European pensions and social security: Can there be a happy ending?

By Elsa Fornero♥

"You see things as they are and ask: "Why?". I dream things as they never were and ask: "Why not?"

George Bernard Shaw, *"Back to Methuselah" (1921), part 1, act 1*

Retirement in 2040: Two European stories

June 1st, 2040. Berlin, Germany

Karl Weiss closes the screen on his multi-media device and sighs with relief. He has just checked his online bank account: his first monthly pension transfer has come in on time and in the expected amount. His pension will allow him to maintain his comfortable lifestyle, and every year from now on it will rise with inflation. Karl's regular income will also include quarterly payments from his voluntary, but tightly structured, private pension fund.

Karl owes the fact that he is so well provided for to the "Finance for everyone" night classes he attended twenty years earlier. Almost every year since then, he has gone to a one-day "Update your finance know-how" seminar. "A small investment for a big return," he thinks, smiling to himself.

Having been born in 1971, Karl is now 69 – the standard retirement age. He started work at 18, immediately after leaving the *Technische Schule,* which had included an apprenticeship period. That was well before the 'Hartz' labor market reforms of 2002-05 and the pension reforms of 2007-11. At the time, the profound changes to Germany's labor market and pension landscape had angered many of his compatriots[1]. But years later, most people admitted that the reforms had been good for the economy and also helped Germany to weather the financial and economic crisis that started in 2007-8.

Karl himself was never very vulnerable to the vagaries of the job market. He was part of a shrinking but still large group of Germans who followed a "traditional" career: in his entire life, he has worked for only two companies, rising through the ranks to become a production manager at 52.

[graph: German retirement age, trend]

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[1] Axel Börsch-Supan; Alexander Ludwig, 'Living standards in an aging Germany: The benefits of reforms and the costs of resistance', Journal of Economics and Statistics, 229 (2+3): 163-179, 2009.

Like most people of his generation, Karl had never dreamt of working for so many years. Karl's own father had retired at 58. But then again, life expectancy of his father's generation had been 65, while that of Karl's generation is 75. Karl understands, not least from the *Financial Education Newsletter* he receives regularly, that no pension system in the world can cover retirement periods of 15 to 20 years -- at least not without putting a crushing burden on the generations of his children and grandchildren. Come to think of it, Karl enjoyed working until the last day. His health is excellent, also thanks to his regular check-ups and active lifestyle. Nevertheless, he has extended his health insurance to cover some help at home, just in case he and his wife should one day struggle with daily chores.

Karl leans back on his sofa. He feels confident about his retirement and glad that he lives in a system that provides stability for both older and younger generations.

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October 1st, 2040. Bologna, Italy

Carlo Bianchi is toasting his last working day with his colleagues at the food distribution company where he has been working for the last 25 years. Carlo is almost 70, and now he is looking forward to moving to Umbria and helping out at the organic vineyard of his daughter, Alessandra.

A long time ago, when Carlo was in the early stages of his professional life, Italy had one of the lowest retirement ages in Europe. After several starts and stops, the pension reforms of 2010-11 substantially increased it, made it much harder to retire early and linked future retirement ages to life expectancy. Many Italians took their time to accept the new system. But now it is widely seen as fair, particularly on the younger generation.

Carlo's working life has had its ups and downs: almost two years to find his first 'proper' job; several spells of unemployment, the longest one during the "great contraction" of 2008-14; and a hectic couple of years when he ran a pizzeria with his wife, Marta. Finally, in 2016, when the Italian economy started to recover, he landed the job at the food distribution company where he stayed until his retirement.

Carlo's pension will not be big but it should be enough for a decent life, especially since the Bianchis – like three quarters of their generation – own their home. Marta also has her own, albeit much smaller, pension. So she is not fully reliant on her husband, or the meagre widow's pension should he die before her.

The Bianchis can rely on a reasonably well-functioning health care system. Like many of their fellow retirees, they would also count on their daughter to provide care should they become frail – although Alessandra is still very busy with her wine business. She started the company with the help of some of her parents' savings and it has become a moderate success of which the whole family is proud.

[Picture of hills in Umbria]

Carlo has done another clever thing: many years ago, he used the option of transferring the 'severance pay fund', to which every Italian was entitled at the time, into his occupational pension fund. This tidy sum (amounting to around 7 per cent of his annual salary) will now bolster his retirement benefits.

