**The challenges facing the new Italian government in the pension area**

by Elsa Fornero; 08/06/2006

After three and a half reforms during the past decade[1], restructuring the pension system is no longer a top priority in the Italian political agenda. The newly appointed Prodi Government, however, will hardly be able to ignore the issue, as Mario Draghi, the new Governor of the Bank of Italy, forcefully pointed out in his recent first official speech. Indeed, the very slow phasing in of the reforms casts doubts on the financial sustainability of the transition, still characterised by a relatively low average retirement age and by large financial imbalances. Moreover, private supplementary schemes, required to prevent the risk of inadequate pension benefits in the future, lag behind, basically unaffected by the regulatory framework introduced as of 1992 and its subsequent numerous modifications.

In tackling this crucial economic and social topic, the government seems uncertain as to which path to undertake. Considering the (rather vague) provision included in the electoral programme of the new majority, two main alternatives are likely to be considered.

The first alternative is in a line of continuity with respect to the past legislation, starting from the 1995 reform, that was indeed introduced by a centre-left coalition (supporting the Dini government) and never disclaimed by the centre-right coalition. It consists of improving the rules approved by Parliament in 2004 and by the Berlusconi government in 2005, but effective starting from 2008. Although improvable (and, indeed, the postponement of their application to 2008 can be explained by the purpose of allowing time for a revision), these measures rest upon a consistent theoretical background.

The 2004 law takes in the need for lengthening the working life in parallel with the increase in life expectancy; the 2005 decree is meant to boost the development of the supplementary pension pillar, in particular by introducing a yes-default option for transferring the TFR (severance pay) flows to pension funds and by creating a level playing field for the various forms of supplementary private pensions. Both measures are largely unavoidable, and Italian workers seem to have come to terms with them. Moreover, the Berlusconi reform can be improved quite easily - without prejudicing its goal in terms of pension expenditure reduction - by spreading the sharp worsening of the requisites for retirement (essentially three years) over the years close to 2008 (possibly also by anticipating an increase already in 2007), thus smoothing the sudden "step" and avoiding sharp differences of treatment between adjacent cohorts. As for the decree on pension funds, this can also be improved to make its structure clearer, and to enhance competition and portability between the different private pension products (including a greater portability of the contribution by the employer, now restricted to occupational pension funds).

[1] The reform process started in 1992 with the Amato reform; it continued in 1995 with the major Dini reform, which introduced the so-called Notional Defined Contribution system; went further in 1997 with the Prodi "half" reform (which affected mostly the public employees) and still further with the Berlusconi intervention, which occurred in two steps: a "delegation law" in 2004, directly increasing the retirement age and empowering the government – which complied in 2005 – to issue a decree with new rules on private pensions.

The second, more radical path consists of changing the foundations of the pension system to reduce the tax wedge (a key point in the agenda of the new Government). This path – supported in particular by the trade unions, in whose opinion the contribution-based formula will not grant a decent level of pensions to workers, given the rather precarious jobs the labour market seems able to provide nowadays – is both very risky and ill-timed, as it would cause an increase in pension expenditure (contrary to the line of action suggested by Mr. Draghi).

This reform path – which has not been properly defined yet – would consist of introducing a basic, universalistic pension, not contribution-based but financed through the general taxation, in order to create a sort of "zero pillar" (basic pension), to be added to the first pillar (contribution-based, public pension), the second pillar (occupational pensions) and the third pillar (individual pension products). The occasion for this innovation could indeed be provided by a rather complex manoeuvre on payroll tax rates aiming at reducing the labour cost and at realigning the contribution rates across different categories of workers. A rebate of five points in the rate paid by the employees (now at 33 per cent) will thus be combined with an increase of the payroll tax rates (currently in the range between 17.4 and 18.4 per cent) paid by both the self-employed and the growing number of "non-typical" workers. These changes in payroll tax rates should be mirrored by parallel changes in pension benefits, but this aspect is opposed by trade unions. Hence the "offer" of a universalistic pension as a sort of compensatory measure.

Per se, the design is certainly not a bad one. However, such a relevant reform cannot be devised on paper; it would rather be superimposed on an already complicated transition and, although aimed at reducing households' uncertainty, it would greatly increase the complexity of the system, implicitly nullifying the efforts towards transparency, uniformity of treatment (with exceptions only for the unfortunate individuals, whether workers or their dependents) and self-balance established in the 1995 pension reform. This rests upon notional capitalization and a contribution-based formula, which, although being far from perfect, has greatly helped in subtracting pensions from political interests and in establishing objective parameters for calculating benefits: the amount of contributions paid during the individual's working life; the GDP growth rate taken as the return rate of contributions; life expectancy at retirement as a base for the conversion of contributions into annuities. It is true that this pension formula does not guarantee good pension levels for individuals with unlucky working lives; however, this drawback – much more linked to the labour market imperfections than to the pension system structure – can hardly be cured through a universalistic pension, but has to be corrected through ad hoc interventions in terms of assistance.

Moreover, although a universalistic pension could be considered a milestone of citizen's right, this principle applies well in those countries (typically of Anglo-Saxon culture) where the State only guarantees the minimum rights, while leaving a high level of freedom, and responsibility, to individuals as far as their (retirement) choices are concerned. In a country such as Italy, characterised by a heavy public deficit, an unstable debt and a massive tax evasion, guaranteeing a minimum pension income not linked to contributions would drive a huge redistribution in favour of the higher income classes. On the contrary, should this minimum be based on contributions (supplement what the worker herself has "capitalized", it would probably discourage those who do not expect to reach the minimum requirement from participating in the labour market.

The effects would be to favour moonlight activities and to discourage labour participation for women and the oldest workers.

A final reason against this second reform path is that it creates the scope for new discretionary interventions in the pension field, that would lead not only to financial imbalances, but also to inequalities and unfair privileges, with ad hoc measures aimed at favouring particular categories (experience shows that, once the process has started, a lot of reasons can be found to support particular measures in favour of privileged groups). These distortions would highly jeopardize the process of convergence towards common rules, begun – and far from being over – with the 1995 reform. Moreover, pension expenditure would start again to grow almost without control, with an increase fuelled by a race to privileges among the different social groups.

In 1997 President Prodi aimed at a "grand" reform of the entire welfare system. Internal opposition within his supporting majority caused him to cut down his plan and satisfy himself with only a half reform. This unhappy precedent should warn him against perhaps too ambitious reforms in the pension arena.

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