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Pensions and the Greek Crisis

A TRAGEDY OF RETROSPECTIVE EXTERNALLY IMPOSED REFORM

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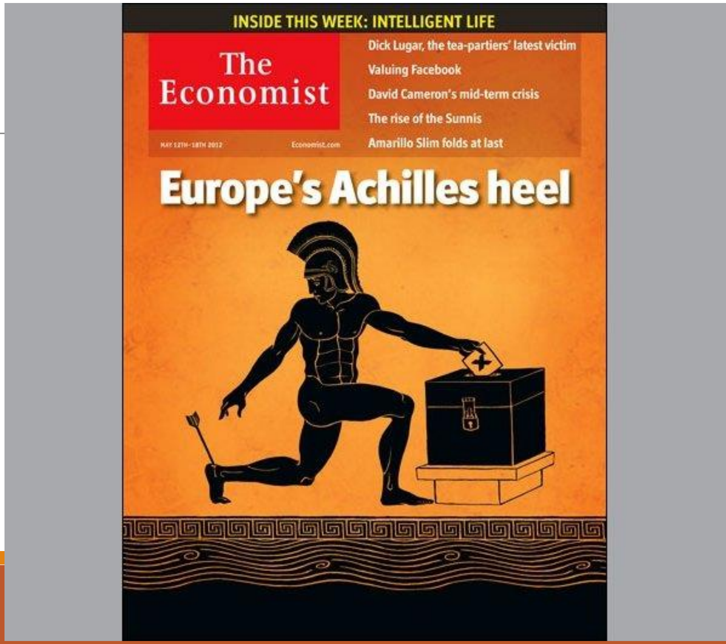
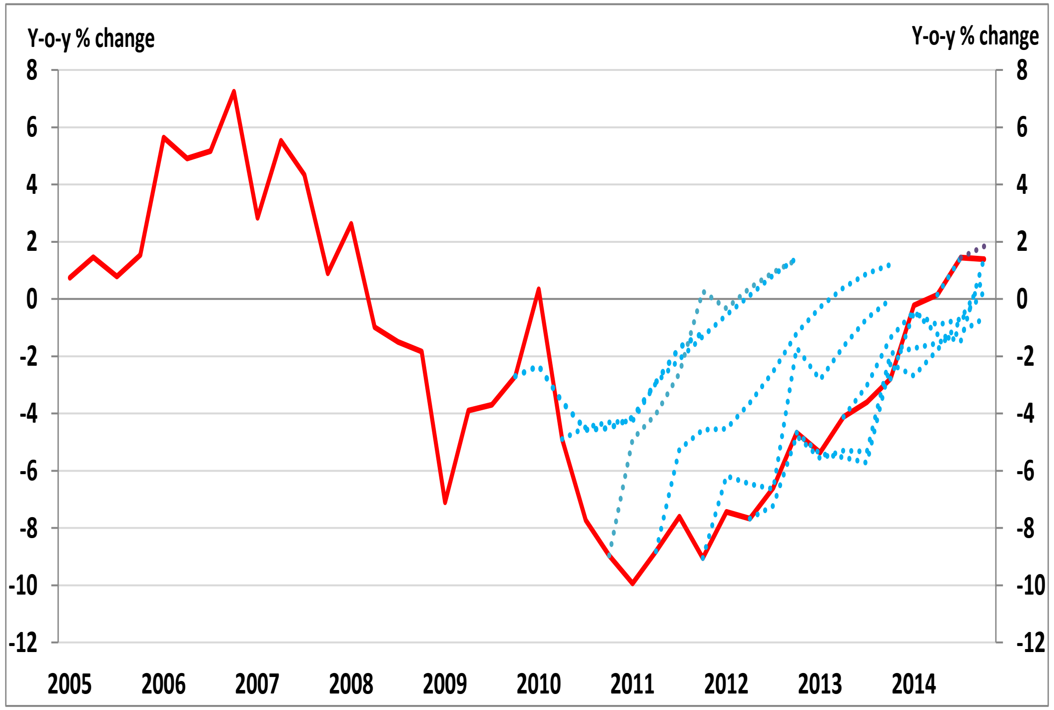


Overview of the Greek Economic Crisis 2009-2018 (?)

