Pension and Labor Market Reforms in an integrated approach

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Italy , November 2011: The looming crisis

1. Sharp worsening of Italian sovereign debt situation

- Increasing refinancing difficulties (*on average* 1billion € 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

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

BCC

SPECIALE RISCHIO ITALIA E MERCATI

Lo spread BTp/Bund

575

Rendimento del BTp decennale

7,25%

MANUALE ANTI PANICO

FATE PRESTO

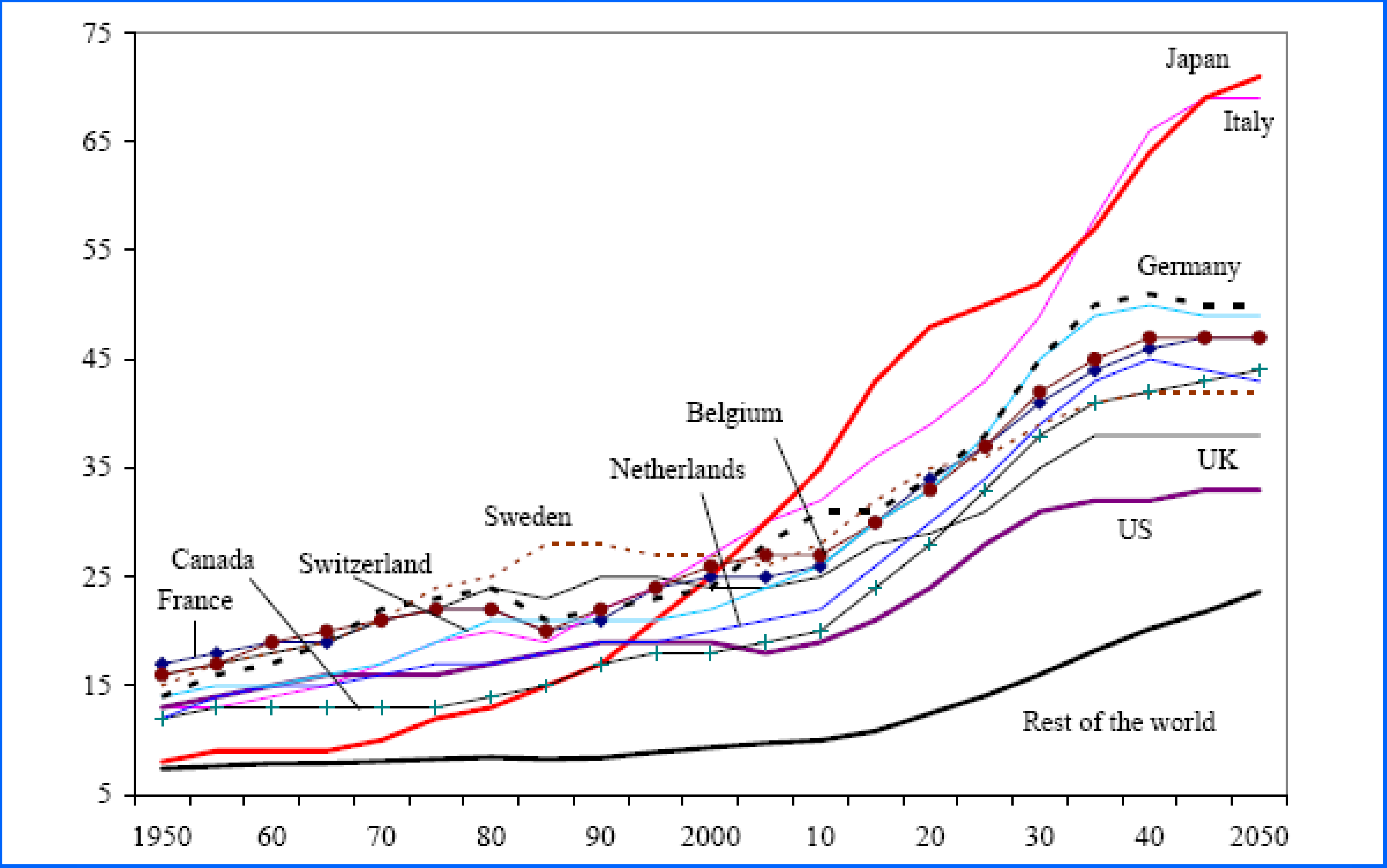
The "Rescue Italy" decree (4 Dec., 2011)

To avoid the financial collapse of the Italian sovereign debt (and the end of the Euro?)

