Understanding the wave of pension reforms

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Introduction

In recent years, leaders throughout the world have sought to reduce the role that the state plays in their economies. In no area has this trend been more apparent than in pension policy. Since 1992, several dozen countries have scaled back the benefits provided by their public pension systems and 11 countries have gone so far as to privatise their systems. Although the state will continue to play a role in the provision and financing of social security benefits in all of these countries, the nature of that role has been transformed dramatically in some cases.

The recent wave of pension reforms is surprising, given the well-known political costs of social security reform. From Argentina to Zimbabwe, social security reforms have traditionally met widespread opposition, and the recent measures are no exception. As Pierson (1994) has argued, social security programmes are difficult to reform because the programmes create beneficiaries who typically have a stake in maintaining the programmes as they are. Moreover, the costs of social security reform are often immediate and concentrated on a specific group, while the benefits are long-term and diffuse.

What then explains the recent trend toward pension reform? Why have so many countries suddenly moved to overhaul their pension systems in spite of the well-known political costs of social security reform?

I will argue here that the recent wave of pension reform has been driven by a confluence of macroeconomic and demographic trends. As I will show, numerous governments have viewed pension reform as necessary not only to solve the financial problems created by the ageing of their populations and pension systems, but also to help the countries compete in an increasingly integrated and highly volatile economic environment.

In the first part of this article, I will explore in greater detail the nature of the recent trend toward social security reform. I will then analyse the causes of the trend. In the final section, I will discuss what effects the recent reforms are likely to have on the people and the economies of the nations that implement them.

Cutbacks in public pension benefits

Although reductions in public pension benefits have been widespread in recent years, the types of cuts have varied considerably from country to country. Some countries, including Germany, Italy, Norway, Canada, Greece, Finland, France,
the United Kingdom, Spain, Sweden, Portugal, and Switzerland, have changed the formula that they use to calculate pension benefits in order to reduce the generosity of the system (Kalisch and Aman 1998). Other countries, such as Japan, Germany, and Finland, have changed the indexation rate in ways that are likely to slow the increase in pension benefits over time. Still other countries have introduced means testing or have begun to tax some types of pension benefits.

A wide variety of nations have also moved to reduce public pension benefits by tightening eligibility requirements for public pensions. Tighter restrictions cause workers to postpone their retirement, which increases the amount of contributions paid into the system and decreases the amount of pension benefits paid out by the system over time. Some countries, particularly in Europe and Latin America, have lengthened the number of years of contributions (or employment) necessary to qualify for a public pension. Lithuania, for example, raised the minimum required years of service from 25 to 30 years for men and from 20 to 30 years for women. Portugal, meanwhile, increased it from 10 to 15 years for both men and women. A much larger number of countries have chosen to increase the minimum age of retirement. Greece, for example, increased the minimum retirement age from 60 to 65 for both men and women, while Peru raised its minimum age of retirement from 60 to 65 for men, and 55 to 60 for women. According to World Bank data, between 1992 and 1996, 21 countries increased their minimum age of retirement, but the World Bank data may actually underestimate the number of changes that took place during this period (Demirgüç-Kunt and Schwarz 1997, Kalisch and Aman 1998).

**Growing private provision**

The most dramatic pension reforms in recent years have involved the expansion of the role of private pension funds in the provision of pension benefits. Many countries have facilitated the growth of voluntary private pension plans through tax incentives or by creating favourable regulatory frameworks as well as by limiting the level of benefits in (and contributions to) the public pension systems. These measures have been particularly common among the industrialised countries, which have long had extensive (usually occupationally related) private pension systems. A few OECD countries have even gone so far as to require workers and/or their employers to contribute to private pension systems in addition to participating in the existing public pension systems. Australia and Denmark, for example, recently made participation in private pension funds mandatory.

The most radical reforms have taken place in Latin America and the former Soviet bloc, however. In the last several years, a large number of countries in these regions have privatised substantial portions of their public pension systems, more or less along the lines of the Chilean model. The 1981 Chilean reform allowed members of the existing public pension system to deposit their social security contributions in individual retirement accounts managed by private pension funds, rather than paying them to the state. (Future entrants to the workforce were required to contribute to the private pension funds rather than to the public pension system.) The money that accumulated in these accounts would be used to finance the pensions of the workers upon retirement. Workers who had contributed to the public pension system in the past received an additional interest-earning bond to compensate them for these contributions.

