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SOCIAL SECURITY REFORMS AND THEIR IMPLICATIONS FOR THE CARIBBEAN

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Abstract

As in many other countries, the viability and sustainability of social security systems in the Caribbean is of concern to policy makers. Although systems in the region remain relatively young, liquid and healthy at this time, timely reform is necessary to prevent a crisis in the future. Reform is required to grapple with population ageing, a fairly large informal (non-contributing) sector in some countries, high open unemployment and the impact of Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome (HIV/AIDS). Caribbean social security systems (pension branch) are defined benefits pay-as-you-go (PAYG) systems that are largely publicly managed. The performance of the systems has been creditable on average, with the accumulation of substantial reserves though administrative costs are too high.

Some countries in the region have pursued parametric reforms-mainly increases in contribution rates and retirement age and adjustment to wage ceilings to maintain the viability of the systems in the future. These reforms could, through various transmission effects, impact on sustainability of social security systems themselves, but also labour markets, capital markets and economic performance.

Importantly, in considering reform options, countries should not rule out including a structural reform pillar, similar to an individual retirement account, which could allow contributors to match their appetite for risk with desire for higher returns. Moreover, there is the possibility that this could have a beneficial effect on savings and investment. Overall, what is clear is all countries should move expeditiously to reform their social security systems and not delay until crisis is on their doorsteps.

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1. Introduction

In the last few years, Caribbean policy makers, like their counterparts around the world, have come to view social security reform as an issue of concern. Nevertheless, while some countries in the region have translated concern into actual steps at reform, others have failed to do so. Across countries it is beyond moot that social security systems are critical to sustainable social welfare and development. However, actuarial projections indicate that flat rate contributions and adverse demographic transition, the result of population ageing, are undermining the sustainability of social security systems in many counties. Since most societies are not prepared to leave the poor and aged at the mercy of Darwinian "survival of the fittest" type economics, social security systems are set to be an important plank of the social compact in many societies. As a result, in most countries the issue is not whether reform is an option, but what will be the form and scope of reform.

Indeed, the debate over social security reform, particularly pension reform has been heated and, at times, vexing, with much confusion over economic and political economy arguments. Nevertheless, overall, as Federick Douglas[1] alluded, perspective, rather than objective economic arguments, often account for much of the difference of views among economists. Ultimately, much of the altercations stem from views on the role and function of the State versus the market mechanism in the operation of social security systems. Indeed, the State-market debate is often so well covered that it is difficult for one to recognise it.

In a way, the demographic transition justifies some form of social security or protection. Since consumption continues after retirement and, in particular, the individual might be confronted with significant spending on medical treatment and other forms of care, it is imperative that he saves during his working life towards this end or that the State or other systems provide for him. Given the propensity of some citizens to free ride on the social security system, most governments have instituted some form of compulsory social insurance contribution system (payroll taxes) to ensure that persons save towards old age, sickness, disability and other expenses and contingencies.

Traditional social security systems were modelled on the Bismarck or Beveridge models or combinations of both. Bismarck developed the "insurance concept" of social security, whereby the system insured workers against the risk of loss of income and enabled income smoothing over their lifetimes. For the most part these schemes were financed by premiums or payroll taxes, which along with benefits depended on earnings.

[1] Federick Douglas in "My Bondage, My Freedom," noted that the longer he lived the more he recognised the importance of perspective on issues.

Traditional social security systems were designed to perform two main functions. In the first place, social security is a system of social insurance that provides coverage for sickness, disability, old age pensions, maternity and other contingencies. Secondly, social security acts as a mechanism for redistributing income from higher income to lower income groups. In more recent times, particularly in developing countries, a third function has been assigned to these systems. That is, social security systems are also charged with catalysing saving and investment and enhancing both financial deepening and economic growth. This stems from the view that in developing countries with imperfect or missing markets, major institutions cannot be tasked only with meeting market conditions or meeting pricing and output targets, but must go further to promote economic transformation and growth. There has been some dispute as to whether and to what extent the insurance function conflicts with the redistribution and economic growth functions. Nevertheless, the three functions: insurance, redistribution and economic growth are interrelated, and virtuous processes in any one can have positive externalities on the others. This more than ever, underscores the need to examine the potential virtuous or adverse impacts of policy in any given one of these areas on the others.

