Economic-Financial Literacy (EFL) and (Sustainable) Pension Reforms

why the former is a key ingredient for the latter

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Outline

1. Pensions and Pension systems
2. Reforms
3. Why reforming pensions is so difficult
4. Impact of Economic-Financial Literacy (EFL) on reforms
5. Italy - November 2011: reforms in an emergency
6. Conclusions

1. Pensions and Pension systems

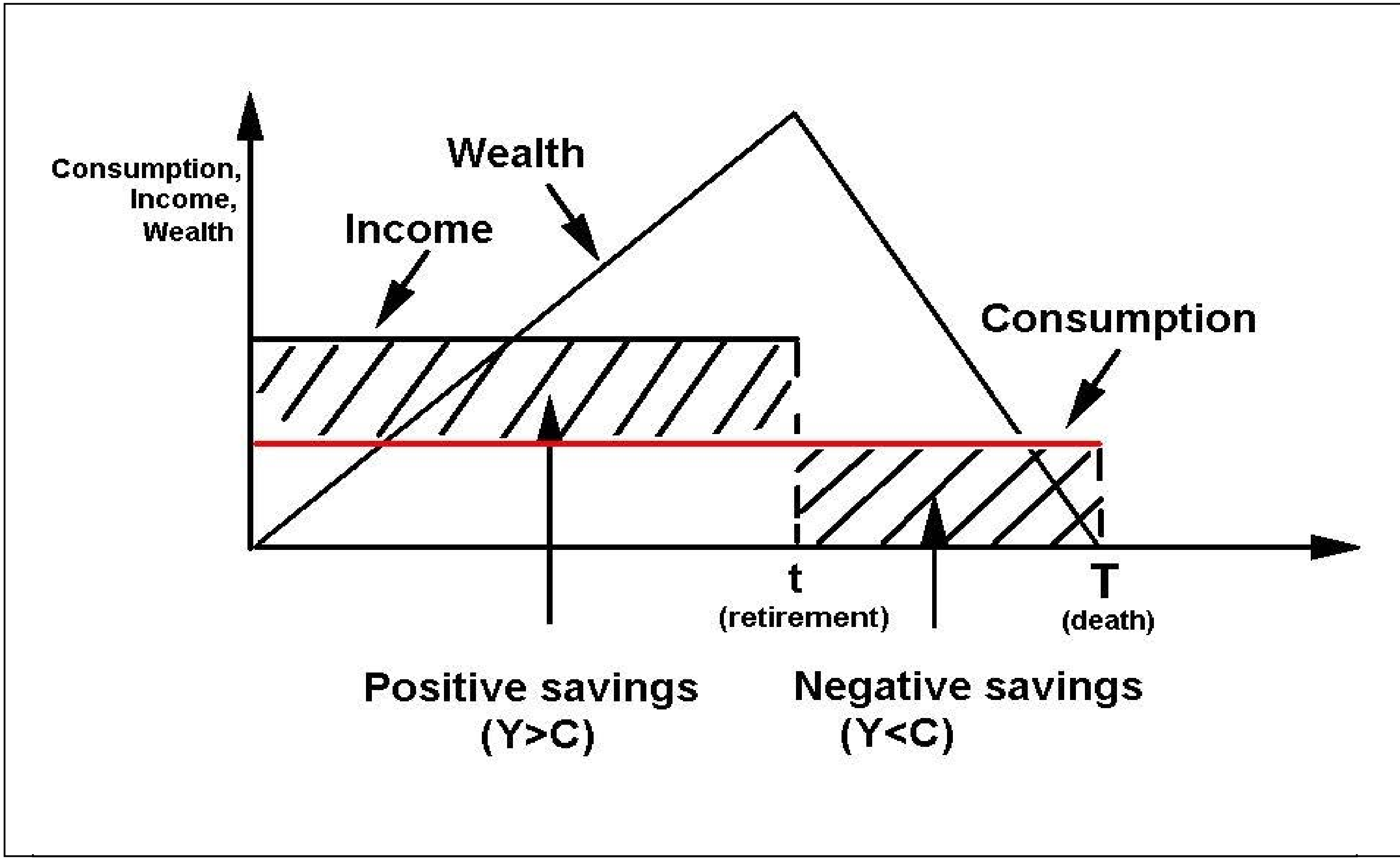
- **A pension**
  - not an ordinary financial instrument, but an insurance product that provides a *flow of income* conditional on the beneficiary' (or his/her dependents') survival
- **A pension system (social security)**

  Typically not a *market arrangement*, but a ***public institution*** governed by the law to

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

  Participation is **compulsory** and **financing** is usually Pay-as-you-Go (PayGo)
- **Risks are pervasive in both micro/macro dimensions**

Pensions in the individual life cycle



Pensions in society:
macro foundations

In PayGo systems: the "young" (*working population*) pay contributions which finance benefits for the *retired*

- **Demography**

  Ageing causes an increase in ***old age dependency ratios*** which threatens the financial sustainability/adequacy of systems; no clear evidence of a negative effect of age on productivity, but less innovation, ambition, initiative…

- **Growth**

  Lower growth/higher unemployment rates (Europe) reduce the (equilibrium) "*internal rate of return*" and increase the economic dependency ratios

- **Politics**

  Tend to favor current generations who have higher electoral weigh

What makes a *good* pension design?

