Pension reform in Spain: Introducing the sustainability factor

José A. Herce[1]

The main policy recommendation from the Experts Committee on pension reform is the introduction of a sustainability factor into the Spanish public pension system, in 2014 if possible. The sustainability factor has the potential to achieve long-term sustainability of the pensions system itself, but if enacted, would require a reorganization of pre-existing Spanish pension schemes to ensure an optimal public/private mix.

This article examines the various reforms of the Spanish social security public pension system since its massive overhaul in the 1960s. Of the multitude of reforms undertaken to date, the 2011 reform was, by far, the most rigorous, but will still only preventing one third of the severe deterioration of system accounts projected to occur by 2050. However, the 2011 reform does contain one element that has the potential to stabilize the system- the sustainability factor. On the basis of the policy options recommended by the Experts Committee in its June report, this factor could achieve the full sustainability of the pension system in the long term. Nevertheless, its introduction would pose serious questions for pre-existing supplementary and/or replacement pension schemes.

Pensions in Spain today

In Spain, a number of pension schemes coexist, encompassing practically every type of collective insurance. The dominant scheme is that of contributory pensions of the social security system, professional and mandatory, based on a pay-as-you-go method and that provides (or promises) defined benefit lifetime pensions for a broad range of contingencies, including retirement, to practically all pensioners and workers and their dependents.

But alongside the contributory pension scheme of the social security system, alternative or supplementary schemes exist that provide more or less broad coverage to large sectors of the population, all of which constitute a reality of protection and collective insurance that cannot be fully described with reference solely to the public scheme.

The following table offers a brief description of the diverse systems presently existing in Spain and their main characteristics and basic indicators.

What becomes evident is the dominance of social security pensions, with coverage of wage earners (in the private sector, non-career civil service and public sector) and the self-employed considerably

[1] Associated Director of A.F.I. - Analistas Financieros Internacionales, S.A. and Associate Professor of Economics at the Complutense University of Madrid.

Table 1
Current pension schemes in Spain – 2012/2013

	Social security pensions	Civil servants' pensions	Social security non-contributory pensions	Pension plans and funds and insured pension plans (PPAs in their Spanish initials)
Covered population and benefits	Mandatory. All employees and self-employed people. Pensions in the form of a monthly income for permanent disability, retirement, survivors, orphans and for family members.	Mandatory for civil servants of state security services and replaces social security. Same benefits as social security.	Universal for all workers that have not paid into the system for the fifteen years required in the ordinary system and who lack financial resources. Pensions in the form of monthly income for retirement and disability.	Voluntary. All individuals and groups (associations, enterprises) that wish to contract a plan or insurance policy. Retirement pensions in the form of monthly income, capital and similar contingencies, including dependency.
Funding	By means of social security taxes paid by employers and employees. Pay-as-you-go method. Reserve fund. Pension entitlement.	Through modest contributions by civil servants (one tenth of their income) and tax resources of the central state (remaining nine tenths). Pension entitlement.	From the tax revenue of the central state. Effective pensions if eligibility criteria met.	By means of contributions by participants or organizers. Effective consolidated rights of defined contribution.
Basic indicators	16 million employed contributors and two million unemployed contributors. 9 million contributory pensions. Average system pension of 856 euros/month (14 payments).	Somewhat more than 600,000 civil servant pensions, slightly less than the number of career civil servants paying into the system. Average system pension of 1,439 euros/month (14 payments).	450,000 beneficiaries of non-contributory pensions. Average pension of 365 euros/month (14 payments).	10.3 million participants, average retirement capital of 8,600 euros per participant and 210,000 beneficiaries in pension plans. 1.1 million persons insured, reserves of 9,000 euros per insured person and 24,000 beneficiaries (2011).
Scope of recent reforms	Postponement of retirement age. Increase in calculation period.	Expected postponement of retirement age. System closed to new participants since January 1st, 2011.	No effect on this scheme.	No effect on this scheme.
Challenges for immediate future	Deepening of reform with adoption of "sustainability factor". Regular information provided to workers.	Sustainability in context of fiscal consolidation and gradual disappearance of revenue from payments into system.	No specific challenges in short term for this scheme, except those arising from demands of consolidation.	Taxation. Regular information provided to participants and insured persons on pension rights.

