

CRISIS, REFORM AND ACHIEVING FINANCIAL STABILITY IN THE ITALIAN PENSION SYSTEM

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Introduction

It has been common practice for industrialized nations to establish government-run pension systems to provide the elderly with income. When these systems were created in the late 19th and early 20th centuries, most elderly people had no income, so pensions afforded some income for survival. Many early pension systems were pay-as-you-go (PAYG) systems in which retirees' pensions were financed by taxing the earnings of the employed. These pensions were sustainable when the elderly constituted a small percentage of the population and the amount of time spent in retirement was short. The situation today is grossly different. Populations in highly industrialized countries are aging and birthrates are dropping. Additionally, improvements in living standards and health care have significantly increased the average amount of time spent in retirement. In view of these trends, the pension systems cre-

ated long ago are no longer adequate. Many nations, however, have not adapted to the changes in retirement patterns and as a result face serious financial and political difficulties. Italy is a prime example: it has ignored the need to modernize its pension system for decades and now must acknowledge a true crisis.

The distinguishing feature of the Italian pension system is its generosity. The benefits allocated by this system are copious even when compared with the relatively generous benefits provided by the systems of other EU nations. Prior to the reforms of 1992 and 1995, an Italian worker who retired after 40 years of service received a pension of approximately 80% of his final annual salary for the remainder of his life. This pension was also indexed to nominal wages so that benefits increased over time in relation to the growth of the earnings of the workforce. Thus, it is not surprising that Italian pension expenditure is proportionally higher than that in any other industrialized western

country. (Franco) Other factors contribute as well to the inordinately high pension expenses in Italy, including, in addition to the demographic challenges of low birthrates and an aging population, the prevalence of early retirement among Italians. Early retirement is pervasive because the pension system contains loopholes that create incentives to stop working at a relatively early age. The combination of an inherently generous system with an aging population has created a cost burden that is rising to dangerous levels.

Pension reform has always been political dynamite in Italy because of the social welfare implications for the elderly and the significant costs and intergenerational wealth transfers involved. Nevertheless, two major reforms of the system were passed in the early 1990s. In this paper, I describe the Italian pension system and the two major reforms enacted in 1992 and 1995. I then argue that although these reforms are significantly improving the pension system, they will prove inadequate when faced with fiscal and demographic trends.

Pension System Overview

An overview of the major features of the Italian pension system reveals complexity and fragmentation. The Italian pension system theoretically is built on three pillars: the first is the state-run mandatory old age insurance scheme (Brugiavini, 2002); the second is employer-sponsored collective pension funds; and the third is a system of individual retirement accounts. For most Italians the mandatory old age insurance is the only source of retirement income; therefore, the system has been characterized as having a monolithic first pillar. (Brugiavini, 2002) Collective pension funds, which are essentially limited to employees in the service, banking and insurance sectors, play a small role overall: these funds cover only 7% of the workforce. (Brugiavini and Fornero) In fact, such funds were not even regulated prior to 1992. Individual retirement accounts also play a limited role largely because the generosity of the current system reduces the incentive

¹INPS (Istituto Nazionale della Previdenza Sociale) is the National Institute for Social Security.

to contribute to personal accounts. (Brugiavini and Fornero) Because the first pillar is the foundation of the Italian pension system, it is the focus of my analysis.

The Pre-1992 System

The state-run pension plan includes mandatory old age benefits, benefits to survivors and disability insurance. Workers qualify for different pension schemes depending on their occupation. The three broad classes of employees are private sector employees, public sector employees and the self-employed. Each sector is covered by a separate fund. The largest fund is the private sector employees' fund (INPS-FPLD),¹ which covers approximately 11.7 million workers and 10.4 million pensioners. (Brugiavini and Fornero) Public employees are covered by several schemes that encompass 3.3 million workers and 2.4 million pensioners. Self-employed workers have various plans orchestrated by the INPS and cover 6.5 million workers and 3.4 million pensioners. The three primary schemes are mandatory and all provide old age and disability pensions to participants and their survivors. Nevertheless, there are significant differences between them, especially in their rules and benefit calculation protocols.

