirements:
  - The legal retirement age (65 years, pre-reform).
  - A minimum of fifteen years of contributions, of which at least 2 must be within the 15 years immediately prior to the date of retirement.

The most important –and the focus of all political debate- is the contributory system of social security, financed by social contributions from workers and employers. The contributions are set as a percentage of the contribution base (wage), with a maximum and a minimum defined annually:

- The most common contribution rate for the General Scheme of Social Security in Spain is 28.3% of salary, of which 23.6% is paid by the company and 4. 7% by the worker.
- The contribution rate for the Special Scheme of self-employed workers is 29.80%.
- There is also a specific contribution to finance unemployment benefits and those arising from work-related accidents.
- There is a maximum and a minimum for the retirement contributions base, which in 2012 was set at 3,262.5 and 754.2 euros per month, respectively.

Pension benefits are linked to contributions. To calculate retirement pension for the first year, earnings during the last 15 years prior to the date of retirement are taken into account. The pension benefits for the rest of the years are indexed to the inflation rate.

Fifteen years of contributions are necessary to qualify for pension benefits. After 15 years of contributions, the pension benefit is 50% of the earnings base. Over the next ten years, an extra 3% is accrued per year, followed by 2% per year thereafter. The maximum accrual is 100%, reached after 35 years of contributions.

The earnings base is based on salary over the last 15 years, adjusted in line with prices, apart from the last two years. This means that the replacement rate relative to final salary is less than 100%.

As is the case with contributions, pension benefits also have a maximum and a minimum, which in 2012 were set to 35,320.46 and 8,664.6 euros per year (14 payments), respectively.

Unlike individual capitalization systems where the pension benefits depend on their contributions, income and expenses, in the pay-as-you-go systems the contributions of current workers and employers pay the pension benefits of the current retirees. And the current workers expect that their pensions will be paid by future workers. So the sustainability of the public pension scheme depends on the number of current workers and the number of pensioners receiving a pension.

Private pensions system

Article 41 of the Spanish Constitution provides for the existence of a complementary private pension scheme to the public one. Although in the Spanish market, there are different savings products, retirement savings mainly focus on private pension plans and savings insurance. There are three types of private pension plans:

- Individual system pension schemes, those in which the promoter is one or several Financial Entities, open to any participant. This system, together with individual savings insurance and other savings, represents the 3rd pillar in Pension Schemes. They must be Non-Defined Benefits.

- Associate system pension schemes, those of which the promoter is an Association, Syndicate or Labour Union, the participants being its associates or members (closed).

- Employment system pension schemes: Those of which the promoter is any Entity, Society or Firm, and whose participants are its employees (closed).

Compared to other developed countries, the development of private pension plans in Spain has been very limited. The main cause of this is that the replacement rate of public pensions in Spain is very high compared to neighbouring countries. In Spain, the replacement rate is 81.2%[2] of pre-retirement salary. Thus, workers do not have incentives to save for retirement (people

Compared to other developed countries, the development of private pension plans in Spain has been very limited mainly due to a high replacement rate of public pensions compared to neighbouring countries. Thus, workers do not have incentives to save for retirement. Another cause is the limited development of the employment system, much larger in other countries.

[2] http://www.oecd-ilibrary.org/finance-and-investment/pensions-at-a-glance-2011/net-pension-replacement-rates_pension_glance-2011-18-en

Table 2

Total pension benefits

Accumulated savings (millions of euros)	2007	2008	2009	2010	2011
Employee pension plans and collective insurance and PPSE	62,657	59,652	60,725	60,677	60,212
Individual and associate pension plans, and PPA	55,037	52,564	58,885	59,619	60,531
Supplementary Social Security	117,694	112,216	119,610	120,296	120,743

Source: DGSFP, Dirección General de Seguros y Fondos de Pensiones.

are not very worried about their future incomes as retirees). Another cause of this reduced growth is the limited development of the employment system, much larger in other countries than in Spain, where the system that has been most developed is the individual system, which concentrates 61.1% of the total of accumulated savings in pension plans at the end of 2011. In addition to the savings accumulated in pension plans, we must also take into account the savings on other products such as savings insurance for retirement, referred to as Insured Pension Plans (commercially known as PPAs).