- Greece is *still* in the midst of the **deepest** and **longest** recession of any developed country (worse than US in the 1930s).
- At least **7 successive years** of falls in GDP. Stagnation after
- GDP per head is **25% lower** than in 2007. Earnings **30%.**
- Three international bailouts (the largest ever). The third is due to end in August 2018 – **still not clear what it will be succeeded. No Exit in sight.**
- A dismal record for economic policy (projections consistently proved too optimistic).
- The crash followed a period of high growth – from 1990s and after Eurozone entry (2001) – 'The Balkan tiger' Phase (?!)

Real GDP growth trajectory and forecasts for different vintages, Greece



Source: OECD Economic Surveys: Greece 2016, page 67. OECD Economic Outlook 87 to 98 databases.

Pensions and the Greek crisis: *3 vignettes*

A. **A pension reform bill for every bailout**.

- Pension reform was **the first bill** passed after **the first bailout** in July 2010.
- Pension changes key prior actions and **May 2016 pension reform** part of **the 3rd bailout in August 2015.**
- **May 2017** – Advance legislation passed for further changes to take place in end-2018

B. **Close Link to sovereign debt crisis –** The **Hierarchy of obligations** imposed by politics

- June 2015 the Government was faced with a dilemma: Cash to pay ***either*** the IMF ***or*** *current pensions*
  - A choice of a **legal** or a **moral** obligation? ***Explicit* vs *Implicit* debt**.
  - The government chose to honour pensions – **It chose moral over legal.**

C. **Who will go bankrupt *first*? The Pension system and the State in a *danse macabre.***

In **1997** a prominent committee warned that the pension system was facing collapse '**by 2007**'

- The head of the Confederation of Trade Unions said "**The *State* will go bankrupt before pensions do"**
- His prediction was right – only off by 3 years.

Pensions and the Greek crisis: *3 paradoxes*

1. Tsipras: "**We must not cut pensions as Grandmothers give pocket money to their Grandchildren".**
   - Why not do something *directly* for the Grandchildren?.
   - Appears to be unaware of basic economics : Who pays for Grandmothers' pensions?
2. **Persistence of pre-crisis perceptions, privileging pensions.**
   - Low income pensioners a perennial 'deserving case', while *in fact* **they were the group least affected by the crisis**.
   - During the crisis Pensioners' poverty risk fell by half (by 7 points) while others' skyrocketed. Prefer pensioners to unemployed families with children.
   - In December 2016 they were singled out to receive a bonus (labelled the '13th pension).
3. **Illogical conclusions:** ***if bond holdings of pension providers were not included in the debt haircut of 2012*** **(known as the PSI), there would now be no pension problem.**
   - Despite bonds being a liability of the State which is providing more than 40% of pension providers revenue in grants. Ageing, etc…

OUTLINE: PENSIONS AND THE CRISIS AS GREEK TRAGEDY

Three strong statements:

1. **THE PAST:** The Greek crisis would not have happened if pensions had been reformed in time.
2. **THE CURRENT:** The exit from the crisis is prevented by side-effects of the pension reform.
3. **THE FUTURE: l**ong term prospects are being poisoned by an inappropriate pension system.

A Greek tragedy has three parts (according to Aristotle):

1. ***Hubris* – Ambition** the preceding period setting up a mechanism for disaster
2. ***Ate* – Blindness/folly** the evolution of the crisis - blame avoidance
3. ***Nemesis* – Punishment.** what pensioners are experiencing now. And the young generation will experience in future.

1. The past

THE PENSION SYSTEM AS A MECHANISM FOR DISASTER

Pensions before the crisis: Fragmentation

Greek pensions *look like* other advanced country systems – direct contemporary of US Social Security.

- IKA founded in 1934. But two key differences
  1. **Governance** – system abandoned. E.g. requirement for regular actuarial review ignored.
  2. **FRAGMENTATION.** Fragmentation by occupational group; by pension tranche; by cohort.

A BUILT-IN LANDMINE: In PAYG system, fragmentation enables widespread **cross-subsidization**.

