Reversing Pension Privatization: Key Issues

Social Protection for All Issue Brief

December 2018

International Labour Office

From 1981 to 2014, thirty countries fully or partially privatized their social security public mandatory pensions (figure 1). Fourteen countries were in Latin America: Chile (first to privatize in 1981), Peru (1993), Argentina and Colombia (1994), Uruguay (1996), the Plurinational State of Bolivia, Mexico and the Bolivarian Republic of Venezuela (1997), El Salvador (1998), Nicaragua (2000), Costa Rica and Ecuador (2001), Dominican Republic (2003) and Panama (2008). Another fourteen countries in Eastern Europe and the former Soviet Union embarked on the experiment to privatize pensions: Hungary and Kazakhstan (1998), Croatia and Poland (1999), Latvia (2001), Bulgaria, Estonia and the Russian Federation (2002), Lithuania and Romania (2004), Slovakia (2005), Macedonia (2006), Czech Republic (2013) and Armenia (2014). Additionally, two countries privatized their public pension system in Africa, Nigeria (2004) and Ghana (2010).

As of 2018, eighteen countries have re-reformed and reversed pension privatization fully or partially: the Bolivarian Republic of Venezuela (2000), Ecuador (2002), Nicaragua (2005), Bulgaria (2007), Argentina (2008), Slovakia (2008), Estonia, Latvia and Lithuania (2009), the Plurinational State of Bolivia (2009), Hungary (2010), Croatia and Macedonia (2011), Poland (2011), the Russian Federation (2012), Kazakhstan (2013), the Czech Republic (2016) and Romania (2017) (Figure 1). The large majority of countries turned away from privatization after the 2008 global financial crisis, when the drawbacks of the private system became evident and had to be redressed.

With the majority of countries having reversed privatization, and with the accumulated evidence of negative social and economic impacts, it can be affirmed that the privatization experiment has failed.

Lessons Learnt from Three Decades of Pension Privatization

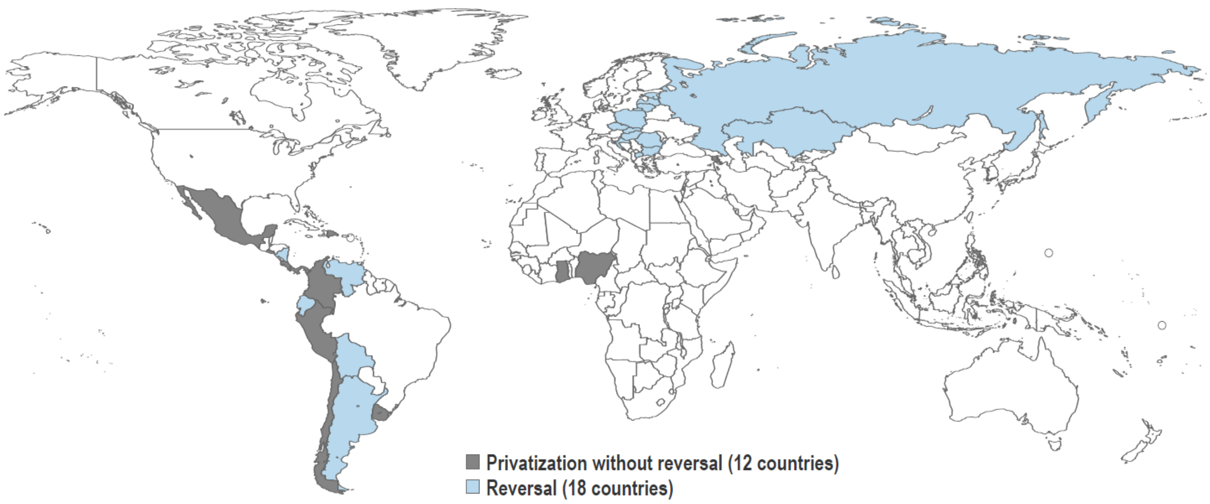
Pension privatization was presented as a clear cut solution to address population ageing and ensure the sustainability of social security pension systems. However, pension privatization did not deliver the expected results:

(a) **Coverage rates stagnated or decreased:** Advocates of pension privatization argued that mandatory individual accounts would earn higher interest and thus improve compliance and willingness to contribute; however, a majority of countries registered a decrease in coverage rates of contributory schemes. In Argentina coverage rates fell by more than 20 per cent. Similar effects were observed in Chile, Hungary, Kazakhstan and Mexico, while in other countries (e.g. Bolivia, Poland, Uruguay) coverage stagnated.

