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PENSION SYSTEM

A Forward-Looking Pension Pact

BY TITO BOERI

The head of Italy's social-security agency says Europe needs to become more flexible in how it treats retirement. The refugee crisis, he argues, offers an opportunity.

WHY IT MATTERS

A reform of pension systems would give people more flexibility and could also increase economic efficiency.

FACTS

Europe currently faces an influx of refugees and last year, Germany accepted more than 1 million people seeking asylum.

E.U. countries agreed a stability and growth pact involving regular monitoring and policy recommendations to maintain fiscal stability.

Some countries in Europe, including Greece and Portugal, are struggling with high debt levels.

Countries with high public debt badly need a credible set of fiscal rules within a monetary union.

This is what the euro-zone's fiscal contract with its members is supposed to achieve. It acts as a commitment device forcing governments to gradually reduce their debt burden. The credibility of this commitment is what makes the high-debt countries less vulnerable to shocks that change market pricing of sovereign risk.

Unfortunately, this contract is not working. Under the pressure of the refugee crisis, the terrorist attacks and the revival of populism, the E.U.'s Stability and Growth Pact is limping and hardly enforceable. Its numerous exemptions make it no longer credible, and the increasing divergence in public debt-to-GDP ratios across

countries certifies that the contract is simply not working.

Rather than diluting the E.U. stability pact, however, it is important to make it forward-looking. That means focusing on fiscal sustainability in the long run. A 2005 reform of the pact did this in words, but not in practice. It stated that a short-run deterioration in the budget deficit could be tolerated if, at the same time, a government reduces its long-run liabilities.

In practice, however, this principle can only be enforced by explicitly including in the pact any efforts that reduce the hidden liabilities associated with social-security entitlements, the most important long-run liabilities in our ageing societies.

This can include government investments in transforming illegal into legal migration, in integrating refugees into the E.U. labor market, and in reducing youth unemployment (which has never been so divergent across the bloc). Such investments should be valued for what they are: They amount to a reduction in the long-term liabilities of governments.

Acknowledging this would reduce the need for introducing one-time exemptions to the stability pact, and would strengthen rather than reduce incentives for governments to carry out reforms that can benefit their economies in the long run.

“Offering sustainable flexibility in retirement decisions could increase economic efficiency.”

How would this work in practice? Such a pact could reward directly the citizens and governments of countries that adopt flexible, sustainable pension systems.

A revised pact should also give citizens more flexibility in their decisions about when to retire, provided that the reformed system is actuarially fair, and that the pension levels paid are adjusted based on age and life expectancy.

Such a flexible system could be budget neutral: More pensions could be paid in any given year without affecting long-term liabilities, as additional pensions for earlier retirees are lower than those paid to people retiring later.

In addition to increasing the overall welfare of citizens, offering sustainable flexibility in retirement decisions could also increase economic efficiency by allowing a form of self-selection for retirement that screens out unmotivated older workers.

Those who are still invested in their occupation would stay on, and those who instead have plans outside the labor market, such as spending more time with their grandchildren or old parents, would be happy to leave. This could relieve firms of workers who are no longer motivated, and hence are a burden for employers.

This freedom is important also from a macroeconomic perspective: with an ageing European workforce, pensions are getting more and more powerful as automatic stabilizers that can avoid deep and protracted recessions.

As highlighted by the experience of European countries that faced double-dip recessions - those hit by both the Great Recession in 2008 and euro-zone debt crisis - the current fiscal rules imposed an increase in the retirement age on countries in the middle of a protracted and deep recession. This in turn has raised youth unemployment, by reducing the job reallocation from older to younger workers that is required for a stronger recovery to materialize later on.

Especially during financial crises, when new business start-ups are limited by credit constraints, job reallocation largely takes place via the natural turnover of workers within existing firms. Older workers are more likely to be attached to jobs that are no longer viable, while it is mostly young workers who are creative and launch new entrepreneurial projects, which can add value and jobs.

Fiscal rules tackling the deficit in the short-run have forced reforms that keep low productivity workers in old jobs at the expense of young workers. It has caused a prolonged and almost full freeze on new hires, particularly

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in those firms where there were more workers "locked in" by the sudden and large increase in the retirement age.

In Italy, for instance, the fraction of young workers in firms fell by almost a quarter over a four-year span. How can the E.U.'s fiscal contract increase debt sustainability if it causes the age of Europe's labor force to rise at a much faster pace than the overall European population?

A pact that allows for sustainable flexibility in retirement would also help out countries facing the huge demographic shock associated with the current massive wave of refugees, including almost 1.2 million to Germany since the beginning of 2015.

Migration is good for social security, provided that the newcomers pay contributions, and provided those who might unavoidably lose their job do not move on to non-contributory social transfers.

Those citizens wishing to retire two to three years before the normal retirement age could also make room for the unprecedented inflows of migrants and refugees looking for new jobs.

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