Privatizing Social Security in Latin America

Indermit Gill
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Based on

Keeping the Promise of Social Security in Latin America
By Indermit S. Gill, Truman Packard and Juan Yermo, with Todd Pugatch

Note: The views expressed here are those of Indermit Gill and should not be attributed to the World Bank.
Three propositions

- Reforms often driven by short term concerns, not to address long-term structural changes
  - Not without longer term benefits: individualization
  - But this feature has not been the headline item
- Reforms often driven by loss of faith in government, not reflection on its proper role
  - Instrument for reducing reliance on govt.: privatization
  - But dependence on government remains heavy
- Reforms often driven by narrow interests, not by broad consensus on social security
  - System was supposed to be popular: participation
  - But coverage of social security remains low
Outline of Discussion

- The Reforms
  - What and how
- The Backdrop
  - Demographics and poverty
- The Analysis
  - Theory and evidence
- The Implications
  - Policy and politics
The Reforms

What and How?
The What?

“Structural” reforms in 12 countries in Latin America
- Chile in 1980s, 7 in the 1990s, 4 more since 2000
- Notable exceptions: Brazil and Venezuela

Multiple tiers instead of reliance on single system
- Phase out or scale down old PAYG tier, replacing it with a minimal pension
- Introduce a fully-funded tier that is privately managed
- Consider incentives for voluntary retirement savings

New approach popular in the region and outside
- Briefly on the menu even in Brazil in 1997
- Popular in Eastern Europe and Central Asia
- US reform debate in 2001, perhaps again in 200
One of the common features of reforms is 
a privately managed tier…

<table>
<thead>
<tr>
<th></th>
<th>Chile</th>
<th>Peru 1992/1993</th>
<th>Colombia</th>
<th>Argentina</th>
<th>Uruguay</th>
<th>Mexico</th>
<th>Bolivia</th>
<th>El Salvador</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contribution-related PAYGO system?</td>
<td>closed</td>
<td>remains</td>
<td>remains</td>
<td>remains</td>
<td>remains</td>
<td>closed</td>
<td>closed</td>
<td>closed</td>
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<tr>
<td>Total payroll tax rate, pre-reform (%)</td>
<td>33</td>
<td>18</td>
<td>17.8</td>
<td>42</td>
<td>40</td>
<td>20</td>
<td>19</td>
<td>11.8</td>
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<tr>
<td>Total payroll tax rate, post-reform (%)</td>
<td>20</td>
<td>20.5/22a</td>
<td>33.8</td>
<td>46b</td>
<td>40</td>
<td>26</td>
<td>24</td>
<td>13.5</td>
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<tr>
<td>Participation of new workers?</td>
<td>mandatory</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntaryc</td>
<td>voluntaryd</td>
<td>mandatory</td>
<td>mandatory</td>
<td>mandatory</td>
</tr>
<tr>
<td>Participation of self employed?</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
<td>mandatory</td>
<td>mandatory</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
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<tr>
<td>Fees &amp; insurance premia (% of wage)</td>
<td>2.31</td>
<td>3.73</td>
<td>3.49</td>
<td>3.28</td>
<td>2.68</td>
<td>4.48</td>
<td>2.50</td>
<td>3</td>
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<tr>
<td>Pay-out options</td>
<td>Annuity or scheduled withdrawal</td>
<td>relative to average</td>
<td>Annuity or scheduled withdrawal</td>
<td>relative to average</td>
<td>Annuity or scheduled withdrawal</td>
<td>relative to average</td>
<td>Annuity only</td>
<td>Annuity or scheduled withdrawal</td>
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<td>Minimum return on investment?</td>
<td>yes</td>
<td>yes (only for affiliates born before 1945)</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
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<tr>
<td>Minimum contributory pension?</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>Social assistance pension?</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>no</td>
</tr>
</tbody>
</table>
…. and later reforms are more likely to make participation in this mandatory

<table>
<thead>
<tr>
<th></th>
<th>Costa Rica</th>
<th>Nicaragua</th>
<th>Ecuador</th>
<th>Dominican Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of reform</td>
<td>1995/2000(^h)</td>
<td>2000, as yet unimplemented</td>
<td>2001, as yet unimplemented</td>
<td>2001(^i)</td>
</tr>
<tr>
<td>Contribution-related public PAYGO system?</td>
<td>remains</td>
<td>closed</td>
<td>remains</td>
<td>closed</td>
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<tr>
<td>Total payroll tax rate, pre-reform (%)</td>
<td>22</td>
<td>17</td>
<td></td>
<td>9.25</td>
</tr>
<tr>
<td>Total payroll tax rate, post-reform (%)</td>
<td>26</td>
<td>21.5</td>
<td>Varies, but no more than 20</td>
<td>20</td>
</tr>
<tr>
<td>Participation of new workers?</td>
<td>mandatory</td>
<td>mandatory</td>
<td>mandatory</td>
<td>mandatory</td>
</tr>
<tr>
<td>Participation of self employed?</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
<td>mandatory</td>
</tr>
<tr>
<td>Fees &amp; insurance premia (% of wage)</td>
<td>(j)</td>
<td>2.5</td>
<td>4.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Minimum return on investment?</td>
<td>unregulated</td>
<td>unregulated</td>
<td>relative to average</td>
<td>relative to average</td>
</tr>
<tr>
<td>Minimum contributory pension?</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>Social assistance pension ?</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>
Governments can define pension benefits, contributions, and/or incentives

