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Issues in Social Security: A Review of Literature

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ABSTRACT

Social security refers to the institutionalized programmes or schemes which provide support to people during periods of retirement, disability, unemployment, illness etc. It is essential for any population, regardless of their nationality, as it ensures the dignity and self esteem of those who are unable to take part in productive activities due to various reasons. There are many dimensions in social security which is reflected in the profuse variety in research and existing literature. Social security system runs on either funded or unfunded basis. In the provision of social security, the advantage associated with the Pay-As-You-Go (PAYG) system is that there is no necessity to maintain a fund to cover the total liability of the system. In recent years, demographic changes in the form of population aging have put tremendous pressure on the existing PAYG systems in the mature western economies making the system unsustainable. Thus there is widespread evidence of such economies migrating to funded systems which are self supporting.

KEYWORDS Social Security, Pay-As-You-Go, Funded System

1. Introduction:
Social security refers to the institutionalized programmes or schemes which provide support to people during periods of retirement, disability, unemployment, illness etc. Old age, disability, loss or lack of employment, disease, death of the earning member of the family are some situations when regular income flow stops, reduces or does not exist at all. In such situations, if the government does not come forward to help, the affected fail or find it very difficult to meet the requirements of day-today life with the many challenges that come with these adverse situations. 'Social security' was introduced to help people in these situations.

Social security is essential for any population, regardless of their nationality, as it ensures the dignity and self esteem of those who are unable to take part in productive activities due to various reasons. Besides it enhances the quality of life for the entire population by effectively removing fear and worries associated with future uncertainties. Eradicating fear of uncertainty in a sense eradicates poverty since poverty has been interpreted by many as living in constant fear. There are many dimensions in social security which is reflected in the profuse variety in research and existing literature. This paper attempts to capture the various facets of social security through a review of the literature in the domain.

2. Definition of Social Security:
International Labour Organization (ILO) defines social security as "the protection which society provides for its members, through a series of public measures against the economic and social distress that otherwise would be caused by the stoppage or substantial reduction in earnings resulting from sickness, maternity, employment injury, unemployment, invalidity, old age and death; the provision of medical care; and the provisions of subsidies for families with children."(Jhabvala, 1998). However this definition of social security is inadequate for developing countries as it is based on the assumption that the most of the people are generally in a state of employment. To overcome the weaknesses of this definition some other definitions were put forward. According to R.K.A. Subramanya (1994), "the concept of social security in its broadest sense should be understood to mean the support provided to the individual by the society to enable him/her to attain a reasonable standard of living and to protect the same from falling due to the occurrence of any contingency." Thus, social security "should be considered as a legitimate insurance mechanism that insures all eligible consumption units against an inadequate income resulting from disability, retirement and death".

3. Pay-As-You-Go (PAYG) vs. Funded System of Social Security:
Social security system runs on either funded or unfunded basis. Under a fully funded pension system, a fund is built up from matching contributions by the employees, who are covered under the system, and their respective employers. On the other hand, when the pensions for retired workers are entirely financed by tax contributions of currently employed workers, it is known as the Pay-As -You -Go (PAYG) system.

Most of the social security systems of the world are either based on the Pay-As-You-Go (PAYG) principle or are funded systems. In the provision of social security, the advantage associated with the Pay-As-You-Go (PAYG) system is that there is no necessity to maintain a fund to cover the total liability of the system. Thus, in this system, all receipts in the form of payroll tax can be directly used for financing the pension benefits for the year. In PAYG, social security budget is balanced. According to Andreas Wagener (2003), in case of PAYG, "the risks of adverse changes in the economic environment is shifted away from the elderly and entirely loaded upon the contributors." If the long-run growth rate of labour income exceeds the average rate of return on capital, the PAYG system helps each generation. But, such an economy is dynamically inefficient and in a mature PAYG retirement system, social security provides current and future workers with below market return (Viard, 2002).The Aaron's Paradox(Aaron,1966) shows that if the rate of interest expected is higher than the expected economic growth rate, the funded method should be adopted. However, if perfect information regarding the future performance of interest rates, wage growth rates and population growth rates are available, this rule cannot be applied. Again, due to the existence of uncertainty, rate of growth and rate of interest cannot be chosen as perfect indicators for choosing a pension system. Capacity of each system to manage risk associated with uncertainty can be regarded as a better criterion. However, it is a challenge to find out the future values of the relevant variables and to correct any errors of estimation. (Eguia & Serrano, 2003-2004).

4. Demographic Change and Social Security:
Demographic changes affect the PAYG Social Security programmes. Proportionate increase in the aging population puts more burdens on the working population for funding social securities. Most of the developed countries are facing this problem and considering reforms in the existing PAYG system. In the U.S.A., increase in the aging population caused by falling fertility and increased life expectancy, has put pressure on

the social security funding. In 1990, each retiree, on average, had 4.7 current workers to support them, which is projected to fall to less than 2.0 after 2030 (Hyman, 2005). Since social security revenue and expenditures are often closely related with employment and earnings, changes in demographic conditions affect not only institutions of social security directly, but also to a great degree indirectly via their effects on the labour market (Schmahl, 1990). PAYG systems are more vulnerable to demographic changes and political risks while funded systems have capital market risks. But, a fully funded system may also be threatened by the population aging if it rests too firmly on the defined-benefit principle (Borsch-Supan & Miegel, 2003). Demographic changes have impact on the optimal retirement age also. Crettez & Maitre (2002) maintain that ageing of the population resulting from increasing life expectancy and falling birthrates have caused serious problems to pay-as-you-go social security schemes of many countries. To overcome this problem, four measures are generally suggested, namely, decrease in benefits, increase in contributions, increase in saving rates and raise in the retirement age.

