Are Old-age Pension System Reforms Moving Away from Individual Retirement Accounts in Latin America?*

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Abstract

This article reviews two rounds of pension reforms in ten Latin American countries to determine whether they are moving away from individual retirement accounts (IRAs). Although the idea is provocative, we conclude that the notion of "moving away from IRAs" is insufficient to characterize the new politics of pension reform. As opposed to the politics of enactment of IRAs of the late twentieth century, pension reform in Latin America in recent years has combined significant comeback of public components in old-age income support with improvement of IRAs. Clearly, the policy prescriptions that were most influential during the first round of reforms in Latin America have been re-evaluated. The World Bank and other organizations that promoted IRAs have recognized that pension reform should pay more attention to poverty reduction, coverage and equity, and to protect participants from market risks. The experience and challenges faced by countries that introduced IRAs, the changes in policies by international financing institutions, and the recent financial volatility and heavy losses experienced in financial markets may have tempered the enthusiasm of other countries from applying the same type of reforms. Scholars and policymakers around the globe could benefit from looking closely at these changes in pension policy.

Keywords: pension reform; pension policy; social security; retirement; Latin America

Introduction

In 1981, Chile initiated old-age pension reforms that introduced mandatory funded individual retirement accounts (IRAs) and moved away from pay-as-you-go (PAYG) schemes. During the next one or two decades, ten other Latin American countries followed in Chile's wake: Argentina, Bolivia, Colombia, Costa Rica, Dominican Republic, El Salvador, Mexico, Panama, Peru, and Uruguay. As illustrated in Table 1, this first round of reforms can be characterized as a full or partial shift from PAYG to IRAs schemes that involved a movement from: contributions and taxes to contributions and savings as financing mechanism, variable to defined contributions, defined to variable benefits, social insurance to personal savings, public to private management, and state to individuals sharing risk. Figure 1 complements Table 1 and illustrates that pension reforms were more complex than two extremes. The first round of pension reforms in Latin America can be divided in three different types: in "mixed" reforms, IRAs complemented the PAYG scheme; in "parallel" reforms, IRAs were created as an alternative to the PAYG scheme; and in "substitutive" reforms, IRAs replaced the PAYG scheme (Mesa-Lago, 2004a).

[TABLE 1 GOES ABOUT HERE]

In recent years, even before the onset of the financial crisis, a second round of pension reforms was initiated to strengthen the public component and address the problems created by individual accounts (Kay and Sinha, 2008). The most notorious case is Argentina, where IRAs have been recently eliminated and replaced by a full PAYG pension system (Poder Ejecutivo Nacional, 2008; Cottani, 2008; Economist, 2008).

Using a comparative historical approach and policy analysis techniques, this article reviews the two rounds of pension reforms to determine whether Latin American countries are moving away from individual pensions. We incorporate into our analysis the influence of the recent financial crisis, which is placing new challenges to pension systems worldwide. We base our analysis on ten countries that introduced some form of IRAs since 1981. Three other countries –Ecuador, Nicaragua, and Panama– are not included because IRAs are not fully implemented or because no revisions have been introduced to the system. Countries such as Brazil are excluded from the analysis because they reformed their pension systems without moving towards IRAs. Brazil, however, has a long history with occupational plans managed by private companies and more recently allowed sub-national state governments to create supplementary occupational pension plans.

Many differences can be found among the Latin American countries that we analyze. However, even though Latin America is quite heterogeneous, its labor markets and social security systems share some common features such as a large informal economy and a variety of uncoordinated institutions providing old age income protection (Gill *et al*., 2005; Kritzer 2000; Marier and Mayer, 2007). These features provide a common ground for pension reform in the region and allow us to compare two rounds of pension reforms maintaining other aspects relatively constant.

Table 2 includes a brief summary of some elements of the two rounds of pension reform that we have discussed above, but more importantly, it incorporates other elements and serves as a guide to the analysis that follows.

First Round of Pension Reforms: The Politics of IRA Enactment

During the late twentieth century, but particularly during the 1990s, the fear of large fiscal imbalances and mismanaged pay-as-you-go (PAYG) pension schemes prompted ten Latin American countries to enact IRAs (see Figure 1). Although the reforms improved long-term system sustainability, problems such as low coverage, a shrinking social safety net, and imperfect regulatory frameworks, remained.

