

Private pensions in Spain: scarce development and meagre public debate

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Abstract: Spain established at the end of the 80s a system of voluntary private pensions which 20 years later has more than eight million participants. But whereas Social Security pensioners amount nowadays to more than 40% of all affiliated workers, pensioners getting private benefits are only 2% of all pension funds' participants. As a matter of fact, assets of Spanish private pension funds are low in comparative terms, slightly below €80 billion. Even though the financial crisis has affected the solvency and return of private pension funds, the saliency of this topic in the public debate has been rather scarce because of different factors. In this paper I explore these factors after presenting a brief introduction in the Spanish pension system (section 1), outlining the main policies and politics of pension reform (section 2) and describing the evolution of Spanish pension funds during the last decades (section 3).

1. A BRIEF INTRODUCTION TO THE SPANISH PENSION SYSTEM

The Spanish pension system has a prevailing public pillar which offers earnings-related pay-as-you-go-financed old age, permanent disability and survivors (widow[er]s, orphans and dependent kin) pensions. This pillar was designed in the 1960s under the Francoist dictatorial regime as a means to restructure and centralize pension provision, until then managed by state-corporatist associations on a funded basis. The new Social Security pension system lacked the actuarial characteristics of the former mutual scheme: benefits were not directly linked to the amount of contributions paid, but to the contribution base (fixed according to the salary) previous to retirement.

The 1978 democratic Constitution established the obligation of the state to maintain “a public Social Security system for all citizens guaranteeing adequate social assistance and benefits in situations of hardship, especially in case of unemployment”, adding that “supplementary assistance and benefits shall be optional”. At the end of the 80s, under the second socialist majority government of Felipe González, a private pension pillar was introduced through a law regulating privately funded and managed occupational and personal pensions aimed at voluntarily supplementing public pensions. To this double pension provision scheme (mandatory pay-as-you go pensions and voluntary funded pensions) the third Gonzalez’ government added at the beginning of the 90s a public non-contributory tax-financed program in order to offer means-tested flat benefits for elderly and disabled people not fulfilling the eligibility conditions for a contributory public pension (15 registered contribution years).

Thus, the Spanish Social Security, a centrally governed institution depending on the Ministry of Labor and Immigration, embraces contributory as well as non-contributory pensions. On the contrary, public health care and social services are competences of the 17 autonomous communities (regional governments) which form the political-administrative structure of the highly decentralized Spanish state. Nationalist parties (specifically Basque and Catalan parties) have repeatedly demanded the decentralization of Social Security, but even though the distribution of political power between the central government and the autonomous communities is one of the most outstanding cleavages of Spanish politics, this demand is not salient in the pension debate.

Social Security is the most important central institution in terms of outlays. In 2009 they amounted to more than €110 billion, ca. 10% of Spanish GDP. The contributions paid in that year by nearly 18 million workers represent the lion’s share of Social Security revenues. During the last decade these revenues have exceeded pension contributory expenditure, so that the different governments (even after financing some non contributory pension outlays) have managed to accumulate nearly €70 billion in the Social Security reserve fund (established in 1997).

As regards its organization, the contributory Social Security pension scheme comprises nowadays the so-called general regime and five special regimes (self-employed, coal miners, fishermen, agricultural workers and domestic employees) offering altogether around eight and a half million pensions (more than five million of them retirement pensions). Civil servants working in municipalities, autonomous communities and specific institutions are integrated in the Social Security general regime, while the rest has been ascribed to different public mutualities. Since 2004 civil servants not integrated in Social Security assign half a percentage point of their contribution base to a collective pension fund. They thus represent the only occupational group in Spain which compulsorily has a supplementary funded pension.

