

This issue of *Ekonomiaz* sets out to analyse what role is and should be played by supplementary pensions, especially employment or workplace pensions, in shoring are reasonable, dignified standard of living in retirement.

Such an analysis of complementary funded pensions (CFP) is relevant and timely for two reasons: first, because it is the only remedy available at present for covering the shortfall left by public pension systems; and second, because the Autonomous Community of the Basque Country has broad powers and scope for action in this field.

In regard to the first of these points, over 15 years of European coordination with a view to generating pensions which are adequate, financially sustainable and secure for citizens can be summed up in two major lines of action: increasing the participation of older people in work by raising the real age of retirement, and generalising the use of capitalised supplementary pensions to a greater or lesser extent. The severity of the current crisis, especially for the public coffers of «periphery» countries such as our own, with highly precise calendars for reforms and aid, has led to attention being directed mainly at the first point.

Indeed, it can be said the elderly are not so much being encouraged to remain in employment as having their pension expectations directly reduced as a measure for improving the outlook of public finances; furthermore, since the reforms introduced are gradual and forward-looking, they do not produce an immediate fall in consumer spending.

In any event, matters are becoming clearer, with professional quantifications at least, since there are now prospects and legal provisions that enable a fairly precise estimate to be drawn up of the fall in public pension coverage as a proportion of wages. In this context we believe that it makes little sense to continue arguing about and denying the effects of the demographic transition on pensions. Under the latest change in social security regulations, economic growth and employment will directly influence pension updates, and it seems clear that the Social Security system will no longer take increasing life expectancy into account, all of which implies lower pensions.

We therefore believe that the outlook is clearer and that we find ourselves facing scenarios in which decisions must be made concerning CFP. Three major issues stand out.

The first is structural, and has to do with the nature of CFP. As stated recently by the UK *Office of Fair Trading*⁷, supplementary pensions are characterised by a demand that has very weak bargaining power due to its lack of size, knowledge, dedication, etc., and furthermore constitute a highly complex product whose virtues and shortcomings it will be impossible to determine until many years after its implementation.

The second issue is this: in spite of immediate financial priorities, best practices in CFP must acquire a stronger presence on the political, social, entrepreneurial and trade union agendas in the coming months. Thus, the European White Paper on Pensions, two years after its publication, is currently at a stage in which the measures proposed are beginning to take shape, or is at least heading into a more specific phase. By the end of this year we may have codes of good practices in workplace or even individual pensions; discussions have also begun concerning the most effective ways of promoting CFP, an issue on which the OECD and the European Union are working jointly.

Some degree of debate is also ongoing in Spain concerning the situation and the possibilities for promoting CFP. This debate is being coordinated by the Directorate General for Insurance, and was instigated with a view to submitting a report to the Toledo Pact. This should have been done by the summer of 2013, but the report has been shelved on grounds of timing. This may be true, or it may simply be that the political capacity required to continue with the process was lacking. In any event, both these potential reasons support the argument that the key points of CFP as regards the need to specify objectives and instruments should occupy a more prominent place on the political agenda.

The third and final issue is exactly how things should be done. In regard to pensions, several of the articles published in this issue agree that the main problem is not what must be done but how to go about it. Pensions have a life cycle which means that they begin with bad news, implying the making of contributions, saving and consuming less; on the other hand they do not coincide at all with the political cycle. Both these facts hinder or prevent reform processes.

The fact is that for CFP to be implemented on a widespread scale efficient, comprehensive collective bargaining or firm public sector intervention is required. It is not enough to give the public diagnostic studies and openness in information

⁷ «Defined contribution workplace pension market study» (2013/2014) Office of Fair Trading. <http://www.of.gov.uk/OFTwork/markets-work/pensions/>

(as regards cuts): they must be given specific solutions that clearly offer good conditions as regards access, efficiency, cost and the suitability of provisions.

The prospects are not good on the collective bargaining side, and the track record suggests that if that trend is bucked it will be only exceptionally and in the distant future. It looks, therefore as if public sector intervention measures must be resorted to, given that they are producing results in benchmark countries such as the UK and Germany. However, we do not have a great local history in this regard either, and that makes the shelving of the debate on CFP in Madrid all the more worrying.

Nevertheless, as indicated above, the Basque Country has other resources in this field: it cannot avoid the public sector cuts decided by the central government, but it does have powers, resources and a body of experience that is not without its success stories in the field of supplementary welfare provisions.