<table>
<thead>
<tr>
<th>Nature of instrument</th>
<th>Mainstay: Pooling</th>
<th>Mainstay: Saving*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mandatory</td>
<td>Mandatory</td>
</tr>
<tr>
<td>Common name</td>
<td>“First pillar”</td>
<td>“Second pillar”</td>
</tr>
<tr>
<td>Main function</td>
<td>Insure against poverty in old age, lower income inequality</td>
<td>Smooth consumption over life cycle</td>
</tr>
<tr>
<td>Main role of Government</td>
<td>Defines <em>Benefits</em></td>
<td>Defines <em>Contributions</em></td>
</tr>
<tr>
<td>Principal risk-bearer</td>
<td>Government</td>
<td>Worker</td>
</tr>
<tr>
<td>Financial instrument</td>
<td>Unfunded pay-as-you-go</td>
<td>Funded: individual accounts</td>
</tr>
</tbody>
</table>
The reforms differ in extent of choice within mandatory pensions

- Bolivia
- Chile
- Dominican Republic
- El Salvador
- Mexico

- Colombia
- Peru

- Argentina
- Costa Rica
- Uruguay
Points to note

- Big government stays: only one country in which payroll tax was actually lowered
  - Tip of iceberg—Chile different in other aspects too
- System costs high: mandatory management and insurance fees
  - Between 2 and 5 percent of wages, or about 15-20 percent of contributions
- Workers have options: Old system closed to younger workers in some, not in others
  - But default system was the new, not the old
The Argentine How?

- Old system gets into trouble in the 1980s, Ministry of Finance puts together a team in 1991
  - Supported by UNDP and World Bank
  - Inclined toward Chilean model
- Argentina commits to structural pension reform in 1992 in standby agreement with IMF
  - Pensioners against reform—high costs, exclusively private, loss of acquired rights for people below 45 years
  - Business and finance community big supporters of reform
- June 1992 draft law presented
  - Mixed model, obligatory for those below 45 years
  - Compromises with unions necessary
  - September 1993 law passed by slimmest of margins
The Bolivian How?

- Old system gets into trouble in the 1970s, Ministry of Finance proposes structural reform in 1992
  - Supported by USAID
  - Inclined toward Chilean model
- New President de Lozado endorses reform in 1993
  - Min. of Enterprise Capitalization entrusted with task
  - World Bank and IDB support reform
- Public relations campaign starts in 1995
  - 50% of shares of SOEs credited to pension funds
  - Pensioners and trade unions object to reform
  - November 1996 law passed, without much debate
- Post reform changes
  - May 1997, Bonosol pension of $250 p.a. paid to elderly
  - Stopped in 1997, replaced by less generous Bolivida in 2001
Points to note

Fiscal balance goals
- Ministries of finance generally proponents of reforms
- Social ministries often opposed to them

Financial deepening goals
- Banking and finance always champions
- Foreign investors reward such reforms

Development goals
- World Bank often in favor given positive longer term fiscal, capital and labor market implications
  - “Reform” sometimes even defined as structural, not parametric
  - Many promises—fiscal, financial, labor, and social
The Backdrop

Demographics and Poverty
The Backdrop

- Rising Life Expectancy
  - Latin Americans living longer and longer lives
  - Can expect the risk of **inability to earn while living** to become an increasingly frequent loss

- Falling Headcount Poverty
  - After setback in 1980s, poverty began falling again
  - Can reasonably expect the risk of **old age poverty** to become an increasingly rare loss

- But High Inequality and Volatility
  - Latin America has high and rising inequality
  - And considerably “excess volatility” of incomes
Life expectancy in Latin America has risen by ten years over last three decades.
Latin Americans still alive at 60 can expect to live for another 15-20 years
Poverty in Latin America has fallen by half over the last three decades...

