Stop and go in the Italian pension reform process

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1. The Government - Unions agreement: an overall evaluation

On July the 27th, 2007 the Government and the Trade Unions reached an agreement (known as the "*welfare protocol*") which has subsequently become a draft law, submitted to Parliament and included, as a separate bill, in the 2008 financial law. The immediate goal of the bill is to prevent the former (2004) pension law to become effective, as originally stipulated, at the beginning of 2008, and consequently to avoid the rather abrupt increase in retirement age (three years) established by that reform, which would cause a sharp discontinuity of treatment between adjacent cohorts (the so-called "*scalone*" - big step - as opposed to a smooth increase in retirement age).

From a political point of view, the *welfare protocol* can be thought of as a "*reasonable compromise*" among the different stances of a composite majority and the rather conservative attitudes of Italian trade unions (whose members are typically rather old).

From a technical point of view, the agreement can be evaluated according to different criteria. In this note, I will concentrate on its contribution to the financial sustainability of the system, both in the short/medium term, i.e. in the transition phase, and in the long run, i.e. when the new *Notional Defined Contribution* (NDC) regime will be fully phased in.

As for the <u>medium/short term</u>, still characterised by a defined benefit type of formula, the main change is the smoothing of the "*scalone*". With respect to the 2004 Maroni law, the new provision stipulates a milder increase in retirement age as of 2008, followed by a phase of progressively more stringent combinations of seniority and steadily increasing minimum retirement ages. Two *caveats*, however, are in order: i) the still unclear definition of the categories of workers in hazardous occupations, to whom the increases will not apply; ii) the amount and coverage of the costs.

As for the <u>long term</u>, a positive feature of the draft law is that it reaffirms the contribution-based method for calculating benefits. Indeed, the law stipulates new and tighter rules for the revision of the *transformation coefficients* (one of the key ingredients of the NDC system), which somehow strengthen the mechanism. However, contradictory signals are also given, such as the further postponement of the first revision (originally due in 2005, it is further deferred to 2010) and the reference to a possible guaranteed replacement ratio for the young generations, which could undermine the commitment to the new system.

In short, the agreement is a mix of lights and shadows, which deserve substantiation under a wider evaluation perspective.

2. Rising retirement age

To provide a proper assessment of the new measures, one needs to take into account the long transition of the Italian pension reform, and its differential impact on the various cohorts. A pay-as-you-go system is necessarily projected into the long term, involving all present and future generations. This feature creates asymmetries as to the effects of legislative innovations: while improving reforms usually find an immediate application, restrictions to benefits tend to be gradual, so as to soften their effects on the elderly, who can hardly offset them by saving more or working longer. The delay in application usually also involve active cohorts, so that the closer a worker is to retirement, the less (s)he will be touched by the cutback.

In Italy, the reform season started in 1992, with the Amato reform, which curtailed both the generous rules for the calculation of the earnings-based pensions and the indexation mechanism (since then applied to prices only, instead of wages). The change in the pension formula, however, only applied to the cohorts with less than 15 years of work, fully for the new generations and on a *pro-rata* basis for the others. This partition was reaffirmed in 1995 by the Dini reform, which introduced the contribution-based formula within the public PAYGO system.

This delay has generated a very long transition which can (approximately) be characterised as follows: until 2013-15 workers are still subject to the more generous pre-reform rules (earnings-based pensions); from 2013-15 to 2033-35 the reform is applied on a *pro rata* basis; from 2033-35 all new pensions will be calculated according to the contribution-based formula; since 2060 all pensions in payment will be of the DC type.

In the transition period, i.e. until 2033-35, the reform is too slow to counteract the progressive worsening of the dependency ratio and the pension expenditure/GDP ratio will continue to rise. Given the sluggishness of the new formula, the strong financial unbalances of this period have been tackled mostly by tightening the eligibility requirements for seniority pensions, and by increasing the average retirement age. Various "incentives" to job prosecution have also been devised[1], insufficient however to compensate for the implicit tax embodied in the seniority pensions. Although in contrast with the flexibility principle at the base of the 1995 NDC reform, Restrictions to eligibility, are certainly not without justification, as they tend to reduce the "gift" implied in the rather generous DB seniority benefits.

After more than a decade of such interventions, the average retirement age in Italy has risen for both men and women to levels not far from the European average (EU 15)[2]; a positive change, insufficient however to make up for the already occurred gains in life expectancy and above all for the prospective ones. Moreover, an important point is that increasing retirement age should not be an exogenously established procedure, decided *a posteriori* as a means to restore financial sustainability, but rather a dynamic feature of the pension system, allowing both for flexible choices and for periodic self-adjustment. From this perspective, neither the 2004, nor the 2007 reform fully incorporate the flexibility principle, as well as its counterpart, i.e. the actuarial neutrality and fairness.

