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SOCIAL SECURITY AND PENSION REFORM IN LATIN AMERICA:  
IMPORTANCE AND EVALUATION OF PRIVATIZATION APPROACHES

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This paper first briefly describes the crisis of social security\* in Latin America in the 1980s and early 1990s as well as its causes, and summarizes the trends and types of reforms on pensions and health-care that are evolving in the region. The core of the paper is the evaluation of the Chilean model of privatization, followed by a review of four cases of pension reform (that apply full or partial privatization techniques) in Argentina, Colombia, Peru and Uruguay. The concluding section of the paper draws lessons from the Chilean experience and discusses whether that model can be successfully replicated in the rest of Latin America.

## I. CRISIS AND REFORM OF SOCIAL SECURITY IN LATIN AMERICA

### A. Magnitude and Causes of the Crisis

The "pioneer" countries, that is those that first introduced social security in Latin America and the Caribbean (Chile, Uruguay, Brazil, Argentina and Cuba), began to suffer severe problems of disequilibria (first actuarial and then financial) in the 1960s and 1970s.

Causes of the crisis in the pioneer countries were: (i) the growing cost of providing virtual universal coverage to the population; (ii) excessively liberal entitlement conditions and generous benefits; (iii) multiplicity of covering institutions with divergent conditions and benefits, as well as financing sources, which led to unjustified inequalities among insured groups and high administrative costs; (iv) maturation of pension schemes and rising costs of health care that rapidly increased their benefit expenditures; (v) increasing payroll contributions to finance the system (which nevertheless were insufficient) combined with growing employer's evasion and payment delays; (vi) declining reserves and poor or negative investment yields; (vii) growing financial deficits (and obviously actuarial ones) which forced a raise in state subsidies; (ix) the heavy financial burden of the system on GDP and the payroll, provoking negative effects on employment

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\* The term social security embraces social insurances (old-age, disability and survivor pensions as well as sickness-maternity, employment-injury and unemployment-compensation schemes), family allowances, public assistance and public health-care programs.

creation and national savings; and (x) demographic changes that resulted in an aging population and higher life expectancy thus reducing the ratio of contributors to pensioners and increasing the cost of pensions.

Until the 1980s the large majority of the remaining countries did not suffer most of the problems described above because they: introduced their systems later, covered a smaller proportion of their population, and some of them had tighter entitlement conditions and benefits as well as more unified and uniform systems. As their pension schemes were newer, they had relatively few pensioners than in the pioneer countries, hence, their payroll contributions were smaller and did not constitute such a heavy burden on national resources. In addition, because their populations were much younger and coverage was expanding, they had a growing number of contributors and a very high ratio of contributors to pensioners. Smaller and relatively unified systems and limitations in coverage to a minority of the population (mostly urban salaried workers) helped to control benefit expenditures and administrative costs. Reserves were high and still growing in most of these countries in spite of poor investment policies. Most of them had partially funded regimes (scaled premium) although some were, in practice, moving to pay-as-you-go. The system in most of these countries therefore generated surpluses and, although many of them suffered actuarial disequilibrium, they did not face immediate financial imbalances.

But these countries' systems were cast in the pioneer mold and latently carried their fundamental flaws. For instance, poor investment policies led to very low yields; evasion and payment delays were important in some countries; liberalization of benefits began to take place; and there were political and economic obstacles to raising payroll contributions. Furthermore, in several of these countries, the state did not honor its financial obligations, and a huge debt ensued. In the least developed countries, the system covered less than one-fifth of the population and confronted serious barriers to expand coverage. The Bismarckian model of social insurance,

workable in developed countries where the large majority of the labor force was urban, formal and salaried, did not work well in developing countries where most of the labor force was informal, rural and self-employed.

The economic crisis of the 1980s in Latin America aggravated the financial problems of social security in the pioneer countries and brought to the floor the latent problems in the rest. Revenue of social security institutions declined because of: increasing unemployment and informality of the labor force; decrease in real wages; skyrocketing inflation that stimulated employers' evasion and payment delays, and led to a sharp decline in real capital returns (because most investment was in instruments not indexed to inflation); the heavy servicing of the debt led to a growing state debt; and delays in payments combined with inflation resulted in a shrinking debt in real terms. On the other hand, the economic crisis induced higher social security expenditures due to the following reasons: salaries of employees were in some countries tied to the cost of living; pensions—at least for a while—were adjusted to inflation as well; the cost of imported medicines and equipment rose sharply; unemployment benefits also increased; and, in those countries where social insurance is integrated with a public assistance program, the insured who lost his job ceased to be a contributor and became a welfare beneficiary. The final result of declining revenue and increasing expenditures was a growing deficit in the pioneer countries, and the end of surpluses and the beginning of financial imbalances in many of the remaining ones. Population coverage also declined and/or the obstacles for expansion of coverage became more formidable as open unemployment and the informal sector grew. The need for social security reform became imperative (Mesa-Lago 1989, 1990, 1991b, 1991d).

#### B. Trends and Types of Reform

In the pioneer countries, partial social security reforms that were introduced in the 1960s and 1970s did not tackle the fundamental problems of their systems, and attempts to introduce

profound reforms failed in the 1980s. An exception was Chile which launched a radical reform (privatization) at the beginning of the 1980s. The Chilean model did not have significant influence in Latin America until the 1990s because it was associated with the military government of Pinochet. When the new Chilean democratic government endorsed the previous social security reform, however, it became politically acceptable in the region. Adjustment and restructuring economic policies advocated by international lending agencies pushed for the Chilean model of privatization. And governments, crushed by the heavy cost of debt service and external pressure, became open to social security reform. In the 1990s, therefore, a series of reforms began to unfold in the region, most of them considering some element of privatization.

Toward the end of the 1980s, about 90% of benefit expenditures of social insurance and family allowances in 24 Latin American and Caribbean countries went to pensions (54%) and sickness-maternity (36%), obviously the two most important social security schemes in the region. As the pension scheme matured, a higher proportion of total benefit expenditures had gone to it in the pioneer countries, e.g., 76%, compared with 28% in latecomer countries such as Central America, the Dominican Republic and Venezuela. Although the problems of health care should not be underestimated, the social security crisis is largely an outcome of disequilibria in the pension scheme, which in the future will bring the crisis to more and more countries. Even worse, the sickness-maternity scheme has usually received transfers from the pension scheme, thus, when the latter suffers financial disequilibria, a major source of funding is closed to the former, and both programs go bankrupt (Mesa-Lago 1991d).

Hence it is not surprising that the majority of social security reforms in Latin America (and the most radical) focuses on the pension scheme. For all these reasons, and also due to space limitations and the theme of this conference, my study concentrates on pensions and on privatization



(full or partial) reforms. This section however offers a general view of all types of ongoing reforms in the region, both on pensions and health care.

### 1. Pensions

Four general types of pension reform are evolving in Latin America: (a) reformed public schemes where the current public scheme continues but substantially modified; (b) substitutive private schemes where the public scheme is closed and supplanted by a fully-funded private scheme; (c) mixed schemes which involve a combination of a reformed public scheme and a fully-funded scheme that could be either public or private or a combination of both; and (d) supplementary pension schemes that assume many forms and complement, but not substitute, a reformed public scheme of the first and third types. In all cases there might be a public assistance, non-contributory pension for the elderly dispossessed not covered by social security. This section briefly describes the four types of reform, while the next section analyzes examples of the second and third types.

a. Reformed Public Schemes. The best example of this approach is found in Costa Rica, which in the 1980s and early 1990s, introduced reforms in its general social security institute (CCSS) to stabilize its pension scheme including: (i) increases in the ages of early retirement from 55/57 for females and males to 60 1/2 and 62 1/2 respectively; (ii) a raise in the overall payroll contribution and the introduction of scaled years of contribution to discourage early retirement so that the lower the age, the higher the years of contribution required and vice-versa; (iii) control measures to reduce evasion and payment delays as well as agreements with the state to pay past debts; and (iv) adjustment and efficient policies to cut administrative expenditures. In addition, a 1992 law "closed" several independent pension schemes for civil servants, who enjoyed unjustified privileges, and incorporated such schemes into the CCSS: those previously insured in the independent schemes maintained their rights while new entrants in those civil-service jobs are

now automatically incorporated into CCSS with uniform entitlement conditions and benefits (Mesa-Lago 1989, 1991d; Cartin 1991).

Mexico and Brazil have so far maintained public pension schemes without major structural reforms. In the former, the general social security institute (IMSS) increased the payroll contributions, and a new compulsory supplementary pension scheme was introduced in 1992 (see d below). In Brazil a constitutional reform, scheduled to take place in 1993, is expected to eliminate or at least restrict the seniority pension and perhaps unify privileged independent pensions into the general public scheme; a supplementary pension scheme is also a possibility.

b. Substitutive Private Schemes. Chile is the pioneer and model of privatization, not only in Latin America but probably in the world. In this type of reform the old public scheme (often based on pay-as-you-go and suffering a deficit) is "closed" (i.e., new affiliations are not allowed) and is substituted by a new mandatory private fully-funded scheme administered by private corporations (AFPs). Those insured in the public scheme are given the option to stay in or move to an AFP within a given period of time. Conditions in the public scheme are standardized and tightened, and this scheme disappears when all its potential beneficiaries have died. Only the insured contributes to the new system (both in the public and private schemes); the employers' contributions are eliminated, and the state finances all ensuing deficit related to the reform.

After enacting a modified Chilean-style reform in 1991, Peru enacted a law in 1992 which adheres to the Chilean model. There are no other implemented reforms of this type in Latin America but, in Colombia, a legal draft submitted to Congress in 1992 followed this approach; the draft however was withdrawn and is currently under discussion. The cases of Chile, Peru and Colombia will be analyzed in section II.

According to the conventional criteria, pension schemes of the Chilean style are not considered social security because, although they are mandatory, they do not apply the solidarity

principle, the employer does not contribute, and they are administered by private corporations. ILO officials claim however that the Chilean scheme is not completely private because it is mandatory, and the state plays a crucial role in providing costly subsidies and guarantees (Gillion and Bonilla 1992).

c. Mixed Schemes. Legal drafts submitted to Congress in Argentina and Uruguay are examples of this approach. In both cases the public scheme continues, but reformed: in Argentina the tightening of entitlement conditions and benefits is more drastic than in Uruguay. In the two countries the public scheme provides a basic pension. In Argentina the supplementary scheme basically follows the Chilean model, but in Uruguay it is voluntary, can be administered by public and private not-for-profit institutions and has divergent benefits and financing (see d below). In Peru and Colombia there were respectively a law decree and projects following the mixed approach before their governments decided to shift to the substitutive private scheme.