(Optimality as an illusion)

- A ***good distribution of risks*** (*in* individual life cycle and *across* generations)
- A good ***incentive structure*** (to encourage work in regular forms and not moonlight; to reward the continuation of work)
- ***Fair redistribution*** (to defeat privileges and segmentation of schemes)
- Effective ***poverty reduction and prevention*** [*EU27: at-risk of-poverty-rate for 65+ slightly below the rate for <65 (15.9 vs 16.5%); older people less affected by material deprivation than the rest of the population (6.4 vs 8.5%); inequality is also lower*]
- ***Transparency, uniformity*** and *low* ***political manipulation***

2. Reforms

(From: Wordreference.com and Oxford Dictionary)

- *«To improve an existing institution, law, practice, etc. by alteration or correction of abuses»*
- *« Make changes in (something, especially an institution or practice) in order to improve it »*
- *«To give up or cause to give up a reprehensible habit or immoral way of life»*

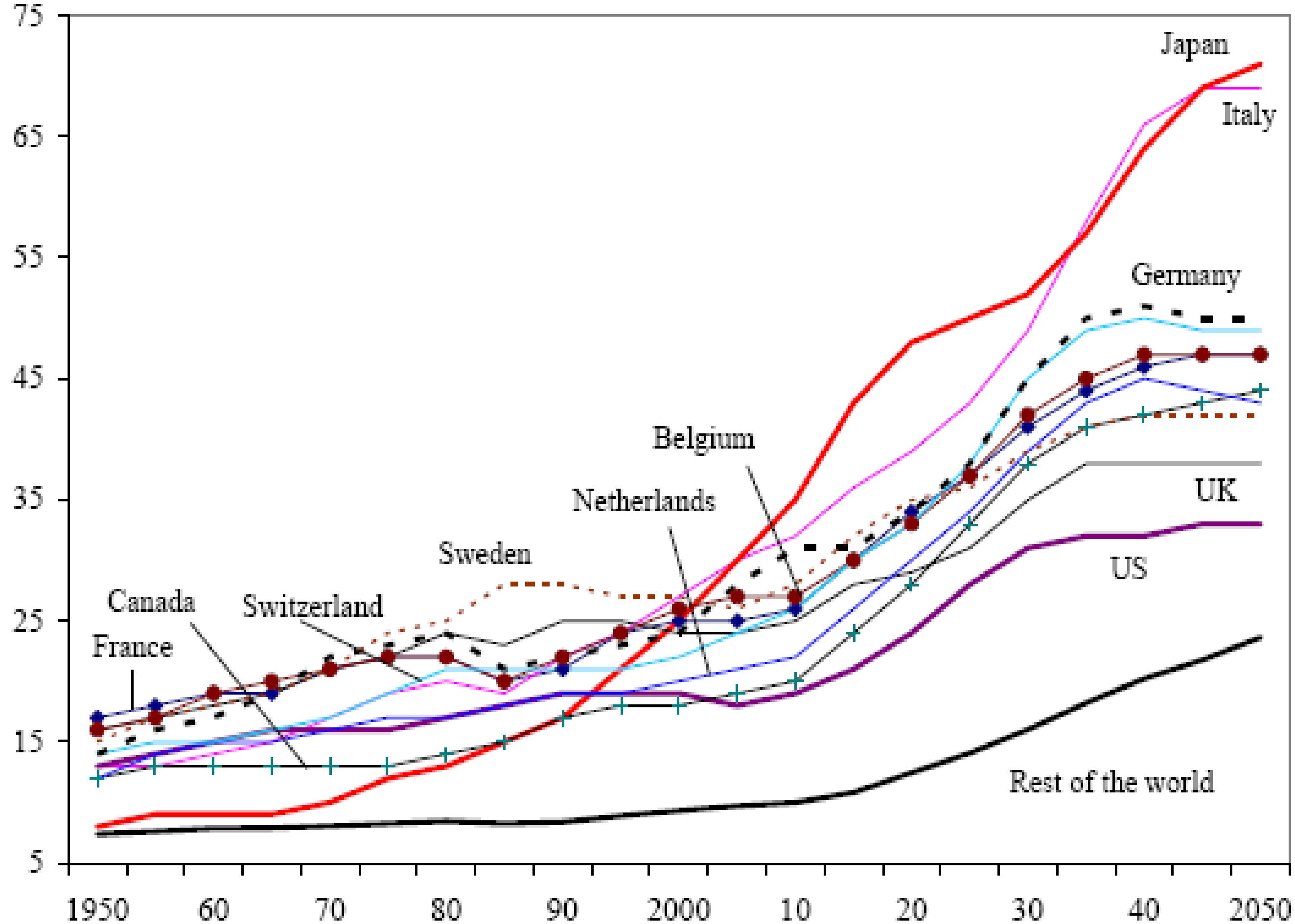
All definitions refer to changes not only in rules and institutions but, more importantly, in behavior

