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Disentangling the Roles of the State:

Pension Provision in Public Enterprises

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DISENTANGLING THE ROLES OF THE STATE
Pension provision in Public Enterprises[1]

I. CREATING AN IMPASSE: THE CASE OF THE GREEK PUBLIC POWER CORPORATION

The Public Power Corporation (PPC) is still the monopoly producer (*de facto*) and (*de jure*) distributor of electric power in Greece[2]. It is a highly vertically integrated company, the largest employer in the country covering all aspects of electricity generation and distribution.

In 1966 employees of the company were withdrawn from the main Social Security Fund (which covers all private sector employees) and were insured for all risks (pensions and health) within the Enterprise. In Contrast to the German-inspired Book reserve systems, (*Pensionrückstellung*) no separate accounts were kept, though initial current balances were heavily in surplus. For much of the period since 1966 no explicit employer contribution was levied; employees, on the other hand, contributed regularly into the general company budget (no book reserves were kept). Initial (imputed) surpluses were invested in electrical plant, hence avoiding the reliance to what was then an underdeveloped, inefficient and expensive capital market.

Seen in the context of the period, the PPC pension arrangements could be interpreted as an ingenious second-best arrangement which short-circuited many problems which stood in the way of the attainment of the major goal that was identified then – the rapid electrification of the country. In terms of social benefits, it allowed one crucial part of the work force to secure social protection, without waiting for the whole country to follow[3].

Forty years on, it must be conceded that the primary aim of the second-best arrangement was successful – electricity spread through the country, and PPC became entrenched as the largest company in Greece, and

[1] The author is an adviser to the Prime Minister. The views expressed are personal and do not necessary reflect those of any official body with which he is or was associated.

[2] For an overview of public enterprise issues in Greece, see Mylonas and Papaconstantinou, 2001, and Mylonas and Joumard, 1999.

[3] The interpretation of the fragmentation of the social security as a second-best response see Börsh-Supan and Tinios, 2001. Fragmentation is one of the key characteristics of the 'Mediterranean Welfare State" (Ferrera, 1996), where welfare arrangements are the result of reaction to corporatist pressures, and not the outcome of the application of uniform principles.

possibly the most efficient (in technical terms, at least) of public enterprises. However, as so often happens with second-best arrangements, the cost of the side-effects ultimately outweighed the benefits of continuing on. What were those effects?

- After the initial period of current surpluses, sometime in the mid-80s, the current charges for pensions turned heavily negative.
- Under the current financing arrangement the costs of maintaining the pension system were treated as personnel costs – and passed on to the consumer.
- The process of the pension funds maturing was only part of the reason for the growth in spending[4]. At least as much was due to the pension arrangements being treated as a blank cheque – by both management and Unions. Thus within the decade after 1966, pension arrangements became far more generous than in the State Fund that they had left.

Conditions in the late 80s and 90s were very different from those pertaining in the 60s.

- Public finance and the necessity to cover pension deficits were dominant concerns. In a highly fragmented social security system "privileged sectors" such as PPC were acting as 'pension rights leaders'.
- There was a growing realisation that the price of electricity was crucial for competitiveness. The quality of production began to be seen as more crucial than the quantity.
- Within the electricity sector the increasing use of natural gas opened possibilities - for smaller-scale private generation.

Given these developments, the business strategy for PPC and its sole Shareholder was obvious:

- Unbundling costs, so that the costs of individual stages (e.g. mining, generation, transmission, distribution) could be separately identified.
- Allowing entry to outside investors, who should be guaranteed a level playing field.
- Seeking finance for investment from the private markets, in order to avoid reliance on the already strained State public finance situation.

This strategy was effectively blocked by problems arising from the pension arrangements:

Ever since the mid-80s the PPC Unions were arguing forcefully that under the pension arrangements, the insured workforce had a legal claim on all PPC Assets. The legal claim was necessarily vague, as the original law (4461/66) did not foresee an explicit employer contribution, but stated blandly that "*the PPC was liable to cover all pension payments in their totality*". The interpretation finally selected by the Unions was one that identified 'assets owned by the work force' as the sum necessary to cover all the current and future pension obligations. The possible size of this claim could exceed the value of the PPC balance sheet.

