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Pension Reform: Lessons From Latin America

Monika Queisser*

Abstract

- There are benefits from Latin American pension reform, but they have been overestimated.
- The approaches taken in second-generation reforms and their still early results hold lessons for OECD and non-OECD countries alike.
- A partial shift to funding is feasible and can be financed in different ways; partial funding of pensions can lead to greater risk diversification.
- High administrative costs and uniformity of investment portfolios make the new systems inefficient; pension regulation has to be designed and implemented to lessen these negative effects.

I. Introduction.

Pension reform is high on the agendas of countries around the world. More and more Organization for Economic Co-operation and Development (OECD) countries are looking for solutions to deal with increasing demographic pressures by putting pension financing on a financially sustainable track to maintain prosperity in ageing societies. Containment of pension spending and the reduction of high contribution rates are also urgent issues for transition countries in Central and Eastern Europe. In the developing countries of Asia, where pension systems are much more limited in size and scope, the financial crisis has painfully demonstrated the problems of weak financial systems coupled with the absence of social safety nets; this situation makes the Latin American attempt to improve old age security, while simultaneously fostering financial sector development, particularly relevant for Asia. This article will examine the early experience of the Latin American pension reforms and discuss their implications for the reform discussion in other parts of the world.

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* Senior Economist, OECD, Paris. The views expressed are those of the author and not necessarily of the OECD. This article is based on OECD Policy Brief No. 15 on Pension Reforms, as prepared by Dr. Queisser. Dr. Queisser is the author of The Second-generation Pension Reforms in Latin America, OECD Development Centre Study, Paris.

II. Latin America Pension Reform - In General.

A. Leading Global Reform.

Latin America has proven to be the most dynamic and innovative region in the area of pension reform. The pioneer in pension reform was Chile, which introduced radical changes as early as 1981 with its revolutionary move from a public pay-as-you-go system to a fully funded, privately managed pension scheme. The role of the state has been reduced from directly providing old age security to regulating, supervising, and, to a certain extent, guaranteeing the provision of old age security by the private sector.

More than a decade after the Chilean reform, seven other countries in Latin America—Peru, Colombia, Argentina, Uruguay, Mexico, Bolivia, and El Salvador—have reformed their pension systems. No two of these “second-generation” pension reforms are alike, but they share the common feature of a greater role for funded, privately managed pensions.

The experience of the Chilean and the second-generation reform countries holds important policy lessons for OECD and non-OECD countries alike. This article will explain:

- why the Latin American countries moved earlier than other regions to reform their pension systems;
- what the new pension models look like and why the countries chose these models;
- which policies governments used to manage the transition from the old to the new systems;
- which reforms were successful and where improvements are needed; and
- what OECD and other countries can learn from the Latin American experience.

The brief will examine in more detail whether the new systems are living up to the reformers' expectations, i.e., whether they are able to provide better and cheaper pensions than the old systems. Also, it will discuss whether using the market is an efficient and effective policy for providing lifelong retirement income security.

B. What Went Wrong with the Old Pension Systems?

The first Latin American pension systems were set up in the 1920s, making Latin America the first region outside Europe to adopt earnings-related social insurance schemes. The oldest systems are found in Chile, Argentina, and Uruguay. In the latter two countries, the age profiles of the population are comparable to those of Western Europe and population growth is low or even negative. Thus, by the 1990s, their pay-as-you-go systems had reached high degrees of maturity and were already struggling with the problems witnessed in many OECD countries today, i.e., rising pension expenditures and increasing contribution rates.
The other second-generation reform countries had relatively young and immature pension systems. Their schemes, too, were based on social insurance principles; originally established as partially funded schemes, the pension systems' reserves were being drawn down rapidly due to generous benefit eligibility conditions and high non-pension expenditure, as well as high evasion of contributions. The financial pressure, however, was not yet due to ageing populations. Since the systems covered only a small part of the economically active population and real benefit levels had deteriorated as a result of inflation, the cost of these systems was low compared to the Southern Cone countries.

The pension systems in all of the reform countries suffered from a range of common problems. The distribution of benefits among the population was uneven and inequitable. The politically powerful groups pressured on policy makers and lobbied for more generous benefits and eligibility conditions. The urban and rural poor, who had no political power, were disadvantaged or even excluded from the systems. In most schemes the relation between benefits and contributions was unsustainable. Benefits had repeatedly been raised while retirement ages had been lowered. Most schemes had originally been partially funded with capital reserves to cover expenditures over an actuarially determined period. Arbitrary benefit increases, cross-subsidization of other social insurance branches, particularly to finance the infrastructure needs for health care, and politically rather than economically motivated investments led to a rapid depletion of pension reserves. In addition, the pension systems suffered from repeated periods of high inflation.

By the end of the 1980s, pension reform had become an urgent and pressing need, particularly in Argentina and Uruguay. The number of active contributors per pensioner was declining dramatically. Unemployment and the informalization of the labor force had increased strongly because of the severe economic crisis and the successive failure of adjustment attempts during the 1980s. The number of pensioners increased as a result of generous early retirement and disability regulations. As financial imbalances grew, contribution rates had to be increased; where this proved politically unfeasible, state subsidies were raised. Fiscal pressures, however, soon made this strategy impossible.

Despite generous legal benefit entitlements, the benefits paid out were very low since pensions were only partially indexed to inflation. In Chile during the late 1970s, for example, seventy percent of all pensioners were receiving only the minimum pension. In Argentina, in 1989, the average pension amounted to only about forty percent of wages despite a defined benefit of at least seventy percent. Some schemes defaulted on their pension promises and started to accumulate substantial debt towards the pensioners. This, in turn, led to even higher evasion of contributions, as workers began to realize that they might not receive any benefits upon retirement.

Throughout the 1980s, most Latin American countries tried, albeit unsuccessfully, to reform their retirement systems. Since all proposals to cut pension expenditures or tighten eligibility conditions failed, the contribution rates reached unsustainable levels. To alleviate the burden on employers, several countries tried to replace the employers' share of contributions by transfers financed out of general tax revenue. However, these measures were not sufficient to arrest the financial deterioration of the pension systems. As piecemeal reform failed, the countries started to look for more fundamental solutions to their problems.
The demonstration effect of the Chilean pension reform promoted a wave of pension reform in Latin America. As the other countries in the region observed more than a decade of operations in Chile with an average real rate of return of more than twelve percent and a rapid accumulation of retirement capital in the new pension system, many governments in the region took this as an incentive to explore reforms along the same path.

The Chinese pension reform of 1981 was an integral component of an economic and political restructuring concept elaborated by a group of economists trained predominantly at the University of Chicago and implemented under the Pinochet military government. Their strategy of structural modernization of the Chinese economy aimed for a stronger reliance on market mechanisms and private sector participation in the economic and social sectors. The rationale for the radical transformation of the pension system was that the public pay-as-you-go system was perceived as having failed for structural reasons and was thus considered beyond repair. In the second-generation reform countries, the move towards free-market policies was less pronounced than in Chile, but there was still a general trend towards more liberalization and less reliance on state intervention throughout the region at the beginning of the 1990s.