Declining Poverty in Latin America, 1970-2000
(Source: Sala-i-Martin, 2002)
But inequality stays high in Latin America, even rises, over last three decades.
Informality is an aspect of inequality in Latin America: coverage ranges between 10% and 60%
The Problem in Latin America: Low and Stagnant Coverage

- After a decade of reform to multi-pillar systems with mandated savings, coverage remains low.
- Results are contrary to expectation that mandating and individualizing savings would expand coverage.
- Redesign the instruments, or rethink the notion of coverage?
The Analysis

Theory and Empirics
What we did

- Regional study of pension reforms co-authored with Truman Packard (WB) and Juan Yermo (OECD), with Todd Pugatch (WB), sponsored by the Office of the Chief Economist, LAC Region of World Bank
- Examined multi-pillar reforms using fiscal, financial, and social criteria
- Employed simple theory, household surveys, administrative data, and actuarial simulations
Briefly, the “theory”

- Simple economics of insurance
  - Three options: market insurance, self-insurance, and self-protection (Ehrlich and Becker, 1972, 2000)
  - Rare losses better insured using market insurance (pooling), frequent losses better through self-insurance (saving)

- Relevant risks related to old age are
  - **Loss of ability to earn while living**—saving becomes more appropriate as loss becomes more frequent
  - **Poverty in old age**—pooling becomes more appropriate as loss becomes rarer

- Appropriate roles of governments are
  - Provide instrument for insuring across states of the world: pooling the losses associated with poverty in old age
  - Regulate instruments transferring incomes across stages of life: saving to offset loss of earning ability while living
Briefly, the main results

- **Theoretical: a mixed picture**
  - Move towards individualization of social security appropriate given demographic changes, but
  - Unclear if huge mandate is appropriate/sustainable

- **Fiscal: a mixed picture**
  - System deficits lowered, build-up of implicit debt slowed, but
  - Strain of transition costs and making debt explicit may have compromised fiscal stability

- **Financial: a mixed picture**
  - Dedicated pension providers deepen markets, but
  - Pose a regulatory challenge as evidenced, e.g., in high fees

- **Social: a mixed picture**
  - Within-system equity improvements, but
  - Little or no gains in coverage, so overall equity gains small
The reforms reduced buildup of governments’ implicit pension debt

![Graph showing government's implicit pension debt as a percentage of GDP for different countries and years with reforms and no reforms.](image-url)
Reforms reduce implicit transfers from poor to richer workers

(Percentage Point Difference Between Wealthier and Poorer Workers in Internal Rates of Return Earned from National Retirement Security System)
But 2/3rds of median country’s fund portfolio consists of government bonds ...
Payroll taxes generally rise….

Except in Chile and Uruguay, Government Got Bigger in Every Country's Labor Market
And costs to workers can be high….

Between 15-20 Percent of Worker Contributions to Private Funds Still go to Management (December 2002)
Sometimes with higher charges for lower wage (younger and poorer) workers...

Figure 2: Chile - Cumulative cost ratio for different salaries, 1990 - 2000
And coverage remains stalled...
So only a tenth to two-thirds of the aged in Latin America get pensions.
The Implications

Policy and Politics
Why the mixed results?

Not worker myopia, but....
- Not lack of information, but rational choice

High mandatory contributions....
- Payroll tax higher, not lower, after reforms;
- Only one case of lowered payroll tax (Chile)

High costs ....
- High commissions and insurance fees (e.g., Peru)
- Transition costs can compromise macro stability (e.g., Bolivia)

....and doubtful benefits.
- Reliance on government remains, and hence persistence of policy risk (e.g., Argentina)
Chile: Government costs of ‘topping-up’ projected to rise

Proyección del flujo de pensiones
(PM crece a 2%, salarios al 2%, rentabilidad 5%)

Chilean Superintendencia of Pensions
Peru: Governments have found it hard to regulate private funds
Bolivia: Countries that managed PAYG systems poorly may not manage transitions well either.

Cash Flow Gap: Bolivia

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual</th>
<th>Projected in 1997</th>
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<tbody>
<tr>
<td>1998</td>
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<td>1999</td>
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<td>2000</td>
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<td>2001</td>
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<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
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</tr>
</tbody>
</table>
Points to conclude

- The main achievement of the LAC reforms is *individualization* of old age income security
  - Appropriate given the demographic changes
  - Observed as stemming of fiscal bleeding, but can be seen as inappropriateness of pooling

- The importance and extent of *privatization* may have been exaggerated
  - Has not meant reduced presence of government—payroll tax rates went up, not down
  - Has not meant that government promises to pensioners are much lower—government bonds biggest part of portfolios

- The main indicator of the weakness of reforms is stalled *participation*
  - Coverage rates have not gone up, and
  - Poverty prevention tiers have not got attention they deserve