Economic Notes

Pension Reform in Latin America
Current and Future Challenges and the Role of the World Bank

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LATIN AMERICA AND THE CARIBBEAN

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The World Bank

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References
PENSION REFORM IN LATIN AMERICA

Current and Future Challenges and the Role of the World Bank

Introduction

1. The purpose of this paper is to examine the current stage of pension reform in Latin America, the challenges the reform effort faces, and will face in the future, and the role of the World Bank in helping the countries of the Region to overcome those challenges.

2. Following the early example of Chile, which introduced a mandatory, fully funded, second tier of individual retirement accounts in 1981, a number of Latin American countries are initiating a process of pension reform. As of March 1996, these countries may be divided into five groups:

   - Chile, where the reform process dates from 1981 and where a certain track record has been established.

   - "Second generation" reformers where the program has been approved by the legislature and is underway: Argentina, Colombia, Peru and Uruguay.

   - Those where a decision to reform has been taken at the executive level and where the enabling legislation is under consideration by the legislature—Mexico and Bolivia are the leading examples.

   - Those where reform is being or has been seriously considered, but where no firm decision to proceed has yet been taken. This group includes Brazil, El Salvador, Costa Rica, Honduras, Nicaragua and Ecuador.

   - Those where reform is barely emerging onto the political agenda—Guatemala, Panamá and Paraguay.

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1 A version of this paper was presented at a conference on "Seguridad Social en el Siglo XXI" at the Universidad Nacional Autónoma de México in March, 1996. I am grateful to the following colleagues who were very generous with their time, written work, and comments on earlier versions of this paper. They do not, of course, bear any responsibility for remaining shortcomings: Estelle James, Dimitri Vittas, Cheikh Kane, Monika Queisser, Tom Glaessner, Paul Meo, Gloria Grandolini, Edgardo Favaro, German von Gersdorff, and Jorge Garcia-Mujica.

2 Uruguay's inclusion in this group reflects the fact that legislation creating fully funded individual pension reform has been approved, although the reform is considered to be relatively minor, especially given the extent of the challenges facing the pre-reform system.
3. It can be seen, therefore, that there is a veritable wave of reform in the Region. Nevertheless, except in the case of Chile, the pension reform is fragile and there are doubts about its longer term sustainability, especially in political terms. Even in the second group of countries, a major scandal involving pension fund managers, or two or three consecutive years of low rates of return on pension fund investments could easily lead to the reforms being reversed or to actions being taken which would threaten their long term viability. In all countries, there are concerns about how democracy will bear upon the feasibility and depth of reform—it is notable that the most deeply rooted reform effort was initiated in Chile under a military dictatorship. Now, if pension reform is to flourish in Latin America, it must do so in democracies. This poses significant challenges of both a strategic and tactical nature, not only for the countries themselves, but also for those outside agencies which would support them.

4. This paper briefly examines the main reasons for the reforms, the characteristics of the reform effort, and the benefits which can already be perceived. It then discusses some important issues and challenges which must be met if the reform process is to be carried forward. It concludes with a discussion of the World Bank's involvement, and the lessons that can be learnt from the joint experience to date with our borrowers.

Reasons for Reform

5. The reasons for reform can be summarized as follows:

- The critical financial state of many public, pay-as-you-go (PAYG) schemes. Many regimes already depend on heavy subsidies by the state since contributions are insufficient to finance current outlays on pensions. In other cases, pension surpluses are consumed through cross subsidization of other social security provisions, notably health care. In still others, any accumulation permitted by the age structure of the population has been invested in low yielding assets.\(^3\) Most such schemes are in actuarial if not in cash deficit, creating a very large hidden (implicit) public debt. Moreover, in some countries, such as Argentina, Uruguay and Chile, declining system dependency ratios, resulting from an aging population, higher unemployment, and greater informlalization of the labor force, added to the pressure.

- Unreformed PAYG pension schemes are, despite frequent claims to the contrary, highly inequitable:
  - reliance on public subsidies means that benefits are financed out of general taxation; since most Latin American countries rely heavily on

\(^3\) Especially government paper with low rates of interest, or on which the government has not met its obligations. Public pension funds are frequently also required to invest in housing schemes where the return tends to be very low for a variety of reasons.
indirect taxation, this means that the poor contribute disproportionately to the funding of benefits to which they probably have no access;

- benefits are spread unevenly among different political and economic sectors—powerful pressure groups, such as the military, senior bureaucrats, and those represented by strong unions, succeed in negotiating for themselves generous eligibility conditions and benefits; and

- unintended inter-generational transfers take place since defined benefit schemes often have high replacement ratios related to the last pre-retirement salary.

- Defined benefit schemes are subject to arbitrary adjustments made for political reasons.

