“The Pension System and the Crisis in Argentina: Learning the Lessons”

by

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I: Introduction

The pension system in Argentina is one of the oldest in the world, since the first schemes were created early in the 20th Century. Since these early schemes, which were organized as independently [check] funded pension funds, there have been many changes in their design and regulation. However, during all these years, one principle has always been maintained, which is that benefits were granted to those who made contributions before retirement. The amount and duration of these contributions varied widely, but the principle of requiring them to qualify for a benefit survived for almost a century. The rationale behind this was that most workers were part of the formal labor force. Thus, requiring contributions would be a simple way to identify workers and, at the same time, make sure that the system was financed by those who would benefit from it.

The dynamics of the labor market in the last 25 years have shown that the proportion of formal workers in the labor force is low, and increasing unemployment has pushed it higher. Also, changes in the system have reduced the proportion of expenditures financed by contributions. As a result, the system in Argentina is leaving increasing proportions of workers without coverage and is increasingly financing the system from general revenue. These trends, which have been evident for several years, have been exacerbated by the serious crisis that has affected Argentina’s economy since 2001, making a review of the design and operation of the pension system indispensable.

This paper contains six sections. After this introduction, Part II briefly describes the history of the pension system in Argentina, its reform in 1994, and its performance since then. Part III presents a short description of the economic crisis, including some of its fiscal and financial aspects and their influence on the pension system. Part IV presents what appear as the most important implications in the short and long term of the crisis on the pension system. Part V develops some ideas on pension policy strategy as a basis for a potential redesign of the system, while Part VI concludes.
II: HOW DID WE GET HERE?

The System before the 1994 Reform

The pension system in Argentina is now very close to its first 100th birthday. As early as 1904, the first pensions systems covering civil servants were created. Thereafter, many occupational schemes were introduced, although they usually covered only a few workers. By the mid-1940s, only 7 percent of the labor force were protected by social security. There was a wide range of heterogeneous schemes, some with retirement ages as low as 47 years, total contributions were around 8 percent, and some benefits were as high as 90 percent of the beneficiary’s last salary. Most of these schemes were apparently funded, but, in most cases, their long-term financial condition was weak. During the late 1940s and most of the 1950s, the system rapidly expanded and became more homogeneous; in 1958, a law established that benefits should be 82 percent of the wage of active workers in a similar job, but no significant increase in contribution rates or retiring ages was enacted. As a result, by the mid-1960s, the different funds had serious financial problems. Thus, a new law was approved, consolidating most of the previously existing funds at the national level into only three (for civil servants, the self-employed, and for those in manufacturing, commerce, and other professions). The law also increased the minimum retirement age to 60 years old for men and 55 years old for women and increased contribution rates to a total of 20 percent (5 percent from employees and 15 percent from their employers. Other schemes run by the provincial governments (for civil servants and special independent activities) continued operating with variable financial outcomes.

This scheme was in place for more than 25 years, at which point growing difficulties in its financing forced the government to consider introducing a major reform. During most of the 1980s, the system had increasing deficits, financed in part by the government unlawfully postponing cost-of-living adjustments to the benefits. This strategy resulted in massive lawsuits against the government, the majority of which were won by the retirees.

By the early 1990s, the need for a reform had become overwhelming. The deficit incurred by the national system, which had never exceeded 1 percent of GDB in previous years, escalated to 1.7 percent by 1993, while the provincial systems and other special schemes added another 2 percent of deficit to the consolidated balance (DGSC, 2000 and ANSES, 1995). The government’s strategy of failing to increase benefits was backfiring, and the accumulated debt to pensioners was estimated to be 3 percent of GDP. At this point, with the system’s ability to pay benefits seriously
weakened, the fiscal situation worsening, and serious inefficiencies in the institutional structure, the
government prepared a proposal to reform the system and introduced it to the Congress in 1992.

The Reform

After a lengthy discussion in Congress, a new law was passed in October 1993, and the new
system started operating in July 1994. The main reforms included changes in the system’s
parameters and institutional arrangements. The most relevant parametric reforms were an increase
in employees’ contribution rate (from 10 percent to 11 percent), an increase in the minimum
retirement age (by five years), an increase in the number of years of contributions required to obtain
retirement benefits (from 20 to 30 years), and a reduction in the expected replacement rate (from 70
to 82 percent of the average of the previous three years of wages to an average of approximately 60
percent of previous 10 years of wages with a strong redistributive formula). All of these changes
were to be introduced gradually, with the first one being fully enacted by 2001, the second one by
2007, and the last one after approximately a 40-year transition period.

