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## Basic issues in reforming social security systems

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# 71

**DISCUSSION PAPER**

Originally published by Ipea in December 1997 as number 535 of the series Texto para Discussão.

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**Francisco Eduardo Barreto de Oliveira**





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Brasília, January 2015

## **BASIC ISSUES IN REFORMING SOCIAL SECURITY SYSTEMS**

Francisco Eduardo Barreto de Oliveira<sup>1</sup>

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# SUMÁRIO

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RESUMO

ABSTRACT

1 - THE CONCEPTUAL FRAMEWORK OF SOCIAL SECURITY SYSTEMS .....	1
2 - THE COMPONENTS OF A SOCIAL SECURITY SYSTEM.....	1
3 - THE STRUCTURE OF SOCIAL SECURITY SYSTEMS .....	3
3.1 - General Characteristics.....	3
3.2 - Basic Funding Issues .....	10
3.3 - Basic Operational Aspects .....	18
4 - SPECIAL ISSUES.....	22
4.1 - The Issues of Coverage and Inequality.....	22
4.2 - The Issues of Evasion, Fraud and Corruption.....	23
5 - GETTING THE REFORMS DONE.....	25
5.1 - Transition Problems in Social Insurance.....	25
5.2 - The Political Dilemma .....	26
BIBLIOGRAPHY .....	28

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## RESUMO

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O paper analisa questões conceituais envolvidas no desenho/reforma de sistemas de seguridade social, classificados conforme três grandes grupos: características gerais, aspectos de custeio e operacionais.

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# ABSTRACT

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The paper analyses conceptual issues involved in the design and/or reform of social security systems classified in three major groups: general characteristics, costing and operational issues.

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## **1 - THE CONCEPTUAL FRAMEWORK OF SOCIAL SECURITY SYSTEMS**

The conceptual issue is very critical when discussing Social Security everywhere. Far from an academic question, the right conceptual framework is essential to a rational discussion of the various particular issues.

What is really Social Security? Some tend to view it as an insurance-like scheme: the citizen pays contributions in order to have some "basic social risks" covered. Others, view it as social assistance: society as a whole must pay contributions for the collective protection against "social risks".

A good starting point would perhaps be the definition of what is a "basic social risk." Of course, this definition varies according to the values of each society, but in general, sickness, disability, premature death, and, sometimes, unemployment, are generally recognized as "basic social risks" of the non programmable type. Old age — that in fact, is presumed disability — and, very rarely, length of service, are "basic social risks" of the programmable type.

To this basic list of social risks many others can be added, depending on economical, social, cultural, and political factors: maternity, large family, housing, food etc., benefits are commonplace in many Social Security systems all over the world.

Social Security can thus be defined as the **set** of policies and actions aiming to cover basic social risks.

## **2 - THE COMPONENTS OF A SOCIAL SECURITY SYSTEM**

Despite the considerable diversity of models which naturally exists, the vast majority of social security programs consists of three basic components:

- Social insurance consists of a program of payments made in cash or in the form of services rendered to an individual or his dependent relatives as a form of partial or total compensation for the loss of earning capacity, generally linked to a scale of contributions. Benefits are usually restricted to those who are insured, and there is some proportionality between benefits and contributions.
- Health care includes the totality of policies and actions of a medical, sanitary, nutritional, educational or environmental nature which aim to prevent and treat the problems affecting the physical and mental well-being of the individual, his dependent relatives and the community as a whole. Depending of the system the beneficiaries may be restricted to certain population groups, characterized by factor such as contribution link status, living and working conditions etc.
- Social assistance consists of programs involving cash payments, distribution of goods in kind and provision of services, focused on a residual beneficiary group

where the only criterion for inclusion is necessity, not necessarily including a contribution requirement. Where payments are made in cash, they rarely bear any relation to the previous income patterns of their target population group.

It is of fundamental importance to stress, once more, that in the case of “**pure**” **insurance**, the expected present value of contributions is equal to the expected present value of the benefits accruing to each participant. **Social assistance** lies at the other end of the scale; in this case the contributions paid in and the benefits received are absolutely unrelated. Social insurance is characterized by the fact that it is not a “**pure**” form of insurance and may admit some degree of wealth redistribution. Even so, its fundamental objective is the replacement of the income of the worker, or more specifically of the insured person. The system’s redistributive objectives are of clearly secondary importance.

In spite of the interrelationships between the various components of the social security system and the system’s various state and private elements, to facilitate analysis the programs can be broken down using even finer subdivisions. Thus, the category of **social insurance** is usually broken down into.

- Basic social insurance, which includes those cash benefits and other programs (retraining, counseling, etc.) the objective of which is to provide the individual and his dependent relatives with the conditions defined by society as indispensable to their upkeep following the loss of capacity to work; and
- Supplementary social insurance whose objective is to supplement the benefits and services provided under basic social insurance.

The subjective nature of the identification of what is basic and what supplementary means that this definition is left to the political process, which theoretically reflects in turn the scale of values of each society. The term “supplementary” does not necessarily mean that the values of the benefits included in this program must be linked to those benefits paid under basic social insurance; it simply refers to what is included in addition to basic social insurance.

Supplementary social insurance is, in turn, generally broken down into:

- Open supplementary benefit schemes, which aim to cover a general clientele where the only prerequisite for inclusion is the regular depositing of the sums required as contributions, and where although special conditions may be offered for certain groups, participation is on an individual basis, and
- Restricted (or corporate) supplementary benefit schemes, which are intended to serve limited groups — the employees of one or more companies, the members of one or more labor unions etc. —, also known as “Pension Funds”.

### 3 - THE STRUCTURE OF SOCIAL SECURITY SYSTEMS

The design of an appropriate social security model can be visualized as a choice of the combination of elements of a matrix as set out below:

Attributes Components of social security		General			Funding			Operational		
		Compulsory Vs. optional	Clientele: Universal Vs. restricted	etc.	Pay-as-you-go Vs. capitalization	Collection base: Payroll Vs. other	etc.	Centralized Vs. decentralized	State Vs. private	etc.
Social	Basic									
Security	Complementary									
Health Insurance										
Social assistance										

Not all the cells of the matrix should or can be filled in and not all choices can be made independently.<sup>1</sup> Although we recognize these imitations, we have opted to discuss each aspect individually, making references to the non-applicability of some choices and/or to incompatibility between choices where appropriate.

With the intention of facilitating discussion we have used the technique of discussing each characteristic in the form of a set of pro and cons of extreme and opposing alternatives. In practice, many of the solutions require the choice of an intermediate point at which, without abandoning respect for principles of logic and rationality, political negotiation of the proposals can be made viable.

