

# Grounds for the Selection of Funding Models for a Modern Social Security System

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**Abstract**—This article defines the major requirements that the selection of a funding model for a modern social security system should satisfy. The objective of the study is to reveal the major principles and rules that should underlie the development of the funding system. A series of conclusions have been formulated, that might be of interest for the future improvement of the organization and management of the social security system

**Index Terms**—funding models, social security system

## I. INTRODUCTION

In their development the individual states come to a stage from which onwards their further existence becomes impossible without an adequate social security system. This stage speaks of an achieved level of social development and it is the outcome of the people's struggle for economic and social rights and freedoms.

Germany, under the reign of Chancellor Otto von Bismarck could be viewed as the initiator for development of the social security model within the legal framework of the state. Since then, the world has seen the creation and evolution of social security systems in almost all states, each one having specific characteristics of its own. Furthermore, decisions are already being taken for establishment of single social security systems within certain international structures, such as the European Economic Community.

If these systems are to be sustainable however, they must meet certain requirements. Their sustainability depends above all on their financing. This is what has motivated us to seek and define the main requirements that the funding models for a modern social security system should satisfy. Every model, in our opinion, should be integrated into two processes running in parallel. The first process relates to the securing of financial resources for the system, and the second one – to the spending of these resources.

## II. REQUIREMENTS FOR THE SELECTION OF FUNDING MODELS

To make the social security system efficient in terms of securing financial resources, it should satisfy the following requirements:

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### A. The First Requirement

It should be developed in full conformity with the reached and expected level of economic development. The social security system is not an abstract notion and it may develop only as far as the capacities of the state to finance it allow. This means that its parameters in a specific moment and in the future should be well known. A practical formula for meeting this requirement and creating a sustainable system is to bind the parameters of its development to the size of the gross domestic product. This will lend the necessary concrete character to the development of the social security system. Other summary indicators could be also applied, provided that they are generally accepted and developed on the basis of the same methodology. Such indicators could be: average per capita income, average per household income, etc. This also allows making analysis and comparisons between the systems of different states and between the systems in different periods.

There exists no direct link between the amount of funds foreseen for financing the system of social security and the level at which it will be built. The decision on the amount of contributions and the overall amount of funds, as well as the level at which the funds of the social security system will be managed is made by the political elite, responsible for the development of the system.

### B. The Second Requirement

The funding of the system should be compulsory. For the social security system to sustain, it is necessary to have the taxes (contributions) regularly paid. The voluntary scheme simply does not work, because it is not in a position to generate sufficient resources for financing the system. Thus, by making the system compulsory, the individuals may not autonomously make the decision alone when and how much to contribute to the system, which would certainly doom it to collapse.

### C. The Third Requirement

The system is universal, which is generally determined by the requirement for compulsory contribution to its funding. An exception to the rule of universality will be only the beneficiaries of the system who, for reasons beyond their control, are not capable of earning an income, or sufficient income for their own and their families' life and reproduction. Such are basically the beneficiaries of the social assistance network. They are subject to certain property and income tests

and may become recipients of the system only if they do not satisfy the tests. This is how the compulsory protection of the families is achieved.

#### *D. The Fourth Requirement*

The financing sources of the social security system should be identified in advance. Possible options could be the contributions and personal income taxes, corporate income taxes, consumption taxes, etc. Financing could be also provided at the expense of the general tax proceeds in the central and local budgets. The selection of one or more specific financing sources also aims to bind these sources to a greater extent to the earmarked use of the funds. This is not always appropriate, because a crisis or recession might create conditions for underfunding of the social security system.

#### *E. The Fifth Requirement*

The financing of the system must be regular, thus securing chronic proceeds to the system. For this end the system should have several funding sources, or else should be financed through the general tax and contribution proceeds.

#### *F. The Sixth Requirement*

The financing of the social security system is at the expense of the current generation. Any borrowing should be only of short-term nature and used as an exception to the rule. With other conditions being equal, debt financing will doom the future generations to lack of security.

### III. REQUIREMENTS REGARDING THE EXPENDITURE OF FUNDS

The spending of funds should meet the following requirements:

#### *A. The First Requirement*

The first requirement concerns the scope of the social security system. Should it cover the whole population or only parts of it? Should it apply only to those working or to all? In short, should it be universal, with 100% coverage of the population? Any attempt of exclusion of parts of the population will result in depriving parts of the society from social security. This will deprive the system of one of its major characteristics – of being a social system, which implies securing all members of the society, and it will oppose some parts of the population to others. This is the reason why the social security system should be universal, with 100% coverage of the population.

