



CÍRCULO
DE EMPRESARIOS
ideas for growth

An urgent reform to our pensions system

20
21

November





Executive Summary

4

Introduction

7

1. Situation and diagnosis

9

2. Recent reforms made to the system

15

3. Main lines of action in a crucial reform favouring the sustainability of the pensions system

19



Executive Summary

4

An efficient, sustainable pensions system must respect a series of fundamental principles: the contributory principle (proportionality between contributions and receipts), fairness, intergenerational solidarity, adequacy and economic balance. In the case of Spain, these principles were defined within a context of broad consensus between political parties in what would become known as the Toledo Pact.

Although the Spanish system has worked properly in the past, **the foundations have been undermined and its sustainability threatened as a result of demographic and social trends, in particular the ageing of the population and fall in the birth rate, along with certain recent political decisions.** The trend in the dependency ratio and progressive increase in the benefit ratio further explain the 90% increase in pensions spending. Social Security **spending has exceeded revenue** since 2010 and the gap has grown progressively, to the extent that **the Reserve Fund has been exhausted leading to a debt amounting to €91.855 billion in the third quarter of 2021. This represents some 7.9% of GDP.**

Following significant reforms approved in 2013, namely delaying the retirement age, increasing the qualifying period, introducing the sustainability factor and a new adjustment mechanism, the **most recent reforms** have, during the first phase, consisted of transferring part of the system's expenditure to the National Budget, restoring pension increases in line with the Consumer Price Index and removing the sustainability factor. In the second phase, a proposal has been made for an alternative intergenerational fairness mechanism agreed with the trade unions and in the absence of support from employers. The foregoing does not improve the sustainability or fairness of the pensions system. These **partial measures, some of which reverse the preceding policies, once again threaten the sustainability of the system, often more so.**

There is therefore a **crucial and compelling need to transform the system with long-term vision to ensure its sustainability, balance, efficiency and respect for solidarity between generations.**

The **establishment of a system of notional individual accounts** could be a way forward in solving the problem. We are talking about a defined contribution and distribution system that establishes actuarial balance between contributions and pensions, as already successfully implemented in nearby countries. **Alongside the postponement of the retirement age, this model would ensure the sustainability of the system following a necessary transition period.** It would also offer citizens a forecast of their future pension, **increasing transparency and trust in the system.** It would give them greater freedom to decide on the length of their working life and **incentivise postponing their retirement.**

In order to **achieve actuarial balance and maintain the current level of the Spanish state pension**, providing citizens with a pension equivalent to 2.5 times the contributions made, **the age of retirement should be raised to 70.** Citizens would be offered a retirement span of between 68 and 72, with a lower pension in the case of retirement before 70 and higher benefits for postponing this beyond 70. This would enable citizens to properly plan the moment at which to retire and the amount of their pension.

In tandem, it would also be necessary **to encourage supplementary retirement funding through private savings such as company and private savings plans**, reverse mortgages and the sale of property titles, whilst also providing tax incentives and other support measures. The establishment of an **“Austrian backpack” model**, proposed by Círculo de Empresarios as a key component of labour reforms, would likewise **contribute to increasing the amount of retirement savings** while improving the availability of the financial resources necessary for economic growth and business investment.

As an essential component of the welfare state, **any major reform** affecting the Social Security system to ensure its medium and long-term sustainability **must come about through the greatest degree of Parliamentary consensus possible, preferably by means of an agreement between social and economic stakeholders and with long-term outlook** placing the common interest above electoral and short-term interests. There is a profound lack of solidarity in continuing to put off reforms, loading the burden of essential changes onto future generations.

A system of notional accounts as proposed here could tackle a challenge of this magnitude and **solve the problem of the sustainability of a balanced pension system**, provided that it is established gradually and adequately funded. It would, however, need to be complemented by the measures proposed here, along with structural reforms that contribute to an increase in the potential growth of our economy and a reduction in unemployment to a level close to that of our European partners.

Introduction

More than 25 years ago, more specifically on April 6, 1995, a full session of Parliament with **broad consensus between political parties** ratified the text approved by the Budgetary Commission to carry out an analysis of the structural problems of the Social Security system and the main reforms necessary to address these and thus contribute towards their sustainability. This would become known as the «**Toledo Pact**».

At the beginning, the Pact consisted of 15 recommendations that set out the basis of an agreement between the Government and main social representatives, subsequently giving rise to the **Social Security System Consolidation and Rationalisation Act of 1997**.

The guiding principles of the measures contained in the aforementioned Act were the contributory principle, in other words proportionality between contributions and receipts, intergenerational equity and solidarity which, together with the financial balancing of the system, would enable the consolidation and rationalisation of the Social Security system.