Although Carlo has never enrolled in any financial courses, he has benefited from a general increase in financial awareness that followed the crisis years of 2008-14. Back then, Italians began to realize that their reformed pension system would require them to make important choices themselves. TV programs, newspaper supplements and government-sponsored leaflets helped Carlo's and Marta's generation to understand things like compound interest and risk diversification. As a result, the Bianchis can look forward to sunny times in the hills of Umbria.

From crisis to turning point

Let's stay in 2040 and dream on. Let's assume that these two stylized stories illustrate the success that European countries have had with big and bold reforms in the early decades of the 21st century. Pension reform had been on the agenda in Europe for decades. But it was the financial and economic crisis that started in 2007-8 which forced several European countries – not only Italy, but also Spain, Portugal and Greece – to get serious about putting their social security systems on a sounder footing. Given how turbulent these crisis years were, this was a difficult task. But the troubled countries lived up to the original meaning of the Greek word "crisis", namely "turning point". A turning point can mean opportunity as well as a catastrophe.

[By 2014, Europe was at a crossroads: would reforms slacken? Or create a virtuous circle?]

European countries grasped this particular opportunity and pushed through important changes[2]. By 2014, Europe was at a crossroads: with the European economy slowly recovering, would governments slacken their reform efforts? Or would the reforms already implemented create a kind of self-perpetuating virtuous circle in which positive changes generate the growth and the courage needed for further measures? Let's assume for a moment that Europe went into this virtuous circle and spin our story further...

Following the initial changes to job markets and pensions systems in the troubled southern European countries, the reform momentum spread to other places, including France, Belgium but also Germany, the Netherlands and some northern European countries that had been doing better economically but were resting on their laurels. Those countries that had done initial pension reforms in 2008-14 went further and redesigned their entire social security systems in a consistent way.

In many European countries, the ratio of old-age pensioners to the working age population (the old-age dependency ratio) has nearly doubled between 2000 and 2040. In the early years of the new century, this resulted in an ever-growing tax burden on workers and a shift in government spending away from education and other investments, and towards pensions and healthcare for older generations. Only the social security reforms implemented after the 2008 crisis helped to restore a fairer generational balance in Europe.

Although European countries followed their own, tailored paths to pension reforms in 2020-30, a common pattern emerged, as governments everywhere

- strengthened the link between individual contributions and pensions pay-outs;
- encouraged pre-funding of pensions, through making it easier for people to participate in (mainly occupational) pension funds;

[2] See, European Commission, 'The 2012 ageing report', Economic and budgetary projections for the 27 EU Member States (2010-2060), 2012; OECD, 'Pensions at a glance 2013', OECD and G20 Indicators, 2013; European Commission, 'Pension adequacy in the EU 2010-2050', 2012.

- gave workers the possibility (within strict limits) to link their pension to prices or nominal wages;

- harmonized the entitlements for men and women;

- raised retirement ages and, thanks to the link between contributions and benefits, made them more flexible, i.e. gave the worker freedom to choose when to retire, within a certain time period, with his/her pension accordingly adjusted;

- created automatic links between demographic changes, such as increases in life expectancy, and adjustments in the pension system;

- tightened access to early retirement and disability schemes;

- reduced pension pay-outs for those choosing the remaining early retirement options;

- enhanced transparency, also through better information for workers;

- allowed people to transfer their pension entitlements from one EU country to another.

Europeans did not only reshape their pension systems; they implemented a self-reinforcing package of reforms designed to boost their economies' competitiveness, generate steady growth, deal with the ageing of societies and to some extent harmonize social security systems across the European Union[3]. They also addressed some of the gaps in income and wealth that had widened during the "golden age" of free markets before 2008. During the turbulences of 2008-14, few Europeans could have imagined that the crisis would result in a successful move towards efficiency and solidarity.

The reform package that European countries implemented included more flexible labor markets, the privatization of some public services and more emphasis on education, innovation and scientific research. Other measures were designed to bring more women into employment and to give younger people an easier start to their working lives.

[*Younger people often faced spells of unemployment, got stuck in part-time or temporary jobs and struggled to get a reliable monthly salary.*]

[Picture: young people unemployed / jobless queue / protesting]

Younger people in particular had faced growing uncertainty from around the 1990s onwards, as globalization and technological change started to profoundly affect the job market. While their parents had mostly enjoyed secure jobs and steady earnings growth, younger people often faced spells of unemployment, got stuck in part-time or temporary jobs and struggled to get a reliable monthly salary.