(b) **Pension benefits deteriorated:** The shift from defined benefits to defined contributions had a serious negative impact on pension benefit adequacy, with pension replacement rates often not meeting ILO standards, and resulting in significant social protests, making pension privatization unpopular. In Bolivia, private pension benefits averaged only 20 per cent of the average salary during working life. In Chile, the median future replacement rates average 15 per cent and only 3.8 for low-income workers. The deterioration of benefit levels resulted in increases in old-age poverty, undermining the main purpose of pension systems which is to provide adequate income security in old-age, and requiring significant public support.

(c) **Gender and income inequality increased:** Pension privatization broke the social contract enshrined in social security. Well-designed social insurance schemes are redistributive for two main reasons: (i) they include transfers from employers to workers, and (ii) they are

Figure 1. Countries that privatized social security mandatory pensions and that reversed privatization, 1981–2018



designed to redistribute income from those with higher lifetime earnings to those with lower lifetime earnings, and from the healthy and able to those sick, disabled or unable to work, such as during maternity. The redistributive components of social security systems were eliminated with the introduction of individual accounts. Employer contributions were eliminated. Pensions were a result of personal savings; therefore, those with low incomes or with interrupted careers (e.g. because of maternity or family care) had very small savings and consequently ended with small pensions, thereby increasing inequalities. In Bolivia, for instance, the share of elderly women receiving a pension fell from 23.7 per cent in 1995 to 12.8 per cent in 2007; in Poland, 22.5 percent of older women were poor.

(d) High transition costs created large fiscal pressures: The transition costs from the public solidarity based systems to private individual account systems were not properly assessed by the international financial institutions; the costs were seriously underestimated across all reformed countries, and created new fiscal pressures. In Bolivia the actual transition costs were 2.5 times the initial projection. Similarly, in Argentina the cost was estimated not to exceed 0.2 per cent of GDP; however the estimation was later adjusted and increased 18 fold, to around 3.6 per cent of GDP. The newly created fiscal distress was unacceptable to many governments, particularly as concerns regarding fiscal pressures and the financial sustainability of public pension systems were the main driver behind privatization reforms in all countries – privatization had been presented as the remedy to avoid a "social security crisis and to ensure more sustainable future financing for pension systems. In Poland, between 1999 and 2012, the cumulative transition costs of the reform were estimated at 14.4 per cent of GDP. In general, transition costs were very high in all countries, a main reason why governments reversed pension privatization and returned to a public system.

(e) High administrative costs: The administrative costs of private pension funds were very high and as a consequence made returns and ultimately pensions lower. Private pension fund administrators need to finance many overhead costs that do not occur in public systems such as administration charges, investment management fees, custodian fees, guarantee fees, audit fees, marketing fees and legal fees, among others, that reduce accumulated assets (or pensions) over a 40 year period by as much as 39 per cent in Latvia, 31 per cent in Estonia and 20 per cent in Bulgaria.

Table 1. Administrative costs before and after pension privatization (as a percentage of contributions)

