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THE NATURE OF SOCIAL INSURANCE PROGRAMS AND THEIR FUNDS (PART 1 OF 2)

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This article consists of a point-counterpoint dialogue addressing important aspects of social insurance programs. It discusses the desirability and advantages of these programs that provide financial assistance to those who are retired, disabled, ill or unemployed. The second part of this article that will be included in the next issue of *In the Public Interest* will address whether pre-funding of a social insurance program can occur and contribute to the financial security of the participants.

Further, it discusses whether these programs are Ponzi schemes or whether their social contract can form a sustainable basis for generational equity. Fundamental differences of opinion exist regarding these programs, not only due to different personal and political values, but also as a result of the viewpoint from which it is evaluated (for example, the program in isolation, the sponsoring government's financial situation or the overall national economy).

Together this and the subsequent article summarize a longer paper that can be downloaded from the website of the Social Insurance and Public Finance Section at http://www.soa.org/professional-interests/social-ins/default.aspx. Note that the author does not agree with all the views described. A single best answer may not exist for each issue, with different points of view being legitimately held.

BACKGROUND

A social insurance program is designed to protect individuals against the adverse financial effects of demographic-based hazards (such as greater-than-expected longevity after retirement, disability, expensive medical treatment and unemployment) by sharing these costs across population segments and generations. Its benefits are payable when designated events occur and indicated criteria are met. It normally disregards the individual's income or assets, although contributions or benefits can be tilted to favor a population segment more in need.

Government can make participation compulsory or heavily enough subsidize it so that most of those eligible choose to participate, resulting in coverage of a large part of the population. These programs are often financed by contributions from employers and employees, as well as in some cases from general government revenue and related investment income. Law or regulation defines their features, including eligibility requirements, benefits, and financing. They contrast with social assistance (welfare) programs that provide benefits only for those in need.

In many cases there is at least some pre-funding from contributions in excess of benefits because of higher cost per participant as they age or the program matures. In some cases pre-funding is not used, in which case the program operates strictly on a pay-as-you-go (PAYGO) basis in which current contributions pay for today's benefits.

Two views are presented, expressing opposing perspectives that have been taken by various stakeholders and commentators on social insurance programs. One perspective Supports (S) the long-term nature of these programs and a mechanism to provide for pre-funding of benefits, while the other presents the Alternative (A) view that argues that either (1) program benefits are badly targeted or inappropriate and can have adverse consequences or (2) funds generated under these programs are illusory. These views have often been taken by different political camps, with those supporting greater collective societal responsibility tending to support S, while those in the A camp tending to support more individual responsibility for personal financial planning. Concerns over the sustainability of a population financial system to support adverse financial effects of individual's risks are contrasted with those more concerned with the well-being of the economy as a whole.

POINT-COUNTERPOINT

Is social insurance insurance?

S — Social insurance is similar to other insurance programs that incorporate pooling of risks.

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Its benefits, determined by formula, are payable to designated beneficiaries. It protects participants financially from current and future changes in their condition, including their longevity and health status. Social insurance is not intended to provide for first class benefits, but it is intended to be sufficient for most participants to cover the types of risks that might be provided by private insurance.

A — It has little in common with a private insurance plan other than the pooling concept, although it does deal with some of the same risks commonly covered by private insurance. In contrast, it also pools demographic and financial risks across generations and various population segments. Other differences include an emphasis on social adequacy at the expense of private equity, mandatory or heavily subsidized rates to ensure close to universal participation, legal/regulatory rights (thus, changeable if the law/regulation changes) rather than contractual rights, and use of partly pre-funded or PAYGO financing rather than full funding. From the government's perspective, it is not very different from other public programs, although there may be a hint of an implicit guarantee because of its long-term nature, but that is similar to other functions as defense and education.

Don't most social insurance programs operate just like private retirement plans?

S — A social insurance program that provides benefits after retirement can be viewed as a large defined-benefit pension or health plan, with contribution rates and benefits enacted by law. In many social insurance programs, contributions or benefits favor those who need public support more. It is developed to provide for the systematic payment of determinable benefits after retirement—just like a private defined-benefit pension plan. The more a participant contributes, the greater his or her benefits are. Social insurance programs also anticipate a continuous flow of new entrants (e.g., births and new entrants to the labor force), just like newly hired workers in a private pension plan. Thus, although social insurance cross-generational issues are somewhat unique, as long as the employer remains a going concern, there is no difference.