- The "*Rescue Italy decree*" delivered in two weeks and consisting of two major measures:
  i. The tax on housing wealth (IMU, unwisely cancelled by the subsequent government: it was the only tax on wealth in the Italian tax system)
  ii. The pension reform

- The **pension reform**, together with the labor market reform, had been an explicit commitment of the previous Italian government to the ECB

The pension reform had to cope with one of the worst dependency ratio



Fonte: Visco, I. (2006), "Longevity risk and financial markets", keynote speech, 26th SUERF Colloquium, Lisbon

…….and with a (still) badly designed and fragmented system

- A very high pension expenditure (16.1% of GDP) and a very high "pension debt"
- An unbalanced social expenditure (52% for pensions, with less than 10% for children)
- Still a relatively low average retirement age (≈59 years) , due to the prevalence of *seniority pensions* The tendency to use the pension system more as a social protection scheme (to cover undeclared unemployment) than as longevity insurance
- A maze of rules favored by the fragmentation of the system into many different schemes favoring privileges and social run ups

The (long, slow and reluctant) reform process

I Pillar

1992 – Cutback of the DB formula (DLg 503/1992)

1995 – Introduction of the DC formula for new entrants and young workers (l. 335/1995),

1997 - Stricter eligibility criteria for public employees (l.499/1997)

2001 - Increase in Social allowance (l.448/2001)

2004 – Further restrictions in eligibility criteria (l.243/2004)

2006 - Increase in payroll tax rates (l.296/2006) (effective=notional)

2007 – Stricter eligibility criteria (l.247/2007) ("quota" system: age + seniority)

2009 – Indexation (as of 2015) of ret ages to longevity and possibility to cumulate earnings and pension benefit (l.102/2009)