The basis of the pensions system is thus founded upon intergenerational trust between stakeholders that currently form part of this group and those of whom it will comprise in the future. In this manner, the contributions of people currently working pay the pensions of the retired in the expectation that, when the time arrives, the workers of the following generation will provide the system with the resources to fund their pensions. **Although the system worked properly along these lines**, thanks mainly to demographic trends in Spain, **the changes in terms of these and other variables over the final third of the twentieth century have begun to undermine the foundations of the system.**

**The guiding principles
of the Toledo Pact
were: the contributory
principle, fairness and
intergenerational solidarity**

A political pact that puts the common interest before party interests is the only way to establish a reform that ensures the adequacy, sustainability and intergenerational solidarity of the pensions system

It has been clearly evident for some time now **that the principles behind our current pensions system are not being fulfilled**, thus preventing the achievement of its intended goals. By way of example, **there are cases in which the contributory and fairness principles are not being met**. It is possible for some people to contribute more during their working life and receive pensions that are comparable or even lower than those who have contributed less. What is more, the system is **out of balance and, in the absence of reforms, demographic trends will not provide for its sustainability**. This will require additional efforts with respect to solidarity between generations.

Today **it seems that the Toledo Pact has abandoned its guiding principles and spirit of reform in the face of the difficulties of balancing the forces that reflect the current composition of Parliament, with political interests that are often worlds apart**.

The electoral cost of any reform of the pensions system is evident. As a result, political parties do not appear willing to put to citizens the solutions that are necessary from a technical point of view. The only pathway to ensuring an ambitious reform that guarantees the adequacy, sustainability and intergenerational solidarity of this system is to reach **a majority pact that puts the general interest before party and electoral interests**.

Situation and diagnosis

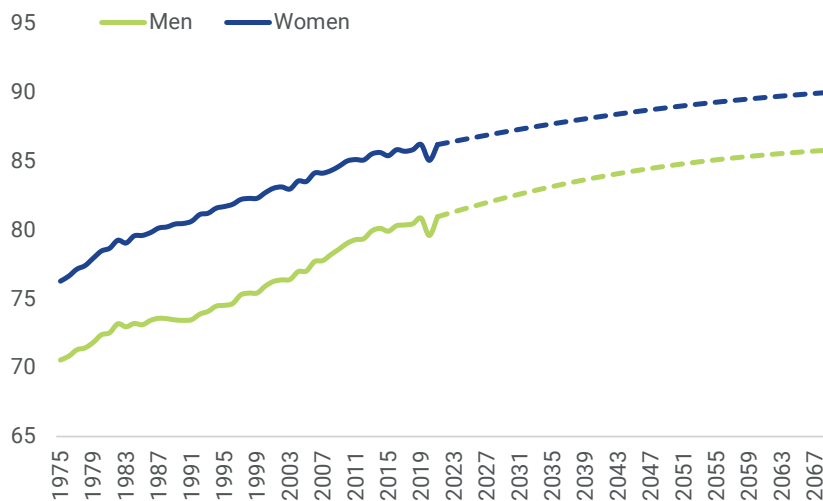
The profound demographic and social changes experienced by Spain in recent decades have transformed elements that are closely bound up with population and the fall in the birth rate.

Economic and social progress have fortunately led to a **significant increase in life expectancy** to 83 years at birth and 21.6 years for people aged 65. Forecasts of population trends point towards this increase in life expectancy persisting over the medium term. In fact, the National Statistics Institute (INE) estimates that this figure will have increased by at least two years by 2050.

The ageing of the population and the fall in the birth rate have impacted the workings of the pensions system

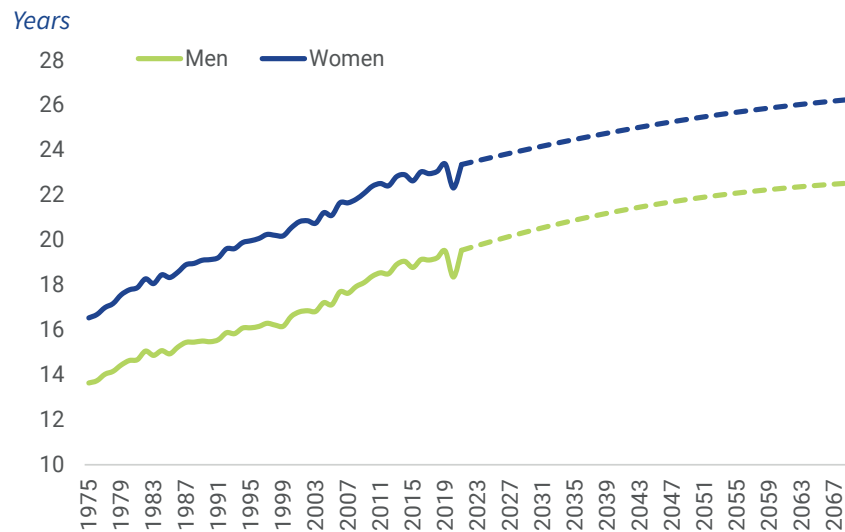
Trend in life expectancy at birth

Years



Source: Círculo de Empresarios based on INE, 2021.

