Work as the key to individual and social welfare

Elsa Fornero
University of Turin, CeRP-CCA, Netspar and IZA

1. 3. Everywhere in rich countries, but particularly in Europe, the Welfare State (WS) seems to be in a crisis. The crisis, however, is not a terminal identity crisis but an adaptation one. It reflects the difficulties of adapting a glorious institution to the demographic transition; to a sluggish economy, which goes back well before the latest protracted recession; and to deep changes in both the labor market and the social structure, which have produced precariousness, on the one side, and strenuous defense of “acquired rights”, on the other.

2. The pension system is at the core of the welfare system, so it is no wonder that it finds itself also at the core of this transformation. Like many problems in modern society this one too has been generated by its very success. The dramatic progress in health, living conditions and life expectancy, coupled with a fall in fertility rate, has determined an almost inversion of the demographic pyramid. This determined a financial unsustainability and showed clear design inconsistencies. Pension promises no longer could be cheerfully loaded on the shoulders of younger and yet unborn generations since their projected numbers were rapidly declining just when the number of present and projected pensioners was steadily climbing and their work conditions were worsening. Mere adjustment of single features of the system, the so-called parametric reforms, was clearly insufficient. As Douglass North said: “Attempting to understand economic, political and social change requires a fundamental recasting of the way we think”.

3. Economic analysis has profoundly contributed to the revision of the conceptual frame in which pension systems were enclosed. There is to-day a rather large consensus on what a solid pension reform should look like.

– A “mixed” system – partly public and funded through taxes (pay-as-you-go) and partly private and reliant on pension funds – allows a better diversification of risk. The transition from one system to another is however tricky and needs to be planned carefully.

– Governments must consider the individual’s entire life cycle – education, active working life, retirement – which means integrated policies: education is key to work; work is key to adequate retirement income. In term of pensions, it means moving from a system based on “defined benefits” (pertaining to the realm of “acquired rights”, in which retirees are entitled to a pre-determined, usually generous, monthly benefit) to one based on “defined contributions” (in which retirement income is the result of the contributions an individual has made throughout his/her working life, with returns based on macro variables such as GDP or labor income growth rates).

– The defined contribution formula increases the “savings” function of the pensions system, accommodates flexible and gradual retirement, avoids the “penalties” on later retirement that occur in the a defined benefits system, and makes it easier for workers to take their pension from one job to the next – the so-called “pension portability”, which is important in today’s more dynamic labor markets. Defined contribution systems are also more transparent and less vulnerable to political meddling.

– Just as pension benefits increase with the increase in retirement age (benefiting from both higher contributions and lower life expectancy, according to an actuarial principle), retirement ages should go up automatically with life expectancy. Such an indexation avoids the political agony and social tensions that usually accompanies every decision to increase the pension age.

– Rules should be uniform and transparent to avoid a fragmentation of the pension system and the emergence of hard-to-abolish pockets of privileges. Instead, the system should include straightforward, tax-financed provisions for those workers who did not manage to pay sufficient contributions during their working lives to reach an adequate retirement income.

– Redistribution must still be part of the system. Benefits should be targeted towards the most needy and financed through taxes, rather than through social contributions levied on wages.

– Governments must make sure that such changes are recognized as progress towards a more sustainable and equitable system, which not only improves financial sustainability but, more importantly, reduces the burden on today’s younger generations as well as on those not yet born. Statements about how “fiscal emergencies require austerity” just create despondency among the population. The reform must be seen as a rebalancing of the financial and economic relationships between generations.

– Increases in economic-financial literacy are necessary to create the broad societal consensus without which pension reforms cannot work. Citizens must be enabled to react to reforms by changing their spending and working habits and improve their planning for the future. Financial literacy is not a sufficient condition for the success of reforms, but a necessary one.

4. With perhaps excessive slowness, drawbacks and setbacks, this “technical” analysis has somewhat guided welfare policy in the last twenty years and translated into reforms in most European Countries. Apparently slow, inadequate and uncoordinated, the reform process has nevertheless produced results. Retirement ages have been raised and made more flexible; the link between individual contributions and benefits has been strengthened, so has the link between benefits and retirement age. In most countries benefits have been de-indexed from wages to prices, while in a few (Italy, for example) retirement ages have been indexed to longevity. Overall, reforms have reduced the massive intergenerational unbalance in the form of large "implicit obligations" and also corrected the major distortions, privileges and opaqueness.

5. We cannot however just sit and relax. The job is not only to restore financial sustainability, but to ensure adequacy and fairness, and this is still very much to be accomplished.

I see two big challenges for a truly performing reform agenda.

The first challenge is the poor performance of the labor market. It is now commonly recognized that the best premises for a sustainable pension system lie in an efficient, inclusive and dynamic labor market. The pension and the labor market reforms should thus go in parallel. All social protection schemes and social security is no exception, should respond to the logic of activating (healthy) people, and not encourage them to moonlight jobs or to early retirement, as it was with the substantial implicit tax on the continuation of work, which characterized, for example, the Italian “seniority pensions”.

Consequently, more than focusing on just the “old age dependency ratio” (the ratio of people older than 65 to working-age population, i.e. 15-65 years)”, the focus of policies should be on economic dependency ratios, which consider the composition of the working age population according to the economic status of individuals: employed, unemployed and out of the labor force (in education, early retired, homemaker). For example, it has been calculated that while the average EU-27 old age dependency ratio, in 2010, was 26 per cent, the economic one, measured as the percentage of retirees and unemployed relative to the employed population was 64[1]. Although more ambiguous, particularly for projections, these measures point to produced income as the basis to finance pensions. The rest is redistribution, which is still important in a public system, but has to be transparent and go in the right direction.

