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Appearance by the Governor of the Banco de España

Parliamentary Committee for the Monitoring and Assessment of the Toledo Pact Agreements

Luis M. Linde Governor

Ladies and Gentlemen,

I appear before this Committee for the Monitoring and Assessment of the Toledo Pact Agreements to present the Banco de España's analysis of the current status of and outlook for our public pensions system and its reform.

The analysis is in a paper recently published by the Banco de España and takes a technical approach. This means we have attempted not to enter into political considerations, though these prove difficult to avoid when it comes to choosing one or more of the different reform options available.

I shall begin with some thoughts on the recent developments in our public pensions system, moving on to the medium- and long-term outlook, and concluding with some general comments on possible reforms.

Drawing on the final annual figures for 2015, the Social Security System deficit stood at 1.5% of GDP, in contrast to the surplus of 1.4% of GDP posted at the start of the crisis. The information on the budget outturn for last year, 2016, suggests that this deficit will have increased. Analysing the source of this deterioration, we can conclude that it came about essentially owing to the increase in expenditure, which rose as a proportion of GDP by 3.9 pp from 2007 to 2015 to 13%, while revenue expressed as a proportion of GDP increased by 0.9 pp.

Three types of factors lie behind this increase in expenditure.

The **first** is demographic. An increase in the retired population as a proportion of the working age population — which is known as the **dependency ratio** – automatically generates an increase in spending on pensions relative to GDP. So, in the 2007-2015 period, the dependency ratio rose by 3.8 pp to 31% of the working age population at the end of 2015.

The **second** factor is related to labour market developments: the lower the rate of employment in the economy, the higher the pension spending as a proportion of GDP, and vice versa. The economic crisis led to a most significant rise in unemployment which has only been reversed, in part, in the past three years: over the 2007-2015 period as a whole, the employment rate declined by 8.9 pp.

Finally, the **third** factor pertains to the ratio of the average pension to the average wage in the economy, which is known as the **replacement rate**. This rate increased by 4.8 pp from 2007 to 2015, as average pensions outpaced wages, as a result of which, in 2015, the average pension was equivalent to almost 44% of the average wage. Behind this result are aspects such as pension indexation decisions or the so-called substitution effect which arises from the fact that new entrants into the system have pensions which, on average, are higher than the pensions of those leaving the system.

Distinguishing between the various determinants of pension spending is also useful to illustrate the medium-and long-term challenges the system faces. The most significant challenge stems from the progressive increase in longevity and, consequently, from the gradual rise in the retirement-age population as a proportion of the total population, i.e. progressive population ageing.

By way of illustration, the life expectancy of a 65-year-old today is six years more than that for a person of the same age in 1975 and, on the latest INE demographic projections, that same person today will live around five years less than a 65-year-old in 2060. As a result, the dependency ratio may be estimated to more than double from 2016 to 2060.

One initial means of checking or compensating for the effect of the rise in longevity on pension expenditure is to raise the employment rate. For example, if it is assumed that the Spanish economy can increase its employment rate from the current rate of 56% to 80% by 2060, up to 60% of the pressure on spending derived from population ageing might be offset.

A second means of compensating for demographic pressure is by reducing the replacement rate. Changes in macroeconomic variables – in productivity in particular – and the definition of the various parameters used to calculate the system's benefits may both contribute to achieving this reduction.

A higher productivity growth rate in the economy – which is one of our main economic policy challenges – has a stabilising impact on pension spending as a proportion of GDP, precisely through a reduction in the replacement rate, insofar as existing pensions are indexed below productivity growth. The sustainability factor, which will come into force in 2019, and the new pension revaluation index, introduced in the 2013 reform, also temper spending by reducing the replacement rate.

In practice, the new pension revaluation method, in force since 2014, sets the annual growth of pensions according to past and future behaviour of revenue and expenditure in the system, which depends on factors such as the number of pensioners and average pensions, with ceilings and floors equal to the change in the CPI+0.50% and 0.25%, respectively.

On the projections available, in macroeconomic scenarios that are fairly favourable in terms of employment and productivity developments, and in which inflation stands at close to 2%, the recent reforms (i.e. putting back the retirement age, a sustainability factor and a new revaluation mechanism) would manage to counter the effect of the expected increase in the dependency ratio on pension spending and, therefore, would succeed in restoring the system's financial sustainability in the long term.

