
Reforming welfare systems
Economic and Financial Education to Bridge the Gap
between Knowledgeable Theoretical Agents and
Uninformed Citizens

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Summary♥

1. The plea for (economic) reforms
2. Economic Policy vs *reforms*
3. Behavioral economics and Economic-Financial Literacy (EFL) for the effectiveness of reforms
4. Features of “good” pension reforms
5. Lessons from the Italian experience of pension reform

♥from: *Economic-Financial Literacy and (Sustainable) Pension Reforms: Why the Former is a Key Ingredient for the Latter*, in: *Bankers, Markets & Investors* n° 134, january-february 2015

1. The *crisis* of Welfare Stateand the pressure for “reforms”

- The (European) Welfare State is often believed to be in a condition of (irreversible?) decline
- **Pension systems** at the core of this crisis
- The crisis is not an *identity* but an *adaptation* one
- As a result of *structural demographic and economic changes*, its original design and financial structure have become *unsustainable, inefficient and unfair*
- Reforms are thus necessary.....but not sufficient
- To recover *sustainability, efficiency and fairness* a more comprehensive, three-D paradigm should be adopted and pursued:

“Reform, Inform and Educate”

2. Reforms (vs economic policy)

From: Wordreference.com and Oxford Dictionary

i. «To improve an existing institution, law, practice, etc. by alteration or correction of abuses»

ii. « Make changes in (something, especially an institution or practice) in order to improve it »

iii. «To give up or cause to give up a reprehensible habit or immoral way of life»

All definitions refer not to implementing the «perfect policy» but to *changes in status quo and in behavior*

The respective roles of political parties and “experts” in carrying out reforms

- **Economic reforms:** *a mix of political and technical elements*, the former in the forefront of communication, the latter more behind the scene
- Political communication: starts from an ideological perspective, and play down more “technical” aspects
- This scheme weakens in emergency situations, when technical aspects become *dominant*
- It is then more the task of technocrats (or experts from institutions such as IMF, WB, the Troika) to prepare the reform
- If people are not correctly informed and do not understand its basic principles, the reform risks having little effects or being repealed
- **Information and EFL thus matter not only for individual wellbeing, but also for society**

3. *FinLit* for personal wealth formation and management

- *Fin illiteracy*: widespread regardless of the country's economic development stage; knowledge of inflation correlated to personal experience; risk diversification the most difficult concept
- *Fin knowledge*: a hump-shaped profile over the life cycle (highest at ages 45-55)
- Significant and pervasive *gender differences*: women more likely to suffer the consequences of wrong/myopic/imprudent choices
- *Fin lit and human capital indicators* are (strongly) positively correlated
- *Fin lit and the generosity of social security system* are negatively correlated
- *Fin knowledge is a key determinant of wealth distribution*, accounting from 30-40% of US wealth inequality

George Stigler: a pioneer of **EFL**

Advocated not just fin but *economic literacy* and wrote*:

*Why should people be **economically literate**, rather than musically literate, or historically literate? If we are to give economics some special position, and ask that most people learn at least a modicum of economics, it must accordingly fall into one of two classes of knowledge: 1) as a means of communication among people, incorporating a basic vocabulary or logic that is so frequently encountered that the knowledge should be possessed by everyone; 2) as a type of knowledge frequently needed and yet not susceptible to economical purchase from experts....*

Economic logic does not tell us what to do, but it teaches us to look for the non-obvious costs and benefits of various policies.

*Stigler, G. (1970), The Case, If Any, for Economic Literacy, *Journal of Economic Education*, Vol. 1(2), pp. 77–84.

Do politicians prefer to exploit citizens' ignorance?

- Jean-Claude Juncker's aphorism:
“We all know what to do, but we don't know how to get re-elected once we have done it” (*The Economist*, March 15, 2007)
- «*We*» as opposed to «*them*», the people, who apparently cannot see the good in a reform
- Awareness of costs/benefits involved in a reform could be a more important determinant of its viability: EFL could become a better alternative to concealment from citizens of unpleasant short term consequences of a reform
- Since literacy is primarily a result of education, government policy could indirectly induce long-run support for virtuous reforms