The apprenticeship systems that had helped Germany and other Central European countries to get so many young people into decent jobs needed updating. By 2014, between a quarter and a third of new jobs were in innovative and fast-changing areas where the traditional three-year apprenticeships made little sense. Politicians and experts started looking at measures that would allow young people periodically to leave work in order to

[3] Axel Börsch-Supan; Klaus Härtl; Alexander Ludwig, 'Aging in Europe: Reforms, international diversification, and behavioral reactions', American Economic Review, 104 (5): 224-29, 2014.

update their education. Today, in 2040, public financial support for lifelong learning is part of the new integrated work-retirement welfare.

Women also benefited from the general reform momentum. Changes to the welfare system interacted with longer-term trends affecting women's role in the economy and society. In the 20th century, women had been enabled to join the labor force, not only because of changing social attitudes but also because of the broader availability of organized care for children and the elderly and, not least, the universal introduction of washing machines, vacuum cleaners and electric ovens.

[Unreformed pension systems "compensated" women through letting them retire earlier than men.]

However, while women were free to go to out to work, they still had to do the bulk of household chores. Especially in Southern Europe, many women still did an additional (unpaid) job at home. Unreformed pension systems "compensated" women through letting them retire earlier than men and giving them generous widow's pensions.

With increased participation in the labor market and public life, as well as changing family structure, women demanded more say over their pensions. They wanted equal treatment with men, the same retirement age (which meant better career opportunities in the later working years) and more responsibility for their own incomes. By 2040, all European countries finally treated women as "normal" citizens rather than as (dependent) spouses.

These policies designed to support younger workers and women resulted in an increase in the labor force. More people in jobs meant not only a boost to output but also higher tax revenue, both of which made it easier for European countries to support a growing population of retirees.

Politically, this virtuous circle of reforms was not easy. Initially, many Europeans resented the "austerity" imposed by the EU institutions in Brussels. But then the debate became more nuanced, especially after some eurozone countries could show off the first successful reforms. After much controversy, misgivings and lively debate, an entire generation – the then 40-65 year olds – accepted substantial reductions in their original pension promises. In that way, they helped to restore Europe's social and political stability.

Until the turn of the century, reforms in Europe had often been piecemeal and excessively cautious, as politicians worried about a backlash from their voters[4]. It was the crisis of 2008-14 that helped politicians to overcome their fear of "big" reforms and allowed them to devise and adopt long-term and consistent programs designed to tackle demographic, economic, social and political changes all in one go. These programs are in full swing in 2040.

A new understanding of "reform"

Coming back to the realities of today, we need to ask ourselves what it would take to move from the deadlocked and often antagonistic reform debates of the past to the kind of virtuous circle that I have described in my 2040 scenario.

As Minister of Labor in Italy's "technocratic" government during the economic crisis, I was responsible for the design and introduction of a comprehensive pension reform in 2011 as well as labor market reforms in 2012[5]. From this very hands-on experience, I have concluded that what we need is nothing less

[4] Gøsta Esping-Andersen, 'Welfare state at the end of the century', in: OECD, 'Family, market and the community', 1997.

[5] Elsa Fornero, 'Reforming labor markets: Reflections of an economist who (unexpectedly) became the Italian Minister of Labor', IZA Journal of European Labor Studies, 2(20), 2013.

than a more comprehensive understanding of what "reform" means for a government, an economy and a society.

Today, international institutions and economists talk about "reform" as some kind of panacea that will magically improve complex financial, economic and social structures simply through the passage of a law. They seem to assume that once the law is passed, everyone and everything will comply with its letter and spirit.

In practice, however, such transformative effects only work on a small scale for "incremental reforms" – changes that do not shake the foundations of the system but build upon them. Think of a car company designing a new model but taking it for granted that a car should have four wheels, an engine and a steering wheel. Things look very different for "fundamental reforms" that affect the workings of system itself. In our example, the car company would call into question the four-wheel concept and the way in which a vehicle is powered and steered. The implementation of fundamental reforms is much more complex and its implications are wide-ranging.

[Welfare reforms demand not only legal but also cultural and economic changes.]

European welfare reforms are of the fundamental kind, since they demand not only legal but also cultural and economic changes. People have to abandon long-standing convictions, such as that when older people work longer, they take jobs away from the young. Business have to change their practices, for example they need to learn to use older workers in a really productive manner. Most importantly, the current generation of workers has to abandon the idea that they are "owed" a certain old-age provision irrespective of the demographic, economic or fiscal framework.

