Privatizing Social Security in Latin America

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Executive Summary

Chile, the first nation in the Western Hemisphere to establish a social security system, was the first nation in the world to privatize its system. Since Chile instituted a privatized system in 1981, seven other Latin American countries — Peru in 1993, followed by Argentina, Colombia, Uruguay, Bolivia, Mexico and El Salvador — have adopted the Chilean model to some degree. The new Mexican system, launched in February 1997, already is the largest in Latin America. Most other Latin American countries are considering such a move.

Although the mechanics of the privatized systems vary from country to country, certain features are common to all:

- Workers are required to contribute to individual retirement accounts, managed by private investment funds.
- The private investment funds are required to invest conservatively in a diversified portfolio of assets.

In all but one of the privatized systems, the private fund also provides disability and survivors insurance. The exception is Mexico, where the government continues to provide disability and survivors benefits.

Bolivia requires workers to buy an annuity when they retire. All the other countries give the retiree three options: (1) purchase an annuity, (2) make monthly withdrawals from their accounts based on life expectancy, or (3) withdraw funds on a schedule until annuity payments begin at a future time.

Chile, Bolivia, Mexico and El Salvador require all workers entering the labor force for the first time to join the private system, whereas Peru, Argentina, Colombia and Uruguay give them an option. For example, Colombia allows workers to switch back and forth between the public and private systems throughout their work lives. In some of the countries, political opposition has made complete privatization impossible.

Workers in privatized systems fund their own pensions, unlike government systems that use current tax revenues to pay benefits to current retirees. Privatization is expected to bring workers higher benefits than they would receive in a pay-as-you-go system and to increase economic growth by providing new investment capital.

In Chile, the only nation with long-term experience with a privatized system, the average annual real return on assets has been 10.7 percent, and retirement benefits are 19.6 percent higher than under the old system. Private disability pensions are 30.9 percent higher, and survivors benefits are 17.8 percent higher for widows, although they currently are only 75 percent of those under the old system for orphan children. The reformed pension system also has bolstered Chile’s economy.

Introduction

Almost 18 years ago, Chile privatized its pension system, a move that eventually led to one of its most important cultural and economic transformations of the latter part of this century. Seven other Latin American countries have followed the Chilean example to some degree, and several others are considering such a move. [See Figure I.]

All of the Latin American social security reforms share three fundamental elements: (1) private administration, (2) individual accounts and (3) investment in real assets. Other features vary from one country to another. For example, some countries guarantee a minimum pension on retirement

"Seven other Latin American countries have followed Chile's example to some degree."

FIGURE I

Privatizing Social Security in Latin America

TABLE I

Latin America's Privatized Systems

	Year Private System Established	Total Population (millions)	Total Work-Force [a] (millions)	No. of Participants (1997)	Required Contribution From earnings [b]	Employer Contribution	Worker Can Join Old System	Pop. Over Age 65
Chile	**1981**	**14.5**	**5.6**	**5,600,000**	**10%**	**0**	**No**	**7%**
Peru	**1993**	**24.9**	**7.6**	**1,700,000**	**10%**	**0**	**Yes**	**5%**
Argentina	**1994**	**35.7**	**14.5**	**6,170,000**	**11%**	**0[d]**	**Yes**	**10%**
Colombia	**1994**	**37.4**	**12.0**	**2,440,000**	**2.5%**	**7.5%**	**Yes**	**5%**
Uruguay	**1996**	**3.3**	**1.4**	**408,000**	**12%[c]**	**12.5%[c]**	**Yes**	**13%**
Bolivia	**1997**	**7.7**	**2.3**	**500,000**	**10%**	**0**	**No**	**4%**
Mexico	**1997**	**97.5**	**36.3**	**10,700,000**	**4.5%**	**2%**	**No**	**4%**
El Salvador	**1997**	**5.7**	**2.2**	**N/A**	**3.25%**	**6.75%**	**No**	**5%**

a. Total workforce includes self-employed, who in most countries are not required to participate in the retirement system.

b. In addition, participants pay a fee for disability and survivors insurance and administrative costs, usually from 2 percent to 4 percent.

c. A portion goes to the old system. Contribution also covers health insurance, unemployment and family allowance benefits.

d. Employers must pay 16 percent of earnings to the old system in Argentina, regardless of whether the worker is in the old system or the new.

Source: *Social Security Programs throughout the World — 1997,* U.S. Social Security Administration, Washington, D.C.; *World Factbook 1997,* U.S. Central Intelligence Agency, Washington, D.C.; *Private Pension Funds in Latin America, 1997 Update,* Salomon Smith Barney, New York.

"Features of reform vary from one country to another, but private administration, individual accounts and investment in real assets are fundamental elements."

while others do not. Several allow new workers to join either the old state-run system or the new private system. Required contributions from workers vary among countries, and in some employers are required to contribute while in others they are not. [See Table I.] The pressure of an aging population and a shrinking pool of active workers to support the system — a prominent problem in the U.S. social security system — has been secondary in Latin America, where most populations are younger. Instead, their primary motivation has been to boost savings rates and develop financial markets.

This study looks first at the principles of pension reform in Chile, the pioneer in privatizing social security, and then at the reforms in other countries, describing the differences as well as the problems. Some of the analysis is subjective, reflecting the experience the author gained from helping to design the Chilean system in 1980 as a member of the Technical Committee that advised former Minister Jose Piñera.

