The Privatization of Social Security: Governance Challenges of Partnership Provision

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Introduction

A SPECTER OF marketization is haunting mandatory social security around the world. There has been a profound shift over the last 20 years in the ideology underpinning statutory social security provision from collective to individual responsibility (Dixon, 1999; Dixon and Hyde, forthcoming). The objectives of this paper are two fold; first, to provide a global perspective on the market provision of mandatory social security and, secondly, to explore the challenges facing governments that see privatization to be, at least, a part of their panacea for perceived public social security system ailments.

The Mandated Market Provision of Social Security: A Global Perspective

Statutory social security provision by market providers (typically, commercial pension funds and insurance companies operating in a competitive or contestable market environment) spread rapidly in the 1980s and 1990s, particularly in Latin America, although it has begun to make in-roads into Western and post-socialist Europe. As yet, its appeal in both Asia and Africa is quite limited (US, SSA, 1999; Dixon, 1999). Provision has taken a variety of forms.

Complementary Benefit Privatization

Complementary benefit privatization occurs when governments oblige individuals to purchase (with or without employer contributions) approved benefits (whether defined-benefit or defined-contribution in form) from approved market providers to supplement the publicly provided primary benefits. The use of approved market providers (including, in this instance, independent non-profit “social partner” organizations [typically, industry-based and administered by trade unions and/or employer organizations] operating under collective agreements as regulated monopolies) to provide mandatory complementary (supplementary) benefits in addition to long term contingencies first occurred in Finland (1961) and France (1960s). Such mandated market provision typically covers all the long term contingencies on a defined-contribution basis, financed by employer and employee contributions.
Coverage Privatization

Coverage privatization occurs when government privatizes the existing public provision of primary social security benefits. It takes two forms; coverage contracting out and mandatory market provision.

Coverage contracting out occurs when contracting out of public provision is permitted by individuals who have purchased (with or without employer contributions) approved benefits (whether defined-benefit or defined-contribution in form) from approved market providers. Contracting out public, old age disability and survivor program coverage by contributors to approved occupational plans that provided equivalent (typically defined-contribution) benefits was first permitted in Greece and Malaysia (1951).  

The contracting out of public social security program coverage by contributors to approved personal plans began in Chile (1981) with respect to its sickness and maternity insurance programs. This approach was subsequently adopted in the United Kingdom (1988) with respect to its public old age, disability and survivor insurance programs; in Peru (1991); with respect to both its public, old age disability and survivor insurance programs and its public sickness and maternity programs; and then in Argentina (1994) and Colombia (1994), both with respect to their public, old age disability and survivor programs. Colombia (1995) also permits the contracting out of its public healthcare insurance program into individual healthcare plans.

Mandatory Market Provision occurs when individuals are obliged to purchase (with or without employer contributions) approved benefits (whether defined-benefit or defined-contribution in form) from approved market providers to replace publicly provided primary benefits. Replacing the public provision of long term contingency social insurance programs with mandatory personal (defined-contribution) programs first began in the 1980s in Chile (1981).  Mandatory personal (defined-contribution) programs have also been used to replace mandatory employer-liability measures in Afghanistan (1987) for its employment-injury programs and, in Colombia (1991), for its unemployment program.

Coverage Marketization

Coverage marketization occurs when government creates a market for the provision of new social security benefits by obliging individuals to purchase (with or without employer contributions) approved benefits (whether defined-benefit or defined-contribution in form) from approved market providers in lieu of the public provision of such benefits. Guatemala (1991) established a mandatory personal (defined-contribution) program to provide its only form of unemployment provision.

The Mandated Market Provision of Social Security: The Limited Asian Experience

The driving force behind the global push for market provision of statutory social security came from public social security being perceived as a significant cause of budget deficits,
a major barrier to economic growth, and a generator of welfare dependency. With the conspicuous exception being China, these perceptions do not apply, for three reasons, to Asian public social security systems (Dixon, 1999). First, the social security contribution has, in recent years, been shifted significantly from employers to employees in many countries, thereby, arguably, diminishing the threat of reduced global market competitiveness. Secondly, in most countries, social security provision is only modestly supported financially by government, thereby, arguably, diminishing the risk of an induced public finance crisis. Finally, most countries have focused their social security system on keeping the relatively small, but politically important, urban middle-class elites out of poverty (except Hong Kong and Japan), thereby, arguably, minimizing the risk of increased welfare dependency.