A theoretical variant of the mixed approach has been proposed by ILO officials but has not yet been considered by any country: the public scheme guarantees a minimum pension; a collective partially funded scheme (instead of individually fully-funded) retains employers' contributions and pays an earning-related pension; an optional supplementary scheme (of non-specified nature) pays another supplement; and a public-assistance pension is available for the noninsured lacking resources (Gillion and Bonilla 1992).

Reforms are currently being studied in Bolivia, Ecuador, Guatemala and Venezuela, but it still premature to determine what model they will apply (Abril 1991; Uthoff and Szalachman 1991; CIEN 1992; Mesa-Lago 1992b).

d. Supplementary Pension Schemes. Supplementary pension schemes (SPS) have been under discussion and in operation in Europe for the last 25 years, but they are incipient in Latin America and were not the subject of analysis by a regional meeting until 1989. The

supplementary pension complements the pension of the general public scheme, usually because the latter is basic or minimal and uniform, hence, its level is very low and does not provide adequate protection. The purpose of the supplement therefore is to raise the combined pension to maintain the standard of living that the pensioner had prior to retirement. But in Latin America, most of the few existing SPS do not follow that definition as they complement general-scheme pensions, which are not basic and uniform but related to both the insured's previous income and their periods of affiliation and contributions. However, as pensions of the general scheme in many LAC countries were eroded by inflation during the crisis, they became closer to a basic or minimum level, a situation which has raised the demand for SPS. The latter could assume a variety of forms: mandatory or voluntary; established by law, collective agreements or enterprises; managed by social security institutions, private corporations (non-profit or for-profit) or both; and financed by the insured, the employer or both (Castro Gutiérrez 1990).

At least four Latin American countries have SPS: Ecuador, Guatemala, Mexico and Uruguay. In addition, there are projects under consideration in Argentina, Colombia and other countries. In Ecuador SPS are: of voluntary affiliation; regulated by law; exclusively administered by the general social security institute (IESS) through contracts with individuals or groups of insured; and financed by both employer's and insured's contributions. In 1990 there were only three SPS in Ecuador (for public teachers and communication and printing workers) which offered early retirement and an additional pension over the general one. In Guatemala SPS are: voluntary; regulated by law; administered by private non-profit associations or enterprises (authorized and supervised by the general institute—IGSS); and financed by both employers and insured. In 1990 there were eight SPS (for employees in several banks, autonomous institutions, one each municipality and university, and a port enterprise) which offered old-age pensions (with earlier retirement and additional pension) and disability-survivor pensions. In Uruguay the SPS are:

voluntary; regulated by law; administered by either the social security institute (BPS) or the state insurance bank or by non-profit associations and corporations (authorized and supervised by the BPS); and with varying types of benefits and financing. There were 24 SPS in 1991, but they only had 30,000 members or 4% of the number of insured (see III-E-2). In Mexico there were 1,160 SOS in 1990 which covered almost one million workers; SPS are regulated by law but assume a wide variety of forms (Castro Gutiérrez 1990). In 1992 a law established mandatory SPS for all workers covered by the major social security institute of the private sector (IMSS); federal civil servants are expected to be entitled to SPS soon. Employers mandatorily contribute 2% of the payroll (insured can add voluntary contributions), which is collected through the banking system responsible for opening and maintaining individual accounts for the insured. All funds however must be deposited in the Bank of Mexico (in the account of the IMSS) which invests them in treasury bills. The sums in the individual accounts are adjusted to the price index and exempted from taxes, and must earn a real interest rate no lower than 2% yearly. The insured will have access to the accumulated fund when reaching 65 years of age or becoming entitled to an IMSS pension; the fund could then be paid in a lump sum or be used to buy a life annuity from an insurance company. The law considers the possibility that the individual fund could be transferred to private investment corporations to increase its yield (Soto 1992). In addition to the SPS regulated by law, there are many more in Latin America established by collective agreements or by enterprise plans.

## 2. Health Care

Health care in Latin America is provided by three sectors. The public sector is led by the ministry of public health which normally covers the lowest income groups of the population. The social insurance sector (the sickness-maternity scheme) usually covers middle-income groups. These two sectors combined cover the large majority of the population and continue to be the

largest in the region. The private sector is the smallest, it usually covers high and upper-middle income groups but is rapidly expanding in many countries. This sector comprises non-profit institutions (NGOs, such as religious and charitable organizations, development institutes and community organizations) and for-profit providers, such as prepaid plans, private hospitals clinics and medical personnel, and traditional medical practitioners (Mesa-Lago 1992c).

There are so far no examples in the region of full privatization of health care services as is the case with pensions. Three types of health-care reforms are taking place: (a) continuation of the public-social insurance system but with marginal privatization or collaboration with the private sector; (b) partial substitutive private schemes; and (c) supplementary private schemes.

a. Public-Private Collaboration and Marginal Privatization. In Costa Rica the public and social-insurance (CCSS) sectors have integrated their health care facilities and services since the 1970s: all hospitals are operated by the CCSS, while the ministry of public health offers preventive medicine and primary health care for marginal urban and rural groups. The CCSS has reduced health-care costs, increased its efficiency and improved the quality of its services through five collaborative programs with the private sector: (i) enterprise physicians (enterprises hire and pay a physician and supply an office and a nurse, while the CCSS provides laboratory, diagnostic services and drugs); (ii) mixed medicine (the CCSS insured select and pay an enrolled physician, and the CCSS supplies support services and drugs); (iii) capitation (the insured register with a physician of their choice and the latter receives a monthly payment for each patient registered); (iv) SILOS program (integrated health care program managed by a cooperative or self-managed organization through a contract with the CCSS and the ministry); and (v) contracts of the CCSS with private pharmacies (to reduce delays in drug deliveries and cut operation costs). So far, all these services do not cover more than one-fifth of the insured in the CCSS.

Under the influence of Costa Rica, in the late 1980s Colombia's major social security institute (ISS) signed agreements with cooperatives but without the same positive results. A law enacted in 1991 empowered the ministry of public health and ISS to sign contracts with private institutions, and provided incentives to promote integration of public and private health services. It is expected that a full reform of social security (combining pensions and health care) will take place in 1993 (see III-C).

In Jamaica the public sector (ministry of health) legally covers all the population, as social insurance lacks a sickness-maternity scheme. Since the late 1980s there has been an increasing use of private facilities to reduce costs and improve the quality of the ministry's non-medical services, such as housekeeping, janitorial and portering, catering, and laundry. In addition, more than one-fourth of the doctors in the public sector are now private practitioners. The ministry signs contracts with private providers and oversees their services. Privatization of hospitals and selected preventive and curative services was scheduled to start in 1989 but was halted by the change in government that year (Mesa-Lago 1991d, 1992c).

b. Partial Substitutive Private Schemes. In 1981 Chile reformed its health care system allowing the insured to select between the public-social insurance scheme (FONASA) or private HMOs of their choice (ISAPRES). The payroll contribution of 7% is paid either to FONASA or the ISAPRE; the insured in the latter have to add a co-payment to finance the package of benefits offered, which must be better than in the public sector but does not offer preventive, maternity and emergency services (hence, it is indirectly subsidized by the public scheme). In 1991, 72% of the population was covered by FONASA, 19% by ISAPRES, 5% by the armed forces and 4% was not covered; it is projected that in 1996, 29% will be covered by ISAPRES. As the latter grows, the lower-income groups have been left in the public scheme, increasingly deprived of the contribution of higher income groups, hence, public services have deteriorated and

emergency services were in crisis at the end of 1992. Those insured in ISAPRES can either: pay to the provider and get reimbursed by the ISAPRE in the percentage agreed, buy vouchers from the ISAPRE to pay the provider who gets reimbursed by the ISAPRE, or receive direct services from an ISAPRE which has those facilities. The number of ISAPRES rapidly increased to 34 at the end of 1991 (more than twice the number of AFPs); the six largest ISAPRES cover close to three-fourths of the beneficiaries. There seems to be more competition among ISAPRES than among AFPs; the costs of administration and sales declined in the former from 40.5% to 18.9% of total expenditures in 1981-1991 but still are quite high. A Superintendency of ISAPRES supervises the private sector. In spite of its rapid expansion, the private health sector in Chile only covers about one-fifth of the population (Iglesias and Acuña 1991; CIEDESS 1992; Gillion and Bonilla 1992).

A law enacted in Peru in November of 1991, following the Chilean model, introduced a health private system: the insured can stay in the social security institute (IPSS) or transfer to the HMOs (abbreviated as OSS) which offer different health packages. However, the Peruvian system adds a solidarity element lacking in the Chilean one: the entire employer's contribution and part of the insured's is kept at the IPSS. The rest of the insured's compulsory contribution (as well as an additional voluntary contribution) is transferred to the OSS of their choice, which freely charges commissions for its services too. The IPSS can subcontract with OSS for the provision of emergency and high-tech medical services. A Superintendency of OSS regulates and supervises the private system. By the end of 1992 the new system had not yet been regulated, hence, it was not operative ("Crean el Sistema...1991; López and Céspedes 1992).

c. Supplementary Private Schemes. In a small but increasing number of Latin American countries, HMOs are expanding their coverage among the non-insured. In the Dominican Republic, where social security covers only about 4% of the population and its health



services are not of adequate quality, HMOs (iguallas) are not only enlisting the non-insured but also offering supplementary better services for the few insured. For a monthly premium, iguallas provide comprehensive health care to about 7% of the population, part of whom are covered by social security but do not use its services. Employers of large and middle enterprises finance 75% of the premium, but 145,000 microenterprises that employ 400,000 workers cannot afford that payment. Recently, there have been negotiations between associations of these microenterprises (willing to enroll members and collect fees) and iguallas, which are studying a low-cost package--based on a large group of insured--to provide primary-health-care and related services to potential members (Mesa-Lago 1992c).

## II. CASE STUDIES IN PENSION REFORM

This section evaluates the Chilean model of substitutive private scheme and summarizes the features of a similar reform just passed in Peru. In addition, it studies proposals for mixed and legal drafts for private schemes in Colombia, as well as legal drafts for mixed schemes in Argentina and Uruguay.

### A. Chile: Pioneer and Model in Privatization

#### 1. General Characteristics of the Reform

Together with Uruguay, Chile is a pioneer in the introduction of social insurance in Latin America. At the beginning of the 1970s the Chilean social security system was one of the two most advanced in the western hemisphere: it covered all contingencies, reached virtually all the population (combining contributory and non-contributory schemes), and offered generous benefits. But it was extremely fragmented, legally complex and stratified, lacked effective coordination, allowed unjustified privileges and significant inequalities, constituted a heavy economic burden, suffered financial and actuarial disequilibria, and required substantial state subsidies. Interest groups blocked the urgently needed reforms of the system recommended under successive

administrations (Mesa-Lago 1989; Piñera 1991; Cheyre 1991; Iglesias and Acuña 1991; Santamaría 1992).

