

This book chapter was published in Finance, Growth and Inequality Post-Keynesian Perspectives (<https://www.e-elgar.com/shop/finance-growth-and-inequality>), September 2019.

Private pension funds in emerging economies: from broken promises to financialisation

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## <a>INTRODUCTION

In recent decades, private pension funds have emerged as important players in financial markets across many emerging economies. While being promoted by virtue of their alleged economic and financial benefits, pension funds have in many respects failed to deliver on their promise of reduced fiscal pressures, increasing saving for national development and raising the coverage rate. Furthermore, while often mentioned as an important aspect of financialisation, they have remained nevertheless under-analysed in the context of developing and emerging economies. Financialisation is not a uniform process, and despite the limited development and sophistication of capital markets, pension funds have been key in shaping financialisation in these countries.

In this chapter, we will focus on the development of private pension funds and their relationship with financialisation in emerging economies. Firstly, we will show how in the last decades (since the 1990s) in developing countries private pension funds have been imposed on public pay-as-you-go (PAYGO) pension systems under the neoclassical argument of saving causing investment in order to have financial deepening. Secondly, we will expose how private pension funds promises in emerging economies have not been actually delivered in terms of coverage, low pension values, replacement rates, decrease of fiscal pressures and national saving rates. Finally, we analyse how private pension funds can be framed as financialisation promoters in emerging economies, by increasing risk and dependency in local economies.

## <a>FROM THE PAY-AS-YOU-GO SYSTEM TO THE PRIVATE PENSION FUNDS

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Pension arrangements have been at the core of policymakers' discussions since the early 90s. Traditional 'Pay As You Go' (PAYGO) systems were based on a social solidarity principle, using a collective fund against risk and with public sector support, to finance non-contributory pensions. In many cases the State guaranteed a minimum pension for wage contributors and other social protection programmes. However, some elements of the PAYGO system came under fire, as critics put forward the idea of an impending crisis due to the aging of the population and the impact that this could have on the fiscal sustainability of pension systems (World Bank, 1994). As the baby boomer generation aged and started to retire, it was argued, the PAYGO would become unsustainable. As Palley (1998, p.93) states: 'the key element in the retirement crisis hypothesis is the claim that an increased number of retirees will pose an insupportably large burden on the future working age population'. Against this looming crisis, the introduction pre-funded private schemes was seen as a sustainable alternative.

However, this argument forgets how in the last few decades, with the help of technological progress, labour productivity has increased, and with it the capacity to produce enough income for a larger population. Crucially to sustain retirement income, productivity growth should be associated with increases in wages, out which pensions can be paid. Therefore, key to reduce the burden of a rising retired population are the issues of productivity growth and income distribution. In this order of ideas Palley (1998, p.97) states that:

**<quotation>**The issue of income distribution is central to the problem of supporting a growing population of elderly. Not only must total productivity be growing, so that society has enough total income to provide for the elderly, but the income must get into workers' hands. That is, the income must first get into the hands of those paying for the retirement system, and then get transferred to retirees. If the system is financed through payroll taxes, then wages must also grow. Absent this, the burden on workers of supporting the elderly will grow. Avoiding wage stagnation is therefore central to successfully reducing the burden of public pensions financed by payroll taxes.  
**</quotation>**

In other words, the growing literature testifying the evidence of economic inequality needs to be introduced in the PAYGO system sustainability debate. The point is clear, if the

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distribution of income favours wage-earners, the traditional public system will not necessarily result in fiscal pressures.

While the arguments in favour of the capitalisation and privatisation of pensions are mainly associated with the reduction of fiscal burden for the State, they also are connected to the standard neoclassical growth theories, which highlight the connections between saving and investment. In this sense Cesaratto (2002, p.160) affirms that:

**<quotation>**The causal link that runs from the ‘foresight motive’ for saving to capital accumulation may lead those who argue along conventional lines to the conclusion that the mere existence of Capitalisation System (CS) ... is necessarily associated with a higher share of saving in income. **</quotation>**

Private pension funds are seen to promote investment, through their role as enhancers of financial deepening: by accumulating saving, private schemes would mobilise a greater amount of ‘funds’ available to be lent out to support real investment, thus favouring economic growth. Holzman and Hinz (2005) argue that significant long-term saving in the CS supports innovative securities markets that can deliver growth of private fixed-capital investment. In sum, ‘a higher rate of saving would lead to more finance available for the private sector to carry out real investment’ (Trigg and Lowe, 2011, p.1253).

