TRANSLATING RESEARCH INTO POLICIES

The case of the Italian Pension Reform

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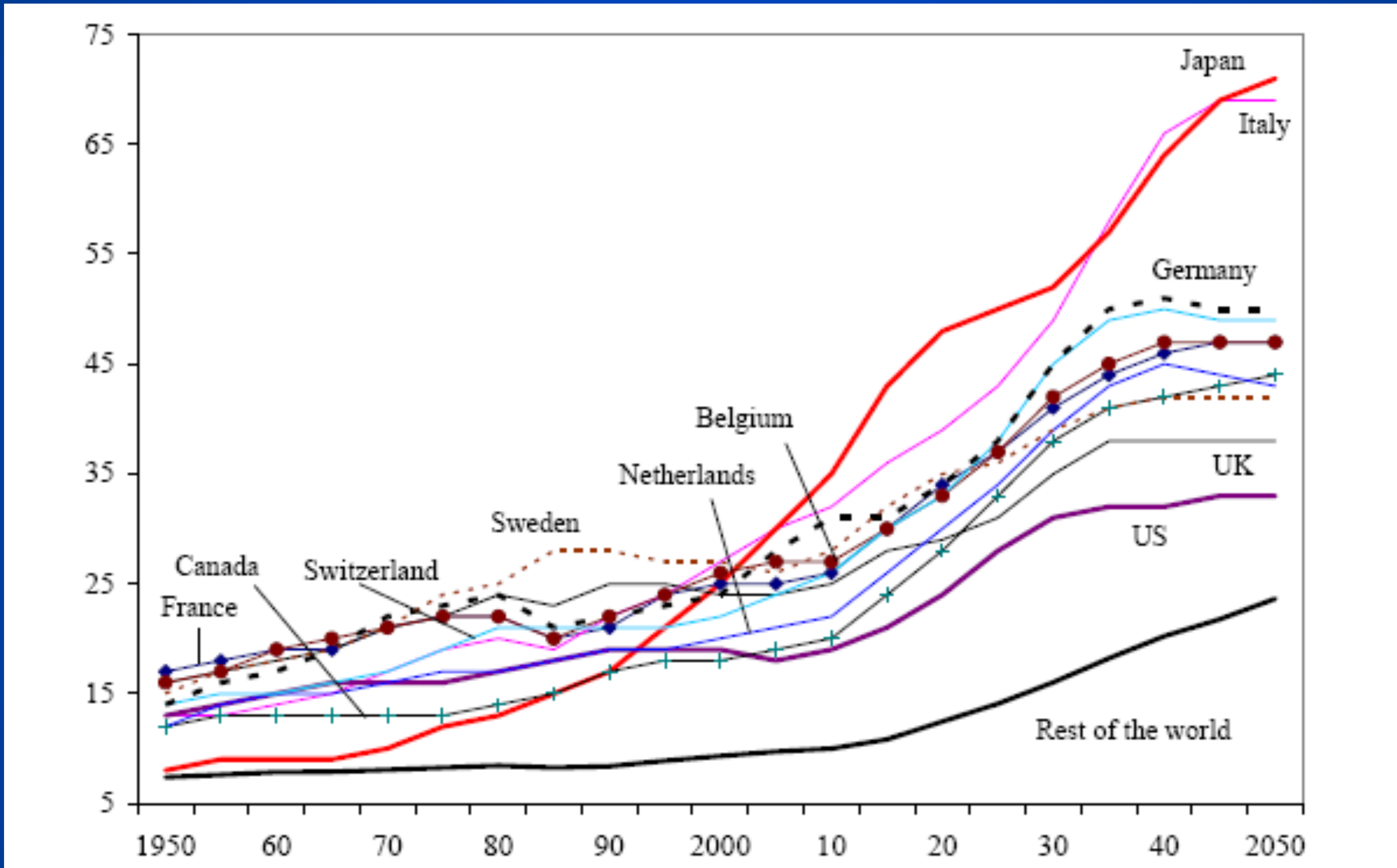
Pension reforms: why are they needed?

- **Financial unsustainability**: ever growing "implicit" debt
- **Economic unsustainability** (poor scheme design):
  - inefficient allocation of risks: inability to cope with the effects of demographic and economic changes
  - inefficient incentive structure : incentives to early retirement
  - bad redistribution (segmentation of schemes, privileges)
  - lack of transparency
  - "excessive" political interference
- **Social unsustainability** (inadequacy of old age provisions):
  - inadequate insurance coverage
  - type of pension benefits (indexation of benefits to wages?)
  - inadequate provisions for Long Term Care
  - inadequacies in the amount and composition of wealth in old age

Requirements for 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
- **Benefits directly correlated to retirement age** (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, choices and responsibilities
- **Financial literacy**

Coping with the demographic challenge:
evolution of the dependency ratios



Fonte: Visco, I. (2006), "Longevity risk and financial markets", keynote speech, 26th SUERF Colloquium, Lisbon

Policy Implementation Questions

How will households respond to changes in pension provisions w.r.t.

