The Italian pension system

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THE BEGINNING OF THE REFORM PROCESS

Italy, among the European countries, belongs to those countries that have most profoundly reformed their pension systems. Italy, probably, had more need for reform, not only because of demographic and macroeconomic trends, but also because of the existing regulations – characterised by a profound difference in the treatment of workers in different sectors.

The decisive push towards an initial reform came about, however, only with the monetary crisis in September of 1992 and with the need to begin the process of balancing the public accounts that was imposed by the Treaty of Maastricht. The reform process, brought about in successive phases during the nineties, was strongly conditioned, therefore, by the need to control public spending in order to reduce the annual deficit.

The need for financial sustainability of the pension system, and the adequacy of the system to avoid social exclusion and to maintain an adequate lifestyle after retirement are factors that have, however, often entered into conflict.

THE EXISTING IMBALANCES

The demographic trend, specifically the ageing population, was and is the first reason for the difficulty of the Italian pension system.

Alongside the demographic reasons there are also the macroeconomic ones. The relationship between pension expenditure and the gross domestic product is, in fact, linked to the growth of the national income: the strong slowing in growth brought about by monetary policy and by restrictive budgets makes it more difficult to keep a stable relationship between pension expenditure and the gross national product.

The increase in unemployment, the increase in illegal employment, as well as the proliferation of irregular workers provoked a decrease in the sources of financing. Moreover the existing pension system, before reforms, was characterised by particularly "generous"
regulations and by strong diversities – for the calculation of pensions, for the access age to a pension, and for the contribution rates – between the diverse and numerous pension schemes. These differences produced replacement rates and rates of return that were noticeably different, and this, in turn, created privileged positions and inequality not only among workers of the different pension schemes, but even within each schemes.

THE REFORM PROCESS

The reform process that is underway has noticeably changed this situation, and has brought control over the dynamics of spending, as well as greater financial sustainability and greater equity among workers.

The analyses recently completed by government commissions has confirmed that the saving targets proposed by various laws of the reform have been reached, and that the current trend is towards a stabilisation of the ratio between expenses and the gross domestic product. However, medium-long term forecasts by government organisations remain negative. The microeconomic effects produced by the reform have also been important.

The pension system retains the pay-as-you-go mechanism in the compulsory public part, but pension calculation is linked to paid contributions and includes the entire working life of the person. While retaining pay-as-you-go financing, the system works, in the calculation of a pension, as if it were a funded pension, insuring a correspondence between contributions that have been paid during an entire working life and the pension granted.

The value of the pension is, furthermore, determined by the retirement age with the introduction of a direct link between the value of the return and life expectancy. There is, therefore, an incentive to continue working for a longer time, but there is also the possibility for the worker to choose when to retire.

The retirement age has been raised and a minimum age for early retirement has been introduced.

The system of adjusting pensions according to economic growth and prices has been reduced or eliminated.

The pension systems for public and private workers have been made much more similar among the different pension schemes.

A voluntary funded system has been introduced to flank the public compulsory pay-as-you-go system.

The new pension system is, therefore, profoundly different from the previous system; it is more sustainable from the financial point of view and is characterised by greater equity among workers.

There are still numerous problems connected, on the one hand, to the dynamics of spending in the period necessary before the new system fully enters into effect, and on the other hand, to the ability to insure adequate pensions in the future.

Maurizio Benetti
THE LINK TO THE ENTIRE WORKING LIFE

One of the most important structural measures has been the introduction of a link between the pension and the entire working life. This bond establishes a more correct relationship between pensions and received salaries (or paid contributions). The new system eliminates the existing distortions in the preceding system, which was based on last few working years, but reduces pension coverage in comparison to the last salary, from a value equal to 70-80 per cent before the reform to a value between 55-65 per cent.

The replacement rate is an especially important indicator, above all, for those who depend entirely on their salary for their needs, and afterwards depend entirely on their pensions. A high replacement rate assures the possibility of maintaining the same level of income and consumption achieved at the end of one’s working life; a lower replacement rate produces a fall in income at the moment of retirement. For this reason the reform introduced a second pillar of pensions on a voluntary basis in a funded system. When you add the coverage ratio assured by the compulsory public system to the voluntary, private, funded system, the pension level should not be that different from the levels before the reform. These estimates still have the long and regular careers of employees as a reference point, even though today the labour market is characterised by the more widespread presence of "atypical" workers, both in terms of contracts as well as for types of careers.

In the next few years, given the trends present in the labour market in terms of contract types and mobility, there will probably be an ever-increasing number of workers with overall contribution periods that are shorter or irregular. In this case the coverage percentage assured by the public pension will be markedly lower. Pensioners with significantly reduced pension levels, levels not sufficient to assure an adequate income, would typify the pension situation.

