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THE FINANCIAL CRISIS AND DIFFERENCES IN STATE PENSION GENEROSITY ACROSS EU COUNTRIES

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Introduction

In pensions, major reforms, to some extent, predate the onset of the financial crisis. However, the crisis has led to significant changes – especially in those countries that had left their pension systems relatively unchanged prior to 2008. European countries entered the crisis with very different pension systems, for instance in terms of generosity or reliance on the state. The crisis led to a greater degree of convergence in two respects at least. Eastern European countries, which had sought to lessen the role of the state prior to the crisis, ended up undoing many of these reforms. Meanwhile, Southern European countries, which traditionally had relatively generous pension schemes, introduced substantial cutbacks. This paper will seek to describe this process of convergence imposed to some degree by the financial crisis.

Pension reform during the financial crisis

EU pension systems differ greatly. In fact, a number of typologies of welfare states put different European systems in quite separate categories. For instance, Liebfried (1992) divided Europe into Anglo-Saxon countries (with a residual welfare state), Bismarkian systems (where the welfare state maintains income differentials), the Scandinavian block (with a progressive welfare state focused on moderating inequalities) and the Latin rim (where the welfare state is a semi-institutionalised promise with in-built differences in generosity towards certain groups). Similarly Bonoli (1997) and Soede, Vrooman, Ferraresi and Segre (2004), using

data on a number of characteristics of welfare regimes, categorise Western European welfare states into these four blocks, with the Eastern European countries falling into a distinct group. The latter group is quite a hybrid mix, as a number of these countries traditionally had a very progressive pension system, which is changing rapidly for new contributors into arrangements with a much tighter link between benefits and contributions. On the other hand, Ferrera (1996) and Katrougalos and Lazaridis (2008) describe the main elements of the so-called Southern European (or Latin rim) welfare state as being a low degree of institutionalism (and related political clientelism), a high fragmentation of policies and the grafting of universalist schemes onto occupational systems, but with few work incentives, leading to excessive spending and endemic early retirement.

Prior to the crisis, there were substantial changes in EU pension systems (for details see European Commission 2010 and Grech 2014). Early in their transition to becoming market economies, many Eastern European countries introduced mandatory individual private schemes as the main mandatory pension provision (see Fultz and Steinhilber 2003). The crisis had a major impact on the image of private pensions being a stable source of long-term income (Yermo and Severinson 2010 and Impavido and Tower 2009). Orszag (2013) nevertheless argues that while the downturn threw new light on certain issues, such as over-reliance on defined contribution pensions, the structure of pension provision may not change over much, as pensions are a difficult long term issue that induces avoidance behaviour amongst policymakers.

The financial crisis, however, exacerbated the impact on government finances of the adoption of mandatory individual pensions (Whitehouse 2009). Hirose (2011) and World Bank (2013) document the major changes effected in many Central and Eastern European states, with countries like Hungary nationalising their mandatory private provision, while others like Slovakia and Poland are undoing most pension reforms and shifting back contributors to the previous state system. While tight finances undoubtedly played a role, Drahokoupil and Domonkos (2012) argue that another important cause of these developments was the change in the consensus

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on the benefits of pension individualisation and privatisation. They argue that the IMF, for instance, provided tacit support for decisions to scale down mandatory private systems, while the World Bank's previous advocacy of these schemes became much more muted.

Natali (2011) notes that two common responses to the crisis in many EU countries have been to increase minimum pensions and to raise retirement ages. In Western European countries another strong driver of pension reform appeared to be the continued move towards adopting stronger activation policies in welfare policies (Vis, van Kersbergen and Hylands 2011). Pensions in most countries already had a strong contributory principle embedded in them, but recent reforms sought to strengthen this principle even further (European Commission 2010). This process predated the crisis and has also affected countries (like Scandinavia, for example) that traditionally had a more universalist focus (Bosco and Chassard 1999). This common reaction may possibly have been an attempt to get people to seek to re-enter labour markets quickly.

