United Nations Research Institute for Social Development

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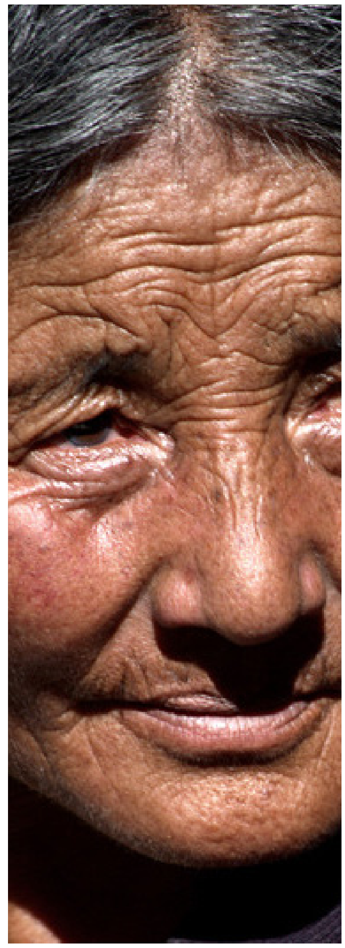
A Global Policy Laboratory
REFORMING PENSIONS IN DEVELOPING AND TRANSITION COUNTRIES

Pension reform has been something of a global policy laboratory over the last three decades. UNRISD research on the drivers of pension reform and the diversity of models and outcomes provides evidence to undermine three of the most unhelpful myths around pension reform, showing that privatization is not a silver bullet; declared blueprints for reform are not in fact suitable for all country contexts; and policy space *can* be regained to reform pension systems for the better.



Pension systems as a global policy laboratory

Over the last three decades, pension systems have seen a wide variety of reform models, processes and outcomes. In the 1980s, with neoliberalism and structural adjustment came a slew of welfare state retrenchment policies, but reform pathways differed substantially in developed countries on the one hand, and in developing countries and those countries that switched from central planning to market economies (transition countries) on the other.

Debunking three myths about pension reform

The findings from this UNRISD research challenge a number of persistent myths which have dominated recent pension debates, as for example, discussed by Orszag and Stiglitz (1999).

- Myth 1: Only private fully funded systems successfully combine the role of protecting the old and contributing to economic development.
- Myth 2: A universal reform model exists and can successfully be applied to different country contexts.
- Myth 3: Once chosen, pension models are carved in stone making gradual improvements at later stages unlikely.

Debunking 1: Pension systems have multiple roles and public systems are best suited to deliver on all of them.

Economic development influences pension systems, while pension systems impact on economic performance, in particular on state finances, labour markets and the financial sector. It is, therefore, misleading to argue that positive developmental impacts can only be expected from privately funded systems.

Evidence shows that pension privatization and the implementation of the *multi-pillar model*[1] have not kept their promises. Expectations regarding higher rates of return from market-based systems have largely not been met, partly as a result of the high administrative costs of private pension funds. The transition from *pay-as-you-go* (*PAYG*) to funded systems, with the corresponding loss of pension contributions collected by the state to fund current pensions, has furthermore created huge fiscal costs (in Chile amounting to 2.5 per cent of GDP annually for over 25 years) and narrowed the scope for progressive distribution between different insured groups and between men and women. It has exposed old-age protection systems to market risks, as demonstrated by the 2008-2009 global economic and financial crisis and its negative impact on pension fund assets. Conversely, in countries with strong public systems and non-contributory benefits, *demand stabilization* helped to overcome the crisis. And finally, privatization has had a limited effect on private investments, as pension fund regulation stipulated that a high share of the funds collected should be invested in public bonds to cover government financing needs which were partly created through the pension reforms themselves.

As well as not delivering on its promises regarding economic development, the private model has been especially weak on the other functions of social protection systems such as redistribution, gender equality and protection (see box 2). And the very nature of individual private pension funds

Box 1: UNRISD Research on Pensions and Development

This Research and Policy Brief summarizes selected findings from the UNRISD research project on ***Reforming Pensions in Developing and Transition Countries***. The project took a political economy approach to recent pension reforms in development and transition contexts. It examined the developmental role of various pension systems, (for example, *pay-as-you-go* versus funded systems; decentralized models versus *National Provident Funds*, contributory versus non-contributory programmes) as well as the drivers, processes and impacts of pension reform.