In the course of 20th century, European countries have become wedded to the idea that pensions should consist of guaranteed, stable and generous payouts at relatively young ages. Typically, these were "defined benefit" pensions, which means that the amount that a retiree could expect was fixed in advance as a proportion of an average income in late career.

As societies aged, this system resulted in a huge and increasing mountain of "pension debt" (the net value of future pension entitlement in today's money). This implicit debt mountain added to growing (visible) public debt and was clearly becoming unsustainable, especially against the background of fast-ageing societies and sluggish increases in productivity. This left younger workers – and their dwindling number of offspring – with the impossible burden of paying lavish benefits to a fast-growing number of people who retired early but lived ever longer.

[Pension systems created a "perverse" redistribution from the less well-off to the middle classes.]

Not only were Europe's welfare systems relatively expensive, they also often worked badly. Over the years Many had become incredibly complex, fragmented and hard to understand. This lack of transparency encouraged political tinkering and allowed benefits for the privileged few to persist. The result was often a kind of perverse redistribution that channeled benefits from the less well-off to the middle classes or even the wealthy. European countries had little choice but to redesign the systems – or face sovereign bankruptcy.

In principle, it would have been easier to introduce reforms during a period of steady growth, when sacrifices are easier to make than at times of recession. Redistributing a growing pie is always easier than cutting up a shrinking one. But it lies in the nature of electoral politics that no political party will promise to "spoil" the good times by introducing painful reforms designed to prevent distant problems. This did not happen in Germany, which had to become "the sick man of Europe" before it implemented effective pension and labor market reforms (and they still cost Chancellor Gerhard Schroeder his job in the 2005 elections). Italy, Spain, Greece and Portugal had to push through reforms in much stormier economic times, and both the sacrifices required from the people and the political upheaval were far greater.

[*Graph: Italian GDP and public debt*]

In the Italian case, the need finally to tackle pension and labor reforms was one, perhaps the main, reason for appointing a technocratic government, whose members did not belong to any political party. Italy's center-right and center-left parties put aside their longstanding and bitter quarrels and passed the reforms with a huge parliament majority – albeit with little conviction or enthusiasm. Immediately after they had approved the laws, the same parties, indeed the same politicians, started to criticize them and tried (unsuccessfully) to cripple them with amendments.

The Italian example shows that fundamental reforms are not mere technical matters or a quick fix for deep-seated problems. To work, these reforms require not only changes of rules, but changes of behavior. Indeed, they often alter the structure of society. For example, when Italy introduced compulsory primary education in 1873, it took families about 15 years to really grasp that their kids now must go to school.

Fundamental reforms are "social investments" in that they require sacrifices today in expectations of tomorrow's benefits. They therefore need the strong support of most citizens affected. It is important to get the technical aspects of reforms right. It is at least as important to inform the population about the planned steps and their implications and to give them access to financial education so that they can benefit from the new system in the future.

Inform, implement, educate

Given the demographic transition that we are undergoing in Europe, fundamental reforms cannot be distant ideas but they are a political necessity. Today, those of us who are middle-aged or above are still enjoying an almost unprecedented concentration of wealth (including generous pension entitlements), privileges and political power. But this concentration has left many younger people struggling financially and with limited options. In many European countries, unemployment rates for younger people are twice what they are for more senior workers.

The demographic transition therefore represents a challenge not only because of shrinking labor forces but also in terms of income distribution and the perspective we can offer to younger people. Fundamental reforms are needed to offset the effects of demographic transition: we need them to make our social systems efficient, inclusive and sustainable again.

Social security reform cannot be left to economists, lawyers and actuaries. The concept of reform must become much more comprehensive, and encompass three different dimensions:

1) Information[6]

   Reforms will be useless, or even produce a backlash, if they are not firmly endorsed by the political forces that have a parliamentary majority. These political forces must act as a bridge between the public, government officials and experts. Reforms must never be mere theoretical constructs, concocted by eggheads behind the closed doors

[6] Tito Boeri; Guido Tabellini,' Does information increase political support for pension reform?', Public Choice, 150: 327-362, 2012.

of universities or research centers. Any big reform must entail a broad social and political debate. Politicians must personally stand up for their reform projects, to give them a "face" and make them less abstract.

