Economic-financial literacy for sustainable welfare reforms

Professor Elsa Fornero, University of Turin, CeRP, IZA and Netspar

Reforms are not mere "technical remedies"

Serious difficulties have emerged over the last quarter of a century in the European Welfare State and in particular in its most important programme, the Pension System. While in public debates these difficulties are sometimes described as a possibly terminal crisis, the need for sustainable welfare programmes continues to be well recognised in Europe as well as all over the world[51]. It is also generally recognized that the answer lies in *structural reforms* capable of responding to profound demographic, economic and social transformations[52].

To be effective and sustainable, and thus able to save the European social model, reforms require people's involvement and *de facto* endorsement. Prerequisites of this are truthful information and understanding of the reforms' basic principles and mechanisms. While this is true in general, it is even more so for reforms that profoundly affect individuals' present and future life, as is the case with comprehensive reforms of the welfare system.

A new paradigm is thus necessary, based on three building blocks: *reforms, information and education*. I have learned this from my academic activity but even more so from my direct experience as Italian Minister of Labour and Social Policies (November 2011 - April 2013), in charge of the pension and labor market reforms, in the technocratic government led by Mario Monti[53].

[51] Huber E. and J.D. Stephens (2001), Development and Crisis of the Welfare State: Parties and Policies in Global Markets, University of Chicago Press.
[52] Barr, N. and P. Diamond (2008), Reforming Pensions: Principles and Policy Choices, Oxford University Press, Oxford. Lindbeck A. and M. Persson (2003), The Gains from Pension Reform, *Journal of Economic Literature*, Vol. 41(1), pp. 74–112.
[53] Fornero, E. (2013), Reforming Labor Markets: Reflections of an Economist Who (Unexpectedly) Became the Italian Minister of Labor, *IZA Journal of European Labor Studies*, Vol. 2(20).

Rewriting the intergenerational contract: scope and role of pension reforms

For a better understanding of why welfare systems need reforms it is useful to start from a (very stylized) description of their main characteristics, both the good and bad.

Over the course of the 20th century, European countries have been able, mainly through their *welfare* systems, to substantially reduce material deprivation and prevent poverty among older cohorts, whose most important income source has become the public pension. Gradually, they have also become committed to the idea that pensions should consist of guaranteed, stable and generous payouts at relatively young ages.

The system has typically been financed on a pay-as-you-go (PayGo) basis, with revenues (contributions on wages and other labour incomes) directly used, year-by-year, to pay for pensions, with little or no accumulation of funds and often with a top-up from the public budget to cover the annual deficit. Underlying this seeming "*tax and transfer*" mechanism there is an "*intergenerational contract*": the young/active population pays for the current retirees and expects the same will apply when they will be retired, as in a chain-letter mechanism.

An associated Defined Benefit (DB) formula typically granted pension income based on a predetermined proportion of an individual's final earnings, thus making life cycle planning much more comfortable for the prospective pensioner. This pension was then indexed to average salary, allowing retirees' standard of living to keep pace with workers' increasing income level. The formula could be made even more generous when combined with a mere "seniority" exit requirement (i.e. a number of years of contributions, irrespective of age).

These attractive features, however, were not free. They were the result of "liberal" laws, applied to an entire cohort or to specific groups, usually motivated by reference to some kind of "social protection" functions. They were also the result of policy makers' confidence in their ability to act systematically better than an appropriate mathematical formula, more respondent to budget constraints.

The system worked to everybody's satisfaction in times of both demographic and economic expansion: an increasing number of young workers were able to

pay for their parents'-grandparents' pensions with their paychecks on a sharply increasing trend because of economic booms and increasing productivity. When these favorable conditions waned, shortsightedness took the place of enthusiasm and it was considered feasible to continue to operate the system although the essential conditions were no longer there.

This political game was reinforced by the demographic transition which steadily increased the *median voter's* age, giving a decisive electoral weight to older cohorts[54]. The DB formula could be used to meet the expectations of the most prominent pressure groups (high bureaucrats, managers and public employees, not to mention politicians themselves), ending up in socially unacceptable "gifts" being graciously presented to them on retirement day in the form of sometimes unwarranted large pension checks.

