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EDITORIAL

Pension Reforms
Roadmap for Pushing Individual Savings to the Vagaries of Market

- Piyush Pant

Though privatized pension system does exist in India in the form of National Pension System since 2004 when Government of India launched it on 1st January by moving from a defined benefit pension to the defined contribution based pension system as a first step towards bringing reforms in the pension system, the government is now on fast gear to bring Pension Fund Regulatory and Development Authority Bill or Pension Bill to open the doors for foreign companies to invest up to 49 % in companies that manage pension assets in India. It also aims to officially create a regulator for India's pension sector. The Pension Fund Regulatory and Development Authority was created in 2003 as a regulator for pension assets, but wasn't given any powers. The bill, if passed, would legally empower it to make rules for this sector, including for fund companies which manage pension assets. Also, until now foreign companies can't be a part of pension fund companies, but the new rule would allow them part ownership. If the bill is approved, the pension regulator would oversee the New Pension Scheme, which became effective in 2004. Under the plan, central and state government employees that joined service after 2004 contribute a part of their salary to this scheme, which is matched partly by the government. The funds thus collected by the National Pension Scheme are managed by asset-management companies, who in turn invest it in a combination of stocks and bonds. The goal of the Scheme is to make this money grow until the pensioner retires and draws on his or her savings in the pension plan.

This system is different from the previous government pension plans, which fall into defined-benefits category-where pension was guaranteed as a set percentage of the most recent salary received by the employee.

The newly found enthusiasm of the Government to open up the pension sector for foreign companies seems to have been derived from the assumption that the type of pension reforms carried out in Chile helps in developing the financial market wherever the reform is adopted. Says Holzmann-The Chilean pension reform of 1981 by which a shift from an unfunded to a funded pension system was affected is seen to have special attraction for other emerging economies of the world as this is considered to have contributed to the country's excellent economic performance. According to Holzmann (1997), the fundamental claim about the effects of this pension reform, echoed globally, is its contribution to financial sector development. However, recently, growing criticism has continued to trail the World Bank's recommended pension reform programmes. An example is the assessment of the World Bank's Independent Evaluation Group (IEG, 2006) of the various pension reform programmes initiated in many countries of the world. Among their various criticisms the IEG study noted that the Bank pushed ahead with pension privatization in several countries of Central Eastern Europe and Central Asia despite lacking sound financial system. The report mentions three Latin America countries: Dominican Republic, Ecuador and Nicaragua, which enacted Bank recommended pension privatization without sound financial sector. In Nicaragua, the Bank finally, had to accept to put the reform on hold (IEG, 2006).

If we talk about the impact of pension reforms on the economic development in Latin countries, the facts and figures provided from cross section experience indicate that Pension reforms in Latin American countries particularly that of Chile did not have much growth and savings effect whereas they have provided boost to capital market development but at a high cost, offsetting the gains of capital market development. On the other hand countries like Sweden, Singapore and Malaysia with alternative arrangements and Pension Systems have registered better growth in GDP, Saving and Capital Markets. Experience in Chile shows that desired cost effective return could not be achieved there.

In this issue of **Infopack** we have given the summary of various documents highlighting the success and failure of privatised Pension System, particularly the Chilean model.

Chronicle of a Disaster: Pension Privatization and the Credit Crunch

By:

Robin Blackburn

Bird's Eye View

The 43-page document states that public and private pension arrangements involve huge financial flows because they are required to cover increasing sections of the population. The course of globalization itself has been shaped by institutional investors, many of them pension funds. At present pension provision is largely confined to the richer countries but it is gradually dawning that pension arrangements are needed everywhere and faltering and failing everywhere. Public pensions survive better but their finances will be strained as rising unemployment weakens their contributor base. Many governments have favoured commercial pension producers but the latter are reeling from stock markets which were 'a disaster for savers' (Economist 2008). Many of the banks which orchestrated the speculative orgy themselves became its victim as they have had to absorb many billions of losses. But that still leaves several trillions of losses to be accounted for and among the worst hit have been pension funds of every type, both collective and individual. An OECD report in October 2009 calculated that pension funds incurred losses of $5,400 billion in 2008. The following year saw some recovery allowing the funds to claw back $1,500 billion of these losses. But losses of nearly $4 trillion across two years cast a chill shadow over a world about to experience dramatic ageing. Worst hit were pension funds in a variety of countries where the pension funds had been persuaded to rely heavily on equities.

An Ageing World

The document says that by 2050 the UN Population Division expects there to be two billion persons aged 60 or over worldwide, with 1.6 billion of these in the less developed countries. By 2050 Asia, a category that includes India and China is expected to have no less than 1,249 million older persons (UN Population Division 2006).

There were 88 million persons aged 80 and above worldwide in 2005, a figure that is projected to rise to 402 million by 2050 according to the UN Population Division mid-range projections.

The document further says that there are few countries which have arrangements fully adequate to the rising future need for the care and support of the elderly. In the developing world and poor countries many of the aged are sunk in absolute or extreme poverty.

The ageing process is more advanced in the richer countries of Western Europe, Japan and North America and this is matched by much stronger pension provision. Nevertheless, an increasing number of the aged in these countries are likely to suffer relative poverty if current arrangements are not improved.

The document points out that less than a quarter of the world's population have arrangements in place to pay them pensions when they are old. While the old in the OECD group of rich countries enjoy the best coverage, some are much better than others. Nearly every advanced country has a public old age pension system, usually financed by a pay-as-you-go system of pay-roll taxes or insurance contributions.

The Rise of Public Pensions

The document further says that the public and the private have long had a stake in pension provision, sometimes a clear division of labour, sometimes in stark competition with one another. The first state-supplied social insurance schemes were introduced to fill the yawning gaps left by commercial suppliers and to furnish at least a measure to social security to all at times of general economic distress. Commercial suppliers of pensions and company retirement schemes did not aim to cover the whole population, and often failed their beneficiaries in economically troubled times. Between 1914 and 1950 political and economic shocks - war, depression, hyper-inflation and bank collapse - destroyed many pre-second-world-war pension schemes and revealed others to be vulnerable or incomplete. The Second World War was a watershed after which universal public pensions schemes spread within most of the industrial nations. Universal coverage was expensive but the war had shown that huge sums could be raised from taxation.

The document further says that in the US Social Security was widened in 1949 to embrace the whole population while in Western Europe and Japan around this time universal provision of old age pensions was put on a new and, as it turned out, viable basis by resort to pay-as-you-go financing principles. As contributions flowed into the new schemes from a pay-roll (national insurance) tax, these revenues were paid out to cover the first pension entitlements. And so far as the future was concerned, the government was able to pledge its taxing power to promise that the entitlements created by current contributions would be redeemed by future streams of revenue. Private pension providers could not match this pledge. They needed to build up a fund before they could make any pay-outs.

The United States, Britain and a few other states (Netherlands, Switzerland) still had commercial pensions. These states, with their 'mixed' or 'divided' pension regime, had long-established stock markets and politically-influential financial corporations.

The high tide of public pensions was reached in about 1980 after which determined efforts were to be made to weaken public provision in a pattern that has been called 'implicit privatization', since the mass of citizens were urged to look to commercial pensions to make up for the public shortfall. While Esping-Andersen showed that public systems could generate impressive levels of public pension provision, the more surprising finding was that private pension delivery still had an elite rather popular character in the United States and Britain, generating pension amounting to only about one per cent of GDP in 1980 (Esping-Andersen 1990). While pay-as-you-go had immediately generated large streams of pension payments, the commercially-funded approach would take decades to mature and until it did its efficiency and reliability remained unclear. However, the very success of public provision seemed alarming to some observers, especially free market economists like Milton and Rose Friedman who attacked US Social Security as a socialist cuckoo introducing an alien collectivism to the cosy nest of US capitalism. (Friedman 1980). The woes of capitalism in the 1970s and 1980s were laid at the door of a collectivism that was crowding out capital accumulation.

From Implicit to Explicit Privatisation

The document says that Margaret Thatcher was the first to take a small but significant step towards what came to be known as 'implicit privatisation'. In 1987, the returns to the State Earning Related Pension (SERPS) were slashed. While public pension shrivelled, new opportunities and tax breaks were opened to commercial suppliers. Members of occupational schemes, whether public or private, were encouraged to leave them and to establish individual pension pots instead. This laid the basis for a gigantic 'mis-selling' scandal in which one and a half million savers were able to sue the commercial pension suppliers for having promised, but not delivered, better returns than the occupational schemes they had been persuaded to leave.

The relative value of the British state pension declined remorselessly - worth 20 per cent of median earnings in 1980 it dropped to 14 per cent by 1997. The steady decline in public provision meant that employees needed to take out a private plan if they wished to avoid the breadline in old age - the logic dubbed 'implicit privatization' by Paul Pierson (Pierson 1996). In the 1990s and 2000s, fund managers found a ready market for their tax-favoured pension plans. London's facilities as an international financial centre, helped them to distribute the money entrusted to them amongst a wide range of investments throughout the globe.

The document further says that while the UK showed what 'implicit privatization' could achieve, a small South American state was to be hailed as the model for 'explicit' privatization. Chile suffered hyper-inflation and a military coup in the 1970s and then a deep depression in the early 1980s. The public pension scheme was drastically weakened. Jose Pinera, the finance minister appointed by the military dictatorship proposed that contributions to the state pension scheme be made voluntary, with employees who agreed to leave it being required to join tax favoured privately-managed accounts instead. Those who remained in the state system were warned not to expect more than a modest subsistence denominated in a still weak currency. Pinera believed that a private, funded scheme with a wide membership would solve two problems at one stroke. It would lift much of the burden of pension provision from the public budget while simultaneously deepening local capital markets. The pension contributions were to be invested in property, shares and other marketable assets. Following introduction of the new scheme, these could rely on a steady stream of business. The AFPs offered 'definite contribution' benefits - whatever income could be obtained by the savings in the personal account - so their members were directly at risk from high charges and rocky markets.

The 1980s and 1990s were marked by a gathering process of financialization as the financial services industry offered sophisticated new products which, so it was claimed, would help customers to negotiate the longer life course and would also furnish new revenue streams to the finance houses. Such instruments included student loans, 'baby bonds' and credit card debt but the real money related to housing mortgages and pension funds, especially personal pension plans. (Blackburn 2006 [a] and 2006 [b] 20-9, 172-77)

By 2006 the US mortgage market, inflated by a housing bubble, was worth $11 trillion. The global value of all assets in pension funds in December 2007 was $26 trillion, compared with global GDP of $55trillion. In 1998 the value of equities held by pension funds was around $5 trillion (Monks 2001). By the end of 2007 this had grown to around $15 trillion of equities and $11 trillion of other assets. The tripling of pension fund equity holdings in a decade reflected both continuing net contributions to these systems and a stock market peak. While US pension funds might place around ten to twenty per cent of their investments overseas, the European states often placed a half or more of their investments in foreign, often US, capital markets. By 2007 the US and British funds still managed about a third of all pension assets, but public funds in Japan, China, Singapore and Norway, as well as the US and UK, accounted for 67 per cent of the pension assets held by the world's 300 largest funds (Watson Wyatt 2008).

The Resilience of US Social Security

The document states that French insurance houses and German banks wanted legislation that would prune back public pensions and encourage savers to go for individual accounts by giving tax relief. The campaign for pension privatization certainly reflected the banks' hunger for new business but there was also a strong ideological component as free market think tanks identified public pension systems as a drag on capital accumulation. Privatization would widen capital markets and would diminish the role of the state in redistribution.

Most US neoliberal or conservative think tanks supported Social Security 'reform'. The privatizing lobby in the US found that there was fierce resistance to even partial privatization of Social Security. The privatizing lobby in the United States found that there was fierce resistance to even partial privatization of Social Security. When George W. Bush proposed in 2004-2005 to divert a portion of the pay-roll tax to 'individual accounts' to be invested in the stock market they encountered stiff resistance from the American Association of Retired Persons (AARP). Republican Congress quickly learned that Social Security reform alarmed their voters.

Current retirees worried that there would be less income flowing in to pay their pensions while their children did not want to put at risk either their parents or their own pension entitlement. The rebuff to George W. echoed the defeat of earlier schemes to part-privatize Social Security. Reagan abandoned an attempt to downsize Social Security in 1983 while in 1999 President Clinton junked an elaborate plan to establish private accounts drawn up by his Treasury Secretary, Lawrence Summers, the former World Bank Chief Economist, who was a strong partisan of pension privatization. Clinton had the political instinct to see that he could not escape impeachment if he tried to tamper with Social Security.

The World Bank Focuses on Privatization in Richer Markets

The document says that though checked at home the US privatizing lobby, together with local allies, vigorously pursued their cause overseas. While US administrations could not persuade their own electorate to swallow the medicine of pension privatization they had much more success in foreign lands. The cause of pension privatization was given priority by the World Bank, with strategic support from IMF and USAID, Washington's own development agency. While these institutions took the lead in promoting the replacement of public by commercial pension provision the neoliberal think tanks and the big banks played a supporting role, helping to cover the cost of seminars, surveys and position papers, and undertaking a major promotional effort once legislation was imminent (Orenstein 2008).

The document further says that the rationale for the campaign of pension privatization was given by a landmark report issued by the Bank in 1994, *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (World Bank 1994). The Bank claimed to address the global ageing problem but in practice it had little to say about preventing destitution among the elderly in the poorer and less developed countries. If one considers the plight of the world's two billion poorest inhabitants, living on $2 a day or less, it is clear that they are not a realistic target for financial products and that expecting highly-paid fund-managers in the world's financial centres to handle their money would be a grotesque mismatch. In fact it would be much more appropriate to levy a world-wide Tobin-style tax on financial transactions - or a share levy on corporate profits - in order to fund a global age pension of, say, one dollar a day (Blackburn 2007). But this was the very last thing on the minds of the World Bank.

The World Bank's real focus was instead on middle income states on Eastern Europe and Latin America - and on developed states with a 'dominant' public pension system. The former Communist states were already shaken by free market 'shock therapy' and were consequently less resistant to drastic neo-liberal reform than, say, the Asian 'tigers'. In Latin America the recent experience of hyper-inflation, military dictatorship and 'structural adjustment' traumatized public opinion and prepared the way for privatization: public pensions had already become practically worthless and few rallied to their defence. The Bank's idea was to replace exhausted public systems with 'mandatory (i.e. compulsory) individual pension plans offered by commercial suppliers.

The document further points out that one of the thorniest problems faced by the advocates of pension privatization was that of explaining how the transition from pay-as-you-go to funded personal accounts could be negotiated. The case for privatization stressed that it was far better for pension contributions to be invested in the stock market than used to pay current pensions. The returns would be better and the arrangement would not be vulnerable to big differences in cohort size, with a small working age cohort obliged to fork out ever higher contributions to pay pensions to a large retired cohort. But if pay-roll taxes were paid into personal accounts they would not be available to pay the pensions of current retirees in the public system. This was a political as well as economic problem since voters would worry about the fate of their own entitlements.

The European Prize

The document says that the campaign for pension privatization was to win its first victories in Eastern Europe and Latin America but the real prize was a change of regime in the world's richer countries, with their potentially valuable contributor base. Japan was an unrealistic target. It already possessed a mixed regime of public and private pensions and the nineties - the aftermath of the collapse of the 'bubble economy' of the late eighties - was scarcely the right moment to compel citizens to put their life savings in the stock exchanges. But Europe was another matter. There was unhappiness at the performance of the European economy. Strong public pension systems were blamed for labour market 'rigidity' and high unemployment. Pension systems in Germany, Italy and France offered pensions to which all employees contributed and paid out pensions which all could claim. Though quite complex, with special schemes for different types of employee and some reliance on employer support, these arrangements were all overseen by, and backed by, the state.

The advice offered by the World Bank proposed a variant of the Chilean 'model', whereby all employees would be required to save in commercially-managed individual pension accounts. The citizens of the European Union were suspicious of the World Bank's market-friendly message but the centre left and left parties seemed to have reached an impasse and could not see an alternative. It made a demoralising accommodation to market economics. The failure of Gorbachev's reforms weakened the Left everywhere.

The document further says that most countries belonging to the European Union still had little commercial pension provision. The publicly-mandated schemes in France, Germany and Italy had close to universal coverage and delivered a pension, together with occupational supplements, of 60-70 per cent of pre-retirement earnings. These deeply entrenched public pension systems, and the collectivist welfare arrangements of which they were a part, represented a hold-out against the now triumphant formulas of free market economics. At the same time they acted as a barrier against the ambitions of the global financial services industry.

Some sections of the European financial services industry, notably the French insurance houses and some of the German and Swiss banks, became strongly committed to pension reforms since it would open up impressive new business opportunities.

The World Bank Model

Here, the document says that as the analysis of the report unfolded public pension provision, and the payroll taxes used to finance it, were indicted for being major culprits generating stagnation, firstly because of the economic distortions they generated and secondly because they stood in the way of private pensions which would expand the capital market. The payroll taxes deterred employers from taking on workers, leading to unemployment and a growth of the 'informal sector'. The impact on capital markets of overweening public systems was as nefarious as the impact on labour markets, squandering savings, deterring private entrepreneurs and blocking the inventiveness of the financial services industry.

The document further says that the report advocated a change in the weight and importance of the three pillars of pension provision. (1) The first pillar was the tax -financed public pension, which was to be reduced to a safety net. (2) The second pillar was occupational pension schemes, which were to move from 'defined benefit' to 'defined contribution' and to be managed by the financial services industry. (3) The third pillar was personal savings, which were to become mandatory, with contributions channelled to and managed by commercial suppliers.

