Original Article

The reform of some European public pension systems: Spain, Italy and Sweden: A breakthrough?

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ABSTRACT European public pension systems were established as part of the welfare state in order to achieve a better distribution of wealth and equity among all the population. However, recent demographic changes, such as increased life expectancy and the ageing of the population, have questioned their viability. For this reason, their reform is necessary; in fact, some governments have already begun, whereas others have delayed, opting for complementary insurance systems such as pension plans, as these reforms can lead to major debates in society. This article aims to study the pension systems in three European countries: Spain, Italy and Sweden, and also the reforms that these countries have made or are trying to execute. Finally, we examine whether these proposals are able to solve the existing problems.

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INTRODUCTION

The creation of the Welfare States in Europe established the basis for the Social Security systems and, in turn, for the public pension systems.¹ The goal of the public systems was to provide a guaranteed income to citizens at the moment of retirement, in other words when they lost the capacity to generate income for themselves.

However, Western countries have for some time been experiencing a series of demographic and social changes: inversion of the population pyramid, increased life expectancy, ageing population, shorter working lives and longer retirement, which, along with the budget deficit of some countries, is jeopardising the delicate financial-economic situation of the public pension systems.

All these circumstances have led to the need for reform. Some countries, such as Sweden, have already undertaken reforms, whereas in others the issue has been delayed. An example

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of this is Spain, where, despite some modifications of the Toledo Pact (1995), further reform is still required.²

However, the issue of reform has created great controversy, as, although there are different alternatives, none of them seem to be entirely satisfactory. One possibility is a move from a disbursement method (also known as pay-as-you-go method, PAYG) to one of funded system (funded pension plans). Nevertheless, this step would involve great cost and cause uncertainty regarding the performance of the contributions made. Other proposals include replacing the current system of funding by way of contributions with one of funding through indirect taxation,³ although this would create losses of welfare for the generations affected at the moment of reform, whereas individuals would be somewhat better off in the long term.

Despite much discussion, over recent years different developed economies are undergoing a progressive trend towards replacing traditional Social Security systems and traditional defined benefit pension plans with ones with defined contributions.⁴ In this manner, workers finance their pensions without risking their future income, receiving only what they have accumulated during their working lives.

As a result of the current situation, some governments have promoted complementary social insurance systems using favourable fiscal measures when taking out specific financial investment and savings instruments such as pension plans.

Pension plans form a long-term private savings and insurance system that provides capital at the moment of retirement, as most people experience a drop in income following retirement. In this manner, the pension plans constitute a savings instrument in which individuals make regular or occasional contributions in order to, in the long term, build up capital that can be used to complement public pension at the moment of retirement.

For all the foregoing, in this work, we are going to review the different public and private pension systems, along with the reforms that have been carried out, in Spain, Italy and Sweden,

weighing up their consequences, benefits and drawbacks, and try to find a feasible solution to the current problem.

THE PUBLIC PENSION SYSTEM AND COMPLEMENTARY PENSION SYSTEMS

The Welfare State has abandoned some parts of the liberal theory of the State, in which it has a more active role, as it strives to achieve a situation of full employment and a Social Security system that covers the entire population, guaranteeing a minimum quality of life, based on the fundamentals of distribution and equity.

Although two models of the Welfare State, the European and the American, are often distinguished, the European model can in fact be broken down into four:

1. Nordic model, representative model of the following countries: Denmark, Norway, Iceland, Finland, Sweden and Holland.
2. Continental model: introduced in Austria, Belgium, France, Germany and Luxembourg.
3. Anglo-Saxon model: in Ireland and Great Britain.
4. Mediterranean model: in Greece, Italy, Portugal and Spain.

The Continental and Nordic models are similar, although the Continental model has a greater proportion of expenditure dedicated to pensions. On the other hand, the Anglo-Saxon model is the least generous for Social Security expenditure.

Finally, the Mediterranean model corresponds to the countries that implemented their Welfare State later on, in the 1970s and 1980s: it is a social model with less expenditure, based strongly on pensions.

Notwithstanding, all the European pension systems use the *Lovania approach*, known as the three pillars⁵:

First pillar: Constituted by the public system, obligatory, PAYG and with defined benefit pensions, guaranteeing a minimum pension level. The PAYG system is based on active workers paying for current pensions through their contributions. Each worker's pension depends

on the contributions made during his or her working life.

Second pillar. This is a labour regime financed by companies and workers, constituted by private and complementary regimes of occupational character. This pillar can be obligatory or voluntary, replacing or complementing the first, and of public or private character.

Third pillar. This is formed by the individual savings decisions of each individual, and therefore it has got private and voluntary character, of which personal pension plans are a clear exponent.

Hence, in summary, the first pillar includes the public Social Security system, whereas the second and third pillars are complementary social pension systems, of private character, in which personal and occupational pension plans are most notable.