In 1973 the long Chilean democratic tradition was interrupted and the new authoritarian regime destabilized or banned trade unions, professional associations and political parties. The weakening of the pressure groups and empowering of the state allowed the reform of social security. Legislation enacted in 1979 eliminated the most blatant inequalities and standardized some entitlement conditions, e.g., retirement ages were uniformly set at 65/60 for males/females. A gradual process of unification of the old system took place in the 1970s and 1980s. An Institute of Social Insurance Standardization (INP) was appointed to merge and manage the unified schemes, standardize them, and administer a special fund to cover the growing deficit. The military and police schemes were completely excluded from the reform.

A new pension scheme, with uniform entitlement conditions and regulations, was introduced in 1980 and began to operate in 1981. Based on the "social market" ideology, it assigns to the state a subsidiary role in social security, entrusting the operation of the new scheme to competing private Pension Fund Administrative Corporations (AFPs) regulated and supervised by a new Superintendency (SAFP), and with a series of state guarantees. The scheme establishes a compulsory saving/pension (for old age), plus disability and survivor coverage through separate private insurance companies. The insured contributions (employers do not contribute) are credited to an individual account and all funds are invested by the AFP in different instruments; investment returns are credited to the insured's account.

Those insured in the old pension scheme were allowed to exercise some of their acquired rights only during a transition period but to keep other rights permanently. In addition, they were given a five-year period (which expired in 1986) to stay in the old scheme or move into the new one. A strong incentive to move was a significant reduction in the insured's payroll contribution

in the new system, combined with a publicity campaign criticizing the flaws of the old scheme and exalting the virtues of the new one. By the end of 1982, one-half of the labor force and close to 70% of all the insured had moved to the new scheme. Since 1983 all salaried new entrants in the labor force are obligated to join the new scheme. The old scheme is expected to last for about 40 to 50 years. In the following analysis we refer to the old and new pension schemes as public and private respectively (Baeza and Manubens 1988; Arellano 1989; Ferrara 1989; Mesa-Lago 1989; Borzutzky 1991; Piñera 1991; Iglesias and Acuña 1992; CIEDESS 1992).

## 2. Population Coverage and Compliance

All salaried workers are compulsorily covered in the private scheme while the self-employed can join voluntarily. Those insured who do not fulfill the needed requirements for a regular pension are entitled to a minimum pension with state support. The non-insured are entitled to a public assistance pension paid by the state.

The proportion of the labor force covered by the public scheme steadily increased and peaked at 76% in 1973; it declined to about 62% in 1980. Combining the two schemes (but excluding the armed forces), coverage continued decreasing to a trough of 57% in 1982 (in the midst of the economic crisis), and steadily rose thereafter to 86% in 1991. (Percentage of coverage based on registered insured is considerably higher than that based on contributing insured—see below.) In 1991, 90% of the insured were registered in the private scheme and 60% of their members were less than 35 years of age, while the public scheme had been left mostly with people close to retirement (SAFP 1981 to 1992; SSS 1982 to 1992; Mesa-Lago 1987, 1988, 1989; Cheire 1991; Iglesias and Acuña 1991; Arrau 1992; CIEDESS 1992).

In 1988, 19.5% of the labor force was not covered by social security, but that proportion reached 58% among employees of microenterprises, 71% among self-employed, and 92% among unpaid family workers (Mesa-Lago 1990; Marcel and Arenas 1991).

The creators of the private scheme thought that it would reduce evasion and payment delays: the workers would register and pay their contributions (because these would be safe and grow into a sizable sum), while employers would not have to pay contributions and lack an incentive to underreport salaries (Piñera 1991; CIEDESS 1992; Santamaría 1992). But that hope has not materialized due to: lack of adequate controls, a high contribution for the insured, high inflation which created an incentive for employers to delay the transfer of salary deductions, difficulties in incorporating the self-employed, and cheaper alternatives in public assistance.

The proportion of those registered in the private scheme who pay their contribution steadily decreased from a peak of 76% in 1983 to 52% in 1991 (40% among self-employed). This behavior might have been caused by flaws in the SAFP data, actual increases in evasion and payment delays or by the fact that low-income insured delay payment to reduce contributions in order to get a minimum pension. A good portion of the non-contributors are temporary workers and unemployed, while others have withdrawn from the labor force. When the number of contributors instead of those registered is used, the proportion of the labor force covered in 1990 is reduced from 79% to 42% ; adding the public system, coverage is 50%). There is significant underreporting of earnings as well: one-fourth of the contributors pay on the base of earnings equal or lower than the minimum wage, largely because they are interested in the minimum pension only (SAFP 1981 to 1992; SSS 1982 to 1992; Iglesias and Acuña 1991; Arrau 1992; CIEDESS 1992).

Improvement of compliance is not easy. The insured are expected to check the AFP's quarterly report of their individual accounts and hence detect if employers are not transferring their contributions, but many don't do it and others cannot understand the report. The AFPs can prosecute delinquent employers but many fail to do so because of the fear that the employer will encourage his/her employees to shift to another AFP. The employer must complete as many monthly forms as social security institutions that cover his/her employees, hence, large enterprises

complete dozens of forms, but the problem is actually worse for middle-sized enterprises without computer facilities. A unified fully-computerized collection system, with one single form to report, would speed up payments, reduce employer costs, and strengthen control of evasion and payment delays. In the 1980s, there were several projects to accomplish that task, but the SAFP and the largest AFPs opposed that change, because of: fear that a state agency could use information against AFPs; loss of the largest AFPs' competitive edge based on a national network of collecting branches; potential that the collecting agency could incur in computational errors and resulting legal issues on the responsibility for such errors; and questions on who would pay the collecting agency fee (Mesa-Lago 1987, 1988).

### 3. Benefits and Entitlement Conditions

Entitlement conditions and regulations of pensions are uniform in the private scheme. The old-age pension requires age 65 for males and 60 for females, plus 20 years of contribution. Early retirement is allowed but submitted to strict regulation. The old-age pension fund consists of: the insured's net contributions (after deducting commissions to AFP), a state recognition bond\*\*, investment returns, and the transfer from a potential savings account. The insured has three options at the time of retirement: (i) A life annuity from a private insurance company which guarantees a fixed monthly pension for the insured and his/her survivors; the insured's decision for this option is irrevocable. (ii) A programmed pension directly paid by the AFP, annually calculated (hence fluctuating); the insured can change his decision at any time. (iii) A programmed pension for a number of years and a life annuity later. The AFP must provide all the needed information to make a decision, but reportedly 90% of the insured does not understand the complexities involved and hire an expert who charges a fee ranging from 3% to 5% of the total value of the accumulated

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\*\* The bond accounts for contributions to the public system; it is calculated with a complex formula and the resulting sum is adjusted to inflation and earns a 4% annual interest from the time of transfer to the time of retirement when it is paid by the state.

fund (Gillion and Bonilla 1992). The AFP is never responsible if the insured's decision results in an insufficient length or amount of the pension.

Disability and survivors pensions are not paid by the AFP but by the insurance company contracted for that purpose. A total disability pension pays 70% of average earnings of the last 10 years to those younger than old-age retirement age; while a partial disability pension pays 50%. Survivor pensions are paid to: widows or disabled widowers, children below age 18 (or 24 if a student, any age if an invalid), and parents if there are no other beneficiaries. A minimum pension is guaranteed by the state if the insured's accumulated fund is not sufficient to finance that amount, but other requirements are met. A public assistance pension is paid by the state to all the noninsured and those insured not entitled to minimum pensions.

The entire social security system (benefits, accounts, investment, etc.) is denominated in terms of a separate monetary currency whose value is adjusted monthly for inflation so that currency units maintain a constant value. A comparison of the average level of pensions in the public and private schemes showed that by 1991 the latter was 43% above the former in old-age pensions, 100% above in disability, and 46% above in survivors. But it should be noted that there are less than 100,000 pensioners in the private scheme but close to one million in the public scheme. The level of pensions for the armed forces is probably higher than the average pension in the private scheme. Pensions of female insured are considerably lower than those of males because the former have a lower retirement age and live longer. The minimum pension appears insufficient to meet basic needs: in 1991 it was 22% of the average national wage, and it is estimated that about half of the insured will receive a minimum pension. The public assistance pension is about half the minimum pension, and the number of such pensions is limited to 300,000 and there is a long waiting list (Mesa-Lago 1988; Arellano 1989; Ferrara 1989; SAF 1991-1992; Gillion and Bonilla 1992).

Estimates of the future levels of average private pensions are based on too many assumptions, hence, results vary widely, depending on whether such assumptions are optimistic or pessimistic. A Chilean research institution (CIEDESS 1992) based on a 5% interest rate—which is considered to be low, in view of the average yield of 14% reached in 1981-1991, has calculated a replacement rate of 80% to 86% for males (53% to 56% for females). The ILO (Gillion and Bonilla 1992) using a 3% interest rate—which is considered to be high—has in turn projected a 30% to 44% replacement rate.

Processing of the pensions has been greatly simplified and made much faster in the private scheme. An application form can be mailed or presented to any AFP, and the individual accounts facilitate the process. Since 1990 a preliminary pension is paid after ten days of the application and it is readjusted later. In 1988 a system of voluntary savings accounts was introduced, handled by the AFPs, and total savings had increased three-fold by 1991 (Mesa-Lago 1988; Iglesias and Acuña 1991; Margozzini 1991).

#### 4. Insured Contributions and Commissions

In both the public and private pension schemes only the insured contribute, but the state finances the deficit of the public scheme and contributes to the private scheme as well. The employer's contribution for pensions was abolished in 1980 and other employers' contributions (for unemployment compensation and family allowances) were eliminated in 1988 and totally absorbed by the state, except for employment injury. The insured percentage contribution for pensions is uniform in the private scheme (although there are still differences in the public scheme): 10% for old age plus an additional 2.5% to 3.7% (varying among AFPs), which pays the premium for disability and survivors in an insurance company and the rest goes as a commission to the AFP. There is a voluntary additional contribution of 10% to increase the basic old-age pension, available for salaried workers but not for the self-employed. The total compulsory contribution to pensions

fluctuates from 12.5% to 13.7%. In addition, the insured pay 7% for sickness-maternity for a mandatory total of 19.5% to 20.7% in the private scheme, compared with 25.6% to 27.7% in the public scheme. The lower contribution in the private scheme was initially justified by its allegedly more efficient administration but largely resulted from the 1979 reform which eliminated costly benefits and tightened entitlement conditions; and yet such savings were not passed on to the insured in the public scheme as an incentive for transferring to the private scheme (Arellano 1989; Mesa-Lago 1989; SAFP 1992).

