ESS – Extension of Social Security

Repeal of the Privatization
of the Pension System in Nicaragua

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INTERNATIONAL LABOUR OFFICE, GENEVA
Abstract

This paper documents the reversal of pension privatization and the reforms that took place in the 1990s and 2000s in Nicaragua. The report analyses the political economy of different reform proposals, and the characteristics of the new pension system, including laws enacted, governance and social security administration, social dialogue, positive impacts and other key issues of the Nicaraguan pension system.

**JEL Classification:** I3, H53, H55, J14, J26

**Keywords:** pension privatization, pension reform, social security policy
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Acronyms

<table>
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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>AISS</td>
<td>International Social Security Association</td>
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<td>AFP</td>
<td>Pension fund administrator</td>
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<td>ANASE</td>
<td>National Association of Insured People</td>
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<tr>
<td>ANDEN</td>
<td>National Association of Educators of Nicaragua</td>
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<tr>
<td>CISS</td>
<td>Inter-American Conference on Social Security</td>
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<td>COSEP</td>
<td>High Council of Private Enterprises</td>
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<td>CREPEN</td>
<td>Commission to Reform the Pension System in Nicaragua</td>
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<td>CST</td>
<td>Sandinista Worker’s Central</td>
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<td>ESAF</td>
<td>Enhanced Structural Adjustment Facility</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>HIPC</td>
<td>Highly-Indebted Poor Countries Initiative</td>
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<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
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<td>IDA</td>
<td>World Bank International Development Association</td>
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<td>IDB</td>
<td>Inter-American Development Bank</td>
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<td>ILO</td>
<td>International Labour Organization</td>
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<td>INSS</td>
<td>Nicaraguan Social Security Institute</td>
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<td>ISSA</td>
<td>International Social Security Association</td>
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<tr>
<td>ODS</td>
<td>Old-age, disability and survivors</td>
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<td>OISS</td>
<td>Ibero-American Organization of Social Security</td>
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<td>PAYG</td>
<td>Pay-as-you-go</td>
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<td>SNUS</td>
<td>Single National Health System</td>
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<td>UNYD</td>
<td>Union of Business Owners and Executives for National Development</td>
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Summary of Reforms related to Pension Privatization and its Reversal

<table>
<thead>
<tr>
<th>Year</th>
<th>Events</th>
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<tr>
<td>1990-1993</td>
<td>Implementation of the first Enhanced Structural Adjustment Facility (ESAF) with support from the IMF and the World Bank. This involved reducing the role of government, public spending, the fiscal deficit and the size of the public sector; opening a financial system; promoting free trade and privatization; and, the decentralization of public services.</td>
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<tr>
<td>1994-1995</td>
<td>The government, in collaboration with international development organizations, commissioned studies to analyse the feasibility of different parametric and systemic reforms. The most influential were conducted by the ILO, in collaboration with the International Social Security Association (ISSA) and the Inter-American Conference on Social Security (CISS); Julio Bustamante (superintendent of the Chilean pension system); and Carmelo Mesa-Lago (Friedrich Ebert Foundation).</td>
</tr>
<tr>
<td>1999</td>
<td>The government commission responsible for the pension reform submitted a draft bill for the reformed pension system. While the pro-government trade union supported the law, other unions and civil organizations protested against the bill.</td>
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<tr>
<td>2000</td>
<td>Parametric reforms increased contribution rates from 17.5 per cent to 21.5 per cent (including all three areas of coverage).</td>
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<td>2000</td>
<td>Approval of the Law of the Pension Saving System No. 340, privatizing the pension system, promoted by the World Bank and the IDB.</td>
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<td>2001</td>
<td>The Organic Law of the Superintendent of Pensions (Law No. 388) was passed, yet the law was never implemented (in response to the World Bank recommendation). Between US$ 12 and US$ 14 million was spent on consultancies, assessments, studies, trips to Chile, equipment purchases, training seminars, etc.</td>
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Repeal of the Privatization of the Pension System in Nicaragua

The Failed Implementation of the Chilean Model of Private Pension Fund Administrators in Nicaragua

1. **Background on the implementation of private pension fund administrators (AFP)**

The social security system in Nicaragua has experienced three phases:

(a) Phase 1: Began in 1956 and ended in 1978. The 1950 Constitution of the Republic of Nicaragua established the mandatory social security system.

(b) Phase 2: 1978-1990. In 1979, the Sandinistas came into power and enacted Decree No. 974 on 11 February 1982. The Social Security Law went into effect on 1 March 1982, when it was published in *La Gaceta* No. 49. This law is still in effect today.