Trend in life expectancy at 65 years of age

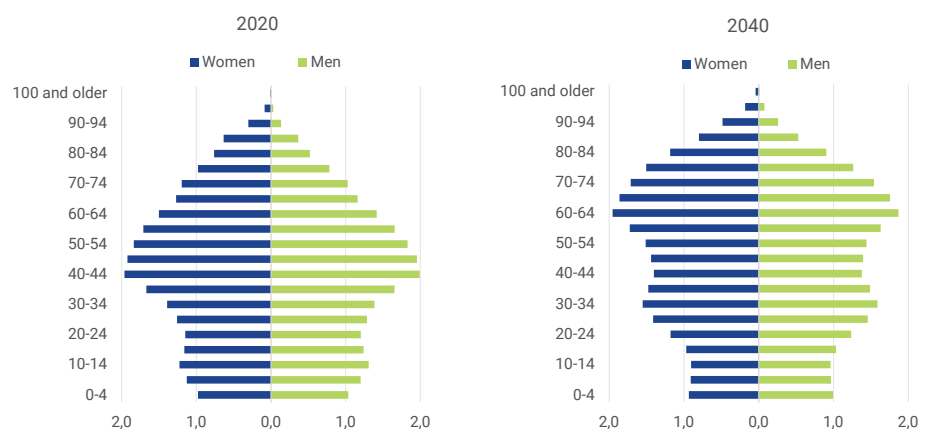


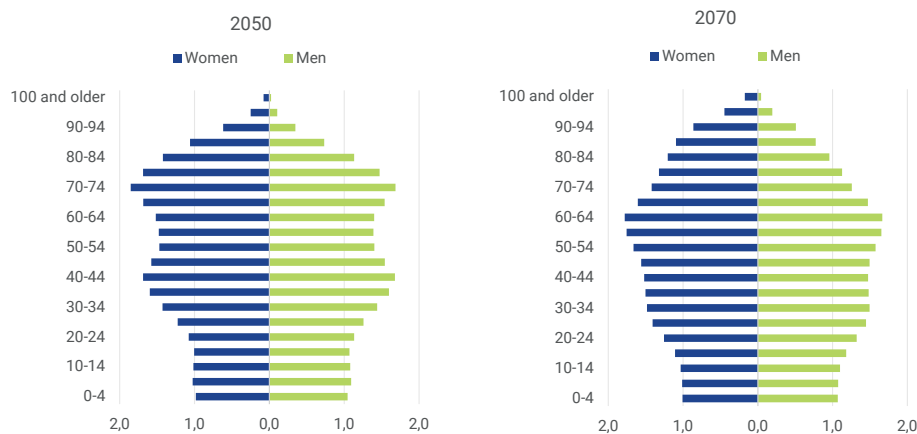
Source: Círculo de Empresarios based on INE, 2021.

The number of births has, in turn, fallen by 30% over the past ten years. As a consequence, the dependency ratio, in other words the ratio between the population aged 65 or over and the working age population, will grow by 80% over the coming 30 years. This demographic trend will mean that the weight of persons aged 65 or over (i.e. potential pension recipients) will continue to grow over those of less than 65 years of age (potential contributors to the Social Security system).

Forecasts of trends in the population pyramid for Spain

Millions of persons

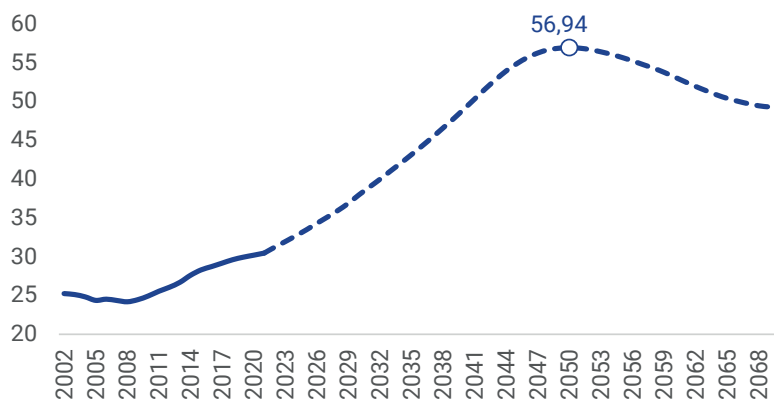




Source: Círculo de Empresarios based on INE, 2021.