The prescriptive bias of the report was thus directed against the 'dominant public pillar', which was the problem, towards mandatory personal savings plans, which were the solution. (World Bank 1994 107) State pension entitlements needed to be cut right back. They were cursed by increasing dependency ratios, overgenerous and ill-thought-out benefits, overmaturity and negative side effects. Existing schemes were 'financially unsustainable' because they could only be paid for by doubling or trebling payroll taxes that were already too high. The 'tough choices' imposed by the 'unsustainability' of the pay-as-you-go (PAYGO)systems included cutting back benefit levels, raising the retirement age, raising taxes - and moving to a new regime where state pensions no longer bore the burnt of retirement provision but instead acted as a safety net. The occupational pillar was treated with a little more respect but with an emphasis on moving to a fully commercial basis. Overall the retention of the re-assuring and time-hallowed image of three 'pillars'-each of which was meant to be strong -accommodated a shift to an ungainly structure with a weak first pillar, a shifting second pillar and a dominant third pillar.

The Bias in Favour of Personal Accounts

The document says that while the report emphatically supported private over public provision it also favoured personal accounts, organised on the 'defined contribution' (DC) model, over occupational schemes, organised on the 'defined benefit' (DB) model. The DC schemes usually had (and have) a lower employers' contribution, but they were more likely to be portable. An advantage of the traditional occupational schemes was that contributions could be easily implemented through payroll deductions. If employees were to have a choice of personal pensions, as in the US 401 (k) DC-style schemes, then this would lead to extra marketing and administrative expenses. However, by making deductions mandatory at least some of these costs could be reduced, allowing the report blandly to conclude: 'Overall, personal savings schemes would seem to have the edge for the privately managed mandatory pillar.' (World Bank 1994 246).

The case against ever-higher payroll tax rates was, by itself, not without merit. Unlike income tax, payroll taxes are not 'progressive', that is they do not take more from the rich than the poor. Analysis showed that the workers actually bore the cost of so-called 'employers contributions' to the payroll tax. But decisive argument against high payroll taxes - say above about 15 per cent of salary - is that this would sap demand and raise labour costs.

Public Funds Can Supplement PAYGO

The document says that the criticisms made by the report strained logic and credulity when they claimed that the answer was pension privatization and mandatory membership in commercially-managed schemes. The demographic challenge, in itself, yielded absolutely no conclusions about the best way of delivering pensions. While public pension systems have met the challenge of raising great chunks of GDP, private funds have yet to equal this ability. The greying of the population does indeed demand supplementary sources of finance - perhaps the taxing of capital not labour - but this does not require commercial fund management. Already in 1994, there were many successful public sector pension funds.

The document further says that in fact the case for allowing pay-as-you-go (PAYGO) to remain a major source of pension finance was never squarely addressed. It was claimed that PAYGO was 'unsustainable' when it really meant that payroll taxes were likely to raise something less than 100 per cent of the target level, instead of being grateful that PAYGO could raise 80 or 90 per cent of needed revenues and looking for a supplement. It also neglected the efficiency of pay-roll taxes.

While the authors of the report rule out tax increase as politically unfeasible, they instead assume that citizens will accept compulsory deductions from their earnings so long as they are put into approved, tax-favoured personal or occupational funds. At this point their argument could have concluded that social insurance contributions should go into publicly-managed fund or network of funds and not be treated as another tax and that social funds should be visibly more accountable to those they were supposed to benefit. Likewise the report could have suggested that taxes on corporations or the rich could have been called on to make up for shortfall in pension receipts. But the report is, in fact, hostile to such approaches. Instead, it insisted that pension funds had to be commercially managed and subject to lighter public regulation. It claimed that those forced to pay contributions will see them as the price they are paying for a purchase and that this perception will banish all the negative aspects of payroll taxes.

The Cost Disease of Private Pensions

While singing the praises of privately furnished pension schemes the report admitted that the coverage of private pension funds is usually too narrow and that is why a mandatory approach is needed. The report urged that pension funds should be free from political interference and that they should be 'liberated' from such irksome restraints as minimum holdings of public bonds or controls on the export of capital.

Employees would accept the obligation to pay a portion of their earnings to the financial services industry because of the promise of good returns from the stock market. The capital markets would receive a much-needed boost and the employment-harming effects of high taxes would be avoided. Tax breaks were to continue.

The pension fund industry, having been created in its present form by lavish tax concessions, was thus now to be further boosted by compulsory, government-subsidized contributions from the entire workforce. The report's recommendations supposedly applied to a swathe of developing countries too. It was urged that lack of trained administrators need be no obstacle: 'The shortage of local expertise in many developing countries may be overcome by using foreign fund managers in joint ventures with local firms' (World Bank 1994, 139-40).

The document further says that the report mildly favoured personal savings over occupational funds, but strongly favoured private funds of any description over state sponsored provident funds - despite what was admitted to be the higher administrative and marketing charges involved in the former.

The document further says that the report did not completely ignore over-charging and competitive waste in privately-run schemes. It also noted that commercial fund managers could be guilty of 'short-termism', herd-like behaviour and elitism vis-a-vis the local or small-scale. But whereas the failure of private pension schemes posed 'regulatory issues' which could be addressed, those of funded public schemes were irredeemable, so they should be abandoned.The report worried that if 'centralized provident funds' were to 'invest in corporate equities, public officials could gain control of corporate affairs, a back door to nationalization' (World Bank 1994, 93-4).

The message of the report offered a one-size-fits-all recipe. But the main pre-occupation was not reaching out to the majority of the world's population who have no pension coverage, but rather to concentrate on dismantling public provision in richer countries where this might deliver new business to the fund managers. Notwithstanding, the references to the 'multi-pillar' approach, few readers could miss the emphasis on, and the novelty of, the proposal for mandatory personal savings plans. Joseph Stiglitz, a later Chief Economist at the World Bank, became alarmed at the new dogma of pension privatization and co-authored (with Peter Orszag) a trenchant critique of *Averting the Old Age Crisis* in 1999. Some of the Bank's operational staff admitted that there were risks in scrapping public provision and placing all resources in vulnerable commercial funds. But the momentum of the privatization campaign was only momentarily disturbed. Shortly thereafter Stiglitz was removed from his post. (Stiglitz and Orzsag 2001, Stiglitz 2002)

The document further states that the report had strong bureaucratic backing in the Bank and IMF. Privatization often meant that public pensions could be cut to the bone and pay-roll taxes converted into contributions to a local branch of the international financial services industry. Whether stock market investments would really lead to better pensions in the future was something that only time would tell - for the moment it meant one less headache for the authorities. Meanwhile, the World Bank and IMF offered expert assistance and conveyed the message that governments that followed their advice would get better credit scores and favoured treatment from international lenders.

The document further says that the 'privatizing' of pensions matched the privatization of public assets that was already underway. Shares in privatized railways and telecoms could be purchased by the fund managers with money supplied by scheme participants. This offered lush new grazing grounds to banks, insurance houses, fund managers and stock exchanges. The fund managers would also be able to purchase US securities, adding zest to the US exchanges. To call this a recipe for wild capitalism would not be fair since it required a new regime of publicly-managed, publicly-organised and publicly-subsidised contributions from the mass of employees. Governments were not only to offer handsome tax incentives but were often expected to turn public bodies into collection agencies for commercial concerns. However, even the magic of financial engineering finds more difficulty in conjuring a profit out of public obligations than out of public assets. While undervaluing the latter led to the brisk take-up of shares, the devaluing of public pension obligations by no means ensured that commercial funds would be able to take their place.

Pension Privatization

In this context, the document states that supposedly Western Europeans could replace lost public pensions by taking out private pension coverage. Fearful of popular reaction, and aware that it would aggravate the deflationary climate, their governments had declined to make commercial provision compulsory. Those who reach retirement age around 2030 are headed for a double shortfall. Their public pension has shrunk and accumulation in commercial funds will not be able to take their place. The advocates of pension privatization claimed that savers could look forward to an annual rate of return of 7 per cent or more in real terms. But this is a delusion. The roller coaster of the stock markets in 1997-2008 - ending close to where they began - have confounded such expectations. The loss of a decade of growth will be very difficult to make up prior to the retirement of the baby-boomers. Financial crises have not been external to the regimes of financialization and globalization but integral to it

(Brenner 2006, Glyn 2006, Turner 2006).

Despite tax concessions fund managers have failed to demonstrate that they can generate the huge sums needed to avoid pensioners falling further and further behind the rest of the population.

The document further says that in Pension Privatization, Mitchell Orenstein notes that the World Bank identified key political leaders, state officials and opinion-formers and invited them to conferences on pension privatization in 'attractive locations'. The World Bank paid for public relations campaigns - $1.4 million in the case of Poland. He adds: 'The World Bank not only seconded or released its own employees to participate in the reform teams for pension privatization ... it has also hired prominent (local) pension reform officials onto its staff (Orenstein 2005, 91). The IMF played a different but complementary role. In another dimension of what Orenstein terms 'resource coverage' it indicated that loans would not be forthcoming unless and until pension reform was tackled. Loans to assist transition costs, on the other hand, were made available by the Bank not the IMF.

Nevertheless, the pension fund managers did help to attract a flow of European capital to the US and thus to cover current account deficits that were placing great pressure on the financial systems. The Harvard economist Martin Feldstein was a prominent champion of pension privatization. He also worried about the huge inflow of capital into the US (Blackburn 2003 392-99). This was less inconsistent that it might appear. If the US needed an inflow of funds to offset it deficits then better that it should be in the form of penny-parcels managed by US finance houses than that it take the form of the purchase of entire corporations, as happened with Japanese investments. However, from the standpoint of the European savers, prospects were bleak. When the crash came in 2007-2008 many European banks and insurance houses were left holding toxic assets. Those who had invested in the new pension schemes found that the value of their funds had fallen by a half or more.

It is testament to the persuasive powers and 'resource leverage' of the financial services industry and the free market think tanks that they persuaded so many governments to jettison public systems that simply needed supplementary finance and instead plumped for private systems which were a recurrent source of scandal in the US and UK, and whose returns had always been poor. The global growth in pension funds was part of a wave of financialization which helped to generate a succession of asset bubbles and their eventual collapse.

The Private Pension Bonanza 1990 to 2007

Under this title, the document says that in the US and Britain de-regulation of financial institutions and privatization of non-commercial entities allowed for a dramatic expansion of commercial money management. DB schemes were withdrawn by many employers and DC pension plans their place. The types of funds included public and private sector employer-sponsored occupational funds, usually organised on a DB basis, and individual savings plans, operated by money managers offering DC pensions. By the 1990s, pension funds of various sorts had become major investors and potential customers for the new structured finance products and Special Purpose Vehicles offered by the banks and brokers.

The US authorities left the corporations great latitude in estimating future liabilities since to have done otherwise would have risked pushing them into bankruptcy. Nevertheless, several giant steel, airlines and auto companies were driven close to bankruptcy. This created a new type of entrepreneur, the 'vulture capitalist' who bought up troubled companies, and they then applied to the bankruptcy court to allow them legally to transfer the company's pension and health care promises to the Pension Benefits Guarantee Corporation (PBGC), a Federally-mandated insurance scheme set up in 1974. On average the PBGC pays out about 70 per cent of the benefits promised by the schemes it has taken over. If the courts agree to this transfer of liability, as they usually do, then the value of the company rises and it can be sold for a healthy profit. Hundreds of thousands of workers find that their pensions have shrunk - and some may lose their jobs too. While this spectacle is a wretched one the brutality of the vulture capitalists is only part of the problem. The root flaw is that the pension fund is sponsored by a single employer which, over a few decades, may go from blue chip to a basket case. (Blackburn 2006 [a] and [b])

Public sector workers have been in a somewhat stronger position since their employers find it more difficult to escape the promises they have made. They have also had the advantage of cost-effective and sometimes enlightened fund management. US pension funds began investing overseas on a large scale in the 1990s and foreign pension funds have increased their US holdings. However, the speculative fevers of financialization communicated themselves to even said pension funds and they began to take stakes in hedge funds and private equity partnerships.

The individual plans beloved of pension reformers have been the most vulnerable to poor returns and the gaming of the small saver. The years 2001 to 2008 were marked not only by market fluctuations but also by an extraordinary succession of scandals associated with insider dealing, phony accounting, off balance-sheet entities (SPEs), back-dated executive opinions, exorbitant bonuses, bid-rigging by insurers, and fund managers permitting afterhours arbitrage at the expense of their own customers. The term 'grey capitalism' evokes important features of a financial regime riddled by insider abuse and in which pension beneficiaries do not know what is happening to their savings. Fund managers were not responsible to policy holders and CEOs were not accountable to share-holders (Useem 1996, Bogle 2006). The term also sought to draw attention to the murky practices of financialization, including the growth of an unregulated secondary banking system (Blackburn 2006 [b] and 2008).

The Credit Crunch

The document points out that the people arrive at the credit crunch and the swooning stock markets of 2007-8. At its core the crisis was caused by politicians who believed in the magic of markets and in the exemplary qualities of business. They did what the consultants and special interest lobbies told them made business sense.

Huge global imbalances - China's mountainous surpluses and the chasm of the US deficit - prompted the US Federal Reserve Bank to adopt absurdly low interest rates in 2001-2006, which in turn led to 120 percent mortgages, a shower of gold cards and a proliferation of structured finance products, better thought of as instruments of mass self-deception.

The document further says that US households were cast as the world's 'customers of last resort' but had to go deep into debt carry this off. The banks and hedge funds took on huge amounts of 'leverage' and companies taken over by private equity groups were burdened with massive debt. Politicians helped the party along by de-regulating and privatizing. Investment banks were no longer barred from retail finance and the pressure to financialize becomes ubiquitous. People were encouraged to see themselves as two-legged profit and loss centres. Households were meant to behave like businesses, businesses to behave like banks, and banks to behave like hedge funds. By taking on leverage one supposedly did away with 'unrewarded risk'. Giant companies like GM and GE now made their profit not from selling their products but from arranging the accompanying consumer finance. The derivatives revolution made poor people's debt the caviar of the finance houses.

The privatised model of pension's provision has been engulfed by the onset of the credit crunch. Tens of millions have been persuaded to invest in commercially-managed schemes that have lost much of their value. Recession and/or unemployment have forced many to raid their savings to meet current living expenses. Nevertheless, the crisis has witnessed a resort to collective solutions that could point in a quite different direction. States which still have a pay-as-you-go system of pension finance will want to protect it.

The recession, aggravated by the credit crunch, has delivered a body blow to almost all pension funds. Global Pensions cited a study estimating that US pension fund looses of all types had lost $3.4 trillion - $2 trn for the DC schemes and 1.8 trn pound for the DB schemes - between January and October 2008 (Legorano 2008). The shock to non-US funds could be larger or smaller depending on their portfolio and currency.

As the recession shrinks the labour force and earnings, the yield of PAYGO pension systems will also be reduced. Poverty helped to create the credit crunch, both the domestic poverty of subprime borrowers and the low earnings of China's workers and farmers, since the latter led to huge global imbalances. (Blackburn 2008, Turner 2008, Glyn 2006) Rising unemployment will reduce the yield of PAYGO schemes but these remain in a far healthier state than all DC, and most DB schemes. The best solution would combine (1) some extra resources for the PAYGO scheme, (2) a new publicly organised layer of funded second pensions, absorbing existing DC and DB arrangements. A well-balanced pension regime could contribute to redistribution and better governance, helping to mobilize investment resources in needed direction.

At the end, the document says that following the credit crunch the siren song of privatization is now likely to be muted. However, it would be foolish to suppose that schemes of implicit or explicit privatization will not again be pressed as solutions to the pensions crisis. Such proposals are backed by powerful lobbies and will not disappear until the underlying pension challenge has been met.

Rethinking Pension Reform: Ten Myths about Social Security System

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Bird's Eye View

This 48-page document was prepared and was presented at the Conference on pension reform, titled "New Ideas About Old Age Security".

The document says that in 1994, the World Bank published a seminal book on pension reform, entitled Averting the Old Age Crisis. The book noted that "myths abound in discussions of old age security". This document examines ten such myths in a deliberately provocative manner.

The ten myths examined in the document include:

Macroeconomic myths

Myth 1: Individual accounts raise national saving

Myth 2: Rates of return are higher under individual accounts

Myth 3: Declining rates of return on pay-as-you-go systems reflect fundamental problems

Myth 4: Investment of public trust funds in equities has no macroeconomic effects

Microeconomic myths

Myth 5: Labour market incentives are better under individual accounts

Myth 6: Defined benefit plans necessarily provide more of an incentive to retire early

Myth 7: Competition ensures low administrative costs under individual accounts

Political Economy myths

Myth 8: Corrupt and inefficient governments provide a rationale for individual accounts

Myth 9: Bailout politics are worse under public defined benefit plans

Myth 10: Investment of public trust funds is always squandered and mismanaged

This document debunks these myths, implying that the arguments most frequently used to promote individual retirement accounts are often not substantiated in either theory or practice.

In the Introduction, the writers say that they hope not only to spur debate during this " New Ideas About Old Age Security" conference, but more broadly to ensure that policy-makers understand the complexity of pension reform.

They say that the complexity of optimal pension policy should caution us against believing that a similar set of recommendations would be appropriate in countries ranging from Argentina to Azerbaijan, from China to Costa Rica, from Sierra Leone to Sweden. In response to the question "What should we do about our pension system?" we should be wary of offering a single answer across the globe.

The document further says that the problems that motivated the pension reform across the globe are real and reforms are needed. . In many developing countries, soaring deficit - gap between pension fund obligations and revenues - not only threaten economic stability, but also crowd out necessary investments in education, health, and infrastructure. Too often, the benefits of pension programme have accrued to those already privileged; forcing poor farmers to finance the largesse of the urban elite is surely not sound economic policy. Furthermore, the structure of the pension programme in many cases has served not only to undermine macroeconomic stability, but also to weaken the functioning of labour markets and to distort resource allocations.

Defining the "three pillars"

The document says that the necessity of serious reforms in many countries tells us nothing about which specific reforms should be undertaken in which countries. Unfortunately, evaluations of such reform options have too often been clouded by a set of myths that have dominated public discussions and derailed rational decision-making. The purpose of this document is to dispel those myths - or, at the very least, to raise questions concerning their general validity.

