REFORM, INFORM, EDUCATE
A NEW PARADIGM FOR THE SUSTAINABILITY OF PENSION SYSTEMS

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BASIC PENSION CONCEPTS

- **A pension**
  - not an ordinary financial instrument, but a promise of an *income flow* conditional on the beneficiary's (or his/her dependents) survival
- **A public pension system (social insurance/security)**

  A public institution – Intergenerational Contract - governed by the law to

  - help people provide for their retirement (saving function)
  - *prevent poverty* among the older population (assistance function) and contribute to *reduce inequality* (social goal)

  Participation is **compulsory** and **financing** is usually **Pay-as-you-Go**
- **Integrated by private savings (normally financially funded)**

➢ ***Risks are pervasive in both micro/macro dimension and in both PayGo/funded systems (*** *market vs policy imperfections* ***)***

PayGo systems: macro foundations, challenges and the rationale for reforms

A PayGo: **a social compact** between the *working* ("the young"*) and the retired* ("the old") population resting on:

- **Demography**

Ageing : declining fertility/increasing longevity increase in ***old age dependency ratios*** and threatens the financial sustainability/future adequacy of the PAYGO

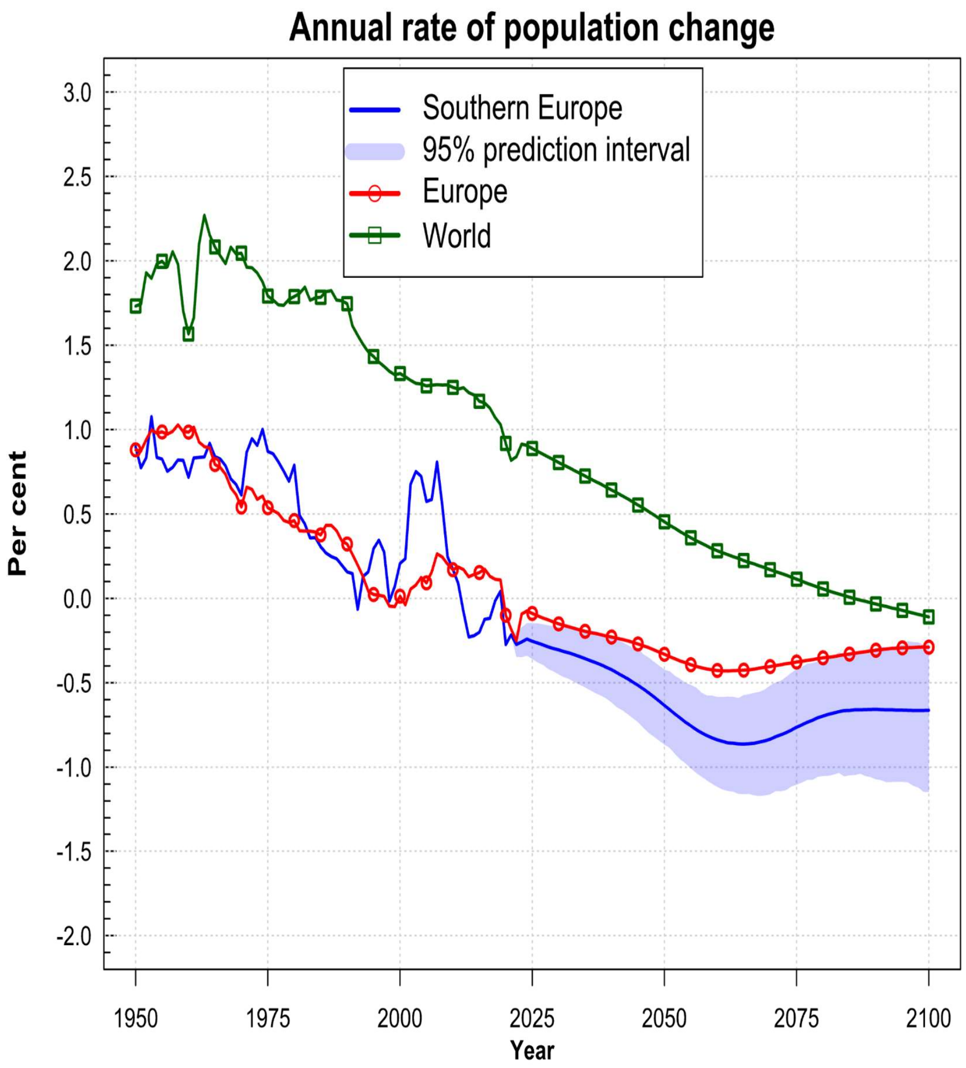
- **Growth**

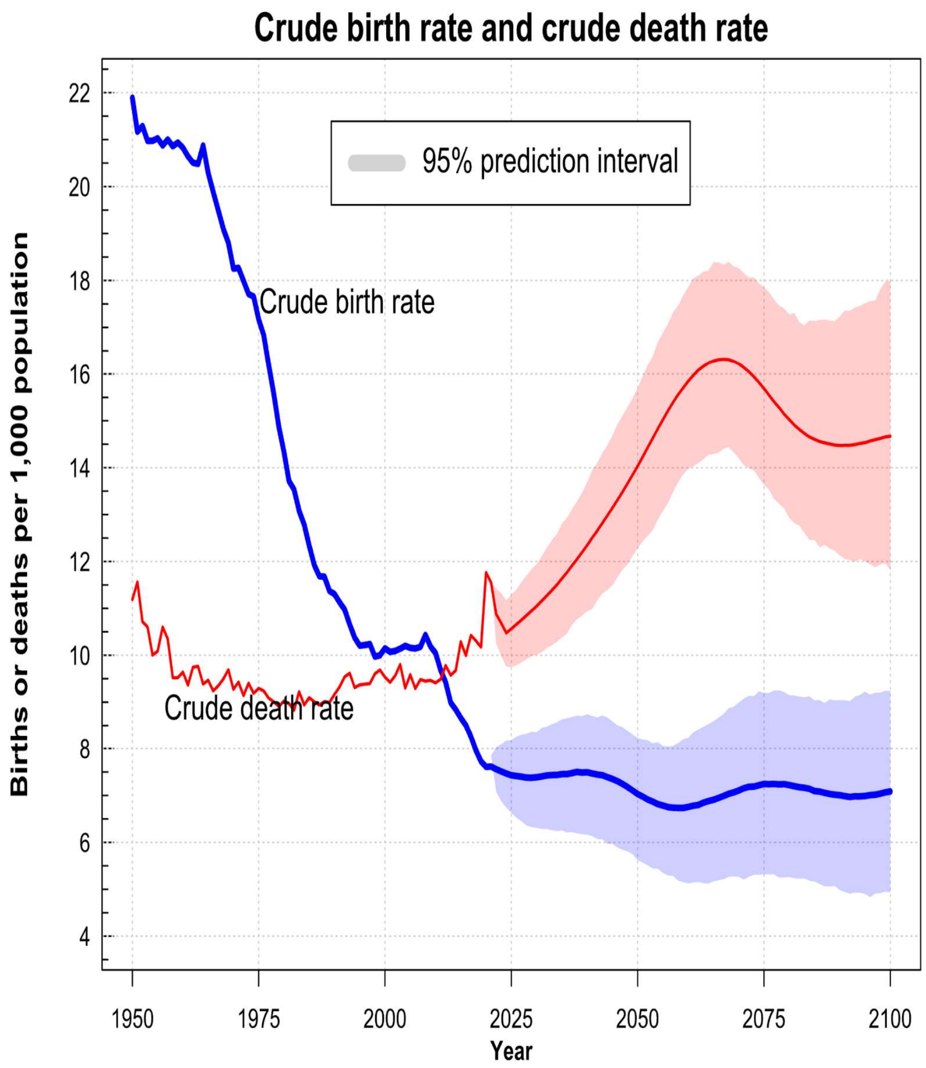
No clear evidence of a negative effect of age on productivity, but less innovation, ambition, initiative. In the last decades, a succession of shocks (financial crisis, Great Recession, pandemics, Russia-Ukraine war, energy crisis) impacted negatively on growth thus reducing the (equilibrium) "*internal rate of return*" of Pay-GO