Observed and predicted trend in the dependency ratio*

As %



* The dependency ratio is defined as the proportion of dependent persons. In other words, persons aged 65 and above over the working age population (between 16 and 65).

Source: Círculo de Empresarios based on INE, 2021.

This demographic and economic trend illustrates why, **since 2010, Social Security spending has exceeded revenue, the gap growing ever wider**. In 2019, prior to the outbreak of the Covid-19 crisis, the Social Security system already showed an annual deficit of €15.859 billion, representing some 1.3% of GDP. Funding needs practically doubled in 2020, reaching €29.685 billion or 2.6% of GDP. Looking towards the future outlook and **in the absence of corrective measures on either the spending or revenue side, the deficit of the Social Security system will con-**

Social Security spending has exceeded revenue since 2010 and the gap is widening

tinue to grow steadily as a consequence of the imbalance between pensioners and contributors, rendering the current system unsustainable.

The main components that explain the evolution in pensions spending are largely **the aforementioned dependency ratio**, which grew from 24.4% in 2007 to 29.9% in 2019, along with **the benefit ratio**, defined as the ratio between average pensions and average salaries. The latter went from 38% in 2007 to 46.4% in 2019. As a result, and using data produced recently by the Bank of Spain with reference to the pensions system, **the performance of these two variables explained more than 90% of pensions spending.**

All told, contributory pensions (excluding supplementary aid to minimum pensions) grew from a GDP share of 6.9% in 2007 to 10.3% in 2019. In tandem, social contributions represented 10% of GDP in 2019, 0.4 percentage points higher than in 2007, in a period in which the effective rate of social contributions had gone from 22.5% in 2007 to 24% in 2019. Total payroll as a percentage of GDP had meanwhile fallen from 42.7% to 41.5%.

The aggregate debt of the Social Security system has reached 7.9% of GDP

According to the most recent data available, **the foregoing have led to the Social Security system accumulating a debt of €91.855 billion** (7.9% of GDP) in the third quarter of 2021, whilst more than 70% of pensions spending is swallowed up by retirement pensions.

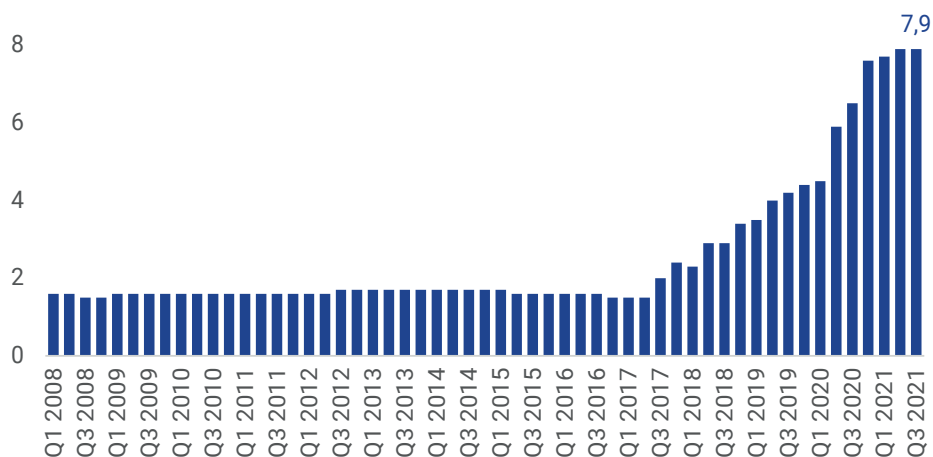
For its part, **the Social Security Reserve Fund has shrunk steadily since 2011.** Up until that year it had accrued resources of €66.815 billion, 2011 being the first year in which the spending of the system began to exceed revenue. **By 2017 the aggregate balance was already residual and, in 2020, amounted to just €2.138 billion, a figure approximately equivalent to 20% of the monthly payments currently made by the system.**

It is necessary to gradually transform the pensions system into a system that is sustainable, balanced and efficient

There is consequently a need to steadily transform the current pensions system into one that is sustainable and balanced, without the transition representing an excessive burden for any of the groups that currently participate. **The latter is essential in order to respect the principle of solidarity between generations.**

