

Miguel Fernández Ordóñez: Taking of stock of the Toledo Pact

Testimony by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Non-Standing Committee for the Monitoring and Assessment of the Toledo Pact Agreements, Madrid, 15 April 2009.

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Five years since the last assessment of the Toledo Pact, and under a new assessment process initiated by Parliament in 2008, I appear today before this Committee to convey my views on the situation of and possible reforms to the pension system. These opinions are the summary of a note drafted by the Banco de España Research Department, which will shortly be forwarded to you.

Before I begin, I should stress that the content of the Toledo Pact, i.e. the pension system and its reform, does not come under the purview of the Banco de España. Defining specific reforms to the pensions system is an eminently political matter and is thus for the legislature to decide upon. Accordingly, the note the Research Department is finalising and whose content I shall outline for you today should not be considered as a reform proposed by the Banco de España. It is simply a summary of what may be taken as a consensus among experts regarding the diagnosis of our pension system and its attendant problems, and the potential means for tackling them. Indeed, the summary is an update of that presented before this same Committee by the Director General of the Research Department in 2000.

As you know, the Toledo Pact has already been in place for more than 13 years. Over that period demographic and, until recently, macroeconomic developments made for a significant improvement in the Social Security system's financial position. Since the signing of the Pact, the Spanish population has grown strongly by more than 6 million, most of whom immigrants. Immigration has been significant not only in terms of volume but also of its composition, insofar as it tends to be concentrated in the younger age groups.

In parallel, macroeconomic developments enabled this strong growth in population to be absorbed by the labour market. Notable in this connection was not only the contribution of the foreign population but also the significant role played by female nationals progressively joining the labour market. These developments occurred against a background of very low growth in the number of pensioners as retirement was centred on the generations born during the Spanish Civil War and the post-war period.

As a result, Social Security registrations far outgrew pensions in recent years, which explains how the Social Security system ran growing surpluses, rising to 1.3% of GDP in 2007. These surpluses were assigned, in part, to the Reserve Fund, which reached a significant size of close to 5% of GDP at the end of 2008.

In the past year, however, the impact of the economic crisis has also been felt in the Social Security accounts, meaning there has been a rapid deterioration in this surplus, which could even disappear within a year.

Analysis of the Social Security system should not, however, be based on its results in the short term. The signing of the Toledo Pact was but an acknowledgement that the viability of a pay-as-you-go pension system should be analysed from a long-term perspective.

Taking this perspective, I should stress that, according to analyses conducted by national and international analysts and institutions, neither the Social Security surpluses of the past decade nor the foreseeable worsening of the financial situation in the coming years will essentially alter the diagnosis. Accordingly, we may assert that the problems relating to the financial sustainability of the current Social Security system were the same ones that led at the time, among other reasons, to the signing of the Pact.

There are essentially two factors at the root of these problems: the sharp reduction in the birth rate and the progressive rise in life expectancy, both of which bear on the current and future structure of the Spanish population pyramid. On one hand, the outcome of the increase in life expectancy will see the over-65 segment progressively gain weight in the population total, while the pyramid base will narrow as a result of the birth rate falling below replacement levels. Consequently, the shape of the population age structure is changing from its current pyramid form to look more like a pillar. This will be so even assuming some pick-up in the birth rate and continuing positive migrant inflows into Spain. In sum, on Eurostat's current population projections, prepared in 2008, the dependency ratio (the over-65s as a proportion of the working-age population) might more than double between 2008 and 2050 from 24% to almost 59%.

Everybody is aware of the consequences of these population developments for the sustainability of our pay-as-you-go pension system. Growing pressure would build up on pension spending, meaning that the models currently available, including those devised by the Economy and Finance and Labour and Social Security Ministries which incorporate all the legislative amendments approved in recent years, show that this public spending item would double over the time period referred to above. As a result, the system could run a rising deficit as from 2025.

It should also be highlighted that the latest demographic developments, in particular the heightened migrant inflows into Spain, do not resolve the problem. At best, the inflow of working-age immigrants holds back the increase in the dependency ratio derived from population ageing and, therefore, delays the emergence of the problems. But the full scale of these problems will persist.

