Old-age state social insurance: may its failure be averted?

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Abstract

Old-age social insurance in the European Union is facing negative long-term demographic trends, as chronically unbalanced state social insurance fund budgets put the system's existence at risk. Various measures to save the system are being employed, undermining people's sense of security about their future retirement, which is the main goal of the system. The flaws of the public pension schemes suggest that failure is a possible outcome of the unfunded nature of the schemes. The paper examines the characteristics, historic financial trends, and flaws of old-age social insurance and assesses the various options to save the system from failure.

Introduction

The 130th anniversary of the first comprehensive social insurance scheme will be marked on June 15, 2013. The state social security system has been hailed by many as one of humanity's greatest achievements, which provides financial alleviation for individuals during times of sickness, maternity leave, unemployment, occupational diseases, accidents at work, and, eventually, in old-age.

However, as is the case with most governmental programs, this system has many flaws. Analysts often point to the high and growing costs of maintaining social insurance schemes, their ungrounded generosity, as well as an inherent vulnerability of pay-as-you-go systems to economic, demographic, and political changes.

In recent decades, the growth in the European Union's public social spending has outpaced economic growth in real terms. This has resulted in deficits within state social security funds and added to sovereign debt problems that many EU member states currently experience. As decision-makers of the EU look ahead at the social security systems' prospects within the next 50 years, they face unfavorable demographic projections. Given that old-age benefits usually constitute the largest share of spending within most state social security systems, this paper will focus on this type of social insurance.

The public discourse on pensions is typically concentrated on finding ways to save the old-age social insurance, such as raising the retirement age or increasing the rate of contributions. Thus, the system can only be saved at its participants' expense – by making them contribute more, work for longer and live off lower pensions than they have paid for.

The goal of this paper is to review the characteristics and historical dynamics of social insurance in Europe, examine its flaws and their ultimate outcome, which may include the system's failure, and assess the results which prolonging the system's existence may bring about.

Macmillan dictionary defines failure as "a lack of success in doing something" or "something that has not achieved success". There may be different approaches to defining failure of old-age social insurance; for the purpose of this paper, let us adhere to the following criteria:

- Inability to provide its goal of *secure* old age;

- Chronically unbalanced social insurance budgets, which lead to a breach of the system's pay-as-you-go principle;

- Anticipation of future economic and demographic trends that will further worsen the financial imbalance.

The paper consists of three parts. The origin, characteristics and historical trends of European social insurance systems will be overviewed in the first part. The main flaws of old-age social insurance will be identified and analyzed in the second part. In the third part of the paper, ways to prolong the existence of old-age social insurance will be examined, aiming to assess their results and whether they help to avoid failure in the long run. The experiences of three countries – the Union of Soviet Socialist Republics (USSR), Lithuania and Georgia – will be reviewed. Conclusions will be made in the final part of the paper.

1. European Social Insurance Systems: Characteristics and Historic Financial Trends

When the first compulsory state social insurance system was introduced in Germany in the late 19th c., few – perhaps even its "Godfather" Chancellor Otto von Bismarck among them – could have imagined the extent of such a system's growth throughout the coming 130 years.

The German social security program first began as a health insurance, with the Law concerning Health Insurance for Workers being adopted in 1883[1]. Initially covering most manual and white-collar workers, health insurance soon became compulsory for workers in transport, agriculture and forestry sectors.

In 1884, state social security system was expanded to include accident insurance. Initially compulsory for workers in dangerous establishments, it was soon extended for other sectors of the economy such as construction, agriculture, forestry, and shipping.

A broad trend can thus already be observed, whereby certain insurance would be introduced to only one sector of the economy, but its coverage would be very rapidly expanded. It is interesting to note these two acts "did not allow for either a centralized scheme or for government contributions", as law on health insurance "made membership of a private sickness insurance scheme compulsory for all workers in listed occupations", while accident insurance was to be provided through trade associations (formed by each industry), which administered their own insurance fund[2].

In 1889, the structure of the first state social security system was completed with the adoption of the Law on Invalidity and Old Age Insurance for Workers, Journeymen and Apprentices. In contrast to health and accident insurance, old-age insurance allowed for government funding and the government administered and guaranteed the regional insurance funds that ran this type of social insurance.[3] At the time, the regular retirement age was 70, pensions were rarely above the subsistence level and the maximum social insurance contributions were no more than 6 percent of gross wages[4].

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[1] „Bismarck's Social Security Legislation," Eurofound, 14 August 2009. http://www.eurofound.europa.eu/emire/GERMANY/BISMARCKSSOCIALSECURITYLEGISLATION-DE.htm [accessed August 1, 2012]

[2] Katherine Lyons and Christine Cheyne, "Social Insurance Mechanisms in the European Union," RECON Online Working Paper 2011/26, December 2011, p. 11 – 12.

[3] Ibid., p. 12.

[4] Antony P. Mueller. "Bye-bye Bismarck," *Mises Daily*, July 24 2003. http://mises.org/daily/1275 [accessed August 1, 2012]

The Bismarck system of state social security has three broad characteristics:

- the insured persons are employees or gainfully employed;
- the financing is via contributions;
- the contributions are based on wages or salaries[5].

In its essence, it is a pay-as-you-go (PAYG) system where contributions of the current working generation are used to finance the benefits of the currently retired generation. In return for its contributions, the current working generation gets a promise that its future benefits will be financed by future generation. Thus, this scheme performs an intergenerational transfer of wealth from current workers to current retirees.

The Bismarck or Continental insurance-based system was later adopted in Austria, Italy and France (although France's social insurance scheme predated Bismarck's, its pension fund was voluntary, while the overall scheme "lacked the comprehensiveness of the early German schemes, reflecting both a liberal inclination to leave the state out of welfare and a lack of urban class pressure"[6]). As noted by Lyons and Cheyne, the first architects of the German system "were conservative, elitist, and corporativistic, and correspondingly the Continental welfare state focused not on meeting egalitarianist ideas of redistribution but on maintaining status differentials."[7]

However, a social security system need not be construed as a social *insurance* scheme – Scandinavia has followed a strikingly different path of social security. Just two years after the introduction of the Bismarck system in Germany, Denmark adopted a horizontally universal, means-tested scheme which was redistributive and financed by tax revenues[8]. In contrast to Bismarckian benefits, which depend on the amount of contributions, benefits in Denmark are partly flat-rate and partly means-tested.[9]

A third type of social security systems emerged in Anglo-Saxon states, with its typical characteristics being means-tested assistance, modest social insurance and an encouragement to care for one's old age through the market.[10]

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[5] „Bismarck versus Beveridge: A Comparison of Social Insurance Systems in Europe," CESinfo DICE report 4/2008, p. 70. http://www.cesifo-group.de/portal/page/portal/DICE_Content/SOCIAL_POLICY/Basic_Protection/SP060_GUARANTEEING_SUFFICIENT_RESSOURCES/bsimarck-beveridge-dicereport408-db6.pdf [accessed August 1, 2012]

[6] Katherine Lyons and Christine Cheyne, "Social Insurance Mechanisms in the European Union," RECON Online Working Paper 2011/26, December 2011, p. 14.

[7] Ibid., p. 11.

[8] Ibid., p. 17.

[9] Igor Guardiancich. "Country Report. Denmark. Current pension system: first assessment of reform outcomes and outpu," European Social Observatory. May 2010.

[10] Op. Cit., p. 21.

Since characteristics of the Bismarck or Continental system are more widespread among the social security systems in the European Union, this paper will focus on the flaws of this particular type of social security system.

Over the past 130 years European social security systems have bulged into extensive and expensive programs. The following graphs indicate a clear trend in the growth of public social spending as a percentage of gross domestic product (GDP) in Belgium, Finland, France, Germany, Italy and Spain since 1880 (N.B.: social expenditure is not limited to social security, but also includes Health, Family, Active labor market programs, Unemployment, Housing, and Other social policy areas).