[FIGURE 1 GOES AROUND HERE]

IRAs were intended to create a stronger link between benefits and contributions to get workers to view their contributions as personal savings rather than as a tax. This mindset would in turn encourage workers to contribute and increase coverage and compliance rates. However, the evidence from Latin America suggests that introducing IRAs did not improve coverage and compliance rates (ECLAC, 2006; Rofman and Lucchetti, 2006; Mesa-Lago, 2008). Figure 2 shows that coverage rates, measured as the ratio of contributors to workers, actually declined after the reforms. This result clearly illustrates that structural features of labor markets are more relevant than pension system design in driving coverage.

[FIGURE 2 GOES AROUND HERE]

Numerous other factors, including the type of benefits offered, funding mechanisms, administrative arrangements, and incentives, explain the variations in coverage (Bertranou, 2004; Calvo and Williamson, 2008; FIAP, 2006). For example, the 1994 reform in Argentina raised retirement ages and vesting periods, creating stricter conditions to access benefits and thus reducing benefit coverage for the population aged 65 and over from 78 percent in 1992 to about 65 percent in the mid-2000s. In addition, unemployment, informal labor markets, and cultural factors are strong determinants of compliance and coverage rates.

Besides their failure to expand pension coverage, IRAs also removed some solidarity or redistributive mechanisms of PAYG schemes (Mesa-Lago, 2004b). Although with important limitations, PAYG schemes involve not only intergenerational redistribution (contributions from active workers are used to pay the bill of retirees) but also redistribution between income groups (they aim to transfer income across different cohorts).[1] In contrast, IRAs are based on personal savings and leave the responsibility of income redistribution to social assistance and minimum pensions provided by state-run programs. As contributory coverage declined or remained stagnant, social safety net and non-contributory programs have grown in number of beneficiaries in several countries such as Argentina, Chile, and Colombia, among others.

A third challenging area of IRA reforms relate to imperfect regulations, such as protection from political interference (Bertranou *et al.*, 2003; Calvo and Williamson,

[1] Although PAYG schemes have progressive solidarity mechanisms, privileged groups in Latin American countries have sometimes used their political influence in order to get more generous pension benefit rules that have resulted in increased inequalities (Mesa-Lago, 1978).

2008; Gill *et al.*, 2005). Although PAYG may also suffer from weak regulations, IRAs were oversold in their capacity to prevent political manipulation. A driving reason for reform towards private administration was the intention to create pension systems highly insulated from political intervention; however, the evidence suggests that the reformed systems remain vulnerable to political manipulation. For example, loose regulation led to ambiguous approaches to transition rules in Bolivia and in the early 2000s allowed the government of Argentina to defer its debt by “selling” bonds to fund management companies until a default occurred.

Because of low coverage rates and decreased solidarity, governments continue financing a substantial part of the pension bill and public institutions continue managing pension benefits, including defined benefit, minimum guaranteed benefits, and social assistance pensions. Public institutions also work as guarantors of the private IRA scheme. In sum, although IRAs play an important role in reformed pension systems in Latin America, their enactment did not result in a full withdrawal of governments from the pension systems (Barr, 2002; Kay and Sinha, 2008; Schulz, 2009; Williamson, 2001). As has been pointed out previously, the line between private and public can be “fuzzy” when states regulate, promote, finance, and mandate private pension provision (Béland and Gran, 2008).

Second Round of Pension Reforms: The Politics of Expansion of Public Pensions and Improvement of IRAs

During the last few years, Latin America started a second round of pension reforms in response to the shortcomings of IRAs. The new political context is characterized by governments being less enthusiastic about privatization. The reforms are resulting in a significant comeback of public components in old-age income support systems in an attempt to better balance social risks with individual savings. The case that best ilustrates this trend is Chile, where a comprehensive pension bill was approved in 2008 (Barr and Diamond, 2008; Kritzer, 2008; Vial and Melguizo, 2008). The 2008-2009 financial turmoil will probably reinforce the changes of the second round of reforms in Latin America. The most extreme case is Argentina, which re-nationalized IRAs partly in response to the financial crisis.

The Comeback of Public Pensions

Public institutions have maintained an important role even after privatization. In the second round of reforms, the direct involvement of public institutions in pension provision has been reinforced in three ways: 1) allowing workers to switch back to the PAYG scheme; 2) incorporating solidarity and income redistribution mechanisms; and 3) creating new public pension reserve funds.

