

Challenges to social security pensions in times of global financial and economic crisis¹

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Introduction – major concerns

This paper to a large extent focuses on old-age pensions but it looks as well here and there at other security programmes, as social security forms a comprehensive system where different programmes are complementary and interlinked. At the same time we do not discuss here social security programmes which aim at providing income security for unemployed (like unemployment insurance or unemployment assistance): role of these programmes is crucial in particular in times of crisis, however their importance would require a separate discussion linked closely to labour market and economic policies aimed at faster recovery.

In times of any economic downturn, revenues from contributions or taxes earmarked to finance social security programmes are falling, while expenditure – due increased number of beneficiaries – is on the rise. The countercyclical behaviour of social security expenditure is its inbuilt feature and a source of its power as automatic stabilizer of individual incomes and aggregate demand. However, funding for increased expenditure does not come automatically (beyond existing reserves of those social security systems which keep such contingency reserves) and has to come from increased overall deficit financing of public finance.

When reviewing² experiences of different countries there are a number of key areas at which one has to look in particular when discussing the role of social security in the crisis: (1) expansion of protection (either as automatic reaction of the existing social security system or policy induced changes or both; (2) financial constraints caused by the crisis lead to cuts or restrictions in benefit levels and – specifically for pre-funded define-contribution pensions (3) negative rates of returns of the pension funds undermine benefit levels of those already retired, those about to retire and those retiring in the future. But the biggest challenge stays in fact that large majority of world's populations have no access to even basic protection from social security schemes which leaves them vulnerable to all economic and social risks, including those brought by the current crisis.

(1) Expansion of social security – crisis response on the right track

In those countries reviewed that have developed at least elements of comprehensive social security responses in the areas like pensions, health schemes or family benefits are usually **expansions in coverage and in benefit levels of the existing schemes**, except for a limited number of countries which were forced by circumstances to actually decrease benefits or narrow coverage..

Measures expanding benefits and coverage one can find everywhere – high, medium and low income countries. The difference is of course in the scale of the impact of such measures. In countries where coverage is comprehensive the expected impact in terms of not just of individual income levels of the covered recipients but in terms of the overall aggregate demand change is significant. On the other hand in countries with coverage limited only to

¹ Prepared with extensive help from Ellen Ehmke and using results of the analysis undertaken by staff of the ILO Social Security Department.

² Sources are the ILO 48 country reviews, ILO Social Security Department own continuous monitoring of selected countries experiences ongoing since the onset of the crisis, results of a survey undertaken by International Social Security Association (ISSA Survey: Social security responses to the financial crisis: <http://www.issa.int/ais/News-Events/News/ISSA-Survey-Social-security-responses-to-the-financial-crisis> as well as information provided by OECD, in particular in chapter on “Pensions and the crisis; published in “Pensions at a Glance 2009, OECD, Paris.

those in small formal economy the impact is important from the point of view of the effective protection of covered recipients, however from the point of view of aggregate demand it is negligible.

Expansion (of various scale) of benefits and coverage we found in *Armenia* (various benefits), *Australia* (pension benefits), *Bangladesh* (old-age pension by 20 per cent), *Brazil* (social assistance extension, raise of old-age pension in line with minimum wage), *Chile* (extension of social pensions to another 5% of the poor elderly, raise in benefit level), *China* (gradual extension of the old-age pensions to rural population, lower health insurance premiums are encouraged), *Costa Rica* (15% increase in benefit level in non-contributory pensions), *Egypt* (health coverage has been extended), *France* (6.9% raise in old-age pensions, extension in health coverage), *India* (expansion of pension and health coverage), *Italy* (extension of certain social security coverage to hitherto excluded groups), *Kenya* (cash transfers to the elderly), *Pakistan* (health coverage and social safety net extended), *Philippines* (extension of health coverage), *Russia* (adjusted pensions to inflation forecast), *South Africa* (decreased retirement age for men, prolonged child benefit payments), *Spain* (increase in minimum pension benefit), *Tanzania* (increased minimum pension benefit levels), *UK* (child benefits raised), *Uruguay* (shortened minimum contribution period for full pensions from 35 to 30 years), *US* (extended health insurance coverage).