- labor market behavior at younger and older ages
- participation and saving in supplementary pensions

*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, planning capability and wealth accumulation?

What can policy do to improve saving choices?

- programs to improve risk and financial literacy
- appropriate design (for example, of default options) to induce the "right" choices

The social dimension

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

Impact of pension reforms

Although European countries have followed different reform paths

- pension promises have generally been downsized
- replacement rates have been reduced
- benefits indexation has been downgraded 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 have ***greater choice, responsibility and risk***

Italy - November 2011:
the looming financial crisis and the sense of urgency

AUMENTIAMO LO SPREAD DELLA FIDUCIA.

Il Sole 24 ORE

BCC

SPECIALE RISCHIO ITALIA E MERCATI

Lo spread BTp/Bund

575

Rendimento del BTp decennale

7,25%

MANUALE ANTI PANICO

FATE PRESTO

The "Rescue Italy" decree

The task: avoiding the financial collapse of the Italian sovereign debt (and the end of the Euro?)

- The "*Rescue Italy decree*" delivered in two weeks and consisting of two major measures:
  - A tax on housing wealth (later cancelled by the new government)
  - 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)

1995 – Introduction of the Defined Contribution (DC) formula (l. 335/1995)

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)

2007 - New eligibility criteria (l.247/2007) ("quota" system: age + seniority)

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)
………..
2030 - New pensions: , entirely DC-type
…………
2050 - All Pension: entirely DC-type

II Pillar

1993 - Introduction (D.Lgs 124/1993)

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)

The 2011 “cold shower” reform

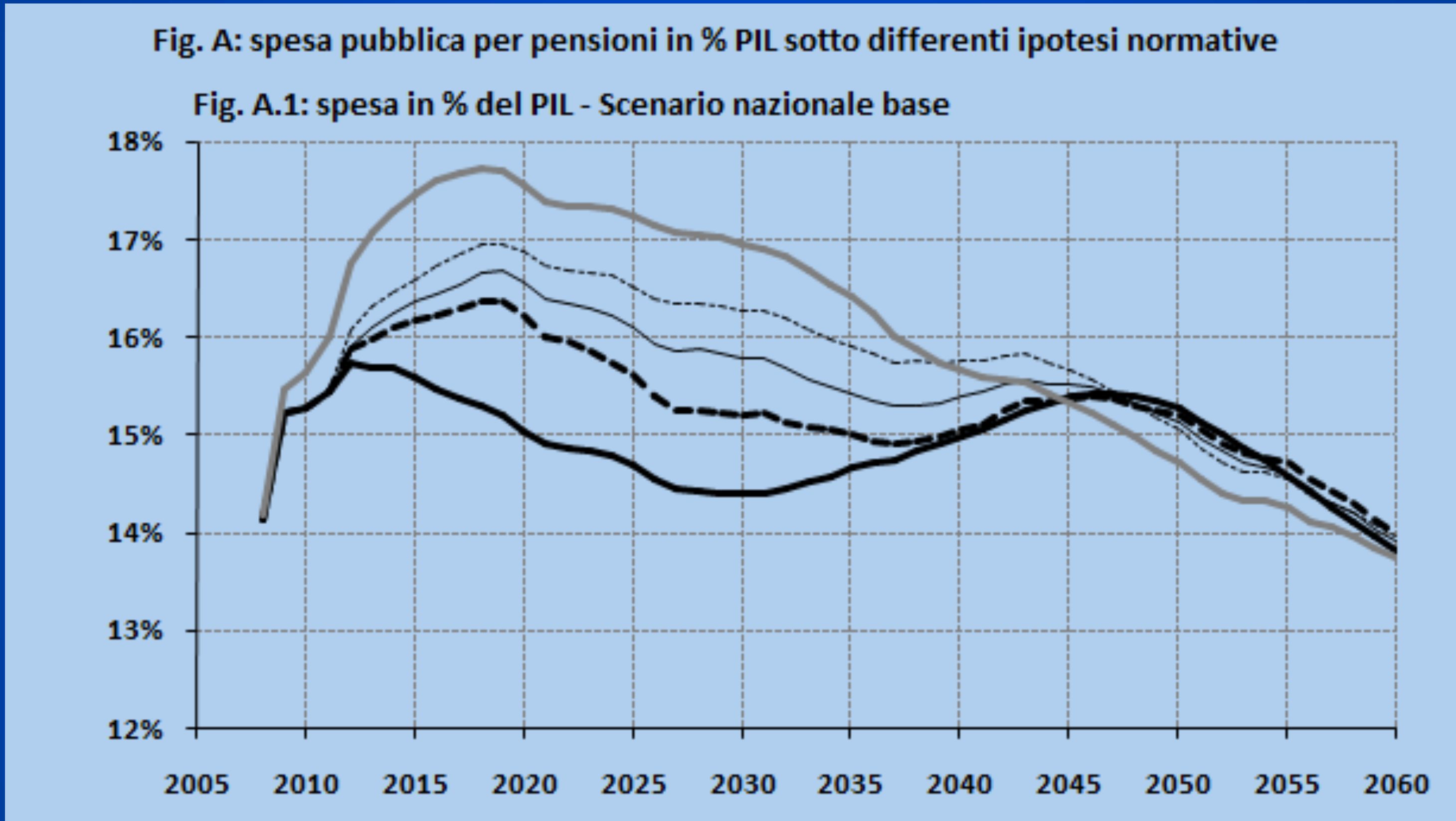
- Application, as of Jan 2012 and for future seniorities, of the DC formula to all workers, with periodic (every 2 years) updates of annuity rate coefficients
- Increases in the statutory retirement ages (66+longevity, in 2018) and phasedown of seniority pensions
- Alignment, as of 2018, of ages and seniority requirements for women in the private sector to those of men/women in the public sector
- Indexation of eligibility requirements to changes (three preceding years) in life expectancy
- Increases in payroll tax rates for farmers and the self-employed
- Temporary freeze of indexation for average-high pensions (>1400 €)
- Solidarity tax on higher pensions (sadly cancelled, later, by the Constitutional Court)
- Free “totalization” of contributions for NDC benefits
- Elimination of “exit windows”, by which workers had to wait 12/18 months to retire after reaching pensionable age