The Social Security Law mandates a scaled premium system. Contributions to the pension system are mandatory for employees and voluntary for self-employed workers. A worker must be 60 years old and have paid into the system for a minimum of 750 weeks (15 years) to receive a pension. The pension is calculated based on workers’ average weekly wage of the past 250 weeks (five years) of employment.

(c) Phase 3: 1990-2006. The post-Sandinista period begins, which is characterized by the government reform and privatization of the pension system (Navarro, 2003).

During the early years of the post-Sandinista government administration (1990-1993), President Violeta Barrios Chamorro implemented the first Enhanced Structural Adjustment Facility (ESAF) with support from the International Monetary Fund (IMF) and the World Bank’s International Development Association (IDA). This entailed reducing the role of government, public spending, the fiscal deficit and the size of the public sector; opening the financial system; promoting free trade; and, the privatization and decentralization of public services.

2. **Initial efforts to privatize the pension system: proposals for reform and the report of the International Technical Commission**

Executive Decree 44-94 was the legal framework for decentralization and reform of the public administration. Article 9 of this decree established the creation of the Sector Commission for Social Security and Welfare Reform to guarantee the adequate restructuring, reorganization, rationalization and efficiency of institutions and/or companies that provide social security services.

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1 This document has been translated into English from its original version in Spanish. We apologize for any discrepancy due to translation error and for any possible deterioration in the style of language.
During the first half of the 1990s, several assessments and studies on social security reform were carried out. The most important included the studies by the International Labour Organization (ILO), the International Social Security Association (ISSA), the Inter-American Conference on Social Security (CISS), Julio Bustamante, superintendent of Chile, and an assessment by Carmelo Mesa-Lago commissioned by the Friedrich Ebert Foundation 2.

The recommendations of these studies are summarized below.

(a) **ILO recommendations**

At the request of the Nicaraguan Social Security Institute (INSS), the ILO conducted a study highlighting the need to improve health services and recommended modernizing enrolment and payment procedures, including measures to extend coverage, and applying parametric reforms to improve system sustainability. In response, the INSS eliminated the regulations that made access conditions more flexible and replacement rates more reasonable, resulting in an improved financial position.

(b) **Report of the ILO-AISS-CISS-OISS International Technical Commission, 1995**

The Commission analysed the feasibility of: (a) the modification of the current system (of the scaled premium established by law); (b) replacing the current system with another based exclusively on individual savings; and (c) creating a mixed system. The Commission concluded that the individual savings option (b) was not feasible under the current conditions, considering Nicaragua’s macroeconomic situation, while for the mixed system (c) (defined-benefit scheme complemented by one of several individual savings schemes), it stressed the need for further studies to determine financial viability. Finally, the Commission reported that the main advantage of modifying the current system (option a) was that it did not involve any transition costs, making it the most financially feasible option.

(c) **Proposal by Julio Bustamante, 1995**

In 1995, at the request of the INSS, Julio Bustamante, the superintendent of private pension fund administrators (AFP) of Chile, and a team of Chilean advisors, prepared a study. Bustamante recommended keeping the INSS’s pension programme mandatory but dividing it into two sub-systems. He suggested a closed transitory subsystem that would incorporate all people aged 45 and over who are currently enrolled in the INSS pension system, as well as pensioners receiving benefits and future pensioners in this subsystem. This system would be eliminated following the death of all active and passive members.

Mesa Lago wrote: «Although it is not specified in the proposal, the transitory subsystem appears to be based on a system of partial collective funding with undefined solidarity contributions and defined benefits.»

Additionally, a permanent subsystem would be created, in which currently-covered individuals under age 45 would be incorporated, along with new entrants to the labour force. A voluntary system would pay complementary pensions to the two subsystems of the mandatory system. The entire system would be based on individual accounts and administered by private administrators. The income from contributions would be deposited

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2 For a detailed discussion of this issue, see: Carmeno Meza-Lago, La Seguridad Social en Nicaragua, pp. 109-126 and Instituto de Promoción Humana, *La privatización que sangra*. 
in the member’s individual retirement account, along with the returns on the investment. Individual retirement accounts would be opened with a cash balance equal to the recognized pension contribution before the reform (a type of recognition bond).

The contribution rate would be 9 per cent: 5 per cent would be deposited in the individual account (old-age retirement); 2 per cent would be allocated to disability and survivors’ benefits; 0.5 per cent would go to administrative costs; and, 1.5 per cent would cover the cost of transferring to the transitory subsystem (to reduce its deficit).

In financial terms, the permanent subsystem would be organized as a single pension fund with three types of accounts: (a) the individual retirement account; (b) the reserve for old-age pensions; and (c) the reserve for disability and survivors’ pensions.