The Chinese model was the first of its kind, not only in Latin America, but worldwide. It is a defined-contribution scheme in which every worker has an individual retirement account. The pension depends on the amount of contributions and the interest accrued in the individual account. The pension system is administered by private fund management companies, the Administradoras de Fondos de Pensiones (AFPs), which compete in the market for members. Membership in the AFP system is mandatory for all private and public sector employees entering the workforce and optional for the self-employed. Workers contribute ten percent of their earnings for old age and, on average, an additional three percent to pay for disability and survivors' insurance as well as the fund management commissions. Strict regulations for the investment of the funds specify the allowed financial instruments and maximum investment limits by instrument and issuer. The retirement age is sixty-five years for men and sixty years for women. At retirement, members have the choice of using their account balance to purchase an annuity from a life insurance company or to leave the account with the AFP and draw down the balance according to their individual life expectancy. The government subsidizes the payment of minimum pensions for members with insufficient balances if they have at least twenty years of contributions and backs the provision of benefits by the private financial institutions. Fund managers also must guarantee a minimum profitability, defined as a band around the average performance of all fund management companies.

The new funded pension systems in Peru, Colombia, and Mexico have incorporated many features of the Chinese system. The extent of these second-generation reforms, however, reflects the political difficulties of passing a comprehensive pension reform. This is true even in the case of Peru where the reform was decreed by an authoritarian government. In both Peru and Colombia, the new individual account system was originally meant to replace the existing public pay-as-you-go scheme as it did in Chile, but, due to the resistance of trade unions, the social insurance bureaucracy, and other groups, the
reformers had to accept a compromise: the new schemes are offered only as an alternative to the existing public pension scheme and there is no obligation for new labor force entrants to join the private system. Only in Mexico is the new system mandatory for all private sector workers. Even there, it is still an incomplete reform, given that the public sector workers keep their old, more generous systems and that the reformers have so far been unable to transfer the substantial mandatory contribution for the housing fund to the individual retirement accounts.

In Argentina and Uruguay, the new pension systems are mixed: they have a public pay-as-you-go component, as well as a privately managed funded pillar. As the pension systems in both countries were already experiencing severe financial difficulties and contribution rates had increased substantially, a full transition to a funded system was not a realistic option due to the extremely high costs involved. Further, in both countries the political power of trade unions and pensioners’ associations favoring the preservation of the pay-as-you-go system is strong. Therefore, a large pay-as-you-go pillar was retained in the new pension systems.

The Argentine pension reform is more comprehensive and far-reaching than the Uruguayan reform. Argentina established a true multi-pillar system where all workers must contribute both to a public pay-as-you-go pillar and to a second pillar that can be either a privately managed defined-contribution or a public defined-benefit scheme. In Uruguay, only workers above a certain income threshold are required to contribute to the second pillar. Since the threshold is set at a relatively high level, few workers are mandatorily affiliated; however, the response of workers has been positive and voluntary affiliation to the new system has been high.

Bolivia chose a completely new approach of combining pension reform with the privatization and capitalization of state-owned enterprises. The old pay-as-you-go pension system was closed and all affiliates were automatically transferred to a privately managed, funded system with individual accounts. At the same time, a universal pension was introduced in which all persons aged twenty-one or older will be entitled once they reach sixty-five years; it is financed out of a “collective capitalization fund.” This fund was created during the privatization process: the government sold fifty percent of the public enterprises’ shares to capitalize the companies and retained the other half for the collective fund. The fund is managed by the same fund management companies and subject to the same investment rules as the pension funds thus minimizing the danger of discretionary investment decisions by the government.

The most recent pension reform was launched in El Salvador. Of all the second-generation pension reforms, the Salvadoran reform is the one most similar to the Chilean pension reform. As in Chile, the old pay-as-you-go system is phased out and replaced by a funded, privately managed system of individual accounts. The Salvadoran pension reform law was passed in December of 1996, but the new system did not start operations until April of 1998 due to a crisis in the financial sector and political controversies about the new system.

The main features of the second-generation pension systems in Latin America are summarized in Table 1.
Table 1. The Second-Generation Pension Reforms: Main Features of the New Models

<table>
<thead>
<tr>
<th>Feature</th>
<th>Chile</th>
<th>Peru</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>Public 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>
</tr>
<tr>
<td>Private funded system</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Affiliation of new workers</td>
<td>mandatory</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
<td>voluntary</td>
<td>mandatory</td>
<td>mandatory</td>
<td>mandatory</td>
</tr>
<tr>
<td>Fund management companies</td>
<td>AFP</td>
<td>AFP</td>
<td>AFP</td>
<td>AFJP</td>
<td>AFAP</td>
<td>AFORES</td>
<td>AFP</td>
<td>IAFFP</td>
</tr>
<tr>
<td>Contribution rate for savings (% of wage)</td>
<td>10</td>
<td>8b</td>
<td>10</td>
<td>7.5</td>
<td>7.5</td>
<td>6.5 + subsidy</td>
<td>10</td>
<td>4.5b</td>
</tr>
<tr>
<td>Commissions + insurance (% of wage)</td>
<td>2.94</td>
<td>3.72</td>
<td>3.49</td>
<td>3.45</td>
<td>2.62</td>
<td>4.42</td>
<td>3.00</td>
<td>3.5</td>
</tr>
<tr>
<td>Contribution collection</td>
<td>decentralised</td>
<td>decentralised</td>
<td>decentralised</td>
<td>centralised</td>
<td>centralised</td>
<td>decentralised</td>
<td>decentralised</td>
<td>decentralised</td>
</tr>
<tr>
<td>Past contributions</td>
<td>RB</td>
<td>RB</td>
<td>RB</td>
<td>CP</td>
<td>no recognition</td>
<td>lifetime switch</td>
<td>CP</td>
<td>RB</td>
</tr>
<tr>
<td>Disability/survivors insurance</td>
<td>private</td>
<td>private</td>
<td>private</td>
<td>private</td>
<td>integrated</td>
<td>public</td>
<td>private</td>
<td>integrated</td>
</tr>
<tr>
<td>Supervision</td>
<td>specialised</td>
<td>specialised</td>
<td>integrated</td>
<td>specialised</td>
<td></td>
<td>specialised</td>
<td></td>
<td>specialised</td>
</tr>
<tr>
<td>Account transfersC</td>
<td>2 x p.a.</td>
<td>2 x p.a.</td>
<td>2 x p.a.</td>
<td>2 x p.a.</td>
<td>2 x p.a.</td>
<td>1 x p.a.</td>
<td>1 x p.a.</td>
<td>2 x p.a.</td>
</tr>
<tr>
<td>Minimum rate of return</td>
<td>relative</td>
<td>unregulated</td>
<td>relative</td>
<td>relative</td>
<td>absolute</td>
<td>no</td>
<td>no d</td>
<td>relative</td>
</tr>
<tr>
<td>Minimum pension</td>
<td>yes</td>
<td>no</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
</tbody>
</table>

Notes: RB = Recognition Bond; CP = Compensatory Pension.

a) Participation in the funded system in Uruguay is mandatory only for high-income workers.
b) Contribution rate will be increased gradually to 10 percent.
c) Due to administrative delays, transfers may be more limited.
d) Guarantees are required from the fund management companies.
III. Funded Individual Retirement Accounts.