The edited volume that presents the findings from this project (Hujo 2014) is organized around groups of country and regional studies. These reflect diversity in levels of development, characteristics of pension systems, and reform processes.

- Section I: Political Economy Issues in Pension Reform. Case studies: Poland and Hungary, the Middle East and the Republic of Korea.
- Section II: Pension Systems and Reform in the BRICS. Case studies: Brazil, India, China and South Africa.
- Section III: Bringing the State Back In. Case studies: Bolivia, Chile and Argentina.

1. Terms in italics are explained in a glossary on page 3 of this brief.

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makes it a poor instrument for creating stronger ties between social groups and different generations, significantly limiting its capacity to foster social cohesion and solidarity in society.

Country	Pre-reform system	Type of reform and post-reform system	Date of reform
Argentina	Public *PAYG-DB* *Social pensions*	Privatization and *multi-pillar system* *Renationalization* Extension of non and semi-contributory pensions	1994 2008 2004-8
Bolivia	Public PAYG-DB	Privatization and multi-pillar system Universal social pension Renationalization	1996 1997/2007 2010
Brazil	Public PAYG-DB Social pensions	*Parametric reform*	1998/99, 2005
Chile	Public PAYG-DB Social pensions	Privatization and multi-pillar system Basic solidarity pension	1981 2008
China	Public PAYG-DB (Enterprise-based)	Privatization and multi-pillar system Social pensions	1997 2009/10
Hungary	Public PAYG-DB	Privatization and multi-pillar system Renationalization	1998 2011
India	*NPF*	Parametric reform	2004
MENA region	Public PAYG-DB	Parametric reform	Various
Poland	Public PAYG-DB	Privatization and multi-pillar system	1999
Republic of Korea	Public PAYG-DB	Parametric reform	2000/ 2009
South Africa	NPF Tax-financed social pension	Semi-structural reform	1996

Source: Hujo 2014. Abbreviations and terms explained in glossary.

Debunking 2: Universal reform blueprints are losing impact as international and national reform drivers shape reform options and outcomes.

The Chilean privatization model was promoted by the World Bank and other aid agencies as a blueprint to be reproduced around the globe. While many countries did privatize their pension systems, UNRISD research provides a more nuanced picture of the type and scope of reforms that governments were able to implement. Reforms in some case study countries responded to long-term concerns (for example, financial sustainability or equity), while others were prompted by conjunctural factors, in particular economic and fiscal crises and different objectives of pension systems pursued by different governments. Reforms were influenced, to varying degrees, by global trends and international reform drivers in some countries, and in others by national or country-specific drivers. As a result, instead of blanket implementation of a blueprint, we in fact see a range of reform models including privatization, renationalization, or more specific reforms such as the expansion of social pensions or reform of civil servant pension schemes.

International reform drivers. All case study countries were affected by globalization and by pressures to implement market-oriented reforms, in particular in the context of debt or balance of payments crises. However, from the 2000s onwards, and especially after the global economic and financial crisis of 2008, there was a more balanced approach in international pension advice, with a stronger focus on equity issues and poverty reduction as well as a growing critique of the neoliberal model, including the private pension fund model. Some countries turned to temporary or permanent re-reforms, as was the case in Argentina, Bolivia and Hungary, which all switched back from market to state pension systems. The introduction and expansion of social pensions in Argentina, Bolivia, Chile, China, India and South Africa have also been shaped internationally through the global anti-poverty agenda and the rise of social protection policies within it (Hujo and Cook 2012).

In terms of geographical patterns, international drivers were especially powerful in Latin America and Central and Eastern Europe, leading to a high number of privatization reforms in these regions, usually in the context of radical market-oriented reforms in the 1990s. They were less influential in Asian countries, the MENA region, sub-Saharan Africa and in the BRICS countries analysed in this project. Countries such as Brazil, India and the Republic of Korea even discarded the privatization option entirely because they had greater fiscal space and hence were less subject to influence from external actors such as donors and international organizations. They also anticipated high transition costs associated with privatization and capitalization, and complex internal bargaining processes between the central government and subnational entities.

