Why financial literacy is a fundamental ingredient for pension reforms

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Research Education Outreach CCA

Structure

1. *FinLit and (Economic) Reforms*
2. *A case in point: the pension reforms and its rationale*
3. *Why reforming pensions is politically so difficult*
4. *The role of basic financial education*
5. *A "new paradigm"?*

1. Fin Lit and Economic Reforms

- Reforms are not "*deus ex machina*" problem-solvers but "*social drivers*", meant to change people's attitudes, plans and behavior
- They require acceptance/"care" by (the majority of) people, who must be able to assess reform-related costs and benefits, now and in the future, for themselves/their family
- This is particularly true of reforms intended to alter individuals' life cycle, such as pension and labor market reforms
- *FL* is not a sufficient condition for the success of reforms; illiteracy can thwart their effectiveness by exerting pressure on politicians to either establish an excessively long phase-in or undo reforms approved by a previous Gov
- *FL* can help view the reform as *social investments*, involving immediate costs in exchange for likely future benefits.

2. Pensions, Pension systems and Reforms

- **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)**

  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 contribute to *reduce inequality* (social goal)
  - compulsory participation and (usually) **Pay-Go** financing
  - *integrated by* private accumulation: (financially funded) pension funds, individual plans, personal wealth

➢ ***Risks are pervasive in both the micro and macro dimension***

Pensions in society: macro foundations and challenges

A PayGo system involves **a social compact** between the "the young" (*working population)* who pays contributions which finance benefits for "the old" (*retired)*

- **Demography**

Ageing causes an increase in ***old age dependency ratios*** which threatens the financial sustainability/adequacy of systems

- **Growth**

Lower growth/higher unemployment rates (some European Countries) reduce the (equilibrium) "*internal rate of return*" and increase the *dependency ratio;* no clear evidence of a negative effect of age on productivity, but less innovation, ambition, initiative

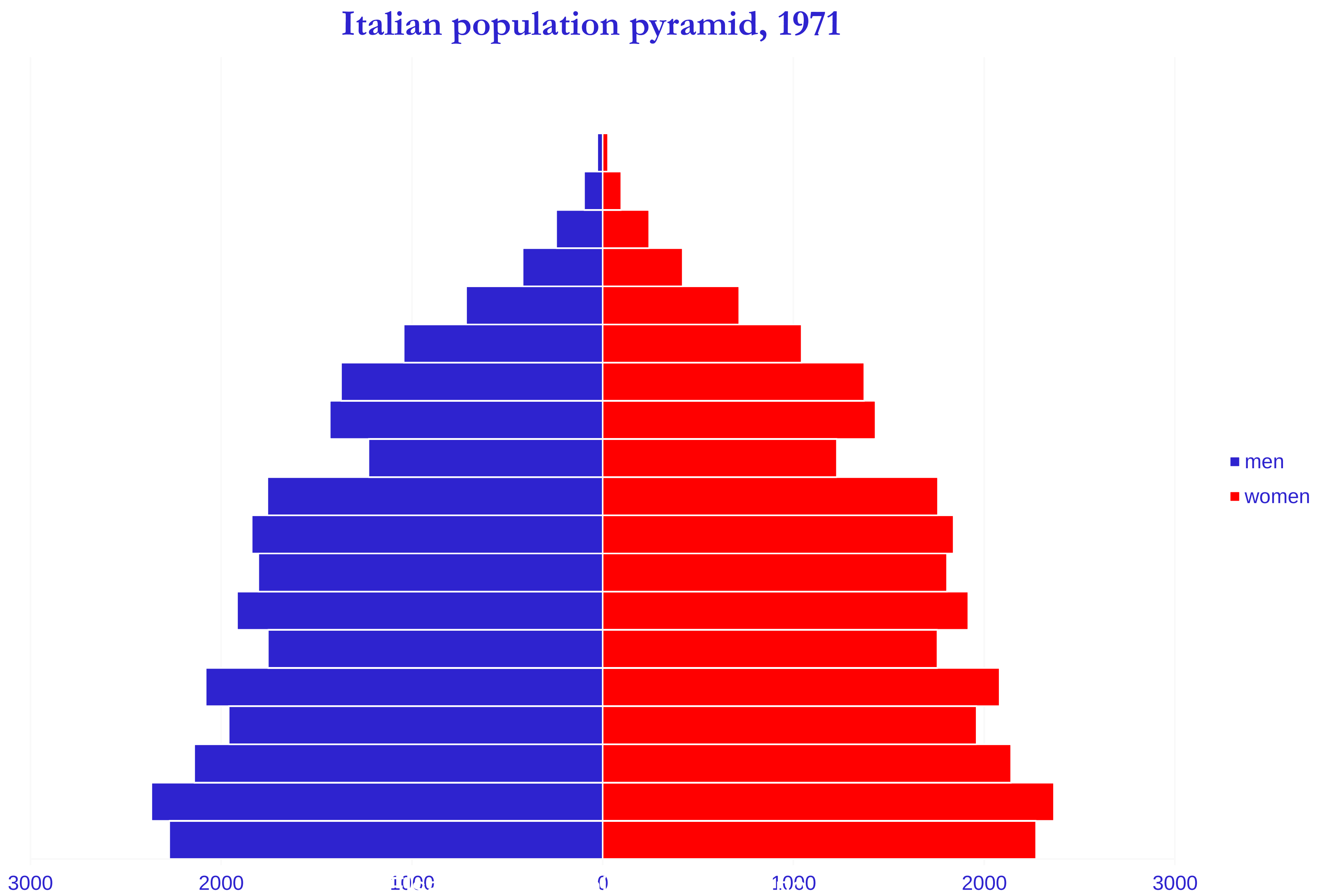
- **Politics**

Determines the rules favoring generations/categories having higher electoral weigh

The rationale for pension reforms

- *The demographic transition* - declining fertility/increasing longevity/pop. recession - challenges the PAYGO sustainability
- *Lower growth rates and higher structural unemployment* reduce the ***irr***
- Effects of the green transition, digitalization and IA on productivity and employment?
- *Implicit pension debt:* pervasive political intervention & rather loose pension formulae increased promises, privileges and social runs up
- *Greater uncertainty & Black Swans* (financial crisis, Great Recession, COVID-19, wars) have reduced and made financial returns more volatile casting doubts on *their stochastic dominance over GDP growth rates*.