The 2004 reform dealt with the issue with effectiveness but also with unevenness, by introducing, starting from 2008, the abrupt increase in the retirement age (from 57 to 60 years, combined with 35 years of seniority). Although the measure was welcomed by international institutions, during the 2006 electoral campaign the current Government coalition promised, maybe somewhat incautiously, to smooth the discontinuity of treatment.

The July 2007 agreement with the social parties (later approved by the large majority of workers through a referendum) which replaces the "*scalone*" with more gradual increases, represents the attainment of that promise.

Despite its greater gradualism the new law aims at the same targets of the 2004 reform, while the establishment of a minimum age for seniority pensions is important because it helps containing the generosity of the still valid earning-based benefits. According to the 2004 reform the requirements for an employee in 2013 would be age 61 (62 for self-employed) and 35 years of contributions; in the new law these are replaced by "quota 97" (98 for self-employed), i.e. an age/seniority combination of either 61/36 (62/36) or of 62/35 (63/35). Another continuity of the draft law with respect to the 2004 reform is that it preserved the rather anachronistic age difference between men and women as far as old age benefits are concerned: 60 for women and 65 for men. While, on the one side, this could be a measure to compensate for women's double activities – at work and in the household – on the other side it could go to the detriment of women when their benefits will be calculated through the contribution-based formula, as they usually have shorter and more discontinuous careers and, correspondingly, lower pension benefits.

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[1] Incentives for job prosecution were enclosed in the 2001 financial law as well as in the 2004 pension reform.

[2] According to the last available data, in 2002 the ages (source: Eurostat, Labour Force Survey, 2004) for Italy were, respectively for men, women and total: 60.2, 59.7, 59.9; the corresponding average European values were 61.0, 60.5, 60.8.

Electoral promises however are often made without much reference to their costs. When they become law, however, costs have to be estimated. For the smoothing of the *scalone*, costs will amount at a total of 10 billions € in the next decade. What is even more important, is who will bear them. The laws relies on a rather vague reorganization of pension institutes, or, failing the savings coming from it, on increasing payroll tax rates by 0.09 points for all workers, a measure which is inconsistent with the Government's commitment to reduce the tax wedge on labour income. A second open issue, which could further increase the cost of the reform, concerns the definition of workers occupied in hazardous jobs, who are excluded by the reform and can access retirement at lower ages; barring scientific knowledge for the definition, the possibility that Parliament decide on an ideological basis, ending up with listing a too large number of categories under this label, is not to be ruled out, with further expenses to be added to an already high bill.

To sum up, the evaluation on the sustainability of the Italian transition phase is a mixed one. It has to be stressed that, regrettably enough, once more, irrespective of all the rhetoric about the need to restore the generational balance, the older generations have been favoured with respect to the younger and future ones. For this reason, it is likely that the 2007 reform cannot be considered as the last intervention on the transition process. Many issues, such as the definition of the categories excluded by the reform, the differentiation between men and women, the possible increase in payroll taxes, are still open. However, even more important is the time consistency problem created by the many *ad hoc* measures introduced to deal with the very long transition period, which risk disconnecting the transition form its endpoint, i.e. the full application of the NDC system, and reducing the credibility of the method itself. The next section deals with how much credibility is left to the commitment towards implementing the original 1995 reform.

3. A reform in danger?

Moving to the long run perspective. i.e. the full application of the contribution-based formula, the 2007 draft law has not abandoned the method, but made it more uncertain.

On the one hand, the method appears reinforced by the willingness to revise the transformation coefficients, so that the calculation of benefits will take into account the variations in longevity. According to the 1995 reform, the coefficients should have been updated every 10 years, but the first revision in 2005 did not take place. With the new law, the revision is delayed to 2010. After that, however, it will occur every 3 years, with a first update in 2013, two years before what would have happened without this reform.

On the other hand, however, the new delay in the application of the adjustment mechanism could undermine its credibility. Some could think that this provision, before coming into force, could be revised another time or even cancelled. Also, the draft law refers to a newly appointed commission to evaluate the "consistency" of the NDC method with the evolution of both the demography and the labour market, but the tasks of the commission are still quite vague.

A second weakness lies the (generic) commitment to guarantee at least a 60% *net replacement rate*, a rather loose statement, which does not embody a true guarantee, but which could undermine the contribution based method and which has been included in the draft law at the very last time, without being given enough space in the debate.

As already mentioned, the younger generations are subject to the more severe DC pension rule. This means that if they will retire at the same ages as their fathers, their pension benefits will be much less, and possibly inadequate. However, the NDC system embodies the right incentive to delay retirement, and thus underline the basic fact that when longevity increases the length of the working period should also increase. So, working longer should be, for the majority of workers, the correct answer, rather than the state guarantee.