No progress could be made on unbundling, as that would presuppose that the claim could be apportioned. Proceeding without resolution of the employee claim would almost certainly lead to the move being blocked for years in the courts.

[4] The work force also grew rapidly in the 70s, partly due to the decision to develop domestic lignite production as a reaction to the oil crises.t

Development within the field of pensions brought the matter to a head between 1990-2[5]. The fact that the PPC had one of the most generous systems, meant it could not be excluded from the general rules. In terms of finance Law 2084/92 for the first time sanctioned the payment of employer contributions, and imposed a limit on the amount PPC management could subsidise their pensions over and above what was due in employer contributions.

The financing provisions of Law 2084/92 implied that the PPC had a period of around 5 years before the subsidy limit was exceeded. That amounted to a grace period in which to come to an agreement about the organisation and finance of the pension arrangements. This period coincided with the discussions in the EU regarding the Electricity Internal Market directive, which was finally passed as Directive 96/92 and came in force in 19 Feb 1997. According to the Directive Greece was granted an extra 2 years to introduce eligible customers (19 Feb 2001), i.e. customers having the right to choose their electricity supplier .

This paper sets out some of the issues and arguments that were used in the discussions regarding the nature of enterprise-specific pension arrangements[6]. The discussion is general in nature, before returning to the case of the PPC in the conclusion.

II: THE ACCOUNTANCY OF PROMISES – FIRMS AND THE STATE

Occupational pensions in companies

The offer of a pension package as part of employees' remuneration is a common strategy in many countries, and becoming more widespread in the EU. According to the case law of the ECJ ('the Barber judgment"), pension benefits are treated as part of the salary and are hence subject to the same kind of restrictions and obligations as salaries.

For occupational pensions to be able to play their role, pension systems should avoid two kind of pitfalls: (a) the use of reserves as a cheap source of finance by the employer, (b) the granting of blank cheques to the work force. Thus for the system to be able to function there should be, on the one hand, an adequate system of supervision to prevent the first, and conditions of transparency to avert the second. This paper is concerned primarily with the second.

Transparency implies the existence of an "*accountancy of promises*", in order to assuage two justified sources of concern:

- Safeguarding the workforce that the promises will be honoured.

[5] For the political economy of pension reform, see Börsch-Supan and Tinios, 2001, Featherstone, et al, 2001. For law 2084/92, Mylonas and de la Maisonneuve, 1999.

[6] The PPC is a very clear case of the issues involved, as there never was a legal distinction between the pension provider and the enterprise. Nevertheless, the same issues arise in cases where there exists a separate legal entity, but it enjoys a de facto guarantee from the parent enterprise. In Greece, such is the case with many banks, the telecoms operator, and other smaller public enterprises. See Tinios 1999.

- Safeguarding the shareholders regarding the true state of the enterprise.

In order to be able to play its role– in effect to provide a budget constraint - the accountancy of promises should be based on commonly accepted rules and regulations, so as not to be able to hide behind a shrewd set of assumptions.

The International Accounting Standards 19 (New IAS-19)[7], are designed to address this need. IAS-19 have three key implications:

1. **Transparency**. The accounting entry should appear to be a liability of the real guarantor of the pension system. Shifting the liability to a different legal entity may not serve as a 'legal veil' to hide the culpability.
2. **Credibility**. Only accrued liabilities and existing assets may count. Hypothetical assets (such as future contributions yet to be collected) may not be set against actual liabilities.
3. **Double entry**. System liabilities should be entered on the balance sheet in the same way, regardless of method of finance. Ear marked assets are entered on the positive side and can balance the negative entries. This is the key item that differentiates the treatment of a prefunded and a PAYG system of finance.

This procedure has implications on the operating account. In the same way that the need to service a loan to creditors appears as a cost item in the balance sheet, running a pension system creates an equivalent cost item to service liabilities. These entries are a charge on operating costs and enter into the determination of the unit cost of the enterprise.