The demographic challenge (the case of Italy)



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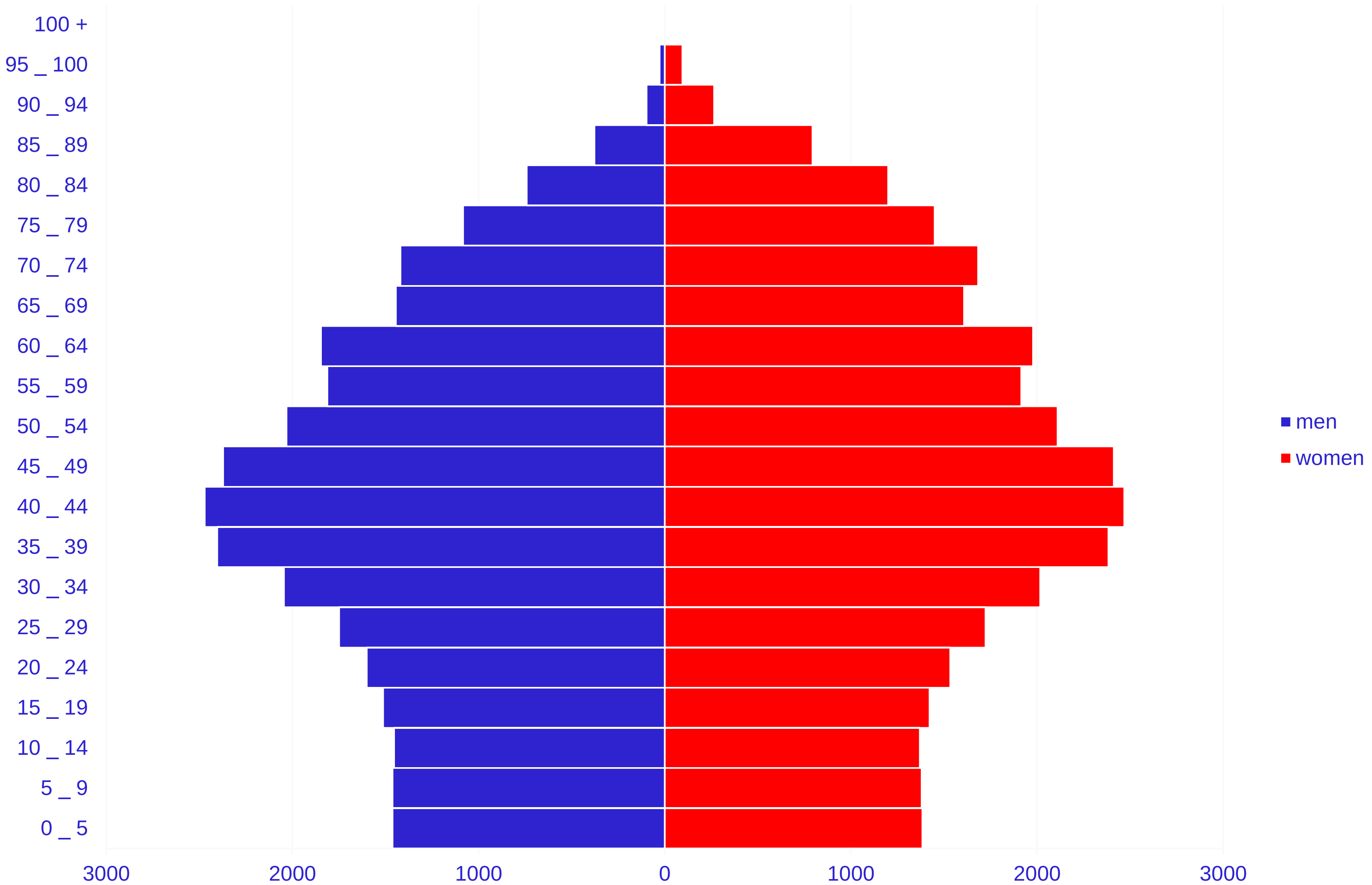
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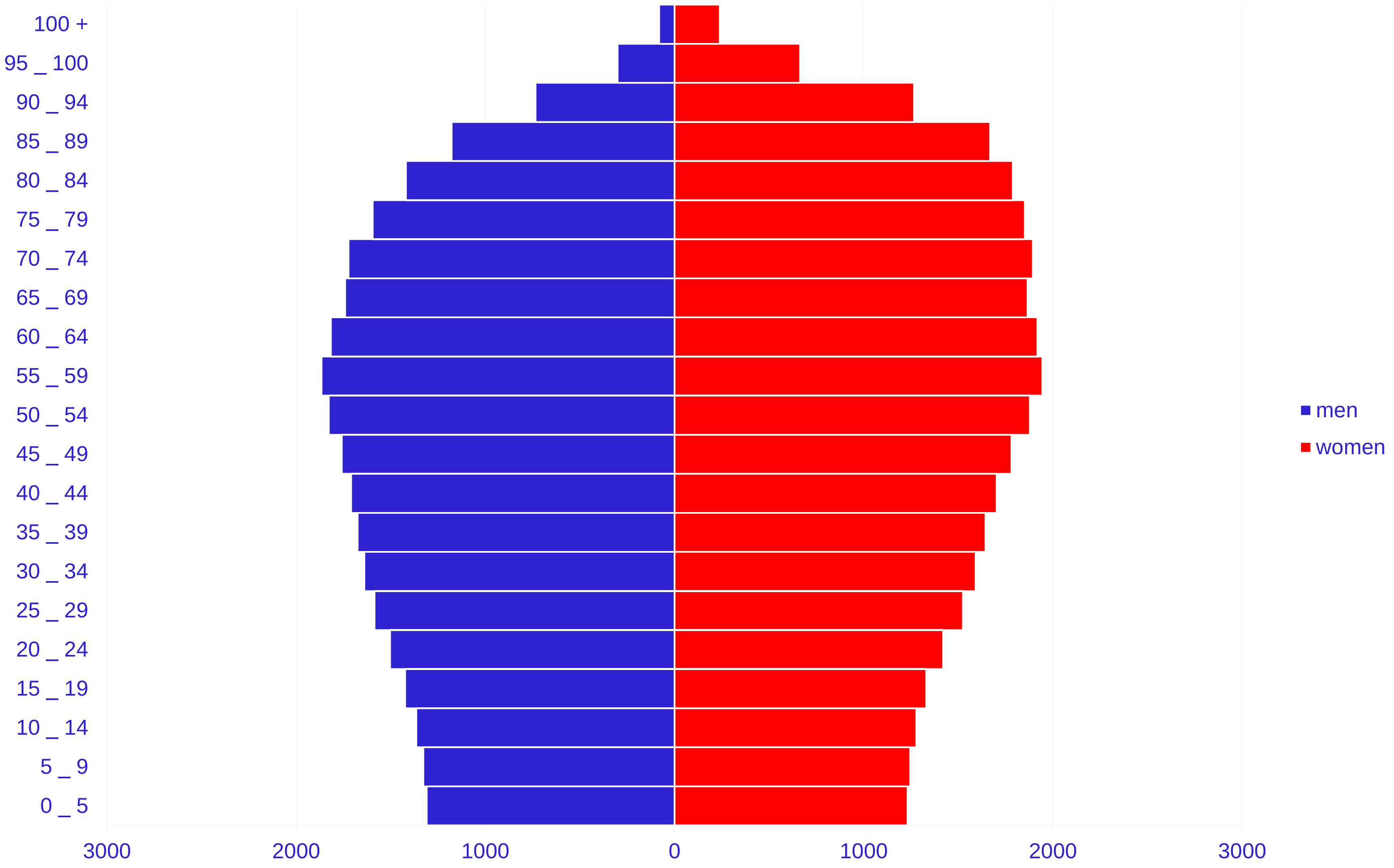