The problems that have motivated pension reform across the globe are real, and reforms are needed. In principle, the "the three pillars" approach delineated in *Averting Old Age Crisis* is expansive enough to reflect any potential combination of policy measures -especially if the second (funded) pillar incorporates both privately and publicly managed systems. But in practice, the "World Bank model" has been interpreted as involving one specific constellation of pension pillars: a publicly managed, pay-as-you-go, defined benefit pillar; a privately managed, mandatory, defined contribution pillar; and a voluntary private pillar. That interpretation - especially the inclusion of a *privately managed, defined contribution* component - is common among policy-makers and pension analysts, regardless of whether it fully reflects the nuances of *Averting the Old age Crisis* itself. And it is precisely the private, mandatory, defined contribution component that the writers wish to explore in this document.

The document further says that over the past decades, following the seminal reforms in Chile in the early 1980s, and with support from the World bank, many nations have moved away from a public defined benefit pension system and toward a private defined contribution one. Important reforms in this direction have occurred in, among other places, Argentina, Bolivia, Columbia, Hungary, Kazakhstan, Latvia, Peru, Poland, Sweden, and Uruguay. The focus throughout the paper will therefore be on whether this type of shift - to a private defined contribution (individual account) pension system - is as universally beneficial as many of its proponents claim.

Framework

The document says that many of today's myths emanate from a failure to distinguish four aspects of a pension system. These are:

- <u>Privatization:</u> Privatization is the replacing of a publicly run pension with a privately managed one.
- <u>Prefunding:</u> Prefunding means accumulating assets against future pension payments.
- <u>Diversification:</u> Diversification involves allowing investments in a variety of assets, rather than government bonds alone.
- <u>Defined benefit versus defined contribution:</u> Defined benefit plans assign accrual risk to the sponsor; conditional on a worker's earnings history, retirement benefits are supposedly deterministic. Defined contribution plans, on the other hand, assign accrual risk to the individual worker; even conditional on an earnings,, history, retirement benefits depend on the efficacy with which contributions were financially managed.

Analytical foundation

The document says that before examining the myths, four further background points are worth highlighting to inform our subsequent analysis of individual accounts:

- <u>Inherent features versus imperfect implementation:</u> A key issue surrounding both public defined benefit systems and individual accounts is which elements are inherent to the system, and which elements are merely common in how that system has been implemented in practice. Many of the myths arise from mixing comparisons between inherent and as-implemented features. Writers' initial focus is on inherent features, for it is these inherent features that would tend to make one system or the other universally applicable. Statements about historic tendencies regarding implementation must be treated with much more caution than inherent features, especially since the historic tendencies in one nation are not necessarily reflective of those in another country.
- <u>Tabula rasa choices versus transformation choices:</u> In evaluating the effect of pension reforms, initial conditions are important. In particular, this must be kept in mind that the social effects of transforming a mature pension system into a system of individual accounts may be substantially different than the social accounts. Very few nations face that initial choice; almost all have some form of old age insurance programme.

- Inter-generational analysis: Politicians are known for focusing exclusively on the short run, ignoring the long-run costs (or even viability) of public programmes. In analyzing transitions and reforms, however, we have to be careful not to make the opposite mistake: focusing exclusively on the long run, and ignoring short-run costs. When some generations are made worse off, and some better off, we face a complex welfare calculus - how to weigh the gains of one generation against the losses of another.
- Ultimate focus on welfare: Savings and growth are not ends in themselves, but means to an end: the increase in well-being of members of the society. Thus, we, could perhaps induce people to save more by exposing them to more risk. But that need not improve their welfare. For example, risk-averse individuals might respond to increased variance in the real return of their pension plan by increasing their saving rates. The increased risk, however, would make them unambiguously worse off. Even the future generations that benefit from the higher wages associated with a larger capital stock may be worse off.

THE MYTHS

The document says that the writers divide their ten myths into three broad areas: Macroeconomic effects; Microeconomic efficiency; and Political economy. It also says that their purpose in exploring these myths is not to argue that individual accounts are always and everywhere a bad idea. Rather, it is to clarify that many of the arguments advanced in their favour are not necessarily valid, and that pension policy therefore requires a more nuanced approach than that implied by a single "optimal" constellation of pillars. In particular, a second pillar that relies exclusively on a privately managed, defined contribution approach may not be appropriate for many countries. The optimal approach is likely to vary across countries, depending on differential attitudes toward risk-sharing, inter-generational and intra-generational redistribution, and other factors.

MACROECONOMIC MYTHS

Myth 1: Private defined contribution plans raise national saving

The document says that it is common to assert that moving toward a system of "prefunded" individual accounts would raise national saving. "Prefunding" can be used in a narrow or broad sense. In its narrow sense, prefunding means that the pension system is accumulating assets against future projected payments. In a broader sense, however, prefunding means increasing national saving.

Narrow prefunding can be a misleading guide to broad prefunding. Furthermore, narrow prefunding has no macroeconomic implications; only broad prefunding offers the potential for macroeconomic benefits.

Broad prefunding can be accomplished without privatization. In particular, the government can accumulate assets in anticipation of future benefit payments due under the public defined benefit plan. Such prefunding does not have to take the form of private market investments, about which many analysts have expressed political economy concerns (e.g. that the government would interfere unduly in private asset markets). Interestingly, those who argue that a public system cannot prefund have often pointed to the United States as their example of a country that has failed to do so.

The document further says that this myth highlights the *tabula rasa* point above. A large academic literature exists on whether the introduction of pay-as-you-go social security system reduces national saving. It is entirely possible that the introduction of a pay-as-you-go system reduces national saving (as some studies suggest), but that a shift to individual accounts would not raise national saving.

The conclusion is that the tradeoffs involved in how to prefund - for example, through a public and private approach - are distinct from the tradeoffs involved in whether to prefund. Indeed, Heller (1998) and Modigliani, Ceprini, and Muralidhar (1999) argue that a prefunded, public, defined benefit system may be preferable to a prefunded, private, defined contribution system. Automatically linking privatization and broad prefunding, rather than examining each choice separately, fails to reflect the full range of policy options.

Myth 2: Rates of return are higher under individual account

The document says that a second myth is that rates of return would be higher under individual accounts than under a pay-as-you-go system. Palacios and Whitehouse (1998) argue that the higher rate of return under a private scheme "is an important reason for reform". As in Myth I, this myth conflates "privatization" with "prefunding". But in addition, most simple rate-of-return comparisons conflate "privatization" with "diversification".

The document further says that in a dynamically efficient economy without risky assets, the real interest rate must exceed the growth rate. Therefore, in dynamically efficient economy, individual accounts -even without diversification-will always appear to offer a higher rate of return than a pay-as-you-go system. But appearances can be deceiving. The simple rate-of-return comparison, even without the diversification issues discussed below, is fundamentally misleading for two reasons: administrative costs and transition costs.

- Administrative costs: The simple rate-of-return comparison usually compares gross rates of return, even though administrative costs may differ even under idealized versions of the two systems and higher administrative costs reduce the rate of return an individual receives. Such administrative costs imply that on a risk-adjusted basis, once the costs of financing the unfunded liability under the old system are incorporated, the rate of return on a decentralized private system is likely to be lower than under the public system.
- Transition costs: Since individual accounts are financed from revenue currently devoted to the public social security system, computations of the rate of return under individual accounts need to include the cost of continuing to pay the benefits promised to retirees and older workers under the extant system. Assuming that society is unwilling to renege on its promises to such retirees and older workers, the costs remain even if the social security system is eliminated for new workers and replaced entirely by individual accounts. Since payments to current beneficiaries are not avoided by setting up individual accounts, the returns on individual accounts should not be artificially inflated by excluding their cost.

The document further says that if the economy is dynamically efficient, one cannot improve the welfare of later generations without making intervening generations worse off. Reform of pension systems must thus address equity issues both within and across generations. The fundamentally inter-generational nature of the trade-off involved in moving to individual accounts has been emphasized by many authors, including Breyer (1989).

The comparison of rates of return is thus misguided because *higher returns in the long run can be obtained only at the expense of reduced consumption and returns for intervening generations*.

Risk and diversification

The document says that risk issues raise further complications for the simple rate-of-return comparison. Most simple rate-of-return comparisons conflate privatization and diversification. The two need not go together; one can imagine private accounts that are restricted to risk-free financial assets, and public systems that invest in risky assets.

Diversification should produce higher average financial returns over long periods of time. But individual generally dislikes risk; a much risker asset with a slightly higher rate of return is not necessarily preferable to a much safer asset with a slightly lower rate of return. And if capital markets are perfect, the higher mean return from diversification should merely compensate for additional risk. In other words, in efficient markets, returns are commensurate with risk.

Other complicating factors exist for risk adjustments to public versus private systems. For example, *diversification undertaken through a public defined benefit system involves less financial risk for any given individual than diversification undertaken through a private defined contribution system*. The reason is that a public defined benefit system can spread risk across generations in a way that is not possible under a private defined contribution programme.

The document further says that full risk analysis of a public defined benefit system relative to individual accounts would entail evaluations of not just diversification, but also a wide variety of other risks inherent in the typical as-implemented forms of the two systems. For example, defined benefit systems are usually progressive and therefore provide a form of lifetime earnings insurance. If lifetime earnings are lower than expected, the replacement rate is higher than expected, at least partially cushioning the blow in retirement of the lower-than-expected earnings. Furthermore, even under a non-progressive defined benefit plan, pensioners do not face accrual risk, although many systems often included under the "defined benefit" heading still contain residual risks of various kinds (e.g. real risks arising from imperfect indexation, or demographic risks from the adjustment of benefits depending on the status of public finances). Finally, once we depart from an idealized comparison and examine the political economy of the two systems, a variety of political risk issues arise with respect to public systems that may or may not be less extreme under private systems.

Myth 3: Declining rates of return on pay-as-you-go systems reflect fundamental problems with those systems

The document says another myth surrounding reform of public pay-as-you-go system is that observed declines in rates of return on pay-as-you-go system are indicative of some fundamental flaw in those systems. Instead, that decline reflects the natural convergence of a pay-as-you-go system to its mature steady-state.

This decline in rates of return from the earliest groups of beneficiaries is a feature of any pay-as-you-go system, under which the early beneficiaries receive very high rates of return because they contributed little during their working years. The rate of return for subsequent beneficiaries necessarily declines. As the system matures, that decline in rates of return may be attenuated or exacerbated by changes in productivity and labour force growth rates.

Two other points worth noting. First, the decision to provide benefits at the beginning of the programme to those who did not contribute over their entire lives - to make the system a pay-as-you-go one rather than a funded one - may be understandable in terms of political exigencies, but may or may not make much sense in terms of inter-generational welfare policy. Unless we are now willing to let existing retirees or older workers suffer because earlier generations received a super-normal rate of return, we are forced to bear the consequences of that decision regardless of whether the pension system is privatized. Second, and relatedly, the super-normal rates of return enjoyed by early beneficiaries are the mirror reflection of the sub-market rate of return on the mature system. As Geanakoplos, Mitchell, and Zeldes (1998, 1999) emphasize, the net value of the pay-as-you-go system across all generations is zero. If some generations receive super-market rates of return, all other generations must therefore receive sub-market rates of return. Again, the introduction of individual accounts does not change that conclusion.

Myth 4: Investment of public trust funds in equities has no macroeconomic effects or welfare implications

The document states that many analysts of pension reform believe that investing a public trust fund in equities rather than government bonds would have no macroeconomic or social welfare effects. The argument is simply that such diversification is merely as asset shift, and does not change national saving. It therefore may alter asset prices or rates of return, but not the macroeconomy.

In this context, the document says that the argument is not about whether public trust funds should be invested in equities. Rather, it is about whether social security funds should be shifted into equities through any mechanism - either through public trust funds or private accounts. In other words, the issue is purely one of whether diversification per se is beneficial. Interestingly, proponents of private accounts often hail the diversification potential of such accounts as a substantial social benefit, yet simultaneously claim that diversification undertaken through a public trust fund would yield no benefits. At least from a strictly economic perspective, that dichotomy does not seem to make much sense. To be sure, how to best accomplish diversification involves numerous issues, including both administrative costs and political economy issues. The writers now focus on the effects of diversification absent such administrative cost or political economy concerns.

The document further says that according to the writers underlying examination of this myth is a fundamental theory that provides conditions under which public sector financial structure makes no difference. The conditions were developed in a series of papers by Stiglitz. Given perfect capital markets and the ability of individuals to reverse the actions of government financial policies, such policies have no real effects.

Given implications in the financial markets, however, Stiglitz also shows that government financial policy - including its approach to investing its trust funds -could have important real effects. More recently, economists have highlighted imperfections or non-convexities such as learning costs, minimum investment thresholds, or other factors. In the presence of such imperfections and assuming that pensioners assume some of the accrual risk from the government's financial policies (which means that the pension system is not a pure defined benefit plan), diversification can produce real welfare gains and possibly macroeconomic effects. The key insight is that given the imperfections, many individuals do not hold equities - and government diversification can effectively eliminate the non-convexities, producing a welfare gain.

Finally, it is also interesting to note that from a risk perspective, the socially optimal system may be a diversified, partially funded one. Metron (1983), Metron, Bodie, and Marcus (1987), and Dutta, Kapur, and Orszag (1999) show that combining an unfunded component (with a rate of return tied to earnings growth) with a diversified, funded component (with a rate of return tied to a market index) may reduce risk relative to a completely funded system. The intuition is simply that partial funding provides access to an asset - the human capital of the young - that is not normally tradable on the financial markets, thereby providing further diversification relative to the set of assets available on financial markets. They conclude that "diversification of risk provides an additional reason to invest in both human and physical capital"

MICROECONOMIC MYTHS

Myth 5: Labour market incentives are better under private defined contribution plans

The document says that a common claim regarding individual accounts is that they provide better labour market incentives than traditional (defined benefit) social security systems.

It also says that any differential labour market incentives of individual accounts result from differences in both risk and redistribution. It is therefore important to note:

1. We are ultimately interested in welfare, not labour supply. It is possible to design structures that accentuate labour market incentives but reduce welfare. For example, if individuals were very risk averse, imposing a large random lump sum tax on individuals in the latter part of their lives may induce both more savings and more labour supply, since individuals would work harder as a precaution against this adverse contingency. Yet such a tax could have large adverse effects on welfare.
2. A key tradeoff exists between redistribution and incentives. It is usually possible to provide stronger incentives only at the cost of less redistribution. Redistribution typically creates labour market distortions.
3. More generally, given other distortions in the labour market (e.g., a progressive tax system), assessing how specific provisions of a pension programme affect the efficiency of the labour market is a complicated matter. As one example, the redistributive aspects of the Social Security programme in the United States increase the return to working among the poor who, given the phase-outs associated with various other welfare programmes, often face very high marginal tax rates.
4. The distortion imposed by the payroll tax is not measured by the payroll tax itself, but rather by any difference between the net present value of marginal benefits and the marginal tax. Similarly, the labour supply of those who do not fully value mandatory retirement savings - those who would not on their own have saved as much - will generally be affected by such a programme, but it is wrong to infer that the mandatory savings programme necessarily reduces labour supply. The key issue is what happens to the mean marginal utility of consumption, which could either increase or decrease.
5. One of the most difficult questions in assessing any programme is the appropriate counterfactual against which to judge it. For example, lets assume that workers who did not save for retirement - or who invested their contributions poorly - knew that they would be bailed out by the government. Funds for the bailouts would have to be raised through distortionary taxes, which would then affect labour supply. Savings, investments, and labour supply behavior would all be affected by the (potential) bailout and associated taxes.
6. Most of the discussion of the labour market effects of social insurance has focused on supply side effects in competitive markets. Particularly in developing countries, the assumption of a perfectly competitive labour market seems inappropriate - suggesting that an exclusive focus on the supply side may be misplaced. Orszag, Snower, and Stiglitz (1999) explore these issues in a model that incorporates interactions between the characteristics of the labour market and the pension system, while also being capable of studying interactions between the pension system and the unemployment insurance system. They conclude that there is no simple dominance of one system over another in terms of labour market incentives.

Myth 6: Defined benefit plans necessarily provide more of an incentive to retire early

The document says that this myth is related to myth 5, but focuses specifically on older workers. A critical question in evaluating its importance is the degree to which we should be concerned about early retirement per se. Some social insurance programmes implicitly provide "obsolescence" insurance against technological shocks that affect the value of human capital. Experience normally increases an individual's human capital, but rapid technological change may diminish its value, so that older workers face diminishing productivity and wages. Some workers may want to obtain insurance against this risk, in the form of an 'option' to retire early. Carefully defined retirement insurance programmes could provide an element of such insurance by providing early retirees some increment insurance programme in the present value of benefits over contributions.

Even if one concludes that the optimal tradeoff between insurance and work should be tilted toward work, this issue provides a vivid illustration of the "inherent vs, implemented" point the writers noted in the introduction. A public defined benefit plan need not necessarily impose an additional tax on elderly work. Similarly, a defined contribution approach could potentially impose such a tax. The net effect of a pension system on the incentive to retire comprises three components: the marginal accrual rate for additional work, the actuarial adjustment for delaying the initial receipt of benefits, and the rules for whether benefits are reduced because of earnings. In all three components, defined benefit plans need not provide more of a disincentive against work and in favour of claiming benefits than a defined contribution plan. For example, benefit accrual rates are higher under many forms of defined benefits plans than under defined contribution plans - potentially providing a stronger incentive for continued work at older ages. The actuarial adjustment within a defined benefit plan is a policy parameter. And the presence or absence of an earnings test need not depend on the form of the pension system. An idealized comparison between a defined benefit and defined contribution approach therefore does not uphold this myth.