In the first place, it has its own regulatory framework, and holds exclusive authority in matters of social welfare, although in this it is often hindered by the central government. It also has a diagnostic study already drawn up in the form of the Basque Supplementary Provision Plan (Plan de Previsión Complementaria de Euskadi) of 2006, which events and demographic trends have shown to be on the right lines.

As a result of all this, the Basque government has legislation in place that establishes certain «preferential» organisations with a view to offering an efficient, across-the-board solution as mentioned above. Finally, it also has the powers of taxation required to promote the type of firm, public sector intervention already implemented by other countries. In short, the Basque Country has no need to wait for the central government to move forward on matters of supplementary pension provision. EU directives and experiences are clear and sufficient, strategic reflection and highly positive experiences already exist, and the required regulatory and fiscal powers are in place.

This monographic issue of *Ekonomiaz* seeks to contribute to the debate and to the process of developing «social technology» capable of setting up an effective, general solution to the problem of reductions in public pensions. In other words, the debate needs to answer the questions posed in several of the articles published here, which are highly consistent with the Basque CFP Plan of 2006. Those questions are basic and quite simple, but hard to answer clearly because of the consequences that they entail. They can be summed up as follows:

- Is it necessary for a large majority of workers to have significant CFP to maintain their standard of living in retirement?
- Is it acknowledged that the current system, with all the financial interest that it has generated (which runs into hundreds of millions of euros per year in

commissions) is incapable of meeting the challenge and needs a thorough overhaul?

- Is the workplace system the only one capable of offering the widespread social coverage and financial efficiency required to meet the challenge posed by reforming the Social Security system?
- Does CFP need to be widespread in SMEs and in the service sector, taking into account the low level of development in Bizkaia and Alava, where there is still a great deal left to do?
- Is it necessary to adhere to clear, firm implementation strategies with precisely marked targets along the lines followed in Australia, New Zealand, the UK and Germany, as promoted by the OECD in view of the fact that after more than 25 years and billions of euros of tax expenditure the current, voluntary system of soft incentives or «accompaniment» is still far from attaining not just desirable but necessary levels of implementation and efficient operation?

All this is not as conceptually complex as it may appear. Germany is a case in point: the conclusion has simply been reached that its citizens need to save a minimum of 4% of their wages, i.e. a little over 2000 per annum. Incentives have been set in place with this specific goal in mind, along with the means for attaining it simply and efficiently through payrolls.

The science of behavioural economics has made great strides in recent years, and there is now more experience, so it is known with a fair degree of certainty how people are likely to behave when faced with certain systems, options (usually default options) and incentives. In short, it is known what works and what does not work in CFP. The matter is now in the hands of the regulators, with whom social actors will hopefully join forces.

The Basque CFP plan has addressed many of these basic issues, which have not yet been clarified by the central Spanish government, though in view of the actions taken and the results (or lack of results) obtained it seems that the matter of pensions has not been given sufficient importance or priority. The plan was set up to be instrumented via collective bargaining. However, this has proved a failure not just because of the crisis and the generally negative employment situation but also because the social actors seem not to have been convinced by the plan: indeed they made their lack of conviction known when the plan was approved.

The Plan therefore has yet to be turned into a clear, powerful national strategy. It is based on the «preferential» provident societies (known as EPSV) mentioned above and enshrined in the Basque regulations, but suffers from a total lack of practical, specific provisions concerned with how it is to be promoted politically, socially and fiscally.

To help answer the questions listed above, and particularly to demonstrate that technically efficient, socially viable, acceptable solutions do exist, the articles in this issue are grouped into three progressive areas.

In the first a general overview is given of the prospects and needs for coverage and of the main strategic lines possible, and the various policy options available are outlined.

The articles in the second group analyse the current situation and assess specific positions and experiences based on the implementation of CFP in the Basque Country and the associated legal framework, but with reference also to the positions being taken in Spain as a whole, in Europe and around the world.

The third group comprises more technical articles, which deal with the main design issues involved in making CFP into the efficient instrument that is needed. They also examine the links between financial activity and investment and the social environment in which provisions must operate, taking into account recent debates sparked largely by the crisis concerning other responsibilities of institutional investors apart from paying pensions.

The article by **Diego Valero** on the outlook for the Social Security system and the role of CFP examines the pension system in Spain, looking at both the public system and the supplementary private system. He analyses the process of reform in the public sector from an overall perspective, and finds that it is focused on sustainability, which may be detrimental to the suitability and sufficiency of the system. He sustains that suitability and sufficiency can be palliated by developing supplementary pension systems if those systems can play the role assigned to them in social protection.