A — Social insurance at most shares the form and certainly not the substance of a private retirement program. Although it also protects against longevity risk, the amount of these benefits normally does not provide by itself a standard of living most participants would be happy with. It normally involves some form of wealth transfer between generations, as those who contribute to the program (employers and employees) don't have to pre-fund all of their benefits, nor are contributions necessarily determined in a direct actuarial relationship to their benefits.

How is social insurance different from a welfare program?

S — In contrast to a government-sponsored welfare program that incorporates a needs-conditioned set of criteria for eligibility, the financial condition of beneficiaries normally does not directly affect benefits of a social insurance program, but it can provide a minimum level of benefits to their participants. Social adequacy, a key characteristic of social insurance, provides what society considers a minimum level of benefits for all participants. It is a program for the middle class, the vast majority of the population. In contrast, welfare benefits, being means-tested, only focus on social adequacy. Social insurance can redistribute income to those who have not been able to prepare financially for an adverse event or condition, but do so independent of consideration of the beneficiaries' current financial history or current financial status. It also provides some benefit to or increased peace of mind for all participants.

A — There is no need for the government to provide such a benefit to those who don't need it. The wealthy should be embarrassed by accepting a public pension while others live in near-poverty conditions. The middle class shouldn't come to expect what may be an unaffordable level of benefits—they need to better provide for their own future. The purpose of a government safety net is to help keep people out of extreme poverty or to redistribute income, either between population segments or generations, although recently it has provided benefits to the middle class who have lived beyond their means. Society cannot afford to provide benefits forever to those who can and should provide for themselves. Our aging societies cannot support all of these extravagant benefit programs, as there will also be other demands for society's limited resources.

There are at least two possible views of social insurance—as a stand-alone program and as part of the overall economy. Do higher earlier contributions really constitute pre-funding? Why pre-fund at all?

S — Pre-funding is desirable for many social insurance programs where increasing costs are expected, for example, due to an aging population. Pre-funding reduces somewhat the burden on future generations and tends to reduce intergenerational inequities. Further, to operate independently and avoid periodic borrowing, a small contingency fund is useful to smooth out short-term fluctuations in contributions or benefits. As a result, segregated social insurance funds are generated as an accumulation of historical revenues, reduced by benefits and administrative costs. Perfect PAYGO financing assumes that subsequent generations will always be willing to pay for their parents and grandparents. A fund can focus attention by producing clearer measures regarding future funding risks compared with PAYGO financing information that defers cost pressure.

A — Partial pre-funding of most social insurance programs costs less than if provided through a fully funded private insurance or pension plan, due in part to its potentially huge size (in some countries the resulting fund might be greater than the size of the entire economy) and the understandable unwillingness to accumulate a huge public fund that would constitute a significant drag on the economy and would likely prove politically unsustainable. In essence, since money is fungible, the program's funds are in effect commingled with general government accounts. Arguments in favor of even partial pre-funding are at best theoretical, with the so-called funds just a large suspense account. That is, any pre-funding of assets held as government bonds are economically equivalent to using a pure PAYGO funding method, with accumulated funds representing a combination of money already spent and a gross-up of calculations that result in bonds both owed and invested in different parts of the government. A change in a fund balance doesn't create sudden attention and action. Even if the current generation remains committed to the program or if an identifiable fund

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has been accumulated, it is a wealth transfer scheme dependent on future governments to pay currently promised benefits after the current working population retires. Since benefits and contributions can be changed, whether the program is said to be pre-funded is not relevant. At best, the pre-funding slightly increases the likelihood that benefits will not be decreased and contributions won't increase—but if taxpayers/workers pay the interest, what is the real difference?

Some claim that social insurance is no more than a Ponzi scheme. At best, social insurance redistributes income earned during participants' working years, that would otherwise be used for consumption that could drive economic growth, to the old, who tend to hoard it; at worst, current workers pay for benefits for current retirees with no guarantee of receiving benefits when they need it. Is this accurate?

S — A key characteristic of a Ponzi scheme is an intent to defraud, by taking advantage of and cheating participants by promising extraordinary returns on their investments, often needing an ever-increasing number of participants to continue. There is no evil intent underlying the design of a social insurance program, as those in government responsible for these benefit programs receive no financial reward from the program. It is not a scheme to obtain immediate profit and its finances are transparent. Although later generations may end up bearing a significant share of the program's cost, it is the most practical and efficient approach available to address the huge social needs that it can meet.

