Political Risk and Pension Reform in Latin America and Central and Eastern Europe

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Introduction

Advocates of switching from defined benefit (DB) to defined contribution (DC) pension systems argue that DC can provide greater financial stability and make pension less prone to political interference. Given political manipulation (Mesa-Lago 1978; Borzutzky 2002, Gokhale 2013) and consequent large deficits in defined benefit public pay-as-you-go (PAYG) systems in Latin America, advocates of privatization argued that removing pensions from the political arena would prevent politicians from expanding benefits at a fiscally unsustainable rate – indeed, this was an important justification for pension reforms throughout the world in the 1990s and 2000s (see World Bank 1994; Diamond and Valdés-Prieto 1994). The argument wasn’t just that DB systems promised overly-generous (i.e. unsustainable) benefits, but that, given political incentives for the continued expansion of benefits, DB systems were inherently non-viable over the long-term. By shrinking the role of the state, DC would put pension systems on sounder political and financial footing.

However the defined contribution pension reforms of the 1990s and 2000s were not by any means insulated by politics, and in fact faced a wide range of policy challenges with respect to both efficiency and equity even prior to the 2008-2009 financial crisis. For example, coverage rates and benefit levels did not live up to expectations. The transition costs, which were not widely discussed during reform debates in Latin America (Kay 1999) or Central and Eastern Europe (Mueller 2008), imposed a heavy fiscal burden and in some cases became unsustainable. In response to this range of challenges, some governments strengthened their defined contribution individual account pension systems with a range of second-generation reforms – this was the case in the Latin American countries of Chile, Mexico, Peru, Colombia and Uruguay. In other cases, defined contribution pension systems were downsized, often with workers
contributions being redirected from their personal accounts to the financially strapped public defined benefit system. This took place in several Central and Eastern European (CEE) countries, including Estonia, Latvia, Poland (2011), Lithuania, and Slovakia. In one Latin American case, Bolivia, the government took over the management of the individual account system and increased redistribution. In still other cases, like Argentina and Hungary, the defined contribution systems were eliminated altogether, with the government seizing pension assets (in 2014 this process was underway in Poland).

In this paper we analyze this most recent wave of pension reforms – which we label the reforms of the reforms - and describe in detail the three patterns we observe, from reforms aimed at consolidating and strengthening defined contribution individual account systems, to weakening and shrinking them, to eliminating individual accounts altogether.\(^1\) We assess the range of policy challenges that governments faced, and the political and economic factors that contributed to these reform outcomes. The countries that have adopted Defined Contribution reforms are largely (but not exclusively) clustered in Latin America and Central and Eastern Europe, and for the purposes of understanding these significant reforms, it is useful to compare and contrast the reforms in this broad set of cases.

A brief survey of the Latin American vs. Central and Eastern European reforms suggests that the very different reform outcomes in the two regions result from differing sets of causal factors. In Latin America pressure to reform the DC individual account systems came from internal political pressure to introduce greater equity and efficiency, including extending coverage, lowering costs, and improving gender equity (as will be discussed further below, Argentina and Bolivia are outliers in the region). In Central and Eastern Europe, financial

\(^1\) Mesa-Lago (2012) called the reforms in Argentina, Bolivia, Chile, and Hungary the “re-reforms”.
pressures exacerbated by the global financial crisis, the funding-gap crisis, and post-Maastricht EU fiscal constraints played a central role in reducing or eliminating DC.

This recent wave of reforms illustrates the various ways that political factors continue to shape pension reform after the shift to individual accounts. As outlined below, switching from Defined Benefit to Defined Contribution created a range of policy challenges for governments. Where governments faced domestic demands for improvements in efficiency and equity, which was largely the case in Latin America, reform measures were introduced and/or implemented that sought to strengthen the DC systems in order to meet these demands. Where demands for reform resulted from economic shocks and fiscal crises that made funding the transition costs to DC unsustainable, as was largely the case in Central and Eastern Europe, policy reforms resulted at a minimum, in downsized DC systems.
Starting with Chile in 1981, countries throughout Latin America switched from defined benefit public pay-as-you-go pension systems to defined contribution systems of individual accounts (see Brooks 2009, Cruz-Saco et al 1999, Kritzer et al 2011, Madrid 2003). This trend also occurred in Central and Eastern Europe (Kawinski et al 2012).

However, beginning with Chile in 2008, another wave of pension reforms occurred. In this more recent set of reforms, divergent reform paths emerged (see Table 1). While some governments adjusted, and arguably consolidated their defined contribution accounts with a range of second generation reforms, other governments diminished their DC systems (either temporarily or permanently), while still others took the more drastic step of abandoning the defined contribution system altogether.

Table 1: Three Paths to Pension Reform

<table>
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<tr>
<th>Second Generation Reform</th>
<th>Weaken Individual Accounts</th>
<th>End Individual Accounts</th>
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<tbody>
<tr>
<td>Colombia (in process)</td>
<td>Slovakia (2012)</td>
<td></td>
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<tr>
<td></td>
<td>Bolivia (2011)</td>
<td></td>
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<td></td>
<td>Romania (2009)</td>
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The countries that acted to strengthen and consolidate their individual account systems include Chile, Peru, Uruguay, Mexico, and Colombia. These Latin American governments implemented a range of reforms designed to boost coverage, lower costs, improve competition, diversify investment options and reduce investment risk, improve gender equity, and increase financial literacy. Chile instituted the first major second-generation reform, based on proposals from the Marcel commission, which had been appointed by President Michelle Bachelet when she came into office in 2006. In 2014 she called for another reform, arguing that pensions were still insufficient (Romo 2014). Mexico, Peru, and Uruguay, have all also taken measures to reduce costs and increase competition (the details of these reforms are discussed elsewhere in this book).

Another set of countries took a very different path. Estonia, Latvia, Lithuania, Poland, and Slovakia all drastically reduced the size of their DC systems by lowering contribution rates and redirecting those funds to the public, defined benefit system. The cuts in contributions will result in less capital being accumulated in individual accounts. In some countries these cuts were only temporary, and then later restored, as was the case in Estonia, when contributions were suspended in 2009 and restored in 2011. The Czech Republic is an outlier, in that it introduced a voluntary defined contribution system in 2013, long after any of the other countries cited in this study, but in 2014 a new government announced that it would be closed.

Finally, in the case of Argentina in 2009, and Hungary in 2011, the individual accounts systems were dismantled. In both cases the governments seized the assets and workers were shifted to the public, pay-as-you-go defined benefit pension system. In Argentina the legislature approved the switch at the end of 2008 and it was implemented in 2009, while in Hungary, the takeover took place in 2011, after the contribution rate to individual accounts was first lowered.
in 2010. In Poland, the legislature voted in 2013 to transfer all government bonds held by the
OFE private system back to the public ZUS pay-as-you-go system, while giving people the
option to return to the ZUS – measures that portend the eventual elimination of the OFEs.