On the face of it, the downturn should not have impacted some pension systems, such as the German one. Yet, Hinrichs (2013) notes contribution rates were lowered and projected cuts in benefits (due to the sustainability factor embedded in the German system)² were delayed. The author argues that the crisis' impact on employment careers has to be taken into account, as pension reforms have significantly tightened the link between contributions and entitlements. The increasing use of atypical jobs, particularly part-time and temporary contracts, means that individuals will accumulate less pensions in the long term. Moreover, Hinrichs notes that, in most cases, these jobs would not result in individuals getting contribution credits.

Bodor and Rutkowski (2013) argue that the crisis changed the political context and framing of pension reform decisions. Policymakers in stressed countries could have arrived at the conclusion that a stance supporting pension reform driven by fiscal pressure could be the lesser evil between resistance to reform and the price of avoiding a default. Systemic reforms need a longer period for design development, and therefore crisis times could be more conducive to parametric reforms. An in-depth review of reforms in those countries most heavily affected by the crisis can be found in

Social Justice Ireland (2013) or Petmesidou and Guillen (2014). In cases where radical reforms have been put in place, these seem to have been imposed from the outside (see Matsaganis 2012 for an extensive discussion of the Greek experience), although even in such cases policy-makers have found it hard to tackle the entitlements of the more privileged groups (Venieris 2013).

Even countries, like Portugal, which came to the crisis with reformed systems that were supposed to have tackled long-term increases in spending through complex design features, like sustainability factors and longevity indexes, were not spared further changes. Pedrosa (2014) indicates that amongst the first actions to be taken was a reduction in current benefits, particularly by stopping indexation. A lot of these measures have been deemed unconstitutional in Portugal. Zartaloudis (2014) argues that reforms have been more dramatic in Greece and Portugal than in Italy and Spain as the latter countries have less economic and political power to resist reform. He observes that retrenchment highlights that these countries have not yet converged to their richer neighbours' income standards. That said, other studies (like Sanchez 2014) argue that even in Italy and Spain - while changes may not be immediate - the introduction of adjustment factors aimed at reducing indexation to keep the system in financial balance means that some cohorts will bear a disproportionate share of the costs and current retirees may face sharply decreasing relative pensions during retirement.

Symeonidis (2013) argues that while the crisis brought down the social security system in other countries, in Greece the system was already on its knees due to the political actions of the preceding thirty years. Amongst the most pressing issues was the excessive fragmentation of the system, which featured 133 funds all with their particular rules. Indexation was arbitrary and subject to political pressure most of the time. He argues that politicians tended to make the system more generous in order to reduce pensioner poverty, but failed to understand that the inherent problem was inadequate coverage and not low pensions as such. To make things worse, the crisis directly affected the 133 pension funds directly as they mostly held Greek government bonds and the value of their assets plummeted.

The troika, a tripartite committee composed of the European Commission, the European Central Bank and the International Monetary Fund included explicit references to pension reform in their Memorandum of Understanding with the Greek government. They in-

² This factor takes into account the changing worker to pensioner ratio and tries to ensure that the contribution rate required to finance pension expenditure remains stable.

roduced a basic pension to serve as a safety net, but halved the accrual rates of the general pension regime. The effective retirement age was increased and linked to life expectancy after 2021. The contribution period required was boosted to 40 years, benefit calculation was moved to career earnings and the indexation of benefits was prevented from exceeding inflation. Moreover, if expenditure increases by more than 2.5 percent of GDP by 2060, system parameters need to change (similar to a notional defined contribution system). In that case individuals who retired earlier will be obliged to return part of their pensions to a Government fund. According to Symeonidis (2013) pensions were cut by 20 percent for normal retirees and by 40 percent for early retirees, although those on lower incomes were spared. All of these measures are projected to lower growth in public pension spending by 2060 from 12 percent of GDP under the old regime to virtually nothing under the new one (European Commission 2015).

Greece may present an extreme case. Looking also at Spain, Italy and Portugal, Matsaganis and Leventi (2014) present evidence that pension cuts had a mixed distributional impact, as some of the changes were progressive. On the other hand, Natali and Stamati (2014) argue that cost containment measures put future adequacy at risk and gave rise to new problems of inequality, risk individualisation and increasing vulnerability to external shocks.

Quantifying the difference in the impact of pension reforms

To study whether pension reforms reflected the size of the economic downturn affecting the country, we look at estimates of pension entitlements made by the OECD in its biennial ‘Pensions at a Glance’ publication issued in 2007 (just before the crisis) and in 2014. These estimates were made using pension system rules before and after the crisis in 19 EU countries (comprising 92 percent of the total population of the Union).