Source: Afi.

broader than under the regime of retirement pensions for career civil servants. Both regimes determine full coverage of contributory public pensions in Spain.

Alongside the two aforementioned contributory public pension schemes is the non-contributory pension scheme, to which people are entitled at the age of 65 or in the event of a contingency of disability at any age if they have not completed an earning record of at least 15 years and they lack equivalent (or greater) financial resources than the benefits under this scheme.

Lastly, there are "supplementary social benefit" schemes, or private pensions, that have the status of pensions to supplement social security or civil servant pensions. In any case, these are voluntary. Naturally, these schemes are open to people who are not working, as they can participate through the individual or associate systems if done so within the pension plan schemes or by purchasing an insured pension plan (PPA in its Spanish initials).

All private social benefit schemes in Spain are, as noted, voluntary and supplementary to public contributory pensions, never a replacement. They are based on individual capitalization and may be insured or not, and benefits –whether in the form of capital, lifetime income or mixed– are based on the defined contribution principle.

Although the number of participants in pension plans or of insured persons in PPAs might suggest a large presence of such products in Spanish social benefit culture, the fact remains that behind the approximately 11.5 million participants or insured persons in such products lies weak capitalization: they carry retirement capital that ranges between 6,693 euros per participant in the individual pension plan system (INVERCO, as of March 2013) to the 15,663 euros per participant in the employment system (INVERCO, as of March 2013), and including the 8,968 euros per insured person in PPAs (General Directorate of Insurance and Pension Funds (DGSFP) as of 2012). The number of beneficiaries is also low, amounting to 211,385 and 26,643 benefit recipients for the PP and PPAs, respectively (INVERCO, as of March 2013 and DGSFP as of 2011).

Hence, the predominance of public pensions and the low intensity of private pensions and bio-demographic trends in the Spanish population pose significant challenges to pension sustainability or sufficiency that cannot be resolved without drastic changes in the design of public pensions and in the public/private mix.

Three decades of pension reforms

Indeed, what we may call the "pension problem" is mainly due to the fact that life expectancy is constantly increasing. This otherwise positive factor, as such, should not cause any problems if all life cycle decisions are adapted to the lengthening of life. But, as with individuals' decisions on the period for schooling, forming a household, or the arrival of one's first child have been nearly spontaneously adjusted to this bio-demographic trend, the decision to increase the retirement age has barely begun to be implemented in the advanced countries and, in any case, forced by reforms of pension systems.

Pension reforms have always given rise to huge social and political controversy in all countries, and in Spain, in particular. Although the managers of public pension systems are constantly claiming that these systems are facing "permanent reform", this is only partly true. It has been shown, however, that permanent reforms of pension systems never build up enough momentum to offset the obsolescence of current formulas in the face of quickly accumulating imbalances resulting from demographic or economic changes. Such reforms rarely introduce instantaneous and sufficient adjustment mechanisms in pension sustainability and sufficiency formulas.

In Spain, new regulations have been enacted continuously in order to, in one way or another, *For over three decades, since the drastic restructuring and reorganization of the social benefits system, regulators have been attempting to reform the public pension system through one way or another.*

reform the public pension system since the 1960s, when the system of social benefits was drastically restructured and reorganized. But by the 1980s, the first truly substantial change in the system became necessary. Since then, a series of low intensity, “productive” or “counterproductive” reforms and institutional events have taken place that failed to change the outlook for the pension system until the reform adopted in 2011 and implemented from January 1st, 2013.