Pension liabilities are treated as a loan from the ultimate beneficiaries (the work force) to the enterprise; as happens with all loans, this needs to be serviced. If there exist earmarked assets (as in prefunded systems) these are set off against the liability. In this way a balanced funded system can actually work in the direction of reducing costs of the firm. Conversely, if no such assets exist, an unfunded system will be a drain on competitiveness.

Participation in State social insurance

Alternately, let us think of a company that only participates in the *State* PAYG system and does not have its own pension arrangements. In what way is its situation different?

The key difference is *not* the system of finance. It is true to say that most State systems are PAYG – i.e. current income is supposed to pay for current outgo. However, the cases of underfunded (and unfunded) enterprise systems are legion. The distinction lies in the identity of the ultimate guarantor. In the case of Social security, which is built on solidarity, the final guarantor is never an enterprise on its own, but society at large[8].

If an enterprise takes part in the State system, its only obligation is to cover current contributions. If payments to workers exceed contributions, the company ought not to be concerned:

- The shortfall may be covered, by other firms of the same sector, or by other sectors which are emerging.

[7] See, for example PWC, 1999 or Deloitte, Touche and Tohmatsu, 2002.

[8] Accounting for the promises that *society* has made, is of course, a very live issue – though not one which (at present) should concern the individual firm. See Chand and Yeager, 1996 for an approach based on implicit debt. Barr, 2001, discusses the issue of how to represent PAYG pensions in the National Accounts.

- If the totality of the country is facing a problem (e.g. due to demographic factors), this will lead to measures of a general nature, which will be pursued by the government.

So in social insurance the existence of unfunded obligations is without consequences for the specific firm. This is due to three factors:

1. The law of large numbers means that risks of different firms balance out.
2. The final guarantor is not the firm but the State.
3. The system is myopic as regards the firm. Though the State may need to take a long view, this is certainly not the case for the firm.

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Hybrid situations: Enterprise-specific social insurance systems

In Greece, but also in many European countries and frequently in the developing world, one meets cases where the enterprise model and that of State insurance coexist. *In other words, we see firms which undertake social insurance on behalf of the State:* enterprise-specific defined benefit pensions schemes, financed through PAYG, with no reserves.

The reasons for the spread of such systems must be sought in the historical conjuncture of the time of their foundation:

1. Many sectoral systems predated the general system,
2. It was thought (often with justification, given the underdevelopment of financial markets) that returns to investment were higher inside the firm.
3. Their foundation coincided with rapid payroll growth, when participation in a general system would have meant funds flowing out of the firm.

In actual fact, the firms serving this hybrid role were as a rule operating in monopoly or oligopolistic product markets. In those kinds of markets, the State could ask the firms to undertake on its behalf important functions – the electrification of the country, or the financing of industrialization. In the typical case, we had monopoly state enterprises, in which *three* separate roles of the State coexisted[9]:

1. The State as the market regulator
2. The State as a pension provider and operator of social insurance.
3. The State as owner and sole shareholder.

In a sheltered environment this multiple identity did not give rise to problems. It could just be added to the other 'general service obligations;

[9] As in Christian theology, these enterprises had two natures which coexisted – a commercial enterprise and a pension body. Of the two natures, entrepreneurial and solidary, neither is in the ascendant; according to circumstances they might be the one or the other, or both. A Greek court has ruled that the PPC acting in the cases of pensions is subject to public law and not enterprise law.

III. OPENING OF THE MARKET AND THE CHALLENGE OF COMPETITIVENESS

The key development in recent times is the opening to competition of previously protected markets. This opening up severs the umbilical cord linking the State to the enterprise. The three roles of the State which up to then could remain undefined and indistinct now must be distinguished.

For firms with their own pension system this translates into pressure to adopt international standards. For those firms with dealings with international credit institutions such a compliance reduces the cost of capital, while for those hoping to tap international funds through IPOs, the application of IAS is required.

Application of international standards in a hybrid firm means that the 'social insurance' nature is denied. A PAYG totally unfunded system would have to begin acting as if it were funded from day one. It will be treated as a mature funded system, which has just lost its reserves.