Reasons for public pension plan reform

There are two main causes of the sustainability problems of the public pension scheme: Structural causes closely related to demographic trends of the Spanish population, and other causes of a cyclical nature arising from the current economic crisis.

Structural problems: Demography

Demographic trends of the last decades play a role in the sustainability of public pension schemes and the restrictions in public expenditure on pensions, as it is the case in most developed countries. The evolution of the Spanish population in the coming decades will change sharply the structure of age groups. These trends in Spain are even more pronounced than in other neighbouring countries:

Life expectancy: Improvements in living conditions and health system have resulted in a significant increase in life expectancy both at birth and life expectancy at 65 years old. In the last two decades, life expectancy has risen from 77.1 to 82.0 years old, assuming an increase in life expectancy of 2 years per decade. The life expectancy at 65 years in 2010 was 20.3 years, while the legal retirement age has stayed at 65 years since the beginning of Social Security (1908).

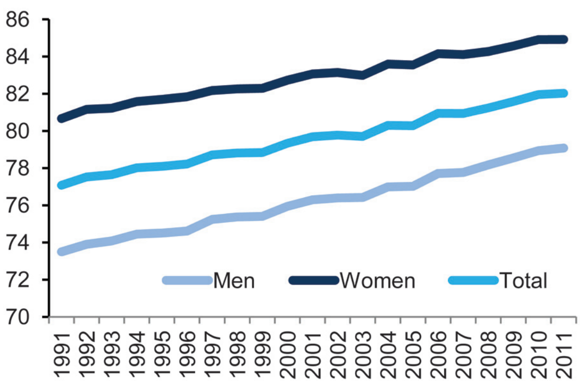
The crucial fact is that the percentage of people older than 65 will grow to 31.9 by the year 2050, while population groups between 15-64 will decrease down from 68.9 % in 2008 to 53.6 in the year 2050. The dependency ratio[3] will go down from 2.25 in 2008 to 1.15 in the year 2050, thus hindering the financial sustainability of the current pension scheme.

Birth rate: In Spain between 1975 and 1995 there was a sharp drop in the birth rate, falling below 10 (per 1,000 inhabitants). During the late ‘90s and the first decade of the century, that rate stabilized

[3] Number of persons aged between 15 and 64 years, among those under 15 and over 64 years old.

Exhibit 1

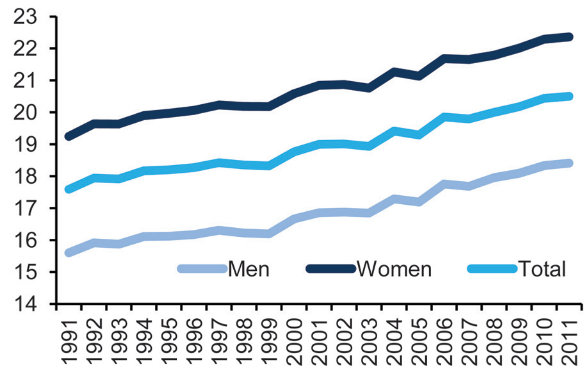
Life expectancy at birth (years)



Source: INE, National Statistics Institute.

Exhibit 2

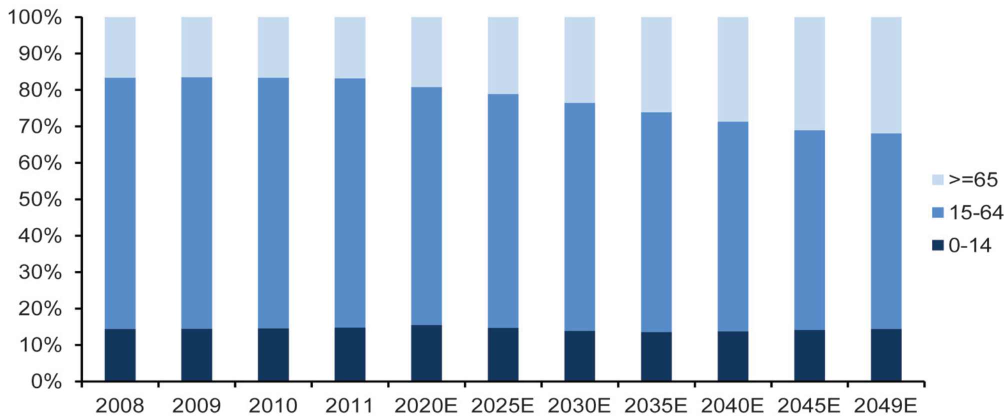
Life expectancy at 65 years (years)



Source: INE, National Statistics Institute.