Long-term employment enhancing policies, such as apprenticeship, re-training and lifelong learning, must be given more importance and more resources. Efficient labor services, with public and private agencies working together, must be implemented to reduce the search/unemployment spells.

Specific policies should go in the direction of stabilizing the work prospects of the young. Younger generations experience much greater employment/earning risks than their elders. Unemployment spells and income discontinuity are taking the place of the uninterrupted and ever-increasing earning profiles that were the norm for their fathers. Solutions have gone in the direction of “flexicurity,” a formula combining job flexibility with higher work probability or higher security at the family level (one full-time and one part-time job per family). Actual solutions, however, have often resulted in too much flexibility (with frequent out-of-job periods) and too little security. As a consequence, the young seem to have little or no confidence in the pension system, a situation which is likely to depend on the uncertainty that characterizes their precarious position in the labor market.

Reforms that extended the working life set out to correct the myopic, but widely held, ‘lump of labor fallacy’ (conducive to ‘work less, work all’ kind of policies) and to reduce the implicit tax on staying in work implicit in the DB formula. Both measures are essential to strengthen older workers’ willingness to work, while granting them a greater freedom to decide when to withdraw from the labor market. Flexible retirement (not to be confused with the pre-reform early retirement provisions) requires an age-related incentive structure. Research has demonstrated that workers respond to financial incentives: if they are taxed, they leave as soon as possible; if they are rewarded for staying longer in their jobs, they tend to stay. In this more neutral scenario, a minimum age, usually complemented with an income-eligibility test, is typically established to prevent people from making shortsighted decisions and to avoid an increase in future claims on public funds. To encourage forms of gradual retirement, provisions also increasingly separate the actual cashing-in of the pension benefit from effective withdrawal from the labor force. Older workers are not always less productive; on normal work conditions, they are not opposed to

[1] Wöss J., “*The impact of labour markets on economic dependency ratios – Presentation of Dependency ratio calculator*”, OECD, 2011.

continue working, at least till their health is good (and indeed research seems to show a positive correlation between retirement and health deterioration); they seem to appreciate working in a team with younger workers, possibly as mentors; and would welcome the introduction of gradual retirement options.

While a comprehensive array of measures have been introduced on the supply side, to induce workers to stay in employment longer, less attention has been paid to the question of how to induce firms to retain their elderly labor force - i.e. the demand side. Empirical evidence suggests that age-discrimination practices persist and that firms are not doing enough to adapt to the drastic change in the age composition of their workforce. Direct surveys of firms' attitudes reveal negative stereotypes of older workers, particularly with respect to their capacity to adapt to new technologies or organizational models. On the other hand, it suggests a positive correlation between the educational levels of the elderly and their participation in the labor market, and that the health of individuals with less human capital (skills and knowledge) deteriorates faster than that of those with a higher human capital. Targeted education, (on the job) training and lifelong learning programs to enhance workers' employability and productivity are thus very important. Other aspects of the labor market will also have to be redesigned. For example, seniority-based earning schemes may contribute to a mismatch between compensation and workers' productivity, and have extensive undesirable consequences. More generally, labor-market rigidities tend to create suboptimal age-based coalitions of interests.

6. The second challenge is psychological and consists in convincing people of both the necessity and the positive aspects of reforms. Any successful pension reform starts with a shift in attitudes. People should no longer see pensions as public guarantees or redistribution but as an insurance mechanism that is tailored to each individual and also takes into account broader risks that apply to whole generations and groups of people. Social security reform cannot be left to economists, lawyers and actuaries. This is where the technicalities of reforms have to be integrated with political/social aspects and convince the social partners and political parties. The concept of reform must become much more comprehensive, and encompass three different dimensions2:

• **Information**

Reforms will be useless, or even produce a backlash, if they are not firmly endorsed by the political forces that have a parliamentary majority. These political forces must act as a bridge between the public, government officials and experts. Reforms must never be mere theoretical constructs, concocted by eggheads behind the closed doors of universities or research centers. Any big reform must entail a broad social and political debate. Politicians must personally stand up for their reform projects, to give them a "face" and make them less abstract.

• **Implementation**

We must move away from the naïve idea that one legal change can miraculously save a whole economy. Even if we just look at the legal aspects of fundamental reforms, these are a complex process designed to deal with a complex society. Any big "reform" will require several laws, usually over a period of years. To implement reforms, governments often have to set up new institutions or teach new procedures to existing bureaucracies. It can therefore take a year or

---

[2] Elsa Fornero: Economic-financial Literacy and (Sustainable) PensionReforms: Why the Former is a Key Ingredient for the Latter, in: Bankers, Markets & Investors nº 134 january-february 2015

more for a new law to show any effects; and even longer if the law is groundbreaking and bureaucracies must first learn how to actually deal with them.

• Education

Understanding the basic elements of reforms requires not only good information, but also economic-financial literacy. Research has shown that the vast majority of workers can be described as financially illiterate. Reform processes are a learning experience not only for the government but also for society: just like the bureaucracies implementing new laws, a society needs to get accustomed to the new framework. Most changes to the welfare system only work if the population has at least some level of financial education. Universal literacy – reading and writing – was essential for the establishment of democracies in the 19th century. What we need for successful reforms in the 21st century are societies that are numerate as well literate. The efficiencies of electronic banking can only be reaped if customers understand how their bank accounts work. People can only make clever choices if they understand how interest rates and yields affect their savings and if they grasp the difference between risk and uncertainty.

Therefore, economic-financial education must not be confined to helping wealthy individuals understand their complex financial portfolios. It must become a tool that allows citizens to make less complex, but fundamental, choices about their life cycle.