Annex 8 – EUROFRAME-EFN Autumn 2007 Report

The Pension Reforms in Italy: a Never Ending Story

Paolo Onofri, Prometeia

The Italian pension system is a mandatory public system for employees since 1919. It was revised in a very generous way in the sixties of the last century including also self employed workers in the pay-as-you-go system. In 1960 pension expenditure was 4.3 per cent of Gdp; it had reached 13.5 per cent in 1993, when a long process of reforms started, aiming at rolling back the generous promises of the past. The goal was manifold: to change the rules for both old age and seniority pensions in order to reduce the growth of the number of pensioners; to change the rules for the computation of the benefit in order to make it consistent with the future output per employee; to allow complementary funded employment pensions.

As for the individually funded part of the future benefits, the reform started in 1993 was actually enacted fourteen years later, in 2007. The reward of the working effort of the Italian employee is made of two parts: the current wage, and a severance payment due when the employee quits the job. The severance fund accruals (about the 7 per cent of the yearly wages) are accumulated year by year by the employer and remunerated according to a rate of return made of the ¾ of the current inflation rate plus 1.5 percentage points. Since July 1st 2007, about the 40 per cent of the employees have chosen to use the future severance fund accruals to finance either a sector employment pension fund ("closed" pension fund), or an "open" pension fund. The fiscal incentives granted to the funded part of the future pension benefit are aimed at supporting the development of the complementary funded schemes in order to compensate for the future reduction of the pay-as-you-go benefits. Moreover, the diversion of the future severance funds to complementary pension funds does not require the reduction of the current social contributions financing the benefits of the current pensioners. The cost for the employee consists of giving up the severance allowances when quitting the job.

However, the main pension reforms implemented in Italy during the last fifteen years involve the pay-as-you-go system. The first step was enacted in 1992-93. It changed both the evolution of the number of pensioners, and the amount of the benefit. It was followed by a further fundamental change in the computation rules of the benefits in 1995, and two further interventions, in 1997 and in 2004, to accelerate the transition phase. As a result of all these measures, within about ten years from the first move, the requisites for the old age pension changed from 60 to 65 years for men and

from 55 to 60 for women. The conditions for the seniority pension were drastically restricted from a variety of very generous conditions to a uniform rule: 57 years of age joint with 35 years of seniority, independently of the gender.

About the value of the benefit, two fundamental changes have been enacted. First, the abolition of the indexation of benefits to the real wage dynamics. In other words, since 1993, Italian pensioners do not any longer share the outcome of technical progress with the working population. The consumer price indexation has obviously been preserved, but with a degree lower than hundred per cent in the case of benefit higher than five times the minimum benefit. Secondly, the new Notional Contribution System (NCS) of computation enacted in 1995. Under NCS the benefit depends on the contributions paid during the whole working career, virtually capitalised according to the five years moving average rate of growth of nominal Gdp and transformed in pension annuities by coefficients ("transformation coefficients") taking into account life expectancy and applying the discount rate of 1.5 per cent.

During the current phase of transition (1995-2033), the workers have been divided into three different generations: the older workers who still keep the older rules of computation, the so-called "mixed" workers who are going to have the benefit computed according to the two different sets of rules, with weights given by the number of years they have been working under the two systems, and the younger workers who started they working career after 1995, under the new system. Old and "mixed" workers are still entitled to seniority pensions (not actuarially fair) when they reach 57 years of age and 35 of seniority, whereas younger workers, according to the 1995 law, can choose to retire for the old age pension within the interval of age 57-65, independently of the seniority and of the gender, but with a benefit which is actuarially fair.

Under the old computation rules, the benefit depends on the number of years of seniority, on the wage level of the last ten years of work, and on the rate of return per year of work, not the same for every employee. Of course, the NCS is still a pay-go system; however, it reduces the degree of inequality within the pensioners (the benefit return to the contribution paid is the same for every worker), and, moreover, the NCS includes self-adjusting mechanisms to shocks on growth and demography. The reaction to changes in the rate of growth of the economy is reflected every year in the notional capitalisation rate, whereas the feedback on the new issued annuities of changes in the life expectancy is due only every ten years. The first adjustment had to be done in 2005.

This was the state of the reforms when in 2004 the Berlusconi government enacted a further adjustment to the pay-go. The first aim was to restrict further seniority pensions, and at the same time to avoid the negative electoral impact on the 2006 general elections. The solution was that the age for seniority pensions was increased from 57 to 60 years, to be effective all in the night between December 31st, 2007 and January 1st, 2008, and to be later increased to 62 years in 2014. The latter increase does not involve women.

The second aim was to restrict the old age pension options for the younger workers, within the new NCS. The range 57-65, independently of the seniority, will be allowed only to women. The age of old age pension for currently young male workers will be restricted to 65. In order to have the possibility to choose the old age pension within that range, men will be required to have a seniority of 40 years.

On the other hand, in 2005 an increase of life expectancy included in the so-called transformation coefficients was due, but not implemented by the Berlusconi government. Such a revision would have implied a reduction of the order of 6-8 per cent in the future benefits of the current "mixed" and younger workers.