The Chilean Model

Like most state-run programs, including that of the United States, Chile's old social security system operated on a pay-as-you-go basis. Taxes collected from current workers paid benefits to current retirees. The benefits workers ultimately received from the system bore little relationship to the amounts they contributed through payroll deductions.

Defects of the Old System. The old system comprised a number of separate social security systems. There was one system for manual workers, another for salaried employees, still another for government workers and about 50 additional programs for workers in different occupations and different locations. The groups with the greatest political influence had the most favorable programs.[1]

- Some workers paid lower payroll taxes than others for similar benefits.
- Some salaried workers received retirement benefits equal to 100 percent of average wages for their last five years of employment, while manual workers received only 75 percent.
- Some workers were allowed to collect benefits after only 35 years of employment, while the general system for manual workers had a retirement age of 65.

"In 1981 Chile replaced the public system with a private system in which benefits were directly related to worker contributions."

In 1981 Chile replaced the public system with a private system in which the benefits workers received were directly related to their contributions. All workers entering the labor force for the first time were required to enter the new privatized system. Workers already in the labor force could remain in the state-run system or enter the new system but could not participate in both. [See the sidebar, "Who Is in Chile's Pension System?"]

Reform Options: Insurance or Capital Accumulation? Once the decision had been made that benefits would directly relate to contributions, Chile considered two ways to organize the new system: on the basis of insurance or of capital accumulation.

Under an insurance-based system, workers would contract with an insurance company to receive a pension in exchange for regular contributions (premiums). The relationship between the contribution and the pension would be determined by expected long-term market returns in effect at the time the agreement was signed.

The primary advantage of this defined-benefit approach is that workers know exactly how much their monthly benefit will be upon retirement. However, such a system presents a significant risk for the insurer, which must commit to a specific rate of return in order to pay benefits. Moreover, long-term investment instruments of this type were rare in Chile, and the likelihood

Who Is in Chile's Pension System?

The Chilean pension system has about 5.6 million participants, but only about 56 percent of them are active contributors. In Chile, every employee is required to join a pension fund, but membership is voluntary for self-employed workers, who make up about 26 percent of the nation's workforce. An estimated 22 percent of the self-employed — about 150,000 — are members of a pension fund. Of the 44 percent of pension system participants who are not active contributors, some are self-employed workers or workers in the informal, or underground, economy who work occasionally in the formal sector and some have left the workforce or are currently unemployed.

The military in Chile remain in their own retirement system. Critics of privatization point to this as evidence of favoritism to the military, but the military system in fact is in financial straits. Three years ago the Chilean Defense Ministry asked outside experts to analyze the military pension system and suggest reforms. The study is still under way.

Source: *Private Pension Funds in Latin America, 1997 Update*, Salomon Smith Barney; Dimitri Vittas, "Designing Mandatory Pension Schemes: Some Lessons from Argentina, Chile, Malaysia and Singapore," *Public Policy for the Private Sector*, Note No. 72, February 1996, World Bank.

that such a program could succeed was greatly diminished by the fact that Chile's (exclusively domestic) financial markets were underdeveloped.

Insurance companies might have been able to offset their risks through large capital holdings and reserves. However, only the most heavily capitalized companies could have taken part, which would have reduced competition in the system. In addition, even with increased capital and reserves, insurance companies still would have had limited opportunities for diversified investment, given the condition of Chile's financial market. Thus policymakers concluded that only foreign companies might have the strength to manage an insurance-based system — a politically difficult situation.

"The new private system was based on capital accumulation rather than insurance."

The better option — the one chosen — was a defined-contribution approach, allowing the amount of the pension to vary with the return on investment made with funds accumulated in individual accounts. While the risk to the worker was greater, the overall danger to the system itself was modest. What's more, the accumulation system ensured greater competition because it did not require large amounts of investment capital. To compensate for the risk individuals undertook, they were permitted to make additional, voluntary contributions to supplement their pensions so they could retire early.

The Creation of Private Investment Funds. The designers of the new system realized that private institutions were needed to make the new system a reality. Banks were one option. However, the designers had doubts about both the stability and the supervision of Chile's banks. (Two years later, a crisis in Chilean capital markets proved that not using banks had been

a wise decision.) Further, there was a question of a possible conflict of interest, given that bank deposits were one logical investment option for social security funds.

"Pension Fund Administrators (AFPs) manage and administer individual accounts, but don't own them."

Instead, Chile's policy planners created a system of wholly new private entities called Pension Fund Administrators (known from their Spanish initials as AFPs) to manage the retirement funds.[2] They created a regulatory agency with a small, highly qualified staff to oversee the system. The period between the passage of legislation and the actual launch of the new system gave the private sector enough time to design the AFPs. The AFPs were to manage and administer the new accounts, not own them. This was important because the workers' money in the separate equity accounts would not be affected even if an AFP went bankrupt.

There currently are nine AFPs, and they compete actively for workers' accounts.[3] Workers may move their accounts among the various AFPs. About one-third of the active accounts are moved each year.[4]

Transition from Old to New Systems.[5] Pensions for workers already retired when the privatized system was inaugurated and for those choosing to stay in the old system were paid from Chile's general treasury. "Recognition bonds" covering credits earned under the old system were issued to workers who switched from the old to the new. These nontransferable bonds earned 4 percent interest (adjusted for inflation). Upon retirement, individuals could redeem the bonds for lump sum payments into their retirement accounts.