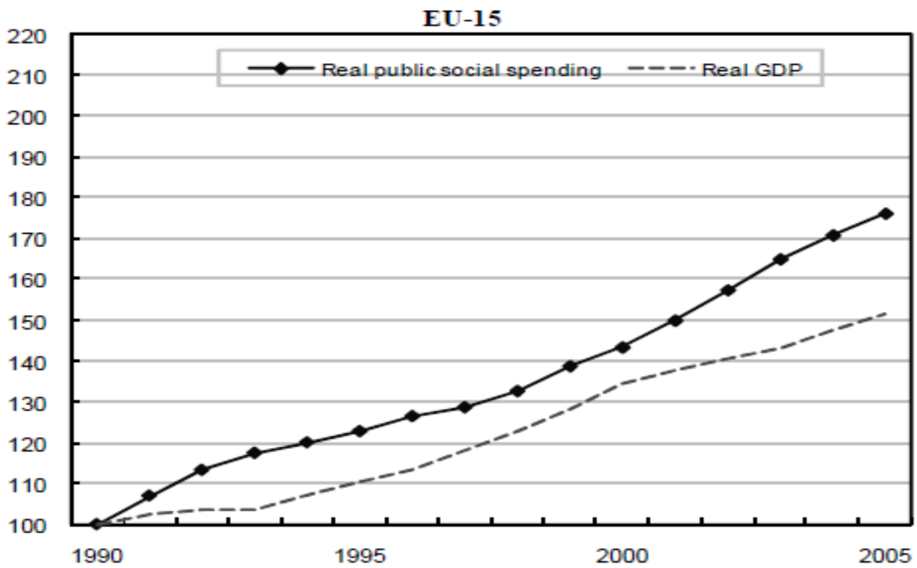
In 2009, total spending on social protection in EU member states comprised 30 percent of GDP and made up the biggest share of government spending[11]. The average EU spending on old-age social security (i.e. pensions), which is the primary focus of this paper, in the same year constituted 13.1 percent of GDP[12]. Countries with highest spending on pensions relative to GDP were Italy (16 percent), France (14.5 percent), and Germany (13.1 percent), while the ones with lowest relative spending on pensions were Ireland (7.3 percent), Cyprus (7.4 percent) and Slovakia (8.4 percent).

One could argue that the growth in public social spending would not be worrying, if it was accompanied by corresponding economic growth. However, statistics indicate that the growth in social spending has been exceedingly outpacing GDP growth, which has been an alarming development over the last few decades, as can be seen in the next graph.

[11] "Expenditure on social protection," Eurostat, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tps00098&plugin=1 [accessed August 14, 2012]

[12] "Expenditure on pensions," Eurostat, http://epp.eurostat.ec.europa.eu/tgm/table.do?tab=table&init=1&language=en&pcode=tps00103&plugin=1 [accessed August 14, 2012]

Graph 3. Public social spending and GDP growth in real terms, 1990-2005



Source: Adema W. and Ladaique M., How expensive is the welfare state? Gross and net indicators in the OECD social expenditure database (SOCX), p. 24.

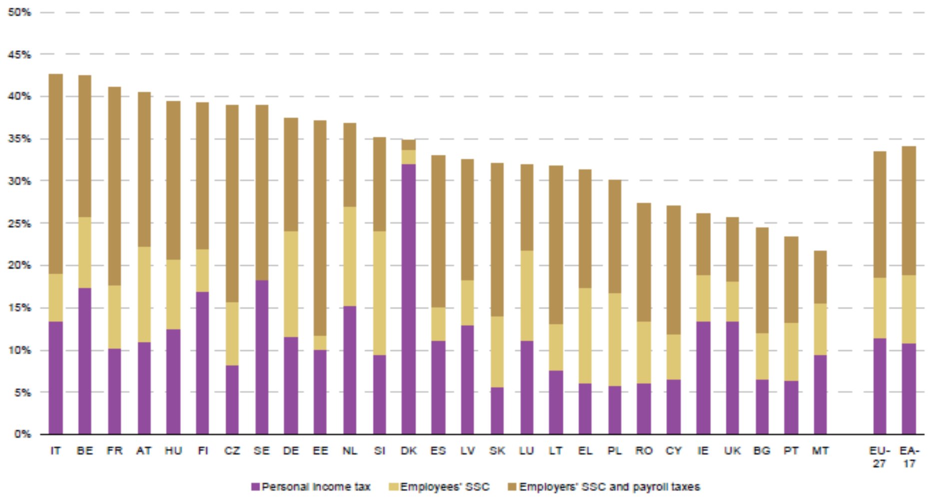
A high social spending means that it has to be financed through high taxes, borrowing, or monetary expansion. In 2010, the share of social security contributions constituted 31.1 percent of total tax burden[13].

In the same year, the average social security contributions in the 27 European Union member states comprised two thirds of the implicit tax rate on labor (which stood at 33 percent)[14]. Social security contributions vary across countries, but in most cases they make up the lion's share of labor taxes in the European Union, as can be seen in the next graph.

[13] Ibid., p. 25.

[14] „Taxation Trends in the European Union. Data for the EU Member States, Iceland and Norway," Eurostat Statistical Books, 2012 edition. P. 32. http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-DU-12-001/EN/KS-DU-12-001-EN.PDF [accessed August 2, 2012]

Graph 4. Composition of the implicit tax rate on labor in 2010 (in %).



Source: Eurostat, Taxation Trends in the European Union. Data for the EU Member States, Iceland and Norway. Eurostat Statistical Books, 2012 edition. P. 32.

The high tax burden has proven not to be sufficient to finance the social security spending, resulting in deficits of state social security funds. The following graph illustrates state social security fund balance in two EU countries – Germany and France, whereby negative balance implies deficits.

Growing deficits of state social security funds have contributed to an overall growth in sovereign debt of EU member states. For example, the outstanding debt of the French state social security fund was forecast to stand at 7.1 percent of GDP at the end of 2011[15]. The sustainability of such pay-as-you-go systems, and whether they can continue to be named pay-as-you-go rather than pay-as-you-borrow systems will be further explored in the next part of this paper.

To summarize, social security contributions today make up a third of total tax burden in the EU, while almost a third of GDP is redistributed on social protection. Given that at its inception, the state social security system could be described as relatively cheap and neither extensive nor generous, one is impelled to view with distrust the introduction of any new taxes, for their burden may unexpectedly increase in the future.

[15] "Les Chiffres clés de la Sécurité sociale," Direction de la Sécurité sociale, 2010. P. 29. http://www.securite-sociale.fr/IMG/pdf/2011_chiffres_cles.pdf [accessed July 27, 2012]

2. Flaws of old-age social insurance

2.1 Old-age social insurance: welfare or insurance?

The proponents of the system maintain that it is a form of insurance, because the benefits are related to contributions. Since the underlying logic of "social insurance" hinges on it being a public sector alternative to free market insurance, we should examine whether insurance is an appropriate financial instrument to provide and prepare for old age.

The principles of insurance require that insured events are contingent and accidental by their nature, rather than planned and anticipated. In the case of old age, one knows exactly the year and date when one will retire (unless the retirement age is raised), thus retirement cannot be described as a contingent event. Insurance would be a suitable instrument for somewhat an opposite case – if one dies and does not reach the retirement age (i.e. life insurance).

Insurance contributions normally depend on the risk of a certain event taking place (for example, a car accident, fire, etc.), while the benefits depend on how much an individual has paid into the insurance program. As noted by John Attarian, "under true insurance, one's premium reflects one's own risk of income loss and the cost to the insurer of assuming that risk, and buys one protection against one's own loss. But when one's [social security] taxes are increased following a legislated increase in benefits for current beneficiaries – due, say, to politics – one's "premium" is being driven, not by one's own "risk" nor by the cost of protecting against it, but by politicians' decisions to be generous towards others bringing political pressure to bear."[16] In contrast to regular insurance, where the risk is pooled and distributed among participants of the fund, there is no risk pooling in state social insurance.