On the institutional arrangements, the new system was organized in two pillars. A first
pillar, financed by employer contributions of 16 percent, granted a flat benefit of around 28 percent
of the average wage to those who satisfy the minimum age and minimum number of years of
contributions. The second pillar has two schemes, and workers must choose between them. If they
want to join a new PAYG government-run scheme, their personal contributions will be used to
finance a benefit of 0.85 percent of reference income (the average of their wages over the previous
10 years) per year of contribution. Thus, a retiring worker with 35 years of contributions would
receive benefits from this pillar of approximately 30 percent of his salary. In the case of an
individual with an average salary, the total benefit would be nearly 58 percent of his salary (28
percent from the first pillar and 30 percent from the second). The second scheme is a funded model
based on individual accounts in which individuals accumulate personal contributions (net of
administrative costs and of disability and survivors insurance) and obtain a defined contribution
benefit when they retire. Simulations based on reasonable assumptions about accumulated returns
indicate that the benefits from this scheme should approach 35 percent of a worker’s salary for a
total benefit of 63 percent of wages. In short, simulations indicate that the expected benefits from
both schemes would be very similar, with the funded scheme having a slight advantage. A

1 For a detailed description of the new system, see Rofman (2000)
transitional benefit designed to compensate workers for their years of contributions before 1994 was created and paid to all retiring workers.

The System after the Reform

The reform enacted in 1993-1994 was the tool chosen by policymakers in Argentina to confront the growing crisis of the pension system. The main goals of these reforms were to promote the formal sector in the labor market, to contain the growing fiscal cost of the system, and to create the basic conditions for the strong development of the local capital market.

*Formality and Coverage.* The new system was strongly promoted, both by the government and by the new pension fund managing companies (“AFJP”). At the outset of the system, active workers were given the choice of joining the new PAYG scheme or the funded scheme, the latter being the default choice if the worker expressed no preference [check]. The new AFJPs got off the ground very quickly. In a just few months they had created a sales force of almost 30,000 and had spent more than half a billion dollars in marketing and sales commissions. This resulted in an enrollment of 2.2 million workers into the AFJPs, while **2.7 million** chose the PAYG scheme. Another 800,000 who had not made a choice were randomly assigned to an AFJP, making a total of 5.7 million workers registered in the new system. This figure was relatively low since there were around 14 million workers in the labor force. Even taking into account the enrollment in provincial and special systems, the coverage was clearly low. After the first massive enrollment, the number of members of the pension funds continued to grow, reaching 8.8 million by the end of 2001, which added to a total of 11.2 million when both schemes are taken into account. This growth can be explained by new enrollments in the AFJP (2.3 million) but most importantly by the assignment of 2.8 million workers who did not make any explicit choice. The increase in the number of registered workers was not accompanied by an increase in the number of actual contributors, which remained at around 4 to 4.5 million during the whole period. This is an indication that most of the newly enrolled workers were informal workers who only spent very short periods of time in formal employment or other individuals who move in and out of the labor force.
While younger workers’ participation in the system did not increase after the reform, the stricter requirements for obtaining benefits resulted in a decline in the coverage of older individuals. The old system, though it suffered from serious fiscal problems, was able to offer widespread coverage to the elderly. By 1993, the percentage of the population older than 65 who were not covered by the pension system was 23 percent, a percentage that declines to 12.5 percent if we consider the spouses of retirees as being covered. The first statistic (of the percentage of the population older than 65 who were not covered by the pension system) increased to almost 33 percent in 2001, and the second statistic (these people plus their spouses) increased by a similar amount (12.5 percent to 22.7 percent) if we take into account the percentage of people over 65 who have no pensions of their own or through their spouses. A related indicator (the proportion who have no pension or other source of income) went up from 7.4 percent in 1993 to 16 percent in 2001, a dramatic increase in the population with no retirement income at all.

Source: Own, based on data from SAFJP
The Fiscal Situation. While most workers joined the funded scheme (either by choice or by being assigned to it by default), their benefits were still paid by the government’s pension agency, ANSES. The benefits of all workers who retired before the reform and of those who opted for the new PAYG plus any transitional benefits had to be financed by ANSES. Also, beginning in 1994, the government decided to integrate the provincial schemes into the national system, which resulted in increased central government expenditures. Meanwhile, the government’s revenue was being greatly reduced as a result of reductions in employer contribution rates, part of the policy to promote labor market competitiveness adopted in the same year. As a result of this combination of factors, ANSES was able to finance less than 30 percent of its budget with contributions, while the rest was covered by general revenue and other earmarked taxes.

The fiscal effect of the reform can be seen in the amount of revenue being transferred to the new funded scheme, which by the year 2001 was close to 1.5 percent of GDP. However, it is important to consider the effect of the parametric reforms, which reduced expenditures. Assuming
that expenditures grew by 3 percent a year,\(^2\) benefits payments in 2001 should have been approximately 1.1 percent of GDP more, which means that the net effect of the reform was an increase in funding for the social security system of 0.4 percent of GDP. Other policies had an impact on ANSES finances, such as the reduction in employer contributions (1.4 percent of GDP by 2001) and the cost of transferring the provincial systems to ANSES (0.9 percent of GDP). Overall, the apparent consolidated effect of the reform and other policies was a deficit of 3.8 percent of GDP by 2001 or 2.7 percent if the savings are considered.