- PAYG regimes in Latin America have traditionally been subject to high evasion rates.\footnote{A not uncommon phenomenon in some Latin American countries was to evade social security payments by not declaring income for most of the working life. Then, as retirement neared, pensionable income was inflated. Benefits were frequently related to the most favorable pre-retirement salary (see Queisser, 1995).} This problem has been accentuated by the need to raise contributions in an attempt to finance higher benefits and, later, by the consequences of economic adjustment.

- The frequently arbitrary nature of adjustment to benefits meant that pensions were frequently not properly indexed; as a consequence, high inflation including initial surges in the consumer price index during early phases of adjustment) wiped out their real values. This led quickly to the realization that people would only receive, at best, the minimum pension upon retirement.\footnote{In Argentina, for example, the replacement ratio under the pre-reform regime was meant to be 80%; in practice, it was just over 30%.}

- Distortions to the labor market arise from the high tax component in pension contributions, the increased cost of labor, and the sectoral specificity (lack of portability) of many public schemes.

- Countries see pension reform as means of raising the level of domestic savings, a central macroeconomic goal in Latin America. While there is considerable controversy about the impact of pension reform on national savings,\footnote{A careful analysis of the Chilean case tentatively concludes that increased savings equivalent to about 3% of GDP may be directly attributed to pension reform (see Schmidt-Hebbel, 1994). However, other economists disagree.} it would seem clear, first, that countries should not worry that pension reform would reduce savings (as Martin Feldstein once suggested they might) and, second,
that pension reform does lead to a more efficient allocation of whatever stock of savings is available.

Characterization of Reform Efforts

6. Although there are important differences between the reform efforts of the Latin American countries, they also have several features in common, among them:

- a change in the role of the state in the provision of old age security from financing to regulation;

- an increase in the role of the private sector both in the management of pension funds and in the provision of insurance;

- complete separation of pensions from other forms of social insurance, especially health;

- rationalization and unification of existing schemes;

- more realistic and sustainable benefit levels;

- less generous eligibility conditions; and

- a shift to a multi-pillar system, involving some combination of: (i) a first tier consisting of a guaranteed minimum pension financed either from general taxation or from payroll contributions; (ii) a second tier fully funded mandatory scheme involving individual accounts managed by specialized pension fund managers; and (iii) a voluntary third tier made up of either additional voluntary contributions to the second tier accounts, separate voluntary individual retirement accounts, or both.

Benefits of the Reform

7. With the exception of the Chilean case, pension reform in Latin America is too recent to evaluate. Indeed, even the Chilean program is being constantly refined and some of its consequences are still to be made apparent. In particular, the effects on old age security (the core objective) are still to be determined for the great majority of affiliates.\(^7\) It is also the case that the Chilean reform is the most “complete” and that some benefits

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\(^7\) Although the indications are very encouraging: the pension funds have enjoyed a high real rate of return (14% annual average between 1981 and 1994). It is also the case that the pre-reform PAYG system has failed to provide for adequate old age security in Chile and in the majority of other Latin American countries. Even on the assumption of an average annual real return of 5%, it was calculated that Chile’s privatized pensions would pay 70% higher benefits than under the pre-reform system, while contributions are 40% lower.
may not accrue, at least to the same extent, to other countries whose reform efforts depart significantly from the Chilean "model."

8. With these reservations in mind, and with reference principally to Chile, it is possible to identify the following actual or potential benefits of pension reform:

- **Reduced labor market distortions**: a lower "employment tax" component which (i) reduces the cost of labor relative to capital thus helping to induce higher levels of employment, (ii) frequently leads to higher net, though lower gross, wages, and (iii) encourages a higher proportion of employment to take place in formal rather than informal markets.

- **A much closer relationship between benefits and contributions** thanks to the individualization of accounts and the removal of distortions and incentives to abuse the system.

- **Widening and deepening of capital markets**: here the effect has been very dramatic. In Chile by 1994, accumulated pension funds accounted for over $22 billion or 43% of GDP. This has stimulated: (a) the deepening and broadening of the stock exchange and other financial and capital markets; (b) the improved regulation and supervision of financial intermediaries and markets; (c) encouragement of ancillary financial services and self-regulatory associations; (d) better information about companies (through disclosure rules); (e) modernization of commercial laws (including bankruptcy) to decrease investor uncertainty about companies; (f) a modern legal/regulatory framework for new instruments such as asset-backed securities and exchange traded derivatives; (g) a legal/regulatory framework to permit a broad range of movable property to secure loans and instruments; (h) the development of primary and secondary markets for securities of medium-sized companies; and (i) last, but not least, the development of credit rating agencies. Moreover, due to the competition between Pension Fund Administrators (AFPs) combined with strict but flexible regulation, institutional savings are much more efficiently allocated than would otherwise have been the case.

- **Growth of the fund management industry**: what was once a very scarce skill has received an important stimulus from the pension reform. In Chile, there are 21 AFPs which, as well as managing and investing their affiliates' portfolios, provide them with information and advice through their office networks. Foreign investment is permitted in AFPs (the two largest have substantial equity from Bankers' Trust and Aetna in the US), and this has enabled them to become an important source of technical expertise and economies of scale. A related benefit is the economy-wide improvement in corporate governance through the presence of AFP representatives on the boards of directors of some of the companies they invest in.
- **Infrastructure investment**: pension funds have permitted significantly greater investments in infrastructure projects than would otherwise have been the case through their purchase of bonds issued by the relevant public agencies.