The operating costs of the firms in question are especially vulnerable:

1. Their payroll is already falling, in industries generally retrenching.
2. They frequently have to finance benefits far above the average.
3. They must form reserves to balance obligations. The fact that they are one among many competing firms means that they cannot appeal to general solidarity.

In contrast, their private competitors only needs to pay current employer's contributions.

So, *even if benefits are identical*, the private firm has lower costs; paradoxically, this is because he can appeal to the State guarantee that is given to social insurance. The *same* State guarantee is not available for State enterprises with their own pension fund[10]. The State thus gives out a guarantee to private firms, which it cannot extend to its own enterprises.

One way forward: Disentangling the roles

One solution will be to transfer funds to the pension systems of the State enterprises. However, apart from the huge amounts involved, that will have perverse effects on the social insurance system[11].

Another solution is to extend to state firms the same kind of PAYG guarantee enjoyed by the private firms. The three roles of the state, the State as owner, the State as regulator, and the State as guarantor, must be separated, so that all workers, whether in the State or the private sector receive the same kind of guarantees[12].

The financing of current outgo could be notionally split in two parts, without affecting in any way the current benefit levels:

- In a general part that tracks the general system that is followed by its competitors and is financed in the same way – PAYG.

[10] IAS, unlike Greek courts, cannot accommodate and does not recognise multiple identities.

[11] It is hard to justify using public money to provide a guarantee which is denied to the general taxpayer.

[12] This scheme is analysed in greater detail in Börsch-Supan and Tinios, 2001.

- In a specific part that finances the excess over the general system and is financed through prefunding as occupational insurance.

It must be clear that the first constitutes *social* insurance. A possible deficit will be met in the same way as the general system deficits. The State will take part in its capacity of guarantor, offering the same level of protection. The important point is not so much to belong to the general system organizationally, but being able to call on the guarantee. Such a guarantee could be attained through a clearing mechanism, retaining the separate organization, if that is desired[13].

The second (specific or occupational part) can finance all departures from the general system, (age limits, replacement rates) as occupational insurance. They can be financed by the part of today's contributions which exceed the general system. To the contributions could be added injections of funds that can be transferred to the occupational fund by the State acting in its capacity as owner-shareholder (e.g. as part of the proceeds of the IPO), as well as with whatever assets pre-existing structures possess[14].

In this way:

- Benefits and payments to the pensioners can remain as they were, the difference being one of accountancy (i.e. two cheques instead of one).
- The workforce receive a stronger guarantee than they have today, given that the totality of current assets is directed to secure the differences from the current system.
- The public enterprises can claim with justification that they have 'cleaned' their balance sheet of the greatest part of their pension obligations.
- The change can be seen in social security terms as a major move in the direction of equal treatment and equal rights. The State does not pay in guarantees more than what any worker in the private sector is entitled to; payments over and above that are financed by the people directly concerned. Endowments of the occupational funds can be interpreted as payments due from the shareholders in lieu of past returns.

Precedents for Occupational Top-ups

Occupational funds topping-up State benefits are, of course, not unknown in the OECD. (The system in Australia is essentially built around them). However, such arrangements already exist in the field of 'traditional' Social Insurance in Greece. The employees of two banks, who were entitled to private-sector benefits, achieved parity in pension entitlements with a larger State Bank. The parity meant earlier retirement ages and larger replacement rates. The two groups remained affiliated to the general system, but enterprise-specific funds for auxiliary pensions took over the task of financing the top up. Thus, an individual retiree receives what he is entitled to under the *general* system; that amount is topped up by extra payments from occupational insurance so that parity with the other bank is reached.

The difference with occupational insurance, alas, is that the two enterprise funds were themselves financed by PAYG and became, in time, hugely problematical. Nevertheless, the top-up model is currently under discussion in the context of dealing with the social insurance problem of the banking sector in Greece.

[13] The flows of money in and out of the enterprise if it were part of the State system could be calculated and gthe balance accorded either to the enterprise or to the State fund, as the case may be. In the case of enterprises which have yet to reach full maturity, one would expect the clearing mechanism to lead to payments out of the enterprise initially, to be reversed in the future.