The FPLD (covering private sector employees), founded in 1919, is the largest and most important program. It was originally financed through a combination of funding and PAYG techniques but has since been converted to an entirely PAYG system.² Prior to 1992, pension eligibility began for males at age 60 and for females at age 55, provided the worker had been employed and paid payroll taxes for at least 15 years. Early retirement, known as a "seniority pension," was an option that allowed workers with at least 35 years of service to retire at any age. Under this system, benefits were earnings

²PAYG pension systems operate by taxing current workers and transferring the tax to pensioners. Thus, in a PAYG system, the workers never actually accumulate savings for retirement because their contributions are funding current retirees and their pensions will be financed by future generations of workers. ("Survey") Funded pension systems, on the other hand, accumulate an employee's contributions (in the form of taxes) and use these savings to provide a pension for that employee in retirement.

related because the benefits were computed as a function of both earnings and the number of years of contributions. Benefits were computed by multiplying 2% of the last five years' average salary by the number of years of contributions up to a maximum of 40 years. As a result, workers with 40 years of experience could receive an annual pension of approximately 80% of their final salary.

Eligibility requirements in the public sector were somewhat different in that public sector employees were granted significant perks. The normal retirement age in the public sector was 65 for both males and females but the early retirement option was available for males with 20 years and females with only 15 years of service. The formula for computing benefits was identical to that used in the private sector except that the last monthly salary was used rather than the average of the final five years. The self-employed scheme also was similar, except that the pension formula used the average of the last ten years of earnings. The retirement age for the self-employed was 60 for females and 65 for males, with 35 years of service required for early retirement. In addition, the benefits in all three systems were indexed to nominal wages (consumer price growth plus real earnings growth).

The Italian pension system has had significant redistributive features. One technique for redistribution was capping earnings used in the benefit calculations. From 1969 until 1988, there was a limit on earnings that could be used in calculating benefits. In 1988, the capping process was made less rigid by allowing all earnings to be used in benefit computation but applying a lower rate (i.e., less than 2%) to earnings above a set limit. (Brugiavini, 1997) Thus, those pensioners with very high earnings have traditionally received pension benefits that are limited compared with their contributions. The other significant source of redistribution was the minimum benefit system. This system guaranteed all pensioners a minimum level of benefits determined by the INPS. (Brugiavini, 2002) If a pensioner had computed benefits below the established minimum level, those benefits were adjusted up to the minimum.

Historical Problems

The most significant problem with the Italian system prior to 1992 was its lack of consistency and transparency. The unevenness of the system is exemplified by the disparities in the pensions of workers across different sectors: workers in different sectors were subject to the particular pension scheme for their sectors. Some sectors contained features that granted special benefits for workers of that sector. One of the more notorious features was the early retirement clause for public sector employees. As mentioned previously, public sector male employees could retire with pension benefits after 20 years of service and female employees were eligible for pensions after only 15 years. This created a significant financial liability for the system because public sector employees could retire at a relatively young age and collect benefits for a long time. The early retirement clause for public sector employees epitomized the inequity across the pension system.

The transparency of a pension system is a measure of the relationship between an employee's pension contributions and the actual pension received during retirement. A major problem with the pre-1992 system was its lack of transparency. Workers received pension benefits that were computed as a function of their earnings rather than their total contributions. Systems of this nature are commonly known as defined benefits systems. The tenuous link between contributions and benefits caused workers to view payroll deductions simply as taxes rather than as contributions to fund their retirement. (Franco) The early retirement option further distorted the link between earnings and contributions because there was no actuarial penalty for early retirees. The combination of generous benefits and the early retirement option created a significant motive for older workers to retire as early as possible. For example, in 1994 approximately 30% of men in the 60-to-64-year age group were employed compared with approximately 60% employment in this group in 1958. (Brugiavini, 1997) The structure of the pension system created an incentive to retire, thereby increasing the state's financial burden. It also appears that the gen-

erosity of the mandatory pension system discouraged household savings because workers believed their pension benefits would provide sufficient income in retirement. (Brugiavini, 1997)

