Social Security in Times of Crisis: an International Perspective

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A. INTRODUCTION

This paper to a large extent focuses on old-age pensions but also looks at other security programmes, as social security forms a comprehensive system where different programmes are complementary and interlinked. The paper also does not discuss social security programmes which aim at providing income security for the unemployed (like unemployment insurance or unemployment assistance): though the role of such programmes is crucial particularly in times of crisis, their importance would require a separate discussion linked closely to labour market and economic policies aimed at faster recovery.

Pension systems have multiple objectives which include preventing poverty and providing minimum income security in the old-age. Another important objective is consumption smoothing and thus providing income at retirement in a reasonable proportion to income received during the working life. Notion of benefit adequacy relates to how pension systems meet the above objectives.

Pension systems are usually composed of different components: contributory and non-contributory, public and private, defined benefit and defined contribution, mandatory and voluntary. However every country has a different mix of these elements. Often certain components are focused on providing minimum income security in old age, other at generating adequate replacement income.

For pension system based mainly on earnings related schemes, the International Labour Organization (ILO) Conventions define adequate benefits in terms of minimum replacement rates guaranteed to at least those with lower incomes, while for schemes were entitlement to benefits are based on residence minimum benefit is defined as a proportion of low earnings levels in a given country. ILO standards also attach great importance to sustainability of social security pensions (see details in Hagemejer, 2009).

There is a strong link between adequacy and financial sustainability. Generous benefit promises within financial unsustainable schemes will never be delivered. On the other hand, benefit schemes providing inadequate benefit will – sooner or later – become unsustainable as the willingness of contributors and tax payers to support them will be eroded soon.

To secure financial sustainability of pension schemes in the ageing societies many countries introduced reforms which include new rules automatically linking future benefit levels to changes in demographic, labour market and economic environment. Defined contribution schemes decrease benefit levels for cohorts retiring at a given age when statistically, life expectancy at retirement increases. In addition, many schemes (for example in Sweden, Germany, and Canada) link adjustment of accrued benefit entitlements and pensions to payment to system dependency ratio or related variables. These automatic balancing mechanisms may be securing financial or actuarial equilibrium in the shorter and the longer-run, however when they are activated they push benefit levels down.

Simulation of the European Union (EU) and the Organization for Economic Cooperation and Development (OECD) show that as a result of the reforms, replacement rates, particularly for those with shorter or broken careers and low incomes, will deteriorate substantially in many EU and OECD countries over the period until 2050. For many countries, these may mean pensions falling below the levels required by ILO Conventions and European Code of Social Security. There is a need in these countries to straighten and expand mechanisms guaranteeing minimum benefit levels: non-contributory universal pensions, minimum rate of returns and subsidised contributions.

The crisis shows that rules like “automatic balancing mechanisms” are not necessarily viable solutions. In a number of countries, crisis and its unfavourable economic and labour market developments activated balancing mechanisms, which in result would push the benefit levels down. In a number of cases there was a discretionary political intervention into the “rules” to prevent the benefits from decreasing in a pro-cyclical manner. Such an intervention was justified both in social policy terms (protecting living standards in the crisis) and in economic policy terms (protecting aggregate demand).
Will the fate of these rules be the same when in the future demographic changes activate automatic balancing mechanisms more often and then adequacy of benefits and relative livings standards of the elderly deteriorate? There is no doubt that there will be growing political pressures for discretionary interventions correcting or abolishing the functioning of the systemic rules.

Should the future adequacy of benefits be left to political discretion completely? Or do we need to supplement the rules relating to financial equilibrium with other rules that would prevent benefits levels from falling below acceptable levels. Acceptable levels can related to international standards but should be developed nationally and be monitored, verified and adjusted through social dialogue, including all stakeholders.