In 1985, soon after the end of the long oil crisis and the emergence of the first symptoms that the pension system might run into financial difficulties, the so-called pension “calculation period” was extended from two years prior to retirement to eight years, and the payroll tax “grace period” from ten to 15 years.

This reform effectively reined in expenditure throughout the following decade, but it did not prevent the 1992-93 recession, which had a sharp impact on employment, from structurally impairing the financial position of the system. The 1993 electoral campaign, unprecedentedly focused on the subject of pensions, to the point that many analysts at that time attributed the socialists’ narrow victory to the bitter debate over pensions, and to what the Popular Party (PP) intended to do with the pension system if it came into office.

The debate left a bad taste in the mouths of all political parties and, in 1995, the Toledo Pact, the dialogue with social groups and in Parliament, was signed, having originated in an initiative by the Convergencia I Uniò party from the previous year in reaction to this widespread dissatisfaction. The Toledo Pact was not a pension reform, but rather a parliamentary move for permanent debate on the system and its gradual adjustment to changing demographic and economic conditions in Spain, with the theoretical aim of taking the subject of pensions out of the electoral arena.

The 1996 elections brought the PP into office by a very narrow margin. While an exit from the labor market challenges of the recession of a few years before was clearly taking shape, the aftertaste of the pension debate in the 1993 elections and the climate of the Toledo Pact, along with the new government’s need to generate trust among the trade unions, would lead to a series of agreements with social agents followed by legislative reform of pensions. The first was the Agreement for Consolidation and Rationalization of the Social Security System, the content of which was later introduced under Law 24/1997 of the same name.

Under this reform, among other less significant measures, the pension calculation period was extended from eight years to 15 years –the period in force until a few months ago. This change, in fact, allowed pensions to increase, as new participants recovered their best payment years, while it had no effect on the rest. This is why the reform easily passed through the filter of the trade unions who, a few years before, had responded with a general strike to a nominally similar, yet much more effective reform.

The 1997 reform also created the pension reserve fund, which would be set up in the year 2000 on the basis of the annual surpluses of the system and the corresponding returns. The fund amount managed to surpass 6% of GDP, totaling 66.815 billion euros in 2011.

A number of reforms of this kind have been introduced since 1997. Specifically, in 2002 (Law 35/2002, which incentivized retirement after the age of 65 and “reinstated” early retirement from the age of 61) and in 2007 (Law 40/2007, which adjusted the effective grace period to 15 years and regulated partial retirement from the age of 61).

None of these reforms dispelled the impression among analysts that they failed to tackle the long-term sustainability problem threatening the Spanish pension system.

What is more, these reforms, undertaken in a period of a veritable boom in social security registration, in the midst of spectacular growth of contributions to the system and significant stabilization of pension expenditure due to the move toward retirement of the small amount of people born during and immediately after the Spanish Civil War, did not lend the system even one one-hundredth of the stability that an unusually long and intense cycle of economic expansion would have provided.

The harsh crisis that, since 2008, has devastated the Spanish labor market and social security figures, combined with the retirement of the largest generations of workers preceding those of the Spanish baby boom (1965-1975) has impaired the revenue of the social security contributory pension system. Since 2011, the system has carried a growing deficit that may surpass 1.5% of GDP in 2013 (about 15 billion euros) and thereby required frequent disbursements from the reserve funds and credit extensions by the state in order to cover regular payments by the system. The crisis has brought forward by an entire decade a deficit that, given the advance of underlying structural factors, can be corrected only with decisive and early action by regulators and system managers.

In such circumstances, it is not surprising that there was a great deal of concern beginning in May 2010 over the financial outlook of the pension system, among the other preoccupations regarding the grave structural problems that had begun to emerge in the economy due to the 2009 recession. Indeed, one of the components of the government's economic policy change in that month was a fresh – this time substantive – reform of the social security pension system.

