Economic-Financial Literacy and (Sustainable) Pension Reforms

why the former is a key ingredient for the latter

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Summary

1. The significance of (economic) *reforms*
2. Impact of Economic-Financial Literacy (EFL) on reforms
3. Lessons from the Italian experience of pension reform

The *crisis* of Welfare State
……and the never ending plea for "reforms"

- The (European) Welfare State is often believed to be in a condition of (possibly irreversible) decline
- **Pension systems** are at the core of this crisis
- The crisis, however, is not an *identity* but an *adaptation* one
- As a result of *structural demographic and economic changes*, its original design and financial structure have become *unsustainable*, *inefficient* and *unfair*
- Reforms are thus necessary…..but not sufficient

➢ To recover *sustainability*, *efficiency* and *fairness* a more comprehensive, three-D paradigm should be adopted and pursued:

"Reform, Inform and Educate"

Reforms

Definitions of "reform"

(from: Wordreference.com and Oxford Dictionary)

i. «To improve an existing institution, law, practice, etc. by alteration or correction of abuses»

ii. « Make changes in (something, especially an institution or practice) in order to improve it »

iii. «To give up or cause to give up a reprehensible habit or immoral way of life»

The respective roles of political parties and of "experts" in carrying out reforms

- Economic reforms are *a mix of political and technical elements*, the former in the forefront of communication, the latter more behind the scene
- The political communication tends to look at reforms from an ideological perspective (and to play down their more "technical" aspects)
- This scheme weakens or breaks up in emergency situations, when technical aspects become *dominant*
- It is then the task of technocrats (or experts from international institutions, i.e. the IMF, WB, the Troika) to prepare the reform
- However, if people do not understand its basic principles, the reform risks having little effects or being repealed

➢ **Information and EFL thus matter not only for individual wellbeing, but also for society**

FinLit for personal wealth formation and management

- ***Fin illiteracy*** is widespread, regardless of the country's economic development stage; knowledge of inflation is correlated to personal experience; risk diversification is the most difficult concept
- ***Fin knowledge*** has a hump-shaped profile over the life cycle (Lusardi and Mitchell, 2011): it is highest among ages 45-55 and lower at younger and older ages
- ***Gender differences*** are significant and pervasive: women are more likely to suffer the consequences of wrong/myopic/imprudent choices (Sunden and Surette, 1998; Lusardi and Mitchell, 2008; Bertocchi, Brunetti, and Torricelli, 2012; Bücher-Koenen, Lusardi, Alessie, and van Rooij, 2012; Boggio, Fornero, Prast, and Sanders, 2014)
- *Fin lit and human capital indicators* are (strongly) positively correlated (Jappelli, 2010)
- ***Fin lit and the generosity of social security system*** are negatively correlated (Jappelli and Padula, 2013)
- *Fin knowledge is a key determinant of wealth distribution*, accounting from 30-40 per cent of wealth inequality in the US (Lusardi, Michaud and Mitchell 2014).

George Stigler: a pioneer

Advocated not just fin but ***economic*** *literacy* and wrote*:

> *Why should people be economically literate, rather that musically literate, or historically literate? If we are to give economics some special position, and ask that most people learn at least a modicum of economics, it must accordingly fall into one of two classes of knowledge: 1) as a means of communication among people, incorporating a basic vocabulary or logic that is so frequently encountered that the knowledge should be possessed by everyone; 2) as a type of knowledge frequently needed and yet not susceptible to economical purchase from experts…. Economic logic does not tell us what to do, but it teaches us to look for the non-obvious costs and benefits of various policies.*

*Stigler, G. (1970), The Case, If Any, for Economic Literacy, *Journal of Economic Education*, Vol. 1(2), pp. 77–84.

Why is fin lit ignored in political-economy models?

