Summary

This report analyses social insurance, i.e. mandatory publicly provided insurance schemes. Our main message is that social insurance provides utility for all insured persons by providing protection against the risk of undesired events. The focus is on insurance that provides protection against the loss of income caused by unemployment, sickness, work injuries, disability and old age. We further argue that protection against poverty as well as high costs in case of need for old age care benefit from being analysed from an insurance perspective. We also discuss trust and confidence in social insurance, justice, equality, and how the benefits are financed.

All societies must cope with the problem of life cycle redistribution and risk prevention. The state, the market and the family are institutions that can be used to handle these problems. We conclude – from economic analyses – that the state has advantages both from an efficiency point of view and from a distributional point of view. Certainly, many risks can be handled, at least theoretically, by private, individual savings. Individual savings are, however, likely to be an inefficient solution. Due to risk aversion, individuals are likely to save more than needed in order to safeguard against the risk of income loss or lack of resources when old.

Social insurance contributes to a more efficient use of resources by using the law of large numbers. By joining a sufficiently large insurance group, the individual need only to save/pay premiums in accordance with the average risk calculated for the whole group. Uniform and mandatory insurance also creates redistribution in a way that may well be preferred from a distributional perspective (e.g., from those who are often sick to those who are healthier). Equally important, in our view, is however, that social insurance can benefit all insured by providing safety.

Challenges

Social insurance and welfare systems have developed over a long period. They were introduced and developed in a society quite different from today's, especially when it comes to technology, level of income, labour markets and family patterns. One purpose of this report is to investigate whether their design is still adequate, identify problems and suggest remedies.

Social insurance faces a number of challenges, such as an ageing population, migration and new technologies that transform both labour markets and other parts of the economy. Some groups will benefit from these changes, while other groups will be made worse off, at least in the short run. Well-functioning social insurance can cushion the effects of these structural adjustments by spreading risks and providing protection for workers.

An important aspect of social insurance design is to find the right level of protection and benefit generosity. The right level should be sufficiently generous to provide adequate protection and safety, but not so generous as to induce unsustainable changes in behaviour due to e.g. work disincentives. Inadequately designed systems may obstruct structural changes by increasing labour immobility. At the same time the legitimacy and the transparency of the system are both important. To promote transparency, we suggest an explicit connection between the contributions/insurance fees and the benefits, and that fees are clearly visible on the pay slip.

Still another important aspect is to adjust the systems to a changing demography with increases in longevity and decreases in fertility. The demographic pressure is especially notable in pensions and in old age care. The pension system is to a large extent adapted to an ageing population. However, the political stability of the Swedish pension system is currently under pressure.

Migration is also a potential challenge. It can influence social insurance by changing the demographic structure, the relation between those working and those not working, and by influencing the level of risk and the distribution of risk in the society. Theoretically, the influence from migration does not have to be problematic. However, in Sweden the challenge posed by migration emanates from migrants not doing well in the Swedish labour market. This strains public finances, causes segregation and low disposable income for the immigrants. With a more flexible labour market, the chances of avoiding or mitigating these problems increase. The design of social insurances can contribute by creating incentives for increased labour market participation.

Social insurance schemes in Sweden are typically price indexed. This means that economic growth causes the real value of the protection to fall. When benefits are price indexed, the growth rate in the economy determines both relative benefit levels and the scope of social insurance. We find this unacceptable. This process has been going on for a long time, increasing the importance of the insurance complements negotiated by unions and employer associations. As a result, the advantages of social insurances are undermined. We call attention to the fact that if the principle of remuneration in accordance with loss of income weakens, the role of insurance negotiated between the parties in the labour market increases. In this way, social insurance is gradually privatised. The negotiated systems are not uniform and give rise to redistribution. A significant challenge today is to safeguard social insurance and stop the on-going privatisation.

Below we summarise our suggestions for strengthening the social insurances.

Our twelve most important suggestions

1. Secure social insurance's role of protecting loss of income by using income index and make the financing transparent by changing payroll taxes into fees. These fees should be shown on the monthly payslip. The fees should be adjusted in order to cover actual insurance expenditures (at least approximately and during a business cycle). Fees are to be paid only on income covered by the insurance.
2. Make the unemployment insurance compulsory.
3. Abolish the employers' period of sick pay in the sickness insurance and phase out the work injury insurance.
4. Remove the income pension supplement. Add to the automatic balance mechanism an analogous mechanism for

increasing benefits in good times. Recalculate remaining life expectancy also after retirement.

5. To calculate the premium pension, use average rather than individual rate of return.
6. Allow the use of some pension wealth during working life (in a budget neutral manner).
7. Increase the possibilities and economic incentives to explore one's ability to work while receiving support from social insurance.
8. Poverty relief should be individual and administered by the central government.
9. Increase maximum fees in elder care and use income indexation to maintain their relative level.
10. Evaluate distributional policies using data on long term poverty.
11. Pension wealth should be marital property.
12. Facilitate the exchange of information within and between authorities in the public sector to discover and curb fraud and misuse.

Concluding comments

Social insurance increases utility and creates safety. Prerequisites are that the rules are clear and transparent and sufficiently stable so that the insured knows what to expect. For all social insurance schemes, a balance must be found between the security and the need for work incentives.

One of the greatest challenges facing social insurance is to uphold its value. Price indexation must be abolished and replaced by growth indexation. Price level indexation means that economic growth (not political decisions) will determine the level of benefits. It also increases the scope for insurance systems negotiated between the parties in the labour market, which is a privatisation of social insurance that increases inequality.

Old age pension is the financially largest social insurance. It is a long run obligation that builds on a (implicit) social contract between generations. So far, it has been a relatively stable and transparent system. However, after nearly a quarter of a century, the system is under political pressure and is at risk of breaking down. Insecurity has increased and the individuals' planning possibilities are hampered.

Authorities at the local level, the municipalities, handle poverty relief. A centralization of poverty relief to the state is desirable, both to spread risks and to facilitate mobility between municipalities.

In the debate on how to organise and finance old age care, insurance solutions have been proposed. This would mean that resources are earmarked for old age care. We find such a solution to be inflexible and that today's organisation is preferable.

The main function of social insurance is to provide security and spread risks. Social insurance is also a forceful tool for redistribution. To adequately evaluate redistribution efforts and policies, it is of great importance to measure and be aware of persistent poverty, which is far more harmful than short-term poverty.

Throughout the report, we have maintained that social insurance should be income indexed. The price index used today in most of the insurances lowers the expenditures in time of growth but causes several problems. An important one is that the value of the protection the insurance is supposed to give diminishes. This in turn increases the role of insurances negotiated between the parties in the labour market and other private solutions. The advantages of obligatory and uniform design are lost. Price index causes still another problem: economic growth determines the value of the insurance as well as the distribution between individuals, not conscious political decisions.

Our proposal to finance social insurance by fees means that economic growth/wage increases will result in increased revenues. At the same time the benefits increase accordingly. Financing by fees and indexing by growth means that social insurance expenditure forms a constant share of the GDP.