- **Effects on insurance industry**: in Chile, the life insurance market has burgeoned. This has led to lower costs fostered by competition\(^8\)—disability and life insurance premia for pension fund affiliates have fallen from 1.2% to 0.8% of taxable income between 1991 and 1994.

## Current and Future Challenges

9. Pension reform is a continuous process which is never concluded. Even in Chile, which has the oldest and most complete pension reform in the Region, the system is subject to constant modification and adjustment. Despite this, a number of serious problems remain to be resolved. The programs in the so-called “second generation” countries, which followed Chile, demonstrate more major weaknesses; as a result, the reforms there remain fragile and more susceptible to reversal. This section discusses some of the main outstanding issues under three headings: challenges facing all reforming countries; problems of particular importance to the “second generation” reformers; and some emerging issues with regard to sub-national pension schemes and pension reform in small countries.

### Challenges Facing All Countries

10. These include equity and coverage, insurance industry issues, portfolio regulation, and the trade-off between competition and administrative cost.

#### Equity and Coverage

11. As already indicated, many pre-reform PAYG schemes in Latin America have not catered for the poor, and have failed to comply with their promises of equity and solidarity. It is, moreover, likely that, in the post-reform era, governments will be better placed, through concentration of their scarce resources, to meet the basic old age security needs of the poor through the “first pillar” minimum pension.

12. However, there are some worrying signs in Chile (which is the only country with a long enough track record to sustain even a preliminary judgment) that low income groups are being increasingly neglected by the reformed system. First, the percentage of total affiliates who are not contributing rose from 24% in 1983 to 43% in 1994. Although some increase in non-contributing members may be expected due to factors such as retirement and job mobility, this cannot explain the significant and steady rise which has taken place. Moreover, the share of non-contributing affiliates is greater among the lower

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\(^8\) This is a significant factor in Latin America where pre-reform insurance markets are frequently characterized by underdevelopment, a repressive and restrictive regulatory framework, domination by one or two companies (sometimes state owned), and restricted access for foreign operators.
income groups—AFPs catering for the higher income affiliates have much better contribution rates (Queisser 1995). Second, the new system has failed to increase coverage significantly, especially among the self-employed. Self-employed enrollment is voluntary, and only about 10% of this category of workers are currently affiliated. Of these, about 40% (i.e., 4% of the total) are contributing. If these trends continue, it is likely that many of the self-employed will not have an adequate retirement pension and that a significant number will not have made the twenty years’ contributions required to qualify for the minimum pension. The increasing share of non-contributors, particularly among the self-employed, and among the lower income groups, is thus jeopardizing the system’s ability to provide old age security.

13. A policy to increase coverage needs careful design. Incentives to the self-employed to affiliate and to maintain contributions should vary by income level—a general contribution will increase distortions and be fiscally wasteful. Colombia’s new pension system has an interesting feature in that all affiliates earning more than four times the minimum wage contribute an extra 1% “solidarity tax” which is matched by budget transfers and used to subsidize the contributions of targeted poor groups. This contrasts with Mexico where the Government contributes a “social quota” of N$1 per day which goes into the accounts of all affiliates irrespective of income. In addition, policies to increase coverage must recognize that both recruiting and servicing the lower income self-employed is significantly more costly for pension fund managers. These higher costs may need to be at least partially compensated for.

**Insurance Industry Problems**

14. There are three main issues here: lack of transparency and clarity concerning options open to affiliates; the cost of annuities; and investment risk. Even in rich societies, the life insurance industry is often criticized for lack of transparency, in developing countries, the situation is worse. In Chile, for instance, nearly half of all pensioners opt for a “scheduled retirement pension” rather than annuities because they have insufficient information concerning the latter or because their cost is too high. Unfortunately, the

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9 Overall coverage, including both the new and old systems together, averaged 60% of the work force between 1989 and 1993, compared with 49% under the pre-reform system between 1976 and 1980. However, coverage has basically stagnated since the mid 1980s. The self-employed account for a significant proportion of the existing work force (nearly 1.5 million or 27% of the total in 1994).

10 Which frequently coincide with each other—high income self-employed can avail themselves of several “third pillar” voluntary substitutes for the mandatory scheme.

11 There was, for example, a major scandal in the United Kingdom in the late 1980s when several hundred thousand people were sold personal pension plans which delivered benefits well below what was promised. The Government had to intervene with substantial financial assistance which nonetheless failed to fully compensate many of the victims.

12 Affiliates at retirement must choose between three options: (i) scheduled retirement under which affiliates keep their accounts with their AFPs and withdraw annual installments calculated by dividing the amount accrued in the account by the “necessary capital.” Necessary capital is defined actuarially
‘scheduled retirement’ option provides no protection against either the risk of longevity or the investment risk.