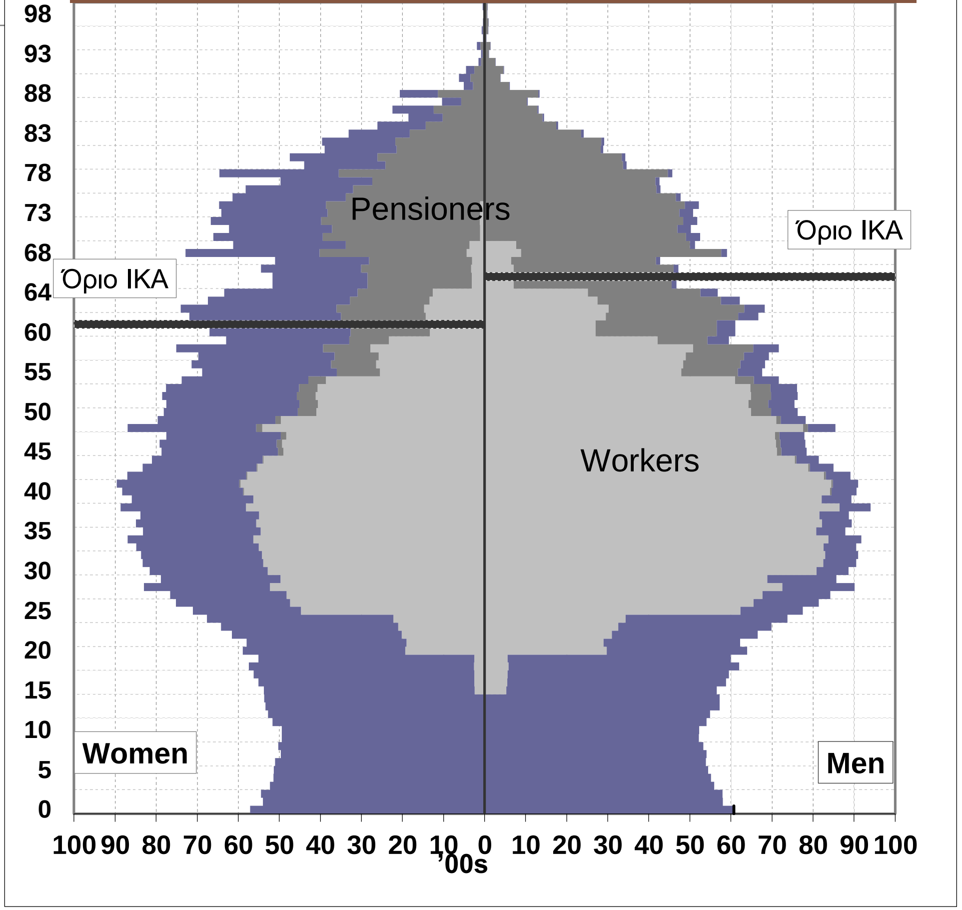
1. Pensions used to secure **privileges for different occupations – a component of clientelistic system**
   - E.g. in retirement ages the 'rule' was followed by 15%. The remainder 85% followed various exceptions.
2. Removed **constraints on expenditure growth** at the *micro* level.
   - Groups tried to secure privileges and shift the costs to others (consumers; taxpayers; other groups).
3. After 1980s' inflation, **expenditure decoupled from revenue** – government grants make up.
   - Removed constraint to expenditure at the macro level.
4. **Reform proceeds in piecemeal fashion**– Syncopated progress *in the right direction* **but** *too little* :
   - ***within-generation* issues** overshadow ***between-generations* equity**.

The system in 2009: A mechanism for disaster

1st EU Joint Report on pension strategy (2002). The pension system was :

1. **Costly.** 2009 Pensions ≈ 14% of GDP
2. **Faced dramatic demographic challenges.** Highest expected pension expenditure in 2060.. **(+12,5 points)**
3. **Was economically inefficient.** Cross-subsidisation, and high non-wage costs.
4. **Is socially ineffective.** *'Poverty is grey in colour'*.
5. **Is resistant to change.** Attempts in 1990, 1992, 1998, 2002, 2008…
   - EMU membership removes urgency for change as made financing deficits easier (Fernandez et al 2013)

