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SOCIAL SECURITY REFORM IN LESS DEVELOPED COUNTRIES

Giovanna Ferrara – Social Security Consultant – Member of Istituto Italiano degli Attuari

Summary

This paper is aimed at offering an actuarial and personal point of view in respect of the possibility of carrying out reforms in less developed countries. In order to illustrate the main impediments to the introduction of major structural reforms, the case of African experience is dealt with. Considerations on some actuarial concepts applicable to social security are presented.

Scope of the paper

The situation of pension protection in less developed countries is here examined with respect to African schemes. Even if the scope seems reduced, the variety of the solutions is nevertheless very large. It cannot be forgotten that Africa is a continent consisting of over 50 countries, which differ in term of their politic systems, economic and human development and social security protection[1]. Moreover, the paper deals with some specific problems relevant to private sector schemes that may not include the protection of civil servants.

The historical background

The private sector is usually covered by self-financed social security schemes. Most of them were originally designed to benefit salaried employees. In spite of the purpose expressed in many occasions by African governments of a progressive extension of the social protection to other categories of workers, the present situation shows that the degree of coverage is still very low. It is estimated that less than 20 per cent of the active population is concerned by social security protection. Several studies have been carried out in order to include workers of the informal sector. The main obstacle seems to be the administrative capacity of the existing schemes to face the complexity of handling compliance problems.

Broadly speaking the old-age compulsory programs concerning the private sectors may be subdivided into three main groups:

- pension arrangements which date back to the years 1970s or even before;

- provident funds and pensions programs derived from the transformation of previous provident funds;
- pensions plans which started recently in countries with a previous high development of private occupational schemes.

Moreover there are still countries where the social protection for old age is non-existing or in the phase of implementation.

Long lasting pension schemes

The oldest pension schemes are mainly found in the francophone Africa. Most of them, established with the technical assistance of the ILO, are earnings-related schemes with the amount of benefits depending on a ceiling. A limited solidarity is achieved by fixing a minimum pension and by providing special conditions for invalids, survivors and elder members at the inception of the schemes. Because of the ceiling, any perverse redistribution from the poor to the rich is avoided. In any case the benefit amount is not so generous as shown in some economic analysis. Benefit package was designed by bearing in mind the objectives of providing adequate pensions to low and medium earners and enhancing private insurance arrangements for the well-off members. It must be recognised that with very few exceptions the expected development of either private pension funds or insurance life policies did not occur: the insurance industry was still at an infant stage and even the public insurance company were not interested in embarking themselves in this business.

From a technical point of views, the main concern of social security actuaries involved in establishing the schemes was directed at avoiding a large accumulation of funds and at fixing rates that could be affordable. Obviously such concern leads to a partial funding, which is not unfamiliar in financing social security programs and implies periodical readjustment of the contribution rate. All the actuarial studies tried to illustrate this point and sometimes the legislation enforced the principle of partial funding by fixing rules concerning the expected rise of the contribution rate. In some cases those rules concerned the annual minimum amount of the pension reserve (e.g. two or three times the annual benefit amount). The economic literature of the recent years has completely misunderstood the principles of partial funding: these schemes have been classified as pay-as-you-go systems, which generate reserves during the first period of their existence and become unsustainable after reaching the maturity [2].

Looking back at some actuarial valuations carried out in the past, I still think that the solution adopted was sensible. Due to the limited choice of investment instruments and to government interference, the financial performance of the schemes has been generally very poor and in any case below the initial expectation. Moreover inflation rates were high. Hence, the low rates of contribution applied in those partial funded schemes, ranging from 3 to 10 per cent, were tailored to take into account more the affordability of an additional labour cost than the expectation of investment skills.

A factor that was over-estimated in these first actuarial studies was the growth of the insured population and the ability of the scheme managers to cope with compliance. At the start there

were several reasons to have an optimistic approach: all the systems showed an increasing number of members and there was a manifest willingness to extend the coverage to other strata of the population. During the 1980s, the African countries experienced a dramatic crisis that led to adopt severe programs of structural adjustment and reforms. These stabilisation programs had large effects on the social security schemes: higher unemployment, underemployment, early-retirement programs and falling real wages reduced the amount of contributions, increased the expenditures and created new problems of lack of compliance. Moreover, because of the high rates of inflation and low interest rates, the reserves of the social security institutions were severely eroded [3].