To facilitate comparisons, countries are classified into groups using two classifications. In the first, the 19 countries are divided into a group where the relative difference in the GDP level for 2013 compared to that in 2008 is higher than the EU average and another where economic recovery is more pronounced. The first group entitled ‘countries with under-performing economies’ (CUPE) includes the Czech Republic, Denmark, Finland, Greece, Hungary, Ireland, Italy, the

Netherlands, Portugal and Spain. It amounts to 39 percent of the EU’s total population. In the second classification, we divided the 19 countries into a group with countries heavily affected by the sovereign debt crisis, i.e. Greece, Ireland, Italy, Portugal and Spain, and the rest. The first group denoted henceforth as the “stressed countries” comprises 29 percent of the EU’s total population. It is worth noting that while the CUPE group includes countries with very different pension systems, stressed countries are nearly all members of the so-called Latin Rim or Southern European welfare model.

Table 1 presents estimates of replacement rates for someone on the average wage, and who was covered by the mandatory pension system in that country using the pension rules as in 2006, and those in place seven years later. Estimates are calculated assuming a 40-year uninterrupted career.

Table 1

Replacement rates for someone retiring in forty years’ time		
	2006	2013
Austria	90.9	90.2
Belgium	63.0	62.1
Czech Rep.	75.6	64.7
Denmark	86.7	77.4
Finland	68.8	62.8
France	63.1	71.4
Germany	58.0	57.1
Greece	110.1	70.5
Hungary	102.2	95.2
Ireland	38.5	44.8
Italy	77.9	81.5
Luxembourg	96.2	69.4
Netherlands	96.8	101.1
Poland	74.9	59.5
Portugal	69.2	67.8
Slovakia	72.9	85.4
Spain	84.5	80.1
Sweden	64.0	55.3
UK	41.1	41.8
CUPE	83.0	79.6
Others	59.4	59.0
Stressed	80.9	77.7
Others	63.7	62.7
Total	68.6	67.0

The replacement rate compares the initial pension accruing to an individual retiring after a 40-year uninterrupted career with their previous wage (assumed equal to the average wage).

Source: OECD (2007), OECD (2014).

On the face of it, it appears that the financial crisis did not result in a substantial weakening of pension entitlements. Even in stressed countries, replacement rates fell by an average of just 3.2 percentage points. The drop in countries less affected by the crisis was more restrained, at 0.4 percentage points. Pension entitlements fell in 13 countries, with the largest drops in Greece and Luxembourg. Meanwhile, three of the five biggest nations boosted pension generosity. One of the interesting facts emerging from Table 1 is that when one assumes full careers, the generosity of pensions is substantially higher in the countries that faced large economic downturns, including the stressed countries. The OECD estimates suggest that, despite the cuts, replacement rates remain high in most countries. In fact, the replacement rates in most countries, particularly those facing the most economic turmoil, exceed the 60 percent replacement rate benchmark that the World Bank deems

as unaffordable (Holzmann and Hinz 2005) and the 45 percent replacement rate that the International Labour Office deems as providing a decent standard of living (Humblet and Silva 2002).

These results are contradicted by Eurostat data on the proportion of elderly people living in relative poverty. The elderly poverty rate in stressed economies stands at 13.7 percent for men and 17.4 percent for women, versus 11 percent and 14.8 percent in the non-stressed economies. Yet Table 1 implies that pension generosity is significantly lower in the latter group. This paradox is easily explained. Replacement rate measures estimated using the full-career assumption are not very representative of actual generosity. Grech (2013) shows how these measures show very little correlation with at-risk-of-poverty rates. Especially for women and those on low incomes, career lengths are much shorter. Eurostat data on the duration of working lives suggests that in 2013, only men in Denmark, the Netherlands, Sweden and the UK worked 40 years or more. In Hungary the average man worked 32.5 years, while the average Greek and Italian man worked 35 years. Amongst women, careers tend to be even shorter, standing at about 32 years on average across the EU. In the Mediterranean countries, the contrast is even starker, with the average woman in Italy having a 25 year career, while women in Greece work for 28 years on average. Since recent reforms have strengthened the link between entitlements and career length, estimates such as those in Table 1 can be deceptive.