- Little has been done up to now to include *fin illiteracy* in models studying why governments fail to deliver and implement economic reforms, even when both experts and politicians agree that these would improve welfare

Explanations:

- *Distributional conflicts* focused on the preservation of the status quo (Alesina and Drazen, 1991).
- *Interest groups* hurt by the reform process could succeed in blocking it (Grossman and Helpman, 2001)
- Lack of knowledge about the *distribution of costs and benefits* of a reform could spoil citizens' chances to benefit from them if they are risk averse (Fernandez and Rodrik, 1991)

Jean-Claude Juncker's aphorism: "*We all know what to do, but we don't know how to get re-elected once we have done it**"

- While distributional conflicts play a key role, other models exploit citizens' ignorance
- Bonfiglioli and Gancia (2013) assume that short-run costs of reforms (a transitory decrease in output) cause a decline in political support for the incumbents. Politicians tend to introduce politically costly reforms in times of exceptional economic instability, when voters are less sure of the impact of gov policy and the reform's short-run costs translate less precisely into a decline in the incumbents' chances of re-election
- Citizens' awareness of what is involved in a reform could however be an equally important determinant of its viability: EFL could become a better alternative to concealment from citizens of its unpleasant short term consequences
- Since **literacy is primarily a result of education**, government policy could thus indirectly induce long-run support for virtuous reforms

**The Economist (2007), The quest for prosperity, March 15. Quoted in Buti et al. (2008).*

EFL: An alternative to both *paternalism* and *populism*

- Reforms are not "*deus ex machina*" problem-solvers but "social drivers", meant to change people's plans, behavior, and attitudes
- They require acceptance and "care" by the (majority of the) people, who must be able to evaluate reform-related costs and benefits, now and in the future, for herself/family
- This is particularly true of reforms intended to alter individuals' life cycle, such as the pension and labor market reforms
- EFL is not a sufficient condition for the success of reforms; illiteracy can thwart their effectiveness by exerting pressure on politicians to either establish an excessively long phase-in or undo reforms approved by a previous gov
- EFL can help view the reform as ***social investments***, involving immediate costs in exchange for likely future benefits. Like all social investments, reforms have a public good component: EFL will thus not be enough to convince complete egoists but these are hopefully a minority and both theoretical and empirical research confirms a certain commitment to the common good in individuals' attitudes

Italy , November 2011: The looming crisis

1. Sharp worsening of Italian sovereign debt credibility

- Increasing refinancing difficulties (*on average* 1billion € per day)
- Record levels (550 b.p) of the spread against German gov bonds
- Increasing concern of EU and world monetary authorities
- ECB letter (Aug 5th) to Italian Gov pledging (pension and labor) reforms
- Gov Resignation amid mounting political uncertainty

2. Unsolved Italian structural weaknesses

- Worsening of the deficit(debt)/GDP ratios
- Growth rate lower than other EU countries; stagnant/declining productivity
- Reduced Italian presence in high productivity sectors and employment shift to low productivity ones

Paul Krugman «Now, with Italy falling off a cliff, it's hard to see how the euro can survive at all",The New York Times, November 10, 2011

TIME (November 7): «[Italy,] the world's most dangerous economy»

Süddeutsche Zeitung (October 24), «Italien–schlimmer als Griechenland » (Italy – worst than Greece)

