

Social security privatization

Business



Introduction This research paper will deal with the issue of privatizing of social security and it will mainly focus on the privatization of the social security that has been done in countries like Chile and Sweden. The paper will take a critical and scientific view of the issue of privatizing the security fund based on the studied of the mentioned countries. The critique view and agreements presented on the issue will include an economic view that lays an emphasis on reference economic biases and standard economic theory. The paper will over theoretical analysis of the problem of privatizing the social security, empirical evaluation of the problem and state the policy implications of the action as well as offer recommendations on the lessons learnt from the two countries.

It will focus and offer recommendations on the best way forward regarding the problematic issue of privatizing of the social security by a country. Behavioral economic is a field of knowledge that focuses on the way people and institutions behave with money especially when making economic choices regarding issues of money when it comes to production, work, spending and investment opportunities. The field therefore entails collective, individual, emotional and cognitive biases that often affect economic decisions hence creating economic anomalies with certain harmful effects that weaken standard economic paradigms that are based on hypotheses of rational decisions (Galasso, 456). Privatization of social security has been a thorny issue for many countries in the recent past and policy makers have been at cross roads whether to privatize their social security or to remain with the old system. Many countries have been forced to reflect on the

progresses that have been made by countries that have privatized their social security system for instance countries like Chile and Sweden.

Therefore the topic is of utter importance as it unravels terms that have been used by countries to evaluate on the successes and failures that come with privatizing of social security and hence yield useful recommendations that can be used to make decisions on whether the issue is really worth a try or not. Background While most of the countries around the world still rely on the traditional social security systems, there are an increasing number of countries especially those in Latin America and Eastern Europe that have privatized at least part of their social security system. Such countries include Chile, Sweden, Peru, Argentina, Australia, Poland and Britain. Social security is an insurance program that is intended to protect workers and their families from income loss especially when they become disabled or retire. The term privatization as used in this paper means a social security system in which the public run part of the system become privately funded and managed and mandatory accounts are included in the definition given.

Chile privatized its social security system in 1981 under the rule of the right-wing dictator Augusto Pinochet but it's no longer a fully private system as it was revamped in 2008 in order to expand the public pensions for other initially left out by the system for instance the low-income seniors. Sweden was the first country in the world's to implement a universal government-run system of retirement but today its in the process of privatizing part of its pension scheme as it was faced with demographic and financial strains and decided that personal accounts could offer the best mean of making its workers enjoy a safe and comfortable retirement. The Swedish model <https://assignbuster.com/social-security-privatization/>

consists of four features: partial privatization, notional accounts, safety net to protect the poor and the transition to protect retirees and older workers. Both Chile and Sweden have faced problems with the privatization of their social security system. Some people have described the Chilean model as successful and the Sweden as a failure as others describe both models to be a failure. To understand such claims this paper will attempt to identify criteria used by such policy makers on what's defined as 'right' or wrong model when it comes to privatization of the social security of a nation (Gruber, et al 45).

Privatization social security in Sweden In the years between 1998 and 2001, Sweden converted its pension scheme from PAYGO pay as you go which managed by the government funds to a system that includes money saved and invested in individual funds. The current system factors in the indexing of future pensions into the GDP growth thus ensuring sustainability even in times of unfavorable economic development in the country. The government pension payments are financed through an 18.5% tax on country's taxed incomes, which partly is derived from a tax category called the public pension fee, which is a 7% on the gross income and a 30% of employer fees on salaries forming 33% of netted income. Since January 2001, the stated 18.

5% pension tax has been divided in to two parts. This includes 16% which goes to current payments and a 2.5% which goes into individual retirement accounts and the money saved and invested in the government funds and IRA'S that are to be used for future pension costs form a roughly five fold of the government annual expenses (Hubbard et al 345). The money intended <https://assignbuster.com/social-security-privatization/>

for future retirees are managed by five government funds. Advantages and problems with Swedish social security Advantages The model provides a lesson that reforms work and that they popular despite the fact that Sweden is considered the ultimate welfare state the fact that its legislators opted for a new approach to solving their deteriorating pension scheme and managed to succeed is a lesson to reckon with. Secondly, the Swedish new system provides many benefits like – greater incentives to work, increased savings, offers a flexible retirement age, promotes lower government spending, lower taxes, offer opportunities for reform, provides a greater retirement income for retiree and finally it's a fairer system that doesn't redistribute income from the poor people to the rich ones.