#### *B. The Second Requirement*

The second requirement concerns the proportionality of funds contributed to the system and benefits received by the insured persons. In order to maintain the interest of the people in the existence and development of the social security system, the benefits received from it, should be commensurate with the contributions made, not with the needs of the insured persons. This means to bind the salaries and other income received and contributions to the system made on the basis of income with the benefits (payments) received from it. Or the

payments (benefits) should be made according to the acquired rights. If this is not the case, the insured persons will be interested in evading the payments to the social security system. This is how this system differs from any other system financed through donations or built on the basis of charitable activities. Such systems do not provide security to the insured persons, because the proceeds there have incidental nature and the payments to insured persons therefore cannot be planned accurately and in advance.

#### *C. The Third Requirement*

This requirement concerns the level of autonomy of the social security system. More specifically, whether it should be financed from own revenues or should rely on the general budget revenues. If relying on the budget revenues, it will be dependent on frequent political decisions. If it is maintained through contributions determined in advance (target taxes) and from income of their investing, the system will be relatively autonomous. Such a system would have the following advantages:

1) *As an autonomous system it may avail only of its own funds and may not rely on any other funds.* At the first glance this fact might be seen as a drawback, mainly because of the lack of flexibility in cases when it is necessary to attract considerable additional resources. This drawback, however, pales before the existing independence in making decisions for payments according to the funds available in the system. Should the system be part of the budget, it would always depend on the political decisions concerning financing priorities. In pre-election times such a system is usually financed with priority, and afterwards other systems are usually given priority.

2) *As an autonomous system it makes the insured persons' behaviour more disciplined in two directions.* Regarding the contributions, the insured persons realize that every change in their size exerts an impact on the amount of revenue of the system. Regarding the payments from the system, they realize that payments can be made only in accordance with available resources. Insured persons will therefore be inclined to increase their contributions to the system only if they are confident that they will get higher benefits from it. This motivates them to track the conformity of contributions to the size of payments from the system. In the same time, they will refrain from supporting excessive liberalism in defining the benefits (payments) and will be motivated to support enhancement of the control over payments. All this makes their behaviour more disciplined and forms a balanced and enhanced feeling of responsibility with respect to both paying contributions to and receiving benefits from the system.

The autonomy of the system requires the forms of its funding to be accurately defined. These may be insurance contributions in the form of target taxes or income generated by investing the contributions. Since the system is built for a relatively long period of time, the contributions must be determined in advance and must stay relatively constant. They are paid by the employers, employees and self-employed

persons. Contributions made by employers and employees may be equal, or in a different proportion, the ones made by self-employed persons must be equal to the total sum of the contribution paid by the employer and employee. The relative independence of the financing of the social security system does not exclude a specific role of the state in its financing. In any case however, it should be minimal and should be known in advance.

#### *D. The Fourth Requirement*

The fourth requirement concerns the boundaries of reallocation within the system of social security. These boundaries should be defined in a way that will guarantee the permanent interest of all working people in paying their contributions. Highly paid workers are interested to have no reallocation in the system, so that they can get proportionately to what they have contributed to the system. They, the wealthy people at large, are the ones who largely finance social insurance through the taxes. This means that they will be always opposed to the reallocation in the system. The low income workers are interested in receiving more than what they have contributed to the system and if this interest is not satisfied they will not be motivated to pay contributions, because as pensioners they will also have to live with the low living standards they have while actively employed.

Besides, the social insurance schemes make transfers from the economically active part of the population to the part which is not active, be it temporarily or permanently. This creates problems in the eyes of the active and they realize that they cannot expect to receive as benefits the equivalent of the funds they contribute to the social security system. This poses the question – to what an extent the funds should be reallocated so that the active participants in the system should not lose their desire and incentives to work. If the social security system is not fair, it will create contradictions between the active and inactive parts of the society and will not be able to ensure decent living standards for any of them. This contradiction must be resolved, which may be achieved by applying a formula for reallocation of income. It should not oppose highly paid with lowly paid, active with the persons unable to work. Apart from the reallocation formula, the highly paid should be provided opportunities for additional savings, with a definite tax privilege for them. What they lose from the reallocation in the pay-as-you-go scheme may be won from the tax exemptions when saving in the private account scheme. What is typical for it is the proportionality and dependence between contributions made and benefits received.