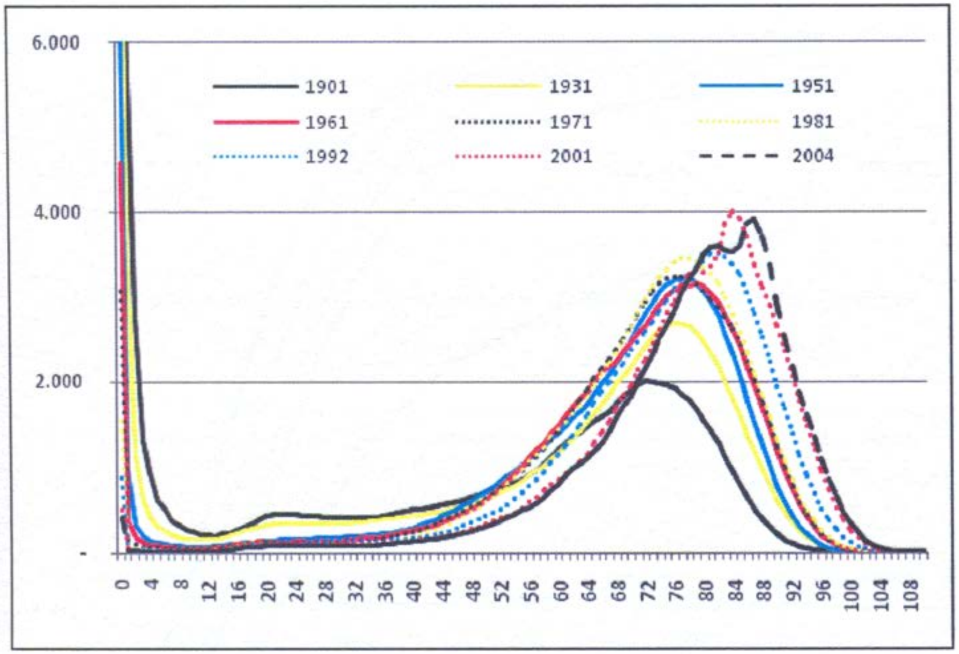
Pension reforms:
why are they needed?

- **to regain *financial sustainability*:**
  - to remedy the long run negative impact of population ageing, low growth
- **to reduce *distortions/inefficiency and inequality***
- **to strengthen *adequacy* of provisions for old age:**
  - which mix work/retirement, PayGo/funding and public/private?
  - which indexation (wages or prices) of pension benefits?
  - which mix of monetary benefits/services (i.e. Long Term Care)

The demographic challenge

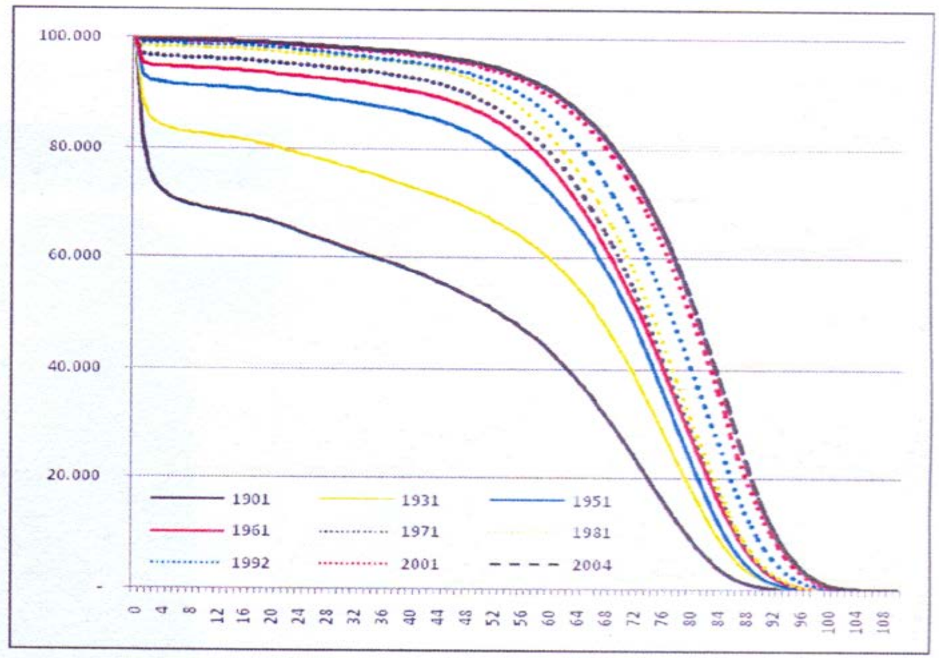
(% ratio of the population aged 65 years or over to the population aged 15-64)