A. A Movement Toward.

The Latin American pension reforms entailed two radical changes from previous pension policies: the move from defined-benefit to defined-contribution plans and the shift from pay-as-you-go financed to fully or partially funded pension systems. Moving to a defined-contribution plan means that workers will receive a pension that depends on their individual contributions, unlike in the old systems where the benefit was defined as a certain percentage of the workers' previous earnings. The move to funding, on the other hand, means that every cohort of workers will now save for its own retirement while in a pay-as-you-go system today's workers pay pension contributions to finance the benefits for today's pensioners.

Advocates of the new funded pension systems with individual retirement accounts see the following advantages in such systems: a tight link between contributions and benefits that can reduce distortions in the labor market, a potentially positive impact on national savings and thereby on economic growth, the mobilization of domestic resources available for long-term investment that can contribute to capital market development, and finally, through the build up of a pool of investable funds, a boost for the development of the domestic financial sector.

High payroll taxes in pay-as-you-go systems put a wedge between the total cost of labor payable by the employer and the wage actually received by the worker. This wedge represents a disincentive for workers to enter into formal sector labor contracts. A contribution for pensions that is paid into an individual account is more likely to be perceived by workers as personal savings rather than as a tax. In that case, workers would be more willing to work in the formal sector and forsake part of their wages in order to save for retirement. Therefore, a defined-contribution system relying on individual accounts may make labor markets more efficient and reduce distortions.

Funded systems encourage or, if they are mandatory, oblige workers to increase savings for retirement. It is often argued that pension savings can lead to an increase of national savings, although the increase in pension wealth may merely displace voluntary savings. Therefore, there is a great deal of controversy on whether moving to a funded pension system will actually increase overall national savings. Nevertheless, evidence exists that funded pension systems can increase national savings under certain circumstances, notably when groups that traditionally save only low amounts are required to participate in funded schemes, when tax incentives related to pensions are limited, and when borrowing against the accumulated mandatory pension assets is discouraged.²

Funded pension systems engage in long-term financial contracts. These contracts may last several decades because they go beyond the active contribution and accumulation phase throughout the retirement phase when beneficiaries are receiving benefits.

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from the fund. Contrary to other financial institutions, which manage assets that can be withdrawn anytime, funded pension systems mobilize savings, which are available for long-term investment in the domestic economy. The management of substantial pension reserves, particularly if they are managed by private investment companies, requires financial services such as accounting, securities rating, and investment management. Through the mobilization of longer-term savings, funded pension systems can, therefore, stimulate and accelerate the deepening of capital markets and support the establishment of a modern financial infrastructure.

Thus, the rationale for the introduction of funded, defined-contribution systems in the second-generation reform countries was a combination of the following factors: (1) the severe financial crisis, and in some cases bankruptcy, of the existing pay-as-you-go systems; (2) the impressive performance of the Chilean pension system in terms of real returns and capital accumulation that led reformers to the conclusion that funded, defined-contribution schemes were superior to the old systems; (3) a general trend towards more market oriented economic policies, which favored a radical reform of the pension system; and (4) a desire on the part of policy makers to mobilize domestic long-term resources and support the development of the financial sector.

B. Transition to Funding: Tricky but Not Impossible.

In the transition from pay-as-you-go to a fully or partially funded system, pension liabilities that are implicit in the old scheme are made explicit. The current workers' contributions can no longer be used for the payment of current pensions, as they must be accumulated to build retirement capital. At the same time, previous contributions of workers to the pay-as-you-go scheme have to be honored. Thus, the government has to come up with a financing mechanism to repay the implicit debt.

Once the general decision for more funding has been taken, pension reform requires policy decisions at two levels. First, policy makers need to define a transition strategy to structure the cash flows required for repayment of the implicit pension debt; the transition strategy determines the depth and speed of reform. Then, the transition cash flows can be fine-tuned by choosing the appropriate mix of instruments. In most countries, systemic pension reforms are not launched until the systems are experiencing substantial financial difficulties. In this situation, contribution rates have usually reached or are rapidly approaching unsustainable levels and often governments are already subsidizing the pension systems. Moving towards a more funded system exacerbates the financial problems in the short to medium term. Most countries therefore need to devise transition strategies that reduce the costs of transition or at least reduce the annual cash flows to manageable levels.

A first strategy for transition financing—albeit politically the most difficult—is the downsizing of the pay-as-you-go systems. A smaller public system will reduce the cost of transition, particularly if most of the transition workers are affected by the change of rules. Benefit commitments are downsized by tightening the pension eligibility conditions, such as the retirement age, the minimum years of contributions for access to full benefits, the rules under which early retirement options may be taken, and by modifying
the accrual rate for future pensioners. Pensions currently in payment and the benefits of workers close to retirement are usually not affected; pensioners and older workers should not be subjected to sudden changes in their retirement income since they are unable to adjust their financial planning in the short term. Ideally, the downsizing measures should be taken before the shift to funding is made but, since cutting benefits has proven politically very difficult, most countries (e.g., Argentina, Uruguay, Peru) have only been able to downsize the old system simultaneously with the introduction of a new system. If changes in the benefit structure are combined with cutting entitlements in the old system, winners and losers of the reform are less easily identified, which lowers resistance to systemic reforms.

The second strategy is to reduce the speed of transition. By stretching out the move from pay-as-you-go to funding over a longer period, the annual financing requirements can be reduced. This can be achieved by setting limits, for example, cut-off ages, for workers’ participation in the new funded system. The most gradual transition to a funded system would be to allow only new entrants to the labor force to join the funded system. The cash flow requirements for the government would then consist initially only in covering the gap caused by the diversion of the new entrants’ contributions. Deficits would increase gradually as more and more workers retire from the old system. The most radical transition, on the other hand, would be to close the old system immediately and oblige all workers to join the new system; Bolivia is the only country where this avenue was chosen. Countries that have strongly fragmented public pension systems may also decide to switch only part of the affiliated workers to a new system and postpone the transfer of other groups to a later date; but in most cases, for example in Mexico, the exclusion of certain groups of workers is due to political pressures of such groups rather than to financial considerations.

A third strategy to cope with the problem of transition financing is a partial shift to a funded system. Partial shifts from pay-as-you-go to funded schemes can take different forms. One type of partial shift would be to keep a pay-as-you-go financed public pillar and move only part of the contributions to the funded system. The pay-as-you-go pillar would continue to pay out current pensions and the government would have to make up for the share of contributions diverted into the funded pillar. Depending on their budgetary constraints, governments could choose to gradually increase the contribution rate to the funded pillar while lowering the rate for the unfunded pillar until the desired relation between the two pillars has been reached. Another way of achieving a partial shift would be to introduce an optional funded system as an alternative to the existing pay-as-you-go system like in Peru and Colombia; in this case, the speed of the shift depends on the reaction of workers to the two options. This option, however, provides very little certainty for governments in terms of their financial planning, particularly if workers are allowed to switch back and forth between the pay-as-you-go and the funded system.