### Table 1: Fiscal Effects of Pension Reform and Other Related Policies, 1993-2001

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue to AFJPs</th>
<th>Reduction in Employers Contribution Rates</th>
<th>Cost of Provincial Systems</th>
<th>Total Effect</th>
<th>Savings in Expenditures</th>
<th>&quot;Real&quot; Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>1993</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>1994</td>
<td>0.3%</td>
<td>0.4%</td>
<td>0.2%</td>
<td>1.0%</td>
<td>0.1%</td>
<td>0.8%</td>
</tr>
<tr>
<td>1995</td>
<td>0.9%</td>
<td>0.4%</td>
<td>0.4%</td>
<td>1.6%</td>
<td>0.3%</td>
<td>1.4%</td>
</tr>
<tr>
<td>1996</td>
<td>1.1%</td>
<td>0.8%</td>
<td>0.7%</td>
<td>2.6%</td>
<td>0.4%</td>
<td>2.2%</td>
</tr>
<tr>
<td>1997</td>
<td>1.3%</td>
<td>0.8%</td>
<td>0.8%</td>
<td>2.9%</td>
<td>0.5%</td>
<td>2.4%</td>
</tr>
<tr>
<td>1998</td>
<td>1.4%</td>
<td>0.8%</td>
<td>0.8%</td>
<td>3.0%</td>
<td>0.6%</td>
<td>2.4%</td>
</tr>
<tr>
<td>1999</td>
<td>1.5%</td>
<td>1.1%</td>
<td>0.9%</td>
<td>3.5%</td>
<td>0.8%</td>
<td>2.7%</td>
</tr>
<tr>
<td>2000</td>
<td>1.5%</td>
<td>1.5%</td>
<td>0.9%</td>
<td>3.9%</td>
<td>0.9%</td>
<td>2.9%</td>
</tr>
<tr>
<td>2001</td>
<td>1.5%</td>
<td>1.4%</td>
<td>0.9%</td>
<td>3.8%</td>
<td>1.1%</td>
<td>2.7%</td>
</tr>
</tbody>
</table>

Source: Own, based on data from ANSES.

*The Funded Scheme.* The funded scheme, created as part of the new integrated system in 1994, has a short history, which makes it difficult to assess its performance. As we saw above, around 80 percent of formal workers are enrolled in this scheme, but actual contributors amount to less than 25 percent of the labor force. Funds have accumulated since the beginning of the system and by the end of 2001 represented 7.4 percent of GDP. Returns on these funds have been higher than expected with a real annual average of 7.5 percent, but part of these returns are strongly affected by valuation criteria, defined by the supervisory agency. Although this is still a young scheme, benefits are being paid to approximately 92,000 retirees, disabled people, and survivors.

\(^2\) This estimation is based in a growth in the population of retirement age of 1.5 percent a year and a growth in average benefits of 1.5 percent a year.
Of all of the problems besetting the funded scheme, investment diversification has been one of the most serious. Since the onset of the system, nearly 50 percent of its assets have been government bonds, except in 1997, when term deposits grew quickly in the form of stock derivatives and when investment in stocks was also large. The concentration of risk, usually explained by the lack of alternatives and the high yields of the government bonds, made the pension funds extremely vulnerable to the fiscal problems of the Argentine government.

Table 2: Pension Funds, Investment Structure. 1994-2001

<table>
<thead>
<tr>
<th></th>
<th>Dec 94</th>
<th>Dec 95</th>
<th>Dec 96</th>
<th>Dec 97</th>
<th>Dec 98</th>
<th>Dec 99</th>
<th>Dec 00</th>
<th>Dec 01</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Cash accounts</strong></td>
<td>6,33</td>
<td>1,68</td>
<td>1,83</td>
<td>0,98</td>
<td>1,52</td>
<td>0,97</td>
<td>0,28</td>
<td>2,23</td>
</tr>
<tr>
<td><strong>Government Debt</strong></td>
<td>49,83</td>
<td>52,68</td>
<td>52,70</td>
<td>43,36</td>
<td>49,99</td>
<td>52,30</td>
<td>54,62</td>
<td>67,97</td>
</tr>
<tr>
<td><strong>Corporate Debt</strong></td>
<td>5,84</td>
<td>8,71</td>
<td>7,78</td>
<td>2,86</td>
<td>2,50</td>
<td>2,13</td>
<td>2,80</td>
<td>1,69</td>
</tr>
<tr>
<td><strong>Term Deposits</strong></td>
<td>27,55</td>
<td>24,76</td>
<td>14,19</td>
<td>24,44</td>
<td>18,83</td>
<td>15,47</td>
<td>15,63</td>
<td>10,89</td>
</tr>
<tr>
<td><strong>Stocks</strong></td>
<td>1,53</td>
<td>5,85</td>
<td>18,74</td>
<td>21,46</td>
<td>18,36</td>
<td>20,54</td>
<td>12,26</td>
<td>10,24</td>
</tr>
<tr>
<td><strong>Mutual Funds</strong></td>
<td>5,01</td>
<td>1,74</td>
<td>2,34</td>
<td>4,47</td>
<td>6,59</td>
<td>6,28</td>
<td>8,21</td>
<td>1,97</td>
</tr>
<tr>
<td><strong>Foreign Investment</strong></td>
<td>0,08</td>
<td>0,73</td>
<td>0,16</td>
<td>0,37</td>
<td>0,25</td>
<td>0,37</td>
<td>4,47</td>
<td>1,84</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>3,82</td>
<td>3,86</td>
<td>2,26</td>
<td>2,06</td>
<td>1,97</td>
<td>1,93</td>
<td>1,73</td>
<td>3,16</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
<td>100,00</td>
</tr>
</tbody>
</table>

Source: SAFJP, 2002

III: The Crisis

While the goal of this paper is to discuss the relationship between the pension system and the economic crisis in Argentina, it is necessary to consider the context within which this crisis developed. The fiscal and financial problems in Argentina in late 2001 and 2002 had important effects on the pension system. Thus, in this section, I present a basic description of the crisis in order to clarify the background. One problem of attempting this task is that this document was being written while the crisis was still developing rather than after it was solved. Consequently, many considerations may become rapidly obsolete as the situation is changing rapidly.