- **Democracy/Politics**

Tends to favor current generations/groups/categories having higher electoral weigh, with low retirement ages & "generous" pension formulae (DB type)

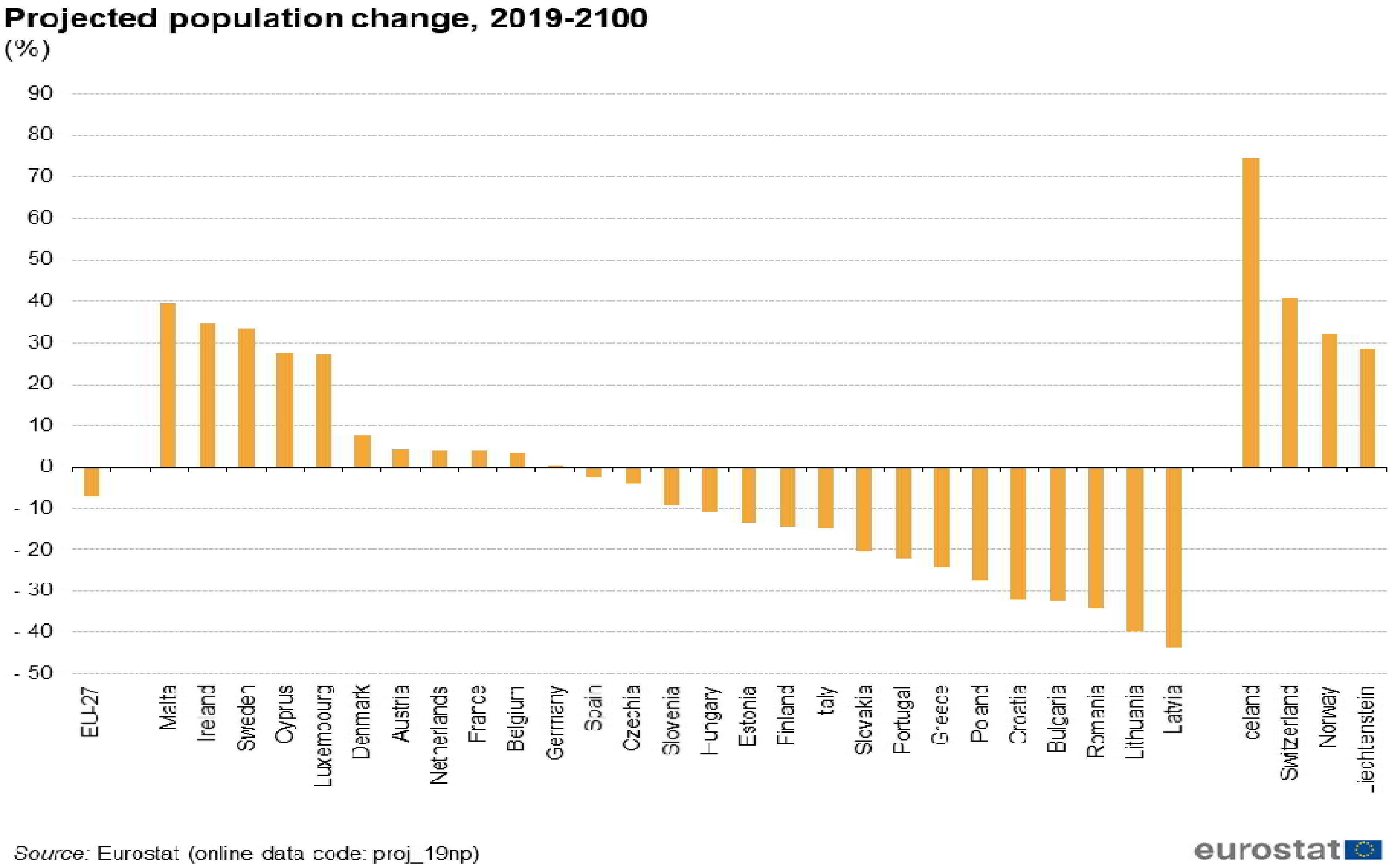
Population: Europe/Southern Europe vs RoW