Once the strategy has been defined, the cash flow requirements of transition can be fine-tuned by the choice of mechanism to compensate workers for past contributions to the old system. The largest cash flows would be required in a solution where all the workers switching from the old system would be compensated with immediate lump sum pay-
ments corresponding to the present value of their acquired rights. If past contributions are recognized through the issue of bonds that mature at retirement of the individual worker, the pressure on cash flows is reduced since workers retire gradually, but, since there are lump sum payments due at retirement, cash flows are still high compared to using a compensatory pension. Under this solution, past contributions are honored through the payment of a monthly pension, either from the old system or directly from the government budget, which supplements the benefit of the new pension system. The total cost of transition, however, does not depend so much on the instrument used but on the way the recognized rights are calculated and on the discount rate applied.

The problem of how to compensate workers through the use of different payment mechanisms needs to be separated from the question of how governments finance the gap caused by the transition to a funded system. The government’s options for financing the transition are, in principle, the same as for any other kind of public expenditure. Issuing debt, selling off government assets such as public enterprises, real estate, or other holdings, raising taxes, and reducing public expenditure in other areas can cover the gap.

Selling off government assets and increasing government debt have the same effect: in both cases a swap of pension liabilities for government assets takes place. In the first case, the government loses future returns on the sold assets; in the second case, interest payments have to be made on debt issued for transition. In both scenarios, future generations will have to pay for the shift to funding through higher taxes. If the transition is fully financed by these two instruments, the macroeconomic impact, i.e., the effect on savings and growth, is equivalent to the situation where the pay-as-you-go system is continued. Either way, future generations will have to pay more, be it in the form of higher taxes or higher contributions.

Raising taxes or cutting public expenditure, on the other hand, puts the burden of transition on the current generations that are living through the transition process. Thus, the initial income redistribution in favor of the first pensioner generation at the introduction of the pay-as-you-go system is being undone through this type of transition. The active generations have to reduce their consumption to pay for the transition. If the reduced consumption is not compensated through transfers from pensioners to the active generation, the move to a partially or fully funded pension system will have a positive effect on savings. Future generations will thus benefit from increased economic growth and higher income levels.

The second-generation reform countries in Latin America have chosen different ways of financing the transition to the funded systems depending on the financing requirements and the fiscal situation in the individual country. Estimates of the implicit debt of the old pension systems ranged between more than two hundred percent of GDP in Uruguay, around ninety percent in Colombia, and around thirty percent in Peru.

In Chile, the government issued recognition bonds to each worker who switched to the new system. These bonds are calculated to correspond to the present value of a pension, replacing eighty percent of earnings for a full contribution period; they are adjusted for inflation and carry a real rate of return of four percent annually. The bonds are calculated at the moment of transfer and mature at retirement of the eligible member. The
resulting sum is placed into the individual account. Current and future pensions for members who chose to remain in the public system are financed from current contributions to the public scheme and from general budget subsidies.

The same approach is being used in Colombia, Peru, and El Salvador, although past contributions are recognized less generously. Argentina chose instead to use a compensatory pension payment for the recognition of past contributions to the old system. This benefit is paid out by the public pay-as-you-go pillar, and it is financed out of current contributions and budgetary transfers for which certain taxes have been earmarked. This mechanism reflects Argentina's limited capacity for additional public debt on the one hand and the high implicit debt of the system on the other hand. By paying out a monthly pension instead of redeeming a recognition bond at the moment of retirement, the financial burden is stretched out over a longer period reducing cash flow pressures for the government. Bolivia also decided to offer a compensatory pension to workers affiliated in the old system.

Uruguay has no explicit compensation for acquired rights but continues to pay all old benefit entitlements through the public pillar. The public system will continue to provide the bulk of pension benefits anyway since the second pillar is very limited in size and scope. Mexico decided to offer no compensation for acquired rights at all but to give all workers a "lifetime switch" option. Workers nearing retirement are allowed to compare their benefit entitlements under the new and the old system and to then choose the more advantageous option. If they opt for the public benefit, the balance accumulated in the individual account must be turned over to the public system.

Transition financing in Chile was facilitated by the strict budgetary policies of the government during the early 1980s. The recognition bonds were issued between 1981 and 1984. In 1981, when the reform was introduced, the government was running an overall budget surplus. From 1982 to 1984, an overall budget deficit was registered due to the severe economic crisis and due to a strong increase of social assistance pensions. If all pension expenditures are excluded from the budget, however, a surplus persists throughout the 1980s and early 1990s. These observations, however, do not imply that one can identify the financial resources used for the financing of the transition.

The Chilean economy has been undergoing profound structural changes during the last decades, including tax and trade reforms, privatization, and labor market and financial sector reforms. Not only pension reform but also numerous other factors have had an impact on the government budget. Therefore, it is impossible to say from which specific source—budget surpluses, taxes, or government debt—the transition deficit was and is being financed. The same holds true for most of the second-generation reform countries where pension reform was launched at the same time as other important structural reforms that had an impact on the fiscal situation of the countries. Similarly, using compensatory pensions instead of recognition bonds gives no indication of the source of financing since the government can issue debt to obtain the revenue necessary for transfers to the pension institution, but it is safe to conclude that the favorable fiscal situation made transition financing much easier for the Chilean government than it is for the second-generation reform countries, none of which is in a similarly good fiscal position.
The fiscal requirements and future cash flows resulting from pension reform are difficult to estimate in most of the second-generation reform countries. In Colombia, for example, cost projections are complicated by the fact that affiliates may switch between the new and the old system. In most second-generation reform countries, affiliation in the new systems is not mandatory for new workers, and it is difficult to estimate what affiliation rates and thus contribution volumes in the future will be. In Argentina, future costs are also unclear, since the government passed an emergency law in which it commits itself to pay only what it can afford. In Mexico, where the lifetime switch option is offered, the fiscal costs will not become clear until the workers with acquired rights reach retirement age.

IV. Reform Critique.

A. Reform Results: Early Evidence.

The acceptance of the new private systems has been high, particularly among younger age groups. Workers under thirty-five years of age account for about seventy percent of all affiliates in Peru, almost eighty percent in Colombia, and about half of all affiliates in Argentina. The income distribution of the affiliates in the new systems reflects the general levels of earnings in the respective countries. In Colombia, almost eighty percent of affiliates earn less than two minimum wages. In 1997, the average salary of Colombian workers contributing to the private system was $358, compared to $608 in Chile and $905 in Argentina.

The introduction of the new funded systems has led to a rapid build up of retirement capital. The Chilean pension system has accumulated more than $30 billion corresponding to about forty percent of Gross Domestic Product (GDP). In the second-generation reform countries, the largest fund has been accumulated by the Argentine pension system, which has now reached 3.2 percent of GDP. Compared to the evolution of the Chilean system, which after three years already amounted to 8.6 percent of GDP, growth has been much slower in Argentina. This is mostly due to the fact that in Argentina only about 7.7 percent of wages are being saved in the individual account while in Chile, ten percent of wages are being saved. Also, all Argentine workers, including new entrants to the labor force, are still given the option of contributing to the public second pillar where capital is accumulated. In Colombia and Peru, contribution rates were also lower during the first years, but the coverage of the system is also much lower, which explains why the pension funds' assets make up only around two percent of GDP.