Thus, the idea of privatizing statutory social security has not been enthusiastically embraced in Asia, in very stark contrast to Latin America, although Hong Kong and, arguably, China have taken exploratory steps in that direction. The mandatory market provision that does exist in Asia has taken two forms; coverage contracting-out and complementary benefit privatization. The most common marketization approach in Asia is to allow employees to contract-out public, old age disability and survivor program coverage if they have joined approved equivalent occupational plans (US, SSA, 1999; Dixon, 1999). This is a long standing practice that dates back to the early 1950s in Japan and, subsequently, in four newly-emerging Asian countries that were constructing national provident funds systems. It emerged, in recognition that public social security provision was, by the standards of some occupational plans, modest in the extent of the protection offered.

The complementary benefit privatization approach has only very recently been adopted in Asia. Hong Kong has adopted the mandatory occupational (defined-contribution) strategy as its policy response to the concerns, evident from the early 1990s, that its publicly funded residualist social assistance system would, because of Hong Kong’s aging population, become a growing burden on economic growth—one that could not be shifted, even by default, to traditional family-support networks. China is piloting, on a regional basis, a variant that was more in keeping with its market socialist ideology which it developed in light of Singapore’s experience with its Central Provident Fund and which has much in common with Denmark’s recently introduced special pension savings program. This initiative has the clear intention of shifting at least some of the future social security cost burden away from ailing state enterprises and of immediately mobilizing savings for the promotion of economic development. It does have, however, considerable future privatization potential in light of further development of China’s capital markets.

The Mandated Provision of Social Security: A Contested Policy Discourse

The pressures to introduce market provision of statutory social security have blossomed over the last two decades, particularly in Latin America and, increasingly, elsewhere under pressure exerted by increasingly globalized private pension funds and insurance companies aggressively lobbying governments to mandate market provision. This is no doubt
contemporaneously motivated by the desire to correct the evident stagnation in most elements of the global insurance market (Swiss RE, 1999) and legitimated by the rhetoric of the World Bank and, more recently, by the Organization for Economic Cooperation and Development (OECD, 1998), both of which emphasize the perceived uneconomic excesses and inefficiencies of state welfare and the economic benefits of privatization.

In less developed countries, market reform has its advocates because it offers the hope, if not the promise, of enhanced economic performance—increased domestic savings; enhanced domestic capital market efficiency, depth and liquidity; and reduced labor-market distortions (World Bank, 1994). In developed countries, market reform has its advocates because public social security systems are perceived to be heading rapidly towards financial crisis, which, they assert, can be addressed by re-alignment of boundaries that demarcate public-private responsibilities for social security, especially its funding. This is a view that gives credence to the new orthodoxy of anti-statism (Freeden, 1978) and justifies the call, with almost missionary zeal, for radical systemic surgery, however politically unpalatable that may be in the short-term. The challenge this creates for privatizing governments is how to ensure that any economic development benefits generated by the capital market participation of mandated private social security providers are not entirely captured by them as economic rent (Johnston and Kouzmin, 1998).

Evidence is beginning to emerge that popular acceptance of mandated market provision cannot be taken for granted. In Chile, a survey conducted in 1987, a mere six years after complete privatization, by the Centro de Estudios Publicos (1987), revealed that only nine percent of those interviewed preferred to leave the administration of the pension program to private enterprise. In New Zealand, a referendum conducted in 1997 to consider a proposal for mandated market retirement income provision to replace the existing public universal retirement income was rejected by over 93 percent of the electorate (Else and St. John, 1998). In Hong Kong, a survey conducted, in December 1999, by the City University of Hong Kong revealed that 57.9 percent of those interviewed had little confidence about their mandatory retirement contributions being managed by private provident funds and 61.1 percent indicated that they did not feel safe with their retirement funds in private provident funds (Ngan, 1999). In Germany, the Social Democrat government proposed, in 1999, the introduction of a mandatory personal (defined-contribution) program, but its controversial rejection of the “parity principle” (the parity of employee and employer contributions) was widely seen as unacceptable and the proposal was withdrawn (Taylor-Gooby, 1999b; Bonoli, 2000). In France, governments have been toying with the idea of a mandatory private provision since the mid-1990s, most recently in the form of Epargne Salariale (wage-earner savings funds), but the idea is not popular and progress has been slow (Taylor-Gooby, 1999b; Bonoli, 2000).