Table 2: Defined Contribution –Shrunk, Suspended, or Ended

<table>
<thead>
<tr>
<th>Country</th>
<th>Policy Response</th>
<th>Timeline</th>
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<tbody>
<tr>
<td>Czech R.</td>
<td>New Govt. ends Individual Accounts System that began in 2013</td>
<td>2014</td>
</tr>
<tr>
<td>Poland</td>
<td>Govt. seizes govt. bonds from private system, likely ending it</td>
<td>2014</td>
</tr>
<tr>
<td>Slovakia</td>
<td>Individual Acct. contribution cut from 9% to 4%</td>
<td>2012</td>
</tr>
<tr>
<td>Poland</td>
<td>Individual Acct. contribution cut from 7.3% to 2.3%</td>
<td>2011</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Govt. Takes Over Management of Individual Accounts System</td>
<td>2011</td>
</tr>
<tr>
<td>Hungary</td>
<td>Govt. Ends Individual Accounts System</td>
<td>2011</td>
</tr>
<tr>
<td>Latvia</td>
<td>Individual Acct. contribution cut from 8% to 2%/to be raised to 6%</td>
<td>2010/2013</td>
</tr>
<tr>
<td>Estonia</td>
<td>Govt. 2nd pillar 4% contribution suspended/restored</td>
<td>2009/2011</td>
</tr>
<tr>
<td>Romania</td>
<td>Govt. reduces scheduled 2nd pillar contribution</td>
<td>2009</td>
</tr>
<tr>
<td>Lithuania</td>
<td>Individual Acct. contribution cut from 5.5% to 1.5%</td>
<td>2009-11</td>
</tr>
<tr>
<td>Argentina</td>
<td>Govt. Ends Individual Accounts System</td>
<td>2009</td>
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</table>

In short, policy reforms moved in two very different directions. In one set of cases –
including Chile, Colombia, Mexico, Peru, and Uruguay - governments expanded coverage and
reduced costs and inequities as part of an effort to strengthen and consolidate systems with
defined contribution individual accounts. That is, these measures contained both valuable
reforms for DC systems and redistributional measures for the significant portion of the
population not covered by DC. In the other two sets of cases, DC pension systems were
diminished (Bolivia, Poland (2011), Slovakia, Lithuania, Latvia, and Estonia temporarily) or
dismantled (Argentina, Hungary, and Poland in 2014). As described below, the varying causal
factors behind these reforms – that is, whether demand for reform came from domestic demands
for greater efficiency and equity, or external fiscal and financial crisis – contribute to explaining these divergent policy reform pathways.

**Latin America and the CEE Countries: Internal Efficiency/Equity Demands vs. External Economic Shocks and Fiscal Crisis**

As Barr noted (2002), pension programs are subject to a range of uncertainty, including macroeconomic shocks, demographic shocks, and political risk. The latter two risks are more likely to be generated internally, while macroeconomic shocks may be internal or external in origin. The source of these political challenges to DC – whether endogenous or exogenous – will shape policy outcomes. In the cases discussed here, if demands for reform are focused on endogenous demands to improve efficiency and equity (generated by any combination of demographic pressures and/or pension system feature that generate inadequate pensions) it is far more likely that there will be a second generation reform aimed at preserving and consolidating the DC system. In cases where, governments face a sudden or severe fiscal or financial crisis and seek out pension funds to alleviate the crisis, it is far more likely to lead to either a diminished or a dismantled DC system.
Table 3: Primary Causal Factors for Reform of Individual Accounts Systems: Internal vs. External

<table>
<thead>
<tr>
<th></th>
<th>Internal: Efficiency/Equity</th>
<th>External: Fiscal/Financial Crisis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second Generation Reform</td>
<td>Chile, Peru, Uruguay, Mexico, Colombia</td>
<td></td>
</tr>
<tr>
<td>Temporary Reduction in</td>
<td></td>
<td>Estonia, Latvia, Romania</td>
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<tr>
<td>Contributions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Permanent Downsizing</td>
<td>Bolivia</td>
<td>Poland (2011), Lithuania, Slovakia</td>
</tr>
<tr>
<td>End Individual Accounts</td>
<td></td>
<td>Hungary, Argentina, Poland (2014)</td>
</tr>
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</table>

The switch toward individual defined contribution accounts has always been politically contentious, as potential winners and losers from policy reforms seek to shape policy outcomes (Kay 1999, Madrid 2003, Brooks 2009). In describing policy challenges with respect to efficiency, critics have described structural flaws in the design of reforms, implementation failure, weak competition, high administrative costs, transition costs, and investment risk, among other issues. With respect to equity, concerns have been raised about low rates of coverage (especially given large informal sectors).

Some of the most detailed critiques of individual DC accounts in Latin America have come from scholars affiliated with the World Bank (Shah 1997, Gill et al 2005, World Bank...
2006, James et al 2008), an institution which had led the process of reform through advocating and supporting policies outlined in its influential 1994 report Averting the Old Age Crisis (World Bank 1994). In Chile, the Marcel Commission Report (Consejo 2006) provides a detailed description of the challenges facing DC pension schemes and it served as the basis for the 2008 Chile second-generation pension reform. The goals of the 2008 Chilean reform were to provide universal coverage, improve pension adequacy, improve gender equity, and increase competition and lower the fees workers are charged.

While other countries in the region have not (or at least not yet) adopted reforms that were as far ranging as those in Chile, the basic concerns of the Marcel Commission – high costs, insufficient competition, low coverage, and gender inequity - were echoed to varying degrees in pension reforms in Chile, Colombia, Mexico, Peru, and Uruguay. While other countries have not expanded their social welfare pensions to the same comprehensive degree that Chile has with its Solidarity pension, equity-related issues continue to receive attention. For example, in March, 2013, Mexico’s government implemented a national non-contributory benefit for individuals 65 and older who are not receiving any other public pension. This replaced a program for workers 70 and older that was instituted in 2006, and is expected to reach 5.6 million beneficiaries. Mexico City instituted a universal old-age pension scheme equivalent to one-half of the minimum wage in 2003 (Lajous-Loaeza 2009).

Pension reform remains a contentious political issue, even years after adopting DC systems. Both candidates in the 2005 Chilean Presidential election, Michelle Bachelet from the center-left coalition and Sebastian Piñera from the conservative coalition, promised to reform Chile’s pension system in response to broad-based demand from the electorate. The winner of that election, Michelle Bachelet, created the Marcel Commission to deliver on that promise.
Pension reform became an issue in the 2013 Chilean presidential election as well, and upon taking office President Bachelet appointed another reform commission led by David Bravo (see below). Reforms in Colombia, Mexico, Peru, and Uruguay were also the result of domestic political actors’ demands to improve efficiency and equity, and reform efforts have been ongoing in all of these countries, as is discussed below.

Hungary and Poland adopted defined-contribution (DC) systems during a time of fiscal and economic crisis and growing concern about indebtedness. Instituting DC sent a signal to markets that these two countries were serious about structural reform (Mueller 2008 p. 30). Years later, when the 2008 economic crisis swept Europe, the CEE countries had already been coping with external fiscal constraints. For example, even prior to the financial crisis, countries that wanted to join the Eurozone had already been receiving exemptions to the 3% of GDP Maastricht limit on fiscal deficits.