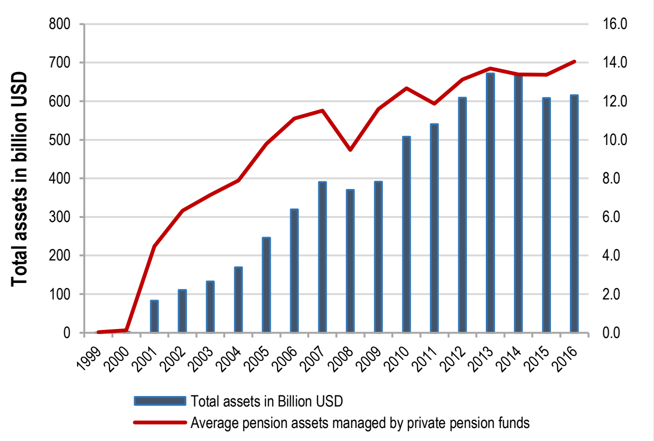
Country	Before privatization	After privatization
Argentina	6.6 (1990)	50.8 (2002)
Bolivia, Plurinat. State of	8.6 (1992)	18.1 (2002)
Hungary	2.0 (1998)	14.5 (2007)
Colombia	2.6 (1993)	25.9 (2002)
Chile	8.0 (1980)	19.5 (2002)
El Salvador	7.8 (1996)	21.3 (2002)
Peru	n.a.	30.5 (2002)
Mexico	n.a.	40.3 (2002)
Uruguay	6.5 (1990)	18.2 (2002)

(f) Weak governance: Capture of regulation and supervision functions: Regulatory capture is the situation in which a regulatory agency, created to defend the public interest, acts on behalf of certain economic interest groups in the industry which it is required to supervise. In general, the management, supervision and regulation of the private pension funds was weak; close ties between politicians and the financial sector, as well as the scarcity of high-level staff skilled in financial market regulation, contributed to the selection of regulators from the existing industry, accommodating private interests. Furthermore, in many countries like the Plurinational State of Bolivia and Poland, the involvement of social partners in the supervision of the private pension funds was excluded, thus decreasing the supervisory oversight in place.

(g) Concentration of the private insurance industry: A further argument advanced by proponents of the pension privatization was that it was expected to generate competition among many pension administrators and thus improve efficiency and service delivery. Competition between pension funds was low, with some countries (e.g. Bolivia, El Salvador) having only a two major pension administrators, creating oligopolistic markets and thus defeating the benefits of competition. The number of Chilean private pension fund administrators (or AFPs) fell from 21 (1994) to 5 (2008); concentration of contributors in the biggest three firms rose from 67 per cent to 86 per cent. Often international financial groups are major shareholders of national pension fund administrators, or the national pension funds are subsidiaries.

(h) Who benefitted from people's pension savings? The financial sector: This is an important developmental question. In many countries, the pension reserves in the accumulative phase were used for national development (e.g. Europe). However, the use of pension funds for national public investment was generally lost with "funded" privatized systems, which invested the savings of individual members in capital markets seeking high returns, without prioritizing national development goals. The experience with privatization in developing countries shows that it is the financial sector, the private pension administrators and commercial life insurance companies, who appear to benefit most from people's pension savings – often with international financial groups holding a majority of the invested funds. In fact, in a majority of countries national investment regulations do not include any restrictions on the investment of pension funds abroad, even in countries in much dire need of social and economic investments (e.g. Armenia, Bulgaria, Croatia, Czech Republic, Estonia, Lithuania, Romania and Slovakia) In others, some limits are indicated – in Chile, private pension administrators can invest up to 80 per cent of their assets abroad representing 56 per cent of Chile's GDP.

Figure 2. Assets in funded and private pension funds in 25 countries that privatized pensions (in billion USD and percentage of the countries' GDP)



(i) Limited effect on capital markets in developing countries: In countries with not very deep and undiversified capital markets, investments could either be heavily concentrated abroad or focused on government bonds. Government bonds were often issued to finance the high transition costs of pension privatization, generating a vicious and costly cycle, where the private pension fund administrators were the only beneficiaries of this cycle, cashing in the administrative costs for the financial transactions. In Hungary, El Salvador and the Plurinational State of Bolivia, government bonds initially constituted around 80 per cent of all assets. However, in Chile and the high-income economies, there is evidence of positive effects on capital markets.