#### 3.1 - General Characteristics

##### 3.1.1 - Insurance (“individual equity”) **versus** redistribution (“collective equity”)

Many of the public’s problems in genuinely understanding social security derive from the already mentioned conceptual conflict between insurance and redistribution. If the system’s social insurance component is understood as a form of obligatory insurance whose objective is to replace the income of the individual or family when earning capacity has been lost, than the value of the benefits should correspond strictly to the sums contributed.<sup>2</sup> If, on the other hand, the social insurance system is seen as an income redistribution program, contributions should be made on the basis of each individual’s ability to pay and benefits should be received according to need. In the first case, to principle of **individual equity** would apply, while in the second case the underlying principle would be that of **collective equity**.

<sup>1</sup> For example, it would not made sense to choose a pay-as-you-go mechanism for the system’s social basis and at the same time opt for a predefined contribution plan.

<sup>2</sup> For programmable type events.

On these definitions, a redistributive program would come close to falling within the concept of social assistance. The insurance viewpoint is diametrically opposed to the redistributive one, for the simple reason that in order to carry out a redistribution, resources must be taken away from someone who will receive less than he or she has paid in.

In practical terms, it should be noted that the incentives to join (or to evade) the system vary depending on its nature: completely redistributed systems usually give taxpayers a larger incentive to evade as compared to insurance type systems.

Few social security systems have their guiding concepts and objectives laid out clearly, and tend to mix elements from both the insurance and redistributive approaches. This fact, which derives from attempts to conciliate conflicting objectives results in enormous difficulties for the general public's perception and discussion of the problems of the basic social insurance system. In reality, many systems seek to maintain the appearance of an insurance system while actually carrying out significant transfers of income between generations and frequently within a single generation.

The lack of comprehension is greater still when the discussion moves on to problems of the social security system. The public, constantly fed the mythical image of an **insurance** policy, resists absorbing the concept of social **security**. When all the activities (in the fields of social insurance, health care and social assistance) are funded from a single budget (such as in Brazil), an insured person frequently feels that he or she has been hard done by when social insurance funds are transferred to the assistance component of the social security system. This reaction is only to be expected; the concept of the social security is relatively recent — established among specialists and has a long way to go before it overcomes the communication barriers which separate it from the general public.

### 3.1.2 - Compulsory **versus** voluntary saving<sup>3</sup>

In an era when ultra-liberal views are frequently expressed by some sectors of society, the claim that a compulsory social security system is unnecessary is constantly heard.

These views question the need for the State to interfere in individual's decisions on consumption, savings and investment, on the basis that this inevitably results in losses in economic efficiency. The situation, however, is one where the market does not provide satisfactory solutions. If the approach taken emphasizes redistribution and assistance, the justification for an obligatory social security system is obvious enough: voluntary charity does exist, but it usually falls far behind the demands of the needy. The essential question is what degree of

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<sup>3</sup> Several of the issues raised below have been covered by Oliveira (1982). Surprisingly, over a decade later the same questions remain current. For this reason they are discussed here once again.

redistribution is desirable and feasible, in line with the savings capacity and scale of values within the society which the system is located.

Although the authors of this paper are completely opposed to excessive State oversight and interference in the public's decisions on consumption and investment, **the application of a principle of complete individual free will in the field of social security cannot be justified either in theory or in practice.**

The process of deciding how much save, when to save and how to invest savings in order to guarantee an adequate flow of income during the period after retirement<sup>4</sup> is without doubt a highly complex one. The individual would need to have at his disposal an extremely broad and accurate array of data and information about the risks affecting his future: the duration, type and treatment cost of the sicknesses which may affect him or his dependent relatives, the probabilities affecting prospects of unemployment, death, invalidity and life expectancy (his own and that of his dependent relatives) etc.

On the investment side, he would need reasonably precise information were available, assessing it would represent a demanding assignment for a team of actuaries and investment analysts. For an individual, it would simply be an impossible task. In other words, even if all the needed information was available, the calculations for a rational consumption-savings-investment decision would be rather complex, certainly beyond the reach of our average consumer.

It should also be taken into account that the probability of error is very high and the evaluation process highly sensitive to minor fluctuations in specific variables. Let us take as an example a small shift in the discount rate, or the capitalization rate: when taken over the course of the economically active lifetime of an individual<sup>5</sup> it may, in many cases, invert the results of the assessment. In sum, the complete information hypothesis, a necessity if the individual's well-being is to be maximized according to consumer theory, is far from being the reality in the case of decisions on social security. On the other hand, in a probabilistic world, the magnitude of the possible error absolutely does not recommend that the issue be completely left to individual free choice in this specific case.

In practical terms, one must take into account the fact that savings and investment decisions are taken over the course of a lifetime, with no chance of a second try if a mistake is made. In general, once a wrong decision has been taken during the decision-making process (where retirement pensions are concerned), there is no going back. In addition, the consequences of an error of assessment or even of incorrect information can in most cases be drastic and irreversible, leaving the individual reduced to a standard of living incompatible with human dignity itself.

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<sup>4</sup> Of course, the uncertainty problem is even greater in the case of non programable events such as disability, premature death etc.

<sup>5</sup> Plus the expected length of time by which his dependent relatives may survive him.

One can also be sure that some people, out of pure lack of prudence (in technical terms, “risk lovers”) would opt for short-term consumption and run the risk of being left at the mercy of society’s goodwill once they have lost their earning capacity. Others would not be able to save enough to take out an insurance coverage. Both would probably force society to supply them, in what may well be an inefficient and uncoordinated fashion, some form of assistance through acts of public charity. In this case, having an institutionalized social insurance system is nothing more than a rational economic approach.

In the case of social security, the arguments in favor of an obligatory system are further reinforced by the existence of what are known as catastrophic risks, particularly in the fields of health care. Once more, society would be called upon to provide funds to treat those suffering from diseases whose treatment costs are beyond what can be met out of the individual’s own resources.

Finally, if the decision to join a social security system were left entirely up to individual preference, the phenomenon known as “adverse selection” would probably take place: the individuals who are in practice subjected to higher risk are precisely those who would seek to take out insurance. In other words, if we could divide the population among “risk lovers” and “risk averse,” only the last group would tend to join a voluntary insurance scheme. The immediate consequence is that insurance premiums tend to get higher and higher, as more and more “risk averse” join the “risk lovers” group, kicked out of the first group by the growing price of insurance. Even the most orthodox would agree that in this case the sovereignty of the consumer does not produce effective results.

All these arguments serve to justify the existence of some form of compulsory social security system. For that, compulsory social security is much more than a humanitarian need, but it is an economically justified one as it would probably cost society more to bear the burden of public charity than the inefficient use of resources due to compulsory savings.

The system’s obligatory nature, however, implies only that the State has the power to police every citizen’s obligation to join it. In essence, the arguments which justify its obligatory nature are the same as those which justify the very necessity of a social security system. **This obligatory character does not necessarily imply that it is the State which should administer the mechanisms of collection, application and transfer of funds**, nor that services in the fields of social security should necessarily be provided directly by agents of the State. **It is thus very important to separate the concepts of an obligatory system imposed by the State from and a State-managed system.**

### 3.1.3 - Minimum or maximum coverage

In general, the contingencies in which an individual is subjected may, from a point of view relevant to the social security system, be classified as **predictable** (or programmable) and **unpredictable** (or non-programmable). Premature death,

invalidity, sickness and involuntary unemployment are characteristic examples of unpredictable contingencies.