In a time where the main accent of the economists is put on the expected demographic changes and inter-generational transfers, I personally think that more emphasis should be placed in analysing the factors relevant to the economy of each country. Obviously it would be useful if the economists may help in replying to questions such as: Who will pay for the economic shocks? Are these shocks just isolated events or is it expected that they will happen in the future? In this respect the future economic perspectives are not so promising: according to the analysis made by UNCTAD the "growth forecasts of the African countries were being revised downwards because of the continued sluggishness of some of the large economies, severe weather conditions and disruption caused by civil and political unrest. In these circumstances, any global shock could be particularly damaging for African countries" [4].

Another point deserves careful economic studies: we all agree that the viability of a social security scheme depends on the ratio between number of retirees and active contributors. However, nowadays, it seems that a growing economy (when measured in term of GDP) does not imply automatic increases in labour sectors. It would be sensible to study alternatives in the financing of social security old-age programs.

Provident Funds

At their inception the provident funds, established in Anglophone countries of Africa, were expected to be transformed in pension schemes in a short-term horizon. However, they survived long enough (some of them are still in the process of conversion) to generate severe criticisms.

It has been argued that their investment yields were below the inflation rates with an evident loss for the purchasing power of the accumulated saving; the administration expenditures were eroding the members' reserves and even if financed by high rates of contribution the final lump-sums at the retirement were meaningless.

It must be said that the reference to high rates of contribution is misleading: in English speaking countries contributions were levied on the so-called basic salary, i.e. the salary before considering allowances. As the basic salary presently represents a modest part of the take-home pay, the individual saving accumulation was very low and did not generate enough income to finance reserves and administrative expenses.

To partially counteract the criticisms regarding the investment performance it must be recognised that the provident funds had to confront themselves with the paucity of in-countries investment avenue: a substantial part of their portfolio was placed in public sectors products and (short-term) bank deposits[5]. The prevalence of government bonds is easily explained by considering the state supervision and impositions, while the short-term deposits were generally chosen because the yields generated by them were generally higher than those from other forms of investments.

The malfunction of the provident funds has induced the conversion of them in pension schemes. Presently it seems that provident funds will survive only in Kenya, where the national provident fund will act in competition with private voluntary schemes.

I am afraid that the "basic salary" concept has been imported into the converted pension systems. This should be certainly the case of Nigeria and Uganda, while the Ghana pension scheme has defined an appropriate base of earnings as for contribution and benefit calculations. Obviously, the basic salary concept will lead to the same drawbacks of the previous provident funds: i.e. meaningless pension amounts and high percentage of administration expenses.

New pension schemes

Where no social insurance is available, the process of introducing a compulsory scheme may take long time. This was the case of Zimbabwe: the preliminary studies were carried out in 1983 and the relevant law enforced after 10 years. In delaying the process an important role was played by the existing private occupational funds which were reluctant to organise themselves in a "second pillar". I think that the same will happen in Namibia where the private plans (which, by the way, use the basic salary concept) are supported by the World Bank economists.

Present situation and possibility of reforming

In spite of the urgency put by the economists in implementing structural reforms in social security, few changes are recorded in Africa. However, after the structural adjustments in the economy there are satisfying developments in the administration and governance of the schemes.

The present main objectives of the national schemes are the adequacy of the benefits to the members' needs and the extension of the coverage to other workers presently excluded. These two targets may be attained only by rationalising the present administration with new accounting procedures, an enlarged use of the technology, an appropriate autonomy in making investment decisions and training activities at all levels[6]. Only when and if these objectives are attained, it would be possible to speak about some structural reforms in the schemes.

It seems to me that the African managers are presently not inclined to follow the economists' advices to "strengthen the links between contributions and benefits". The failure of most of the provident funds, the poor performance of the investment policy, the low rates of contribution which would assure only insufficient benefits and the abolition of solidarity principle are the natural impediments to the conversion of the schemes in defined contribution systems.

Another point that I like to deal with concerns the implementation of the three pillars reform, which is usually described as

i) a compulsory basic scheme with limited goals;
ii) a compulsory saving plan;
iii) a voluntary saving plan.

The main question is: are the African countries prepared for such extensive reform? Obviously, the implementation of the reform requires the extension of the basic coverage to the whole working population. A significant involvement of the government in dealing with social security may be justified only in this way. Once this prerequisite is attained and all the working population is included in the first pillar, may the other pillars be implemented without changing the present economic structure?

According to my personal experience, extensive changes in the legal and regulatory framework should be needed. Those changes concern not only the financial markets but also the whole economy of the countries. Their implementation and the relevant incorporation into the norm of business practice could be lengthy.

In particular, African states should set up efficient supervision systems. Presently, even in the countries with a large number of insurance operators, the supervisory authorities, when present, perform only formal controls. Actuaries are quite non-existing (or at least invisible) in pension registers and insurance companies. The establishment of an efficient supervisory system cannot be done by means of a theoretical recipe applicable to all countries: solutions should be studied by taking into account all in-country features. Generally, the economists' accent is put on the supervision of mandatory pension systems; I would like to stress the need of an effective control of all insurance and financial business.

