Voting in the aftermath of a Pension Reform: the Role of Economic Literacy

Elsa Fornero - Anna Lo Prete
University of Turin and CeRP

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Fin Lit: an essential ingredient for personal wealth formation and management

In the last couple of decades, *financial (il)literacy* has been conceptualized, measured, analyzed, correlated to:

- *various aspects individual behavior*, from savings to portfolio choices, from retirement decisions to pension plans participation, from human capital formation to debt taking up (Lusardi and Mitchell, 2014)
- *the distribution of wealth* (accounting for 30-40 per cent of US wealth inequality; Lusardi, Michaud and Mitchell 2014).

Little has been done, however, to include *Fin Literacy* – or *Economic-Financial Literacy (EFL)* in models which study why governments are reluctant to introduce ***economic reforms***, even when both politicians and experts agree that these would be welfare improving

Fin Lit and Economic Reforms

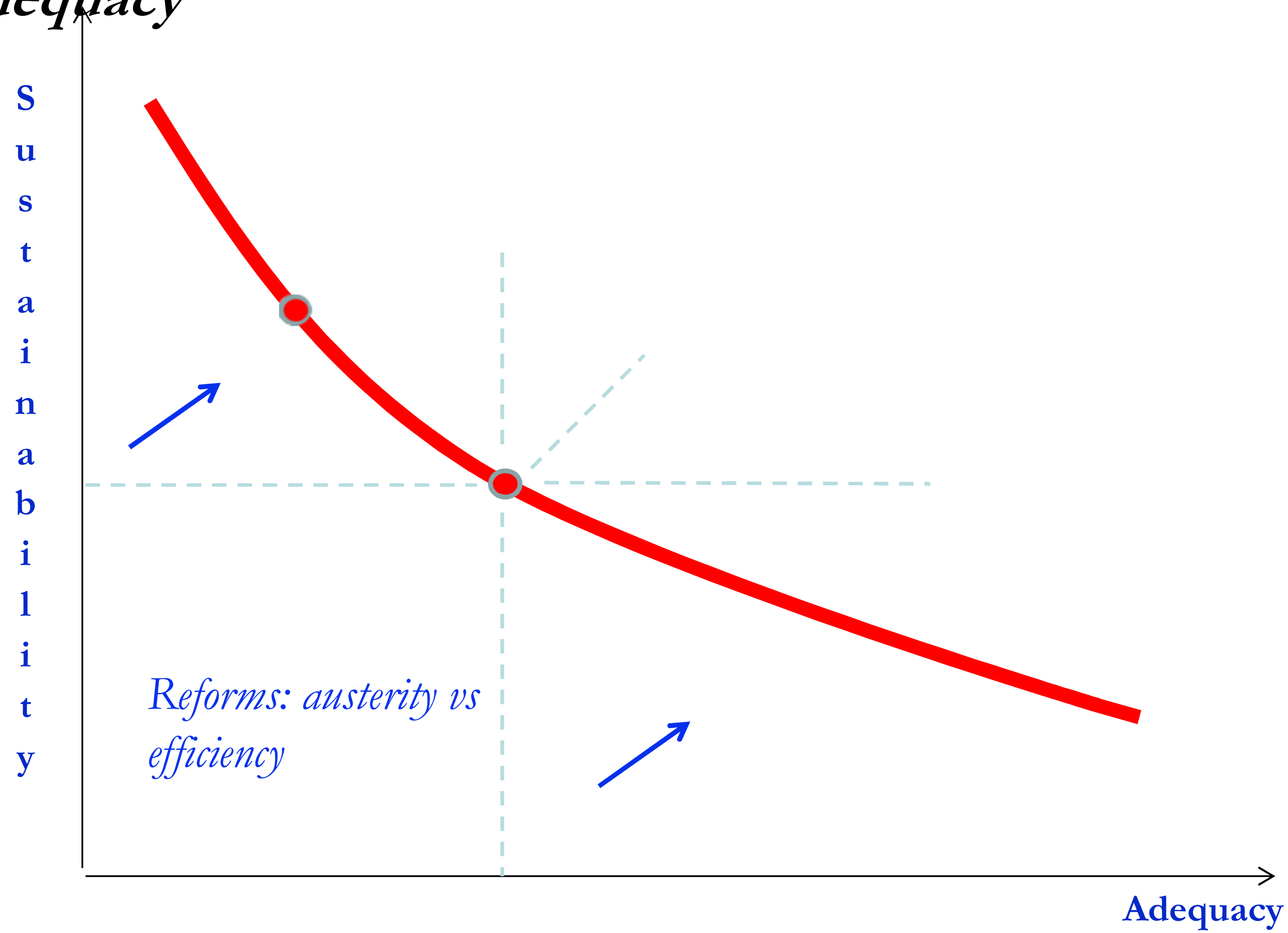
- Reforms are not "*deus ex machina*" problem-solvers but "*social drivers*", meant to change people's attitudes, plans and behavior (Fornero, 2015)
- They require acceptance/"care" by (the majority of) people, who must be able to assess reform-related costs and benefits, now and in the future, for themselves/their family
- This is particularly true of reforms intended to alter individuals' life cycle, such as 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

Reforming the Pension System

- PayGo pension systems - the core of the (European) Welfare State - are often described as being in a situation of severe crisis (See: Citi-GPS, *THE COMING PENSIONS CRISIS Recommendations for Keeping the Global Pensions System Afloat, March 2016)*
- ***Structural reforms*** have long been invoked (and still are) by international institutions to prevent the crisis becoming irreversible
- In ***technical terms***, reforms are seen as a necessary adaptation to the demographic transition*;* a way to regain sustainability, efficiency and fairness (by reducing distortions, inefficiencies and deadweight losses) and to achieve a better risk diversification
- In the ***public opinion***, pension reforms are instead seen simply as unnecessary "austerity" or unjustified cut back of their entitlements ("acquired rights")