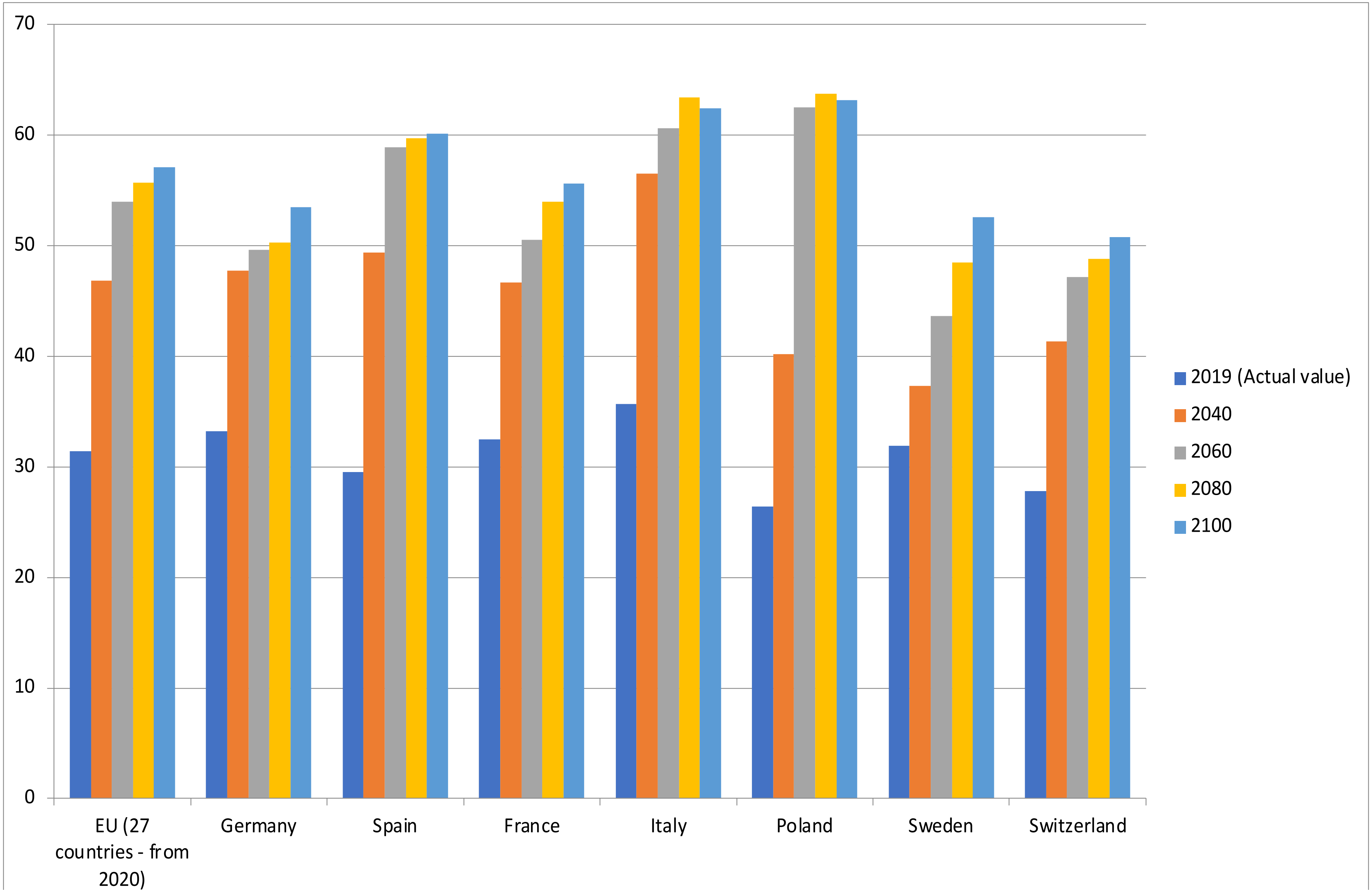


Fertility, mortality, migration, and population scenarios for 195 countries and territories from 2017 to 2100: a forecasting analysis for the Global Burden of Disease Study, The Lancet, 2020