Exhibit 3

Population by age group



Source: INE, National Statistics Institute.

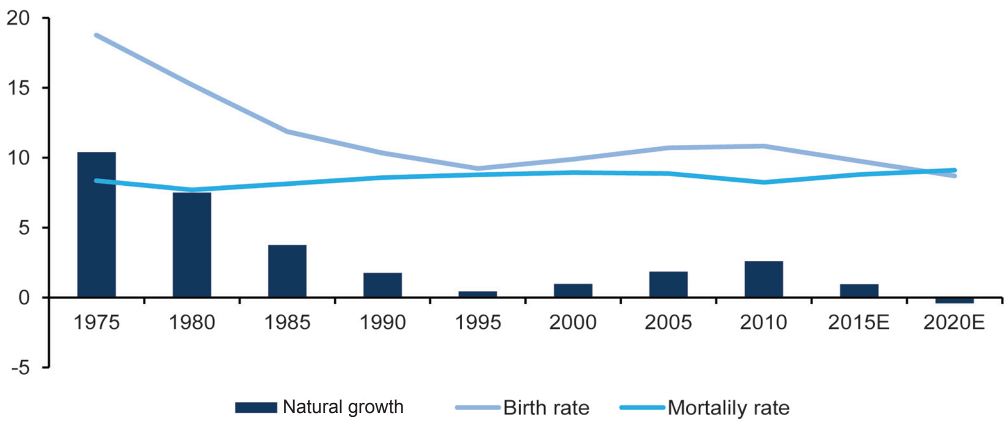
and even increased slightly because of increased immigration in Spain. Despite these years, the return of immigrants to their countries as a result of the economic crisis will cause a further drop in the birth rate to below the death rate, which would be a negative natural growth.

The increase in life expectancy, together with low birth rates, results in a projection for a substantial increase in the number of retirees over the next decades.

Increased average pension benefits: The factors behind the increase in average pension benefits are the growth of wages and contribution years.

Exhibit 4

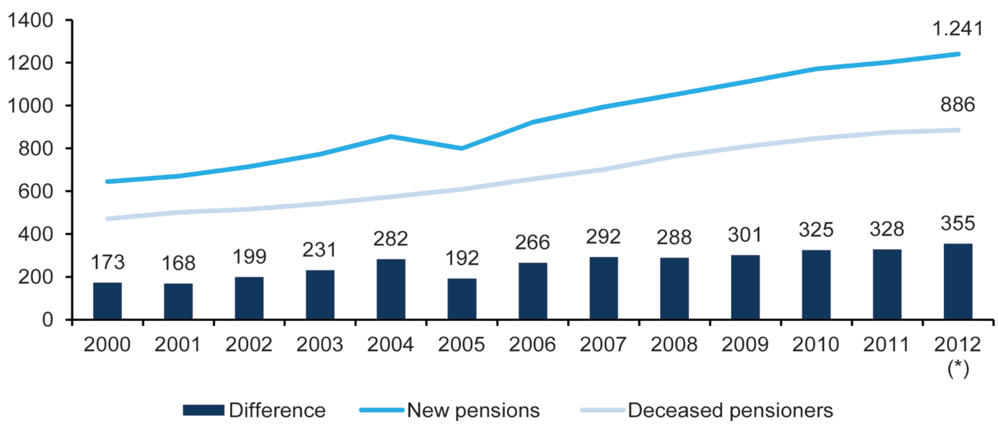
Birth rate, mortality rate and natural growth (per 1,000 inhabitants)



Source: INE, National Statistics Institute.

Exhibit 5

New pensions *vs*. discontinued pensions (euros)



Source: Social Security.

The new pensions are higher than the pension of retirees who leave (become deceased) the system. This trend increases the annual pension cost.

Pension benefits are price-indexed: Pension benefits grow every year with the inflation rate.

The trend of the variables mentioned will cause an increase in both the number of retirees and the average pension, so that the expected increase in public pension expenditure is very important.