(j) Financial market and demographic risks transferred to individuals: Private individual account schemes shifted the systemic risks burden to the individual, with workers/pensioners bearing the investment, longevity and inflation risks. In Chile in the 2008 crisis, the AFPs lost 60 per cent of all benefits accrued during 1982–2008. In Argentina, the domestic financial crisis of 2001–02 led to a 44 per cent decrease in the values of the pension funds. In Peru, the assets of pension funds dropped by 50 per cent during the 2008 financial crisis as the private funds managers had invested the funds in high-risk instruments. In some countries, the State had to step in to supplement the pensions that should have been provided by the private system. For instance, in 2008 the government of Chile had to provide pension top-ups, and the government of Argentina had to step in to cover in full 77 per cent of the pensions payments to 445,000 private pillar pensioners, as well as additional payments to 179,000 pensioners to maintain the minimum guarantee.

(k) Deteriorated social dialogue: Most structural reforms were implemented with limited social dialogue, which later led to questionable legitimacy. There were strong media campaigns to promote private pensions, often marketing by private pension funds, to diminish public opposition. Distrust in private pension systems increased rapidly when replacement rates plummeted, and pension benefit adequacy became a serious problem, failing to provide sufficient protection in old age. Before the reforms, most social security pension funds had some form of tripartite governance through representatives of workers, employers and the government, in accordance with ILO standards. Privatization eliminated such participation in the new system, even though workers were the sole contributors and the owners of the individual account.

Rebuilding Public Pension Systems

After a couple of decades of problematic implementation, many countries began to re-reform their pension systems. The privatization of pensions did not meet expectations and generated frustration. The 2008 financial crisis severely affected capital markets, significantly reducing the real value of private pension assets and, consequently, causing popular outrage given the results of the private system. Many pensioners had to rely on social support as the value of their pension benefits had fallen to very low levels, often below the poverty line. In addition, for countries within the Eurozone that were struggling to comply with the Maastricht criteria regarding debt and fiscal deficits, the costs of transition were excessive and found little support among governments as they were ultimately transferring badly needed public funds to the financial sector. The political support which had brought about privatization reversed gear, to support a return to the public system or to minimize the share of mandatory private pension schemes.

Other countries questioned the private model earlier, like the Bolivarian Republic of Venezuela, Ecuador and Nicaragua. These countries had strong national debates questioning the public benefit of private pensions, ultimately leading to declaring private pensions unconstitutional and repealing the laws that had created them. The experience on pensions is similar to other sectors such as water supply, transport, energy and postal services that also reversed earlier privatizations and re-nationalized or re-municipalized public services in recent years.

In total, eighteen countries, thirteen in Eastern Europe and the former Soviet Union and five in Latin America, reversed pension privatizations.

While every country case is specific and needs to be assessed according to its specific context, there are common elements of the experience summarized below:

Timing of the re-reforms. Timing is of critical importance to policy makers. How long can re-reforming a pension system take? Pension privatization can be reversed quickly, in as a little as a few months. In Hungary the renationalization of pensions was implemented between April and December of 2010, and in Argentina, from October to December 2008. In Kazakhstan, the re-reform happened in about one year between 2012 and 2013; in Poland, on the other hand, it was implemented in several steps starting in 2010 and taking around 4 years to complete.

Laws enacted. Some countries first had to approve a law to downsizing the private system, then another law to terminate it (Argentina, Hungary, and Poland), while in other cases it only required one law to reverse the privatization and introduce the new public system (Kazakhstan and the Plurinational State of Bolivia).

Basic characteristics of the new public model. There are common elements in the configuration of the re-reformed pension systems. We can differentiate between re-reforms that weakened the individual accounts of a pension system and re-reforms that terminated them (table 2).

A number of countries returned to a public PAYG system as before the privatization, following ILO international social security standards, with defined benefits, such as Argentina, the Plurinational State of Bolivia, and Hungary; or with notional defined contributions in Poland.

