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Greece: Extreme crisis in a monolithic unreformed pension system

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Pensions have played a key role in the Greek sovereign debt crisis. Failure to introduce pension reform proved a central cause and, following the bailout by the Troika (EU, ECB and IMF), pensions were the first target for structural reform. As the crisis has unfolded, pensioner incomes have been repeatedly cut.

Pensions and the origins of the crisis

Greece stood out among the EU-15 with the largest projected ageing-related expenditure increase (EPC, 2009). Even so, this failed to prevent old age poverty. Nevertheless, the country had failed to promote meaningful reform (Tinios, 2012). A succession of timorous parametric reforms did not prevent a build-up of deficits among the fragmented pension providers. These were met by direct budget transfers, financed by borrowing. The pension issue was subsumed and 'hidden' in wider magnitudes of public debt, essentially removing budget constraints on pensions. Over time, pension transfers became a key determinant of public sector deficits, and thus an issue in the sustainability of Greek debt. Reform became imperative only when Greece threatened the stability of the Eurozone in late 2009; the sovereign debt crisis provided the missing budget constraint on the pension system.

The lack of pension reform can be explained by myopia on the part of the Greek political class (Tinios, 2005). No political adrenaline flowed from a statement that the pension situation would become critical 'after 2025'; if time is measured in electoral cycles, 2025 was 'too far ahead to worry about'. Bond traders, nevertheless, take a longer view: to rate the repayment prospects of debt, they have to consider the conditions prevailing when repayment is due to take place. When the EU Open Method of Coordination provided projections allowing such a view (EPC, 2009), markets took notice. Faced with 'defective telescopic faculty' on the part of governments, bond markets supplied the missing 'telescopes' and *forced* reform to take place.[1]

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The quality of forced pension reform

When Greece was bailed out in May 2010, pension reform was at the top of the agenda. Indeed, Law 3863/10 of July 2010 was the first piece of Memorandum-inspired structural reform, hailed by the IMF as 'a landmark pension reform, which is far-reaching by international standards' (IMF, 2010b; OECD, 2011). This law had three key features: it rationalized the existing state-run pension system, chiefly by defining a new two-tier system to be implemented gradually after 2015; it raised retirement ages for younger cohorts; and it facilitated restructuring of employment (chiefly in the public sector) by extensive grandfathering, which in some cases amounted to early retirement.

Nowhere in the law do we encounter the slightest hint of encouragement for a second pillar. Commentators, who might have expected the Troika (or at least its transatlantic component) to promote a neoliberal agenda by privatizing pensions, must have been disappointed. The new pension system intended for the long term remains resolutely public-owned, financed and run by the state. A contributor to the *new* state system, who will receive their pension after 2050, can expect around 80% income replacement, which hardly leaves room for supplementary systems.

Unreformed pensions and crisis dynamics

On the other hand, the grandfathering provisions of the law mean that Greece is navigating the crisis with an essentially unreformed pension system. Workers nearing retirement are still entitled to (relatively generous) defined benefit pensions, at a time when the labour market is radically insecure. This cyclical behaviour stabilizes effective demand, but at the expense of further borrowing. In a public finance crisis such as the current one, its effect is seriously *destabilizing*.

After May 2010 Greece faces a *single* creditor (the Troika), who supervises public finances on a quarterly basis. Deficit overruns in one quarter need to be made up by equivalent savings within the same calendar year, enforcing a rigidly effective budget constraint. The combination of lax implementation of reforms and cyclical overruns necessitates savings elsewhere, wherever these can be easily found and quickly implemented. Given that public pensions are under the easy control of government, pensions-in-payment are cut repeatedly. Thus, repeated public assurances that no more pension cuts would take place have had to be abandoned in practice.

Under generalized public finance strains, defined benefit pensions did *not* afford pensioners much protection. The inexorable pressures of state near-bankruptcy have, in practice, dictated a disorderly piecemeal *re*-definition of 'defined benefits' already granted, of an order (in late 2011) greater than 15% and rising. This unplanned readjustment can be thought of as similar in its effect on real pensions to a 'retrospective devaluation'.