With the onset of the global financial crisis, fiscal deficits worsened dramatically, and as is described below, pension funds proved to be an irresistible source of funding for governments in Estonia, Latvia, Lithuania, Poland, Slovakia, and Hungary. That is, in addition to whatever other policy challenges these systems may have faced either due to limitations of their original design or with respect to implementation (such as the efficiency and equity critique of the Latin American countries listed above), these countries faced external financial shocks and severe fiscal constraints that had a direct impact on financing pension systems.

Europe also suffered more during the crisis than Latin America did. Although there are exceptions like Poland, which grew 1.6% in 2009, other countries like Hungary (-6.8%), Estonia (-13.9%), Latvia (-18%), Lithuania (-15%), and Slovakia (-5%) all experienced severe recessions.
that year. In Latin America, Mexico’s GDP fell 6%, while Chile’s declined 0.9%, but Argentina (0.9%), Bolivia (3.4%), Colombia (1.7%), Peru (0.9%), and Uruguay (2.4%) all had positive growth. As discussed below, this divergence in economic growth and financial conditions more generally, played a significant role in shaping the reform paths in these countries.

**Demand for Improved Efficiency and Equity: Transition Costs, Coverage, and Gender**

Pension reform is not a one-time event. While landmark legislation may capture public attention and establish a new legal and institutional framework for reform, for reforms to succeed, a range of complementary policy reforms and adjustments are necessary. There are questions of how to structure reformed pension systems, and related questions about how to finance them. Olivia Mitchell noted that much of the focus has been on the “front-end”, with too little attention going to essential complementary measures like tax reform (Mitchell 2008 p.406). For example, in the case of switching to individual accounts, there are significant fiscal costs associated with the transition – and tax measures to finance the transition may be necessary to ameliorate these costs. Criticism with respect to coverage and gender equity, which became more pronounced as DC systems matured, were also at the center of reform debates, especially in Latin America. Proponents of individual account systems forecasted an increase in rates of coverage (it was argued that workers had an increased incentive to contribute as funds went to their own accounts). When coverage proved to be unsatisfactory, there were calls for additional reform.

Demands to ameliorate gender inequity were also a critical feature of subsequent DC reforms - since DC accounts depend on total contributions and years in the workforce, higher
earning men who bear less child-rearing responsibilities will systematically have higher benefits (gender bias was emphasized in the Marcel Commission report – see Consejo 2006). However, given the initial political challenge of achieving pension reform, which involves intense distributional conflict, it is not surprising that political expediency requires that some vital policy decisions are postponed as policymakers pursue tradeoffs to get legislation approved.

**Diversifying Investment**

Diversification of investment is a fundamental principle of risk management, yet when pension funds were first established, they tended to be concentrated in state-issued bonds. Since investment-grade instruments are usually in short supply in emerging economies, this trend persists (see Uthoff 1997). Foreign investment provides a tool for diversification. The common pattern in countries switching to DC individual accounts was that pension funds were not permitted to invest in foreign markets when reforms were passed because of widespread opposition, but over time, pension fund managers were ultimately able to diversify country and currency risk through foreign investment. Investment abroad can provide protection against both country and currency risk, but it political leaders have a hard time making the case that their contributions should be sent abroad rather than invested at home. Even in Chile, which implemented its system under a military dictatorship in 1981, first allowed foreign investment in 1990 when it set a ceiling of 2.5% of pension fund assets. In 2010, the foreign investment ceiling was raised from 60% to 80% of total investment.

The same pattern took place in Mexico, Peru, and Uruguay and nearly every other country that instituted individual accounts: foreign investment was not part of the original reform
(Srinivas et al 2000), but was incorporated in later years out of concerns over diversifying risk and saturating domestic capital markets. In fact, as described elsewhere in this book, investment regimes have changed considerably since the first pension funds were introduced in Chile, with the 2000 introduction of multifunds in Chile (and later adopted elsewhere) that give workers choices among a range of funds along the risk/return frontier (also see Kritzer et al 2011).

**Transition costs**

Switching from a defined benefit PAYG system – where workers contributions fund retirement benefits - to a defined contribution system of individual accounts creates transition costs. With the switch to individual accounts, all or part of worker contributions funding the public benefit are diverted to private accounts. This means that the government is responsible for paying out current pension obligations, as well as some type of “recognition bond” that recognizes the past contributions of workers who have switched to the private system. The transition period can last forty to sixty years, and if well-managed, can lead to structural surpluses in the pension system (Titelman et al 2009).

During legislative and policy debates over switching to DC individual accounts, opponents often raised concerns about funding the transition. For example, opponents of privatization in Argentina accused the government of deliberately understating the transition costs of privatization. Dissident Peronist Deputy Juan Gonzalez Gaviola, argued that government projections that improved tax collection would compensate for the lost revenue were false (Gonzalez Gaviola, mimeo, 11-14-94). A study funded by a labor union think tank affiliated with the opposition CTA union argued that given the budget surpluses, high rates of growth, and
foreign investment that would be required in order to pay off the transition costs, privatization would not likely succeed in Argentina (Jauregui 1991 p.25).

In Argentina, the public system ran deficits of 3.3% of GDP by the year 2000, with around 1.5% of GDP representing contributions diverted to the private system (transition costs) and the rest due to reduced overall contribution rates and the fact that the state-run system had absorbed a number of financially distressed Provincial pension systems (Titelman 2009). The transition costs were part of a larger fiscal challenge that Argentina faced as it veered toward default in 2001. The government forced pension funds to accept a debt swap that prolonged maturities and paid lower interest. Negotiations with the pension funds bogged down, and in December 2001, just prior to the Argentine government default, the government ordered pension funds to transfer $2.3 billion to the national treasury in exchange for treasury bills (this meant that 70% of total pension fund investments were in government-issued debt). Pension funds objected, but were unable to prevent the seizure. In this case, transition costs had contributed to worsening government finances, but the subsequent seizure of pension funds served as a last-ditch source of financing.

Transition costs were also a critical part of the financial challenges facing Hungary and Poland, yet according to Drahokoupil and Domonkos (2012), the funding gap problem was not part of public discussion of pension reform in Hungary in the 1990s, and in Poland it was based upon unrealistic assumptions. For example, only 30% of workers were expected to join the private system instead of the 70% that ultimately joined, leading to a larger than expected drop-off in contributions to the public system (Bloomberg 2014). Given that plans to cover transition costs were either excessively optimistic or politically unfeasible, it suggests that debt-financing was the major implicit financing option among reformers (Drahokoupil et al). Fultz makes a
similar point when she argues that when the economic crisis hit, Hungary and Poland’s pension systems still had key design flaws, noting that there were critical questions about how benefits would be paid more than a decade after the new systems had been created, and there were no means to protect pension funds against inflation risk (Fultz 2012). Without a plan to account for transition costs, both governments had to borrow to cover fiscal shortfalls (Ibid).