On the other hand, one of the few certainties that a person may have in his or her life is that one day he or she will grow old, probably after a long working life.

The principle of collective insurance (mutuality) perfectly fits coverage against unpredictable contingencies: catastrophic risks at the individual level are “watered down” when a large group is considered. This is not necessarily the case for predictable contingencies. For example, old age coverage may be covered by a forced savings scheme.

Questions of **obligation** to contribute and **rate of income replacement** (see item 3.1.5) also impose different requirements, depending on the type of contingency under consideration. Thus, for unpredictable contingencies one could hardly argue against an obligation to participate or an above-minimum rate of income replacement, in addition to the absolute necessity of coverage.

Where the contingency of old age is concerned, however, an obligatory participation requirement may be justifiable but the rate of income replacement provided by the obligatory system may, in principle, be basic or minimal. Thus, those individuals who have a strong preference for immediate consumption (those who, theoretically speaking, apply high discount rates to future events) would have some guarantee, however basic, against the consequences of their own thoughtlessness. On the other hand, those people economically incapable of accumulating the savings necessary to secure an income flow after old age has put an end to their earning capacity would also be guaranteed at the minimum level. Finally, the uncertainty inherent in the process of decision-making would be reduced by the guarantee of at least an amount sufficient to avoid the individual’s being reduced to begging at old age, given the existence of a **basic social safety net**.

In relation to **length of service**, the argument for an obligatory system, mutuality and high rates of income replacement is even more questionable. Strictly speaking, length of service is not a risk<sup>6</sup> but rather a certainty resulting from the individual’s working life. If it is the case that work, and particularly certain specific types of work, can bring about physical and mental wear and tear, it is equally the case that obligatory social insurance normally covers the consequences of this wear and test, through covering sickness and invalidity benefit.

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<sup>6</sup> Old age is not a risk in itself, unless a significant disability probably is assumed to occur after a certain age. In most contemporary societies it is normally accepted that working capacity will be reduced from a certain age, located somewhere between 55 and 70 depending on the period and country in question. In reality, irrespective of whether a loss of working capacity really takes place, every society has established that it is opportune to allocate funds to sustain its elderly people however heterogeneous, subjective and vague the definition of old age may be. Thus, in the vast majority of the cases the obligatory social insurance system already covers the contingency of length of service through its coverage of old age.

### 3.1.4 - The beneficiary group: universal or selective?

The range of beneficiaries of social security system may vary between the entirety of the resident population, under the **Beveridge Model**, and a restricted group of insured people, under what is known as the **Bismarck Model**.<sup>7</sup>

In fact, it makes little sense to define universality for the social security as a whole. It is essential to define the beneficiary groups for each of its component elements, if only because the conceptual basis of some parts of the social security system is wholly incompatible in practice with the idea of universality.

This is, for example, the case for social insurance. In every society there is always a group that will not be able to join a social insurance scheme: their immediate consumption needs surpass their income, leaving absolutely no room for contributions or savings. In summary, social insurance is aimed at the **insured group** whereas social assistance has often an universal **potential** clientele but it should be a very selective program — only the ones that need social assistance should get it.

The health component is certainly the perfect case for the need of universal coverage. It should be noted, however, that universal coverage just means that services are available to everyone. It does not mean some selectivity cannot be applied for cost recovery to stay with a single example.

In summary, universality and selectivity are not exactly opposite concepts: a certain social security component might be potentially universal, in the sense that it is available to everyone, but delivered selectively.

### 3.1.5 - Rate of income replacement (or replacement rate)

The rate of income replacement may be understood as the relation between the value of the benefit paid and the value of the individual's salary or income. For social insurance purposes, the relevant variable is the **contribution salary**, defined as the sum earned by the insured person during a certain period of time, on the basis of which contribution and/or benefit levels are calculated.<sup>8</sup>

For social assistance purposes, on the other hand, the rate of income replacement may be understood as the proportion of (real presumed) income prior to the loss of earning capacity which is replaced by the benefit paid. The concept naturally does

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<sup>7</sup> Under the Beveridge Model, social security is a right of the citizen — the entire population is covered and the value of the benefit paid is usually low. The United Kingdom is principal example of this model. Under the Bismarck Model, social security is granted in return for a payment, along the lines of private insurance policy, and those contributing constitute the beneficiary population covered. The sum insured is the individual's salary and the premium is proportional to its value.

<sup>8</sup> Even if it is the employer who pays the contributions in full.



not apply to welfare services or to supplementary cash benefits and/or benefits paid to the destitute.

From the social insurance point of view, it is considered reasonable for the rate of income replacement to bear some relation to the nature of the contingency. The rate of income replacement for unpredictable contingencies should, all other things being equal, be greater than or at least equal to the established for predictable contingencies.

The rate of income replacement of social insurance can be — and in many actual systems is — inversely proportional to the insured person's income level, since it is higher in the lower income brackets and lower in the higher brackets. The very existence of minimum and maximum levels reflects this tendency in the majority of existing systems. In this fashion, a certain progressiveness is ensured in the system.

It should be noted, however, that an exaggeration of this progressive formula may destroy the insurance component transforming it in a social assistance scheme.

### 3.1.6 - Single layer or multi-layer

Again, the distinction of what is basic — and should therefore be compulsory and what is supplemental — and, therefore, could be optional governs the number of layers or tiers of a social security system.

The so-called 3 tier model is a popular alternative among many specialists. A basic non-contributive public assistance system guarantees survival level cash benefits and medical attention to all citizens who need it and have no other form of coverage. A second contributive compulsory social insurance tier provide salary related benefits to the insured; medical attention might be the same for both the first or second tiers, if deemed universal. The third tier — supplemental social insurance — might be either compulsory or optional, depending on which objectives one want to achieve (maximum or minimum income replacement).

It should be noted that even the so called “Chilean Model” is a 2 tier scheme, with State guarantee of minimum benefits.

### 3.1.7 - Separated workmen's compensation programs **versus** general programs

From the strict standpoint of compensating the worker for the loss of his earning capacity, it is irrelevant whether sickness or disability is related to work or not. Although some specialization might be of advantage,<sup>9</sup> even medical care facilities can be the same for accidents and professional diseases.

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<sup>9</sup> Trauma Centers, for example.

From the preventive standpoint it is a whole different story. A separated workmen's compensation fund, specially if fully cosseted by employers can, and very often do contribute to better/safer work place environment/practices. Specialized medical facilities, with greater emphasis on accident and trauma, have demonstrated far more effectiveness in the prevention of lesions than general facilities. Finally, there is a clear need for particular rehabilitation and retraining and replacement services which are better suited within a specialized structure.