The importance of each pillar varies from country to country: in those countries where the first pillar is highly developed, the other two are of complementary nature, and vice versa. For this reason, private pension funds and plans operate differently in accordance with the country, as they are marked by political decisions on fiscal and social matters. Pension funds and pension plans are the most developed instruments around the world for covering pensions, and in most cases complement the public pension.

PUBLIC AND PRIVATE PENSION SYSTEMS IN SPAIN

The Spanish public pension system, of obligatory character, is based on a PAYG system, namely an 'implicit, permanent intergenerational agreement by virtue of which workers will receive, in return for their contributions during their working lives, a pension paid for by those currently in work'.⁶ In other words, in a PAYG system, the contributions of active workers cover the pensions of retired persons at all times. Moreover, the Spanish Government is entrusted with the management of the entire process, with all excess being invested in a Reserve Fund.

In Spain, the retirement age is 65 years, it being necessary to have made national insurance contributions for at least 15 years, including the 2 years immediately before retirement.

In consequence, the Spanish Social Security pension system can be defined as 'the series of elements which give shape to all the resources related to the contingencies of retirement, invalidity, widowhood, orphanhood and family favour in society as a whole'.⁷

In this manner, the Spanish Social Security model presents four coverage options:

1. The first provides income to those workers who have made Social Security contributions, and is used to cover the contingencies of illness, accident, unemployment, family needs, incapacity, ageing and death, with the amount of the allowance depending on the time and significance of the contributions made. This protection modality is funded by the contributions of workers and/or employers, and is managed publicly.
2. The second pension is a non-contributory pension: there are also payments for people who have not made Social Security contributions, covering situations of invalidity, ageing, unemployment and family needs, although in this case the amount received is a fixed sum that does not depend on previous contributions; for this reason, they are financed by state contributions, that is, taxes.
3. The third coverage option covers universal allowances: health care and social services, guaranteed for all society, and funded by the State.
4. There is a final form of protection, which, unlike the foregoing, is of complementary character and managed by private initiative, represented by the Mutual Societies, Collective Life Insurance Group and Pension Funds.

As in other European countries, in Spain there are doubts with regard to the viability of the public system, leading to several legislative items being introduced over recent years. Two of these are Legislative Royal Decree 16/2001 and Act 35/2002, which aim to make the system more flexible⁸ by allowing the possibility to extend working life or to combine part-time work with partial retirement.

Moreover, in 2007, Act 40/2007 was passed, with a view to adapting legislation to new habits

and social needs.⁹ The most significant part of this Act is the introduction of measures that encourage the extension of working life and the reduction of early retirement. Specifically, it stipulates that entitlement to a pension shall be based solely on the effective number of days for which contributions have been made, with extraordinary payments being disregarded. Moreover, in order to encourage the voluntary extension of working life, following ordinary retirement age, a two percent pension increase was established for each year of contributions after the age of 65 years.

However, these reforms are not sufficient, as the Spanish Social Security system will have to confront the challenges resulting from the current economic crisis.¹⁰

As a consequence of the current situation, in February 2010 the Spanish Government proposed reforming current legislation on pensions, which has led to much public debate and scrutiny.

This proposal envisages calculating pensions on more years of salary, or on a longer period of contributions, while at the same time putting back the effective age of retirement, reducing early retirement and creating incentives for voluntary deferment of retirement. Moreover, extending the retirement age by 2 years, from 65 to 67 years, has been suggested.

Clearly, the purpose of this reform is to maintain the current Social Security system in the medium term, given that as of 2025 the cost of paying out pensions will be greater than the income received from worker contributions, although, thanks to the Reserve Fund, which it is estimated will have provisions of around 28 per cent of Gross Domestic Product in 2027, the Social Security system will not show a deficit until 2029. Moreover, expenditure on pensions could reach 14.48 per cent of Gross Domestic Product in 2048, with a deficit of 4.19 per cent in 2060.¹¹

The proposal to extend the period to calculate pensions at the moment of retirement would involve an average reduction of 15 per cent in the amount of new pensions, although it would also reduce the deficit of the system to 1.15 times the Gross Domestic Product in 2050, down from

1.83, which is the forecast should the current system continue.¹²

On the other hand, increasing the contributions period by encouraging people to work beyond the age of 65 years would be justified as the average age for starting work increased by 6 years between 1940 and 1986, from 14 to 20 years, respectively. This difference would justify putting back the age of retirement by 6 years for those now aged 20 years, who would have to retire at the age of 71 years in order to remain for the same period of time on the employment market.¹³

However, there are other initiatives, independent of those proposed by the Government, such as complementing the PAYG system with a funded system, in order to create a more efficient model, although this would not be optimum as it would involve multiple sources, because income could be adapted more to economic and demographic evolution. However, this proposal would generate high initial costs, for example the total transfer from a PAYG system to a funded system in Chile cost the State the equivalent of 8 per cent of GDP.¹⁴ It is also true that administration costs in private systems are often greater than in public systems, and indeed international private insurance experience shows that it has been of greater benefit to financial capital (banking entities) than to beneficiaries, meaning that total privatisation would not be beneficial for the system.