Conclusion: the crisis as a case of counterparty risk

In the Greek crisis, the functioning of an unreformed pay-as-you-go defined benefit pension system was a key mechanism in the 'micro foundations of disaster'. The macroeconomic logic of retrenchment applied to a state-run ‘traditional’ pension system, justified major downward pension adjustments and fed pensioner insecurity. What in a privatized system would have been *financial* risk to pensioners was translated to an equivalent (and no less painful) *political* risk.

The case of crisis-torn Greece may be used as a warning against easy generalizations. No ‘neoliberal agenda’ was forced on pensions; on the contrary, the public character of the system was emphatically reaffirmed. That, however, could not provide pensioners with any significant protection against (seemingly arbitrary) income readjustments.

Note

1. Reactions to the misreporting of the deficit in October 2009 explain the timing of the debt crisis; they made clear that no implicit ‘guarantees’ existed.

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Biographical note

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Re-nationalizing the mandatory private pension pillar in Hungary

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Since 1990 a number of countries have attempted to convert their public pension liabilities into mandatory private savings in order to limit welfare state costs and boost financial markets. A frequently neglected problem in this process is the emergence of so-called transition costs: in order to redirect part of the public pension contributions to private savings, the government must finance the temporarily lost revenues to the public pillar. The international financial and economic crisis underlined the limits of this transformation: the public and the private pillars suffered from the contraction of GDP and the drop of stock prices, respectively. Some governments reduced the contributions flowing to the private pillar in order to make room for anti-cyclical stimulus measures. The Hungarian government has not only suspended this flow but raided the accumulated capital in individual accounts.

Building up the private pillar

Following the 1994 advice from the World Bank, the Hungarian government, in 1998, carved out a mandatory funded private pension (second pillar) from the mandatory pay-as-you-go public pension (first pillar), thus creating a mixed system. Members of the pension funds were to pay about a quarter of future pension contributions to a private account. The government made the mixed system mandatory for beginners and offered two possibilities to those already working: either to stay in the reformed monopillar system, or to enter the mixed system and renounce a quarter of the pension rights already acquired. About half of those affected joined the second pillar voluntarily in 1998–1999 and another quarter of the workforce entered mandatorily between 1998 and 2010.

The Hungarian private pension schemes did not function as real funds. Rather, they were more comparable to associations, with members as the proprietors of their own funds as in a genuine cooperative. In fact, the majority of members joined one of five associations, each managed by a large, international financial institution (i.e. a bank or insurance company). The operating costs of these funds were very high, and the resulting (real) yields were rather low. For example: an investment made at the beginning of the new pension programme would have, by May 2011, earned a real gain of only 10% over 13 years. Neither governments nor the participants in these pension funds paid much attention to problems inherent in the funds; even the issue of the unisex life annuity was not solved until after the system had been shut down.

There was also a more fundamental problem with the 1998 reform. The reformers were not in a position to raise the already very high contribution rates (31% of gross wage); nor were they able to reduce pension benefits significantly. As a consequence, the shortfall in incoming contributions to the monopillar public pension system was made up by an increase in the government deficit and debt. Some reformers naively assumed that this solution would constrain other public expenditures, but this expectation proved faulty: budget deficits ran between 4 and 9% of GDP. Until 2008, these deficits were easy to finance; with the arrival of the international financial and economic crisis, however, everything changed. After October 2008, the Hungarian government was finally forced to reduce its public expenditure, further contributing to the pain caused by a sharply contracting economy.

The elimination of the private pillar

In April 2010 a populist 'conservative' party won a landslide victory in the parliamentary elections. With its super-majority, it was capable of instituting sweeping changes, including to the constitution. When the EU declined the request of the Hungarian government, along with others, to deduct the flow and stock of transition costs from the official budget deficit and from government debt (1.3% and 11% of GDP, respectively), the Hungarian government chose a 'revolutionary solution': it effectively closed down the private pillar.

Rather than explicitly eliminating the private funds, the Hungarian government simply made its citizens an offer they couldn't refuse. Participants in private funds were given a choice: they could either return to the public monopillar system and cash the positive real yields accumulated in the account; or stay in the private pillar and accept that future contributions to the public pillar (24%) would not earn any new returns. It is a small wonder, therefore, that only 3% of the members stayed – representing about 10% of the total capital.