Demographic changes (1)
Figure 1 –- Deaths curve – Italy, various years

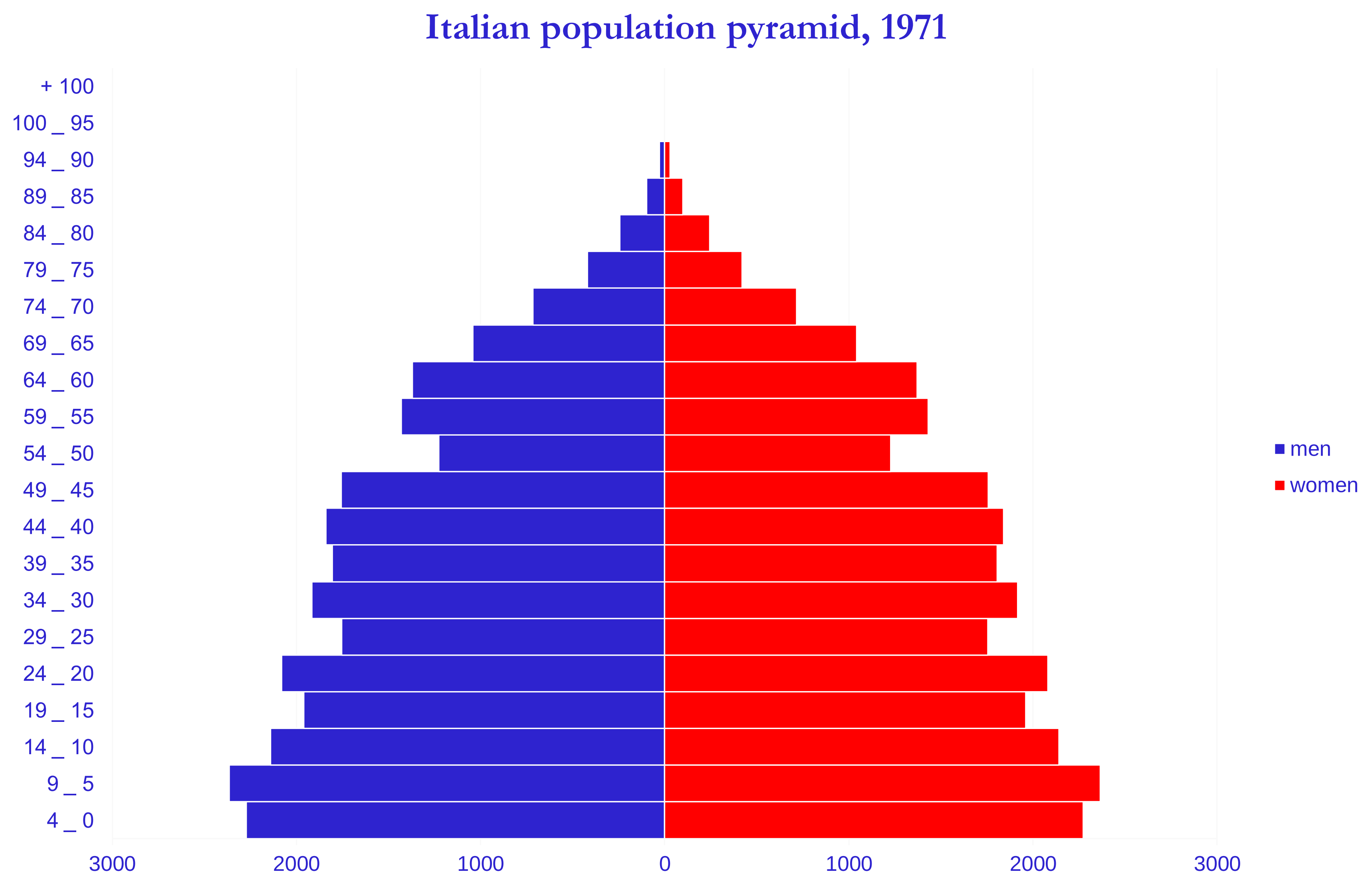
Demographic changes (2)
Figure 2 – Survival function – Italy, various years



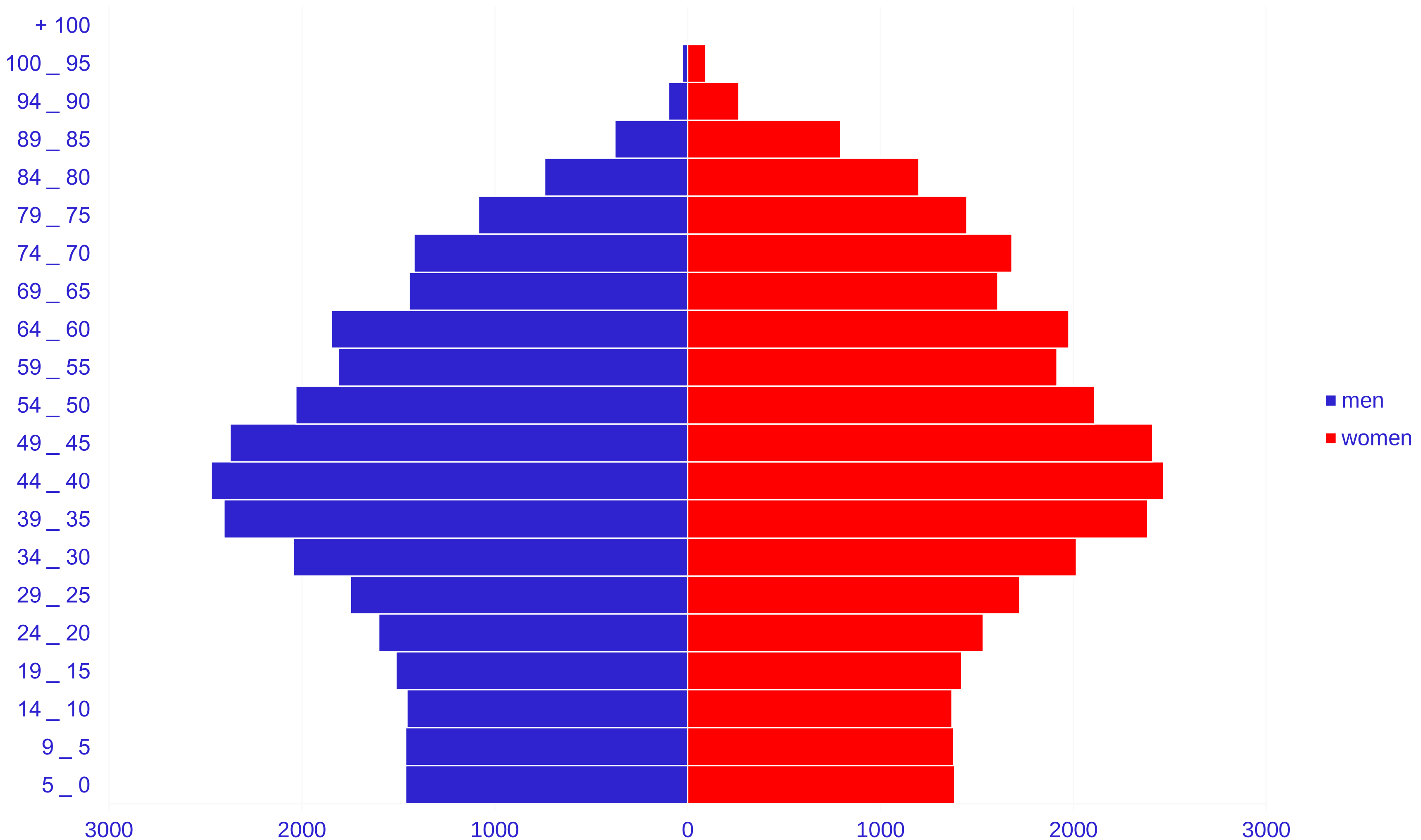
Demographic changes (3)
Fertility rates – Italy various years