The Italian system evaluated according to:

- **Financial sustainability**
  - Pension expenditure/GDP
- **Economic sustainability**
  - Efficiency, uniformity of rules, transparency, credibility
- **Social sustainability (**Adequacy**)**
  - Replacement rates
  - Inter and intra generational redistribution

Financial sustainability: effects on expenditure

Public pension expenditure/GDPwith 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)
grey continuous line: legislation ante 2004 reform (L.243/2004)

PENSION EXPENDITURE REDUCTION (in mln €)

Overall effects of major measures of the reform: (i.e. changes in access requirements and in the method of calculation									
2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
2,515	4,600	7,024	9,953	12,401	15,391	18,355	20,704	21,609	20,695
-250	659	2,543	5,135	7,069	9,758	12,318	14,662	15,572	14,681

Legend

1. Overall effects of the pension reform (net of tax effects and of the effects of three safeguard interventions)

2. Excluding payroll tax rates increases and de-indexation of pension benefits

E**conomic sustainability** to be achieved by:

- relying on an actuarial formula and on automatic adjustments
- allowing for flexible retirement (as of now very limited)
- adopting uniform rules, instead of the former wide variety

the system realizes a better, more efficient and more transparent design, particularly concerning the diversification of risks between generations.

One problem still remain, as the system is still almost exclusively centered upon the PayGO financing method and far from the multi-pillars approach

Social sustainability (adequacy) to be achieved by:

- introducing (on a *pro rata* basis) the DC method which encourage later retirement
- increasing retirement age
- encouraging postponement of retirement through the variation with age of the transformation coefficient
- increasing payroll tax rates for the self-employed
- the greater transparency makes room and scope for policies directed at workers considered to be worthy of help (instead of helping current generations at the expenses of young and future generations)

the reform will increase the **adequacy** of retirement savings for most individuals, and particularly for women

Redistributive impacts of reforms (CeRPSIM2)

Present Value Ratio (PVR), behavioral scenario

	PVR				PVR(25)-PVR(75)			
	Men		Women		Men		Women	
	Private	Self	Private	Self	Private	Self	Private	Self
Pre-1992	1.595	3.192	1.856	3.559	0.181	0.333	0.234	0.047
1992	1.522	3.146	1.719	3.270	0.236	0.089	0.261	0.046
1995	0.999	1.057	1.032	1.086	0.016	0.004	0.017	0.006
2008	0.990	0.996	1.019	1.020	0.012	-0.006	0.013	0.008

PVR: present value ratio of pension benefits on present value of contributions, both evaluated at retirement.
Reforms reduces the “Generosity” of the scheme

Transitional and communication problems

- Due to the emergency situation (prospect of a financial crisis), the social dialogue had to be foregone
- Insufficiency of data caused insufficiency of safeguarding clauses and the need for subsequent amendments
- The reform aims at dismantling the rooted notions that:
  - workers over 54-55 are lost to the labor market and just destined to retirement
  - elderly workers take away jobs from younger ones
- Difficulties in:
  - having the reform understood
  - overcoming the notion of "acquired rights"
  - explaining the implied generational rebalancing

Conclusions

- The distance between theoretical and effective 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 crucial for its effectiveness
- For the long run sustainability of the reform, however, the efficiency of the labor market is essential