4. Pension reforms from a *technical* perspective

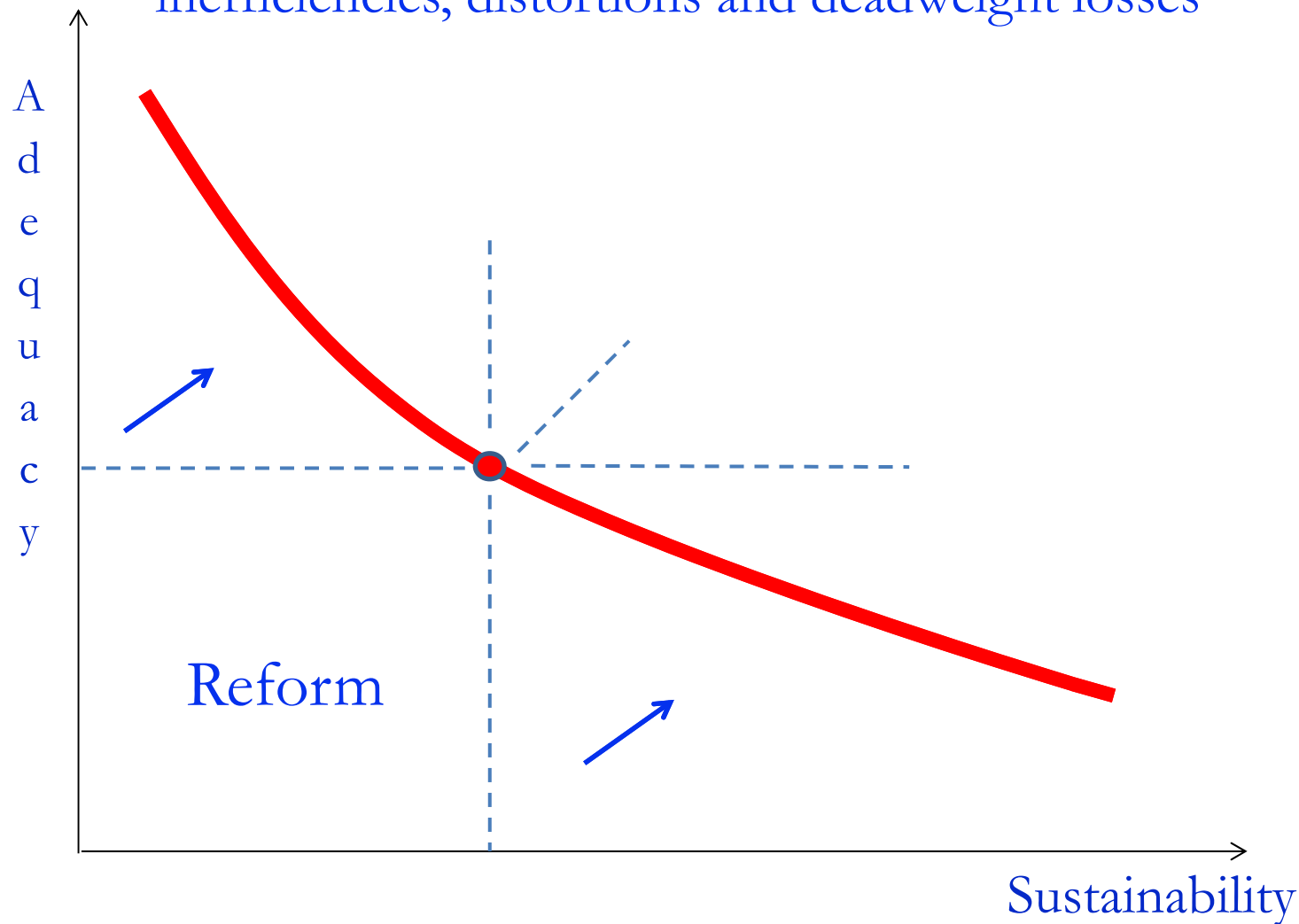
- more *social insurance* (more DC than DB?)
- more uniform transparent and flexible *rules*
- less (opaque) discretionary political *redistribution* (conducive to privileges)
- more *efficient (inclusive and dynamic)* labor markets
- complementarity between *state and market*
- good supervision of *annuity markets*

The four cardinal points of (public) pensions

- ***Responsibility***: pensions (generally) financed by savings/contributions
- ***Flexibility***: benefit correlated to retirement age; choice between constant and increasing pension; gradual retirement
- ***Sustainability***: retirement age indexed to longevity; an internal rate of return consistent with balanced budget
- ***Adequacy***: a multi-pillar system, integrated with LTC; solidarity instead of privileges