How can we tackle the challenge that demographics pose for our pension system? The scale of the problem calls for a three-pronged strategy. First, the strategy should be far-reaching, i.e. blending measures on different fronts. Specifically, the measures should pursue healthy public finances, implement structural reforms in the economy and seek to reform the pension system, as I shall now expand upon. Second, discussion of these measures should not stretch out over time. And, finally, the reforms should have sufficient scope, acting along the lines of the recommendations made in the review of the Toledo Pact.

Regarding the scale of the strategy, its first pillar should be based on maintaining healthy public finances. Once again, we should adopt a medium-term perspective here. Irrespective of the fact that 2008 saw the re-emergence of a budget deficit and that, almost certainly, it will hit significantly higher levels in 2009, two matters will be vital in the medium term, once the effects of the economic crisis have abated. We must resume a healthy public finances path and, above all, bring public debt back onto the declining trend witnessed recurrently, with the exception of 2008, since 1997. These considerations also clarify why the rise in the budget deficit cannot go unchecked in the current situation, so as to prevent a strong increase in public debt arising, which would impose an excessive burden on future generations. In this respect, commitment to the medium-term fiscal rules laid down in the Stability Pact at the European level and in Spanish budgetary stability laws continue to offer the best guidelines for conducting fiscal policy.

Secondly, as the specialist reports emphasise, from the macroeconomic standpoint the public finance sustainability problems are eased if employment and productivity in the economy trend favourably. Here the room for improvement is extensive and calls for structural reforms in many areas, such as the labour market and the markets for goods and services, along with education and job training. Once again, the time perspective is important here. The long-term view that should underpin any analysis of the sustainability of the pension system is perfectly compatible with the fact that many of the reforms needed to improve employment and, above all, productivity in the economy can only bear fruit after a relatively lengthy period of time.

These two pillars of the strategy are evidently important. And tackling the problem of the impact of population ageing on the pension system in the long run will also require reforms. Further, these pension system reforms will complement the structural reforms mentioned earlier, in particular those relating to the labour market, and the reform to maintain healthy public finances.

It is this matter which is central to this Committee's mission. It has been working intensely in this connection over the past decade, particularly on how to modify the pension system's current parameters to ensure its long-term sustainability. That brings me back to two other key aspects of the strategy to be agreed: the speed and scope of the changes to be made.

Although the emergence of the first deficit in the system may appear a long way off, it should be borne in mind that the reform planning and implementation horizon is also long. Accordingly, the reforms should be discussed without delay so that, following their gradual implementation, they may prove fully effective when population ageing begins to exert a more virulent effect.

Pension system reforms must also be sufficient. Since the signing of the Toledo Pact and its subsequent renewal, various legislative amendments – which may generally be seen as in the right direction – have been made. Examples include the (still incomplete) separation of the sources of financing of the Social Security system, the unification of the contribution bases, the creation of the Reserve Fund and the progressive simplification of the different contribution schemes, among others. However, among the Pact's recommendations are other measures worthy of discussion, since they may considerably impact the system's sustainability.

At this stage we should ask ourselves which pension system reforms merit assessment. The range of possibilities is an extensive one, and a decision on which reforms should be made requires not only an expert assessment but a political one too. Resolving the system's problems may involve changes in the parameters of revenue or expenditure, but choosing the right or the most reasonable mix requires considerable political assessment. Yet some combinations may be preferable to others from the standpoint of economic efficiency in that they may generate greater incentives, for instance, to join the labour market. In this respect, what is important from a technical viewpoint is to maintain a high degree of proportionality between benefits received and contributions paid, a point that has been underscored from the outset in the Toledo Pact recommendations.

Regarding the various options available, I shall refer to some already deployed by European countries and which, therefore, have been tested to some extent. I reiterate that these are not proposals of the Banco de España; the aim of my institution is to help this Committee in its work by setting out the measures applied in other countries.