The alluring long-term policy vision, if not promise, for any reforming government intent on introducing market provision is improved efficiency and the imposition of limits on penalizing tax and contribution burdens imposed on future generations by the short-sighted and wasteful politico-administrative axis (see, for example, Tanner, 1996; Shapiro, 1998). Market provision advocates are, indeed calling for a shift in responsibility for statutory social security provision away from public sector to the market place.11 This
A paradigmatic shift moves the social security discourse away from issues of social justice, social inclusion and equality of opportunity (Kouzmin, Korac-Kakabadse and Korac-Kakabadse, 1999) towards issues related to the technical realignment of boundaries that demarcate public-private responsibilities for the funding of social security. The fact that the market place can deliver adequate social security protection more cost efficiently than the public sector is axiomatic to market reform advocates. The premises upon which this proposition rests are, however, tenuous:

- That adequate social security protection can be provided, without risk pooling and without the inflation (or wage) indexing of the final benefit provided, by making obligatory the long period of contribution payment necessary to accumulate the savings needed (if not actually legally required) to purchase the annuity or to finance the installment payments that achieve the minimally acceptable rates of income replacement;

- That a capital market infrastructure exists, or can be created, to allow the market providers to invest profitably the mandatory contributions they collect;

- That market providers can deliver the required statutory social security outputs (typically defined contribution benefits to a designated population upon the occurrence of a designated social security contingency) more cost-efficiently than a public agency;

- That the enabling market environment established by government for the market provision of statutory social security is, and remains, a competitive or, at the very least, contestable market; and

- That market providers can be disciplined by state-sanctioned incentives and disincentives to achieve articulated public social security policy goals (such as to provide a designated population cohort, a designated form of approved protection, in the event of a designated social security contingency in the distant as well as the near future, that will avoid both unintended beneficiary or market-provider recourse to future public financial support).

At risk are the working poor and near-poor who confront the prospect of paying contributions, they can ill afford for a promised and remote benefit of uncertain, even unknown value, with their fall-back being a residualist welfare safety net, informal family provision or charity. The policy dilemma facing privatizing governments are, first, how to integrate low wage employees, atypical employees (in part-time, casual or piece-rate employment) and intermittent employees (those with caring responsibilities) into any privatized; and, secondly, how to offset the limited savings capacity that limits their ability to achieve the desired inter-temporal consumption transfer.
The Mandated Market Provision of Social Security: Protecting the Public Interest

The state’s mandating of market provision, which places constrains on the principle of *caveat emptor*, obligates it to ensure that market providers conduct their affairs in the “public interest” (Mitnick, 1980; Ward, 1983; Martin, 1993) and for the “common good,” which, however defined, must reflect a society’s shared values about social cohesion and identity (Schubert, 1960; Elster, 1991; Plant, 1991) and which must, thus, be a matter of public policy. The fiduciary principle of the “public interest” holds that the state has a duty to serve and enhance the well being of all its citizens: citizenship rights and obligations must be expounded clearly; social assets must be conserved and enhanced; the vulnerable must be protected; and diversity must be recognized and acknowledged (Brown, 1994).

Determining the public interest involves a delicate balancing act: on one side is private interest “autonomy” (promoting positive freedom or “freedom to”); on the other side is public interest “control” (constraining positive freedom to promote negative freedom or “freedom from”) (Dahl, 1982; Goodin, 1982). Where the market place—with its egotistical assumptions and individualistic presumptions—has become the dominant ideology and the centerpiece of the privatizing state (Engler, 1995), government has a duty, as a matter of public policy, to define an appropriate enabling market environment for the market provision of mandatory social security that ensures that market providers contribute to the “common good” by achieving articulated public social security policy goals. In so doing, the state needs to address the fundamental social security policy issue: Who should be obliged to pay what price—and receive what form of government support (if any)—for what form of benefit, whether payable in the distant or near future, in the event of what social security contingency, purchased from what types of market providers, operating in what type of market environment and subject to what regulatory arrangements and requirements (Gustafsson and Klevmarken, 1988)?

