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Some Observations Concerning the Privatization of Social Security Systems

by Klaus Heubeck*

1. In social security systems generally, a development can be discerned which, at the risk of generalization, can be characterized by two tendencies worldwide:

– A shift in responsibility from the state to the private sector;
– Conversion of financing from "labour" to "capital".

This development emerged at the start of the 1980s in countries such as Switzerland and Chile; in countries such as Italy, France or Germany it has led to little more than interminable discussion. The former socialist countries are, however, under pressure not merely to reconsider appropriate conversion of their systems but to introduce fundamental changes.

As a general rule, social security systems have as their principal aim the provision of a guaranteed income or equivalent benefit for as broad a segment of the population as possible where the risks of life result in income from employment not (any longer) being earned. Whilst this explains the historical linkage to the employment situation, it does not make it compelling.

Many of the reasons which underlay the development of social security systems in their "classic" form and their customary basis of financing ("pay as you go") today no longer exist or indeed now have the contrary effect: these were the heavy demand for benefits and the inadequate provisions available to the lower and middle income classes, the loss of assets by widespread groups of the elderly as a result of wars and inflation, and an inadequate accumulation of capital often linked with a high rate of growth of productivity of employment.

In the industrial nations, in particular, today it appears to be unjustifiable to leave the financing of social insurance largely to the "labour" factor, for here one can identify an increasing erosion of employment relationships, a hugely increased accumulation of capital and at the same time a decreasing population.

2. Politicians seem to have recognized these changes only reluctantly and in many countries they have evidently had great difficulty in undertaking the necessary measures for a reform of the system. Previously the situation was easier as conditions permitted the expansion of social systems and the chosen financial basis of "pay as you go" meant that the application of criteria of financial efficiency could be dispensed with.

Eventually attitudes changed when it became clear and incontrovertible that the ageing of the population would entail additional problems for the financing of security systems based on "pay as you go". The social policy sector has been put under pressure for justification and

*Professor, Versicherungsmathematischer Sachverständiger für Altersveroorgung, Cologne.

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action, social security systems have become too expensive. The problem of an equitable distribution of income must no longer be answered merely in relation to one generation (or one electoral term) on its own but in relation to future generations, and the social policy sector – within its own limitations – cannot find a solution to the problem of the optimum financing.

As long as social policy is based on social needs without limit it will naturally encounter difficulties in developing measures for their reduction and for cost-saving. One cannot expect the social policy sector to appreciate the ability of market mechanisms to function in the social security sector so that supply and demand can be better, and thus more cost efficiently, matched. The impetus for increased privatization of social security systems must therefore come from finance policy, preferably from a common viewpoint representing economic policy and social policy.

3. For most countries it can be demonstrated that a greater degree of capitalization would significantly ameliorate the financing of those social security systems in particular where a long accumulation period is involved as in the case of retirement provision and health care insurance. The problem of the ageing population reinforces the argument for a greater degree of advance funding even if in the longer term one can expect only a relatively low real rate of return.

On the other hand, one must recognize that a very comprehensive capitalization might possibly be too risky or could become less effective as neither at the national level nor internationally is a continuing positive development of the capital markets and yields guaranteed. In addition, there is the as yet unanswered question as to whether every country will have the ability to manage not only the necessary savings process but also, more particularly, the subsequent dis-savings process equitably and without friction. Reference to the openings and the internationalization of the capital markets can only give limited assurance because the rich industrial nations, where retirement provision is financed increasingly (if not already predominantly) by capitalization, will be pursuing this process at the same time.

This all points to a combination in the financing of social security systems with a mix of financing systems defined according to the specifics and policies of individual countries.

4. Capitalization does not automatically mean the privatization of the risks thus financed and (in theory) "pay as you go" is not only possible in state systems. Nevertheless it is not only appropriate but it also meets the criteria of the private and market economies if the accumulation and disposition of capital is the responsibility of the private sector.

In many countries private and occupational retirement benefits are available to provide for security in old age. The state determines the framework but should not thereby assume that the aims and responsibilities, which from an overall point of view it considers appropriate or essential, will automatically be realized.

For example, political aims for income distribution such as securing continuation of living standards in retirement can only be achieved by supplementary private schemes if, as in Switzerland and now in Hungary, it is obligatory to contribute to pension funds. Security of living standards entails not only a requirement to pay contributions but a guarantee of future benefits, that is "defined benefits" and not just "defined contributions" if the risks are not to be borne by the individuals or by the state.

The political will to secure within the social security systems, comprehensive provision for cases of occupational unemployment or health care can only be undertaken by the private sector if the insurance industry is able and prepared to assume and manage the total risks involved.

This means that notwithstanding an extension of privatization, state systems will continue to have social security obligations and the state must beware that it does not become the insurer of last resort or is left with sole responsibility for those residual risks which are expensive and difficult to handle.

5. Conversely, the fact that some elements of social security can be more efficiently organized in the private sector is no guarantee that in the event and in the long run this will actually come about. Close attention must be given to the question of whether the possibilities and concepts offered by the private sector in undertaking social security provisions match state and political requirements.

In this respect, it is pertinent to question the concepts for retirement provision that the World Bank has suggested for many of the former socialist countries of Central and Eastern Europe. There, the lengthy and deeply rooted experiences with centralized state decision-making and social provision are (still) hard to reconcile with models which require greater responsibility from the individual for his own provision. Concepts based on systems involving capitalized pension funds are met with incomprehension or with fundamental practical difficulties if the necessary capital markets still do not exist, if their methods of operation, their advantages and the risks attached are scarcely understood and if neither the personnel requirements nor the legal frameworks are available for the indispensible security measures.

A development in Germany, where the banking sector is calling for increased privatization by way of pension funds in the light of the expected difficulties of the state scheme for retirement provision and is attempting to achieve this by every means politically, must be viewed in a similarly critical light. So long as such initiatives are pursued in the interests of the capital market and its service providers and the specific requirements of provision for retirement are neglected, the state has no grounds for recognizing and supporting such proposals as a private alternative to the state system.

These examples relating to retirement provision, as well as examples to do with sickness and health care insurance, demonstrate clearly that it is a prerequisite for each and every privatization of an existing social security system that robust long-term organizations exist or can be set up which are ready and able to undertake the practical implementation of the political imperatives efficiently and comprehensively. And even in countries with a highly developed system of private insurance, it appears to be necessary that the state supervises and continuously improves the performance of the market.

Summary of conclusions

Changes in the labour conditions in the industrial countries, the imminent ageing of the population in the European countries and the development of worldwide capital markets require the adaptation of social security systems, development of financing by capitalization to a greater degree, and a shift from the state to the private sector.

The social policy sector is fundamentally unsuitable to effect such an adaptation. The initiative for more privatization can certainly be led by financial policy, but it must be supported by all politically responsible sectors, including the social policy sector, to ensure its long-term success.

Capitalization is undoubtedly the more efficient financing system where long accumulation periods exist. But capital market risks should not be overlooked in the case of retirement provision and one should in general regard a mix of capitalization and "pay as you go" as the best solution and attempt to combine them in optimal proportions, having regard to the historical and structural situation of the country concerned.

Privatization should go hand-in-hand with capitalization and vice versa. The state must define the framework in such a way that advantages gained as a result of privatization of some social elements are not outweighted by disadvantages to the state resulting from residual risks and guarantees of last resort.

The shift of social security to the private sector subjects it to market forces. Adequate performance in relation to the political imperatives can only be expected from this market if the state continually supervises its products and operations.

Retirement provision cannot be guaranteed by capitalization alone. Partial privatization of social pension insurance can result only in such products that offer more than performance prospects and capital market support.