Without fiscal adjustment to cope with transition costs, the risk to the balance sheets of reforming countries increased. Cuevas et al (2008) found that ratings agencies do not take into account implicit pension debt when formulating sovereign ratings, but focus on explicit financial debt. The transition to individual accounts takes the implicit debt of a defined benefit pay-as-you-go system, and makes it explicit debt – therefore countries seeking to preserve their credit standing when shifting to a defined contribution system had to strengthen their non-pension fiscal standing – otherwise it would be better off sticking to parametric reforms. As discussed below, CEE countries argued unsuccessfully for exemption from EU fiscal requirements for this very reason – that explicit pension liabilities were causing them to exceed fiscal deficit targets.

Debt as a strategy for covering transition costs is more viable in countries with access to credit markets and strong macroeconomic policies. This was the case in Chile, Colombia, Mexico, Peru, and Uruguay, which have relied on debt financing to cover the funding gap and were in far better fiscal shape when the financial crisis hit. However, in countries facing severe fiscal constraints or soaring debt levels, funding the transition costs can force a drastic policy response, as was the case in Argentina and several CEE countries.

Coverage
Although proponents of individual accounts expected that workers’ incentive to contribute to personal accounts would discourage evasion and expand coverage (World Bank 1994 p.96), coverage ratios under the new systems stagnated (Gill et al 2005 p. 5), as is discussed elsewhere in this book. As defined contribution account systems matured and it became apparent that coverage ratios were low, expanding coverage became (to varying degrees) an important policy issue in the countries that had switched to DC.

In Chile’s 2005 presidential election, both candidates in the run-off election, Michelle Bachelet from the center-left coalition and Sebastian Piñera from the right, both promised to improve coverage and reform the pension system. The coverage gap had become a salient issue, as data showed that about half of the labor force would not contribute enough to obtain a pension equivalent to the minimum pension, nor would they be guaranteed to receive a public subsidy (Berstein et al 2005). Expanding coverage became a primary goal of the reform commission appointed by Michelle Bachelet (Consejo 2006). As a result of the reform, the coverage gap was closed (discussed elsewhere in this book), with sixty percent of households qualifying for a public subsidy.

Pension reform became an important issue once again in the 2013 political campaign. Outgoing President Sebastian Piñera argued that contributions to pension funds and the retirement age be raised in order to improve pension benefits – measures that would have to be undertaken by his successor. Former President Bachelet, who was once again running for office, argued that the creation of a state-run pension fund would improve competition, which was an idea that had been debated but never adopted during the 2006 pension reform (EIU 2013b). The continued political salience of pension reform reflects the fact that pension reform can be a continuous and sequential process (discussed further below).
Chile’s 1981 pension reform influenced the adoption of DC in other countries, as has its 2008 reforms, which have shaped policy debates in other countries that are also seeking efficiency and equity-enhancing measures. For example, Peru’s 2012 reform was also aimed at expanding coverage. Since only 34% of workers who could do so were making contributions to the pension system, the government introduced a subsidy to encourage micro-enterprise workers earning at least 1.5 times the minimum wage to contribute up to 7 percent of their salaries to their pension accounts. As in Chile, self-employed workers were for the first time also required to contribute to pension fund accounts, there were provisions to make back-office operations more efficient, and financial education programs were established (Social Security Administration 2012).

Chile’s reform appears to have influenced debate in Colombia, where in 2013 the labor ministry announced a proposed pension reform bill aimed at reducing inequality, increasing coverage, and ensuring financial sustainability. The Labor Minister emphasized need for a basic benefit when he noted that the poorest 20% of the population receive 0.1% of benefits, while the wealthiest 20% receive 86.3% of benefits (Business News Americas 2013). Only 7.7 million of Colombia’s 22 million workers were making contributions to their pension funds in 2013, and less than 2 million of these workers would save enough to obtain a retirement pension. The government proposed that all contributions on salaries up to the minimum wage go to the state system, while contributions beyond that go to a private individual account with the intent to expand pension coverage from one-third to 85% of the population, and to guarantee that every worker that contributes obtains at least a minimum pension (EIU 2013).

In Mexico, demands to expand coverage also became a top policy priority. The Peña Nieto government entered office in 2012 with a promise to implement a “Pact for Mexico” that
would provide a universal pension, universal healthcare, and unemployment insurance, all of which would be financed by a major fiscal reform.

Following agreements made after the National Dialogue on Social Security in 2007, Uruguay made significant reforms aimed at easing access to benefits (Busquets et al 2010). Government expansion of healthcare coverage led to a sharp increase in the number of workers in the formal sector, which boosted pension fund contributions, while new regulations led to lower commission charges (Papadópulos 2013). Workers age 65 now need 25 years of service to receive an old-age pension (the requirement for older workers is lower). Like Chile, the law also provides credits for women who have children via childbirth or adoption – women receive one year of credit for each child (up to five). The reform also creates an unemployment benefit for workers aged 58 or older with at least 28 years of work who have been unemployed for at least one year.

**Exogenous Pressures – Maastricht and Economic Crisis**

When countries first switched to DC plans in the CEE countries, it sent a signal to the EU that a country was serious about structural reform and commitment to free markets (Mueller 2008). Ironically, after the switch to DC, EU rules requiring countries to meet a fiscal deficit target of no more than 3% of GDP (the Maastricht debt criteria) contributed to fiscal pressures that led governments to diminish the role of DC pension plans.

As described earlier, Latin American countries (with the exception of Argentina) did not face the severe fiscal crises that the CEE countries confronted during the global economic downturn in 2008. That is, reforms in Latin America were largely driven by domestic demands
for greater efficiency and equity, as exemplified by the reforms that followed Chile’s 2006 Marcel Commission report, while external financial crises and their fiscal impact drove the pension reform process in Europe. All countries contended with structural flaws from the original reforms (the front-end vs. back-end reforms described above), including unrealistic assessments of future transition costs and failure to implement necessary follow-up reforms (as described by Fultz 2012).

Yet unlike the situation in Latin America, European governments also faced structural fiscal constraints associated with the Maastricht criteria, as well as the full impact of the global financial crisis. Several European governments asked for and received exemptions to the Maastricht deficit ceiling as they dealt with the fiscal costs of pension reform, but in the midst of the economic crisis those renewals were not extended. In 2009, Hungary, Poland, Latvia, Lithuania and Estonia were on track to exceed the Maastricht limit of 3 percent of GDP and faced the prospect of penalties from the European Commission after it started excessive deficit procedures against them (PNB 2010). Faced with the dilemma of meeting commitments to these fiscal targets while at the same time honoring fiscally burdensome pension commitments (including transition costs), pension commitments were ultimately scaled back. That is, the fiscal priorities prevailed, but with differing long-term outcomes for all three countries: the end of individual accounts in Hungary and ultimately Poland (2014), a reduced DC component in Poland (2011), Lithuania, and Slovakia, and a temporary reduction in DC contributions in Estonia, Latvia, and Romania.