An economic reading of pension reforms:

improving the trade off between *adequacy* and *sustainability* by removing inefficiencies, distortions and deadweight losses





Information

- The accumulation of pension wealth is a long and complex endeavor
 - Workers must have an idea, as precise as possible, of their accumulated wealth, retirement options, the benefit they will get
 - This knowledge is essential, particularly in the DC world, for individual planning/decision making (join a pension plan, save more...)
- Information is fundamental also for the sustainability of reforms: if people misinterpret the reform they will try to reverse it
- Technical possibilities for a good and transparent information are now available and good practices exist

The example of the *orange envelope*

What citizens should know about the pension system

- A PAYGO system represents an “**intergenerational compact**”
- It has an **implicit debt** dimension which must be kept under control
- The crucial variable is the **rate of return on contributions**, which depends on demographic and economic trends
- The generosity of today’s system is not secured by past (myopic?) political promises and cannot be independent of the structural decline in $n+g$
- Two intrinsic elements of *unsustainability*:
 - the political tendency to favor the present generations at the expense to the young and future ones
 - the inability of badly designed systems to effectively respond to the economic and demographic challenge

5. Italy , November 2011: The looming crisis

1. Sharp worsening of Italian sovereign debt credibility

- Increasing refinancing difficulties (*on average* 1 billion € per day)
- Record levels (550 b.p) of the spread against German gov bonds
- Increasing concern of EU and world monetary authorities
- ECB letter (Aug 5th) to Italian Gov pledging (pension and labor) reforms
- Gov Resignation amid mounting political uncertainty

2. Unsolved Italian structural weaknesses

- Worsening of the deficit(debt)/GDP ratios
- Growth rate lower than other EU countries; stagnant/declining productivity
- Reduced Italian presence in high productivity sectors and employment shift to low productivity ones

The Economist

JULY 16TH-22ND 2011

Economist.com

Murdoch's empire under siege
Will the F-35 be the last manned fighter?
The Arab spring, six months on
Remembering the Orgasmatron
The greatest Habsburg



On the edge

Why the euro crisis has just got a lot worse

Paul Krugman «Now, with Italy falling off a cliff, it's hard to see how the euro can survive at all», The New York Times, November 10, 2011

TIME (November 7): «[Italy,] the world's most dangerous economy»

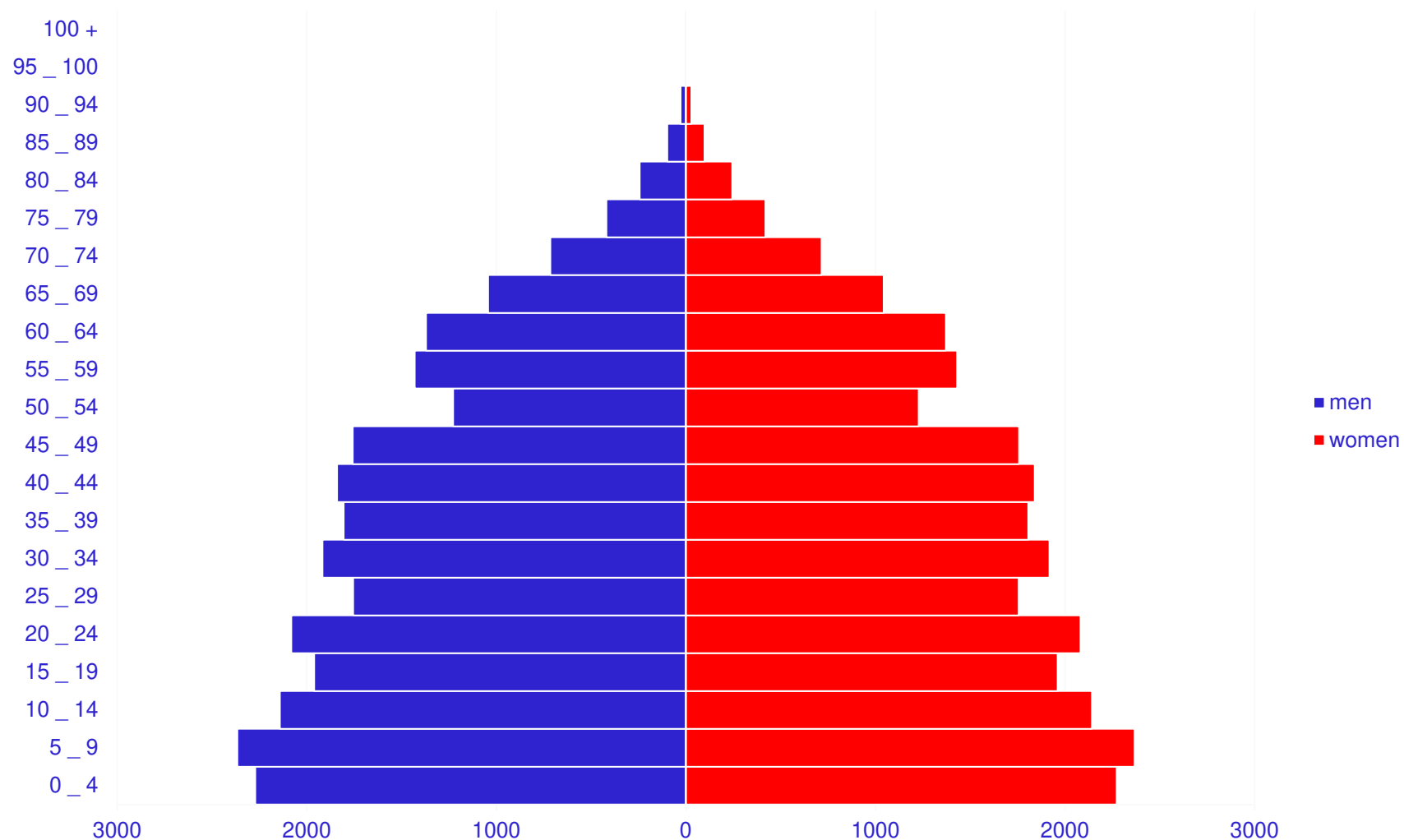
Süddeutsche Zeitung (October 24), «Italien—schlimmer als Griechenland » (Italy – worst than Greece)

