

Social security: Responding to the crisis

*The financial and economic crisis that began in 2007 has delivered a tumultuous two years for the financial world, sending many financial institutions into a tailspin and putting governments in difficulty. As one might expect with such an extensive crisis, social security systems have also been affected, and social security funds have suffered. A large number of these schemes witnessed a sharp contraction of their asset portfolio values in 2008, affecting their long-term sustainability. Nevertheless, social security systems have responded effectively to the test by softening the impact of the crisis. The challenge for social security now is to continue to cope with rising unemployment and the burden of future debt. Ian Orton, working for the International Social Security Association's (ISSA) Social Security Observatory, looks at the impact of the crisis on social security.*¹

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The crisis has highlighted the centrality and strengths of social security systems, but also their potential weaknesses. Increasing unemployment has hurt contribution revenues and increased expenditure due to increased benefit demand. Yet many governments have seized on social security systems as a vital policy tool to counteract the social and economic impacts of the crisis and act as counter-cyclical automatic stabilizers.

The impact of the crisis on social security financing

In the longer term, the 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 systems has been one of maintaining financial equilibrium. A recent ISSA survey¹ of the impacts of the crisis on social security funds has revealed that many funds, especially in industrialized countries, have experienced a negative investment performance.

Many national pension systems have experienced substantial losses on the asset portfolio values. For example, the negative returns suffered by industrialized countries in 2008 ranged from -29.5 per cent to -3.2 per cent. But not all funds have suffered to the same degree. In some countries (see Figure 1) 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. A number of developing countries have fared quite well, with Mexico returning 7.46 per cent and Thailand 9.4 per cent in 2008. More recent data on the performance of pension funds seems to suggest that some funds in the industrialized countries have begun to recover with a number of funds posting positive returns in the 2nd quarter of 2009.

There are additional financial challenges facing social security in the short to medium term. Rising unemployment rates, reduced contributions, and surges in new claims for benefits have placed and continue to place social security systems under considerable strain, especially as unemployment continues to grow.² For instance, increasing cash benefits or introducing new ones or freezing or reducing contribution rates for businesses, all of which may be considered useful mechanisms to boost consumer spending and support economic activity, may also lead to financial imbalances in social security programmes. These measures, as part of wider stimulus packages, will constitute a semi-permanent financial burden for social security. The risk for social security is one of increasing deficits, therefore limiting future capacity to pay adequate benefits in years to come.

Moreover, an additional medium-term risk is the high probability of a prolonged labour market recession. This is a very real possibility and according to the International Institute for Labour Studies, evidence from the experience of previous crises indicates that labour markets tend to recover only four

¹ *Le Figaro*, 17 Sept. 2009. Somavia: "L'emploi doit être au rendez-vous de la reprise", www.lefigaro.fr/economie/2009/09/17/04001-20090917ARTFIG00008-juan-somavia-l-emploi-doit-etre-au-rendez-vous-de-la-reprise-.php

² ISSA survey: *Social security responses to the financial crisis*. ISSA 2009. www.issa.int/aiss/News-Events/News/ISSA-Survey-Social-security-responses-to-the-financial-crisis

to five years after an economic recovery has begun.³ This scenario spells continued labour market problems and serves to reaffirm once again the relevance of social security to compensate for labour market failure. Coupled with the additional burden of demographic ageing, all of these factors pose problems which have to be overcome by social security.

Counteracting the crisis through active fund management ⁴

The Danish pensions institution Arbejdsmarkedets Tillægspension ATP proved particularly adept at limiting its financial losses through the active management of its fund portfolio. Early on in the crisis, it recognized the need to be proactive, employing a targeted use of financial instruments and more crucially reallocating a large portion of its assets from foreign securities to DKK assets. Consequently, the ATP sustained a -3.2 per cent loss on its fund's returns during the year 2008. Compared with its peers, who fared much worse, this was a rather moderate loss and emphasized the validity of its approach.⁵

At the 2009 ISSA seminar on the crisis,⁶ the ATP outlined the key ingredients of its successful approach. This included:

- the hedging of uncompensated risks by hedging liabilities in separate portfolios;
- active portfolio management with an aggressive reallocation and diversification of investment portfolios;
- running appropriately drastic risk scenarios to test the vulnerability of its system in order to anticipate the impact of a crisis and therefore limit potential losses.

Whether such an approach is replicable elsewhere depends on governance rules and capacity, and of course what works in one place or one specific time may not work in another.

Nevertheless, 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. In response, some public pension schemes are now being asked to respond to political pressure for 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. However, it has also given some food for thought and posited suggestions for improving social security system design. The crisis has:

- Revealed the fragility of pension systems reliant on financial markets.
- 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.
- Forced reflection on what constitutes an appropriate investment strategy.

³ International Institute for Labour Studies. ILO, 2009. *The financial and economic crisis: A Decent Work response*. www.ilo.org/public/libdoc/ilo/2009/109B09_59_engl.pdf

⁴ The ATP Group, Annual Report 2008. http://loke.datagraf.dk/atp_rapporter/admin/local/pregenerated_reports/report_atp2008_uk_123737165

⁵ This result however does not include the result of ATP's hedging activities – activities that are not intended to yield a return in the longer term but serve to protect liabilities in the short and mid-term. If hedging activities are included ATP had a positive return of 17.8 per cent.

⁶ Seminar on *Social Security in Times of Crisis: Impact, Challenges and Responses*, Geneva. ISSA, 2009. www.issa.int/aiss/News-Events/Events/Seminar-on-Social-Security-in-Times-of-Crisis-Impact-Challenges-and-Responses

- Reiterated the need for adequate and efficient regulation, supervision, and investment policies.

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

Looking ahead

In recent weeks a number of commentators have suggested that the economic downturn seems to be easing with the recession being declared as over in some countries. However, the human fallout continues unabated with unemployment rising in many countries, underlining the increased relevance of social security institutions as agents of crisis management. In fact, several important lessons can already be drawn on the potential roles of social security in this regard:

- Social security has demonstrated that it is an important component of the exit strategy from the crisis by revitalizing the economy through the stimulation of aggregate demand and the support of social cohesion.
- 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.
- The financial losses experienced by public social security systems have weakened the financial capacity of these systems to confront future challenges, potentially exposing governments to new financial risks.
- Social security policy responses must not lose sight of a long-term perspective that ensures the financial sustainability of social security promises.
- The crisis illustrates that countries with strong fiscal positions have, naturally, been better able to provide financial stimuli including tax-financed social assistance initiatives.

While the crisis has posed many problems for social security systems to solve, it has also presented new opportunities to be had. It illustrates how social security is not just an emergency response mechanism, but integral to the smooth functioning of society. The crisis has showcased the existing weaknesses of social security systems and bolstered the value of social security as a form of social solidarity. Finally, one ought perhaps to bear in mind that if it were not for government stimulus packages and social security, the crisis, which threatened to be more severe than that of the Great Depression, could have generated far more catastrophic consequences.