15. Life annuities, which are chosen by about 40% of Chilean pensioners, do offer protection against longevity, but are problematic in terms of both their price and the way in which they are marketed. The annuities are expensive—insurance companies charge nearly 4% on average of the present value of the annuity stream reflecting the fact that they are purchased by individual pensioners rather than on a group basis. In addition, annuities are marketed mainly through brokers. There is lack of adequate information on both sides—the brokers have little access to data concerning potential pensioners, while most of the latter possess little understanding of the commodity they are purchasing. Furthermore, pensioners are currently at risk from a low market value of accumulated assets at the point of retirement since under Chilean law annuity contracts cannot be revised or reversed. This could mean that some pensioners will receive a low annuity for the rest of their lives.

16. Some changes are being considered which should improve this situation. First, pensioners would be allowed to purchase variable annuities whereby pensions are stated in terms of annuity units, the number of which are set upon payment of the single premium. While the number of units would remain the same for the rest of the pensioner’s life, their value would vary to the extent that the rate of return or expected mortality do not conform to expected values. Implementation of this proposal will be far from easy since it calls for the existence of specialized institutions capable of managing the funds of those pensioners who choose this option. The institutions would also need to be carefully supervised and regulated as are the AFPs. Second, consideration could be given to group rather than individual contracts to bring down the transaction costs and hence the price of marketing annuities. Third, information could be improved by allowing insurance companies some limited access to AFP records, and requiring those companies to offer standard form contracts on which prices and other features could be more readily compared. Again, this would require extension and beefing up of the regulatory and supervisory apparatus for the life insurance industry.

**Portfolio Regulation**

17. There are two main issues here—limitations on the type of instruments in which funds may invest and rate of return regulation. With regard to the first, there are a variety of policies extant in Latin America, depending on each country’s circumstances and the

using the family group’s life expectations and the discount rate applied by the AFPs. Affiliates assume both survival and investment risks. They have the choice to switch to a life annuity alternative at any time; (ii) a life annuity contracted with a life insurance company of the affiliate’s choice, with the insurance company assuming both financial and survival risk; and (iii) temporary income with deferred life annuity—the pensioner contracts to receive an indexed monthly income from a life insurance company starting from a specified date after retirement. Between retirement and that date, the pensioner receives a pension by drawing down on funds left in his/her AFP account for that purpose. All survival risk is assumed by the insurance company, and the pensioner assumes financial risk only for those funds left in the AFP account and only until the annuity kicks in.
prior experience of others. Chile’s approach, as a pioneer in the field, has been
categorized by very tight regulation and a gradual relaxation in the range of permitted
instruments.  
Colombia and Argentina have, from the beginning, been more liberal in
their policies. Mexico’s Congress specifically introduced a prohibition on foreign
investment, a particularly unfortunate restriction in the light of the paucity of sound and
high earning domestic instruments.

18. Rate of return regulation is designed to help ensure old age security by stipulating
a minimum yield on pension fund investments. While there are sound reasons for such a
policy, the mechanism used to implement it raises a number of questions. In Chile, which
has been substantially imitated in this respect by later reformers, the minimum yield is
based on the average yield of all AFPs in the system. This has a number of drawbacks:

- it gives no real assurance regarding old age security since the system’s average
  yield is not guaranteed;

- the cost of the state guarantee of a minimum pension is open-ended since the
  average system yield may slump below levels required to provide the said
  minimum;

- it puts a premium on homogeneity—penalties are incurred not for losing
  money but for being different from everyone else, while any earnings above the
  average must be placed in a reserve fund to be drawn upon to compensate for
  the results of poor performance; and

- the emphasis on homogeneity also impedes product differentiation to suit, for
  example, the different risk acceptance profiles of different groups of affiliates.

19. There is clearly an overriding need to safeguard social security savings. With this
in mind, reform options should be founded on greater product differentiation and hence on
competition based more on track records regarding yields. Substantial further work is
required in this area.

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13 Initially, all investment had to be in state securities, mortgage bonds, bank liabilities and corporate
bonds. In 1985, funds were permitted to invest up to 30% of their value in equities of privatized state
enterprises; in 1986 in corporate equity (provided ownership was sufficiently dispersed); and in 1989 in
real estate companies. In 1990, investment in foreign securities was permitted at a very low initial
level, gradually increasing. Investments in venture capital and infrastructure funds were permitted in
1993, and in 1995 the limit on foreign securities was raised to 9% (up to 4.5% in foreign equities).
Actual holdings of foreign securities are, however, yet to rise above 1% of assets which partly explains
the disappointing results in 1995 when Chile’s pension funds failed to earn a real return on capital for
the first time. In order to encourage more foreign investment within the limits, the AFPs were
permitted to hedge in 1995.
Administrative Cost