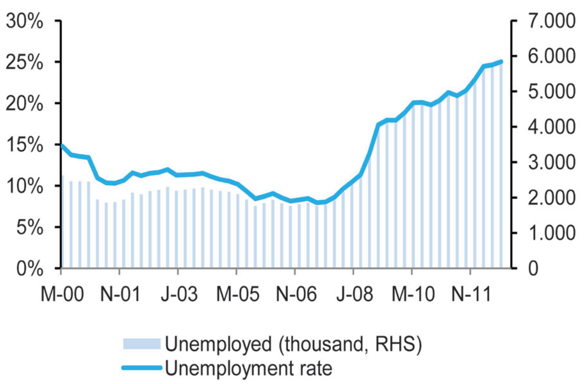
Present economic crisis

Along with the structural problems already mentioned, the impact of the economic crisis on employment must be considered. The unemployment rate, in September 2012 reached 25.02%. Social Security lost 2.5 million of workers since 2007. Thus, the number pensioners, has gone from 4.9 million in 2007 to 5.3 million in 2012.

Therefore, the system has recorded a sharp decline in incomes, and a surge in unemployment benefits, which have caused Social Security to register deficits in 2010 and 2011, and it is expected to end the year 2012 with a deficit of 1% of GDP.

Exhibit 6

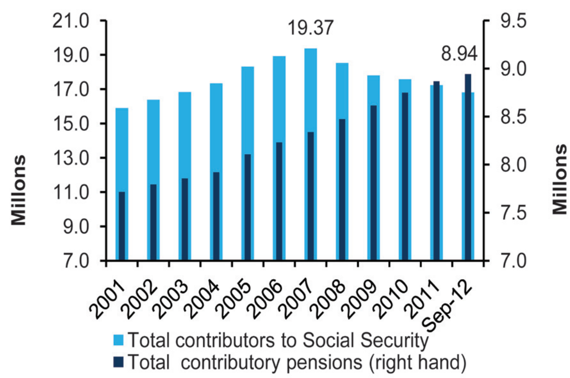
Unemployment rate



Source: INE, National Statistics Institute.

Exhibit 7

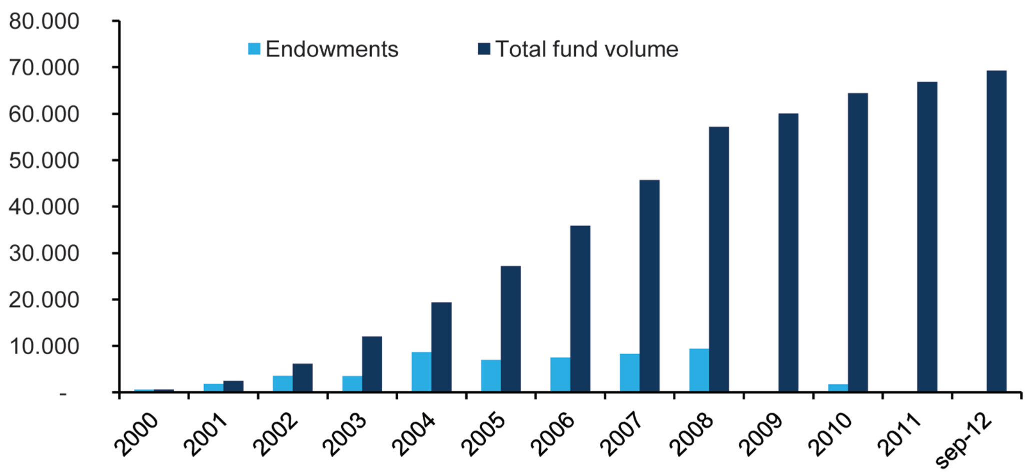
Contributors *vs* Pensioners



Source: Social Security.

Exhibit 8

Pension Reserve Fund of Social Security



Source: Reserve Fund of Social Security.

In fact, in June 2012, the government used 4,400 million euros from the Prevention Fund or *Fondo para la Prevención* of Social Security to the payment of pensions and in October it used another 3,063 million euros from the Reserve Pension Fund of the Social Security, or *Fondo de Reserva*.

The *Fondo de Reserva* was constituted in 2000 with surpluses earned by Social Security in different years, reaching a total amount of 69,252.36 million euros as of September 2012, representing 6.45% of GDP. Although this is a huge amount of money, if the system does not have other income, the fund would only be able to pay 13 months of pension benefits.