Country-specific drivers are often related to major economic or political transitions, for example, the former socialist states' transition to market economies (Hungary and Poland), the democratic transitions in Brazil, Chile and South Africa, and recent democratic movements in the MENA region. At these critical junctures, governments aimed to align pension systems with the new economic system (in the case of transition countries), or responded to claims from previously excluded groups through expansion of entitlements (in the case of post-authoritarian countries). Other internal drivers resulted from changes in political leadership and ideology, as in the cases of Argentina, Bolivia, Brazil and Chile, or more gradual change processes, as with the maturing of the developmental state and democratic transition in the Republic of Korea. Additionally, reforms were driven by demographic changes that have resulted in rapidly

Box 2: Pension systems' multiple functions for development

Pensions reflect the ***protective role*** of social policy, guaranteeing income security and preventing poverty during retirement/old-age (or in case of disability or death of the main earner); the ***productive role***, through accumulation of domestic savings (contributions) and demand stabilization (benefits); the ***redistributive role***, through risk and income redistribution between different groups of insured and across generations; and the ***reproductive role***, reducing the financial and care burden associated with ageing, thereby improving gender equity and supporting households in their efforts to maintain a healthy and educated family and a functioning social fabric.
Source: UNRISD 2006; Hujo 2014.

ageing populations and consequently deteriorating *pension dependency ratios*. In the cases of China and India, increased labour migration, both internal and international, is a further demographic driver that has led to adjustments in both contributory and non-contributory pension programmes to improve migrants' access to social protection.

Debunking 3: Policy space can be regained to reform pension systems for the better

Discussions about reform options for pension systems in the past were dominated by either/or choices and a certain pessimism regarding governments' capacities to overcome political resistance by powerful actors and vested interests. While this argument was initially made with regard to public schemes in particular, once countries had privatized their pension systems the same pessimism about reform was expressed regarding the possibility of improving equity and coverage in private systems. The case studies in this project show, however, that policy space does indeed exist in different contexts, and that it is actually possible to improve the economic and social outcomes as well as governance of pension schemes, in both public and private systems.

Box 3: Glossary

Defined benefit (DB) plan	Benefits are linked through a formula to the members' wages or salaries, length of employment or other factors
Defined contribution (DC) plan	The system only specifies the contribution rate, benefits are determined by accumulated savings, investment returns and demographic characteristics (such as life expectancy, dependents) of the insured.
Demand stabilization	Social insurance benefits such as pensions serve as "automatic stabilizers", stabilizing domestic demand in the economy as they prevent consumer demand from declining when people lose their market earnings (due to sickness, old-age or unemployment).
Individual fully-funded (IFF) pensions	An individual pension scheme whose benefit promises are fully backed by a fund of assets set aside and invested for the purpose of meeting the scheme's liability for benefit payments as they arise.
Multi-pillar pension model	Universal reform blueprint proposed in a World Bank study (1994), consisting of a first pillar for poverty prevention (basic or flat benefit or means-tested benefit), a second pillar for income replacement (IFF pension accounts), and a third pillar of voluntary savings.
National Provident Fund (NPF)	State-managed capitalization systems.
Parametric pension reform	PAYG financing and public administration is maintained, variables such as retirement age, contribution rates are changed.
Pay-as-you-go (PAYG) system	Pension contributions collected by the state to fund current pensions.
Pension dependency ratios	The old-age dependency ratio is the ratio between the active population (usually working age persons) and the inactive population (usually children and young people as well as persons above retirement age); the system dependency rate is the ratio of those receiving pension benefits to those accruing pension rights.
Renationalization	A switch from a public to a private (privatization) and back to a public (renationalization) pension scheme.
Social pension	Non-contributory or social assistance pension benefit (usually tax or aid-funded).
Structural or paradigmatic pension reform	Switch to privately managed fully-funded pension funds.

Improving economic and social outcomes of pension systems

The 2008 Chilean reform is considered an example of best practice in the way it addressed several shortcomings of a private pension system: coverage, gender equality and market performance of the system have been greatly improved through the reform, and the cost of approximately 1 per cent of GDP per year was affordable because falling transition costs and booming copper prices led to increased fiscal space. In Argentina and Bolivia greater social inclusion was achieved by extending coverage and improving gender equity, although challenges remain in terms of fiscal sustainability to maintain these gains in the future. The MENA countries have not embarked on substantive pension reform yet but face the need to confront issues of coverage, inequities, fiscal sustainability and governance of pension schemes in the near future.

