Social Security Systems and the Neo-Liberal Challenge

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Introduction

In the half-century since the International Labour Organization adopted its Social Security Convention[1], social security systems have been under considerable strain in the face of phenomena such as the rapid growth of the so-called informal economy, especially in developing countries, and ageing populations in industrialized countries. Well over half of the world's workers do not enjoy any formal coverage for old-age security, which is the specific type of programme that this paper considers.

Numerous questions have been raised as to whether some models for reform that have been put forward with the purported aim of addressing weaknesses in State-run old-age pensions systems will actually bring about needed improvements to the systems. This paper focuses on two such examples of structural reform that have received considerable attention: (i) the proposal of US president George W. Bush, launched shortly after his November 2004 re-election, to partially privatize the US Social Security system and (ii) the World Bank's approach to pension reform in developing and transition countries over the past fifteen years. The paper examines whether the two approaches on reforming pensions systems meet the standards affirmed during the ILO's most recent discussions on the theme of social security, or whether they are in fact driven by motives largely unrelated with objectives of improving and expanding social security.

Points of consensus on social security

While expressions of highly conflicting points of view have characterized recent debates on the future of social security both within countries and internationally, the ILO was able to reach consensus on several important points after a two-week discussion that took place at the 2001 International Labour Conference. The tripartite plenary session of the ILO's general conference adopted a resolution on social security that indicated agreement on a number of issues, including the following[2]:

- Adequate social security should be seen as an instrument for economic as well as social development since it is an investment in people
- There is no single right model of social security, but the State has a priority role in the facilitation, promotion and extension of coverage of social security
- Social security is not available to a majority of the world's people and the highest priority must be given to the extension of social security to those who are not covered

[1] International Labour Organization, *Social Security (Minimum Standards) Convention - C102* (Geneva 1952)
[2] International Labour Organization, *Social Security: A New Consensus* (Geneva, 2001)

- Policies must aim at integrating the informal economy into the formal economy
- Social security systems must not only provide equal treatment for men and women but also ensure equitable outcomes for women
- Concerning pensions systems, the ageing of the population has just as real an impact on advance-funded as on pay-as-you-go systems
- Systems of individual savings accounts, where the risk is borne by the individual, should not weaken solidarity systems which spread risks throughout the whole of the system's membership
- Statutory pension schemes must guarantee adequate benefits and ensure national solidarity
- Initiatives to establish or extend social security require social dialogue, including on the development of policy options to address any financial imbalance

The two specific examples considered in this paper are analyzed taking into account the above criteria for reform enunciated in the ILO's 2001 resolution.

President Bush's plan for partial privatization of US Social Security

The old-age pension system in the United States known as Social Security was established in 1935 as a statutory government-run system for all American workers. It consists of a pay-as-you-go retirement system financed by contributions from employers and workers and also provides benefits for dependents and the disabled.

Compared to many pay-as-you-go pensions schemes throughout the world, the US system is in relatively solid financial shape and will require only fairly minor changes in contributions or benefits to remain self-financing. According to the US Congressional Budget Office, if nothing in the current Social Security regime is changed, the system's "trust fund" has sufficient accumulated revenues to ensure payment of full benefits until 2052. At that point, the system would still be able to pay 80 per cent of promised benefits[3]. Nevertheless, President Bush began questioning the long-term solvency of the system early during his first mandate beginning in 2001 and also during the 2004 presidential election campaign.

However it was only during a press conference held two days after his November 2004 re-election that Bush announced that changes to the Social Security system would be a centrepiece of domestic reform initiatives undertaken by his second administration. During his February 2005 State of the Union address, Bush declared that the Social Security system was "headed toward bankruptcy" and proposed that younger workers should be able to place part of their contributions in private retirement accounts for which they would make individual investment decisions. A few weeks later, the White House released the details of the Bush proposal[4]. "Younger workers", defined as all those born in 1950 or later, would be allowed to place up to one-third of the contributions normally

[3] "Partisan Social Security claims questioned", *Washington Post*, 27 February 2005
[4] George W. Bush, *Strengthening Social Security for the 21st Century* (Washington, February 2005)

made on their behalf into Social Security in personal accounts which would be invested in stocks and bonds according to choices made by the worker. The savings and interest accumulated in the account would be available to the worker upon retirement.