These measures marked a dramatic reversal – after all, DC plans were originally justified as a way to resolve long-term deficits as well as to spur economic growth and improve coverage for an aging population. As Drahakoupil and Domonkos (2012) describe, when the economic
crisis hit in 2008 and funding the transition to DC would have required severe fiscal austerity, countries faced little choice but to downsize the second pillar. They note the CEE countries saw the pension funds as a source of revenue to cope with the fiscal crisis (Ibid), just as Argentina did when it nationalized its pension system in 2009 (Kay 2009). These cases all demonstrate that one of the key political risks of DC pension systems is that governments facing a fiscal crisis will utilize pension fund assets or revenue in order to meet government financing needs – as was the case in Argentina and the CEE countries described here.

Temporary Reversals: Estonia and Latvia

Both Estonia and Latvia were on track to join the Eurozone, and in both countries cuts to the second pillar private pension accounts were temporary. In Estonia prior to the crisis, each worker contributed 2% of their wage to an individual private account, with the government allocating 4 of the 20 percent that workers pay as a social security tax to the individual account (the rest goes to the first pillar). The government’s 4% payment was suspended in 2009 and 2010, but 2% was resumed in 2011 when Estonia joined the Eurozone, and was restored to 4% in 2012.

In Latvia, which joined the Eurozone in 2014, workers’ contributions to their mandatory individual accounts were cut from 8 percent to 2 percent of wages in January 2010. The system of individual accounts had been introduced in 2001 and prior to the crisis, employee contributions had been scheduled to reach 10 percent by 2010. In a 2012 memorandum with the European Commission, Latvia’s government had agreed to restore contributions to 6% if the budget had improved in line with forecasts (BNS News 2012).
Romania’s defined contribution system began operations in 2008 with worker contributions of 2% of their salaries, which were scheduled to rise by 0.5% per year until it reached 6%. Due to the financial crisis, the escalation in contributions was delayed when the contribution rate was frozen for one year (NRPN 2014).

Among the Central and Eastern European countries that had adopted individual accounts, Estonia and Latvia were furthest along with respect to joining the Eurozone, and being two small, relatively open economies dependent on global capital, raised the potential cost of abandoning their pension reforms. Lithuania had originally announced a plan to join the Eurozone in January 2007, which was postponed until 2015. Poland and Hungary had previously announced plans to join the Eurozone, but when and if that will occur became an open question after the onset of the European economic crisis.

**Downsizings of Individual Accounts: Poland, Lithuania, and Slovakia**

Poland, Lithuania, and Slovakia all faced severe fiscal constraints and made significant cuts to defined contribution individual accounts for a prolonged or indefinite duration. Poland, which was seeking to meet the Maastricht 3% criteria, had pension fund transition costs of 1.7% of GDP in 2010 (Egert 2012). At the time of the reform, the expectations were that the transition costs would largely be funded by the sale of state assets, however the transition ended up being financed entirely by borrowing, and 70 percent of pension funds were used to purchase government bonds (Cienski 2011). In 2011 Poland responded to the funding gap by cutting the government’s contribution to the private system from 7.3% to 2.3% of salary, with the 5% going to the public first pillar system and would be used to make current pension payments. The rate
rose to 2.8% in 2013 and is scheduled to rise to 3.5% by 2017. Given that the funds in the private accounts were largely invested in government bonds, which were used to fund the transition costs, the move would lead to lower holdings of government bonds and reduced exposure to future pension liabilities.

In 2013, the future of the DC system appeared to be in doubt. In February the government announced that it would let workers divert their contributions from the private funds to the state-run pension plan. Poland’s finance minister announced that the government would work to correct the “giant mistake” that is the private pension system (Sobczyk 2013), and there was speculation that Poland’s pension funds would be nationalized (Moss 2013). In July, 2013, Poland moved closer toward ending its private pension system when it floated proposals that included requiring workers to opt in to the second pillar open pension funds (OFEs) or otherwise be transferred to the public system, or requiring workers who stay in the OFEs to pay an additional 2 percent of their income (Johnson 2013). Poland also faced a looming deadline to come up with a payout system for its defined contribution system – a fundamental piece of reform that was not included in the original legislation – because the first significant group of workers in the new system were set to retire in 2014 (Krzyzak 2013).

Finally, in 2014 the government transferred government bonds held by the private OFE system (51.5% of pension fund assets) to the public ZUS system, leaving the OFEs with portfolios largely in equities. The bill was debated and passed by both houses of the legislature in just four days (Krzyzak 2014). Poles were given until July to decide upon whether or not to leave some of their assets in OFEs, but only 100,000 had done so by May (Wasilewski 2014). Furthermore, the government also banned OFEs from advertising from January through August 2014 (Polish News Bulletin 2014). The future of the private system was in doubt, with Poland
appearing to be well on its way to joining Argentina and Hungary on the path toward dismantling their DC system.

While pension reform had once been viewed as a signal that a country was serious about market reforms, a Standard and Poor’s analyst downplayed the significance of the retreat on pension reforms, noting that “we do not see them as a major diversion from the economic policy that has translated into a stable macroeconomic environment for the country” (Polish News Bulletin 2014).

In 2008, Lithuania’s legislature initially cut contributions to the mandatory defined contribution individual accounts from 5 percent to 3 percent, which was then reduced to 2 percent, and ultimately 1.5 percent in 2011. In 2012 a new pension system reform was passed that raised contributions to individual accounts to 2.5 percent in 2013, before dropping to 2 percent thereafter. In addition, workers who were in the old system can contribute an additional 1% starting in 2014, and that will be boosted by an additional government contribution of 1% of the average salary. For new workers, these additional contributions will be mandatory, and the additional contributions will go up to 2% in 2016, which would be matched by a government contribution of 2 percent of the average salary (Baltic Daily 2012).

In August 2012 Slovakia also reduced the size of its private pillar when it reduced contribution rates from 9 percent to 4 percent, and would provide workers with a four-month window of time at the end of 2012 to opt out of the DC individual account system altogether. The measure would provide the government with an additional 71.6 million euros in 2012 and 230 million euros in 2013 which contribute to Slovakia’s goal of a fiscal deficit no greater than 3
percent (Reuters 2012). As was the case in Lithuania, the reforms also included a rise in the retirement age.

**Reform Reversal: Hungary**

Hungary turned to the IMF and EU for credit in the wake of the 2008 crisis (it was more dependent on external borrowing than other CEE countries), and these financial constraints were decisive in its decision to nationalize its DC system (Drahokoupil and Domonkos 2012). Facing a fiscal crisis with a deadline to reach the EU’s budget ceiling of 3 percent of GDP by 2011, Hungary and eight other countries pleaded (unsuccessfully) for the EU to take into account the cost of pension reforms when considering compliance with the budget target. The EU had already granted a five-year period to reduce fiscal deficits on account of transition costs, and it rejected the request that it should exempt the pension reform transition costs when calculating the 3% fiscal deficit limit.