The insured must pay to the AFP freely set commissions, usually of two types: a fixed sum (deducted from the 10% contribution for old-age pension) and a variable percentage (deducted from the contribution to disability-survivor coverage). The commission on the latter took about 70% of the total payment made by the insured, the other 30% going to pay the premium. Because of the large number of insured in the AFPs, insurance companies reduced the disability-survivor premium, and yet the resulting economies of scale were not transferred to the insured but absorbed by the AFP. Since 1987 the premium and the commission have been separated and the greater transparency has led to a cut in the latter (Mesa-Lago 1987, 1988).

The fixed commission has a regressive effect because it is proportionally higher among lower-income insured (hence reducing their net contribution for old-age and their investment return), while it is proportionally lower for high-income insured. The fixed commission was the subject of strong criticism in the 1980s from both domestic and foreign experts who suggested different alternatives to substitute it, but the smaller AFPs opposed such change (because they have a concentration of lower-income insured and the fixed commission generated most of their revenue) and the government also resisted the modification. Despite wide criticism of the fixed commission by experts who now have prominent positions in the new democratic government, it has not been abolished, apparently due to technical difficulties.



Commissions have been declining. In current pesos the fixed monthly commission reached a peak of 695 in 1983 and declined to 250 in 1991; in constant pesos the commission declined by three-fourths therefore reducing the regressive effect. The average percentage commission peaked at 3.6% in 1983 and declined to 3.1% in 1991. The total combined commission decreased from 4.5% to 3.6% in 1983-1990. Finally, differences in the combined commissions charged by the various AFPs have gradually shrunk—allegedly due to increased competition among them—but see section 7 below (SAFP 1983 to 1992; Mesa-Lago 1988; Arellano 1989; Bonilla 1991; Cheyre 1991; Marcel and Arenas 1991; Arrau 1992; CIEDESS 1992).

#### 5. Investment

The combined pension funds of all AFPs increased two-fold every two or three years in 1981-1991; in the latter year they reached US \$10 billion equal to 34.5% of GDP and half of the external debt (CIEDESS 1992; SAFP 1992). It is projected that, under favorable conditions, the funds will reach 50% of GDP in the year 2000 and 100% in 2025. The average annual real investment yield in 1981-1991 was 14% (the highest in Latin America and the Caribbean), it steadily surpassed the real commercial bank interest for deposits. But many claim that such high yields will not be sustainable in the future.

There has been a gradual diversification of the portfolio, particularly after laws in 1985, 1989 and 1990 expanded the range of instruments. The Central Bank determines the ceilings for investment of the instruments. In 1983, when the economic crisis forced the state intervention of several banks and enterprises to prevent wide-spread bankruptcy, 97% of investment was in debt instruments and 72% was in state instruments. This was considered to be dangerous, hence the 1985 law allowed investment in shares and private bonds, and the 1990 law did the same for foreign instruments. The portfolio became more diversified between 1983 and 1991: from 44% to 38% in state securities, from 51% to 14% in mortgage bills, from 3% to 13% in bank

deposits/bonds, and from zero to 24% in enterprise shares. Therefore, in 1991 only 38% of the portfolio was in state instruments and 65% in debt instruments (Mesa-Lago 1991a; Iglesias and Acuña 1991; SAFP 1983 to 1992).

The creators of the private scheme initially believed that it would help to significantly develop the domestic capital market (Piñera 1991); although the later has indeed grown, the huge accumulation of pension funds has not met the original expectations. Only in 1991 the proportion of investment in private enterprise shares and bonds exceeded one-third of the total. It is argued that the high yields of the 1980s reflected a similar performance in other stock and bond markets throughout the world, recovering from the decline suffered in the second half of the 1970s and the start of the 1980s. The very high Chilean yields of 1990-1991 are then explained by the high demand for these type of instruments (particularly shares) and the relatively few which are eligible for AFP investment. (A Commission for Risk Classification ranks stocks suitable for AFP investment according to their degree of risk.) (Mesa-Lago 1988; Bonilla 1991; Gillion and Bonilla 1992). An opposite viewpoint is that the pension funds have significantly contributed to increase domestic and foreign confidence in the domestic stock market and stimulated the growth of insurance companies. In addition, the funds have played a principal role in debt equity swaps, thus reducing the external debt and promoting foreign investment (Cheyre 1991; Iglesias and Acuña 1991; Santamaría 1992).

Another important question is whether enough alternatives for investment of the pension funds will be available in the future. If the total value of the fund grows to equal 50% of GDP by the year 2000, it might foster higher rates of investment (provided there are enough opportunities) and foster economic growth. Conversely, if capital supply exceeds demand, the rates of return might decline and/or capital outflows increase. One view is that opportunities for investment were dramatically expanded in the 1980s by the government privatization program but now, when such

process is virtually completed, there are fewer opportunities. The 1990 authorization to invest in foreign instruments (with a ceiling increasing from 1% to 10% in 1991-1996) has been seen by some as a way out for the constraints of the domestic capital market. But another group opposes the export of domestic savings (Manubens 1988; Arrau 1991; Marcel and Arenas 1991; Margozzini 1991; Mesa-Lago 1991a).

Finally, there is the issue of the impact of the private pension funds on national savings and investment. The original argument of the founders of the scheme was that the substitution of the pay-as-you-go system by a fully-funded pension scheme would increase capital accumulation (Piñera 1991). A divergent viewpoint was that in order to have such a positive effect, AFP's savings had to be greater than the public deficit generated by the reform (Arellano 1989). Recent analyses of the relationship, conducted by experts with divergent views, concur that there is no conclusive evidence that private pensions have generated higher national savings (Arrau 1992; CIEDESS 1992; Gillion and Bonilla 1992; Santamaría 1992).

#### 6. The Burden of the Pension Deficit and State Subsidies

Social security expenditures as a percentage of GDP peaked at 17.5% in 1971 (a historical record in the western hemisphere), declined to 9.3% in 1975, steadily rose again to 15.6% in 1982 (in the midst of the crisis) and decreased to 13.1% in 1986. Two-thirds of the expenditures were from all pension programs. The active/passive ratio steadily declined from 10.6 in 1960 to 1.9 in 1988. The decrease in the share of social security expenditures/GDP in 1982-1986 and the slowdown in the decline of the active/passive ratio in the 1980s are the result of the social security reform particularly the increase in ages of retirement (Mesa-Lago 1988, 1989, 1991b).

The state contributes to the private pension scheme in two ways: the recognition bond, which accounts from one-half to three-fourths of the capital of those retiring until the end of the current century; and the needed difference to pay the minimum pension for those who lack

sufficient funds in the AFP. In addition, the state has to finance: the deficit of the public pension scheme (civilian and armed forces), public assistance pensions, unemployment compensation, family allowances and health care for indigents. Therefore, to secure a sound private pension scheme, the state made a long-run financial commitment to the entire social security system (Arellano 1989; Bonilla 1991).

Within the pension system, in 1988, the private scheme had 84% of the total number of active contributors and only 4% of the total number of pensioners, hence, it generated a substantial surplus. But the public sector (civilian, armed forces, public assistance pensions) had only 16% of active contributors and 96% of pensioners, therefore, it ended in a huge deficit which increased from 2.2% of GDP in 1981 to 6.3% in 1986 (Mesa-Lago 1988, 1991b). Unfortunately, there are no consolidated data to estimate the balance of the entire social security system. Experts have provided contradictory estimates of the state subsidy (as % of GDP) to cover the cost of the deficit in various sectors in 1991: 3% for the public pension scheme alone, 6% for the state subsidy to the private scheme (these two combined would be 9%), 5% for all the deficit of the pension reform (which should be higher) and 4% for all the social security system deficit (that should be even higher) (Arrau 1992; CIEDESS 1992; Gillion and Bonilla 1992; Santamaría 1992). The lack of coherence of these figures and imprecision of what they exactly cover ratifies the vacuum of accurate global data. But it is clear that the state's commitment to the pension scheme has reduced public funds for other programs, such as health care for the lowest income groups.

It is unclear how the state will finance the pension deficit: if with taxes, public debt, reduction in consumption or a combination of all three. Financing the deficit with public debt will place the burden on future generations and the young to benefit the current generation and the old; financing with taxes will place the burden on the current generation. The first alternative has been so far predominant; it has been estimated that if all the deficit is financed with debt, the latter, as

a percentage of GDP, will increase from 25% to 67% in 30 years and stabilize at 56% later (Arrau 1992).

### 7. Administration

The creators of the private pension scheme assumed that its market elements (free entry and exit, competition, free change of AFP by the insured), combined with state supervision and minimum guarantees, would ensure its efficiency and result in: expanded population coverage, improved compliance, increased number of AFPs, decreased administrative costs and commissions, and maximized investment yields (Piñera 1991). We have noted that some of these goals have not been met (coverage, compliance), while others have (investment yields, commissions). In this section we analyze whether the system is truly competitive, as well as its effects on administrative efficiency, and the role of the state in establishing minimum guarantees.

The number of AFPs was practically stagnant in the first decade of the scheme: initially there were 12, 13 in 1991 and 15 in 1992. Nine AFPs have been controlled by the largest economic conglomerates which surged in the 1970s from the privatization process. During the 1982 crisis, two of these conglomerates went bankrupt and their assets were temporarily administered by the state; they were reprivatized later and sold to foreign corporations under the debt-for-equity swap program. There is a high degree of concentration in the AFPs: the largest three combined 60% of the all the insured in 1981, and such proportion increased to almost 68% in 1991 (Mesa-Lago 1988, 1989; SAFP 1992; CIEDESS 1992).

Data on AFPs operational costs are fragmentary and contradictory. One analyst estimates that such costs per insured, in constant pesos, were halved in 1982-1986. Another claims that in 1989, 25% of total revenue from contributions went to operational costs. Still another expert concludes that overall costs of the entire system are almost twice as high as before. In 1981 there were 3,500 employees in the public scheme, which was considered the single largest public

institution in Chile; the number of employees in the private scheme was 8,000 in 1990. About 30% of AFPs personnel is made up by sellers (see below) and the share of publicity expenditures is very high; these types of expenditures were not needed in the old system.