.....and the sense of urgency

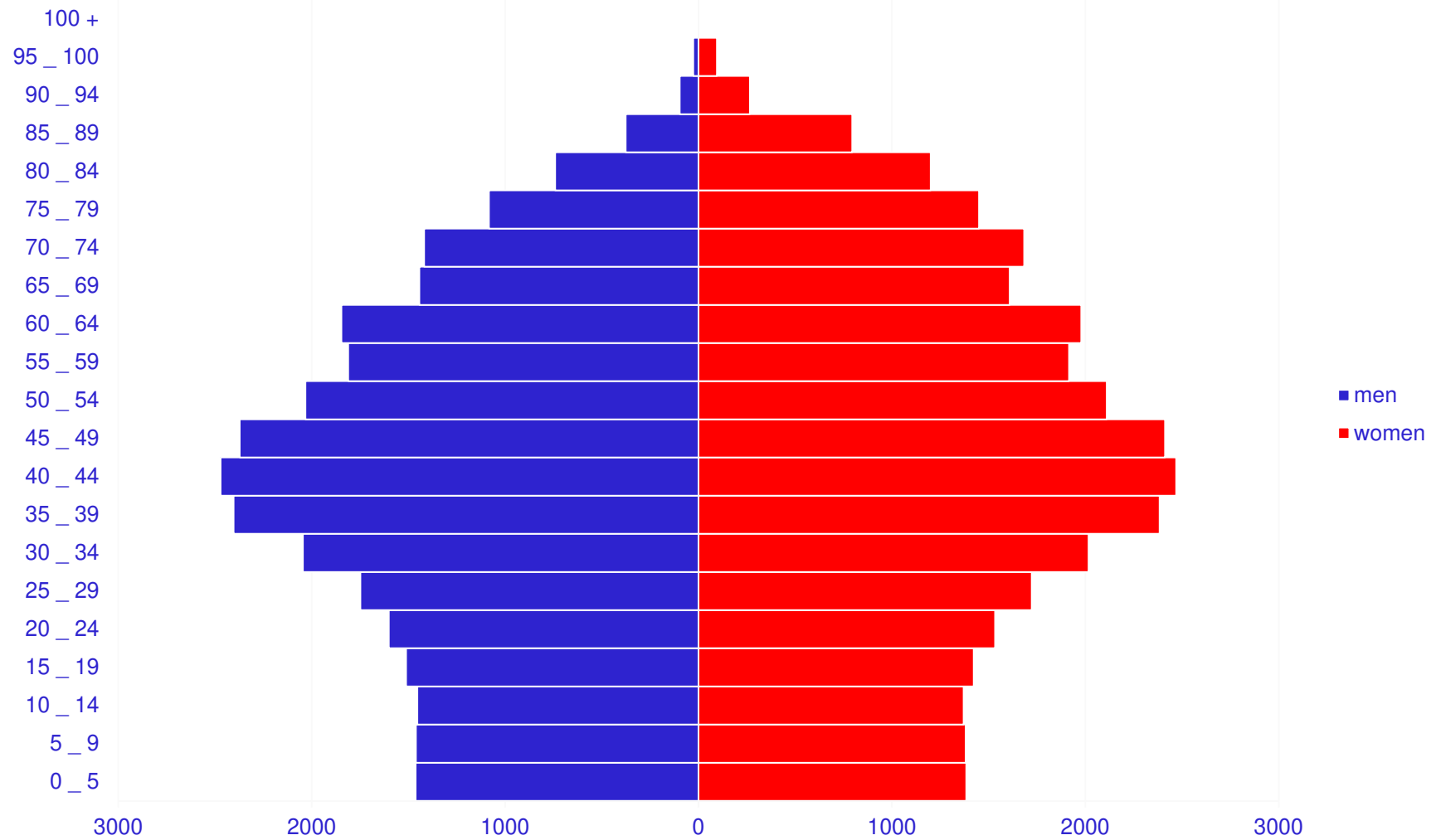
The image shows the front page of the Italian newspaper 'Il Sole 24 ORE'. At the top left, a box contains the text 'AUMENTIAMO LO SPREAD DELLA FIDUCIA.' The main title 'Il Sole 24 ORE' is prominently displayed in the center, with the website 'www.24ore.it' below it. To the right is the logo for 'BCC' (Banca di Credito Cooperativo). Below the title, it says 'QUOTIDIANO POLITICO-ECONOMICO FINANZIARIO - FONDATO NEL 1868'. The page features three main financial data boxes: 'SPECIALE RISCHIO ITALIA E MERCATI' with 'Lo spread BTp/Bund' at 575; 'Rendimento del BTp decennale' at 7,25%; and 'MANUALE ANTI PANICO' with the subtitle 'Diamo la bufera, rischi e opportunità di muoversi in questi tempi turbolenti'. At the bottom, the headline 'FATE PRESTO' is written in very large, bold, black letters.