2010 - Increase of minimum age criteria to 65 years for women in the public sector (l.122/2010)

2011 - Increase of age requirements (from D.l.138/2011 and l.111/2011 for women in the private sector, l.148/2011 also), "windows"

2011 - Universal introduction of pro-rata DC scheme from 2012, restructuring of seniority pensions, new eligibility criteria, indexation to longevity (l.214/2011)

………..

2030 - New pension flows: entirely DC-type

…………

2050 - All Pensions: entirely DC-type

II Pillar

1993 - Introduction (D.Lgs 124/1993)

1995 - Collective participation in open pension funds (l.335/1995)

2000 - Individual pension plans and fiscal incentives (D.Lgs 47/2000)

2001- Further fiscal incentives (D.Lgs 168/2001)

2005 – Change of default for participation in pension funds ("tacit consent" rule for TFR, flexibility, fiscal incentives (D.Lgs 252/2005)

2006 - Anticipation of TFR transfer terms (D.l.279/2006)

Weak economic/political sustainability of the reform path

- A tendency to introduce reforms in emergency situations ('92, '95, 2011)
- A very slow phasing in, and thus a systematic tendency to procrastinate the implementation and to transfer the adjustment costs onto the young and new generations (having little or no weight in elections)
- Little transparency (a preference for introducing surreptitious restrictions, like "exit windows", or to package reforms in a "deceptive" way)
- A propensity to undo/mitigate reforms introduced by a previous government, supported by a different majority

….*could not 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 (in the two preceding years) in life expectancy
- 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 “windows”

The Italian system evaluated according to:

i. **Financial/Economic sustainability**

- Pension expenditure/GDP

ii. **Adequacy**

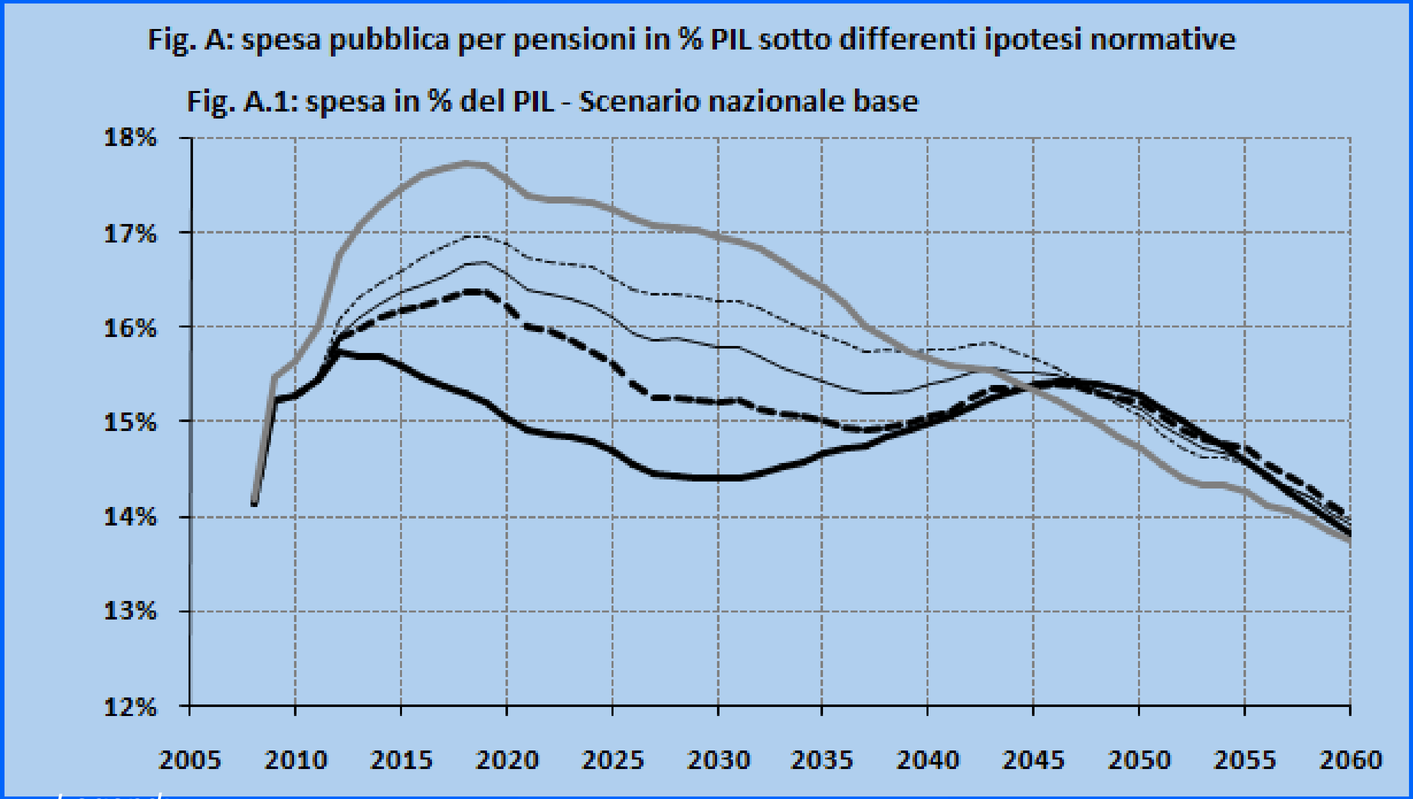
- Replacement rates
- Inter and intra generational redistribution

