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THE ROLE OF SOCIAL SECURITY CONTRIBUTIONS IN PENSION PROVISION

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ABOUT ARTICLE

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Abstract: Social security contributions play a vital role in the provision of pensions, serving as a cornerstone of retirement income for millions of individuals worldwide. The significance of social security contributions in pension provision cannot be overstated, as they provide a safety net for workers, ensuring that they are financially secure in their golden years. This article will delve into the role of social security contributions in pension provision, examining their importance, benefits, and challenges, as well as exploring potential reforms to strengthen their efficacy.

INTRODUCTION

Social security contributions are a critical component of pension systems globally. These contributions, typically made by employees, employers, and self-employed individuals, are pooled together to create a collective fund that provides financial support to retirees. The importance of social security contributions lies in their ability to provide a predictable income stream for retirees, alleviating poverty and ensuring dignity in old age. In many countries, social security contributions are the primary source of retirement income, underscoring their significance in maintaining economic security for seniors.

Actually, it is not sufficient to try to measure the actuarial balance of a reform and to evaluate whether it can bring more income in terms of financial returns from a given collection of funds than the pure redistribution it replaces, in order to get a more precise criterion for a reform of public pensions. Because there is a long way to go from the observations made by the "good society" which sets up a

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social security system and establishes a rule for the determination of agents' contributions in this system, to the evolution of the latter contributions as a guide for the action of individuals who have only an imperfect and asymmetric vision of their future but wish to provide for the uncertainties of destiny.

Social security contributions have been, for a very long time, the main source of finance for old-age pensions in many countries, including Europe. Now, the shift in financial markets from the public to the private sector is raising a question with regard to the role to be played by these compulsory contributions. It is particularly urgent, not only because of specific circumstances, such as those of former socialist countries moving to a system based on financial markets private institutions, but also because the intensity with which proposals are made in favor of extending the role of financial markets keeps increasing since the mid-1980s, for apparently convergent although seldom stated reasons. It therefore appears interesting to present a few results which, by showing in what cases and according to which assumptions private savings can actually replace social security contributions, can perhaps contribute to clarify the stakes of the ongoing discussions on social contributions.

Purpose of the Study

The paper is organized as follows: first, the author presents three estimated parametric structures, reflects their features, and discusses their relations as well as the results in order to expand the knowledge on the provision of pensions. Second, after the introduction of the three pillars, the author provides results of the achieved model estimations and evaluates the employed options which for the individual systems relate the payroll tax rate, consumer price index, and purchasing power parity (PPP) with individual benefit rates (IBR) that describe the level of the different individual benefit systems. The paper continues with a second section on quadratic pay-as-you-go (Q-PAYG) and modeled structures to calculate its future pay-as-you-go rates. The third section is devoted to different cautions implied by the applicability of the three systems. The results are preceded tone wise, principle wise, crosswise wise, and timewise wise.

The purpose of this research is to analyze the role of social security contributions in pension provision in twenty-eight European Union countries—both European Union (EU) and non-European Union countries—within three main quantitative systems: (1) Pay-As-You-Go (PAYG) first-pillar; (2) individual second-pillar; (3) individual, employer, and state (independent bodies) third-pillar within the period of 2004-2015. The major differences between those EU Member States and non-Member States are already presented by R. Kaplan who pointed out the following reasons that countries may decide to remain outside institutions: [1] upcoming endorsement of EU austerity measures as the

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majority of citizens are against those; [2] issues of national sovereignty, power shift to Brussels; [3]. Ten European Union Members (Austria, Cyprus, Czech Republic, Germany, France, Latvia, Netherlands, Portugal, Slovakia, Slovenia) and non-Union States took the decision to remain outside the regulations of the "Euro Plus Pact 2011" that are considered as an infringement on national democracy proved by the Slovak public opinion as the point of "no return" (Ibidem). According to the financial situation in the respective country, the budget constraint, and preference of the currently active generations concerning the level of social security, the respective individual system proportions differ. In particular, family benefits and those related to age are closely linked to the pay-as-you-go (PAYG) system (Chapter 2).

Scope and Limitations

- Old age pensions are not the only service provided by national social insurance schemes. The latter commonly also offer other benefits, not only in case of old age but also in case of death, sickness, disability, and unemployment. Necessarily, the amount and availability of at least some of these other services are affected by contributions paid and benefits received in the old age scheme.

