Pension Reforms
in Theory and in Practice

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Pension reforms: why are they needed?

- Financial unsustainability: ever growing “implicit” debt
- Poor design:
  - inability to cope with the effects of demographic and economic changes
  - inefficient allocation of risks
  - inadequate insurance coverage
  - inefficient incentive structure
  - bad redistribution (segmentation of schemes, privileges)
  - lack of transparency
  - “excessive” political interference
- Inadequacy of provisions for old age:
  - (amount and composition of) savings for old age
  - type of pension benefits (indexation of benefits to wages?)
  - Long Term Care
Coping with the demographic challenge: evolution of the dependency ratios

Features of a good pension design

- Good diversification of risks (i.e. a mixed pension provision, partly public and PAYGO and partly private and funded)
- Good correlation, at the individual level, between contributions and benefits to enhance the “saving” role of a pension scheme
- Direct correlation of benefits to the age of retirement (actuarial principle)
- No “implicit taxation” of pension wealth with the postponement of retirement
- Uniformity of rules, with limited and transparent exceptions
- A balanced combination of mandates and choices (responsibilities)
- Financial literacy
Social dimensions and Policy Implementation Issues

- “Gradualism” *versus* “cold showers”
- Transitional, credibility and time consistency problems
- Correlation with other reforms (typically the labor market reform)
- Problems of communication and the need for Social dialogue
- Problems with widespread erroneous beliefs (the notion of acquired rights, the lump of labor fallacy…)

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Behavioral Issues

How will households respond to changes in pension provisions w.r.t.
- participation and saving in supplementary pensions
- labor market behavior at younger and older ages?

How can household “preparedness” for retirement be improved:
- are “conventional models” really able to capture individual behavior?
- are households able to understand and manage the new risks?
- what conceptual framework defines the relation between financial knowledge and planning capability and wealth accumulation?

What can policy do to improve saving choices?
- programs how to improve risk and financial literacy
- appropriate design (for example, of default options) to induce the “right” choices
Impact of pension reforms

Although European countries have followed different reform paths,

• pension promises have generally been downsized
• replacement rates have been reduced
• benefits have been de-indexed from wages to prices
• the link between individual benefits and contributions has been strengthened

Over time, reforms will

• reduce the relative importance of the first pillar
• strengthen the role of occupational and personal plans
• replace DB with DC schemes

As a consequence, workers will retire later (to avoid lower pensions) and have greater choice, responsibility and risk
Italy - November 2011: the looming crisis and the sense of urgency
The “Rescue Italy” decree

To avoid the financial collapse of the Italian sovereign debt (and the end of the Euro?)

- The “Rescue Italy decree” delivered in a couple of weeks and consisting of two major measures:
  - The tax on housing wealth (IMU)
  - The pension reform

- The pension reform, together with the labor market reform, had been an explicit commitment of the previous Italian government in a letter sent to the ECB
The (long and reluctant) reform process of the Italian Pension System

I Pillar

1992 – Cutback of the Defined Benefit (DB) formula (DLg 503/1992)
1997 - New eligibility criteria for public employees (l.499/1997)
2001 - Increase in Social allowance (l.448/2001)
2004 – Further restrictions in eligibility criteria (l.243/2004)
2006 - Increase in payroll tax rates (l.296/2006) (effective=notional)
2009 – Indexation of ret ages to longevity and possibility to cumulate earnings and pension benefit (l.102/2009)
2010 - Increase of minimum age criteria to 65 years for women in the public sector (l.122/2010)
2011 - Increase of age requirements (from D.l.138/2011 and l.111/2011 for women in the private sector, l.148/2011 also), "windows"
2011 - Universal introduction of pro-rata DC scheme from 2012, restructuring of seniority pensions, new eligibility criteria (l.214/2011)

II and III Pillar

1995 - Collective subscription to open pension funds (l.335/1995)
2000 - Individual pension plans and fiscal incentives (D.Lgs 47/2000)
2001 - Further fiscal incentives (D.Lgs 168/2001)
2005 – Change of default for participation in pension funds ("tacit consent" rule for TFR, flexibility, fiscal incentives (D.Lgs 252/2005)
2006 - Anticipation of TFR transfer terms (D.l.279/2006)

..........2030 - New pensions: , entirely DC-type
..........2050 - All Pension: entirely DC-type
The 2011 reform: not a revolution, but radical in its application

- Application of the DC formula to all workers, as of Jan 2012 and for future seniorities, with periodic update (every 2 years) of annuity rate coefficients
- Increases in the statutory retirement ages (66 + longevity, in 2018) and cutback of seniority pensions
- Alignment, as of 2018, of ages and seniority requirements for women (in private sector) to those of men (and women in public sector)
- Indexation of eligibility requirements to changes (in the three preceding years) in life expectancy
- Increases in payroll tax rates for farmers and self-employed
- Temporary freeze of indexation for average-high pensions (>1400 €) and q solidarity tax on higher pensions
- No restrictions in cumulating contributions for NDC benefits
- Elimination of “exit windows”
The Italian system evaluated w.r.t.:

- **Sustainability**
  - Pension expenditure/GDP

- **Adequacy**
  - Replacement rates
  - Inter and intra generational redistribution
  - PVR

- **Transparency/simplicity/credibility**
Sustainability: effects on expenditure
Public pension expenditure/GDP with the different reform

Legend:
dark thick continuous line: current legislation
dark thick dotted line: legislation ante second 2011 reform (DL 201/2011)
dark thin continuous line: legislation ante first 2011 reform (DL 98/2011)
dark thin dotted line: legislation ante 2010 reform (DL 78/2010)
(NET OF TAXES) PENSION EXPENDITURE REDUCTION
(in mln €)

<table>
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<th>Year</th>
<th>Overall effects of major measures of the reform: (i.e. changes in access requirements and in the method of calculation)</th>
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<td>2021</td>
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</tr>
</tbody>
</table>

Legend

1. Overall effects of the pension reform (net of two major safeguard interventions)

2. Excluding payroll tax rates increases and de-indexation of pension benefits
By:
- postponing retirement, particularly for women
- introducing pro rata the DC method
- introducing flexibility in retirement
- increasing payroll tax rates for the self-employed

the reform:
- will increase the adequacy of retirement savings for most individuals

By:
- introducing (on a pro-rata basis) the DC method for all workers

the reform
- Increases transparency and reduces the “unfair” redistribution characteristic of the previous DB schemes
Transitional and communication problems

• Insufficiency of safeguarding clauses and the need for amendments

• The reform aims at dismantling the rooted notions that:
  ➢ workers over 54-55 are lost to the labor market and just need to retire
  ➢ elderly workers take away jobs from younger ones

• Difficulties with the notion of “acquired rights” (where the Constitutional Court sentences do not always help)

• Difficulties of making the reform understood, particularly in the intergenerational rebalance of burdens
Conclusions

• The distance between theoretical and actual reforms can be quite large

• In an emergency situation, when swift change is required, both time constraint and lack of the degrees of freedom can prevent a smooth adaptation of the reform to the theoretical model

• Having the reform shared by the social partners and owned by citizens can be essential for its effectiveness