Thus, in old-age social insurance, the contributions depend on political decisions and an individual's earnings, rather than possible risks (this is true not only for old-age social security, but also for all the other types of social security – sickness, maternity, disability, unemployment, etc.).

The benefits are then calculated "under a formula that, in general, grants higher benefit amounts to those who have paid higher social security taxes."[17] Although the benefits are supposed to reflect the contributions one has paid towards his old-age social insurance, this is not always the case. Some state social security systems (for example, in Lithuania) cap benefits, but not contributions, resulting in progressivity of the whole social insurance scheme.

Moreover, in a true, private insurance scheme the risk is transferred from the insured person to the insurer, while in social insurance it is simply transferred onto the taxpayers. If a private insurance company's costs exceed the predictions and spending, it will turn bankrupt, yet if this happens in a social insurance scheme, taxes will be raised or money will be borrowed, so that the risk is not born by the state insurance scheme but rather by the taxpayers.

Therefore, judging by its content rather than form or title, old-age social insurance is not insurance and the principles of insurance cannot be applied to the case of old age.

Savings rather than insurance would be an appropriate instrument to provide for in old age, and this is the mechanism which has been used before the introduction of state social security systems. Moreover, in many EU countries today old-age social insurance is complemented by voluntary or compulsory private savings accounts funded by employees and employers (II pension pillar) and supplementary private savings accounts (III pension pillar) precisely because of the inability of old-age state social insurance (I pension pillar) to provide adequate income for retirees.

Having established that insurance is not an appropriate instrument for income provision in old age, we should now question what it is (for simplicity, we will continue using the term "insurance"

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[16] John Attarian, "The Roots of the Social Security Myth," *Essays in Political Economy*, Ludwig von Mises Institute: Auburn, Alabama, 2001, p. 31.

[17] Peter J. Ferrara. "Social Security. The Inherent Contradiction," Cato Institute Studies in Public Policy, 1980, p. 6.

throughout the rest of this paper). In addition to insurance goals, most social security programs aim to serve some welfare functions. Social security schemes often have minimum pensions (for example in Belgium, Czech Republic, Italy, Lithuania, Malta, Portugal, etc.), meaning that these minimum amounts are paid regardless of their recipients' past social security contributions[18]. This welfare function adds to the progressivity of social security programs, whereby individuals with lower earnings and contributions can expect to receive higher benefits, while the benefits paid to individuals with higher earnings and contributions may even be capped.

According to the pension progressivity index by OECD, Ireland and the United Kingdom have highly progressive pensions, while in Finland, Greece, Hungary, Italy, the Netherlands, Poland, Portugal and the Slovak Republic the pension systems are almost entirely proportional and limited in progressivity[19]. In the progressivity index, a progressive scheme is close to 70 or higher, while a proportional scheme is closer to 0. Results of the progressivity index can be seen in the following table.

Country	Progressivity Index	Country	Progressivity Index
Austria	25.4	Ireland	100.0
Belgium	60.5	Italy	1.1
Czech Republic	68.4	Luxembourg	18.6
Denmark	56.1	Netherlands	5.7
Estonia	27	Poland	3.0
Finland	7.9	Slovak Republic	0.8
France	29.3	Spain	19.6
Germany	24.3	Sweden	-10.1
Greece	3.4	United Kingdom	82.8
Hungary	0.0		

Source: Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011.

As social insurance tries to serve both welfare and insurance functions, the principles of welfare and insurance are applied in an inconsistent and disordered manner. The absence of consistent social security principles results in a directionless and even chaotic redistribution within social security programs. Moreover, there is redistribution among the different types of social insurance as old-age social insurance contributions may be used to finance maternity or unemployment benefits. Although this may not be the case in all the EU member states, as some countries may have implemented measures to minimize this redistribution, it does exist in some cases.

As noted by Peter J. Ferrara in his profound critique of the social security programs, the two functions of welfare and insurance "are fundamentally incompatible, and the result is very bad

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[18] „Social Security Programs Throughout the World: Europe, 2010," Social Security Administration, International Social Security Association. http://www.ssa.gov/policy/docs/progdesc/ssptw/2010-2011/europe/ssptw10europe.pdf [accessed August 15, 2012]

[19] „Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011. P. 136. http://dx.doi.org/10.1787/pension_glance-2011-en [accessed August 15, 2012]

welfare and very bad insurance. Insurance pays benefits to individuals on the basis of what they have paid into the program in the past, regardless of their need. Welfare pays benefits to individuals based on their need, regardless of what they have paid into the program in the past."[20]

Thus, the pursuit of two divergent functions does not realize either of them. Since insurance is inappropriate to old-age income provision and the mixture of welfare and insurance has not worked either, it can be concluded that welfare should be provided for those individuals in need of income relief, while the chief financial way of preparing for one's old age should be performed through private savings (as well as other non-financial means, such as intergenerational family support, communities, charities, etc.).

2.2 Vulnerability of pay-as-you-go social insurance systems to economic, demographic and political changes

One of the main characteristics of old-age social insurance systems is that they are unfunded and financed through current contributions. In some cases, the size of old-age pensions depends on the number of pensioners and contributors (for example, in Germany), but typically the pensions depend on an insured person's reference earnings during the years when one paid old-age social insurance contributions[21]. This means that for the large part, current benefits depend on previous rather than current contributions, from which pensions are paid. Even in the countries which have introduced automatic stabilizers, the spending is not necessarily equal to revenues. This creates a fundamental problem of vulnerability and even unsustainability due to the unfunded nature of pay-as-you-go social insurance systems.

The unfunded nature of pay-as-you-go social security schemes has led Milton Friedman to call it "The Biggest Ponzi Scheme on Earth", whereby "The link between the payroll tax and benefit payments is part of a confidence game to convince the public that what the Social Security Administration calls a social insurance program is equivalent to private insurance"[22].

Of course, there are some notable difference between state social security systems and Ponzi's scheme. As Murray Rothbard vividly explains, "Ponzi's notorious swindle at least rested solely on his ability to con his victims, whereas the government swindlers, of course, rely also on a vast apparatus of tax-coercion."[23] Also, in contrast to the creators of the financial pyramids, governments are able to finance the crippling pay-as-you-go schemes through borrowing and monetary expansion).

The confidence game played by governments throughout the world appears to be successful, since participants of social insurance systems tend to be convinced that their contributions are invested in trust funds rather than immediately paid out to current benefit recipients. Such convictions and false beliefs are showcased during protests against raising the retirement age or reducing pensions (which have occurred in recent years in various EU member states) – people have been led on to believe

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[20] Peter J. Ferrara. "Social Security. The Inherent Contradiction," Cato Institute Studies in Public Policy, 1980, p. 6.

[21] Op. Cit.

[22] Milton Friedman, "The Biggest Ponzi Scheme on Earth", *Hoover Digest* 1999 no. 2., http://www.hoover.org/publications/hoover-digest/article/7523 [accessed August 15, 2012]

[23] Murray N. Rothbard. "Making Economic Sense", Ludwig von Mises Institute: Auburn, Alabama, 1995, p. 73.

their money is safely invested in a "trust fund" and they naturally do not understand why the governments chooses not to pay out the benefits they have "accumulated" over their working years.

An unfunded social insurance scheme is very attractive to the politicians and the scheme's participants in the initial stage, since they receive windfall benefits funded by current contributions. As Peter J. Ferrara notes, "With the program generating huge unclaimed surpluses, the system appears to have eminent financial soundness."[24] However, once the social insurance scheme enters a mature stage, its shortcomings begin to appear: retirees will now have built up vast benefit claims which have to be financed through current revenues, since unclaimed surpluses no longer exist. It is at this stage that bankruptcy becomes a real threat "because the program has accumulated no assets to aid in the payment of these liabilities. Such payment depends solely on the maintenance of sufficient current tax revenues to meet the accrued benefit obligations."[25]

The European social insurance systems are at the mature stage, where their financial pyramid-like nature makes them vulnerable to any negative economic, demographic and political influences:

- *Economics*: revenues of pay-as-you-go systems depend on the rate of unemployment, level of wages, whereby fewer workers and lower wages will result in declining revenues. Therefore recessions pose a significant challenge to the solvency of social insurances schemes, particularly if there is no buffer fund.