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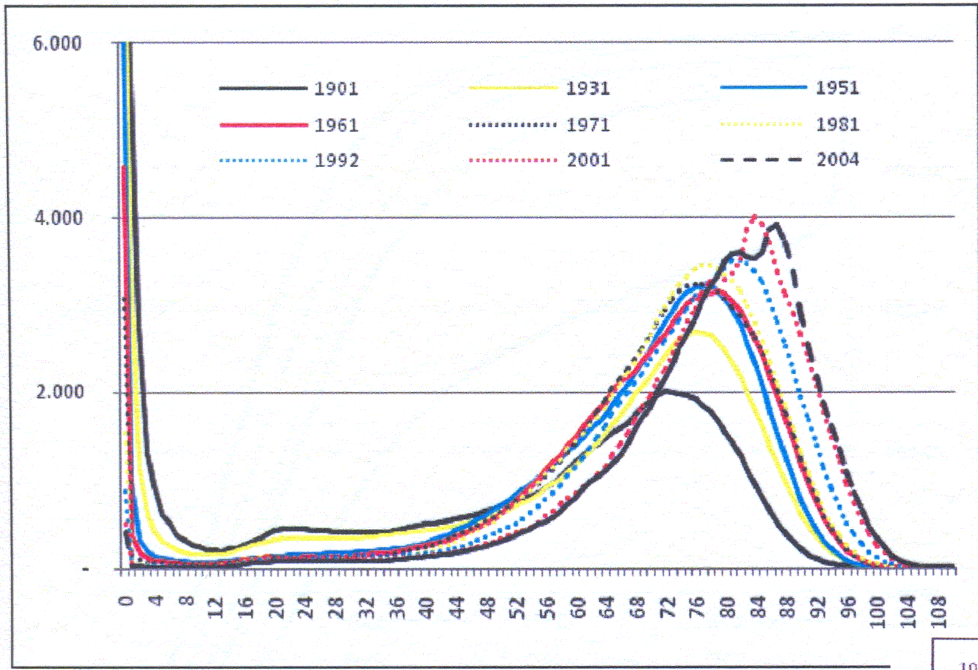
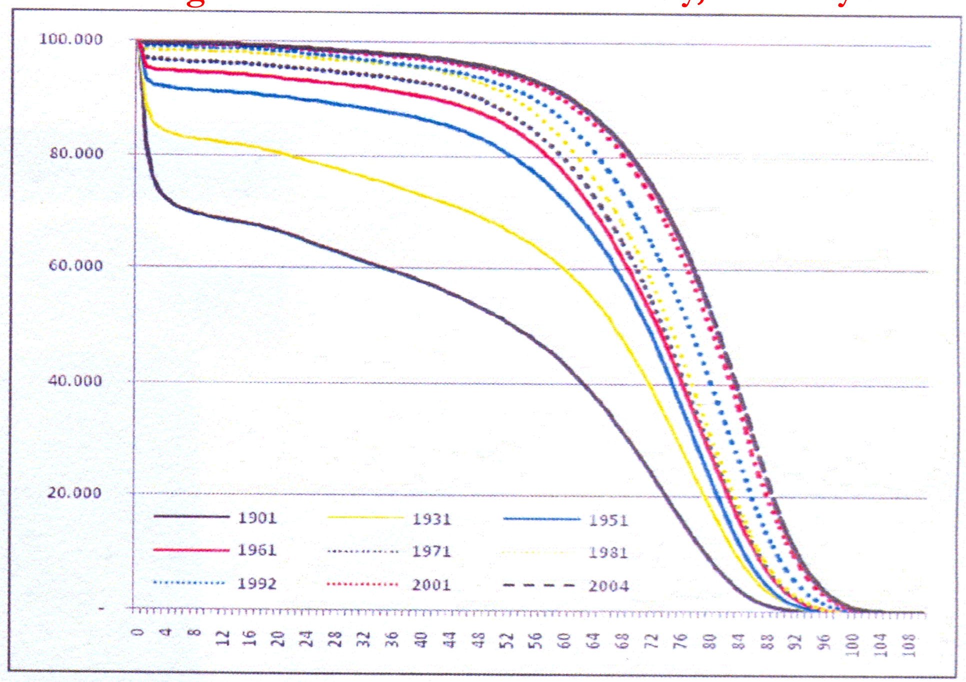