In respect to workmen's compensation, there are many lessons to be learnt from the Chilean experience. The **Mutualidades** were — and still are — in comparative terms, so efficient in administrating the workmen's compensation program that they remained untouched by the reform. In essence, solidary employers of an economic sector pool their resources and mutually insure the work related risks, each firm paying an actuarially calculated tax, as a function of its own risk experience as compared to average sectorial records. There is, of course, an economic incentive for each entrepreneur to adopt preventive measures as a way of reducing his own costs.

### **3.2 - Basic Funding Issues**

#### **3.2.1 - Capitalization or pay-as-you-go**

Under a **capitalization** system, the contributions made are capitalized either in real or in accounting terms and form reserves to cover the future cost of benefits. Under **pay-as-you-go** system, on the other hand, the funds collected during a given fiscal year are used for the payment of benefits in the same fiscal year. Occasionally, even under a pay-as-you-go system contingency reserves are set up with the objective of cushioning the impact of seasonal fluctuations in revenue performance and the costs of the system funded .

Under the second system, if all other factors (rate of income replacement, real-terms increase in the contribution base, contribution levels etc.) are constant, the system's equilibrium depends on the ratio between the number of contributors and the number of beneficiaries. If the demographic variables and/or other structural or economic factors bring about reduction in the level of the ratio over time, three alternatives are available to restore the system's equilibrium:

- a) an increase in contribution rates;
- b) a reduction in the rate of income replacement; or
- c) the establishment of more restrictive rules governing the individual's change in the status from contributor to beneficiary.

In practice, in many cases a combination of these alternatives is adopted, not always explicitly or in a way perceptible to the general public. The conclusion is that a pay-as-you-go system requires frequent adjustments, which, if public opinion is reasonably well-informed, is not necessarily a disadvantage.

Since the **pay-as-you-go system** consists essentially of transfers both within a single generation and also among different generations, **the relationship between contributions and benefits is not necessarily direct or clear**. The pay-as-you-go system adopted in many underdeveloped countries favors evasion of payment of contributions since as benefits are, in majority of cases, granted on condition of proof of a formal employment contract and not of the actual payment of contributions into the funds of the social security system. In such systems, even if the employer wrongfully appropriates the contributions deducted from the employee's wages, the insured person does not lose his access to the benefit provided he/she can prove he/she was formally employed for the necessary period.

Such a system depends completely on third-party (government) monitoring and inspection, which does not always meet the minimum requirements of effectiveness in enforcement of collection of contributions. Indeed, it is doubtful whether it is technically and economically feasible to establish an inspection system capable of doing without the participation of the contributor acting as an inspector monitoring his own interests. **The effects of this drawback could be minimized, even under a pay-as-you-go system, by establishing the need for administrative records of contributions actually made as a precondition for the provision of a benefit to the insured person.** The agency responsible for administering the social security/insurance system should in turn provide the insured person with a statement of the situation of his account, enabling him the monitor it himself.<sup>10</sup>

A second argument used against the pay-as-you-go system is that it is **a system of transfers which takes resources away from social groups with a higher marginal propensity to save and invest than the social groups to which the resources are transferred**. Indeed, retired people, benefit recipients, the sick, the unemployed and the poor in general have a generally very high marginal propensity to consume, itself the result of their low socioeconomic status. Attempts to quantify these effects on savings and capital accumulation<sup>11</sup> come up against considerable theoretical, methodological and practical difficulties. In any case, it can be stated with some degree of certainty that a pay-as-you-go system does not encourage saving.

The Chilean reform indicates that a relatively high level of compulsory savings might have some very good effects on the macroeconomics scenario. A capitalized scheme may also result in lower interest rates.

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<sup>10</sup> This is the system theoretically adopted for the FGTS (the Time of Service Guarantee Fund — the personal saving systems also based on the contributions on payroll). In practice, although some banks supply the statement, this is not a generally-followed procedure.

<sup>11</sup> See, for example, Feldstein (1982), Barro (1974) and other authors on the social security system's effects levels of savings and investment in the United States. The debate has dragged on for almost 15 years without any definitive conclusion being reached on either side.

Unfortunately, it also can have very bad adverse effects. Accumulation of reserves might occur too fast for the size of the economy, leading to an explosion of the real asset's prices. Oligopolization of national savings — with very dangerous economic and political power concentrated in the hands of a few firms<sup>12</sup> — is also a risk, if necessary care is not taken when designing the system.

On the other hand, under a **capitalization system**, which may function individually or on the basis of collective account, the principal difficulties lie in ensuring that the government does not make use of the system's reserves to fund deficits and/or programs whose rate of return is not always compatible with the requirements of a minimum actuarial yield. The history many social security system is rich in examples of this type of behavior. The worst scenario is one in which funds capitalized by the social insurance system (basic or supplementary) are used to fund the government's budget deficit. The government debt securities offered as a guarantee,<sup>13</sup> normally compulsorily purchased, often provide low yields and even more questionable liquidity, undermining the capacity to provide a return of the reserves which should back the concession of future benefits and the continued payment of those already conceded. In addition, the viability of the future redemption of these securities often depends on an implicit promise of increases in the tax base and/or burden which are not always feasible.

This problem, of an eminently political nature, may be partially resolved or minimized through a process of capitalization in individual accounts, including a permanent process of provision to the insured person of information on the value and make-up of his assets. The political pressure applied by thousands or millions of insured people, each with their own individual account, would serve to prevent the deleterious consequences of the government's pressure on the small number of managers of funds capitalized in collective accounts.

On the other hand, the system of individual capitalization of contributions often makes it impossible to offer even minimally reasonable benefits to the less favored sectors of society, given the irregularity and/or insufficiency of their deposits. In such cases, the government usually finds itself obliged to supplement the benefits from the general funds. If this supplementary funding is on a large scale and becomes the rule rather than the exception, the system becomes in practice a pay-as-you-go one.

On the plus side, the capitalization system offers the opportunity to secure funds for investments with a medium or long-term return, which in a developing economy represents a fundamental factor in obtaining sustained economic growth. In addition, evasion of contribution payments tends to be drastically reduced in comparison with a pay-as-you-go system, especially if the system is based on

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<sup>12</sup> In Chile, more than 2/3 of the assets are concentrated in only three Administradoras de Fondos de Pensiones (AFPs).

<sup>13</sup> When debt securities are not used, their place is taken by "development fund quotas" or similar mechanisms.

individual accounts: each insured person monitors his own interests. In countries where the rate of social insurance contribution evasion is high, this may represent a strategic consideration in assessing the alternatives for an effective reform. Finally, under a well-structured and administered capitalization system, with application limits established according to technical criteria<sup>14</sup> the adjustments will tend to be less frequent. This form, from the point of view of public confidence, may represent a significant political advantage.