  Also, since old-age pensions are often indexed to inflation, a rapid increase of inflation can create serious problem for the social insurance systems, as it automatically requires higher expenditures.

- *Demographics*: EU member states are facing negative long-term demographic outlook, as decreasing fertility rate is coupled with aging population. Although rising life expectancy is a desirable development in itself and would be entirely beneficial in the absence of old-age insurance systems, it stretches the retirement duration, posing a financial threat to pay-as-you-go systems. According to Eurostat forecasts, the projected old-age dependency ratio, which is defined as the projected number of persons aged 65 and over expressed as a percentage of the projected number of persons aged between 15 and 64, for the 27 EU member states is set to double within the next 50 years (from 25.9 percent in 2010 to 52.6 percent in 2060). This ratio is set to reach as much as 57-65 percent in some of the most populous European states – Germany, Spain, Italy, Poland and Romania (which together account for 50 percent of the EU population), as illustrated in the following graph.

[24] Peter J. Ferrara. "Social Security: Averting the Crisis," Cato Institute Studies in Domestic Issues, 1982, p. 54.

[25] Ibid.

It should also be mentioned that declining fertility rates have been linked with the expansion of public pension schemes. On the one hand, the existence of old-age social insurance reduces the old-age motive for having children, while on the other, extensive and expensive old-age social insurance discriminates against those families that bear more children. As Philip Booth and Oskari Juurikkala have concluded, "the empirical evidence linking fertility decline to the growth of public pensions is striking and undeniable", whereby "simulations estimate that the growth of public PAYGO pensions can explain as much as 50 per cent of the decline in fertility rates in Europe and the USA between 1950 and 2000."[26] It is thus ironic that the pay-as-you-go system is suffering from declining fertility rates which the system itself partly induces.

The negative demographic outlook for the EU will lead to severe financial strains on the European state social security systems, as a decreasing number of working individuals will have to finance pensions of an increasing number of retirees. Social insurance systems are already very expensive at the existing 1:4 ratio of retirees to workers, and the situation will be very complicated once this ratio reaches less than 1:2. If the social insurance systems are not reformed, the old-age pension replacement rate (which compares the old-age pension with the earnings which were the main source of income prior to retirement) will fall, and the ability of the social security systems to provide *security* – the main goal of these systems' existence – will be greatly diminished.

- *Political influence*: politicians have the power to create the overall design of the social insurance systems, as well as to tweak any nuts and bolts within the systems. Typically, politicians will decide on the specific details related to old-age pensions such as the retirement age, the amount of social insurance contributions, caps on contributions and benefits, and sometimes even the average earnings.

Lithuania can be given as a bad case example, where politicians intervene even in such specific details as which years could be used for an insured person's reference earnings. Populist meddling with old-age pensions is another bad example, coming from Lithuania. Pension hikes in 2008 coincided not only with the parliamentary elections, but also with a sharp GDP contraction of 15 percent in 2009. This move resulted in a staggering deficit of 3.1 percent of GDP just within the State Social Insurance Fund (making up a third of the public sector deficit, which stood at 9.4 percent of GDP in 2009)[27]. As can be seen in the

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[26] Oskari Juurikkala and Philip Booth, "Introduction: old age in a free society – a proposal for pensions reform", in *Pension Provision: Government Failure around the World*, ed. Philip Booth, Oskari Juurikkala and Nick Silver, The Institute of Economic Affairs: London, 2008, p. 43 – 44.

[27] Decree on the Confirmation Report of the Indicators of the State Social Insurance Fund Budget in 2009, Seimas of the Republic of Lithuania, http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=387257&p_query=&p_tr2=2 [accessed August 16, 2012]

> following graph, the main reason for the deficit was a sharp increase in expenditure rather than a shortfall of revenues to the economic contraction:
>
> Even the events covered by social insurance (such as unemployment, maternity, disability, etc.) have been decided in a politicized manner. The politicization of social insurance systems creates insupportable expectations and may mislead all the participants of these systems.

Returning to the overall flaw of vulnerability of social insurance schemes, it should be emphasized that sudden contractions in social insurance funds' revenues cannot be accompanied by corresponding benefit reductions. In Germany, where benefits are annually adjusted according to changes in wages and the ratio between the number of pensioners and contributors, there is nonetheless an important and perhaps even fatal rule that prevents (any) absolute decrease in pension benefit[28]. In some countries, pensions are indexed according to inflation (which creates a tendency of spending growth) or average wages (which can be increasing even though the ratio between the employed and pensioners is falling, so in reality revenues may be falling as spending rises). Indexation is often viewed as a self-explanatory instrument, but it can add to the vulnerability of social insurance schemes and reinforce the lack of economic rationale determining the exact level of spending.

As long as social insurance spending is not limited by social insurance contributions, it is not a true pay-as-you-go system, for it can easily become a pay-as-you-borrow or pay-as-you-print-more-money system. This transformation has happened unnoticed, and what we still call pay-as-you-go has become pay-as-you-borrow.

For the participants of social insurance schemes either of the solutions is not desirable: if the scheme is a truly pay-as-you-go scheme, it would mean decreasing benefits in the long term due to negative demographic developments; if the scheme is pay-as-you-borrow, it is *de facto* bankrupt, with only sovereign debt saving it from bankruptcy; if the scheme is pay-as-you-print-more-money, it creates inflation (so the retirees are the primary victims) and leads to economic booms and busts, according to the Austrian business cycle theory.

It should be noted that proponents of social insurance see the ability of such schemes to borrow as a positive feature of social insurance. For example, Lyons and Cheyne state that "Social insurance […] improves on private insurance in that the state can also borrow if it needs additional resources to pay the costs of dealing with a widespread threat."[29] However, these proponents fail to indicate a source for repaying the long-term debt in a way that would not reduce the living standards of the

[28] „Social Security Programs Throughout the World: Europe, 2010," Social Security Administration, International Social Security Association. http://www.ssa.gov/policy/docs/progdesc/ssptw/2010-2011/europe/ssptw10europe.pdf [accessed August 16, 2012]

[29] Katherine Lyons and Christine Cheyne, "Social Insurance Mechanisms in the European Union," RECON Online Working Paper 2011/26, December 2011, p. 7.

social insurance benefit recipients. Thus, the claim that the ability to borrow money is an advantage of social insurance can be regarded as irrelevant.

2.3 Compulsory system

When the state social security system was first introduced by Bismarck, one of the aims was to stave off the introduction of more radical alternatives proposed by the socialists[30]. Nowadays, the proponents of the public pensions system tend to base it on a paternalist idea that in its absence, people would not prepare for their old age.

The development and magnitude of supplementary private pension savings throughout the developed world is a clear indicator of people's inclination to make financial preparations for their retirement. The following table of pension fund assets in certain OECD countries serves to underscore the groundlessness of the paternalist idea of people's short-sightedness.

Country	Assets in pension funds as a % of GDP	Country	Assets in pension funds as a % of GDP
Australia	82.3	Israel	46.9
Canada	62.9	Netherlands	129.8
Chile	65.1	Switzerland	101.2
Denmark	43.3	United Kingdom	73.0
Finland	76.8	United States	67.6
Iceland	118.3	OECD-34	67.6
Ireland	44.1		

Source: Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011.

As Ludwig von Mises notes, there is a profound contradiction when the social security system is justified by the paternalist view "that the wage earners lack the insight and the moral strength to provide spontaneously for their own future. But then it is not easy to silence the voices of those who ask whether it is not paradoxical to entrust the nation's welfare to the decisions of voters whom the law itself considers incapable of managing their own affairs […] Is it reasonable to assign to wards the right to elect their guardians?"[31] Thus, if the wage earners really do lack the insight to caring for their own retirement, it is not clear why they are entrusted with the right to elect their leaders.