…….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

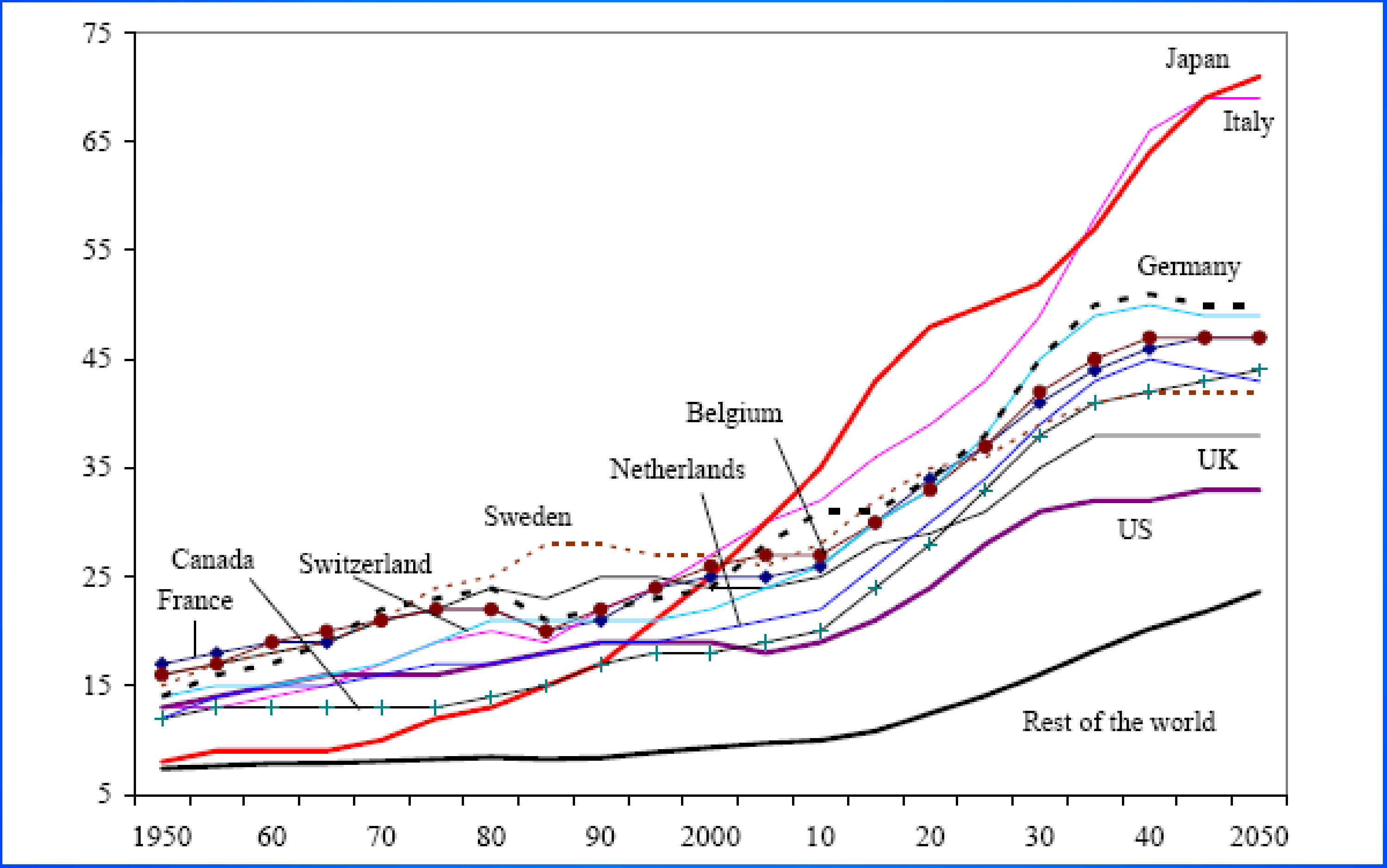
FATE PRESTO

The technocratic govt and the "Rescue Italy" decree (4 Dec., 2011)

To avoid the financial collapse of the Italian sovereign debt (and the end of the Euro?) a technocratic government was formed, which in two weeks delivered

- the "*Rescue Italy decree*" consisting of two major measures:
  i. The tax on housing wealth (IMU, unwisely cancelled by the subsequent government: it was the only tax on wealth in the Italian tax system)
  ii. The pension reform
- The **pension reform**, together with the labor market reform, had been an explicit commitment of the previous Italian government to the ECB

The reform had to cope with one of the worst old age dependency ratios



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

…….and a still hardly sustainable design

- A very high pension expenditure (16.1% of GDP) and a very high "pension debt" (280% of GDP?)
- An unbalanced social expenditure (52% for pensions vs less than 10% for children)
- Still a relatively low average retirement age, due to the prevalence of *seniority pensions* (≈59 years)
- The tendency to use the pension system more as a social protection scheme (to cover undeclared unemployment) than as longevity insurance
- A persistent fragmentation into different schemes favoring opacity, privileges and social run ups

The (long, slow and reluctant) reform process

I Pillar

1992 – Cutback of the DB formula (DLg 503/1992)

1995 – Introduction of the DC formula for new entrants and young workers (l. 335/1995),

1997 - Stricter 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 – Stricter eligibility criteria (l.247/2007) ("quota" system: age + seniority)

2009 – Indexation (as of 2015) 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, indexation to longevity (l.214/2011)

………..