5. Social Security and Private Savings:

Regarding the impacts of social security on private saving, Feldstein (1977) provided evidence that other things remaining the same, the countries with larger social security system tended to have lower private saving rates. Without social security, people have strong incentive to save during their working years to provide financial support during their retirement years. Empirical studies show that the PAYG systems are associated with lower rates of national saving and in countries where PAYG system is operating, a transition from PAYG to funded system can provide opportunity to increase national saving (Samwick, 2000). Contrary to the funded system, a pay-as-you-go system lacks financial sustainability when population is ageing rapidly. However, in both the systems, there is a cost involved in adjusting the real effective return to the real return necessary to achieve the target pension. Real effective return is the income available at any time with accumulated savings while the real return is the income needed to access the desired expenditure. Empirical study shows that individuals will not adjust contributions when effective return is less than desired return leading to insufficient savings. In that case, there will be reduction in pensions (Eguia & Serrano, 2003-2004). In a PAYG public pension, intergenerational transfer from young to old takes place which discourages private saving and reduces capital accumulation (Wigger, 1999). Moreover, in a perfect pay-as-you-go system, the saving will be low for another reason. In such a system, there is perfect altruism. As the consumption of the retirees is entirely financed by the currently working population, there is no need of saving. This will adversely affect growth. However, the pay-as-you-go system is often supplemented by other funded systems like employer provided pensions or private investment for retirement (Mirrlees, 1997).

The negative correlation between social security and private saving is not accepted by many writers. Leimer & Lesnoy (1983) showed that there are no sufficient evidences to support the hypothesis that social security had reduced private saving. In 1974, Martin Feldstein concluded that the introduction of social security had reduced private savings in United States by 50%. In 1980, Leimer and Lesnoy expressed their doubt on Feldstein's conclusion. But in 1982, Feldstein provided new evidence supporting his original conclusion.

Although people save for many reasons, one of the primary reasons for saving is for retirement. In the presence of social security such savings decline. Aggregate savings in the economy is the difference between the saving by the younger generation and the dissaving by the older generation. Since generally the younger generation is larger and richer than the older generation, aggregate saving is normally positive without social security. Younger generation saves for retirement in the form of real and financial assets. But in the presence of social security, accumulation of retirement wealth takes place in the form of 'social security wealth' and workers save less in anticipation of promised future social security benefits. In a pay-as -you-go social security system, contributions do not flow into the capital market, rather they are used to pay the benefits of the current retirees. Thus if the individuals save less in anticipation of future promised benefits, social security will reduce private saving.

Arguments can also be provided to support the view that social security does not reduce private saving. As social security benefits are linked to retirement, they can induce early retirement, thus increasing the retirement years and decreasing the working years. It may induce the workers to increase the rate of savings. Again, people save for contingencies and for bequests also. But, the effect of social security on savings for contingencies is unclear. Emergencies can happen in the working years and in that case, it is not possible to use social security wealth for meeting emergencies. It asserts the need of private saving. Moreover as social security wealth cannot be bequeathed, savings for bequests is also not affected by social security. Thus all types of private savings are not affected by social security; at best it can have some effect on savings for retirement.

Older generation may like to compensate their children for payment of taxes for social security, for which they may tend to save more for bequests. But, if such intergenerational transfers are made in the form of expenditures on health and education, total savings will decline and more human capital will be created in comparison to physical capital.

Theoretically, it is difficult to find out the effect of social security on private saving. To a great extent, it depends on the importance of retirement saving relative to total saving (Lesnoy & Leimer, 1985). Development of funded pensions actually contributes to higher aggregate savings. However, for this the funded pension schemes should be mandatory rather than voluntary and it should effectively cover the low savers group. Funded pensions can contribute to higher savings if a large portion of workers are forced to save through pension plans at a rate higher than that is offered in other forms of savings. Moreover, the excess savings should not be offset by borrowing. A positive link between funded pension and higher savings may not take place because increase in savings for pension may lead to reduction in other forms of savings. Precautionary savings may decline due to the increased credibility of pension schemes.

Funded pensions may increase the awareness among general population to save for retirement. Again, it may induce early retirement leading to more savings in the working years. Empirical study shows the difference among the OECD and non-OECD countries regarding the impact of funded pension on savings. In non-OECD countries, there is positive impact of funded pension on savings due to tight borrowing constraints and near mandatory nature of funded schemes. But in OECD countries, funded pension schemes do not lead to increase in savings because capital market is more developed in such countries and the funded schemes are not mandatory in nature (Bailliu & Reisen, 1998). Schroder (1983) maintains that in an economy in which growth of total income is determined by labour productivity, the influence of a decrease in social security contributions on private voluntary saving depends on the relationship between labour productivity and the interest rate.

Conclusion:

There is no general definition of social security as the concept has to be defined in the backdrop of existing socio-economic and political reality. This is specially true when social security is defined in the context of the level of development of a country. However, it can be concluded that funded pension system is preferable over the PAYG system on one critical count; it does not impose the liability of the pension system on the non-beneficiaries. However, unlike the PAYG it is imperative to maintain a fund to cover the total liability of the system.

In recent years, demographic changes in the form of population aging have put tremendous pressure on the existing PAYG systems in the mature western economies making the system unsustainable. Thus there is widespread evidence of such economies migrating to funded systems which are self supporting.

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