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Greek Pension System: Legislation submitted to Parliament

1. Background and Summary

The government has submitted to Parliament legislation on pension reform, which, in our judgement, creates more problems than it solves because it would raise the actuarial deficit of the pension system. With the government's comfortable majority in Parliament, there is little doubt that the draft legislation will be voted into law **next week**.

Social dialogue completed: Following two general strikes last year to protest the government's pension reform proposals, the proposals were withdrawn and the Labor Minister replaced. Social dialogue was re-launched last March after the government caved in to demands of the main labor union, GSEE (the umbrella organization representing both private and public sector unions) that the government guarantees funding needed to broadly maintain current benefits. The dialogue with GSEE was successfully concluded, but the reform proposals fell short of a "national agreement" as the Federation of Greek Industries expressed concern about its budgetary cost.

Financing plan for IKA: The reform proposals focus on securing adequate financing for the main pension fund, IKA (Table 1). The financing plan includes three parts: (a) Funding of EUR 9.6 billion to cover **past due state obligations** to IKA as well as IKA obligations to other state entities, through government bond issues. (b) Build-up of a **reserve fund** for IKA to help meet future obligations, through issuance of special, non-marketable, zero-coupon government bonds, yielding a 3% real return. Issuance averaging about EUR 1 billion is due to start in 2008, with redemptions starting in 2023 (c**) Budgetary contributions** of 1% of GDP a year, starting in 2003, to help cover IKA's cash deficit.

Consolidation of pension funds and creation of private funds: Recognizing the need to reduce administrative costs, the draft legislation calls for consolidation of the numerous existing funds for salaried employees into IKA by 2008. The same would apply to the associated supplementary funds, which would be consolidated into a single fund (ETEAM) by June 2003. The draft law also provides for the creation of private, fully funded pension funds, regulated by the Ministry of Labor. Contributions to private funds would be optional and additional to the compulsory contributions to the state-run funds.

Budgetary impact: The financing plan will not increase the general government deficit or debt as defined by Eurostat, even though it would involve a massive transfer of resources, of an unspecified magnitude, from the central government (i.e. taxpayers) to IKA (i.e. retirees). Since IKA is part of the general government, government bonds held by IKA are considered intergovernmental debt and cancel out. Similarly, the annual budgetary contributions would raise the central government deficit and correspondingly reduce the deficit of IKA, thus leaving the general government deficit unchanged.

2. Why Reform is Urgent

Demographic trends: As is the case with other continental European pay-as-you go state pension systems, the Greek pension system is in urgent need of reform, as it will face significant financial pressures due to demographic trends that gradually will reduce the ratio of the working to the retired population from 2.1 currently to 1.1 by 2050. The need for reform is particularly acute in Greece where, a government-commissioned study conducted by the U.K. Government Actuaries Department, estimated the present discounted value of unfunded liabilities of the state pension system at 300% of GDP, the highest in the EU. Lack of fundamental reform will sooner or later create a conflict between Greece's obligations under the EU Stability Pact and the financing requirements of the pension system.

The British Actuaries report: According to the study, released a year ago, the deficit of the pension system will increase from 4.8% of GDP currently to 9.1% in 2025 and to 16.8% of GDP in 2050 in the absence of reform. If increases in the –comparatively high– contribution rates are ruled out, demographic trends imply that the current retirement age and other benefits, including early retirement at full pension for a large segment of the labor force, are untenable.

The IMF Report: A recent IMF report on the Greek pension system[1] concludes “Greece is facing among the more dramatic demographic prospects in the coming decade. Moreover, current pension expenditures [as a % of GDP] are among the highest of EU economies…Regardless of the reforms ultimately chosen, the importance of introducing them as soon as feasible, especially given the long transition periods needed with such reforms, cannot be overly stressed.”

3. The Proposed Reform

Besides securing funding for IKA, the draft legislation seeks to create a uniform benefits and contributions, administered by a single pension fund, for salaried employees in the public and private sectors, irrespective of whether they entered the labor force before or after the 1992 pension reform [2]. In doing so, it raises benefits for some categories of workers and reduces them for others thus raising, on balance, the actuarial deficit of the pension system.