2030 - New pension flows: entirely DC-type

…………

2050 - All Pensions: entirely DC-type

II Pillar

1993 - Introduction (D.Lgs 124/1993)

1995 - Collective participation in 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)

Weak economic/political sustainability of reforms

- A propensity to introduce reforms in emergency situations ('92, '95, 2011)
- A **very slow phasing in**, and thus a systematic tendency to procrastinate the implementation and to transfer the adjustment costs onto the young and new generations (having little or no weight in elections)
- **Little transparency** (a preference for introducing surreptitious restrictions, like "exit windows", or to package reforms in a "deceptive" way)
- A propensity to undo/mitigate reforms introduced by a previous government, supported by a different majority

…. *All this could hardly endure the financial crisis*

The 2011 "cold shower" reform

- 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 two preceding years) in life expectancy
- Increases in payroll tax rates for farmers and self-employed
- Temporary freeze of indexation for average-high pensions (>1400 €)
- Free summing up of contributions for NDC benefits
- A "solidarity contribution" on high pensions
- Elimination of "exit windows"

The Italian system evaluated according to:

i. **Economic sustainability**

- Pension expenditure/GDP

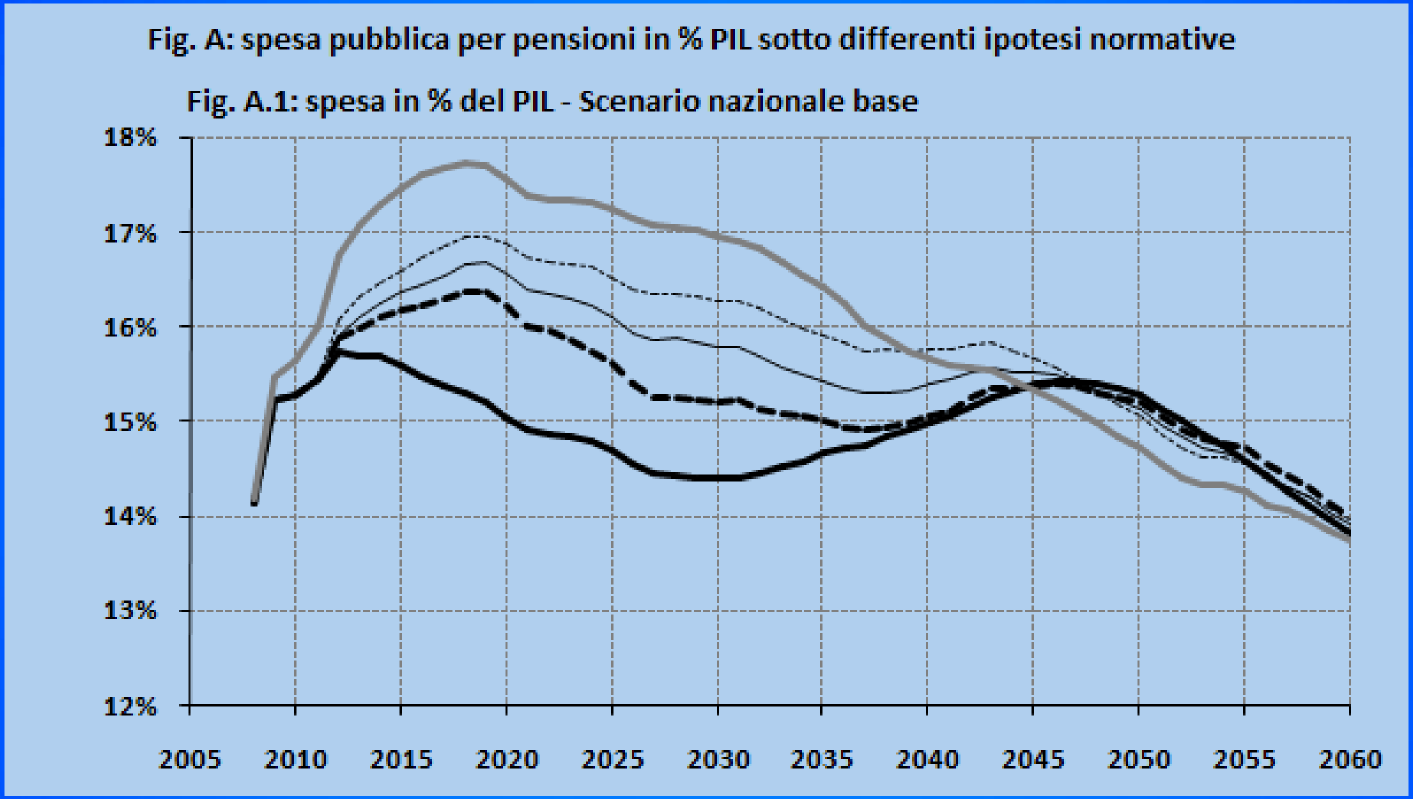
ii. **Adequacy**

- Replacement rates
- Inter and intra generational redistribution

iii. **Political sustainability: transparency/simplicity/credibility**

Economic 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)
grey continuous line: legislation ante 2004 reform (L.243/2004)