Numerous experts spoke out, either in favour or against the plan, and contributed to voluminous media coverage of the proposal. President Bush himself contributed to the coverage by undertaking an extensive speaking tour during the first half of 2005 to promote his plan for partial privatization of Social Security. However he managed to garner little support for the proposal. The AARP retirees' association and the AFL-CIO trade union federation expressed their strong opposition to the privatization plan, as did several members of the US Congress, which would have to adopt legislation to make changes to the system. In July 2005, congressional leaders of the president's own Republican Party decided to postpone consideration of Social Security reform, a day after the *Wall Street Journal* published the results of a public opinion poll which showed that only 33 per cent of Americans supported private accounts whereas 57 per cent were opposed[5].

The main points raised by critics were that the privatization plan would reduce benefits for many retirees and potentially increase poverty among the elderly, and would cause a substantial rise in the federal government's deficit as Social Security contributions were diverted into private accounts[6]. In addition, the AFL-CIO noted that the massive borrowing necessary to finance private accounts would drive up interest rates and reduce the value of bond holdings in existing pension funds, and also the equity holdings if the higher interest rates were to precipitate an economic slowdown[7].

While proponents and opponents have differed as to whether the system really is "headed toward bankruptcy" and on the levels of risk and extra administrative costs associated with the privatized accounts, it is notable that there has been no disagreement on some substantial points[8]. One point of consensus is that the creation of private accounts would not improve the system's solvency; in fact, there is agreement that the diversion of part of the system's contributions out of the trust fund would worsen the situation. In later speeches on the issue, Bush seemed to have accepted this consensus since he no longer spoke of his plan as a means of preventing the system from going bankrupt, but rather as a way for younger workers to protect part of their contributions by putting them in a safe place before the system "goes bust". While there is disagreement among experts as to whether those who opt for private accounts are more or less likely to

[5] "Delay to Social Security reform", *Financial Times*, 15 July 2005

[6] Some may be surprised to find the International Monetary Fund among those expressing warnings about the fiscal implications of the Bush plan: "The Administration proposal to permit younger workers to divert a portion of their Social Security contributions into personal retirement accounts … would also imply a significant increase in federal deficits and debt in coming decades …" (International Monetary Fund, *2005 Article IV Consultation with the United States of America: Concluding Statement of the IMF Mission* (Washington, May 2005), p. 6).

[7] AFL-CIO Center for Working Capital, *The Negative Impact of Social Security Privatization on Defined Benefit Pension Funds* (Washington, March 2005)

[8] See for example the opinion articles of seven Social Security experts published under the heading "A new act for Social Security", *Washington Post*, 23 January 2005

see their retirement income increase, both sides agree that there will be losers as well as winners[9].

Since even the proponents of partial privatization of Social Security no longer claimed that their plan would prevent the insolvency of the system that they predicted, one must look elsewhere for the motives behind the plan. An obvious beneficiary would be the financial services industry, which would administer investments in stocks and bonds estimated at around $100 billion a year. However, given that these will be small, relatively low-fee accounts, there is some doubt as to how much profit brokerage firms would actually obtain from the accounts, especially in the initial period[10].

More certain motives can be identified among those proponents who see privatization of Social Security as a privileged tool for achieving certain ideological or political transformations. Some, including a staff economist with the President's Commission to Strengthen Social Security, Jeffrey Brown, have seen the creation of private accounts as a key building block of George W. Bush's "Ownership Society", since the accounts "would extend to all workers the benefits of asset ownership" and thus their stake in the private enterprise system[11].

Related to this motive is that of proponents who see the proposal as a way to reduce Americans' expectations that the government has a responsibility in assuring senior citizens' financial well-being. Thus, the White House's director of strategic initiatives was quoted as stressing in a memo sent to Republican Party activists that the Bush plan deserved support because it would operate a shift "away from dependency on government and toward giving greater power and responsibility to individuals"[12]. A long-time proponent of Social Security privatization, Michel Tanner of the Cato Institute, spoke more explicitly about how the initiative would help to bury the Welfare State: "We're changing fundamentally the relationship of people to their government … [It would be] the biggest shift since the New Deal"[13].

The World Bank's involvement in pension reforms

Starting in the late 1980s, the World Bank has offered technical and financial support for pension reforms in more than 80 developing and transition countries. In 1994 the Bank published a policy paper, *Averting the Old-Age Crisis*, which enunciated its overall approach on pensions. The principal theme of the policy was the affirmation that partial privatization of pensions systems would protect pensions against the effects of ageing populations, extend coverage to unprotected workers and contribute to the country's financial development and economic growth[14].