Such an argument, however, forgets that saving is not a constraint on lending and actually what is important is that financial constraints ‘reflect congestion in financial markets that arises because of insufficient liquidity or an excessive degree of liquidity preference. Thus, banks and financial intermediaries may be short of liquidity as a result of a monetary tightening imposed by the central bank, or they may be unwilling to lend because of excessive risk aversion’ (Palley, 1998, p.100). By implication, increasing saving may not necessarily increase lending, let alone investment.

Other arguments focus on the increased efficiency of markets, as the introduction of a private system can reduce payroll taxes, thus eliminating market distortions and enhancing the flexibility between working, lifelong education, and retirement (Trigg and Lowe, 2011). As

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we have will show in the second section, however, private pension systems in emerging economies have not promoted less taxes.

Beyond the neoclassical arguments in favour of an individual capitalisation system for retirement, the emergence of this new retirement structure raises warning concerns regarding risk, transactions costs and fairness. In terms of risks there is as a main factor associated to the market unpredictability and the variability of individual investment returns; inadequate saving or poor financial returns increases the risk of poverty of retirees (Palley, 1998). And 20 years after the introduction of private pension funds in Latin America, this discussion resonates as nowadays the benefits that pensioners are receiving in some countries under more than two decades of CS are lower than in the PAYGO system, as evidenced in countries as Colombia or Peru, which maintain alternative private and public systems.

Despite the different arguments against private pension funds, a wave of pension reforms were introduced in the 80s and 90s across several emerging economies, aimed at changing the public PAYG pension system with a private pension fund system. The new systems were based on the principle of an individual account for the insured worker.<sup>1</sup> Basically, private pension funds (known as AFP [*Administradoras de Fondos de Pensión*] in Latin America) can be understood as an individual saving plan for retirement, which is managed with financial criteria by fund managers, rather than intergenerational solidarity and state support as in the PAYGO system.

The privatisation of pension systems in developing countries occurs in the context of structural reforms that took place in the 1980s and 1990s, and were part of a broader privatisation package. Thus, the pension system went from a public model of defined benefits, to one of defined contributions, individual accounts and private managers.

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<sup>1</sup> As Mesa Lago (2014) stated, private pensions systems normally lack endogenous social solidarity.

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Latin America, Eastern Europe and Central Asia undertook reforms of their pension systems and introduced a substitute, mixed or parallel model based on individual accounts (Mesa Lago, 2014). The first country to implement the privatisation of the pension system was Chile in 1981 followed by Peru in 1993, Argentina and Colombia in 1994, Mexico in 1997. Other countries of the region like Nicaragua Costa Rica and Ecuador implemented their reforms after the year 2000. A similar pattern was followed in Eastern Europe and Central Asia, where under the worldwide neoliberal wave individual private accounts for pensions were introduced for Hungary in 1998, Poland in 1999, Latvia and Kazakhstan in 2001, Bulgaria, Croatia and Estonia in 2002, Lithuania in 2004, Slovakia in 2005 and Romania in 2008. In many countries in Latin America, private systems with individual accounts were introduced but in some cases as Colombia and Peru, a public PAYGO system remained as a parallel alternative for workers. Cohabitation of both systems was not part of the original plan from the multilateral entities which supported the reform, however public pressure and political cost on this sensitive issue helped to maintain the possibility to choose alternative retirement options.

Despite the private system with individual capitalisation was introduced in more than 20 emerging countries, after 2008 some of them, such as Argentina (2008), Bolivia (Plurinational State of) (2011), Hungary (2011), Kazakhstan (2013), Poland (2011/2014) and the Czech Republic (2014) have reversed the previous reforms and recovered or strengthened their public and PAYGO system. Other countries, such as Slovakia (2012), Estonia (2009), Latvia (2009) and Lithuania (2009) drastically reduced the size of their individual accounts regimes decreasing contribution rates and redirecting funding towards public pension systems (ILO, 2017).

