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## Social Security Reform in Latin America

Olivia S. Mitchell

Latin America has seen a great deal of political and economic upheaval over the last hundred years. What happened in Chile in 1981, however, was a “quiet” revolution—one that dramatically changed the way people look at retirement programs around the world. In that year, the Chilean government pioneered the radical idea of completely overhauling the nation’s then-bankrupt national social security reform program, replacing it with a privately managed, funded, defined-contribution pension system. Today, more than 15 years later, the Chilean pension fund “success story” has caught the attention of economists and policymakers everywhere.

To understand why Chile’s restructuring of its social security system has caught the attention of its Latin American neighbors—and many other nations as well—it is useful to begin by asking what that country did and why. Next we summarize what other countries did, following in Chile’s footsteps. Finally we offer a brief assessment of the Latin model for social security reform.<sup>1</sup>

### WHAT THE CHILEAN SOCIAL REFORM ACCOMPLISHED

At the end of the 1970s, Chile’s old-age retirement program was in disarray. Many “cajas”—publicly managed pension programs—were critically under-funded, placing the government in the unenviable position of either closing them down or radically restructuring them. In 1981, the

government decided to terminate these old plans, instituting in their place a national two-tiered social security system.

Most widely discussed is the private pension tier in this new system, known as the AFP plan (Association of Pension Funds). This structure mandates that every (formal sector) worker pay 10 percent of earnings into a privately administered defined-contribution pension plan. System taxes are collected by a pension sales force of more than 19,000 agents; individual workers may designate a fund manager from among approximately 20 state-licensed and regulated fund managers who compete for the privilege of managing workers’ investments. AFP sales agents hence devote substantial effort to trying to get workers to switch AFPs up to four times per year. Less well known, but also important, is the other tier in the Chilean national system, which takes the form of a government-supported old-age benefit promise. This is a floor or minimum benefit, payable by the government to workers whose private AFP pension is too small to generate a minimum payout.

Several financing techniques were needed to pay for the transition to this new system. The Chilean government was fortunate to have a budget surplus worth about 5 percent of GDP. In addition, benefit entitlements under the old plan were pared down, in part by raising the retirement ages and years of service required for full benefits. Finally, the government issued new debt in the form of “Recognition Bonds” to workers with accrued benefit promises under the old terminated system. These bonds were estimated at around 80 percent of GDP and will be paid down over the next 45 years or so.

Benefit payouts at retirement are determined by workers’ accruals in their AFP accounts. These accumulations may be used to purchase an annuity from an insurance firm, or workers may take a “programmed withdrawal” akin to the minimum distributions computed by the United States Internal Revenue Service. (A retiree with

<sup>1</sup> This paper draws on research described in Barreto and Mitchell (forthcoming) and Mitchell and Barreto (1997).

a very large pension accrual might also be allowed to take a partial lump sum.) Should the retiree's benefit payment be too low, however, the government will instead provide him with a guaranteed minimum benefit—worth about three-quarters of the minimum wage, or one-quarter of the worker's average pay during the decade prior to retirement. In that event, his AFP amount is taxed 100 percent by the government.

One as-yet-unsettled issue is how large this minimum guarantee promise will end up being. Some analysts have opined that perhaps a majority of future retirees may be owed this minimum payout if investment performance and labor earnings fall below current projections. Others worry that the promised minimum will prove to be too low to sustain retirees in old age, but raising it could reduce participants' willingness to pay into the defined contribution system.

Another important aspect of the system is its extensive supervisory and monitoring superstructure: The Chilean government has argued that it needs to control most aspects of private pension operations to protect participants. For example, there is a cap on the amount of equity that pension fund managers may hold in their pension portfolios. The managers also face severe penalties if their rate of investment return diverges markedly from the rates of other funds, and they are permitted to levy only certain types of fees and commissions on investors. Workers participating in the system may move their money across pension funds only a few times per year and may not diversify their pensions by holding shares in several funds at once. The government also regulates the tax status of the pension system; as in the United States, benefits are subject to income tax, but contributions are tax-deferred.

## ADAPTING THE CHILEAN BLUEPRINT

In the years since Chile reformed its social security system, several other Latin countries have devised their own social security privatization efforts by adapting the Chilean blueprint. A recent study of

these reforms found that a Chilean-type two-pillar design had recently been adopted by Peru, Argentina, Colombia, Uruguay, and Mexico, each implementing a form of defined-contribution pension program but also including important modifications (Mitchell and Barreto 1997).

As in Chile, the first pillar in these other countries is a minimum benefit guarantee, typically paid for, at least in part, from general revenue (see Table 1). In each case, the second pillar tends to include a defined-contribution pension, where the earnings-related contribution is tied to an investment account. One difference across countries, however, is the relative size of the first and second pillars. For example, the floor benefit is set at around one-quarter of the average wage in Argentina, but it is as high as 40 percent to 55 percent in Mexico.