The 2011 reform, arising from this urgent situation and in force from January 1st, 2013, is the most ambitious of all the reforms undertaken since the consolidation of the Spanish pension system in 1967. In essence, it consists of two measures with a substantial impact: the postponement of the retirement age from 65 to 67 and the extension of the calculation period from 15 to 25 years. It contains other measures, such as the rebalancing of pension points per year of contribution, but the most effective will be, unquestionably, the aforementioned two of these.

The reform also refers to the introduction of a so-called "sustainability factor", which incorporates into the system corrections calculated on the basis of growing life expectancy and other system sustainability indicators from 2027. The measure, however, is aimed at long term sustainability and as a consequence, would have no noticeable effect before 2035.

The outlook for pensions before and after the 2011 reform

Numerous prospective studies since the 1990s on the accounts of the social security contributory pension system have repeatedly shown that the entry into retirement of the Spanish baby boom generations starting in the decade of 2030 would lead to the start of a rapid erosion of the financial equilibrium of the system due to the increased expenditure in pensions in proportion to GDP, while income from contributions would barely change in proportion to output.

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Projections made prior to the crisis foresaw the first pension system deficit for after 2020. The reserve fund would still help finance growing deficits until past 2030 and would then become a debt of the social security system, with a ratio to GDP of about 1 (100% of GDP) by 2050. But the system surplus during the economic boom and in the initial years of the crisis, due to the solid basis of registrants existing until that time, disappeared in 2011 and a number of disbursements from the reserve fund have had to be made, amounting to some 10 billion euros.

Pension expenditure as a percentage of GDP has stood at 10% in recent years, which is practically equal to income from contributions to the system. Projections made on the basis of present regulation up to 2012 showed that by approximately 2050, pension expenditure would range between 16 and 20% of GDP. Income from contributions, in contrast, would constitute a stable proportion of GDP, as it must, if we assume that wages' share of GDP is very stable at roughly 50% and, assuming "constant legislation" (during the projection period), contribution rates and wage bases should not be expected to change either.

Hence, the pension system deficit would sustainably grow to 8% of GDP as an average of projections. The accumulation of these deficits and the growing debt service would cause the latter to exceed GDP in 2050, according to studies that were based on the system regulations in force until the end of 2012.

The 2011 reform, which entered into force on January 1st, 2013, has substantially changed system rules. Although the highly gradual application of the increase in the retirement age and the extension of the pension calculation period to 25 years means that that the effects of the measures will not be noticeable in system accounts until 2030, the expected deficit for 2050 may be reduced by one third from what was expected prior to the 2011 reform, falling from 8% of GDP in 2050 (in the average estimation) to somewhat lower than 6% of GDP. Commensurately, the debt accumulated by the pension system in the projection horizon would be about two thirds of GDP, instead of skyrocketing to equal GDP.

The reasons for this insufficient correction in the expected pension deficit lie in the fact that, in spite of the spending adjustments that the retirement age increase and the extension of the pension calculation period will cause in total spending, the incessant advance of the population's life expectancy and the retirement of the baby boom generations will be even more powerful factors driving spending.

The crisis will have increased Spanish public debt to a ratio of 100% of GDP by 2014, according to the estimates made by international organizations. This does not take into account the burgeoning structural deficit of pensions, which would prevent any significant reduction of public debt, even in the event of a quick economic recovery starting in that year. The insufficiency of the 2011 reform in contributing to the necessary reduction of the debt ratio is, therefore, obvious.

The coming sustainability factor: The last reform?

In July 2012, in the midst of the second recession of the Spanish economy and the general destabilization of markets triggered by the vicious circle of economic crisis-financial crisis-sovereign crisis, EU authorities urged the Spanish government, among other recommendations of "mandatory compliance", to speed up the implementation of measures envisaged in the 2011 pension reform and, in particular, to introduce as quickly as possible the sustainability factor.

The Experts Committee created by the government in April of this year submitted its report on the sustainability factor to the government one and a half months later. The proposal from the group of experts defined the pension sustainability factor as a dual mechanism of adjusting average pensions upon constitution of a pension right and throughout their trajectory.