The Swedish pension reform model has created a better system that benefits the worker, retirees and the nation's entire economy hence same model can be adopted by countries that face similar challenges with their pay-as-you-go system or social security system. Problems When the personal accounts were launched they were over 400 initially participated and such over abundance of investment options paralyzed most Swedes leaving them with less power to chose an account consequently making 80-90% of all the Swedes ended up with the default account foe failing to make a choice. So to avoid paralysis in making of choices policy makers should be bale to limit investment options and preferably should not be more than ten in number to encourage individuals to make personal choice of account (Frontczak et al, 212). In addition to that, the Swedish model involved narrow index funds, which saw an increased tendency for Swedish investors to allocate heavily to sectors that had initially had strong showings therefore participating in

performance chasing and market timing, which yielded disaster for the model. So, setback can be foiled in partially privatized social security models by offering a portfolio singly broad index funds, which make it impossible to overweight on certain factors hence limiting worries that there would be unscrupulous investment managers that are after making unfair profits from the unfortunate public as index are extremely low cost and high quality.

Such broad index funds will make investors to get a good deal as they are protected from themselves by the high quality yet low-cost index fund-based plans of retirement. Another bias that the Swedish model showed was that it was implemented prior to the tech burst hence resulting to large losses for most investors as most of them invested in the default fund ensued by the 30% fall in the stock markets. Other problems associated with partial privatization model include: higher administrative costs especially there are large number of small accounts, exposure to fluctuations in the stock market, increased level of inequality and the potentially lower benefits for those who are low-wage workers especially the women. Social Security Privatization in Chile Introduction According to Edwards Sebastian in his research paper, the system of social security that existed in Chile until 1981 was Pay-As-You-Go pension system (PAYG). At this time, the system was changed to a new system that was called privatization.

The system was privately managed individual accounts that have seen Chile to be a role model to most country around the world. Chile has done many changes in its privatization system over the year in pursuit of making it more independent to its current position. Such changes have been especially in the liberalization of the investments rules and in the addition of the pension <https://assignbuster.com/social-security-privatization/>

funds numbers. A pension fund management company (Administradora De Fondos De Pensiones AFP) was also formed to oversee the pension number that will be given to the account holders. The main challenge that the government of Chile experienced at the initial stage was the number of workers who remained uncovered and even those covered, had inconsistent participation rates. This was seen to lead eventually to insufficient retirement benefits.

According to the international standard, they also realized that the Pension Fund Management Company was charging exorbitant amount of money to the employees. Thus, this discouraged the workers and decreased significantly the number of the account holders who turned for the pension scheme. Therefore, the country enacted a law in March 2008 that ensured that the uncovered group was integrated in their plan. The law provided more benefit and adequate to more people. It ensured that there was gender r provision to enhance gender equity and enhanced competition in the field of the pension. The law was meant to improve the AFP financial risk management.

This was to lent the scheme increase the workers benefit from their contribution and to ensure that the rules of financing the one who are left and the disabled are changed. They made it ensured more opportunities were established to enhance voluntary saving and sensitized workers on financial matters to improve their literacy towards financial management (Tanner, Michael pg 56). Therefore, the 1981 brought reforms in the way people were to engage in the new method of pension scheme. The Chile government posed a rule that it was mandatory for all the workers except <https://assignbuster.com/social-security-privatization/>

those who were to retire within five years were to have individual retirement account to help them chose between pay-as-you-go (PAYG) and privately managed system. The government rule was to ensure that each person entering the labor market must join the new capitalization system as he or she wish, to eradicate the PAYG system by 2050.

The workers are to contribute ten percent of their monthly salary per month according to the law, to their accounts. The AFP, which is a Pension Fund Management Company, ensures that administration fee; premiums for survivors and insurance for the disabled s are deducted from that fund. The workers are sent free to choose the AFP to join. They can also change the AFP any time according to their will. The workers are also free to make any voluntary contributions to their accounts as well as to the voluntary retirement's accounts (Feldstein, Martin pg 87). The employers cannot access neither employee's accounts, nor can they contribute to them.

The participation of any self-employed to the scheme is voluntary. The government but works as a private company formed the AFP. The mandate of the AFP is solely to manage the pension funds of the workers and provide benefits to them. They ensure that the workers contribution is collected, their accounts credited and their monies invested in accordance to the government directions. The AFPs also ensures that they have an insurance company that they are working hand in hand with them in contractual basis to oversee the provision of insurance to the survivor and the disabled.