The Fiscal Crisis

Argentina has had serious fiscal problems for many years. The different levels of government (federal, provincial, and municipal) have been unable to balance their budgets, partly
due to increasing expenditures and, more importantly, due to their inability to collect taxes efficiently.

During most of the 1990s, the deficits were financed with privatization revenue and an increasing federal and provincial debt. The situation was difficult but controllable until an economic recession started to have a serious negative impact on revenues. Meanwhile, the accumulated debt meant that services took up a growing share of total expenditures, just as the international emerging financial markets were becoming tighter. Aggregated expenditures were, during the 1990s, very stable, at 30-32 percent of GDP, but after 1998, they grew to 35 percent in 2001. Most of the growth was due to debt payments [check], which went from 1.6 percent of GDP in 1990 to 5.3 in 2001. Pensions expenditures, on the other hand, were very stable, at around 8 percent of GDP (although this figure was larger than the 1980s’ average of 5.3 percent).

**Figure 3: Aggregate Public Expenditures (Federal, Provincial, and Municipal), 1990-2001**

![Figure 3: Aggregate Public Expenditures (Federal, Provincial, and Municipal), 1990-2001](image)

Source: *Ministerio de Economía*, 2002

During 2001 the crisis accelerated, resulting in a decline of 9 percent in federal revenues. This prompted the government to apply policies aimed to limit expenditures, increase tax compliance, and promote economic growth. These policies were not always consistent (for example, in November employees’ contributions were reduced from 11 percent to 5 percent of
wages in an attempt to increase consumers demand, but this reduced revenue into the social security system).

Tax collection fell rapidly in the second half of 2001 and the first few months of 2002. This drop was particularly severe in the most important tax in Argentina – the value-added tax (VAT). Social security revenue also fell but not by as much. This lack of resources prompted the government to reduce civil servant salaries and pension benefits. Thus, in July 2001, pensions higher than $500 were reduced by 13 percent. Also, during the first quarter of 2002, an inflation rate of 20 percent resulted in a 28.5 percent aggregated reduction in the real value of the pensions of many retirees.

The fiscal crisis ended when the government formally defaulted on its debt payments in late December 2001. The federal government and most provincial governments continue to be unable to finance their current expenditures and have started to issue low denomination bonds to be used as cash. These bonds, issued by 14 of the 24 provinces, are used as currency in some areas of the economy but they are not accepted in others, which has further eroded the effectiveness of tax collection and has reinforced a negative circle. At the time this paper was written (May 2002), the government had no clear strategy to reverse this tendency.

The Financial Crisis

While the fiscal problems were growing, the banking sector in Argentina suffered an increasing run on deposits. Total deposits fell 22 percent between February 2001 and November 2001. This decline prompted the government to limit cash withdrawals and international transfers of funds in December 2001. Even so, deposits continued to decline, with a total loss of nearly 47 percent by April 2002. The default in government debt, the devaluation of the peso (which fell by almost 70 percent in three months), and the “pesofication”3 of all local deposits and loans rapidly accelerated the crisis. Thousands of individual account holders have sued the banks and the government looking to recover the value of their deposits in dollars, and in many cases banks have been forced to return the deposits in hard currency.

3 After the devaluation, the government decided to convert into pesos deposits denominated in US Dollars at an exchange rate of 1.40 pesos per dollar and loans at an exchange rate of 1 peso per dollar. This asymmetric conversion and the fact that external debt was not affected put most banks in an extremely vulnerable position.
The Pension System Crisis

In the context of this deep fiscal and financial crisis, the pension system has been affected in several ways. A very large number of “urgent” policies implemented in the last few months of 2001 and early 2002 have had a direct effect on the pension system. Most of these policies ought to have required a change in the basic legislation, but they were approved by decree due to “exceptional” circumstances. This is an important factor, since the lack of support that many of these measures had in Congress made the system highly volatile. The changes affected many aspects of the system, including the value of current benefits, contribution rates, investment rules for the funded scheme, pension fund fees, and the funded scheme’s benefits. While some of these aspects of the original reform legislation needed to be revised and improved, the government did this without adequate analysis or through the proper legislative channels. In several cases, important changes were “hidden” within larger decrees, and the government used legal technicalities to ensure that lower regulatory authorities enacted other major reforms. Among the regulations issued in this period, we can list the following:

a) As mentioned before, pension benefits of more than $500 monthly were reduced by 13 percent to limit public expenditures. (Law 24.453, enacted 7/30/2001.)