2) *Implementation*

We must move away from the naïve idea that one legal change can miraculously save a whole economy. Even if we just look at the legal aspects of fundamental reforms, these are a complex process designed to deal with a complex society. Any big "reform" will require several laws, usually over a period of years. To implement reforms, governments often have to set up new institutions or teach new procedures to existing bureaucracies. It can therefore take a year or more for a new law to show any effects; and even longer if the law is groundbreaking and bureaucracies must first learn how to actually deal with them.

3) *Education*

Reform processes are a learning experience not only for the government but also for society: just like the bureaucracies implementing new laws, a society needs to get accustomed to the new framework. Most changes to the welfare system only work if the population has at least some level of financial education[7]. Universal literacy – reading and writing – was essential for the establishment of democracies in the 19th century. What we need for successful reforms in the 21st century are societies that are numerate as well literate.

[Picture: young women studying / financial education]

The efficiencies of electronic banking can only be reaped if customers understand how their bank accounts work. People can only make clever investments if they understand how interest rates and yields affect their savings and if they grasp the difference between risk and uncertainty.

Therefore, financial education must not be confined to helping wealthy individuals understand their complex financial portfolios. It must become a tool that allows citizens to make less complex, but fundamental, choices about their financial future.

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The future scenarios that I have painted here are not a rose-colored, happy-end story. What I have tried to suggest is a possible path, perhaps the only possible path, (and many European Countries are already moving along it), for Europe to maintain its unity, identity, fundamental liberties and social cohesion, while achieving a huge and necessary shift of income, power and expectations from the old and middle-aged to the young and future generations.

[Text Box to be placed in the main text]

Start Box

[7] Annamaria Lusardi; Olivia S. Mitchell, 'Financial literacy around the world – an overview', Journal of Pension Economics and Finance, 10(4): 497-508, 2011.

What solid pension reform should look like[8]

Any successful pension reform starts with a shift in attitudes. People should no longer see pensions as welfare or redistribution but as an insurance mechanism that is tailored to each individual and also takes into account broader risks that apply to whole generations and groups of people.

What governments should aim for in a pension system is a balance between general obligations (for example, what share of your salary you must pay into the system) and personal choices (for example, when you decide to retire within the given options). Like this, citizens become aware of the features, options and costs of their pension system. They no longer see a pension as something that the government will "somehow" provide but as an entitlement that they first need to acquire.

Bearing this in mind, a solid pension reform should contain the following elements:

- A "mixed" system -- partly public and funded through taxes (pay-as-you-go) and partly private and reliant on pension funds – allows the best diversification of risk. The transition from one system to another is tricky and needs to be planned carefully.
- Governments must consider a society's entire life cycle – education, active working life, retirement – which means integrating labor market and pension policies. It also means moving from a pension system based on "defined benefits" (in which retirees receive a pre-determined, usually generous, monthly pension) to one based on "defined contributions" (in which the size of the monthly pension depends on the contributions an individual has made throughout his or her working life).

  The defined contribution formula increases the "savings" function of the pensions system, avoids the "penalties" on later retirement that occur in the a defined benefits system, and makes it easier for workers to take their pension from one job to the next – which is important in today's more dynamic labor markets. Defined contribution systems are also more transparent and less vulnerable to political meddling.
- Retirement ages should go up automatically with life expectancy. Such an indexation avoids the political agony and social tensions that usually accompanies every decision to increase the pension age.
- Rules should be uniform and transparent to avoid a fragmentation of the pension system and the emergence of hard-to-abolish pockets of privileges. Instead, the system should include straightforward, tax-financed benefits for those workers who did not manage to pay sufficient contributions during their working lives to reach an acceptable retirement income.
- Redistribution must still be part of the system. Benefits should targeted towards the most needy and financed through taxes, rather than through social contributions levied on wages.
- Governments must make sure that such changes are recognized as progress towards a more sustainable and equitable system, which also reduces the burden today's younger generations as well as of those not yet born. Statements about how "fiscal emergencies require austerity" are less helpful. Instead governments must present reforms as a rebalancing of the financial and economic relationship between the generations.
- Increases in financial literacy are necessary to create the broad societal consensus without which pension reforms cannot work. Citizens must be

[8] Peter Diamond, 'Social security', American Economic Review, 94 (1): 1-24, 2004.

enabled to react to reforms by changing their spending and working habits and improve their planning for the future. Financial literacy is not a sufficient condition for the success of reforms, but a necessary one.

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End Box