In addition, delaying retirement in fact involves an increase in regressive taxes, as life expectancy is shorter when income is lower, meaning that the workers who live shorter lives would be financing the larger income pensions of those who live longer.¹⁵ This explains the large level of resistance to this measure among the population.

In this manner, as we have indicated at the start of the work, the reform of the public pension system is a highly complex issue that brings about opposing positions. Other studies indicate that, even if pensions were calculated as a mean of the entire working life, this would only delay the appearance of the deficit for around 4 years and would prolong compensation capacity by around 6 years (up to some point

between 2024 and 2030). Moreover, the measure that involves prolonging working life up to the age of 70 years would only delay the appearance of the deficit by 17 years, and the Reserve Fund would cover expenditure up to at least 2046.¹⁵

Viewed globally, this reform would not be sufficient to significantly prevent imbalances, and, moreover, pensioners' amounts would be considerably reduced.

In addition, other calculations and predictions indicate the possible viability of the public system, because of the integration of women and immigrants in the labour market.¹⁶

In conclusion, it can be seen that thus far the possible solutions are not complete, as some only solve the problem provisionally and involve a series of negative repercussions on a social level.

With regard to the private system, this has been adopted as a complement to public pensions, with pension plans being the most representative product,¹⁷ even though these were not introduced in Spain until 1988 by way of Act 8/1987; this was somewhat later than in other countries such as the United Kingdom and Germany, where it had been shown that they helped in the development of capital markets.^{18,19} These are currently governed by the following two basic regulations:

- Legislative Royal Decree 1/2002, of 29th November, the Consolidated Text of the Pension Plans and Pension Funds Regulatory Act.
- Royal Decree 304/2004, of 20th February, which passes a new Pension Plans and Pension Funds Regulation, which complements the Consolidated Text of the Act.

Moreover, the government has tried to promote this type of investments through fiscal benefits, as set out in Royal Decree 439/2007. Indeed, these products have experienced continuous growth right from their creation, exceeding 3300 pension plans in 2009, involving more than ten and a half million participants and an investment of over 84700 million euros.

PUBLIC AND PRIVATE PENSION SYSTEMS IN ITALY

In Italy, public pensions are also based on a PAYG system, although in this case they are characterised by generous public pensions, with little development of private systems. A series of reforms was implemented during the 1990s, in order to tackle a series of problems inherent in the previous system. Below, we summarise the most important changes carried out in each one of the reforms.

First, in 1992, Act 421/1992 and Act 124/1993 introduced an increase in the retirement age for men (from 60 to 65 years) and women (from 55 to 60 years). Moreover, the minimum number of years of contributions necessary for early retirement was increased from 15 to 20 years.

In 1993, Act 537/1993 set out an economic penalty on pensions, removing the years of least contribution in the calculation of the pension. These measures clearly aimed to reduce public expenditure. Moreover, in 1995, Act 335/1995 introduced the 'contributive' method to calculate pensions, allowing a flexible retirement age (57–65 years). In 1997, Act 449/1997 temporarily froze pensions and increased the national contribution percentage for self-employed workers.

Of all these reforms, it is the 1995 reform that brought about the greatest reduction in expenditure on pensions. Moreover, it is notable for the introduction of a mixed system, which is in part PAYG and in part a funded system, placing emphasis on complementary social insurance systems. However, this system is not fully developed, as the complementary social insurance measures have experienced something of a regression.

All these modifications have not only helped to bring expenditure on pensions under control and balance Italian public finances, but have also brought about a significant decrease in the levels of social coverage. The result is that, with equality of national insurance contributions over 40 years, 80 per cent of the last retribution received by the worker before retirement will no longer be received, but rather a significantly lower amount, around 50 per cent.

Globally, this series of reforms has not fully eradicated the distribution distortions in the system, but has improved the structural conditions and the institutional mechanisms to balance public expenditure, although it is true that at the end of the 1990s, Italy still had one of the largest ratios of pension expenditure on GDP in the European Community. Moreover, the reforms placed emphasis on early retirement, and were unable to distinguish between the diverse regional situations of different Italian nuclei (differences between the richer north and the south, which has traditionally suffered from slow economic development), and this in turn has brought about a reduction in the level of well-being for many people, and in some cases has placed a burden on the efficiency of the production system.

As a result of this deficiency, in 2008, the *Delega Act* finally established the retirement age at 65 years for men and 60 years for women who have completed at least 40 years of national insurance contributions (compared to 35 years previously). In this manner, anybody who wishes to retire before completing 40 years of contributions may do so, but will receive a pension based entirely on the contributions paid up until this moment.