1960	2.37
1970	2.38
1980	1.64
1990	1.33
2000	1.26
2010	1.46

The demographic challenge



2011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94 _ 90
89 _ 85
84 _ 80
79 _ 75
74 _ 70
69 _ 65
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34 _ 30
29 _ 25
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14 _ 10
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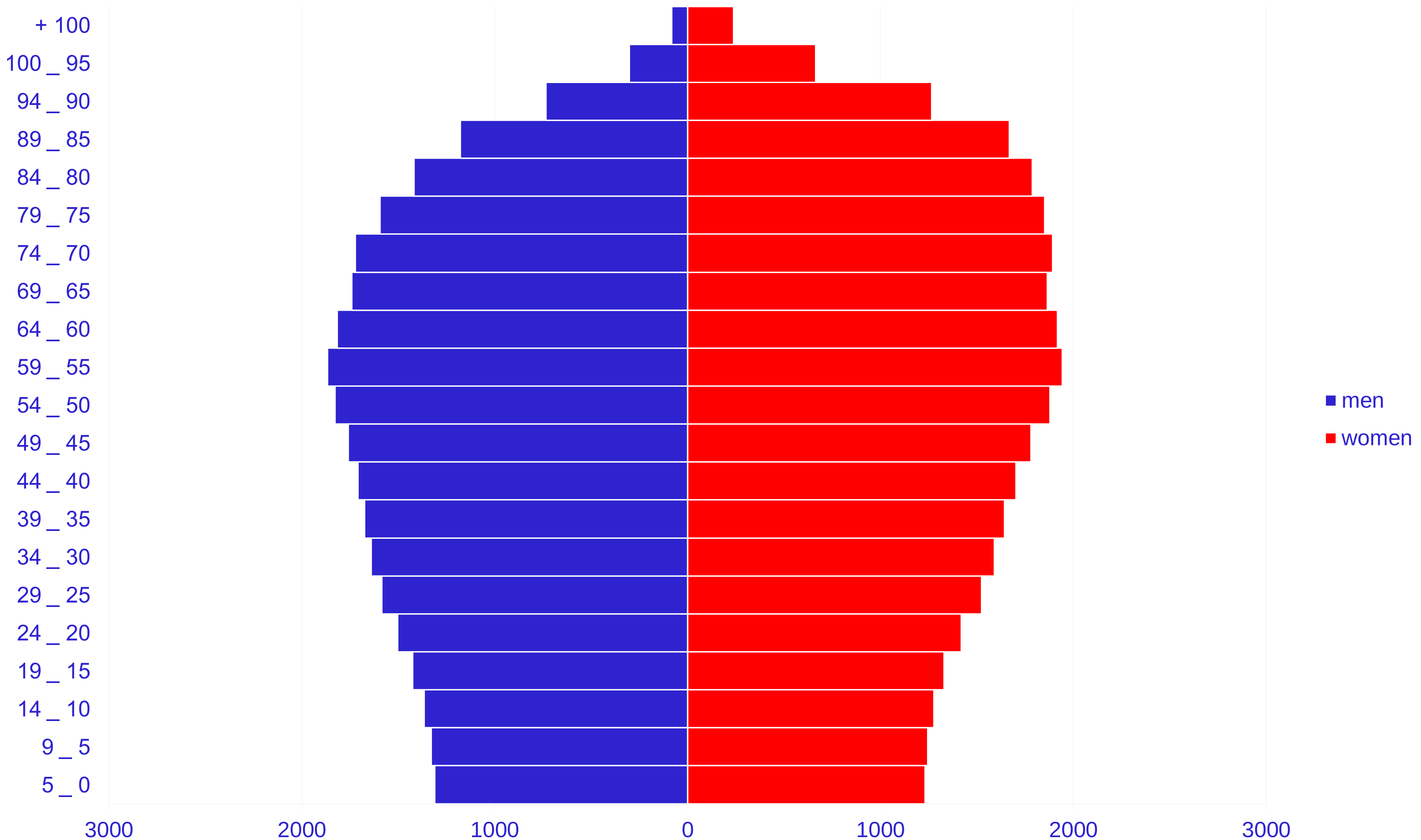
women