Choice between IRAs and PAYG. The first round of reforms generally established that new workers were to join the IRAs, with no option to switch back to the PAYG scheme. Perhaps one of the more radical transformations of the second round of pension reforms has been allowing some workers to switch back to the PAYG scheme (US Social Security Administration, 2007-09, 2007-04, 2005-02, 2004-04). For example, in 2007 Peru permitted workers enrolled in IRAs to rejoin the PAYG scheme if they had contributed to the PAYG scheme before 1996 and met conditions to retire under that scheme. This law aimed to increase pensions for eligible workers who would have otherwise received a smaller pension in the IRA scheme. In 2008, Uruguay also enacted regulations that allowed some affiliates to leave IRAs and switch back to the defined benefit scheme. Argentina had taken the reforms one step further before the re-nationalization in 2008. During 2007, the government changed the default affiliation to the PAYG scheme for workers entering the formal labor market and – for a six-month window – allowed individuals already in the IRA scheme to switch back to the PAYG scheme. Notably, of those eligible to switch, 80 percent stayed in the IRA scheme. In addition, individuals within 10 years of retirement with low IRA balances were automatically transferred to the PAYG scheme. Insured with low balances were defined as those that, at the normal age of retirement, would not be able to buy an annuity equivalent to the minimum pension paid by the defined benefit scheme. Furthermore, the variable percentage of the replacement rate paid by the PAYG scheme for each year of contribution increased from 0.85 percent to 1.5 percent of pre-retirement wages. This means that for a worker retiring with 30 years of contributions, the replacement rate would increase from 25.5 percent (30*0.85) to 45 percent (30*1.5). Note that this benefit is paid on top of the basic pension. This change considerably raised the rate of return on contributions made to the public defined benefit scheme. In 2008, Argentina decided to re-nationalize its IRA scheme (Cottani, 2008; Economist, 2008; The Wall Street Journal, 2008). The government justified this aggressive move as a reaction to the financial market crisis, but reducing its budget constraints was clearly a big incentive. The approved bill stated that by January of 2009 IRA funds were to be absorbed by the public PAYG scheme.

Solidarity and income redistribution. The first round of pension reforms partially removed important solidarity and redistribution mechanisms. In response, several countries introduced cash transfer programs and expanded their non-contributory pensions, financed by general tax revenue, to supplement contributory pensions and protect old-age people against poverty (Consejo Asesor Presidencial Para la Reforma Previsional, 2006; US Social Security Administration, 2008-02, 2007-01, 2006-07, 2003-12). Using the World Bank conceptual framework, the traditional three-pillar system prescription (including mandatory PAYG, mandatory IRAs, and voluntary savings) has been superseded by a multi-pillar approach including two new poverty prevention pillars: non-contributory pensions and non-financial informal support (Gill *et al*., 2005). For example, El Salvador created a subsidy for retirees receiving IRA benefits that are lower than they would have been under the old PAYG scheme. In early 2008, Chile approved a pension reform bill aiming to provide universal and more equitable benefits. The new system of "solidarity pensions" gradually replaces the means-tested pensions and the guaranteed minimum pensions with two types of benefits: a non-contributory pension and a supplementary pension (top-up) benefit for those who have contributed to the private system. The supplementary monthly benefit starts at the level of the non-contributory solidarity pension and ends at about US$ 400. It also provides a tax credit for voluntary savings, which is targeted to low-income workers. Another interesting case is Colombia; in 2003 it introduced a solidarity pension fund, which pays non-contributory benefits and matches contributions for low-income workers. Although solidarity and income redistribution mechanisms have been enhanced elsewhere in the region, poverty reduction and gender equality are still considered missing or incomplete pieces of pension reform in Latin America (Barrientos, 2006).

Reserve funds for public pensions. Latin American countries have also passed legislation creating separate reserve funds to provide greater financial stability and reduce the burden on general revenues of funding the government's pension obligations (US Social Security Administration, 2007-09, 2006-09). Chile has instituted two separate reserve funds (Pension Reserve Fund and Economic and Social Stabilization Fund) in response to the large budget surpluses attributed to the country's record copper prices during recent years. Both funds are not managed directly by the government, but by the Central Bank (65 percent of the funds) and third parties (35 percent of the funds). In Argentina, a state-owned bank supervised by multiple-institutions manages a Sustainability Fund, and a committee including members from different agencies oversees investment decisions.

Improvement of IRAs

Governments and private administrators have clearly acknowledged the shortcomings of IRAs and the need for intervention. However, this recognition does not necessarily imply the termination of IRAs, as what happened in Argentina. The second round of pension reform in Latin America is also about revision and correction of the flaws of IRAs. Three examples of reforms aiming to improve IRAs are: (1) extending mandatory contributions to workers not currently covered, (2) lowering costs to account holders, and (3) changing the investment rules for pension assets.