### 3.2.2 - Employee or employer

Taxes or contributions paid by companies appear to be object of a rare consensus among economists: in the end it seems always to be the individual consumer who pays the bill, or at least most of it. In fact, in modern economies, largely characterized by a high rate of oligopolization, marking-up is a widely-used practice. Taxes and indirect contributions are passed on to product prices, and are, in the end, paid by society as a whole.

There is, however, a difference in the taxpayer's perception of these contributions which is extremely important from a political standpoint. Taxes, charges or contributions directly paid by the individual are clearly perceived as resulting in a reduction in his disposable income. Those paid by companies are, in general, invisible to the taxpayer, even when they are passed on to prices in full.

This indirect incidence makes it extraordinarily difficult to deduce what exactly is the share of the overall contribution burden met by each sector, and also results in people who are not insured paying contributions to the social security system included in the price of the goods and services which they acquire, without having access to any benefit. The empirical evidence available on the question of the differential impact of indirect taxation on the various socioeconomic classes suggests that the low-income groups are usually those who most suffer from this form of taxation.

On the other hand, the myths surrounding employer contributions can be politically useful to the government, since the redistributive conflict is not clearly expressed. To what extent this matter of political convenience is in fact advantageous is a genuinely difficult question to answer. Under a democratic system which emphasizes the provision of correct information to its citizens and the explicit discussion of any conflicts, the option of contributions (on income from work or from capital) paid directly by individual's is the more appropriate one.

### 3.2.3 - Payroll or other taxation base (value added, profits or sales)

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<sup>14</sup> Criteria of prudence, in terms of a requirement to diversify the range of issuers of the securities held, minimum return requirements, trusteeship guidelines etc. in line with sound portfolio administration practice.

If we bear in mind that social insurance aims to replace the salaries of those who have lost their capacity to earn, payroll taxation may be considered conceptually appropriate.

In contrast to what many claim, the elasticity of payroll levels relative to GDP fluctuations tend to be smaller than those for the other alternative taxation bases. This fact is clearly explained by the existence of hiring and re-hiring costs. These costs become increasingly important as the production process develops and employs an ever greater amount of skilled labor.

In terms of future potential, growth in the share of national income accounted for by wages and salaries is expected for most developing countries.

Furthermore, as pointed out before, taxation of wages and salaries makes a positive contribution to perception of the costs of the system on the part of taxpayers, the overwhelming majority of whom are in wage-earning employment. The arguments in favor of payroll taxation as a funding source for **health** and **social assistance** programs are not so strong as they are for funding of social **insurance**. In conceptual terms, it is not appropriate for a universalized health service, and even less a social assistance system, to be funded from a tax levied exclusively on one sector of society. Even so the possibility of using payroll taxation as one of the components of the funding structure of these programs may be considered exclusively as a question of taxation convenience.

The most frequently-used arguments against the use of payroll taxation refer to its regressive nature and to its restriction of absorption of labor by companies.

The argument that payroll taxation is **regressive** in character, particularly when the existence of maximum contribution level is taken into account, should be assessed with care. Were it to be seen as a tax, it would clearly be a regressive tax. In the case of social insurance, however, a contribution is paid in order to a benefit to be received, and it is exactly this characteristic which distinguishes a contribution from a tax. Though specialists agree that taxation should be progressive, only rarely are arguments heard in favor of progressive contributions. In the latter case, what matters is that the insured person's contributions cover the cost of the benefits. Further, the concept of regressiveness only applies if low-income groups pay more than they receive from the social security system, subsidizing higher-income groups.<sup>15</sup>

As for question of absorption of labor **vis-à-vis** capital, the levying of labor charges on payroll does result in an increase in the cost of the labor element in the production process in relation to the other elements. Thus, it does not encourage the use of the labor-intensive technologies when alternatives are available.<sup>16</sup>

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<sup>15</sup> This occurs frequently in a pay-as-you-go system.

<sup>16</sup> Among the empirical studies of the elasticity of use of labor relative to cost of payroll labor charges, that of Bacha, Mata and Mondest (1972) stands out.

On the other hand, as production processes evolve the elasticity of use of labor relative to its cost tends to be dramatically reduced in the modern sector of the economy. Today, when an industrialist chooses to produce something he also chooses to use specific technology within which the relative use of capital and labor is rarely variable. In technical terms today's industrial processes are for the most part fixed-proportion processes. In these processes, the degree of utilization of production factors for generating a given quantity of the product is fixed over a wide band of variation in the relative costs of the different factors. The degree of substitution of capital for labor described in macroeconomics textbooks is more characteristic of the agricultural production processes of the last century than to the scenario of the technological world of today. Furthermore, today, and very probably for the foreseeable future, labor costs represent a small fraction of overall production costs. In summary, decisions in production factor utilization are intended to maximize the total productivity of the manufacturing process within given technologies, and situations of margin adjustment are rare.

The arguments against using **sales** as the taxation base for funding a social security system are far greater than those in favor. The only strong arguments in favor are that sales taxes are easy to apply and that this tax base affords a high revenue potential. On the other hand it is (as any elementary textbook on government finance make clear) the worst choice in terms of regressiveness, taxpayer awareness, control of inflation etc. A tax or contribution on sales applies on a compound basis, is passed onto product prices, and is paid essentially by the least well-off classes. Rises in rates charged are almost immediately reflected in increases in inflation.

As for the use of **value added** as a taxation base, while it is appropriate for taxation in general it is hard to conceptualize and calculate in some areas of the economy (such as the financial sector). As a source of funding specifically for social insurance it has the disadvantage of being hard for the taxpayer to visualize, a factor which would not help to create the contribution-consciousness needed in most developing countries. The levying of taxes and/or contributions on value added requires a sophisticated apparatus capable of monitoring the complex accounting mechanisms involved. Given this complexity and the extent of the inspection difficulties involved, the level of value added tax evasion also tends to be high.

The establishment of contributions based on **profit**, theoretically in order to ensure that the return on capital contributes to the funding of the social security system, also has serious drawbacks. The first of these drawbacks is the fact that taxable profits usually represent a relatively small taxation base in comparison to payroll or sales. Profit is not only for the most part highly sensitive to the fluctuations of the economic cycle but also subject to all forms of accounting manipulation which may be hard to detect.

Another drawback is the fact that rates of tax charged on profit are already extremely high in some countries. Thus, the increases in tax rates on this base which would be required to fund the social security system would probably lead to an increase in evasion, even negatively impacting the revenue already generated by corporate income tax.

Finally, other taxation bases (income from lotteries, horse-racing, property, sales of agricultural produce etc.) have no logical connection with the social security system capable of justifying their use in funding it, addition to their low revenue potential and operational difficulties. Although taxation of fuel has an apparently high revenue potential, it has the drawback of unnecessarily increasing the prices of essential goods, which are significantly affected by transport costs. Since almost all urban transport (cars, taxis, buses and trucks) of goods and passengers runs on fossil fuels, fuel taxation would have a far from desirable social impact.

