A new pension reform? Better stick to the 1995 NDC system, yet to be implemented!
by Elsa Fornero (*University of Turin and CeRP*)
January 2007

1. *The risk of too many reforms*. In spite of an incomparable series of reforms and adjustments since 1992, the Italian pension system still presents a vast number of unsolved problems: retirement still occurs at relatively young ages; the participation rate of older workers is still comparatively low; the link between contributions/age of exit and benefits is still rather poor; unjustified differences in treatment are still pervasive, usually to the detriment of the young and of the less advantaged groups.

This explains why the pension reform continues to be a top priority in the government agenda.

The challenge for the Prodi Government, possibly in 2007, is to reverse the trend of postponed - and therefore hardly effective and credible - reforms, by assuming a far-sighted approach and open the path towards a sustainable, fair and diversified system, with a relevant space for the supplementary pillar.

The foundation of this system, however, is not to be searched far-away, since it lies in the full application of the 1995 Dini reform, which introduced the (notional) defined contribution (NDC) formula for the computation of benefits. Although mostly unapplied up to now, this reform has been often the object of distorted representations, and blamed for delivering inadequate benefits. Actually, the NDC method offers, on average and for given contributions, the highest possible benefits compatible with the long run sustainability of the system, and, while it will generate lower replacement rates for the same retirement ages of the past, this reduction will shrink for longer working periods.

It is indeed crucial to aim at lengthening the working life, by relying on the incentives and disincentives embedded in the NDC formula. A different perspective than the one lying beneath the 2004 Berlusconi reform, that tried to achieve the good objective of increasing retirement age through a mix of controversial measures, either only weakly effective (such as the so called “super bonus” rewarding job prosecution at retirement) or, in contrast to the principle of flexible retirement, restricting the degree of freedom embedded in the previous rules (such as the so-called “big step” (“scalone”), an abrupt increase of age requirements for seniority pensions between 2007 and 2008).

To amend this situation, instead of *ad hoc* measures, a full implementation of 1995 reform is needed, the NDC method being the reference target as well as the driving principle of the transition phase.

2. *The inadequate 2004 reform.* The 2004 reform established a strong discontinuity of treatment between December 2007 and January 2008, with a three-year increase – too drastic to be socially accepted – in the eligibility age to seniority pensions. At the same time, the minimum age for men to be eligible to a contribution-based pension will increase from 57 to 65 years, a less questioned measure since in 2008 and the immediately following years most workers will still retire under the retributive regime. Yet, this provision contradicts the NDC principle granting freedom of choice as far as retirement age is concerned, and carries the system back to the idea of pensions as a “gift” supplied by the State and therefore dependent on the conditions posed by the supplier.

Similarly, few critics have accompanied the reintroduction of different men/women age requirements for eligibility to old-age pensions: 60 vs. 65, with at least 5 years of seniority: while neutralising for women the stricter 35-year requirement for seniority pension, this measure again lies on a surpassed logic: compensating ex post instead of granting equal opportunities ex ante.

Clearly, the drawback of the Berlusconi reform is not that it misses its goals, but that it uses partial and rough instruments to achieve them. Indeed, it has positive effects on the financial side: savings in expenditure will be low at the beginning but will strongly increase over the years (to reach 8 billions in 2011).

3. *Possible (and desirable) corrections*. While, at this stage, it would not be advisable to cancel the 2004 reform, the "scalone" could be spread over a longer period beyond 2008, at the same time implementing measures to make up for part of the lost savings. Again, a full implementation of the 1995 reform is of primary importance: first of all, it is necessary to extend the formula to all workers, regardless of their remaining years of activity; second, a revision of the transformation coefficients, based on statistical mortality tables, is required – a fundamental action in the contribution-based method, that should have been undertaken in 2005, but was not because of its expected unpopularity.

A third reasonable measure would be to reconsider the age-band of flexible retirement (i.e. the 57-65 band where the actuarial principle applies, with appropriate variation of the transformation coefficients), by linking it to longevity growth. In a scenario of continuous demographic evolution, instead of defining absolute values, it is preferable to update these values along with the longevity variations, at least every 5 years. Such a measure would reduce the difference of treatment implied in the ten-year revision mechanism, help overcoming the jump from 57 to 65 years for contribution-based pensions and restore equality between men and women as far as the age of exit is concerned. Finally, it is crucial that pension bodies periodically inform workers in a transparent way about their accrued contributions and the corresponding benefits, so as to encourage free, responsible and informed pension choices.

A revision of the Italian system along the lines described above is still possible, and certainly desirable: apparently, the only sensible reform now is to enforce the one devised on paper more than 10 years ago. Whether politics will go in this direction it is difficult to say, although the most likely scenario is just a new and unsatisfactory compromise between those who are prone to reform in government and those who much prefer the status quo.

ef – January 2007