Moreover, all the saving plans rely upon the existence of investment opportunities that are very remote in the current situation. Investment avenues are still at an early stage and it is questionable that a large flood of saving automatically produces a development of a financial market. In the past, most of the African crises were attributed to the internal barriers of the economies. Nowadays, it has been recognised that African governments made considerable efforts towards the liberalisation, the strengthening of the rule of the law, the privatisation. However all those efforts did not automatically attract the expected flow of foreign investments[7].

Needs of a reform in actuarial definitions?

Directly connected with the reform of pension system in less developed countries, there is my personal need of clarifying some social security expressions. In the past I had some certainties about actuarial terms. I knew that full funding was not coincident with defined contributions system, but a technical way of achieving the financial equilibrium of any scheme (even defined benefit scheme) for its full duration (i.e. up to the infinity). I knew that partial funding had, as a less ambitious target, the financial equilibrium in a limited period. Technically, I knew that in

setting up partial funded schemes I had to fix some conditions regarding the performance of the expected reserve at the end of the limited period (e.g. its size or its non-decreasing value). I knew that the techniques developed for private insurance are not always applicable in social insurance: the future cost being always estimated on an open-fund basis, that is by taking into account not only the acquired and prospective rights of the present participants, but also the prospective rights of the expected new entrants into the scheme [8].

At the edge of the 21st century my convictions are shaking. World Bank economists definitely praise the theoretical and controversial concept of "Implicit Pension Debt", that is the present value of the unfunded actuarial liabilities of a social security scheme calculated in a closed fund basis. Moreover they distinguish between explicit and implicit debts: explicit debt is what the social security actuaries call "fund ratio" (i.e. the ratio between reserve fund at the end of the year and the annual amount of benefits) and use to measure the maintenance of the targeted level of reserve fixed in partial funding valuation or in the legislation.

In their views, the implicit pension debt is an ideal indicator of long-term fiscal commitments. It can be compared across countries and over time and examined in relation to national income and wage bill. Its calculation may provide international lending institutions and governments with an objective indicator. I deem that the actuarial profession should intervene in this respect and try to redefine the concept in an open group basis or, at least, to alert economists about the fallacy of a direct comparison[9].

Coming back to the economists' explanation of our actuarial concepts, in a World Bank country report I have found the following definitions:

- The implicit pension debt is the amount that one would need to liquidate the system (i.e. give everybody the benefit they are entitled to according to the contract).
- A true partial funding is the one that keeps the reserve constant in terms of total implicit pension debt. Fully funded is a system in which assets match the total liability one-to-one.

It is clear that those are new concepts that do not correspond with the principles that I thought were applicable to social security. Apart from my personal distress, I have a very crucial problem to solve. The number of young social security actuaries in Africa is now increasing: they need a correct training. What kind of principles may we pass to them?

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[1] A detailed description of the different social security schemes may be found in "Social Security in Africa: New realities"- Social Security Documentation N° 21 - ISSA - 2000

[2] In "Taking Stock of Pension Reforms Around the World" by Anita Schwarz and Asli Demirguc-Kunt – World Bank 1999 – Social Protection Discussion Paper - is stated : "While most public plans accumulate a cash surplus in their early years, as the systems mature, these reserves disappear and the plans shift into deficit. Therefore the initial cash surplus is an illusion". This statement does not take into account that social security institutions were always aware of the functioning of partial funding.

[3] The dramatic situation is vividly described in "Implications for social security of structural adjustment policies: The point of view of French-speaking Africa" by Pierre D. Engo in Studies and Researches N° 34 – ISSA 1993

[4] UNCTAD – Trade and Development Report 2001.

[5] "Investment of Social Security Funds by Social Security Organisations in English-speaking Africa" – ISSA survey – 1997

[6] The main targets of the social security schemes may be found in "L'avenir de la sécurité sociale en Afrique" – Colloque des Directeurs des institutions de sécurité sociale des pays francophones d'Afrique" – ISSA – Bamako, 12-14 February 2001.

[7] The point is dealt with in the UNCTAD report "Foreign direct investment in Africa" 1999.

[8] The main characteristics of social security techniques are illustrated by J.P. Picard in "Valuation of the financial equilibrium of long-term benefit scheme" – ISSA 1996 – Social Security financing: Issues and perspectives.

[9] In this respect it is interesting to read the careful analysis made in "A crisis of longer life: reforming pension systems" by C.D. Daykin and D. Lewis – British Actuarial Journal – April 1999