#### 3.2.4 - General State revenue funding or earmarked revenue

One of the points on which those who argue in favor a social security system insist most strongly is the need for captive and dedicated (**earmarked**) revenue of the kind generated by obligatory contributions on payroll. The guarantee of a revenue source would be beneficial or indeed indispensable were the system really one of **insurance** (which is at the very least questionable in the case of a system that provides **assistance**).

Earmarked revenues, nevertheless, mean that the social security system eventually becomes a powerful State within the State. When all goes well, its funds are used to extend the programs provided; in less favorable periods general funding is resorted to ensure the system's survival. The wealth redistribution function of a social security system with its own earmarked funding does not suffer from the effects of competing for resources against other government programs and, for this very reason, is little questioned.

As for the social insurance component, it is quite clear that it must be financed by earmarked funds. Social insurance must be viewed as a long term contract and, even in a "pay-as-you-go" system its funds must be preserved from malversation of use. The question here is to preserve the insurance credibility and enhance public cost consciousness and awareness.

The Chilean old-age-retirement scheme is a good example of the clear and exclusive use of earmarked funds, at the individual level, to cost individual benefits. Even when thinking on mutual or collective arrangements, it may be very important to have a clear tie between earmarked contributions and the benefits, as means of giving participants some incentive to control the system.

Thus, what is genuinely **insurance** can and should be funded from earmarked revenues which can ensure that the "insurance contract" entered into is honored in full; it also provides for transparency and accountability of the program.



The system's function of providing assistance, however, should be funded out of **general State revenues** on the principle that the taxation system should be just, and budget resources rationally allocated among the government's various functions. If this principle is not observed there is a tendency towards the consolidation of transfer mechanisms which are not explicit and not under the control of society as a whole — in some cases not even under the control of the government itself.

In other words, these programs, destined to relieve extreme hardship, should compete in terms of priority with other government programs. The use of an earmarked fund has no theoretical advantage; in practice, such uses of guaranteed resources, with no threat or competition from other programs, tend to perpetuate assistance programs that are no longer needed.

In theory, the financing of a universal basic health system must also be through general revenues. Political reasons may indicate that the use of some earmarked funds may be a wise policy. Some health programs require continuity of allocation of resources to be effective; this technical characteristic is not always compatible with some variations in the level of resources according to yearly changing political priorities.

Even when earmarked contributions are used, there is no sense in financing individual health plans according to individual contributions, as it is the case of Isapres in Chile. The health risk is definitely not proportional to one's income/contribution. For that reason, social basic health coverage has to be redistributive. Resources from all contributions must be pooled in a single fund, to be applied according to the needs and priorities of an overall health policy.

Curiously enough, this pooling of resources does not necessarily means a state-owned state-operated health system. Various alternative schemes can be devised and implemented, which can put together the need of a redistributive policy with private enterprise effectiveness.<sup>17</sup>

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<sup>17</sup>See, for example, the "health-bonus" prepaid universal health system proposed for Brazil. A full description of the system can be found in Oliveira and Médici (1991).

### 3.2.5 - Defined benefit or defined contribution

With a **defined benefit** plan, whether the system is pay-as-you-go or capitalization-based, the rules for calculation of the benefit's value are pre-defined, usually on the basis of the most recent contribution salaries. The value of the benefit paid does not depend on the yield of the reserves, under a capitalization system, or on the economic performance of the system as a whole, under a pay-as-you-go system. If the actuarial forecasts prove wrong, the only alternative is for the plan's contribution rates to be restructured. If, on the other hand, the plan is a **defined contribution** one, it is the value of the benefit that is adjusted according to the yield of the reserves.

The defined benefit concept is more appropriate in the case of minimum benefits paid out to cover predictable contingencies, as well as of those which aim to cover unpredictable contingencies. In the former case, the fact that the benefits are minimum-level provides the primary reason why they cannot be reduced any circumstances. In the latter case, the fact that the event is unpredictable provides ample justification for the insured person to be familiar with the extent of the benefit beforehand.

The fixed contribution concept is more appropriate for above minimum benefits aimed at covering predictable contingencies and the supplementary coverage of unpredictable contingencies.

In terms of motivation for joining the system, from the point of view of an individual, a fixed benefit is usually more attractive, provided that someone else pays when contribution rates go up. From the point of view of the system's sponsor,<sup>18</sup> the adoption of a fixed contribution plan clearly reduces the degree of risk involved.

## 3.3 - Basic Operational Aspects

### 3.3.1 - Social or private insurance

Private insurance is distinguished from social insurance by the fact that the latter is compulsory and/or involves some element of redistribution. Thus, for the basic social security benefits, a social insurance scheme represents the most appropriate option.

In practice, given the existence of minimum benefit levels even a scheme based on obligatory individual savings<sup>19</sup> ends up resulting in some form of redistribution. In such cases general State funding is (should be) used to cover shortfalls in the

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<sup>18</sup> A term used here to refer to a state or privately-owned institution subject to the effects of possible cost increases.

<sup>19</sup> Such as, for example, that established in Chile.

funds accumulated in the insured person's account when these are below the level necessary to ensure a minimum income during the period after retirement.

In the case of supplementary benefits, the ideal is a system operating under rules as close as possible to those of private insurance system: once the conditions imposed by the principle of mutuality have been observed, the expected value accruing from the contributions should be close to the expected value of the benefits and services to be provided in the case of each insured individual.

Once again, the definition of what is basic and what supplementary depends on a political decision. On the one hand is the question of to what extent society considers it acceptable for some people not to save voluntarily an amount sufficient level of income in the case of loss of earning capacity. On the other hand is the fact that an obligatory scheme represents interference on the part of the State in individual's decisions on consumption, savings and investment, with resulting losses in economic efficiency.

### 3.3.2 - Centralization or decentralization

Generally speaking, decentralized schemes favor efficiency, flexibility and social monitoring. For each social security component, decentralization involves a broad set of issues which range from funding (state and/or municipal taxes, co-payments etc.) to the service provision (public bodies at State, municipal, or neighborhood level, charitable institutions, employers' and unions, private-sector agencies etc.).

There are components, such as basic social insurance, where there are clearly advantages to the application of some form of centralization: the existence of centralized records makes it easier to solve a vast range of problems deriving from the physical or professional mobility of those insured (the **portability** problem). Social insurance also has a lot of **economies of scale**, in the sense that unit costs are substantially reduced as the system grows in terms of covered population. This same characteristic implies a trend towards monopoly, that most of the time should be avoided by both economic and political reasons.

It should be also noted that some social security systems tend to present high political risk if the centralized option is adopted. For example, a national centralized fully capitalized social insurance system — which rapidly accumulates huge amounts of capital — is almost always an irresistible temptation to politicians eager to satisfy their present voters, even if at the expense of the future solvency of the system. Experience has shown that decentralized schemes work much better in such cases.

As a consequence, even when a first step is the centralization of a particular function, this procedure should be thought of as merely part of a transition

towards a decentralized scheme.<sup>20</sup> It should be noted, however, that decentralization usually carries a higher complexity and coordination problems, requiring sophisticated managing techniques.