The new model consists of a three-pillar system:

– *Pillar 0: Social Protection Floor.* A non-contributory solidarity pension (universal in Argentina, the Plurinational State of Bolivia and Kazakhstan; means and pension tested in Hungary and Poland).
– *Pillar 1: Social Insurance.* A public Pay-As-You-Go defined benefit mandatory scheme.
– *Pillar 2: Complementary Pillar*. Not all countries need to have this contributory pillar (e.g. in Poland and Kazakhstan for high-risk occupations).
– *Pillar 3: Voluntary schemes*. This pillar is also complementary, for those able to have additional personal savings, managed by private pension administrators under government regulation.
– Strengthened solidarity and shared responsibility among government, employers and workers.

New rights and entitlements. With the reversal of private pension systems, benefit levels improved in most of the countries. There was a large increase of replacement rates and non-contributory solidarity pensions have been introduced in most countries. Hungary's contributory PAYG DB scheme for instance guarantees a replacement rate at 74 per cent of average earnings after 35 years of contributions. The replacement rate in Argentina also improved and was estimated at 71.6 per cent assuming 35 years of contributions. In the Plurinational State of Bolivia, the pensionable ages were lowered for the new public PAYG DB pension to 55 for men and 50 for women, and a replacement rate of 70 per cent is guaranteed with 30 years or more of contributions.

Re-establishing or creating a public pension administrator. With the end of privately managed individual accounts, where multiple private administrators collected contributions and managed smaller funds a centralized and more efficient public administrator was reinstalled. In some cases, a new entity was created to manage the individual accounts (e.g. Kazakhstan), while in others accounts were transferred to pre-existent public pension administrators (e.g. Poland). This led to increased administrative efficiency; reduction of administrative costs; and consequently, improvement of benefit levels in most countries. The reduced number of funds increased transparency and allowed for better risk pooling.

Table 2. Reversal of individual accounts and pension privatization

Terminating Individual Accounts	Downsizing Individual Accounts
■ Venezuela, Bolivarian Republic of (2000), Ecuador (2002) and Nicaragua (2005). ■ Argentina, 2008 (government ends individual accounts and transfers funds to Pay-As-You-Go or PAYG system) ■ Hungary, 2010 (government transfers individual accounts to PAYG system, merging with state budget) ■ Bolivia (Plurinational State of), 2009 (constitutional ban on social security privatization and closing of individual accounts system for new entrants) ■ Russian Federation, 2012 (contributions to individual accounts are diverted to social insurance) ■ Poland, 2011 (downsizing) and 2014 (transfer of all individual accounts back to the ZUS social insurance PAYG system) ■ Czech Republic, 2016 (new government ends Individual Accounts System)	■ Bulgaria, 2007 (cancelled the contribution increase in the individual account pillar – currently frozen at 5 per cent) ■ Estonia, 2009 (government suspended its 4 per cent contribution to the 2nd pillar) ■ Latvia, 2009 (individual account contribution reduced from 8 per cent to 2 per cent) ■ Lithuania 2009 (individual account contribution reduced from 5.5 per cent to 1.5 per cent) ■ Macedonia, 2011 (Contributions to mandatory individual accounts reduced from 7.42 per cent to 5.25 per cent) ■ Croatia, 2011 (mandatory individual account contribution reduced from 10 per cent to 5 per cent). ■ Slovakia, 2012 (Individual account contribution reduced from 9 per cent to 4 per cent) ■ Kazakhstan, 2013 (transfer of administration to the Government) ■ Romania, 2017 (government reduced and froze contribution rates to 2nd individual account pillar)

Transfer of members and funds and recognition of past entitlements. In the main cases, the reversal of private pension systems meant the transfer of most members and their cumulated assets to a collective public fund. The funds transferred improved governments' fiscal position, ending the pressures created by privatization transition costs, relieving public debts and deficits.

In Argentina, all members and assets from the mandatory private funds – around 9.5 million people and USD 25.5 billion – were transferred to the public system. In Bolivia all members, their entitlements and funds were transferred to the public system –around 0.5 million members and USD 5.4 billion. In Hungary, almost all members – 2.93 million out of 3 million – chose to return to the public PAYG system with their assets totalling USD 11 billion. In Kazakhstan, the management of all individual account pension funds and members was transferred automatically to the public Unified Pension Fund. In Poland, no transfer of members was required as every individual account member was also affiliated with the public system. Approximately USD 33 billion of assets from the individual account pension funds were transferred to the individual NDC accounts in the public scheme in 2014.

