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Greek-Spanish Pension Split Illustrates Europe's Dilemma

By Landon Thomas Jr.
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The differences in approach could not be more distinct — or telling.

Two of the most economically distraught countries in the euro zone, Greece and Spain, mapped out additional budget cuts last week.

In the case of Greece, under last-chance pressure from its international creditors, the governing coalition tentatively agreed on an austerity package that includes some of the most severe cuts in public pensions ever imposed in a developed country. Pension payouts to retirees would be trimmed by as much as 10 percent.

And then there was Spain, where last Thursday the government of Prime Minister Mariano Rajoy introduced one of the most draconian budgets in the country's history. It was intended to reassure international investors and demonstrate the fiscal discipline that the euro zone was demanding of Madrid.

The markets need reassuring: Spain has a stubbornly high budget deficit, its banks require tens of billions of euros in rescue loans and the government may soon have little choice but to request European aid.

Nevertheless, Mr. Rajoy declined to cut pensions or even to freeze them. Instead, his budget would actually increase payouts 1 percent next year on pensions for former public employees as well as on the social security payments that go to all retired Spaniards.

Politically, it is understandable that Mr. Rajoy would want to put a protective bubble around the country's 10 million retirees at a time when people are marching in the streets and the economically crucial region of Catalonia is threatening to secede.

But pension expenditures represent the single biggest line item in the Spanish government's budget, at nearly 40 percent of public spending and 9 percent of Spanish gross domestic product.

That 9 percent still trails France (15 percent) and Italy (13 percent). But given Spain's rapidly aging population — 30 percent of Spaniards are expected to be older than 65 by 2050 — the portion of government spending on pensions seems certain to rise in the future.

The fact that Spanish public pensions are being enhanced is a reminder of one reason European debt and deficit problems have proved so difficult to resolve.

Only Greece, under duress and at a point where the move may be coming too late to salvage the government's finances, seems prepared to risk the consequences of severe pension cuts.

By contrast, France, under its new president, François Hollande, has lowered its retirement age to 60 from 62 for certain categories of workers. To be sure, the French budget outlook is not as dire as that of Spain.

But over the longer term, the deficit-reduction plan Mr. Hollande's government announced with much fanfare on Friday could have a limited effect because it left pensions largely untouched.

Portugal, under pressure from a fresh wave of street protests, is likely to rescind a bold plan that would have required workers to increase their personal contributions to pension plans. And in Britain, the coalition government of Prime Minister David Cameron continues to resist any pension changes that would come down hard on older conservative voters.

"These policies are unsustainable," said Jagadeesh Gokhale, an expert on pensions and social spending at the Cato Institute, a politically conservative research group in Washington. "The implicit liabilities of the pension programs will soon turn into explicit debts. But the political dynamic in Europe is opposed to policies that make economic sense."

Pensions have become a critical lifeline in Spain. With the unemployment rate at 25 percent, and even higher among young people, many Spaniards have become reliant on pension-drawing parents and grandparents to support them. Economists estimate that as many as 1.7 million of Spain's 16 million households have no salary earners.

Arguably, Spain's pension benefits are more important than unemployment insurance, a benefit for which eligibility eventually expires.

To pay for the 1 percent pension increase in the 2013 budget, Mr. Rajoy's government dipped into its main safety net for retirees, the pension reserve fund. That could make it even harder for Spain to find the money for pension payments in coming years.

Senior members of Mr. Rajoy's cabinet made no bones in laying out the political calculations behind the move. They argued that it was crucial for the economy and society to enhance support for pensioners.

The previous government in Madrid took some steps to address the issue in 2011, passing legislation that would increase Spain's retirement age to 67 from 65. But it will not be until 2027 that the change takes full effect, limiting the near-term budgetary effect.

As for actually cutting pension payments, the notion remains politically off limits.

"There are a lot of pensioners who vote and the unions are dead set against it," said Ángel de la Fuente, an economist based in Barcelona and co-author of a recent paper on pension policies in Spain.

"The government has been holding off as long as it can," he added, "but it will have to do something. Even to just freeze pensions could save as much as 4 billion euros a year," or about $5.1 billion.

For Greece, the longtime generosity of its pension system, in which large numbers were previously allowed to retire at 50 and younger, came to define the bankrupt condition of the Greek state. In the years before the crisis hit, pension payments in Greece totaled as much as 14 percent of gross domestic product.

But those days are over. If all goes according to plan, the Greek retirement age will increase to 67 next year from 65. And reductions in pensions and wages will make up the bulk of the 11.5 billion euros in spending cuts that Greece's creditors are demanding from Prime Minister Antonis Samaras's government.

As many economists would note, such a reduction in Greek public spending is likely to compound an economic decline in which gross domestic product shrank 25 percent over the last five years. And while government negotiators in Athens fought hard with creditors to ease the sting, there is a broad agreement that such measures, difficult as they may be, must be put in place now, while the government still has credibility.

“You would be amazed how committed they are,” said Petros Christodoulou, former head of Greece’s debt management agency who is now a top executive at the National Bank of Greece. “There will be pain and it will not be smooth. But this government will use its honeymoon to do the really hard stuff now.”

In Spain, the last-ditch pressure to do the really hard stuff has not arrived.

Not yet, at least.