Generous pension benefits and structural system weaknesses, combined with unfavorable demographic trends, have resulted in financial disequilibrium plaguing the system. In 1992, the payroll tax necessary to balance the pension system budget was estimated to be in the range of 35%–42%, but the actual payroll tax was 26.4%. (Brugiavini, 2002) This deficit had to be financed through government subsidy. A related problem was that the high payroll tax rates, although insufficient to finance pension expenditures, were sufficiently high to discourage the use of private pensions. (Brugiavini and Fornero) This inauspicious state of the system was the impetus behind two significant reforms in the 1990s.

The 1992 Reform

The first major reform, the Amato reform, was passed in 1992. The objective of this act was to reduce pension liabilities by tightening eligibility conditions and eliminating the special features that existed for employees in certain sectors. For example, the normal retirement age was raised from 55 to 60 for females and from 60 to 65 for males. Early retirement provisions were standardized by gradually raising the early retirement requirement for public sector employees to 35 years of service. Additionally, the minimum number of years of work required to qualify for a pension was increased from 15 to 20.

The Amato reform was not limited to the harmonization of rules across each sector; much of the reform was devoted to considerably amending the formula for pension computation. The modified benefit formula used the last 10 years' earnings rather than the last 5 years' earnings for employees in the public and private sectors. This change was scheduled to be phased in over a 10-year transition period beginning in 1992. The adjustment was especially significant for employees with fewer than 15 years of work experience in 1992 because

they became subject to a new benefit computation formula that used lifetime earnings rather than the final ten years. These lifetime earnings were converted into real terms, however, by adjusting earnings with the cost of living index plus 1%.

Another practice that received significant amendment was benefit indexation. Prior to 1992, benefit indexation was based on nominal wages. Nominal wage indexation is the adjustment of benefits each year according to the growth of consumer prices plus the growth in real earnings. The 1992 reform immediately eliminated nominal indexation and replaced it with a price indexation system. Under this price indexation system, benefits are adjusted by only the growth in consumer prices. (Brugiavini, 1997)

Analysis of the 1992 Reform

The reforms enacted in 1992 were successful in decreasing the liabilities of the pension system. Economists estimate that at least 25% of net pension liabilities were cancelled by this reform. (Franco) The reform also was valuable because it initiated a general harmonization of pension rules across the different segments of workers. The elimination of special rules, such as the early retirement provision for public sector employees, not only reduced costs but also increased the equity of the system. Although the reformed system was still an earnings-related system, the use of adjusted lifetime earnings in benefit calculation reinforced the link between contributions and benefits. Furthermore, because the Amato reform used lifetime earnings for benefit calculation, it eliminated the original system's bias towards workers whose earnings increased near the end of their careers. (Franco)

One amendment that has had substantial effects was the switch from wage indexation to price indexation. This change immediately reduced pension liabilities because of the resulting smaller annual pension adjustments. (Brugiavini, 2002) This is because, under the original system, pensioners' benefits were increased by the growth in consumer prices plus the growth in real wages whereas, since

1992, benefits have been adjusted by only the growth in consumer prices. Although price indexation reduces pension liabilities, it also means that the purchasing power of a pensioner drops over time relative to the purchasing power of workers and younger pensioners. (Brugiavini, 2002)

Although the 1992 reform successfully reduced pension liabilities, it failed to address several critical areas. The special early retirement conditions (20 years of service for men, 15 years for women) for public sector employees were eliminated but employees in all sectors still retained the right to retire after 35 years of service without any actuarial reduction of their pension. This was a serious concern because the availability of early retirement undermined the increase in retirement age. That is, increasing the standard retirement age to 65 for men and 60 for women was ineffective in delaying retirement because workers could circumvent the new age requirements simply by retiring early. (Franco)

The most significant limitation of the Amato reform was that many of its components required a long transitional period, so that the benefits could not be immediately implemented. For example, the change to a lifetime salary average for benefit computation only applied to those with fewer than 15 years of service as of 1992; a substantial portion of the population was unaffected by much of the reform. The full impact of this reform could not be realized until years later.

