Many Latin American governments have radically restructured their old age income security systems, starting with Chile’s 1981 pension reform. The reforms move national pension system from purely social to largely individual responsibility; from purely risk pooling arrangements to primarily individual savings accounts. They maintain reduced public risk pooling features, combined with mandatory and voluntary individual private savings to finance pensions and diversify the risks to adequate income in old age—the “multi-pillar” approach.

How has the new approach to pensions in Latin America fared? Are workers and their families better off?

A Brief Assessment of Reforms

Increased coverage, a major reform objective, would open access to protection under pension systems more widely and equitably. Changing from defined benefit pay-as-you-go (PAYG) systems—where payroll taxes paid by today’s workers finance pension benefits for today’s retirees—to individual savings, defined contribution systems where workers contribute to their own pension accounts, was expected to increase coverage, offering workers stronger incentives to participate in formal pension plans. Yet despite an initial improvement in incentives, coverage remains persistently low in most countries, even long after the introduction of individual accounts (Figure 1).

There has been greater, although qualified success, in meeting other objectives of pension reforms:

1. Overall, reforms improved fiscal sustainability, shown by simulations of governments’ pension debt, and a much lower rate of accumulation of pension obligations with reforms, especially in Peru, Bolivia, Uruguay, Chile and El Salvador. Some transitions were more costly than expected, however. In Bolivia, for instance, the actual pension-related deficit increased as a percentage of GDP instead of falling, due to insufficient regulation and fraudulent claims; lax interpretation of retirement rules; indexation linked to the exchange rate (recently reversed); and a high minimum pension (nearly twice the minimum salary). In Argentina, policies introduced after the reform— to integrate provincial civil servants into the new pension system, and to encourage formal job creation by lowering employer contributions—aggravated the transition costs of reform.
2. Growth of pension funds and other institutional investors can make capital markets more resilient and dynamic. In turn, **capital market development** improves the efficiency of resource mobilization and investment in the economy, contributing to economic growth. Latin America's new pension fund administration industries are beginning to dominate financial systems. Asset growth has been rapid in countries that have reformed pensions. In Chile, assets managed by pension funds are over 50 percent of GDP. In all Latin America, pension fund assets as a share of GDP have almost doubled in five years. However, many pension funds invest heavily in government debt, curtailing their contribution to private investment, and leaving them insufficiently diversified and excessively exposed to sovereign risk. Moreover, the fund management industries in several reform countries fail to fully pass along their gains in efficiency and savings to investors, reneging on one of the principal promised benefits of privatization brought by reforms.

3. **Increased equity**: Single-pillar public pension systems in developing countries, particularly in Latin America, tend to generate regressive transfers from poorer workers to the relatively small number of higher income workers covered by the systems. Moving from PAYG systems to multi-pillar systems with a large funded component can reduce regressive transfers and increases equity among covered workers (Figure 2). But retaining a reduced risk-pooling component is essential: poorly-run risk-pooling systems are bad for equity, but well-run risk-pooling components with an explicit poverty-prevention function are good for equity. Fearing misuse, many Latin American countries have made eligibility for the minimum pension (the poverty prevention pillar) conditional on contributions to individual savings accounts, rather than keeping the two pillars separate. To the extent that pooling-arrangements are financed through general taxation, this can perpetuate regressive transfers from those without coverage, to those covered by the system.

**Why Hasn't Coverage Increased?**

Despite improvements, the failure of reforms to improve coverage significantly has frustrated reformers. There is emerging evidence that stagnating coverage may result not from worker myopia or lack of information, but from rational choice by workers and their households.

Individuals may find alternative savings instruments more attractive than the reformed pension systems. The returns to investment in the new funded pillars, although relatively high, have been volatile. Fees for private management of retirement savings have been high, and early affiliates have borne the brunt of new system start-up costs (Figures 3a). Management fees – in particular, flat fees – have been especially burdensome on workers with lower incomes (Figure 3b). Finally, many reforms pay benefits as an annuity, costly for disadvantaged groups with low life expectancy, since premiums (based on average life
expectancy of the whole population) are above the actuarially fair rate for these groups. Annuities can also introduce interest rate risk, as the amount of an affiliate’s retirement benefit will depend on the real rate of interest at the moment the annuity is purchased. These factors can raise the relative cost and risk of the new funded pillar compared to other formal and informal instruments available to secure adequate retirement income, perhaps explaining why so many Latin American workers still ignore formal pension systems, despite the improvements in incentives brought about by reforms.

Workers reveal a preference for government to provide a poverty-reduction instrument. Most reforms have essentially split the government’s role in pension provision in two: providing (or regulating) a savings vehicle, through individual accounts, and a poverty-reduction vehicle, through a risk pooling mechanism (for example, minimum pension guarantees and social assistance pensions). In Chile contribution behavior suggest that workers want insurance against poverty in old age from government. Workers tend to contribute just enough to qualify for a minimum pension. This is observed among workers earning average incomes and higher—those least likely to suffer poverty in old age—revealing a preference for government-provided instruments for pooling against the risk of poverty, over forced saving to smooth consumption. Policy makers may not have fully appreciated the importance of individual preferences and incentives as determinants of participation in the formal pension system.

Workers make reasonable decisions about securing adequate retirement income. If reformed pension systems fail to make workers better off, they may rationally choose to avoid contributing. They may also be averse to the policy risk inherent even in privately managed public pension systems, of which the Argentine crisis is a pointed reminder. Heavy investment in government bonds makes pension funds vulnerable to government’s fiscal problems and risk of default.