Extend coverage. The first round of pension reforms typically made IRAs voluntary for self-employed workers. The second round extends mandatory participation to these workers (Consejo Asesor Presidencial Para la Reforma Previsional, 2006; US Social Security Administration, 2008-02, 2007-01, 2006-08, 2006-07, 2005-05). For example, following Costa Rica and Colombia, Chile will start requiring the self-employed to gradually join the IRA scheme within the next seven years. Mexico has enacted similar measures for the self-employed and has extended IRAs to federal public employees. Other countries, such as Peru, are also discussing compulsory savings for all categories of workers. In Chile, self-employed workers will be entitled to family allowances with the expectation that this will provide an incentive to join the system. Other countries are creating incentives by lowering the contribution rates, particularly for low-income self-employed workers. For instance, Argentina and Uruguay have created a small mono-tax instrument that simplifies the taxes and contributions levied facilitating the administrative procedures and reducing its tax burden.

Lower IRAs costs. High administrative fees and premiums for survivors and disability insurance have lowered net rates of return for account holders and produced very large profits for many fund management and insurance companies (Centro de Estudios Públicos, 2006; Iglesias-Palau, 2009). The problem has been aggravated by participants' lack of awareness of the importance of fees (Holzman and Hinz, 2005; James *et al.*, 2008). To lower costs for account holders, countries have implemented a number of measures (AIOS 2007; US Social Security Administration, 2008-04, 2008-02, 2007-11, 2007-06, 2007-04, 2006-11, 2006-09, 2006-08, 2006-03, 2005-12, 2005-09, 2005-05, 2003-12). For example, in 2008 Mexico created an indicator to help account holders compare the net rate of return of pension fund management companies. New entrants to the labor force who do not choose a management company are assigned by default to the one with the highest rate of return. Transfers between companies are allowed once a year, but transfers to the company with the highest rate of return are now permitted without restrictions. In addition, companies are now allowed to charge a fee on account balances, but not on monthly contributions. Countries such as El Salvador, Chile, and Peru took a similar path. Eventhough these policies are expected to have a positive effect, it is difficult to predict their magnitude. Some of the instruments to induce lower costs rely on past performace and thus their actual effectiveness is uncertain.

Investment rules for pension assets. Portfolios have been heavily concentrated in government bonds, but new types of instruments and multi-fund strategies have been authorized during the second round of reforms. Numerous countries have implemented such changes, including: Chile, Colombia, Mexico, and Peru (AIOS 2007; US Social Security Administration, 2008-04, 2007-08, 2006-12, 2006-08, 2006-01, 2005-03, 2004-06, 2003-12, 2003-10). Another way to cope with risks has been the implementation of multi-funds, where insured workers can choose among several risk-related portfolios. It is not clear that multi-funds have and would actually contribute to financial literacy and adequate returns for the average insured worker. Furthermore, the recent financial market turmoil resulted in serious declines in IRA saving assets, suggesting that they were too exposed to market risks. Numerous reasonable concerns have been raised on the limitations of letting workers choose high risk portfolios.

Conclusion

This article addresses whether pension reforms in Latin America are moving away from IRAs. Although the idea is provocative, we conclude that the notion of "moving away from IRAs" alone is insufficient to characterize the new politics and political economy of old-age pension reform. Table 2 summarizes our argument. As opposed to what happened in the 1980s and 1990s, pension reforms in Latin America in recent years have combined a significant expansion of the public components of retirement income support with improvement of IRAs.

During the period of enactment, ten Latin American countries introduced mandatory funded IRAs as a full or partial replacement for the old PAYG public schemes. One remarkable aspect about this first round of pension reforms is that, even though it introduced substantial changes in funding and management, in most countries public institutions assumed a crucial role not only as regulating agents, but also in managing and financing minimum guaranteed and social assistance pension benefits.

The second round of pension reforms, which began after 2005, has reinforced the involvement of public institutions in the pension system. In addition, numerous countries have introduced measures to improve IRAs. The driving force of the second round of reforms has been to increase coverage, equity, and efficiency of the overall system. With the exception of Argentina, which has re-nationalized its pension system, the magnitude in the second round of reforms seems to be less radical compared to the path-breaking changes introduced by the first round. We characterize the recent transformations as path-dependent and shaped by policy feedbacks (Pierson 2000); that is, constrained by the enduring impact of previously enacted IRAs.

The dominant policy prescriptions in vogue during the first round of reforms in Latin America –three pillars system– have been clearly re-evaluated (Kay and Sinha, 2008). As countries started to engage in a second round of reforms, the World Bank – and other international organizations that promoted IRA pension reforms – has acknowledged that more attention should be paid to mechanisms to reduce poverty in old-age, to expand coverage and equity, and to protect participants from market risks. Non-contributory and universal pensions are recognized as playing a greater role. The experience and challenges faced by countries that introduced IRAs in their pension systems, the changes in policies by international financing institutions, and the recent financial volatility and heavy losses experienced in financial markets may have tempered the enthusiasm of other countries from applying the same type of reforms. Scholars and policymakers around the globe could benefit from looking closely at these changes in pension policy.