The Chilean model thus involved not only a shift from public to private management, but two other fundamental changes in the nature of the existing pension system as well. First, it shifted the pension system from a pay-as-you-go basis toward a fully funded basis. Whereas in the old Chilean system, as in most other public pension systems, the social security contributions of active workers had financed the pension benefits of current retirees, in the new private system, each worker’s pension contributions were to be saved for his or her use alone. Second, the Chilean reform shifted the operating method of the system from defined benefits to defined contributions. The public pension system in Chile, as in most other countries, had traditionally promised workers a specified pension upon retirement, which represented a percentage of the worker’s salary during his or her last years of employment.
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The new private pension system made no such promises, however. In the new private system, the contributions of workers were fixed, but their pensions varied depending upon the amount of contributions they made over time, the market returns that these funds generated, and the commissions charged by the private pension funds.

Although most of the countries that have privatised their pension systems in recent years have used the general framework of the Chilean reform, they have not copied the Chilean reform to the letter. Some countries, such as Bolivia, Mexico and Kazakhstan, have gone beyond the Chilean reform in that they have obliged current workers as well as future workers to join the new private system. Other countries, such as Colombia and Peru, have allowed future workers, as well as current workers, to choose between the public and private systems. Still other countries, like Argentina, Uruguay, Hungary, and Poland, have opted for partial privatisation schemes that allow workers to transfer only a portion of their contributions to the private pension funds. Under the latter reforms, workers continue to pay some social security taxes to the state, from which they will receive a reduced benefit upon retirement. Countries have also used very different methods to compensate workers for past contributions to the public pension funds. The administrative deficiencies were manageable when the pension systems were relatively young, but as the systems aged, they began to encounter more serious difficulties. In the first decades after the pension systems were established, few people had contributed to the systems long enough to qualify for a pension. As the systems matured, however, an increasing share of the population became eligible for pension benefits, which pushed pension expenditures upward. In many countries, the maturation

The roots of reform

The recent wave of reforms is partly a response to the financial difficulties that many countries have encountered with their pension systems. In many countries, pension spending has risen considerably, which has created pressure for reform. Average public pension expenditures among Western European countries, for example, rose from approximately 7 per cent of GDP in 1980 to 9 per cent in 1993 (Espina 1996). In Eastern Europe, pension expenditures grew even more quickly, climbing from 6 per cent of GDP in 1980 to approximately 11 per cent in 1995 (Holzmann 1997, 9). In numerous countries, particularly in Europe and the former Soviet Union, payroll taxes have been insufficient to cover the growing pension expenditures, obliging the countries to divert other revenues to their pension systems. These problems, moreover, are projected to worsen in the future in the absence of reform.

The financial problems stem in part from administrative deficiencies. Many of the world’s pension systems have not been managed according to sound actuarial principles, and, as a result, contribution levels have been inadequate to support the benefits that have traditionally been paid out of the systems. This is especially true for special pension systems serving privileged categories of workers. State employees, and particularly congressmen, diplomats, and members of the military and the judiciary, often received quite lucrative pension benefits, which far exceeded what they contributed to the system. Pension systems in some countries have also been plagued by widespread evasion of payments—in some Latin American countries more than 50 per cent of the members of the social security system have failed to make their payments in recent years.

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process has been accelerated by loose requirements for gaining access to pensions. Many Latin American countries, for example, set low minimum ages for retirement and allowed people to retire even earlier based on time of service. In Europe, governments also allowed workers to retire early in order to provide jobs to the young. To compound matters, numerous countries failed to wisely invest the surpluses that their pension systems generated in their first decades. Instead, the surpluses were spent on a variety of government projects or they were invested in financial instruments that generated low or negative real returns.

The financial problems have been aggravated by recent demographic trends, which have caused much of the world’s population to age rapidly. Average life expectancies have risen dramatically in recent years largely as a result of advances in health care and sanitation. Between the early 1950s and the early 1990s, life expectancy rose by 8 years in the most developed countries, 21 years in the developing regions and 15 years amongst the least developed nations (UN 1995, 117). In some countries, notably in Europe and Latin America, birth rates have also declined, which has contributed further to the greying of the population. The ageing of the population has been particularly dramatic in Europe, where the proportion of the population over 65 years old grew from 8.7 per cent in 1950 to 13.4 per cent in 1990, but it has also been noticeable in much of the western hemisphere as well as parts of Asia (UN 1993, 24). The demographic trends have meant not only that a larger percentage of the population is eligible for pension benefits, which has driven up pension expenditures, but also that the proportion of the population (i.e., active workers) that must support the pensioners has declined.