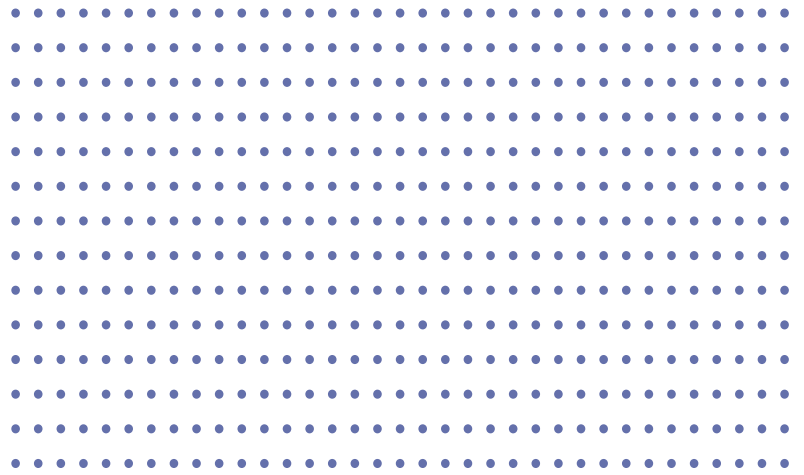
Trend in Social Security debt

As % of GDP



Source: Círculo de Empresarios based on Bank of Spain, 2021.

However, **not all of the decisions adopted recently appear to take into account trends in terms of any of the basic parameters that are leading to the production of this actuarial deficit.** On the contrary, some of these reforms will contribute towards increasing structural spending, thus delaying any real overhaul that would enable a remedying of the deficiencies of the current pensions system.



Recent reforms made to the system

One of the significant recent reforms relating to the Social Security system was approved in 2013. This tried to tackle the challenge of its sustainability by introducing a number of changes. Aside from **postponing the age of retirement and increasing the qualifying period** for the regulatory base, **a sustainability factor enabling** the linking of the amount of retirement pensions to trends in pensioner life expectancies was introduced, adjusting the amounts that would be received by those who retire in similar conditions in different time periods. An **adjustment mechanism** was additionally approved - the pension revaluation index (IRP). This would produce a minimum increase of 0.25% and not exceed the change in the consumer price index (CPI) plus 0.5%, and would be linked to the mathematical formula established by the financial situation of the system.

The 2013 reforms postponed the age of retirement, introduced a sustainability factor and approved a revaluation mechanism

Since then however, **legislative amendments have been driven more by electoral strategies** and the weight of retired voters than any search for the sustainability of the system and fairness between generations. As a result, in 2018 the Toledo Pact Commission reached a majority agreement to adjust pensions according to the CPI, this rise not being subject to trends in terms of any other variable.

Even more evidently, **many of the modifications adopted in 2013 in favour of sustainability have been reversed over the past year**, following an agreement between the Government and social stakeholders in June 2021 to reform the pensions system. The aforementioned agreement was based on a very partial diagnosis of the current status and future outlook for the system, in that **the most important consideration was that the Social Security system assume expenditure that should be borne by the State rather than financed through the system**. Although this is highly debatable, in August the Cabinet approved a bill guaranteeing the purchasing power of pensions, along with other measures to strengthen the financial and social sustainability of the public pensions system, based on the aforementioned agreement.

The 2013 modifications aimed at sustainability have been reversed

According to their impact on the system, **the most noteworthy changes** involve a consideration that the General National Budget Act should contemplate, **on an annual basis, a transfer from the State to the Social Security budget for the funding of various items**, such as early retirement support, reductions in contributions to foster employment, favourable treatment for systems such as agriculture and maternity supplements.

This measure will merely have a positive accounting effect by reducing the deficit recorded by the Social Security system, transferring this to the national accounts. In fact, the General National Budget Bill for 2022 approved by the Cabinet envisages an extraordinary transfer to the Social Security system of €18.396 billion in order to, according to the Government, guarantee the pension system. Nevertheless, this will not have an impact on the structural deficit of Public Authorities as a whole, estimated by the European Commission as being 4.9% of GDP in 2021 and 5.2% in 2022.

The new intergenerational fairness mechanism does not represent a structural element improving the sustainability or fairness of the system

Recently **the Government has similarly proposed replacing the sustainability factor** introduced in 2013 (the application of which was anticipated as of 2023) with **a new mechanism, the “intergenerational fairness factor”**. By considering life expectancy in pension calculations, the sustainability factor introduced the crucial concept of intergenerational solidarity and, above all, contributed towards the viability of the system. The new proposed mechanism, agreed only with the trade unions, consists of a specific contribution between 2023 and 2032 of 0.6 percentage points of common contingency contributions, split between the company (0.5) and worker (0.1), enabling an increase of provisions to the Social Security Reserve Fund.

