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Abstract

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Keywords

development, social security, economic security, growth

Comments

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REFORMING SOCIAL SECURITY AND SOCIAL SAFETY NET PROGRAMS IN DEVELOPING COUNTRIES

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1. Introduction

Developing country governments around the world, as well as the development agencies advising them, have become increasingly alarmed about the cost of social security systems and social safety net programs and economic inefficiencies resulting from these programs' operation. Taken together, both social security and safety net programs may be jointly referred to as "economic security programs". In this paper we identify the main sources of economic insecurity facing developing country populations, highlight the ways in which existing social safety net and social security programs meet (or fail to meet) these risks, and draw out some high-priority reforms required to help such programs meet the challenges of the 1990s and beyond. Finally, we enumerate several steps that international agencies could take which would dramatically enhance the environment in which these reforms are carried out.

2. Economic Insecurity in Developing Countries

Economic insecurity is endemic everywhere. The major causes of economic insecurity are the same around the world. They include

- individual inability to command resources (e.g. un-/under-employment, low and unreliable pay, infirmity, death)
- family transitions (e.g. divorce, arrival of children, migration)
- industrial shocks (e.g. decline in prices of traded goods, loss of former markets, sudden changes in industrial ownership and control)
- regional/national events (e.g. inflation, bank failures, natural disasters, political crisis)
- international events (e.g. worldwide depression).

What is common to each of these sources of economic insecurity is they inflict economic losses on part or all of a population. In some cases, these causes of insecurity may be longstanding enough that they imply severe consumption deficits for long periods of time.

It is well known that some of these factors generating economic insecurity can be circumvented if people have access to and acquire private insurance. For example, in developed countries with strong private insurance markets, workers purchase private insurance to guard against their premature death and the consequent loss of family income. As another example, many private companies in the OECD nations offer corporate disability and old-age pensions, making it possible for employees to obtain income insurance at attractive group rates. In many countries, the family plays a role as well: throughout Africa and Asia, children regularly support their elderly parents, providing yet another a private vehicle for old-age economic security.

In general, private insurance has worked better when there is good information about potential risks and losses (e.g. mortality statistics), the existence of strong and long-term ties between people (e.g. families, clans, work groups), and large enough groups over which to pool risk. Often, private coverage adequately protects well-off people against economic insecurity, because they are able to pay for the coverage directly, and because they can afford to obtain it indirectly via foregone wages or other transfers when security is provided by companies or in the family setting. Conversely, people with permanent health problems or low incomes tend to not be able to afford, or even obtain, private insurance, a problem which is especially marked in countries where few insurance institutions exist. For these reasons, social programs to provide economic security may be needed in instances where the private market for insurance is seen as inadequate.

3. How Economic Security Programs Operate in Practice

Government-run economic security systems around the world differ in their emphasis on social assistance versus social insurance, depending on the country's ability to pay, as well as the economic and political pressures to "tilt" one way or the other. In addition, coverage patterns can vary even within a given country. For example, many republics in the former Soviet Union promised generous pensions to workers from key occupational groups such as the military, civil servants, and miners; retirees not in these groups receive little or nothing. In contrast, the Australian Social Security system provides pensions primarily to the poor under its government-run old age system, and supplies health care benefits irrespective of income. To some extent, the redistributive pattern depends on whether the government actually operates the system itself or contracts out: for example in Chile, the national pension system relies on private investment managers to invest workers' contributions in a way to maximize earnings replacement after retirement.

Despite these differences, the common feature of economic security systems is that they are deemed to be long-term institutions, part of the social contract between generations. This implies that they differ from social safety net programs at least conceptually, because safety-net programs are usually seen as short-term measures "mitigating major transitory adverse effects of economic reform measures on vulnerable groups" (Joint Issues Paper 8/2/93). Programs meeting this criterion are varied, and are generally thought to include targeted transfers of cash, food, or other services, and sometimes public employment.

Partly because they are conceived as short-term measures, safety-net programs have tended to be implemented hurriedly without considering their long term consequences for labor market behavior or their ultimate budgetary impact. Thus in the 1980's, for example, many European nations offered special unemployment bonus schemes to redundant older workers which enabled them to remain unemployed until they attained eligibility for early retirement pension benefits. Once in place, however, these redundancy schemes garnered political support and came to be viewed as long-term entitlements, making it extremely difficult to change or eliminate the subsidies. A related problem is that the programs themselves can engender long term changes in behavior, as occurred when unemployment schemes encourage earlier and more costly claims on the national old-age pension system.