During most of the 1980s the three AFPs with the largest number of insured charged the highest fixed and percentage commissions but, by 1991, they had the lowest percentage commissions and two of them also had the lowest fixed commissions. In 1981-1991 the average investment yield of those three AFPs was below the overall average yield. Therefore, at least in the 1980s, the insured's selection of AFPs was not made on the basis of lower commissions and higher yields, hence, competition did not seem to work. The selection apparently was made based on the work of sellers and the publicity displayed by the largest AFPs. Although there is no limit on the number of times an insured can change AFPs, in practice it can be done three times a year and at no cost to the insured. In 1990, 17% of all contributors shifted AFPs and 90% of those changes were managed by sellers who work on commission. The insured--particularly the elderly and females--usually ignore the differences among AFPs in terms of commissions and yields and hence are easy prey for the sellers. The change is not always beneficial. Information provided by the AFPs on commissions and yields were poor until the end of the 1980s when it became more transparent and improved its quality. But a very substantial amount of AFPs costs still goes to publicity and very little or none to effectively educate the public on how to make a wise decision based on the real advantages of specific AFPs (Mesa-Lago 1988, 1989; Iglesias and Acuña 1991; CIEDESS 1992).

The state has established a series of guarantees (particularly after the bankruptcies of 1982) to make the private scheme as sound as possible. These measures have largely achieved their goal but a few of them have raised significant barriers for the entry of new AFPs. The most important guarantees are: (i) AFPs cannot be involved in business other than pensions; (ii) the pension fund

is separated from the AFP's own assets, in case of bankruptcy the SAFP manages the fund until it is transferred to another AFP; (iii) each AFP has to count with an initial capital which increases with its number of insured, the initial requirement was US \$100,000 but now US \$2 million are needed in practice; (iv) the AFPs are responsible for a monthly average yield in the last 12 months not less than the lesser of the following two: the average yield of all funds minus two percentage points or 50% of the average yield of all funds; (v) all AFPs must establish a "reserve of yield fluctuation" to cover any gap in the required yield, and a second reserve (encaje) is required, equal to 1% of the value of the pension fund; if both reserves are insufficient to reach the required minimum yield, the state is obliged to finance the difference; and (vi) 90% of the investment instruments must be deposited in the Central Bank (Marcel and Arenas 1991; Margozzini 1991).

#### 8. Overall Evaluation

The social security reform and the private pension scheme have brought advantages and disadvantages for the three major participants. The insured workers have benefitted from: lower payroll contributions, a higher level of benefits (so far), freedom of choice of AFPs and retirement plans, the recognition of previous contributions, eligibility for a minimum pension, a sounder pension program with state guarantees, high investment yields, and faster and simpler processing of pensions. Disadvantages are: the decline in coverage (based on compliance), the payment of commissions to the AFPs, poor transparency at least until recently, impediment to use the accumulated fund until the time of retirement (e.g., to invest in a small business, buy a house, etc.), lack of knowledge on crucial issues and decisions, and the loss in the employer's contribution. The latter has been the employer's gain whose only disadvantage is the considerable paperwork involved in monthly reporting and transferring of their workers' contributions. The state seems to have mostly disadvantages (subsidies to the whole system) and few advantages, most of which are not clearly demonstrated, e.g., the potential correction of a negative impact of the

employers' payroll tax on employment, some beneficial effect on the capital market (although not as much as originally expected), the eventual termination of the troublesome public scheme. Society as a whole has profited with the elimination of unjustified costly privileges (although not all have been terminated) but will have to confront the heavy cost of state obligations in the future. Outcomes of the schemes are extremely sensitive to the interest rate, level of compliance and general economic conditions. The state may be required to meet various guarantees at once, and some risks may also occur simultaneously, such as high unemployment and inflation combined with low real rates of return. There is no evidence that the capitalization system has generated higher national savings.

Prior to the 1990 elections the opposition cautiously accepted the social security reform and the private scheme but was critical of various aspects: the lack of solidarity and participation of the insured in the administration, the poor coverage of important sectors of the population, such as the self-employed, the low minimum pensions, the regression of the fixed commission, the need to have more AFPs, the foreign ownership of AFP, and investment of funds in foreign instruments. The democratic government has not introduced any substantial changes in the system but has focused on tax reform to improve redistribution; it has also increased minimum pensions and is planning to extend population coverage (Mesa-Lago 1989c; Borzutzky 1991; Marcel and Arenas 1991; Gillion and Bonilla 1992).

#### B. Peru: Moving Closer to the Chilean Model

The social security system of Peru is administered by the Peruvian Institute of Social Security (IPSS). Its pension fund has suffered a dramatic decapitalization in real terms (particularly in the 1980s) due to: negative real investment yields (from -21% to -29% in 1981-87); a significant state debt (US \$194 million, which virtually vanished due to very high inflation rates and lack of debt indexation); considerable employers' evasion and payment delays (33% only on



evasion); and huge administrative costs (52% of total expenditures in 1986, largely due to adjustment of personal salaries to inflation). Additional problems are: a low population coverage (one-third of the labor force and one-fifth of the population), a sharp decline in the real value of pensions, excessively long and bureaucratic procedures to solicit such pensions, lack of actuarial studies for a long period, and overall inefficiency and waste. Obviously, there was a need for reform but the debate focused on the proper type: improvement of the public scheme, privatization or a mixed approach. Important differences of the Peruvian system with that of Chile prior to the reform were: one central social insurance agency (instead of multiplicity of funds), considerably lower population coverage, and a worse financial and administrative situation (Mesa-Lago 1989, 1990, 1991a, 1991b, 1992c; Marcos 1992).

In November 1991—within the general economic framework of an adjustment and restructuring program—a decree law was enacted by the Executive which introduced a private pension scheme almost identical to Chile's. It was scheduled to begin operation on July 28, 1992 and, although its title referred to "supplementary private pensions," it was really an alternative to the public pension scheme, as the insured in the latter could freely transfer to AFPs providing the latter with better conditions and benefits than the IPSS. However, there were some differences with the Chilean model: (i) because of Constitutional regulations, the public scheme in Peru (IPSS) could not be terminated, hence, the law granted all workers (including future participants) the right to choose affiliation in the public or private schemes; (ii) entitlement conditions in the public scheme remained unchanged, and they are more liberal than in the private scheme (e.g., 60/55 versus 65/60 ages of retirement); (iii) there was no minimum pension guaranteed by the state in the law decree; (iv) the employer's contribution was to be reduced from 6% to 1% while the insured's was to be increased from 3% to 8% (plus additional voluntary contributions and commissions), contributions in the public scheme apparently were not changed; and (v) based on

the solidarity principle, the entire employer's contributions and part of the insured's was to be transferred to the public scheme ("Créase Sistema"...1991; Marcos 1992). Incentives provided to move to the private scheme were: the financial crisis of the public scheme and the potential for a financially sounder private scheme with higher pensions, and the lower contribution charged to the employer (who could try to influence his/her employees to move). Incentives to stay in the public scheme were: significantly lower contributions for the insured and more liberal entitlement conditions.

The coup led by President Fujimore and the suspension of the political constitution paved the way to move the Peruvian pension reform closer to its Chilean counterpart. A draft of a new decree law and its regulations, published in the official gazette on July 16, 1992 abrogated the 1991 decree law (just before it was to be enforced) and introduced significant changes. Inclusion in the private scheme (AFPs) was to become mandatory to all those not previously insured in the IPSS who retained the right to move to the private system. All new entrants into the labor force or those who lost affiliation to the IPSS had to enter the private scheme; therefore, as in the Chilean case, the public scheme was to be closed (Anteproyecto...1992). The final law, enacted in December 1992, basically followed the legal draft. Those insured in the IPSS has the right to stay or move to the private scheme; if they do so they still can return to the IPSS within a two-year period after enactment of the law. If they stay in the IPSS their contributions and those of their employers continue unchanged, and the insured retain all rights under the public scheme. It is not clear in the law if the private scheme is voluntary or mandatory to new entrants into the labor force, the latter seems to be the case, and hence, the IPSS is closed. A summary of the new features of the private scheme under the 1992 law follows.

Contributions of the insured have been further increased to make them equal to the Chilean model: a mandatory 10% for old-age pensions plus another contribution (freely set by the AFPs)

for disability and survivors, and a voluntary additional contribution for the old age pension with a maximum of 20% (twice that of Chile). In addition, there is a compulsory 1% contribution by the insured (formerly imposed on the employer by the 1991 decree law) to be transferred—in solidarity—to the IPSS to defray the cost of public assistance to the disabled and elderly who are destitute. Therefore, the insured contribution probably would be higher than in Chile. Mandatory contributions for employers have been eliminated and only voluntary ones are left. As in the case of Chile, salaries of insured who move from the public to the private scheme are to be increased by 10% (a transfer from the eliminated employer's contribution) plus another 3%. There are a few differences with the Chilean model. A maximum of 60,000 new soles is placed on the recognition bond, a ceiling which does not exist in Chile (at the end of 1992 the ceiling was equal to US \$40,000, which was quite high for Peru but the new sol was declining). The bond is indexed for inflation but does not earn interest. It is granted only to those registered in the IPSS with six months of contributions immediately before the enactment of the law plus a minimum of 4 years of contributions in the last 10 years; the number of years accounted for by the bond increases with the age of the insured with a maximum of 19 years. The minimum capital needed for an AFP to enter the market is only 500,000 soles (equal to US \$400,000 at the end of 1992) compared with a theoretical minimum of US \$100,000 in Chile but no less than US \$2 million in practice. Finally, maxima for instruments also differ, e.g., 60% for state securities (compared with 45% in Chile), and 5% in foreign instrument versus 10% in Chile ("Sistema Privado..." 1992).

Incentives to move to the new system are now greater: not only would the insured get a substantial salary increase, but employers will augment pressure on their employees to shift in order to save their contribution. If the insured moves to the private scheme and then return to the IPSS, all salary increments are eliminated. There is also a government-sponsored campaign encouraging people to move to the AFP and minimizing the role of the IPSS. The latter's financial situation

has worsened: there are 300,000 pensioners who are expected to be paid US \$35 million monthly in pensions, but it is not clear where the money will come from. Procedures for new pensions are halted, there is no attempt to control compliance, and the personnel is being induced to resign (López and Céspedes 1992). Predictably, under these conditions, an overwhelming majority of IPSS insured will move into the new system.

The new Peruvian model reduces the cost of the transition by eliminating the minimum pension and placing limits (and not paying interest) on the recognition bond. But Peru has always been below the Chilean level of development and the former's economy is currently in chaos (compared with Chile in 1980). Furthermore, population coverage in Chile prior to the reform approximated universality, but in Peru more than two-thirds of the labor force is not insured and about half is informal (in addition, there is a very large population of peasants outside the national market), hence, expansion of coverage will be extremely difficult. Finally, in a country with much more poverty and lower-income groups than Chile, the state commitment to subsidize the transition (even if at somewhat lower costs) would deplete resources from basic services for those most in need.