Despite its shortcomings, the 1992 reform was the first major reform to reduce pension liabilities and to attempt to achieve financial equilibrium. It was particularly important because it brought to light the challenges facing the pension system and opened the door to further reform. The 1992 (Amato) system will never achieve a steady state, however, as it was replaced by the Dini reform of 1995. (Brugiavini, 2002)

The 1995 Reform

The 1995 Dini reform sought to improve the viability of the pension system in a fundamentally different way. Its primary objective was to create a contribution-based pension scheme

that would both decrease pension expenditures and increase equity. (Franco) The Dini reform created a system known as a notionally defined contribution (NDC) system. The system is so named because workers contribute throughout their careers, notionally accumulating rights to a retirement account. Then, at the time of retirement, that value is converted into a lifetime annuity according to actuarial criteria. (Brugiavini and Fornero) The system is notional in the sense that it uses a benefit computation protocol similar to that of a funded system but retains its PAYG financing. Contributions from the currently employed pay the retirees' benefits. The pension benefits are calculated as a function of the individual's lifetime wage profile, length of employment, retirement age and the growth rate of the economy. (Brugiavini and Fornero)

The Dini scheme addresses early retirement by eliminating the standard retirement age and creating a flexible retirement age of 57 to 65. Equity of benefits is ensured by applying actuarial adjustment factors to account for the age of retirement in benefit computations. A person who chooses to retire at age 57 receives a smaller pension than if retirement is delayed, because that person has reduced his or her total pension contributions and increased the amount of time spent in retirement. The Dini reform eliminated seniority pensions for those entering the workforce after 1995 and gradually abolished the practice of traditional early retirement that was still available to older workers. Finally, the Dini reform lowered the minimum number of years of contribution to receive a pension from 20 (under the 1992 reform) to 5.

Current Analysis

The Dini reform is important because it built on the improvements of the 1992 reform. The switch from a defined benefits system to a defined contribution system greatly enhanced the transparency of the system.³ The 1995 reform also created a more equitable system because it reduced the number of redistributive

³As noted, the system retains its PAYG financing but pension benefits are calculated using the sum of all contributions to the notional pension fund.

elements. For example, the 1995 reform established a cap on earnings subject to contributions. This is an equitable method of capping benefits for high earners. (Kidric and Stanovnik) Prior to this, there was no cap on contributions but benefits were effectively capped because earnings above a certain level factored less heavily in benefit computation. The Dini reform also eliminated the guaranteed minimum pension level. Most of the social assistance functions previously administered through the pension system were delegated to the central government. This restricting of pension expenditures to retirement and disability payments limited the degree of redistribution and, consequently, tightened the relationship between employee contributions and pension benefits. (Brugiavini, 2002)

The reforms of 1995 will, in theory, ameliorate many of the problems inherent to the historical system. The increased transparency should foster a stronger incentive to work longer and retire later because benefits are explicitly related to total contributions to the notional pension fund. The Dini system reduces the incentive for early retirement, a recently pervasive phenomenon, by ultimately holding employees more accountable for their pensions. The incorporation of actuarial factors is a breakthrough for a system that previously never penalized early retirees. The Dini system establishes an appropriate protocol for adjusting pension benefits according to retirement preferences. It also provides protection from certain economic and demographic shocks because it incorporates GDP growth rates and life expectancy estimates in the computation of pension benefits. If, for example, there is an increase in average life expectancy, it is accounted for in the benefit calculation formula and pension benefits can be adjusted accordingly. The 1995 reform is, at least on paper, significantly more equitable and uniform than any previous system.