Provisions that raise the actuarial deficit: Numerous concessions granted to contributors who entered the labor force after the 1992 reform, as well as to other categories of contributors, would raise the actuarial deficit over the period 2008-2032 based on both our own assessment and the Ministry of Economy[3] statements. In particular, the proposals would partly rescind the provisions of a 1992 reform that sought to create a uniform, less generous, system for post-1992 entrants to the labor force. For these workers: (a) the replacement ratio (ratio of pension to salary) would rise from 60% of salary to 70%, and the minimum pension would increase; (b) the 65-year minimum retirement age would no longer apply to workers with at least 35 years of service. Other categories of contributors (e.g. working mothers, early retirees), also would benefit from the new provisions.

Provisions that reduce the actuarial deficit: The proposed legislation reduces excessive benefits (relative to both contributions and private sector benefits) granted to employees in the broader public sector (notably state-controlled enterprises and banks). Benefits for these workers would be gradually aligned with IKA benefits, i.e.: (a) the replacement ratio would gradually decline from 80% to 70% of salary over a ten-year period starting in 2008. (b) the base salary on which pensions are calculated would gradually decline, from the last salary currently to the average salary of the last five years, with full effect from 2012.

No fundamental reform: The draft legislation makes only marginal, parametric changes to the existing state-run, pay-as-you-go system for both basic and supplementary pensions. The only new element is the introduction of a "third pillar" through optional contributions to fully funded private funds, similar to those that have recently gained ground in a number of EU countries including Germany, the Netherlands, Spain, and Sweden. The introduction of a single pension fund for all salaried employees, intended to replace the maze of existing funds with different benefits, has been delayed until 2008. No reform is proposed for the self-employed.

4. Political Backdrop Not Helpful to Reform

Falling government popularity: The ruling Socialist party (PASOK) was re-elected in April 2000 on promises to implement structural reforms needed to keep Greece competitive in EMU and promote convergence of living standards with the EU average. However, reforms have been delayed in the face of political pressure partly linked to the poor performance of the stock market and partly to resistance from public sector labor unions, long-standing PASOK supporters. The Government’s popularity has dropped as it is under fire from both the unions – with some groups arguing that state funding is insufficient to preserve current benefits – and the business community – for excessive state largesse. Recent opinion polls show PASOK trailing about 8% behind the opposition New Democracy, ahead of municipal elections due in October, has prompted the government to appease its grass-root supporters in the labor unions.

Fiscal concerns: The government’s attempt to tackle the issue of pension reform is linked to broader concerns about fiscal viability. These concerns prompted last year’s postponement of military spending in order to make room for the cost of hosting the 2004 Olympics, projected at EUR 6 billion over three years. Small fiscal surpluses are only

[1] IMF Country Report No. 02/58, “Greece-An Overview of Pension Reform”, March 2002.
[2] The 1992 reform, implemented by the conservative government with technical assistance from the IMF, sought to create a uniform, less generous, system for post-1992 entrants to the labor force by reducing pensions relative to salaries and raising the minimum retirement age to 65 for both men and women.
[3] See Ministry of National Economy Press Release on the IKA fnancing proposal, April 3, 2002.

achieved through significant off-budget shifts, e.g. in the form of below-the-line capital increases granted to loss-making state enterprises and entities. Falling privatization revenues from equity placements of government holdings prompted the government to raise EUR 5.8 billion in revenues (4.4% of GDP) from securitization, convertible bonds, and privatization certificates last year alone. These sums were so far excluded from the general government debt figures, either because they are likely to be converted to equity or because they are issued by special-purpose vehicles. Last month, Eurostat (the statistical office of the EU Commission) decided to include privatization certificates in public debt, thus causing the Greek debt ratio to rise from 99.7% to 101.7% of GDP at end-2001 Eurostat also warned that it is reviewing the treatment of securitizations and convertible bonds, with a final decision expected next month.

5. Assessment

Rationale of reform: The draft legislation states that the aim of the reform is, inter alia, to ensure equity of treatment across generations - a principle that was allegedly violated by the 1992 pension reform. This argument overlooks the fact that demographic trends will burden future generations of contributors with rapidly rising pension expenditures. In our view, equity of treatment across generations is better served by cuts in benefits and/or a rise in the retirement age in line with the rise in life expectancy - which was the aim of the 1992 reform.