B. FACING THE CRISIS WITH SOCIAL SECURITY

In times of economic downturn, revenues earmarked from contributions or taxes to finance social security programmes fall, while expenditure – due to the increased number of beneficiaries – rises. The countercyclical behaviour of social security expenditure is its inbuilt feature as a source of automatic stabilizer of individual incomes and aggregate demand. However, funding for increased expenditure does not come automatically (beyond existing reserves of those social security systems which keep such contingency reserves) and may come from either reallocation of existing public spending, increased contributions and taxes, or from an increase in public financing deficit.

When reviewing experiences of different countries, there are a number of key areas at which one has to look in particular when discussing the role of social security in a crisis: (1) expansion of protection (either as automatic reaction of the existing social security system or policy induced changes or both; (2) financial constraints caused by the crisis which may lead to cuts or restrictions in benefit levels – specifically for pre-funded define-contribution pensions; (3) negative rates of returns of the pension funds that undermine benefit levels of those already retired, those about to retire and those retiring in the future. But the biggest challenge remains, which is, in fact, a large majority of the world’s populations have no access to basic social security schemes, which leaves them vulnerable to economic and social risks, including those brought by the current crisis.

1. Expansion of social security as a crisis response

In those countries reviewed that have developed at least elements of comprehensive social security responses in areas like pensions, health schemes or family benefits, are usually expansions in coverage and in benefit levels of the existing schemes, except for a limited number of countries which were forced by circumstances to actually decrease benefits or narrow coverage.

Measures expanding benefits and coverage can be found everywhere – in high, medium and low income countries. The difference is, of course, in the scale of the impact of such measures. In countries where coverage is comprehensive the expected impact in terms of both the individual income levels of the covered recipients and the overall aggregate demand, is significant. On the other hand, in countries with coverage limited only to those in small formal economy the impact is important from the point of view of the effective protection of covered recipients, however from the point of view of aggregate demand it is negligible.

Expansion (of various scale) of benefits and coverage found in Armenia (various benefits), Australia (pension benefits), Bangladesh (old-age pension by 20 per cent), Brazil (social assistance extension, raise of old-age pension in line with minimum wage), Chile (extension of social pensions to another 5 per cent of the poor elderly, raise in benefit level), China (gradual extension of the old-age pensions to rural population, lower health insurance premiums are encouraged), Costa Rica (15 per cent increase in benefit level in non-contributory pensions), Egypt (health coverage has been extended), France (6.9 per cent raise in old-age pensions, extension in health coverage), India (extension of pension and health coverage), Italy (extension of certain social security coverage to hitherto excluded groups), Kenya (cash transfers to the elderly), Pakistan (health coverage and social safety net extended), the Philippines (extension of health coverage), Russia (adjusted pensions to inflation forecast), South Africa (decreased retirement age for men, prolonged child benefit
payments), Spain (increase in minimum pension benefit), United Republic of Tanzania (increased minimum pension benefit levels), the United Kingdom (child benefits raised), Uruguay (shortened minimum contribution period for full pensions from 35 to 30 years) and the United States (extended health insurance coverage).

In addition to these changes in benefit levels of existing social security systems, some governments have announced special one-time payments, usually to low-income households, for example, in Australia, France, Indonesia, Italy, Thailand and the United Kingdom. But as opposed to the extension of coverage or permanent adjustments in benefit levels, such measures give temporary relief and may also boost aggregate demand, but do not make long-term impact on households’ income situation.

Other responses include (usually temporary) exemptions from social security contributions with a view either to reduce costs for employers and thus stimulate employment or to raise net earnings of (low-income) workers. Among countries which introduced such measures one can find: Canada (lowering the contribution rate to unemployment insurance), China (numerous exemptions to unemployment insurance contributions), Czech Republic (degressive reduction of contributions compensated with higher state support to unemployment insurance), Germany (reduced contributions to health and unemployment insurance schemes) Japan (unemployment insurance contributions reduced by 0.4 per cent), Spain (various exemptions from social security contributions for employers).

However tempting might be such a measure like exemptions from social security contributions, when applying it one has to make sure that these are properly compensated both in terms of financing of the benefits currently paid as well as in terms of future benefit entitlements of contributors in case these depend on the amount of contributions actually paid.