Assuming no new revenue sources, the adjustment mechanism would operate through reductions in the replacement rate, which would need to be significant to stabilise the system's spending. The most effective mechanism is the revaluation index, the application of which, in the current model, leads to below-inflation increases in existing pensions insofar as revenue and expenditure are not in equilibrium.

Evidently, more favourable scenarios in demographic or employment terms allow the sustainability of the system to be achieved with fewer reductions in the replacement rate. But even in highly optimistic scenarios, the reduction needed in that rate to ensure the system's sustainability would be considerable.

What is the main conclusion to be drawn from this analysis? Since the challenge posed by the impact of demographic trends is to ensure the financial sustainability of the public pension system, even once full employment has been reached, there are, in fact, only **two**

options to achieve this: 1) to reduce the pension replacement rate, and/or 2) to broaden the sources of funding.

Given the magnitude of the problem, it would seem reasonable to consider both options.

1) With respect to the measures to curb expenditure through the replacement rate, the desirability of a more balanced distribution between **a**) the adjustment arising from the reduction in the initial pension, and **b**) that operating via the indexation mechanisms, should be studied. The option to further push back the retirement age may also be considered, since it could be justified by people's longer life expectancy, their joining the workforce later, the reduced physical demands of most jobs today, and people's better health at more advanced ages.

In this regard, any measures that discourage early retirement and allow people to extend their working lives beyond the age of 67 would have a positive bearing on the financial sustainability of the system. Some countries have opted to build in an automatic link between life expectancy and the permitted retirement age in their sustainability mechanisms. Others have undertaken a broader change, adopting a notional definedcontribution accounts system, which has some advantages in terms of increasing the transparency of the system.

Moreover, against the background of a significant rise in the dependency ratio and future reductions in pension replacement rates, it might make sense to extend the role of retirement saving to complement the resources of the public contributory system with the accumulation of financial assets supplementing future public pensions. In any event, implementing a funded system is complex and requires detailed prior analysis of issues such as the length of time needed to implement it, whether it is voluntary or compulsory, the returns it can offer in a scenario of demographic stagnation and sluggish productivity growth, and how the costs associated with implementing this change are to be shared out intergenerationally.

2) As regards new sources of funding, the alternative is to raise social contributions or other taxes, or permutations along these lines.

Increasing social contributions may have adverse consequences for employment, since their weight in overall taxation is already higher in Spain than in other comparable countries. For example, the elimination of ceilings on the contribution base would significantly raise revenues, but it would also mean a substantial increase in labour costs, and if there is no parallel increase in maximum pensions the relationship between contributions and benefits which, in my opinion, should be preserved, would be considerably weakened.

Another option would be to confine the concept of contributory pensions exclusively to retirement pensions, which would continue to be funded from social contributions, while other pensions would be funded from general taxes. Clearly, this would require increasing general taxes, or reducing other public expenditure in order to be able to pay for the pensions transferred from the social security fund to central government.

As regards raising general taxes to pay for pensions, it is crucial that the resulting tax basket has the mildest possible distortionary effects on growth, bearing in mind the point of departure.

To conclude, I would like to share three considerations with you.

Firstly, I would like to highlight that the recent reforms have built in an automatic mechanism for the financial equilibrium of the pension system (sustainability factor and revaluation index), bringing it closer to other European public pension systems. This automatic mechanism, as it is currently defined or under alternative definitions in the future, should be preserved.

Secondly, current regulations or any additional reforms should be implemented as transparently as possible in order to give the public the necessary information about the sufficiency of future pensions and allow individuals to make optimal saving decisions.

Lastly, the challenges of population ageing must be tackled by means of a broad economic policy strategy. It is vital here that the path of fiscal consolidation should be resumed and that the public debt should return to a downward trend, so as to better position public finances to address the issues arising from ageing.

The sustainability problems of the pension system may indeed be alleviated if employment and productivity in the economy trend favourably. In this respect, there is much room for improvement in the goods and services markets, in education and employee training, and in the labour market too.