Financing: New contribution rates including re-introducing employers' contribution. In many of the re-reform cases employers' contributions were re-introduced and the principles of solidarity and participation of all social stakeholders in financing pensions strengthened (table 3). The non-contributory solidarity pensions (floor) are financed from the general budget.

Table 3. New contribution rates of public Pay-As-You-Go pension system (as a percentage of worker's wage)

Country	Workers	Employers
Argentina	11	10.17
Bolivia, Plurinat. State of	12.71	3
Hungary	10	24
Poland	9.76	9.76

Contribution collection and fund management. Governments in all cases centralized the collection of contributions through a public agency, either the tax collector or the public pension administrator, and increased efficiency and effectiveness. In Argentina, the Federal Administration of Public Revenue, a central tax collection agency, is now responsible for collecting contribution payments. In Poland, the public social insurance ZUS remains in-charge of collecting contributions, paying out benefits and managing the funds investment. And, by centralizing the management of the investments in a public entity, it resulted in more diversified portfolios, e.g. in the Plurinational State of Bolivia, and a focus on development projects, such as in Argentina and Kazakhstan.

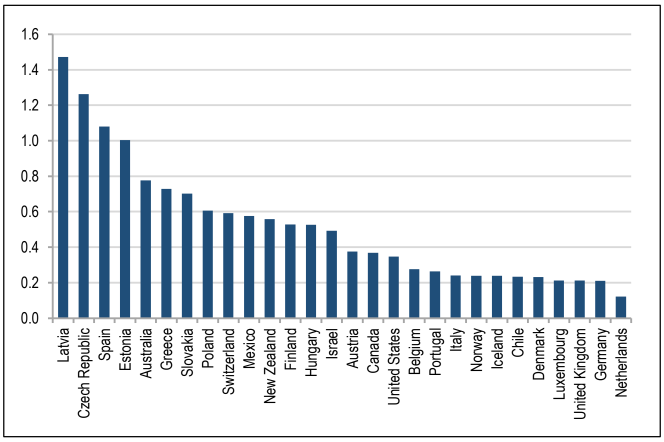
Supervisory and regulatory changes. With the reversal of the privatizations, most supervisory and regulatory agencies were abolished and replaced by newly created or reinforced public entities, often part of a broader regulatory structure, therefore increasing the transparency, accountability, and governance of the pension system, at the same time making it less prone to industry capture. For example, Argentina abolished the Pension Superintendency and introduced a congressional committee that monitors the public PAYG scheme. The Plurinational State of Bolivia also abolished the Superintendency; the Pension and Insurance Supervisory and Control Authority has the mandate to oversee both pensions and insurances. In Hungary, the supervisory and regulatory functions are now under the Ministry of Human Resources and the Hungarian National Bank.

Governance of the re-reformed systems. The re-reforms reinforced the government's role in the administration, regulation and supervision of the pensions systems in all cases. In some cases, such as in Argentina, the new governance system includes a tripartite structure in accordance with ILO international standards on social security. In Hungary, a tripartite Economic and Social Council was created as a consultative body. However, others have not yet included tripartite representation.

Social Dialogue in the re-reform process. The overall weak performance of the private schemes in terms of lowering benefit levels – making them very unpopular – as well as the high transition and administrative costs, motivated governments to undertake the re-reform process with eagerness, the population was, in general, supportive of the re-reforms switching back to public pension systems. In most re-reforms, speed was generally prioritized over social dialogue.

Positive impacts: Reduced administrative costs. While the reversals of pension privatization need more years to mature, clear and measurable improvements and positive impacts can already be observed. Many countries introduced measures to curb administrative costs to ensure that the new pension systems would be less costly. Commissions and fees were effectively abolished in Argentina including for the public system, as was the case for the remaining individual account funds in Hungary; commission fees and operational costs were halved in Kazakhstan and significantly reduced in Poland. OECD countries with DC systems and a large number of small funds had higher operating costs, including administrative costs and investment expenses, than countries with public PAYG defined benefits.