All this contributed to a general social and political climate in which attention shifted from the insurance/saving principles of a pension scheme to entitlements (or "acquired rights", considered unalterable), with little consideration, if at all, for "*who pays the price*". The system progressively became not only financially untenable but also more and more opaque, with large and small groups of workers scrambling for some privileges. As societies aged, it resulted in a huge and increasing "*pension debt*" (the net value of future pension entitlement translated in today's money), which was often much larger than the "explicit" public debt. Their combination, against the background of fast-ageing societies and sluggish productivity, left younger workers - and their dwindling offspring – with the impossible burden of paying "generous" benefits to a fast-growing number of early retirees who lived ever longer (where generosity refers of course not to the absolute amount of benefits, but to the proportion paid by own contributions).

European countries had little choice but to redesign the systems – or face sovereign bankruptcy. In principle, it would have been wiser to introduce reforms during a period of steady growth, when sacrifices would have been more easily acceptable than at times of recession: it is easier to reduce the slices of a growing pie than of a shrinking one. It lies however in the nature of electoral politics that political parties will be reluctant to "spoil" present good times by introducing painful reforms designed to prevent future problems[55]. This

[54] Galasso V., (2006), The Political Future of Social Security in Aging Societies", 2006, The MIT Press
[55] As Jean-Claude Juncker's once said: "*We all know what to do, but we don't know how to get re-elected*

is why reforms are usually introduced in difficult times, if not in an emergency[56].

A new notion of "reform"

Reforms have both a technical and a political side. From a *technical* point of view, research has reached a relative convergence towards a prevalent "insurance view" of pension programs, based on an analysis of both individual and macro risks, in order to respond more efficiently to their changes across generations, age and gender. Requirements for a "good" pension system have shaped policy discussions and determined, at least partially, the course of reforms in Europe. These include:

- a *mixed system,* partly public and PayGo and partly private and funded, based on financial markets' returns. Feasibility considerations recommend limited and gradual funding because even a partial transition from PayGo to funding raises important financing problems that risk jeopardizing the result. In this regard, the PayGo has to be more balanced towards young and future cohorts. A greater correlation, at the individual level, between contributions and pensions can serve the purpose. The combination of "*notional*" *funding* with a Defined Contribution formula[57] makes it possible to tailor pension benefits to individual workers' contributions without actually having to capitalise and invest the sums paid in. Each worker has their own pension account, where all contributions paid in their name are reported, summed up, and rewarded at a rate of return that, for the system to be balanced, must be (approximately) equal to the national income (or wage bill) growth rate. At retirement, which can occur within a given age range, an actuarial factor, taking expected longevity at retirement into account, can be applied to determine the initial benefit.

- An automatic adjustment of retirement ages to longevity (i.e. life expectancy at the beginning of the pension period) helps avoid the social tensions that usually accompany parametric changes of the system, provided the quality of life of the extra years is good and the increase in longevity is somehow split between

---

once we have done it". The Economist, The Quest for Prosperity, 15 March 2007.

[56]In the early 2000s, Germany was able to implement effective pension and labor market reforms, after having become "*the sick man of Europe*" and not without political cost: Chancellor Gerhard Schroeder lost his job in the 2005 elections. Nearly a decade later, Italy, Spain, Greece and Portugal had to push through pension and labor market reforms in much stormier economic times. Understandably, both the sacrifices required from the people and the political upheaval were far greater, as was resentment against "austerity".

[57] the so called NDC system, see: Holzmann R and Palmer E., eds., (2012), Nonfinancial Defined Contribution Pension Schemes in a Changing Pension World, Volume 1: Progress, Lessons, and Implementation, The World Bank, Washington DC.

working life and retirement.

- Solidarity, in the form of explicit tax-financed exceptions, directed at workers who could not reach an acceptable retirement income during their working lives, has to continue to be part of a public pension scheme while transparency and more uniform rules (with exceptions directed, as just said, at less fortunate workers) should reduce privileges.

The paradigm "Reform, Inform, and Educate" as an alternative to both paternalism and populism

Reforms, however, are not academic exercises and not mere technical problems. They necessarily include a political angle inasmuch as they change people's expectations and life plans and must receive not only formal consensus in Parliament but also basic consensus from the population at large. Should this basic consensus be lacking, the reform will be met with hostility and run the risk of being either formally reversed or practically disregarded.

Conditions for practical success of a pension reform must therefore include the reform's capability to provoke a shift in attitudes and behaviour. Those of us who are middle-aged (or above) are enjoying (collectively) an almost unprecedented concentration of wealth (including generous pension entitlements), privileges and political power. This concentration has left many younger people with a much smaller range of lifetime options than their parents. In many European countries, unemployment rates for younger people are twice or three times higher than for more senior workers.