The new systems have enjoyed high real rates of return. Despite the recent downturn and a record low of -6.3 percent real return in the period between July of 1997 and 1998, the Chilean system still boasts an average real return of more than eleven percent over the last seventeen years. In the second-generation reform countries, returns should be assessed taking into account the relatively short period of operations. Also, the returns in all Latin American countries reflect the high-risk premiums in emerging markets. To date, the highest real rate of return has been achieved in Argentina, on average almost thirteen percent; again, this result reflects the high level of interest rates in Argentina more than specific investment strategies of the Argentine pension fund managers.
In all of the reform countries, the differences between the portfolios of the individual Administradores de Fondos de Pensiones (AFPs) are small. The reasons for the fund managers' similar investment choices may be due to several factors, including the direct and indirect regulatory restrictions on investment and the still limited availability of investment instruments in incipient capital markets. Another factor that may influence the herding behavior of the pension fund managers is the minimum rate of return rule with which the managers have to comply.

Investment in foreign securities has been either negligible or disallowed during the start-up of the systems. Even in Chile, where more than ten percent of assets may now be invested abroad, the share of foreign securities in the portfolio has always remained below four percent. There are several reasons for this "home bias," i.e., the preference of pension managers to invest in domestic assets. Investment overseas involves higher transaction costs and foreign exchange risk. For pension managers, the shortfall risk is often more important than the upside potential. Managers may also be limited by internal restrictions on foreign investment imposed by the shareholders of the pension fund management companies. Particularly in developing economies, fund managers may not be sufficiently familiar with foreign markets and tax laws in other countries and would have to conduct extensive research to collect the necessary information. Fund management companies would need to hire a specialized team of experts to manage their overseas investment activities.

In the Latin American reform countries where the majority of fund management companies have still not broken even, managers are hesitating to incur these additional expenses, particularly since high returns can be obtained in the emerging domestic markets. Under these circumstances, pension fund managers find it unprofitable to invest pension fund assets overseas. This view is shortsighted, however, since international diversification would lower risk substantially. Especially in small countries with underdeveloped capital markets, private pension systems will not function without international diversification. Otherwise, capital would not only be concentrated in very few instruments with highly correlated risks but also concentrated in too few companies or conglomerates.

The introduction of private pension funds has supported the development of the financial sector, particularly in countries with an underdeveloped financial and regulatory infrastructure. The Latin American reform experience illustrates how systemic pension reforms can spill over to other areas of the financial sector. In most of the reform countries, the regulatory framework of the securities and insurance markets was overhauled simultaneously with pension reform, and providers of financial services are now required to disclose information according to international standards. The financial data required by the supervisors in Latin America is accessible to the public; fund unit values, rates of return, and other data is published daily in the major newspapers. The continuous monitoring of financial indicators by supervisors, analysts, and specialized information ser-

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vices facilitates the establishment of early warning systems. The development of reliable public information systems can help to build confidence and trust in the financial sector among the population and, thus, contribute to the reduction of volatility.

B. RETIREMENT INCOME SECURITY ONLY FOR A FEW?

A major criticism of the new defined-contribution systems centers on their capacity to provide adequate old age income given that many workers do not contribute regularly to their accounts and may find themselves with very low balances at the moment of retirement. In a defined-benefit system that guarantees a certain replacement rate, the risk of interrupted careers or periods of low earnings is pooled among all members of the scheme while these risks are individualized in defined-contribution systems. However, in defined-benefit systems where there is a close link between contributions and benefits, the same problem arises if workers do not contribute regularly.

First of all, the informal sector is large in most Latin American countries, particularly in the poorer countries such as Peru, Colombia, and Bolivia, which limits the coverage and effectiveness of pension systems tied to formal sector employment. In all of the private pension systems in Latin America, a large discrepancy between the number of affiliates, i.e., account holders, and the number of active contributors can be observed. In Argentina and Chile, the ratio of contributors and affiliates has been fluctuating around fifty percent; in Peru, about forty-four percent of all affiliates contribute regularly to their accounts; this is the lowest ratio in Latin America.

There are various reasons for this discrepancy. In the case of dependent workers, employers may default on their payment obligations; often, mistakes are made in the contribution data submitted to the fund management companies or in the payment of contributions. Some of the evasion is simply due to the fact that workers leave the labor market to pursue further studies, stay at home, or start up their own business, in which case they are no longer obliged to contribute, except in Argentina where the self-employed must also contribute. Independent workers often stop contributing due to the instability of their incomes, other priorities in the allocation of their savings, or misunderstanding of the benefits and mechanics of the system.

In Chile, the AFPs' association claims that ninety-seven percent of all workers required to contribute to the overall pension system were actually complying with this obligation in 1996. A calculation shows that out of the total Chilean labor force of 5.3 million, 3.3 million workers were in dependent employment and below the age of sixty-five years. The number of active contributors below the age of sixty-five in the private system, the public system contributors, and the contributing members of the special retirement schemes added up to 3.2 million, i.e., ninety-seven percent of the dependent employees under sixty-five years. Thus, the problem of effective pension coverage in Chile appears to be more a problem of affiliating self-employed workers than ensuring contribution compliance of dependent workers. Currently, only about twenty percent of all self-employed are affiliated to the pension system.

In Argentina, affiliation to the overall pension system, i.e., in the first pillar and the two second pillar options, increased substantially after the pension reform. Nevertheless, noncontributing affiliates are still a problem in the private system where the ratio has dropped from sixty-two percent initially to forty-nine percent at the end of 1997. It should be taken into account though that the Argentine economy underwent a severe recession in 1995, during which unemployment rates increased strongly; this may explain a large part of the ratio's decline.

The increasing share of noncontributing affiliates jeopardizes the effectiveness of the new pension systems in providing old age income security. It is mostly among lower income groups that the share of noncontributing members is highest; in most countries, pension fund management companies with higher average base salaries have much higher shares of contributing members. In those countries that provide a minimum pension guarantee, the high shares of noncontributing members will translate into an increased need for fiscal subsidies to attain the minimum benefit level. In addition, many affiliates might not even complete the necessary contribution period in order to receive the minimum pension, particularly in countries like Argentina and Uruguay where the required contribution periods are very long. In that case, the noncontributory old age assistance programs would require additional budgetary resources.

C. PRIVATE PENSIONS: BETTER AND CHEAPER?

Introducing a market-based solution for the provision of pensions with competitive management was intended to produce better and cheaper pensions than the old publicly administered systems. Has this objective been met?

Given that the public pay-as-you-go systems in Latin America functioned badly and paid low benefits to the majority of workers, any comparison between the old and the new systems would, for the time being at least, give results in favor of the private systems. In the second-generation reform countries, the number of pensioners retiring from the new systems is still very low. In Chile, where more and more workers are beginning to receive benefits from the new systems, the benefit levels are on average substantially higher than in the old system. It should be taken into account, however, that workers retiring from the new system today have benefited from the generously calculated recognition bond. Therefore, the pension level can be only partially attributed to the performance of the new system.