### C. Colombia: Mixed or Private Schemes?

#### 1. The Current Situation

The social security system of Colombia is one of the most fragmented in the region: in 1990 there were 1,040 institutions. About 70% of those covered are private salaried workers under ISS; 5% are under the institute that covers civil servants (CAJANAL); and the remaining 25% are in multiple public funds. Combining all these institutions, only 30% of the labor force and 21% of the total population was covered in 1990, basically formal workers. About half of those expected to be registered are evaders, and expansion into the informal sector (about 57% of urban employment) is virtually impossible. Benefits and entitlement conditions for the insured,

particularly in the public pension funds, are very generous, e.g., 55 years of age for retirement (compared with 60/55 for male/female in ISS) or retirement with 10 to 20 years of work regardless of age; the average CAJANAL pension almost doubles that of ISS. In 1988 a law established mandatory adjustment of all pensions to the cost of living, without providing the needed resources. Administrative costs reached a record 42% of total expenditures in 1986.

The total payroll contribution of ISS is one of the highest in the region but grossly insufficient to finance the system; CAJANAL's contribution is smaller but even more inadequate. The combined cumulative state debt and private employers' non-compliance to ISS toward the end of the 1980s was close to US \$400 million. The real value of the ISS reserves decreased by two-thirds in 1975-1985. The required total contributions to put ISS back on partial capitalization (it is currently on pay-as-you-go) would have to be increased from 6.5% to 18% (in 1991-1995) and to 21% by the end of the century. (However, with a pay-as-you-go regime, the contribution would be 11% by the year 2000 and 21% by 2109.) CAJANAL neither has reserves nor a financing method (in 1989 the state financed 67% of its expenditures), hence, its contribution would have to be raised with pay-as-you-go from 21% to 24% in 1992-1995, 30% in 2000 and 52% in 2019. The current value of ongoing and future pensions in 1993-2020 (in ISS and CAJANAL) has been estimated to be close to one-half of Colombia's GDP in 1991 (Mesa-Lago and De Geyndt 1987; Jaime 1991; López Castaño 1991; López and Martínez 1991; Contraloría 1992; López Montaña 1992b; Zulueta 1992).

## 2. Proposals for Reform: Public, Mixed and Private

At the beginning of the 1990s, there was a generalized consensus in Colombia that the social security system was in crisis and needed a drastic reform. The new Constitution of 1991 states that social security is: a mandatory public service to be provided under state direction and control; the state guarantees it to all inhabitants based on universality and solidarity principles; and

population coverage should be extended by the state with private participation hence allowing its operation by public or private institutions. A lively debate ensued on what form the reform should take (FESCOL 1992b). There were three divergent positions concerning the reform of the pension scheme similar to those explained in section I-B of this study: (i) a reformed public scheme, (ii) a mixed scheme, and (iii) a substitutive private scheme.

The first position argued that the ISS actuarial deficit was so huge (and more so CAJANAL's) that it made impossible the creation of a Chilean-style fully-funded private pension scheme: it would cost 30% of public expenditures for about 45 years to finance the reform. Furthermore, economic and political differences between the two countries would make the application of the Chilean model very difficult in Colombia (see section 3). Therefore, the crisis should be solved within the current system through a series of reforms, such as: (i) unification of the private and public pension funds and standardization of entitlement conditions and benefits; (ii) extension of population coverage with state support to finance the incorporation of urban informal and rural sectors; (iii) gradual raise in the age of retirement from 60/55 (55 in CAJANAL) to 65/60, (iv) increase in payroll contributions and the required weeks of contribution to put the system in a sound financial base; (v) aggressive pursuit of payment evaders and late payers through improved computerization, inspection and prosecution techniques; and (vi) reduction of administrative costs with higher efficiency (Jaime 1991; López Montaña 1992a).

The second position endorsed a mixed scheme, arguing that total privatization was not allowed by the Constitution (Cárdenas 1992). Three alternative proposals elaborated in 1990-1991 by experts. All of them agreed that the current scheme could not be put back on a fully funded or partially funded basis, but it could be financed by pay-as-you-go provided that current entitlement conditions were significantly tightened and contributions moderately increased. All three proposals: maintained the current pensioners' rights; provided a basic (reduced) pension for

future pensioners, ranging from 1/2 to 3 minimum salaries; increased the age of retirement for future pensions, as well as the weeks of contribution and the years used to compute the base salary; and offered a supplementary pension program, mainly through private providers. The proposals also recommended the incorporation of public pension funds within the reformed ISS system but with much tighter entitlement conditions and increased contributions plus effective payment of state subsidies. The proposals differed on: the timing of the transition (rapid or gradual), whether current contributions would have to be increased, and whether state subsidies would be necessary. Contributions to the fully funded supplementary pensions were expected to be high, although specific rates were not provided (López and Martínez 1991; López Castaño 1991, 1992).

The third position contended that the mixed approach would retain the flaws of the public system, the fiscal burden would continue, and the supplementary funds would be very small and hence not be able to be a proper channel for savings and investment. Thus, a fully-funded capitalization scheme should be developed. Although some followers of this approach said that it did not have to be tantamount to privatization, most supporters advocated the Chilean model. Some of those who first endorsed the mixed approach, shifted to the third stand in 1992 (Zulueta 1992).

### 3. The Government Proposal of Privatization

The second position described above appeared to be the most popular in 1991, but supporters of privatization grew stronger and ultimately prevailed. In September 1992 the president submitted a legal draft to congress, basically following the Chilean model but with some important differences summarized below.

The ISS, CAJANAL and other public funds would be closed and substituted by a new private scheme (SAFPs). All salaried workers entering the labor force would become mandatorily covered by the private scheme; voluntary coverage would be available for non-salaried workers. Those currently insured younger than age 55/50 (male/female) would have the option to move to

the new private scheme; the rest of the insured would have to remain in the old schemes unless they decide to continue their contributions until age 65. The old schemes would be terminated in about 40 years.

Entitlement conditions and benefits in the ISS would be tightened: a gradual increment of the retirement age from 60/55 to 65 for both sexes; a raise in years of contribution from 10-20 to 30; an expansion of the years of work to calculate the base salary from two to ten; and a new maximum pension equal to 90% of the insured's salary at the time of retirement or 15 minimum salaries. All pensions would be adjusted to the cost of living. All public funds would be integrated into a new Fund for National Public Pensions, but their privileged conditions were left untouched by the draft, which completely excluded the armed forces. Starting in 1994 those age 70 and above who are destitute would be entitled to a public assistance pension that will pay up to half a minimum salary.

Within the private scheme, conditions for old age would be 65 years of age plus 30 years of contributions. These conditions are tougher than Chile's: five more years of age for women and ten years more of contributions for both sexes. Other conditions would be similar to Chile: a recognition bond (although the draft did not specify the interest rate), a minimum pension guaranteed by the state and so forth.

At the beginning of 1992 the total payroll contribution for pensions in ISS was 6.5% (4.3% the employer and 2.2% the insured) but lower in public funds. A few weeks before the legal draft was submitted to Congress, the ISS total rate was increased to 8% (5.3% and 2.7% respectively), but contributions to public funds were not changed. The proposal would establish a uniform rate of 13.5% for all the old and new schemes, 10% to be paid by the employer and 3.5% by the insured. In the new private scheme, all the employers' contribution would go to the insured's individual account for old-age pension, while the insured's contribution would finance the premium



for disability-survivor insurance, any remnant would go to the SAFP as a commission. Contrary to the Chilean model, therefore, the Colombian proposal did not eliminate the employer's contribution but increased it by 132%, and did not reduce the insured's contribution to the private scheme but raised it by 60%. State financial obligations in the proposal are almost identical to Chile's.

The administration of the private scheme would be done by Chilean-style SAFPs, but also by private fiduciary and savings associations and public financial institutions. SAFPs could charge a percentage contribution but not a fixed one, hence, eliminating the regression discussed in the Chilean case. Changes of SAFP by the insured would be limited to two per year, one less than the practice in Chile. Publicity would be regulated by the state. And a similar maximum for SAFP investment in state securities would be set at 45% (MTSS 1992).

#### 4. Criticism and Failure of the Government Proposal

The legal draft became the target of strong criticism by some congressmen, state agencies, research institutions and experts. The following is a summary of the major criticisms (Contraloría 1992; López Castaño 1992; López Montaña 1992b; Ocampo 1992; Ruiz Llano 1992).

The draft violated the constitutional principles of universality, solidarity, and the state's prominent role in social security. The reform should be global (including health care) and not limited to pensions because of the need to assess all its costs, for instance, the total payroll contribution (combining all programs except family allowances) was estimated to be 25%, almost twice the proposal pension contribution. The key impact of the proposed reform would result from the tightening of conditions, and increase in contributions rather than from privatization and a shift to capitalization, hence—with similar changes—the ISS could be maintained and generate the same outcome.

The draft ignored the constitutional mandate to expand population coverage and made it more difficult with the increase in the contribution rate. The latter would catapult Colombia from the ninth to the fifth highest payroll contribution in Latin America, the same rank of Chile, but this country ranks fourth in population coverage while Colombia is twelfth, and the raise in the contribution would not improve that situation. In Chile, coverage of the labor force prior to the reform was 75%, but in Colombia it is 30%; furthermore, the latter's poverty incidence, informal sector and self-employment are considerable larger than in the former. The government claims that its pro-market economic policies would ultimately lead to complete "formalization" of the labor force and universal coverage--an optimistic scenario which at best would take many years to materialize. The reform therefore would at great cost consolidate the protection of less than one-third of the labor force (insured, with high or middle income) at the expense of the majority, which is non-covered and has the lowest income. The proposal similarly lacks equity by imposing sacrifices on those covered by the ISS but leaving untouched the privileged public schemes.

The proposal suggested that the salary replacement rate of an average insured with 30 years of contributions would be 54% with an interest rate of 5%. Not only is the latter high (see below), but that calculation assumes full compliance throughout the working life of the insured. Due to labor instability and evasion however, the ISS average has been 50% and, in addition, 80% of its insured earn two minimum salaries or less. Therefore, a large majority could end up receiving a minimum pension and the state subsidy would be higher.