Demography and labour participation as the inexorable drivers



2009 Demographic pyramid

What happened?
Incomplete pension reform → Debt bubble

- **Structural Deficits** in the pension system endemic from early 1980s
  - (due to linking minimum pensions to the minimum wage -- 2/3 of pensions rise to the minimum)
  - So, pensioners were exempt from stabilisation; **waited for structural pension reform**.
- BUT, reform was hard to implement and painful to discuss**. *While waiting for reform*, deficits were financed by government grants**.
- A reform increasing **contributions** was passed in 1990/2; but the changes affecting **entitlements** (age; system structure; privileges) **were left for later**
- Reform of **Pension expenditure** was repeatedly postponed (in 1998, 2001, 2003 and 2008). But, as contributions were already high, **all expenditure increases were financed by grants**.
- After Eurozone entry in 2001, interest rates and external borrowing became cheaper just as deficits were rising . **Borrowing to finance pension deficits** after 2001 was *directly* responsible for fuelling the national debt which finally led to the bankruptcy in 2010.

Why did expenditure *keep rising*? Pensions and Buying off political influence

- **A fragmented PAYG system** allows transfers between occupational groups.
  - In Greece fragmentation by occupational group; by layer of protection; by cohort;
  - In IKA retirement ages: **85% of men follow exceptions; 15% the rule**.

- Pensions redistribute resources **between generations** but also **between occupational groups.** The latter allowed the pension system to be used **in buying political support. *Examples:***
  1. Pension privileges bypass income policies and can 'buy influence' without immediate budgetary cost.
  2. E.g. 'Heavy and Hazardous occupations' – allow hairdressers and newscasters of state TV earlier retirement; One year's contribution count for 3; unmarried daughters of generals receive pensions for life.
  3. Invalidity pensions buy *individual* support (Zakynthos blind taxi drivers arranged by aspiring MP).
  4. Operation of **minimum pensions** subsidises non-payment of contributions. With between 15 and 23 years' contributions you received the same minimum pension is received.

'**Collateral damage of the political hijacking of pensions'** : Three consequences key for long term developments:

i. The **reform agenda** was one of consolidation – reducing inequality – **and remained unchanged** throughout**.**

ii. Entrenched tendencies to **raise expenditure, over and above the rises due to ageing.**

iii. Very little reciprocity – the ***insurance function* of pensions** was totally neglected.

Why was it not *prevented*?
The role or **non-reform/ governance**

Any system should have homeostatic mechanisms – bringing back to balance. In Greece these did not work**. Why?**

I. The **absence of discussion**
   - **Hiding the elephant in the room** ("*Somebody else's problem*" – no one wants to raise the issue)
   - Dearth of data. Data starts being produced by the EU centrally, but still ignored.

II. **Pension reform comes in spurts.** *In between* episodes everyone behaved as if a problem did not exist

III. **Organisational fragmentation.**-*The '**Why Me?'** argument always works.* Expenditure ratchets up
   - Asymmetry: Deficit funds receive grants; surplus funds can increase expenditure.
   - Easier for deficit funds to secure grants.

IV. **Actuarial studies never produced. Requirement for regular studies ignored**.
   - No one responsible to produce studies for the system as a whole. Each sector shifts the blame.
   - Difference of view between **Ministry of Finance** (who saw flows of grants) and **Ministry of Pensions** (who saw stocks of entitlement)

2. The crisis period

REFORM *AT LAST*?

A pension reform game with new rules

What *should have* happened?

1. **Macroeconomic adjustment**– Greece was proved not as rich as was thought
   - Average GDP per head down by 25%. Pensioners had to share in overall adjustment
   - In previous stabilisations this was done by inflation erosion. When in the EZ adjustment had to be in the forms of nominal cuts.
2. **Postponed** change **externally** imposed after delay. Equalising privileges
   - As the bailout was financed by German taxpayers, sensitivity to comparisons
     - E.g.: Why should Hildegard the German hairdresser (retirement age recently raised to 67) pay for her colleague Maria to retire at 50?
3. **Deal with future challenges --** ageing rapidly accelerates; transformation of work
4. Key Difficulty: Had to be done in a **deep crisis without a functioning social safety net**. Social safety net needed to be built at the same time

Two key differences in the rules of the game with previous period:

A. **A new player with a veto** – the troika representing the creditors. **Blame avoidance** on the part of governments

B. **An absolute budget constraint** – no borrowing possible – expenditure overruns lead repeated **to cuts in pensions**

The process of reform:
Discussions without change replaced by *change without discussions*

A **confused process** unfolds **between 2010 and 2018**, 5 major pension laws, over three bailouts and five governments and over 12 pension cuts. Last major law passed in May 2017.

