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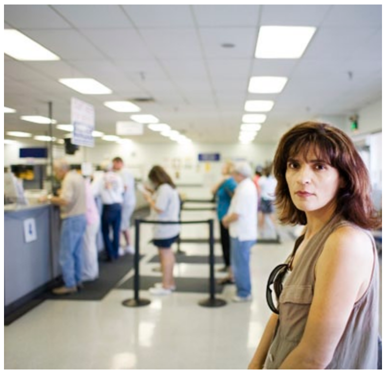
Social Policy Highlight 10



Social security systems: Responding to the crisis

Social security systems have been negatively affected by the current financial and economic crisis. Financial portfolios have been undermined by slumping markets and negative investment performance. Increasing unemployment has reduced contribution revenues while expenditure on benefits has increased. Yet many governments have seized on social security systems as a vital policy tool to counteract the crisis. The challenges presented by the crisis have drawn attention to the strengths of these systems, thus energizing arguments in favour of the more vigorous promotion of social security worldwide. On the basis of recent evidence, this *Highlight* argues a need for the better design and coordination of social security systems and for broad-ranging national and international collaboration to respond more effectively to the social and economic challenges posed in times of crisis, and beyond.

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The impact of the crisis on social security financing

In the longer term, the current global crisis may lead to a reassessment of the roles and scope of many national social security systems. In the shorter term, however, a challenge facing many social security systems is one of maintaining financial equilibrium. A recent International Social Security Association (ISSA) survey[1] of the impacts of the crisis on social security funds has revealed that many funds have experienced a negative investment performance. This has been especially so in industrialized countries. For some the losses experienced represent as much as five years of investment income, or around 25 per cent of the fund's net asset value.

This issue

- Summarizes the impact of the crisis on social security financing
- Reports on national social security responses to the crisis
- Details some of the challenges faced by pension funds
- Considers the role accorded to social security systems as agents of crisis management

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With the initial "subprime" crisis having evolved into a major global economic crisis, many countries have seen unemployment rates rise. Worldwide, the International Labour Organization has forecast that unemployment could reach 239 million by the end of 2009, which would represent an increase of around 59 million since 2007.[2] For many social security systems, increased unemployment has reduced contribution inflows while new claims for benefits have surged.

There are additional financial challenges facing social security in the short to medium term. For instance, the options of bolstering cash payments to beneficiaries or freezing or reducing contribution rates for businesses, as potential measures to boost consumer spending and support economic activity, may also lead to financial imbalances in social security programmes. The concern is that these measures, as part of wider stimulus packages, may constitute a semi-permanent financial burden for social security. But the hope is that the economy will stabilize and recover, sooner rather than later. Of course, the big risk for social security is one of incurring operational deficits, which will limit the generosity of benefits in years to come. In an evolving context, with demographic ageing fully expected to increase demands for higher social security spending, this is deeply problematic.

Financing pensions

Since the 1990s, a number of countries have increased the role of pre-funding in their national pension systems. In 2008 many funds' asset portfolio values contracted sharply, jeopardizing the future retirement income prospects of many individuals.

Recent data on the performance of social security funds indicates that some social security funds have begun to recover. It needs little repeating, however, that it will not be on the basis of positive returns in one semester that funds will be able to recover the major losses incurred in 2008.

But not all funds have suffered losses to the same degree. In some countries financial investment strategies have proven less risky and volatile. This is particularly so for strategies focused on domestic, fixed-income securities, albeit that these may produce potentially lower average returns. For example, pension funds in Mexico and Thailand produced returns of 7.46 per cent and 9.40 per cent, respectively, in 2008.

Another example comes from Denmark, where one fund reported relatively low losses of –3.2 per cent on its investments in 2008. The same fund has since reported a positive first semester result for 2009 of 3 per cent.

Although the investment approach of the Danish fund was defined by its governance rules and capacities, three general elements of note were:

- The hedging of uncompensated risks by hedging liabilities in separate portfolios.
- Active portfolio management with an aggressive reallocation and diversification of investment portfolios.
- Running appropriate severe-risk scenarios to test the vulnerability of its system in order to anticipate the impact of a crisis and therefore limit potential losses.