The government's financial projections incorrectly assumed that none of the current insured would move to the private scheme, hence, the payroll contribution of 13.5% should be insufficient to finance ISS in the long run and much less CAJANAL, which would need a 21% contribution at the start. The required combined contribution would be 14% in 1993 and rise to 31% in 2020. Estimates of the debt generated by the entire reform range from 20% to 64% of GDP by the year

2025; the bond of recognition alone would cost from 8% to 46% of GDP (such divergent estimates depend on how many of the insured would move to the private scheme). The real interest rates used in the government projections ranged from 5% to 8% (three different rates were used and not consistently), but the average interest rate in Colombia in 1951-1992 was slightly less than 4%, and international rates have been even lower. In view of Colombia's trend toward economic opening, the domestic rate would have to decrease to be competitive in the world market. If that happens, SAFPs yields should be lower than projected; state costs could be higher on one hand (because more insured would need a state subsidy to collect a minimum pension) but lower on the other hand (because government borrowing and adjustment of recognition bonds would be cheaper).

Because of many more limitations in Colombia's capital market compared with Chile's in the early 1980s, either a very high proportion of investment would have to go to public-debt instruments (much more than the 45% maximum set in the proposal), or pressure would build to allow the insured to withdraw funds from the SAFPs (e.g., to buy homes, finance education) or a sizable portion of investment would go to foreign instruments.

Mounting criticism forced the president, toward the end of 1992, to withdraw his proposal from congress. All parties have agreed to carefully discuss the draft (widening its scope to include health-care reform), revise and resubmit it to Congress. In the best scenario, final approval can not be expected until 1993.

#### D. Argentina: A Proposed Mixed Model

##### 1. The Situation Prior to the Reform

Together with Uruguay, Argentina suffers the worst financial disequilibrium of pension schemes in the region. In the 1960s and 1970s, multiple pension funds were unified and relatively standardized under the Secretariat of Social Security. There are three branches: industry and commerce (salaried private workers), state (civil servants) and self-employed. Population coverage

is almost universal except for the lowest-income self-employed and some rural temporary and seasonal workers.

Pension benefits are excessively generous, e.g., in spite of one of the highest life expectancies in the region, the overall ages of retirement is 60 for males and 55 for females. Disability pensions are easily granted, and due irregularities, 30% of all pensioners under the legal age of retirement receive that type of pension. Privileged regimes (judiciary, legislative, top executive) allow retirement with minimum years of work, regardless of age. According to law, the pension should be set at 70% to 82% of the base salary, which is calculated as the average of the best three years of salary out of the ten years prior to retirement, and pensions should be adjusted according to overall salary adjustment. Those unrealistic norms could not be enforced in the long run (when the financial deficit of the system expanded dramatically and inflation skyrocketed), hence, the real level of pensions declined by 25% in 1981-1988 and by another 30% in 1988-1991. More than 20,000 judicial claims have been granted to retroactively collect the difference between the pension actually paid and that legally established, and another 60,000 claims are pending; all of these, however, account for only 4% of the total number of pensioners. In 1991 the government agreed to settle the debt to the pensioners for the previous 12 years at US \$7 billion but, since then, the debt continues growing at a rate of US \$2.4 billion per year.

There are significant inequalities in the scheme. The privileged regimes which cover a tiny fraction of one percent of all pensioners receive 2% of all expenditures, and the state branch which has 0.7% of all pensioners gets 6% of total pension expenditures. Some insured contribute all their working lives, but others (particularly the self-employed) underreport their income in the early years and concentrate their contributions on the last three years, thus, both groups may end up receiving the same pension. Multiple benefits that can be legally received by one person account for 12% of total expenditures. Non-contributory pensions are paid to former judges of the Supreme

Court and church dignitaries; in 1991 there were 150,000 of these pensions with a cost of US \$16 million. In 1991 a law was passed abolishing privileged regimes, but some of them have managed to maintain their perquisites.

Social security expenditures in Argentina equalled 9% of GDP in 1980 and 13% in 1991; about 80% of such expenditures go to pensions. The total wage tax to social security is 56% (21% for pensions), the highest in the region. Since the mid-1980s there are taxes on gas and public utilities as well, but these revenues are grossly insufficient to finance the system. The state therefore has to subsidize 35% of pension expenditures and that burden has been rapidly increasing. The industry-commerce branch surplus is used to cover the expanding deficit of the state and self-employed branches (the latter's revenue only covers 20% of its expenditures).

In addition to the explained largesse in benefits, the deficit has been caused by a gradual decline in real revenues for several reasons. The employers' contribution was eliminated in 1980 and substituted by a proportion of IVA revenues, but these turned out to be considerably lower than previous revenue from the employers contribution and the latter was re-established in 1984. Evasion is officially estimated at 30% and unofficially at 40%; payment delays are even worse. We have also noted widespread underreporting of income and salaries. Reserves used to account for as much as 28% of GDP, but they were invested in state securities at a fixed interest rate (which resulted in a 16% negative rate); when the state canceled its obligation in 1970, those funds had shrunk to 1% of GDP.

The economic crisis of the 1980s aggravated the deficit: industrial employment declined 39% in 1975-1988 and industrial real salaries by 25%, thus reducing revenues. The percentage of the population age 65 and over increased from 4% to 10% in 1950-1991, and life-expectancy also grew significantly. As coverage was almost universal, the ratio of contributors to pensioners rapidly declined to 1.62 to 1 in 1990 and was projected to further decrease to 1.46 to 1 by 2025.

To finance the pension scheme under current conditions, the ratio should be 4 to 1. Projections for 1995-2025 show that the wage contribution will have to almost triple (to 55%) or the state subsidy increase to 62% of expenditures in order to keep paying pensions. The cumulative deficit of the scheme in the next 30 years is estimated to be equal to the national debt with all foreign banks in 1991 (Schulthess 1990; Mesa-Lago 1991d, 1992a; Feldman 1992; "El Poder Ejecutivo..." 1992).

## 2. Reform Proposals

For at least a decade, the urgent need for a global radical reform has been obvious, but several legal drafts to accomplish that task have failed. Part of the explanation is the absence of knowledge of the population, another reason is the reluctance of politicians to bite the bullet. Interviews conducted in 1990 with leaders of political parties, trade unions, associations of pensioners and selected employer groups, showed that they had a remarkable lack of information on both the current pension scheme and proposals for its reform. The situation among the mass of the population had to be much worse (Isuani 1991).

An unsuccessful legal draft, elaborated in 1990, tried to solve the problem, mostly by tightening conditions and benefits of the existing scheme: raising the age of retirement to 65/62 plus 35 years of contribution; reducing pensions to 65% of a base salary calculated as an average of the 10 years prior to retirement; increasing the contribution by 1%; eliminating privileged regimes; and converting the costly self-employed branch into a public assistance program in charge of and totally financed by the state. The draft also allowed a private supplementary scheme to which those insured in the public scheme could shift as much as 2% of their own contributions (Feldman 1992).

The previous draft was not preceded by substantial study and was virtually kept secret by the secretariat of social security. A new approach was followed by the Menem's administration.

With external funding, some 30 technical studies were conducted in 1989-1991 covering virtually all legal, economic and statistical aspects of the reform (Mesa-Lago 1992a). Several legal drafts were elaborated by the secretariat, but the one submitted to Congress in May 1992 was voted down. A revised draft, incorporating substantial modifications requested by legislators was delivered to the Chamber of Deputies toward the end of the year, but it was not expected to be discussed until February 1993; if approved, it would go to the Senate. After enactment of the law, the system can not begin operation until at least nine months have elapsed, hence, it would never become operational until 1994.

a. General Features of the Proposed Reform. The proposed system is mixed, a combination of a permanent public scheme based on pay-as-you-go and paying a basic pension, and a supplementary private scheme, fully funded and very similar to Chile's. All those age 18 and over are mandatorily covered by the new system as well as future entrants in the labor force. Therefore, the public scheme is not closed, and the private scheme supplements rather than substitutes the public scheme. Another important distinction is that the self-employed are compulsorily covered in Argentina (a situation that predated the new system), while they have voluntary coverage in Chile. Employer contributions are maintained in Argentina. There is no reduction in the insured's contribution hence no increase in their salary (as in Chile).

All salaried workers in the private and public sectors (except the armed forces; provinces and municipalities may choose not to enter the system) as well as the self-employed are covered. Voluntary coverage is available for members of coops, housewives and other minor groups. Payroll contributions are uniform for the whole system: the salaried insured pays 11% and the employer 16%, while the self-employed pays 27% of his/her income (the sum of both percentages for salaried workers). The employers' contribution as well as 16% of the self-employed's contribution goes to the public scheme, and the salaried insured's contribution plus 11% of the self-

employed's goes to the private scheme. All contributions are collected by ANSES, the administrative arm of the Unified System of Social Security, which transfers the corresponding portions to the public and private schemes. The destitute who have reached a certain age but who are not covered by the system are entitled to a public assistance pension (conditioned to a means test) directly paid and financed by the state. The age of retirement is ultimately set in both schemes at 65 for both sexes, gradually increasing in the next 20 years; 30 years of work and contributions are also required. These conditions are tougher than Chile's: five more years for females and ten more years of contributions. But the debt of the Argentinean system is considerably worse than it was in Chile in 1980.

b. Public Scheme. All the insured is entitled to an basic pension plus a "compensatory benefit." The former is equal to 2.5 "AMPOs", i.e., the average that is estimated twice a year, dividing the contributions going to the private scheme (basically the insured's) by the number of those registered in the system. If an insured has more than 30 and up to 45 years of contributions, the basic pension is increased at a rate of 1% per year. The basic pension thus eliminates the need for a minimum pension as in Chile.

The "compensatory benefit" is similar to Chile's recognition bond, but rather than be deposited by the state in the insured's private scheme individual account (at the time of retirement) it is paid to the public scheme. It is calculated at the rate of 1.5% of the base salary (the salary average of the last ten years prior to retirement) for each year of work/contribution with a maximum of 36 years, and the resulting sum is adjusted to inflation. There is a ceiling of 60% of the base salary (as well as a maximum of one AMPO for each year of work) and no payment of 4% interest as in the Chilean case. These differences should reduce the cost of this benefit. (A previous draft version excluded this benefit altogether, but legislative pressure forced its inclusion.)



For those who are age 45 and older, disability and survivor pensions are paid by the public scheme. Adjustment of all public pensions to the cost of living will be based on the AMPO. The draft also eliminates the duplication of pensions as well as the accumulation of a pension with income from work.