It is worth noting that only half the pension funds' capital was used to diminish the government's explicit debt, and that even this reduction has been partially eliminated by irresponsible economic policy. In 2012 the Hungarian public finances are as bad as they were in 2010, but with no private pillar. In a typical move, the government decided one year later that there would no longer be any choice in the matter of personal pension funds: it simply forbade anyone from making further contributions to the private pillar. Most likely, it sought to gain access to the remaining 0.2% of GDP flowing annually to the funds, and also wanted to acquire the remaining pension capital (1% of GDP).

Since the funds are not allowed to use their members' capital to finance operating costs, they will almost certainly have to be closed down. At the same time, the government reinstated accrual rights from the public pillar for those who had stayed in the private pillar. Using the language of game theory, because future governments could return the lost rights to the public pillar of the remaining members, the government's original threat was not credible. However, the two-stage strategy probably did serve its aim: to completely eliminate the second pillar while maintaining the illusion of free choice. The 'only' loss is an intangible one – the Hungarian people trust their government even less than they did before. Accordingly, they will be more likely to cheat, and will probably pay fewer taxes and contributions. Unfounded rumours that the government will seize bank accounts further contribute to this deep distrust. It remains to be seen what the government's new pension policy will be.

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The Swedish public pension under financial stress

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The Swedish pension reform, conceived in the early 1990s and enacted in 1998, is often presented as an example of an interesting new pension system. This essay is a description of the Notional Defined Contribution (NDC) part of this new system and how it reacted to the 2008 financial crisis.[1]

Automatic stabilizers

A number of reformed pension systems include automatic stabilizers that aim to mitigate financial strains on pay-as-you-go (PAYG) defined benefit (DB) schemes. They can be classified into three broad groups, each with different characteristics:

1. Automation of the first order – whereby benefits depend on changes in factors external to the pension system, such as demography and economy, which otherwise tend to disturb the financial balance of the system.
2. NDC principles – whereby benefits depend on contributions paid in on an individual basis.
3. Automation of the second order – whereby benefits depend on contributions and the financial balance itself, whereby the latter is guaranteed under all circumstances.

Automation of the first order. Germany is one example of this kind of scheme. The 'sustainability factor' contains an adjustment to the indexation of pensions in payment. The latter is dependent on the relation between contributor and pensioner numbers. This does not, in itself, guarantee financial sustainability, nor does it hinder adjustments to contribution rates. Instead, there is a commitment for the government to take action and make proposals to parliament, should it appear there is a risk that either replacement rate or contribution rate target might fail to be met. In the Canada Pension Plan there is a similar provision.

There are a range of other examples, each with different designs, which base scheme parameters on factors external to the pension system, such as life expectancy, among those Finland, Norway and Japan.

NDC principles. Some countries have taken reforms a step further and introduced NDC schemes. These include Italy, Latvia and Poland, as well as Sweden. In addition to having elements of automation of the first order, these schemes contain one additional component, contributions that are the basis for accumulation of pension rights, and one political pledge, contributions that are intended to be unchanged into the indefinite future. In such a scheme, the situation is radically changed, because pension rights depend on *contributions*, not on *earnings*. This means that NDC schemes respond differently to financial stress than schemes based upon 'automation of the first order'.

In the international discussion, it is sometimes argued that 'life time earnings' are equivalent to contributions as the basis for pension rights accumulation under an NDC scheme. However, this is true only when, faced with demographic or economic changes, the steering parameters (the indexation rules, etc.) built into an NDC scheme are sufficient to keep it in financial balance without any increase in contribution rates necessary. Under such circumstances, when it comes to accumulation of pension rights and pensions in payment, a traditional PAYG DB (point) scheme can function like an NDC scheme. The difference between the two becomes apparent only when the system comes under financial stress.

When under financial stress, every traditional PAYG DB scheme becomes subject to review, regardless of any feature of the type described under the heading 'automation of the first order' that it might contain. Benefit levels, pension age and contributions are all discussed. Basically, what happens is a political process that aims to recalibrate these parameters. Such a reaction is not feasible in an NDC scheme, where contributions, themselves, are the basis for the accumulation of pension rights. Consequently, under an NDC scheme, it is not appropriate to try to solve current financial problems by increasing the contribution rate. Such an increase would create new pension rights and, hence, would risk creating further financial problems in the future.