Even though this Italian pension system is much improved, it remains beset with inadequacies that undermine its efficacy. One major flaw of the 1995 reform is its long phase-in period. In fact, an estimated 40% of the current workforce will retire under the pre-1992 formula for benefit computation because those

workers with at least 18 years of service in 1992 will receive pensions based on the pre-1992 system. (Franco) Those employees with fewer than 18 years of service in 1995 will receive their pension pro rata, calculated as two different benefits: one based on contributions before 1995 and one based on contributions made in 1995 and thereafter. Only workers who began working after 1995 will have their entire pension calculated under the 1995 rules. (Franco) There is little doubt that the 1995 system is significantly more transparent than those developed in previous regimes. Yet the current system, an intricate conglomeration of three different systems, is convoluted and difficult to decipher. It will not be until the 1995 system is fully phased in that a high level of transparency will be achieved. Hence, the long phase-in period temporarily reduces the efficacy of the 1995 reform. (Brugiavini, 2002)

The 1995 reform has potential weaknesses other than its protracted phase-in period. There is controversy regarding the effectiveness of the actuarial coefficients in delaying retirement. The actuarial calculations are used to adjust benefits according to the age of retirement so that an individual retiring at age 57 receives a lower benefit than if retiring later. According to Brugiavini and other experts, the current actuarial factors do not exact a penalty sufficient to discourage early retirement. (Franco) As a result, workers are willing to accept moderately lower pensions in exchange for longer time in retirement. Another frequent criticism of the 1995 system centers on the adjustment factors for life expectancy, updated only every 10 years. This is judged as too infrequent to account for changing life expectancies. (Kidric and Stanovnik) This problem could be corrected by simply updating the tables more frequently.

The most pressing issue facing the pension system now, in 2003, is its financial imbalance. The Dini system, once fully phased in, will improve the balance between pension obligations and revenues. This system, however, because it employs PAYG financing, will always be vulnerable to demographic shocks. (Franco) All PAYG pension systems face financial troubles when birthrates decline, as fewer young people are paying the pension costs of older

workers. This is the exact situation that Italy is now facing. All the reforms to this point have been extremely helpful in improving the structure of the pension system and in reducing costs, but a serious problem remains in that the extant system is running a deficit and demographic projections are unfavorable for the next several decades. Numerous models have been used to predict pension expenditures and, based on these predictions, the Italian Treasury reports that the pension expenditure to GDP ratio will continue to increase until between 2030 and 2035. (Brugiavini and Fornero) After this time, the pension expenditure to GDP ratio is expected to decline moderately. Nevertheless, it is evident that the pension deficit will only increase over the next 30 years and, therefore, immediate intervention is necessary.

One simple solution is to increase payroll taxes to help finance current pensions. The inadequacy of this solution is that an increase in the contribution rate for existing employees translates into higher benefits later when these employees retire. An ancillary obstacle is that increasing the already high payroll taxes would

make Italian labor even more expensive, potentially making Italy less economically competitive. (Brugiavini, 2002)

It appears that Italy's present situation will require sacrifice on the part of older workers. Unless Italy is prepared to finance pension deficits by accumulating national debt, there will have to be a reduction of pension expenditures to equilibrate finances. The source of this expenditure decrease would have to come from the reduction of benefits. The immediate implementation of the Dini regime is one means of reducing current liabilities. Ferraresi and Fornero estimate that this course of action would trim pension expenditures by 0.8% of GDP in 2020. (Franco) The underlying problem is that any reforms attempting to reduce the pension levels of pensioners or workers nearing retirement are met with hostility, for changing the rules of their accumulated entitlements late in the game. Yet, for Italy to overcome its immediate problems, current pension expenditures must be diminished, even if that requires treading on politically sensitive ground.

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