Demographic changes (1)
Figure 1 –- Deaths curve – Italy, various years

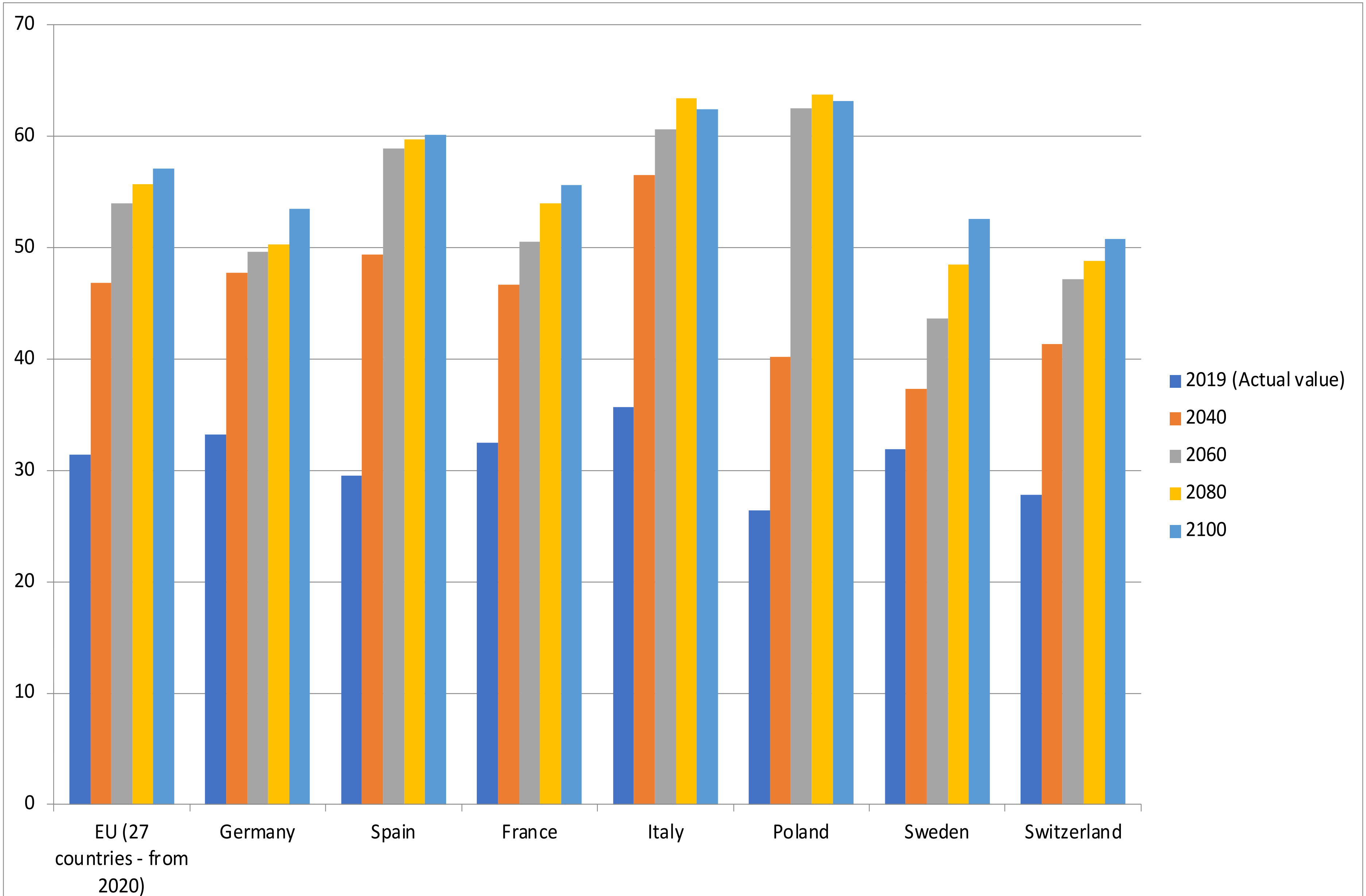
Demographic changes (2)
Figure 2 – Survival function – Italy, various years



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
2022	1.24

The consequence: old-age dependency ratios
(Eurostat 2019)

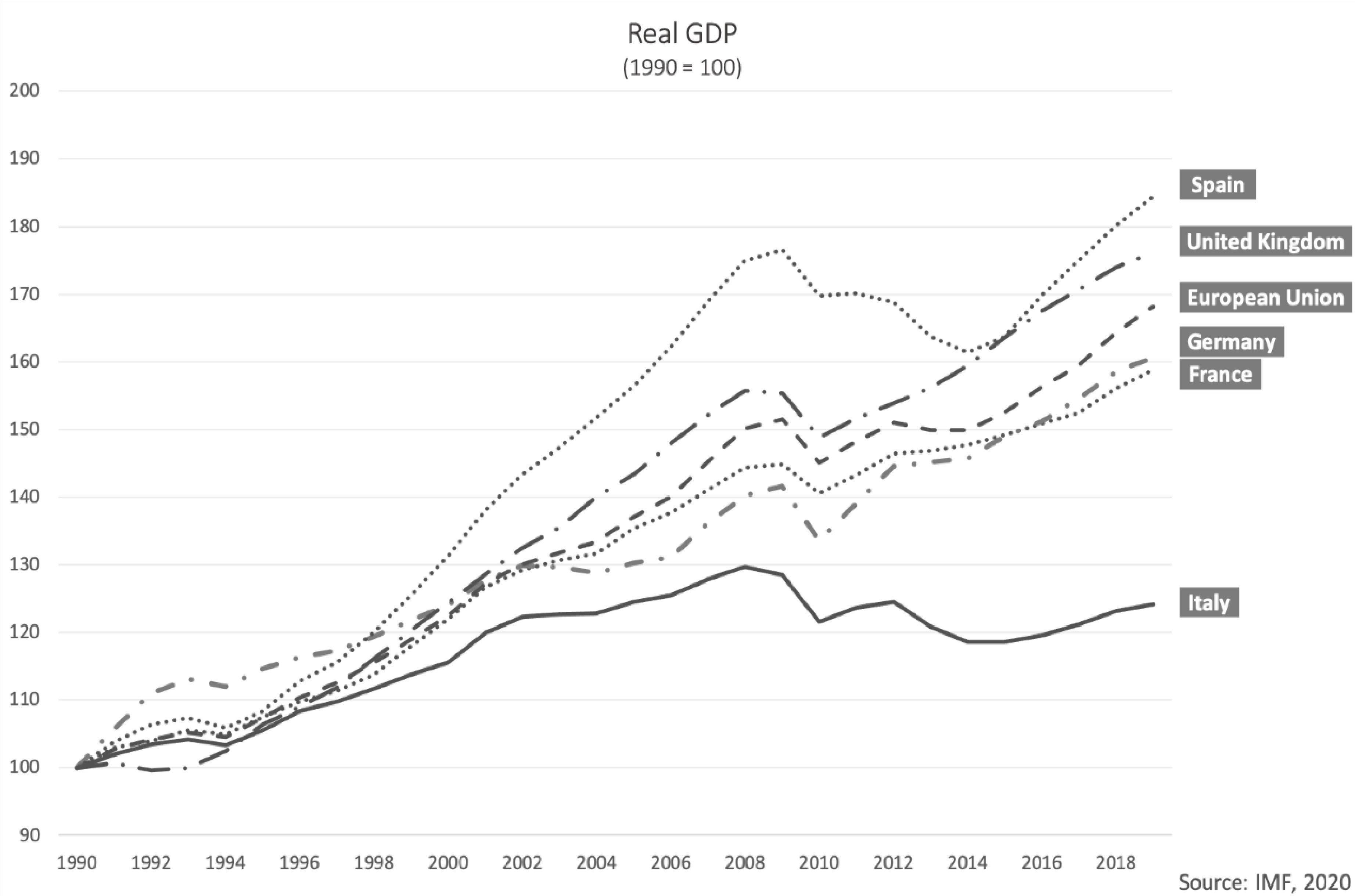


The economic challenge

Poor risk diversification, reduced growth and increasing *economic* dependency ratios