In the former case, the sustainability factor has a mechanism that adjusts a recently constituted

Through the intergenerational equity factor (IEF), a recently constituted pension right for future retirees can be adjusted by taking into account trends in the life expectancy of the representative generation compared to the life expectancy of the benchmark generation in a baseline year.

pension right for future retirees by taking into account trends in the life expectancy of the representative generation compared to the life expectancy of the benchmark generation in a baseline year. This is the intergenerational equity factor (IEF), which transfers the change in life expectancy (at the age of 65, an expected increase of 1% a year), with an opposite effect, to the resulting pension under the current formula.

Hence, all new pensions in the future would be adjusted downwards as life expectancy increases. A worker retiring, for example, in 2051, would see a life expectancy increase of 24% compared to his 2014 counterpart (28% for men and 20% for women, if gender differentiation criteria are used). In that proportion, consequently, the recently qualified pension would be lower. In some years, there may be a decrease in life expectancy, with the resulting upward effect on recently qualified pensions, but this is extremely unlikely in the foreseeable future.

In the latter case, the sustainability factor has another mechanism that adjusts all pensions in accordance with the evolution of pension system income, the number of pensions, the gap between the value of new pensions and discontinued pensions and the balance between the system's income and expenditure. This is the annual revalorization factor (ARF) which, by means of a lengthy formula, transfers all these key pension system sustainability factors to all pensions every year at revalorization.

Therefore, pensions are also revalorized upwards or downwards according to the balance of factors defined by the ARF. This mechanism completely replaces the CPI revalorization mechanism that had been used, with some exceptions, since the 1997 reform. A constant deterioration of the factors in the ARF should be expected, although not necessarily. Hence the Experts Committee report warns that it would be possible, at least in theory, for the ARF to yield an upward revalorization of pensions. Such an eventuality requires a sustained increase in system income at some point, as the elements making up the ARF are established on the basis of moving averages centered on each year that comprise thirteen years, including past years and future projections. The number of pensions will continue to grow, while the gap between new pensions and discontinued pensions will remain positive for many years unless the sustainability factor can fully eliminate this gap. At present, the gap is 40%. Lastly, while the system receives less income than the expenditure to be covered, the ARF will reinforce the downward direction of the adjustment.

Alongside the possible effect of the IEF, the ARF would complete the adjustment necessary to balance pension accounts by means of a reduction in pensions, assuming constancy in other system rules. The only way to avoid a significant reduction and limit the playing out of sustainability factor elements would be to increase contributions or to increase the retirement age even more.

The sustainability factor is, therefore, the silver bullet of any pension reform that truly seeks to ensure pension sustainability. Indeed these mechanisms enact what might be called "sustainability by default" of the system and, in the case of pay-as-you-go systems, the instant and full distribution of social contributions received by the system among current pensioners, distributing the burden of this adjustment among a large proportion of them in accordance with the longevity of their generation.

The most reasonable expectation is for pensions to be lower, not in comparison to current levels, but rather compared to the levels they would otherwise have reached as a result of strict application of present formulas without the sustainability factor.

This means that if the structural elements of the system (demographic and economic factors) evolve towards improved sustainability, pensions could be increased. But the most reasonable expectation is for pensions to be lower, not in comparison to current levels, but rather compared to the levels they would otherwise have reached as a result of strict application of present formulas without the sustainability factor.

The sustainability factor is, for now, nothing more than a proposal by a group of experts. It has yet to be addressed within the Toledo Pact in accordance with standard practice since 1995. This phase will not be simple, as the introduction of a sustainability factor would truly be a definitive reform of the pension system with a view to its full sustainability over time. If it is enacted, a thorough rethinking would be in order of all other pre-existing pension schemes in Spain, as they would have to supplement – and in some cases go beyond supplementing – the social security public pensions, with much more efficient formulas to achieve sustainable and sufficient pensions for all.