The unfunded pension liability from the old state system was estimated to have a present value in 1981 of about 80 percent of Chile's gross domestic product.[6] Part of the funds to pay for the recognition bonds came from a budget surplus in existence before the new system was introduced. The country also sold the assets of many state-owned enterprises to help pay for the recognition bonds. Spending to redeem recognition bonds has declined annually since 1991, and the last bond is expected to be cashed around 2025.

"There is a minimum pension guarantee designed to keep a pensioner out of poverty."

The new system provides a minimum pension guarantee for all workers who have contributed for at least 20 years, topping up the pension if funds accumulated in the worker's account are not enough to finance the minimum. The minimum pension guarantee, with the difference coming from general tax funds, is designed to be enough to keep the pensioner out of poverty.

Rates of Return. Because the merits of the new system depended on the level of benefits paid to participants, policymakers wanted to ensure that the rates of return on workers' accounts were adequate. Actuarial calculations indicated that if workers contributed 10 percent of their earnings, men could retire at age 65 and women at age 60 with a pension equal to approximately 75 percent of their final year of income if the average annual return on contributions was 4 percent. This figure appeared to be realistic for the Chilean economy.

The next challenge was to formulate an investment portfolio that would allow the private investment funds to compete profitably and still achieve the needed rate of return while protecting the workers' contributions. In addition to the supervisory agency to watch over the system, the designers established regulations requiring that investments be diversified to reduce risks. Furthermore, new laws established conservative investment options and limits, initially oriented toward debt instruments, particularly public debt.

"Pension fund investments are limited to conservative options."

The pension funds were permitted to invest only in government-issued instruments, bank time deposits, corporate bonds and shares of other pension funds. Any percentage could be invested in government-issued instruments, but no more than 40 percent could be invested in time deposits, 60 percent in corporate bonds and 30 percent in shares of other pension funds.

As the system matured, AFPs were allowed to invest in corporate stocks, a move that provided higher rates of return and more opportunities to diversify. This also helped reduce Chile's debt-to-capital ratio by recapitalizing companies hit by the 1982 financial crisis. Of equal importance, the option of investing in private stocks helped the government pursue its policy of privatizing state-owned companies. Beginning in 1985, the funds were allowed to invest up to 30 percent of their assets in stocks. The availability of institutional buyers for the shares issued by these companies was a distinct boon to the privatization program, which required large-scale acquisitions and vast purchasing power to be successful.

As of September 1997 the pension funds had 28.4 percent of their assets invested in Chilean stocks and held about 14 percent of the country's publicly traded stocks.[7]

The new retirement system has been continually fine-tuned to ensure its integrity. Eventually it became clear that investment instruments needed to be classified for risk, and the government created a risk-rating commission. Most rating commission members are from the private sector.

The new system requires each AFP to earn, over a 12-month period, a minimum return on workers' investments equal to 50 percent of the average return of all AFPs or the average return minus 2 percent, whichever is lower.

An AFP must keep a reserve equal to 1 percent of the total assets in the fund it manages and must invest the reserve in the same assets as the fund. If the fund's rate of return is not within the maximum deviation, the AFP must make up the difference from this reserve.

Administrative Costs. In addition to contributing 10 percent of their income to the private retirement accounts, Chilean workers pay a fee for survivors and disability insurance and administrative costs. The insurance and administrative fee can range from 2 percent to 3.75 percent, depending on the AFP, and this is a point of competition among the AFPs. From this fee, currently averaging about 2.7 percent (down in the last year from about 3

percent), an AFP must buy the insurance for the worker, pay expenses and get its profit.

Some critics of privatized systems have pointed out that administrative costs for government-run pay-as-you-go systems are much lower. Decentralized systems offering a choice of funds and allowing switching among funds do have additional marketing expenses, but they also provide a higher rate of return for participants than do the pay-as-you-go systems.

"The insurance and administrative fee currently averages about 2.7 percent (down in the last year from about 3 percent)."

Opponents of privatized systems like to say, as one writer did, that "up to 20 percent of worker contributions go to middlemen."[8] They obtain this figure by dividing the administrative fee by the total contribution. However, administrative costs as a percentage of total assets have fallen dramatically as the Chilean system has matured and now average less than 2 percent of total assets.[9]

One factor contributing to administrative costs in the Chilean system is the absence of any limit on the number and frequency of transfers a participant can make from one AFP to another. In 1996 there were 1.6 million transfers. A new regulation effective in late 1997 requires an affiliate to go in person to his or her AFP office to transfer. Previously, a worker could change AFPs simply by signing a piece of paper. The new regulation is expected to reduce transfers among funds — and consequently reduce operating costs of the AFPs.[10]

AFPs must provide statements to contributors three times a year, showing the last four monthly contributions paid by employers, the financial performance of the fund and the accumulated balance and rate of return on individual accounts.[11]

Other Benefits for Workers: Life Insurance. The new social security system provides three types of benefits: old age, disability and survivors. The different needs of each determined the new framework for the benefits. Since old age is predictable, old-age pensions can be covered by a straightforward accumulation of funds, given the contribution rate of 10 percent of worker income. (As previously noted, workers can make additional voluntary contributions.) Disability or death, on the other hand, are not predictable. A stricken worker may not have sufficient accumulated funds to ensure a pension somewhere near his or her level of income. This is the reason the AFPs acquire private insurance for the worker. The relationship between this insurance and the participant's income level is established by law. The insurance premium currently averages about 0.7 percentage points of the 2.7 percent insurance and administrative fee.