In addition to these changes in benefit levels of existing social security systems, some governments have announced special **one-time payments**, usually to low-income households, e.g. in Australia, France, Indonesia, Italy, Thailand, and the UK. But as opposed to the extension of coverage or permanent adjustments in benefit levels, such measures give temporary relief and may also boost aggregate demand if large in scale, but are not making a long-term impact on households' income situation.

Other responses include (usually temporary) **exemptions from social security contributions** with a view either to reduce costs for employers and thus stimulate employment or to raise net earnings of (low-income) workers. Among countries which introduced such measures one can find: *Canada* (lowering the contribution rate to unemployment insurance), *China* (numerous exemptions to unemployment insurance contributions), *Czech Republic* (regressive reduction of contributions compensated with higher state support to unemployment insurance), *Germany* (reduced contributions to health and unemployment insurance schemes) *Japan* (unemployment insurance contributions reduced by 0,4%), *Spain* (various exemptions from social security contributions for employers).

However tempting might be such reductions in social security contributions to decrease labour costs or increase net wages, when applying such measures one has to make sure that these are properly compensated both in terms of financing of the benefits currently paid as well as in terms of future benefit entitlements of contributors in case these depend on amount of contributions actually paid.

(2) Consolidating social expenditure – short-term and long-term concerns

While most countries have expanded social security coverage and benefits as a reaction to the crisis, a few of the reviewed countries have announced cuts or freezes in social spending and in benefits, usually as part of the wider plan of consolidating public finances and reducing public deficits.

Ireland has halved its unemployment benefit for jobseekers under the age of 20, introduced a pension levy of 1 per cent across all wage earners and announced a freeze in welfare expenditure for at least two years. In *Hungary* the 13th month pension and the 13th month salary have been scrapped, the time of paid parental leave was reduced, future pension increase will be indexed to GDP growth and inflation (rather than wages and inflation), and retirement age will be gradually increased from 2012 on. *Latvia* announced cuts in the unemployment benefit scheme, where benefits decrease quicker than originally foreseen, pensions for working pensioners decrease by 70%, family allowance are down by 10%, pre-

retirement pension decreased from 80% of the full benefit to 50%, retirement pensions and length-of-service pensions will be decreased by 10% globally, parental benefits will be reduced by 50% for working parents; additionally the number of health centres will be halved and prep classes will be abolished. *Ukraine* tightened the eligibility conditions for the unemployment scheme, with the effect that the number of registered unemployed decreased by 17% compared to previous year, at the same time the level of contributions and contributors was widened (whether the benefit level has been affected is difficult to assess).

While the above examples show that in countries in questions restrictions of public spending to limit public finance deficits in view of the (often dramatic) crisis situation is treated as a priority, it is too early now to fully assess not just negative social impacts of the measures (in terms of living standards of the affected groups), but also potential longer term economic impacts in terms of the depth and lengths of the recession. In some countries measures of the above nature were adopted as a condition to receive large scale loans supporting financial sector and the economy.

There is always a conflict between the long-term financial sustainability concerns and countercyclical role of social security (and wider public) spending. Interesting illustration and solution comes from Sweden. Several years ago, within the main Swedish old-age pension scheme (which is PAYG funded but organised as so-called Notional Defined Contribution - NDC - principles) special feature was added in a form of a so-called automatic balancing mechanism. Special calculation methods have been established to make it possible to estimate the long-term assets and liabilities of the PAYG scheme. If the estimated liabilities of the system exceed its assets, the annual indexation both of the acquired pension rights and pensions in payment is supposed to be (automatically) reduced for a period necessary to bring equilibrium back. Obviously, such a mechanism would make the system financially stable. Whatever happens, it reduces current and future pensions by as much as needed in order to restore financial equilibrium to the system.

Until 2007 the so-called “balance ratio” of the Swedish pension system was above one (assets higher than liabilities) and thus automatic balancing mechanism was not activated. However situation has changed with the crisis. For year 2008 calculated balance ratio first became less than one (liabilities surpassed the assets). This means that pension levels would need to be actually decreased in 2010 and for at least another several years grow at much lower pace than with balancing mechanism activated. However, such perspective opened a debate if this should be allowed in the conditions of crisis. The debate concluded that one should allow discretionary intervention suspending existing rule and reducing scale of decrease of pension levels expected for 2010 and spreading it over longer period to cushion the impact on pensioners’ living standards³.