[14] If as, is the case in Greece, new entrants' entitlements are closer to the State system, then the financing problem is simplified as one of providing finance for the privileges of a closed population – which is an capital sum that is subject to exact measurement and will not grow over time.

In order for the scheme to work, good actuarial estimates of the pension liabilities both as they exist currently, and what they would have been, were the employees to belong to the general system are required. Given the stake that the insured population rightfully possesses in the insurance system, strict rules of transparency and legitimacy must apply and must be seen to apply. In this respect, rules that exist ex ante and have wide application internationally, will play a pivotal role.

IV. SOME QUESTIONS RESOLVED: THE PPC REVISITED

The PPC narrative in the introduction left the story halfway, with the passing of the pension Law 2084/92 essentially giving notice to all concerned that the 1966 arrangements could not survive forever. The initial reaction was a hardening of positions, by insisting on literal interpretations of the 1966 Law: Any change to PPC organization structure would have to be preceded by a satisfactory resolution to the pension problem. This meant disentangling the various claims on the PPC balance sheet.

Outside actuaries were engaged to compute 'the company's debt' to the pension system. Of the various possible interpretations, the one selected was to identify pension system '*assets'* as the sum total of future *liabilities.* This conclusion followed from the following reasoning: the PPC was supposed under the 1966 law to cover 'all pension payments'[15]; the best kind of security is a capital sum; the work force could at any time demand to be paid what they were owed. *Ergo*, what they owned is what they were owed[16]. This sum was calculated by actuaries and came to a sum more than 2-3 times annual turnover. Though the exact capitalization of PPC at the time was not known, there was a fair possibility that paying this amount would amount to a worker takeover of the firm. Given the enormity of this sum, many used it as a counterargument to block change. The key issue was the continuation of the 1966 arrangements – of the identity of the firm and the pension provider.

Table 1 Key Magnitudes of the PPC, 1998-2001

	1998	1999	2000	2001
Company Data (PPC S.A.)				
Total sales (€ million)	2539.8	2713.0	2932.2	3166.0
-Electricity sales	2465.1	2632.6	2835.8	3053.0
Operating result (€ million)	827.8	864.3	820.7	951.3
Profits before tax (€ million)	-52.5	30.5	5.5	353.5
Insurance account shortfall[1]	126.4	134.3	179.4	220.0
PPC employees (31/12)	33,505	32,888	31,645	29,486[2]
Insurance system magnitudes				
Total outlay (€ million)	464.0	490.5	546.2	602.5

[15] The precise wording of Article 7(2) was that the PPC (in return to contributions being vested in the firm) 'would undertake the responsibility of the full coverage of all Insurance System expenditure and obligations arising as a result of this law". Under Article 35, this obligation would be transferred to all PPC successors.

[16] Thus, the PPC system was treated as any kind of funded system. However, the legal entity who was owed this amount was left purposely vague.

-Pensions	376.1	403.9	442.5	486.0
Total revenue	337.6	356.9	366.8	381.8
Number of pensions	25,237	26,573	27,871	28,066

Source: PPC SA, and Personnel Insurance Organisation

1 After 2000 this amount is no longer a charge to the company.

2. After transfer of 1089 employees to the Personnel Insurance Organisation and to the Transmission Authorirty

However, the internal market directive had the effect of changing the decision structure facing the PPC work-force[17]. In the previous position of possessing a guaranteed monopoly position, the way was open to defend (and even expand) pension rights, secure in the knowledge that the cost could be passed on to the consumer. There was no conflict, thus, between the roles of current employees and future pensioners. In contrast, in a situation where the company has to compete against new entrants, arrangements which set competitiveness at risk could threaten the position of the company. In a competitive market, the incentive of the work force is to ensure the continuity of their job as a first priority. Generous pension provisions which posed a threat to the market strength of the company could be in the long-term self-defeating: A high replacement rate is meaningless if there is nothing to replace[18]. In the meantime, the more forward looking unionists saw that being able to proceed in the direction of an IPO could benefit their own position in major ways: better access to capital could aid investment; being quoted in the stock markets would strengthen the hand of the PPC in its relations with the Government, notably over price increases. Finally, a not inconsequential consideration was the very rapid rise of the Athens Stock Exchange from 1996 to 1999.