It is true that not all developed countries have high levels of assets in pension funds as a percentage of GDP. For example, the figures for Austria are 4.9 percent of GDP, Czech Republic – 6, Italy – 4.1, Spain – 8.1.[32] Proponents of social insurance may use the low figures of pension fund asset

[30] "From Bismarck to Beveridge: Social security for all," *World of Work, No. 67*, International Labor Organization, December 2009, p. 2, http://www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcm_041914.pdf [accessed August 17, 2012]

[31] Ludwig von Mises, "Human Action," Fox & Wilkes: Little Rock, Arkansas, 1996, p. 617.

[32] „Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011, p. 179. http://dx.doi.org/10.1787/pension_glance-2011-en [accessed August 16, 2012]

accumulation in a given country to claim that people are short-sighted and the state's participation in providing for old age is justified. However, low pension fund asset accumulation may be attributed to the problem of reduced savings (which will be analyzed next) rather than people's short-sightedness.

2.4 Lower level of savings in an economy

The compulsory nature of social insurance schemes creates a disincentive for people to save for retirement, in turn resulting in a lower level of savings in an economy. Researching this issue, Oskari Juurikkala noted that "The irony of this is that […] public pension schemes create incentives that undermine the systems themselves. As governments begin to promise extensive retirement benefits and to tax people at rising rates, the consequence is inevitable: self-reliance, thrift and private saving go down, and people become more dependent on government provision and more vulnerable to systematic breakdown."[33]

The presence of old-age social insurance schemes reduces saving for retirement by (a) making promises to pay pensions and (b) by taxing individuals and thus reducing the financial possibilities to save for pensions. Once a fifth or even more of an individual's salary is taken from him as social security contribution, one's ability to save for pension (no matter how great his willingness to do so is) becomes greatly diminished. People become dependent on the state system and while private savings schemes exist as an alternative, they appear insufficient and even incapable of financing old-age provision.

Social insurance proponents are quick to point out that a large share of social insurance contributions is levied on an employer rather than employee, yet this illusory separation has been long proven wrong. As marked by Ludwig von Mises, "Whatever the provisions of a social security law may be, their incidence ultimately burden the employee, not the employer. […] Social security does not enjoin upon the employers the obligation to expend more in buying labor. It imposes upon the wage earners a restriction concerning the spending of their total income."[34] Therefore, social insurance contributions are a part of employees' wages, and the high level of these contributions reduces people's ability to save for their old age.

The lower level of savings in turn has negative effects on an economy: it reduces investment and exacerbates the recessions since investment projects have to be dropped due to their lost profitability. This occurs because there is "a lack of the necessary supply, at favourable interest rates, of real financial resources previously saved."[35] At a higher level of savings, more investment projects would have been profitable and could be pursued, rather than cancelled and abandoned, which has often happened.

2.5 People left financially worse off

[33] Oskari Juurikkala, "Retire early, save little: the ironic disincentives of public pension systems," in *Pension Provision: Government Failure around the World*, ed. Philip Booth, Oskari Juurikkala and Nick Silver, The Institute of Economic Affairs: London, 2008, p. 82 – 83.

[34] Ludwig von Mises, "Human Action," Fox & Wilkes: Little Rock, Arkansas, 1996, p. 617.

[35] Jesus Huerta de Soto, "The Theory of Dynamic Efficiency," Oxon: Routledge, 2009, p. 121.

Social insurance reduces the available alternatives of old-age provision and prevents people from pursuing more profitable options. Various research shows that returns from savings are higher and therefore more attractive than returns from social insurance. Michael Tanner in his study for Cato Institute analyzed outcomes for hypothetical individuals under various investment scenarios and compared them with the benefits those individuals could expect to receive from Social Security. The conclusion was that "In every case, a worker would have received higher monthly benefits from private investment than from Social Security. In fact, even in the worst-case scenario, a low-wage worker who invests entirely in bonds, the worker does no worse than Social Security."[36]

Thus historical experience shows that if individuals had the possibility to opt out of social security and instead invest and save for their pensions, they would have enjoyed higher rates of return and higher standards of life. Since opting out of the social insurance scheme is not an option, all workers are condemned to lower rates of return of their contributions. Consequently, compared with social insurance, private investment would be a better tool for achieving its main goal of providing a source of income for individuals in their old age.

2.6 Distorted morality and other ethical problems

It has already been highlighted that the compulsory nature of old-age social insurance lowers the motivations to save, so that in the long run, the public pension systems contribute to the destruction of the virtue of thrift. Moreover, as people increase their reliance on public pensions, they become less dependent on their families, communities and charities as a source of support in old age. Once the state assumes the function of providing for people in their old age, it takes away this function from all the other, smaller communities, in many cases resulting in a state monopoly of old-age income provision. Since the smaller units, such as communities and families, provide not only financial, but also important non-financial support to the elderly, state monopoly in effect deprives the people of non-financial communion and assistance. The effects of an undermined link between the retirees and their families and communities are difficult to measure in economic terms, yet they are real and painful, as they reduce solidarity and the sense of security.

People's increased reliance on the State and, subsequently, the growing role of the State goes hand in hand with diminishing individual liberty. In the absence of public pension schemes, there could be no state-mandated retirement age, yet today the state decides the exact date when each individual will retire (unless he qualifies for early retirement, or decides to continue working past his retirement age). The state tries to fit all the citizens into a one-size-for-all working life plan, thus seriously undermining personal liberty.

Pay-as-you-go systems also create an irresolvable conflict among generations, since the benefits of current retirees are paid by the contributions of current workers. Jesus Huerta de Soto concludes that "social security is a destabilizing instrument in modern societies, which endangers the harmonious and pacific progress thereof, leading to serious tension and conflicts which are impossible to solve."[37] Building upon this thought, we can observe how the younger generation

[36] Michael Tanner, "Still a Better Deal. Private Investment vs. Social Security," Cato Institute Policy Analysis No. 692, February 13, 2012, p. 7.

[37] Jesus Huerta de Soto, "The Theory of Dynamic Efficiency," Oxon: Routledge, 2009, p. 124.

tends to blame the retirees for the problems inflicting public pension schemes, while the retirees demand their "earned benefits" and protest any benefit reductions.

Although the proponents of pay-as-you-go systems describe them as a "contract" or "compact" between generations, this view is inaccurate. A contract would imply two contractual sides coming into a voluntary agreement, yet neither the workers nor the retirees can alter the terms of the social insurance – the state is the only actor mandating all the clauses, sections, subsections, etc. John Attarian neatly summarizes a critique of the view of social insurance as a "compact between generations": "A contract or compact that only one party (e.g. one generation, or, more specifically, that generation's Congress) creates and forces on the other (young present and future taxpayers and unborn future taxpayers), while reserving to itself the sole power to rewrite it, and under which generations yet unborn are bound without being consulted, much less consenting, hardly lives up to the term."[38] The solidarity between generations, so celebrated by proponents of pay-as-you-go systems, is enforced, therefore "coercion" rather than "solidarity" (which in its true meaning can only be voluntary) is a more appropriate term.

Finally, the high stakes, divergent interests and expectations of public pension systems' participants, in addition to short-term motivations of politicians, intertwine in such a way that makes long-term oriented reforms a mission impossible. On the one hand, the retired generation is an important force resisting undesirable changes made to the spending side of the pension system. On the other hand, the working generation and the employers oppose negative changes made to the revenue side of the pension system, while those workers closer to the retirement age would be more likely to act as if they were already retired. An essential reform of public pension schemes would mean that some cohorts would have to pay twice – both for the pensions of current retirees and for their own, which makes every generation interested to pass this role on to their successors, the next cohort. Politicians endeavor to balance all the conflicting interests and prop up the system in the short run (even if that means getting deeper into debt). A long-term oriented reform or liquidation of the pay-as-you-go system may imply suicide at the ballot box. For such a reform to happen, one generation has to be willing to make the sacrifice and pay twice. If this solidarity and consent is not present, the generation that makes the sacrifice will emerge spontaneously, once the system fails. Before this happens, further improvements of the system will be similar to the most recent "reforms" that raised the retirement age or increased contributions.