Contributory pension benefits are in Spain rather modest in comparative terms (in 2009 the average monthly amount of old age pensions was €831)¹. Nevertheless, according to different

¹ Paid 14 times each year (12 ordinary and 2 extraordinary benefits in June and December).

sources they are much more generous than in other countries: whereas the OECD average pension replacement rate is 59%, the Spanish pension replacement rate is 81%, the second highest (after Greece) among this group of countries (OECD 2009). Different authors have also shown that the Spanish Social Security pension system generates positive rates of (real) return, i.e. the “investment” in pension rights is very “profitable”. In fact the system provides very unbalanced results from an actuarial point of view (Alonso 2006).

The number of contributory pensions and the average benefits have experienced a considerable increase in the last two decades as a consequence of population ageing and system’s maturation intermittently stimulating the public debate about the financial sustainability of the pension system. However, non-contributory pensions are less than half a million and show a slow but steady decline. Because of this recent evolution as well as their very modest benefit level, they do not represent an important topic in the Spanish pension debate.

In contrast, private pension funds have been since their creation in the late 80s in some way present in this discussion, even though not representing its main focus. At the end of 2009 more than eight million individuals owned private pension plans (some of them having subscribed more than one). The majority of the 10,5 million pension plans’ contracts had been signed by participants on their own initiative. Employment pension plans are scarcely developed, embracing slightly less than two million contracts. Compared with other European countries, assets accumulated by participants in private pension funds are low (roughly 85.000 million euros, ca. 8% of Spanish GDP). Private pension beneficiaries in 2009 amounted to 206.000, which means that less than 2,5% of all pensioners supplemented their public pension with a private one.

Chart 1 offers an overview of the Spanish pension system including the main information put forward in this section.

Chart 1 - Spanish pension system (2009)

(see PDF file attached to the paper)

2. THE EVOLUTION OF PRIVATE PENSIONS SINCE THE LATE 80S: POLICIES AND POLITICS

The launch of the Spanish Social Security in the 60s did not sweep away the system of social protection mutual aid societies which had developed in the XIX century. They persisted in a weak form as a means to voluntarily supplement Social Security benefits, but were not conceived of as a part of the pension system. At the beginning of 1985, while the first socialist (PSOE) government was preparing a reform to rationalize the Social Security organization, restrict the eligibility conditions for pensions, avoid strategic behaviour through which pensioners were able to obtain under certain circumstances disproportionately high benefits and top up pension benefits, it declared its will to create not only a non-contributory regime but also to regulate the creation and development of supplementary private schemes. The latter should allow the better-off workers to maintain their income level after retirement.

After the approval of the 1985 pension law, which so far (summer 2010) represents the most substantial reform in the history of Spanish Social Security, the government prepared in 1986 a bill on private pension plans and funds.² Pension plans were defined as “institutions of free and voluntary prevision” covering risks derived from retirement, permanent disability and death and understood as a possible complement, “in no way” as an alternative, to the mandatory Social

² Law 8/1987 of June 8. The Law distinguished explicitly between pension plans and pension funds, the former referring to the arrangements and conditions under which these private pensions are subscribed and the latter to the pool of assets bought with the contributions to the pension plan.

Security pension system. The bill established a threefold distinction between pension funds: the employment system should enclose pension funds set up by firms and enterprises for their employees; the associate system was to include plans promoted by associations and trade unions and the individual system those launched by financial entities and subscribed by individuals. The Law furthermore regulated their supervising institutions, the investment requirements which they had to satisfy and the tax treatment of promoters, participants and beneficiaries.

The project on pensions plans and funds put forward by the socialist government met great resistance inside and outside the parliament. Whereas right-wing parties criticised the scarcity of tax incentives to participate in pension plans and the excessive political and administrative controls upon the operation of the funds, parties to the left of the PSOE and trade unions were suspicious of the increased power with which these financial instruments would provide banks and insurance companies. Although backed by an absolute majority, the government made several amendments proposed by a sector of its own party in the Congress and in the Senate. Thus, it fixed a limited amount of annual contributions (either made by the participants or by the employer on behalf of employees), strengthened the state competences to supervise the performance of fund managers and ensured the universal character of employment funds within a firm (preventing them from becoming selective incentives only for some employees).