This balancing act raises one particular policy dilemma for government. Should it limit any market-driven ownership concentration in the mandated private social security industry, especially when it involves foreign corporations, in order to ensure the survival of the market’s “automatic” disciplining mechanism which constrains the rent-seeking behavior of oligopolists and monopolists? The ownership concentration experience in Chile12 (Borzutzky, forthcoming) and Hong Kong13 (Ngan, 1999) is, if replicable elsewhere, a significant challenge to those required to regulate mandatory private provision. Protecting the public interest can only be achieved by regulatory compliance within the context of a socio-political governance mechanism (Kooiman, 1993; 1999; Rhodes, 1997; Peters and Pierre, 1998). The achievement of public social security policy goals in a market environment requires such a mechanism to coordinate, steer, influence and balance diverse pluralist interactions (Gilbert and Gilbert, 1989; Wright, 1994; Rose, 1996), with the civil service acting as the public trustee (Ott and Goodman, 1998). However, there have long been debates about whether any governance mechanism can be, and remain, focused on the public interest (Schubert, 1960; Edelman, 1964; Lowi, 1969; Peltzman, 1976), and about the causes of regulatory failure (Donohue, 1989; Kettle, 1993; Gormley, 1994). The central socio-political governance challenges emerge because
market providers desire to serve “private interest” goals that feed their drive for efficiency, almost regardless of social cost (Kouzmin and Korac-Kakabadse, 1999). Yet the desire stands in stark contrast to the public sector’s desire to serve competing public policy goals that feeds its drive to protect and promote the public interest, almost regardless of efficiencies forgone (LeGrand, 1990). Thus, the key governance questions are:

- What is the best way of creating an enabling market environment that will foster adequately profitable, but socially and politically acceptable, market provision of statutory social security, in both the distant and the near future?

- What multi-level political, administrative and regulatory structures, culture and processes are needed to protect the public interest in a privatized statutory social security environment?

- How should sub-optimal provision by market providers be dealt with in a market environment?

Whether public interest becomes subservient to private interests depends crucially on whether the state is willing and able to design, implement and administer a set of regulatory arrangements that require market providers to deliver their promised social security outputs when contracted to do so (Johnston and Kouzmin, 1998). This raises as the key governance policy issue: What administrative and financial constraints (if any) should be placed on market providers to permit the effective socio-political governance of:

- Investment risks, which relate to contracted market providers’ inability to provide their promised or expected benefits because they achieve a lower rate of return than anticipated on accumulated contributions collected (due, perhaps, to exogenous downturn in the capital market, to management inefficiency or to corporate or management malfeasance), the financial cost of which is carried by beneficiaries under defined-contribution programs and by market providers under defined-benefit programs; and

- Corporate risks, which relate to contracted market providers’ inability to provide their promised or expected benefits because of organizational termination, which may result from corporate bankruptcy (due, perhaps, to exogenous downturn in the capital market, to management inefficiency or to corporate or management malfeasance), or from deliberate boardroom business strategy decisions (such as, undertaking a business rationalization because of, for example, the emergence of new, more profitable, business opportunities, the threats and challenges expected or generated by a mutually beneficial corporate merger or a hostile corporate take-over), the financial costs of which would be carried by beneficiaries, if market providers can legally abdicate from their full contractual obligations because of organizational termination; such as
Institutional management constraints;
Portfolio management constraints;
The public acceptability (reporting and disclosure) requirements;
The statutory records-keeping requirements;
The statutory right-of-access by contributors and beneficiaries to information stored by private providers;
The statutory guarantee of confidentiality of such information;
The probity (auditing) requirements;
The statutory sanctions (at the corporate and responsible-individual level) available to government in the event of institutions acting contrary to the current and future public interests; and
The statutory winding-up provisions in the event of market providers being unable (even unwilling) to meet their financial obligations.