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9 "Whichever way we go, some get left behind", *Washington Post*, 13 March 2005
10 "Unions muffle Wall Street support of private accounts", *Washington Post*, 8 March 2005
11 "Why personal accounts are a real benefit", *Washington Post*, 23 January 2005
12 "A bit of social engineering in disguise", *Washington Post*, 23 January 2005
13 ibid.
14 World Bank, *Averting the Old-Age Crisis* (Washington, 1994)

The specific model for pension reform that the World Bank put forward in *Averting the Old-Age Crisis* was called the "three-pillar" model. The Bank recommended that countries reduce the scope of the pay-as-you-go public pension system (the "first pillar"); that they create a second "foundation pillar" consisting of mandatory defined-contribution privately managed pension funds, following the example of the pioneering pension privatization carried out in Pinochet-era Chile in 1981; and that they encourage (for example through tax incentives) voluntary retirement savings composing the "third pillar"[15].

The three-pillar model constituted the template for World Bank-sponsored reforms in a number of countries, but the Bank particularly concentrated its efforts on middle-income countries that already had comprehensive public pensions schemes, most notably in Latin America and in Central and Eastern Europe. The Bank paid scant attention to lower-income countries that offered little or no old-age security protection. The Bank gave its priority to encouraging the former group of countries to scale down the public system and devoted most of its technical and financial assistance to helping countries establish a system of private accounts, into which part of pension contributions would be diverted.

A few years after the World Bank claimed to have discovered the recipe for "Averting the Old-Age Crisis" and extending coverage to the unprotected, it had become obvious to many analysts that not only had the Bank not achieved the objectives it had set for itself, but it had created some new problems. Trade unions in several countries, most notably in Latin America and in Central and Eastern Europe, were among the first to point out these problems.

In April 2001 the International Confederation of Free Trade Unions (ICFTU) and its Global Unions partners summarized the labour movement's objections in a statement in which they criticized the World Bank for its policy of encouraging governments to reduce or dismantle public pension plans: the World Bank's "haste to scale back or dismantle public pension schemes is particularly troublesome in view of the high level of corruption and administrative costs associated with the privatized 'multi-pillar' schemes. … Instead, the Bank must accept fully the need to promote comprehensive public pension schemes that can provide the equitable basis for old-age protection that all people desire and need"[16].

Eventually, the failures of the Bank's approach on pension reforms became recognized by no less an authority than the World Bank itself, in a paper dealing with the reform experience of Latin America prepared by the Latin America and Caribbean regional division of the Bank. Given that Latin America is the region that has

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[15] ibid.

[16] ICFTU, TUAC & ITS, *Statement by the ICFTU, TUAC and the ITS to the Spring 2001 Meetings of the IMF and World Bank* (Washington, April 2001)

experienced the longest period of Bank involvement in pension reforms, this report is of particular significance[17].

The findings of the Bank's report, *Keeping the Promise of Old Age Income Security in Latin America,* confirmed earlier assessments made by trade unions and others critical of the Bank's approach on pension reforms. Among the most important failures is no doubt the fact that one of the primary goals of the reforms – extending pension coverage to the unprotected – had not been met. The Bank's report found that "pension coverage remains low and unequally shared among income groups in Latin America" and "are perhaps the most revealing sign of the need to re-examine design issues surrounding the multi-pillar model"[18]. The report also confirmed complaints that high administrative costs for the privatized pillars, as compared to the public schemes, had severely reduced pensioners' income: the private accounts "are faced with steep commissions that reduce the accumulated balances drastically"[19].

A further important criticism made by trade unions and others of the World Bank-sponsored pension reforms relates to the fact that women have suffered a greater loss of benefits than have men. *Keeping the Promise* agrees with this critique, noting that "women earn lower returns from the new systems relative to men" in most of the Latin American countries where the reforms took place[20].

Another important objective that the World Bank announced in *Averting the Old-Age Crisis* for supporting pension privatization concerned the expected beneficial financial impact. It was predicted that the development of private pension funds would, on the one hand, stimulate the development of capital markets and overall economic growth, and on the other hand, reduce the burden of the pension system for the State.

Keeping the Promise found that both predictions had been vastly over-stated in the case of Latin America. In almost all of the countries where a second-pillar reform of privatized pensions took place, "the main beneficiary has been the government debt market", with most of the funds used to buy government bonds[21]. Thus the State continues to finance a nominally private scheme, while allowing private administrators to offer reduced benefits in exchange for generous fees. Even where there may be some evidence, notably in Chile, of privatized pensions having contributed to the growth in debt and equities markets, *Keeping the Promise* observes that a similar expansion of the capital market took place in Brazil, which did not privatize its pension scheme. The Bank's report concludes that "financial sector development can take place effectively in the absence of pension privatization"[22].