3. May the failure of old-age social insurance be averted?

[38] John Attarian, "The Roots of the Social Security Myth," Essays in Political Economy, Ludwig von Mises Institute: Auburn, Alabama, 2001, p. 40.

Failure of old-age social insurance is defined as inability to provide its goal of *secure* old age; chronically unbalanced budgets – a breach of the system's pay-as-you-go principle; and anticipation of future trends that will further worsen the financial imbalance. These features are often accompanied by public distrust of the system and rising evasion.

A number of pay-as-you-go schemes in the EU have in effect been transformed into pay-as-you-borrow schemes, which is tantamount to labeling them as failing. As stated on p. 9, the French state social insurance fund has been running deficits for the past decade and its outstanding debt was forecast to stand at 7.1 percent of GDP at the end of 2011. The Lithuanian state social insurance fund has been running deficits since 2008, its outstanding debt is set to be above 8 percent of GDP by the end of 2012, while the servicing of the debt costs 0.5 percent of GDP or 4.2 percent of the fund's spending just in 2012[39].

Considering that the long-term demographic situation will pose increasing challenges for the social insurance schemes, their ability to return the debt – while providing all the promised benefits – is questionable, at best. Therefore, these systems will be less able to fulfill their obligations and are unsustainable in the long run.

It is important to note that as countries become wealthier, the strain on social insurance schemes increases in a number of ways. Since future benefits will depend on current earnings, growing wealth today will call for higher pensions in the future. Rising life expectancy, a development also associated with growing wealth, will mean that retirees will receive pensions for longer periods. Paradoxically, growing wealth of a certain country augments rather than diminishes the role and scope of the state's participation in providing old-age security, eventually undermining the social insurance system and dooming it for failure.

The conclusion of unsustainability is in line with the analysis of the financial pyramid-like nature of the public pension schemes. Once the old-age social insurance scheme enters a mature stage, bankruptcy is a real threat because the program has no accumulated assets. Any negative economic, demographic and political changes will have serious implications for the potential of old-age social insurance to meet its outstanding, unfunded liabilities. If it were a regular financial pyramid, it would crumble in its mature stage. However, public pension schemes are different from regular financial pyramids because they are created by the state, which mandates compulsory participation and allows for debt financing of the outstanding obligations.

If financial pyramids, such as Maddof's scheme, are allowed to crumble despite all the negative consequences this brings about for its participants, how should the decision-makers deal with failing old-age social insurance: should they let it fail, or prolong its existence at all costs, hoping its failure can eventually be averted?

Next, examples of three countries will be analyzed. The USSR has been chosen, since it is an example of a failed system. Lithuania is examined, because its public pension system contains all of the three criteria of a failing system. Georgia's experience is overviewed, since it is often presented as an example of an exit from a state social insurance scheme, yet a public pension system is still

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[39] Law on the 2012 Indicators of the State Social Insurance Fund Budgets, Seimas of the Republic of Lithuania, http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=415505&p_query=&p_tr2=2 [accessed August 19, 2012]

present in the country and it satisfies two of the criteria of a failing system (lack of security and anticipation of negative future trends).

3.1 The case of USSR

When a system fails

The USSR is an example of a failure of the whole communist system, rather than just the old-age social insurance scheme. Nonetheless, this is a useful case to note briefly when considering possible scenarios of a pension system failure: it changed the situation of the elderly instantly and dramatically.

In the USSR, the retirees enjoyed high replacement rates, ranging from 50 to 100 percent of the recipient's highest wage year[40]. Following the fall of the Soviet Union, the newly independent republics generally honored the obligations to retirees inherited from the soviet pension system. However, the systems were strained due to economic turmoil and a shrinking contributions base. Most of the newly emerged states suffered from high inflation, following the freeing up of the prices. Consequently, the retired population was among the society groups hardest hit by inflation. The situation of the retirees, who live on fixed income, was further worsened by the wiping out of their lifetime savings.

This example warns about the poverty, chronic insecurity and over-politicization if a failure of the pension system occurs unexpectedly and alternative pension pillars are nonexistent (or are wiped out).

However, the failed pension systems were not exited. One of the possible solutions was to accept the pension liabilities into the state budget and to design a new, sustainable system of old-age provision. Instead, Soviet obligations to the retirees were financed by the current contributors, in exchange to a promise that the future generation will finance their benefits.

3.2: The case of Lithuania

When a failing system is not allowed to fail

Lithuanian old-age social insurance may be used as an example of a failing system that is continuously being saved. Before the economic crisis of 2008, the Lithuanian State Social Insurance Fund was running surpluses which were quickly used up to raise pensions as well as other benefits. The image of state social insurance as a generous system was being supported by campaigns such as "Mother Social Security" ("Mama SoDra" in Lithuanian), a children's book depicting how the

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[40] Cynthia Buckley, "Renegotiating Pensions in Russia: Obligations and Expectations*," Continuity and Change, Vol. 13:2*, 1997, p.5.

fund is an irreplaceable “umbrella” that supports a child’s relatives during periods of maternity, unemployment and old-age[41].

On the outset of the economic crisis, the surpluses and the generosity of the State Social Insurance Fund ran dry. As already noted, the deficit of the fund stood at 3.1 percent of GDP in 2009 and made up a third of the public sector deficit (9.4 percent). Although the government was able to reduce state budget deficit from 6.3 down to 0.5 percent of GDP from 2009 to 2012, deficit within the state social insurance fund has been exceeding 2 percent of GDP every year since 2009[42]. In 2012, every sixth Litas (the Lithuanian currency) paid from the State Social Insurance Fund is borrowed, down from every fifth borrowed Litas in 2010[43].

Social insurance deficit reduction is hindered by the Supreme Court’s decision that benefit reductions due to economic recessions ought to be temporary (limited to the duration of the recession) and “fairly compensated” once the recession is over. In effect, this dooms the public pensions system by committing it to ever-growing indebtedness without giving it a chance to return the debts. Politicians become less likely to reduce pensions during recession, because pensions will have to be restored and compensated in any case, and the source for compensation (given the restoration of pensions to the previous level) is unclear. This reinforces the unattractiveness of pension reductions, which is undesirable due to political implications (since retirees tend to be more active voters, compared to younger people) as well as judicial ones (retirees take the state to court over pension reductions, challenging the decision’s constitutionality).

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[41] Imandra Nekrošiūtė – Daukšienė, „Sodros skėtis“ (“The Social Security Umbrella”), http://www.sodra.lt/client/e-book-1.html [accessed August 19, 2012]

[42] See Laws on the Indicators of the State Social Insurance Fund Budgets, Seimas of the Republic of Lithuania, http://www3.lrs.lt/pls/inter/w2008_home.home?p_kalb_id=2 [accessed August 19, 2012]

[43] Ibid.

Dangers of financial strains on the public pension system were recognized by politicians in the late 1990s, and a II pension pillar was introduced in 2003. Participation in the funded private pension scheme was voluntary, whereby a part of old-age social insurance contributions was transferred to employees' personal accounts in pension funds. The law-mandated savings rate started out as 2.5 percent of individual's income in 2004 and by 2007, it had reached 5.5 percent[44]. When politicians urgently explored means to reduce the state social security fund deficit in late 2008, transfers into personal savings account were labeled as "spending of the State Social Insurance Fund" – even though the fund was just an intermediary – and the savings rate was cut first to 3 percent, then to 2 percent (as of 1 July, 2009) and later to 1.5 percent (as of 1 January, 2012). The cut in the savings rate barely contributed to the state fund's deficit reduction, yet it reversed a much-needed pension reform and will mean that the losses to future retirees will run in billions of euros. A long-term solution, which was set to lessen the public pension scheme's obligations, has been sacrificed for an illusion of a short-term solution, which had immediately proven its futility but was pursued nonetheless.