2. Consolidating social expenditure – short-term versus long-term concerns

While most countries have expanded social security coverage and benefits as a reaction to the crisis, a few of the reviewed countries have announced cuts or freezes in social spending and in benefits, usually as part of the wider plan of consolidating public finances and reducing public deficits.

Ireland has halved its unemployment benefit for jobseekers under the age of 20, introduced a pension levy of 1 per cent across all wage earners and announced a freeze in welfare expenditure for at least two years. In Hungary the 13th month pension and the 13th month salary have been scrapped, the time of paid parental leave was reduced, future pension increase will be indexed to GDP growth and inflation (rather than wages and inflation), and retirement age will be gradually increased from 2012 on. Latvia announced cuts in the unemployment benefit scheme, where benefits decrease quicker than originally foreseen, pensions for working pensioners decrease by 70 per cent, family allowance are down by 10 per cent, pre-retirement pension decreased from 80 per cent of the full benefit to 50 per cent, retirement pensions and length-of-service pensions will be decreased by 10 per cent globally, parental benefits will be reduced by 50 per cent for working parents; additionally the number of health centres will be halved and prep classes will be abolished. Ukraine tightened the eligibility conditions for the unemployment scheme, with the effect that the number of registered unemployed decreased by 17 per cent compared to previous year, at the same time the level of contributions and contributors was widened (whether the benefit level has been affected is difficult to assess).

While the above examples show that some countries treated as a priority restrictions on public spending to limit public finance deficits in view of the (often dramatic) crisis situation it is too early to fully assess not just the negative social impacts of their measures (in terms of living standards of the affected groups), but also potential longer term economic impacts with regard to the depth and length of the recession. In some countries, measures of the above nature were adopted as a condition to receive large scale loans to support the financial sector and the economy.

There is always a conflict between the long-term financial sustainability concerns and the countercyclical role of social security (and wider public) spending. An interesting illustration and
solution comes from Sweden. Several years ago, within the main Swedish old-age pension scheme (which is PAYG funded but organised as a so-called Notional Defined Contribution (NDC) principles) a special feature was added in the form of a so-called automatic balancing mechanism. Special calculation methods have been established to make it possible to estimate the long-term assets and liabilities of the PAYG scheme. If the estimated liabilities of the system exceed its assets, the annual indexation, both of the acquired pension rights and pensions in payment is supposed to be (automatically) reduced for a period necessary to bring equilibrium back. Obviously, such a mechanism would make the system financially stable. Whatever happens, it reduces current and future pensions by as much as is needed in order to restore financial equilibrium to the system.

Until 2007, the so-called “balance ratio” of the Swedish pension system was above one (assets higher than liabilities) and thus automatic balancing mechanism was not activated. However, the situation has changed with the crisis. For year 2008, the calculated balance ratio became less than one (liabilities surpassed assets). This means that pension levels would need to be decreased in 2010 and for another several years grow at a much lower pace than balancing mechanism activated. However, such a perspective opened a debate on whether this should be allowed in the conditions of crisis. The debate concluded that one should allow discretionary intervention suspending existing rules and reduce the pension levels expected for 2010 and spread it over a longer period to cushion the impact on pensioners’ living standards (Scherrman, 2009).

Automatic adjustment mechanisms linking pension entitlements to state of the pension system finances exists also in different forms in the Netherlands (occupational pensions), Canada and Germany.