Above example shows clearly an important dilemma. On the one hand there is a revealed willingness to introduce automatic budgetary mechanisms which would help to ensure long term sustainability of specific expenditure programmes or overall public finances making it immune to discretionary political decisions. This one can see it not only in Sweden but also in other recent reforms of social security pension programmes in many countries and also in wider public finances’ reforms requiring permanently balanced budgets at the local or national level. These long term automatic mechanisms and rules in the times of economic downturn, like a current one, may however act as “automatic de-stabilizers” rather than stabilizers as Joseph Stiglitz stressed in his speech in the ILO in March 2009, unless – like in case of Sweden or Germany⁴ – politicians come in time with discretionary corrections of the “rules” in order to achieve policy outcomes desired in the current circumstances. OECD

³ See article by KG Scherman in Svenska Dagbladet, June 3rd, 2009. Automatic adjustment mechanisms linking pension entitlements to state of the pension system finances exists also in different forms in Netherlands (occupational pensions), Canada and Germany.

⁴ “Sustainability” factor of the German pension system would lead in 2008 ad 2009 to pension increases of 0.46% and 1.76%. But the government has over-ridden the “automatic” mechanism increasing pensions by 1.1% and 2.41% respectively.

experts in the recent report apparently support such discretionary interventions and come to the conclusion that design of such “automatic balancing” “needs a re-think” as “it does not seem sensible to reduce benefits in a pro-cyclical way, taking money from the economy when it is weak”⁵.

(3) Special concern – pension funding

The effect of the financial and economic on crisis pensions systems and depends on category of pension schemes people belong to (defined contribution, defined benefit, PAYG or fully funded) and if they are already retirees, close to retirement or still have many years of contributing ahead of them.

In defined benefit (DB) schemes where pension amounts are calculated without regard to the level of reserves the immediate impact will be less than in defined contribution schemes where benefits guarantees are less effective by nature. However, long-term contraction of employment and hence the number of contributors will also force governments to downward adjustments in defined benefit schemes.

However, in fully funded pension schemes pension entitlements in some cases might be lost completely. In OECD countries private pension funds lost their 23% of their value.⁶ If the crisis turns into a long-term downward adjustment of asset prices, the outcome in defined contribution schemes will inevitably be lower benefits paid at retirement. Any prolonged suppression of interest rates and asset prices will lead to serious difficulties by way of destabilized annuity rates (prices) and management of annuity reserve funds. The size of the long-term effect will depend on the depth and the duration of the downturn of asset prices. If the present price reductions turn into permanent level adjustments then old age income will be reduced, if the downturn is short-lived the effect will be transitional.

While these losses may not be permanent, they still show the vulnerability of pension levels in defined contributions schemes, notably for people that are close to retirement and whose savings portfolios might not recover during their remaining active life. . The most affected are people that will retire within the next months and years, those with long-period of membership in DB funded pension plans and in particular those with investment policy heavily exposed to riskier assets (many in US, UK and Australia). Also those pensioners in private pension plans who did not take annuity on retirement may be seriously affected.⁷

Now in OECD, private financial sources constitute on average fifth of retirement incomes, but more than 40% in 5 countries: Australia, Canada, the Netherlands, the United Kingdom and the United States (on the other hand less than 5% in countries like Austria, Czech Republic Slovak Republic, Hungary and Poland). However in the future private pensions (mandatory and voluntary) are expected to provide 75% of future retirement incomes in Mexico, 60% in Slovak Republic, half in Poland, 30% in Hungary. As many of the latter schemes are relatively young and thus even if current losses of the pension funds are significant (in Poland ILO estimates that in real terms members lost on average three years of their contributions), impact on incomes of future retirees of this single crisis might be relatively minor. However, as OECD stresses, these development “highlight the need for resilience to future crisis”⁸.

The way forward

Three things are needed. The first is a fundamental overview of existing social security systems and the correction of mistakes made during the last two decades in countries where social security systems already are fairly developed. The second and perhaps more fundamental task is to introduce sound social security systems in countries where only

⁵ Pensions and the crisis, p.8, published in “Pensions at a Glance 2009”, OECD, Paris

⁶ OECD: Pensions and the Crisis, p.1, from “Pension at Glance 2009”

⁷ The reason that ILO Social Security (Minimum Standards) Convention No. 102 requires old-age pension to be paid as life annuity (periodical payment throughout a contingency) is also to protect income security of the elderly against the impact of such events as the financial and economic crisis.