20. Considerable concern has been raised about the high administrative costs of fully funded, privately managed pension schemes, and Chile is often cited as an example. Much of this concern is misplaced. First, through 1994, Chile’s AFPs earned a *net* (i.e., after costs) average real return on assets of over 10%, which would make many private fund managers in OECD countries envious let alone those of public PAYG schemes. Second, it is a myth that privately managed pension schemes are substantially more costly than public ones. A recent World Bank report (Reid, 1995) compared Chile’s costs with those of other (public) systems in the Region and found that they were not out of line, and were in fact substantially lower than some (including Chile’s own pre-reform costs and those of the public social security agency in Argentina). Third, when comparing costs it is also necessary to measure service quality. For instance, Reid (1995) identified remarkably low costs in Costa Rica’s social security administration, but also pointed out that the quality of service delivery was correspondingly low.

21. These are not, however, arguments for being complacent about costs. In Chile, average AFP and insurance company costs fell from 40.3% of total contributions (5.1% of average income) in 1982 to 24.4% (3.15% of income) in 1990 (Bustamante, 1995). This was to be expected given initially high start up costs, later economies of scale, higher affiliate incomes (and hence contributions) and so forth. The concern is that, since 1990, costs have remained constant in relation to income and revenues despite the fact that the latter have risen by over 40%. This reflects sharply increased advertising and other promotional expenditures as a growing number of AFPs competed for affiliates following liberalization of the transfer rules in March, 1988. These expenditures per affiliate rose from Ch$2,723 in 1987 to Ch$9,325 in 1994; over the same period, the number of sales persons employed by the AFPs rose by 443% and the share of promotional expenses in total costs from 23% to 37% (Bustamante 1995).

22. A number of measures are under consideration to reduce these costs, including limiting the number of times a given affiliate can transfer in the course of a working lifetime and the frequency of such transfers (from the current once every four months to once a year), as well as offering loyalty premium discounts. Clearly a balance needs to be struck between such measures and maintaining a competitive environment.

Challenges Facing Recent Reformers

23. These challenges stem precisely from significant differences between Chile’s pension reform and later efforts. Chile initiated its reform under a military dictatorship. Although it is not the case that democracy is incompatible with sustainable pension reform, democracy means that change will likely take longer. A “complete” reform effort may require several bites of the cherry. Not only have the second generation countries

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14 After that date, affiliates no longer had to present themselves personally in the offices of their AFP in order to file for a transfer to another AFP. In response to this, the number of transfers more than tripled from about 307,000 in 1988 to over 970,000 in 1994.
been unable, in the first stage of their reforms, to go as far as Chile, but in each case the original proposal by the Executive has been diluted by the Legislature. The resulting schemes differ from Chile in four important respects.

24. **First**, in Colombia, Argentina, and Perú, the public PAYG scheme is being allowed to coexist with the private fully-funded one. None of these three countries made affiliation in the new system mandatory either for new entrants or for existing entrants below a certain age. In Colombia, affiliates are allowed to switch every three years between the public and private schemes, an option also available initially (though no longer) in Perú. The potentially negative impact of this may be felt in three ways: (i) if the public scheme offers a defined benefit, as in Colombia, then this sets a benchmark for the performance of the privately managed funds which may reduce their incentive to perform better; (ii) transaction and administrative costs rise sharply if affiliates choose to exercise their switching option; and (iii) the choice may lead to a concentration of the poor and the old in the public scheme.

25. The only solution to this problem is to enact legislation eliminating, or at least severely reducing, this choice. Options include prohibiting switching all together (a mandatory, one time choice), limiting the number of switches that can take place during a lifetime and their frequency, and imposing a tax on affiliates who exercise their right to switch.

26. The **second** issue, which is closely related to the first, is that of incentives for existing workers to transfer to the new scheme, and some recent reform efforts are facing difficulties in this respect. In Chile, a net increase in take home pay induced many to make a once-and-for-all switch. In Perú, while a one-time 13.5% gross salary increase was given to transferees, new system contribution rates amount to 15% which is borne entirely by the employee; by contrast, in the public system the contribution rate is 9% of which the employee pays only 3%. In Colombia, contribution rates are the same for both public and private systems, and will gradually rise to 13.5%. Mexico has differed significantly from all other reforming countries in not giving existing workers recognition bonds supposedly reflecting their acquired rights under the pre-reform system. Instead, these workers will obtain a guaranteed pension equal to their average last five years’ wages or the minimum wage at retirement, whichever is the greater, and indexed to the minimum wage thereafter. This guarantee is extended to all transition workers, irrespective of age. It could have a negative effect on incentives to make the new system work well (in particular it creates the potential for evasion and moral hazard) and, depending on the behavior of minimum wages, could also significantly raise the fiscal cost of the reform.

27. **Third**, in Colombia, Argentina, Perú, and Mexico, some previous PAYG schemes, especially for public sector workers, have been allowed to remain in existence. In Colombia, various special regimes were left intact. In Perú, an extremely generous PAYG scheme for public sector workers (the so-called "Cédula Viva") continues to operate.