The Law on Pension Plans and Funds was finally passed in June 1987. Neither the employers' association CEOE and the financial sector nor the trade unions liked it. The former thought that the incentives introduced by the Law were too weak to stimulate savings and contribute to the development of a vigorous private pension pillar; the latter mostly disliked the deductibility of contributions to pension funds which they deemed discriminatory with respect to Social Security contributions and in general feared a rapid development of the private pension market that could be used as an argument to justify public pensions' cuts.

Contrary to the position of trade unions, the PSOE governments increased the amount of deductible contributions to pension plans claimed from time to time by representatives of the financial and insurance sectors. Initially established at ca. €3000 (500.000 *pesetas*) per family unit, this limit turned out to be only applicable to individual tax payers when the Constitutional Court forced the parliament in 1989 to reform the tax legislation in order to allow the members of a family unit to present separate income tax returns.³ In 1991 the third socialist government raised the limit of deductible contributions to private pension through the Law on Personal Income Tax, which established that participants in pension plans could deduct up to ca. €4500 euros (750.000 *pesetas*) of their income tax base as of 1992.⁴ As for the taxation of benefits, the conditions established by the 1987 Law on Pension Plans and Funds remained stable: benefits either in form of annuities, or as a lump sum or as a combination of both would be taxed as income from work (i.e., included in the income tax taxable base of beneficiaries).

This policy of improving incentives to subscribe or increase contributions to pension plans was more resolutely pursued by the center-right People's Party (PP). In 1998 the first PP minority government increased the deductible amount to ca. €6600 (1.100.000 *pesetas*). One year later it passed different pieces of legislation which introduced gradual additional increases to this limit for people aged 53 and over with a ceiling of ca. €13220 euros (2.200.000 *pesetas*) for people aged 65 and over, allowed individuals to subscribe pension plans in favour of handicapped relatives also enjoying tax advantages and to retrieve pension assets under the special circumstances of severe illness and long unemployment⁵.

Two years after winning elections with an absolute majority, the PP approved in 2002 a reform of the personal income tax which included a new substantial rise of the tax exempted

³ Law 20/1989 of July 28.

⁴ Law 18/1991 of June 6.

⁵ Law 40/1998 of December 9, Royal Decree 215/1999 and Royal Decree 1589/1999 of October 15.

contributions to pension plans. Starting in 2003 tax payers have been able to subtract €8000 from their taxable base. To this sum people over 52 years can add €1250 per each year above this age (with a ceiling of €24 250 for people aged 65 and over).⁶ Moreover, the government also established that since 2003 benefits of pension plans captured in a lump sum should enjoy a 40% reduction from the income tax taxable base. Finally, in order to promote the development of occupational pensions the renewed text of the Law on Pension Plans and Funds published in December 2002, which derogated the 1987 Law, allowed several companies to constitute jointly one pension scheme.⁷

All these incentives notwithstanding, the PP governments never maintained a public discourse in favour of weakening public pensions nor of praising too much private pensions. Their commitment to Social Security was firm during the whole period in which they led the government (1996-2004) and their praise of private pensions rather cautious and noiseless. Aside from this discreet encouragement of private pensions, the behaviour of the center-right governments has not differed significantly from the behaviour of the socialist governments previous and subsequent to it. Particularly since 1995, Spanish pension policy has been framed by the Toledo Pact, a parliamentary arrangement supported by all political parties which have stressed their commitment to the public pension system and their will to consolidate and enhance it. In addition, economic expansion and a favourable labour market evolution between 1996 and 2006 alleviated the pressure to reform the public pension system in order to ensure its financial sustainability. Albeit the warnings coming from different international economic organizations (first and foremost OECD and IMF, but also the European Commission), Spain is probably the European country which has more modestly advanced public pension reform during the last two decades (Chuliá 2006, 2010).