The European demographic winter



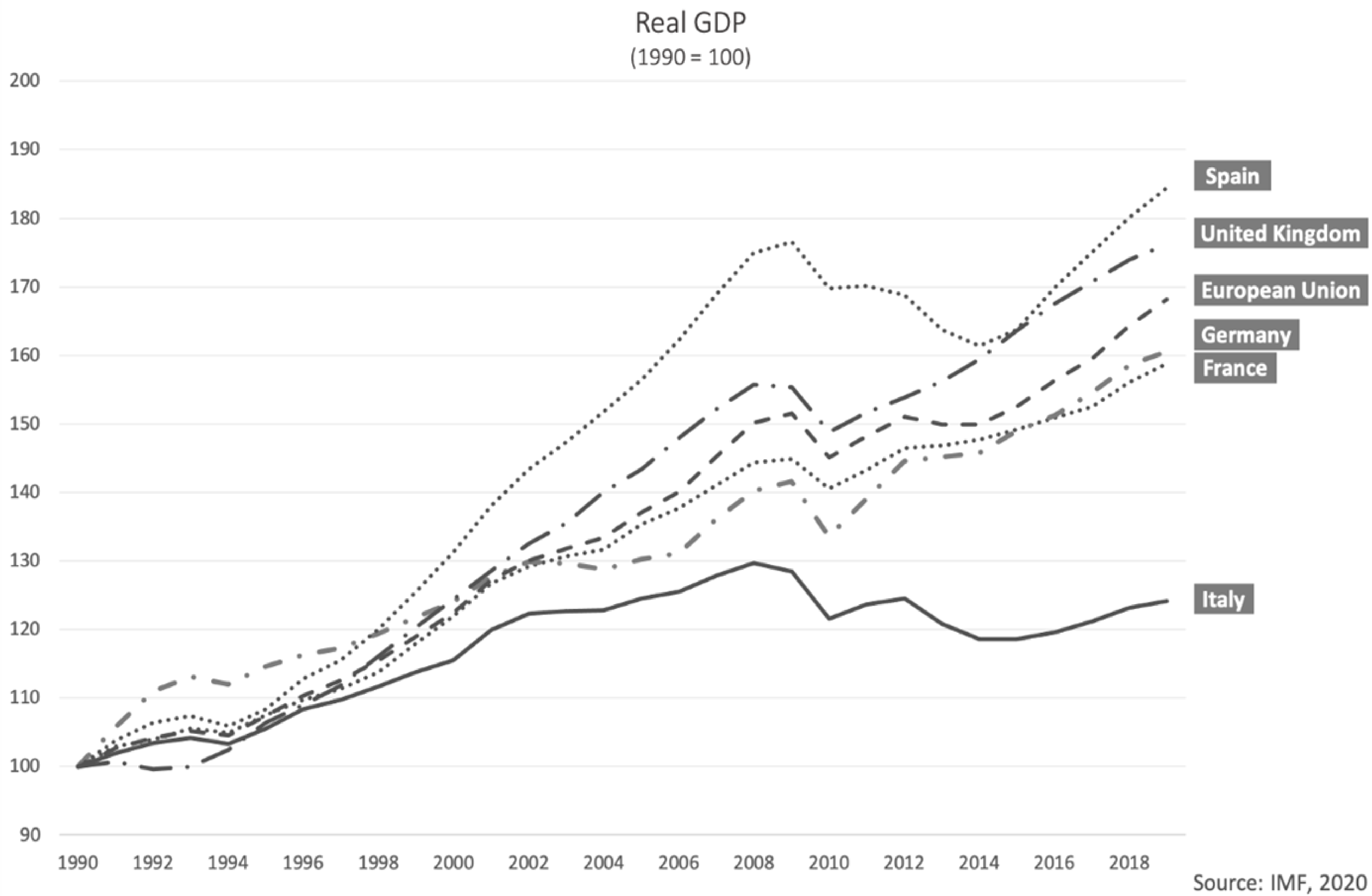
The consequence: old-age dependency ratios
(Eurostat 2019)