b) A technical change in the insurance policies brought the cost of insurance for the year 2001-2002 to almost zero. This was approved in November by the Insurance Regulator, but payments made by workers to insurance companies between July and October 2001 (approximately $200 million) were not returned. (Res. 28433/2001, enacted 10/18/2001.)

c) The government proposed a swap of bonds held by domestic investors, mostly banks and pension funds. In exchange for the old bonds (which had a market value and were regularly traded in the local stock market and in New York), the government issued a “Guaranteed Loan.” These new instruments had a low interest rate and no secondary market, making their valuation mode subjective. The swap was voluntary but was strongly promoted by the government and the supervisors of pension funds. (Decree 1387/2001, enacted 11/02/2001.)

d) In October 2001, the government issued a decree ordering that all money invested in CDs by pension funds must be used to buy treasury bills directly from the government. (Decree 1582/2001, enacted 11/02/2001.)
e) Beginning in November 2001, employees’ contribution rates were reduced from 11 percent to 5 percent for a period of one year extendible to two years. (Decree 1387/2001, enacted 11/02/2001.)

f) In November 2001, the government created the National Institute of Social Security Collection (“INARSS”). This new organization has a Board of Directors with representatives of AFJPs and private health insurance providers and has authority to collect contributions to pension funds, unemployment insurance, family allowances, and health care. (Decree 1394/2001, enacted 11/05/2001.)

g) In November 2001, the pension law was modified, and flat fees were eliminated. Also, the fund managers were authorized to charge an insurance fee to workers with no contributions in a given month (this applies under limited circumstances). A fixed fee on returns over 5 percent was also established, and workers who had not enrolled by themselves (“indecisos”) were assigned to the lowest cost AFJPs. (Decree 1495/2001, enacted 11/23/2001.)

h) The reduction in employees’ contributions for workers enrolled in the second pillar PAYG scheme was reversed, but it was maintained for those in the funded scheme. (Decree 1676/2001, enacted 12/19/2001.)

i) A new maximum benefit for current pensioners was created, reducing it from $3,100 to $2,400 a month (Decree 85/2001, enacted 12/31/2001.)

j) New annuity contracts were suspended, forcing all retiring workers to remain in scheduled withdrawal for 60 days (Res. 1/2002 SAFJP, enacted 02/01/2002.)

k) The fee on returns created by Decree 1495/2001 was “suspended” *sine die*. (Decree 216/2002, enacted 2/4/2002.)

l) In March 2002, the government decided to convert the Guaranteed Loans (denominated in US Dollars) to pesos at an exchange rate of 1.4 pesos per dollar. These new loans are indexed to inflation and receive an annual interest rate between 3 and 5.5 percent. The first scheduled payment of interest was made in April 2002, and the Pension Funds Regulator applied the 1.4 exchange
rate to the funds’ valuation on April 15, resulting in an instant return of about 30 percent. (Decree 471/2002, enacted 3/8/2002.)

m) The suspension period of Resolution 1/2002 SAFJP was extended for another 30 days (Res. 3/2002 SAFJP, enacted 04/04/2002.)

IV: Where Do We Go Now?

The crisis in Argentina will have clear effects on the pension system. Some of them are short-term, meaning that their influence will be felt in the near future, but their consequences will probably be felt later. Others are long-term effects, in the sense that they affect the basic design of the system and, as such, need to be addressed as part of a review of the fundamental principles underlying the system.

Short-term Implications

Nevertheless, the short-term implications of the economic crisis on the pension system are important, as they affect many individuals.

The first effect was that many retirees had their benefits reduced. Not only was a 13 percent cut applied to those earning $500 or more (about 15 percent of the beneficiaries) but also no cost of living adjustments were made to the benefits, which produced an important loss in their real value during the first few months of 2002. While consumer prices grew by 21 percent in the first quarter of the year, the prices of basic consumer goods (those considered to be part of a minimum diet) increased by 35 percent. As a result of this price increase, in May 2002 a single male retiree earning the minimum benefit was now below the poverty line. The fact that the pension has no automatic, explicit indexation procedure is a matter of great political and judicial controversy and leaves open the possibility that the benefit levels can be manipulated.

In the case of the funded scheme, the difficulties involved in determining the actual value of the funds and its lack of liquidity convinced the supervisors not to take on any new annuities for at least five months. Consequently, all new retirees, survivors, and disabled workers have been forced to accept a scheduled withdrawal scheme for a minimum period.

A major controversy between the fund managing industry and the government appeared when the decree converting the Guaranteed Loans to pesos was issued. This change produced an “instant” return of 31 percent on April 15th, but some pension funds are considering denouncing the
conversion, which would result in the recovery of the original bonds denominated in US Dollars and a reduction in the value of the funds to levels below those before the conversion (due to the very low market value of the public debt bonds).