#### **<a>PRIVATE PENSION FUNDS: BROKEN PROMISES**

The private funded system (AFP) was originally presented as a virtuous system that would bring multiple benefits, including economic growth through greater savings, as it was explained in the previous section. They would support capital markets deepening and at the

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same time it would ensure sustainability. They had also promised as an element in favour of the private pension system an increase in coverage rates, benefit levels and even replacement rates.

Such benefits have however, to a very large extent, failed to materialise. The ILO (1995) had already warned in recent times of the CS regimes that the substitution of social security by individual savings schemes would lead to an unacceptably high risk for workers and pensioners, and it also would increase the cost of protection for adults and the transition would place a heavy burden on the generation of current workers. Many of these warnings were not taken into account and the promises of social policy makers in the 1990s were not fulfilled.

In terms of coverage in almost all countries that established private pension systems with individual accounts, rates fell and benefit levels stagnated or decreased. For example, in Argentina, after the implementation of a private system, the coverage rate fell by 10% between 1992 and 2004, while in Bolivia the coverage stagnated at 12% (ILO, 2017). In other countries such as Hungary, Kazakhstan and Poland, coverage rates also did not meet ambitious expectations and stagnated or even suffered a slight drop compared to pre-reform levels (ILO, 2017). For 18 Latin American countries<sup>2</sup> in aggregate terms, average coverage rate fell from 42% before the reforms to 32% in 2002 when the reforms have been implemented and developed in the region and then recovered to 37% for 2010 (Rofman and Oliveri, 2012). This small increase was largely due to the sustained output and employment growth rates in several emerging economics during the 2000s. Nevertheless, it is important to argue that despite the recovery for 2010, still the level is lower than in in the early nineties. Such low levels of coverage are to a large extent the product of the labour market structure typical of emerging economies, with many employed in informal sectors, and therefore unable to be contribute to the private pension system. This is a large contributor to inequalities among the elderly in Latin America (Arza, 2008).

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<sup>2</sup> Argentina, Bolivia, Chile, Colombia, Costa Rica, El Salvador, Mexico, Peru, Uruguay, Honduras, Nicaragua, Guyana, Dominican Republic, Venezuela, Mexico, Paraguay, Ecuador and Brazil.

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In terms of management fees in private pension systems, the increase has been significant and usually above the management fees in the PAYGO system. The main explanations for the high cost of CS are associated with two points: first, high management fees and expensive premiums to finance disabilities insurance and pensions for relatives' survivors. The consequences of this high fees scheme are reflected in a significant reduction in the net rate of return for contributors, which in turn affects the net value of the return on investments. According to ILO (2017) in El Salvador, the management fees of the public system before the reform (expressed as a percentage of the workers' salary) amounted to 0.5% and increased to 2.98% in 2003, after privatisation; in the case of Chile, the total administrative costs increased from 2.44% of the salaries in the contributory schemes in 1981 to 3.6% in 1984, and only decreased to 2.26% in 2003 and in Poland until the year 2004, the commissions fees was not regulated and the pension fund managers charged up to 10% of the value of the contribution. The highest management fees were recorded in Mexico and Argentina, where they represented 38% and 32% of the contributions, respectively. According to Mesa Lago (2004), the average of the management costs of 11 countries in Latin America, expressed as a percentage of contributions, was 26% in 2003.

Another unfulfilled promise relates to the limited capacity to generate adequate retirement incomes. This is particularly clear when examining the replacement rate, i.e. the ratio between pension entitlements and pre-retirement income. For example in Chile, between 1990 and 2000, replacement rates dropped, as the minimum pension decreased, which is received by 50% of the affiliates to the AFP (Crabbe, 2005). Borzutzky and Hyde (2015) also indicate that replacement rates were especially low in the case of women, due to the low level of female enrolment in the pension system. Overall pension performance in Chile was poor, which is translated into inadequate pensions. In 2015, Chilean Government established a special commission '*Comisión Asesora Presidencial sobre el Sistema de Pensiones (CAPSP)*' to undertake a comprehensive analysis of the adequacy of the pension system. The commission found that 79% of the pensions in Chile were under the minimum wage (CAPSP, 2015). Cichon et al (2004) also concludes that the average of the amounts of pensions tends to fall to the minimum levels and according to Crabbe (2005), There is general agreement

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that a large of the population will not meet the requirements established to receive the minimum pension (Cichon et al, 2004; Crabbe, 2005). The CAPSP (2015) suggest reforms to the pension system that recognise the importance of a public and solidarity pillar for low income workers.

