

1. Executive Summary

Over ten years ago, *Círculo de Empresarios* presented a proposal for a transition from our current pension system to a capitalization plan. Since then, there certainly have been significant changes. At the economic level, until a few months ago, Spain has experienced the longest period of sustained growth in its recent history. We have also had an unexpected demographic boost from intense immigration. Related to these two phenomena, the increase in both the demand and supply of labor has led to a great increase in the number of contributors to the Social Security system, which has been posting surpluses and accumulating a large reserve fund.

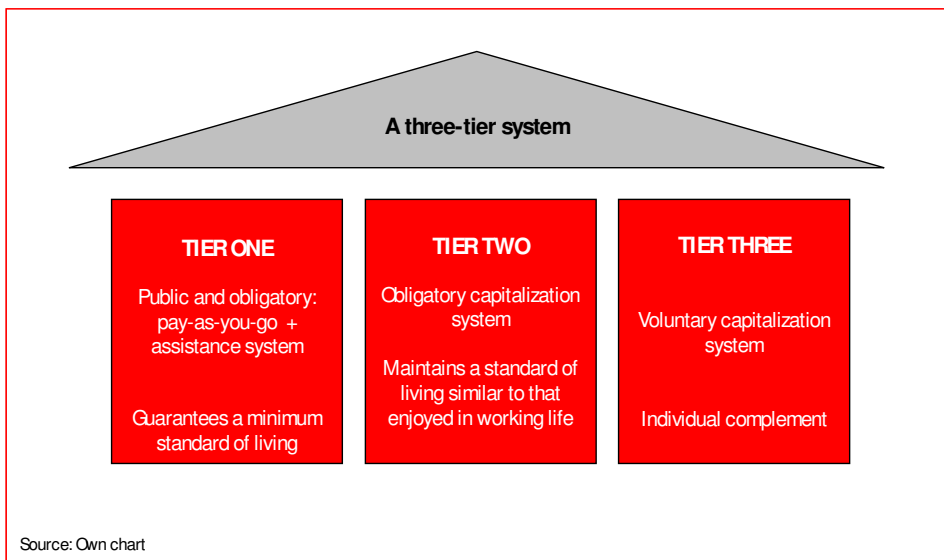
The combination of these factors has meant that the forecasts made a decade ago regarding the short-term situation of the Social Security system have not come to pass. However, the long-term problems predicted then can still reasonably be projected for the coming decades. Specifically, **the aging of the population is an unstoppable process that will manifest itself in Spain with greater intensity** than in the countries around us. This will put increasing pressure on the pension system: the dependency rates will rise steadily, increasing the percentage of pensioners and reducing the relative size of the working age population – those who contribute to the system. Even Spain's new immigrants, who in recent years have boosted the country's demographics, will add to this pressure since they belong to our biggest age groups, which are precisely the ones that will be retiring in 30 or 40 years.

We also have to keep in mind that **the economic boom that improved the Social Security's balance sheet has reached its end**. Spain's economy, now deep in a major recession, is shedding jobs at a rate unequalled in Europe and among developed countries. **In the past year alone, the number of active contributors to the Social Security system has dropped by nearly 7%**. The forecasts in this respect are quite pessimistic, so much so that different organizations put the **unemployment rate in Spain at 20% in 2010**. **Structural reforms must be made** to allow the Spanish economy to emerge stronger from the steep decline caused by imbalances that have been accumulating for years.

These reforms, **which will make the Spanish economy competitive, prosperous and a generator of employment**, are also necessary to strengthen the pension system. In this regard, those that do the most to **generate employment and boost productivity** are most important, in particular three areas that *Círculo de Empresarios* has already discussed in various publications: improvements to the **educational system**, a more flexible **labor market** and measures to **foster work-life balance**.

But, given the magnitude of the demographic challenges, this will not be enough. The financial solidity of the pension system requires the implementation of reforms to the system itself. This, in turn, requires a prior, broad, serious and considered debate on the current state of the pension system and the measures that could and should be taken. This is the right time for such a debate, since we are now in the midst of evaluating the Toledo Pact, an excellent opportunity to seek the broadest possible political and social consensus on the implementation of effective solutions to pension issues. Spanish society would do well to become more aware of the magnitude of these issues and the importance of personal responsibility in decisions on pension savings, taking the debate beyond the limits imposed to date by the Toledo Pact itself. We should all be aware that the pension system, in its current configuration, will not be able to meet the challenges it will face in the medium and long term. As a result, if reforms are not made, we will be faced with harsher contribution conditions or reduced pension amounts.

Based on these considerations, **the proposal presented here reaffirms the position that *Círculo de Empresarios* has expressed on several occasions: our pension system must develop capitalization plans, which today have a merely token role. The formula to do this may involve establishing a three-tier mixed system, with one part based on capitalization and another on a pay-as-you-go basis, as can be found in several countries: a system that would respond to the principles of justice and individual freedom, solid foundations on which it could evolve smoothly toward an increasingly advanced capitalization system, with the pay-as-you-go system remaining in place to guarantee a minimum income, as the figure below shows very well.**



These three tiers are described below. **The first two tiers would result from splitting the current public pay-as-you-go system into two parts. The first tier would focus on guaranteeing a minimum income** with basic pension benefits. It would function like a public pay-as-you-go

system, complemented by non-contributory pensions. **The second tier would be an obligatory capitalization system to which employers and workers would contribute** in the case of employees with income above a certain level. **The objective would be to bring a person's pension more in line with the standard of living they enjoyed during their working life.** The **third tier** would correspond to the current **voluntary system of contributions to pension plans and funds.** This would be encouraged through **tax incentives** aimed at enabling people to save up to build a complement to their pension benefits, if they wish to do this.

The pay-as-you-go part would also require changes aimed at making it financially stronger than it now is. It would be wise to introduce incentives to **extend working life** and to find **new formulas to calculate the benefit base** so as to include a bigger part of an individual's working life. Consideration should also be given to establishing **notional accounts** in order to shift from the current defined benefits system to a defined contributions system.

This reform, in the form considered here, is based on five basic principles:

- **Promoting personal responsibility** as a basic component to guarantee sufficient retirement benefits.
- **A system that guarantees freedom and justice.** A pension system must be based on the principles of **justice**, as well as individual freedom: Justice in terms of the burden carried by different generations, and justice in terms of protecting the less privileged. The system must aspire to a **balance** between both ideals: the freedom for each person to use his or her current savings capacity to make decisions affecting his or her future, while assisting persons with little or no savings capacity.
- **A simple system** that everyone can understand, one that clarifies the role of government, companies and workers.
- A system that **can be financed** and that does not have negative macroeconomic effects.
- A system that is **sustainable** and will not be a heavy burden in the future, and that is based on a broad, long-term social consensus.