Another difference is that most of the countries following in Chile's path gave middle-aged workers the option to choose between an ongoing government pay-as-you-go plan and a funded, privately held, defined-contribution pension. This is a very different result from that of the Chilean AFP system, inasmuch as the Chilean system required all to join it (after a very short phase-in period). While most nations also raised their normal (and sometimes early) retirement ages as a part of the national system overhaul, in many countries workers are still able to quit work at young ages because of generous early retirement and disability retirement benefits, sometimes at actuarially subsidized rates.

## A FRAMEWORK FOR EVALUATION

The growth of these new systems all over Latin America has produced calls for formal evaluation of the programs, though it should be kept in mind that "success" cannot be measured until an entire generation of workers moves through, and then retires from, the system. On the other hand, analysts lack the luxury of being able to wait 75 to 100 years, and these

Table 1

## Various Latin American Social Security System Reforms

	Chile	Peru	Argentina	Columbia	Uruguay	Mexico
Nature of program	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory	Mandatory
1st pillar	Public	Public	Public	Public	Public	Public
2nd pillar	Private Only	Optional Pub/Priv.	Optional Pub/Priv.	Optional Pub/Priv.	Optional Pub/Priv.	Private Only
Financing						
Employer payroll tax	0%	0%	0%	10%/7.5%	na/0%	0%
Employee payroll tax	10%	11% or 10%	11% both	3.5% or 2.5%	na/0%-7.5%	6.5%
Other general revenue	Yes	Yes	Yes	Yes	Yes	Yes
Benefits Payouts						
Ret. age (m/f)	65/60	65	65/60	62/57	60	65
1st pillar: % Average Pay	25%	na	28%	55%	na	40%
2nd pillar: payout	Lump ProgWD-Annuity	ProgWD-Annuity	ProgWD-Annuity	ProgWD-Annuity	Annuity	Annuity-ProgWD
Regulatory Structure						
Commission regulatory	Yes	No	No	na	No	No
International Investment OK	Yes	Yes	Yes	na	No	Yes
Minimum ROR required	Yes	Yes	Yes	na	Yes	No
Transition Costs						
% of GDP	100-80%	27%	na	87%	na	80%
Recognition bond	Yes	Yes	No	Yes	No	No
System Performance						
Fund (US\$)	\$28B	\$900M	\$4.5B	\$50M	\$25.6M	\$3.9B
Fund (%GDP)	41% ('94)	1.5% ('96)	0.7% ('95)	na	na	na
Recent ROR (%)	12.5% ('82 -95)	15.5% ('94-95)	19.9% ('95-96)	15.5% ('96)	na	na
AFPs (No.)	15	6	21	9	6	25
Affiliates (No.)	5.5M	1.5M	5.5M	2.1M	0.5M	11.2M

NOTES: Derived from Barreto and Mitchell (forthcoming). na signifies not available. ProgWD signifies programmed withdrawal.

systems are constantly being tinkered with through time. Thus the evaluation process is inherently dynamic, like the institutions themselves.

Some initial observations may be noted, in any event. For one thing, AFP accounts have grown rapidly in Latin America over the last decade, particularly in Chile and Argentina. While smaller asset accumulations have been seen in Peru, Colombia, Uruguay, and Mexico, these programs are also much newer. Investment performance has been variable, with a decade of high returns in Chile followed by two years of negative real rates that spurred calls for liberalized investment management. In Chile in particular, experts have not explained why so few of the funds are invested internationally (under 1 percent of assets), particularly since portfolio diversification could reduce retirees' exposure to country risk. Analysts also complain about the apparently high administrative costs of these programs, which is probably attributable to the small scale of the programs and the regulatory overhead under which they operate (Mitchell 1996).

Still to be confronted are concerns that, even after reform, these Latin American countries still have extremely high social security payroll taxes (see Table 1) and hence strong disincentives for workers to participate in the formal labor market. Also troubling is the fact that reforms in the insurance business and banking system are typically required to strengthen a privately managed retirement system's credibility (Mitchell 1997). Building an environment supportive of private pensions requires more than just pension reform.

## CONCLUSIONS

Chile's adoption of the AFP private pension system paved the way for social security reforms undertaken throughout Latin America in the last decade. This reform process has not been a uniform one, however, as each country has had to develop its own financing and benefit designs while building a regulatory structure needed to foster confidence in its

national retirement system. By replacing bankrupt and unsustainable retirement plans, this reform process has brought increased confidence to an aging Latin American workforce worried about retirement prospects. Nevertheless, it is certain that continued reforms will be required as demographic, economic, and political realities evolve.

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