⁸ OECD: Pensions and the Crisis, p.3, from “Pension at Glance 2009”

rudimentary systems exist so far. The third and most challenging task would be to combine these two measures into a coherent long term developments paradigms for national social security systems. The crisis bears the risk that we are only seeking short-term quick fixes to poverty and insecurity while neglecting longer-term solutions that would help to correct the fundamental inequities in the global economy and society.

Correcting past mistakes

Corrections are needed first and foremost in pension systems. The vulnerability of pension levels to the performance of capital markets that was introduced in so many pension systems during the last that three decades clearly was a mistake that stands to be corrected. What is needed immediately is to protect the pension levels of people that are close to retirement. Existence of strong minimum pension guarantees may work here as “automatic stabilizer” of the retirees living standards. Some countries have it already; others included on-off payments to older people into their stimulus packages as a temporary relief (Greece, Australia, UK and US). Others, as a result of the current crisis, decided to strengthen and expand minimum guarantees in their pension systems (Finland, Belgium, France and UK, and also countries with the higher than average poverty incidence among elderly: Australia, Korea, and Spain).

Policies of strengthening pension guarantees of low income earners and thus significantly correcting past reform trends will have to be strengthened further. As OECD shows, in the future, in countries like Germany, Japan or United States low income earners will be receiving pensions at the level of 20-25% of the average earnings (OECD average will be 36% with Denmark at the top of the list with 62%)⁹

In the short run the state may authorize pension schemes to reduce the level of capitalization for a transitional period (like it was done for example in Netherlands). This is probably the only realistic option at the moment – given global resource constraints. If asset prices rebound at some point than the overall cost of the guarantees will be only a fraction of the momentary losses of pension assets.

In their observations in response to the crisis, the OECD have suggested that governments could play a more active role in managing risks associated with the payout phase of pensions and annuities, with the idea they could encourage the market for longevity hedging products by producing an official longevity index. Other OECD experts’ proposals included suggestions that governments should issue longevity bonds that “would set a benchmark for private issuers”, while they “should also consider” issuing more long-term and inflation-indexed bonds, a move already taken by a small number of countries; most recently by the Danish government with the release of a 30-year bond that was primarily bought by domestic pension funds and insurance companies¹⁰.

But much more fundamentally, this is the time to for a systematic overall reassessment of global pension policies. The ILO does not have a specific pension model – but it does have a set of basic requirements for pension systems. These are included in social security standards which have been built up over many decades, and specify the way in which social security systems should perform. It has never been timelier than now to remind, to promote and to apply those principles:

- (1) Universal coverage: Everybody has a right to affordable retirement through pension systems that provide all residents with at least a minimum level of income protection in old age. Similarly, everybody has a right to income security in case of a loss of a breadwinner and disability.
- (2) Benefits as a right: Entitlements to pension benefits should be precisely specified as predictable rights.

⁹ OECD: Pensions and the Crisis, p.5, from “Pension at Glance 2009”

¹⁰ IPE.com 13 November 2008 12:06

- (3) Equity and fairness. There should be no discrimination and equal treatment of all, including equal treatment of national and non-national residents. Entitlement conditions and benefit provisions should be gender-fair.
- (4) Protection against poverty: Pension systems should provide a reliable minimum benefit guarantee that effectively protects people against poverty in old-age, loss of a breadwinner or disability
- (5) Lost income replacement: contributory earnings-related systems should provide guaranteed replacement rates at least to those with earning lower than average
- (6) Collective actuarial equivalence of contributions and pension levels: amounts of benefits for all contributors should adequately reflect the level of the contributions paid
- (7) Guarantee of a minimum rate of return on savings: The real value of contributions paid into savings schemes wherever these are part of the national pension systems should be protected.
- (8) Sound financing and fiscal responsibility: Schemes should be financed in such a way as to avoid uncertainty about their long-term viability. Pension schemes should not crowd out the fiscal space for other social benefits in the context of limited overall national social budgets.
- (9) Policy coherence and coordination: pension policies should be inherent part of coherent and coordinated social security policies aimed at providing affordable access to essential health care and income security to all those in need.
- (10) State responsibility: The State should remain the ultimate guarantor of the right to affordable retirement and access to adequate pensions.