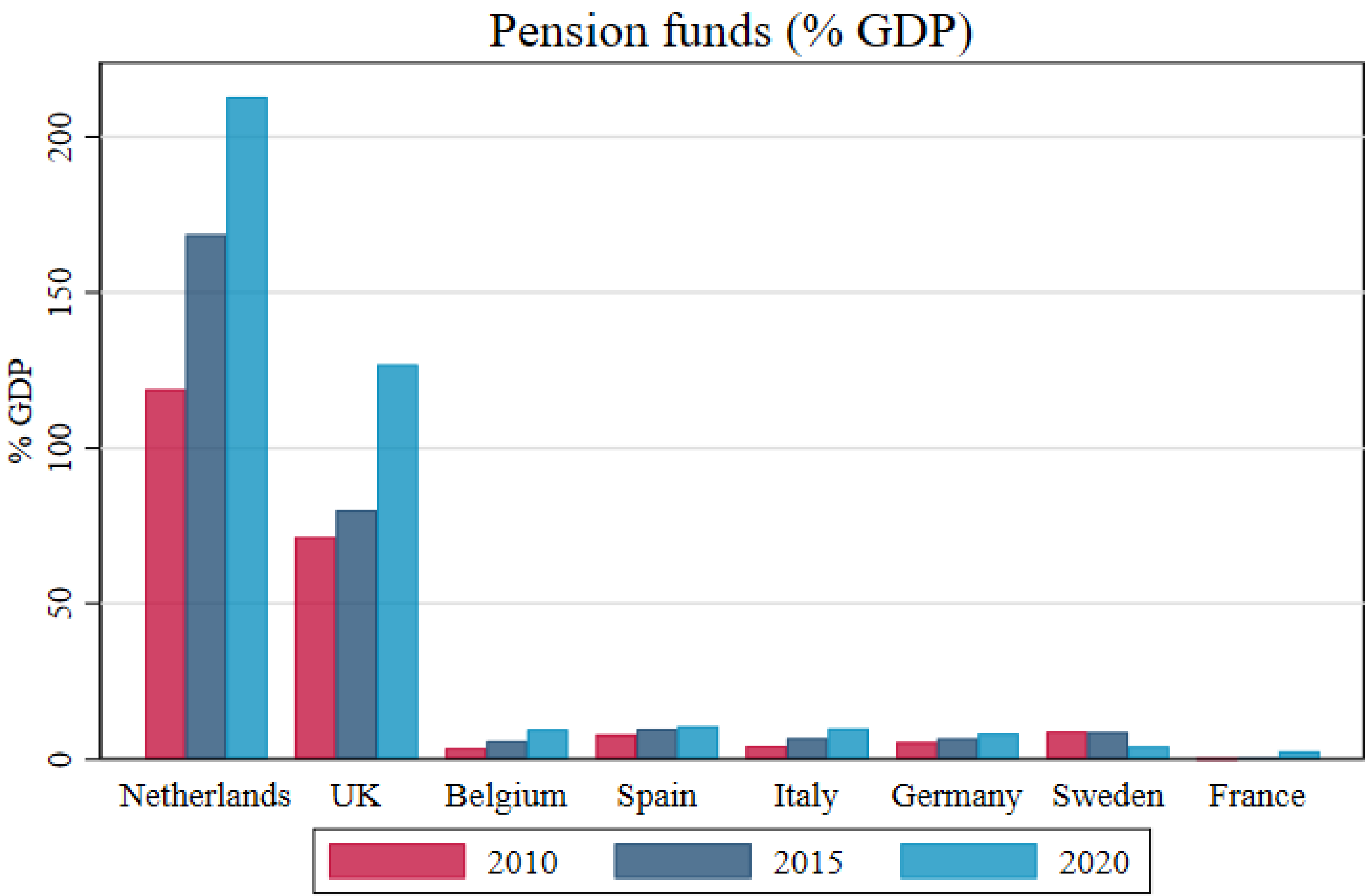
- The unsustainability of pension systems does not depend only on demographic trends
- The GDP growth rate (n+g) and the composition of *working age population* **matter:** employed, unemployed and out of the labor force: a too low participation of women
- The *economic dependency ratio*: the number of retirees plus unemployed and out of the l.f. relative to the number of employed people
- A *well-functioning labor market* is the best premise for good pensions

The Italian disease



Source: IMF, 2020

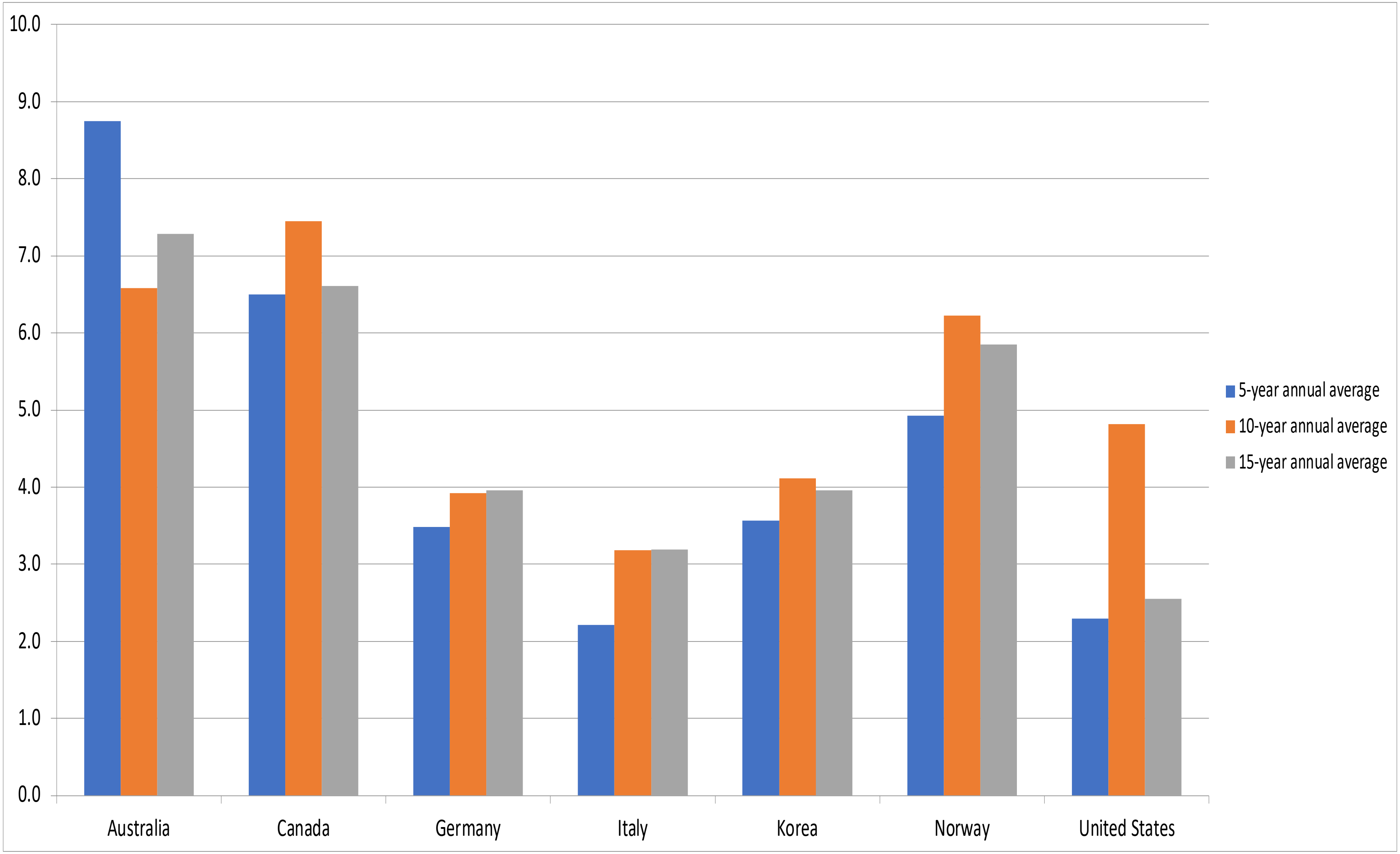
Public vs Private: a (geographically) very diversified pension mix