Social security and safety net programs have many positive features. Only with a national, mandatory system can a government provide social assistance transfers to groups that others would not willingly pay for. Only governments have the taxing authority to spread income variability risk across generations. For instance, many developed economies' social security systems grew during the world-wide Depression of the 1930's, in order to transfer income from active workers to the unfortunate generation reaching retirement age with no assets. At the same time, however, the shortcomings of these schemes are many, and include high costs, inequitable provision of benefits, and often undesirable effects on the labor market and other markets. Too often, benefits are seen as an entitlement rather than insurance, producing a clash in perspectives leading to opposing conclusions. For example, from an insurance point of view, in the Eastern European countries displaced civil servants would not be entitled to benefits if they had not paid into an unemployment insurance system, but under an entitlement perspective they might receive benefits if their jobs were declared redundant.

Below, we detail reform priorities. Before we do, however, it is important to acknowledge that all forms of economic insecurity cannot be insured against, either in the private market or by national government Social Security and safety net programs. For example, collapsing political and economic institutions (as in times of war or political upheaval, or during hyperinflation) can seriously curtail real consumption for many segments of the population. In this instance, better diversified and more global institutions could help provide some of the social transfers and social insurance required to reduce economic insecurity.

4. Issues in Designing Economic Security Programs

Social security and safety net programs have been asked to address many diverse problems. Here we contend that economic security systems have a single primary purpose: to assume adequate consumption. Hence the goals of reform as stated in the Joint Issues Paper are perfectly consistent with this purpose: "to (a) minimize allocative distortions and contribute to macroeconomic stability by reducing fiscal imbalances, and (b) promote equity, both inter-generational and between income groups, particularly to ensure maximum protection against life-cycle risks and unemployment at minimum cost" (Joint Issues Paper). To this end, very important decisions need to be made regarding what standard of adequacy to adopt, how to design appropriate programs for each target group, and how to allocate budgetary resources among different programs. We take up each in turn.

Determining the standard of adequacy: Even if a country's economic security system seeks to assure adequate consumption, it remains to be determined what standard of adequacy is used in practice. A standard of absolute adequacy might be set, as in the case of a national poverty line; this is the amount below which an individual or a family in a particular country is said to be poor. Alternatively, a standard of relative adequacy might be adopted where adequacy could be judged relative to one's level of consumption prior to the event precipitating economic insecurity (retirement, unemployment, etc.). As indicated below, it makes a difference which standard is chosen.

Deciding whom to insure: Careful attention must be paid to the choice of a target group. In this regard, three groups should be distinguished: the poor, the vulnerable, and the losers. While some analysts speak of the "poor and vulnerable" as if they were the same people with identical economic security needs, this is frequently inaccurate. Some of the poor have an assured level of income which is simply very low. Conversely some of the vulnerable are quite well-to-do, yet are vulnerable because their incomes are variable. Because some, but not all, or the poor are vulnerable, and some but not all of the vulnerable are poor, policymakers must decide which of these groups should be the targets for economic security programs. As for the losers, some of the largest losers are those who start in the best initial position, and hence have the most to lose.

After clearly distinguishing among these groups, the country must then decide for whom the economic security program is intended: the poor, the vulnerable, or the losers? Appropriate program design requires delineating who is, and who is not, in the target group.

Designing appropriate programs: Having decided whether to adopt an absolute adequacy target or a relative adequacy standard, and having decided whether to target on the poor, the vulnerable or the losers, a country is then in a position to design its economic security program. Suppose that a country's goal is to provide a floor of economic protection for the poor. This may be achieved by transferring cash or benefits in kind to those falling below the minimum standard of consumption (i.e. those suffering from absolute inadequacy). This is commonly called "social assistance", consisting of needs-based transfers aimed at reducing poverty. Such efforts encompass food relief, cash welfare payments, and/or housing subsidies.

If the country's goal is to design a system which protects the vulnerable, a very different approach is called for. For example, rich and poor alike face the economic risk of outliving their working years and therefore needing old-age economic security programs. People in all economic strata are vulnerable to this risk, and old-age pension systems can be devised to insure against it. Since the typical beneficiary of such a system is not poor, it is better seen as an insurance program rather than an anti-poverty scheme. If private insurance markets are absent or incomplete, a public system may help overcome undesirable market failures.

As for plans which compensate the losers, political considerations sometimes dominate economic ones. In developing countries on every continent, employees of governmental agencies and parastatal corporations are highly-paid relative to other workers with similar qualifications in their countries. Furthermore in many of these same countries, public employment rolls are being subjected to cutbacks. When an economic reform package requires employment cuts, those who lose public sector jobs suffer a very real loss, precisely because the jobs available elsewhere are not as remunerative as the jobs they held.

Facing the fiscal tradeoff: The Bank and the Fund, along with other development agencies, have devoted considerable staff effort and loan monies to programs aimed at compensating the losers. Such programs are often justified as the price that must be paid for client countries to undertake an otherwise desirable reform. Still, it must be asked how scarce budgetary resources should be divided among the poor, the vulnerable, and the losers. At the moment however, no one even knows how economic security expenditures are currently divided among these groups. It is also necessary to bear in mind constantly that social security systems and social safety net programs require real resource transfers, and that budgetary limitations imply often hard tradeoffs between economic security and other programs, as well as between one economic security program and another.