Main areas of reform under Law 27/2011

Given the demographic trend of the Spanish population and the impact of the economic crisis on employment, sustainability of public pensions under the current regime is not possible. For these reasons, and to contain public pension expenditure over the coming decades, a reform of the main parameters of the public pension scheme was carried out in 2011. The reform will come into force in 2013 and will take place gradually until its full implementation in 2027. The main areas of the reform are:

Legal retirement age

The legal retirement age to obtain full benefits is 65 years for men and women. The legal retirement age will increase from 65 to 67 (through a gradual increase from 2013 to 2027), with certain exceptions:

- Long contributing careers: Workers having contributed at least 38.5 years will be allowed to retire at the age of 65 with full pension benefits.
- Professionals in dangerous occupations: Workers performing work that is of an especially dangerous or arduous nature may be allowed to retire before the age of 67.
- Mothers having interrupted their contributing career due to child care: Their cumulative period of contribution will be increased to account for the interruption in their careers related to having children. It will be increased by the duration of the period of interruption (up to a maximum of 9 months per child and 24 months per family) as long as they meet certain requirements regarding contributions to the system.

Pension benefits

When the reform comes into force in 2013, the earnings record taken into account to determine full pension benefits will be gradually lengthened from 15 years to 25 years (one per year until 2022). Additionally, the number of years of contributions required to obtain full pension benefits will gradually increase from 35 to 37 – calculations will be made on the basis of monthly contributions, rather than rounding to the next full year, as was the case prior to the reform.

The percentage of the full pension received by a worker will be proportional to the number of years contributed, starting at 50% for careers of 15 years up to 100% for careers of 37 years. By comparison, before the reform, the system was biased in favour of shorter careers.

Early, partial and delayed retirement

The possibility of early retirement is delayed from 61 to 63 years. Eligibility for early retirement is limited, since it will only be possible after 33 years of contributions to the pension system (*versus* 30 prior to the reform). Penalization applied to pension benefits will be 7.5% per year of early retirement (prior to the reform, penalization

Table 3

Transition period: Legal retirement age

Years	Contribution Periods	Retirement Age
2013	35 years and 3 months or more Less 35 years and 3 months	65 years 65 years and 1 months
2014	35 years and 6 months or more Less 35 years and 6 months	65 years 65 years and 2 months
2015	35 years and 9 months or more Less 35 years and 9 months	65 years 65 years and 3 months
2016	36 years or more Less 36 years	65 years 65 years and 4 months
2017	36 years and 3 months or more Less 36 years and 3 months	65 years 65 years and 5 months
2018	36 years and 6 months or more Less 36 years and 6 months	65 years 65 years and 6 months
2019	36 years and 9 months or more Less 36 years and 9 months	65 years 65 years and 8 months
2020	37 years or more Less 37 years	65 years 65 years and 10 months
2021	37 years and 3 months or more Less 37 years and 3 months	65 years 65 years
2022	37 years and 6 months or more Less 37 years and 6 months	65 years 66 years and 2 months
2023	37 years and 9 months or more Less 37 years and 9 months	65 years 66 years and 4 months
2024	38 years or more Less 38 years	65 years 66 years and 6 months
2025	38 years and 3 months or more Less 38 years and 3 months	65 years 66 years and 8 months
2026	38 years and 3 months or more Less 38 years and 3 months	65 years 66 years and 10 months
From 2027	38 years and 6 months or more Less 38 years and 6 months	65 years 67 years

Source: Law 27/2011, of August 1, for updating, adapting and modernizing of the Social Security system.

Table 4

Transition period: Earnings record to determine pension benefits

Transition Period	Time (Years)
During 2012	15
During 2013	16
During 2014	17
During 2015	18
During 2016	19
During 2017	20
During 2018	21
During 2019	22
During 2020	23
During 2021	24
From 2022	25

Source: Law 27/2011, of August 1, for updating, adapting and modernizing of the Social Security system.

depended on the years of contribution from 7.5% to 6% for long careers where early pensions were concentrated); the resulting pension cannot be lower than 125% of the minimum pension.

There is one exception to the 63 rule - early retirement during an economic crisis. In that case, workers will be allowed to retire at 61, provided that they contributed for at least 33 years. The reform removes the possibility of a special retirement modality at 64.