Social security reform, as hinted at before, is a world-wide trend, stemming from socio-economic developments at the global level. Ageing, the result of the demographic transition, is a major structural driver of reform. The demographic transition has accelerated in most countries during the last century because of sharp declines in both birth and death rates. World population grew from 1.6 billion in 1900 to 2.5 billion by 1950 and to over 6 billion by 2000. In spite of rapid growth, declining mortality is also resulting in population ageing in many countries, a trend that is set to accelerate in the next few decades. For instance, the proportion of the world population over 60 is projected to increase from roughly 9% in 1990 to over 16% by 2030[2]. Since most social security systems depend on the working population to provide for pensioners, a higher number of pensioners relative to the working population (the pensioner support ratio) naturally places financial pressure on these systems. The demographic transition combined with factors, such as the increasing use of short-term work contracts, large informal sectors and high open unemployment continue to impinge on contribution income in social security schemes in the Caribbean and other countries. These factors, combined with over-leveraged governments with weighty fiscal constraints and uncertainty about the long-term trajectory of growth in countries such as the Organisation of Eastern Caribbean States (OECS), make it incumbent that social security reform is undertaken in a timely manner to ensure that schemes can meet their obligations to members, especially retirees.

This study analyses social security reform and their implications for Caribbean countries. Although other aspects are mentioned, the main focus is on the pension or retirement plank of social security, the most important component. The rationale for the study is the limited research on scope of reforms and what their potential impact on Caribbean economies and societies. The study provides an initial foray in this area. The study is divided into seven sections. Section 2 provides a broad overview or typology of

[2] See James, Estelle (2002). "Social Security reform Around the World: Lessons from other Countries", National Center for Policy Analysis.

the structure and rules of the systems. Section 3 is a big picture of the performance of the systems. The next section, examines the reforms undertaken by social security systems in the region, while section 5 analyses the implications of these reforms for the systems and the wider economy. Section 6 provides pointers on the way forward for social security and section 7 concludes the study.

2. Overview of Caribbean Social Security Systems: Structure and rules

Social security spread from Britain to her former colonies in the Caribbean in the form of provident funds based on contributions. These funds were similar to today's funded, defined contribution schemes[3]. With the move to self-governance, governments enacted full social security legislation based on the principles of solidarity and redistribution to guarantee a minimum level of welfare for persons aged, the sick, women on maternity leave, retirees and other categories of workers. National insurance or social security schemes were implemented, spreading from Jamaica in 1965 to St. Vincent and the Grenadines in 1986. Full social security was deemed particularly necessary in light of intractable poverty among large segments of the population, dualistic economies with skewed distribution of income and wealth and the need to move beyond insurance to redistribution and consumption smoothing for lower income groups.

Caribbean social security systems, like those in most countries are variants of the pay-as-you-go (PAYG) system. One of the earliest models of social security, PAYG is structured such that the current workforce pays the benefits for the current group of retirees. In this system, the social security trust fund acts as a checking account from which payments are made to the beneficiaries. Therefore, no funds are allocated in advance and benefits and administrative expenses are met from current contributions. This structure leads to costs of funding the scheme that are low at the beginning, but which increase steadily as it matures.

A simple PAYG works as follows:

Pay-in from Workers → [Trust Fund
Pay-as – you-go] → Pay-out to Beneficiaries

The major issue of concern in a PAYG is long-term structural balance or equilibrium and sustainabililty. Balance and stability is achieved where:

Annual pay in =Annual pay-out

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[3] In a defined contribution scheme, the outstanding liability of the scheme is the value of the assets in the scheme. This implies that if the funds in the scheme are depleted through poor management or other reasons, pensioners might not receive any benefit payments. By contrast, in a defined benefit scheme, the liability is the present value of the benefits forecasted by the scheme, which is worked out by actuaries. The risk sharing in this scheme often means that the State is prepared to bail out schemes facing financial difficulties.