Figure 3. Operating expenses in selected OECD countries, 2016 (as a percentage of total assets)



Positive social and economic impacts. The reversal of pension privatization and reintroduction of solidarity elements significantly improved the level of benefits. Replacement rates rose substantially, as presented earlier. Benefits for women were improved in countries such as Argentina, the Plurinational State of Bolivia, and Hungary. Additionally, most re-reforms also resulted in an increase of coverage, including through the creation or strengthening of social pensions. With the increase in coverage, introduction/extension of non-contributory benefits and higher replacement rates, the risk of old-age poverty has been significantly lowered. Government invested a part of the nationalized funds in public investment projects (e.g. nuclear power electricity plants, roads, trains, public housing, etc.) which are expected to create positive multiplier effects.

Positive fiscal impacts. Short term government finances improved significantly as a result of the re-reform. The transfer of accumulated assets as well as contributions from the private to the public system naturally had an overwhelmingly positive impact improving pension finances and fiscal balance. Yet the longer term implications will depend on the countries' ability to adapt their pensions systems to the changing demographic, economic and labour market conditions through timely and properly designed parametric reforms.

Table 4. Positive impacts of switching from private to public pensions systems, 2009–14 (selected countries)

Argentina	USD 25.5 billion were transferred from private funds into the public fund, eliminating the public system's deficit and decreasing the government debt from 53 to 38 per cent between 2009 and 2011.
Bolivia	USD 5.4 billion were transferred from the private to the public system, decreasing the public debt from 38.5 to 33.9 per cent of GDP between 2010 and 2011.
Hungary	USD 11 billion of the private funds were transferred to the public fund, decreasing the fiscal deficit from 5.8 between 2005–10 to 2.75 per cent in 2011 and public debt decreased from 81.8 to 79 per cent of GDP between 2010 and 2012.
Poland	USD 33 billion were transferred to the ZUS, reducing the fiscal deficit from 4.78 per cent (between 2006 and 2011) to 3.72 per cent (between 2012 and 2017), and public debt from 56.2 to 50.2 per cent of GDP between 2011 and 2014.

Policy steps to reverse pension privatization

Pension privatization can be reversed quickly, in as a little as a few months. For those countries considering rebuilding their public pension systems, there are eleven main policy steps:

1. Start social dialogue to generate consensus and launch communication campaigns
2. Constitute a technical tripartite reform committee, in charge of designing and implementing the renationalization of the pension system
3. Enact law(s) with the main characteristics of the pay-as-you go defined benefits scheme, in compliance with ILO social security standards
4. Create a public pension institution/ administrator ensuring tripartite governance
5. Transfer members from the private to the public system
6. Transfer the accumulated resources of the individual accounts
7. Set new contribution rates and start collecting contributions for the new public pension system
8. Close the contribution collection mechanism of the private system
9. Implement inspection services and contribution enforcement mechanism
10. Create the unit or entity in charge of investment management of the public pension scheme
11. Close the private sector pension supervisory and regulatory body

Concluding

This brief, based on the publication "Reversing Pension Privatizations – Rebuilding public pension systems in Eastern Europe and Latin America", documents the underperformance of private mandatory pensions, and abstract lessons for governments intending to improve their national pension systems. Strengthening public social insurance, coupled with non-contributory solidarity pensions, as recommended by ILO standards, has improved the financial sustainability of pension systems, and made pension entitlements better and more predictable, allowing people to enjoy a better retirement in their older years. The responsibility of States to guarantee income security in old-age is best achieved by strengthening public pension systems.

The issues brief is based on the publication "Reversing Pension Privatizations – Rebuilding public pension systems in Eastern Europe and Latin America" by I. Ortiz, F. Duran-Valverde, S. Urban and V. Wodsak.

The editor of the series is Isabel Ortiz, Director of the Social Protection Department, International Labour Organization (ILO). For more information, contact: socpro@ilo.org.

International Labour Office, 4, route des Morillons, 1211 Genève 22, Switzerland

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