Economic globalisation and pension reform

The recent wave of pension reforms has been driven not only by the financial problems affecting the pension systems of many countries, but also by a changing international economic environment, which has wreaked havoc on the economies of many countries throughout the world. In recent years, pension reform has become an integral part of economic as well as social policy. Governments have undertaken pension reforms partly in order to improve their international competitiveness and insulate themselves from the capital shortages that have begun to plague them. Indeed, many of the reforms that have been undertaken in the last few years only begin to make sense when viewed from this perspective.

Barriers to foreign trade and capital flows have declined considerably in the last several decades as the world’s economies have become more closely linked. Economic globalisation has stemmed partly from technological innovations, which have reduced transportation costs and improved global communications, making it easier for individuals and firms to conduct trade as well as manage assets overseas. Governmental decisions to liberalise barriers to foreign trade and capital flows, often under pressure from market forces, has also played an important role in the internationalisation of the world’s economies.

The decline in barriers to trade and capital flows has created an increasingly competitive international economic environment in which governments must struggle to maintain their economic edge or see trade and capital flow elsewhere. It has also made countries increasingly vulnerable to capital shortages, both by increasing their dependence on unstable foreign capital and by making it easier for investors quickly to transfer their assets overseas. In the last two decades, numerous countries have experienced massive capital outflows when investors suddenly lost confidence in their economies. Latin American countries, for example, suffered from massive capital flight in the 1980s, which worsened the capital shortages that were brought on by the cut-off of foreign lending. Asian countries, meanwhile, were plagued by severe capital flight in 1997 and 1998.

Many governments, particularly those with high payroll taxes, have come to the conclusion that in this highly competitive economic environment, some cutbacks in pension benefits are necessary. By reducing pension benefits, they have hoped to cut their fiscal deficits, maintain low production costs and improve their international competitiveness. Although cut-
backs in benefits have invariably met opposition from those affected by the cuts, many political leaders have believed that the long-term economic benefits of such measures warrant the short-term political costs.

As we have seen, however, some countries, particularly those that have suffered from chronic capital shortages in recent years, have gone beyond mere cutbacks in their public pension benefits and sought to privatise their pension systems. By privatising their pension systems, governments have hoped not only to resolve the long-term financial problems of their pension systems, but also to boost their domestic savings rates and bolster their local capital markets, thereby reducing their dependence on unstable foreign capital. Former Bolivian president, Gonzalo Sánchez de Losada, for example, maintained that his country’s pension privatisation plan would ‘mean the development of domestic savings, capital formation, a stock and bond market almost overnight’ (Bowen 1996, 12). In presenting his privatisation plan to the legislature, Mexican President Ernesto Zedillo argued that the new private pension funds would ‘deepen financial intermediation, leading to . . . the appearance of new financial instruments. The increase in the availability of resources in the financial markets will result in the decrease of interest rates for business loans, the development of new debt instruments and the growth of capital markets’ (Cámara de Diputados 1996, 202). (See note for translators below.)

Proponents of pension privatisation frequently point to the Chilean example to illustrate the benefits of privatisation. The 1981 Chilean reform channeled vast amounts of resources to the private pension funds, which invested much of them in the local capital markets. This led to the rapid growth of the local capital markets and the creation of new financial
instruments and intermediaries. Advocates of pension privatisation also maintain that the Chilean reform fuelled the rapid rise in the domestic savings rate of the country, although this is the subject of a great deal of scholarly debate (Agosín et al. 1996, Holzmann 1996, Schmidt-Hebbel 1995). In the wake of the 1981 Chilean reform, the domestic savings rate in Chile rose sharply, climbing from 16.4 per cent in 1981 to 30 per cent in 1990, which gave it the highest savings rate in the region.

Where pension spending is particularly high, such as in most European countries, political leaders have sometimes been able to build a broad consensus for minor cutbacks in benefits. Pension privatisation has tended to be more politically controversial than mere cutbacks in the existing public pension systems, however, which has prevented political leaders from forging broad coalitions in favour of the reforms. Instead, they have had to rely on their political strength to push through the reforms in the face of determined resistance from pensioners, labour unions, and opposition parties.

**Implications of the reforms**

The recent reforms will have an important, if varied, impact on the pension systems as well as the economies of the countries that have implemented them. Cutbacks in pension benefits, for example, will help to alleviate the financial problems of the pension systems in the short to medium term. Although most of these measures do not represent a long-term solution to the financial difficulties afflicting the pension systems, they will relieve some of the immediate financial pressures that these systems have been experiencing.