The above example shows clearly an important dilemma. On the one hand there is clear willingness to introduce automatic budgetary mechanisms which would help to ensure long-term sustainability of specific expenditure programmes or overall public finances making it immune to discretionary political decisions. This can be seen not only in Sweden but in recent reforms in social security programmes and in wider public finance reforms requiring permanently balanced budgets at the local or national level in many other countries. These long-term automatic mechanisms and rules in times of economic downturn such as the current one, may however act as “automatic destabilizers” rather than stabilizers as Joseph Stiglitz (2009) stressed in his speech to ILO in March 2009, unless – like in the case of Sweden described above or Germany (where “sustainability” factor of the German pension system would lead in 2008 and 2009 to pension increases of 0.46 per cent and 1.76 per cent, but the government has over-ridden the “automatic” mechanism increasing pensions by 1.1 per cent and 2.4 1per cent respectively) – politicians come up with discretionary corrections of the “rules” in order to achieve the policy outcomes desired in the current circumstances. OECD experts in a recent report support such discretionary interventions and concluded that the design of such “automatic balancing” “needs a re-think” as “it does not seem sensible to reduce benefits in a pro-cyclical way, taking money from the economy when it is weak” (OECD, 2009a).

3. Special concern – pension funding

The effects of the financial and economic crisis pensions systems depends on the category of pension schemes people belong to (defined contribution, defined benefit, PAYG or fully funded) and if they are already retirees, close to retirement or still have many years of contributing ahead of them.

In defined benefit (DB) schemes where pension amounts are calculated without regard to the level of reserves the immediate impact will be less than in defined contribution schemes where benefits guarantees are less effective by nature. However, long-term contraction of employment and hence the number of contributors will also force governments to make downward adjustments in defined benefit schemes.

In fully funded pension schemes however, pension entitlements in some cases might be lost completely. In OECD countries, private pension funds lost 23 per cent of their value (OECD, 2009a). If the crisis turns into a long-term downward adjustment of asset prices, the outcome in defined contribution schemes will inevitably be lower benefits paid at retirement. Any prolonged suppression of interest rates and asset prices will lead to serious difficulties by way of destabilized annuity rates
(prices) and management of annuity reserve funds. The size of the long-term effect will depend on the depth and the duration of the downturn of asset prices. If the present price reductions turn into permanent level adjustments then old-age income will be reduced, if the downturn is short-lived the effect will be transitional.

While these losses may not be permanent, they still show the vulnerability of pension levels in defined contributions schemes, notably for people that are close to retirement and whose savings portfolios might not recover during their remaining active life. The most affected are people that will retire within the next months and years, those with long-period of membership in DB funded pension plans and, in particular, those with investment policy heavily exposed to riskier assets (many in US, UK and Australia). Also those pensioners in private pension plans who did not take annuity on retirement may be seriously affected. The reason that ILO Social Security (Minimum Standards) Convention No. 102 requires old-age pension to be paid as life annuity (periodical payment throughout a contingency) is exactly to protect income security of the elderly against the impact of such events as the financial and economic crisis.

In OECD now, private financial sources constitute on average, a fifth of retirement incomes, but more than 40 per cent in five countries: Australia, Canada, the Netherlands, the United Kingdom and the United States (less than 5 per cent in countries like Austria, Czech Republic, Slovakia, Hungary and Poland). However, in the future, private pensions (mandatory and voluntary) are expected to provide 75 per cent of future retirement incomes in Mexico, 60 per cent in Slovakia, 50 per cent in Poland and 30 per cent in Hungary. As many of the latter schemes are relatively young and thus even if current losses of the pension funds are significant (in Poland, ILO estimates that in real terms members lost on average three years of their contributions), the impact on incomes of future retirees from this current crisis might be relatively minor. However, as the OECD stressed, these developments “highlight the need for resilience to future crisis” (OECD, 2009a, p.3).

C. NEXT STEPS

Three things are needed. The first is a fundamental overview of existing social security systems and the correction of mistakes made during the last two decades in countries where social security systems are well developed. The second and perhaps more fundamental task, is to develop comprehensive social security systems in countries where only rudimentary systems exist, starting with providing basic income security and affordable access to essential health care to all in need. The crisis bears the risk that we are only seeking short-term quick fixes to poverty and insecurity while neglecting longer-term solutions that would help to correct the fundamental inequities in the global economy and society.

