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CHAPTER 5

SOCIAL SECURITY AND EFFICIENCY

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Efficiency is defined as the capacity to achieve a result with minimum errors, efforts, resources, energy and time. For the particular case of a public policy, its efficiency would be measured by comparing the results achieved and the efforts and distortions generated for the achievement of its objectives.

The purpose of a social security regime is to guarantee that the insured will receive income after they fulfil the necessary requirements to have the right to the social security benefits. As is the norm in any governmental action, the social benefits are obtained with social costs. In the case of Social Security, the benefits enjoyed by society as a result of the amounts paid by the government to retirees and pensioners must be compared to the social costs imposed by a social security regime. Within a more macro line, the social costs or, alternatively, the loss of efficiency generated by social security, are divided into two natures: dead weight and administrative burden.

Dead weight is understood as reduction of the size of the markets and consequent loss of welfare caused to various social agents, namely, firms, workers, consumers, producers, savers and borrowers, as a result of the alterations of incentives under social security rules. In turn, administrative burden refers to the time spent by the insured to pay their contributions and receive their benefits, to the ease in obtaining and keeping the documents required by social security as well as their recovery if they are lost, to the simplicity of the rules for collection of contributions and application for benefits in view of the fact that the complexity of the rules increases the administrative burden because it involves the hiring of lawyers, accountants and specialized staff or greater time spent to comply with the obligations and to receive the social security benefits. The last factor to measure the administrative burden would be the size of the administrative apparatus needed for the operation of social security.

Social Security can change the allocation of resources and generate dead weight in three different spheres: labour market, savings decision, and allocation of investment portfolio.

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Regarding the labour market, it should be noted that most of the Brazilian Social Security collection is payroll-based. Taxes or contributions reduce the size of the market by differentiating the price that the applicant pays from the price that the provider receives, generating the dead weight. The salary cost for the firms exceeds the salaries received by the workers. There are two disincentives: firms employ less and, in principle, depending on the behaviour of manpower supply, workers would supply less work. However, most of the time it is hard to claim that the substitution of the payroll-based contribution by a value-added tax, for example, would be a desirable option. This is because public policy goals are not limited to efficiency, but are also related to equity. From the distributive point of view, replacing payroll-based contributions with value-added taxes, for example, tends to increase the regressive character of the taxes or contributions. Payroll-based contributions are generally proportional or progressive in relation to income, while indirect taxes befall lower-income people more strongly. Moreover, with simultaneous effects on distribution and allocation aspects, the difficult discussion ensues regarding which productive sector or type of firm should be burdened and which should benefit from the tax structure. Incentives given to sectors based on cheap labour and disincentives given to firms that innovate technologically deserve careful consideration. Finally, doubts emerge as to whether the dead weight generated in the goods market will not exceed that of the labour market. Finally, from the point of view of stabilization, the extent to which the substitution of incidence bases will affect total collection should be verified.

The second argument to consider in the relation between social security efficiency and the labour market would be the Laffer curve. Smaller payroll-based contribution aliquots might stimulate formalization, besides encouraging firms to employ more and the workers to work more. As a result, even if the government loses in the collection from each payer, it would gain from stimulating the expansion of the contribution base. The counter-argument is quite pragmatic: fiscal conservativeness. In principle, there is no guarantee that a reduction of the contribution aliquot will encourage individuals to produce more in a way that will compensate the smaller aliquot.

The last aspect that associates social security with the labour market refers to the incentives that a social security regime could have over an insured person's decision to abandon the labour market prematurely. An efficient economy makes the most of its production factors. Social security plans that allow early retirement discourage the full use of labour, as the insured will no longer produce to enjoy their retirement because they will have the benefit of an income without the *disutility* caused by labour.

The second aspect where Social Security could alter individuals' decisions and promote resource allocation different from that of the free market would be the savings decision. Economic theory does not offer a final conclusion concerning the impacts of Social Security on accumulation of capital. Social security can encourage an individual to save less because social security would provide the resources that the individual was previously forced to obtain by means of saving. There would be no need to save as much for retirement, since the government will pay the benefit. However, national saving can be increased if individuals believe that the government will not pay the benefits promised or if there are other reasons to save apart from forming a reserve for the purpose of retirement, such as precautionary saving. In the latter case, the increased public collection could exceed a possible drop in private saving and therefore increase national saving. For not trusting the government or for saving for reasons other than retirement, the private sector would not promote substantial alterations in its saving. Nor is there, from the empirical point of view, enough evidence to determine the impact of Social Security on saving.

The last aspect referring to Social Security and allocation is related to the composition of the investment portfolio. There are two different approaches. In the first place, it is possible to investigate whether the existence of a social security regime would alter the way people invest financially, e.g., if Social Security influences the composition of the portfolio among real estate, fixed income and variable income. Another example: tax incentives combined with long-term saving can alter the way agents make their financial investments. Regarding the former aspect, there is no empirical evidence or theoretical facts that allows drawing an unambiguous conclusion. A second approach would consider countries such as Brazil, which regulates the applications of institutional investors such as retirement and pension funds. For this situation, since there is direct imposition of quantitative limits, regulation changes the composition of the portfolio, except in cases of very flexible regulatory structures.

The other side of the loss of efficiency caused by Social Security is related to the administrative burden. As a positive aspect of the Brazilian case, it should be noted that the costing and personnel expenditure of the General Regime of Social Security (RGPS) is around 3% a year of the total collection and expenditure of the National Institute of Social Security (INSS). For the purpose of comparison, there are private social security plans managed by large national banks whose administration fee reaches 5% a year on the investment value. It is clear that a thorough analysis would require comparison between the costs of the administration fee and the benefits gained by it. However, when taking into account the complexity, the geographic distribution and the catering to various social groups, the 3% fee of the RGPS is not high.

A second positive aspect referring to the administrative burden is related to the payment of benefits after they are granted. Very few benefits are deposited inaccurately or not corrected as determined in legislation. This saves time and confusion, and reduces the need for staff to ensure the operation of the administrative apparatus.

The downside of the administrative burden is related to the complexity of the legislation on social security collection and granting of benefits, which imposes several costs particularly on small companies, as well as time spent in queues for INSS services.

In conclusion, it should be noted that, given society's choice for the existence of a social security regime, its design must minimize the loss of efficiency caused by distortion of incentives, the so-called dead weight, as well as the administrative burden. However, two comments should be made to balance this point of view. In the first place, public policies are not based only on efficiency principles. In societies marked by inequality, as in the case of Brazil, issues related to equity must be taken into account. Secondly, a shortsighted behaviour regarding the formation of saving on the part of individuals may lead to negative externality and more poverty in the absence of an appropriate social security system. In this way, poverty reduction as a consequence of Social Security actions could generate a positive externality for society as a whole. In other words, the existence of social security regimes is justified by market imperfections, to the extent that Social Security does not only generate dead weight, but it also serves as a potential reducer of inefficiencies generated by the market itself and by individual decisions.