The public system is an essential reference point in Spain due to its weight in the economy. The article looks at the reforms of 2011, in which retirement age was raised to 67, and the background to the most recent reforms in regard to sustainability. This last reform establishes a review and updating of pensions depending on to elements, so that pensions are linked with generational life expectancy and with balancing the income and outgoings of the system⁸.

This reform guarantees the financial sustainability of the social security system, but it does so by simply undertaking to pay pensions according to the resources available. The main conclusion that can be drawn from this, although matters will always depend on future events, is that pensions will account for a smaller proportion of wages.

⁸ Report of the Committee of Experts on the sustainability factor of the public pension system. See www.lamoncloa.gob.es/NR/.../informesostenibilidadpensiones.pdf

To offset this, the article examines the main options for the development of CFP, from a compulsory system to the increasing of incentives for voluntary provisions. In this regard, mention is made of the debate that is currently ongoing throughout Spain as a result of the legal mandate of the Directorate General for Insurance. The preliminary documents show a considerable deficit in CFP and a need to promote the system in the workplace.

In this regard, given that without a reform of the constitution there is no way of introducing compulsory supplementary systems into the workplace in Spain, the proven insufficiency of the fiscal measures taken and the low level of implementation that has resulted from collective bargaining, the only remaining option (and one that has been thoroughly tested here) is soft compulsion, with low level expenses and incentives aimed at those who find it most difficult to save.

Jon Aramburu and **Toni Canals** present their ideas on the development of CFP in Spain as a whole. They estimate CFP does not need to be extended among high wage earners, as they already have such provisions in place or have other ways of saving. However, less than 30% of those earning between € 12,000 and € 60,000 make contributions to a supplementary system, and total contributions from these white brackets account for little more than 1% of their taxable base. It is on this group that targets and concerns must be focused.

They therefore conclude that the current form and level of development of CFP in Spain do not now and never will represent any significant, relevant support for public pensions or for raising the age of retirement. They are and will continue to be a niche product for high income earners in terms of how widespread they are and how much money they involve.

There are also problems of efficiency (not just profitability). These problems are structural in the individual level supplementary provisions that currently account for most CFP. The authors therefore consider that if it is intended for CFP to play a significant role in supporting the Social Security system, its approach and objectives must be changed entirely and redirected towards average wage earners, with incentives focusing on average and low incomes. To judge from experience in other countries, significant, widespread supplementary coverage can only be obtained by the widespread implementation of workplace systems.

In regard to whether these proposals are timely in the context of the current crisis, the authors assert that whatever strategy for generalising workplace CFP is implemented, significant additional contributions will only be made from 2018/2020 onwards. No immediate economic effort is therefore involved, so the current crisis should not be used as an excuse for shelving the debate.

On the other hand, they believe that the main issue does not lie in technical points, since there are plenty of successful experiences around the world and many

fiscal, regulatory, administrative, economic and social instruments available to the public authorities and social actors.

Clara Izurieta and **Iñaki Zabala** examine how widespread CFP is in the Basque Country and whether it is sufficient. It was these authors who drew up the *Basque Supplementary Welfare Plan* (Plan de Previsión Complementaria de Euskadi) of 2006 for the public authorities; now they assess the objectives set in that plan. Specifically, it was intended that 70% of those in work should generate supplementary pensions to the tune of at least 20% of their earnings from work or professional/entrepreneurial activities.

This target has turned out to be quite consistent with the current perspective of the Social Security system. The report by the commission of experts on the sustainability factor that has come into force in the Social Security system states that the downward adjustment in provisions due to increases in life expectancy will be 20% over 40 years. However, in their day the forecasts in the Plan were criticised or ignored, and they have not therefore been prioritised in collective bargaining agendas.

The assessment of objectives is based on information from three sources: data provided by the sector itself, information from the Basque provincial treasury departments, especially that of Bizkaia, and data from the Basque government's new DEC (Statistical Account Information application). Specifically, the DEC data, especially those on risk profiles, expenses and commissions, enable the necessary more accurate assessments to be made in regard to a large group which makes significant contributions to the individual system.

The authors conclude with an estimate that only around 30% of the target figure of 70% of workers are actually in a position to meet the target, either because they have a good workplace system or because they combine the two systems. A further 30% will miss the target by a long way, but will still make significant contributions to supplementary social welfare provisions. The remaining 40% have no significant CFP. In short, we are a long way from meeting the target of having 70% of workers with significant supplementary coverage, for reasons attributable not to a lack of contributions or incentives but to the system itself.