Myth 7: Competition ensures low administrative costs under private defined contribution plans

The document says that another myth is that competition among financial providers will necessarily reduce administrative costs on individual accounts. For example, the Economist has written that in creating individual accounts, countries should "let many kinds of firms (banks, insurance companies, mutual funds) compete for the business. Fierce competition in sophisticated markets has driven down costs in these businesses. There is no reason why the same should not be true for pensions, although the need for adequate prudential and saver-protection regulation will clearly remain".

But the document says that competition, however, only preludes excess rents; it does not ensure low costs. Instead, the structure of the accounts determines how high the costs are. Furthermore, centralized approaches - under which choices are constrained and economies of scale are captured - appear to have substantially lower costs than decentralized approaches. Low administrative costs thus may be possible under an idealized set of accounts - one that involves a centralized approach - but not under a decentralized approach.

An alternative approach would be a decentralized system of individual accounts, in which workers held their accounts with various financial firms and were allowed a broad array of investment options. Under such an approach, costs tend to be significantly higher because of advertising expenses, the loss of economies-of-scale, competitive returns on financial company capital, and various other additional costs.

The document further says that experience from both Chile and the United Kingdom is consistent with these predictions and indicates that a decentralized system of individual accounts involves significant administrative expenses. Both Chile and the U. K. have decentralized, privately managed accounts, and administrative costs in both the countries have also proven to be surprisingly high.

Taking into account interaction effects, Murthi, Orszag, and Orszag estimate that, on average, between 40 and 45 percent of the value of individual accounts in the U.K. is consumed by various fees and costs. Given the fixed costs associated with individual accounts, furthermore, costs for smaller accounts (e.g. in developing economies with lower level of GDP per capita) would be even higher relative to the account size if the U.K. experience were replicated in such countries. Charges can be high either because profits are high or because underlying costs which include sales and marketing costs, fund management charges, regulatory and compliance costs, record-keeping, and adverse selection effects are high.

The bottom line is that both the U.K. and Chilean experiences indicate a decentralized approach to individual accounts is expensive - and the administrative costs would be even more higher if accounts were smaller. But one may wonder why government interference and government governance concerns are less problematic under such a centralized approach than under a public trust fund system.

POLITICAL ECONOMY MYTHS

Myth 8: Inefficient governments provide a rationale for private defined contribution plans

The document says that some proponents of individual accounts argue that corrupt and inefficient governments provide a strong motivation from moving away from public systems and toward private ones. To be true to their idealized vs, as-implemented distinction, we should emphasize that this myth is very much in the "as-implemented" world, since in an idealized world the government is not inefficient or corrupt.

The document further says that on an "as-implemented" basis, however, the issue is more complicated than it may initially appear. Even under a private system, as James (1997) emphasizes, "considerable government regulation is essential to avoid investments that are overly risky and managers who are fraudulent. Some minimum reliability is required from the civil service for regulation to be effective". Similarly, as Heller (1998) argues, "a government supervisory authority may be seen as necessary to ensure adequate prudential standards are the norm for those private sector agents given license to manage and invest pension funds. The possibility of fraud and abuse cannot be discounted, particularly for countries with poorly developed capital markets or where the potential for conflicts of interest within financial institutions (associated with their possible multiple roles as lenders and pension fund investors) are great. It is difficult to know why a government that is inefficient and corrupt in administering a public benefit system would be efficient and honest in regulating a private one.

The document further points out that the "mis-selling" controversy in the United Kingdom also illustrate the difficulties of regulating individual accounts. In 1988, new regulations allowed investors in private pensions to contract out of the public pension system. As it turned out, the U.K. experienced substantial difficulties with the movement to personal pensions. In what has become known as the "mis-selling" controversy, high-pressure sales tactics were used to persuade members of good occupational pension schemes (especially older, long-serving members) to switch into unsuitable personal pension schemes. Sales agents had often sought too little information from potential clients to provide proper advice, and their firms did not keep adequate records to defend themselves against subsequent mis-selling claims.

The bottom line is that public malfeasance or incompetence can be just as dangerous under individual accounts as under public defined benefit systems. The key questions are thus the difficulties of constructing open, transparent systems under alternative regimes, and the capacities of individuals and organizations to monitor the public sector.

Myth 9: Bailout politics are worse under public defined benefit plans than under private defined contribution plans

The document says that another political economy myth is that bailout politics are more severe under public defined benefit plans than under private defined contribution plans. In other words, the assertion is that the government will experience greater pressure for social protection under s public defined benefit system than a private defined contribution one.

To be sure, this myth is an as-implemented one. After all, in an idealized world, bailout politics may not be of particular concern. But it is simply not politically realistic to claim that governments will fail to come to the rescue in some way if financial disaster looms for a non-trivial share of the population.

In a sense, this myth is related to the previous one. If the government fails to do an effective job in regulating the private sector, and if individuals are allowed to invest in risky securities, those whose investment decisions turn out to be poor will likely turn to the government for assistance. In many countries, the guarantee is more than implicit: Governments often provide some sort of guarantee on the returns earned under the individual account approach.

The extent of bailout politics in a private, defined contribution system relative to a public, defined benefit one is difficult to assess ex ante. The outcome depends on a complicated political dynamic, which undoubtedly differs from country to country. To what extent does any increased risk under a defined contribution approach - and the related inability to spread risk across generations - increase the likelihood of a bailout? To what extent does the "privatized" nature of a private defined contribution system insulate the government from pressure for bailouts? These are important questions, and worthy of further study.

Finally, the likelihood of a bailout of individual accounts may be heightened in post-socialist economics that had engaged in voucher privatizations. In such voucher privatizations, shares in large and medium-sized companies were sold in exchange for vouchers. Since the normal fiduciary rules to be listed on a public stock exchange were bypassed by many firms undergoing privatization, shares in these firms are illiquid. Voucher investment funds, which were organized as intermediaries for the voucher privatizations, hold most of the illiquid shares from the voucher funds to pension funds. Such a transfer may benefit the voucher funds, but could also necessitate a government bailout of the pension funds should the illiquid shares prove to be worth less than their current "market price". To be sure, the pension reforms are often touted as "deepening the stock market". Yet they may ultimately merely reallocate losses from one set of funds to another - and in a potentially regressive fashion.

Myth 10: Investment of public funds is always squandered and mismanaged

The document says that another myth is that public trust funds are always squandered or mismanaged. As Estelle James has written, " … data gathered for the 1980s indicate that publicly managed pension reserves fared poorly and in many cases lost money - largely because public managers were required to invest in government securities or loans to failing state enterprises at low nominal interest rates that became negative real rates that became negative real rates during inflationary periods."

The document further says that several points are worth noting here. The first concerns the nature of the capital market. If capital markets were perfect, then it would simply not be possible for funds to be badly invested. Efficient markets ensure that returns are commensurate with risk, as long as the investment portfolio is sufficiently diversified. Given efficient markets, those that accuse the government of investing poorly therefore must be accusing the government either of corruption, or of choosing a portfolio that does not correspond to the risk preferences of pensioners.

Furthermore, as Stiglitz shows in a series of papers, the assumption of perfect capital markets is not entirely convincing, especially in many developing countries. But then the opportunities for uninformed investors to make mistakes or to be exploited are increased. Furthermore, even in the presence of imperfect capital markets, the government may choose to invest in a more restricted class of assets than are generally available because the social returns from such restrictions justify any costs *Averting the Old Age Crisis* noted that real rates of return on many public trust funds were negative during the 1980s.

But the document points out that by revealed preference, not all public trust funds are mismanaged. Individuals in many countries prefer a public trust fund. In Kazakhstan, for example, more than 85 percent of citizens initially held their individual accounts, by choice, with State Accumulation Fund rather than private funds. Finally, countries are experimenting with institutional arrangements - such as independent boards and clear legislative mandates to avoid political investing - to protect trust funds from political pressures.One potential conclusion from this literature is that public funds with sound corporate governance protections - independent boards and sources of financing, along with a clear legal mandate to pursue competitive returns - may avoid some of the pitfalls associated with pension fund investing.

In the **conclusion,** the government says that underfunded public pension systems represent a potential threat to the fiscal soundness - and, more broadly, economic stability - of many developing countries. The World Bank's study, *Averting the Old Age Crisis*, provided an invaluable service in drawing attention to this problem and discussing specific policy changes to address the issue. Unfortunately, as often happens, the suggestions have come to be viewed narrowly - focusing on a second pillar limited to a private, non-redistributive, defined contribution pension plan. The writers have shown that most of the arguments in favour of this particular reform are based on a set of myths that are often not substantiated in either theory or practice.

Pension Privatization in Eastern Europe and Beyond

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Bird's Eye View

This 41-page document explains why do countries privatize their pension system. It says that extant accounts see pension reform as the product of non-responsive and non-accountable governments who can ignore public preferences. Recent privatizations in the new democracies of Eastern Europe belie this view. When citizens lose faith in the existing pension system and have faith in capital markets, privatization can become an exercise in political credit-claiming.

The document says that in 2004 State of the Union Address, George W. Bush committed himself to privatizing a portion of Social Security. It was a common question - Will he succeed in his attempt? Most theories of pension politics answered no. Pensions are purportedly the third rail of politics that cannot be touched without electoral retribution. And the larger the change in pension policy, the more resistance politicians will face.

The document says ,yet, lately pension privatization has succeeded in a large number of states around the world including Chile, Argentina, Mexico, Peru, and Kazakhstan. The first privatizations were passed in Latin America. But these countries are poor comparators to the US. Recently, a better set of comparators has emerged. In 1997, two relatively consolidated democracies with mature and universal pension schemes - Hungary and Poland -- voted partially privatize their pension systems.

The document argues that privatization was possible in Hungary and Poland because public opinion permitted it. They saw it as a solution to serious problems in the existing pension system, which in their view was heading towards bankruptcy and delivered unjust benefits. Privatization thus became a matter of credit-claiming and responsiveness rather than blame-avoidance and unaccountability. Politicians came to see it as a way to improve their re-election prospects.

Theories of Pension Privatization

The document mentions that most extant pension schemes in the world function on the pay-as-you-go (PAYGO) principle: payroll taxes are collected from workers and immediately paid out to current retirees. And privatization means replacing this system in whole or in part with one where workers' contributions accumulate in private investment accounts whose returns are paid out to workers at their retirement. A system that runs entirely on this principle is called a funded or fully-funded pension scheme because it always has the funds to pay out its promised benefits.

The document further says that until recently little was written about the politics of privatization. Because, until Chile privatized its pension system in 1981, no country had undertaken a privatization. This, however, has changed. In the late eighties and nineties a number of states - particularly in Latin America and Eastern Europe - have privatized or partially privatized their pension schemes.

Another reason is that there is the double-payment problem. Privatization requires economically-active people to support two pension schemes at once. They must pay pensions for those at or near the retirement age and they must begin to build up savings for their own pensions. This constitutes a large economic burden on either working citizens or the government budget.

In practice governments have been able to overcome this hurdle through debt-financing. The large obstacle is the political one. In the first place, PAYGO systems are built on an implicit social contract between workers and retirees: current workers pay for the pensions of current retirees in the expectation that future generations of workers will pay for their pensions. Privatization breaks this contract by forcing workers to pay both for current retirees and for themselves.

The effect this change has on the possibility of redistribution within the system is politically important. Most pension systems redistribute income from rich to poor. Contributions in most PAYGO systems can be redistributed fairly easily. Under the funded system, contributions go into individual accounts which make it far more difficult for government to redistribute.

The document says that the upshot is that privatization will be more difficult as countries become more democratic - because democratic governments are more responsive to majority public opinion which tends to oppose privatization - and as their pension systems are more encompassing and mature - because transition costs will be higher and more citizens will have a stake in the social contract, lose out from reduced redistribution, or be affected by benefit cuts.

The document points out that the first privatizations were in Latin American countries which were either undemocratic or only partially democratic. Their governments could presumably privatize because they were neither responsive nor accountable. The most comprehensive work on pension privatization has been done by Madrid. In a cross-national analysis of 81 countries, he finds that privatization is correlated with strong executive power. He also finds that international pressure was important. In 1994, the World Bank published a report entitled "Averting the Old Age Crisis" which recommended that developing countries partially privatize their pension schemes. Madrid notes that outside pressure - frequently in the form of advisory missions from international financial organizations - played an important role pushing privatization. With this variable too, democratic processes cease to function; politicians are not responding to the public, but are compelled by outside forces. Finally, he finds that low savings rates encourage privatization because privatization is reputed to raise savings rates, something that politician in these countries want. Other accounts of privatization on smaller samples of countries confirm this view of governments ignoring public opinion. Governments simply impose privatization regardless of what the public wants.

Madrid is more explicit in dealing with privatizations. He argues that politicians privatize because they wish to increase national savings, which will then spur growth. And indeed this is how politicians did justify their privatization plans. But even if privatization were to increase savings, its benefits would come only with considerable delay.

A New Model of Pension Privatization

Under this title, while referring to pension privatization, the document says that virtually all accounts of pension politics in consolidated democracies begin with the constraints placed on reform by public opinion. The PAYAGO system is strongly supported by its current beneficiaries and most future beneficiaries. Both are represented by strong interest groups, retired person's organizations and trade unions. These organizations fight hard to preserve the system. At the same time, public opinion as a whole tends to be staunchly in favour of the extant pension system. These forces pose a dilemma for politicians who find they must change the parameters of the system.

The writer further argues that two things need to happen for the environment to be conducive to privatization.

First, citizens must lose faith in the existing social contract. If they lose faith, they will be less likely to fight for the status quo. Second, citizens must have a degree of faith in their country's capital markets. If workers harbor doubts about the reliability of existing funds and government's regulation of them, it is unlikely that they will support a mandatory funded pillar.

These opinions should spur re-election-seeking politicians to act. Politicians will be reluctant to privatize without public support because of the high salience of the issue and the requirement of spontaneous compliance. If Privatization becomes popular, however, it presents a rare opportunity to politicians. They can take credit for a new programme that can plausibly be sold as a benefit to most citizens. Such opportunities are rare in most countries, particularly ones which already have a large welfare state as is the case in Eastern Europe.

In this account, the politics of privatization can change from one of blame avoidance to one of credit-claiming. Politicians come to see privatization as an opportunity to increase their likelihood of being reelected.

Implications

The document says that if the preceding account of privatization is correct, what evidence should we expect to see in privatizers and non-privatizers? Evidence can be found in two different levels. First, since the account views public opinions as the permissive force for privatization, we should be able to find evidence that public opinion supported reforms where they were adopted. We should further expect all major social groups to share these opinions. We should also find evidence for this account in the political process. If the decision to reform is based on politicians' concern for their re-election prospects, this has implications for the way that reforms are passed. To start with, most major interest groups included directly in the reform process. Politicians will be reluctant to implement these reforms in the face of opposition from significant interest groups like labour union or retired people. Similarly, we should expect that the parliamentary vote on the final bill will feature support from all major parties. A corollary is that privatization will not be pushed by an ideologically motivated right-wing coalition, such a strategy would carry far too high electoral risks. One additional piece of evidence in favour of this account comes from the implementation of privatization. If citizens were genuinely in favour of privatization we should see them signing up for the new system in significant numbers.

Further, the document points out that to test this model of privatization, the writer looks at three countries in Eastern Europe: the Czech Republic, Hungary, and Poland. All are consolidated democracies with mature and universal pension schemes. Most importantly, the three countries differ in their outcomes on our dependent variable. While Poland privatized in 1997 and Hungary in 1998, privatization has still not been put on the agenda in the Czech Republic.

Public Support for Reforms

In this section, the writer not only shows cross-national differences in public preferences, but also shows where they come from. He also shows that negative or positive attitudes towards privatization were based on the actual performance of the pension system and capital markets.

The document says that pension systems in the Czech Republic, Hungary, and Poland were based PAYGO pension systems which were introduced soon after World War II and quickly expanded them so that the entire population was covered. The pension systems were one of the more popular and best functioning aspects of the communist system.

Differences, however, began to emerge after the transition to democracy. Poland used its pension to pay off losers to the transition. Early retirement was made very easy and benefits were raised and indexed quarterly to inflation. Behind this policy were two factors. One was high unemployment which caused intense social pain. Generous pensions were meant to move older workers out of the labour force. The other was the communist-era tradition of responding to social difficulties with payoffs. Poland along with Hungary, was a cooperative state; the Polish communist had frequently responded to protests with payoffs - wage or pension increases or price cut. Polish citizens thus expected to be compensated for social hardship.

The document says that the upshot of these policies was that pensions rose from 7% to over 15% of GDP between 1990 and 1994. This dramatic rise in spending opened large deficits in the system, which were exacerbated by falling contributions. At the same time, powerful groups managed to maintain their privileged place in the system and even received additional privileges, making the system quite unfair. Though successive governments proposed austerity measures, public and union outcry consistently forced them to back down.

The Czech Republic pursued an almost diametrically opposite course after 1989. Successive governments kept pension spending very much under control. Early retirement was not common and benefits were not increased. The pension system even ran a surplus - contribution exceeded expenditures - until 1997. At the same time, the country managed to eliminate the footholds for almost all privileged groups. Unlike the Polish communists, the Czech communists maintained order with sticks rather than carrots.

Hungary took something of a middle course between these two extremes. As in Poland, high unemployment and traditions of co-opting the population led to spending increases. Combined with dropping contributions (a result of rising unemployment), the system plunged into deficit. Ultimately, benefits became almost completely detached from contributions. Two citizens with identical work histories might have widely different pensions merely because they retired in different years. Palacios and Rocha note that these rules "have been perceived as arbitrary and unfair by the Hungarian public". The dismal state of the general budget and large external debts further added to doubts about the pension system. As the fiscal circumstances and unfairness of benefits became increasingly clear to Polish and Hungarian publics, faith in the pension system declined. By the mid-nineties, two-third of respondents in both countries rated the pension system as in bad shape.