The **new structural mechanism suggested does not represent a structural element to improve the sustainability or fairness of the system** and goes against the contributory principle in that the increase in contributions will not give rise to higher pensions. What is more, the agreed 0.6% would represent solely 7.1% of anticipated state transfers to the system in 2022, a deficit which is forecast to grow in the coming years. Rather than facing up to this imbalance, the new mechanism solely attempts to correct those that arise as of 2032, and up to a limit of a percentage of GDP.

It is clear that it **is essential to properly define this intergenerational fairness factor** in order to ensure the sustainability of the system, **linking the retirement age to life expectancy**. In this vein, the OECD has just proposed that the retirement age should in future increase at a rate equal to two thirds of the forecast rise in life expectancy. In the case of Spain, the OECD calculates that the application of a measure of this type would raise the GDP of the Spanish economy by 5.5% in 2060.

The bill additionally contemplates pension rises in line with the CPI, eliminating the aforementioned **pensions revaluation index**. Although providing for increases, however minimal they may be, the latter measure would offset major budget imbalances that could arise in times of high inflation. As it happens, the CPI could rise to slightly above 5% in the final months of this year, further consolidating the spread away from our main competitors. This may, in turn, set a precedent of indexing the salaries of public sector workers, entailing an additional burden on structural public sector spending.

The Bank of Spain has calculated that increasing pensions in line with the CPI together with the elimination of the sustainability factor could increase the public sector deficit by 4 percentage points of GDP in 2050. The Independent Authority for Fiscal Responsibility (AIReF) additionally estimates that this would grow public-sector debt to over 160% of GDP, a level that is entirely unsustainable financially.

As a result, **it would be advisable to salvage this and take into account variables other than price indices, such as economic and productivity growth**.

In short, the transfer of the deficit from Social Security to the national budget and the elimination of the sustainability factor do not appear to quash the risk to the sustainability of the current distribution system given that the real problem is demographic and related to the vitality of the labour market.

The penalty and incentive system has also recently been modified. As of 2024, a penalty system would enter into force that would be applied to the amount of the pension rather than the base. This would be calculated on a monthly basis (as opposed to quarterly under current legislation). Reduction coefficients would

It is essential to define the intergenerational fairness factor by linking the age of retirement to life expectancy

The risk of the unsustainability of the current system persists despite the transfer of the Social Security deficit to the national budget and the elimination of the sustainability factor

be reduced according to the years of contributions. Nonetheless, these proposals would not significantly reduce expenditure.

As a result, we are dealing with **a very much partial reform that postpones the resolution of the main defects** that are features of the current pensions system in Spain. It would therefore be advisable to **take a long-term, realistic outlook with respect to the pact and the reforms, aiming at solutions that are definitive, comprehensive and with broad consensus.**

Main lines of action in a crucial reform favouring the sustainability of the pensions system

The need to make progress towards a sustainable, efficient system is unquestionable given its importance as a fundamental element of social cohesion that generates trust. As a result, **this must be the first area of consensus reached across Parliament within a framework of social dialogue.**

The pensions system is not only a **fundamental component of the current welfare state** but also ensures quality of life during retirement. **Its design also has major macroeconomic implications.** The mechanisms comprising the pensions system as a whole **determine private savings** within an economy and, together with public savings, **constitute a fundamental source of financing for investment**, even in those countries which possess integrated capital markets.

The most viable reform proposals and a progressive transformation towards a system that is responsive to demographic and social realities **have been widely studied and already adapted to the pension systems in other countries.** These are of a very diverse nature.

Across **technical and professional viewpoints there is ample consensus concerning the suitability of establishing a system of notional accounts in Spain**, such as that already implemented in **Sweden**. The main reason is that this has considerable advantages over the current system in terms of sustainability, enhanced through adjustments made by the introduction of a methodology for the calculation of retirement benefits.

A system of personal, **notional accounts is a defined distribution and contribution system that establishes actuarial balance between contributions and pensions.** The balance is ensured by calculating the pension at the point of retirement as a **ratio between the present value of the accrued**

There is broad consensus over the suitability of establishing a system of notional accounts

amount of contributions made by the worker throughout their working life and the life expectancy of the worker. Given that **the system remains redistributive**, because the contributions of active workers fund the pensions of the retired, if the actuarial balance does not correspond to the financial balance of the system over the long term, the **calculation of the initial pension and its revaluation may be modified** in accordance with economic and demographic forecasts in order **to ensure the aggregate sustainability of the system**.