Whether private interests can subvert the public interest depends on the design features of the regulatory regime in situ. These features including its structures, culture, requirements and processes determine the degree of risk of governance failure due to (Bernstein, 1955; Wright, 1992; Majone, 1994; Thompson, Rayner and Ney, 1998):

- Asymmetrical information flows, when the regulated market providers distort or withhold from regulators the information they need to regulate effectively (say, information on financial product commission rates, management incentive and bonus payments, actual administrative costs, actual profit margins, proposed or likely business rationalization measures, corporate mergers or take-overs to achieve their private interest ends), and

- Agency capture, when the regulated market providers manipulate the regulators (by, perhaps, strategic agenda setting or compromise bargaining at the political or administrative levels) to achieve their private interest ends.

Thus, a regulatory mechanism for a mandated private social security industry should have the following objectives (LeGrand and Robinson, 1984; Doyal and Gough, 1991; Drover and Kerans, 1993; Rees, Rodley and Stilwell, 1993; Lamour, 1997; Gunningham and Sinclaire, 1999; Taylor-Gooby, 1999a):

- To ensure that the appropriate degree of market competition or contestability is attained and maintained;

- To encourage compliance by not imposing excessive administrative cost on the regulated market providers while discouraging non-compliance by imposing deterrent punishments;
• To be flexible enough to allow the regulated market providers to respond to the challenges of complexity, diversity and the dynamics of modern society;

• To ensure that both the private and the public sectors act cooperatively, working together towards the achievement of mutually beneficial public policy outcomes;

• To be transparent, so as to engender public trust and to foster coordination and cooperation between the community-at-large, the regulated market providers and the public regulators;

• To ensure participation by involving contributors and beneficiaries directly or indirectly in strategically important decision making; and

• To ensure that equitable outcomes are achieved.

These socio-political governance imperatives are central to the building and maintaining of public trust and confidence in, and support for, mandated market provision of social security. The need for a regulatory regime that ensures that the interests of future beneficiaries do not become incongruous, incompatible or even subservient to the private interest goals of market providers is clear. There is, however, little reason to be confident that the state can resist the appropriation of the public interest by the marketplace, for any socio-political governance failure may well encourage the specter of government subsidization (Johnston and Kouzmin, 1998).

Protecting the Public Interest: The Smart State’s Response

Any state seeking to re-position itself along the public-private spectrum in market-oriented economies must acknowledge the importance of the social dimension of economic development, for it is one of prime means by which governments can minimize the social dislocation caused when the role of the market expands beyond extant moral and political boundaries (Dertouzos, Lester and Solow, 1989; Taylor, 1990; Boyer and Drache, 1996; Kouzmin, 1998). Public domains, of course, define the politico-institutional capacity to achieve social consensus on the role of the market, to achieve social equity outcomes, and to protect the public interests. All these are key elements of any public social security policy. The key challenge thus confronting the privatizing state is how it can efficiently and effectively regulate the mandated private social security industry so as to ensure that any market failures and social distortions generated do not compromise the public consensus built up on the basis of “social equity” and public interest presumptions (whatever they may be) (Hult and Walcott, 1990).

New policy and administrative capabilities are required if these desirable public policy outcomes are to be achieved and if the public interest is to be protected. The challenge confronting a diminishing public social security domain is to re-invent itself in such a way as to ensure the state’s continued legitimacy and effectiveness in protecting the public interest in perpetuity—central is the maintenance of public trust and confidence in mandatory market provision (Littlewood, 1998). There is, thus a need for clarification
and empirical verification of the relationship between any residual public provision, governance practices and the market place in order to appropriately frame critical public policy debates and discourse (Cable, 1995). Moreover, the public social security domain must be administered by agencies with characteristics that have not always been in evidence in the public sector. They must be capable of learning, based from their experiences and the experiences of other institutions in other jurisdictions (Rose, 1993). They must focus on long-term and strategic policy perspectives—the privatized delivery of desirable policy outcomes in perpetuity. They must facilitate modes of policy reasoning capable of identifying and addressing threats to the public interest or the common good—essentially, when private interest goals come into conflict with public interest goals.