iii. **Political sustainability:**

- transparency/simplicity/credibility

Financial/Economic sustainability:

Public pension expenditure/GDP with the different reform



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)

(Net of Taxes) Saving in Pension Expenditure (in mln €)

Overall effects of major measures of the reform: (i.e. changes in access requirements and in the method of calculation									
2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
2,515	4,600	7,024	9,953	12,401	15,391	18,355	20,704	21,609	20,695
-250	659	2,543	5,135	7,069	9,758	12,318	14,662	15,572	14,681

1. Overall effects of the pension reform (net of two major safeguard interventions)
2. Excluding payroll tax rates increases and de-indexation of pension benefits

Fin/Economic s**ustainability** achieved through:

- introduction (on a *pro rata* basis) of the DC method which encourages later retirement through the variation with age of the **transformation coefficient**, stopping the implicit taxation in DB seniority pensions
- increased statutory retirement ages
- automatic adjustments (through indexation to longevity) of retirement ages and seniority requirements
- flexible retirement ages (as of now very limited, but more extended within the NDC system)
- more uniform rules, with few and transparent exception
- increases of payroll tax rates for the self-employed

As for **adequacy** (s**ocial sustainability**):

- The same factors that support economic sustainability also support adequacy of provisions
- The system realizes a more sustainable, more efficient and more equitable (both within and between generations) design
- The DC formula reduces the «unfair" redistribution characteristic of the "previous" DB one
- Transparency makes political interference more difficult, while making room and scope for policies directed at the "weaker" segments (the young, women and older workers)

Transitional and communication problems

- Insufficiency of safeguarding clauses and the need for amendments
- Cultural changes needed
- The reform aims at dismantling the deep-rooted notions that:
  - workers over 54-55 are lost to the labor market and just destined to retirement;
  - older workers take away jobs from younger ones;
- Problems with the notion of "acquired rights" (reinforced by pronunciations of the Constitutional Court)
- Difficulties in communicating the "positive" aspects of the reform, i.e. the generational rebalancing

Caveats

- **<u>The main challenge is the labor market</u>**, with the young and women more at risk of inadequate contributions and thus inadequate pensions
- Dismissed older workers also at risk of not finding another job
- The very rapid implementation of the reform has created a problem with workers who had been dismissed/left their job in anticipation of a relatively near retirement
- Notional contributions (to be paid by the public budget) are envisaged for out of work periods (for unemployment and care services) but may not be enough
- The system is still almost exclusively centered on the PayGo (unfunded) financing and far from the multi-pillars approach

The need to inform and politicians' reluctance

• Accumulation of pension wealth is a long and complex endeavor

• Workers must have an idea of their pension wealth, retirement options, benefits they will get at various possible ret ages

• This knowledge is essential - particularly in the DC world - for individual planning/decision making (participate in a pension plan, work longer, avoid mistakes/big disappointments /ensuing painful adjustments

• Information is also fundamental for the sustainability of a pension reform: 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

Labor and pensions: two sides of the same coin

- As Franco Modigliani's life cycle hypothesis has taught us long ago, work and retirement are two matching segments of our life and what happens in the latter is not independent of what happens in the former
- No pension system can deliver adequate benefits if the labor market – which generates the resources on which current pensions are paid - does not perform adequately
- No political "alchemy" can substantially alter this
- In terms of reforms, ideally, first comes the labor market and then the pension reform. In Italy, due to the financial emergency, the Gov. had to start with a swift restructuring of pensions