1. Correcting past mistakes

Corrections are needed first and foremost in pension systems. The vulnerability of pension levels to the performance of capital markets that was introduced in so many pension systems during the last three decades clearly was a mistake that stands to be corrected. What is needed immediately is to protect the pension levels of people that are close to retirement. Existence of strong minimum pension guarantees may work as an “automatic stabilizer” of the retirees’ living standards. Some countries already have it; others included on-off payments to older people into their stimulus packages as a temporary relief (Greece, Australia, UK and US). Others, as a result of the current crisis, decided to strengthen and expand minimum guarantees in their pension systems (Finland, Belgium, France and UK, and also countries with the higher than average poverty incidence among elderly: Australia, Korea, and Spain).

Policies for strengthening pension guarantees of low income earners and thus significantly correcting past reform trends will have to be further improved. As OECD shows, in the future, in countries like Germany, Japan or United States low income earners will be receiving pensions at the level of 20-25 per cent of the average earnings (OECD average will be 36 per cent with Denmark at the top of the list with 62 per cent, see OECD, 2009a, p.5),

\[ \text{(prices)} \]
In the short run, the state may authorize pension schemes to reduce the level of capitalization for a transitional period (like it was done for example in the Netherlands). This is probably the only realistic option at the moment – given global resource constraints. If asset prices rebound at some point than the overall cost of the guarantees will be only a fraction of the momentary losses of pension assets.

In their observations of the response to the crisis, the OECD have suggested that governments could play a more active role in managing risks associated with the payout phase of pensions and annuities, with the idea that they could encourage the market for longevity hedging products by producing an official longevity index. Other OECD experts’ proposals included suggestions that governments should issue longevity bonds that “would set a benchmark for private issuers”, while they "should also consider" issuing more long-term and inflation-indexed bonds, a move already taken by a small number of countries; most recently by the Danish government with the release of a 30-year bond that was primarily bought by domestic pension funds and insurance companies.

But much more fundamentally, this is the time for a systematic overall reassessment of global pension policies. The ILO does not have a specific pension model but it does have a set of basic requirements for pension systems. These are included in social security standards which have been built-up over many decades, and specify the way in which social security systems should perform. It has never been timelier than now to remind, promote and apply those principles:

1. Universal coverage: Everybody has a right to affordable retirement through pension systems that provide all residents with at least a minimum level of income protection in old age. Similarly, everybody has a right to income security in case of a loss of a breadwinner and disability.
2. Benefits as a right: Entitlements to pension benefits should be precisely specified as predictable rights.
3. Equity and fairness. There should be no discrimination and equal treatment of all, including equal treatment of national and non-national residents. Entitlement conditions and benefit provisions should be gender-fair.
4. Protection against poverty: Pension systems should provide a reliable minimum benefit guarantee that effectively protects people against poverty in old-age, loss of a breadwinner or disability
5. Lost income replacement: contributory earnings-related systems should provide guaranteed replacement rates at least to those with earning lower than average
6. Collective actuarial equivalence of contributions and pension levels: amounts of benefits for all contributors should adequately reflect the level of the contributions paid
7. Guarantee of a minimum rate of return on savings: The real value of contributions paid into savings schemes wherever these are part of the national pension systems should be protected.
8. Sound financing and fiscal responsibility: Schemes should be financed in such a way as to avoid uncertainty about their long-term viability. Pension schemes should not crowd out the fiscal space for other social benefits in the context of limited overall national social budgets.
9. Policy coherence and coordination: pension policies should be inherent part of coherent and coordinated social security policies aimed at providing affordable access to essential health care and income security to all those in need.
10. State responsibility: The State should remain the ultimate guarantor of the right to affordable retirement and access to adequate pensions.
Such guarantees can be applied to both PAYG and fully funded pension schemes. They can be legislated by any government. Most likely they will not lead to major real expenditure, but in any case they will cost a fraction of what the present bail-out of the financial system could cost us.