Statutory social security’s appropriation by the market thus makes imperative the designing of a socio-political governance mechanism that requires and supports the building of the corporate structures and capacities that make market providers capable of “high reliability” (La Porte, 1996) and, thus, of surviving through “inter-generational infinity.” This obliges public regulators to have long-term horizons (Goodman, 1973) and to gain learning capacities that enable them to provide corporate sanction and steering that go well beyond the putative market discipline of organizational termination which, effectively, permits the abdication of contractual responsibilities.

Conclusion

The shift from public provision of mandatory social security (which reflects a collective responsibility that enhances social cohesion, integration and inclusion) to market provision (which reflects an individual responsibility that enhances choice and produces enforceable contractual rights) has moved the global social security policy discourse away from issues of social justice, social inclusion and equality of opportunity towards technical issues related to the demarcation of public-private financial responsibilities. These privation pressures have blossomed, especially over the last two decades, the legacy of which is the market provision of statutory social security benefits in 33 countries by the late 1990s.

The daunting challenges facing governments intent on privatizing their statutory social security systems are three-fold. First, who should be obliged to pay what price—and receive what form of government support (if any)—for what form of benefit, whether payable in the distant or the near future in the event of what social security contingency, purchased from what types of market providers operating in what type of market environment. Secondly, they must design a set of regulatory arrangements that can protect the public interest in perpetuity in an environment where private interest goals can easily come into conflict with public interest goals. Finally, they must resist calls for government subsidies to support the “economic rent” (Tullock and Eller, 1994; Johnston and Kouzmin, 1998) or excessive profit expectations of market providers. To meet these challenges the privatized state must become a “smart” state (Kouzmin and Jarman, 1999). The policy dream—that the mandatory market provision of social security will allow governments to reduce fiscal deficits or even limit or reduce future tax burdens—may very well become a public interest nightmare, if policy success encourages governments to create, by statute, mandatory private insurance markets to facilitate the retrenchment of public expenditure on, or the divestiture of government responsibility for, public programs that address other
insurable social risks, such as old age (for long-term institutional care), disability (for long-term institutional care), unemployment (for re-training), sickness (for health care) and child rearing (for health care and non-compulsory education provision).

ENDNOTES

1 Long-term contingencies occurred later in Bolivia (1972); Coete d’Ivoire (1976); Switzerland (1985); Liechtenstein (late 1980s); Australia (1988); Venezuela (1990); Mexico (1992); Argentina (1994); Denmark (1998); and Hong Kong (1988).

2 The exceptions are Argentina (old age only) and Denmark (old age and survivors only).

3 The exceptions being Finland, where entitlements are based on average pensionable earnings and contribution periods and Denmark, where maximum flat rate, old age entitlement is payable proportionally reduced if the contribution period is less than the specified maximum.

4 Except in Australia and Venezuela, where only employer contributions are mandated.

5 Then India (1952); Singapore (1953); Japan (1954); Sri Lanka (1958); followed by Fiji (1966); Zambia (1973); the Solomon Islands (1976); Papua New Guinea (1980); Vanuatu (1987); and, finally, the United Kingdom (1988).

6 And a decade later in Peru (1991), then subsequently, Uruguay (1996); Bolivia and Mexico (1997); El Salvador and Hungary (1998); and Poland (1999).

7 Notably, China; India; Malaysia; the Philippines; Singapore; South Korea; Thailand; Taiwan; and Vietnam.

8 The conspicuous exceptions being China; Hong Kong; Japan; and the Philippines.

9 Malaysia (1951); India (1952); Singapore (1953); and Sri Lanka (1958).

10 World Bank, 1994. See also, for example, Hagemann and Nicoletti, 1989; Commander and Jackman, 1993; Estrin, Shaffer and Singh, 1994; Beattie and McGillivray, 1995; but also Deacon, Hulse and Stubbs, 1997).

11 Public sector provisions reflects community solidarity, through the acceptance of collective responsibility, by means of risk pooling and seeks to enhance social cohesion, integration and inclusion. Meanwhile, market provisions reflects individual responsibility, through the medium of work and savings, and seeks to enhance choice and produce enforceable contractual rights, promote efficiency and de-politicize policy decision making typically in the form of mandated occupational or personal defined-contribution programs—thereby divesting government of, at least, part of its social security obligations, if not responsibilities.

12 Where three market providers hold over 80 percent of the market.

13 Four market providers hold about 60 percent of the market.

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