Conversely, a majority of Czechs rated their own system as in good shape and they did not think the old system required large changes. Substantial majority viewed future benefits as both secure and adequate for their retirement needs.

The document further says that these attitudes paralleled judgments of capital markets. While all three countries experienced bankruptcies and scandals in their financial sectors, Hungary and Poland had cleaned up theirs much earlier than Czechs. Non-transparency and lack of regulation in financial markets are widely considered the bête noir of the Czech transition. This was reflected in low public confidence in financial institutions.

One of the clearest indications to citizens of the advisability of privatization was the performance of voluntary pension funds in the early nineties. Both Czech Republic and Hungary had established so-called third pillars to their pension schemes - voluntary pension savings schemes supported with public subsidy.

The performance of private pension funds, however, was quite different. The Czech system staggered. Regulation was almost non-existent and returns were not made to public. Forty-four funds initially entered the market, but due to bankruptcies the number dropped to 26 by1998 and 14 by 2002. The public was not ignorant of this state of affairs. Most citizens looked negatively on the main Czech experience with investing - the voucher privatization programme.

Hungary's voluntary pension scheme functioned far differently. Though smaller than the Czech system, the Hungarian system appealed to young people, was far more transparent, had good rates of return, and quickly overcame regulatory problems. As evidence of faith in the system, those who had invested or planned to invest in a private pension fund were much more likely to support privatization than those who had not. Hungarian funds also lobbied hard for privatization and became the main recipients of new private investments. Though Poland did not have a state-subsidized voluntary pension scheme, its experience more closely approximated Hungary's.

While the Czech case present exactly the opposite structure of preferences. A plurality of respondents thought that minor changes would suffice to keep the system in balance and just short of majority preferred to retain the current system of funding. Citizens were also quite averse to being forced to invest in pension funds. 61% disagreed or strongly disagreed with being forced to save for retirement in pension funds and 81% opposed being forced to invest in special bank accounts.

But in Hungary and Poland, citizens were very pessimistic about the sustainability of the PAYGO system, looked positively at capital markets and the possibility of earning high returns through investment, and thus came to strongly favour privatization. Conversely, in the Czech Republic, confidence in the public scheme and suspicion of investment combined to produce opposition to privatization.

The Politics of Reforms

The document points out what would be expected to see in the political process, if politicians were following public preferences in adopting pension reforms? The writer would argue that if public preferences were the key facilitating variable, then one would expect to see interest groups invited to participate in the process, the policy process to cross party lines, and reforms to be passed prior to elections so that politicians could claim credit for reform. The writer shows below that such a behavior has been observed in Hungary and Poland.

Poland

The document says that Poland's path to privatization began in 1994 as a consequence of the enormous costs of the pension system. Poland was spending 15% of GDP on pensions. Benefits cuts had proven politically difficult and even led to the fall of one government. Concern over unemployment was also important in Poland. High unemployment was politically sensitive and its reduction seemed to require cuts in payroll taxes, which stood at 45% of wages. Since payroll taxes primarily funded the pension system, pension reform gained salience.

Privatization was put on the agenda by a left-of-center party, the post-communist Democratic Left Alliance, which had come to power in 1993 promising to help the losers of the transition. The Minister of Finance Grzegorz Kolodko, in his long term economic programme, titled Strategy for Poland, proposed a ten-point programme that included pension privatization.

The left-wing government passed Kolodko's economic plan and directed the Ministry of Labour to work on the new funded pillar. Under the powerful Leszek Miller, the Labour Ministry ignored this directive and instead prepared a rationalization scheme with benefit cuts, but without privatization. With technical help from the World Bank, the Ministry of Finance prepared a counter-proposal including privatization. There was a deadlock between these two proposals that lasted until mid-2006. Public opinion polls showed that the public wanted more radical reforms than those proposed by Miller.

The reforms prepared by the Office were clearly designed to win public support. The reform package was entitled "Security through Adversity", indicating the government's commitment to guarantee benefits. Complementary benefit cuts were delayed until after elections. This decision likely made privatization even more popular than in Hungary where it was connected with such cuts.

The reform process was accompanied by significant consultations with the major trade unions through the tripartite commission as well as in less formal setting. Both major unions, the right-wing Solidarity and the left-wing OPZZ, supported privatization and voted to go forward with it at a tripartite meeting in April 1997.

In the end, the reform sailed through parliament. When it came to a vote in 1997, ninety percent of MPs voted in favour. The final privatization scheme was passed in August 1997, only a month before parliamentary election. In almost all respects then, privatization in Poland appears to resemble democratic responsiveness rather than autonomy or blame avoidance.

Hungary

The document says that reform in Hungary took a similar, though slightly more conflictual path. Discussion of pension privatization began in Hungary around 1995 when serious budget difficulties - the deficit reached 9% of GDP - and the Mexican currency crisis forced the government to engage in financial fire-fighting. The government at that time was dominated by the left-wing Hungarian Socialist Party which had come to power pledging to reduce the social costs of the transition. Fiscal problems, however, forced the Socialist Minister of Finance, Lajos Bokros, to introduce an austerity package consisting of a currency devaluation, import restrictions, and minor spending cuts.

While the so-called Bokros Package put the economy back on track, long-term fiscal balance required attention be given to major programmes like pensions. The job of preparing a pension reform fell to a newly-formed Committee for Reform of the Treasury under Ministry of Finance. Unsatisfied with the depth of the plan, Bokros, in consultation with World Bank, produced Hungary's first privatization plan.

The key moment in Hungary's pension reforms was the agreement of the two ministries, Finance and Welfare Ministries on a joint proposal in April 1996. The agreement included a mandatory funded pillar comprising 30% of pension contributions. This agreement appears to have been at the behest of the Prime Minister and leader of the Socialist Party Gyula Horn. Reforms of the existing system - tighter eligibility to receive a pension, weaker indexation, and stronger links between benefits and contributions - also formed a part, in fact the most controversial part, of the plan. Indeed, part of the attraction of privatization was that its popularity would mask unpopular benefit cuts.

In presenting the plan to the public, the government committed itself to securing the agreement of the major labour unions. Hungary had adopted a tripartite institution, called Interest Reconciliation Council, in 1990. There followed numerous meetings between the government and a wide variety of public organizations. In these meetings, the government was able to negotiate a compromise plan that was agreeable to union representatives in the tripartite council. Except for a decision to reduce the size of privatization from 30% to 25% of contributions, most of the concessions demanded by interest groups and granted by government concerned cuts to the existing system. The country's largest union, the left-leaning MSZOSZ dropped its opposition when it was given permanent seats on the Pension Insurance Fund which ran the PAYGO scheme. All major groups ultimate gave their assent to the reform. Though a large number of amendments were proposed, few passed and none substantially changed the private pillar. Parliament voted on the final version in July 1997, less than a year in advance of elections scheduled for May 1998. Operations of the system were to begin in January 1998, which means that reforms would be fresh in voter's minds.

Czech Republic

The document, further says that in many respects, the Czech Republic appeared to be more fertile ground for privatization. But the country did not adopt privatization. For most of the nineties and all of the period when Hungary and Poland were debating privatization, the Czech Republic was governed by the most vocally neo-liberal party in the region, Vaclav Klaus's Civic Democratic Party.

The Czech Republic was the first country in the region to adopt a voluntary pension scheme with state support, which it instituted in 1994. Its stated goal was to lower public dependence on public pensions. But was the extent of movement toward privatization in the Czech Republic.

Throughout the nineties, no significant political actor in the Czech Republic advocated privatization. The only party somewhat interested in privatization was one minor party, the Civic Democratic Alliance (ODA). This silence of privatization continued under the Social Democratic government from 1998 to 2002. Though the liberal Freedom Union party mentioned privatization during the 2002 elections, they ultimately joined a coalition with the Social Democrats who refuse to discuss privatization.

Interest groups have been similarly silent. Though some economists associated with major investment banks have pushed the idea in the media, their influence on policy is minimal. A study by the Czechoslovak Commercial Bank at the end of 1997 argued that it would take from two to five years to prepare unregulated Czech capital markets for reforms, this at a time when Hungary and Poland were already privatizing. In sum, Czech politicians followed the Czech public in avoiding privatization.

Alternative Explanations

Under this title, before proceeding to the conclusion, the document considers a number of alternatives. It says that to some extent it appears that reforms are correlated with economic conditions. Economic pressure in fact make reform more difficult: privatization dramatically increases short-term fiscal deficits. Economic deficits militated in favour of cost-saving benefit cuts, not cost-creating privatization.

One might further argue that World Bank pressure was key and that the World Bank had greater leverage in Hungary and Poland because of their higher external debts. This argument falls short on two counts. The Bank's support in both countries was requested by the government in question, rather than based on conditionality. Further, looking at external indebtedness in the mid-nineties shows that the Czech Republic was not much less saddled with debt than Poland and Hungary.

The document further says that institutional explanations are also common in accounts of reform. It is argued that a higher number of veto points make policy change more difficult. These cases, however, do not allow us to test such an explanation. In most respects, institutions are similar across these cases. As a semi-presidential regime, Poland has slightly more veto points than the other countries, but policy adoption was smoothest in Poland.

Further, the writer would point first to the ability of the public and unions to delay and block important reforms in many areas, including pension policy. The dire fiscal situation of the Hungarian and Polish pension system was due to public demands for compensation for social hardship. The inability of these governments to restore pension systems to balance through benefit cuts is likewise testimony to the power of the public when it chose to exercise it.

There is some evidence that politicians dramatized the crisis of the old system, thus reducing faith in it, and trumpeted public accounts; but there are no accounts of deliberately misleading statements. Finally, the writer would add that all of the countries in question certainly had free presses that offered citizens a wide variety of opinions. If people were interested in hearing alternative views, opposition parties had every incentive to propagate them and media outlets were there to present them.

The document also says that while some elements of these alternative accounts played a role in pension privatization, they all appear to have worked through public opinion rather than around them. Economic factors had effects, but by weakening faith in the system and focusing attention on the broader economic consequences of the pension system. Similarly, partisan effects mattered, but mainly because left-wing parties had to prove their reform credentials to voters. Lack of information and political manipulation may have had effects on the margin, but it is hard to believe that they can account for all the facts presented here. None of these explanations overturns the dynamic the writer had portrayed.

Implications

The document has argued that in democracies with mature pension systems, privatization proceeds when mass publics come to support it. Public support in turn is a consequence of a loss of faith in the existing PAYGO system and confidence in capital markets.

The writer describes the public influence thus - the public had doubts about the old system and wanted substantial changes. Politicians responded to this general demand. Their response involved weighing alternative options according to whether they would enable them to pick up votes or avoid losing votes. Privatization was that policy which fit this bill better than others. The writer claims that if public had not been receptive, these reforms would not have happened.

Pension Privatization: The Transnational Campaign

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Bird's Eye View

The objectives of this 15-page paper are to analyze the rise and spread of the new pension reforms, a set of privatizing reforms that is part of a broader neoliberal agenda for global economic policy; to propose a definition of global policy; to explore the content of the new pension reforms, and to demonstrate that the new pension reforms meet this definition of global policy, through an analysis of their development, transfer, and implementation.

Introduction

The paper says that it analyzes the rise and spread of pension privatization, the partial or full replacement of pay-as-you-go pension systems with ones based on individual, private pension savings accounts. It notes that what is particularly notable about the spread of pension privatization since 1980 is that transnational actors have been involved directly in their development, transfer, and implementation in 30 countries around the world. In this sense, pension privatization is a case of global public policy making.

Pension privatization is significant both because it revolutionizes the post-war social contract and exemplifies the emergence and spread of transnational public policy.

Pension Privatization

The paper says that pension privatization revolutionized welfare state practices as part of a broader 'neoliberal' agenda of economic reform that swept the world since being enacted in Chile and Britain in the 1970s and 1980s (Campbell and Pedersen, 2001). It says that pension privatizations are important for three reasons: 1) they radically alter the social contract and are thus highly controversial; 2) they represent a large proportion of the total economy; and 3) they have been implemented through a global policy process with the direct involvement of transnational actors.

Financing

The paper says that in most developed countries; nearly 90 percent employers comply with payroll tax requirements. In many developing countries, payroll tax compliance is much lower. Some countries do not require all workers to contribute to pension systems, but only those in certain privileged sectors. While both social security and new pension reform systems rely on payroll tax revenue, they differ in the use of these payroll taxes. In social security systems, current payroll tax contributions are used to pay current beneficiaries as a 'pay-as-you-go' system. New pension reform systems are pre-funded. Individuals deposit contributions in their private pension savings accounts during their working life and draw on these contributions, plus investment returns and minus management fees, in their retirement.

Redistribution

Under this, the paper says that social security systems combine aspects of pension savings, old-age insurance, and social redistribution in a single system. Social security type systems may redistribute funds in three ways: from those who die young to those who die old, from one generation to another, and from people in one part of the income distribution to those in another. New pension reforms reduce redistribution within pension systems, since they tie pension benefits firmly to individual contributions. Advocates of pension privatization argue that aspects of savings, insurance, and redistribution within pension systems need to be separated out and that individual private pension funds are an excellent tools for savings, while other government programmes can achieve the goals of insurance and social redistribution (World Bank, 1994).

Risks and Returns

While talking about risks and returns, the document says that a central problem of social security type systems is vulnerability to risk, particularly broad-based demographic aging due to increased standards of living, higher life expectancy, and reduced fertility rates in many countries (World Bank, 1994). In addition, social security systems may face economic risks arising from unexpected changes in growth rates, wages, or prices that may reduce the ability of social security systems to obtain sufficient revenues through payroll taxes. There are political risks, such as failure of the political system to respond to changes in the policy environment adequately or institutional risks that may arise from failures of the social security administration to adequately predict system balance or to administrate benefits properly. Finally, there are individual risks that people take, arising from uncertainties about the future of a work career and earnings.

The paper further says that privatized pension systems face a different set of risks. While demographic risks are substantially reduced since pension benefits do not rely on the earnings of another generation, individual economic risks are increased. Institutional risks are also different, as pensions do not depend on the health of a single government agency, but on the health of a private pension fund and an annuity insurance company regulated by the state.

The Transnational Campaign for Pension Privatization

Under this title, the paper says that the story of the new pension reform begins in Chile in the early 1980s. The new pension reforms designed in Chile in 1980-81 eliminated the old pay-as-you-go system and replaced it with one based on individual, private accounts. People who had contributed to the old system received 'recognition bonds' from the state that were deposited in their individual accounts and paid a four percent interest rate (Edwards, 1998:50). The new funds were managed by pension fund management companies that each established a single pension fund which reduced payroll tax rates and increased take-home pay, making the programme popular among workers.

A turning point in the development of the transnational campaign for pension privatization came in 1994 with publication of "Averting the Old Age Crisis", which brought the World Bank and its resources fully on board with the campaign for pension privatization.

The paper further says that the transnational coalition that supported pension privatization grew in the early and mid-1990s to include not only the World Bank, but also US Agency for International Development (USAID), the Inter-American Development Bank (IDB), and other actors. As in other areas of reform, this transnational advocacy coalition was not without opponents. Pension privatization was opposed by a second coalition composed primarily of the International Society Security Association (ISSA) and International Labour Organization (ILO), organizations deeply involved in the spread of the early social security model pension systems. The transnational advocacy coalition in favour of pension privatization was focused around a clear platform for change after 1994, but it did face, and overcome, opposition. Reasons for the success of pension privatization may include:

- A clearly focused reform agenda;
- A platform that emphasized ancillary benefits for economy-wide savings and investment (Brooks, 2004);
- Consistency with neoliberal reform agenda;
- Limited opposition from vested interest groups;
- Coordination of campaign organization and ability to leverage various resources more effectively.

In sum, pension privatization were developed by a transnational advocacy coalition of transnational actors including Chilean reformers, US economists, US government agencies, and World Bank and other multi-lateral international organizations. The success of this transnational policy campaign should cause us to reshape views of how policy is made in both developing and developed countries.

Policy Transfer

In this context, the paper says that transnational actors have a multiplicity of tools to encourage countries to adopt pension privatization or other policy reforms. Transnational actors often operate as proposal actors in domestic politics. While lacking veto rights, they have the power to formulate legitimate and well-elaborated policy proposals. Proposal actors orient their activity toward convincing domestic veto players to adopt their problem definitions, norms, and proposed solutions.

Because of their lack of formal, concentrated veto power, transnational actors are forced to use a variety of channels of influence to co-opt, cajole, inspire, and recruit domestic veto players to their cause.

As a first step, World Bank and other institutional actor officials seek to identify promising candidates for reform and country officials who are potential partners. One method is to use conferences and seminars on pension privatization to get to know a wide variety of pension reform officials from countries around the world. The World Bank and other organizations also have developed substantial publication series on pension privatization.

However, transnational actors focus most of their resources on countries where they have already established willing partners. Here the emphasis shifts to providing these partners with resources to elevate their political fortunes ("partnership"), creating incentives for other domestic veto players to join the reform bandwagon ("subsidy"), and training new pension reform officials in the technical tasks of administration. One of the key contributions of the World Bank to pension privatization reform efforts worldwide has been the provision of sophisticated modeling software that enables officials to enter parameters and make projections about future of a country's pension system under different scenarios.

Other ideational resources provided by transnational actors also act to bolster the political power of domestic reformers. Large loans also provide necessary resources and encourage governments to adopt reforms.

The paper further says that one often overlooked channel of World Bank influence has been through personnel policies. Opening a revolving door between leading transnational actors and national governments creates individual incentives for top reformers to participate in the pension privatization campaign and also helps to provide high-level personnel resources to reform teams.

One of the most important comparative studies of pension privatization in Latin America and Central Europe was conducted by Muller (2003), who shows that in the eight countries selected for the study, all had substantial direct involvement from transnational actors. Chief among the transnational actors pushing pension privatization was the World Bank. In addition to the World Bank, transnational actors included leading Chilean economists, the International Monetary Fund (IMF), USAID, IDB, the United Nations Development Programme (UNDP) and the Asian Development Bank (ADB).