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15 Other than the military’s pension scheme which was left untouched in Chile also.
parallel to the new fully funded plans for some private sector employees. In Mexico, the reform has concentrated exclusively on the private sector workers covered by the Mexican Social Security Institute (IMSS), while the public sector plan, run by a separate institution (ISSSTEE) has not been included. Nearly all these schemes are characterized by underfunding and are already dependent on fiscal subsidies.\(^{16}\) This carries the dangers that the unreformed public sector schemes will lead to a worsening fiscal drain and a consequent temptation for governments to loot the private pension funds.

28. Countries are clearly aware of these dangers and are considering actions to counter them. In Perú, the Government's options include closing the Cédula Viva to all new entrants who would choose between entering the privately managed fully funded scheme or contributing to a publicly managed capitalized plan run on the same lines. Currently active beneficiaries of the Cédula Viva would receive a recognition bond covering their acquired rights. In Mexico, the options for dealing with ISSSTEE's crisis have still to be worked out. In the short term, a near doubling of the contribution rate from 7.25\% to 13.07\% is being considered together with an increase in the retirement age (from 55 to 65) and in the minimum years of contribution (from 30 to 35). However, it is recognized that such palliatives do not attack the root causes of the problem.

29. Fourth, some countries, e.g., Mexico and Uruguay, have permitted a publicly owned pension fund manager to remain in existence to compete with private companies for the management of the individual retirement accounts. Although, in principle, this may appear unobjectionable, it is likely to be highly problematic in practice. Private management maximizes the likelihood that investments will follow economic and financial rather than political dictates. Partly because of their vulnerability to political considerations, the rate of return earned on assets of even the most successful publicly managed pension schemes fall far short of their private equivalents.\(^{17}\) Then, partly as a consequence of this, but also for other reasons, it may be difficult for governments to ensure a level playing field between public and private competitors. They may, for example, be tempted to reduce the investment options of all pension funds in order to enable the publicly owned manager to compete more easily.

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\(^{16}\) In Perú, an estimated 50,000 active and 210,000 retired public sector employees are covered by the Cédula Viva system under which pensions are linked to current salaries. The present value of existing and future pension obligations (in the absence of reform) is estimated at nearly US$11 billion equivalent. In Mexico, ISSSTEE served 285,000 pensioners in 1995, with a ratio of active to inactive workers of 7.6:1. The "break even" point at which contributions cover pensions is 14:1. Currently pensions absorb 48\% of ISSSTEE's budget and within five years will absorb 78\%. ISSSTEE has an obligation to provide a wide variety of other benefits also, including health care, to its members. As in Perú, the replacement rate is 100\% of current salary.

\(^{17}\) During the 1980s, the average real rate of return on investment achieved by eleven publicly managed pension funds ranged from -37.4\% in the case of Perú to 4.8\% by the US Social Security. During the same period, the return achieved by private pension fund managers ranged from 6.7\% to 9.2\% (World Bank, 1994).
30. The main reasons for allowing continued public management are political. As in the case of Mexico, such stipulations are frequently introduced by the legislature as part of the “political price” for approving the wider reform. Once the privately managed funds have demonstrated a good track record, it may be opportune to revisit this question in the congress.

Two Other Emerging Issues

Small Countries

31. Pension reform is now being seriously considered in some of the smaller economies of the Region such as Bolivia and the Central American countries. Some of the features of these smaller economies suggest that modifications may be appropriate to the “standard approach” contained in “Averting the Old Age Crisis” and largely implemented in the Chilean reform (see Glaessner 1996).

32. In particular, these countries may be characterized by relatively greater international labor mobility, scarcer specialized human capital, weak tax administration, a less “autonomous” state, and greater political vulnerability. A tailored approach to reform may require greater reliance on international financial services for the management of the system and greater freedom from the outset to invest pension funds in foreign instruments. The former would be especially important in order to secure economies of scale and scope in such activities as account processing, collection of contributions, and payment of benefits. This would imply greater harmonization of local regulatory and accounting practices with international standards.

33. In such circumstances, there may be a temptation for the government simply to contract out the operation of the whole system to an internationally recognized fund manager, subject to the regulatory regime in the latter’s home country. While this option would indeed have certain advantages, it does present at least three drawbacks. First, it would restrict competition to the selection process rather than the operation of the system. Second, it may undermine the sustainability of the reform, since it would be (or perceived to be) relatively easy for the authorities to reverse the changes upon the cancellation or termination of the contract. Third, it would severely diminish reform externalities in the form of the development of local institutional and regulatory capacity.

34. Combining access to international expertise, while retaining at least some of the advantages of competition, might be secured by a careful unbundling of some of the component parts of the system (e.g., collections, benefits, investments, life insurance services) and contracting them to separate managers. Sustainability and institutional development objectives could be attained by involving local private and regulatory institutions in joint ventures or partnerships with international operators.
Sub-national Systems

35. In some of the larger countries of the Region, notably Argentina and Brazil, the pension systems of the state and provincial governments present major problems of their own.