"About 0.7 percentage points is used to acquire private life insurance for the worker."

Other Benefits for Workers: Disability Pensions. Active workers who are below the minimum retirement age and who lose at least 50 percent of their ability to work are entitled to disability pensions. A committee of three physicians appointed by the AFP supervisory agency, which has offices throughout Chile, determines whether a person qualifies for the pension. To

be declared completely disabled, the worker must lose more than 66 percent of capability. Those losing more than 50 percent but less than 66 percent of their capability are considered partially disabled. A "transitory disability" entitles a worker to a three-year pension; at the end of the three years, the worker undergoes a second examination which determines whether benefits will be retracted or made permanent.

Other Benefits to Workers: Survivors Pensions. Survivors pensions are provided by the private insurance purchased from the administrative fee the worker pays. The survivors benefits are the same whether the worker is active or retired at the time of death, and they are based on the worker's pension or average base salary for the last five years. Spouses, dependent children (whether legitimate or not) and orphan children receive survivors pensions — or the parents receive pensions if there are no other beneficiaries.

"Retirees can choose three options: an immediate life annuity, scheduled withdrawals or a blend of temporary income with a deferred life annuity."

Retirement Withdrawal Options. Workers can retire when they reach retirement age (65 for men, 60 for women) or when their account has accumulated funds that are actuarially sufficient for early retirement. The amount required for early retirement is tied to preretirement income to ensure that workers do not experience a dramatic drop in living standards and do not become a burden to society.

Withdrawal Option: Immediate life annuity. Funds in the individual's account are transferred to a life insurance company the retiree chooses. In exchange, the retiree receives a life-long monthly payment that is periodically adjusted to economic indices. The annuity includes a survivors pension for beneficiaries.

Withdrawal Option: Scheduled withdrawals. Funds in the account remain with the AFP and the retiree makes monthly withdrawals in indexed monetary units in accordance with a preestablished schedule, recalculated annually based on life expectancy.[12] Unlike the traditional annuity, the amount of the pension payments under this option can change and may drop over time if the retiree lives longer than initial life expectancy calculations indicate. However, this option has two important advantages: the retiree can collect larger benefits during the early years of retirement and can authorize the transfer of any funds remaining in the account after death to his or her heirs.

Withdrawal Option: Temporary income with a deferred life annuity. This is a blend of the other two options. The retiree buys a life annuity to begin at a future date established by contract and leaves sufficient funds in the AFP account to provide a temporary income until the date the annuity payments begin.

Performance of the New System. From its inception in 1981 through September 1998, the average real return on assets of the privatized system has been 10.7 percent.[13] Compared to the old system:[14]

- Retirement benefits are now 19.6 percent higher.
- Disability pensions are 30.9 percent higher.
- Survivors benefits are 17.8 percent higher for widows.

However, survivors benefits for orphan children currently are only 75 percent of those under the old system.

The reformed pension system favorably affected Chile's economy. As the AFPs have been allowed to diversify their investments, the financial markets have gained liquidity, with more trading of shares of stock and more variety in financial instruments. The increasing investments by the AFPs have encouraged the disclosure of information in financial markets and the development of credit rating institutions.[15]

Reform In Peru

"Peruvian workers can still join the old pay-as-you-go system."

In 1993 Peru became the first nation to follow in Chile's footsteps in reforming its pension system. Peru used a similar conceptual framework, including individual accounts invested in real assets, "recognition bonds" for retirement credits earned under the old system and private institutions dedicated exclusively to managing the private funds. In addition, the system provides disability and survivors benefits administered by insurance companies, and old-age pensions can take the form of either scheduled withdrawals or life annuities. However, unlike Chile, Peru's new system has no minimum benefit, and social assistance — welfare — is the only backup.

Peru's system has some unique features — mostly concessions made for political reasons — that have hindered its implementation. Most important, workers are allowed to continue joining the old pay-as-you-go system, thus conveying the message to Peruvians that the old system, with an implicit social security debt of about two-thirds of gross domestic product, is valid and sustainable, which it is not.

A second problem is that Peruvian policymakers gave in to the temptation to tax the new system. This resulted in employers being required by law to pay more per worker into the private system than they were paying under the old system. Also, individual workers had to pay more under the new system. Logically, employers discouraged shifting to the new system, slowing its implementation considerably, and workers had no incentive to move into what they perceived as an expensive alternative to the old system. As a result, by late 1994 the new system had only 950,000 participants, less than half of initial projections.

In July 1995 the error was corrected by a law making contributions to both systems equal, and by September 1997 the total number of participants had risen to 1.7 million, or about 44 percent of the formal workforce. At that point, the number of participants in the old system had dropped below one million.[16]

The average age of participants in Peru's new system is 25, substantially younger than that of participants in most other Latin American countries' privatized systems. More than 50 percent of the participants are under age 30 and only about 15 percent are over 40.[17]

One major challenge for any retirement system in Peru is that as much as 51 percent of the workforce is in the informal economy, covered by neither the old nor the new system.

Reform in Argentina

Argentina reformed its pension system in 1994, creating individual capitalized accounts administered by companies known as Retirement and Pension Fund Administrators (AFJPs). The AFJPs operate somewhat differently from the AFPs of Chile and Peru; the retirement component, the "J," reflects several important conceptual differences.