5. The Reform Agenda

We now offer several propositions to help guide policy discussion.

PROPOSITION 1: The decision of what economic security benefits to offer should be made concurrently with the decision of how to pay for them. Governments should not promise nor mandate benefits that the country cannot afford now and in the future.

PROPOSITION 2: The poor, the vulnerable, and the losers, are not the same groups of people. Separate systems need to be designed to provide economic security to each. Social insurance and social assistance programs should be run independently, though in coordinated fashion. Social assistance programs, targeted at the needy, should not be confused with benefits for which all may apply.

PROPOSITION 3: Public and private systems each have their advantages and disadvantages. Most countries' systems are a mix of the two. The appropriate blend depends on the objectives of the government in question, on the government's skill and commitment to efficient management of development, the country's ability to pay, and the existence of the necessary private sector institutions.

PROPOSITION 4: Policymakers should agree that the primary purpose of government-run economic security programs is to insure adequate consumption by the poor, where "adequacy" is defined relative to an absolute standard such as a nationally-determined poverty line. Because the poor lack the ability to pay for such programs themselves, it is necessary for others to pay for them. (If the poor could pay for them, the programs would not be needed in the first place.) In many cases, it is efficient for social assistance payments to be targeted or self-targeted so that it is the poor and only the poor who receive benefits (to the extent possible).

PROPOSITION 5: Another objective of economic security programs is to provide insurance against possible income-reducing events such as old-age, disability, and unemployment. Such programs should be regarded as insurance against relatively inadequate consumption, and should be paid for in advance by the insured group itself. Sound insurance principles can and should be used to set premium rates of sufficient magnitude to assure these programs' financial soundness. Governments may be able to help facilitate the development of private insurance groups to protect against diversifiable risks.

PROPOSITION 6: If voluntary insurance programs are created, people may lack the self-control needed to look out for their own best long-term interests. In order to prevent people from underinsuring and thereby turning to government-funded programs when adverse economic events befall them, it is appropriate for the government to require such insurance. Whether this is more efficiently done through government-run or through government-run privately operated programs depends on individual country circumstances.

PROPOSITION 7: Some social safety net programs have been targeted on neither the poor nor the vulnerable, but instead on the losers. For example, powerful groups in some countries have demanded and received unemployment benefits as the price for agreeing to economic reforms and structural adjustment. These people are not usually the most needy in society. Governments and international agencies should resist using such programs to gain political support, because these programs can be quite costly and hard to shut down, and because giving in to some may encourage others.

6. Roles for International Development Institutions

As the developing nations design and reform their economic security systems in the larger context of making their economies more productive, each will shape its program to meet its own institutional capacity and priorities. Still, there are important ways in which international development organizations can help streamline this process.

Perhaps the most important role for the Fund, the Bank, and the other international agencies is to provide technical assistance to the developing countries' economic security administrations. The benefit and financing structures of social security systems and social safety net programs influence the economy through labor markets, capital markets, and other arenas such as insurance markets. These effects are often predictable (e.g., payroll taxes discourage employment in covered sector jobs, generous old-age benefits encourage earlier retirement), and outside experts can help officials in the developing countries take account of them. These technical experts can also help design reforms by drawing on the lessons from other countries' systems. For example, they could point out the large and long-lasting costs imposed on the public resulting from the Chilean and U.S. government's decisions to guarantee private pension benefits.

Another thing that all developing countries need is a standardized framework for reporting and disclosure of social assistance and social insurance benefits and financing. International agencies could develop and implement international standards for the audit of such systems. They could also supply additional technical sophistication in a number of areas such as evaluating benefit structures (e.g., in defined benefit plans, computing the actuarial value of contributions), financing systems (what contribution rates are required to generate benefits of a certain size), money management practices, and recordkeeping practices.

Another area in which international agencies can help is establishing an agency which can oversee private insurance and capital market regulation, so as to take some of the burden off developing countries' public sectors. An international administrative structure like the U.S. Securities and Exchange Commission could oversee and regulate the quality and conditions of investments in developing world, and a similar organization is needed with regulatory and audit control over international insurance standards and practices. These oversight agencies could establish and supervise the growth of new banks and investment firms, and supervise the growth of new insurance companies.

Finally, prefunded economic security programs require an investment vehicle, yet few developing countries have the necessary capital market structures to make future benefit promises credible. This is particularly a problem in times of high inflation. We suggest that international financial institutions consider making it easier to access a portfolio of developed country bonds, real interest rate insurance, and other improved investment opportunities. These steps would vastly enhance the environment for economic security systems operating in the developing world.