A supplementary pension cannot resolve the situation for these kinds of workers, at least for a part of them. This form of pension, in fact, requires contributions, and these workers, given their salary levels, probably do not have the necessary resources. Tax incentives are useful and necessary, but they refer, above all, to those who have sufficient incomes – those who can pay the contributions and those who can take advantage of tax benefits.

In fact the scheme adopted in these years, less public pension coverage and integration with a funded pension, appears valid in a labour market characterised by the presence of "regular" workers; those workers who have sufficient income resources in order to integrate the public pension with the funded one. However this solution does not appear adequate to guarantee an adequate pension for "irregular" workers; this applies to both a public pension, given the irregularity of contributions, and to a funded pension, given the lack of sufficient income to pay for it.

THE LINK TO RETIREMENT AGE

A factor of actuarial imbalances in the previous system was a result of the possibility of retiring at different ages, corresponding to the number of years actually worked, without having any effect on the pension level.
Who can retire, according to the period of contributions, at an earlier age can benefit from the pension income for a longer time; if the pension level is not connected to age, the younger pensioners take advantage of the higher rates of return.

The introduction of retirement flexibility between 57 and 65 years of age in the system of contributions, but with returns that correspond to the person's age, has eliminated this situation, introducing a reduction in the pension income when the pensioner retires at an earlier age. All of this has made the Italian pension system more equitable on the actuarial level.

There are exceptions to this "equity" related to reasons of "solidarity": these reasons refer to women, disabilities, and early death.

The level of pensions, contributions and retirement age being equal, is the same between men and women, even though women have longer life expectancy. The reform, in fact, acknowledges that the role of the woman in the family and in child rearing justifies this exception to pure actuarial equality.

A similar action was taken for cases involving disabilities and early death in which a straight calculation of pensions based on paid contributions has been avoided. Also in this case general solidarity prevails over actuarial equity.

The pension system is, therefore, certainly more fair, even though the connection to life expectancy presents some problems. In this way less-qualified workers are treated unfairly and receive lower pensions.

The adoption of coefficients linked to retirement age favours workers who, after a long training period, enter the labour market at an older age, in comparison to those who enter the labour market earlier. In order to enjoy a conversion rate that is equal to the first group, these workers have to work for a longer period. If we compare the late entry into the labour market with a higher salary, the result of a longer training period, to the early age with lower salaries of unskilled workers, it becomes clear that this method of calculation requires less skilled workers to work for a longer time in order to have the same conversion rates.

Furthermore, the calculation of pensions in terms of life expectancy refers to the entire population. If the differences in life expectancy, based on different professions, are not insignificant, the adoption of equal transformation coefficients creates in reality higher return rates for those who can enjoy longer life expectancy.

If unskilled workers have a shorter life expectancy, which is probable, not only do they have to work longer to have the same conversion rates, but they will also have an lower return due to the shorter period in which to enjoy the pension.

SOLIDARITY

Differences in rate of return among different subjects of a pension system is not always negative: there can certainly be valid political-social reasons that justify giving an advantage to particular categories of workers, who are held to merit special attention.

Maurizio Benetti
This is the case of women, for example, by virtue of their role in the family, but it may also be extended to workers who have dangerous and physically debilitating jobs. What is important is that this consideration, and therefore the different rate of return, is explicit and motivated, otherwise the system remains characterised by arbitrariness, by randomness, and/or by unjustified privileges.

Italy’s public system is characterised by a high degree of solidarity, in terms of both each pension schemes, thus among the contributors to such plans, and state intervention. In fact, state transfers flow through the proper channels to cover part of the benefits; such cost is borne by the collectivity as a whole and accounts for 16 per cent of total pension spending.

The transition from a mandatory pay-as-you-go system to a mixed one, involving a funding component, raises a number of questions concerning the preservation of this solidarity. In fact, in defined contribution schemes pension benefits are related to contributions paid and there is no internal solidarity; contributors would be required to join supplementary pension plans. Furthermore, there is no solidarity by the collectivity through state transfers. In absence of policy changes, the greater the reliance of a pension system on funding schemes the lower the level of solidarity.

Those who will suffer the consequences will be women and workers, especially those who are in a weaker social position or are subject to negative events. Actuarial equity is certainly a fundamental element for the sustainability of a pension system, but it should not be the only basis of a pension system: a high level of solidarity is necessary to avoid social exclusion and to realize an equity that takes different social situations into account.

INDEX-LINKING OF PENSIONS

The existing index linking of pensions to an index represents an element that might trigger a future "crisis".

Once rights are vested, the initial pension payment cannot be modified, though the sum the pensioner receives throughout the retirement period may vary when the type of indexation is changed.

A pension, in fact, is not a lump-sum payment but it is a flow subject to change, depending on the type of indexation; under the different public and private schemes, pensions may be indexed to such variables as prices, yields on financial markets, wage changes, contribution changes, among others.