The end result (apparent only now):

1. New pensions will apply to everyone (even old pensioners – retrospectively)
2. Retirement ages increased to 67 for everyone not able to retire by May 2016. In some cases increases of up to 17 years.
3. All separate pension providers consolidated into a single unitary pension organization.

However the confused process generated major extra costs: A **large cohort of early retirees** (mostly women) meaning permanently higher costs plus **a reduction of trust in the pension system**.

It happened through a **process repeated at least 3 times** (2010, 2013, 2015-7):

- The Troika pushes for decisive action to cure fiscal problems.
- The Government tries to protect those close to retirement – favouring a dual system (old/new contributors).
- The attempt to protect leads to early retirement and increases deficits.
- Two reactions: **(a)** cut existing pensions **(b)** pass new law **extending application** of new system retrospectively.

By the third attempt, new system should apply to *everyone* **by 2019**. As if system always existed

Four key aspects of reform 2010-2018

1. **New' State 1st pillar system** - Two-tier PAYG pension system.
   a. First tier EUR 384 / month for everyone with >15 years contributions
   b. Second tier proportional to years of constitution on Defined benefit base
   c. Income to be replaced is career average (up from 5 years)
   d. Replacement rates for minimum pay recipients close to 80% for 40 years contributions (current average c 23 years)
   e. Low ceilings (EUR 2000 mean than better paid contributors receive low replacement.)
   f. Applies to all (even pensioners who retired under the previous system –to forestall a court decision on unconstitutionality.

2. **Retirement ages**
   a. 67 for all (62 with 40 years' contributions).
   b. Applies to all who retire after May 2016.
   c. Exceptions for the Hazardous Occupations
   d. Retirement ages to be reconsidered every 10 years to match longevity increases.
   e. Work by pensioners severely discouraged

3. **Consolidation on the revenue side**
   - All contributors equated to salaried workers and pay the same contribution rates
   - Major change for the self employed and farmers (who from a system of classes move to paying 27% on declared net business income)
   - Workers on non-starndard contracts and for second jobs face big rises in contribution payments.

4. **Organisational consolidation**
   - All primary pension providers folded into a single organization.

A unique feature of the 2010-8 period: Cuts in pensions-in-payment.

Pension cuts as ‘**collateral damage**’.

In the context of the bailout, there is no finance for **fiscal surprises.** Any overruns from budget execution had to be met from within the system:

Repeated Cuts in pensions-in-payment (10 occasions 2010-3; smaller ones 14/5, again in 2017)

- In some cases over half of the pension was lost
- Hopes were kept up that the cuts would be made up.

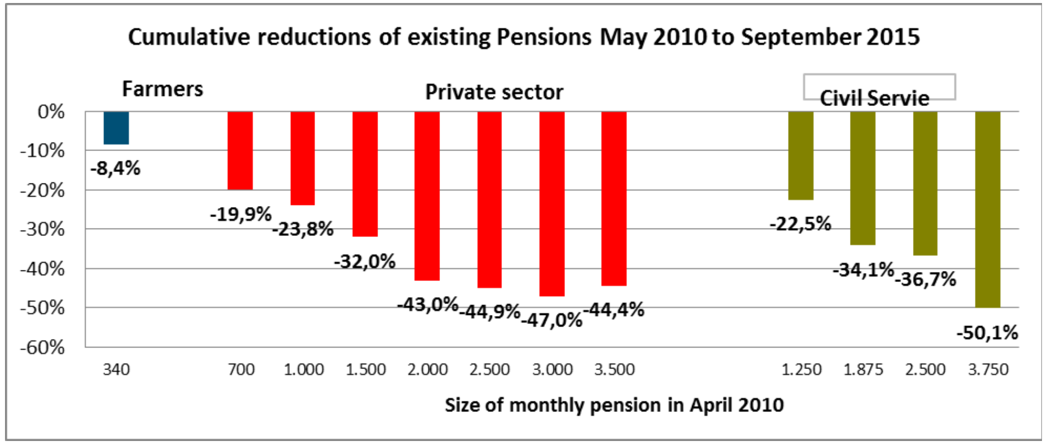
Imposed solely on size of pension. No influence of (a) age or (b) contribution record.