**Long-term Implications**

The economic crisis deepened the problem of coverage in the pension system. Since its creation in 1994, the number of contributors to the pension system had been very stable, at around 4.5 million workers. During 2001, the country’s economic problems started to affect the number of contributors, resulting in a decline of 7 percent between December 2000 and November 2001. In December, there was a decline of more than 20 percent over the previous month, and this figure did not recover in the first few months of 2002. This loss of contributors can be explained by the rapid increase in unemployment (while official data will not be available until July, private consultants estimate that the unemployment rate may be higher than 25 percent) and by increasing informality among small and medium-size companies. While this problem could be considered to be a short-term one, the dynamics of the labor market in the last 15 years show that rapid increases in the formal labor market cannot be expected. In fact, even if there is a recovery, it is important to remember that, even before the crisis, the system covered less than 30 percent of the labor force. In short, low participation appears to be a structural problem of the economy and appears not to be directly linked to labor market policies.\(^4\) This situation is similar in most countries in Latin America, as coverage rarely exceeds 50 percent of the labor force.\(^5\)

A projection of coverage of the elderly over the next 20 years shows how serious this situation is, since the proportion of the population aged 65 and older who do not receive benefits will grow from the current 33 percent to more than 50 percent.

\(^4\) In fact, it is interesting to consider the evolution of the number of contributors to the system between 1993 and 1999 before the financial crisis started. In this period, the number of contributors appears to have remained almost invariable despite major changes in the pension system, large reductions in employers’ contributions, the application of several policies promoting increasing employment, and important declines and recoveries in the economy as a whole, indicating that changes in the labor market in Argentina occur mostly in the informal sector (Rofman, 1999). This explanation does not seem to be applicable to other Latin American countries, where econometric studies have found a link between individual account contributory systems and workers’ participation (Packard, 2001 and Valdes-Prieto, 2001)

\(^5\) Chile is the only Latin American country where more than 50 percent of the active population contributes regularly to the pension system at a rate estimated to be 58 percent in 1999 (Arenas de Mesa and Hernandez Sanchez, 2001).
The recent economic crisis has had a serious effect on the financial situation of the pension system in the short term, since it has affected government revenue in general and, as mentioned before, most of the funds used to pay the benefits came from general revenue and not from contributions. The crisis, however, has also reduced real expenditures on benefits from a level that was already low. Argentina spends approximately 4.5 percent of GDP on pensions. This amount is difficult to finance in the context of rapidly declining revenue but should not be impossible to finance in a more “normal” context. In fact, data from the ILO indicates that pension expenditures are lower in Argentina than in many comparable countries.

Table 3: Pension Expenditure as Percentage of GDP, Selected Countries (around 1996)

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage of GDP spent in Pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>15.0%</td>
</tr>
<tr>
<td>Spain</td>
<td>10.9%</td>
</tr>
<tr>
<td>UK</td>
<td>10.2%</td>
</tr>
<tr>
<td>Uruguay</td>
<td>8.7%</td>
</tr>
</tbody>
</table>
While the data presented by ILO have a number of methodological problems (it is usually very difficult to obtain comparable figures across countries), these figures indicate that the pension system in Argentina does not represent a major fiscal problem. If we add the declining trend in coverage mentioned before, it becomes clear that any medium- and short-term fiscal problems may be due to poor collection and not to excessive expenditures.

However, the current crisis has generated a number of long-term risks for the funded scheme. First, the increasing concentration of investments in government debt, which started in 2001 and has quickly accelerated since November 2001, reaching 77.5 percent of the total portfolio. This concentration would be dangerous in any case, but, given that the Argentine government has already defaulted on part of its debt, it becomes a major concern. As mentioned before, the government has declared its intention to honor its guaranteed bonds and other papers, but the instability of the general economic situation makes it probable that this promise will not be fulfilled. Pension fund managers should be working with the government to try to increase the likelihood of recovering the money invested by workers, taking advantage of the fact the pension funds do not need liquid assets and their maturation horizon is very long term. In this sense, the conversion to pesos, with price indexation and a moderate interest rate for the guaranteed loans, appears to be a reasonable approach since it alleviates pressures on the government in the short term while maintaining the local purchasing power of accumulated retirement savings (in fact, increasing it by 40 percent). At the same time, a great effort should be made to develop new financial instruments and to improve the performance of capital markets to allow future contributions to be invested in safer, more diverse assets.

Other problems in the funded scheme, such as high administrative costs, poor competition and transparency, delays in granting benefits, and the supervision body’s lack of independence from the government need to be addressed too. These problems are not new, but the crisis has made them more visible.
V: Ideas on Policy Strategy

In the previous sections, I have presented a quick review of the design and performance of the pension system before the economic crisis in Argentina and an overview of the main aspects of this crisis. In this section, I concentrate on how we can build a stronger, more efficient pension system in this context.

The basic rationale of pension systems is to provide individuals who are too old to work with a reasonable income. Definitions of what constitutes a “reasonable income” and what is the best institutional organization to provide it are, of course, controversial topics in the academic and political arenas, and finding an optimum solution both in technical and political terms will be a complex task.