The demographic transition therefore represents a very serious challenge to society not only because of shrinking labour forces but also in terms of income distribution and of perspectives offered to younger people. All this implies that social security reforms cannot be entrusted to a cluster of specialists, such as economists, lawyers and actuaries. The concept of reform must become much more comprehensive, and encompass three different dimensions, of which the reform is just one and not the most difficult.

i. Reform. The reform process has to be completed, according to consistent insurance principles, coupled with a fair amount of transparent income redistribution in the right direction, i.e. from richer to poorer, and not vice versa. Adequate old age insurance, inclusive not only of retirement income but also of Long-Term Care in old age, requires individuals to be safeguarded against

both adverse general economic conditions (such as the Great Recession) and personal misfortunes affecting their pre-active and active life such as lack of education, unemployment, sickness, and invalidity. The welfare system cannot be separated from the macro economy. At the end of eight years of downright recession or abnormally low growth, the time has come for a soberer analysis on the links between the pension system and the labour market. Dynamic and inclusive labour markets, that make it easier for workers to find a job and for employers to hire and fire, are the best prerequisite for adequate pension systems. Long-term employment-enhancing policies, such as apprenticeship and lifelong learning, must be given greater importance and more resources.

On top of everything, it should be recalled that economic growth remains the major force supporting both the adequacy and the long run stability of a PayGo system. Since it creates additional jobs, growth at suitable rates tends to strengthen the association between being in *active age (20-64)* and being *employed*, by reducing unemployment and encouraging labour force participation (through reduced incentives to early retirement or to homemaking). Unfortunately, since the early 1990s, the rate of growth of productivity has slowed in Europe and the US. With constant or declining population, per capita income growth should regain its centrality in supporting welfare.

ii. Inform. The accumulation of pension wealth is a long and complex process. Workers must have an idea, as precise as possible, of where they stand on pension wealth and retirement options so that they can make the sensible personal retirement choices the reforms require from them: first, whether to retire early, on a comparatively low pension or to stay in work longer aiming for a higher, although further away pension. And, second, how to make sensible general decisions on how the funded part of their pension wealth should be invested by pension funds. This knowledge should help them to avoid mistakes and disappointments such as shortfalls of actual versus expected retirement income and ensuing painful lifestyle adjustments.

iii. Educate. While information is essential, *per se* it is not enough. People have to be able to understand. Information thus has to be integrated with Economic Financial Literacy (EFL), not as a basis for abstract knowledge but as another essential part of pension reforms. Without the EFL-information mix, the fundamentals for the reforms' political sustainability are clearly at risk. In spite of their essential role, both information and EFL are very poor. Statistical surveys

have shown widespread financial illiteracy as well as information gaps[58]; research has shown the importance of such literacy[59].

Some fundamentals of EFL should be here summarily remembered: a) the notion of compound interest - in no way intuitive or easy for people with only a light arithmetical background - is crucial to the understanding of how pension wealth accumulation works; b) the core concept of risk diversification is a good preliminary concept for rational decisions about participating in pension funds or, more generally, in considering the different risk–return combinations of an unfunded and a funded pension scheme; c) elementary knowledge about money flows and its instruments (from credit and debit cards to bank accounts) is rapidly becoming essential for the ordinary citizen; d) some very general knowledge about national income accounts, taxation and public sector accounts appears to be a necessary complement to the predominantly individualistic approach of most popular financial literature and education programs. EFL should accompany individuals throughout their educational period and become a constant element of their adult life. The depth and complexity of this knowledge may, of course, vary considerably according to their study curriculum and their profession.

A general increase in EFL (even on a very large scale) cannot, of course, be the successful answer to all economic and financial problems; it would be naive to think so, particularly as empirical evidence has yet to be provided to support the hypothesis of a direct correlation between EFL and the effectiveness of reforms. “Nudges” can still encourage even economically and financially literate people to make “wise” choices[60]. EFL appears, however, a substitute to be preferred to both populism and paternalism.

[58] Lusardi, A. and O. S. Mitchell (2011), Financial Literacy around the World. An Overview, *Journal of Pension Economics and Finance*, Vol. 10(4), pp. 497–508

[59] Lusardi, A. and O. S. Mitchell (2014), The Economic Importance of Financial Literacy: Theory and Evidence, *Journal of Economic Literature*, Vol. 52(1), pp. 5–44.

[60] Thaler, R. H. and C. R. Sunstein (2008), Nudge: Improving Decisions about Health, Wealth and Happiness, Yale University Press, New Haven