While it still remains to be seen whether the new systems will provide “better” pensions in the future, it is clear that presently the provision of benefits is not cheap. The operating costs of the new systems are very high. In systems that rely on individual retirement savings, high administrative costs endanger effective old age protection by cutting into the retirement capital. Workers in the Latin American reform countries are charged up to 3.5 percent of their base salaries to cover disability and survivors’ insurance as well as the administrative costs of the systems. Despite falling insurance costs, the total charge to workers has remained fairly constant. As insurance premiums have declined, the share dedicated to covering the AFPs’ operating costs has increased from about one percent to almost three percent of wages in some countries. Depending on the contribution rates in
the individual countries, administrative costs thus correspond to between twenty and thirty percent of contributions.

In the second-generation reform countries, the pension fund management companies are still struggling to amortize the very high start-up expenditures of the new systems. To launch the system, the companies employed large numbers of sales agents, engaged in expensive advertising campaigns, and invested heavily in computer equipment and other office infrastructure. Thus, the current cost structure and financial performance of all the newer systems still reflects the start-up expenditures. In the medium to longer term, the operating costs of the pension fund management companies should decline substantially. As the companies enlist more affiliates and accumulate larger volumes of assets under management, they should be able to benefit from economies of scale, which should translate into lower costs to workers. The Chilean system, however, which has been in operation for seventeen years, does not present any evidence of decreasing costs to workers, while still less than half of the companies are profitable.

The main reason for the high operating costs in the private systems is related to the transfers of members' accounts between the different fund management companies. All second-generation reform countries have adopted the principle of free choice between management companies, which is one of the central features of the Chilean pension model. Workers, however, do not seem to choose their fund managers on the basis of fee levels or rate of return differences. Instead, they choose their managers because of advertising campaigns, promotional gifts, and cash payments, because of advice they receive from their peer groups, or even just to do agents a favor. As the agents are paid their commissions per affiliate, they have a strong incentive to switch as many affiliates as often as possible.

The fund management companies employ large numbers of selling agents and spend substantial sums on advertising. This has led to "transfer wars" between the different companies. The problem is compounded by the fact that the fund management companies display very similar investment behavior both with respect to the classes of instruments and the individual security issues. Switching large numbers of workers around between fund management companies with practically identical portfolios is obviously highly inefficient. In Chile, fifty percent of all contributors switch AFPs each year; in Argentina, about thirty percent of all contributors change fund managers. Competition between the fund management companies was meant to provide the highest quality of services at the lowest prices for workers. Instead, the mechanism has produced cutthroat competition among companies for the individual accounts and high prices for all workers.

Several proposals have been made regarding how to lower marketing costs. Some countries have chosen to limit the number of transfers allowed annually. In Mexico, for example, workers will only be allowed to switch once per year. Other proposals suggest allowing more than one account per worker, which would reduce the competition for accounts, or to allow multiple providers of pension fund management services (banks, insurance companies, other financial institutions) instead of segmenting the market by permitting only single purpose companies to conduct the business. This, it is argued, would lead to lower fees because there would be much greater competition among providers. It is questionable, however, whether this approach could work in countries
with incipient capital markets and a limited number of well-developed, sound financial institutions to compete with the pension funds. Furthermore, segregation of the mandatory pension savings from both the business capital and all other types of investment funds, which is a crucial element in the Chilean-style pension systems, would be difficult to achieve and even more difficult to supervise.

Other reform suggestions address the type and level of the administrative fees directly. Some countries allow both collection-based and asset-based management fees. Clearly, in the start-up phase of pension funds when workers’ balances are slowly beginning to build up, collection-based fees are more advantageous for the pension fund management companies than asset-based management fees, which would be much cheaper for workers in the beginning, but more expensive in the long run. At the end of a worker’s career, however, collection-based fees will be very low when expressed as a percentage of assets.

One possibility to reduce the level of commissions would be to let employers negotiate group affiliation with AFPs at a lower fee. Another option would be to allow AFPs to differentiate the fees among affiliates instead of mandating the same price for all; that way, AFPs could offer loyalty discounts to workers who stay with the same AFP for a longer period of time.

Finally, although there is no doubt that the costs of the new pension systems are high, there still remains the problem of finding the adequate comparator. Should the costs and efficiency of the private pension funds be compared to those of the old public pay-as-you-go systems, to publicly managed funded systems such as the complementary funded pension system in Sweden and the Provident Funds in Singapore and Malaysia, or to similar non-bank financial institutions such as mutual funds? Often, cost comparisons are made between pension and mutual funds. Here, however, the relevant comparators are not U.S. mutual funds that offer a wide variety of choices at low costs. Rather, comparisons should be made with Latin American mutual funds. The fees charged by Latin American mutual funds are currently still very high; Chilean mutual funds, for example, in 1997 charged retail investors more than five percent of assets as fees for equity funds and around 2.5 percent for fixed income funds.

Comparing systems across countries, one could argue that for workers the cost of the private pension systems in Latin America is still lower than that of the above mentioned publicly managed funded pension systems such as the Southeast Asian Provident Funds. These publicly managed schemes are more expensive because the governments grant workers much lower rates of return than they would receive on bank deposits and investments in diversified portfolios; in Singapore, for example, workers are credited the average interest rate on bank deposits regardless of what returns the government gets on the investment of the provident fund’s assets. Taking this implicit tax into account, Chilean commissions are substantially lower than the costs that Southeast Asian workers have to shoulder.

What matters to workers is the net return on their balances. As long as the pension systems are able to reach real rates of return as high as those observed in Chile, workers can indeed “afford” to spend considerable amounts of money on the administration of the schemes, but as soon as the real rates of return start to fall, the net returns will be reduced substantially. This will jeopardize the accumulation of retirement capital in the workers’ indi-
individual accounts. Therefore, the problem of high operating costs will need to be addressed in a more comprehensive way even if the net returns of the systems are currently high.

In this respect, the experience of the new Bolivian system will be interesting to observe. The two successful bidders were selected on the basis of the fees they will charge to workers. The fees proposed by the two companies are the lowest in Latin America and correspond to about one percent of the base salary, i.e., between a half and a third of what pension fund managers charge in the other Latin American countries. If the companies succeed in operating profitably at such fee levels, a similar bidding approach could be taken in other countries as well.

D. Drawing Down the Balance: The Problem of Annuities.

The new pension systems of the second-generation reform countries are currently all in the accumulation phase. The workers affiliated with the defined-contribution systems are predominantly young and the number of old age pensioners is still very small. Therefore, the problem of how to draw down the balance accumulated in the individual account has not yet become an issue in the countries with recently reformed pension systems. In Chile, the number of pensioners in the private pension system is rapidly increasing. Most of the pensioners, however, have not reached the official retirement age yet but have accumulated sufficient balances in their individual accounts in order to retire early. About seventy percent of the annuities paid in 1996 were due to early retirement.