The Hungarian government then announced that payments to the private pension funds would be suspended in 2010 and 2011 as payments were diverted to the public system (Reuters 2011). It later announced that the state would take over the individual accounts, and that workers could opt out and remain in the private system but it would mean a 70% cut in the public benefit. As a result, 2.9 out of 3 million workers (and their savings) went back to the public system (resulting in a fiscal boost of $13.9 billion). In December 2011, Prime Minister Viktor Orban announced that the temporary suspension of payments to the second pillar was permanent and that the 100,000 workers who did not return to the public system would lose their public benefits if they did not go back to the public system (AFP 2011), making the pension reversal complete.
As noted earlier, when Hungary first adopted the DC system it was seen as a signal to policymakers that Hungary was serious about market reforms (Mueller 2008), so not surprisingly, the decision to eliminate the second pillar defined contribution plan was not well-received by external actors. The EU criticized Hungary’s takeover of the pension scheme as not “a sound measure” because it would not lead to sustainable deficit reduction (Reuters 2011). Moody’s responded with a downgrade of Hungary’s government bond ratings, arguing that the dismantling of the pension system would have a negative impact on public finance because it would allow for increased expenditures without meeting budget targets, it would reduce fiscal transparency, and it would reduce liquidity in domestic bond and equity markets (Moody’s 2011). Danske Bank analyst Lars Christensen commented that “in our view the erratic behavior of the Hungarian government is a serious risk to the country’s credit rating and the government’s unorthodox and damaging economic-political measures are clearly scaring away international investors.” (Feher 2011). Others noted the reduced presence of foreign insurance companies after the takeover (Eder 2012).

Yet, despite these words of criticism, it appeared as if the global policy consensus on Defined Contribution had shifted. While the World Bank’s had been a vital source of support for the diffusion of defined contribution individual account systems in Latin America (Kay 2000 p.192) and the CEE countries (Mueller 2008), by the time Hungary had reversed course, the World Bank no longer played the role of advocate (Orenstein 2013). In fact, as Huber and Stephens (2012 p. 207) note, by the end of the first decade of the 21st Century, the World Bank had abandoned the Chilean pension model and instead endorsed Notional Defined Contribution (NDC) accounts. Thus rhetoric aside, Hungary did not face lasting repercussions for ending DC, which was just one of several of the Orban administration’s unorthodox monetary and fiscal
policy decisions that displeased the markets (Gergely 2013). While adopting a DC system had at one time been seen as a strong signal to global markets about a country’s intentions, individual accounts were no longer a litmus test, and Hungary had many other options for sending signals of its good intentions to the markets. In January 2013, Hungary announced that it no longer needed IMF assistance and would turn to international markets for financing (Hungary’s borrowing needs are the highest in Eastern Europe - Lovasz 2013).

Reform Reversal: Argentina

When Hungary ended its defined contribution individual account system in 2010-11, it was following in the footsteps of Argentina. In October 2008, President Fernández de Kirchner announced legislation that would nationalize the private pension system. Under the proposal the US$ 24 billion in assets managed by the ten pension funds would be placed under government control, and all workers would join the public PAYG defined benefit system.

The takeover appeared to be motivated by fiscal concerns – the government relied on export taxes for income, and commodity prices fell sharply during the second half of 2008. Government debt in 2009 was forecast at $20 billion, with a projected fiscal surplus of $7.7 billion (Economist 2008). Taking over the pension funds would appear to provide sufficient fiscal support to provide for Argentina’s financing needs through 2009, although analysts were skeptical whether such self-financing could last until the next presidential election in October 2011 (Business News Americas, 2008). Furthermore, since at the time of the proposed takeover 55 per cent of pension fund assets were invested in government bonds, the government would be taking control of over around US$ 13 billion of its own debt, which it could then restructure.
As in Hungary, these fiscal concerns were exacerbated by the lack of access to international credit markets. The fact that the option of borrowing from abroad was not available actually made the option of ending the DC system and seizing assets more appealing. That is, with Argentina a pariah in the global capital markets, the government did not confront the wrath of global investors. Furthermore, the fact that the pension reform was so politically unpopular meant that there was relatively little domestic political opposition when the government reversed the pension reform and seized pension fund assets (Kay 2009). The legislative opposition, realizing it was not going to be able to block the measure, could only demand that the funds be prudently managed and not used for political ends.

As will be discussed further below, the fourteen-year history of Argentina’s system of individual accounts demonstrated that governments may, at times, be unable to resist the temptation to gain access to pension funds. The 2008 takeover was in fact the second time that the government seized pension assets during a financial crisis. The form of acquiring pension fund assets varied – in 2001 it forced pension funds to accept government bonds under conditions that no prudent manager would willingly accept (the fund managers had no choice in the matter), while in 2008, the government expropriated pension fund assets held in affiliates’ individual accounts.

**The Outlier: Bolivia**

Bolivia’s reforms differed significantly from the other reforms. The demand for reform in Bolivia was internal in origin – it was not caused by an external financial crisis. While the individual accounts still exist, they have been taken over by the state and combined with a
redistributive component – move that represented a partial return to the public pay-as-you-go system (Laserna 2013 p. 107). In 2011 the government merged and nationalized the two private pension funds, lowered the retirement age from 65 to 58 (and lower for certain categories of workers like miners), and introduced new payroll taxes of 0.5 percent on workers (more for higher income workers) and 3% on employers to fund a solidarity benefit. Some analysts argue that given the commitments of the new benefit scheme, the DC system will not be financially sustainable, and that the government takeover will lead to politicized investment decisions, including investments in non-investment grade small and medium sized enterprises (EIU 2011).

Bolivia also differs from Argentina and Hungary, which also renationalized their pension systems, in two important respects. First, Bolivia took over the pension funds during an economic boom, with the aim of improving access to pension benefits and expanding redistribution. In contrast, Argentina and Hungary took over pension funds during fiscal and financial crises, with the goal of using pension fund assets to finance the government. More importantly, Bolivia did not abolish individual accounts but rather switched the management of those accounts from the private to the public sector. The assets in the accounts continue to belong to the account-holders. In the case of Argentina and Hungary, the accounts - and their assets – were taken over by the government. Unlike Argentina and Hungary, Bolivian workers continue to contribute to their individual accounts.

Like Chile, Colombia, Uruguay, and Peru, Bolivia’s reforms were done in the name of greater equity. However, even as individual accounts remain, Bolivia’s reform is different in that
management of the pension funds was taken over by the government, and will likely to lead to different investment patterns.\(^2\)

**Three Paths, Two Causal Explanations, Two Regions**

In summary, with respect to the recent wave of pension reforms, we have seen three basic paths and two primary causal explanations, with reforms themselves largely taking place in Latin America and Central and Eastern Europe. All of the countries that had switched to DC faced the challenge of improving efficiency and equity, but some countries had the additional burden of external financial constraints that shaped policy decisions. With the notable exceptions of Argentina and Bolivia, there was a regional pattern in the outcomes. The countries of Central and Eastern Europe (and Argentina) faced severe external financial constraints while the Latin American countries, which had undergone structural reforms in the 1990s, and were benefitting from prudent macroeconomic and fiscal policies and gains from international trade, were in a far stronger financial condition when the global financial crisis hit.