Policymakers aiming to redesign the pension system must meet three important goals: to provide the highest possible benefits to the largest possible number of beneficiaries at the lowest possible cost. Before the 1994 reform, Argentina had a system that provided low to medium benefits to a large proportion of the population at an increasing cost that was difficult to finance. The 1994 reform clearly aimed to solve the third problem in the medium term, mostly by reducing coverage. At the same time, it shifted part of the risk of future increases in costs from the state to individuals by moving from a government-financed, defined-benefit scheme to a mixed scheme that involved the private sector and a design that included defined contributions. This change was expected to promote compliance (due to the strong link between contributions and future benefits), which would, in turn compensate for the loss of coverage due to the stricter eligibility requirements.

As discussed before, the reform was successful in some goals but not in others. The fiscal costs of the system stopped increasing and even began to decline. However, compliance did not improve (in fact, it deteriorated), and coverage declined. This is critical, since a pension system that fails to cover a large proportion of the population (who, being informally employed or unemployed, are the ones that most need the protection) is failing as a policy, and its existence becomes questionable.

A new, more stable pension system should be adopted in Argentina. This system should maintain the current multipillar approach but should differentiate the roles of each pillar more clearly and make them more efficient. This would produce a system that, while keeping the fiscal and social costs under control, would satisfy two principles: providing minimum income security to
all retirees and providing income replacement (with some proportionality to pre-retirement income) to the largest possible proportion of the population.

The first pillar, designed to provide minimum income security, should be non-contributive with universal access based on age. Thus, each worker aged 65 or older would receive a flat benefit of an amount close to 25 percent of his or her average wage. This benefit would provide enough resources to guarantee that all older individuals have an income above the poverty line.

Two arguments have been made against offering a universal benefit with these characteristics. First, some question whether it is reasonable to spend resources to pay a flat benefit to individuals with high incomes. Those who take this view believe that a means-tested benefit would be easier to finance. While this argument is logical, there are several reasons why universal coverage is preferable. On the one hand, most older individuals have little or no income of their own so that the number who would be excluded because they are “rich” is very small. This is not necessarily the case when we look at the distribution of wealth as opposed to income, but in practice measuring wealth is complicated, and older individuals cannot always convert their wealth stock into cash flow. Another reason to keep the benefit universal is its operational simplicity, since the only eligibility factor that would need to be verified before authorizing payment would be the person’s age. Also, there is an important political consideration. Being universal, the program would be more likely to attract widespread political support than a program aimed only at poor individuals. Finally, if necessary, whatever funds are paid to rich individuals can be recovered through a well-designed income tax program.

The second argument against the universal benefit is fiscal. The question of whether the government would have the capacity to pay these benefits (and how it would obtain those funds) is important. An estimation of the number of beneficiaries and the potential cost of a flat benefit as of 2002 is presented in Table 4. If a monthly benefit of $200 is paid to every citizen aged 65 and older, the total cost would be slightly less than 8.9 billion pesos, equivalent to 3.3 percent of GDP or 59 percent of current pension expenditure. Of course, it would not be legally or politically possible to replace the old system immediately, but it is important to point out that the total cost of this kind of system would be less than the cost of the current system. A very aggressive [in what sense?] policy that granted this benefit to every individual older than 65 who currently receives [check] no benefits would cost 2.9 billion pesos, or 1.1 percent of GDP.
### Table 4: Beneficiaries and Cost of a Universal Flat Benefit, 2002-2025

#### Data as of 2002

<table>
<thead>
<tr>
<th>Age Interval</th>
<th>Population</th>
<th>Population without Pension</th>
<th>Cost of a flat benefit of $200</th>
<th>Universal</th>
<th>For those without pension</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>#</td>
<td>million</td>
<td>% of current pensions</td>
<td>% of GDP</td>
</tr>
<tr>
<td>65 and older</td>
<td>3,707,959</td>
<td>32.8%</td>
<td>1,217,568</td>
<td>8.899</td>
<td>59.3%</td>
</tr>
<tr>
<td>70 and older</td>
<td>2,500,876</td>
<td>24.7%</td>
<td>618,305</td>
<td>6.002</td>
<td>40.0%</td>
</tr>
<tr>
<td>75 and older</td>
<td>1,464,886</td>
<td>17.4%</td>
<td>255,396</td>
<td>3.516</td>
<td>23.4%</td>
</tr>
</tbody>
</table>

#### Data as of 2025

<table>
<thead>
<tr>
<th>Age Interval</th>
<th>Population</th>
<th>Population without Pension</th>
<th>Cost of a flat benefit of $200 (in $ of 2002)</th>
<th>Universal</th>
<th>For those without pension</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>#</td>
<td>million</td>
<td>% of current pensions</td>
<td>% of GDP</td>
</tr>
<tr>
<td>65 and older</td>
<td>5,797,068</td>
<td>56.2%</td>
<td>3,257,952</td>
<td>13.913</td>
<td>92.8%</td>
</tr>
<tr>
<td>70 and older</td>
<td>3,994,013</td>
<td>42.9%</td>
<td>1,690,045</td>
<td>9.586</td>
<td>63.9%</td>
</tr>
<tr>
<td>75 and older</td>
<td>2,463,720</td>
<td>29.8%</td>
<td>735,168</td>
<td>5.913</td>
<td>39.4%</td>
</tr>
</tbody>
</table>

Sources: Own, Based on INDEC (2001) and CELADE (2002)

