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SOCIAL SECURITY REFORM

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Chapter 1:

Problems and Experience of the Social Security Reforms

Notes on the political economy of social security reform

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1. Introduction

Pension reform is a complex undertaking involving scenarios that will take decades to play out. It concerns such fundamental aspects of a society as the nature of its political process and, at least in democracies, its citizens' views on intergenerational equity, the utility of work and leisure, the role of the state, and the degree to which they are responsible for the welfare of their fellow citizens. Each country presents a unique mixture of these elements and the outcomes differ accordingly.

Old-age pension systems – especially those of the pay-as-you-go (PAYG) type – differ from virtually all other types of social-policy measures. By making pension contributions, we insure ourselves against a contingency that we all expect to face (to live beyond retirement age). For other types of risk, such as disability or catastrophic illness, we can convince ourselves that the beneficiaries will be someone else (from another race, class, gender, region, and so on). This perhaps explains why even such individualistic peoples as Americans willingly submit to PAYG pension and old-age medical care schemes, while eschewing all other social programs funded in that manner.

However, it is well known that there are features built into PAYG pensions that make them less viable as time goes on, especially in aging societies. A natural reform is to complement or replace PAYG systems with funded systems tying one's benefits to one's contributions.[1] While some developed capitalist countries, such as Sweden, have managed to effect thorough pension reforms relatively quickly, most have had a great deal of trouble in this area. Strikingly, among such countries, the correlation between the capacity to reform and liberalize their economies in general and the ability to reform their pension systems appears to be low.

There are many rocks on which pension reform may founder. The PAYG pension system seems to be one of the central features of the welfare state and as such is sacrosanct in many countries. Characteristics of developed capitalist democracies antithetical to serious pension reform are legion. Among the most important are the following: a lack of concern with intergenerational equity; a belief that the state must insure individuals against all financially debilitating contingencies; and a view that work is a „bad" and that „progress" means ever-earlier retirement (and ever-longer vacations, *inter alia*).[2]

Nonetheless, a growing number of countries have succeeded in reforming their pension systems. As mentioned above, Sweden stands out in this regard among West European welfare states, while Chile has been the leader in Latin America (followed by several other countries in the region), and Latvia, Estonia, Hungary, and Poland are the stars among the post-communist economies. Interestingly, the characteristics of the leading reformist country within each group relative to the other members of its group vary widely. This suggests that the determinants of what makes for a successful pension reform differ by type of country (socioeconomic system, region, and so on).

There has recently emerged a new literature attempting to explain theoretically why developing countries often fail to stabilize their economies or why they are sometimes suddenly able to stabilize after many years of failing to do so (for a survey, see Rodrik, 1996). It is useful to ask whether what we have learned about

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[1]In the Third World, and increasingly in the postcommunist countries, pension reform is being driven by advice and financial support from the World Bank, which has a standard model of a reformed pension system. See World Bank (1994) for a presentation of the model and a wealth of useful empirical material on the subject.

[2]The items in this list are all individual preferences, perhaps those of the proverbial median voter. In democracies, policy-making is a complex process involving many social elements, so the outcome in a given context often does not reflect the preferences of anyone in particular. This fact bedevils any attempt to come up with general rules governing such outcomes. Note also that the discussion in the text applies only to democracies. In a dictatorship, it is tempting to suppose that it is the dictator's preferences that matter, but that too would be a gross oversimplification in all but the most repressive societies.

the political economy of macroeconomic stabilization also applies to pension reform. Heretofore, work on the political economy of pensions has generally been in a public choice vein, focusing on decisions made by a median voter confronted with the inherent features of PAYG pension schemes.[3]

All of this suggests a number of questions, including the following:

- Is there something specific about pension reform in transition countries relative to other nations attempting such reform?
- To what extent does the political economy of pension reform differ from the political economy of macroeconomic stabilization? and
- How much of reality does the literature in a public choice vein on pension reform explain?

The remainder of this brief essay will attempt to shed some light on each of these questions.