Despite signs of improvement, the sharp contraction in the value of equities in industrialized countries – averaging a drop of 23 per cent in 2008 – and a dramatic policy-induced fall in interest rates have increased the financial insecurity of current and future retirees who expect to rely heavily on private pension plans for much of their retirement incomes. Even though some governments guarantee minimum pension payments, this has raised concerns about the degree of risk borne by individuals in private schemes.

In response to the problems faced by private schemes, some public pension schemes are under political pressure to provide higher benefits, even as they too look to mounting financial challenges stemming from the crisis and population ageing.

Improving social security system design

The current crisis has tested the finances of many social security systems. Nonetheless, analysis of the impacts of the crisis suggests six pointers for improving social security system design. The crisis has:

- Revealed some of the strengths and weaknesses of different pension systems, especially the challenges facing those reliant for the financing of adequate benefits on the expectation of consistent high returns from financial market investments.
- Underlined the need for an appropriate balance of risk sharing between individuals and the state and between pay-as-you-go and fully pre-funded schemes.
- Questioned what constitutes an appropriate asset allocation when investing social security funds.
- Emphasized the importance of the ex ante design of social protection programmes with a capacity to react flexibly and quickly to crisis scenarios.
- Reiterated the need for adequate and efficient regulation, supervision, and investment policies.
- Highlighted that the provision of unemployment insurance benefits may be inadequate or absent in many developing countries.

The role of social security in national recovery plans

Although the financial crisis has weakened the financial position of many social security programmes, it has also underscored the critical role social security systems play, both as an income replacement mechanism and as a policy tool to help respond to economic downturn. In seeking to alleviate the impacts of growing unemployment, reduced levels of remittance income, and rising poverty rates, countries have recognized and exploited the important delivery capacities of social security institutions. Specifically, these include their capacity for outreach to households, through local offices, as well as their ability to channel financial resources quickly to different populations groups, whether to the most vulnerable or the unemployed.

In addition to efforts to stimulate aggregate demand and support the creation of jobs, policy-makers recognize that social security systems provide a powerful means for smoothing individual and family income. Unlike for larger-scale investments in public infrastructure, which can take time to plan and implement, cash benefit payments can be made with little delay. This is essential for beneficiary groups that are likely to have important immediate and ongoing household consumption needs.

In a number of countries, the crisis has led policy-makers to innovate by using social security systems to pursue policy goals that have gone considerably beyond what had been the traditional scope of these systems before the crisis.

A wide range of implemented social security policy responses have been observed during the current crisis. A number of these, which were presented at the 2009 ISSA *Seminar on Social Security in Times of Crisis: Impact, Challenges and Responses*,[3] are presented in Box 1.

In designing policy responses, many countries have considered whether these policies, intended as temporary relief in a crisis situation, might have unintended, undesirable and durable side effects. Might they encourage workers to remain unemployed? Or to retire early with full retirement benefits? Might they encourage firms to lay off workers, who might then become eligible for retirement or disability benefits? Will they further exacerbate the long-term financial weaknesses of social security systems already threatened by the prospect of demographic ageing? As a consequence, some countries, such as Australia and Portugal, have proactively tried to structure their responses to avoid creating a group of permanently unemployed or inactive persons.

For countries with limited coverage under pensions or unemployment insurance programmes, the crisis has demonstrated the value of such forms of social security provision, both in cushioning economic shocks and providing incomes to households. Significantly, these are key roles prioritized as part of the ISSA's Dynamic Social Security conceptual framework. Broadly, the framework seeks to promote the development of social security systems that provide protection, encourage prevention, and proactively support rehabilitation and reintegration, and do so in a manner that contributes to better realizing socially inclusive and economically productive societies.