Low pensions only cut by holiday bonuses (14%)

- Half of the fall of private sector earnings (30%)
- **Low pensions become more attractive compared to working.**

The arbitrary nature of the cuts mean that a vicious circle further reinforced. **Function of pensions as promoting old age income security put in question**

Figure 2: Cumulative falls of different kinds of pensions, May 2010-September 2015



Source: Tinios, 2013, updated for 2014 cuts in auxiliary pensions and 2015 increase of pensioners health contributions. Impact may differ according to the type of auxiliary pensions and their share of the total. Sums are annualised to take into account the abolition of holiday bonuses.

Two decisions of the Supreme Court

1. Cuts up to 2012 constitutional – 2012 decisions
2. Cuts *after* 2013 *un*constitutional – 2015 decision)

Still promoting disaster…

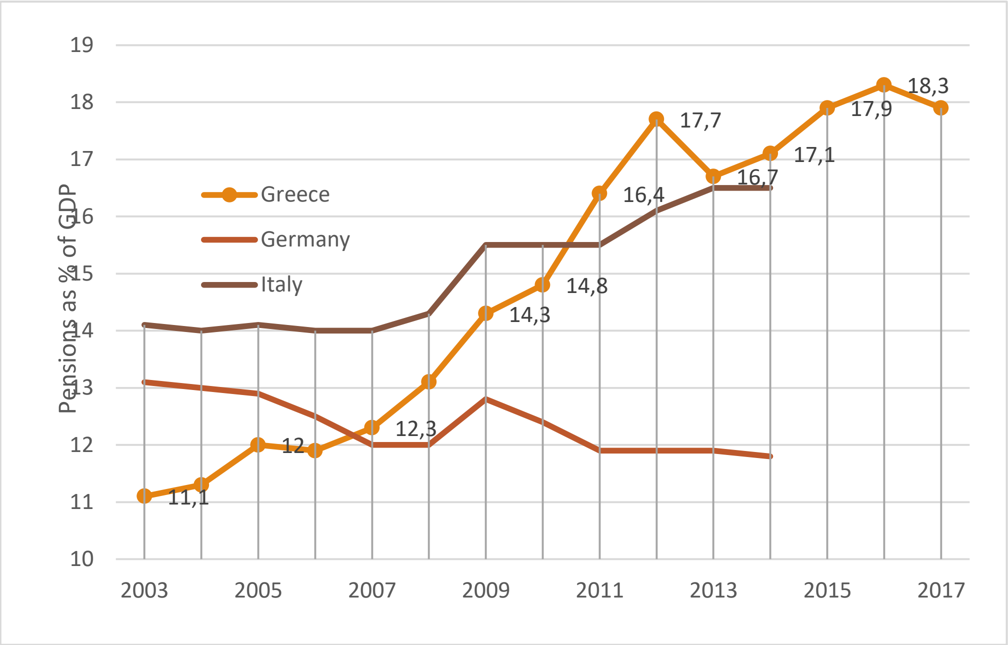
Even after 5 years' implementation, pensions are the highest in the EU.

Revenue down due to (a) unemployment (b) rising evasion due to liquidity problems.

Pensions are rising fast because: (a) Demographic change (b) early retirement, especially of women, public sector; (c) Denominator ↓ – **GDP fell by 26 per cent**.

The pension system relies **on transfers from the central government** of more than 10% of GDP – the largest in the EU>

Pensions as a percent of GDP, Italy, Germany and Greece 2003-2017



Source: Eurostat (accessed 13/1/2016), Ministry of Labour (for 2015 on).

Evaluation:
Parametric reform *or* Neoliberal agenda?

Resistance to reform to 2010 was in to protect pension rights. What did *actually* happen?

A. **Retirement ages** – those who could retire by 2016 were able to. The others have to work to 62 or 67. Early retirees especially women vulnerable to pension cuts. Women are overrepresented in the early retirees and hence lose most

B. **Pension amounts** – Noone escaped. Pensions are lower than they were. There was a major redistribution from high to low pensions
   - A major change in **the reciprocity of the system**. High pensions amongst greatest losers > low pensions amongst relative winners

C. **Organisational change –** despite early resistance all are now included in a single provider – private+public;

The reform is a major change in parameters**. One of the most drastic *parametric* reforms ever.**

"Implementation of a neo-liberal agenda"? Continuity chosen over systemic change. New system relies on the State **exclusively**. No advance in the direction of a multi-pillar system. PAYG, Defined Benefit.