2. Specific characteristics of pension reform in transition countries

The leading pension reformers among transition countries are for the most part the leaders in other areas of economic reform as well. Latvia is the acknowledged front-runner in the reform of its pension system, with Estonia, Hungary, and Poland not far behind. All of these lands have been in the forefront of general economic reform and political democratization, even if Latvia was not among the five associated countries invited to begin accession negotiations.[4]

This point may not at first seem surprising. However, it is useful to recall that this has not generally been the case for other groups of countries. In Western Europe, while Sweden has probably gone the furthest in its pension reform, changing anything else in its welfare state seems almost impossible, at least under the ruling social democrats. Moreover, the U.K., which generally speaking has a more liberal economy than continental European countries, has not yet managed to adopt a serious pension reform.

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[3] The classic early work in this type was Browning (1975); mention should also be made of Disney (1996), Boadway and Wildasin (1989), Sjoblom (1985), Verbon (1988).

[4] These four countries, along with the Czech Republic, Lithuania, and Slovenia, have earned the highest marks on both economic reform and democracy from Freedom House (see Shor, 1997). The reader might wonder how the treatment of ethnic Russians in Estonia and Latvia affected these ratings. In any case, it is enouraging that the Latvian pension reform does not discriminate against resident non-citizens.

In Latin America, the situation also differs from that of the transition countries, but not in the same way: here it is the degree of democratization that seems to conflict with pension reform, rather than overall economic liberalism. Chile was the world's forerunner in pension reform, in 1981 replacing a public PAYG system with a mandatory savings scheme. At the time, Chile was under a dictatorial regime with liberal views on economic policy; that regime promulgated many other liberalizing economic reforms, including ones in the spheres of foreign trade and the agriculture. Meanwhile, Costa Rica, with perhaps the best democratic credentials in the region, has not put forth a radical pension reform.[5]

Accordingly, we may ask what accounts for the happy coincidence of democratization, systemic economic reform, and thorough pension reform in transition countries. First, we can explain much by referring to the fact that in many transition countries the old pension systems had either collapsed or were functioning at minimal levels. Certainly in the two Baltic states and Poland, hyperinflation had eroded the value of old savings and financial systems had to be rebuilt from scratch.

More broadly, in these three countries, it has been obvious to all concerned that the current governments were not mere extensions of the communist regimes. Accordingly, a sharp discontinuity occurred in these lands on both the economic and political planes. No West European welfare state is „blessed" with such a complete collapse of its economic and political systems, and arguments of looming crises and the need for radical reform often fall on deaf ears there.

Second, it is useful to recall the sacrifices made by elderly Balts for future generations. Most strikingly, they endured unheated or barely heated apartments through the early winters of (regained) independence, rather than surrendering a degree of national independence by asking Russia for cheap oil and gas. It is hardly surprising that these same elderly voters would support pension reforms that stop PAYG systems from burdening younger workers with ever-higher contribution rates. By the same token, it makes sense that those countries where older voters insist on keeping in power politicians opposed to systemic change (e.g., Belarus, Bulgaria and Romania until recently) are also ones where serious pension reform has been unthinkable.

Third, note that the policy-making process is different in transition (and developing) countries from its counterparts in the majority of developed market economies. Although we can cite many aspects of this divergence, the most important is

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[5] For a survey of social welfare reform in Latin America, see Mesa-Lago (1995).

undoubtedly the conditionality imposed by the international financial institutions (IFI's). It is true that the most reformed post-communist lands have had more room to maneuver than their struggling neighbours. Moreover, those countries that have been most dependent on international finance, such as Bulgaria, Romania, or the Transcaucasian states, have done little in the way of pension reform.

Nonetheless, all transition countries are engaged in a constant dialogue with the International Monetary Fund and World Bank over whether (and how) they will promulgate certain reforms and the financing that they will receive if they do so. The game governing the policy-making process is clearly different in situations where it is non-cooperative, as an outside force presses for a certain outcome, from where it is cooperative, as domestic social partners engage in a long dialogue over where to go next.[6]

3. How the political economy of pension reform differs from that of macroeconomic stabilization

In all types of lands, there are many factors making pension reform a different matter from macroeconomic stabilization. In this section, we briefly discuss some of those factors.

Much of the distinction between the two types of economic policy arises because pension reform deals with long-term matters, while stabilization is essentially a short-term question. Observers frequently assert that it is its long-term nature that makes pension reform difficult, partly because of the proverbial shortsightedness of elected politicians is unusually damaging in this context. Furthermore, such reform deals with the welfare of the unborn, making it particularly unlikely that the political process will produce efficient outcomes.