The economic challenge: investing in human capital (n+g)

- The unsustainability of pension systems does not depend only on demographic trends (n)
- The distribution of *working age population* **matter:** employed, unemployed and out of the labor force
- Offsetting a negative n with increased participation and higher employment rates is essential to reduce the *economic dependency ratio* and raise PayGO returns
- While taxes and debt may finance the *solidarity component* of the pension system, *a well-functioning labor market is the best premise for good pensions*
- In parallel: education, research and innovation to enhance productivity (g)

The Italian disease: lack of growth



Directions for reforms

- **Moving towards (N)DC:** strengthen the correlation, at the individual level, between contributions/ret. age and benefits
- Increase **effective retirement age** (by raising the ***statutory*** age and reducing early retirement options)
- Link **retirement age to longevity (?)**
- Boost **employment opportunities (**particularly of women and older workers)
- Encourage **participation in supplementary private pensions** (FE/nudges/fiscal advantages vs compulsory participation)
- Reduce privileges and make **redistribution clear:** (notional contribution for unemployment/care periods, recognition of hardship of some jobs) with special attention to groups *more at risk* of inadequate accumulation (the young, women)
- Attention to **transitional issues**

Is Europe converging towards a good design?

The reform process started in the early Nineties: *a painful, never-ending,, "stop and go" process, with some convergence in the final design:*

- **ret ages** have been raised and (in some cases) made more flexible
- **access conditions** to early retirement and disability benefits have been tightened
- the link between **individual benefits and contributions** has been strengthened and **actuarial corrections** introduced
- **benefits indexation** downgraded from wages to prices
- **gender differences** have been reduced
- **transparency** has been improved, also through greater information ("orange letter" and the like)
- **pre-funding**, i.e. participation in (occupational) pension funds, has been encouraged
- **pension portability** among EU countries has been enhanced

Why reforming pensions is so difficult

It is a reform that:

- affects all generations
- is mainly in the interest of the young, who are politically less important in an ageing society
- is permeated by ideological/value judgments that tend to dominate the (quite complex) technicalities and make more difficult the necessary social dialogue
- has great problems of communication, also motivated by widespread erroneous beliefs (the notion of *acquired rights*, the *lump of labor fallacy*…)

Politically:

- important trade offs are involved (gradual *versus* sudden reforms)
- transitional, credibility and time consistency problems are pervasive
- counter-reforms are electorally quite appealing
- correlation with other reforms (the labor market reform) is required

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*).
- *There are exemptions:*

"Pension reform can be hard to talk about. In the long run, reform now means fewer demands for layoffs and less draconian measures in the future. It's in the best interest of all Californians to fix this system now." (Jerry Brown)

- *Viability*: awareness of a reform's costs/benefits is important
- *FinLit:* could make citizens understand the reform's ***social investment nature***
- *Policy*: Governments should promote *FL* to indirectly induce long-run support for reforms

Our paper: "*Voting in the aftermath of a pension reform: the role of economic-financial literacy*" (JPEF, Volume 18, Issue 1 January 2019 , pp. 1-30)

- the electoral cost of a pension reform is significantly *lower* in countries where the level of economic-financial literacy is higher

- evidence from data on legislative elections held between 1990 -2010 in 21 (advanced) countries is robust when we control for macro-economic conditions, demographic factors, and characteristics of the political system

- findings not robust when *less specific indicators of human capital* – such as general schooling – are used, supporting the view that FL has distinctive features that may help reduce the electoral cost of reforms having a relevant impact on the life cycle of individuals

A new paradigm for pension reforms

Four building blocks:

- **A wider perspective of reforms:** *Social security* is part of the general *welfare state*, meant to enforce social rights; it is the whole welfare that needs restructuring, by looking at the *entire life cycle* of individuals.
- **Good financial market regulation, taxes provisions plus good default options** to encourage private complements to public provision
- **Honest, transparent and adequate information** to restore confidence in pensions
- **Financial literacy and retirement educational programs**

➢ ***Technocrats must help with research and policy recommendations, not substitute a political government***