Reform proposals: There is little doubt that the proposed reform would raise the actuarial deficit over the period 2008-32 (and beyond), because benefits would rise for *all* workers who joined the labor force after the 1992 reform, whereas benefits would fall only gradually for workers in the broader public sector, who represent only about 10% of the labor force. The reform thus does not address the issue of rising pension expenditure relative to GDP, it just seeks sources of funding for the resulting deficit of the main pension fund, IKA. Under current proposals, IKA funding will be exhausted after 2032 and new reform efforts will need to be launched.

IKA Financing plan: It is not clear whether the EU would condone the large off-balance sheet borrowing implied by the IKA financing plan. Down the road, when the “special bonds” start maturing, the general government debt would rise as the government borrows to fund the redemptions.

Consolidation of pension funds and creation of private funds: This is a step in the right direction, insofar as it would cut administrative costs and provide the framework for the creation of fully funded private funds. In contrast to the state system, which is forced to invest in Greek assets only, the private funds would be able to maximize returns by investing in foreign assets (both EU and non-EU).

Implications of delay in fundamental reform: The delay in fundamental reform implied by the draft legislation raises three related issues relating to fiscal sustainability. Specifically, delay reduces the scope for: (a) grandfathering clauses to protect the rights of existing workers, thus increasing political opposition to future reform efforts; (b) a lasting reduction in the debt ratio toward the 60% of GDP Maastrchit target; (c) upgrades in Greece’s sovereign credit rating, with adverse consequences on future borrowing costs. In light of the introduction of new BIS rules on bank capital adequacy in 2005, Greece needs to be upgraded two notches to AA- by then to avoid losing the zero-risk weighting that Greek bonds now enjoy under existing BIS rules.

Table 1. IKA: Projected Deficits and State Funding, 2003-2032 (in billion EUR)

Year	GDP	IKA Deficit	State Funding EUR bl.	State Funding % GDP	Total Reserves	Special Bond Reserves
Period A (2003-2008)						
2003	146.6	1.4	1.4	0.9%	0.0	0.0
2004	155.7	1.3	1.5	0.9%	0.2	0.0
2005	165.1	1.3	1.6	1.0%	0.5	0.0
2006	174.9	1.3	1.8	1.0%	1.0	0.0
2007	185.3	1.3	1.9	1.0%	1.7	0.0
2008	196.3	1.2	2.1	1.0%	2.7	1.5
Period B (2009-2032)						
2009	207.9	1.2	2.1	1.0%	3.6	2.4
2010	220.1	1.2	2.2	1.0%	4.5	3.4
2011	231.8	1.3	2.3	1.0%	5.8	4.4
2012	244.1	1.3	2.4	1.0%	7.0	5.6
2013	256.9	1.4	2.6	1.0%	8.2	6.7
2014	270.3	1.5	2.7	1.0%	9.5	8.0
2015	284.2	1.6	2.8	1.0%	10.9	9.2
2016	297.7	1.7	3.0	1.0%	12.2	10.3
2017	311.6	1.9	3.1	1.0%	13.6	11.4
2018	326.0	2.1	3.3	1.0%	14.8	12.4
2019	341.0	2.4	3.4	1.0%	15.9	13.2
2020	356.5	2.7	3.6	1.0%	16.9	13.8
2021	372.4	3.1	3.7	1.0%	17.7	14.1
2022	388.8	3.6	3.9	1.0%	18.2	15.2
2023	405.8	4.1	4.1	1.0%	21.1	16.4
2024	423.4	4.6	4.2	1.0%	22.1	16.8
2025	441.5	5.3	4.4	1.0%	22.7	16.8
2026	460.7	6.0	4.6	1.0%	23.0	16.3
2027	480.5	6.7	4.8	1.0%	23.4	15.9
2028	500.9	7.6	5.0	1.0%	23.8	15.3
2029	521.9	8.5	5.2	1.0%	22.8	13.4
2030	543.6	9.4	5.4	1.0%	21.6	11.3
2031	566.9	10.4	5.7	1.0%	20.7	9.3
2032	591.3	11.4	5.9	1.0%	17.1	4.4

Source: Ministry of Economy, April 2002.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST