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DISADVANTAGES.

INTRODUCTION

insurance in 1911 and greatly expanded it in 1948. After 1920, social insurance on a compulsory basis was rapidly adopted throughout Europe a

The first compulsory social insurance programs on a national scale were established in [Germany](https://www.britannica.com/place/Germany) under Chancellor [Otto von Bismarck:](https://www.britannica.com/biography/Otto-von-Bismarck) [health insurance](https://www.britannica.com/topic/health-insurance) in 1883, [workmen’s compensation](https://www.britannica.com/topic/workers-compensation) in 1884, and old-age and invalidity pensions in 1889. Germany’s example was soon followed by Austria and Hungary. The issue of social insurance elsewhere in Europe was dominated by a debate between those who preferred voluntary, subsidized insurance and those who advocated a compulsory system. Great [Britain](https://www.britannica.com/place/United-Kingdom) adopted national compulsory health nd in the [Western Hemisphere](https://www.britannica.com/place/Western-Hemisphere). The [United States](https://www.britannica.com/place/United-States) lagged behind Europe; until 1935, with the passage of the [Social Security Act](https://www.britannica.com/topic/Social-Security-Act-United-States-1935), government insurance programs were exclusively the responsibility of state or local governments. The three federal insurance programs adopted in the United States since 1935 provide retirement and survivor benefits, health care for persons over 65, and insurance against disability.

Social insurance programs differ from private insurance in several ways. Contributions are normally compulsory and may be made by the insured’s employer and the state, as well as by the insured himself. Also, benefits are not as strictly tied to contributions as in private insurance. For example, to make the programs serve certain social purposes, some groups are included among beneficiaries even though they have not contributed for the required periods of time. Benefits may be raised in response to increases in the [cost of living](https://www.britannica.com/topic/cost-of-living), again weakening the link between contributions and benefits.

MAIN PARTS OF THE PROJECT

The following was delivered by the author to the High Level American Meeting of Experts on The Challenges of Social Reform and New Administrative and Financial Management Techniques. The meeting, which took place September 5-7, 1994, in Mar de1 Plata, Argentina, was sponsored by the International Social Security Association at the invitation of the Argentine Secretariat for Social Security in collaboration with the ISSA Member Organizations of that country. \* Deputy Commissioner of the Social Security Administration. The views expressed in this article are the author’s own and do not necessarily reflect those of the U.S. Government or the Social Security Administration. Throughout the world, societies are reexamining, reforming, and restructuring their social welfare systems. New ways are being sought to manage and finance these systems, and new approaches are being developed that alter the relative roles of government, private business, and individuals. Not surprisingly, this activity has triggered spirited debate about the relative merits of the various ways of structuring social welfare systems in general and social security programs in particular. The current changes respond to a variety of forces. First, many societies are adjusting their institutions to reflect changes in social philosophies about the relative responsibilities of government and the individual. These philosophical changes are especially dramatic in China, the former socialist countries of Eastern Europe, and the former Soviet Union; but they are also occurring in what has traditionally been thought of as the capitalist West. Second, some societies are struggling to adjust to the rising costs associated with aging populations, a problem particularly acute in the OECD countries of Asia, Europe, and North America. Third, some countries are adjusting their social institutions to reflect new development strategies, a change particularly important in those countries in the Americas that seek economic growth through greater economic integration. And, finally, in many parts of the world, social welfare reform is motivated by the need to adjust the costs of welfare systems to economies that are no longer growing as fast as they did in the first three or four decades after World War II. Whatever their motivation, these changes are being discussed and debated widely. And the current discussions seem in several ways to reflect a new level of sophistication about the complexities of social welfare policy. One example of this is the recognition of the important relationships between social welfare systems and the economy in which they exist. The state of its economy will often influence a society’s willingness to support its social welfare system. Healthier economies facilitate more generous social welfare systems, while economic difficulties frequently lead, sooner or later, to retrenchments. At the same time, the size and structure .

CAUSUSES / EFFECTS

social welfare systems can themselves influence the pace and rate of growth of economic activity. Social welfare systems that inadvertently discourage work activity --or encourage a shift from the formal sector to the informal sector---can reduce the aggregate amount of income available for distribution among society’s Another indication of the increased sophistication of current debates is the members. Similarly. a system which realization that social welfare policies are developed to achieve a variety of different and often competing social objecdiscourages domestic savings can have tives. These social objectives include the effective protection of the population the effect of slowing economic growth, from various economic risks, the promotion of increased economic activity. the while. given the proper environment, one redistribution of economic resources, the facilitation of the smooth operation of a that increases domestic savings could free labor market, and the efficient operation of social institutions. No single enhance economic growth. policy will be best able to achieve all of these various objectives, so the choices actually made will necessarily reflect decisions, either implicit or explicit. about the relative importance of the various ob.jectives. Since assessments of the relative importance of competing social objectives will vary from country to country and from time to time, social welfare policies appropriate in one time and place need not necessarily be appropriate in another. Moreover, the degree to which a particular approach to the social welfare system does, in fBct, advance a particular objective will also vary from place to place and from time to time, Put simply, the policy that is most effective in achieving a given objective in Argentina may not achieve that objective in the United States, and the people of the United States tnay wish to pursue a particular objective with their social welfare system that is not as important to the people of Argentina. No particular structure is the most appropriate one at all times and in all societies. Philosophical considerations will always he important to social welfare decisions. But careful and objective analyses of the many implications of each possible social welfare option are also very important. That conclusion emerged from a recent expert meeting hosted by the International Labor Office (ILO) in Mexico City. The experts noted that a key element of social security My purpose in developing this paper is to contribute to the rational debate and reform was: ” discourse referred to in the IL0 communique by developing further some of the . ..careful and rigorous exthoughts 1 have just outlined. In particuploration of all of the options-in a parlar. 1 wish to suggest a framework for thinking about the various goals, objecticular country’s context--considering tives, and structures and to offer some suggestions about the relative advantages and disadvantages of different ap- [such objectives as] administrative ef’iiproaches to achieving the various goals. ciency, cost containment, breadth of coverage. and transparency . . .” 1 seek to further the dialogue about these topics by producing a document that will provoke others to think and react. Some may suggest the addition of important social objectives that they believe I have overlooked. Others may suggest additional ways in w-hich particular social and economic structures may help achieve a given social objective. All such suggestions and elaborations will help us to increase our understanding of these important issues. Finally, in order to simplify (somewhat) an already complicated discussion, my analysis focuses almost exclusiveiq on programs that supply cash benefits; indeed the implicit focus is almost exclusively on pension programs. Much of the discussion contained here would be appropriate for other major social welfare programs, such as those concerned with acute health care services. But health programs also introduce other issues that go beyond the scope of this paper, such as provider reactions to different institutional arrangements. The Competing Approaches Most advanced societies rely on some combination of six approaches (or close variations) to structuring income support programs.’ I begin by describing briefly each in turn. Social Insurance Social insurance is the largest single element in and the foundation for the social welfare system of most countries. It grew out of voluntary insurance arrangements of the medieval European craft guilds, was institutionalized by European governments in the late 19th and early 20th centuries, and soon spread from there to the Americas. Since social insurance is the foundation of so many social welfare systems, it seems the reasonable starting place for this discussion. Although details vary from one country to another, social insurance programs throughout the world share certain characteristics. The interaction of these characteristics gives social insurance a unique set of attributes, and the differences between social insurance and other social welfare approaches can be traced primarily to differences in the mix of these characteristics. Some expert commentators cite seven characteristics as essential elements of social insurance. 1. Compulsory participation. Most people participating in social insurance programs do so as a result of a legal requirement. In some programs, a small minority may be allowed to choose whether to participate.” 2. Government sponsorship (and regulation). Governments create and supervise social insurance programs, but do not necessarily manage them. The programs may actually be operated entirely by private sector institutions (for example, the German health and pension systems); by a combination of public agencies and private contractors (the model used for Medicare. the health insurance program for the aged in the United States); or directly by a public sector agency (the model used by AngloSaxon countries for operating their public pension programs). Where the private sector runs these programs, however, operations are tightly supervised by the public sector.

MEASSURES/ SUGGESTIONS

Contributory finance. Mostsometimes virtually all-of the resources needed to run the program are raised through explicit contributions collected from the employer or from both the employer and the employee. A worker’s contribution is usually a fixed percentage of his or her wage or income.3 4. Eligibility derived from contributions. Eligibility for benefits under social insurance programs rests, in part, on current or previous contributions by the individual and/or the individual’s employer. 5. Benefits prescribed in law. Uniform sets of entitling events and schedules of benefits are developed, announced, and applied to all participants. Administrators of the program have little discretion in determining who should get benefits or how much they should get. 6. Benefits not directly related to contributions. Social insurance programs usually redistribute toward lower-wage workers or toward persons engaged in activities deemed to be socially desirable. Perhaps the most dramatic redistribution occurs in health insurance and flat pension benefit programs, in which higherwage workers contribute more than lower-wage workers but everyone receives the same benefits. In most public pension programs, benefits are scaled to previous earnings. Even then, the lowerwage worker tends to get back proportionately more than the higher-wage worker, sometimes much more. Many social insurance schemes also subsidize benefits for nonworking members of the families of workers, students, members of the armed forces, homemakers caring for children, and others whose activities are deemed to be socially beneficial. 7. Separate accounting and explicit long-range financing plan. Social insurance contributions are usually earmarked to pay the social insurance benefits. Governments typically keep separate accounts that permit comparisons of program receipts and program benefits, though they may also present financial information that integrates the social insurance programs with the other government operations. Governments also typically develop an explicit plan showing that projected revenues are sufficient to finance projected expenditures for several years into the future (or, if revenues are not sufficient, explaining how the government proposes to balance projected receipts and scheduled benefits). Some of these characteristics are necessarily linked. For example, if a social insurance program is to provide adequate support to lower-income households, it must redistribute from higher-income participants to lower-income participants (characteristic 6). But a program that redistributes explicitly and significantly must also be compulsory (characteristic 1) or else higher-income people will choose not to participate. And a program that is compulsory must be sponsored by the government (characteristic 2). Other characteristics combine to give social insurance some of its key attributes. For example, advocates of the social insurance approach argue that it delivers benefits in a way that promotes a sense of individual worth and dignity among recipients. They argue that this result flows from the fact that social insurance is financed by explicit contributions (characteristic 3) and that entitlement to benefits derives from the payment of these contributions (characteristic 4). The underlying philosophy of the program, then, is that beneficiaries have earned the right to receive their benefits by paying in their contributions. The linkage between contributions and benefits can also serve as an incentive for compliance with social security taxes, although the strength of this incentive will obviously depend on how closely benefit amounts are linked to prior contributions. Some advocates of the social insurance approach also argue that it introduces fiscal discipline into the political process. Beneficiaries of social welfare programs (whether pensioners or health care providers) naturally favor raising the level of benefits paid under the program. Because of the combination of contributory finance (characteristic 3) and the separate accounting of program receipts and benefits (characteristic 7), however, program expansions are likely to require an increase in contribution rates. Thus, they argue, wage earners-who will have to pay higher contributions to finance program expansions-have an incentive