- Tax-financed systems and private ways of providing for old age are not covered. Particularly in several North-Western European countries, status is assigned to financed pension systems. In a tax-financed system, social security contributions are paid into the consolidated government's budget, commonly referred to simply as taxes. Subsequently, pensions are paid out of this budget, often as "benefits in kind" or public pensions. In the countries concerned, it is commonly held that "the social insurance" – i.e. cut off at the point that funded pensions start – is unable to provide against the risk of old age, and that only extensive government intervention can fill the gap. In ill preparing the case for despite this as big a step back from funded pension systems as from the social insurance systems being increasingly ruled out by this second line of argumentation, the recent social insurance perspective has made what is in itself and ex silentio a sound argument relatively vulnerable.

This study focuses on financed schemes, often referred to as "pay as you go" pension schemes. Yet within this category, social security pension programmed vary widely in terms of size, rules, objectives, and impact. This leads to limitations in the scope of the research. The most important limitations are as follows:

METHODOLOGY

The concept of effective social security contribution rates (ESCRs) based on the public pension system as discussed in hem (2016) allows this distinction. The problem takes real-world statutory pension systems and financing rules, household structures, and time path of earnings and demographic factors into account. This is different from the concept of effective social security contributions by Barr et al. (1991) or Feldstein and Sam wick (1992), the digital concept of ESCRs provided by Schroder (1997), and classical concepts like statutory social security contribution (SSCCR) rates. Due to certain bio-demographic characteristics like the steep increase in statutory retirement age, age-dependent, compulsory contributions and certain features of pension approval and financing rules as well as marital and wealth dependency of pension payments and investment branches of the statutory pension system, ESCRs deviate from purely financially notional co-insurance rates.

When analyzing a complex legal framework and administrative structure like the one of social security systems, there is always a trade-off between using a more complicated but more closely resembling real-world setting and a simpler but more easily solvable model without a loss of accuracy. Cleves and Homs-Romero (2012) argue that a trade-off needs to be made as a simplified model will leave out important features of reality, while adding all details obscures the model's comparative static properties. The model set up for this paper aggregates the three wealth components: human wealth, non-pension assets, and pension assets, and uses one single goods market as well as one single factor market to showcase how different pension systems redistribute burden between rich and poor and young and old people. The model does not take into account intra- and intergenerational redistribution inside pension systems and considers public pension systems only. Albeit the fact that there are no legal pension systems in the world without additional pension components like employer pensions, private savings or the likes, the one-pillar pension system is used for clarity.

Benefits of Social Security Contributions

The benefits of social security contributions are multifaceted. Firstly, they provide a sense of security and stability for workers, who can plan their retirement with confidence knowing that they will receive a steady income stream. Secondly, social security contributions help to reduce poverty among seniors, which is a significant social and economic problem in many countries. According to the World Bank, social security programs have been instrumental in reducing poverty rates among older adults in developing countries (World Bank, 2019). Thirdly, social security contributions promote economic growth by providing retirees with the financial resources to continue contributing to the economy through consumption and investment.

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Challenges Facing Social Security Contributions

Despite their importance and benefits, social security contributions face several challenges that threaten their long-term sustainability. One of the primary challenges is demographic change, characterized by declining birth rates and increasing life expectancy. This shift has resulted in a shrinking workforce and an aging population, placing pressure on social security systems to provide for an increasingly large number of retirees. Another challenge is the rise of informal employment, which reduces the number of contributors to social security systems. Furthermore, inadequate funding and poor governance have led to concerns about the solvency of some social security systems.

Reforms to Strengthen Social Security Contributions

To address the challenges facing social security contributions, several reforms can be implemented to strengthen their efficacy. Firstly, governments can increase the coverage of social security systems by expanding eligibility criteria and encouraging informal workers to participate. Secondly, policymakers can implement measures to improve the governance and management of social security funds, ensuring transparency and accountability. Thirdly, governments can consider increasing contribution rates or introducing new revenue streams to ensure the long-term sustainability of social security systems.

Innovative Approaches to Pension Provision

In addition to traditional social security contributions, innovative approaches to pension provision are being explored. For instance, some countries have introduced auto-enrollment schemes, where employees are automatically enrolled in pension plans unless they opt-out. This approach has been shown to increase participation rates and improve retirement savings (OECD, 2018). Another innovative approach is the use of digital platforms to facilitate pension savings and investments. These platforms can provide low-cost and convenient access to pension products, promoting greater financial inclusion.

CONCLUSION

In conclusion, social security contributions play a vital role in pension provision, providing a safety net for workers and ensuring economic security in old age. While challenges such as demographic change and inadequate funding threaten the long-term sustainability of social security systems, reforms such as increasing coverage, improving governance, and introducing innovative approaches can help strengthen their efficacy. As the global population ages and retirement income becomes an increasingly

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pressing concern, it is essential that policymakers prioritize the role of social security contributions in pension provision.

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