The DEC also enables behaviour to be analysed by age groups. This confirms that people begin to make contributions to individual systems relatively late, that their contributions are low at the outset, and that the theoretical risk profiles are not consistent with age.

The article by **Luis Carlos Izquierdo** recounts how the Basque social welfare system came into being, how it has been updated and what major challenges it faces if a system supplementary to the public social welfare system is to be constructed in such a way as to gain the confidence and reassurance of beneficiaries.

The story begins with the devolution of authority to the Autonomous Community of the Basque Country and the subsequent EPSV (Voluntary Provident Societies) Act of 1981. With the support of social actors in its early years and special tax treatment, the resulting framework consolidated the basis for a supplementary system in which 30% of Basque residents enrolled in the course of the 30 years for which it was in force, up to its recent repeal.

A unique feature of the Basque system is that it contains practically the only sectoral systems with significant coverage for both large groups and SMEs. In any event, an analysis of the circumstances of the average Basque resident reveals that supplementary provisions are still not sufficiently widespread among middle and low income earners, who are unable to save much. This assessment, along with the evidence that CFP was failing to reach SMEs (with the exception of Geroa EPSV) led to the decision to draw up the *Basque Supplementary Welfare Plan*.

This article outlines the measures that have been implemented in the 7 years since the Plan was approved, including degrees awarding aid for the setting up of EPSV, the decree that updated the regulations governing their operation and activities in 2007, an order establishing the qualifications required of members of their governing boards, an order in 2009 concerning certain investments and forward accounting, the Accounting Decree of 2010 and the new EPSV Act of 2012.

A stand-out point in the new Act is its creation of «preferential» EPSV with reinforced social characteristics, such as the principle of non-discrimination, a more targeted approach, shared contributions and collection in the form of income. These organisations were set up to facilitate the spread of sufficient, adequate supplementary pension coverage on optimal terms and conditions.

The article ends with a far-reaching proposal for reforms and improvements. It points out that the latest fiscal reform basically seeks to save on taxes by lowering the maximum limits on the taxable base for contributions to supplementary provisions, but as yet there has been no reform to encourage, promote and extend the use of CFP. The 2006 Plan itself made mention of some of these potential modifications. To supplement the pensions of the vast majority of the population of medium and low wage earners via workplace systems, there is a need to increase tax aid at medium income levels, rationalising and redistributing the cost for the provincial treasury departments⁹. Among other options assessed, the article proposes that a reasonable part of the taxable base reduction should be reserved for workplace systems, and within that category for preferential systems.

The article by **Juan Yermo** of the OECD deals with public policy options for promoting CFP. In his initial general assessment the supplementary role of

⁹ This is very much in line with the subsequent proposals put forward by the OECD which are currently being developed jointly with the EU.

capitalised private pensions is of prime importance, given that the substitution rate with regard to the apportionment-type public system is expected to fall to the point where significant losses of quality-of-life may ensue for retired persons. This is happening in most OECD countries. Although the theoretical coverage rates in Spain are high (up to €30,000 per annum) a highly significant fall can also be expected.

A comparison with the various capitalised supplementary systems in place in OECD countries reveals that the highest enrolment (defined as the number of persons enrolled for a private pension plan) are found in countries where private pension plans are compulsory or quasi-compulsory, including auto-enrolment systems. In those countries where private pension schemes are voluntary, the coverage rates observed range between 13% and 50% of the working-age population, compared to rates of 70% or more for compulsory systems.

The article looks basically at the experience gained in Italy, New Zealand and Germany, and ends by discussing expenses and commissions and the right financial profiles.

The article in English by **Matti Leppälä** presents his thoughts on experiences in and ways of extending accession to and coverage of supplementary pension systems.

In his initial diagnosis he coincides with the Basque Plan, the OECD and the sustainability factor committee in his expectation that the ratio of public pensions to wages in Europe will drop by 20% by 2060. He therefore believes that people will be unable to maintain their standard of living after retirement, and may even fall below the poverty line if they do not have additional savings.

He believes that workplace pensions are the key to ensuring that supplementary pensions achieve a good level of coverage, since they can be extended much more widely than individual schemes and, if they are properly managed, can offer greater benefits thanks to cost efficiency and economies of scale.

Different countries have used different systems and combinations of systems to increase the number of people enrolled in workplace pension schemes, including compulsory schemes, auto-enrolment, tax incentives, collective bargaining, incentives for employers, etc. He considers collective bargaining systems with quasi-compulsory enrolment and default option and enrolment systems such as NEST in the UK to be preferable. He also considers that if Prudential or other requirements become too burdensome (doubtless a reference to Solvency II) then this type of supplementary pensions may be discouraged and enrolment rates could fall.