With the introduction of an NDC scheme, the desire to stabilize contributions becomes a basic principle; contribution rates are to remain unchanged into the indefinite future. Under such schemes, all adjustments must be made on the benefit side, either of the benefits that are being accumulated and/or of the benefits that are being paid out.

Automation of the second order. Only the Swedish NDC scheme contains a component that automatically ensures that the changes needed to guarantee financial stability occur while the contribution rate is held constant. This component is the automatic balancing mechanism (ABM) that operates directly in relation to the financial balance.

New methods were established to estimate the assets and liabilities of the scheme. If the liabilities of the scheme exceed its assets, the yearly revaluation of pension rights and pensions in payment are reduced as much as is needed to restore the balance. Obviously, such a mechanism makes the scheme financially stable. Whatever happens, it reduces current and future pensions by whatever is needed to restore financial equilibrium. This is the component that is required to transform a PAYG DB scheme into a 'contribution defined' scheme. Once it is inserted, politicians can, technically speaking, leave the scheme to its own devices.

Earnings-related pensions 2009–2015

In one of their regular forecasts (that of July 2011), the Pensions Authority showed how earnings-related pensions had developed and would develop in the coming years. The 'typical public pension' – SEK 12,000 per month in 2009 – would fall to SEK 11,300 in 2011 and would only climb back to SEK 12,000 in 2014. A salary that was SEK 12,000 per month in 2009 could be expected to be SEK 14,000 per month by 2014, making the working person around SEK 2000 per month better off than the pensioner.

An important reason for the pension level declining, and for the gap between the retiree and the active worker increasing, was that the ABM was activated. It reduced the monthly pension by SEK 200 in 2010, and an additional SEK 500 in 2011. The ABM was expected to continue to be applied in 2015. Indeed, according to recent forecasts, it will continue to affect pension levels until at least 2020.

The ABM allows for a nominal decrease in pension amounts – a drastic effect indeed. This is how an NDC scheme, consistent with basic requirements for such a scheme to deserve the label 'contribution defined' functions when it comes under financial stress. And this way of functioning is fully automatic.

Quo vadis?

A crucial question arises: Is the Swedish system sustainable? Financially – yes. Politically – this is less clear. Will the broad alliance behind the original reform hold?

Food for thought is what happened in late 2008. At the time, it was realized that if nothing were done, the ABM would reduce both new pensions and pensions in payment by about 4% in 2010. That was the year when a general election was to take place. Representatives of the alliance behind the reform responded by altering the way in which some details in the formulas function, thereby postponing most of the reduction for one year – i.e. until after the election. But, to compensate for this, the reduction the following year was increased.

This raises the question of what will happen in the long run. What about pension adequacy? What will be the reaction from the general public when this system develops further? So far, no one knows. Political troubles have not yet arisen and the broad political agreement behind the 1990s reform is still in force.

Note

1. For a full analysis of the new system, see my paper for the PBSS colloquia of the International Actuarial Association (IAA) in Edinburgh, September 2011 (www.actuaries.org).

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Karl-Gustaf Scherman is Honorary President of the International Social Security Association. He was Director General of the Swedish National Social Insurance Board 1981–1996.

The stewardship of workers' capital – does it work?

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For many years trade unions have neglected pension funds' investment policy. What mattered to them was to obtain the best possible package in terms of performance and security. By the end of the 1990s, however, trade unions came to realize the importance of investment policy and that pension money should work for, not against, the very same workers whose right to retirement was being financed. The concept of stewardship of 'workers' capital' was born. It draws on a two-track approach to trade union action:

representing workers as employees and as shareholders via their pension funds and/or other long-term saving schemes. In practice, workers' capital strategies use the same instruments as those of the broader 'responsible investment' movement: positive or negative screening of portfolios (i.e. 'best in class' selection), shareholder activism and proxy voting campaigns, and specific investments in sustainability mandates (i.e. job creation, housing, social or green infrastructure).

It is in North America that workers' capital is most advanced as a union campaigning tool. In the US labour pension funds are far more active than other investors in making effective use of shareholder proposals to challenge the boardroom and executive management (Choi and Fisch, 2008). Within Europe, it is relevant in countries where prefunding schemes account for a substantial proportion of workers' retirement income – the UK, the Netherlands and the Nordic countries (Habbard, 2011). It is less so where pay-as-you-go and tax financed schemes prevail.

