PROCEEDINGS OF THE
INTERNATIONAL WORKSHOP ON

SOCIAL SECURITY REFORM

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Chapter 1:

Problems and Experience of the Social Security Reforms

The many dimensions of social security reform

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1. Introduction

Low birth rates coupled with increasing life expectancy are changing the world's demographic characteristics. By 2030, the World Bank estimates that 16% of the world's population will be age 60 or older. This means that the total number of the elderly will exceed a billion people, who will average some 20–25 years in retirement. The future high percentage of retired people will place great stresses on global pensions and health care programs.

A majority of government pension programs are pay-as-you-go systems, funded by taxes on current workers rather than from earnings of investment pools. As demographic shifts reduce the ratio of workers to retirees, governments and societies all over the world are clearly drifting into what can be called a social security "crisis," with mounting risks to their national budgets, capital markets and even perhaps social cohesion.

Demographic shifts with this long-term momentum have been, and will be, accompanied by financial liberalization and growth of global security markets. Over the past ten years, the number of nations with significant stock markets has grown from 56 to 85, with equity capitalization increasing threefold to a current total of $18 trillion. For many nations, liquid securities markets make possible private investment options to supplement and strengthen national pension plans.

The IIASA program on Social Security Reform attempts to provide insight into the implications of long-term demographic shifts, the concomitant need for innovative pension strategies, and the consequences of these trends for global economic development.

2. The experiences and problems

Much of the discussion of social security reform (SSR) has concentrated on demographic shifts. Of course it is important to note that the dependency ratio—retirees to active workers—in OECD countries will increase from 1/5 in 1990 to less than 1/3 in 2020. But SSR involves much more than demographic projections with their uncertainties. The changes in the international economic situation that result from financial liberalization and growth of the global securities markets have received far less attention. Further, SSR has major political dimensions with significant international consequences. The shift in global financial markets permits innovations in pension schemes, and both researchers and policy makers must explore them.

Different countries are, and will be, exploring various reform measures, taking into account varied cultural, political and economic situations. As nations develop or modify their own systems, they must learn from the existing findings. To some extent, this already happens. In the early 1990s, Chile, aware that its social security system was bankrupt following the years of political instability during the Allende era, instituted radical reform. With a military dictatorship in place, Pinochet passed a law based on the advice of Milton Friedman of the University of Chicago: a law requiring that workers pay 10% of their monthly wages into one of 13 funds. The funds initially grew exponentially, until they now manage $US 33 billion (40% of GNP). In the early years, the funds' annual rate of return averaged 14%, but in 1996, the returns went negative and only averaged 3.5%.

The basic problems are sky-high marketing costs and poorly diversified portfolios. Pension funds in Chile employ some 68,000 sales persons trying to get workers to switch funds — an extraordinarily difficult task, given the restrictions under which the funds must operate. Government regulations require that all funds charge the same fees in the interest of fairness. The funds' rate of return is about the same – but the only allowable investment is in government bonds. The government now allows 62% of funds to be invested abroad, but so far only 1% are.

Mexico and Bolivia have learned some of the lessons of the Chilean experience. Mexico, whose new system goes into effect this year, permits funds to compete on fees and to offer funds with different risk levels. Bolivia is trying to minimize administrative costs by allowing only two funds.

But neither Mexico nor Bolivia has learned the second lesson – both countries still require domestic investments. As a result, they, and their retirees, lose the potential gains from including foreign securities in their portfolios at a time of globalization of security trading.

As mentioned earlier, discussions of SSR often neglect the crucial political dimension. As an example, in the early 1980s, the United States recognized that the retirement of the baby boom generation would place great strains on the social security system. Under Reagan, a popular President, it became possible to raise the mandatory age of retirement from 65 to 67, to become effective between 2001 and 2007. But this small step has not been accompanied by any additional reforms. Lack of political will has led succeeding Presidents to do no more than appoint study commissions to look into the problem. These commissions were carefully constituted so they would not come up with any politically divisive suggestions, and the results—or lack thereof—have led many to wish for something like the Pinochet dictatorship.

Much the same has happened in Japan. Reform measures in 1986 and 1994 raised the retirement age from 60 to 65, to enter into force between 2001 and 2013. Nothing further has happened. Many would say that these actions are designed as Band-Aids to cover the deep, developing sores.

In examining the political factors, we need to remember that current systems were set up at a time of relatively low unemployment and a high active-to-retired population ratio. Policy makers did not anticipate such major changes as the massive entrance of women into the labor force and the large number of part-time workers as a result of industry downsizing in recent years, particularly in the United States.

Information available to the public is often misleading, placing particular emphasis on demographic trends. Forecasts of economic growth tend to be pessimistic and do not take into account the growth of the global market. Very importantly, the discussion fails to factor in the widely different perceptions of old age. Those who, after long years of training and study, have interesting careers (mainly white-collar workers) may wish to remain productive well beyond the conventional retirement age. Those who began work at a very early age, in different circumstances, and who derive very little satisfaction from their jobs, hold quite a different perspective. These divergent views can lead to a class struggle between professionals and laborers.

Some countries have tried to sidestep the difficult issues raised by SSR. France, in its 1993 reform, carefully avoided changing the retirement age, but instead increased the number of contribution years. The strike action in December 1995 demonstrated the lengths to which French public sector workers will go to protect their special pension rights. In view of these realities, political leaders hesitate to face up to the real issues.

In order to shift the blame for reform, some in Europe are urging that Brussels take the lead. In the 1980s, Brussels' recommendation that women retire at the same age as men has made it easier for a number of countries to raise the age of retirement for women and, thus, the average age at which a citizen becomes eligible for a pension. But the dependence on action by Brussels underlines the lack of political will and courage in many countries, with the exception of Sweden and Finland.

3. The role of IIASA

What role can IIASA play in this complex issue? I see an analogy to the energy crisis of the 1970s. In those years, all industrialized countries conducted studies to develop national energy policies. None looked at the global dimensions of the energy issue. IIASA took up this challenge and met it with great success. The strengths of IIASA include its international stature, its long tradition of demographic analysis, its capabilities in economic analysis, particularly in countries in transition, and its demonstrated capability to work closely with scientists in member countries.

In the future, we must join together to look at the interactions between demographic, finance and political dimensions of SSR – in the international context. By the international dimension, I mean not only comparative analyses of different systems, but also interactions with global capital markets. Different cultural settings are bound to play an important role. The Nordic tradition of government provision of social services differs greatly from the views in the US about the role of government.

To some of us, the phenomenal growth of liquid securities in the global arena makes possible numerous private investment options that can supplement and strengthen government-supported pension schemes. But not all students of SSR are convinced of the long-term strength of global securities markets. Clearly, the multidimensional challenges of SSR will require the highest level of analytical support by IIASA and its partners.

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