That is: $Nw.Wm.Tp=Nb.Bm$

Hence,

$$Bm=Nw/Nb(Wm.Tp)$$

Where:

Nw is the number of workers
Wm is the Average annual wage
Tp is the payroll tax rate
Nb is the number of beneficiaries
Bm is the average annual benefit

The above formula suggests that social security benefits are tied to the current national average annual wage. Therefore to maintain fiscal balance, at a fixed payroll tax rate, the system must maintain a stable ratio (steady state) of workers to retirees. If the steady state condition is not maintained due, for example, to the ageing of population or higher unemployment or the effects of HIV/AIDS, the scheme would soon be thrown into fiscal deficit with benefit payments exceeding contributions. To prevent this, contributions would have to be raised, benefits reduced or the retirement age increased.

Caribbean social security systems are partial PAYG systems. That is, in regional schemes part of the fund is used to finance benefit payments, administrative and other costs and the other part is invested to provide income that could be used to defray future benefit and other costs. Caribbean schemes are relatively young by world standards. As a result, contribution revenue exceeds benefit payments and surpluses have accumulated in the social security trust fund. By their very nature, PAYG schemes follow a growth curve with an excess of contributions over expenses in the early rising phase of the system, followed by an equilibrium or plateau phase where contributions approximate payments, and finally a post-equilibrium declining phase where expenditure exceeds contributions. Temporary measures, such as the transfer of funds from other government budget sources or from other branches of social security, for instance industrial injury, can be put in place to postpone the post-equilibrium effects (system not able to meet payments to pensioners). In the long run, however, these measures only delay the inevitable collapse of the system. Often, radical and fundamental reforms are required to ensure the long-run sustainability of PAYG schemes.

Although the basic structure of most Caribbean social security systems is the same, the rules governing the flow of funds, investments and governance vary according to perception of individual country needs. In the public schemes, mandatory contributions are collected from employers and employees as a flat tax at source. Usually, employers are required to contribute more than workers, although in some countries, contributions are distributed equally.

Countries display wide disparities in their contribution profiles. Contribution rates range from 5% in Jamaica to 16.25% in Barbados (*see* Table 1 below). The relatively high variability is further indicated by a standard deviation of contribution rates of 2.5. There is little or no harmonisation of the insurable wage ceilings across the region. Wage ceilings[4] range from 1.2 times average insurable wages in Trinidad and Tobago to 3.4 times average insurable wage in Saint. Lucia. The low wage ceiling in Trinidad and Tobago might mean that pensions will be quite inadequate to meet the cost of living when they become due. There is a need for an objective and independent criterion for adjusting wage ceilings in a timely manner to reflect living costs and to ensure adequate pensioner living standards. Currently, only Guyana adjusts the wage ceiling automatically, in line with changes in its minimum wage.

In Jamaica, wage-based contributions of 21/2% by employees are matched by an equal rate by employers. The maximum insurable amount per annum is J$250,000, giving maximum contributions per week of J$120.

Persons qualify for a pension on average after about 10 years of contributing or 500 weeks of contribution. However, to forestall future funding problems, some schemes such as Trinidad and Tobago and Guyana have set higher qualifying contributions of 15 years.

With respect to pension benefits it is critical that pensioners' living standards are maintained at a level similar to that during their working lives. This is determined to some extent by the pension replacement rates, which is the percentage of a pensioner's average insurable wages that he receives as his pension. Across the region, pensioners receive an average of 31 % of insurable wages after 10 years of contribution. To prevent persons falling through the safety net, minimum pensions ranging from 6% in Antigua and Barbuda and 31% in Barbados are provided for persons who do not qualify for a full pension.