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Why pensions need to be cut

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Pension cuts and the reduction in the tax-free income threshold constitute structural reforms aimed at a more growth-friendly policy mix, this writer claims.

Earlier this year it appeared likely that Prime Minister Alexis Tsipras would try to capitalize on a smooth exit from the third bailout program by calling early elections this fall – a year ahead of schedule – before politically painful cuts in pensions take effect in 2019. But the government's incompetent handling of the tragic fire that killed 98 people at a resort near Athens in July probably ruled out this option, focusing the administration's attention instead on how to avoid the pension cuts. Senior government officials have stated in recent weeks that the cuts are unnecessary because the primary fiscal target of 3.5 percent of GDP can be achieved without them.

As part of the program's second review, the government agreed to cut pensions and reduce the tax-free income threshold in 2019 and 2020 respectively. These measures were approved by the Greek Parliament under duress in May 2017, amid government statements that they were the result of “blackmail.” Prime Minister Tsipras blasted the Hellenic Federation of Enterprises (SEV) in July for “insisting on the necessity of the cuts irrespective of whether we meet the fiscal targets.” He accused SEV of supporting measures that undermine growth and social fairness. What he doesn’t seem to get is that the pension cuts and the reduction in the tax-free income threshold constitute structural reforms aimed at a more growth-friendly policy mix by creating fiscal space for much-needed public spending and tax cuts. Here’s why:

Intergenerational equity: The 2016 pension reform, known as the “Katrougalos law,” cut significantly the pensions issued after the reform was approved by Parliament (12/5/2016), but left intact the pensions issued before this date. The difference between pensions issued before and after the cutoff date was labeled the “personal difference.” Maintaining the “personal difference” for existing pensioners implies that a new pensioner with the same years of service and the same contributions can receive a pension that is up to 35 percent lower. Greece has committed to recalculate existing pensions based on the new parameters and implement cuts of up to 18 percent by slashing the personal difference – a move that would partly restore intergenerational equity. Starting in January 2023, when pensions will be “unfrozen,” any pension increases linked to growth would be offset against any remaining personal difference until it is eliminated. When this occurs, intergenerational equity will be fully restored.

Fairness: A significant portion of the “old” pensioners (pre-May 2016), who are protected by the personal difference, received pensions that significantly exceeded their lifetime contributions at a relatively young age (between the ages of 50 and 62). These privileged pensioners include public sector and bank employees, as well as lawyers, engineers and journalists whose pension funds retained their own benefit formulas and were partly funded by earmarked taxes levied on their customer base (“taxes collected on behalf of third parties”). The latest data on the HELIOS database (March 2018) indicate that old-age pensioners below 66 years constitute 20 percent of the total (391,221 out of 1,965,427) but receive 25 percent of pension outlays (5.8 billion out of 23.2 billion euros). On a monthly basis, old-age pensioners below 66 years receive an average pension of 1,242 euros while those above 66 receive just 918 euros. How is this “socially fair”? The cuts that are scheduled to take effect on 1/1/2019 will appropriately hit mainly this group of privileged pensioners with above-average pensions.

Burden on production: In a pay-as-you-go pension system with few or no reserves, like the Greek system, pensions are partly funded by employers and employees through pension contributions. Contribution rates have been raised significantly since 2010, increasing the distortionary tax wedge, but revenue from contributions has fallen as incomes declined, the labor force shrank and unemployment rose. Contributions cover less than half the annual pension expenditure, with the deficit funded by budget transfers. Approximately 70 percent of the debt build-up during the decade 2000-09 that preceded the crisis funded the pension system. According to IMF data, pension expenditure rose from 14.8 percent of GDP in 2010 to 17.7 percent in

2015, as pensions lagged behind the fall in GDP. After the 2016 reform, pension expenditure remains above 16 percent of GDP, by far the highest in the euro area. The catastrophic stand-off with creditors in 2015 compounded the problem as the economy returned to recession.

Greece's creditors believe that further pension cuts are necessary to safeguard the viability of the pension system, which is linked to debt sustainability. They have agreed that the contractionary impact of the 2019 pension cuts would be offset by increases in public investment and social spending provided the primary surplus target of 3.5 percent of GDP is met. On the revenue side, a reduction in the tax-free income threshold in 2020 would broaden the tax base and permit a cut in tax and contribution rates. The IMF has repeatedly stressed the need for a growth-friendly restructuring of spending and revenue that would create room for social spending. Currently one-fifth of tax revenue is spent on pensions, while expenditure has been redirected away from public services and investment.

Markets are now focusing on Tsipras's state of the nation address Saturday to assess the extent to which he plans to stick to the agreed reforms or resume the fiery rhetoric that has spooked markets in the past. The government already has backtracked on labor market reform by restoring collective labor agreements and is planning to raise the minimum wage. The 10-year yield on Greek government bonds has widened to 4.5 percent, by far the highest in the euro area. Greece needs to provide reassurance to markets that the reform effort will continue, otherwise market access to roll over maturing debt will remain prohibitive and the country will eventually need a fourth bailout.

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