CONCLUSION

I If we were speaking about social welfare policy more broadly, we would also have to consider a seventh approach, direct provision of social welfare services by the government. This is a common strategy for delivering health services, but not relevant to a discussion of pensions. 2 This list is adapted from the definition of social insurance developed by the Committee on Social Insurance Terminology of the Commission on Insurance Terminology of the American Risk and Insurance Association. This group also specifies that social insurance coverage must extend beyond government employees. See Robert J. Myers, Social Security, 3d ed., Bryn Mawr, PA: McCahan Foundation, 1985, pp. 995-996. i In some countries, such as the United States, social insurance contributions are indistinguishable from taxes since they are specified in law and collected by the taxing authority. The connection between taxes and contributions is not quite so close in some other countries. For example, each German sickness fund (technically, a private sector institution) establishes its own contribution rate and collects all social insurance contributions from its members. Also, voluntary supplemental contributions are allowed under several countries’ pension programs. 4 Social insurance developments around the world suggest that this is an argument more applicable in some political and social systems than in others. Whereas these arrangements appear to have helped assure fiscal discipline in Germany or the United States, different institutional arrangements may be required in other countries to prevent over promising. ( Social insurance also tends to offer a uniform package of benefits, with employers having the option to provide separate, supplemental programs. h As a practical matter, this may be more important for health insurance than pensions. A good case can be made for subsidizing health insurance costs for those with low current period income. It is less clear whether one would want to subsidize pension contributions for those with low current period income. Presumably in pension programs redistribution is more appropriately based on lifetime income rather than current period income. ’ For example, see Nicolas Barr, “Economic Theory and the Welfare State: A Survey and Interpretation,” Journal ofEconomic Literature, Vol. 3, No. 2, June 1992, pp. 741-803. Barr develops the following objectives of the welfare state: macro effciency, micro efficiency, economic incentives, poverty relief, protection of accustomed living standards, income smoothing, vertical equity, horizontal equity, dignity, social solidarity, intelligibility, and absence of abuse. ’ Since the major social purpose of retirement programs is to allow people to retire, these programs will necessarily produce some reduction in work effort relative to the situation that would exist in their absence; if they did not produce any reduction in work effort, they would have failed. Other things equal, however, one would want them to not discourage work effort prior to retirement or to prevent those who decide to retire from supplementing their retirement incomes, should they desire to do so. 9 Nor does the “claw back” policy apply to Canadian health insurance, which also follows the model of a universal program. ‘” See U.S. General Accounting Office, Social Security: Analysis of a Proposal to Privatize Trust Fund Reserves, Washington, DC: U.S. Government Printing Office, 1991. ” See Henry J. Aaron, “The Social Insurance Paradox,” Canadian Journal of Economics and Political Science, Vol. 32, No. 3, August 1966, pp. 371-374. I2 Experience in the United States illustrates the relative magnitudes. The annual administrative costs for the U.S. Old-Age and Survivors social insurance program average about 0.8 percent of annual benefit payments. By comparison, the administrative costs of the parallel means-tested program for the aged and disabled operated by the same agency averages about 7.6 percent of benefit payments. I3 North American health insurance illustrates the potential size of the gap between private and public sector institutions (and among public sector institutions employing different approaches). The Canadian national health insurance system follows the universal model and experiences administrative costs of just under 1 percent of total outlays. The U.S. national health insurance for the aged follows the social insurance model and employs more complicated provider payment mechanisms; its administrative costs run about 2 percent of outlays. U.S. private health insurance companies’ administrative costs average 10 to 12 percent of outlays. See U.S. General Accounting Office, Canadian Health Insurance.. Lessons from the United States. (GAOiHRD91-90, June 1991) Washington, DC: U.S. Government Printing Office, 199 I, p. 3 1, I4 For example, Henry J. .4aron, Economic Effects of Social Security, Washington, DC: The Brookings Institution, 1982; and Michael V. Leonesio, “Social Security and Older Workers,” Social Security Bulletin, Vol. 56, No. 2 (Summer) 1993, pp. 47-57. ” Presumably, the rest of the increase in pension assets is either offset by larger liabilities elsewhere in the economy or replaces asset accumulation @at would have occurred in the absence of private pensions. For example, Alicia H. Munnell, The Economics of Private Pensions, Washington, DC: The Brookings Institution, 1982. ” One can see the importance of this effect in recent reforms in German health care financing. Germany uses contributory social insurance to help finance personal health care services, and in recent years, has enacted a series of reforms that have reduced physician incomes and pharmaceutical company revenues. These reforms could be achieved even though important interest groups were being forced to absorb economic losses because they were advertised as necessary to keep worker contribution rates from rising. In other words, the political influence of those paying the contributions offset the political influence of those benefiting from the program. The same effect was illustrated in the United States in 1983, when the Congress adopted limited taxation of Social Security benefits and a higher retirement age as part of a package to restore fiscal balance