The first path toward reform includes second-generation reforms, where individual accounts were consolidated with the addition of solidarity pensions and other redistributive measures, as well as means to improve competition and lower costs. Chile led the drive to improve efficiency and equity, but as we have seen, Peru, Uruguay, Mexico, and Colombia have all followed suit. Chile’s reform followed the 2005 election, where there was widespread

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\(^2\) Kazakhstan is another outlier. In 2013 Kazakhstan’s government merged the 10 private pension funds with the state-run fund in order to form the Centralized Accumulation Pension Fund, which would be controlled by the Kazakhstan National Bank. The government argued that this would provide a more efficient management of pension savings and easier government access to long-term financing for large scale investment (SSA 2013). The bill also raised the retirement age for women from 58 to 63 (the male retirement age is 64). The DC system continues, but consolidated under state control.
sentiment among the electorate and agreement among both Presidential candidates that reform was necessary. The primary causal explanation for these second-generation reforms was domestic in origin as political actors sought to ameliorate inefficiencies and inequities. The policies were oriented toward fixing the flaws of the DC systems and resolving the funding gap (rather than downsizing or rejecting DC). Chile was set to repeat this process with a new reform commission in 2014.

The second reform path was to downsize, for a predetermined or indefinite period, the defined contribution system. Countries that pursued this included Estonia, Latvia, Lithuania, Poland, and Slovakia, and to a certain extent Bolivia. This meant that contributions to individual accounts were reduced, and were diverted to some degree to the public, pay-as-you-go system, in order to enable the government to meet its fiscal obligations. The duration of these measures varied, but the primary motivation for downsizing was to shore up public finances during a time of economic crisis, when the availability of external financing was limited. Furthermore, countries seeking to join the Eurozone were required to abide by the Maastricht criteria with respect to fiscal deficits.

The third path – ending the defined contribution system – was pursued by Argentina, Hungary, and Poland. These countries also faced severe funding gaps and constraints on external financing, but rather than take interim measures in order to shore up their fiscal accounts, their governments seized pension fund assets and ended their defined contribution systems, announcing that they would pay the promised pensions. For example, when the Polish government expropriated the public debt holdings of the private pension funds in 2014, it reduced public debt from 58% to 47% of GDP (Krzyzak 2014). As in the other cases, taking over
pension fund assets provide an immediate fiscal boost, with the costs of payout obligations being borne well into the future.

**Three Contradictions of Defined Contribution Reforms (Why Reform and Political Risk are Constant)**

As described earlier, pension reform is a continuous process. Policy debates about efficiency and equity are ongoing, while some governments have struggled to cope with financial crises. DC systems contain three inherent contradictions that subject them to political risks.

First, when it comes to pensions, stability is important, but elusive. Whether it is Defined Contribution, Defined Benefit, or notional accounts, credibility is of vital importance - workers need to have faith that the pension system is sound and that promised benefits will be there when they retire. Yet, as Mitchell (2008) notes, reform is a process, not an end in itself, and as Holzmann put it: “pension systems are in a constant state of flux driven by a shifting focus, moving reform needs, and a changing enabling environment” (Holzmann 2013 p. 25).

The reform process never ends for two reasons. First, the political reality is that DC is controversial, and reformers are never able to accomplish all of their reform goals at once, making the process gradual and sequential (Mitchell 2008 p.406). For example, as described here, in Hungary and Poland key pieces of reform legislation that were essential to the success of DC systems were set aside for later. That meant that mandates for funds to cover cost-of-living adjustments and gender equity combined with undefined rules on benefits, high fees, and no revenue plan for persistently steep transition costs, meant that reform goals were impossible to achieve and the reform itself was incomplete (Fultz 2012). As Fultz noted, in 2005 the World
Bank called on Hungary to undertake a “complete overhaul” of the benefits package, but both the Hungarian and Polish governments had been unable to reform their benefits packages by the time the financial crisis occurred (Ibid). In 2013 Poland still had not passed payout legislation even as the first cohort of workers was set to retire under the system in 2014, and the debate itself brought out fundamental questions about the structure of the defined contribution plan (Krzyzak 2013). In short, the reforms in Poland and Hungary were not sustainable as originally passed – they required subsequent legislation to make them viable. The key, as Mitchell (2008 p.406) notes, is to stay on a steady reform path, and that, as Bertranou et al (2011 p.149) argue, benefits are predictable. However, this may not be possible because governments, politics, and policies change over time.

While partially-completed reforms insure that political reform is an ongoing process, so do evolving demographic and labor patterns. Greater female participation in the labor force, a more flexible labor force, the informal economy, and greater longevity have all had an impact on the financial condition of pension systems. In the case of Latin America, the DC reforms that began with Chile and continued into the 1990s were criticized for high costs, inadequate benefit levels, a varying impact on gender, and low rates of coverage. Later reform efforts, including Chile’s 2008 reform, sought to address these challenges, but concerns remain and changing demographic and labor market conditions will lead to more demand for reform in the future (as noted above, pension reform re-emerged as an issue in the 2013 presidential election). In other words, despite the (perhaps wishful) thinking that a switch to DC would reduce the role of politics by removing the opportunity for political actors to use benefits as a political tool, politics is a constant under DC. So while benefits should be predictable and stable, DC benefits are
uncertain not only because of the variability of market outcomes, but because of the fact that reform is a never-ending process.

The second contradiction is that while pension savings accumulated in individual accounts is intended to provide consumption smoothing and insurance against the risks of old-age, during times of economic crisis the capital accumulated in these accounts is at high risk of expropriation. In the event of a financial crisis that leaves government without adequate sources of financing, the funds accumulated in private pension funds become a very attractive, if not irresistible source of financing. As discussed earlier, Argentina seized pension fund assets in 2001 and again in 2009 when the defined contribution system was nationalized, and Hungary took over its DC system in 2011. In 2014, Poland transferred government bonds, representing approximately 55% of total private pension fund assets, to the public pension system (AP Financial Wire 2013) while in Kazakhstan, the assets of six pension funds were transferred to a state-run pension fund. Other countries, like Latvia, Lithuania, and Estonia, left the stock of pension fund assets intact, but diverted all or part of the flow of new contributions from the DC system to the DB system (Hungary did this too prior to the takeover of the DC system).

Thus during financial crisis, in a climate of uncertainty and risk when social insurance is an important source of protection - pension fund assets are likely to be seized. This helps to explain why the Central and Eastern European countries – which were under external pressure from the European Community to rein in fiscal deficits in the midst of the financial crisis – utilized both the flow and stock of pension funds to improve fiscal balance sheets. In Latin America, with the exception of Argentina, governments did not face these external constraints and fiscal challenges, and reforms led to both the consolidation of the DC systems and greater
redistribution through state funded benefits. Argentina, like the CEE countries, also faced financing constraints and also seized pension fund assets.