How Can Pension Systems Be Improved in Latin America?

The multi-pillar approach to pension reform is based on the belief that government has two fundamental roles in promoting old age income security: 1) preventing poverty in old age; and 2) facilitating consumption smoothing, to prepare for the risk of losing earnings-ability that increases with ageing. As life expectancies increase, loss of earnings ability in old age is becoming more frequent in Latin America. Thus savings (i.e. “defined contribution”) mechanisms are better than risk-pooling (i.e. “defined benefits”) for consumption-smoothing. In contrast, risk pooling is cost-effective for relatively rare losses. With economic development, the incidence of poverty in old age should be increasingly rare. Thus, governments still have a risk pooling role: insuring against what should be a relatively rare loss of old age poverty.

1. Improving Old Age Poverty Prevention

A well-run risk pooling component to mitigate old age poverty is within reach of most Latin American governments. As a very generous illustration of this point, the cost of providing pensions equal and indexed to minimum wages to all citizens over 65 regardless of their contribution history or income, is typically comparable to the level of current government transfers to subsidize public pensions.

This illustration is not intended to advocate that poverty prevention pensions should be set as high as minimum wages. Given the typical distribution of wages seen in Latin America, setting the public poverty pension equal to the minimum wage would provide a strong disincentive for workers to save on their own or using the new private systems. The example simply serves to address a strong fiscal concern often faced by policy makers when trying to determine the appropriate size of their poverty-prevention pillar. These are cost simulations of what is a likely upper-bound benefit—that which even the more ardent populist politicians might be willing to support as the acceptable level of the minimum pension in their country—in order to arrive at conservative estimates of the cost of restructuring the pooling pillar in different ways. In this spirit, the simulations also generously index the minimum benefit to current wages. Significant cost saving can be had
from indexing benefits to inflation or to a combination of prices and wages.

Further in the future, longer life expectancy makes such generous policies very costly indeed. But a lower universal benefit or benefit available at later ages in line with longevity; taxed at source to claw back resources from the better off; or targeted to the poor, would be plausible options to contain costs.

There is much that could be done to improve these cost estimates in a country-specific study of viable options. The projected costs do not take account of: (i) the portion of the current transfers to the elderly that are still financing the transitions cost of introducing individual retirement accounts; (ii) the cost of excluding workers without a contribution history from receiving benefits; (iii) the revenue that the government could “claw back” from setting a surcharge on pension payments for workers above certain income levels, or by simply making the universal flat benefit taxable; (iv) the administrative costs of means tests to efficiently target a benefit to the elderly poor; and (v) the costs of corruption and leakage to the non-poor that, given the dismal track record of public pension administration in the region, must be kept in mind. Each of these considerations can change the projected costs of poverty-prevention benefits considerably, and should be carefully examined in country specific analysis.

2. Improving the Savings Component
Forcing workers to participate in the savings component to be eligible for benefits has been advocated to increase coverage. However, evidence indicates that mandating individual saving won’t increase coverage unless savings instruments are sufficiently attractive. Furthermore, a targeted or near-universal minimal benefit would largely solve the coverage problem, at least against the risk of old age poverty. Savings mandates may still be desirable to: 1) mitigate moral hazard inherent in pooling mechanisms; 2) ensure political support for transitioning from PAYG systems; and 3) protect the “infant industry” of private financial management for long-term saving. But each of these reasons also suggests that mandatory savings components should be small or decline over time. Moral hazard can be mitigated with a much lower mandate to save than typically maintained in Latin American countries today. And long experience has shown the dangers of coddling infant industries for too long. Over time, mandates combined with dedicated industries, lead to market concentration and impose welfare costs, denying workers the benefits of privatization. Much more competition based on performance is preferable.

Measures to improve the effectiveness of mandatory savings are needed, that would:

- introduce contestability in the savings pillar to reduce administrative costs and commissions;
- improve risk management of savings to reduce volatility; and
- lower contributions for poor and young people to increase their participation.

Preferably, voluntary savings should play an increasing role in the consumption-smoothing function. Governments should increase voluntary savings options and ensure that even low-income workers can take advantage of tax incentives to save, through innovative schemes like matching contributions or earned income credits.

Conclusion

The Latin American experience with pension reform is still in progress, but already yields important lessons:

1. The poverty prevention pillar needs much more attention. This government’s role in preventing poverty in old age, becomes more important with economic development, not less—as the likelihood of old age poverty declines, pooling this risk becomes more appropriate and affordable. Private insurance markets will not provide this coverage which is critical to ensuring adequate income security in old age.

2. The mainstay for earnings replacement during old age should be individual saving. For most workers, savings schemes should involve no redistribution of benefits or pooling of risk across generations.

3. Mandatory saving schemes are not always necessary, but may be useful for transitioning from overly generous PAYG systems and in providing an initial boost to capital and insurance markets.

4. Countries with mandatory savings schemes should lower costs to affiliates by introducing contestability and increasing competition among pension fund managers. This will lead to more attractive savings options for workers; most other solutions appear ineffective.

By fundamentally remaking pension systems that were bloated and inequitable, structural pension reforms in Latin America and the Caribbean represent a major step forward for the region. There is considerable scope for improvement in the design and operation of the new systems, but policymakers should direct their efforts at carefully assessing and building upon existing reforms, rather than hastily rescinding them.

Notes

1 A conference to discuss the full report on which this article was based was held June 22 and 23, 2004, in Bogota. Details can be found at http://www.worldbank.org/ lacpensionsconf

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