A — Whatever the intention, the result is the same. New money pays for old obligations, and old money was used when contributed for other purposes. Fulfilling the program's promises represents a significant cost or drag to current and future taxpayers. This Ponzi-equivalent scheme is one in which participants are "forced" to join, with early joiners profiting most. Its funding depends on the willingness and ability of subsequent generations to contribute. Considering the long time before they receive benefits, what happens if current or future contributors simply say "enough is enough"? The current and next generation would be out of luck, especially if economic difficulties arise or overly generous promises are given. Many young people are worried that Social Security will not be there for them—should we expect that politicians will always act in the public's long-term best interest? An apparent Ponzi scheme can be just as bad as a real one. Whatever the intent, ultimate cost pressures may lead to cutbacks, possibly turning it into a non-guaranteed welfare scheme with significant financial harm to those who have relied on what they thought were guarantees. With no binding promises exchanged, a social insurance program is just a set of voluntary gifts from one generation to another, while the current generation hopes that the next will be equally charitable. That is as close to a Ponzi scheme as one can find in a public program. It is a massive cookie jar filled with IOUs and promises to pay by possibly an overly indebted country.

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If not a Ponzi scheme, then at least aren't huge intergenerational subsidies involved?

A — In part because of differences in perspective of those in the generations involved, the definition of intergenerational equity or fairness is impossible to agree upon, let alone achieve. Nevertheless, perceived inequity is inevitable because of population dynamics and the impracticality in obtaining agreement as to what are fair contribution and benefit levels. Although a large percent of young American adults think Social Security is important, only one-third think the program will benefit them. In looking ahead to their future financial security, uncertainty and skepticism regarding this program exist. These young people ask their parents why today's rich society will not provide the benefits the previous generations received. Not only do many view social insurance as sacrosanct entitlements, but companies are now less willing to assume longevity or investment risks associated with defined-benefit pension plans. This is in part because the rules that the baby boom generation introduced to ensure their own entitlements cannot be fulfilled. It is hard enough for most people to provide for current needs, let alone to set aside enough funds for future needs.

S — Fairness has several meanings, depending on who you are. Social insurance programs can be viewed as being fair to the extent they adhere to the principles of social adequacy and individual equity. Reflecting voters' views, current and future politicians will stand up to the pressure to avoid future raids on program funds to radically cut back benefits for use in populist programs, expansion of benefits or public debt reduction. Intergenerational equity is an overused but still important concept. Almost all parents want to provide opportunities to their children to become better than what they had. But if each person/generation acts as if they are the only ones deserving of financial rewards, then perverse action will result. The bonds between generations are far stronger than what they are made out to be. A true social contract implemented through a social insurance program can exist if future generations agree to honor the financial obligations created by the past generation, in the expectation that the following generations will do likewise.

Now that we have discussed what you think social insurance is and is not, why do you believe that these programs are a desirable way to create financial security?

S — Social insurance is unique, emphasizing protection for the lower- and middle-income classes while at the same time providing benefits to all participants. It addresses human needs in an effective and cost-efficient manner, with a focus on the financial security risks that people face who either do not or cannot adequately prepare themselves financially. It combines social adequacy and individual equity characteristics. Its scope and breadth of participation results in a broad pooling of risks, provided in a more humanistic and fair manner than other approaches. By reducing dependency on welfare, it does not create a second class citizenry that would reduce social solidarity and harmony. The promotion of social support for those in need benefits society as a whole, as well as providing personal financial security in a period of austerity and cutbacks in private defined-benefit pension plans.

A — Although the objectives of social insurance sound worthwhile, they can be better achieved by other means, through a combination of private insurance/savings and welfare benefits. These can also be designed to meet the financial needs of particular population segments as they arise in a dynamic and more affordable manner, avoiding a one-size-fits-all approach to meeting needs that cannot all be the same. In addition, the very existence of a social insurance safety net reduces personal incentives and responsibility, as well as reducing participants' personal options and liberties. Society cannot continue to take on seemingly unlimited financial obligations to certain population segments without considering the financial effect on society and the economy as a whole. Required and formulaic pre-funding in periods in which such pre-funding is not financially affordable is inadvisable at best.

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