Source: OECD

Financial returns

(Geometric average of nominal annual rates of return of funded pension plans – 2019)



OECD Pension Markets in Focus 2019

3. Why reforming pensions is so difficult

It is a reform that:

- affects all generations
- it is mainly in the interest of the young, who are politically less important in an ageing society
- is permeated by value judgments and ideological aspects that tend to dominate the (quite complex) technicalities and make more difficult the necessary social dialogue
- has great problems of communication, also motivated by widespread erroneous beliefs (the notion of acquired rights, the lump of labor fallacy…)

Politically

- important trade offs are involved (i.e. "gradual" *versus* "cold showers" reforms)
- transitional, credibility and time consistency problems are pervasive
- correlation with other reforms (the labor market reform) is required

What is a reform?

Reforms are (normative) changes meant to

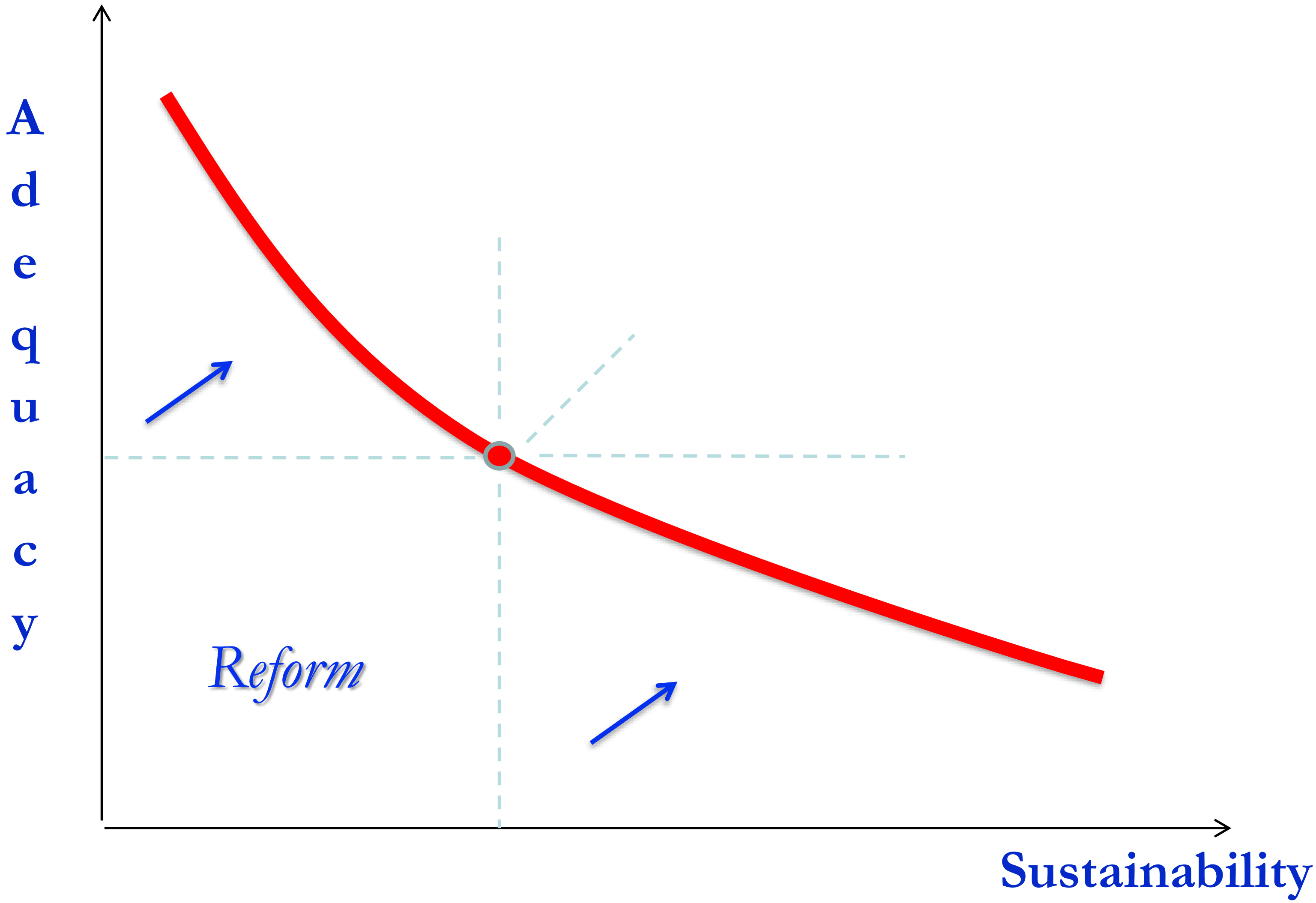
- *« Make changes in (something, especially an institution or practice) in order to improve it »*
- *«Improve an existing institution, law, practice, etc. by alteration or correction of abuses»*
- *«Give up or cause to give up a reprehensible habit or immoral way of life»*

(From: Oxford Dictionary and Wordreference.com)

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

Opposing views of pension reforms:

improving *trade off* "**adequacy** vs **sustainability**" **or austerity?**



Directions for reforms

- Strengthen the correlation (at the individual level) between contributions/ret. age and benefits **(a move from generous DB to DC)**
- Increase the **effective retirement age** (by raising the ***statutory*** age and reducing early retirement options)
- Link **retirement age to longevity (?)**
- Boost **employment opportunities** of older workers
- Encourage (FE/nudges/fiscal advantages) **participation in supplementary private pensions** **(**or make it compulsory?)
- Include **fair redistribution:** (notional contribution for unemployment/care periods, minimum pension level or means-tested minimum income) with special attention to groups *more at risk* of inadequate accumulation (the young, women)
- Attention to **the transition**

