The pension debate

Congratulations are in order. Spain is one of the countries with the longest life expectancy in the world. Our male readers aged 65 will live, on average, until they are 84; our female readers until 88. Some will live even longer if, in addition to reading this *Monthly Report*, they also have other healthy habits such as regular exercise and a balanced diet. Life expectancy is set to go on growing, and probably at an ever-faster rate: six years have been added in the last four decades but it is projected to lengthen by almost eight over the next forty years.

This great piece of news lies at the heart of any discussion about the sustainability of pension systems. The vast majority of advanced economies are now facing this challenge but Spain's medium and long-term demographic pressures are particularly high as its longer life expectancy is accompanied by one of the lowest birth rates in the world. And the additional handicap of a labour market with relatively low employment rates.

A few figures help to illustrate the pressure Spain is under: the number of people paying Social Security contributions is currently around 18 million, about 60% of the working age population, while the number of people over 65 is approaching 9 million. Put another way, there are just over 2 people paying contributions for every person of retirement age.

Demographic projections for 2050 indicate that, keeping the current employment rate, this ratio would fall to 1 or, in other words, the number of people paying contributions would equal the number of people over 67 (around 14.5 million). Even if there were full employment, this ratio would scarcely reach 1.2. The country's demographic trend therefore represents a huge challenge for a pension system such as our own, where retirement pensions must be covered by Social Security contributions.

The reforms carried out in 2011 and especially in 2013 took these pressures into account and proposed a number of rules that help to ensure the system is sustainable. In their day these reforms (in which Spain was a pioneer compared with many countries) were vital in order to regain the confidence of international investors. Among other changes, the retirement age was scaled forward, a sustainability factor was introduced (linking pensions to life expectancy) and a formula was established to determine the annual revision of pensions based on the budgetary situation of the Social Security (with a minimum increase of 0.25%).

The issue at stake is that, in all probability, these rules would achieve a sustainable system but through a substantial, albeit gradual, reduction in the generosity of pensions. For many of the years over the coming decades, the current rules would probably result in annual increases of 0.25% for pensions. For instance, the European Commission has estimated a probable reduction in the ratio between the average pension and average wage, also called the replacement rate, of around 20 points over the long term, pushing this ratio to below 40%.

Discussion today should therefore focus on the appropriateness of concentrating most of the adjustment on pension size, an option that might be difficult to defend politically. There are other options that should be explored, for instance by automatically linking the standard retirement age to life expectancy, as is the case in the Netherlands and Denmark; by increasing incentives to work for longer; by obtaining additional resources for the pension system or promoting private savings for retirement which can supplement the public pension of the future. Whichever measures are implemented, these must be framed within a broader strategy of economic policy that aims to boost the growth prospects of productivity and employment and ensure public finances are sustainable.

In any case, transparency is vital. We must have a clear idea, in advance, of the pension we are likely to receive when we retire in order to plan our savings accordingly.

Enric Fernández
Chief Economist
31 March 2017