By changing the type of indexation, the flow is modified over the relevant time horizon, resulting in a change in the "overall" pension amount. This is a significant and compelling problem, since adjusting pensions to price changes alone is a tool, within the context of reform in Italy, to keep pension spending in check. However, price indexing alone fails to provide adequate protection to the purchasing power of pensioners. A change in pensions lower than a change in average income and/or wages causes pensioners to be relatively worse off compared to the other members of society.
Price-indexing alone would, over time, determine the relative impoverishment of pensioners, as these would be excluded from the redistribution of increases in national income.

In the long run, if pensions do not keep up with wage growth, their value will be impaired to a substantial extent. Within 10/15/20 years from retirement, these losses can reach 20/30/40 percent.

Actually, impoverishment at that point will not only be relative, it will be absolute as well, given the lower replacement rates; this would be highly risky, as there would be a significant increase in poverty and social exclusion.

**RAISING OF THE RETIREMENT AGE**

The problems determined by population ageing may be countered by raising the retirement age.

The summit conferences in Lisbon and Barcelona brought to light the need to raise the rates of activity and employment by raising of the retirement age.

The postponement of the "legal" retirement age and the increase of the employment rate are not necessarily correlated. Over the past few decades, in many industrialised countries raising the "legal" retirement age has been matched by an actual decline of the "effective" retirement age.

This is due to the downsizing of some productive sectors and to the trend to expel workers over fifty years of age from the labour market.

Many countries have adopted measures designed to mitigate the negative consequences of these situations, resulting in a lower actual retirement age. In some cases, high legal retirement ages go hand in hand with high unemployment rates for older citizens.

Data on European activity rates by age group show that Italy has the lowest activity rate in the group from 50 to 64 years of age, or 40 per cent, as opposed to an average of 53.1 per cent for the EU. While negative, this figure should be set against a 4.6 per cent unemployment rate, for the same age group, a level significantly lower than the average for the European Union, or 7 per cent, and much lower than those in countries such as Germany, 10.9 per cent, Spain, 9.4 per cent, or France, 7.6 per cent.

High activity rates for the population over fifty do not entail necessarily high unemployment rates, as demonstrated by Holland, Denmark, United Kingdom and Sweden; on the other hand, a higher activity rate does not necessarily lead to higher employment levels.

In different countries, as already noted, setting a retirement age at 65 determined a higher unemployment rate for workers over fifty.

Italy is characterised by low activity rates, compared to the European average, particularly for women and the population over fifty. Increasing these rates, then, is a priority.
Italy is characterised also by a low unemployment rate for the population over fifty; this is due mostly to the possibility to retire before reaching the minimum age to qualify for old-age pensions without losing anything; in fact, mechanisms intended to discourage such early retirement practices will come into force in ten years, with the first pensions computed with the new system.

Furthermore, Italian companies utilize "inappropriate" early retirement practices, which make it possible to lower even further the minimum retirement age from 57 to 54. Early retirement is often a tool used by firms to mitigate the effects of the layoffs of "obsolete" and/or costly employees and, simultaneously, an instrument to protect such workers.

These scenarios raise, therefore, the problem of older workers who risk unemployment. The tendency of companies to dismiss these workers and the raising of the retirement age are two phenomena that can contradict each other.

Youth unemployment is clearly a serious problem, but old age unemployment can be worse, certainly from the point of view of exclusion from the active world, and often, because of inadequate means of support, exclusion from the point of view of income as well. Early retirement pensions are an improper tool to cope with this problem.

The raising of the retirement age as indicated by the objectives of Lisbon and Barcelona, however, if activated without any intervention in the way in which older workers are excluded from the productive processes, could well produce a rise in the unemployment rate for the over fifty-year olds; this would be accompanied by a dramatic problem of missing income for the excluded workers, especially in the absence of "strong" alternative forms of protection.

CONCLUSION

Financial sustainability is a fundamental element in any pension system. However, the capacities of the system to prevent social exclusion and to insure an adequate income during retirement are just as fundamental.

The current labour market makes it more difficult to achieve these objectives. Job flexibility is held as an important condition if national economic systems are to be both competitive and efficient, above all in advanced countries. To ignore or to underestimate this tendency would be mistaken. On the other hand, in light of these changes, a system of pension financing, as well as social welfare systems in general, that is based solely on salaries would be equal to a progressive reduction of pension benefits and of social protection due to a lack of resources, and would lead to a redistribution of income that is contrary to the principle of social cohesion.

Job flexibility and funding on a contributive basis creates, in fact, a significant risk of income variability in the lives of workers, a risk they face alone. It is necessary to ask, therefore, if and how we can share this risk among all those who benefit from the advantages of flexibility. This means, therefore, to reconcile on one hand the demands of companies and of the labour market, while, on the other, to not neglect the forecast that the contribution system, made up in large part by workers, might prove to be insufficient when it is fully functional. The widening of the financial basis, no longer dependent exclusively on salary contributions, appears to be the strategy to follow in order to have the resources that are
necessary to insure fair and effective pension services, as well as making the system financially sustainable.