3. THE EVOLUTION OF PRIVATE PENSIONS SINCE THE LATE 80S: PARTICIPANTS, ASSETS AND PENSION PLANS' SUPPLY

Following Yermo's taxonomy (2002), all private pension plans in Spain are voluntary; individual system's plans necessarily provide defined contribution pensions while pension plans belonging to the employment and associate systems can be organized according to a defined contribution or a defined benefit scheme (also under a mixed scheme). As shown in the previous section, personal pension plans (either classified under the individual system or under the associate system) and occupational pension plans have been since 1987 regulated through different norms which in general can be described as a policy of "support and legislative encouragement" (Monereo and Fernández 2010: 174). This stimulus policy has been more evident under the center-right PP governments than under socialist governments, but in neither case it has been supported by a public discourse outrightly maintaining arguments in favour of the development of private pensions. Rather, Spanish governments have trusted on the economic rationality of taxpayers to develop the private pensions' market and increase savings for retirement. Although some institutions and experts have pleaded for a much more decisive role of private funds in pension provision, the pension debate in Spain has been centered around parametric reforms of the Social Security system. This central focus has to some extent crowded out the discussion about private pensions, even though their evolution has been looming over the pension debate whenever worries about the financial sustainability of the public pension system have got saliency in the public agenda.

As a matter of fact, the take-off phase of private pensions in Spain seemed to give some support to those expecting a rapid expansion of private pensions after the approval of the 1987 pension funds legislation: between 1989 and 1995, under the González' governments, the number of participants in pension funds grew from little more than 300 000 to nearly 1 800 000. But the

⁶ Law 46/2002 of December 18.

⁷ Royal Legislative Decree 1/2002 of November 29.

bulk of them (83%) had subscribed pension plans belonging to the individual system. In addition, accumulated assets showed a very modest evolution. At the end of 1995 assets of pension funds of the individual system and of the employment system were very similar, amounting each to ca. €6 billion. Funds included in the associate system had accumulated less than 0.4 billion €. Thus, the average investment made by a participant through one of the 379 individual pension plans existing by that time was slightly over €4000, while the average investment made by a participant through one of the 558 occupational pension plans amounted to ca. €26 000.

In the context of economic expansion and pushed by the growing fiscal incentives, pension participants rapidly grew from the end of the 90s until 2007, the individual system drawing the majority of new subscribers. Total pension fund assets approached at the end of 2007 €86 billion, but the average investment made by a participant of the then more than 1075 pension plans was not higher than €6360. True, participants in employment pension funds were more than seven times higher than in 1995, but still only represented 18% of all pension fund participants while their average investment was substantially lower than in that year (€17 500).