Rationale for increasing the funded pillars: r *vs.* (n+g)

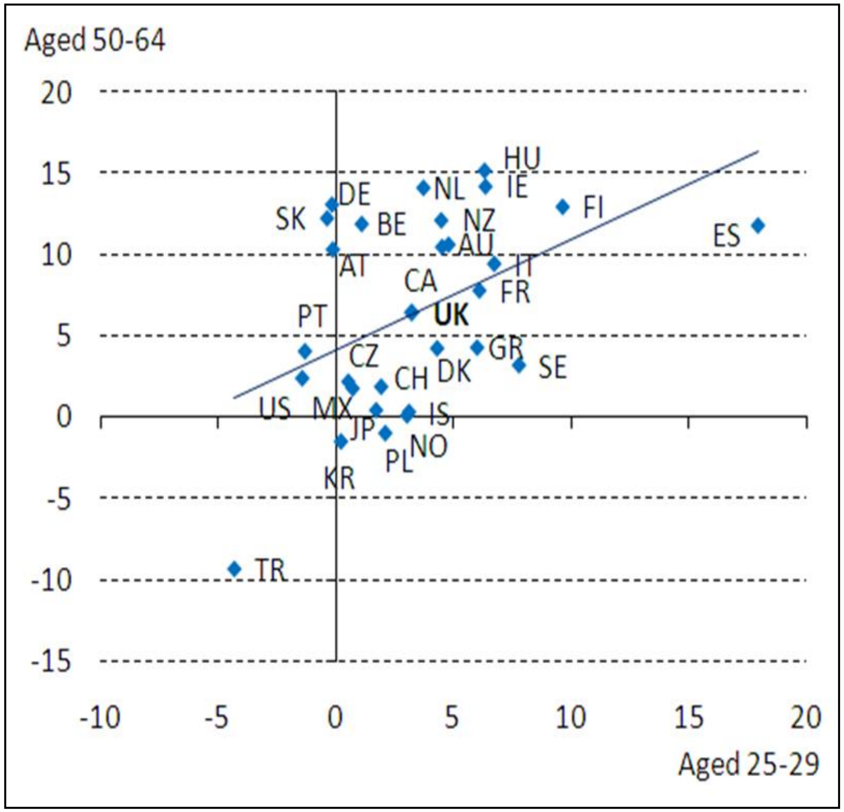
- The individual would (could) receive a higher return on his/her mandatory savings (the difference *wrt* n+g representing a "hidden tax" on compulsory retirement savings)
- Aggregate savings could increase, and help financing real investments
- But: it is not a free meal; a complete transition has prohibitive costs for the involved generations and uncertain benefits
- Consequently, social security privatization is not an option in Europe (nor in any political agenda)
- With gradual/partial funding a better diversification of pension claims and a superior risk/return combination could be reached given the different risks of the two systems, funded & PayGo, and their imperfect/low correlation

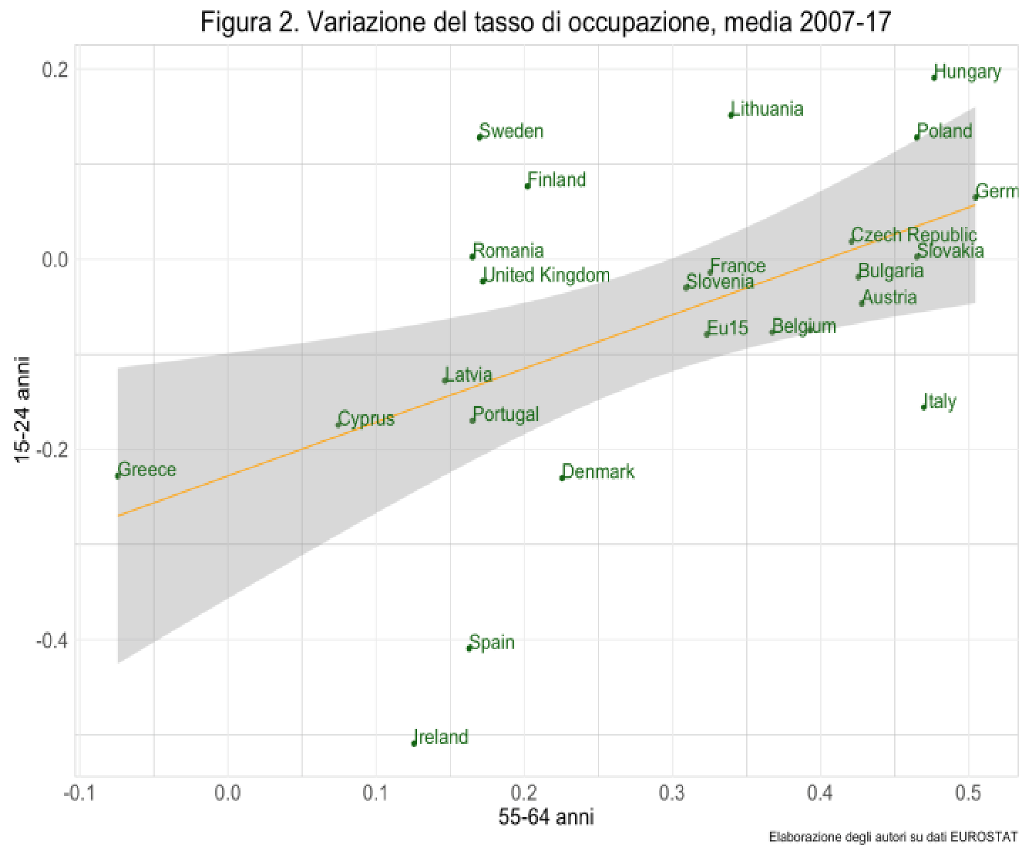
4. The role of basic financial education

Essential notions to smooth the reform path:

- *PAYGO as an **intergenerational contract,*** with an "implicit debt" dimension
- *rate of return and compound interest*
- *postponing retirement increases benefits (*more contributions and lower expected longevity*)*
- *risk diversification*
- *high payroll rates* imply high labor costs
- *"acquired rights" and unjustified privileges* subtract resources to others
- "*lump of labor fallacy*": jobs are not in a fixed number and early retirement does not (in general) help creating jobs for the young

A frequent misperception: the lump of labor fallacy
(% change in employment rates by age group (1997-07 & 2007/17)





See also: Carta F., D'Amuri F., von Watcher T., Worforce Ageing, Pension Reforms and Firms outcome, Banca d'Italia, Temi di Discussione, no 1297; September 2020

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*).
- *There are exemptions:*

'Pension reform can be hard to talk about. In the long run, reform now means fewer demands for layoffs and less draconian measures in the future. It's in the best interest of all Californians to fix this system now." (Jerry Brown)