A response not only to financial crisis, but to demographic change

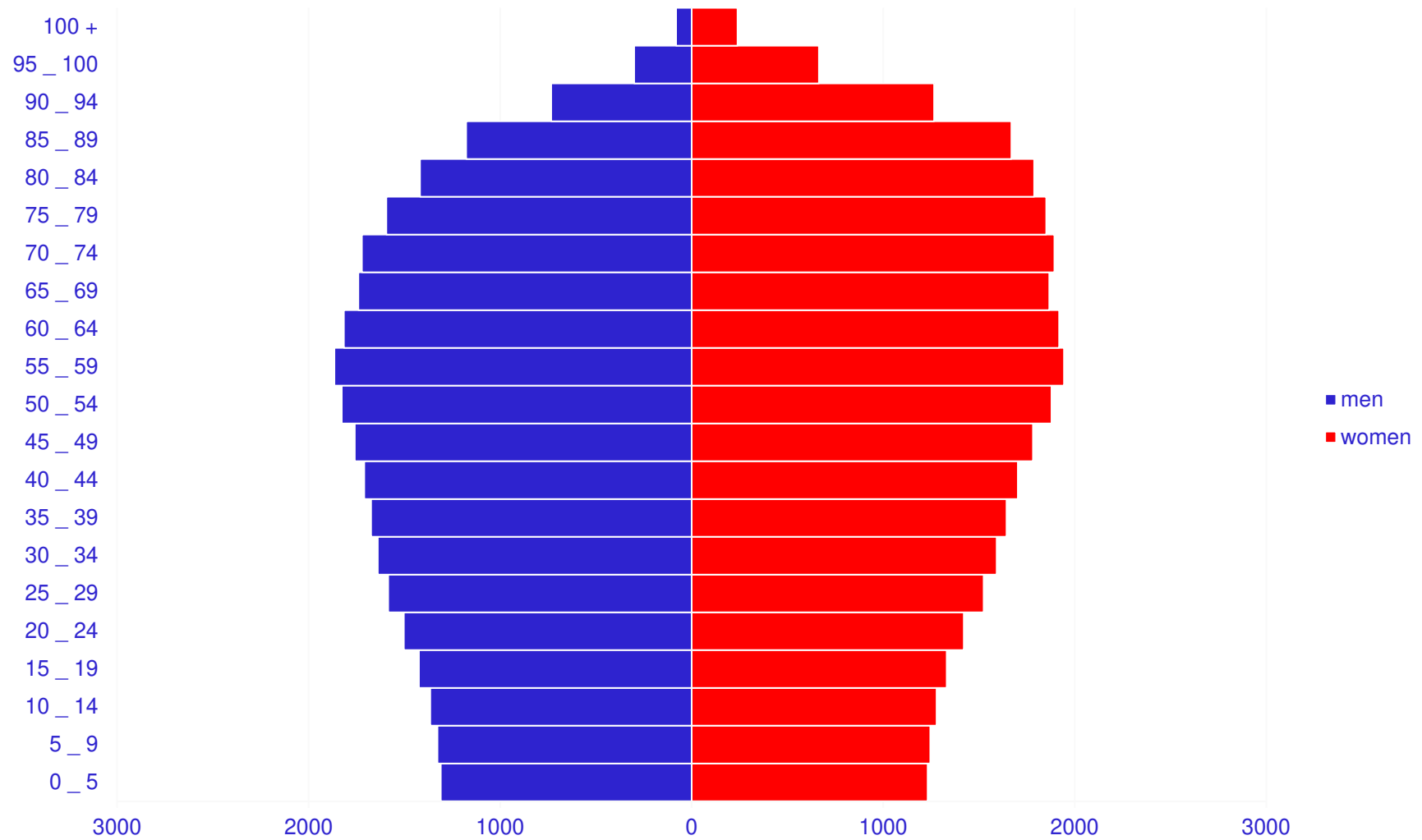
Italian population pyramid, 1971



2011

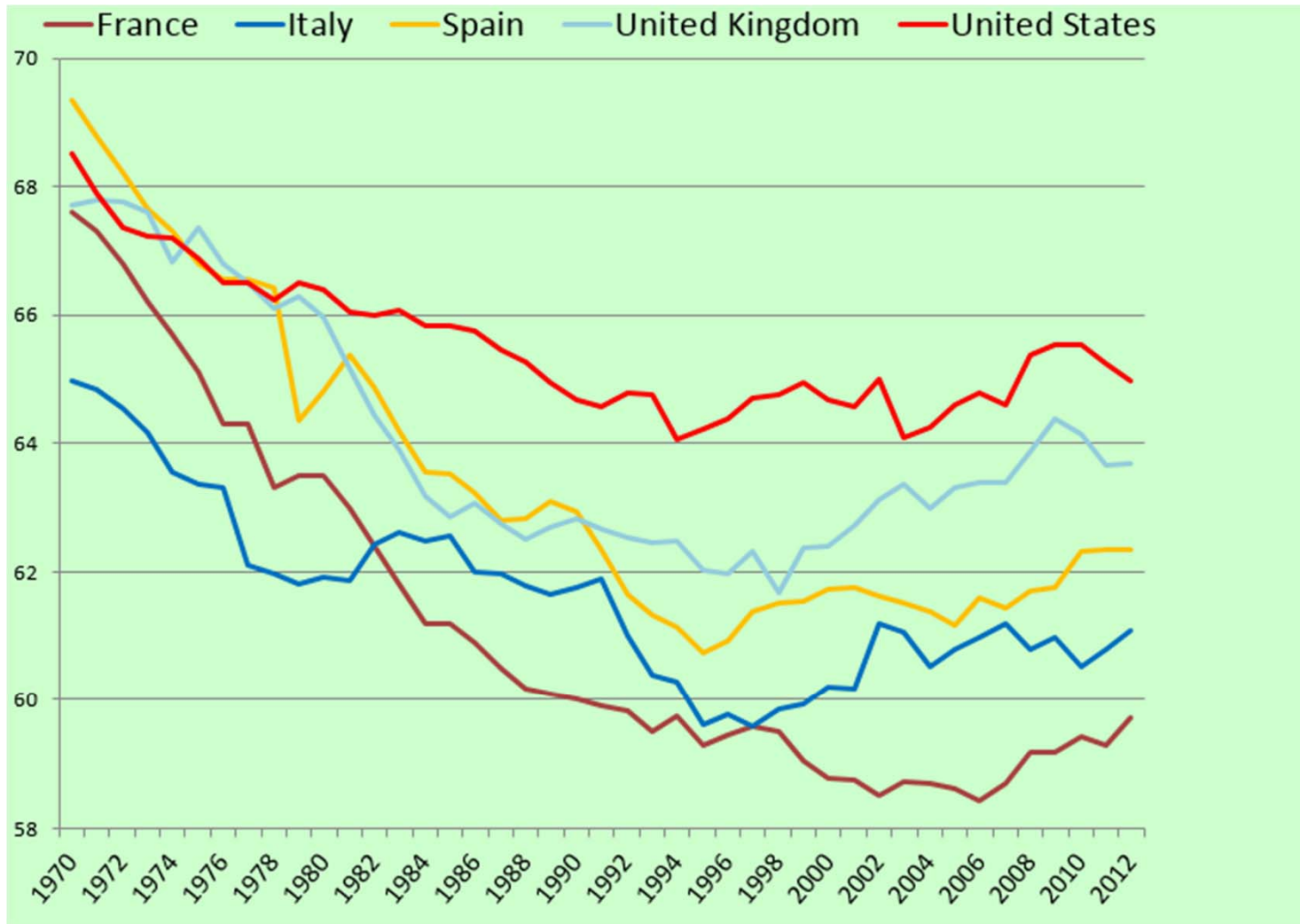


2061



The wrong political response

Men's Effective Retirement Age in some European Countries



A (still) badly designed system, after a long and reluctant reform process

- A long, slow and reluctant reform process, with setback
- A very high pension expenditure/GDP ($\approx 16\%$)
- Still a relatively low average retirement age, due to the prevalence of “*seniority pensions*”
- A tendency to use the pension system as “social protection”
- Fragmentation: a maze of different schemes and rules favoring privileges and social run ups
- Little transparency
- A propensity to undo/mitigate previous reforms
-all this could hardly endure the financial crisis

The 2011 “cold shower” reform

- Application of the DC formula to all workers, as of Jan 2012 and for future seniorities, with periodic update (every 2 years) of annuity rate coefficients
- Increases in the statutory retirement ages (66 +longevity, in 2018) and cutback of seniority pensions
- Alignment, as of 2018, of ages and seniority requirements for women (in private sector) to those of men (and women in public sector)