In every case studied by Muller (2003), government reform teams planning pension privatization were financed by external actors and provided with extensive technical assistance. This suggests that transnational actors made a coordinated effort to spread pension privatization worldwide, with a regional focus on Latin America and Central and Eastern Europe.

Conclusions and Implications

Under this head, the paper says that pension privatization has been pursued by a transnational advocacy coalition that seeks to revolutionize social protection on a global scale. New pension reforms are also a global policy in its development, transfer, and implementation and transnational actors are likely to remain a major force in the advancement of these reforms. As the field of global policy studies develops, further research will be required to establish whether the patterns explored in this paper hold in other countries implementing these reforms, and in particular whether developed countries like the United Kingdom, Denmark, Sweden, and the United States are influenced by the same transnational actors in the same or different ways. Another key issue for future research is determining the relative extent to which transnational actors, local structural conditions, or domestic policy actors shape the outcomes of reform. Available evidence suggests that pension privatization should be seen as part of a global policy process that includes global policy development, transfer, and implementation as well as interaction with domestic policy actors and conditions.

The document also raises questions like, what will be the impact of pension privatization on the countries that have implemented them so far? And what impact will this global policy process have in countries in the future? The global financial crisis of 2008-2009 put these questions in a new light. With the collapse of stock market values worldwide, private pension fund balances have been badly hurt. It remain unclear what impact this will have on the transnational campaign for pension privatization. On the one hand, it is possible that countries will be deterred from implementing such reforms due to the poor performance of funds in other countries and the weakening logic behind neoliberal policy reform generally. On the other hand, the transnational campaign for pension privatization remains in place. It has been highly effective and has trained thousands of officials in reform, most recently in Asia and Africa. It will be interesting to see in coming years whether the trend towards pension privatization is paused, slowed, or ended. Based on the persistence of the transnational campaign described above, the writer guess is that it is paused or slowed, but not ended.

Pension privatization in crisis: Death or rebirth of a global policy trend?

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Bird's Eye View

The objective of this 15-page paper is to advance a debate on the impact of pension privatization.

In the **Introduction**, the paper says that from 1981 to 2007, more than thirty countries worldwide fully or partially replaced their pre-existing social security pay-as-you-go (PAYG) pension systems with ones based on individual, private savings accounts in a process often labeled "pension privatization". To a large extent, pension privatization was fostered by a transnational advocacy campaign that started with Chilean consultants and multinational companies in Latin America and later took hold of the Social Protection and Labour sector of the World Bank. The World Bank, after the 1994 publication of its landmark volume "*Averting the old age crisis*", played an enormous role in advocating mandatory funded pensions in Central and Eastern Europe in the 1990 and 2000s. The economic and fiscal crisis of post-communist countries facilitated the World Bank's efforts at transformative pension reform by promising long-term relief and elevating the importance of international financial institutions (Muller, 2003). Pension privatization, which started as a regional trend in Latin America and Central and Eastern Europe in the 1990s, later spread to Africa and Asia, with Nigeria and Taiwan adopting private pensions in 2004.

The paper further says that pension privatization has been less dramatic in developed Western countries, but still has happened to some extent through the back door (Natali and Rhodes, 2007). Germany cut back its generous public pension system in the 2000s and simultaneously introduced a system of voluntary, state-subsidized pension savings accounts (Palier, 2010). The former President of the United States (US), George W. Bush, notably tried and failed to privatize "Social Security" in 2005. Yet, like other wealthy Member States of the Organization for Economic Co-operation and Development (OECD), the US found a variety of other ways to minimize or cut back on state provision for old-age retirement while placing increasing responsibility and risk on individuals (Hacker, 2006; Munnell and Sass, 2007).

The global financial crisis of 2008-2010 seems to have halted, at least temporarily, the trend towards mandating savings in individual, funded pension accounts worldwide, the core reform of the pension privatization trend. Since the crisis, no countries have adopted mandatory individual accounts and several that were considering doing so have backed away.

The paper also points out that pension privatization has been controversial because it radically revises the post-war social security contract in countries around the world. The International Labour Organization's 1944 Declaration of Philadelphia was the key proclamation of this post-war social policy consensus. Most countries sought to achieve these goals in part through state-sponsored PAYG pension systems in which current contributors paid the pensions of current beneficiaries, but were promised a pension themselves that would increase in line with average wages in the economy.

Yet the post-war social consensus began to fray during the 1970s, in part because of the rising cost of social guarantees in the rich OECD countries and the failure of many poorer countries to implement basic social rights. The ensuing fiscal problems of PAYG pension systems led policy-makers around the world to consider increasing individual responsibility for retirement saving. Pension privatization seemed to offer a comprehensive answer to fiscal problems of social security pension systems: force individuals to save for retirement in tax-sheltered accounts and cut back the level of state guarantees. Rather than relying on the dominant role of the state, individuals could seek greater returns in financial market investments or rely on other private sources of income.

The paper further says that not only are financial market returns highly uncertain and variable, but making pensions reliant on individual savings and investment returns - rather than on average wage growth, as in PAYG pension systems - significantly alters the manner in which wealth and income are distributed. Public pension systems often account for 10 to 15 percent GDP in most wealthy OECD countries and 5 to 10 percent in many developing countries. Redirecting pensions has a big impact on the macro-economy, creating significant winners and losers. **Typically, women and lower-income earners are the big losers from pension privatization, since they may have significant non-contributory periods, broken employment histories and/or lower levels of savings. High-income earners are usually big winners, since the contributions made to their individual accounts are based on higher earnings throughout relatively uninterrupted work lives. Unlike in risk-pooling social security systems, there is normally no redistribution in systems of individual accounts. The even bigger winners, however, are financial services companies, who earn enormous administrative fees running pension funds.** These administrative fees are as much as four to five times those of state social security systems. And then there is the risk that financial markets can go down as well as up, a risk borne by the individual. Financial crises are particularly damaging to funded pensions, eroding the total value of deposits.

Despite these downsides, pension privatization has been popular with governments seeking to confront their long-term fiscal problems. Indeed, some scholars have found that high debt levels increases the propensity of countries to adopt these reforms by forcing policy makers to address a problem that they would rather put off and, in developing countries, by strengthening the hand of reform-minded International Financial Institutions (IFIs). Muller writes that critical indebtedness also increases the likelihood of the IFIs involvement in the local pension reform arena.

A trend in reverse

The paper says that while pension privatization reduces government's long-term fiscal exposure, it increases government debt in the short and medium term. As a result, governments with extremely stretched finances may put off pension privatization (Brooks, 2005). The global financial crisis, and fiscal stimulus efforts that followed, badly affected government balance sheets. Supposing that economic factors are the main force slowing the adoption of pension privatization at present, we should expect the trend to resume as countries pull out of the crisis. In this case the trend would continue after a temporary lull. Yet there are reasons to think that the pause in pension privatization could be more enduring. There is plenty of evidence to suggest that the global financial crisis has had a major impact on economic thinking, at least in the developed West, and on the institutions that have advocated for reform.

For one, the magnitude of the economic collapse may have changed attitudes towards the viability of financial markets as an alternative to state provision. One report commissioned by the Asian Development Bank estimated that global stock market valuations fell by USD 28.7 trillion in 2008 (Bloomberg, 2009), or approximately by half. The collapse was made more dramatic by the failure of many leading banking and securities institutions, such as Lehman Brothers, and the effective nationalization or forced mergers and acquisitions of others. The largest bank of America, lost as much as 90 percent of their shared value at one point. Though equity markets have recovered since the nadir of 2008, such dramatic declines badly affected popular perceptions of the benefits of private pensions.

The paper further says that the severity of the crisis also had the effect of convincing many people that the fundamental model of free market capitalism was flawed. Rather than being a path towards higher productivity and efficiency, more people now see free market capitalism as crisis-prone and potentially dysfunctional (Stiglitz, 2010; Birdsall and Fukuyama, 2011). The free market model of capitalism is based on a number of factual and causal claims that suddenly appeared dubious to many people: that markets are always more efficient than governments, and that government intervention is necessarily distorting and should be kept to a minimum.The thinking behind pension privatization is part and parcel of these broader free market capitalist ideas. It is based on the ideas that markets can provide income-related pension benefits more effectively than governments and private companies are better managers of pension funds than governments.

But these ideas have come under critical scrutiny worldwide. A wide variety of voices from all parts of the world have questioned the relevance of free market ideology in economic policy. This new ideological climate undoubtedly has made it harder to advocate or defend pension privatization in most countries.

This sudden shift in the ideational landscape changed the balance of debates within the World Bank and other international institutions concerning pension privatization. While a wide range of external critics had always opposed pension privatization, criticism within the World Bank and other international financial institutions had been muted during the 1990s and early 2000s. This began to change when, in 1999, the World Bank Chief Economist, Joseph Stiglitz, sponsored a conference intended to throw cold water on the Bank's pension privatization advocacy campaign. Orszag and Stiglitz (2001) authored a paper arguing that the campaign was based on "ten myths" that needed to be debunked and raised questions about the practices of the Bank's Social Protection and

Labour sector. This conference appears to have created intellectual room for further critiques that developed in subsequent year. In 2005, Gill, Packard and Yermo (2005) published a tough criticism of World Bank pension advice in Latin America, arguing that pension privatization had saddled early clients with enormous fees. The World Bank consensus on pension privatization was beginning to fray even before the onset of the crisis.

Another major setback to the pension privatization campaign came in Chile, that most symbolic of places, where centre-left government of President Michelle Bachelet initiated a major reform of Chile's pioneering private pension system in 2006. In her introduction to the report of the Pension Reform Commission, Bachelet announced that the privatized system had "low coverage, very little competition and high commission charges and discrimination against women", (Kay and Sinha, 2008, p.7). Her reforms dramatically increased benefits for the poor, women, and the lowest 60 percent of earners by replacing previous minimum pension with a much more generous solidarity pension, along with a variety of other changes aimed at reducing costs and increasing equity. The Bachelet reforms proved highly popular an sent a strong signal worldwide that pension privatization had major drawbacks that needed to be addressed.

The paper says that it was the global crisis that put a stop to the pension privatization advocacy campaign led by the World Bank sharply increasing the credibility of critics and silencing prominent advocates.

In addition, the global financial crisis forced significant structural changes in the international financial institutions that advocated pension privatization. The World Bank, under the leadership of Robert Zoellick, shifted away from a strict focus on free market liberal policies and began to advocate "inclusive and sustainable globalization", both environmental and social. World Bank advocacy of pension privatization appeared not to be a part of this agenda.

As a result, in contrast to previous crises (such as Latin American debt crisis, the post-communist transition crisis, and the Asian financial crisis), during which international financial institutions pushed pension privatization on weakened governments facing banking and fiscal crises, this time they did not. Even countries experiencing catastrophically weakened finances and applying to the IMF for support did not come under pressure to adopt pension privatization. Economic, ideational and institutional reasons all contributed to a sudden halt in pension privatization worldwide.

Death or rebirth?

The paper says that while in reviewing the present trends, the writer argues that pension privatization in not entirely dead, but rather in the process of being reborn - transmigrating into a different form.

He says that two recent observable trends support this stance. First, while several of the countries that privatized their pension systems have scaled back their commitment to individual, funded accounts, only two - Argentina and Hungary - had eliminated their private pension systems. The crisis has not persuaded most countries to scrap this reform. Second, and perhaps more importantly, the underlying economic problems that helped to foster the trend towards pension privatization have not been resolved, but only exacerbated by the crisis.

Pension privatization did die in Argentina. When the crisis hit, the government took it as an opportunity to shut the private system down. The government transferred the assets of the private funds to the state pension.

Hungary also effectively dismantled its privatized pension system in December 2010, when the government of Fidesz leader Viktor Orban imposed penalties on those choosing to remain in the funded system. These changes forced millions of citizens to transfer a total of around USD 14 billion in assets back to the state PAYG system, money that was used to reduce Hungary's high government debt.

The paper further says that in contrast to Argentina and Hungary, several of the main reforming countries in Central and Eastern Europe have scaled back their privatized pension systems, rather than eliminating them. Slovakia made its private pension system voluntary, enabling workers to choose to contribute or, instead, to rely solely on the state pension system. Poland, Romania and the three Baltic states reduced or curtailed planned increases in contributions to the private system.

In some ways, the financial crisis may have set the stage for an increasing reliance on private pensions. Any retrenchment of public PAYG pension systems naturally leads to an increased reliance on other sources of income, including private pensions. And there is no doubt that cuts in public pensions will be a major outcome of the crisis. In Europe, governments employed extreme deficit spending to counter a recession, reducing the possibility of doing the same to perpetuate out-of-balance pension systems. Then European governments, starting with Greece in 2010, were hit with declining investor confidence in their sovereign debt. Greece increased its retirement age, eliminated extra-month pensions and enacted other austerity measures with long term effect. Romania, also under an IMF programme, announced a 15 percent cut in public pensions in order to bring the budget deficit down, but was rebuffed by its own Constitutional Court on the basis that pensions were an acquired right that could not be adjusted in ad hoc fashion (BBC, 2010). Ukrain similarly came under pressure to cut pension spending with its IMF package. A similar trend has occurred in the developed West, as the United

Kingdom accelerated a planned increase in its retirement age from 65 to 66 and France increased its retirement age from 60 to 62 in the face of dramatic protests. The paper points out that as public PAYG pensions are cut, retirees will need more income from other sources and will naturally turn to private savings, including savings in individual pension savings accounts. By forcing deep cuts in public pension systems, the crisis could ultimately increase demand for funded pensions in one form or other.

Noting a distinct trend over the last decade to "lower the share of public PAYG pensions in total provision while giving an enhanced role to supplementary, prefunded private schemes, which are often of a Defined Contribution (DC) nature", the paper makes a number of critiques of the resulting systems and recommendations intended to strengthen their functioning in future, it recommends that Member States may want to address issues such as minimum pensions, coverage of atypical workers and involuntary employment breaks. Increases in the retirement age are seen as the most significant option for restoring pension finances. Better regulation is also needed to ensure that private pensions remain safe. However, the report also concludes that the trend towards private pension funds continues, particularly in occupational pension systems, where employers are increasingly replacing defined-benefit systems that reward longevity of employment with a particular company with individual pension savings accounts.

The paper further says that pension privatization is thus subject to countervailing trends. Its advocacy campaign no longer has the wind in its sails. Governments have been forced to scale down and eliminate privatized systems in an effort to protect public finances. Yet, as public pension systems continue to be cut, reliance on funded pensions and other alternative sources of income continues to grow. For these reasons, it seems that one should anticipate a rebirth, rather than a death, of the pension privatization trend in the years ahead.

One rapidly emerging international trend in pensions is the rising interest in minimum pensions, in part because of the volte face in Chile and because of a campaign led by the International Labour Organization. While the IOL had limited traction in international pension debates compared to the World Bank from 1994 to 2006, it has had greater success with a new initiative to advocate for the design and implementation of minimum guaranteed pensions worldwide. For the World Bank, minimum pensions were always seen as one option for a basic state social security system that would be redistributed and pro-poor, albeit at a minimal level of income. After the crisis, an emphasis on minimum pensions allowed the Bank to appear more sensitive to the plight of the poor, more in line with the times, and therefore more relevant as an advisory body. From an ILO point of view, an emphasis on minimum pensions provided a way to reframe the global pension debate to address the key problems of developing country pension systems: lack of coverage and poverty reduction. A renewed emphasis on minimum pensions thus allows both organizations to remain relevant in changing times. It does not, however, exclude the possibility of a growth in private pensions in the future.

A further trend that has taken shape in the English-speaking countries in particular is a move away from mandatory savings and towards "behavioural" approaches that encourage, rather than mandate, future-oriented savings plans. While the introduction of mandatory savings has been put on hold, plans that "nudge" employees towards private savings have gone forward during the crisis. These "nudge" type pension systems encourage workers to contribute to individual pension savings accounts by making enrolment automatic when taking a new job or changing employers, but allowing workers to opt out of contributions if they prefer. This allows governments to encourage adequate pension savings, while not being so heavy-handed as to mandate private savings. The United Kingdom has coupled its reform with a significant dose of state regulation of the "nudge" funds, driving down fees and structuring investment options by negotiating hard with the fund industry.

In **Conclusion**, the paper says that transnational campaign for pension privatization that spread mandatory, private pensions around the world is in crisis. As pension fund assets were decimated during the global financial crisis, the free market model itself was called into question. The international financial institutions pushing pension privatization similarly were forced into reorganization.

However, the trend towards funded pensions has not gone away. Demographic ageing is accelerating in many countries and PAYG systems find themselves the target of increased budget austerity. As a result, what appears to be happening at present is a rebirth, rather than a death, of the trend. "Funded" minimum pensions (i.e. tax-financed and/or pre-funded using a sovereign fund-type mechanism) and nudge-type automatic enrolment in pensions may become part of the future pension landscape, as well as notional defined contribution and quasi-mandatory occupational pensions. This constitutes a broadening of the stream. Global pensions policy has shifted from an emphasis on harnessing free market wizardry to controlling costs through raising the pension age, better covering the poor, and nudging people to save, rather than mandating them to do so.

The global financial crisis has had strong ideational and institutional impact, forcing policy-makers to rethink economic development policy worldwide. The rebirth of the pension privatization trend provides one instance that may help us to discern where global economic policy may be heading in the decades ahead.

Rethinking Pension Reforms in Chile:

Implications for Developing Asia

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Bird's Eye View

The main objective of this 88-page document is to analyze the proposed changes to Chile's pension system. It says that the pension reform initiative is the most important change to the existing Pension Fund system since its creation in 1980.