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TABLE 1. Comparison of PAYG and IRAs old-age pension schemes

	PAYG	IRA
Financing	Taxes	Savings
Contributions	Variable	Defined
Benefits	Defined	Variable
Form	Social insurance	Personal savings
Management	Public	Private
Risks	State	Individuals

Source: Authors' elaboration.

TABLE 2. Comparison of first and second round of old-age pension reforms in Latin America

	First round of reforms	Second round of reforms
Timing	Most frequent in the 1990s	Undergoing
Politics	Enactment of IRAs	Expansion of public pensions and improvement of IRAs
Motivation	Fiscal burden	Coverage, equity, and efficiency
Transformation	Path-breaking	Path-dependent
World Bank Prescription	Three-pillar system	Multi-pillar

Source: Authors' elaboration.

Figure 1. Structural reforms to old-age pension systems in Latin America

Note: * Substitutive in 1981; ** Re-nationalized in 2008.

Source: Authors' elaboration based on Mesa-Lago, 2004a; Gill *et al.*, 2005; and US Social Security Administration, 2003-2008, 2008b.

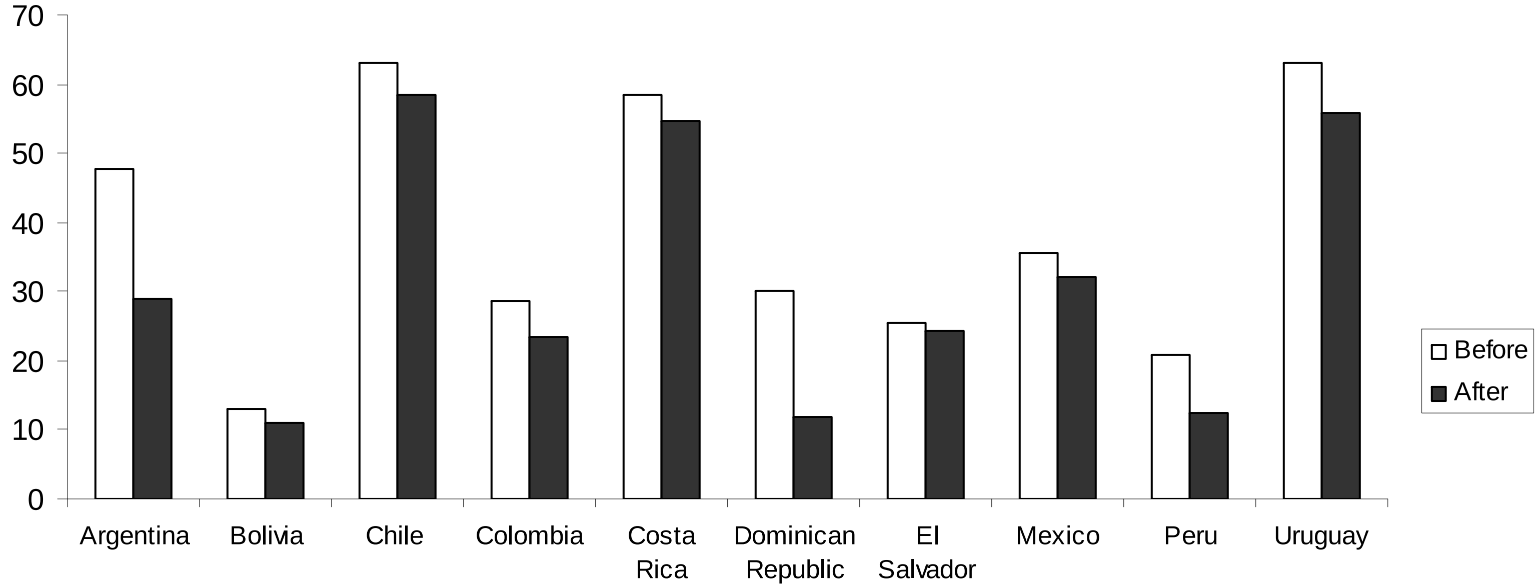

Figure 2. Coverage rates in Latin America before and after first round of old-age pension reforms.
Note: Coverage is measured as contributors/economically active population at two time-points: the year before the reform, and in 2002.
Source: Adapted from Mesa-Lago, 2005; Rofman and Luccetti, 2006.