The new Argentine system is a mixture of the old government-administered system and an individual retirement account program administered by the AFJPs. There is interaction between the two systems. The pay-as-you-go system provides basic, universal old-age coverage (known as PBU) for all workers who reach retirement age and who have contributed for at least 30 years to either the old system, the new system or a combination of the two. It also provides a compensatory payment (PC) designed to recognize the contributions each worker made to the old system prior to reform. Then, to the combination of the PBU and the PC, each worker adds funds — to the AFJP if the worker chooses the individual retirement account program, to a Payment for Additional Permanence (PAP) if the worker chooses to remain under the old system.

"Whether Argentine workers choose the private or public system, their employers must pay 16 percent of their pay to the public system."

Beyond the names for the payments, the major difference from Chile is that Argentina has retained the pay-as-you-go system. Workers must contribute 11 percent of their pay to either the new or the old system, depending on which they have chosen. Regardless of whether workers participate in the private or public system, employers must pay 16 percent of the workers' pay to the public system. Nonsalaried workers must pay the full 27 percent.

From an income distribution perspective, leaving the old system in place is regressive because the government still is financing a portion of the wealthiest Argentines' pensions. And unlike Chile, where the government contributes only to the minimum pension of the poorest workers, Argentina provides a flat benefit to all retirees who have contributed for 30 years.

Refusal to break with the old system creates the pernicious illusion that a pay-as-you-go system can operate soundly. Before the change, the implicit social security debt in Argentina, like that in Peru, was estimated at about two-thirds of gross domestic product.[18] The Argentines who chose not to move into the new individual capitalization system believe that a "new" pay-as-you-go system somehow will be more effective.

Further, in a blatantly statist move, the government authorized the federally owned Nacion bank to create and operate one of the AFJPs. Initially, the bank had a significant advantage over its private competitors: it guaranteed returns in U.S. dollars, a sensitive issue in a country threatened with the devaluation of its overvalued currency. No private institution could offer the same.

Guarantees in U.S. dollars have been dropped, but Nacion continues to guarantee real, positive returns on investments in local currency. No private institution can responsibly offer a similar guarantee over the long term in a privately capitalized system in which benefits are not clearly defined. Still, Nacion ranks only sixth in assets and number of participants among the 18 Argentine AFJPs.

Another important difference from the Chilean system is that in Argentina collections are centralized and are handled by the General Tax Service, whereas the AFPs themselves handle collections in Chile. (This Argentine innovation has been copied in other countries, including Mexico.)

Two flawed systems coexist in Argentina. Worse yet, participation in either is highly discretionary, undermining the whole premise of social security. In a nation of approximately 36 million citizens, only a little over six million participate in the two systems combined.

Reform in Colombia

Reform of the Colombian pension system began in 1994, at which time only about 27 percent of the working population was covered by the pay-as-you-go system despite the existence of an array of subsystems.

"The Colombian system was implemented just four months before a new, unsympathetic administration took office."

Although the conceptual foundation for the private system in Colombia is similar to Chile's, conditions for the transition between the old and new systems are not. In Colombia, as in Argentina and Peru, the old pay-as-you-go system remains in place, administered by a social security agency that receives new contributors. Workers can move freely from one system to the other following a minimum three-year stay. The new private system is taxed under the guise of a "solidarity" contribution of 1 percent deducted from the worker's earnings.

The private system in Colombia is similar to Chile's in contribution requirements and benefits delivery. Also like Chile's, the new Colombian system offers a minimum pension guarantee. Differences between the two countries' systems emerge in implementation, due partly to the fact that the Colombian reform was approved during the final days of Cesar Gaviria's presidential administration and was not supported by incoming president Ernesto Samper's party. Just four months after the rollout of the private alternative, Samper took office and was charged with administering the reform.

This helps explain the vacillations in government support for the new system as well as the obstacles created by some government officials. The Social Security Institute, which oversees the old system, competes openly with the private AFPs and advertises for new participants. While the competition itself is not necessarily a drawback, the confusion it has created among participants has caused problems.

Initially workers were assumed to have chosen the old system unless they formally stated otherwise. Thus the burden of proof fell on the new system, which was barred for three years from appealing to those workers. The legislation has since been modified so that the three-year minimum does not apply until a worker expressly states his or her desire to join one system.

Another obstacle sprang from collection of the new funds. Initially the Social Security Institute collected contributions for both the old and the new systems. The revenue of the AFPs was adversely affected because the Social Security Institute often was slow to transfer the collected funds to them.

Now, three years have passed and about 2.5 million active workers have joined the private plan. Another 4.5 million workers remain in the old system.

Reform in Uruguay

"Before the reform in Uruguay, more than one-third of all government spending was for pensions."

The new Uruguayan system inaugurated in 1996 is mixed, allowing participants to pay into private investment accounts while continuing to contribute to the old government-run system. Participation in the old system is required for workers over age 40 whose income is above a minimum threshold. The first private investment fund (AFAP) to begin operation was government-owned, and it competes with the privately owned AFAPs. Workers must pay 15 percent of their income into the pension system, but with health insurance premiums included, the total premium is 27 percent of income. As in Argentina, collection of the funds is centralized under the government's general tax authority.