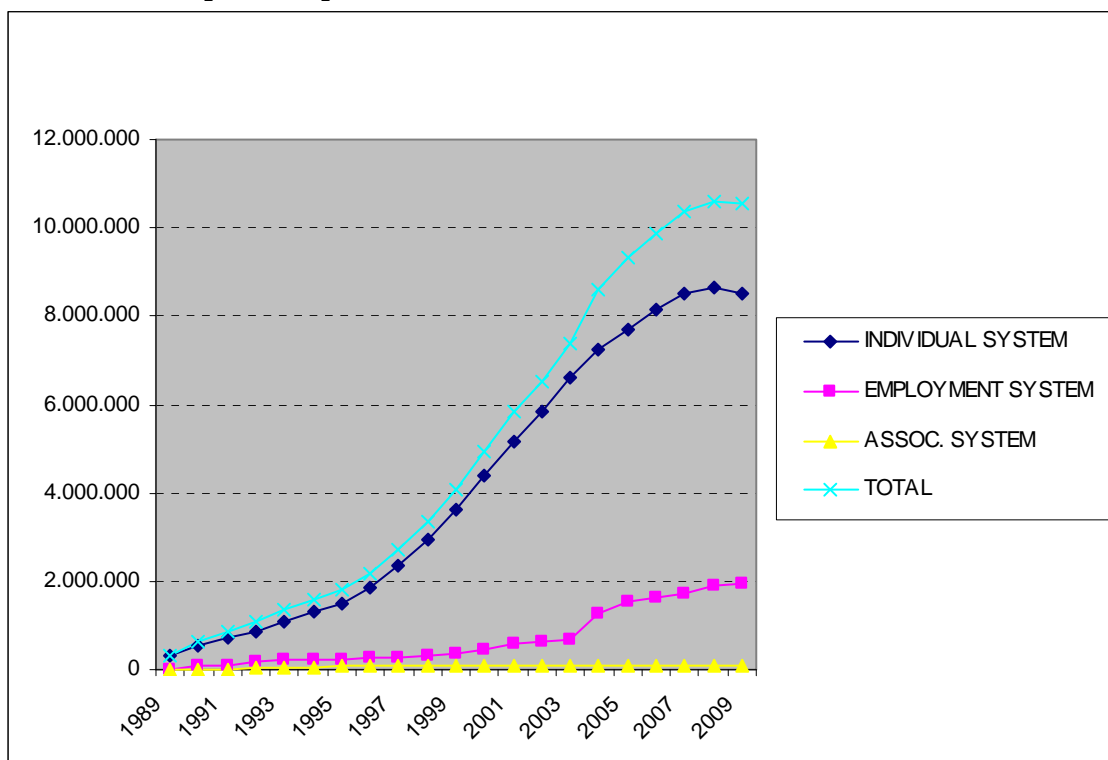
Economic recession following the financial crisis unleashed in 2007 has hit Spain very hard provoking rapid unemployment increase (up to 20% of the working population). For the first time in Spanish private pensions' history the number of participants in pension funds decreased in 2009. Pension funds of the individual system lost more than 120 000 participants in 2009; this suggests that many participants suffering unemployment opted for retrieving their investment (this option has been facilitated by the government). In contrast, occupational pension funds gained 45 000 participants. For their part, assets had already experienced a decrease in 2008 in all pension funds categories, but recovered in 2009 in line with the evidence of the increasing savings rate of Spanish families. Those drawbacks notwithstanding, the number of pension plans offered by financial entities and insurance companies has been steadily increasing. At the end of 2009 it reached nearly 3300. Still, assets were very concentrated: the ten biggest pension funds of the individual system and of the employment system accumulated in 2008 21% and 54% of assets respectively (Fernández and Bermejo 2009: 9).

The general picture of private pensions in Spain has been well described in the recent OECD report: "Although Spain's private pension system was established more than 20 years ago, it is one of the least developed in the OECD zone, and its accumulated assets represent only about 7% of GDP, well below the 60% average for the rest of the OECD. Private pension coverage, which extends to 54% of the working population, is relatively high in comparison with other countries. Yet participants' contributions are very low. Around 66% of participants contribute less than €300 a year" (OECD 2010: 13).

According to the same source, "the low-level of contributions to private pensions could also reflect the generous benefits offered by the public system". As I shall outline in the next section, the reasons of this scarce development may be more complex, including citizens' distrust in private pension provision as an adequate formula to reduce concerns about the future welfare of Spanish pensioners.

Charts 2, 3 and 4 show the evolution of pension funds during their two decades of existence in Spain.