36. In Argentina, most provincial PAYG pension plans for public sector employees are characterized by severe financial disequilibrium. Pensions are generous—they are 100% of the last year’s salary and indexed to wages. Contributions have been stagnating or declining. For many years, the critical state of the provincial pension schemes was hidden through high rates of inflation. When inflation stopped, the problem became impossible to hide. Unfinanced pension obligations account for as much as one-third of the entire public sector deficit in most provinces.

37. The proposed reform aims to integrate the provincial pension schemes with the already reformed national system. All new entrants will pertain to the national system along the same lines as everyone else (i.e., they will have the choice between entering a fully funded individual account plan or the public PAYG scheme). Existing but yet to retire workers would have their acquired rights under the current system financed through recognition bonds. Existing retirees would have to be grandfathered. This last item is the major cost of the program. Sixteen provinces have opted to participate in the program, and if all of them were to transfer their funds in the first year, the cost would be $1.23 billion. It is likely that it will be spread out over two or three years. The cost will be entirely borne by the federal government; not only are provincial governments unable, due to financial weakness, to participate in any major way, but the reform will have a very heavy political cost for them. Benefits to provincial state employees (including the legislators who have to approve the transfers) will fall dramatically. Federal financing for pension reform would, on the other hand, require participating provincial governments to restructure their public expenditures—inter alia, by reducing their deficit by at least the equivalent of the cost of their pension programs.

38. In Brazil, the situation is more complicated. Like Argentina, many state pension schemes are characterized by generous benefits, with pensions equal to 100% of the last years salary indexed to wages, plus other perks. In addition, contributions are close to zero so that pensions must be financed from general tax revenue. In the typical case of the State of Rio de Janeiro, they absorb nearly a third of total revenues. The problem of perverse redistribution, which arises from linking pensions to the last year of salary, is compounded by the practice of joining the civil service late and ‘negotiating’ abnormally high salary increases in the years prior to retirement. Clearly corruption and favoritism play a major part in the system.

39. Where Brazil differs from Argentina is in the limited reform options available. First, the rights of civil servants to a defined benefit pension equal to 100% of the last salary, along with job tenure, salary regimes and other privileges, are guaranteed under the
Constitution of 1988.\textsuperscript{18} Second, even if constitutional changes were to be made, a drastic cut in benefits—including to existing retirees—is practically the only option available for those states who wish to reform.\textsuperscript{19} Third, the national system is unreformed and characterized by grave weaknesses and distortions in both the public and private sectors. So there is nothing for the states to transfer their burden to. At the time of writing, it is unclear how this complex situation will be resolved. Now that the inflation tax is no longer an option (Brazil's current inflation rate is about 20\% per year), the only practical option in the short run may be the \textit{de facto} failure of the states to pay their pension obligations.

\textbf{The Role of the World Bank}

40. Pension reform is an obvious area for World Bank involvement. It has major macroeconomic and fiscal implications, it involves the largest social programs of our borrowers, it is closely linked with complementary reforms in other areas also of great interest to the Bank, and pension reform is a long term development issue of the first order of importance. The Bank has therefore been widely engaged in the Latin American pension reform effort. In most countries, this engagement has taken the form of informal (often confidential) advice in the early stages of the development of the reform program. On occasion, this has been developed into formal economic and sector work. This up front advisory work, normally involving Bank staff or Bank-financed consultants,\textsuperscript{20} has focused on:

- Help in identifying the problem and its magnitude—the fiscal, macroeconomic, social, and other consequences of continuing the current PAYG scheme.

- Articulating possible policy alternatives to address the issues arising from the diagnosis—a conceptual framework and a broad practical approach can both be found in the Bank's 1994 publication "Averting the Old Age Crisis," though

\textsuperscript{18} Constitutional change requires a three fifths congressional majority and the Government failed, during the week of March 4 1996, to obtain the necessary approval precisely in order to tackle the issue of public sector pensions.

\textsuperscript{19} For example, in the case of Rio de Janeiro, the state is unable to borrow (public debt is already in serious arrears). Proceeds from the sale of assets would be derisory. A fully funded pension scheme for existing non-retired employees would require a contribution rate of 115\%. Even a pension equal to one minimum wage would call for a 16\% contribution rate. Under current retirement conditions fully funding a pension scheme for new entrants to the work force would require a 30\% contribution rate. The situation is similar for most of the southern and southeastern states of Brazil since the demographic profile of public employees is similar to that in Rio. In states with less mature populations, such as those in the northeast, reform would be less expensive, but they too are unable to move without constitutional change.

\textsuperscript{20} In this context, it is worth noting that the Bank is the only international agency operating in Latin America which has a specialized, central unit of experts with world-wide experience in social security reform.
clearly the policy prescriptions need to be tailored carefully to each country’s individual circumstances.