Privatisation, in contrast, will have a negative impact on the finances of the pension systems in the medium term, but it may solve the long-term financial difficulties facing the systems. Privatisation destabilises the finances of the pension systems in the medium term, because the systems cease to receive pension contributions from active workers, while the system must continue benefits for existing retirees. Once the current generation of pensioners passes away, however, the state will no longer have to finance the pensions of its citizens, except where the individuals do not have enough funds accumulated in the private pension funds to pay for a minimum pension.

The reforms will have a similarly varied impact on the pension benefits received by the members of the social security systems. Benefit cutbacks will, by definition, reduce the total pension benefits received by the members of the systems over their lifetimes, but the most common kind of benefit cutbacks, measures that tighten the eligibility requirements for pensions, will not alter the monthly pensions received by members of the system. Moreover, most of these measures have been gradually phased in, so they will not affect many older workers.

What effect pension privatisation will have on pension benefits remains to be seen, since the level of benefits paid out will depend in large part on the returns earned by the private pension funds. In Chile, pensions in the private system have so far exceeded those in the public system thanks to the very high returns that the private pension funds have generated to date. In Chile, the private pension funds generated an average real return of 12.2% annually between 1981 and 1995, which falls to 7.4% if administrative costs are taken into account (Mesa-Lago 1997, 473). Nevertheless, it is not at all certain that these sorts of returns are sustainable in the long run; indeed, in the last several years, returns in the Chilean system have been considerably lower than they were previously. Nor is it clear that the other countries that have privatised their pension systems can generate these rates of return.

Moreover, the performance of most of the privatised pension systems has been noticeably lacking in two areas, both of which could negatively affect the pension benefits received by workers. First, the private pension systems have generated very high administrative costs. In most of the countries, the private pension funds charge commissions and insurance premiums equal to 25 to 35 per cent of the participant’s yearly pension contributions (Mesa-Lago 1997, 458–459; Queisser 1998, 45). Administrative costs have been high largely because the private pension funds spend large amounts of money on marketing in an effort to attract new members. The high administrative costs mean that a substantial portion of each worker’s pension contributions is not being accumulated for use upon retirement. Second, the rate of evasion
has been quite high in the new private pension systems. In most of the private systems, only 50 to 75 per cent of the members actually make their pension contributions (Mesa-Lago 1997, 41, Queisser 1998, 41). As a result, many workers will not have sufficient funds in their accounts to finance their pensions upon retirement.

Although the impact of the reforms on the financial health and generosity of the social security systems is likely to be mixed, the macroeconomic impact of the reforms will probably be positive. As we have seen, cutsbacks in benefits will have a favourable macroeconomics impact, since they will reduce government spending and help countries maintain their international competitiveness. Pension privatisation is also likely to have a positive effect on the macroeconomy by stimulating the local capital markets and placing downward pressure on interest rates. Privatising the pension system may also boost the domestic savings rate, although this depends in large part on how the transition from a public, pay-as-you-go system to a private, fully funded system is financed. Where the transition is financed by increased debt, any increase in private savings is likely to be offset by a decline in public savings, but where the transition is financed by fiscal cutbacks the impact on savings will probably be positive.

Conclusions

The recent wave of social security reforms, particularly the privatisation schemes, thus represents a major transformation of the existing public pensions systems, which has important economic and social policy implications. The reforms downscale, in some cases dramatically, the role of the state in the financing and provision of pension benefits. They do not signify the withdrawal of the state as the ultimate guarantor of social security, however. Indeed, even in the privatised systems, the state will continue to guarantee a minimum pension and to supervise the system’s operation.

As we have seen, the roots of the reforms lie not only in the demographic changes that many countries have experienced in recent years, but also in the increased integration of the world’s economies. The decline of barriers to foreign trade and investment has created an increasingly competitive and highly volatile international economic environment. Numerous governments have therefore carried out pension reforms both to slow the growth of their public pension spending as well as to reduce their vulnerability to sudden shortages of foreign capital. Nevertheless, whether these reforms are successful in achieving their manifold objectives remains to be seen.

Notes

1. Many public pension systems are only partly pay-as-you-go, since they maintain substantial reserves that they can draw down as their populations and pension systems age.

2. Some public pension systems, notably the provident funds which operated in many of the formerly British colonies in Africa and Asia, have long been fully funded, operating in a manner similar to that of the private pension funds, except that the individual retirement accounts are managed by the state.

References


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