Creating integrated pension systems and reducing fragmentation

Many countries are pursuing the goal of creating an integrated old-age protection system that combines contributory programmes with non-contributory transfers. While the combination of these two pillars is already a challenge in terms of equity, incentives and public resources needed for the non-contributory pensions, additional complexity emerges as a result of the historical evolution of pension schemes. Expansion of coverage along occupational lines, starting with the most important and powerful groups of employees (for example, civil servants or workers in strategic industries), has led to pension systems incorporating new groups of insured, often based on different entitlements and rules (Mesa-Lago 1978). Pension systems which are fragmented and stratified lead to higher costs, regressive redistribution and exclusion. Better coherence, unity and equity across the pension system is acknowledged either as a key objective or remaining challenge in all the cases studied. Recent reforms in Brazil, Chile and the Republic of Korea have gone a long way towards achieving these objectives, in particular through aligning pension systems for civil servants and public employees with those for private sector workers. Expansion of tax-financed benefits has increased coverage rates in Argentina, Bolivia, Chile, China and South Africa, and, to a lesser degree, India. However, significant challenges with regard to fragmentation and inequities remain in the MENA region, as well as in China and India.

Pension systems which are fragmented and stratified lead to higher costs, regressive redistribution and exclusion.

Improving reform and governance of pension systems

Policy space to improve the quality of governance and institutional development of pension systems is strongly shaped by a country's institutions and degree of democratic governance, as well as by the roles of international and civil society actors. In Chile and the Republic of Korea, a broad range of actors participated in reform processes. As a result, expert knowledge and different (though not all) interests were taken into account, which produced more consensual and legitimate reform outcomes. In contrast, pension reform processes in Argentina, Bolivia and South Africa were less participatory and more top-down, and commentators criticized the short time frames and lack of inclusiveness and transparency in the processes.

BOX 4: LESSONS FOR POLICY

Pension systems have an important developmental role. Harnessing this potential requires:

- **Recognizing and balancing the multiple functions of pension systems** in providing social protection, contributing to redistribution and gender equity, and promoting economic development.
- **Strengthening the role of the state in pension systems** while allowing the private sector to complement public benefits, in particular for higher income groups.
- **Paying attention to country context** and adjusting reform models accordingly.

Successful pension reform processes shared a set of characteristics. They:

- **Created and seized windows of opportunity for reform**, based on clear problem analysis and public debate.
- **Created consensus** by involving different actors (including experts) and social partners in reform debates, and by creating links between generations and different social groups.
- **Mobilized fiscal space** to make reforms progressive and sustainable in economic and political terms.

Maximizing the economic and social impacts of pension systems calls for:

- Designing pension programmes **as part of universal and integrated social policy systems** that protect and promote people's well-being and livelihood security over the lifecycle.
- Combining contributory with non-contributory benefits to **expand coverage** towards difficult-to-cover groups without creating adverse incentives for contribution payments or labour market formalization.
- Adjusting existing or creating **new institutions** and coordinating different components in social protection systems.
- **Increasing gender equity**, fairness and social justice in pension schemes through redistributive mechanisms favouring women and providers of unpaid care and lower-income groups.
- **Strengthening the rights basis of social protection** systems by implementing basic normative principles such as ILO conventions, social security principles, human rights instruments, and social protection floor recommendation R202.

The experiences in these three countries illustrate the fact that policy space and state autonomy to implement reforms does not necessarily imply broad and transparent participation processes, especially in the case of those political regimes that claim to represent the voice and needs of the population against richer elites.

Policy space has also been used differently with regard to administration of pension assets, institutional transparence and accountability as well as institution building. While pension privatization has usually resulted in the dismantling of tripartite governance structures typical of PAYG pension systems, in most Latin American case studies new institutions have been created (private pension fund companies in Latin America are regulated by so-called superintendencies; Chile has created new institutions through its latest reform such as the Pension Institute or the AFP Users Committee), and in some cases former social security administrations have regained control over the pension system (Argentina).

In terms of quality of institutions and governance, problems still remain in all the countries studied, though to a lesser degree in Chile and the Republic of Korea (the countries which displayed more inclusive reform processes).This is typically a reflection of more generalized governance challenges in these countries, a problem that can be exacerbated at the subnational level, in particular in large countries such as China and India.

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This Research and Policy Brief was prepared by Katja Hujo with editorial guidance from Joannah Caborn Wengler.

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