Several conditions need to be met for an effective workers' capital strategy. First, trade unions should have the ability to nominate representatives as pension board trustees, which is not always the case. Once in the boardroom the union voice also needs to be backed by regulated duties of trustees that are wide enough to allow non-financial criteria (such as observance of human rights conventions and core labour standards) to be included in the investment policy, which is not always the case. Workers' capital stewardship also requires trade union in-house resources and expertise, not least to maintain trustee education programmes. For example, the British TUC is putting much effort into strengthening trustee education (TUC, 2009) as does the Canadian CLC and its Shareholder Association for Research and Education.

Regulation of plan design and risk sharing between workers and employers are also key in determining the scope for active responsible strategies. The more risk averse the funding rules are, the less scope there is for an active ownership-oriented investment policy. This is because workers' capital strategies apply to assets that bear ownership responsibilities – listed equity and private funds – and are not designed for fixed-income assets (bonds) whose creditor rights are somewhat limited. There is evidence that worker-friendly defined benefit (DB) schemes will follow more equity-oriented investment strategies than employer-favoured defined contribution (DC) schemes. Thus the pension funds that are leaders in clean energy financing – a new but rising issue in responsible investment and workers' capital strategies – are all DB (or 'hybrid' DB) schemes that were established as part of collective bargaining agreements and have union representatives on their boards. The post-crisis wave of reforms to limit both risk taking behaviours and leverage in the financial sector may have the unintended consequence to limit pension funds' ability to be active owners. Supervisory authorities have their doubts about the level of understanding and skills of pension funds in handling investment portfolios that are increasingly complex (IOPS, 2011). In Europe, the European Commission is openly in favour of an extension of the insurance 'Solvency II' rules to pension funds, which may well force the latter to divest from ownership assets such as equity and over-invest in fixed income.

Finally, the efficiency of capital strategies will rely on the degree to which asset managers are accountable to asset owners (including pension funds). This is particularly true for the exercise of proxy voting rights that are attached to the pension funds' shareholdings. Some jurisdictions do not require asset managers to vote the shares they hold on behalf of their clients. The AFL-CIO regularly publishes its ‘Proxy Voting Guidelines’, which serve as a guide to pension funds delegating their voting rights to asset managers (AFL-CIO, 2012).

Conflict of interests may arise when, as often happens, asset managers belong to an international banking group that maintains business ties with the invested company. They will then have strong incentives not to challenge the board and the executive management and therefore not to exercise their voting rights. The less regulated asset management accountability is – by forms of compulsory disclosure or reporting – the more costly is shareholder activism for pension funds and other asset owners. Thus the European Commission deplores that shareholder ‘engagement is costly and the benefits may be difficult to calculate’ and accordingly is pushing for regulatory reforms in favour of greater shareholder activism (EC, 2010).

Shareholder activism, however, is a means to an end, not an end itself. Making a distinction between ‘good’ and ‘bad’ shareholder activism is crucial for unions that engage in workers’ capital strategy. The case of ‘activist’ hedge funds seeking quick gains by pressuring companies towards restructuring is emblematic of the dark side of shareholder activism. More broadly, the current crisis has exposed the short-termism of the prevailing shareholder value model. The parallel is telling between the huge payouts of Wall Street firms to their shareholders (dividends and share buy-backs) in the years preceding the crisis and the capital injections, including taxpayer financed bailouts, from which they have benefited since then.

Trade unions have had and continue to have the opportunity to develop workers’ capital strategies. Certainly, the opportunity is there. According to a survey of pension experts, they are considered as the most important driver (after public opinion) for future responsible investment in Europe (Allianz, 2010). But as the Dutch FNV (2000) put it, there is an ‘inherent tension that lies between shareholder activism and stakeholders’ rights’. That warning dates back to 2000 and yet it still sounds relevant today.