Under the **Introduction**, the document says that the generally accepted objectives of a pension system are to prevent a steep decline in earnings after retirement by facilitating consumption smoothing over the lifetime of an individual --the consumption smoothing objective; to ensure that individuals have adequate means to satisfy their basic needs in retirement --the income adequacy objective; and to ensure that consumption in old age never falls below a minimum level --the poverty prevention objective. An efficient pension system should provide adequate insurance against longevity and insurance risks.

However, these objectives have to be traded off against economic growth, labour market efficiency and flexibility, and against other objectives like health, education, and infrastructure that may have important claims on public resources.

The document says that although no single idea or system can be considered to be appropriate for all countries, the World Bank's multi-pillar-pension framework is considered to be the most practical for addressing the complex risks involved in providing social security. According to the multi-tier lexicon, Chile has provided a three-tier social security system since a sweeping reform of the system that was undertaken in 1981. The reform of the Chilean Pension System, which was initiated under General Pinochet's military regime, has probably been one of the most widely discussed reform programme in non-OECD countries, and the most widely emulated in Latin America.

The pension system in Chile has two first pillar components- the minimum pension guarantee (MPG) and a means-tested social assistance pension that prevent old age poverty; mandatory defined contribution individual retirement accounts that form a second pillar to facilitate consumption smoothing; and a voluntary third pillar that encourages additional savings for retirement.

Chile's pension system received positive assessments for over two decades after its implementation. The switch from a completely public, PAYGO system to a fiscally sound, privately managed and individually financed system has been acclaimed by organizations such as the World Bank. Recently, however, the outcomes of these reforms are being re-assessed and the effectiveness of the system in under review in Chile.

Under the section **Structure of the Chilean Pension System**, the document says that Chile has always been a pioneer in setting up and reforming pension systems. In 1924, it was the first country in Latin America to set up a National Insurance System with the aim of providing insurance against old age, disability and health. In 1979, there were about 35 schemes or 'cajas' within the system with vastly different conditions of participation and entitlement. The system was subject to rampant abuse by political groups because benefits were decided through lobbying and political power, but paid out of a common pool. Thus early retirement became as popular election "promise", with some 'cajas', such as those covering bank employees, allowing generously funded retirement after just 25 years of service.

The viability of the system was also undermined by widespread social security evasion, as both workers and employers connived to contribute at the legal minimum rate for all except the last few years of the worker's active life, when the contributions were counted for pension purposes. This situation forced the State to raise contributions, which led to even greater evasion. The State's fiscal position worsened steadily under the burden of insufficiently-funded pension benefits, and by 1980, the PAYGO system had a fiscal deficit of 2.7 percent of GDP. While the economic un-viability of the public social security system was manifest, the political will to reform was not summoned until the military dictatorship of General Pinochet. In 1980, the public system was closed and replaced by a private system that started functioning in May 1981.

The document further says that all workers joining the labour force after January 1, 1983 were required to join the new system. Members of the old cajas-based system were given a choice: the existing cajas were merged into a single organization - Institute of Social Security Normalization (Institute de Normalizacion Previsional or IPN), and workers had the option to remain with the IPN. However, there were strong incentives for many workers to move to the new system. Accumulated contributions in the old system were protected by converting them into non-tradable Government-issued "recognition bonds" that would be made available to the worker on retirement. Many workers switched to the new system because it gave them an immediate increase in post-tax earnings. The actual reasons may be debatable, but there was a widespread movement from the INP to the AFP based pension system.

In 1981, social security even in the most advanced countries was provided through partly or fully-public pension systems. Thus Chile's move to a fully privatized pension system revolutionized pension design and created a system that continues to be lauded and emulated.

Features of the Pension System: The document points out that there are four key characteristics of the system: Defined Contribution (DC), non-defined benefits, individual pension accounts and private management of funds. Below are outlined the salient features of the system:

Individual Capitalization - Each worker has an individual pension account which commences at the start of his working life and accumulates his contribution till retirement. The retirement age 65 years for men and 60 years for women; early retirement and withdrawal of pension is permitted only under certain conditions. Members of the pension system have to mandatorily contribute 10 percent of their taxable earnings into this account every month. Contributions made towards the pension account are tax free. Employers do not contribute towards employee pensions, thus creating an entirely self-financed defined contribution system. An additional 2-3 percent of salary is paid to cover administrative costs and premium payments for disability and survivors insurance

Members can voluntarily contribute an additional percentage of their salary into their individual capitalization account. These contributions serve to enhance members' pensions by providing an additional avenue for savings, and also enable members to plan for early retirement. These payments have the same tax advantages as the basic contribution and are not taken into account when deciding entitlement to the Minimum pension.

Since August 1987, members have been permitted to save in a separate Voluntary Savings Account, also known as Account Two or the Ahorro Voluntary Provisional (APV) account. This account is independent of the individual capitalization account. Deposits can be made regularly or frequently into the APV account, though withdrawals are limited to four times per year.

The document further says that workers may have an agreement with their employers to deposit some amounts into their individual capitalization account, either as a one-time fixed payment, a monthly percentage of income or a fixed monthly amount. Such deposits are independent of the mandatory and voluntary contributions, and are called agreed deposits. However, they are paid into the individual capitalization account and form part of the sub-total of voluntary contributions. Funds in the agreed deposit category are not considered as income for the worker, so that they are not taxable and not considered in deciding entitlement to the state minimum pension. However, they are not freely available and can be withdrawn only at retirement.

Private management of funds: The document says that funds flowing into the pension account are managed by one of several privately owned, public limited companies called Administradoras de Fondo de Pensiones (AFPs). AFPs are exclusively involved in management of pension funds: they collect contributions, invest them professionally and efficiently in accordance with prescribed regulations with the objective of maximizing returns, and administer and distribute benefits to affiliates. They also take out disability and survivors insurance policies. AFPs receive a commission, usually paid directly as a percentage of affiliates' salary. These commissions currently vary between 1-2 percent of members' taxable earnings, and are paid out monthly.

An employee can choose and switch between AFPs, but frequent switching involves high costs. Currently, there are six AFPs, of which the top three cover about 70 percent of the market.

The document further says that AFPs are permitted to invest in both domestic and international markets, though tight investment regulations continue to be in place. A "multifondos" or "multifunds" system was introduced in 2002 to provide greater diversification and profit-opportunities to affiliates. AFPs were required to offer five portfolio options with different risk-return combinations: the funds being differentiated by the percentage of equities and fixed-income securities that they may invest in.

Benefits: The document states that on retirement, the accumulated funds in an individual's account can be paid out in one of the following ways:

- Annuity - Members can use their individual account balances to purchase a life annuity from an insurance company.
- Temporary income with deferred annuity - A portion of member funds can be transferred to an insurance

company to purchase a deferred annuity, which provides a monthly income from a future date as stipulated in the purchase agreement.

- Programme withdrawal - Members can withdraw their savings over a period of time according to an actuarially determined schedule set by the Government.
- Programmed withdrawal with annuity - On retirement, a portion of member's fund may be retained with the AFP for a period of time, during which a programmed pension would be paid out to the member. Simultaneously, the remaining accumulated funds would be transferred to an annuity provider, who would provide life-time inflation indexed annuity. Thus the pensioner can obtain two kinds of pension benefits at the same time.

The document further says that early retirement is permitted if the account balance of a member allows him a pension equivalent to at least 70 percent of his average income for the past ten years and 150 percent of the minimum pension. This rule was imposed in August 2007 with a view to discourage early retirement and withdrawal from the system.

Unlike the old PAYGO system, benefits received under this system are uncertain or non-defined, and depend on factors such as the amount, frequency and continuity of contributions made into individual accounts, the returns earned on these contributions and the life-expectancy of the pensioner. The "recognition bonds" issued to members who switched from the old PAYGO system are also inflation indexed and earn an interest of four percent annum, but are available only on retirement, disability or death. (Arenas de Mesa and Mesa-Lago-2006).

State Guarantees: The document says that the basic tenet of Chile's system is that each worker is responsible for financing his own pensions. However, the State does provide some assistance for those unable to fund their retirements. This is achieved in two ways:

i. PASIS : A publicly funded means-tested social assistance pension is provided to the poorest aged, irrespective of their contribution history. The Government limits the number of PASIS pensions granted in order to control expenditure.

ii. MPG : A Minimum Pension Guarantee is provided to all individuals who have contributed to the system for at least 20 years but have not accumulated enough to achieve a minimum pension.

There are other covert guarantees provided by the State. If an AFP goes bankrupt, the Pension Funds belonging to the members do not suffer, instead the worker simply transfer them to another AFP.

In case of bankruptcy of an Insurance Company, the State guarantees 100% of the minimum pension guaranteed by the State, plus 75% of the difference between the pension the pensioner was receiving.

Fiscal Impact: The document says that although the Chilean pension reform of 1981 transferred the responsibility of generating pensions to the workers, the State continued to bear the costs of regulation, providing safety nets and paying the transitions costs of moving from the old PAYGO system. The fiscal costs to the government include the following:

- Pension payments to all retirees who opted to stay under the old system
- Financing of recognition bonds to retirees who switched to the new system
- Guaranteed minimum pensions
- PASIS payments
- Deficits of the public pensions of the armed forces and the police

The document further says that the transition costs in Chile were relatively higher than those of other Latin American countries that undertook similar reform partly because the government opted to recognize accrued obligations under the old system on generous terms. The transition period in Chile is expected to last until 2037, when only the AFP system will be functional.

In the section **Outcomes of the Chilean Pension System**, the document says that the Chilean model of pensions was widely expected to meet the basic objective of a pension system - providing universal and adequate income in old age to enable retirees live with dignity. By providing a clear link between worker contributions and post-retirement benefits, it was expected to impart workers with a sense of ownership of and responsibility for retirement savings. In addition, an accurate assessment of the effectiveness of the system can be made only by studying the market structure of AFPs. In this category, the relevant outcomes are - level of administrative costs, competition among AFPs, regulation of investment of pension funds.

AFP Market Structure

Administrative Costs: The document says that the AFPs charge two types of commissions from their members: fixed and variable. Fixed commissions are levied as a flat sum, irrespective of account balances. Variable commissions are charged as a percent of taxable income, and simply added to member contributions. The variable commission includes the management cost incurred by AFPs as well as the cost of taking out a disability and survivorship insurance.

The document also says that both fixed and variable commissions have declined over the years. Despite the declining trend in fixed commissions, it has been criticized for its regressive nature because the account balances and future pensions contributors. The greatest negative impact of fixed commissions is on irregular contributors with small balances.

On retirement, members pay additional costs in the form of withdrawal commissions or annuity purchase fees, depending on their chosen payout option. The high administrative costs of AFPs can be partly attributed to marketing and advertising expenses, and the costs of maintaining a large sales force in order to attract and retain members. In October 1997, the government tightened the rules for transferring between AFPs. The impact was immediate and significant.

Competition: The document says that AFPs do not compete with each other on price, yield or service offered; thus there is effectively no competition in the market for pension funds. When the pension system was launched, it was expected that market forces would operate through privately managed AFPs to generate competitive prices, efficient services and product differentiation. However, partly as a result of the restrictive regulations imposed by the government, and partly as a consequence of system design, the AFP market has evolved into a concentrated and non-competitive system.

The document further says that over 75 percent of contributors are affiliated to one of the top three AFPs, and no new administrators have entered the market for several years despite the profitable nature of the industry. Clearly, there are steep barriers to entry. Some of the hurdles are regulatory in nature: for instance, the requirement of a single corporate purpose, the creation of obligatory reserves, and the mandatory minimum return that is required to be earned on investment.

Investment Regulation: The document states that the regulation of AFP investments is currently based on rigid portfolio restrictions. For each AFP, there are investment limits for each instrument type, in absolute terms for each investment category, in terms of risk which can be accepted for assets and also for each type of authorized market in which investment is permitted. The limits for the funds put together, number more than 100. The extent of regulation tends to reduce investment efficiency and flexibility, as managers are more concerned with ensuring compliance with prudential norms than maximizing investment efficiency.

The document further says that the Government has attempted to gradually liberalize investment regulations, with a view to increasing yield and flexibility. Two developments in this direction have been of great significance: the introduction of risk-differentiated pension plans, and the gradual easing of portfolio restrictions.

When the pension reforms were launched in 1981, fund managers invested largely in government backed securities or bank deposits, not just because of regulatory requirements but also because the Chilean capital market was not liquid or well-developed. Gradually, restrictions on permitted instruments, markets and investment limits were liberalized. Purchase of shares was authorized in 1985, and foreign investment was permitted in 1992. The creation of the Multi-fund system in 2002 further spurred diversification across markets and instruments. The maximum level of asset allocation in foreign instruments was raised from 20 per cent 30 per cent in 2004; and a recent bill to be enacted in Parliament suggests a range of 30 to 45 per cent for the maximum limit of investments of pension funds in foreign markets. The asset-mix of Chilean pension funds is highly diversified and balanced, especially in comparison with other private systems in Latin America.

***Coverage**:* The document says that coverage is one of the main indicators of the effectiveness of a pension system; a system might be well-designed and fiscally sound, but if it is not able to cover its target population, then it fails in its basic objective of providing income security. There are two phases of human life during which measurement of coverage is relevant: coverage for the working or economically active population, and coverage for the elderly. A brief discussion on the issues involved in measuring coverage in each phase follows.

Coverage for the economically active population: The document says that in countries like Chile with a mandatory defined contribution system, coverage is usually measured with reference to the economically active population; as each person in this category is expected to contribute to the system in order to secure his future pension.

The World Bank recommends three indicators for measuring coverage among workers in the economically active phase:

i. Contributors/Economically Active Persons - known as coverage of the labour force, and is a broad measure of the extent of social security available to the labour force.

ii. Contributors/Employed Persons - known as occupational coverage, which is narrower measure than (i) as it recognizes that unemployed persons are not entitled to regular pensions under Chile's DC system.

iii. Contributors/Wage Earners - called legal coverage, since contribution is mandatory for all wage earners, and this measure actually captures the extent to which national laws are being implemented.

Coverage for the elderly: The document says that it is relatively easy to measure coverage for the elderly as it simply involves identifying the number of individuals among the elderly who are actually receiving pension benefits. Some studies advocate a "joint coverage" measure for the elderly, which counts spouses of benefit recipients as covered persons; or a "joint occupational coverage", which also includes among covered elderly those who remain employed and their spouses. The last measure is sufficiently broad and exclusive, and it is reasonably certain that those elderly who do not qualify as 'covered' under this measure are persons who do depend on savings or transfers for their survival.

Trends in coverage: The document says that coverage under the current pension system has been stagnant, and not substantially better than that under the old defined-benefit system. This pattern is observed irrespective of the indicator used to measure coverage. Estimate based on the National Survey of Socio-Economic Characteristics (CASEN) show that in 2003, only 58.7 percent of the economically active population, 64.7 percent of employed persons and 78.6 percent of wage earners were contributors and so had potential person coverage,

In general, about 40 percent of employed persons did not or were not able to contribute towards an old age pension. This extent of non-contribution is startling: first, because in a DC system there is a direct link between contributions and pension accumulation and therefore a clear incentive to contribute, and second, because rules governing Chile's system mandates contributions from all employees.

Reasons for the low coverage: The document says that disaggregated data reveal that coverage appears to improve with educational levels, income, and size of establishment; as well as vary with gender and residence, both for elderly and economically active persons. Persons with secondary or tertiary education, higher income, persons working in medium and large sized establishments, urban residents and men have relatively higher coverage.

In general, the most vulnerable in terms of low coverage are women; independent workers, which includes the self-employed as well as workers without formal labour contracts; and the very poor, especially in rural areas. The Chilean economy has been characterized by fairly high unemployment (8-10 percent).There is frequent movement between jobs, and between the formal and informal sectors.

The document further says that as markets across the world react to globalization, Chilean labour is also faced with shorter labour contracts, greater job rotation and uncertain employment. As employment becomes riskier, workers are more likely to contribute irregularly, if at all, into their pension accounts. The experience of other countries shows that people contribute only when they have to,; in fact, having a formal employment contract appears to be critical to participation in the pensions system. In Chile, about 95 percent of the self-employed, who constitute more than a quarter of the workforce, do not contribute. Consequently, self-employment explains most of the non-contribution from the male members of the workforce. Female participation in the formal workforce is relatively poor and characterized by long gaps that occur when women leave formal employment to care for their families.

Under **Gender Dimensions**, the document says that gender dimensions of pension design have become increasingly important, especially in ageing societies where women are often observed to have lower access to pensions and government assistance programmes as compared to men. Chile's defined contribution system, which directly links working-life contributions to retirement benefits, was expected to increase work-force participation, contributions and thus pensions across gender. However, owing to demographic differences between genders, and due to the nature of their participation in the labour market, women appear to be at a disadvantage as compared to man.

Labour force participation rate of women (at 38 percent of Chile's labour force) is much lower than that of men (75.2 percent). Less than half of the working women are affiliated with the Social Security System (SSS), as compared with two-thirds of men; largely because women are more likely to be employed in part-time jobs or in the informal sector. Studies have shown that women tend to earn less than men, even after controlling for age and education. Many women drop out of the work force to perform traditional roles of child-bearing and taking care of family. Given the labour market conditions, a DC system that links retirement benefits to contributions would cover fewer women than men, and provide them with lesser end-benefits.

Thus women have lower contribution densities, lower pension account accumulations, and as a result end up with lower replacement rate and lower pensions. The worst affected women were those in the lowest income categories, those with no or minimal education, women in domestic service and those who were categorized as unpaid family workers -these groups of women had significantly lower coverage as compared their male counterparts.

Yet despite these obvious gender biases in the Chilean pension system, the overall impact on women may be ameliorated by public transfers, the minimum pension guarantee and design features that mandate joint annuities and provide survivors pension. Some financial protection is provided to Chilean women through mandatory joint annuitization: when husbands retire they are required to purchase joint annuities or gradual withdrawal spread over both lives. The survivor gets at least 60 percent of the primary benefit. Chile's pension system permits widows to keep their pension benefits in addition to the survivors' pension derived benefits scheme.