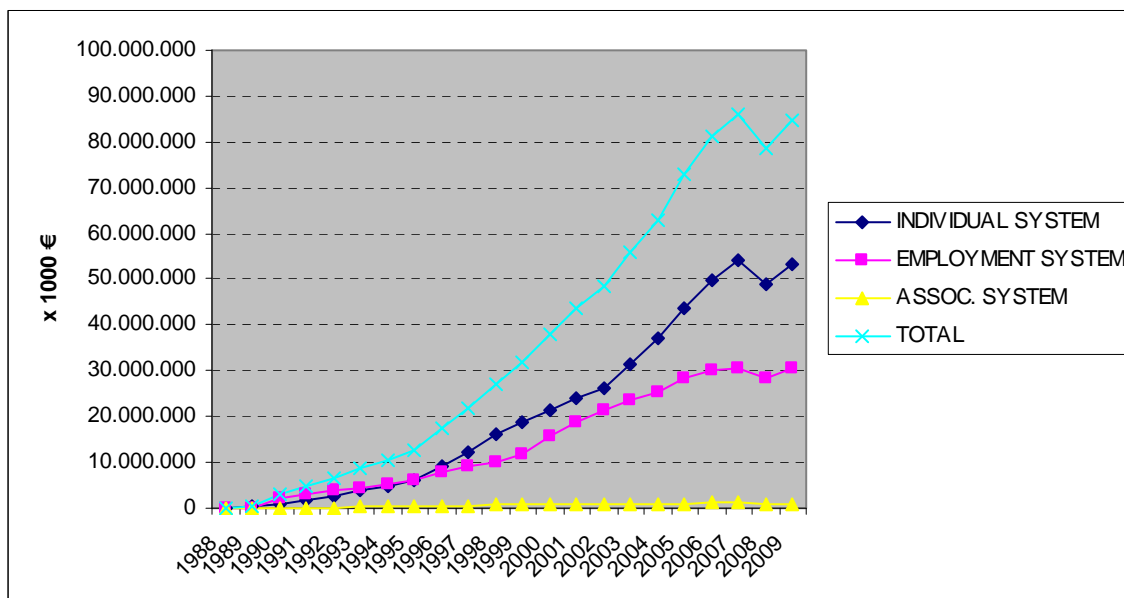
Chart 2 - Participants* in pension funds (1989-2009)



Source: Data provided by Inverco (<http://www.inverco.es>).

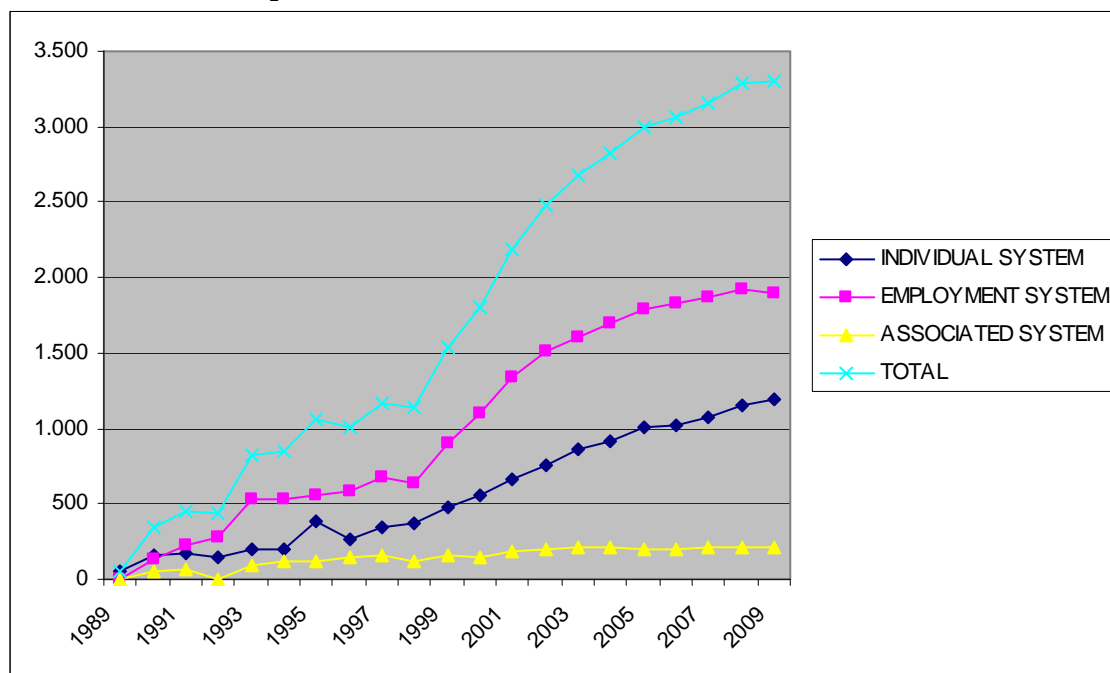
Note: Inverco, the private institution representing the interests of the collective investment institutions, uses the term “participants” in its statistics, although counting the number of contracts signed by them. In fact many participants have invested in more than one pension funds. Inverco estimated 8 million participants at the end of 2009.