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[17] World Bank, *Keeping the Promise of Old Age Income Security in Latin America* (Washington, November 2003)
[18] ibid., p. 69 & p. 6
[19] ibid., p. 111
[20] ibid., p. 71
[21] ibid., p. 67
[22] ibid., p. 212-213

As to the expectation that privatization would reduce the fiscal burden to the State of old-age security, many analysts have pointed out that privatization in fact usually increases costs to the government over a certain period because, while part of workers' contributions are diverted into private funds, the State continues to make payments to current and even new retirees. As well as assuming past obligations, in many countries the government provides minimum pensions to those who otherwise would be destitute, and the failure of private accounts to provide adequate pensions often means that the costs of minimum pension provisions have become substantial.

The World Bank has euphemistically called these costs of privatization "transition costs", in the expectation that they would whither away as the private plans matured. In the case of Chile, the costs to the State of the almost fully privatized pension regime have continued to grow and in 2005, 24 years after pensions were privatized, the so-called transition costs absorbed more than a quarter of the national budget, almost as much as spending for education and health care combined[23]. On the basis of the experience with privatization in several countries, the Bank's report on pension reform in Latin America observes that "fiscal sustainability is far from assured. … Further, pension reforms can create new implicit and explicit liabilities … [and] can produce severe cash-flow problems … and hence seriously constrain public sector liquidity"[24].

A revised World Bank approach?

More than a year after the World Bank's Latin America and Caribbean regional division released its report criticizing various aspects of the Bank's approach on pension reform, the Bank's social protection unit, responsible for overall pension policy, produced its own report. *Old-Age Income Support in the Twenty-First Century*[25] constitutes the Bank's first comprehensive revised policy paper on pensions since it issued *Averting the Old-Age Crisis* in 1994. Many of the optimistic claims made in the 1994 report about the gains to be reaped from privatizing pensions are absent from the new report, and it also contains criticisms (it would be more accurate to speak of self-criticism, but the Bank's report does not go as far as admitting past error) of the previously sacrosanct three-pillar model. Thus, *Old-Age Income Support in the Twenty-First Century*:

- No longer claims, as the Bank previously did, that private accounts systems provide better protection for an ageing workforce than pay-as-you-go systems
- Admits that private accounts pay out benefits that are volatile and unpredictable, and, as compared to public systems, have high administrative costs which "significantly reduce the workers' benefits from the new system"[26]

[23] "Chile's retirees find shortfall in private plan", *New York Times*, 27 January 2005
[24] World Bank, *Keeping the Promise of Old Age Income Security in Latin America* (Washington, November 2003), p. 42
[25] World Bank, *Old-Age Income Support in the Twenty-First Century* (Washington, February 2005)
[26] ibid., p. 201

- Admits that the three-pillar reforms have failed to extend pension coverage; in fact, "coverage has stagnated at low levels and has become the single most important concern of policy makers"[27]
- Emphasizes the need for social dialogue, particularly with trade unions, on pension reform options[28], a position that constitutes a radical change from as recently as 2001, when the Bank's lead pensions expert told an international trade union delegation that "unions have nothing useful to say on pension reform"

While the World Bank's policy paper does announce a more flexible approach by asserting the need for "careful consideration of benefits and costs" before privatizing[29], it is clear that the creation of a second pillar of mandatory private accounts remains the preferred default option. In a key passage, after asserting that the particular context of pension reform varies widely from country to country, *Old-Age Income Support in the Twenty-First Century* states that the Bank's approach "seeks to use the experience of mandated individual retirement-savings systems as a baseline or starting point for analysis of the outcomes of a proposed reform"[30]. Since the Bank is not speaking of laboratory experiments but rather of "real-world experience", it is obvious that the Bank intends to continue pushing countries to put in place second-pillar private accounts, even if the pretext is that they should only serve as a "benchmark"[31].

The Bank's policy document implies that countries should set up the complex bureaucracy for administering millions of mandatory private investment accounts only to create an instrument for measuring the performance of the public pension system. This seems about as plausible as suggesting that a city should build an expensive network of automobile expressways not to carry significant traffic, but just to measure whether it could get people around the city as effectively as the existing subway system. In actuality on a country-level, the World Bank has pressured governments that have taken the plunge and invested in the establishment of second pillars to subsequently increase the contributions to the private accounts, and to decrease those to the public system, in order to make the private system more viable. This was the Bank's policy in 2004 in Bulgaria, a country that had adopted a three-pillar system in 2000 but had left the mandatory second-pillar contributions at a level that the Bank considered too low[32].