### 3.3.3 - Unified budget or independent funds

The existence of a single social security budget,<sup>21</sup> presupposes that funds derived from one set of sources may be allocated or shifted among the different programs, projects and activities according to politically-established priorities. This makes sense for the fields of health care and social assistance, but not in the case of social insurance. Outlay on benefits is absolutely predictable and funds should not be allocated to other areas.

A second drawback is the lack of transparency as to who pays and what they pay for. This aspect could be minimized by the establishment of earmarked funds for each of the component parts of social security system (social insurance, health care and social assistance) according to their collection base and/or specific contribution/tax rates, keeping these funds grouped together under a single budget. Although it would lose part of the interchangeability of funds which characterizes the traditional budget structure, this consolidated budget would maintain the unitary principle of the concept of social security and at the same time include earmarking and greater visibility of the relationship between funding and programs.

### 3.3.4 - State or private sector

Here it is essential to distinguish between the functions of setting up, regulating, standardization, inspection and control of the system and that of its execution. The former functions are traditionally accepted as pertaining exclusively to the State. In the case of social security, as with other characteristically State activities,<sup>22</sup> when matters are simply left to the laws of the market private enterprise does not generate satisfactory solutions from a socioeconomic point of view. Once again, the definition of what is considered to be a satisfactory solution is a political one, involving society's values and perceptions of the issue in question.

The rationality of the State's performing an executive operational role should be severally questioned. In the first place, the State's participation as an implementing agency means that it loses its status as an impartial judge. Secondly, State performance in the implementation of social security services

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<sup>20</sup> For example, today's data storage, transmission and accessing technology means that databases need only to be connected via a network involving a mixture of different kinds of hardware and software: physical centralization is no longer necessary.

<sup>21</sup> Such as that required by existing Brazilian legislation.

<sup>22</sup> Even in the Chilean social insurance scheme there is a very strong State interference; only the administration of the operations was delegated to the private firms (Administradoras de Fondos de Pensiones - AFPs).

should analyse in terms of economic efficiency: who produces the maximum output with minimum cost must be the relevant criteria in most cases.

Indeed, the transfer of executive responsibility to the private sector represents nothing more than a form of decentralization, where it is competitive relations that predominate rather than the administrative controls which are common to and ineffectual in the various spheres of government.

On the other hand, the option for a privatized execution system does not mean that is possible to do without the State's role in generating norms and disciplining the market. On the contrary, in a system where the executive functions are privatized the State has a fundamental in ensuring competition, avoiding the formation of cartels and, above all, spreading the accurate information which is necessary for political decision-making by society and rational decision-making by the individual.

The discussion of privatization is very often held in connection with social security reforming in Latin America. Some "reformers" say Social Security is inefficient because of its public character, as opposed to the bright performance of the private enterprise and the wonders of the market forces.

As it could be taken from the discussion until this point, it is not at all feasible that a reasonable social security system would emerge naturally from the market forces, as a product of profit seeking free enterprise. Theory says and practice confirms that some of governmental intervention is necessary for the creation/maintenance of social security systems.

In one sense, the dilemma public "versus" private is false when concerning social policy in general, and in social security discussions in particular. The government's role is basically one of "promoter" of social policies, through adequate legislation and control. Imposing its taxing powers to collect mandatory contributions and controlling the delivery of cash benefits and services, public authorities simply cannot be substituted in these traditional State functions.

On the other hand, the operation of the various social security programs can be successfully carried out by the private enterprise, even in social assistance programs. Specially in developing countries, governmental institutions have a tradition of very low efficiency in Social Security operations; the payment of benefits and the delivery of health and social services by public agencies has a long history of bad performance, severely marked by ineffective, bureaucratic and costly programs, not to mention simple corruption.

Chile<sup>23</sup> managed, at least in theory, to achieve some kind of equilibrium between public and private actors in its Social Security reforms. At least all the policy

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<sup>23</sup> As well as other recently reformed Latin American social security systems: Argentina, Uruguay, Colombia and Peru .

making, regulation, supervision and controls are done by governmental agencies, while operations are generally carried out by private enterprise.

Very frequently the political opposition to the “privatization” of Social Security operations come from the public servant's corporations. Feeling endangered, they tend to mix their corporate values and privileges — usually maintenance of their jobs and salary hikes — with the defense of “public” social security systems. Since they are large groups, it is natural to expect that this type of political resistance might be very strong.

In sum, if a more efficiently operated system is a desirable goal, policy makers will have to show to the population that public guidance is not incompatible with private operations.

### 3.3.5 - Group restricted or open to all

This choice only applies to the case of the supplementary components of the social insurance and health systems. The advantages of a restricted group are principally in the possibility of reduced administrative and marketing costs. Restricted systems also tend to reinforce the spirit of solidarity in comparison with open ones. Open systems, on the other hand, take advantage of the economies possible as a result of the use of existing infrastructure, the application of modern management processes and specialization of functions.

In reality, the “open versus restricted” dilemma is a false one. There is room for both forms of operation, as well as mixed systems. For the formal labor market and for large corporations with relatively low staff turnover, the restricted scheme is often more appropriate.<sup>24</sup> This is because the social benefits package is often included in the agenda of salary negotiations and, in many cases, in the company's employees. In an intermediary position are funds with multiple sponsors and those for which labor unions are responsible, operational arrangement. Finally, the open sector should be seen as covering the potential residual clientele not covered by the systems mentioned above, not to mention the market niches which exist in various areas of the social security system.

## 4 - SPECIAL ISSUES

### 4.1 - The Issues of Coverage and Inequality

As a consequence of their non-planned historical development most social security systems tend to have very unequal coverage, in the sense that some population groups might not be covered by some/all components. In most developing countries, it is very common to have rural and/or informal workers excluded from social insurance coverage. Others that do have coverage for these

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<sup>24</sup> Given adequate **vesting** and **portability** provisions.

groups, have different levels of protection, with rural programs being usually more modest than their urban counterpart.

In other words, even when there is substantial horizontal coverage, vertical coverage may be extremely unequal and unfair. In fact, it is quite frequent the situation where those who need the least social protection get the most from the systems. Very often, even those who pay more to the system get the least.

This inverse Robin Hood syndrome, could be expected as the result of the political struggle of socioeconomic groups with very unequal powers. As could also be expected, most social security systems just reflect the inequalities of economic and political powers of the various groups in each society.

The issue here is thus, how to reform systems that are usually good for the minorities of relatively wealthy, vocal and, most of the times politically powerful citizens who support it, against the poor, silent and politically weak majority of citizens that actually need social protection.

For certain, this is a formidable challenge, specially in countries where the general public awareness regarding social policies may be low.