Today Lithuanian old-age social insurance is already a failing system. The retirement age has been raised from 60 years for women and 62.5 for men to 65 in 2026 for both sexes, yet despite these painful measures poor demographics make the prospects of the pension system murky. According to the government's forecasts, the gross pension replacement rate in 2060 will constitute a mere 27.2 percent (in 2012, it stood at 38.2 percent)[45]. However, these forecasts rest on Eurostat's demographics projection which neglects emigration (a very painful problem for Lithuania, which has lost a tenth of its population in the past decade), while the social security fund's standing is forecast neglecting debt repayment and its servicing (interest for 2012 stood at 0.5 percent of GDP or 4 percent of the fund's spending)[46]. Taking debt repayment, debt servicing and emigration into account, the gross pension replacement rate in the next 50 years is set to fall even steeper. One should also take into account the shadow economy, where a part of employees' salary is not reported for tax purposes.

It is no surprise that despite politicians' attempts to raise trust in old-age social insurance, public distrust of the system is widespread. According to public opinion polls, only 13.7 percent of respondents believe their future social security pension will allow them to finance their needs[47].

Despite the apparent failure of old-age insurance scheme, the existence of the system is artificially prolonged avoiding any acknowledgement of its failure. Although the current government had four years to reform the system – for example, by removing its insurance aspects and leaving only the welfare function intact – the only measures it took was raising the retirement age and freefalling into debt, in addition to the already mentioned marginalization of the second pension pillar. Politicians falsely maintain that the only problem of old-age social insurance is a lack of revenues,

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44 Law on Pension System Reform, Seimas of the Republic of Lithuania, http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=216021&p_query=&p_tr2=2 [accessed August 19, 2012]

45 Main social indicators, State Social Insurance Fund Board of the Republic of Lithuania, http://www.sodra.lt/index.php?cid=284 [accessed August 19, 2012]

46 Laws on 2012 Indicators of the State Social Insurance Fund Budget, Seimas of the Republic of Lithuania, http://www3.lrs.lt/pls/inter3/dokpaieska.showdoc_l?p_id=415505&p_query=&p_tr2=2 [accessed August 19, 2012]

47 Omnibus research by "Spinter tyrimai", performed in June 15 – 22, 2012 for the Lithuanian Free Market Institute.

as they turn a blind eye on the ethical problems such as reduced thrift and increased reliance on the state rather than one's own family and communities. If the system will not be exited soon, its eventual default may leave its participants (especially those close to retirement) unprepared, and a sudden adaptation to the new conditions will be financially and morally painful.

3.3: The case of Georgia

When an exit from the system is welcome and necessary, but not enough

Georgia is often presented as a country that has successfully exited its old-age social insurance system. The Georgian public pension scheme had been reformed a number of times since the fall of the Soviet Union, first in 1995, when differentiated pensions were replaced with flat payments[48]. However, the system was still suffering from numerous problems such as falling revenues due to economic recessions and tax evasion, and bad demographics.

In 2003, parliament passed bills to introduce the World Bank's proposal of a multi-tiered pension system as of 2004[49]. Social insurance pensions were to be made up of two parts, a minimal base (flat rate) part and an insurance part, dependent on previous earnings and employment history. When a new government formed in the aftermath of the Rose revolution, it first postponed and later rejected the pension reform bills. The liberal-minded government then moved on to abolish the state social security contributions, funding flat rate pensions from general tax revenues and transferring them to the state budget.

The reform made after 2005 was welcome and necessary, but further changes have not been made timely. Several options have been discussed. The government has refused proposals to introduce mandatory savings schemes, citing their unattractiveness in an inflationary environment (it was also unwilling to guarantee a certain level of savings and in true liberal fashion, sought to abstain from introducing mandatory solutions to individual problems)[50]. The absence of monetary reform results in inflation, while tax schemes that would make the transition to private savings attractive and feasible have not been introduced. As a result, voluntary pension savings are minor and there are no viable financial alternatives to the state system[51].

Public pensions as almost the sole old-age provision leaves the system extremely vulnerable to political decisions. Since the benefit levels are mandated by the state, recent history has shown that it is open to pressure from the retirees and may start restoring the traditional pension system. Originally, pensions were set to increase only to those retirees who qualified as extremely poor, yet following social unrest in late 2007 pensions were raised for all retirees. In the following years, pensions were increased amid economic growth and demands for better benefits, yet they are still

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[48] Alexi Gugushvili, "Political Economy of Old-Age Pension Reforms in Georgia," Caucasian Review of International Affairs, Vol. 3(4), Autumn 2009, CRIA, p. 376.

[49] Ibid., p. 379.

[50] Ibid., p. 382.

[51] Jeremy Gadbury and Lotte Schou-Zibell, „Pensions and Pension Reform in Georgia," ADB Central and West Asia Working Paper, No. 1, September 2011, p. 4, 13, http://www.adb.org/sites/default/files/pub/2011/cwrd-wp01.pdf [accessed August 18, 2012]

below the official subsistence level, so that the elderly have to depend on social assistance and intergenerational family support[52]. The pension system continues to attract many populist requests and "solutions".

The current system of old-age provision is also not shielded from negative demographic processes, thus increasing the strain on the state budget (demographics affect pension systems regardless of the fact whether they are financed from a separate fund or from the state budget).

Thus, the public pension system in Georgia has not been exited in the true sense of the word – it has not been abolished, and it can still fail. The government concedes that private savings are not a real option in an inflationary environment. Reliance on the state is not removed, and people may continue to hope that politicians will demonstrate their generosity by increasing pensions, as has already happened, while some may demand an introduction of a "European style social insurance system", which has also been happening. The case of Georgia serves to show that a genuine exit is very difficult to implement by political means, and perhaps the only way for it opens when the system collapses upon itself, and is not being saved by various measures.

3.4 Prolonging the existence of failing systems

The existence of failing old-age social insurance systems may be prolonged by a menu of measures that can be divided into those that increase revenues, or lower spending. However, each of those measures has its negative consequences.

Revenue raising measures:

- *Raising the rates of social insurance contributions*

  Most EU member states are already suffering from a heavy tax burden on labor, so any further increases in the social insurance contributions rates would lower the employees' income, increase unemployment, and reduce the competitiveness of those states. Raising social insurance contributions rate would reduce economic growth and boost incentives for tax evasion.

- *Raising the retirement age*

  This measure has been proposed by various international organizations, such as OECD, and already implemented in many EU member states[53]. Since raising the retirement age increases the amount of contributions a worker pays into the public pension scheme over his working life, it is tantamount to a backdoor increase of social insurance contributions rate.

  Moreover, this measure may not bring about the expected results as the statutory pension age differs from and is usually higher than the average age of labor-market exit (due to

[52] Ibid., p. 4.

[53] „Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011. P. 136. http://dx.doi.org/10.1787/pension_glance-2011-en [accessed August 15, 2012]

earlier retirement options). Early retirement is particularly widespread in Austria, Belgium, Finland, the Netherlands, Poland, and Spain, where men retire on average 3-6 years earlier than the statutory pension age[54].

Country	Men		Women	
	Statutory pension age	Average effective age of labor-market exit	Statutory pension age	Average effective age of labor-market exit
Austria	65	58.9	60	57.5
Belgium	65	59.1	65	59.1
Denmark	65	64.4	65	61.9
Finland	65	61.8	65	61.4
Germany	65	61.8	65	60.5
Greece	65	61.9	60	59.6
Hungary	62	60	62	58.9
Ireland	65	63.3	65	63.7
Italy	65	61.1	60	58.7
Netherlands	65	62.1	65	62.6
Poland	65	61.7	60	58.5
Slovak Republic	62	59.9	60	56.2
Spain	65	61.8	65	63.4

Source: Pensions at a Glance 2011: Retirement-income Systems in OECD and G20 Countries", OECD Publishing, 2011.