2061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29 _ 25
24 _ 20
19 _ 15
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9 _ 5
5 _ 0
3000
2000
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2000
3000
men
women

The economic challenge

Reduced growth and *economic* dependency ratios

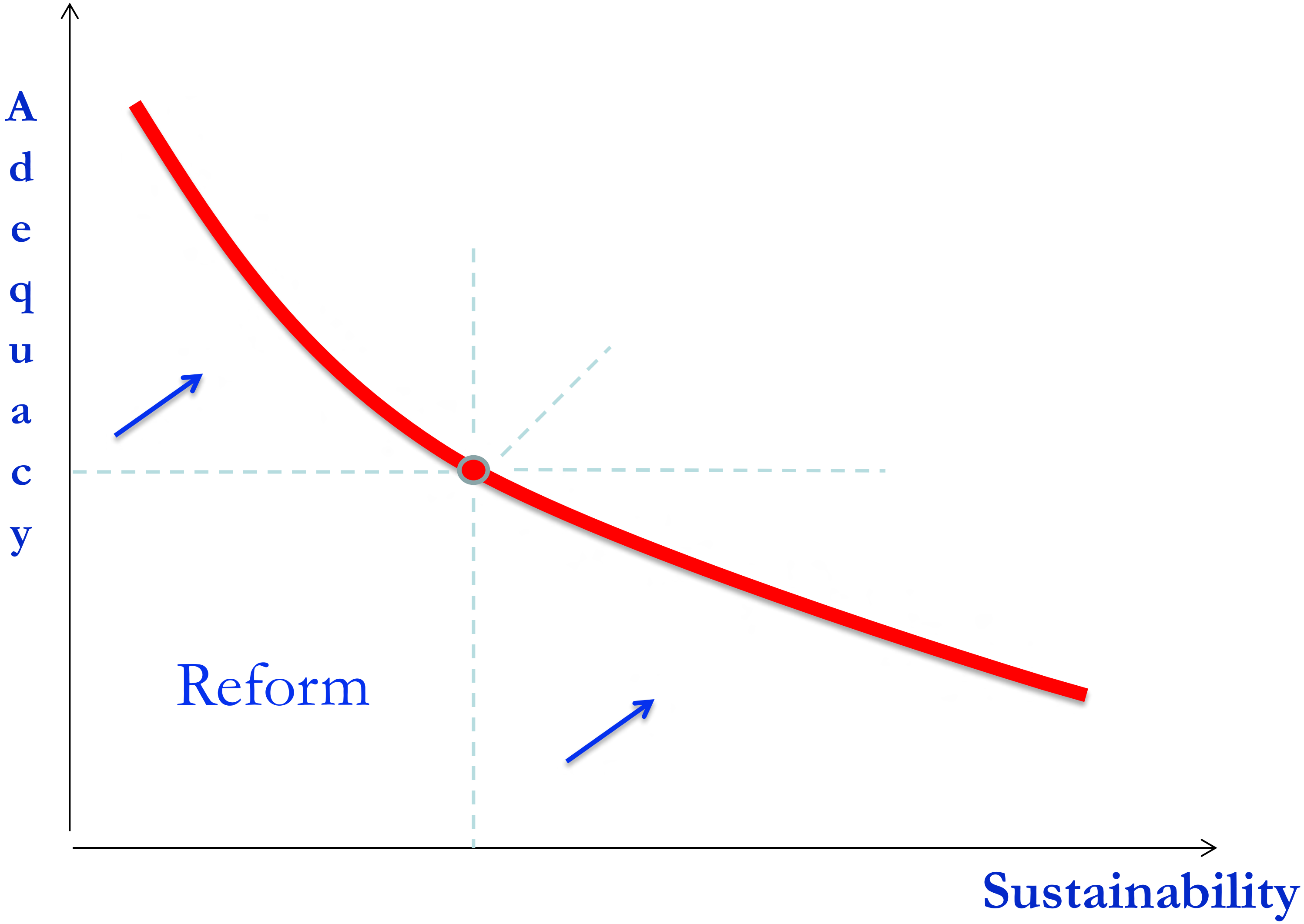
- Unsustainability of pension systems does not depend only on demographic trends
- The GDP growth rate and the composition of *working age population* **matter:** employed, unemployed and out of the labor force (in education, homemakers)
- The economic old age dependency ratio depends both on the changing age structure and the number of pensioners plus unemployed and out of the l.f. relative to the number of employed people
- For Italy (2011): oadr=34,3% eoadr=81%
  - A *well-functioning labor market* is the best premise for good pensions

Directions for reforms

- Strengthen the **correlation** (at the individual level) between **contributions/retirement age and benefits**
- Increase the ***statutory*** retirement ages
- Reduce early retirement options (increase ***effective*** ret. ages)
- Link retirement ages to longevity
- Boost employment opportunities of older workers
- Balance sustainability and adequacy concerns (indexation of pensions, means-tested minimum income or a "zero pillar" pension granted to all senior citizens)
- Encourage (EFE/nudges/fiscal advantages) or make compulsory participation in supplementary private pensions
- Special attention to women and groups *more at risk* of inadequate accumulation

An economic reading of pension reforms:

improving the trade off between **adequacy** and **sustainability**



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» vs «them»*, the people, who cannot see the good in a reform

  But: "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).