In fact, women get a higher relative benefit in this system as compared to the old defined benefit scheme.

Under the section **Rationale for reform: Challenges within the existing pension system**, the document says that the 1981 reform created a homogenous pension system for Chilean civilians, in which each worker was responsible for building up his/her pension fund. For the first time in the history of pension reform, a publicly managed defined-benefit system was replaced by a privately-run defined contribution system at the national level.

The individual capitalization system has worked fairly efficiently for twenty five years. In twenty-five plus years of operation, there are no bankruptcy or fraud. There was no structural crisis in the system. Yet the Government of Chile, under the leadership of President Bachelet, is in the process of legislating significant changes to the existing system.

In order to understand the rationale for another reform, the writers examine outcomes arising as a result of the system design, nature of the pension funds market, regulation and externalities, and consider deviations from what was expected or promised at the time of reform.

Design: The document says that Chile's pension system was designed as a "multi-pillar" structure. The first pillar operates through two instruments - the minimum pension guarantee and PASIS. The second pillar facilitates consumption-smoothing through a privately-managed and publicly-mandated defined contribution scheme. Finally, a third pillar consisting of instruments promoting voluntary savings encourages additional savings for retirement.

The multiple pillar model of social security, strongly endorsed by the World Bank, has been adopted by many countries that reformed their pension systems. Pension literature is clear about the benefits of this system: but the experience of reforming countries in Latin America suggests that the specific factors such as labour market conditions, attitudes of affiliates, efficiency of fund administrators as well as macro-economic factors.

However, the document points out that in Chile's case, both the first and second pillars have yielded worse-than-expected outcomes. The writers below evaluate the challenges faced in each pillar.

Individual Capitalization Accounts and AFPs: The document says that Chile's system was designed to be predominantly contribution-driven, and it is inevitable for it to show poor outcomes if contributions are lower than expected. Thus poor and irregular contributors such as women, self-employed persons, workers in the informal economy and extremely low-income workers are the categories that are at greatest risk of not being covered by the second pillar. This outcome is largely a result of mismatch between assumptions that were made at that time of setting up the system and actual labour market economy.

Jon rotation, frequent retrenchments, and overall employment insecurity are established features of the labour market. There is constant movement between formal and informal sectors; and a growing tendency to take early retirement, at least from the formal, pension-linked sector. Once a worker is in the informal sector, the chances of his participation in the system decline dramatically. This is evident from the contribution record of self-employed workers: 95 percent of workers in this category are not affiliated to the system. As a result of all these uncertainties, actual contribution densities and number of years of contributions are much lower than was envisaged, and so is the replacement rate.

Projections of pension expected to be earned by the cohort of 2020-2025 show that only 52 percent of members are expected to have accumulated sufficient funds to generate pensions higher than the minimum pension. Of the remaining, the MPG top up programme will apply to only two percent, and the remaining 48 percent will have to depend on own savings or handouts. Owing to lower contribution density and lower participation in the labour force, the projections for women are even starker: 61 percent of women will not receive even the minimum pension.

Non-contributory pension benefits: The document says that the first pillar plays a critical role in maintaining equity, because it complements the DC pillar by preventing poverty among those who cannot participate in, or are not adequately provided for by the contributory system. Chile's first pillar is linked with the second, because eligibility to the government's minimum pension guarantee requires twenty years of contributions into the DC system.

The document further says that the PASIS programme is the purely unfunded component of the first pillar, and is a means-tested programme targeted at the elderly indigent. Here are two areas of concern with PASIS. First, the amount of funds appropriated for PASIS is strictly limited by the budget, and so the number of pensions awarded is rationed. Thus all those who pass the means-test are not guaranteed to receive state support. Second, the PASIS benefit is itself quite low, set roughly equal to the poverty line.

Poverty in general has declined in Chile, and so has poverty among the elderly. The Decline in old age poverty is commensurate with the improvement in overall standards of living. Yet non-contributory benefits have not fully succeeded in pooling the risk of old age poverty. In 2003 up to 40 percent of the elderly poor in urban areas and 15 percent in rural areas were not supported by the system. Integrating the poorest elderly into the system is a challenge for the Chilean government.

***Industry efficiency**:* The document further points out that improving pension coverage is probably the greatest task faced by Chilean authorities, but ensuring that pension funds operate efficiently is also important, especially because research shows a link between actual and perceived high commissions and poor participation in the system. If costs of securing a pension benefit are high, it is likely that those who are not mandated to participate, such as self-employed workers, and workers in informal jobs will not be motivated to contribute to the system.

Supply Side Restrictions: There is sufficient evidence that the AFP market in Chile has low competition. The low competitiveness of the AFP market is also indicated by the fact that no new AFP entered the market during the highly profitable period of 1996-2002. This could be because the system shows continuously declining average costs, and new entrants to the market face closure if they are not able to quickly garner a sizeable number of contribution. Thus economies of scale created significant barriers to entry. The vulnerability of smaller, newer fund managers was most apparent during the early nineties, when a vigorous surge in promotional expenditure and spending in "kind" led to a sales war. It was a war in which the legal norm of homogenous pricing was never violated, but the expensive gifts given to attract contributors were equivalent to steep price discount. It has been argued that threat of a commercial war is itself a significant entry barrier for fund managers desirous of setting up AFPs.

Demand Characteristics: The document here says that demand for pension savings with AFPs is highly inelastic. A recent survey found that fewer than two percent of the respondents knew either the fixed or variable commissions in either year; and only 0.5 percent were knowledgeable about both commissions. Since AFPs continued to earn large profits, their sales expenditure was financed by maintaining fees. Thus in the absence of competitive pressures or price elasticity AFPs do not have an incentive to reduce fees or operate at optimal efficiency levels.

Investment Limits: The document says that strict investment regulation has probably played an indirect role in increasing costs and decreasing competition. While limits on type of instrument and restrictions on authorized markets are being liberalized cautiously, the nature of investment continues to be excessively controlled. However, it is the "band of return" rule that directly discourages competition by forcing AFPs to maintain portfolios similar to their competitors.

Under the section **Reforming the System: Recommendations of the Marcel Committee Report**, the document says that the reform of Chile's existing pension system was a key election promise of President Michelle Bachelet, and, upon assuming office, it was given top priority. A Presidential Advisory Committee was convened under the Chairperson of economist Mario Marcel with the objective of assessing the current pension system and providing suggestions to overcome its weaknesses.

The Marcel Committee proposed a system of social security that would minimize the risk of poverty by providing universal pension coverage. At the same time, the reform aimed for significant increases in replacement rate, greater participation of workers in financing their retirement, improved institutional efficiency and greater competition in the pension fund industry. It was emphasized that the reform would maintain fiscal sustainability and responsibility.

The document further says that in order to fulfill its task, the Council carried out an exhaustive study of the Chilean pension system, identifying its strengths, weaknesses and the major challenges. From this diagnosis and based on the goals, the Committee finally elaborated 70 proposals covering eleven areas as stated below:

1. New Solidarity Pillar
2. Coverage, Contribution density and compliance
3. Gender Equity
4. Competition and Organization of the AFP industry of AFP
5. Competition and Prices
6. Investment of Pension Funds
7. Strengthening Contributory Pensions
8. Enlargement of the Voluntary Pillar
9. Education and Information
10. Institutional Strengthening
11. Financial Discipline

The recommendations for reform in the above areas are elaborated below.

Improving Coverage

A. Basic Design: The document says that the new Chilean pension model will be based on a three pillared structure. It says that the first level of social security will be provided by a government financed social safety net called the Solidarity pillar. The basic design of the contributory second pillar will remain unchanged, although its scope will be widened to cover currently excluded workers. The third pillar will be composed of additional voluntary savings for those contributors who wish to enhance accumulations in their pension funds beyond the mandated limits.

Solidarity Pillar: The document says that a new System of Solidarity Pensions (SPS) will replace the existing PASIS scheme and the Minimum Pension Guarantee provided by the government. The aim of creating this pillar is to provide universal pension coverage to all Chileans and to minimize old-age poverty by supporting those with lower capacities of contributing towards their pensions.

Expected Outcome - The document says that the groups that would benefits most from this proposal include workers with low contribution densities; the workers with relatively volatile income, such as seasonal workers and independent workers; the people who have dedicated an important part of their active lives to unremunerated home work such as the care of children, old people or disabled relatives; less-educated workers; and old people with very low pensions.

The Scheme has another advantage - by creating a link between the smallest marginal contributions and additional pensions received, it maintains the incentive to make regular contributions.

Voluntary Pillar: The main component of the voluntary pillar of the present pension system is the Ahorro Voluntary Previsional (APV), which came into effect on first March 2002.

The proposals for strengthening the voluntary pillar can be grouped under two categories: fiscal incentives to promote additional voluntary saving within the current system; and provisions for new voluntary savings plans. The reform proposes to (i) exempt low income individuals from paying tax (at 3 percent) on early withdrawals from their voluntary accounts and (ii) abolish taxes on commissions paid to voluntary savings account providers. The reform bill also includes a provision for new employer sponsored voluntary pension plans, known as Ahorro Previsional Voluntario Colectivo (APVC), which would collect contributions from both employers and employees.

B. Integrating Non-participating Sections: The document says that coverage and contribution density is the lowest among self-employed workers and informal sector workers, and among those in the lowest income categories. The reform proposes to integrate these marginalized workers through the following measures.

- All workers classified as "non-wage earners" will be integrated into the capitalization system by grating them the same benefits and obligations as wage earners. However, non-wage earners will be expected to compulsorily affiliate with the system, rather than participate on a voluntary basis.
- Affiliation of self-employed and informal workers will place over a transition period of, for example five years.
- In order to encourage younger workers and new entrants to participate in the individual retirement account system, the reform proposes a monthly subsidy equivalent to 50 percent of the effective monthly contributions during the first 24 months of contributions for all low income workers. The subsidy will be applicable to all workers between 18 and 35 years of age, and with an income below 1.5 times the minimum wage.

These measures when implemented will permit the individual capitalization system to incorporate workers who work in conditions of total or partial informality, under the same conditions and in receipt of the similar benefits as accessed by wage earning workers.

Gender Equity: The document says that women have not benefitted from the Chilean pension system to the same extent as men. According to results of Surveys of Social Protection, the most important reason for the gender gap is that women tend to drop out of the workforce to care for their families, followed by a tendency for women to work independently or stay unemployed. Thus recommendations of the Council that seek to improve coverage and contribution density of independent and self-employed workers will automatically help women. The establishment of the universal basic pension will also be an important step towards gender equity, because women will account for about 60 percent of the people being eligible for the new solidarity pillar. In addition, the Council has recommended some changes to the existing system in order to specifically reduce gender inequalities in person benefits.

Industry Efficiency

A. Competition: The Marcel Committee pointed out that the AFP industry was not competitive in nature, and recommended measures for addressing challenges both on the supply and demand side. In order to allow AFPs to take better advantage of economies of scale and thereby reduce barriers to the entry, the Committee proposed some measures to re-organize the structure of AFPs. These are:

- Remove restrictions on sub-contracting in order to separate the core fund management function of AFPs from the operational or service platform functions.
- Reinforce rules that seek to avoid conflicts of interest in the management of funds and marketing of pension services, so that when the AFP market is opened up to other agents, their decisions are primarily in the interests of pensioners.

On the demand side of the AFP industry, the Commission made the following recommendations with the objective of increasing price elasticity of demand, lowering barriers to entry and strengthening price-based competition. Some of these measures are:

- Organize an annual tendering of AFPs for new members joining the individual capitalization scheme. This mechanism would allow over 200,000 workers to enter the system annually at the least cost.
- Allow AFPs to offer 'fidelity-based' discounts on their commissions to members who remain with the same administrator for longer than 18 months.
- Facilitate the use of the internet to transfer between AFPs. This will reduce sales costs and generate genuine competition between administrators.
- Fixed Commission to be omitted.

B. Investment: The document says that the Council pointed out that effective management of pension funds was not only relevant to securing adequate future pension flows, but also critical for developing sound capital market. It also says that proposals made the Council aim to create a regulatory framework that facilitates optimization of investment returns. Some of the proposals are:

- Simplify regulations pertaining to investment limits
- Introduce risk based limits as opposed to quantitative limits for pension fund investments
- Institute a Technical Council of Investments consisting of independent experts to deal with minor changes in portfolio limits and investment policies.
- Eliminate limits on overseas investments; and instead put in place risk-based currency exposure limits.
- Change investment limits reserve requirements to allow more competition and reduce hearing behavior.
- Make AFPs more accountable for investment policies

Institutional Strengthening: The document says that the Council put forward a set of recommendations to create an integrated and rational institutional structure that works with efficiency and effectiveness to meet the goals of the system.

Fiscal Implications

A. Nature of Pension Flows in the Proposed System: The document says that the reforms proposed by the Marcel Committee aim to move Chilean social security away from the current system, which relies excessively on the success of the individual capitalization system. The present system is dominated by the contributing pillar; with publicly funded benefits providing only marginal support, and coverage of the voluntary system concentrated among affiliates with higher incomes. This structure results in a situation where disincentive or inability to contribute creates discontinuous spaces that constitute "traps of poverty".

On the other hand the model proposed by the Committee is characterized by a universal pension that supports affiliates with low or zero pension accumulations, but reduces gradually with the rise in individual accumulations. These reforms proposed to increase contribution density and improve investment returns improve the efficiency of the contributory pillar. The voluntary pillar is expected to be enhanced by the introduction of the APVC, and reform of the APV.

If the Proposals of the Marcel Committee are implemented, the resulting structure in 2025 will be more balanced. The contributing pillar would continue to be the main source of financing of pensions (at 2.9 percent of GDP), but the allocation of public resources towards pensions would be higher by almost one percent of GDP.

B. Fiscal Costs: The document says that the gross incremental fiscal cost that will be incurred on implementing the Committee's reform proposals would reach about 1.1 percent of GDP by 2025.

The most important component of incremental fiscal costs in the proposed system is the government's basic minimum pension, which will form around 0.75% of GDP in 2025.

The Government expects to meet the additional fiscal commitments of the reformed system through the Pension Reserve Fund, from economic growth, the release of resources resulting from lower Government's obligations with the old pension system, and in the first five years, making use of part of the interest received by the financial assets held by Government today. The accumulations in the fund cannot be used for the first 10 years. Subsequently the fund will guarantee future pension liabilities.

Both the Pension Reserve Fund and the Economic and Social Stabilization Fund would be managed by a fund manager to be selected through an international bidding process. The funds would invest in domestic and international bonds and local and foreign currency.

Summary of Goals and Measures: The document says that the proposals put forward by the Presidential Council aim to achieve the following goals:

- To provide universal pension coverage to Chileans
- To increase the replacement rate of pensions to levels similar to developed countries
- To eliminate the risk of old age poverty
- To reduce dispersion
- To sustain the proposed benefits and maintain the goals of reform

Implications for Developing Asia : The document says that the recommendations of the Marcel Committee and its implementation in Chile will be particularly relevant to government in Asia, where countries are struggling to cope with ageing populations, albeit at different levels of criticality. Yet although Asian countries are ageing at different rates, the challenge of caring for a growing number of elderly persons will have to be addressed by governments throughout the region.

This phenomenon is simply the result of a transition from the second to the third demographic phase-a period when both birth and death rates are low and people enjoy relatively longer lives. Western countries, which industrialized and developed earlier, are already in this phase, and it is now the turn of Asia to follow the demographic cycle. The decline in birth rates is largely the outcome of economic growth and related urbanization, spread of education and easier and more informed access to birth control technique. This combination of increased life expectation and reduced birth rates has led to a rapidly ageing population, with serious consequences for labour supply.

In addition to declining fertility rates and increasing longevity fast growing markets also exhibit a trend towards rapid urbanization. Urbanization, notably in China and India, is largely the outcome of a shift in economic activity from agrarian to industrial and services sectors. Collectively, these socio-economic changes have weakened the traditional role of the family as a provider of informal financial security to the elderly, and resulted in large numbers of urban poor and/or elderly with no formal access to income or pension.

In response governments of Asian countries have been forced to reconsider and reform their pension systems in order to extend coverage, provide new private plans, and improve the returns provided by existing plans. There is a strong trend towards adopting defined contribution schemes, especially of a mandatory nature. Asian countries appear to be moving towards the multi-pillar pension system suggested by the World Bank. It is against this background that the importance of Chile's reform needs to be viewed.

Efficiency of DC systems: The document says that Chile's experience shows that well managed DC systems work for some portion of the population; and is capable of providing adequate replacement rates. It has been observed that contribution and coverage is highest among salaried employees who are mandated to contribute into the system. The most active contributions and beneficiaries of Chile's system were public sector employees, workers in large corporations, highly educated workers, high-income workers, and those working in urban areas.

The ability of the Chilean DC system to provide old age income security appears to be the least effective for those in irregular and seasonal employment, those without formal employment contracts that mandate contributions, and the lifetime poor. Thus there are "gaps", due to which the most vulnerable sections of society are bypassed by the system.

Thus a critical lesson from Chile is that individual capitalization regimes, although very democratic and effective in theory, has to be supplemented by some defined-benefit tiers. Recent reforms in Europe also reflect this thinking.

Systemic Approach: The document says that reform of the pension system cannot be carried out in isolation if it is to be effective. It has to be accompanied by policy reform in labour and capital markets, as well as institutional and legal changes. An over-emphasis on needs, without making requisite efforts to improve organizational and systemic capabilities, and without increasing economic and fiscal capacities, will lead to dys-functionalities while not meeting the needs of the elderly population. Roles of the state and the private sector must be clearly defined. Ideally, privately managed DC funds should be accompanied by a state-funded and managed social safety net.

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