Understanding labor market reforms

- The reform changes market ***regulation***:
  - how much regulation? Is "just deregulate" always the optimal response?
  - incentives/disincentives vs obligations/prohibitions
  - how much should initial circumstances (structurally *weak* economy experiencing a deep *depression*) weigh?
- A good reform aims at *finding a balance* between:
  - short and medium-run effects: swift deregulation vs building better work relationships
  - conflicting aims of social partners and political parties (social/political constraints not less important than financial constraints)
- A reform centered on two goals: inclusion and dynamism
  - How to increase workers employability (apprenticeship, life long learning, certification of competences)
  - How to enhance productivity (reducing centralization of contracts)
  - How to design an effective social safety net, without discouraging job search
- People's expectations: immediate flow of new jobs

Widespread misconceptions: the "lump of labor fallacy"

- The "*lump of labor fallacy*" – the idea that jobs are, at any given point in time, in a fixed number – has long dominated, in Italy, the public debate on pension reforms and brought about policies directed reducing ret age
- For (too) long, the pension system has been used as an "absorber" of manufacturing and occupational problems
- The belief creates hostility towards the reform and obscures its generational rebalancing by convincing people that the increase in ret age will reduce opportunities for the young (and/or for women: the same erroneous reasoning has also long been applied to women and reduced female labor market participation)
- The labor market reform should just reverse the logic and ask what kind of rules, institutions, behavior could promote a higher employment rate

Spring 2012: tackling Italy's long standing labor problems

- ***Market dualism***: protected (mainly men, over forty, in industries and government jobs) vs marginalized groups (the young, women and older workers), causing rigidities on one side and precariousness, on the other [unemployment by gender and age link – incidence of temporary employment link]
- ***Low participation rates***, particularly among women and older workers [total population by working status link]
- ***Unwarranted separation*** (also ideologically motivated) between school and work; insufficient vocational training and lack of adult education [participation rate in training and education by labor status link]
- ***Predominance of passive policies*** and poor or absent ALMP, regionally provided, with few exceptions [public expenditure on labor market programs link]
- Very high fiscal wedge [fiscal wedge in OECD countries link]

A complex reform resting on five pillars

1. Flexibility in labor market entry
2. Flexibility in labor market exit
3. Social protection schemes
4. Employment services and activation policies
5. Follow up, monitoring and evaluation

The reform has been the result of ***extensive consultation*** *with the social partners and wide ranging debate leading to broad agreement in Parliament. It was then, however, rapidly disowned irrespective of a positive international evaluation as an important step in the right direction*

Dynamic Inconsistencies?

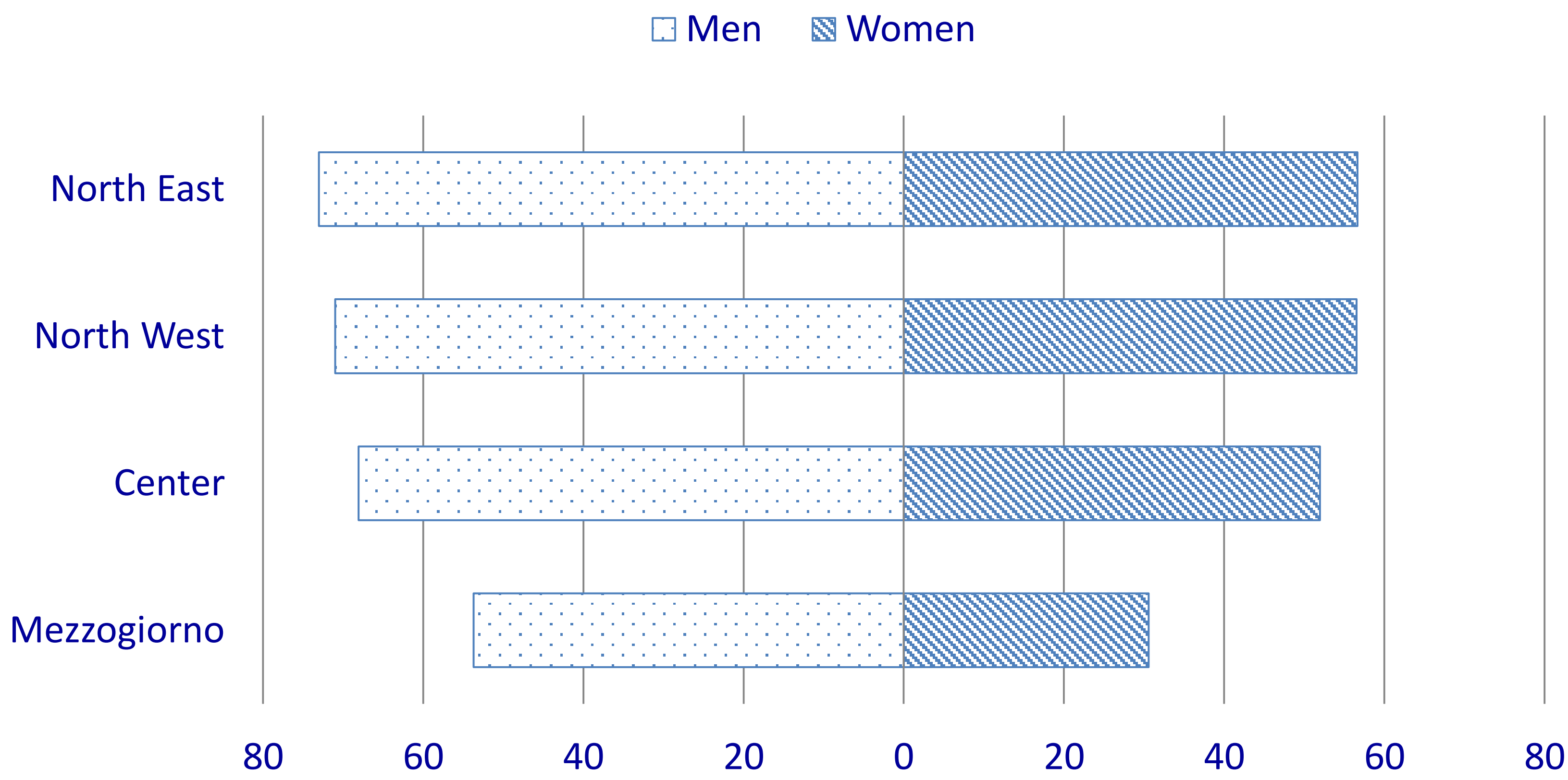
- The reform represented, in principle, a *satisfactory equilibrium*.
- Properly applied it **would have** rebalanced the opportunities in favor of the young, improved productivity and the quality of labor relationships
- The reform took into account the need for adjustment to social and economic change. It is thereby recognized that reforms are never perfect and need regular maintenance in order to be adjusted to social and economic evolution.
- Initial provisions were made for an independent process of monitoring and evaluation in order to assess the fulfillment of its goals with a view to introducing changes where necessary
- Sadly, the reform was introduced right in the middle of a recession (and by a technocratic government**)**
- The absence of immediate results has been at the root of widespread criticism (and vicious personal attacks)