- Assessment of the fiscal and other transition costs associated with the reform, and formulation of recommendations for financing them.

- Access to technology, and alternative models to those used by the authorities for actuarial and macroeconomic projections and simulations.

- Complementing the efforts of other international agencies operating in the area—for example, the Bank’s approach provides a useful conceptual alternative to the advice given by the International Labor Organization, which used to enjoy close to a monopoly in this field in Latin America. The Bank also finds itself collaborating with the IDB in a number of countries. Social security reform is an exception to the generally valid rule that international agencies should avoid overlapping and duplication of effort, especially with respect to analytical work. It is important for a government to have access to as wide a range of policy options as possible, and the Bank’s world wide dimension often signifies additional value added even in carrying out work already covered by others.

- Helping to mobilize opinion in favor of reform through dissemination of Bank publications, seminars, study tours and the like.\textsuperscript{21}

- Supporting complementary reforms—social security reform cannot be expected to work alone; moreover, it will create conditions in other sectors which make reform there necessary as well. First, pension reform where the banking sector is weak is a highly risky and inadvisable enterprise. Pension funds will become important holders of commercial bank liabilities. Moreover, banks are likely to be closely associated, directly or indirectly, with the insurance industry and with the companies managing pension funds (even if, as in Chile, AFPs are legally forbidden from carrying out any other business). Second, reforms will be required in the legal and regulatory frameworks for the insurance industry and capital market development. Third, a part of pension contributions in Latin America is often placed in specialized housing funds frequently characterized by subsidized mortgages, weak credit and commercial management, and, hence, a low or negative return on assets. Restructuring of these funds is usually a \textit{sine qua non} in order to provide the real growth to finance adequate pensions. Finally, many pre-reform social security schemes in Latin America provide health benefits as well as pensions. If, because of demographic structure, pension contributions exceed outlays,

\textsuperscript{21} In the case of one country where the government’s consideration of reform was encountering serious political opposition, knowledge of the Bank’s work and approach by business groups and others favoring reform helped bolster the government’s case.
then the surplus is used to subsidize health expenditures rather than invested. A pension reform results in this source of income being cut off and thus triggers the need for profound health sector reforms as well.

41. In a minority of cases, this initial advisory involvement of the Bank leads to the development of lending operations in support of the pension reforms, either in the form of technical assistance or adjustment lending. Lending for technical assistance has taken place in only three countries. There are sound reasons for this. In general, non-IDA countries are reluctant to borrow for technical assistance they can frequently obtain on a grant basis from elsewhere. Moreover, for pension reform, expertise is readily available from the Region itself, notably from Chile, a world pioneer in this area. Chile has been not only an important source of technical advice for the rest of Latin America, but also an investor in pension fund management companies in a variety of countries.

42. *A priori,* it might be thought that pension reform would be a classic case for Bank adjustment lending—significant initial fiscal, technical and political costs in return for substantial medium and long term benefits. Yet in only four Latin American countries has the Bank made, or is preparing to make, adjustment loans supporting such reforms. Moreover, in only one case is the loan exclusively supporting national pension reform rather than as a component of a wider adjustment program. There are a number of possible reasons for this. First, the highly political nature of pension reform may make it difficult for a government to openly acknowledge Bank support. It is frequently necessary for the Bank to adopt a very low profile and provide advice on a confidential basis. Second, pension reform requires changes in institutions and capabilities which may take time to accomplish and which may provide a poor fit with a traditional adjustment operation.  

43. What are some of the lessons which may be learnt from the Bank’s involvement in Latin American pension reform? First and foremost, unlike the initiation of Chile’s effort, pension reform now takes place in a democratic context. This has a number of implications:

- Political sensitivity is at a premium.
- This means the Bank should adopt a very low profile—sometimes the best contribution we can make is informal, up-front advice. One of the most beneficial services which the Bank can offer its borrowers in this area is a clear articulation of alternatives to the present system and technical and financial support in carrying out the complementary changes which will be necessary to make pension reform succeed.
- The best may be the enemy of the good—in a democracy it may be impossible to complete the “ideal” reform with all components all at once. In particular it may well be politically necessary to retain a public PAYG system parallel to the

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22 Single tranche adjustment operations, which are a new instrument for the Latin American Region, may provide the Bank with greater flexibility in supporting policy reforms, in areas such as social security, over the longer haul.
fully-funded, privately managed one, keeping alive the possibility of deepening the reform over time.

- This means that the demonstration effect is very important—if people can be seen to be benefiting from the new system, others will be motivated to join.
- This in turn places great weight on incentives—workers must be motivated, not only to join the new system but to make it work well.
- The fact that reform takes longer means that the Bank must be prepared to be in for the long haul. This will involve tailoring the lending and technical assistance instruments accordingly.
- Given the very close connection between pension reform and the political and economic circumstances of the country, it is essential that technical expertise be accompanied by in-depth country knowledge.
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