Another reason why it would not be practical to replace the current public pension system by this universal scheme immediately is because it would imply reductions in the benefits of many current retirees. Similarly, it would be very difficult to apply a new universal benefit to all future retirees, since many of those who are now very close to retirement age are expecting to receive a higher pension and have no chance to build up their savings to supplement their reduced benefit. Thus, this scheme should implemented over a relatively long period, balancing the need to expand coverage with fiscal restrictions. A transition program that starts covering those aged 75 and older would cost slightly more than 600 million Argentine pesos, or 0.2 percent of GDP. A controlled expansion to reach those aged 65 in a reasonable period of time is possible. As shown in the second panel of Table 4, by the year 2025 the flat benefit would cost 2.6 percent of GDP (assuming an annual growth of GDP of 3 percent) although, since almost 44 percent of those older than 65 will still receive pension benefits from the current scheme, the actual incremental cost would be only 1.4 percent of GDP.

While the first pillar would provide basic income security for the elderly, a second pillar that would offer income replacement at a reasonable rate will also be necessary to help the middle-income elderly to limit the decline in their consumption after their retirement. This pillar should be strictly contributive, reducing cross-subsidies as much as possible. Since 1994 Argentina has had a system that is supposed to operate like that, but a number of problems have significantly reduce its efficiency.
Participation in this second pillar would be compulsory for workers who earn above a minimum level. This minimum should be linked to the benefit from the first pillar. Thus, participation should be compulsory for all workers earning above 50 percent of the mean wage. Contributions should be 10 percent (plus 1 percent for disability and survivor benefits) of excess income so that, after deducting administration fees and projecting returns, they should produce a benefit close to 40 percent of the worker’s last salary. Thus, the combination of both pillars should generate a replacement rate that starts very high and declines with income to a minimum of 40 percent.

**Figure 6: Replacement Rate for Different Income Levels under the Proposed Pension Scheme**

![Replacement Rate Graph](image)

Source: Own.

In order to make the second pillar more efficient, a number of changes in its regulations should be introduced. The main goals of these changes are to increase competitiveness, reduce costs, and increase security in investments. To satisfy these goals, several measures should be taken, including:

1. Modifying the personal contribution rate from the current 5 percent to 10 percent plus 1 percent for disability and survivor benefits

2. Promoting market transparency and simplifying the fee structure
3. Developing an active approach to fight cartelization of the pension fund management industry, especially with regard to marketing strategies

4. Reducing the possibility of cross-subsidies among related companies, especially in commercial expenditures

5. Replacing the current disability and survivor insurance scheme with a single-provider model that can be run by the government or a private organization selected through an open bidding process

6. Setting strict limits on the investment strategies of pension fund managing companies and requiring wide diversification of risks

7. Most importantly, reinforcing the independence of the pension funds’ regulator, both from political interference and from industry influence.

The ideas developed in this section refer to the pension system in the long term. Of course, it is also critical to define the transition to that model from the current situation. As mentioned before, implementing the proposed model immediately would be impossible for fiscal, legal, and political reasons. The rights of individuals who have already retired cannot be affected, nor should the expectations of those close to retirement be disappointed. However, there is scope for initiating a transition period during which the current tool (the compensatory benefit) can be maintained and an indexation rule defined to reduce the ability of government officials to alter the benefit levels.

VI: Conclusions

The pension system in Argentina is now almost 100 years old. During the 20th century, the system went through many different stages, with recurrent crises and periods of expansion. Over the last 20 years, the financial problems created by the maturation of the scheme, the aging of the population, and fiscal restrictions created a momentum among policymakers for introducing significant changes in the design of the system. In 1994 a new model was introduced, which reduced benefits and coverage and involved private managers in a funded scheme. This new model was successful in limiting the increase in pension expenditures, but, in the context of a weakening labor market, it excluded a growing proportion of the population.

The serious economic crisis that began in 2001 and its fiscal and financial effects intensified the problems that the pension system already had. With low compliance and coverage, declining
nominal and real pension values, and high costs and a concentration of risks in the second pillar, the system is in serious need of another in-depth review.

Having a pension system based exclusively on a contributive scheme in a society whose labor market is mostly informal and financing it from general revenue is not a reasonable social policy, since it is probably regressive and very inefficient. A contributive scheme is not consistent with the goal of providing basic protection to all elderly individuals. Instead, a basic flat benefit for everyone older than a certain age would protect recipients against poverty, and the fiscal cost of the program could be controlled. A second pillar that is strictly contributive and acts as income replacement for formal workers should be maintained to provide income support to middle-class workers, and a funded scheme is the soundest model for achieving this. Maintaining the current system in which competing private managers administer funds is reasonable as long as the current market rules and supervision principles and practices are reviewed and improved.

Alternatively, the current system could be preserved, but this model will continue to exclude workers from the social security system and to provide coverage only to a small proportion of the population in a very expensive way.
References

Arenas de Mesa, Alberto and Hector Hernandez Sanchez (2001) “Cobertura del sistema de pensiones de capitalización individual chileno: Diagnóstico y propuestas”. In Sociales, number 4, Rosario, Argentina