- *Viability*: awareness of a reform's costs/benefits is important
- *FinLit:* could make citizens understand the reform's ***social investment nature***
- *Policy*: Governments should promote *FL* to indirectly induce long-run support for reforms

Our paper: "*Voting in the aftermath of a pension reform: the role of economic-financial literacy*" (JPEF, Volume 18, Issue 1 January 2019 , pp. 1-30)

- the electoral cost of a pension reform is significantly *lower* in countries where the level of economic-financial literacy is higher

- evidence from data on legislative elections held between 1990 -2010 in 21 (advanced) countries is robust when we control for macro-economic conditions, demographic factors, and characteristics of the political system

- findings not robust when *less specific indicators of human capital* – such as general schooling – are used, supporting the view that FL has distinctive features that may help reduce the electoral cost of reforms having a relevant impact on the life cycle of individuals

Policy implications

- FL can become a new, more transparent alternative to concealing from citizens the unpleasant consequences of reforms, a potentially key element in the relationship between citizens and politicians
- Since such literacy is primarily a result of education, government policy could thus indirectly induce long-run support for virtuous reforms
- Hardly compatible with populism and "sovereignist" policies

Overcoming financial illiteracy

- Several countries have started *financial education programs* differing in target audience (general population, students, workers, low income groups...), delivery channel (training, awareness campaigns, booklets, …) and content
- Scarcity of rigorous *programme evaluations* makes it difficult to identify what works best
- Policies are more effective if "*teachable moments*" are identified
- Intermediaries and pension providers should provide information and transparency (however too much information can generate paralysis)
- A good "*choice architecture*" (consisting of good default options and governance rules, and the reduction of intermediaries' conflicts of interest) remains essential

5. A new paradigm for pension reforms

A period of great shocks, high public debt, non conventional monetary policy have profoundly changed the pension landscape

Four building blocks:

- **A wider perspective of reforms:** *Social security* is part of the general welfare system: it is the whole welfare that needs restructuring, by looking at the *entire life cycle* of individuals. Moreover, the pension and labor market reforms have to be intertwined: without a well performing labor market no pension system is adequate & sustainable
- **Good financial market regulation to encourage a private complement to public provision** (i.e. level playing field for the various providers, serious supervision of investment restrictions, administrative and managing costs, selling techniques, reporting)
- **Honest, transparent and adequate information** to restore confidence in pensions
- **Financial literacy and education programs plus good default options**

This presentation is inspired by my recent work on *fin lit and reforms*:

- "*Chi ha paura delle riforme*", Bocconi editore, Milano, 2018
- (with Oggero, Figari, Rossi), *Support for pension reforms: What is the role of financial literacy and pension knowledge*?, Journal of Accounting and Public Policy, 2023
- (with A.Lo Prete) Financial education: From better personal finance to improved citizenship, Cambridge Journal of Financial Literacy and Wellbeing, April 2023
- Review of: OECD, *Towards Improved Retirement Savings Outcome for Women*, 2021
- (with A. Lo Prete and N. Oggero), *Now More Than Ever: Why Financial Literacy Is a Key Element of Post-COVID-19 Recovery*, in: B. Cude and G. Nicolini (eds), Handbook of Financial Literacy, Routledge 2021
- (with Oggero N and Puglisi R, *Information and Financial Literacy for Socially Sustainable NDC Pension Schemes, in: "Progress and Challenges of Nonfinancial Defined Contribution Pension Schemes*", Volume 1, World Bank, 2020.
- (with Christina Wilke), *Pension policy in Europe and the United States, Towards a new public-private pension mix*, Politica economica, April 2020, pp. 35-62
- (with A. Lo Prete) "*Voting in the aftermath of a pension reform: the role of financial literacy*" JPEF, Volume 18, Issue 1 January 2019 , pp. 1-30 https://doi.org/10.1017/S1474747218000185
- (with Flavia Coda Moscarola and Steinar Strøm) *Absenteeism, childcare and the effectiveness of pension reforms*, IZA Journal of European Labor Studies (2016) 5:1, DOI 10.1186/s40174-016-0056-3.
- *"Reform, Inform, Educate": A New Paradigm for Pension Systems* in B. Marin (ed.), "The Future of Welfare in a Global Europe", Ashgate, 2015, pp. 297-324.
- *Reforming labor markets: reflections of an economist who (unexpectedly) became the Italian Minister of Labor*, in IZA Journal of European Labor Studies, 2013, 2:20.
- (with Monticone C.) *Financial literacy and pension plan participation in Italy*, Journal of Pension Economics and Finance, 2011, vol. 10, issue 4, 547-564

Appendix: **Pensions toolkit**

(from: Fornero & LoPrete, JFLW, April 2023)

a) On a *personal level*:

- A pension income (annuity) protects against *longevity risk*, i.e. the risk of outliving one's resources
- The amount of contributions/payroll taxes paid each period into the pension account
- The accrued capital (either *financial* for funded scheme, or *notional*, in a Pay-Go) at given ages and at retirement, i.e. the amount of *pension wealth*
- How wealth is converted into an annuity and whether the conversion reflects (cohort-averaged) expected longevity at retirement

- Retirement ages (early and normal) and how the pension benefit changes in case of deferral
- How the pension benefit will evolve in retirement (indexation rules)
- What supplementary benefits – such as survivors' – are included in pensions
- Whether it is possible to withdraw from the "accumulated" capital before retirement and whether/how paying back is envisaged to avoid benefit depletion.

b) About the *pension system*:

- Governments have good reasons to be involved in pension regulations & provision as the market's ability to protect people in old age is limited (people's myopia & market imperfections)
- In a multi-pillar system, the main one is typically written into law and managed by the state; supplementary benefits come from *occupational pension funds* and *individual accounts*, both state regulated
- Th combination of *public & private* pension schemes *diversifies* the pension sources and reduces the risk of inadequate means in retirement
- The public pillar typically is Pay-Go financed: does not rely on financial reserves, but on the understanding that the (IG) contract will be maintained in the future

- The system's sustainability is granted by pension benefits to a *formula* based on the: total flow of individual contributions, age of retirement and growth rate of total labor income (the i.r.r.)
- Public pensions also promote social solidarity, so that those who are disadvantaged in the labor market do not struggle in retirement
- Solidarity can take the form of early retirement without penalization and/or of tax-financed contributions directed to workers in hazardous jobs, unemployed, or providing long-term cares to close relatives
- The main challenge confronting Pay-Go is the need to adapt to major structural demographic and economic shifts.
- The pension system cannot be separated from the labor market and the economy. Economic growth and inclusive labor markets that make it easier for workers to find a (good) job and for employers to hire are the best prerequisite for adequate pension systems.