On the other hand, the long-term nature of pension reform may be helpful in a political-economic sense. The sort of three-pillar reform advocated by the World Bank (1994) should produce „winners," as well as „losers." Among the former are young workers entering a funded system. In contrast, no one gains in the short run from, for example, large cuts in the state budget.

[6] Note that in their relations with the IFI's, the Latin American countries are more similar to the transition countries than to the West European welfare states. That similarity – and the fact that their pension systems are objectively speaking in worse shape than in Western Europe – helps to explain why radical pension is more common in Latin America than in Western Europe.

Another factor seemingly making pension reform a bit more palatable to a polity is that, unlike macroeconomic stabilization, it often includes compensation for the losers. None of the reforms being implemented or advocated in transition countries involves an immediate and total move to a funded system; the old PAYG system is retained for workers of over a certain age and social pensions are kept for the elderly poor. In contrast, Rodrik (1996, p. 25) asks: „if distributional struggles are at the heart of inefficient policy choices and macroeconomic policy cycles, why do policy makers not design *compensation* schemes to neutralize political opposition?" (emphasis in original).

There is also a number of similarities between reforms in the two areas. In both cases, there are people whose views inform political outcomes but do not bear any of the costs of the systems designed by that process.

In the pension case, especially in developing and transition economies, there are large numbers of people who do not earn wages from which to deduct contributions (or even if they do, they somewhow manage to avoid making those contributions). They may be farmers, whose only money income comes from market sales of their products, or people working full-time in the informal sector; in some countries, these two categories embrace a large proportion of the population. They are probably ineligible for a pension, or at least one beyond the social minimum. There may also be wealthy people with access to capital flight, who care little about the state of the domestic financial system.

These groups may be uninterested in pension reform. But might they actively oppose it, as both the very rich and the very poor may be against macroeconomic stabilization because they benefit from budgetary largess? The answer appears to be positive, since both the rich and poor may be interested in preventing a reform that lowers their customers' – and their own, in the case of the rich – disposable incomes.

Another similarity between the two types of reform is that there are many instances of countries that proved unable to reform the relevant area for many years, only to one day knuckle down and promulgate a radical, lasting systemic change. This phenomenon is especially common in Latin American nations, such as Bolivia, where both macroeconomic performance and the pension system solvency sank to abysmal levels before a government effected a radical change.

Political economists have devoted considerable attention to showing how political instability or polarization can result in delays in stabilization, with the villain of the drama variously being asymmetric information, uncertainty, or the dynamics of flight from the domestic currency (see Rodrik, 1996, for a review). It is possible that such models would also be helpful in explaining delays in instituting pension reform, although the modeler must contend in this case with more complex intergenerational issues.

4. Conclusion

As noted above, a literature exists that attempts to explain certain inherent features of PAYG pension schemes and the difficulty of reforming them. That literature relies on public choice notions, including that of the median voter. This work must reckon with the fact that, while it is easy to impute motivations to young and old workers, the median (middle-aged) voter is in a less straightforward position. Further complexity derives from the fact that each cohort „grows up," the young becoming middle-aged and the latter old, which often leads to unfortunate trends in the system's characteristics.

It is not clear that the median voter is the appropriate focus of analysis for all aspects of pension policy in all political systems. One can imagine such policy as the result of a sequential game. In the first step, players determine the system's rules; in succeeding steps, they fine-tune the system's operating features (for example, contribution rates or retirement ages). In these later steps, the median voter paradigm may be useful, at least in democratic polities.

However, the process of determining the system's characteristics – that is, the first step – is qualitatively different. If the median voter is likely to push for expansion of a PAYG system beyond an efficient level, how can we trust her to approve a set-up that avoids this problem in the first place?

The experience of transition countries suggests that there are circumstances where we can trust the median voter. For example, when Estonia (even before its pension reform) adopted a currency board, it demonstrated how a democracy can produce a system governed by rules that help its citizens avoid the temptation to behave shortsightedly later on. This aspect of reform is often ignored by analyses displaying great awareness of how a given system functions, but little of the forces governing the process of adopting that system.

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