Taking first some of the measures that affect pension spending, some countries have opted to raise the legal retirement age. Measures here have been on three fronts. Firstly, early retirement conditions have tended to be tightened. And this is where the complement to the aforementioned structural reforms is greatest: pension system rules should generate the right incentives to remain in the labour market, and it should also be sought to maximise this permanence through continuous employee training and wage flexibility, tailoring wage rises to productivity. There have also been incentives to continue working beyond the legal retirement age. And finally, decisions have been made to put back the legal retirement age, although only a small number of countries have admittedly adopted this measure. This is so in Germany, where a gradual increase in the retirement age from 65 to 67 has recently been approved. The various simulations available indicate that this is a measure with a strong effect in terms of reducing pension spending.

Secondly, and continuing on the expenditure side, other countries have opted to raise significantly the number of years of contributions used to calculate the amount of the pension (the "regulatory base"). Here, the application of a similar measure in Spain would draw us closer to other European countries. Specifically, France has recently lengthened the period

for calculating the pension entitlement from 10 to 25 years, while Austria has extended it from 15 to 40 years and a significant number of countries (Finland, Poland, Portugal and Sweden) have extended it to cover the entire working life. This reform would be in line with the recommendations of the Toledo Pact and would increase the system's proportionality, i.e. the relationship between pensions received and contributions made. Connected to this issue, there would be a possibility in Spain of furthering the reforms in recent years aimed at bringing the different Social Security schemes onto a more equal footing, so as to ensure that the contributions made under the different schemes are similar.

Thirdly, some countries have lowered the income replacement rate, defined as the net pension divided by net income prior to retirement, by reducing the percentage of the regulatory base received after having contributed for the minimum period (currently set at 50%), by extending this minimum period or by reducing the rates with which this initial percentage increases for each additional year of contributions.

A more novel alternative has involved linking pensions to life expectancy. Insofar as part of the problem arises as a result of the rise in life expectancy, adjusting pension amounts more or less automatically to these increases would be conducive to the sustainability of the system. Currently, this type of measure has been proposed or applied, to differing degrees, in almost half the OECD countries.

As regards updating pensions, many countries have ceased to take wage growth as a reference and have instead used price indices, as in Spain. In this case, potential reform options might address the possibility of compensation for differences between forecast and actual inflation acting both in favour of and against pensioners.

On the revenue side of the system, there appears to be no headroom for increasing social contributions, since that might greatly impair employment. However, accelerating the process of separation of funding sources should be considered so that social contributions cease to cover the portion of top-ups to minimum pensions that they currently finance, as should earmarking the entire Social Security surplus (and not only a portion as to date) to the reserve fund.

Significantly, all these reforms can be made without having to alter the current pay-as-you-go system, through changes in its parameters. Some countries have opted to frame these changes within a single, large-scale change, at least in formal terms. Sweden and other Central and Eastern European countries have set up a system of notional accounts. Under this system, the model remains on a pay-as-you-go basis, but a virtual account is set up for each individual which reflects the individual contributions of each pension scheme contributor and the notional returns that these contributions generate throughout working life, returns that are calculated according to a notional rate linked to some macroeconomic variable. This system provides for a closer relationship between individual contributions and pensions. And, above all, it significantly improves individuals' perception of this relationship, which may lead to incentives systems and their impact on agents' decisions in the labour market working more appropriately, reducing individuals' uncertainty over future income.

In my address I have referred to the projections of various organisations on the sustainability of the system and to the reforms being applied in other European countries, summarising the content of the Research Department document that I shall send you this week. But let me conclude by highlighting the importance of the work entrusted to this Committee, especially at this current juncture where, for other reasons, economic agents are under a cloud of uncertainty.

The agreement reached in Toledo whereby pension sustainability may not be used as a political battering ram is an achievement of which you should all be proud. This agreement, moreover, does not mean you should not react to the problems that may emerge in the pension system as a result of future demographic changes. On the contrary, the agreement obliges us all to examine the problems and seek solutions. I am sure you will be able to convey to the general public that these problems can be resolved if the appropriate

measures are taken and that, moreover, if they are taken without delay, they need not be traumatic. And I am convinced that moderate reforms adopted in sufficient time will not only help resolve long-term problems but, by offering reassurance and reducing uncertainty over the future, they will also have favourable effects in the short run in the difficult economic circumstances currently besetting us.