Partial retirement at age 61 will continue to be permitted, although with the reform, both the new and the partially retired employee will contribute fully to the system. Prior to the reform, the worker partially retiring only contributed by the proportion of the working day effectively worked.

Finally, voluntary extension of working life is encouraged through increased bonuses depending on contributing careers, 2%, 2.75%, and 4% per year of delay for careers below 25 years, between 25 and 37, and over 37, respectively.

Sustainability factor

Beginning in 2027, the parameters of the system will be revised every five years by the difference in life expectancy at the age of 67 in the year of the revision and the life expectancy at 67 in 2027. Calculations will be done on the basis of forecasts by official agencies.

The objective of this element is to ensure the long-term sustainability of the public pension system and maintain the proportionality between contributions to the system and the benefits it is expected to payout.

Economic impact of the pension system reform

Impact of the reforms: Financial sustainability

Currently, Spain spends about 8% of GDP on pensions as of 2007, a little above the OECD average (7%). But the estimations show pension spending in Spain increasing to over 15% of GDP by 2050. The 2011 pension reform in Spain will significantly improve the long-term financial sustainability of Spain's retirement-income system. According to the Spanish government's estimates[4] , the reform will imply savings for the pension system of around 3.5% of GDP in 2050 (2.8% in 2040 and 1.4% in 2030). These savings will be mainly a result of:

- The increase in the activity rate of the population between 16 and 71 years old and higher potential GDP level.
- The increase in the earnings record from 15 years to 25 years.

[4] Ministry of Economy. June 27th, 2011. It is important to recall that these estimates do not include the extension of the social security reform to the central government employees' pension system.

- The enlargement of the years to obtain full pension benefits, from 35 to 37.
- The sustainability factor.

Impact of the reforms: Pension entitlements

Disposable incomes of people aged 65+ in Spain are on average 79% of those of the population as a whole (adjusting for differences in sizes of households). This is a little below the OECD average of 82%. The aggregate replacement rate, a measure that looks at the actual pensions paid out to pensioners today, is 48% which is close to the EU average.

The projected pension replacement rate for Spain for a full-career worker entering the labour market in 2008 is 81.2%. This replacement rate –pension relative to earnings when working– averages much less in the 34 OECD countries: 57.3%. The main impact of the reform on a full career worker is the change in the measure of earnings used to calculate benefits. This is expected to reduce the replacement rate to 73.9% (on the OECD's standard assumptions of 2.5% price inflation and 2% real earnings growth). The left-hand panel in exhibit 9 shows the net replacement rate, taking into account taxes and contributions paid on retirement benefits and on earnings when working. The average net replacement rate in the OECD-34 is 68.8%.

The reform will reinforce the link between contributions and benefits compared with the current system. For example, the number of contribution years needed to receive a full benefit at age 67 will increase from 35 to 37 years. Only with 38.5 years of contributions will retirement at age 65 still be possible. Thus, the reform's impact will be strongest for people with interrupted careers.

The 2011 reform is very likely not to be sufficient to ensure long-term sustainability of the public pension system. And the high cost of changing the pay-as-you-go system into a capitalization system of notional accounts is not acceptable in the current economic crisis. Therefore, it is necessary to examine the system's parameters to ensure its sustainability.

Additional measures for the improvement of the public pensions system

The reform of the public pension scheme was carried out in 2011, and it is very likely not to be sufficient to ensure long-term sustainability of the public pension system.

Because of the high cost of facing a structural reform of the current public pension scheme,