- Awareness of a reform's costs/benefits could be a more important determinant of its viability
- EFL could make citizens understand the reform's **social investment aspects**
- Governments should promote EFL thus indirectly inducing long-run support for virtuous reforms

The respective roles of political parties and of experts/technocrats in carrying out reforms

- Reforms: *a mix of political and technical elements*, the former in forefront of communication, the latter more behind the scene
- Political communication starts from an ideological perspective, plays down more "technical" aspects
- In emergency situations, technical aspects become dominant and "technocrats" (experts from IMF/academics etc.) may be called in to prepare the reform
  - When people are not correctly informed and do not understand its basic principles, the reform risks being ineffective or reversed
  - Information and Economic-Financial Literacy (EFL) matter not only for individual wellbeing, but also for society

Why good information and EFL are essential

- Accumulation of pension wealth: a long and complex endeavor
- Workers must have a correct idea of their accumulated "pension wealth, options, benefits variations with retirement postponement, survivor benefits …."
- This knowledge is essential – especially with DC benefits – to avoid mistakes/disappointments in individual planning/decisions: work longer? participate in a pension plan? consume less?
- Information also fundamental for the sustainability of the pension system and of a reform: if people misinterpret the system and the need for reform they will try to reverse it
- Technical possibilities for a good and transparent information are now available and good practices exist (the US ***Social Security Statement;*** the Swedish ***Orange Envelope).***

KPA PENSION

Orange envelope page 1

Contributions credited based on the most recently confirmed income tax declaration (2008)

Total value of savings up to date (31 december 2009)

Pension forecast, from the age of 65

Incentive to postpone retirement

FinLit for personal wealth formation and management

- *Fin illiteracy* is widespread, regardless of the country's economic development stage; knowledge of inflation is correlated to personal experience; risk diversification is the most difficult concept
- *Fin knowledge* has a hump-shaped profile over the life cycle (Lusardi and Mitchell, 2011): it is highest among ages 45-55 and lower at younger and older ages
- *Gender differences* are significant and pervasive: women are more likely to suffer the consequences of wrong/myopic/imprudent choices (Sunden and Surette, 1998; Lusardi and Mitchell, 2008; Bertocchi, Brunetti, and Torricelli, 2012; Bücher-Koenen, Lusardi, Alessie, and van Rooij, 2012; Boggio, Fornero, Prast, and Sanders, 2014)
- *Fin lit and human capital indicators* are (strongly) positively correlated (Jappelli, 2010)
- *Fin lit and the generosity of social security system* are negatively correlated (Jappelli and Padula, 2013)
- *Fin knowledge is a key determinant of wealth distribution*, accounting from 30-40 per cent of wealth inequality in the US (Lusardi, Michaud and Mitchell 2014).

George Stigler: a pioneer

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

> *Why should people be economically literate, rather that 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.

What people should know about pension systems

- A PAYGO system as an "*intergenerational compact*" that has an implicit debt dimension
- the "rate of return" depends on demographic and economic trends (n+g)
- the notion of *compound interest:* crucial to understand that Wp is accumulated by paying contributions; that each euro paid into their "retirement account" will add to their retirement income and the longer the period the higher the accumulated wealth
- *postponing retirement contributes twice to benefit increase*: through more contributions and lower expected longevity
- the notion of *risk diversification* ("do not put all your eggs in one basket") supports participation in a pension fund, to combine an unfunded with a funded pension, as they are characterized by different risk/returns combinations

….to avoid (pervasive) misconceptions

- *"Acquired rights" or unjustified privileges?*
- If people understand that their pension "entitlements" are partly built on debt to be honored by future generations *they can be less hostile to pensions restructuring*
- The "*lump of labor fallacy*": jobs are not in a fixed number and early retirement does not facilitate jobs for the young
- An expensive pension system is financed mainly from contributions by *workers/employers*, implying a trade-off between "generous" pensions and high labor costs.

4. Italy - November 2011: reforms in an emergency

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


AUMENTIAMO LO SPREAD DELLA FIDUCIA.