(d) Proposal of Carmelo Mesa-Lago, 1997

Carmelo Mesa Lago’s study, published by the Friedrich Ebert Foundation (1997) 3, proposed a mixed system. He stated that: «A structural-type reform (particularly replacement) is inadequate given Nicaragua’s socioeconomic conditions…Accordingly, a reform model for the public system is proposed initially (INSS and the Ministry of Health), with the addition of a voluntary programme of complementary pensions and a special healthcare programme for INSS members, but with a solidarity component of the Single National Health System (SNUS). During a second phase, when adverse conditions have changed, a mixed model adapted to the characteristics and needs of the country is recommended. »

Creation of a commission to reform the pension system in Nicaragua and justification for the reform

In the context of proposals and assessments, Ministerial Resolution No. 014-98 established the Commission to Reform the Pension System in Nicaragua (CREPEN). The Vice-president of the INSS, Alejandro Vogel, chaired the Commission, which was «formed to analyse the reform and create an adequate, feasible and sustainable model tailored to the Nicaraguan reality.»

3 The first part of the study is a detailed assessment of the social and economic context of the social security system in Nicaragua. It identifies key problems of the system’s organization, population coverage, financing, benefits, administration and financial and actuarial balance.

The second part of the study summarizes and discusses the advantages and disadvantages of the main reform models and projects in Latin America, with a view to obtaining lessons from these experiences that can serve in the design of an alternative in Nicaragua.

The third section analyzes and evaluates the social security reform proposals for Nicaragua and offers a detailed reform proposal.

In 2000, the contribution rate for the old-age and war-victim pensions rose to 10 per cent, increasing the total for the three types of coverage to 21.5 per cent. Pensions were paid to 100,000 people, of whom approximately 40,000 were victims of war.

The current level of pensions paid, both contributory and non-contributory, is much higher than what is sustainable. Contributions are inadequate to cover benefits.

Actuarial calculations reveal a negative balance of 80 million córdobas (US$ 7 million) for 1999, which corresponds to 0.8 per cent of GDP. If this trend continues in the current system, the government will be forced to cover future deficits, which would represent 10 per cent of GDP in the medium term.

In the long term, the financial situation will continue to deteriorate, with adverse social repercussions. System reserves will be exhausted in the immediate future and its dependency ratio (the number of beneficiaries per active worker) will increase from 11.2 per cent in 1996 to 27 per cent in 2030. At the same time, the implicit debt of the current pension system—the present value of current pensions plus future old-age pensions—would increase from 85 per cent of GDP in 1996 to more than 400 per cent in 2030.

The current pension system is unsustainable given the imbalance between contributions and benefits, its high administrative costs considering the size of the system and the high rates of evasion. Neither is the system attractive to workers. Despite the imbalance between contributions and benefits, workers receive very low pensions, for which reason the system perpetuates inter-generational inequality. The system does not encourage workers to develop a sense of ownership of their savings, for which reason they view their contributions as a type of tax. Moreover, the system is inefficient in terms of investment management, pension calculation and benefit payments.

The strategy to reform the pension system was designed to avoid the bankruptcy of the current pay-as-you-go (PAYG) system. In the new pension system, future pensioners would receive a pension in accordance with their individual contributions, which would be higher than current pensions.

The Commission concluded that the scaled-premium system had run its course (Aleman, 2001).

The Commission also stated that transition costs of the pension structural reform would be approximately US$ 800 million, equal to 35 per cent of GDP. This debt would require many years to be repaid which, during more difficult periods, would only achieve annual disbursements of 1.5 per cent of GDP. Financing the transition cost does not involve any additional tax on the population. Concessional loans from multilateral agencies such as the World Bank and the Inter-American Development Bank (IDB) would cover this expense.

These agencies offer such low interest rates on the loans that they were practically considered donations. Accordingly, the Commission concluded that the transition from the PAYG system to the individual accounts system was reasonable given that it would be financed by multilateral agencies that wanted to support government efforts to modernize the social security system (Aleman, 2001).

The Commission proposed the individual account as the new model. The AFP would administer the funds and the Superintendent of Stocks, Insurance and Pensions would regulate and oversee those administrators. This followed the Chilean model of replacing the government model with a private one. The reforms were based on the Law of Pension Savings of El Salvador, which was in turn based on the Chilean model.
The funds would be invested in the capital markets to eventually become retirement income paid out by insurance companies. The funds would be established based on the savings of the accountholder together with a recognition bond, maintaining the value and profitability of fund investments.