Each contributor has a personal, notional account in which their contributions are noted throughout their working life. These contributions **are updated according to the “notional goal”** (index for the updating of contributions) applied in each period. In order to ensure that the system tends toward financial equilibrium, **the “notional rate” should refer to the rate of growth of the contribution bases of salary incomes, the trend in the nominal GDP being an approximation of this**. The system of notional accounts would therefore represent a solid first line of action.

Notional accounts would enable efficient planning of saving and spending decisions prior to retirement

This system would entail additional economic benefits in that a degree of sovereignty is returned to citizens. Given that the notional accounts system is transparent, **it would provide active workers with a forecast of future income received in the form of a pension on retirement**. This would facilitate planning and the taking of efficient spending and saving decisions over time and before retirement. Workers would therefore internalise the contributions within the redistribution system as deferred salary, rather than as a tax.

Given the transparency of the increase in pension that would be received for each year worked, this type of system is also flexible with respect to extending one's working life and incentivises the postponement of retirement.

Transition from a redistributive system such as that in Spain to one of notional accounts is not complex in that solely the system for calculating the initial pension is changed. However, it would be necessary to **properly manage gradual change over time** until pensions are fully calculated according to the new system. **As of its full deployment, the system guarantees the sustainability of new pensions**, although it would, during a transition period, require the decreasing deficit of current pensions to be covered until such time as they disappear.

In order **to maintain the current levels of benefits** of Spanish state pensions, **the retirement age should be raised to 70**. Setting that age as a target for retirement, **an age range would be established within which the citizen could freely choose the right moment**. This range would span from 68 to 72 years of age. If the person wishes to retire between 68 and 70, the pension would be lower (up to 15%) and, if he or she wishes to go on working beyond 70 and up to 72 years of age, the pension would be increased (by up to 20%).

In order to maintain the current level of benefits, the target retirement age should be postponed to 70, with a range of between 68 and 72 chosen by the citizen

The aforementioned percentages represent guidelines and would be set out in the system and fixed **during the transition period**, until such time as the determination would be automatic. The foregoing example is built upon the goal of our current pension system, containing a multiplier representing 2.5 workers per pensioner. Moreover, and **in a process with much greater transparency and available information**, the citizen would be the one to decide whether he or she would prefer to sacrifice a small part of their pension by retiring early or increasing this by a greater amount by retiring later.

The implementation of the system must make provision for exceptions to the option to delay retirement, where this is inadvisable due to the nature of certain professions. The state would bear the cost of the pensions of these groups until they reach an age at which they would go on to receive their pension from the system of notional accounts.

Personal savings represent an option to ensure maintenance of individual spending profiles, whilst reducing the pressure on the state pensions system

As a complement to the establishment of a system that contemplates these types of elements, and given that moving from working life to retirement represents a fall in income, **funds originating from personal savings** represent an additional pillar in the form of retirement plans promoted by companies and individual savings. **These are among the options to ensure a stable individual spending profile and reduce the pressure on state pension systems**.

Nevertheless, **their relative importance in Spain is still below that in nearby countries**. Figures corresponding to the third quarter of 2019 indicate that pension plans and life assurance savings - savings instruments specifically ai-

med at retirement, represented some 16% of total household financial assets, compared with 34% for the Eurozone as a whole. However, the weight of investment funds and shares was 14 percentage points higher in Spain, amounting to 42% in comparison with the 28% of the Eurozone. In any event, there is a clear preference in both Spain and Europe for deposits as products in which to hold savings.

Consider the financial options applied in other European countries, including automatic pension plans and the so-called “Austrian backpack”

Traditional initiatives to **incentivise subscription to private plans usually take the form of tax benefits**, such as discounting contributions to the plan from the income tax base (up to a limit), therefore postponing the taxation of this portion of income until withdrawal during retirement. In the absence of information regarding their functioning or governance, the government’s recent proposal, as shown in the Draft Bill for the General State Budget for 2021, to further reduce deductions by way of contributions to private pension plans in exchange for increases to company pension plans is leading to **uncertainty around the future of personal savings aimed at retirement**.

A number of other financial options have emerged, such as reverse mortgages and the sale of property title in exchange for life annuities. These are enabling a diversification of the ways in which personal savings can be channelled and converted into income in retirement.

There is considerable room for the development of products in that property represents around 70% of the assets of Spanish households, although suitable regulation is required in order for this to function properly. It is true, however, that this proportion is likely to fall in the future.