On the contrary, the promise of a state guarantee represents a return to the past, and a hard knock to the design of the 1995 reform, for at least three reasons. First, introducing a generalized guarantee means returning to a defined benefit formula and abandoning the contribution-based method, devised to guarantee the sustainability of the system. Again, the costs for this promise will be charged to the future generations, who cannot protest against the measure.

Second, a state guarantee implies not only direct costs, i.e. the costs for public finances, but also indirect costs, such as distortions in the labour market induced by pension formulae with no match between contributions paid and accrued benefits: tax evasion, retirement at the minimum ages, and so on.

Finally, we have to consider that 60% of a high salary is much more than 60% of a low salary. Since usually higher salaries correspond to higher human capital and more dynamic careers, while lower salaries apply to low human capital and flatter careers, it is apparent that the guarantee implies creating new privileges, unfairly rewarding the more well-off groups.

In order to avoid the disadvantage of such a generalized guarantee, and at the same time to ensure economic security for the elderly, the road to be followed is the contribution-based method. Of course, an integration from public finances has to be foreseen for individuals who, because of an unfortunate working life, weren't able to raise enough pension wealth. To be effective without creating new distortions, public aid must be selective, not generalized.

4. Pensions and labour market

A very relevant question in this context is whether the Italian labour system is still able to create "good jobs" that, in turn, can generate an adequate income to provide for the needs during active life as well over retirement. This is a realistic concern, if we consider the performance of the market, and, in particular, the wage dynamics, over the last decade[3].

Focusing on pensions as a remedy for the labour market deficiencies is like trying to strengthen the effects of a medicine without considering that the diagnosis is wrong. On the contrary, the emphasis should be put on the contribution-based method, which, if properly applied, is the only formula able to guarantee the automatic equilibrium and the long term sustainability of a pay-as-you-go system.

Precisely because of the long transition envisaged since its approval, this method has never been attributed the right merits; unsurprisingly so, as a reform that will be fully applied only in 2030 is not likely to be "owned" by the majority of citizens. As a further weakness, perhaps in order not to attract further unpopularity, the reform has been "packaged" in a reductive way, as if it consisted only of minor interventions. Thus, after more than 10 years, a fundamental measure of transparency foreseen by the 1995 law, i.e the periodical delivery of a pension account sheet to each worker, is still lacking. It's a pity that even the current Government has not put the stress on the contribution-based method.

The main critic made to this method is that it is too severe, as it only guarantees an actuarial equivalent of paid contributions. This critic implies that there exists better formulae, able to guarantee higher benefits with the same contributions, or the same benefits with lower contributions. This is the old debate between pay-as-you-go and funding: can financial markets guarantee better performances than the GDP growth rate, once they are corrected to take into account the higher risk factor? Franco Modigliani would have answered yes, and was in favour of a public funded system, to apply the advantages of financial markets, with lower costs and lower risks.

A more prudent approach takes into account that neither the pay-as-you-go nor the funded system are free of risks. Since the risks borne by either system do not fully overlap, it would be advisable to pursue risk diversification – i.e. a mixed, multi-pillar system –, a criterion that has inspired the recent reforms.

[3] See, for example, the analysis of the Bank of Italy Governor Mario Draghi, delivered at the University of Turin on October 26, 2007 (www.bancaditalia.it).

It is clear, however, that the opponents to the contribution-based method are not thinking about market solutions, but rather to political interventions able to “guarantee”, better than this method, the adequacy of future pension benefits. We are thus back to the previous dilemma: the state should intervene in favour of unlucky individuals or categories, but not in favour of a whole generation, unless it transfers the costs of this intervention on future generations, i.e. raises pension debt. A method of the past, that the 1995 reform had tried to eradicate.

Of course, public assistance interventions should not been taken out of the pension system. However, instead of recognizing *ex ante* differences of treatment to whole cohorts or categories, it would be better to credit workers who spent periods of their active life outside the labour market (because of unemployment, child care, training, etc.) with figurative contributions, covering those periods. These considerations are valid for both women (more exposed to the risk of discontinuous careers) and male workers with low-paid, discontinuous careers.

The provision of notional contributions for these kind of workers could be integrated by other measures, such as those in favour of workers who do tiresome or hazardous activities, or the “summing up” of the contributions to different schemes. All these adjustments are possible within the frame of the contribution-based method, and are an important reason for being of the public system; they should not constitute an alibi to contrast the method itself because it is less generous.

In conclusion, behind the appeal for a return to guarantees hide the old bad habits responsible for the Italian financial disorder. The legislator should not repeat errors of the past and keep confirming and strengthening the contribution-based method, remembering that, once this method is applied, the best pension reform has to occur within the labour market. If this works, so will pensions.