The proposal included a separation of assets between fund administrators and investors to protect the integrity of the savings. In the event of bankruptcy of the administrators, the funds would not be affected and could be transferred to another administrator.

A Superintendent of Pensions, separate from the Superintendent of Banks, would be formed by an advisory board, which would be responsible for dictating standards to oversee and establish general policies related to the supervision and control of the activities and operations of the administrators, in accordance with the Pension Law. The AFP would only manage the pension funds. Titles and other stocks would be in the name of the fund and would be physically deposited in the custodial institution.

The fund management contracts would guarantee a minimum rate of return and establish reserves to support it. The AFP would be prohibited from rejecting workers and from discriminating against members on the basis of age, income level or any other labour or personal condition in their process of joining an AFP, receiving contributions or granting benefits.

To reduce risks to the profitability of these investments overall, funds would initially be invested in the instruments authorized by law and that offer due security conditions. Investing in government bonds, instruments issued by banking institutions and instruments issued by companies would be permitted.

The role of the INSS in the new model would be to collect and distribute the pensions as it does with contributions for sickness, maternity and occupational hazard insurance. Existing infrastructure would be used for this activity, which would gradually diminish over time.

With government funds allocated by the Ministry of Finance, the INSS would cover the cost of current pensions.

Solidarity or non-contributory pensions would be treated similarly, and the war-victims’ benefits would remain unchanged, phasing out over time.

The INSS would administer pensions for occupational hazards and those for common disability, the former with its current financing system and the latter with an additional premium of the pension branch. The pension insurance would be transferred to the AFP.

4. **Legal analysis of the reform**

Trade unions, civil society and the Frente Sandinista Party frequently defend the public social security system and reject the replacement private system with the argument that Nicaragua’s Constitution, Article 105, states that «education, health and social security services are manifest duties of the government, which is obligated to provide, improve on and expand them without exception.»

Nevertheless, CREPEN claimed that despite the inflexibility of that constitutional article, the same Constitution in its Article 82, Clause 7, establishes that: «Workers have the right to working conditions that guarantee the following, especially: social security for integral protection and livelihoods in cases of disability, old age, occupational hazards,
illness and maternity; and of their family members in the case of death in the manner and conditions determined by law.»

According to Alejandro Vogel, INSS vice-minister and president of the Reform Commission, the Organic Social Security Law of Nicaragua regulates all the above.

The Reform Commission argued that for 1987, «the national financial, insurance and reinsurance system and foreign trade will unconditionally correspond to the government (Article 99 of the Constitution).

To resolve this problem without having to reform the Constitution, in 1991, Law No. 125 created the Superintendent of Banks and other Financial Institutions, which allowed for the operation of duly regulated, supervised private banking entities. Additionally, it enabled the creation of the Pension Saving System and private banks and insurance companies without the need to reform the Constitution 5.

The Commission presented the draft bill of the Law of the Pension Saving System to the National Assembly in early November 1999, after consulting with the High Council of Private Enterprise (COSPE) and pro-government trade unions. Other unions, such as the Sandinista Workers’ Central (CST) and the Civil Coordinator (an entity that brings together more than 350 non-profit organizations) protested against the bill. These groups supported a social security reform without pension privatization.

The draft bill of the Pension Saving System was passed on 15 March 2000, with 47 votes in favour, seven abstentions and the opposition of the Frente Sandinista. The law went into effect and became mandatory for Nicaraguan citizens beginning on 12 April 2000, when it was published in the Official Gazette of the Republic of Nicaragua.

The Law of the Pension Saving System had the objective of regulating the saving system, which would be administered by AFP and regulated by the Superintendent of Pensions. This law partly followed the model proposed by Julio Bustamante.

The AFP administer the funds. These companies must hold a minimum social capital of US$ 2 million to be established, to be increased in accordance with the number of members. The AFP are responsible for managing the fund and granting pensions. The pension funds are the property of accountholders and are independent from AFP assets. Enrolment in the pension system is mandatory for all employees, while self-employed workers, diplomats, farmers, domestic workers, Nicaraguans living abroad and all workers who earn an income may enrol. Citizens can freely choose an AFP and transfer funds to other AFP that best serve their interests. Contributors may also make voluntary additional contributions, which are deposited in the individual account and used exclusively to finance increased benefits. Monthly benefits are disbursed starting from the legal retirement age or when members are declared partially or totally disabled.

Members under age 43 must join the Pension Savings System by choosing an AFP. The public pension system cannot accept new members once the law is passed. Workers who transferred to the new Pension Saving System would receive a transfer recognizing their years of contributions to the old system. The most controversial part of this law was the stricter requirements established to have a right to a pension, while employer and employee contributions were increased, and the government contribution was discontinued.