In a revealing passage about what Bank officials intend to do in practice, as opposed to what declared policy may be, the Bank's new pensions policy document states that "most Bank staff see the potential economic benefits of a multi-pillar pension scheme with a major second (mandated) or voluntary (third) funded pillar …"[33], even though the same document includes numerous expressions of caution that the expected benefits of second pillar reforms may not exist. Moreover, recent World Bank country

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27 ibid.
28 ibid., p. 29
29 ibid., p. 15
30 ibid., p.77
31 ibid.
32 Interview with World Bank country team, Sofia, 20 October 2004
33 ibid., p. 66

assistance strategies continue to promote classic three-pillar pension reforms as the only option that the Bank will support[34].

In summary, the World Bank's own recent analyses have confirmed the criticisms made earlier by trade unions and others, that second-pillar reforms have proved to be inefficient, costly, reinforcing of inequality, unsuccessful in extending coverage, and have put considerable strain on public finances. Despite this, the model continues to be the Bank's preferred approach. The one "economic" argument in favour of privatization that still gets some degree of credit in *Old-Age Income Support in the Twenty-First Century* is the supposed role that the private accounts play in contributing to capital market development[35]. This raises the question of why the cost of developing capital markets should be imposed on workers and retirees by forcing them to give up part of their pension benefits to inefficient private-sector administrators. Unfortunately the Bank does not even pose the question, much less offer a rationale, of why retirees, rather than some other sector of society, should be obliged to make this sacrifice to help the financial services industry develop.

A second motive for pushing pension privatization despite the inherent inefficiencies associated with the option might be found in the use of pension reform as an instrument for imposing reductions in other government expenditures. As noted, privatization has the effect of diverting part of pension contributions into private accounts, even though the obligation to pay out benefits from the public system continues.

In a manner similar to that of conservative politicians in the United States who have promoted tax cuts in order to squeeze public finances and oblige the government to curb "wasteful" or "harmful" spending – although the usual end result is less money for big-budget items such as schools that can hardly be considered wasteful –, World Bank officials have pushed governments to partially privatize pensions through second-pillar reforms and then later pressured them to reduce expenditures for other public services in order to pay for the cost of reform. For example, in 2004 the IMF and World Bank signed on to a joint report addressed to the authorities of Nicaragua which stated that "the government will need to rationalize its expenditures to make room for the costs of pension reform"[36]. The operational premise of the international financial institutions in making such policy recommendations is that a smaller and weaker State is necessarily a better State.

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[34] See for example World Bank, *Country Assistance Strategy for Serbia and Montenegro* (Washington, November 2004), p. 14

[35] We noted above that the World Bank's study *Keeping the Promise of Old Age Income Security in Latin America* does not fully share this positive assessment.

[36] IMF and World Bank, *Nicaragua: Joint Staff Assessment of the Poverty Reduction Strategy Paper, Second Progress Report* (Washington, January 2004), p. 11

Conclusion: Pension systems should be not held captive by reformers pushing unrelated goals

Although there are differences in the approaches taken by the Bush administration in the United States and by the World Bank in developing and transition countries as regards the reform of public pensions systems[37], they have one important feature in common: in both cases pension (or Social Security) reform is not promoted with the primary objective of improving the system for its beneficiaries. Neither type of reform meets any of the criteria for social security reform enunciated by the ILO in its consensus resolution of 2001, such as expanding coverage, incorporating the informal economy into the formal economy, ensuring equitable outcomes for women, strengthening solidarity systems, and ensuring adequate benefits.

In both cases examined here, the aim is to remake pension systems in order to achieve goals that are essentially unrelated to the intended beneficiaries of pensions. Our analysis has shown that these goals appear to be related to financial market development and to diminishing and redefining the role of the State in society in conformity with a neo-liberal ideology.

While pensions systems around the world do face important challenges, a starting point for establishing a new system or reforming an existing one must be that any changes should be designed so as to improve the system for workers and retirees, not to prioritize unrelated goals. Policy makers would do well to refer to the ILO's 2001 consensus on social security for establishing the goals and parameters on which the process of reform in their country could be based.

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[37] The most important difference is that the World Bank's model entails putting part of contributions into *mandatory* private accounts, while the Bush plan would make private accounts voluntary, at least for now. However the World Bank sees an identity in the approach. When the Bank officially launched *Old-Age Income Support in the Twenty-First Century*, the first line of the Bank's communiqué declared that the new policy was addressed, among others, to "policy makers in the United States … [who] grapple with the long-term affordability of their pensions systems" (World Bank News Release No. 2005/456/HD, 24 May 2005).