The government came up with Superintendent of Pension Fund Management Companies (SAFP) that was used to oversee the registration and the

licensing of the AFPs until July 2008. The agency worked under the ministry of labor and social security. When a worker attains a normal retirement age, which is sixty-five years for men and sixty years for women, there some provision put in place on how they can use balance in their individual accounts. They can decide to use it to buy immediate annuity to that will provide them with lifetime benefits. Secondly, they may decide to come up with programmed withdrawals. This will help them to raise income over the time they are expected to live.

Nevertheless, if they die before the expected lifetime, their dependants inherit the balance in their individual accounts. The account holder may also decide to set a date for buying an annuity. This will continue until the date becomes a programmed withdrawal date from their accounts. This is referred to as deferred annuity. They may finally decide to use some balance in their account to buy immediate annuity and program withdrawals of the rest of their money.

This annuity is purchased from an insurance company. They are charged extra fee for their purchase. Mostly the AFPs will charge this fee on monthly basis on programmed withdrawals. If the worker decides to have early retirement, the law permits him/her to do so. However, this can only happens under certain conditions.

Nevertheless, the worker can be able to withdrawal excess fund from their account balance if their account can be able to finance 150% of the minimum pension (Scheil-Adlung, Xenia pg 124). Administration guarantees The government recognizes those workers who switched from the old PAYG

by giving them bonds when they retire that is equivalent to the value of the accrued right of that public system. The value of these is updated on annual basis depending with the change that occurs in the consumer price index (Williamson, John Pg 1). They also earn 4% interest dating back the day they joined the new system. This bond either is redeemable and added to the individual account during the time the worker retires, dies or are disabled.

Pension reforms The Capitalization Pension System Policy was mostly skewed towards the workers who had jobs that can regularly enable them to give contribution to individual accounts. Thus, according to the evolving labor force in Chile, the government decided that there must be some reforms provision to collect this. According to a report written on July 2006 by President's Pension Advisory commission, it found that most of the people in Chile works in less stable jobs, temporarily position and part time jobs and do not contribute regularly in their individuals account. They also found that the life expectancy and the aging generation are getting higher each day. In addition, people are also spending much time in education, as higher education is mostly available especially to the younger generation thus postponing their entrance age to the jobs. This decreases the time that the workers use to accumulate the money for retirement.

Therefore, the report provided that the government be supposed to expand pension coverage to ensure that it covers even people without regular payment. They also recommended that they should provide adequate pension to its people. Lastly, they said that if competition is encouraged among the AFP companies, it would lead to lower workers cost which eventually led to higher net rate of return and higher pension. Conclusion <https://assignbuster.com/social-security-privatization/>

Chile of years has seen its system of pension evolved toward the better. This has made most of the country in the world to establish their system in relation to their system. Some countries in the Latin America have completely revolutionaries in their pension schemes system to be completely or partially privatized.

There are various reasons as to why the system is a success. The first one is the ability of each employee to have the freedom to choose his/her own account independently. This boosts the workers morale and enhances the competition thus increasing the accounts. The privatization of the company ensures that there are no political interference in the pension scheme and increase the competition of the company thus lowering the workers charges. The sensitization process where the government provide money for educating the workers on how to choose the right account and AFPs company has lead to increase in the number of people who has registered in scheme. The government also expanded the pension scheme to accommodate even the people in the informal sector has seen the system to be very successful.

The other one is the inclusion of the gender equity that ensures that women especially who were for years sidelined by the previous system are well represented. This increased the number of the workers who participate in the scheme significantly. Lastly, the system gained a lot of popularity due to fully participation of the government who always make sure that the company worked within the required limits. They also ensured the account holders who changed their previous account were guaranteed by offering bonds to them (Williamson, John pg 1). Countries share some issues like high administrative costs, prevalence of keen competition, women do not fare well

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as compared to men, the informal sector is large and not covered, and most investments are largely in government instruments.

The Chilean model has succeeded in offering the three benefits at retirement annuity and the programmed withdrawals annuity, which is combination the two, but the Swedish model offer only one benefits, which is the annuity option (The World Bank, 1994; 123). Both countries did not have any form of supplementary pensions prior to the reform period but those who had opted the Swedish model looked to the Chilean model for options as their pay as you go system were under funded hence making the Chilean a more successful model. In addition, the countries in the eastern central Europe had low had a universal social security while the Chilean had low coverage yet with younger populations. Its counterparts had older populations with lower life expectancy especially the men and such differences promoted the success in the implementation of the pension scheme for those who had adopted Chilean model as those who had opted for the Swedish model fell into the pit financial constraints as they try to cover its members.