Other countries have opted for the implementation of a mandatory or semi-mandatory private pensions system, with the imposition of minimum contributions. Some countries, such as the United States, the UK and Italy, have what are known as **automatic pension plans** to which companies register their employees, usually on a mandatory basis. Employees have the freedom to decide the amount of contributions or even cease participation.

Along the same lines, the application of other proposals aimed at correcting failures in other markets would have positive effects on retirement incomes and, as a result, on pensions. As an example of this, the labour market reforms proposed by *Círculo of Empresarios* include the establishment of a personal accrual fund owned by the worker. This could be used on justified grounds, such as unemployment, training or as a supplement to the worker's retirement pension: **the so-called "Austrian backpack"**, in line with the proposals made by the International Monetary Fund and the Bank of Spain.

All of these initiatives could serve as the basis for dialogue between social stakeholders in reforming the system. Given that the levels of welfare that the **Social Security system** is capable of guaranteeing depend on its ability to adapt to new realities, it **must be considered as an institution that should be subject to continual transformation and reform.**

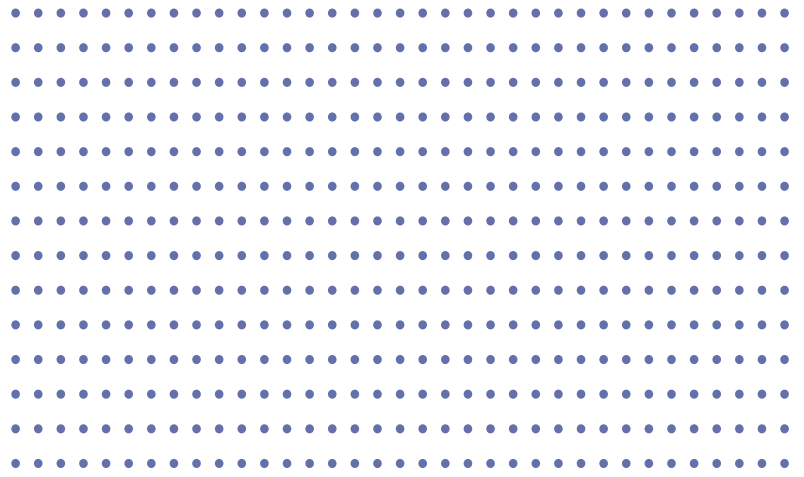
The challenge is of such a scale that a system of notional accounts as proposed herein is only capable of resolving the problem of the sustainability of a balanced pension system provided that there is a gradual introduction of this in the presence of adequate funding.

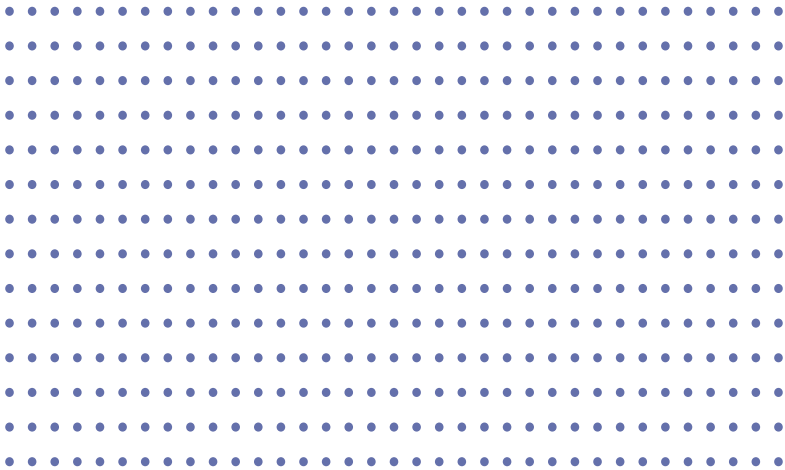
Nevertheless, the system will need to be supplemented with the postponement of the age of retirement and the proposed penalty/incentive scheme according to retirement age, the "Austrian backpack" proposal and, of course, all reforms that contribute to an improvement to the potential growth of our economy and a reduction of unemployment to a level closer to the European average.

Given its importance as an essential component of the welfare state and with a view to medium and long-term sustainability, any major reform affecting Social Security must be implemented with the broadest consensus possible. The common interest must be placed before the short-term electoral interests of political parties.

As correctly stated by the Governor of the Bank of Spain recently in Parliament, the design of the new pensions system will affect the finances of millions of

citizens across multiple generations as they base their saving, spending, investment and working decisions on their expectations regarding the rules that will govern their participation in the pensions system. As a result, **the transparency and stability of these rules and the degree of political consensus through which they are formed are essential.**







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