Chart 3 – Assets in pension funds (1989-2009)



Source: Data provided by Inverco (<http://www.inverco.es>).

Chart 4 – Number of pension funds (1989-2009)



Source: Data provided by Inverco (<http://www.inverco.es>).

3. REASONS OF SOCIAL DISTRUST IN PRIVATE PENSION PROVISION

But how are we going to perform this bigger effort to provide for a longer retirement life? Private savings can be organized in schemes like the ones we have already developed, but that we should develop them further and protect them better because one of the consequences of this crisis is the spread of distrust among the citizenship in the financial system to contribute to this subject

These words were spoken by one of the leading Spanish experts on pensions, José Antonio Herce, in his intervention in the spring 2009 by invitation of the members of the parliamentary commission monitoring the arrangements of the Toledo Pact on pensions. Nevertheless the mentioned distrust may rest on factors which go beyond the crisis.

Thus, according to the findings of Fernández and Bermejo (2009) pension funds' returns have displayed a rather poor performance between 1991 and 2008. In fact, those returns have been in general lower than inflation and less profitable than bonds and shares. None of the pension plans of the individual system with at least 15 years of existence has displayed a higher rate of return than 10 year Spanish bonds. Only 2% of pension funds with at least 10 years of existence showed a higher return than the Madrid stock exchange general index. The bigger pension funds were not the most profitable ones. Quite to the contrary, the 10 pension plans within the individual system with higher rates of returns between 2003 and 2008 accumulated less than 1% of all assets. As regards the employment system, the 20 pension plans with higher rates of return during the same period accumulated less than 5% of assets. The authors explain this disappointing results from an economic point of view by stressing three factors: high commissions (particularly devoted to commercialization), portfolio composition (first and foremost the predominance of fixed interest investments) and active management (i.e. the ample room for manoeuvre of pension managers to allocate assets).

From a legal perspective, Monereo and Fernández (2010: 175) stress some circumstances that hamper the generalization of pension funds as saving mechanisms specifically designed to

supplement retirement benefits. Among those circumstances they mention the lack of a global policy encompassing the different instruments of voluntary social protection (and as a consequence the primarily strategic use of pension funds as a means of tax optimization) and the existence of some questions not properly solved by the legislator, especially affecting the employment system's pension funds.

Putting the different arguments mentioned by Fernández and Bermejo (2009) and by Monereo and Fernández (2010) together, it is not strange that private pensions in Spain are scarcely developed. But when explaining this evidence one should not underestimate another factor linked to the image and problem construction of private pensions in the public discourse. Political actors and mass media have never been very eager in the defense of private pension provision, thus coinciding with a principally suspicious public opinion towards financial institutions, and particularly banks (as opinion polls have repeatedly evidenced). Likewise the financial crisis and its hard economic consequences have intensified both tendencies. Facts and symbols have probably reinforced each other making more difficult to argue for the expansion of private pensions in Spain.

4. FINAL REMARKS

In January 2010 the Spanish government surprised political parties, interest groups and the public in general with an announcement of substantial pension reform consisting of an increase in the retirement age from 65 to 67 and the expansion of the working life period to calculate pension benefits. Both initiatives were in line with the OECD recommendations for Spain on pension reform (OECD 2010). Absent from the government discourse was another explicitly made recommendation of the OECD: the boost of private pension coverage.

In this paper I have tried to figure out some plausible reasons of such an absence. The evolution of pension funds in Spain suggests that those reasons are not grounded on the recent financial crisis, although the latter may have strengthened them. The perspectives of private pension provision in Spain do not only depend on the ability of political and financial actors to surmount the crisis and improve pension regulation and supervision, but also to develop a public discourse which persuades citizens of the advisability to privately save for retirement and presents private pensions as an adequate and safe instrument to achieve this aim.

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