He considers that much can be done to increase the coverage of workplace pension schemes, but that unfortunately there have also been significant changes and retreats in occupational pension policies in some countries in recent years,

especially in the Central and Eastern European countries due to reasons of budget consolidation caused by the crisis.

The article by **Jon Aldecoa**, examines social and fiduciary responsibility in investments in capitalised pension systems and their links with the real economy.

The article begins by analysing the duties of loyalty and professionalism of payroll and pension system managers. The considerable body of law and doctrine on this matter leads him to conclude that organisations can also meet the social, environmental and corporate governance priorities of their members and of society (ISR policy), especially when they have financial repercussions, albeit in the long run. There is also a need to cater for social acceptance of pension systems that normally have a special fiscal, corporate and legal framework. They must therefore be sufficiently skilled to handle that special status as institutional investors. The crisis and malpractice by many managers have made it clear that shareholders cannot be mere passive observers but must exercise control over the managers of the firms that they own.

When implementing this ISR policy, there are three main areas that must be taken into account: setting the environmental, social and good governance (ESG) objectives of the policy, its strategies and its implementation. In regard to strategies, a distinction must be drawn between investments to be avoided and investments to be encouraged. The former require a negative or «exclusion» filter, while the latter require a positive or «integration» filter on investments. Moreover, organisations or funds have the option of involving themselves in the firms in which they invest, usually to modify their behaviour or activities without disinvesting, or at least before doing so. The article also discusses somatic investments in ESG aspects, which are one of the options for integration, albeit a complex one.

Investment in infrastructure is the most common form of actual investment at present within the financial needs of pension systems. The article explains the special characteristics of assets of this type, and asserts that they may be a sub-class compared to variable income, fixed income and venture capital products. In this context, the author explains the institutional schemes currently underway, and those originating from the OECD, the G-30 and now also from the European Commission.

Finally, a number of case studies are examined involving operations occurring during the financial crisis in regard to investment, and demand in the Basque Country for financing for the operating capital of SMEs is contextualised in this framework. Specifically, it is stressed that there are very few precedents in this field, especially compared to requests from employers' representatives. There are thematic investments aimed at promoting growth, normally in developing countries, but they are usually made with the intention of obtaining a yield proportional to the level of risk assumed, which tends to be high.

Indeed, it is more usual for there to be regulations for sovereign funds, etc that prevent them from investing in their natural economic areas for reasons of diversification. However, it is logical for pension schemes, on grounds of reputation and greater knowledge, to invest in their local areas if suitable financial markets and professional venture capital operations exist there.

The last article, by **Ignacio Zubiri** analyses and compares the pros and cons of the systems of distribution and apportionment, in regard to instrumenting the operation of pension systems. For historical reasons and due to potential transition costs, the public system of apportionment is destined to dominate, but the growing importance of supplementary systems is a good reason to conduct a comparative analysis of costs, coverage, assurances, collective and individual risks, effects on production and, in short, the sustainability of the system itself. The main conclusion reached is that the partial capitalisation of the system shows no clear advantages over the apportionment system. If it goes ahead such capitalisation should play a clearly supplementary role based on workplace systems and/or individual accounts with simple management rules so that the role of managers is limited

Apart from this group of articles, two additional documents also appear in this issue. The first of them reproduces much of Chapter 6 of the OECD's 2012 *Pensions Outlook* in regard to the route map for improving the design of defined contribution pension plans. The document is commented on and updated by **Pablo Antolín**, one of its authors, and has been translated and checked by the *Basque Supplementary Social Welfare Observatory* [*Observatorio Vasco de Previsión Social Complementaria*].

It highlights the fact that defined contribution private pension plans are becoming a more and more essential part of general pension systems in most countries, and in some countries are now the main element of their pension systems. Obtaining suitable overall income in retirement therefore depends increasingly on the benefits provided by such plans.

The route map consists of recommendations on designs consistent with public pensions which favour long contribution periods to low-cost systems, with suitable and/or life cycle based automatic investment options, benefits in the form of regular pensions and, finally, good communication.

Finally, the **editorial staff at *Ekonomiaz*** have drawn up a simple guide that clearly sets out the scope and differences in characteristics between *supplementary social welfare* schemes and the public Social Security system. This guide sums up the contents and functions of each of the instruments available for fulfilling the purposes of supplementary social provisions. Special attention is also paid to the different, specific regulations in place in the Basque Country on this issue, including how they are taxed.