- *Bringing in more people into the pension scheme*

  Although attractive in the short term, this measure only increases the number of future benefit recipients, adding to public pension systems' sustainability problems in the long run. These systems are set to experience severe financial strains due to the rising number of retirees, so deliberately increasing their number is not a smart measure.

- *Levying social insurance contributions on presently exempt income*

  Once again, this measure would increase an already heavy tax burden and levy the burden of financing social security on income which is not considered as wage (for example, income from capital). This option may reduce economic growth and create incentives for tax evasion.

- *Direct budget transfers*

  This measure transfers the burden of social insurance onto all the taxpayers, including retirees. It only masks the problems experienced by public pension schemes (which explains the attractiveness of this measure to politicians) and undermines the reason for keeping pay-

[54] Ibid.

as-you-go schemes separate from the state budget. Since the state budget is limited in resources, spending on other functions would have to be cut (which may be a desirable consequence, although a combination of lower spending and lower tax burden would be more desirable).

- *Increasing the money supply*

  Since the retirees are the prime victims of inflation, this measure creates a never-ending circle. Also, this measure discourages savings and distorts business investment decisions, according to the Austrian business cycle theory.

- *Borrowing*

  This measure transfers the burden of social insurance onto future generations, without indicating any possible sources for returning the debt and therefore committing the future generations to solving problems of pay-as-you-go schemes that should be solved today. Paying higher pensions than the system can afford and passing on the bill to those whose voice cannot be politically heard today is unfair and unjust. Moreover, financing pensions through debt is an unsustainable measure and one that has harmful effects to the whole economy, as already experienced during the ongoing sovereign debt crisis.

Expenditure lowering measures:

- *Raising the retirement age*

  As already noted, this option forces people to continue working just to keep the public pension system intact and may be ineffective if people choose earlier retirement plans.

- *Decreasing the overall pensions or maximum caps on them*

  Decreasing the pensions may be prohibited by laws or by Supreme Court decisions, so may be very difficult to implement. Lowering the maximum caps on pensions would increase their progressivity, if there are no corresponding caps on contributions.

- *Changing indexation rules or any other technical changes*

  These measures are the most opaque. Although easier to implement than decreasing the pensions, their continuous implementation would create a situation of unpredictability, thereby further reducing the participants' confidence in the system.

All of these options are undesirable from the point of view of its participants, especially if they are set to receive less in benefits than they had paid into the system over their working lives. If these measures are implemented in cases where individuals are very dependent on the public pension systems, that is, where II and/or III pension pillars are non-existent or minor in proportion, then the negative consequences are even more felt by the retirees.

Raising the retirement age or changing the benefit calculation formula may keep the system afloat for a while, but it will not achieve the overall goal for the system's existence, which is providing a stable, adequate and predictable source of income in old age. It is a paradox that in order to save the system which aims to provide security in old-age, politicians end up eliminating this security, as people are less sure than ever before when they will retire, how much they will pay in over their working lives and how much they will receive. Thus, saving the old-age social insurance system (the means) comes at a cost of sacrificing the people and their security (the end).

Balancing the budget measure

At the first look, this measure could be categorized as a benefit reduction and, therefore, an expenditure lowering measure. However, it is more essential than that and is therefore presented here as a separate solution.

A "balanced budget" measure would imply the return to the pay-as-you-go principle in its true sense. Instead of being decided by politicians, indexed to inflation or average salary growth, the size of pensions would have to be indexed to revenues from the current old-age social insurance contributions. Under this rule, spending would have to be equal to revenues – hence the term "balanced budget". Pension benefits would be revised quarterly, semi-annually or annually, whereby a rising number of retirees or falling social insurance contributions would imply lower pensions, and vice versa.

This is the only way to ensure long-term sustainability of the pay-as-you-go pension schemes. In the absence of this rule, governments that pursue piecemeal changes such as raising the retirement age or changing indexation rules are doomed to go back to the "saving the pension system" issue every few years. Having adopted the "balanced budget" rule, politicians will free themselves from recurring crises of pay-as-you-go systems and the necessity to deal with them. However, this rule will not seem attractive to the retirees since it will imply that pensions will reflect the current economic situation and the ratio between the contributors and beneficiaries, and not the former contributions of the retirees or their expectations.

A sustainable and balanced pay-as-you-go system will liberate the politicians and the system's participants from an illusion that the state can provide an adequate source of income in old age despite economic and demographic realities. Moreover, it may force politicians and market participants to make a transition to a new, sounder system with a diminished role of the state.

The adoption of the "balanced budget" rule may be treated as a "managed failure" of old-age social insurance schemes. It may be the only way out that would not be marked by massive hysteria and despair. But to achieve this, it also has to be a shrinking system (in terms of the number of its participants). The easiest way would be to allow new and recent labor-market participants to be excluded from the pension scheme so as to provide them with resources to prepare for their old age themselves. The topic of exiting public pension systems is a fascinating one, yet beyond the scope of this paper, so it has to be left for future research.

Conclusion

State involvement in providing the function of old-age social security has been expanding over the past century. What started out as a relatively small scheme with low contribution rates and a late retirement age has been transformed into an expensive system with financially deteriorating perspectives in the coming future.

In addition to being unsustainable in the long term, given the demographic projections, old-age social insurance also suffers from other flaws. The instrument of insurance is inappropriate for retirement; more appropriate mechanism would be savings and international family support, communities, charities, etc. If individuals had the possibility to opt out of the public pension schemes and instead invested their money, they would have enjoyed higher replacement rates. The disincentive for people to save, which is created by old-age social insurance, not only leaves people financially worse off but also contributes to social contraposition and the destruction of the virtue of thrift.

As the state pension systems appropriated the role of providing old-age security, these functions were taken away from families, communities and charities, thereby undermining their role and increasing people's reliance on the state. These systems have reduced personal liberty, as the state make a blueprint of people's working lives and when they can retire. Pensioners become hostages of the state. Public pension schemes have created an irresolvable conflict among generations, whereby the expectations of the current retirees to increase pensions can be satisfied only at the expense of the current and/or future workers, making long-term oriented reforms a mission impossible.

The pension issue is a sensitive topic in all of Europe, where people's sense of security about their retirement is undermined by the pension system's poor long-term prospects. Thus, two criteria of a failing system – lack of security and anticipation of negative future trends – are observed in most of the EU countries. A number of countries also satisfy the third criteria of chronically unbalanced social insurance fund budgets, where pay-as-you-go pension systems have been gradually transformed into pay-as-you-borrow.

The existence of failing systems is being prolonged by various measures which increase revenues or lower spending (such as raising the retirement age, the rate of contributions, etc.), yet by trying to save the pension system, which is the means, the decision-makers end up sacrificing old-age security, which is the end goal of the system.

The experience of three countries – the USSR, Lithuania and Georgia – shows that failure is possible economically and demographically, but almost not – politically. Since the failure of public pension schemes has already begun in most of the EU member states, it would be wise to undertake a "managed failure" approach by introducing the "balanced budget" rule and making it a shrinking system. Such a move would allow people to pursue financial and non-financial alternatives to state pensions.

If a "managed failure" is not implemented and politicians continue to maintain that technical improvements can save the system, people will not be ready for the pension system failure once it occurs. The experience of the USSR warns that this would lead to a sudden and dramatic change in conditions of the elderly, bringing about poverty and chronic insecurity.

For the "managed failure" approach to work, one generation has to concede and make a sacrifice by paying for the pensions of the current retirees and for their own. In the absence of such a consent and solidarity, the generation to make the sacrifice would emerge spontaneously, and the process of an unexpected old-age social insurance failure would be much more painful.

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