Moreover, the Italian government envisages, in the long term, gradually and completely replacing the public PAYG pensions system with a private funded system, based on pension funds. However, this is not an easy task, as both systems present benefits and drawbacks. The drawbacks of the funded system include uncertainty regarding the performance of the contributions made, as part of the investment depends on the evolution of the financial markets, whereas the performance of the PAYG pension system depends on the progress of the economic system, that is, on increases in the number of people employed and mean income. The advantages of the funded system include higher returns, although the risk factor is much greater because of the constant uncertainty regarding the evolution of the financial markets and economic growth.

Moreover, the development of the complementary system involves costs both to the worker and to the company, as the worker renounces an effective, secure retributive sum, and the company

has to regularly guarantee resources that were previously only available at the cessation of the labour relationship. In order to resolve this situation, the government has reduced obligatory contributions for new employees.

Finally, the Italian Government has chosen a mixed system, to access advantages of two systems: first, the PAYG system is not secure in the long term, although it does guarantee the redistributive function, whereas the private funded systems offer higher income but do not offer solidarity and redistribution among the entire population. Hence, it can be seen that the government will have to continue to improve the current system and carry out reforms in the future.

As a result of these changes, investment in private pension plans has experienced significant progress over recent years, indeed investment has grown from 12 000 million euros in 1997 to over 60 000 million euros in 2009.

By way of conclusion, we can state that the reforms have partially improved the situation of the public funds, although they have also led to the development of private systems (pension plans), obliging the population to save in the long term in order to complement their public pension.

SWEDEN, AN EXAMPLE OF PARTIAL PRIVATISATION

Sweden was the first country in the world to pass a National Pensions Act, in 1913, guaranteeing universal coverage for all citizens aged over 67 years. Moreover, in the 1990s, Sweden was one of the pioneering countries in terms of reforming the public pension system, as the demographic changes experienced by the population jeopardised its future viability. In this manner, in 1994, the Swedish Parliament (*Riksdag*) decided to reform the system, opting for partial privatisation, which came into force in 1999.

The Swedish pension system is currently made up of three components: national retirement pension, occupational pension and voluntary pension. Focusing on the national system, this is divided into:

1. Income pensions: workers set aside 16 per cent of their income to financing the current retirement pensions.

2. Premium pensions are additional and obligatory, with workers being obliged to set aside 2.5 per cent of their income to a pension fund of their choice.

In this manner, workers' contributions total 18.5 per cent of their income, and hence the system is characterised by its partial privatisation, as part of the contribution made is destined to the worker's own retirement, and not only to the payment of current retirement pensions.

3. Guaranteed pensions are a minimum pension for those people who do not have an income pension, or whose income pension is very small. These are funded through taxation.

As a result of this, pension plans are the most widely used savings instrument in Sweden, with investment reaching over 140 000 million euros in 2008.

It can be seen that, of the countries analysed, Sweden was the pioneer in carrying out a reform of the pension system, opting for a mixed system, which so far has proven to work well.

CONCLUSIONS

Throughout this article, it has been shown that there are different public pension systems, although in all of them there is a clear need for complementary social systems to supplement public pensions, as the income provided by the pension is lower than that received during working life. Moreover, there is currently much discussion on the possibility of public pension systems not being viable in the future as a result of demographic changes, a situation that has led to reforms of the public systems, reducing expenditure and, in some cases, promoting private products, most notably pension plans or mixed systems such as those found in Sweden and, in part, in Italy. With regard to Spain, extensive reforms have not yet taken place, although the aim is certainly to introduce new modifications that will place emphasis on the duration of working life and the reduction of early retirement, in order to reduce public expenditure. However, it is still too soon to say whether these reforms will be sufficient to guarantee the viability of the system, or whether

greater privatisation of the system is the correct solution, since this, as we have seen, also has inherent risks.

Moreover, the existence of these reforms has led to greater investment in pension plans. However, it should be emphasised that the importance of these products is not the same in all countries, because, as seen throughout the study, the amount invested varies not only in accordance with the financial culture of each country but also with the public pension model in place. For this reason, these products can currently be considered as a complement of public pensions.

Moreover, as we have seen, the effectiveness of the reforms carried out in each country depends in part on the characteristics of the labour market, and also on structural aspects and the way in which they are implemented. For all the foregoing, governments need to continue to work on this matter, guaranteeing the principles of redistribution of wealth and equity among the entire population, as established in welfare systems, ensuring that the entire working population can have access to a pension in the future, and that this will not be replaced with a private system. However, it should be emphasised that society as a whole needs to be conscious of the current situation, with people taking out, either individually or through their company, private pension plans that will provide an additional resource to complement the public pension.

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