Before the reform, the payroll tax for retirement was more than 20 percent, one of the highest rates in the world, and a large portion of all government spending — more than one-third in 1990 — was for pensions.[19]

One month after rollout, Uruguay's private system boasted five AFAPs and 40,000 participants, about twice the number of participants expected at that point. The initial success came despite familiar structural weaknesses: (1) the mixed system means that the government still subsidizes the wealthy and (2) the government-run AFAP competes unfairly with firms in the private sector. By June 1997 the private system had 407,000 affiliates, or about 30 percent of the small (3.21 million population) nation's workforce.

Reform in Bolivia

In late 1996 Bolivia passed social security reform based on privately administered individual retirement accounts, and in 1997 it implemented the new system. The system has several unique features.

As part of wide-ranging economic reform, in 1994 Bolivia began privatizing state-run companies under a "state capitalization plan." The government received no proceeds from the privatization. Half the shares were sold to company investors and employees, and the proceeds used to capitalize the companies. The other shares went into the creation of the private pension system. Thus Bolivia's new system gets its funds from two sources.

- So-called contribution funds come from workers' earnings and are administered by AFPs.
- Noncontribution funds come from earnings on shares of the privatized companies that went into the system when it was established.

"Half the proceeds from privatizing state-run companies went into the creation of the private pension system in Bolivia."

All workers in the old state-run system were automatically transferred to the new system, and all new entrants to the workforce must join the new system. Participants cannot transfer between AFPs unless they move to an area of the country not covered by their AFP. This requirement is much more restrictive than in the other countries with privatized pension systems and is scheduled to be relaxed slightly in 2000 to allow transfers at any time after the worker makes a dozen contributions, when a worker changes employers or when an AFP increases commissions or raises insurance premiums.

Workers must contribute 10 percent of their earnings — of which about 1 percentage point goes to administrative expenses — plus 2 percent for disability and life insurance.

After a bidding contest, Bolivia initially licensed only two AFPs and granted them five-year exclusivity. The AFPs invest the contribution funds and manage the noncontribution shares like mutual funds. When the AFPs began operation, the shares of stock making up the noncontribution fund were divided equally between them. They are allowed to sell the shares, convert them to other financial instruments or pledge them as collateral. Other AFPs may be authorized after the five years, although the original AFPs will have a clear competitive advantage.

Bolivia offers fewer options at retirement than the other countries. The retiree must buy an annuity based on funds in the individual account. If the funds are not enough for an annuity meeting the legal minimum, the government guarantees to cover the remainder. In addition to the annuity payment, a retiree receives an annual benefit for life from the noncontribution fund. Workers who contributed at least 60 times to the old system also receive a monthly retirement benefit from it.

Because Bolivia has a very young population — only about 5 percent are over age 60 and 40 percent are under age 15 — economists estimate that the noncontribution funds will last for 60 years, with most of the payments occurring in 30 to 40 years.[20]

Reform in Mexico

Launched in February of 1997, the new Mexican pension system is already the largest in Latin America, thanks to the size of the country, the large-scale transition plan and the reach of the new program. All of the country's private-sector employees are required to contribute to the private capitalization program, and by the end of 1997 Mexico's 17 Afores (the Mexican name for the private pension fund managers) had enrolled more than 10.5 million workers.[21]

"Launched in February of 1997, the new Mexican system is already the largest in Latin America."

The new system stipulates that when a worker reaches retirement age the amount accumulated in his or her individual retirement account will be calculated, as will the amount the worker would have been due from the Mexican Social Security Institute (IMSS), the agency in charge of the old social security system. If the latter amount is larger, the funds in the private account will pass to the IMSS, which will pay the pension. If the individual retirement account is larger, pension benefits will be paid out of it.

In all likelihood, in the first few years of operation the funds from the private accounts will not exceed IMSS benefits. But this will change as the private system accumulates funds over young employees' working lives.

In the private system, workers select the Afore they wish and can change their choice once a year. They pay a total premium of 9 percent, of which 6.5 percent goes to old-age benefits.

Like the Chilean system, Mexico's old-age benefits are payable as either life annuities or scheduled withdrawals. The government provides a minimum pension for the neediest workers, equal to the minimum wage, and collects payments into all funds through its centralized taxing authority (the only way in which the Mexican system mimics the Argentine model).

One unique aspect of the Mexican system is that disability and survivors benefits remain under management of the IMSS. The IMSS charges a premium of 2.5 percent of workers' pay for the service, a high rate that helps to finance the overall transition to the reformed social security system. Another unique aspect of Mexico's system is that no one of the Afores can hold a market share of more than 17 percent.

Reform in El Salvador

El Salvador's National Assembly approved a complete reform of that nation's social security system in late 1996. Based on Chile's model, the

"Once El Salvador's new system is fully implemented, the old system will not accept new workers."

reforms created a wholly private system. Private fund management companies were created to oversee the funds of workers who choose to shift to the new system. The government's participation is limited to providing a minimum pension for the most impoverished and creating an oversight agency for the private funds.

El Salvador's policymakers, like Chile's, were clear in their design of the new system: once the new program is fully implemented, the old, state-run system will not accept new workers.

Evaluating the Reforms

Are the modifications to the Chilean model introduced by other nations minor adjustments that preserve the benefits of the system, or do they change the foundation of Chile's successful experience? In general, the other nations have committed one or more of four major errors that hinder reform.

"In general, nations other than Chile have committed one or more of four major errors that hinder reform."