Another controversial point is that in most of the cases, the introduction of private pension systems has not resulted in significant cost reduction. As discussed, one of the main motivations for introducing private pension systems was the fiscal pressure generated by public systems, due to the existence of financial deficits and/or the accumulation long-term pension liabilities. It was assumed that the privatisation reforms would reduce the fiscal expenditure that social protection implied for the State. However, when CS systems were implemented, there were high transition costs that generated further deficit problems and indebtedness in the PAYGO System, which required more fiscal expenditure. According to the ILO (2017), for example, in Bolivia the transition costs after the reforms were 2.5 times higher than before the reform. Another example is Argentina, where the PAYGO system had a deficit that in the year 2000 represented 3.3% of GDP, while the contributions diverted to the private system amounted to about 1.5%, in Hungary, the transition cost of the reform imposed a fiscal burden on the Government that increased from 0.3% of GDP in 1998 to 1.2% in 2010 (ILO, 2017).

Finally, it is important to highlight that saving levels in emerging economies have by and large not increased and, in many cases, fell in the years following the introduction of private pensions. As Figure 3.1 shows, emerging economies in Europe and Latin America, where the pension privatisation was most intense, present substantially lower saving rates than developing economies in Asia, and present figures similar to the least developed countries in Sub-Saharan Africa.<sup>3</sup> Even if one accepts the problematic view that saving generates investment and growth, pension funds do not seem to substantially contribute to this.

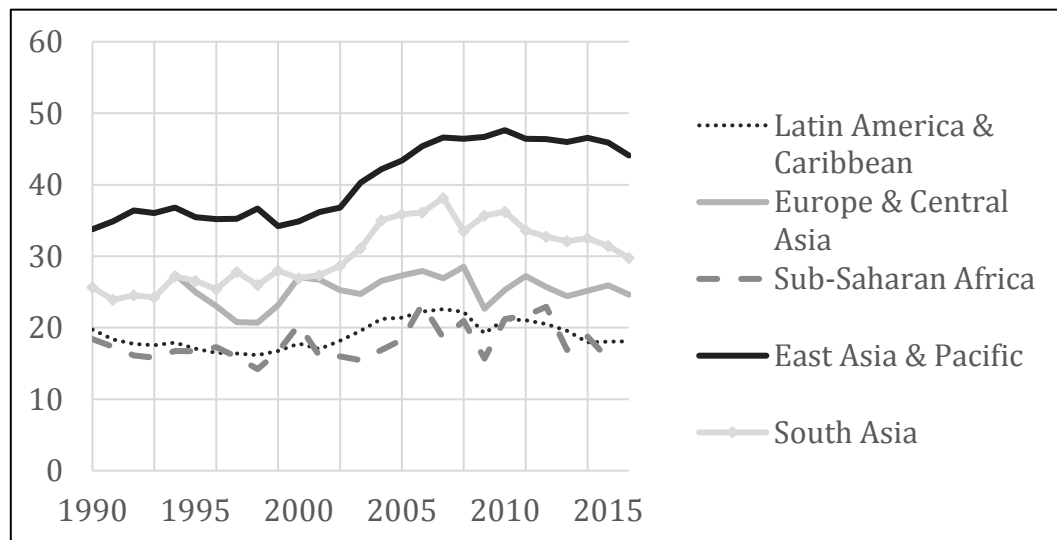
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<sup>3</sup> See Grigoli et al (2015) for further details on Latin America's saving rates.



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*Figure 3.1 Saving Rates, % GNI*



*Source:* Authors' elaboration based on World Bank – World Development Indicators.

*Note:* country groupings exclude high-income countries.

Three decades since the push for pension privatisation, it is clear that many promises have remained unfulfilled. Private pensions have failed to significantly increase saving, raise finance for investment, and have had worsened old-age welfare and increased inequalities. As mentioned, many countries have reversed the private pension funds reforms for all the arguments and failed promises that we have described in this section. However, in other countries, despite these failures financial actors have managed to remain in the game, under political pressure and lobby, while they keep looking for new sources of sustainability and profitability in foreign financial markets that create financialisation scenarios for emerging economies, as we will show in the next section.