Was the system 'imposed from the outside"? True in that the 'troika' was moving things along. "*TINA*".

BUT: The troika proposed what was the logic of preexisting discussion.

3. The future:

MEETING *FUTURE* CHALLENGES

Is *this* what the new system *should* look like?

This is a reform that looked to the past rather than the future. The new system, will still be:

- **Too ambitious.** Pensions which (though lower than before) are still at the top end of the EU.
- **Too expensive.** Non-wage costs are high and will become higher. A major drain on competitiveness.
- **Too inflexible**. Little leeway for individual or sectoral differentiation. No possibility of opting out.
- **Too statist**. Pensions are exclusively provided by the State. Leaves very little room for other providers.
  - Even though occupational and private pensions are permitted, the State system leaves little room for them
  - High nominal replacement rates (80% for 40 years) crowd out demand
  - High social insurance contributions (27-38%) crowd out supply.
  - Discouragement of involvement by the insurance sector in supplementary insurance cover.

The new system is **exclusively State-run, Defined Benefit, PAYG.** It looks like a 1960s type system of the kind being abandoned in the advanced world.

It is better than the pre 2010 system, *but is it good enough?*

Has the baby been thrown out with the bathwater? The new insurance contract

The 2010-8 reforms dealt with **fiscal** problems (macroeconomics). But ignored **insurance** aspects (microeconomics).

i. The way it came about (Blame avoidance, little discussion,) **has eroded trust.**

ii. Arbitrary pension cuts have created a sense of insecurity – **very little security of income**

iii. High non-wage costs coupled with violations of assurances **undermine confidence.**

iv. **Younger** contributors see little difference between **social contributions** and a **tax on work**.

- **So the pension promise is *more viable*, but *it is trusted less*.**

- Needs to be supplemented by a reform to **repackage the pension promise**. A fresh start to regain trust.

A multi-pillar reform is needed to **change the structure** of pension promises

A large DB pension system hands out pension promises, redeemable in the distant future. **Future pensioners are very similar to bondholders**. They want their promises honoured; they don't care how.

External debt is similar. Both mortgage future output a long time ahead. **So, large DB systems replicate in the future the conditions that led Greece to bankruptcy in the past.**

In contrast, in **DC pre-funded systems** pensioners share in the risks of production like **shareholders**. Their pensions will be higher if the economy goes well. A *contingent* and not an *absolute* claim.

The parametric reform has reduced the **size** of future claims. Systemic reform must alter the **structure** of future claims.

Turning a new leaf with a public-private partnership

The trend in the EU is towards **mixed systems.** Total pensions are provided in three layers:

- **1st**: A state pillar focuses on lower pensions and **poverty prevention**
- **2nd** : Occupational pillars focus on **income replacement** and allow sectoral differentiation
- **3rd:** Personal pensions allow individual flexibility .
- Faced with a major challenge – ageing – all sectors of society help out, each according to its comparative advantage.
- Greece indicates that it is not enough to reign in the **total size of future claims**; one must also **manage their structure;**
- **above all that it is important to rebuild trust.**

Two lessons

- **It is important not to postpone pension reform**.
  - The attempt to protect system participants proved self-defeating. Pensions fell, retirement ages rose but in an abrupt fashion – harder to prepare properly. The costs of being caught out.
  - Large State-run systems create a promise bubble similar to external debt. But they are less transparent. There are too many mechanisms to promote complacency until it is too late.
- **The type of pension reform is very important.** Otherwise you may “throw the baby away with the bathwater”:
  - Parametric reform (to reduce the size of the pension promise) is unavoidable. But **it is not enough**:
  - External compulsion (There is no Alternative) is not a good strategy**. Pensions need trust.**
    - The microeconomics of insurance should not be forgotten. Pension reform is more than a fiscal exercise.
  - The reform should make sure that the *basic insurance functions* of the system are preserved.
- Hence it is important to think about managing the **structure of the pension promise** and not only the size.