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Funded pensions and their implications for women and migrant workers

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As documented in this special issue, advanced democracies have sought for over two decades to transfer public liabilities for retirement income into private hands in order to contain welfare state costs and boost financial markets. As a result, European pension systems, in which market principles played a marginal or even negligible role in the past, have been redesigned, with non-public, market-based pensions introduced or reinforced (see Hyde et al., 2003; OECD, 2009). This paper stresses the importance of the international differences in the manner in which hybrid pension systems are institutionalized. Because pension system constituents, characteristics and interconnections are far from homogeneous, the roles played by funded pensions differ. These differences call for very clear and differentiated usage of the extensive category of 'funded' pensions and furthermore, they involve specific implications for future pensions of different social groups of citizens. I argue, therefore, that meaningful insights into the impact of funded pensions can only be drawn from an analysis of current hybrid pension systems in total (i.e. from an analysis of how marketized pensions are institutionalized in the overall pension system).

Funded pensions are not a new phenomenon. 'Private' pensions, often tax-subsidized, have formed an additional income for many elderly, in particular the better-off and/or the self-employed. What is new, however, is that funded pensions have become part of the 'pension norm' – the institutionalized and nationally defined target level for old-age protection – in other words, a component of an 'adequate pension' (in the terminology of European policy documents) which, in economic and market-based terms, is sometimes called the 'target replacement rate'. Most national systems, whether of Bismarckian or Beveridgean design, differentiate between an 'adequate' pension level which is publicly institutionalized and tax-supported, and a basic level of poverty-prevention institutionally related to basic needs or social assistance (Frericks, 2011). Other old-age investments to maintain living standards have existed, but apart from the pension norm. What needs to be studied, therefore, is the change in calculation norms in the current systemic transition from public to hybrid systems of 'adequate' old-age protection, and how this influences the chances of different groups of citizens to reach this target level of protection.

Differences in the institutionalization of funded pensions significantly determine the level of social protection provided to various social groups and the share of future pensioners with adequate pensions. Major risks of underinsurance – the acquisition of pension rights below the adequate pension level – result from life-course transitions (unstable labour-market biographies and thereby irregular contribution payments) and the kind of investment undertaken in funded pensions. Most relevant life-course transitions are faced by women, in particular, since providing (informal or semi-formal) care for children and elderly people remains highly gendered, and also by migrant workers when changing country. For understanding the impact of the various hybrid pension systems we need to know how funded pensions are integrated into social security systems by regulations that try to adapt market principles to public purposes and how responsibilities of stakeholders, contributors and taxpayers are apportioned (Frericks et al., 2010). This depends on substantiating the three classical operations of social policy, namely: establishing sources and resources, defining the attribution of resources and specifying the conditions of exercise of rights over resources (Harvey and Maier, 2004).

These operations determine what resources are used and what rights are financed in both the pay-as-you-go (PAYG) and the funded subsystems. All PAYG systems are based on principles of social insurance (albeit differently realized in the various countries). Shifts in resources undermine this past institutional logic, and policy-makers currently seek to prop it up by various forms of regulation in an attempt to render private schemes publicly accountable (Frericks, 2010). The institutionalization of funded pensions into the overall pension calculation norm defines what future groups of pensioners there are and levels of 'adequate' pension provision depending on whether they include, for instance, tax subsidies for pension investments, pension credits for non-contribution periods, or guarantees on and regulation of particular investments.

Funded pension systems might increase social risks due to life-course transitions if there are no redistributive mechanisms, such as for periods when contributions are not paid (e.g. during informal care work or unemployment). Pension credits for informal care provision, corresponding to social insurance principles, are found in the French occupational (funded) pensions and the German 'private' (funded) pensions, called the *Riester* pension. First-generation migrants have particular difficulties building up pensions when overall pension systems including the funded sub-systems assume continuous residence (this is the case in the Netherlands). For anybody who has worked in another country, future 'adequate' pensions rely on the transferability of acquired public pension rights and private pension contracts. And for medium and low income earners, among whom primarily women and migrants, future adequacy of pensions depend on whether funded sub-schemes are obligatory (Sweden) or voluntary (Germany), whether investments are regulated and monitored (the Netherlands), or potentially guaranteed (Germany), whether there are independent advisors (Sweden, Italy) or not (Germany), and so forth. Finally, so-called savings traps, i.e. non-investment by different social groups who consequently end up below adequate pension levels, characterize some hybrid pension systems (e.g. the German one) but not others (e.g. the Dutch one) (Börsch-Supan et al., 2008; Frericks, 2011). In countries where considerable savings traps exist, public means are distributed to a restricted group, better-protected through the subsidizing of funded pensions; this, then, contradicts both market and social insurance principles.

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