- Indexation of eligibility requirements to changes (two preceding years) in i.e.
- Increases in payroll tax rates for farmers and self-employed
- Temporary freeze of indexation for average-high pensions (>1400 €)
- A “solidarity contribution” on high pensions
- Free summing up of contributions for NDC benefits
- Elimination of “exit windows”

Caveats and drawbacks

- The main challenge is the labor market, with the young, women and elderly workers more at risk of inadequate contributions and thus inadequate pensions
- Notional contributions (to be paid by the public budget) are envisaged for out of work periods
- The very rapid implementation of the reform has created a problem with workers that had left their job in anticipation of a near retirement
- To adequately protect citizens, special attention has to be devoted to groups more at risks, such as women and vulnerable workers

Transitional and communication problems

- The reform aims at dismantling deep-rooted prejudices:
 - workers over 54-55 are lost to the labor market
 - the lump of labor fallacy (older workers take away jobs from younger ones)
- Problems also with the notion of “acquired rights” (also supported by the Constitutional Court)
- Difficulties in making the reform understood and shared

Conclusions

- Large distance between **theoretical** and **real** reforms
- When swift change is required: time/budget/political constraints prevent smooth adaptation to theoretical model
- Running for one's pension is becoming a new sport. People do not understand why pensions have become brainteasers and the old security is no longer feasible
- Technical reforms needed to strengthen pension design but having them shared by citizens is essential for their success
- In the face of higher individual responsibility in a more uncertain world, relying also on information and financial literacy is crucial

The contribution of microsimulation models

- A flexible and pragmatic instrument, that can rely on observed behavior
- Allow for diversity among individuals and for heterogeneity in behavior
- In conjunction with behavioral economics, can formulate stronger empirical predictions and address policy to realistic groups of people instead of “fictional” agents
- Including features such as inertia & ignorance allows for “nudges” and educational programs, which contribute to effectiveness of reforms
- Important also for educational purposes, helping citizens to understand the reasons behind the reforms and their most likely effects on themselves and their children, debunking false myths and irrational fears.