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Social Security: A blueprint for reforms

by Jean Sasseville

"Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth" (A World Bank Policy Research Report, Oxford University Press, phone: 919/677-0977, 1994) is the culmination of a two-year project. The project analyzes policy alternatives around the world according to the impact on the aged and the economy as a whole. The following presents a summary of the report, with the two concluding paragraphs offering the reviewer's comments.

Despite seemingly progressive public pension plan formulas in many countries, researchers have not found much redistribution from the lifetime rich to lifetime poor. This is partly because the rich live longer than the poor and therefore collect benefits for more years.

The report also discusses the following misconceptions:

- Old people are poor, so government programs to alleviate poverty should be directed to the old.
- Social security programs insure pensioners against risk by defining benefits in advance.
- Only governments can insure pensioners against such group risks as inflation and most do.
- Individuals are myopic, but governments take the long view.
- To protect the interests of generations yet unborn, the government needs to act.

Countries around the world deal differently with old age security. In Africa and parts of Asia, the elderly make up a small part of the population. They have long received care from extended family arrangements and mutual aid societies. In Latin America and Eastern Europe, programs that can no longer be afforded should be reevaluated. Organization for Economic Cooperation and Development (OECD) countries face similar problems as their populations age and productivity stagnates.

Most countries combine savings, redistribution, and insurance in a dominant public pillar. They pay an earnings-related defined benefit financed by payroll taxes on a pay-as-you-go basis. Yet evidence suggests that public pillars combining these functions are problematic for both efficiency and distributional reasons. It inevitably produces low costs and large positive transfers to the first covered generations. Negative transfers occur for later cohorts because of both system maturation and population aging. Ironically, the largest transfers go to high-income groups in earlier cohorts.

A dominant pay-as-you-go public pillar also misses an opportunity for capital market development. When the first old generations get pensions that exceed their savings, national consumption may rise and savings may decline. The next few cohorts pay their social security tax instead of saving for their own old age, so they may not recover this loss.

In contrast, a mandatory-funded plan could increase capital accumulation, an important advantage in capital-scarce countries. Large pay-as-you-go public pillars often induce expenditures that exceed expectations. This is because of population aging, system maturation, poor design features (e.g., early retirement and high benefit rates), and political manipulation that lead to poor design features.

Whether covered by higher contribution rates or general treasury subsidies, the system cost makes it difficult for the government to finance important public goods, another growth-inhibiting consequence. Thus, a dominant public pillar in a single pillar system increases risk for the old.

Public systems that try to do it all often produce costly labor and capital market distortions and perverse redistributions to high-income groups, failing to provide security for the old. These outcomes are not efficient, equitable, or sustainable.

Other single pillar systems also are problematic. In a few African countries, publicly managed funded plans have a record of misuse. Privately managed occupational or personal saving plans also would fail as single pillar systems. Occupational plans have better capital market effects than publicly managed plans but may impede smooth labor market functioning. They redistribute funds in accordance with the employer rather than social objectives. These occupational plans usually do not protect those with limited labor market experience or high mobility. They also are subject to employer or insurance company default when not fully funded.

Privately managed personal saving accounts are beneficial for capital market development, have the least distortional effects on labor markets, and are relatively immune to political manipulation by governments or strategic manipulation by workers. They do not address information gap problems or poverty among those with low lifetime incomes whose earning capability diminishes as they near old age. Nor do they insure against the risks of a low investment return or high longevity in the absence of markets for annuities.

This report concludes that a mix of systems is more appropriate than single pillar systems. It recommends a publicly managed system with the limited goal of reducing poverty among the old, a privately managed mandatory savings system, and voluntary savings.

The last chapter contains a concise but interesting discussion of two

countries that implemented mandatory private retirement savings: Australia and Chile. Anyone interested in the Chilean experiment should read Robert J. Myers article, "Chile's Social Security Reform, After Ten Years," in the Third Quarter 1992 and First Quarter 1993 issues of *Benefits Quarterly*.

The effect of a funded retirement scheme on the savings level in the economy is a complex subject. Old age security should not only be a social safety net but also an instrument of economic growth. Some of this funding would undoubtedly be additional savings in the economy. Mandatory private coverage is a straightforward solution to the chronic lack of pension coverage and is advocated in this book.

I believe that the authors wisely discouraged a single pillar, be it funded or not, defined contribution or defined benefit. Each type of arrangement has its own advantages and disadvantages, and a judicious mix is probably a cautious approach.

Although you may not entirely agree with the analysis or the conclusion, I recommend that you read this important and thought-provoking book.

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Comments from Robert J. Myers

Jean Sasseville asked for my comments. I found his review of the World Bank Policy Research Report excellent. However, I have some comments, which relate not to his review, but to the World Bank's views.

> "Researchers have not found much redistribution from the lifetime rich to lifetime poor."

I strongly disagree with this view. To a limited extent, this was true in the very early days of Social Security, but not in recent years or over the long run. The report neglects to consider the offsetting features of disability-benefit and survivor-benefit protection (besides the heavily weighted benefit formula). Note that this is just "the opposite side of the coin" with regard to vigorous complaints currently made by highly paid younger workers who feel they do not get their money's worth. Frankly, the World Bank authors do not have adequate actuarial knowledge to evaluate the situation. They seem to have a major goal of building up huge invested assets, with social security goals being secondary.

> "Evidence suggests that public pillars that combine all these functions are problematic for both efficiency and distributional reasons."

I believe evidence shows the opposite. The U.S. Social Security program has significantly reduced poverty among the population aged 65 and over. It operates very efficiently, with administrative expenses representing only about 0.8 % of tax income currently.

> "A dominant pay-as-you-go public pillar also misses an opportunity for capital market development."

Such market development should be achieved another way. This is not the purpose of Social Security.

> "When the first old generations get pensions that exceed their savings, national consumption may rise and savings may decline. The next few cohorts pay their Social Security tax instead of saving for their old age, so they may never make up this loss in savings."

We cannot tell whether this really occurs. This is mere economic supposition.

> "Each type of arrangement has its own advantages and disadvantages, and a judicious mix is probably a cautious approach."

Yes, but the public system should be a broad social insurance plan, without a means test (which the report advocates). The authors do not realize, possibly because they have "ivory tower" backgrounds and no practical experience with a Social Security system, how bad a means-tested system as the floor of protection would be. The disadvantages are that it is divisive, costly to administer, encourages fraud and abuse through transfer of assets and, most important, discourages savings by all except individuals with a higher income.

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Economic assumption (continued from page 3)

1. How does unemployment affect actuarial assumptions? (It seems it would be difficult to project this out more than two or three years.)
2. Conduct a more focused survey on how actuaries involved in insurance company modeling set the new business assumption. (It may be difficult to generate enthusiasm for this, because cash flow testing does not use a new business assumption. Most appraisals place little weight on the value of new business.)

In summary, what we have from the survey are "impressions" of the survey respondents about the relationship between various actuarial assumptions and various economic assumptions. The purpose of any future research should be to confirm or refute the "impressions" with "demonstrations."

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