Conclusions

- The distance between theoretical and effective reforms can be quite large
- In emergency, when swift change is required, both time constraint and lack of the degrees of freedom can prevent a smooth adaptation of the reform to the theoretical model
- Reforms are living processes, not legal exercises. They need to be endorsed by the social partners as well as by institutions, political parties, the media and the public at large
- Having the reform "shared" by the social partners and basically understood by citizens can be essential for its effectiveness
- In the face of greater uncertainty and individual responsibility, relying on transparent information and economic-financial literacy is essential

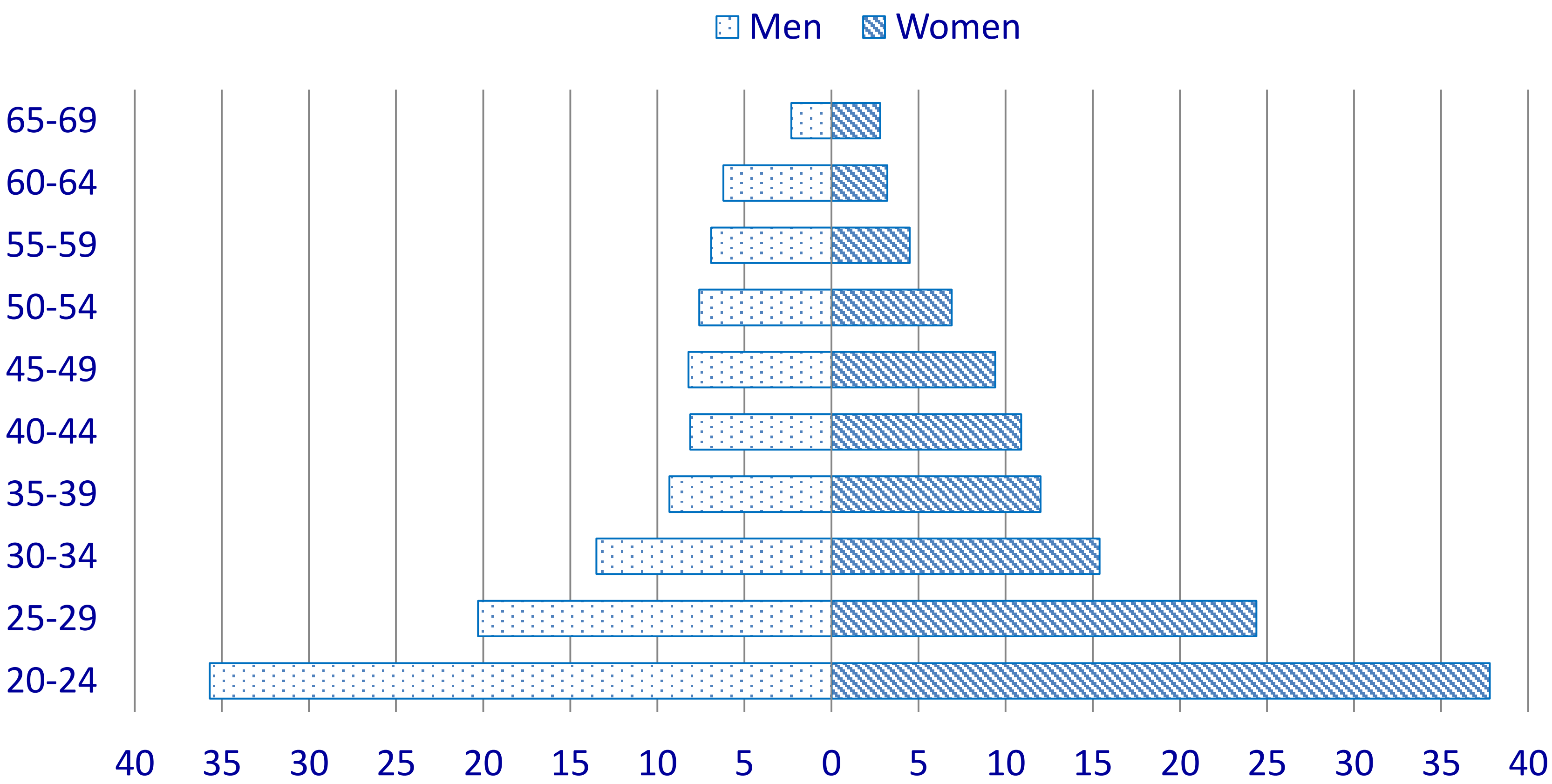
Statistical Annex

Employment rate by gender and macroregion



Source: author's elaboration on Istat data. Year: 2013, Age: 15-64

Unemployment rate by gender and age group



Source: author's elaboration on Eurostat data. Year: 2013

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Incidence of temporary employment

Compared with European or OECD countries, temporary employment is overrepresented between younger workers and underrepresented between older cohorts.

Age	Employment	Italy	Europe	OECD
15 to 24	permanent	48,1	59,9	73,8
	temporary	51,9	40,1	26,2
25 to 54	permanent	89,1	88,9	91,0
	temporary	10,9	11,1	9,0
55 to 64	permanent	94,1	93,2	91,4
	temporary	5,9	6,8	8,6
65+	permanent	88,9	80,7	79,9
	temporary	11,1	19,3	20,2
Total	permanent	87,6	86,3	88,6
	temporary	12,4	13,7	11,4

Source: OECD database. Dataset: Incidence of permanent employment. Year: 2013

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Incidence of unemployment by duration

Long-term unemployment, while affecting mostly the older cohorts in Europe, hits more often younger workers in Italy

	Italy				Europe			
	Men		Women		Men		Women	
	< 1 year	<= 1 year	< 1 year	<= 1 year	< 1 year	<= 1 year	< 1 year	<= 1 year
15 to 19	56,3	43,7	65,0	35,0	78,7	21,3	80,3	19,7
20 to 24	41,1	58,9	46,4	53,6	63,6	36,4	66,6	33,4
25 to 54	43,6	56,4	41,0	59,0	54,6	45,4	52,4	47,6
55+	37,2	62,8	41,7	58,3	41,9	58,1	39,6	60,4
Total	43,2	56,8	42,9	57,1	56,2	43,8	55,2	44,8