Taking stock

Looking back over recent months, several important lessons can be drawn about the roles of social security systems as elected agents of crisis management:

– social security systems have shown to be an important component of the crisis "exit strategy", offering policy measures that can both revitalize the economy, by stimulating aggregate demand, and better guarantee social cohesion, not least by providing adequate protection to the most vulnerable.
– social security policy responses should be paired with active labour market policies that neither distort incentives nor create long-term dependency on social security benefits.
– financial losses have weakened the financial capacity of public social security and private pension systems to confront future challenges. This has potentially exposed governments to new financial risks, not least in guaranteeing a basic social safety net. In turn, there is a need to revisit the regulation

Selected national responses to the financial crisis

Australia: Has enhanced social protection by facilitating greater access to superannuation payments, to social housing and the Jobs Fund; to tackle longer-term dependency, provides skills package for laid-off apprentices and trainees; offers immediate assistance for redundant workers.

Brazil: Has extended unemployment benefits to seriously affected sectors; changed lay-off rules and provides training for laid-off workers; accelerated the minimum wage adjustment and annual CPI adjustment; has increased payments under the *Bolsa Familia* programme; has increased access of beneficiaries to bank credit; has increased the number of local social security offices.

Canada: Accorded additional funding for a long-term training programme to upgrade workers' skills, including those not normally covered by Employment Insurance; extended the duration of unemployment benefits and of work-sharing agreements; extended the wage-earner protection programme to cover severance and termination pay for eligible workers impacted by employer bankruptcy; provides additional payments to older workers; has strengthened apprenticeship programmes.

Chile: Provides additional benefits from the solidarity fund for some workers; has enhanced coverage for unemployed persons; created additional incentives to stimulate youth employment; strengthened programmes for assisting the unemployed; provides additional grants for beneficiaries of the family subsidy.

Sweden: Increased resources for employment services for the unemployed (job coaching, training, and skills development); provides additional compensation to employers hiring persons unemployed for more than a year; a temporary relaxation of eligibility conditions for unemployment insurance.

United States: The Recovery and Reinvestment Act of 2009 provided for one-time payments of USD 250 to individuals who were eligible for Social Security and Supplemental Security Income benefits in any month between November 2008 and January 2009. From the governmental Economic Stimulus Package, USD 500 million has been made available to process additional workloads caused by the crisis.

Russian Federation: The government has pledged to increase the average monthly social pension in 2009; the federal budget has earmarked additional RUB 43.7 billion to stabilize employment; the maximum unemployment benefit has increased by 50 per cent in 2009; and measures were introduced to improve laid-off workers' competitiveness in seeking work.

and governance of private pension systems, particularly with regard to acceptable investment strategies.
- public social security programme and private pension scheme design should not leave households excessively exposed to financial market risks. State responsibilities in the provision of adequate social security cannot be delegated to the private sector.
- social security policy responses should be built on a long-term perspective that ensures the financial sustainability of social security programmes.
- social security organizations must operate with a holistic outlook towards risk management.
- countries with strong fiscal positions have, unsurprisingly, been better able to provide financial stimulus including tax-financed social assistance initiatives. Ultimately, to mitigate risk, protect the vulnerable, and to ensure, at the very least, basic social security for all, the role of the state is indispensable.

Looking ahead

The crisis, and the nature of policy responses to it, has highlighted the key role of social security institutions in realizing national social policy objectives and macroeconomic goals. Social security institutions often occupy a special niche within governments. Their proximity to the general public makes them an ideal vehicle for providing not only benefits but also services and information. Their databases can help policy-makers in the formulation of policy, informing them of what is possible. And social security institutions are the implementers of policy – determining whether the policy that is actually implemented is as intended or different. The diffusion of knowledge, and of lessons learnt, about such policy initiatives may be useful. To this end, the ISSA constitutes a unique forum where social security institutions and policy-makers can discuss, with the aim of cultivating the necessary political will to further promote, the vital societal role played by social security.

Thus, there is much to be said for governments relying more on social security institutions in the formulation of policies, not least during a crisis. International organizations – the multilateral development banks and the United Nations agencies – should foster this collaboration in their own work. And such collaboration is equally essential amongst the ISSA and its worldwide membership.

Sources

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The **International Social Security Association (ISSA)** is the world's leading international organization bringing together national social security administrations and agencies. The ISSA provides information, research, expert advice and platforms for members to build and promote dynamic social security systems and policy worldwide.

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