Different readings of pension reforms:

austerity vs improving the *trade off* between ***sustainability*** and ***adequacy***



The wedge between the technical and the popular view of pension reforms is well known to policy makers, as exemplified by the previuos aphorism by Jean-Claude Juncker *(The Economist, 2007, The quest for prosperity, March 15)*

"We all know what to do, but we don't know how to get re-elected once we have done it"

In our paper, we try to answer the following questions:

- Is Junker's proposition empirically justified? Is there a «political toll» to be paid in the case of pension reforms?
- Is the political cost of reforms reduced when people better understand the reform?
- Is EFL a sufficient ingredient to reduce the wedge and thus the consequent political toll?

Background literature

- Empirically, economic reforms do not seem to imply significant electoral costs (Alesina et al., 2013; Buti et al., 2010)
- Recent works study why it is difficult to carry out economic reforms and under which circumstances they are more likely to occur (Alesina et al., 2006; Prati et al., 2013; Bonfiglioli and Gancia, 2016)
- Focus mainly on real and financial markets reforms…

We study the electoral cost of major pension reforms, and relate it to the ability of people to understand the economic content of reforms

- Economic and financial knowledge relevant to the ability to accumulate wealth and build retirement plans, portfolio diversification, inequality (Lusardi and Mitchell, 2007; Fornero and Monticone, 2011; Jappelli, 2008; Lo Prete, 2013)

Data

Parliamentary elections held between 1990 and 2010 in advanced countries.

Re-election

- the head of the government is elected for a second-term of office;
- the head of the government is from the same party of his/her predecessor.

“Major” pension reform

- introduces a structural change that - according to valuations of the international institutions - has an impact in terms of financial sustainability and/or income adequacy;
- has a broad scope, that is, it affects the generality of workers and not only specific categories.

Pension reforms in our dataset

Country	*Year of parliamentary election*	*Major pension reforms signed into law before the election day*
Austria	2006	Austrian Pension Reform (2003), and Act on the Harmonization of Austrian Pension Systems (2005)
Belgium	1999	Framework Act (1996)
Czech Republic	1996	Pension Reform (1995)
Finland	1999	Pension reform (1996)
	2007	Pension reform (2005)
France	1993	Balladur reform (1993)
	2007	Pension Reform Act (2003)
Germany	1994	Pension reform (1992)
	2002	Riester reform (2001)
	2009	Retirement Age Adjustment Act (2007)
Hungary	1998	Pension Reform Act LXXXII (1997)
Italy	1994	Amato reform (1992)
	1996	Dini reform (1995)
	2006	Maroni reform (2004)
Netherlands	1998	Life Course Savings Scheme (2006) and Privatization of the public pension fund ABP (1996)
Norway	2009	Flexible Retirement Act (2009)
Poland	2001	Pension reform (1999)
Portugal	1995	Law 329/93 (1993)
	2005	Law 60-B/2005 (2005)
Spain	2000	Royal Decree 6/1997 (1997)
Sweden	1998	Pension reform (1998)
	2010	Reform of the ITP occupational pension plan (2007)
United Kingdom	2010	Pensions Act (2007)

Note: according to our coding, three countries recorded no major pension reforms over the period under analysis, namely: Denmark, Greece and Ireland.

Data

Education

- Economic litearcy, education in finance, PISA scores, school attainment.

Control variables

- Political characteristics: compulsory voting, presidential system, years of democracy.
- Political juncture: political orientation, margin of majority, polarization
- Macroeconomic conditions: level and change in the output gap, change in the primary balance, change in price level.

100 elections and 23 reform events in 18 European countries.

Empirical model

$$RE_{jt} = REF_{jt'} * EFL_{jt} + X_{jt} + \varepsilon_{jt}$$

Where t' is the year when the reform, if any, has been enacted.

Estimation method: Probit and LSDV.

Results, LSDV

	Dependent variable: Re-election of the head of the government				
	(1)	(2)	(3)	(4)	(5)
Pension reform	0.118	-0.931*	-0.990**	-1.034**	-1.151**
	(0.143)	(0.452)	(0.439)	(0.436)	(0.496)
Economic literacy		0.060	0.054	0.087	0.089
		(0.066)	(0.073)	(0.079)	(0.084)
Reform*literacy		0.207**	0.222**	0.217**	0.247**
		(0.087)	(0.080)	(0.085)	(0.092)
Margin of majority			0.100		-0.447
			(0.365)		(0.805)
Left orientation			0.063		0.188
			(0.102)		(0.111)
Polarization			-0.006		-0.097**
			(0.080)		(0.042)
Output gap, level				0.024	0.027
				(0.025)	(0.028)
Output gap, change				0.000	-0.007
				(0.043)	(0.043)
Gov.bal., change				0.031	0.009
				(0.067)	(0.066)
Inflation, change				0.013	0.010
				(0.025)	(0.027)
R-square	0.012	0.064	0.069	0.096	0.130
Observations	100	100	98	87	87

Notes: Robust standard errors in parenthesis. (*) (**) (***) denote significance at the (10) (5) (1) percent level. All specifications include country fixed effects.

Robustness checks

- Head of the government from the same party
- Endogeneity: EU after Maastricht Treaty; IV approach
- Other measures of human capital

Work in progress

- IV strategy
- Presidential elections
- Feedback on the reform variable