(Net of Taxes) Saving in Pension Expenditure (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

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

Economic sustainability to be achieved by:

- introduction (on a *pro rata* basis) of the DC method which encourages later retirement through the variation with age of the transformation coefficient, canceling the implicit taxation in seniority DB pensions
- increased statutory retirement ages
- automatic adjustments (through indexation to longevity) of retirement ages and seniority requirements
- flexible retirement ages (as of now very limited, but more extended within the NDC system)
- more uniform rules, with few and transparent exception
- increases of payroll tax rates for the self-employed

As for **adequacy** (s**ocial sustainability**):

- The same factors that support economic sustainability also support adequacy of provisions
- The system thus realizes a more sustainable, more efficient and more equitable (both within and between generations) design
- Transparency makes political interference more difficult, while making room and scope for policies directed at the "weaker" segments (the young, women and older workers)
- The DC formula reduces the "unfair" redistribution characteristic of the "previous" DB one

Open Problems

- The **main challenge is the labor market**, with the young and women more at risk of inadequate contributions and thus inadequate pensions
- **Dismissed older workers** also at risk of not finding another job
- The very rapid implementation of the reform has created a problem with workers that had left their job in anticipation of a relatively near retirement
- Notional contributions (to be paid by the public budget) are envisaged for out of work periods (for unemployment and care services) but may not be enough
- The system is still almost exclusively centered on the PayGo (unfunded) financing and far from the multi-pillars approach

Old-age vs ***economic*** dependency ratio

- Unsustainability of pension systems is not only dependent on demographic trends
- To get a more precise view, one should consider the composition of the *working age population* according to the economic status of individuals: employed, unemployed and out of the labor force
- The economic dependency ratio has been defined as the number of pensioners plus unemployed relative to the number of employed.
- For Italy (2011): old-age dr=34,3% economic dr=80%

Transitional and communication difficulties

- Insufficiency of safeguarding clauses and the need for amendments
- Cultural changes needed
- The reform aims at dismantling the deep-rooted notions that:
  - workers over 54-55 are lost to the labor market and just destined to retirement;
  - older workers take away jobs from younger ones (lump of labor fallacy)
- Problems with the notion of "acquired rights" (reinforced by pronunciations of the Constitutional Court)
- Difficulties in communicating the "positive" aspects of the reform, i.e. the generational rebalancing; to say clearly that with this type of reforms "*things must get worse before they get better*" (Churchill)

The need to inform and politicians' reluctance

- Accumulation of pension wealth is a long and complex endeavor
- Workers must have an idea of their pension wealth, retirement options, benefits they will get at various possible ret ages
- This knowledge is essential - particularly in the DC world - for individual planning/decision making (participate in a pension plan, work longer, avoid mistakes/big disappointments /ensuing painful adjustments
- Information is also fundamental for the sustainability of a pension reform: if people misinterpret the reform they will try to reverse it
- Technical possibilities for a good and transparent information are now available and good practices exist (the "orange letter")

What citizens should know about the pension system

- A PAYGO system represents an "intergenerational compact "
- It has an **implicit debt** dimension which must be kept under control
- The crucial variable is the ***rate of return on contributions***, which depends on demographic and economic trends
- The generosity of today's system is not secured by past (myopic?) political promises and cannot be independent of the structural decline in n+g
- Two intrinsic elements of *unsustainability*:
  - the political tendency to favor the present generations at the expense to the young and future ones
  - the inability of badly designed systems to effectively respond to the economic and demographic challenge

Conclusions

- The distance between reforms in theory and in practice can be quite large
- In an emergency, 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
- Running for one's pension is becoming a new sport. People have difficulties in understanding why they have to run, why the old security provided by the state is no longer feasible, why pensions have become brainteasers
- The sharing of reform by the social partners and by citizens is essential for its effectiveness
- In the face of greater uncertainty and greater individual responsibility, it is essential to rely on both **information** and **EFL**