2. Building social security for all

Social security will effectively cushion the negative impacts of the crisis if its foundations based on solidarity are strengthened. The ILO is promoting the reshaping of national social security systems based on the principle of progressive universalism. We first need to ensure a minimum level set to social security benefits for all, or the social protection floor. Based on that floor, higher levels of social security should then be achieved as economies develop and the fiscal space for redistributive policies widens.

Higher and middle income countries: Despite the talk of over-burdened welfare states in the past decades, this crisis gives new visibility to the crucial role of social security in weathering economic storms, now and in the future. The memories of the devastating effects, which an economic crisis can have on households and individuals, have nearly faded for most people in high-income countries. Where this is the case, the success can largely be attributed to the comprehensive social security systems that have been established – often as response to earlier crises. Thus, also in developed economies, comprehensive and state-organized social security based on the principle of solidarity may not be treated as a relict from the past – they are powerful tools for economic and societal development in the future. It is thus of central importance to sustain the fiscal space for public social security schemes through government policies.

Low-income countries: While many high-income and some middle-income countries are relatively well equipped in social security and thus effective instruments of preventing poverty, this is far from being the case in many other countries of the world, where only large minority have access to even basic levels of social protection. Fortunately, it seems the crisis has helped to reach wide consensus on the necessity of investments in social protection in low-income countries. OECD Development Assistance Committee (DAC) says: “Social protection directly reduces poverty and helps make growth more pro-poor. It stimulates the involvement of poor women and men in economic growth, protects the poorest and most vulnerable in a downturn and contributes to social cohesion and stability. It helps build human capital, manage risks, promote investment and entrepreneurship and improve participation in labour markets. Social protection programmes can be affordable, including for the poorest countries, and represent good value for money.” (OECD-DAC, 2009)

Sharing the above view, the Chief Executives’ Board of the United Nations System proposed the idea of establishing a Social Protection Floor (United Nations CEB, 2009) by ensuring access to basic social services and empowerment and protection of the poor and vulnerable. Such social protection should consist of two main elements: (a) Services: geographical and financial access to essential public services (such as water and sanitation, health, and education); and (b) Transfers: a basic set of essential social transfers, in cash and in kind, paid to the poor and vulnerable to provide a minimum income security and access to essential services, including health care. ILO Global Jobs Pact of June 2009 (International Labour Conference, 2009) thus requests countries to develop “adequate social protection for all, drawing on a basic social protection floor including: access to health care, income security for the elderly and persons with disabilities, child benefits and income security combined with public employment guarantee schemes for the unemployed and the working poor” and urges “the international community to provide development assistance, including budgetary support, to build up a basic social protection floor on a national basis”.

Donors seem to be upbeat about the call for support to expand social protection in low income countries during the crisis and beyond. OECD-DAC declares (op.cit): “Donors’ support for social protection programmes should provide adequate, long-term and predictable financial assistance to help partner governments establish gender-sensitive social protection programmes and create the conditions for those programmes to be politically and financially sustainable. This is especially important in the current situation of contracting fiscal space and declining financial inflows. Such support must be provided through harmonised and co-ordinated financing mechanisms in support of
nationally defined strategies and programmes.” The Government of the United Kingdom in its recent White Paper on International Development, “Building our Common Future” (UK Department for International Development, 2009, p. 25) urges the World Bank to “pay greater attention to social protection” and use the Rapid Social Response Programme to more effectively help low-income countries to build the necessary basic social protection programmes.

Such growing global coalition has a real chance to make a difference and help the uncovered majority to go through the current crisis and be better prepared for future ones as well secure income security to the present and future elderly – the majority of whom are without any pension coverage and live in the countries where only minorities have access to old-age pensions and other social security benefits and services.

NOTES

1 Prepared with extensive help from Ms. Ellen Ehmke as well as using analysis undertaken by other colleagues from the ILO Social Security Department, in particular Michael Cichon and John Woodall.

2 Sources are the ILO 48 country reviews, ILO Social Security Department’s own continuous monitoring of selected countries experiences ongoing since the onset of the crisis, results of a survey undertaken by the International Social Security Association (2009) as well as information provided by OECD (2009).
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