Il Sole 24 ORE

SPECIALE RISCHIO ITALIA E MERCATI

Lo spread BTp/Bund 575

Rendimento del BTp decennale 7,25%

MANUALE ANTI PANICO

FATE PRESTO

The 2011 "cold shower" reform

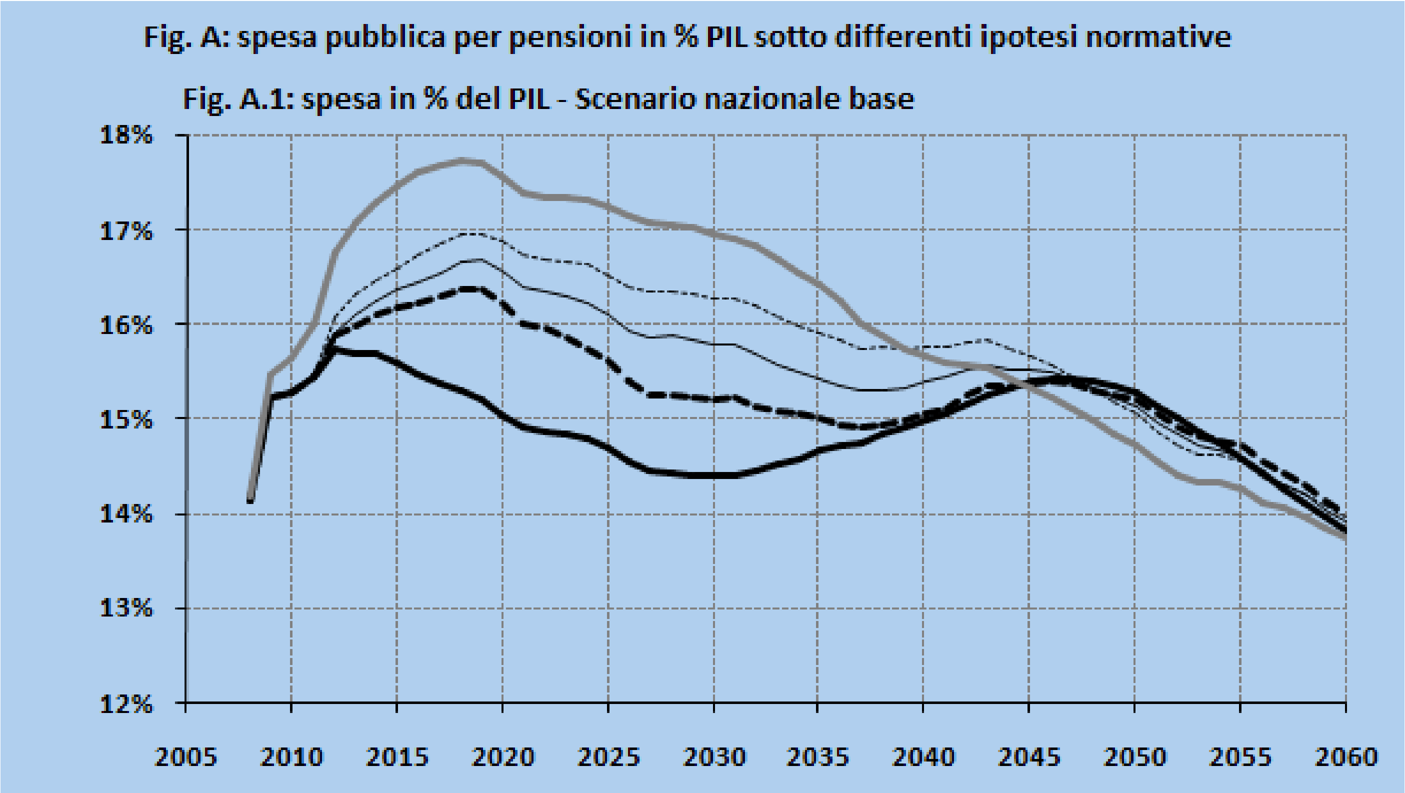
- Application, as of Jan 2012 and for future seniorities, of the **DC formula** to all workers, with periodic (every 2 years) updates of annuity rate coefficients
- **Increases in the statutory retirement ages** (66+longevity, in 2018) and phasedown of seniority pensions
- **Alignment**, as of 2018, **of ages and seniority requirements for women** in the private sector to those of men/women in the public sector
- **Indexation of eligibility requirements to life expectancy** (three preceding years var)
- **Increases in payroll tax rates** for farmers and the self-employed
- **Temporary freeze of indexation** for average-high pensions (>1400 €)
- Solidarity tax on higher pensions (sadly cancelled, later, by the Constitutional Court)
- **Free "totalization**" of contributions for NDC benefits
- **Elimination of "exit windows**", by which workers had to wait 12/18 months to retire after reaching pensionable age

Financial achievements but…social problems

- Important reduction in pension/expenditure over the next decades
- However, the swift implementation of the reform has created a problem with workers that had left their job in anticipation of a relatively near retirement
- 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 devised for out of work periods
- Special attention has to be devoted to groups more at risk

Financial/Economic sustainability:

Public pension expenditure/GDP with the different reforms



Legend:
dark thick continuous line: current legislation
dark thick dotted line: legislation ante second 2011 reform (DL 201/2011)
dark thin continuous line: legislation ante first 2011 reform (DL 98/2011)
dark thin dotted line: legislation ante 2010 reform (DL 78/2010)
grey continuous line: legislation ante 2004 reform (L.243/2004)

Transitional and communication problems

- The reform aims at disproving deep-rooted notions, i.e.:
  - workers over 54-55 are lost to the labor market
  - the lump of labor fallacy (older workers take away jobs from younger ones)
- Difficulties with the notion of "acquired rights" (also supported by the Constitutional Court)
- Difficulties in making the reform understood and shared

6. Conclusions: which way from where we are?

After a period of serious cuts in the public component (and the near collapse of financial markets), a question arises:

- ***how can people's confidence in the welfare system be restored***?

The answer has to be constructed around three building blocks:

1. ***Continuation of reforms*** to strengthen sustainability, improve adequacy and modernize the system
2. ***Transparent information on reforms as social investments***
3. ***Economic-Financial Literacy and education programs***

A new sport: running for your pension