Retiring workers have different benefit options. The first option is a gradual withdrawal of the accumulated balance. The fund management company determines a monthly pension that is recalculated annually. The annual benefit is calculated on the basis of the capital available in the account and the cohort-specific “necessary capital” to provide an income stream until death; the “necessary capital” is determined on the basis of actuarial tables and regulated by the pension superintendency. As the balance is being drawn down, the remainder of the pensioner’s account stays with the fund manager and is invested in the same way as the active accounts. This option does not guarantee a life-long income. A pensioner who outlives the life expectancy of his cohort may eventually receive only the minimum pension or even nothing at all if he or she contributed for less than twenty years.

Choosing this programmed withdrawal option, however, does offer three advantages. First, in case of a pensioner’s death, the remaining balance can be passed on to the survivors. Second, pensioners are allowed to withdraw a lump sum equivalent to the excess capital over the amount that is necessary to finance a pension corresponding to seventy percent of previous earnings. Third, pensioners can change fund managers if they are not satisfied with the services. Currently, there are no fees charged for the programmed withdrawal, which means in effect that the active contributors are subsidizing pensioners. Since many pensioners wish to protect themselves against the risk of insufficient retirement income, however, an increasing number of pensioners are choosing a second option: the purchase of an annuity from a private insurance company.

The purchase of an annuity is only open to pensioners who have enough funds in their balances to finance a benefit greater than the minimum pension. The annuity can be
immediate, i.e., commence with retirement, or deferred, in which case pensioners initially use the programmed withdrawal option and move to an annuity later. According to life insurance industry estimates, about sixty percent of all Chilean pensioners choose the annuity option. The volume of annuity premiums in Chile soared from $51 million in 1987 to an estimated $1.1 billion at the end of 1996. The number of life insurance companies in Chile has increased from nine in 1988, the year in which early retirement was authorized, to more than twenty at present.

The annuity option brings with it the problems of annuity markets arising not only in Latin America but also in all countries around the world. The main problem of annuities is adverse selection: only people who expect to live for a long time, i.e., bad risks from the point of view of an insurance company, will be interested in purchasing an annuity contract. Due to this adverse selection and the fact that insurance companies cannot be sure that mortality tables correctly reflect life expectancy, risk premiums are high and annuity contracts will not be sold at an actuarially fair price to good risks, i.e., pensioners who are expected to die soon.

Depending on the type of annuity contract, a pensioner is exposed to several risks. In a fixed annuity contract, the insurance company commits itself to paying a fixed, usually nominal pension until the pensioner dies. Thus, while the insurance company assumes the demographic and the investment risk, the pensioner is exposed to the risk of inflation, unless the annuity is contracted in real terms, i.e., indexed to inflation. Annuities with inflation protection need adequate investment instruments to back the indexation, i.e., usually CPI-indexed government securities. Very few countries have wide-ranging financial sector indexation, such as that to be found in Chile, so that there are not many private sector issues that are indexed to inflation. Even CPI-indexed government bonds are currently only available in a small number of countries: the UK, Canada, Finland, Israel, Brazil, Chile, Mexico, and, more recently, in the United States.

Under a variable annuity contract, the pensioner uses the accumulated balance to purchase units in a mutual fund; the monthly pension is defined as a number of units and varies depending on the unit value. Premiums are usually invested in a portfolio of stocks but could also be invested in bond or money market funds. The pensioner assumes the investment risk while the insurance company assumes the demographic risk. If the units are adjusted to inflation, the pensioner is protected against price increases; if not, the pensioner also has to bear the inflation risk.

In Chile, annuities, like practically all financial contracts, are expressed in Unidades de Fomento (UF), which are accounting units adjusted monthly to inflation. Currently, all annuities are fixed and indexed to the CPI. The annuity is purchased with the payment of a single premium at the beginning of the contract. The contract is irrevocable, the annuitant is not permitted to switch insurance companies, and it is not possible to adjust the annuities later. Since the annuity is contracted with a single premium payment, the annuity is highly dependent on the value of the balance at the moment of purchase, particularly if the portfolio contains a high proportion of equity. In order to avoid strong fluctuations and expose workers close to retirement to the risk of low balance value and thus below average annuities, the Chilean regulators are considering making gradual pre-retirement conversion to fixed-income securities mandatory.
Annuity intermediation costs in Chile have increased from 1.5 percent of the gross premium in 1988 to more than five percent today. These costs include the marketing and administrative fees of the insurance companies as well as the commissions to brokers. An important factor for the high costs is the fact that all annuities are contracted on an individual basis and group contracts are not allowed. Instead, every pensioner has to negotiate independently with the insurance companies. The annuitant is required to provide the pension authorities with three different quotations for annuity provision. Partly, the high costs of annuities are also due to information problems. Life insurance companies that are part of a group with a related fund management company are in a position to charge commissions that are lower by about 100 basis points than the companies that are not related to any fund manager. There appears to be evidence that the companies' employees are selling information on potential annuitants to life insurance companies; a law has been proposed to publicize this information and thus make it available to all insurance companies.

Several suggestions have been proposed about how to lower the cost of annuities. One way would be to allow group annuities rather than limiting the option to individual annuities. If annuities could be contracted for a whole group of affiliates similar to the purchase of disability and survivors' insurance, which is contracted for all affiliates of a fund management company, the costs could be expected to decline considerably. To reduce the adverse selection and thereby lower the premium, the government could also decide to make annuities mandatory, since insurance companies will then charge a price based on the average of all annuitants and not only the ones who expect to live for a long time. In this respect, the Uruguayan pension reform has introduced an interesting innovation: pensioners affiliated with the private system will not be able to choose a programmed withdrawal; instead, the purchase of an annuity contract will be mandatory.

V. What Can the Rest of the World Learn from Latin America?

In OECD countries, the problems of social security are primarily due to the demographic transition; in recent years, high structural unemployment has aggravated the situation in Western European countries. The pension systems in Latin America confronted crisis much earlier than would be expected judging by their demographic dependency ratios. Some of the reasons for the financial imbalance of the Latin American social security systems are different from those in OECD countries. Evasion, for example, has as yet been much less of a problem in most OECD countries; the management of the pension institutions is usually quite efficient and administrative costs of pension systems are much lower. The effects of the financial crisis, however, are the same: rising contribution rates resulting in unsustainable levels of payroll taxes, increasing government subsidies to stabilize the systems, and gradual reductions of benefit levels.

In the transition countries of Central and Eastern Europe, pension reform has become a pressing issue as real benefit levels have plummeted and pension systems have become financially unsustainable. Two countries, Hungary and Poland, have already adopted pension systems that incorporate many features of the Latin American models, and in several other countries of the region pension reform along the same lines is being
discussed. The early experience of the Latin American reforms is, therefore, particularly
relevant for these countries in order to benefit from the positive experiences and avoid
the mistakes that have been made in the process.

Most developing countries in Asia have more time to consider their options in pen-
sion reform, since their systems still have a favorable ratio of contributors to pensioners
and are not experiencing financial imbalances yet; China is an exception as the one-child
policy will lead to much more rapid process of ageing than that experienced by OECD
countries. Nevertheless, the social protection of the older population has become urgent
in the wake of the financial crisis and has put pension reform on the agenda. For Asian
countries, the Latin American experience is also interesting with respect to financial sec-
tor stabilization as the reforms have shown that pension funds can support and strength-
en the development of the financial sector.