### <a>PRIVATE PENSION FUNDS AND FINANCIALISATION

While the capitalisation system (CS) has not provided the benefits promised, it has helped shape the process of financialisation in emerging economies. The most common idea, financialisation, is associated with Epstein (2005, p.1), who defines the phenomenon as ‘the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions, both at the

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national and international levels'. However, this definition still is introductory as there are different approaches to financialisation; as Sawyer (2013) argues, 'the term ... is not limited to a specific period or place, though it would be anticipated that the pace and form of financialisation varies across time and space' (p.6). Existing accounts of financialisation however remain largely focused on national experiences, and in particular the experiences of developed countries. However, recent works, such as Bonizzi (2013), Karwowski and Stockhammer (2017) and Bortz and Kaltenbrunner (2018), have started to show how some empirical regularities associated with financialisation in developed countries are also replicated in some developing countries. In addition to these common regularities, there are also specific phenomena that can be associated to the financialisation in emerging economies, particularly microfinance (Bateman, 2010; Aitken, 2013) and the recurring vulnerability to external capital inflows and financial Dutch disease (Bortz and Kaltenbrunner, 2018; Botta et al 2016). Even in the small – but expanding – literature on financialisation in developing countries, little attention is given to pension funds from the financialisation approach.

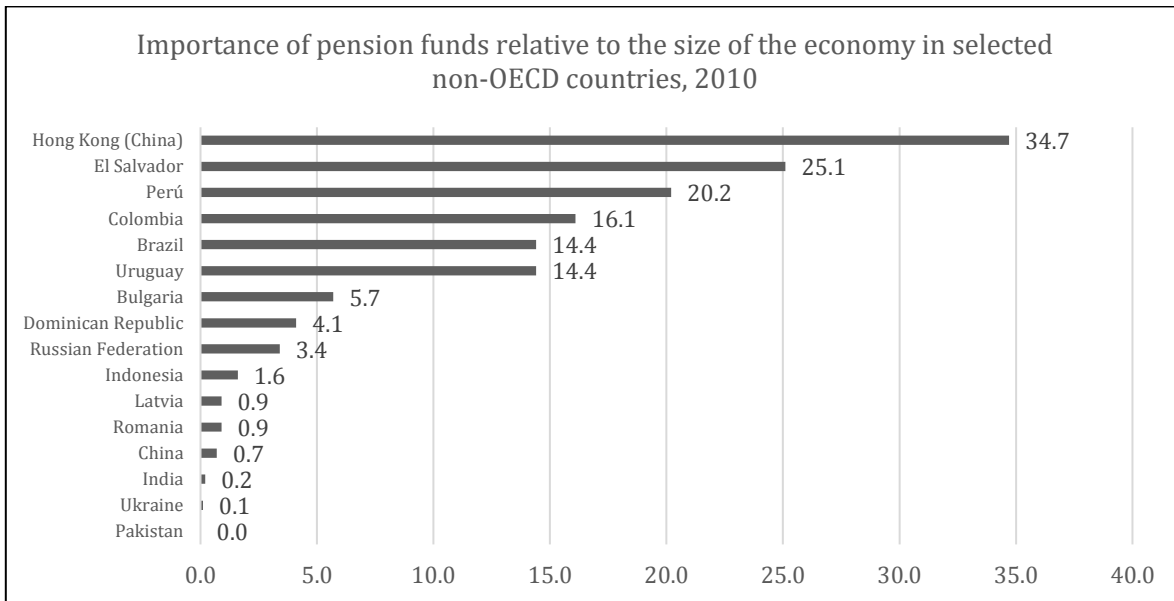
Pension funds can contribute to the process of financialisation. By institutionalising the process of saving, a 'wall of money' (Fernandez and Aalbers, 2016) is generated in search for profitable financial assets, as pension funds need to generate sufficient returns to meet their future commitments. In advanced countries these needs were largely made by the secular expansion and inflation of capital markets (Engelen, 2003; Toporowski, 2000). In the current context, low yields on bonds constitute a barrier in the search of their financial targets, pushing pension funds actors to search for higher yielding assets (Fernandez and Aalbers, 2016; Bonizzi and Churchill, 2017; Bonizzi and Kaltenbrunner, 2017; Bonizzi et al, 2018). Thus, the dimension of financialisation associated with the growth and innovation of the financial markets, is driven by the urgent need of the pension funds to generate profits. With this, possible scenarios of instability can appear, as was seen with derivatives associated with mortgages and hedge funds (Lysandrou and Nesvetailova, 2015).