Error: Retaining Access to the Old Pay-As-You-Go System. Although permitting workers to choose between remaining in the old system or moving into a new system has some advantages — including freedom of choice — it is a mistake to allow workers entering the labor force for the first time to join a system that is doomed to bankruptcy. By keeping both systems in place, the new retirement program, capitalized by individual retirement accounts, ends up paying at least part of the cost of the old system. This error is particularly manifest in Argentina's and Colombia's reforms. Chile, Bolivia, Mexico and El Salvador, on the other hand, have made clean breaks with their old programs.

It is important to note that some of the countries, especially Peru and Argentina, are having difficulty maintaining their pay-as-you-go systems because so many workers have opted out.

Error: Taxing the New System. When Peru introduced reform, it loaded the new program with taxes that made it more expensive than the program it was intended to replace. This mistake cost the Peruvian government two years, during which the incentives encouraged people to stay in the old system.

Error: Creating a State-Run AFP. This is a mistake because, as in Argentina and Uruguay, "official" institutions always have unfair advantages in the competition with private companies for both customers and retirement funds. Many Latin Americans remain enamored of state-run companies; this fact encourages politicians to incorporate state-run AFPs in their reform plans. Even in Chile, the state-run Banco del Estado competes with private commercial banks.

Error: Creating a Mixed System. For those who believe the truth always lies midway between two positions, a mixed social security system is almost irresistible. The most frequent variant has the government

funding a universal pension for all workers, with the private system as a supplement. Although in some cases political considerations may make a mixed system the only option, policymakers should be clear on the option's impact. Mixed systems are inefficient because the state is subsidizing the pensions of the highest- and middle-income sectors from tax revenues. Argentina's system is an example of this error, whereas in Chile, Peru and El Salvador, government resources provide minimum pensions only for the most needy.

However, the centralized collection formats used in Argentina and Mexico do not alter the underpinnings of the private pension framework and may be justified in terms of cost savings.

Conclusion

"The Chilean system had the desired impact on savings and financial markets — and it introduced a new approach to retirement pensions."

When Chile instituted its fully funded retirement pension system based on individual accounts in 1981, its untested idea was driven more by the need to boost savings rates and develop domestic financial markets than by a recognition of the existing social security system's unsustainablibilty. The Chilean system had the desired impact on savings and financial markets — and it introduced a new approach to retirement pensions. Rather than taxing current workers to pay the pensions of current retirees, the new system enabled workers to save for their own retirements, receiving higher benefits than under the old system. It also eliminated the growing unfunded liability of the government under the old system.

The success of the Chilean system has resulted in its use as a model for reform in other Latin American countries and in nations around the world. Some of the Latin American nations have followed the Chilean model more closely than others, and the variations adopted in some countries contain the pitfalls described above. Still, workers in those countries have better prospects of stable, substantial retirement incomes than they had before the reforms.

Meanwhile, Chile has fine-tuned its system and continues to make changes as minor shortcomings or better operating methods are discovered. Yet the basic structure has remained intact: a system of individual, capitalized accounts funded by the workers for their own retirement.

Notes

[1] Peter J. Ferrara, John C. Goodman and Merrill Matthews Jr., "Private Alternatives to Social Security in Other Countries," National Center for Policy Analysis, NCPA Policy Report No. 200, October 1995.

[2] Although policymakers decided that AFPs were the best approach for administering the individual accounts in Chile, insurance companies or financial institutions already engaged in similar areas of business might be valid options for another country, depending on conditions in the country.

[3] Mergers reduced the number of AFPs from 13 to nine in the last year.

[4] Dimitri Vittas, "Designing Mandatory Pension Schemes: Some Lessons from Argentina, Chile, Malaysia and Singapore," *Public Policy for the Private Sector*, Note No. 72, February 1996, World Bank.

[5] Much of this section is based on "How Did Chile Pay Off Its Social Security Debt?" in *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth* (New York: Oxford University Press for the World Bank, 1994), pp. 267-68.

[6] Patricio Arrau, "El Nuevo Regimen Previsional Chilena y su Financimiento Durante la Transicion," *Coleccion Estudios CIEPLAN* 32: 5-44, cited in *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, p. 267.

[7] *Private Pension Funds in Latin America, 1997 Updat*e, Salomon Smith Barney, December 1997, p. 112.

[8] Stephen J. Kay, "The Chile Con: Privatizing Social Security in South America," *American Prospect*, No. 33, July-August 1997, pp. 48-52.

[9] *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, pp. 224-25.

[10]*Private Pension Funds in Latin America, 1997 Updat*e, pp. 99-100.

[11] *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, p. 220.

[12] The primary index-linked monetary unit in Chile, called *unidad de fomento* or UF, is adjusted daily to reflect changes in the cost of living

[13] *Private Pension Funds in Latin America, 1997 Updat*e, p. 96.

[14] AFP Association, based on Quarterly Statistical Report of Superintendence of AFP and information from Superintendence of Social Security.

[15] Estelle James, "Pension Reform: Is There an Efficiency-Equity Trade-Off?" paper for the Conference on Inequality Reducing Growth in Latin America's Market Economies, Inter-American Development Bank, January 1997, p.11.

[16] *Private Pension Funds in Latin America, 1997 Update*, p. 185.

[17] Ibid., p. 188.

[18] *Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth*, p. 276.

[19] James, "Pension Reform: Is There an Efficiency-Equity Trade-Off?" pp. 2, 3.

[20] *Private Pension Funds in Latin America, 1997 Updat*e, p. 67.