The electoral program of the new government elected in 2006 included the smoothing of the jump in the age for seniority pensions at the end of 2007, and the revision of the transformation coefficients, within the constrain to minimise the impact on the government budget. At the end of July 2007 the government reached an agreement with trade unions to dilute the jump into three steps reaching gradually the following final conditions in the year 2013: 62 years of age and 36 years of seniority from the current requisite 57 and 35. The long run outcome is a little bit stricter than the Berlusconi law, but with the possibility to continue to apply the requisite 57-35 to workers who have been doing very heavy jobs during their working career. As for the transformation coefficients, the agreement includes the revision of the timing of adjustment from every ten years to every three and the possibility to differentiate the coefficients among the workers.

The agreement has still to be approved by the Parliament. The vocal opposition of the radical left within the government majority on some aspects of the agreement seems quite strong, but the possibilities to change this very fragile equilibrium solution are very limited, given the fact that a too prolonged discussion, or, even worse, a government crisis will let the current legislation (hence the jump from 57 to 60 years in a night) work.

As a whole, the long story of the pension reforms in Italy, has actually changed the sharp dynamics of pension expenditures over Gdp experienced in the past decades, as the Fig. 1 below shows. The long process of reforms has been able to reduce the future dynamics of pension expenditures, but, of course, not the high level already reached as a consequence of the generous promises of the past. After 1993, pension expenditures have been ranging around 13.5-14.5 per cent of Gdp. The slight increases in the very recent years are mainly due to the upward adjustment of the level of very low pensions, mainly assistance pensions.

As for the long term future of the pay-go system, the government forecasts show a hump shape behaviour of the ratio of expenditures to Gdp with the peak in the thirties of this century, about two percentage points higher than the current level. Some questions remain open in order to reduce that peak. They will be the subject of political discussion in the next years. The old age retirement for women, to be progressively brought to that for men (65 years), and the possibility for the individual to choose the time of old age retirement 65-67 (68?), with an actuarially fair computation of the benefit.

The decline of expenditures in the years following 2033-35 is the result of the full implementation of the new NCS. Actually, the future pay-go system is going to face a new kind of problems. The stronger flexibility of the labour market is going to produce higher volatility of the working career for the youngsters, which, on its turn, reduces the overall amount of contribution for the computation of their benefit. Moreover, given the length of the working career, the self adjustment mechanisms within the NCS produce a sustainable benefit through the reduction of the average benefit (see Fig. 2) from the 18 per cent of the output per employee to the 12 per cent. In the case that real growth declines as population declines, the question of adequacy of the absolute level of the benefit becomes the main question of the Italian pension system.

Fig. 1 Pension expenditure as a percentage of Gdp

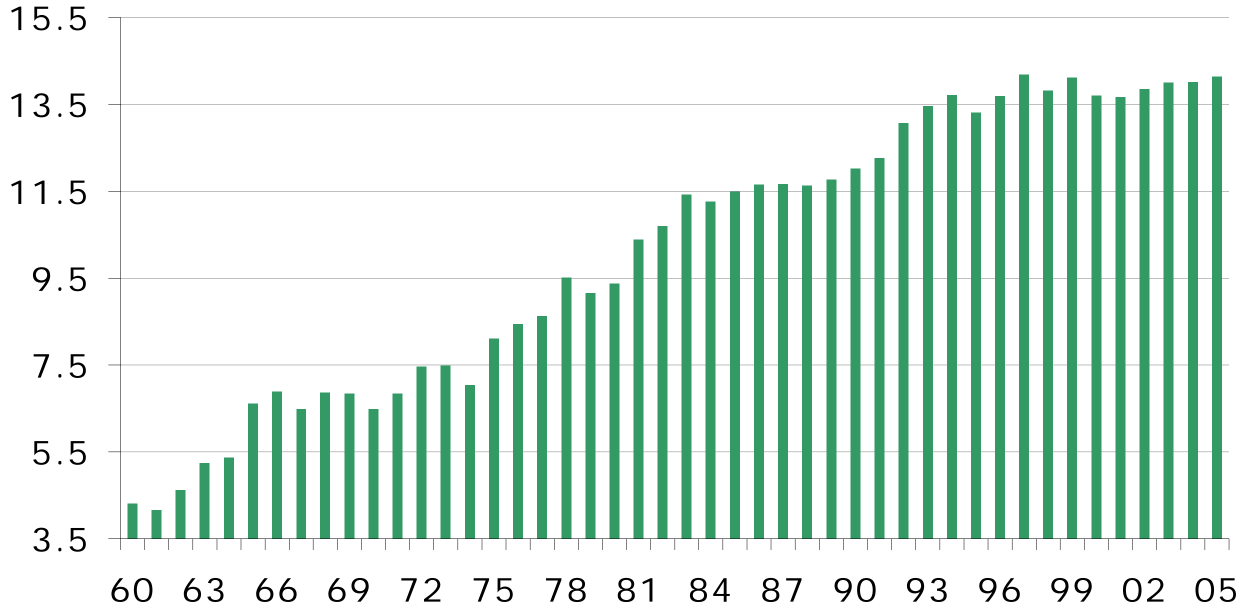

Fig. 2 The government forecast