Pensions in the electoral campaign
by Elsa Fornero 26/03/2008

Public pensions entered the Italian electoral debate in the last weeks as Democratic Party leader Walter Veltroni proposed specific measures aimed at increasing the amount of pension benefits, to match the rise in the cost of living.

The proposed measures are: 1) increasing tax advantages for low income retirees over 65 years; 2) indexing future pension benefits to a sustainability index calculated as the ratio between the wage bill and total pension expenditure. The former measure is meant to improve the living conditions of current retirees, whose pension benefits have been eroded from inflation, while the latter aims at raising all future pensions.

Both measures should be evaluated by considering two aspects: their effects on pension expenditure, and their consistency with the defined contribution method introduced by the 1995 reform, and not yet fully phased in.

As for the first aspect, the estimated yearly cost for raising current pension benefits is about 2.5 billions euro, equal to an average increase of €400 per year for each pensioner. This increase should result from reducing fiscal pressure on pensioners' incomes. The coverage for this measure is yet to be specified (resources will possibly come from a reorganization of public estate as well as from strengthening the fight against tax evasion).

The rationale for this measure is to help many low income elderly whose pensions, which tend to grow slower than prices, have been loosing purchasing power over the last years. The cost for this increase, however, is not covered by the contribution paid by these pensioners, but by active workers: it is important that this measure, meant to restore the elderly's purchasing power, is not perceived as a "gift" from a benevolent political class, but rather as a necessary *una tantum* adjustment, paid through general taxation. To this purpose, it is essential – and we come to the second aspect of the issue – that the proposed actions are consistent with the contribution-based method – implying a separation between the insurance and the assistance role of social security. The main function of a pension systems is to insure workers for old age, making them transfer resources from active life to retirement, thus covering the demographic risk. In the contribution based method, pension benefits are the actuarial correspondents of paid payroll taxes. These can be turned into an annuity in different ways: benefits can be constant in real terms (i.e., indexed to inflation), or indexed to wages, so as to maintain the pensioners' standard of living at the same level as workers'. In both cases, pensions are the result of an efficient and transparent formula. Therefore, too many new redistributive adjustments from active to inactive cohorts risk undermining the credibility of the method.

Changing the indexation of pension benefits implies adjusting the contribution-based formula, assuming that pensions linked to earnings can be higher than pensions calculated through the current formula. *Per se*, the proposed change does not put a threat to the contribution-based method, and it is consistent with its formula. However, the risk is that advocating corrections for a method that has not been totally implemented yet could weaken the commitment to recognizing it as founding element of the pension system.