#### **4.2 - The Issues of Evasion, Fraud and Corruption**

A significant number of social security systems in developing countries is plagued by tax evasion, fraud and corruption. More than an issue in itself, these factors are usually consequences of badly conceived and badly operated programs that do not take into account many particularities of the underdeveloped world. They usually assume that, with due enforcement, people will not evade social security taxes nor they will file for undue benefits.

What happens in real world is that tax evasion and social security benefit frauds are sometimes strategies of survival. Entrepreneurs sometimes face a very cruel option: bankruptcy or evasion. Since social security taxes are usually high, they rather evade them and, eventually, bribe the social security tax collection officers, than paying its costs. In other words, the opportunity costs of evasion and corruption is lower than the cost of paying taxes.

Most government authorities rely heavily on fiscal action to increase revenues. Experience demonstrates that this type of approach tends to be ineffective, specially in developing countries. With very little information at hand, the action of the fiscal auditor tends to be costly, time consuming and with very little result. One has to bear in mind that, in most countries of the region, a substantial part of the economy is "submerged"<sup>25</sup> and invisible to Social Security authorities. For most of this "submerged economy" there is little or no information available to

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<sup>25</sup>Not to mention the real "underground economy" of illegal and criminous activities like drug traffic, illegal gambling etc.

fiscal auditors, making the task of enforcing the legislation a question of random chance.

In such an environment, policy makers have to perceive that it is necessary to have adequate economic incentives, usually at the individual level, for a reasonable social control of the systems. Not even a full army of fiscal auditors can substitute the millions of citizens, if adequate incentives are given to them in order to "audit" social security tax collection process. A good start, without going to the Chilean individual contribution and individual savings account, would be simply tying the right to receive Social Security benefits (and services) to the existence of updated contribution records.

It may seem cruel to lay the burden of controlling the system on the workers' shoulders, specially by depriving him from the benefit if his Social Security tax has not been effectively collected.<sup>26</sup> From the strictly moral standpoint, it does not really make any sense at all. Unfortunately, we are not dealing with pure moral problems but with the reality of a cruel labor market, an underpaid and bad trained fiscal auditors and very weak information systems.

A second "economic incentive" to higher collection of social security taxes may be the reduction of the costs of the programs and, consequently, the reduction of taxes themselves. Although it is very hard to have empirical evidence, one may suspect that some systems are on the downward slopping part of the Laffer's Curve.<sup>27</sup>

Finally there must be some kind of "economic disincentive" in order to reduce fraud in social security benefits. Here, we have a somewhat more difficult problem. It is for certain that, if the advantage of a fraudulent benefit is lower, the overall fraud will tend to be also lower. It is just a matter of opportunity cost of receiving illegal benefits versus the potential utility of receiving it.

What happens, specially in developing, is that the vast majority of benefits already have low values. Fortunately, in this case, relatively simple administrative solutions are at hand. Modern information data handling techniques, including decentralized systems linked through communication networks are well within the technical and economical possibilities of most countries. These systems could easily control fraud in social security benefits, if designed, implemented and managed properly.

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<sup>26</sup>In this case the worker would be entitled only to a minimum social assistance benefit.

<sup>27</sup>The Laffer's Curve relates the level of the tax, as a percent of the tax base, as a percent of the tax base, to the percent of the potencial maximum tax that is effectively collected. It has the general shape of an inverted "U": when the tax is 0%, tax collection is obviously zero; its is also zero, when tax reaches 100% of the base. In other words, when the government takes back everything one earns, either production is zero or evasion is 100%.



In the health area, the need for the correct "economic incentives" is even greater. The "fee-for-service"— "third payer" problem is well known by social security and health insurance administrators. Costs cannot be controlled if: patient wants the more — and usually the most expensive — services he can get; deliverers of health services want to sell the more — and usually the most expensive — services they can sell; and, at the end, a third part pays the bill, having only bureaucratic controls in order to avoid overspending.

One possible solution to this problem is the prepaid group practice, where profits are made by cost minimization rather than by revenue maximization.

Finally, for the social assistance component, it seems that close community surveillance and control are essential to fraud and corruption reduction.

## **5 - GETTING THE REFORMS DONE**

### **5.1 - Transition Problems in Social Insurance**

Reforms in social insurance schemes must carefully consider the effects on three basic groups:

- a) the already retired;
- b) the active population by the time the reform is carried out; and
- c) the active population entering the labor market after the reform.

For the first group — the already retired — the basic concern is the continuity of their benefits. This may be a major problem when "chilean" reforms are adopted, having a public pay-as-you go system substituted by a privately run capitalized system. In these cases, the "chain" game is broken, as contributions are mostly diverted to the new individual accounts leaving the old system severely underfunded.

Solutions can vary from the one adopted in Chile — running huge fiscal surpluses to face the bill — to the one adopted in Argentina — creating a business contribution.<sup>28</sup> In any case, it should be noted that the same generation has to pay twice: contributions to continue paying the retirees of the old system and, at the same time, to the new capitalized scheme. This might be an enormous political obstacle for this type of reforms.

For the second group — the active population prior to the reform — there are two basic issues:

- a) to recognize the accrued or acquired rights in the old system; and

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<sup>28</sup> "Contribuição solidária".

b) to design economic incentives for people to opt for the new system as well as discentives to convince them to renounce the old system.

Again, in real practice solutions vary. The recognition of rights may take into account the present value of past contributions or a **pro-rata of the present value of future benefits or a combination of both**. In most developing countries precarious working history records pose a specially difficult problem in computing these values. On the other hand, all calculations are extremely sensitive to the magnitude of the interest/discount rates used.

**Economic incentives to the option normally involve somekind of immediate increase in take-home pay, such as the one adopted in Chile. Desincentives may include the threat of higher contributions or lower benefits for those opting for remaining in the old system.**

**As for the new entrants — those entering the labor market after the reform — there is considerably more freedom. In fact, in most practical cases, the new system was made compulsory for this latter group.**

## **5.2 - The Political Dilemma**

Along all this paper, the political factor was very often invoked. Lets now look closer to this fundamental element for social security reforming.

Most politicians of most countries recognize the need for deep reforms in the social security programs. Very few would, in fact, take any positive steps towards a reform.

Their attitude is far from irrational. Social security reforms have indeed a very negative political aspect:<sup>29</sup> potential gains occur over a long time span, and usually grow as time goes on; political losses are immediate, and usually very large in the beginning, eventually decreasing in time. In other words, politicians are faced with a trade-off they will very seldom accept; the loss of present day political support in order to get eventual long range recognition of their merits.

In fact, specially in the social insurance component, it is possible to shift the cost of the "adjustment" to future generations, that, in some cases, have not yet been born.

If this is the case in most developed countries, one can easily imagine the problems in developing countries. Using the taxpayer ignorance, some politicians shift the responsibility to the "Federal Government," to the recession etc. Public opinion is diverted from solving the problem to the secondary questions of finding the guilty actors.

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<sup>29</sup> Specially in the social insurance component.

To overcome this problem a very strong political will is needed from the reform promoters, combined with a very well designed aggressive public information program.

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