Source: author's elaboration on OECD database. Year: 2013

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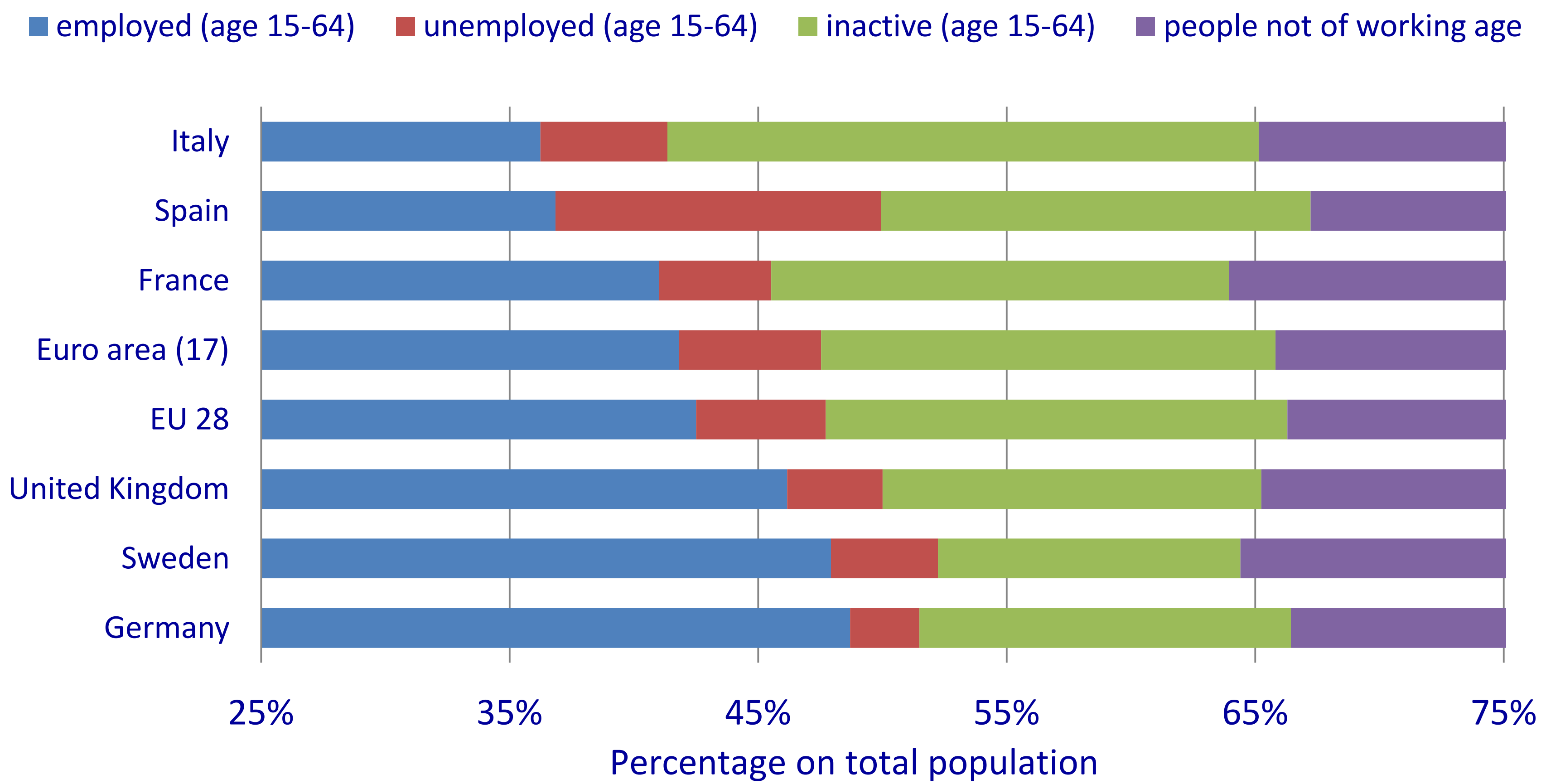
Total population by working status



Source: elaboration on OECD database, Year: 2013

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Inactive population by willingness to work

Inactivity is widespread but not chosen.

		Would like to work but is not seeking employment	Do not want to work	Seeking employment but not ILO unemployed	No answer	Total
EU27	(1000)	15.829,3	75.952,1	2.370,6	2.071,6	95.401,4
	%	17,2%	79,6	2,5	2,2	100,0
Germany	(1000)	1.558,2	10.023,7	576,0	N/A	12.256,0
	%	12,8%	81,8	4,7		100,0
Spain	(1000)	1.592,2	6.136,7	242,7	420,8	8.177,9
	%	20,0%	75,0	3,0	5,1	100,0
France	(1000)	960,3	10.827,7	465,5	N/A	11.864,8
	%	8,4%	91,3	3,9		100,0
Italy	(1000)	3.986,0	11.073,2	119,7	N/A	14.972,2
	%	27,6%	74,0	0,8		100,0
Sweden	(1000)	181,1	967,5	97,8	4,7	1.227,4
	%	15,7%	78,8	8,0	0,4	100,0
United Kingdom	(1000)	1.976,6	6.753,4	317,0	819,6	9.877,6
	%	20,8%	68,4	3,2	8,3	100,0
	AGE: From 15 to 64 years TIME: 2013					