As a result, an important strand of opinion developed within the company, seeking a way out of the impasse. The reaction in 1998 was to form a tripartite committee (Government, management, unions) in order to put out to tender and supervise a study to identify and ascertain the nature and extent of the debt owed to the personnel[19] . The study proceeded by applying IAS-19 – which concluded that the pension liability was *even higher* than in the earlier study[20]. More damagingly, it pointed out, that, if PPC serviced that obligation, this would be tantamount to increasing annual personnel costs by about two thirds. The study went to calculate the liabilities were PPC to have belonged to the main private sector fund, i.e. were it to enjoy the same kind of benefits as its competitors. If this was done, the balance sheet liability could be reduced by over 80%. The report concluded by speculating on the arrangements for a top-up scheme.

The period of twelve months of the operation of the committee until the final submission of the report was crucial in allowing the various parties to reconsider their positions and arrive at arrangements which could carry consensus. The key points at issue were (a) whether a body separate from the PPC itself would be responsible for social insurance (b) the kind of guarantees which that body could enjoy[21]. The

[17] For attitudes of Greek Unions in general, see Ioannou ,2000.

[18] In the case of the PPC there was a considerable demonstration effect from the course of the telecoms operator, which was the first major public entrerprise to proceed to an IPO, with considerable benefits for the workforce.

[19] Their report was submitted to Parliament by the Ministry of Industry, PWC, 1999.

[20] This happened as under IAS no future contribution revenue could be imputed and set against the pension obligations ("Projected Unit Credit Method", as opposed to the "Aggregate Cost Method" which was used in the previous study).

[21] It is important to note that, specifically social security considerations were not decisive in the discussions.

negotiations (which by then had distanced themselves from the consultants' report) led to and agreement between the Industry Ministry, the Unions and management in June 1999 to set up a new pension fund, which would unambiguously function under social security rules, distinct from the company. The cash flow of the new fund would be under Government guarantee. The result of the agreement[22] formed the basis of Law 2773/99. The law (supplemented in some provisions by Law 2919/01) started being implemented in 2000, and details of the new organisations' mode of operations were finalized by a Presidential decree, (51/01). The transition phase terminated in 2002, after which the new pension provider was supposed to be fully independent.

The Law also introduced the harmonization of the Greek electricity market to the provisions of the internal electricity market Directive 96/92. The immediate effect of the passage and implementation of the law was to unblock organizational change in the Electricity sector. Since August 2000, the Regulatory Authority for Energy (RAE) has started functioning and in May 2001 the Hellenic Transmission System Operator(DESMIE S.A.) a 51% state owned company has taken over from PPC the role of transmission system operator. In early 2001 PPC became a joint stock company and there was a successful IPO in 2001 for approximately 16% of company equity[23]. PPC S.A. is competing vigorously, is contemplating entry into new markets at home and abroad. Table 1 provides an overview of key PPC magnitudes.

The case of the PPC can be taken to illustrate something which is well-known in economic theory. Persisting in a second best solution, can ultimately prove a major obstacle, long after the constraints justifying the compromise have ceased to apply. In those situations, the way to break out of the locked in situation is to reconsider the situation, starting from first principles. In this way the costs foregone by not pursuing the first best could be considered and appreciated. In the case of pensions the application of international accounting standards (IAS-19) had that effect. The 'accountancy of promises' essentially provided the missing budget constaint, and hence provided meaning to choice. Thus, the quantification on the basis of external rules broke the impasse, and helped the various parties to cooperate in order to pursue solutions which could be demonstrated to be in their common advantage.

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[22] ratified by the majority of the work-force in a rather adventurous process.

[23] The IPO took place on 12 December 2001. Shares totaling 16.086% of total capitalization were sold. In total the capital tapped came to € thousand 463.3, of which PPC kept € thousand 141.9 (net of expenses). The work force purchased on more favourable terms 1.6 million shares (7% of the total).

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