To address this issue, we can look at another measure of pension generosity, known as the benefit ratio. This measure compares the average pension with the average wage. The main difference compared to the OECD replacement rate measure is that instead of being based on the entitlements of a hypothetical worker, the benefit ratio is computed using projected pension expenditure, estimated on the basis of projected labour participation. These estimates, shown in Table 2, are derived from the projections made using pension rules in 2007 (European Commission 2009) and those made using rules set in 2014 (European Commission 2015). They suggest much lower generosity than the OECD estimates, with the average pension across countries amounting to just 44 percent of the average wage using the 2007 pension rules, versus the replacement estimate of 69 percent. Moreover, the relative difference in pension generosity between the groups of countries suggested by this indicator is somewhat lower. The countries most affected by the crisis have a benefit ratio just 20 percent higher than

Table 2

Benefit ratio for an individual retiring in 2050		
	2007	2014
Austria	42.7	38.7
Belgium	44.6	43.1
Czech Rep.	37.6	39.1
Denmark	37.5	34.8
Finland	48.3	45.6
France	48.3	40.5
Germany	42.5	37.3
Greece	83.7	54.1
Hungary	36.6	32.3
Ireland	31.5	26.2
Italy	51.7	52.4
Luxembourg	42.9	54.4
Netherlands	40.7	34.2
Poland	30.6	32.8
Portugal	34.5	46.7
Slovakia	34.9	32.2
Spain	54.5	40.2
Sweden	31.4	27.6
UK	35.8	34.8
<i>CUPE</i>	<i>49.7</i>	<i>44.1</i>
<i>Others</i>	<i>40.3</i>	<i>36.7</i>
<i>Stressed</i>	<i>53.3</i>	<i>47.0</i>
<i>Others</i>	<i>40.2</i>	<i>36.7</i>
Total	44.0	39.6
The benefit ratio is the ratio of the average pension to the average wage. The average pension is derived by dividing actual and projected pension expenditure by the number of pensioners.		
Source: European Commission (2009), (2015).		

those less affected, versus the 35 percent difference that exists in replacement rates.

The picture that emerges when one compares the projected benefit ratio for someone retiring in 2050 using the pre-crisis pension rules and the post-crisis ones diverges to a far greater degree than that shown by replacement rates. Even before the crisis, the projected benefit ratio was already quite low compared with the benchmarks set by the International Labour Office. The reforms implemented since then have reduced the average benefit ratio across countries by 4.4 percentage points, or a tenth. In the stressed countries, the decline was 6.3 percentage points, or nearly double the decrease observed among other countries. There is a similar difference in the projected reduction in generosity between countries most affected by the crisis and those less affected. One of the most striking results to emerge from Table 2 is that while the pre-crisis benefit ratio for Greece was projected to be double that of Luxembourg, after the reforms enacted since the crisis, the benefit ratio in Greece is now projected to be lower than in Luxembourg.

It is also important to remember that there have been substantial revisions of future economic conditions in these countries. In the 2009 Ageing Report, Greece's GDP was projected to grow on average by 1.8 percent per annum until 2060. The latest Ageing Report now projects an average growth of 0.7 percent per annum. By contrast, Luxembourg's projected average increase in GDP was revised downwards from 2.7 percent to 2.5 percent per annum. Thus, besides the significant decline in projections of relative pension generosity, there has also been a substantial reduction in expected levels of generosity in absolute terms.

Conclusion

EU countries entered the financial crisis with relatively different pension systems. As a result of the crisis, either through direct external intervention or internal domestic political decisions, there now appears to be a greater degree of convergence amongst systems. This has occurred mainly as under-performing economies have cut their system generosity, in some cases like Portugal and Greece quite significantly. Despite the cuts, pension systems in the stressed economies should still be generous enough to keep the majority of pensioners out of relative poverty. However, this depends on a quick turnaround in the labour market performance in these countries,

particularly in terms of youth employment, as the reformed pension systems have introduced a stronger link between entitlements and contributory records. Unless this happens, there is a risk that today's young generations will face an uncertain retirement.

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