Keeping the Promise of Social Security in Latin America

Guillermo Perry
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Based on a book by
Indermit Gill, Truman Packard and Juan Yermo,
with Todd Pugatch

Office of the Chief Economist, LAC Region, The World Bank
Keep in Mind:
Differences across reforms, including structure of pillars

Mandatory Contributions

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

Choice of system

- Colombia
- Peru

Choice of system

- Argentina
- Costa Rica
- Uruguay
Summary of results

- Fiscal: positive results, but...
  - Reduction of implicit pension debt, but...
  - Transition costs and transformation of implicit debt into explicit debt can compromise fiscal stability in some countries

- Financial: positive results, but...
  - Pension funds deepened capital markets...when they didn’t invest excessively in public debt.
  - Regulatory challenges remain, such as high commissions, homogeneous portfolios

- Social: positive results, but with limits...
  - Greater equity among covered population, but...
  - Little progress in coverage, threatening equity gains.
  - Lack of sufficient attention to poverty prevention pillar.

- Structural: positive results, but...
  - Demographic change makes individualization of pensions appropriate, but...
  - Unclear extent to which mandate to save is appropriate: balance between pillars two and three
Three Propositions

- Reforms motivated more by macro (fiscal and financial) concerns than coverage
  - With some important long-term structural benefits: individualization of accounts.

- Reforms motivated by loss of faith in government and not by consideration of government’s role
  - Used to reduce government role in pensions: private administration of funds, but...
  - Government still has central role: funds exposure to country risk, need for regulation, minimum pensions, uncovered old age population.

- Reforms sought to increase coverage, but did not consider range of needs and options available to entire population.
  - Improved incentives to participate, but coverage still low.
Achievements and challenges in fiscal and macroeconomic dimensions
Simulations show that reforms reduced implicit pension debt.
But estimating transition costs is difficult, complicating fiscal management: case of Bolivia

Cash Flow Gap: Bolivia

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual GDP</th>
<th>Projected in 1997 GDP</th>
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<tbody>
<tr>
<td>1998</td>
<td>4.0%</td>
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<td>2002</td>
<td>4.0%</td>
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Legend:
- □ actual
- □ projected in 1997
Transition costs worsened fiscal situation in Argentina

Source: Ministerio de Economía de la República Argentina and International Monetary Fund.
Achievements and challenges in the financial sector
1. Financial impact of reform

- Private, non-financial issuers of securities have benefited only in countries in which fiscal positions have been strong (Government is not crowding out other investment options) and regulation has been adequate.

- Even in successful countries, reform’s contribution to market liquidity has been limited.

- Reforms led to some modernization of financial infrastructure and financial regulation/supervision.
Median of two-thirds of fund assets invested in domestic sovereign debt

Private Pension Fund Portfolios Consist Mainly of Government Paper

Costa Rica
El Salvador
Mexico
Argentina
Bolivia
Uruguay
Chile
Colombia
Peru
Market capitalization has increased in Chile
But stock market liquidity has not taken off

Source: Cifuentes et al.(2001)
Improving the second and third pillars: main challenges

*High mandatory contributions*: possible conflicts with liquidity needs of low-income households and no room for development of third pillar.

*Risk management*: need to consider risk aversion of individuals.

*Management of costs and competition*: economies of scale and asymmetric information.
Problems with high mandatory contributions for the poor

- Greater economic and health risk ⇒ need for liquidity
- Shorter life expectancy ⇒ less savings required
- Greater housing and educational deficiencies ⇒ priority for other forms of saving

Mandatory contributions should be lower in Latin America than OECD
Latin America has high mandatory contribution rates…
Remaining tasks to manage investment risk

- Liberalize investment in foreign instruments without compromising macro stability
- Sovereign bonds with better credit rating
- Opening to instruments with guaranteed minimum income
- Portfolio choice, but simplified, with adjustments based on age
Remaining tasks to manage longevity risk

- Mandatory annuities to cover minimum pension beginning at a certain age?
- Rigidity of early retirement requires purchase of annuities
- Simplification of annuity options, including variable benefits
- Strengthen supervision of insurance companies
Management of costs and competition

- Administrative costs have decreased but remain high in some countries.
- Highly concentrated industries, with little competition and, in some cases, possible conflicts of interest with insurance companies and other financial entities.
- Absence of employer as referee or mediator, in contrast with OECD countries.
Large differences in commissions (December 2003)
Also differences in reduction of commissions (1990-2003)
Regulatory deficiencies: cost savings not passed to consumers (AFPs in Peru)

Conclusions

- A large second pillar does not correspond to level of development in Latin America. Origin: large mandated benefits in previous PAYGO systems that were only modestly reduced through reforms
  - Risk and Cost Management in mandatory pillar can still be improved
  - Voluntary pillar should be more open to competing firms and products
Achievements and challenges in social dimension
Participation rates remain low, worsening equity: in best cases, coverage barely surpasses 60% of EAP
How to close this gap and cover the population against the risk of old age poverty?

- Second pillar is not the appropriate instrument for poverty reduction
- Need to pay more attention to structuring a poverty reduction pillar that is...
  - Fiscally sustainable
  - Equitable in outcomes
  - “Blind” to labor history
Design must respond to realities and preferences of each country; variables to consider are…

- **Benefit level**
  - Minimum wage, poverty line or another threshold?

- **Eligibility age**
  - Eligibility age adjustments with advances in longevity

- **Indexing benefits**
  - To inflation or wage growth?

- **Benefits and the tax system**
  - Financing benefits: through VAT?
  - Benefits taxable to ensure proper targeting?

- **Other considerations**
  - Implications for other public benefits
Looking Forward:

- How to increase coverage? In particular, how to cover the risk of poverty in old age... pillar one, pillar zero or general antipoverty programs?
- How to make pillar two more efficient?
- How to diversify away public risk in pillar two?
- What is the proper balance between pillars two and three?
- How to achieve full fiscal sustainability?