The third contradiction that creates political risk in DC systems, is that the same political incentives that led political actors to expand benefits in pay-as-you-go Defined Benefit systems can also provide incentives for seizing DC assets. Under the old, pre-reform systems, benefits were distributed inequitably (Mesa-Lago 1994 p.54), and politicians had an incentive to reward key political constituencies with benefits in return for support (Kay 1999). That is, politicians were able to reap political rewards for expanding promised benefits, with the cost being borne by future generations and future political leaders.

The switch to DC was considered a remedy, since politicians would no longer be able to trade benefits for support. For example, in referring to the United States Social Security System, Gokhale (2013) argues that personal accounts will not directly resolve solvency issues, but at a minimum “could be effective at sequestering from government spending additional resources intended to reduce Social Security’s unfunded obligations” (Gokhale 2013 p.169). However, as the CEE cases described above demonstrate, where fiscal and financial crises have emerged, this type of sequestering has proven to be ineffective. Political actors facing a fiscal crisis and seizing pension fund assets (stocks and/or flows), face the same incentive structure as their predecessors who used PAYG assets for political gain. In both cases, in seizing assets and promising workers that their future benefits will not be affected by the seizure, they reap an immediate short-term payoff with the actual cost being borne by future political leaders who must make good on the promise not to cut benefits. That is, not only do political leaders find DC pension fund assets to be a convenient source of financing, political leaders face an incentive structure that allows them to benefit immediately while postponing costs, suggests that we can expect DC pension funds to
be borrowed or seized in a crisis. If this is the case, then one of the major arguments for switching from DB to DC – that it reduces political risk – does not hold up.

In short, switching to DC does not diminish political risk, but rather creates new risks. While pension systems benefit from stability, the fact that reforms are done over the long term and are sequential, means that they require consistency. In democracies, elections bring new leadership, which may have differing policy priorities. If there is not broad political support for DC in the first place, or if support for DC wanes, essential follow-up reforms may never be passed, as was the case in Hungary and Poland. As we have seen, if support for DC is weak to begin with, there may be little resistance when the reform is terminated, as was the case in Argentina. Politicians facing financial crises will find pension fund assets irresistible, and will have every incentive to seize them when necessary, a process that is much easier to undertake when there is not significant political support for DC.

With respect to governance risk, Barr and Diamond argued that effective reform rests on policy design and political and administrative implementation (2008, p.189). That is, without good policy design and/or without political and administrative implementation, reform is doomed, a description that is apt for the Polish and Hungarian reforms analyzed by Fultz (2012). As Fultz noted, the Polish and Hungarian reforms suffered incomplete design features in that key rules and legislation that were vital for these defined contribution pension systems to function were never passed. Quite simply, the task of implementing the original reforms requirements with respect to transition costs, cost-of-living adjustments/ inflation protection, and gender equity, proved to be politically impossible, and according to Fultz, led these systems to unravel. In other words, while the economic crisis made pension reform a top priority, governance risk was critical to understanding why these reforms were reversed.
Yet, while pension reform is a never-ending process, as described above, switching from Defined Benefit to Defined Contribution structures political incentives in such a way that all DC systems bear the risk of potential political intervention and expropriation. That is, while Barr and Diamond are correct that good policy design and effective implementation are critical for reforms to succeed, even a well-designed and well-functioning pension system is at risk when a government faces a financial crisis and does not have access to financing. In such dire circumstances, pension funds – either via capturing flows or expropriating stocks – are an irresistible alternative. The fact that pension funds may be the most attractive source of capital in such situations – and that political leaders have the incentive of benefitting from such assets immediately, while postponing costs into the future, will be true regardless of how well (or how poorly) policy is designed.

Conclusions:

This paper explored the degree to which political risk played a role in these policy outcomes. While defined contribution accounts have been described as less subject to political risk given the fact that they were under private management and benefit increases could not be doled out at will by politicians, in reality, they have been subject to political risk and are at risk of expropriation during financial crises. In several countries in Central and Eastern Europe, as well as Argentina, governments seized assets in times of fiscal crisis.

During debates over pension reform it was a common refrain that Defined Contribution would reduce political risk by removing pension fund investment decisions from the political realm. Yet, Defined Contribution pension systems are subject to political risks that were not
well-recognized or widely appreciated when DC reforms were first adopted in Latin America and Eastern Europe. Pension systems were subject to a range of policy challenges, which ranged from internal pressure to improve efficiency and equity, to external financial pressures that led governments to weaken or eliminate DC. As discussed above, political risk is inherent to DC systems. The Latin American and CEE countries are not anomalies – DC systems risks, costs, and coverage have been the locus of ongoing debates, and where external financial pressures are present, the seizure of pension fund assets in some form is highly likely.

The inherent political risk in DC systems has practical policy implications. Since all pension systems require consistent economic growth, stable employment, and high density of contributions, a combination of both DB and DC may prove to be more robust because it diversifies risks. In practice, there are a range of policy solutions with individual accounts being just one part of the equation (Matijascic and Kay 2006). In observing pension systems since 2005, Orentstein (2013) argues that a new paradigm has emerged which moves away from an individual savings mandate and instead emphasizes both minimum pensions, notional defined contribution accounts, and insights from behavioral economics such as making enrollment in a pension fund a default option (on default options see Beshears et al 2008).

The new emphasis on welfare pensions that is described here and elsewhere in the book, resulted from recognition that DC plans had fallen short with respect to expanding coverage (see Gill et al 2005), and domestic political pressures were instrumental to the process of creating the solidarity pension in Chile. The demise of DC and the return to Defined Benefit PAYG systems in Argentina, Hungary, and Poland, and the proportional increase in the public PAYG benefit given the new, reduced role of DC in Estonia, Latvia, and Lithuania are the direct result of political decisions to finance government spending in the short-term, while deferring costs into
the future. Such policies stand in complete opposition to the consumption smoothing premise of DC pensions, where retirement savings are intended to provide income for those no longer in the labor force. However where there are DC systems, political leaders have incentives to seize the assets of defined contribution pension funds during financial crises, as the cases described here demonstrate. Despite expectations or pronouncements to the contrary during the reform period, the track record of the most recent wave of pension reforms in Latin America and Central and Eastern Europe demonstrate that during financial crises, Defined Contribution systems are also subject to severe political risk.

That DC systems carry within them the seeds of their own potential demise should give pause to policymakers, and points to the necessity of incorporating DC, DB, Non-Financial Defined Contribution (NDC) schemes, or other tools in order to diversify risk and insure that pension systems are stable and safe over the long term. As the DC wave has receded, policy debates have shifted from focusing on the merits of DC vs. DB to determining the right policy mix that best provides sufficient coverage and satisfies demands with respect to tradeoffs between risk and return.
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