[21] Ibid., p. 152.

About the Author

Luis Larrain Arroyo is an economist at the Universidad Catolica de Chile in Santiago and deputy director of Instituto Libertad y Desarrollo, a Chilean public policy research institute. He was an advisor to Minister Jose Piñera in 1980 when Chile was designing the world's first privatized social security system, and was Chile's superintendent of social security from 1981 to 1983. Mr. Larrain also served in the Chilean government as deputy director of Odeplan (the Planning Ministry) from 1985 to 1989 and Minister of Odeplan from 1989 to 1990.

About the NCPA

The National Center for Policy Analysis is a nonprofit, nonpartisan research institute founded in 1983 and funded exclusively by private contributions. The mission of the NCPA is to seek innovative private-sector solutions to public policy problems.

The center is probably best known for developing the concept of Medical Savings Accounts (MSAs). Sen. Phil Gramm said MSAs are "the only original idea in health policy in more than a decade." Congress approved a pilot MSA program for small businesses and the self-employed in 1996 and voted in 1997 to allow Medicare beneficiaries to have MSAs.

In fashioning the 1997 budget deal, members of Congress relied on input from the NCPA's Center for Tax Policy. The Balanced Budget Act incorporated many key NCPA ideas, including the capital gains tax cut and the Roth IRA. Both proposals were part of the pro-growth tax cuts agenda contained in the Contract with America and first proposed by the NCPA and the U.S. Chamber of Commerce in 1991. Two other provisions — an increase in the estate tax exemption and the abolition of the 15 percent tax penalty on excess withdrawals from pension accounts — also reflect NCPA proposals.

The NCPA has also developed the concept of taxpayer choice — letting taxpayers rather than government decide where their welfare dollars go. Sen. Dan Coats and Rep. John Kasich have introduced a welfare reform bill incorporating the idea. It is also included in separate legislation in the House sponsored by Rep. Jim Talent and Rep. J.C. Watts.

Another important area is entitlement reform. NCPA research shows that elderly entitlements will require taxes that take between one-half and two-thirds of workers' incomes by the time today's college students retire. A middle-income worker entering the labor market today can expect to pay almost $750,000 in taxes by the time he or she is 65 years of age, but will receive only $140,000 in benefits — assuming benefits are paid. At virtually every income level, Social Security makes people worse off — paying a lower rate of return than they could have earned in private capital markets. To solve this problem, the NCPA has developed a 12-step plan for Social Security privatization.

The NCPA has also developed ways of giving parents the opportunity to choose the best school for their children, whether public or private. For example, one NCPA study recommends a dollar-for-dollar tax credit up to $1,000 per child for money spent on tuition expenses at any qualified nongovernment school — a form of taxpayer choice for education.

The NCPA's Environmental Center works closely with other think tanks to provide common sense alternatives to extreme positions that frequently dominate environmental policy debates. In 1991 the NCPA organized a 76-member task force, representing 64 think tanks and research institutes, to produce *Progressive Environmentalism*, a pro-free enterprise, pro-science, pro-human report on environmental issues. The task force concluded that empowering individuals rather than government bureaucracies offers the greatest promise for a cleaner environment. More recently, the NCPA produced *New Environ-*

mentalism, written by Reason Foundation scholar Lynn Scarlett. The study proposes a framework for making the nation's environmental efforts more effective while reducing regulatory burdens.

In 1990 the center created a health care task force with representatives from 40 think tanks and research institutes. The pro-free enterprise policy proposals developed by the task force became the basis for a 1992 book, *Patient Power*, by John Goodman and Gerald Musgrave. More than 300,000 copies of the book were printed and distributed by the Cato Institute.

A number of bills before Congress promise to protect patients from abuses by HMOs and other managed care plans. Although these bills are portrayed as consumer protection measures, NCPA studies show they would make insurance more costly and increase the number of uninsured Americans. An NCPA proposal to solve the problem of the growing number of Americans without health insurance would provide refundable tax credits for those who purchase their own health insurance.

NCPA studies, ideas and experts are quoted frequently in news stories nationwide. Columns written by NCPA experts appear regularly in national publications such as *The Wall Street Journal*, *The Washington Times* and *Investor's Business Daily*. NCPA Policy Chairman Pete du Pont's radio commentaries are carried on 290 radio stations across America. The NCPA regularly sponsors and participates in *Firing Line Debate*, which is aired on 302 public broadcasting stations. The NCPA additionally sponsors several one-hour televised debates on the PBS program *DebatesDebates* shows each year.

According to Burrelle's, the NCPA reached the average household 10 times in 1997. More than 35,000 column inches devoted to NCPA ideas appeared in newspapers and magazines in 1997. The advertising value of this print and broadcast coverage was more than $90 million, even though the NCPA budget for 1997 was only $3.6 million.

The NCPA has one of the most extensive Internet sites for pro-free enterprise approaches to public policy issues. All NCPA publications are available on-line, and the website provides numerous links to other sites containing related information. The NCPA also produces an on-line journal, *Daily Policy Digest*, which summarizes public policy research findings each business day and is available by e-mail to anyone who requests it.

What Others Say about the NCPA

"...influencing the national debate with studies, reports and seminars."

— TIME

"...steadily thrusting such ideas as 'privatization' of social services into the intellectual marketplace."

— CHRISTIAN SCIENCE MONITOR

"Increasingly influential."

— EVANS AND NOVAK