Such guarantees can be applied to both PAYG and fully funded pension schemes. They can be legislated by any government. Most likely they will not lead to major real expenditure, but in any case they will cost a fraction of what the present bail-out of the financial system could cost us.

Building social security for all

Social security will effectively cushion the negative impacts of the crisis if its foundations based on solidarity are strengthened. The ILO is promoting the reshaping of national social security systems based on the principle of progressive universalism. We first seek to ensure a minimum set to social security benefits for all, or the social protection floor. Based on that floor higher levels of social security should then be achieved for as the economies develop and the fiscal space for redistributive policies widens.

Higher- and middle income countries: Despite the talk of over-burdened welfare states in the past decades, this crisis gives new visibility to the crucial role of social security in weathering economic storms, now and in the future. The memories of the devastating effects, which an economic crisis can have on households and individuals, have nearly faded for most people in the high-income countries. Where this is the case, the success can largely be attributed to the comprehensive social security systems that have been established – often as response to earlier crises. Thus, also in developed economies, comprehensive and state-organized social security based on the principle of solidarity may not be treated as a relict from the past – they are powerful tools for economic and societal development in the future. It is thus of central importance to sustain the fiscal space for public social security schemes through government policies.

Low-income countries: While many higher income and some middle income countries are relatively well equipped in social security and thus effective instruments of preventing poverty, this is far from being a case in many other countries of the world, where only large minority has access to even basic levels of social protection. Fortunately it seems the crisis helps to reach a wide consensus on the necessity of investments in social protection also in

low income countries. OECD Development Assistance Committee says: “*Social protection directly reduces poverty and helps make growth more pro-poor. It stimulates the involvement of poor women and men in economic growth, protects the poorest and most vulnerable in a downturn and contributes to social cohesion and stability. It helps build human capital, manage risks, promote investment and entrepreneurship and improve participation in labour markets. Social protection programmes can be affordable, including for the poorest countries, and represent good value for money.*”¹¹

Sharing the above view, the Chief Executives’ Board of the UN System comes with idea of establishing a Social Protection Floor¹² by ensuring access to basic social services and empowerment and protection of the poor and vulnerable. Such social protection should consist of two broad main elements: (a) Services: geographical and financial access to essential public services (such as water and sanitation, health, and education); and (b) Transfers: a basic set of essential social transfers, in cash and in kind, paid to the poor and vulnerable to provide a minimum income security and access to essential services, including health care. ILO Global Jobs Pact of June 2009 thus requests the countries to develop “*adequate social protection for all, drawing on a basic social protection floor including: access to health care, income security for the elderly and persons with disabilities, child benefits and income security combined with public employment guarantee schemes for the unemployed and the working poor*” and urges “*the international community to provide development assistance, including budgetary support, to build up a basic social protection floor on a national basis*”.

Donors seem to be positive to the call for support to expanding social protection in low income crisis in the crisis and beyond. OECD DAC declares¹³: “*Donors’ support for social protection programmes should provide adequate, long-term and predictable financial assistance to help partner governments establish gender-sensitive social protection programmes and create the conditions for those programmes to be politically and financially sustainable. This is especially important in the current situation of contracting fiscal space and declining financial inflows. Such support must be provided through harmonised and co-ordinated financing mechanisms in support of nationally defined strategies and programmes.*” UK Government in its recent White Paper on International Development, “*Building our Common Future*”¹⁴ urges the World Bank to “*pay greater attention to social protection*” and use the Rapid Social Response Programme to more effectively help low income countries to build necessary basic social protection programmes.

Such growing global coalition has a real chance to make a difference and help the uncovered majority to go through the current crisis and be better prepared to the future ones.

¹¹ OECD DAC: Making Economic Growth More Pro-Poor: The Role of Employment and Social Protection: Policy Statement; DAC High Level Meeting, 27 and 28 May 2009

¹² Secretariat of the United Nations System, Chief Executives Board for Coordination (CEB): COMMUNIQUÉ of 5 April 2009, Paris, France

¹³ op.cit.

¹⁴ DfID, July 2009, p. 25