A. THE SECOND-GENERATION PENSION REFORMS IN LATIN AMERICA SHOW THAT A PARTIAL
TRANSITION TO FUNDING IS FEASIBLE.

The second-generation reforms in Latin America have demonstrated that structural
pension reform is possible under very different economic, political, and social conditions.
Up to the late 1980s, the Chilean pension model was still regarded as too closely connect-
ed to the authoritarian Pinochet government and thus impossible to implement in a
democratic context. The Chilean example has attracted a lot of attention and its perceived
success has reduced the resistance to reform among political interest groups in other
Latin American countries. Partially funded solutions similar to the new pension model
established in Argentina are now being adopted in modified forms even in Eastern
Europe (Hungary, Poland).

For OECD countries, the reform experience of Argentina and Uruguay is particularly
relevant. First, the old age dependency ratios and system dependency ratios in Argentina
and Uruguay are very similar to those found in Western Europe and Japan; in Argentina,
for example, in 1996 there were only 1.5 contributors per pensioner and 3.1 persons of
working age per person above sixty years. Second, both countries had pension systems
modeled on Western European social insurance schemes with high benefit levels, high
contribution rates, and state transfers to finance growing deficits. Thus, policy makers
were faced with a scenario that resembles the crisis of the welfare state in high-income
OECD countries. Third, neither country adopted a pure capitalization scheme such as the
Chilean model. Instead, they introduced mixed models maintaining a reformed version of
their public pay-as-you-go systems combined with a privately managed funded pillar.

B. THE TRANSITION TO A FULLY OR PARTIALLY FUNDED PENSION SYSTEM CAN BE FINANCED
IN DIFFERENT WAYS.

Particularly in OECD countries, it is often argued that a transition to a partially or
fully funded pension scheme is impossible because current generations would have to pay
twice—for the pensions of today's retirees and for their own future retirement. The sec-
ond-generation reforms show that this is not the case. The reforms demonstrate that gov-
ernments have a considerable degree of freedom in the design of the financial transition
path and that there are choices in distributing the fiscal burden of reform. The instruments used to cover the financing gap are crucial as well as the parameters set in the reforms such as the cut-off age for eligible workers, the integration or exclusion of certain occupational groups who have special, more generous pension regimes, and the calculation and recognition of rights acquired under the old system. Further, pre-reform measures streamlining the existing pension programs by increasing the retirement age, scaling down benefit entitlements, and tightening eligibility conditions for old age and disability pensions were an important factor for cost reduction in all of the reform countries.

The second-generation reforms also show the distributional effects of postponing reform over a long period. In Latin America, the pensioners carried a large part of the transition burden in the years prior to reform. Piecemeal reforms and arbitrary benefit reductions, particularly through insufficient indexation, led to very low pension levels. The reforms are carried out on the basis of these low pension levels. While transition and future generations are likely to benefit from much higher pension levels, the current pensioners will see little, if any, improvement in their payments.

C. OTHER COUNTRIES SHOULD CAREFULLY CONSIDER THE APPROPRIATE STRUCTURE OF THE FUNDED PILLAR GIVEN THE HIGH ADMINISTRATIVE COSTS OF THE LATIN AMERICAN MODELS.

The individual account management by specialized fund management firms has proven to be very costly, and the competition among firms has led to an excessive switching of accounts. Some modifications of the rules and regulations for the fund management industry are currently being discussed in Latin America. Such changes may or may not be successful in lowering the costs to workers. For OECD countries considering the introduction of a mandatory second pillar, these experiences are useful when deciding on which providers to allow. Given that many OECD countries already have established employer-based second pillars, the Latin American model may not be the most suitable approach.

An alternative for the management of a compulsory second pillar could be the employer-based second pillar similar to the one in Switzerland where plan sponsors have a choice of in-house management, banks, or insurance companies for the management of the pension plan. Another option would be a public, centralized institution or the establishment of a fund under the umbrella of the existing social security institution with private asset management through competing investment managers. Under such a model, the public institution would be able to negotiate asset management fees for all affiliates, and workers could still be given a choice between different investment portfolios depending on individual risk preferences. This option is currently being explored in the management of the Southeast Asian provident funds. The second-pillar solutions in OECD countries are likely to be much more diverse and shaped to individual country conditions than in Latin America where the funded pillars were built from scratch without any preexisting structures to build on.

D. SUCCESSFUL PENSION REFORM REQUIRES CONSISTENCY AND CONSENSUS.

The experience of Chile and the second-generation reform countries shows that the consistency of the pension reform concept was crucial to bringing reform about and
implementing the adopted strategy. Consistency refers both to the internal consistency of the chosen model and to consistency with the overall economic and social policy framework in the individual country. This can be seen in such diverse cases as in Chile, where pension reform was an integral component of the economic and political restructuring concept elaborated by a group of neoliberal economists, in Colombia, where pension reform was part of a larger reform concept and was preceded by external liberalization and reform of the labor code, and in Bolivia, where pension reform was integrated into the privatization policy of the government. The absence of consistency was the reason for the near failure of the Peruvian reform, which made it necessary to re-launch the private system after the design flaws had been corrected.

The importance of building consensus can be seen in the quality of the political discourse in Latin America in the early 1990s. The overriding objective of pension reforms, regardless of the model proposed, must be the improvement of retirement income security; this should be kept in focus in the political debate. All other effects of pension reforms on capital markets, financial sector infrastructure, or privatization, however beneficial they may be, are subordinated objectives of pension reform. A policy measure that has a positive impact on any of these other areas but fails to improve the provision of pensions should not be given the label of pension reform. Much confusion and unnecessary confrontation has arisen in the political arena because the primary aim of reform—to provide better and sustainable old age benefits—has not been spelled out clearly.

E. FOR OECD AND TRANSITION COUNTRIES IT WILL BE IMPORTANT TO ARREST THE FINANCIAL DETERIORATION OF PENSION SYSTEMS NOW INSTEAD OF WAITING FOR THESE SYSTEMS TO COLLAPSE.

Although reform may be easier when the financial problems are more obvious to the electorate and to the interest groups, measures have to be taken now. The longer reform is postponed, the more expensive the transition to a new system becomes. The history of failed reform attempts in Argentina and Uruguay shows that the political resistance to pension reform can stop all measures to restore financial equilibrium of the system until the situation has deteriorated so much that no interest group can gain any advantage. The financial collapse of the pension system paved the way for systemic reform. Benefit cuts, increases in the retirement age, and tightening of eligibility conditions, which had been impossible in earlier years, were now accepted. Partly, political acceptance was facilitated by the introduction of a completely new system that departed radically from the old structure and seemed more credible in its promise of new and better benefits. Further, it had become clear to the electorate and to policy makers that piecemeal reforms would not be sufficient to put the pension system back on track. The losers in this process are clearly current pensioners whose real benefit levels deteriorated dramatically before the reform and who have little chance of expecting any improvements during the transition process as additional financing requirements are imposed on the government.