5 For a legal analysis of the reforms, see: Karlos Navarro. La evolución de la Seguridad Social en Nicaragua. Bitesca. Managua, Nicaragua.
The contribution rate was set at 10.5 per cent: 6.5 per cent paid by the employer and 4 per cent by worker; 7.5 per cent was deposited in the worker’s individual account and 3 per cent was paid to the AFP for administrative services. Previously, the rate was 5.5 per cent, with the worker contributing 1.75 per cent, the employer, 3.5 per cent and the government, 0.25 per cent. The retirement age of 60 was maintained but the number of required contributions doubled, from 15 to 30 years. Workers who did not reach the required number of contribution years would receive a minimum pension in accordance with the public system. The total disability pension would increase from 56.3 per cent to 70 per cent of the worker’s salary, with the salary being calculated based on the past 10 years rather than the past five, as it was previously. The government would be responsible for pensions of members aged 43 years.

5. **Repeal of the law: rapid return to the public system**

In March 2001, the Organic Law of the Superintendent of Pensions was passed. The National Assembly of Nicaragua allocated a three-year budget of nearly US$ 3 million to establish and operate the Superintendent of Pensions. According to Manuel Israel Ruiz, advisor to the government of President Enrique Bolaños, a total of US$ 12 million was spent on consultancies, assessments, studies, trips to Chile, equipment purchases, training seminars, etc. Others put this figure at US$ 14 million (Bodán, 2004).

During those years, the law was never implemented. This was in response to a World Bank study and recommendation rather than to pressure from the trade unions or political parties. Law No. 568 (passed on 25 November 2005) repealed Law No. 340 (Law of the Pension Saving System).

Section III of this law states that: «The Economic Cabinet of the Government, based on the studies and analyses conducted by the executive and legislative branches, as well as by international financial institutions, resolved to suspend the implementation of Law No. 340, given that it threatens the country’s macroeconomic stability as it would cause an unsustainable deficit for the government. The financing alternatives proposed are insufficient to cover the deficit and it generates social inequality by forcing the population to assume transition costs that benefit only the formal labour sector of the country.»

**Forces for and against the reform**

From 1997 to mid-2005, organizations against the reform included the National Association of Insured People (ANASE), the Union of Business Owners and Executives for National Development (UNYD), the National Association of Educators of Nicaragua (ANDEN), the Sandinista Workers’ Central, the National Workers’ Front, the Health Workers’ Union and the Sandinista Front, the opposition party at the time. Some officials of the Enrique Bolaños administration also opposed the reform (Rocha, 2000).

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6 Law Number 388. Published in Gazette No. 85 of 8 May 2001.

7 Amparo Ballivián, World Bank representative in Nicaragua during that period, in an interview for *Revista Confidencial*, stated that a study was carried out that indicated that “fiscal clearance” should exist to implement the Pension Saving System, for that reason the World Bank informed the government that the system “was not viable;” Bodán, 2004).
6. **The Nicaraguan experience**

The origin, evolution and development of social security in Nicaragua pre-dated the ongoing struggle of workers whose gains were set forth in legislative provisions. Social security under the principle of universality was directed first toward protecting employees and second for covering self-employed workers. Legislation upheld the principle of the gradual, progressive expansion of social security to guarantee fulfilment of the system’s objective of universal coverage of dependent and independent workers.

Nevertheless, this idea, which shaped social security law in Nicaragua and which had enjoyed a consensus, broke down in the 1990s, when economic stabilization and structural adjustment programmes were implemented with support from the IMF and IDA. It was further defeated when Nicaragua joined the Highly-Indebted Poor Countries Initiative (HIPC) to have nearly 80 per cent of its foreign debt forgiven.

In Nicaragua, international financial institutions imposed an economic stabilization process that involved reducing the size of the state, the privatization of public companies, strong economic measures and reduced social spending.

They also recommended creating a new social security model that basically entailed privatizing pensions.

The Nicaraguan reforms were based on Chile’s AFP. Although Article 105 of the Constitution prohibited the implementation of that model, and different studies indicated that it was not a sustainable process due to the high transition costs, some political and business sectors viewed it as a lucrative business opportunity at the cost of workers’ pensions. The new model was falsely touted as a way to increase domestic savings and investment, as well as to create more jobs.

Undoubtedly, if the World Bank, which originally supported the reform, had not advocated for the repeal of Law No. 340 (Law of the Pension Saving System), that pension model would have been implemented, with highly detrimental consequences for Nicaragua.
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