Such a process can also occur, in a particular form, in emerging economies. In some of these countries pension funds have grown substantially, even though they remain small in absolute

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terms compared to developed countries. Figure 3.2 shows how pension fund assets to GDP are quite large, especially in Latin America.

*Figure 3.2 Importance of pension funds relative to the size of the economy in selected non-OECD countries, 2010*



*Source:* OCDE Pension reports (2010).

In their look for profitable investment returns, they have also started to extend their reach to a wider range of asset classes and promoted financial innovation, while pushing for reforms to remove their investment constraints. A good example of this can be seen in Colombia and Perú. For these two countries, the portfolio configuration of pension funds has changed over the last 15 years towards greater diversification and at the same time greater risk in investments. A first key trend has been the substantial increase in the proportion of foreign assets, which have taken advantage of the liberalisation and deregulation that allows them to have more investment in foreign securities. This possibility did not exist at the beginning of the century in Colombia and Peru, but as liberalisation proceeded, foreign assets increased their share in AFP's portfolios to 13% and 9% respectively in 2006, and 33% and 40% in 2015 (FIAP, 2016). The other important point has been how in portfolio allocations fixed-

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income has lost prominence while equity has gained considerable shares. Equities allocations were zero in Colombia's portfolios in 2001 and in Peru it had 30% in 2001. By 2015 they had increased to 48% and 55% respectively. The shares of government bonds have fallen in Colombia, but still represent the most significant asset with 35% in 2016, while in Peru they rose from 13% to 18% (FIAP, 2016). Importantly, pension funds have also been key purchasers of new asset classes, sparking the development of private equity markets and foreign exchange swaps, to hedge their international investments (Bonizzi et al, 2018).

Pension funds and their asset demand are highly important in shaping financialisation in these countries. Domestic capital markets remain peripheral to private and public borrowers in these countries, a situation that pension funds have not managed to substantially affect (Didier and Schumkler, 2013). Furthermore, they receive large sums of foreign capital inflows, with foreign investors and lenders becoming key but volatile players in financial markets, a key feature showing the subordinate character of emerging economies' financial integration (Andrade and Prates, 2013; Powell, 2013; Levy-Orlik and Ortiz, 2016; Bonizzi, 2017; Bortz and Kaltenbrunner, 2018; Kaltenbrunner and Paineira, 2018). Faced with this situation, pension funds have looked beyond domestic capital markets to find avenues for their investments. This has strengthened the pressures for financial innovation and deregulation, and as such is a primary force behind financialisation in these countries. These new investments can however generate more risks, and it is not entirely clear to what extent they will foster economic and social development, at a time where export-led growth is in crisis.

## <a>CONCLUSIONS

Private pension funds are at the core of the latest stage of capitalism in emerging economies. The main arguments behind the policy pressures leading to their rise has been based on the fiscal pressures that are generated by the aging crisis, as well as the promise of increased saving, based on the (neoclassical) argument that this will be causing investment. However, saving is not a constraint on lending and actually what is important is that financial

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constraints reflect congestion in financial markets. Fiscal pressure would ease if distribution of income in favour of wage earners improve, as productivity growth continues. Despite these arguments, since the early 1990s private pension funds based on individual accounts started to replace PAYGO solidary system in many emerging countries around the world. After more than two decades, many of their promises have not been fulfilled: the coverage rate for retirement has not improved, the replacement rate has fallen, saving rates have not significantly increased, and fiscal pressures still exist, driven by the high costs of transition from the solidary system to the individual system. Finally, we have shown how the private pension AFP have emerged as an important characteristic of the financialisation in developing countries. AFP have allocated growing financial share to foreign assets and sparked the development of new asset classes and practices, in a context of high capital inflows that affects the local assets supply.

The balance of evidence overall does not seem to be particularly positive for the privatised pension system in emerging economies. Indeed, the discontent in some countries has been so widespread that they have re-nationalised their systems. A wider rethinking about pension policy is therefore needed, to protect the wellbeing of the elderly, as well as ensuring the financial system is fit to promote economic development.

#### <a>NOTES

[CONVERT FROM FOOTNOTES HERE 1-3]

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