Thus, from the viewpoint of the boundaries of reallocation, it follows that:

1) *Reallocation is admissible, but within certain boundaries with the pay-as-you-go scheme.* The boundaries are defined by the available interest in paying contributions, regardless of whether they are high or low.

2) *Reallocation by definition is not admissible with the private accounts scheme.* The development of this scheme

must be based on the availability of tax preferences for contributors.

#### *E. The Fifth Requirement*

The social security system must guarantee that all citizens will receive at least a minimum amount. This means that a system of social assistance should be developed and maintained in parallel with the social security system. Access to this system shall be provided to all citizens who, for reasons beyond their control, are not able to earn sufficient income for normal life and reproduction.

The main goal of the social security system is to guarantee to the individual a minimum base standard of living and reproduction when there are no possibilities for earning one's living from labour income or assets. Different individuals however have different needs, therefore the level of this standard should also vary. The question is rather whether such differences should be recognized or the minimum standard should be equal for all. The beneficiaries of the social security system may have participated in the system before, but it is also possible that they have never been involved – e.g. persons disabled by birth. Then, should there be a distinction between the two groups on the basis of some kind of a link with the past living standard and labour record, or should an equal minimum standard be guaranteed to all? The answer to this question should be sought in the existing social security system. If it generates payment of contributions by insured persons proportionate to their income, the answer will be positive. Otherwise, the insurance system will create incentives for evasion of paying contributions. But if the contributions paid are not differentiated according to the income of the insured person, then the answer will be negative. In UK for example the contributions are not differentiated, all people are insured in accordance with a minimum standard accepted by the society, which is guaranteed to all. In other states the contributions are differentiated and the minimum standard is therefore bound to the past income. We fully agree with the view that where the rate of payments received from the social security system gets close to the level of previous income, the incentives to work are significantly weakened, [1] particularly in the event of unemployment, as well as in case of payment of compensations for losing income due to a disease.

The main conclusion to be drawn is that for the purposes of social security it is necessary to develop a test for the funds needed for normal living standards and to determine the amount below which the individual and families income should not fall. Such a minimum living standard should be financed by the government, i.e. from the general tax proceeds. The ground for this is the fact that payments from the social assistance system are not based on earned (acquired) rights, unlike the payments under the social security system. The guiding principle underlying the social assistance system is the lack of assets or incapability to earn an income, which principle is not applied in the social security system.

This requirement complements the system of social

security. Thus the system functioning under the pay-as-you-go or private accounts scheme is complemented with a social assistance system.

#### *F. The Sixth Requirement*

The social security system must be stable over time. It is a system established and applied for a relatively long period of time. Therefore a stable and long-term fiscal policy of the government is needed, if the social security is to have a long time horizon.

To be stable, a social security system must meet the following requirements:

1) *The proceeds to the social security system must be adjusted to the dynamics of the remunerations of the employees and self-employed persons.* This is how the purchasing power of the benefits received by its beneficiaries will be retained;

2) *The proceeds to and payments from the social security system must be protected against inflation.* For this purpose the increase of the funds in the system must compensate for the inflation. The funds in the social security system must be therefore periodically adjusted with the consumer price index and the basic values of living allowance. Both of these are dynamic and therefore current reassessments are needed. The government could also play an active role, because by definition it is supposed to maintain the purchasing power of the monetary unit.

3) *The funds accumulated when working for one employer should be easily transferred to another employer without any additional costs for the insured person.* This will create opportunities for free movement of insured persons from employer to another and will comply with the requirement for mobility of the labour force.

#### IV. CONCLUSION

This short analysis of the grounds for the choice of a social security model shows that the choice is not an easy one, because:

- 1) The chosen model should not be frequently changed, mainly because it exists for a relatively very long period of time;
- 2) It is within this model that both the social security system should be built, according to the pay-as-you-go scheme and the private accounts scheme, and the social assistance system;
- 3) The system to be built must satisfy the above mentioned requirements, which need to be developed and implemented in their unity.
- 4) The social security system is an open and dynamic system, subject to permanent improvements, that would not infringe upon its coherent nature.

#### REFERENCES

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