Table 5

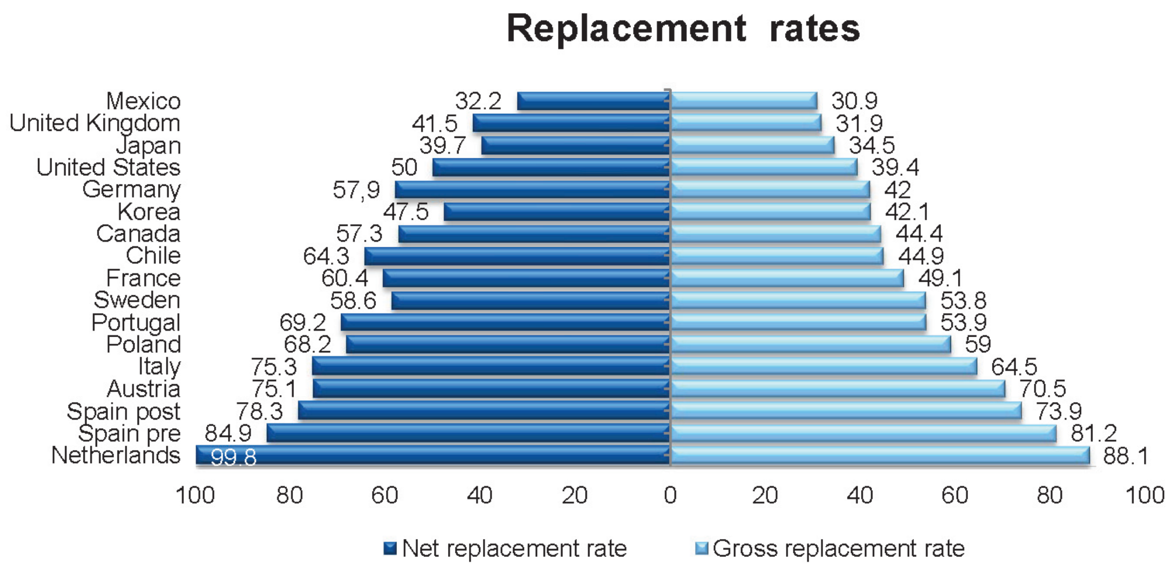
The impact of the reform savings of the social security system

% over GDP Year	Higher potential GDP	Statutory retirement age	Years considered to calculate the pension	Years needed to qualify for full pension	Sustainability factor	TOTAL
2030	0.1	0.8	0.4	0.1	0.0	1.4
2040	0.2	1.0	0.8	0.3	0.5	2.8
2050	0.2	1.0	1.0	0.3	1.0	3.5

Source: Ministry of Economy.

Exhibit 9

Pension replacement rates for new labour-market entrants, average earners



Source: OECD (2011), Pensions at a Glance: Retirement-Income Systems in OECD and G20 Countries; OECD Pensions Models.

Note: In practice, many people will not havefull careers, and so the actual replacement rates received will be lower than those shown by the simulation model.

changing the pay-as-you-go system into a capitalization system of notional accounts is not acceptable in the current economic crisis. Therefore, it is necessary to examine the different parameters of the system to ensure its sustainability. Here are some of them:

- Accelerate the implementation of the legal retirement age to 67 years.
- Postpone the real retirement age, 63.9 years old at 2012[5] , restricting early retirement and increasing incentives to postpone retirement age.
- Increase maximum contribution bases.
- Enhancing the link between contributions and benefits, extending the contribution period used in the calculation of pension benefits to the entire career.
- Change the indexation of pensions to inflation by another economic variable as a percentage of GDP or increase in salary, as in the Swedish model.
- Development of the sustainability factor and advance in its implementation.
- Increase transparency in the public pension scheme, sending a letter every year to employees disclosing the statement of their future pension. Although reform of 2011

[5] Data up to August.

already provided for this measure, this point is pending development and implementation.

In the same line, it would be useful to take some measures to facilitate the development of private pension plans and complement the public system:

- Increase household financial education in order to make people aware of future needs and understand the savings options available to address them.

- Incentivise the creation of a supplementary pension schemes, for example taking the model of United Kingdom’s NEST (National Employment Savings Trust[6]). The employee gives 3% of his or her salary, the company, 4% and the Government 1% in an automatic enrolment scheme for workers in the UK whose company does not provide them with a pension scheme, or simply, wants to provide an additional pension scheme along with the existing one.

NEST creates a single pot in which the employee puts pension money aside in the same account throughout his entire labour life, preventing possible administrative issues because of stopping and restarting labour life, lowering the costs attached.

Apparently, one of the main virtues is that this new scheme provides the employee the necessary transparency regarding his or her pension scheme.

- Increase tax incentives for private retirement products:

  - Establish a real tax exemption, not tax-deferral on private pension plans.

  - Remove the cap on contributions to pension systems, just to prevent a loss of purchasing power of the pension, known as the crowding-out effect.

[6] http://www.nestpensions.org.uk/

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