Source: Eurostat database on labor Force Survey

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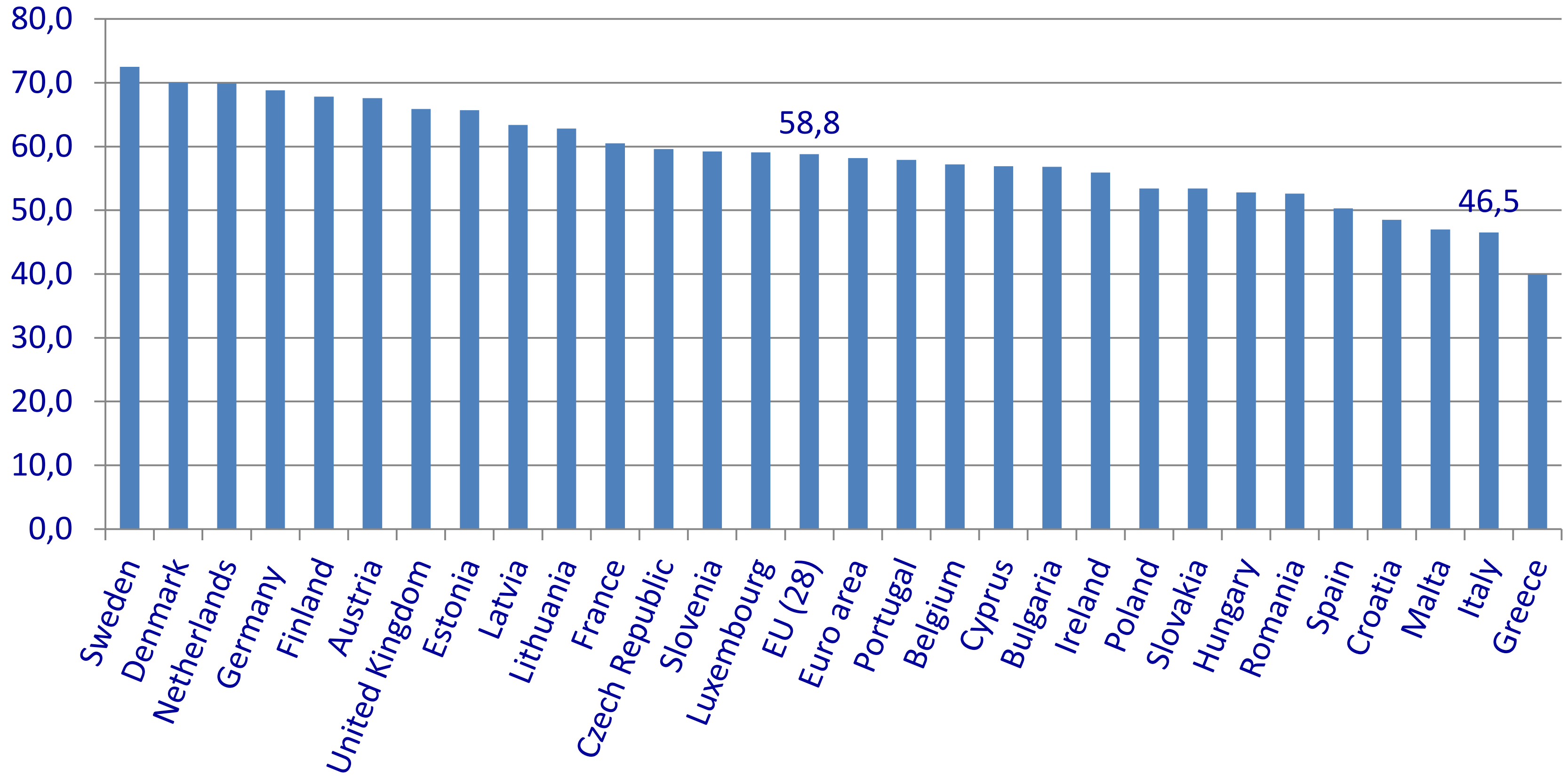
Female employment rate



Neet rates

Young people not in employment and not in any education and training (NEET rates) Age: from 15 to 29 years

	Males	Females	Total
European Union (27)	14	17,7	15,8
Euro area (17)	14,7	17,2	15,9
Germany	6,8	10,7	8,7
Spain	22,8	22,1	22,5
France	12,3	15,3	13,8
Italy	24,4	27,7	26
Sweden	7,5	8,3	7,9
United Kingdom	11,9	17,6	14,7

Source: Eurostat database on Educational attainment, outcomes and returns of education [edat]

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Participation rate in education and training by labor status

A loose integration between school and work means a scarce use of lifelong learning too

Participation rate in education and training by labor status [trng_aes_103]				
TYPTRAI Formal or non-formal education and training TIME 2011				
GEO/WSTATUS	Population	Employed persons	Unemployed persons	Inactive persons
European Union (27)	40,2	48,4	27	19,3
Euro area (17)	44,9	53,3	30,4	22,9
Germany	50	56,6	28,5	30,5
Spain	37,7	43,8	32,5	21,8
France	50,5	57,6	38,8	22,7
Italy	35,7	46,5	22,5	16,1
Sweden	71,8	77,5	52,8	47,5
United Kingdom	35,8	41,4	27,9	20,2
Source of data: Eurostat database on Lifelong Learning based on Adult Education Survey				

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Public expenditure on labor market programmes

Italy’s expenditure on labor market programs is similar to the OECD countries average, but mostly concentrated in passive measures.

Public expenditure on Labor Market Programmes as a percentage of GDP

<table>
<tr><th colspan="2">Programmes</th><th>France</th><th>Germany</th><th>Italy</th><th>Spain</th><th>Sweden</th><th>OECD</th></tr>
<tr><td colspan="2">Total</td><td>2,35</td><td>1,68</td><td>2,07</td><td>3,71</td><td>1,99</td><td>1,42</td></tr>
<tr><td rowspan="2">Total</td><td>Active measures</td><td>0,9</td><td>0,69</td><td>0,45</td><td>0,88</td><td>1,33</td><td>0,57</td></tr>
<tr><td>Passive measures</td><td>1,45</td><td>0,98</td><td>1,61</td><td>2,83</td><td>0,66</td><td>0,85</td></tr>
</table>

Source: OECD database, Public expenditure and Labor stocks on LMP. Year: 2012 (Spain:2011).

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Fiscal wedge

Average tax wedge on Italian workers is higher in comparison to the OECD average; this is true for every kind of family type.

	Italy	OECD
single person, 0 children	47,78	35,85
one-earner married couple, 0 children	46,02	33,19
single parent, 2 children	39,93	27,3
one-earner married couple, 2 children	38,17	26,35

Source: OECD database on Taxing Wages

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