The public scheme is financed by the insured's contribution of 11% (explained above) plus the following: up to 25% of IVA revenue, 100% of revenue from selling shares of the state petroleum enterprise, and 20% from the profit tax. In addition, the private scheme will buy state bonds, and there is the possibility of long-term loans from multilateral lending agencies.

c. Private Scheme. It is virtually identical to Chile's with the differences noted above plus the following: (i) the private corporations administering the system are abbreviated as AFJPs instead of AFPs; (ii) the mandatory insured's contribution of 11% for the old age scheme is one percent higher than Chile's, and the voluntary additional contribution is not specified; (iii) the unified system of payment of contributions through ANSES reduces the burden on employers, particularly small ones, but if not efficient, it may not be fast enough to transfer the funds and could generate errors and legal claims; (iv) the required capital of an AFJP is equivalent to US \$1.5 million, less than the US \$2 million now required in Chile but much more than the initially required sum of US \$100,000 in the latter country; (v) changes among AFJPs are limited to two annually, which reduces the seller's gains but limits the insured's freedom of choice; (vi) AFJPs are not allowed to have publicity until approved and thereafter their publicity is submitted to state control (an advantage over the Chilean system); (vii) the maximum established for AFJP investment in instruments is much wider than in Chile, for instance, as much as 80% can be invested in state securities and 30% in securities from provinces, municipalities and public enterprises (the combined maximum in Chile is 45%); (viii) insurance companies must have exclusive dedication to manage each disability-survivor insurance and life annuity; (ix) trade unions, associations of entrepreneurs

and professionals, cooperatives, mutual-aid societies and banks are allowed to operate AFJPs but as separate enterprises, something prohibited in Chile, which only allows corporations (sociedades anónimas); (x) the Superintendency of the private scheme is not financed by the state but by the AFJP, a practice that should increase the latter's costs and commissions; and (xi) the state provides some guarantees to the insured not available in Chile, for instance, if an insurance company goes bankrupt, the state is responsible for paying the life annuity to the pensioner.

Divergences in the pension system of Chile and the proposed one in Argentina result from diverse legal backgrounds, the magnitude of the deficit in their pension schemes, and political regimes. The latter is a crucial factor. In Chile the reform was introduced by an authoritarian regime which effectively banned all potential opposition, while Argentina currently has a democratic regime where a consensus must be built among political parties, trade unions, associations of pensioners and entrepreneurs.

#### E. Uruguay: Reforming the Prototypical Welfare State

##### 1. The Crisis of the Welfare State

Uruguay is the prototype of the welfare state in the region, and its first pension schemes were introduced early in the 20th century. But the system became one of the most stratified and costly in the region, and its heavy burden contributed to the country's economic stagnation. A process of modest reform that began in the 1960s led to partial administrative unification and fairly standardized entitlement conditions of most schemes. But the reform has not corrected the fundamental problems of a massive growing deficit that requires state subsidies in spite of extremely high payroll contributions. Pensions take 80% of benefit expenditures and cause about 60% of the system's deficit (Mesa-Lago 1989, 1991d; Saldañ 1992).

The Social Insurance Bank (BPS) manages the general social security system (including pensions) and embraces three major branches: (a) civil servants and teachers, (b) industry and

commerce workers, and (c) rural workers and domestic servants. About 87% of the insured and 90% of the pensioners are in the BPS; the rest are covered by seven independent pension schemes. Coverage of the labor force declined from 81% to 76% in the 1980s, but there are public assistance pensions for the poor, hence, protection of the population is virtually universal. Aging of the population combined with generous entitlement conditions have led to a contributor/pensioner ratio of one to one, the lowest in the region. Almost one-fourth of the total population currently receives a pension. In spite of a tightening of entitlement conditions in the late 1970s and the 1980s, the age of retirement is still 60 for males and 55 for females, which results in average pension periods of 16 and 24 years respectively. Political officials and teachers can retire with a given number of years of work regardless of age, hence, they can retire in their late forties. There are unjustified differences in pension amounts, for instance, in relation to the average BPS pension, those of militarymen are 400% higher, civil servants 56% higher but industry-commerce 16% lower and rural-domestic 37% lower. Pensions are calculated on the average salary of the last three years and adjusted for inflation. However, the growing deficit and heavy burden on the state led to a dramatic erosion in the real value of pensions: in 1989 it was 25% of the 1962 level. A constitutional amendment, approved by 80% of the population at the end of 1989, mandated the adjustment of all pensions to the cost of living index in the period immediately before, and rejected a ceiling on pensions established two years before.

The cost of the social security system as a percentage of GDP reached a record 15.4% in 1982 and declined to 10.3% in 1985 (due to some tightening of benefits), but increased steadily thereafter to an estimated 14% in 1992. The BPS takes a rising proportion of total social security expenditures (85% in 1991), and 80% of BPS benefit expenditures are on pensions. The BPS overall deficit averaged 2% of GDP in 1986-1992, and two-thirds of it was the pension deficit. In 1987 the BPS deficit was twice as high as the central government deficit, and in 1990 it was 25

times higher (because the central government successfully reduced its deficit as the BPS deficit soared). Within the BPS the industry-commerce branch generates a surplus which is used to partly offset the deficit of civil servant-teacher and rural-domestic branches; the first transfer has a regressive effect on distribution, while the second has a progressive impact. State subsidies to pensions have an overall regressive effect because they mostly go to high- and middle-income insured groups, such as the armed forces and civil servants.

The total payroll contribution for social security in Uruguay ranges from 39% to 45% (according to the various branches), the second highest in Latin America, but still 20% of costs have to be subsidized by the state. Contributions for pensions are 13% by insured and from 16.5% to 24.5% by employers. In 1990 overall evasion in the BPS was 55%, and two-thirds is extremely difficult to control. About 25% of the VAT, a 20% tax on registration of vehicles and part of the income-tax revenue is channeled to offset the social security deficit. The constitutional mandate to adjust all pensions to the cost of living forced a substantial increase in payroll contributions and taxes in 1990-1991 (Mesa-Lago 1991d; Lacurcia 1991; República 1992).

In 1991 the BPS prepared a projection of its pension deficit showing that it will rise to 33% of income in the year 2000 and to 75% in 2045; a more optimistic projection still sets those figures at 27% and 58%; as a percentage of GDP the pension deficit will be from 4.5% to 5.8%. The BPs concluded that the crisis was irreversible and called for an urgent global reform (BPS 1991a, 1991b, 1991c).

## 2. Reform Proposals

Three alternative models of pension reform were studied, similar to those discussed in section I-A and in the Colombian case: (i) reformed public scheme, (ii) substitutive private scheme, and (iii) mixed scheme. (The following summary of the three alternatives is based on Lacurcia 1992 and República 1992).

The first alternative argued that the current public system (pay-as-you-go) could be saved but with a drastic tightening of entitlement conditions and benefits. A potential increase of contributions and taxes to achieve equilibrium was rejected as non-viable both politically and economically, but a more efficient collection and control of evasion was considered feasible, particularly in the industry-commerce branch. Reduction of expenditures was to be achieved by several measures including: (i) an increase in the age of retirement to 65/60 or 65 for both sexes; (ii) expansion of the salary base from 3 to 45 years; (iii) elimination of all privileges of political officials and teachers; and (iv) reduction of the salary replacement to 60%, reintroduction of the pension ceiling, and restrictions in the adjustment of pensions to the cost of living.

The second alternative was estimated to be extremely costly: the total cost of the reform by the year 2030 was projected to be US \$17 billion at 1991 prices (almost five times the external debt of 1991) if all insured 40 years and older in the old system would move to the new one; the cost would be higher if the option to move was given to all the insured, or lower if those age 30 and over were only granted that right. It was argued that, compared with Chile, entitlement conditions in Uruguay are more liberal, contributor/pensioner ratios considerably lower, and the deficit of the system much bigger. In addition, Uruguay's capital market is less able than Chile's to absorb the enormous flow of funds resulting from capitalization: public securities account for 99% of all instruments in the stock market and 95% of the transactions on private shares is done by only 9 enterprises. Finally, the large number of pensioners in the nation and politicization of the issue made this alternative non-viable politically.

The third alternative combined a reformed public system (as explained in the first alternative) that would pay basic pensions with a fully-funded scheme providing supplementary pensions (the Argentinean model). Two variants were considered: to allow all those currently insured to be part of the new system or to limit the latter to new entrants in the labor force. This

second option would allow the capital market to develop gradually as the flow of funds increased slowly rather than abruptly. Another difference with Chile was that participation in fully-funded schemes would be voluntary and could be administered by both public institutions and private corporations. Furthermore, the employer's contribution could be maintained and geared to the public system. The major problem with this alternative was the high cost of recognition bonds: if all insured in the old system were allowed to participate in the new one, it would cost US \$4.5 billion in constant dollars.

The government eventually selected the third alternative (but with some important modifications) and after considerable discussion with leaders of political parties, unions and employers, submitted a legal draft to Congress in April 1992 (República 1992). The mixed system was composed of three levels: (i) the reformed public scheme but with the addition of individual accounts based on which a basic pension would be paid; (ii) a non-contributory public assistance pension financed by the state; and (iii) supplementary pensions provided by a variety of institutions already approved in the 1980s.

The tightening of conditions in the public scheme was less drastic than described above (possibly responding to political pressure): ages of retirement were not increased and a minimum of ten years of contributions was set; payroll contributions remained unchanged. The most innovative element in the proposal was the introduction of individual accounts that would become the fundamental base to determine all future pensions and earn a 3.5% annual real interest rate. The value of the deposits would be calculated in "pension units" (P.U.) adjusted monthly to the average salary index. The replacement rate for old-age pensions would be 60% of the average monthly deposit (in P.U.) plus 0.5% for every additional year of contributions up to 65%; the maximum in P.U. would gradually increase from 140 to 500. The minimum pension would be equal to the minimum salary. The scheme would also pay basic disability and survivors' pensions.

The non-contributory public-assistance pension would be paid to those age 70 years and older (or to those totally disabled), providing they are not covered by BPS and are destitute. This pension would be financed by state general revenue.

Finally, Societies Administering Supplementary Pension Funds (SAFCPs) were authorized by a 1984 law and regulated in 1989. Ten of them were in operation before that legislation was enacted, and by 1990 their number had increased to 24 but only had 30,000 members or 4% of those covered by the BPS. These funds can be administered by the BPS; the State Insurance Bank; and non-profit societies organized by unions, and professional and trade associations approved by the BPS. Commercial corporations (such as Chile's AFPs) are excluded. Contributions can be by the insured but also mixed (by insured and employers) hence another difference with Chile. Participation is voluntary rather than mandatory: SAFCPs could be "open" for all those covered by the BPS or "closed" for those insured who belong to the same enterprise, union, profession or trade. Investment should be mostly in public instruments, and a minority in real estate and personal loans. The brief periods of operation and small number covered (largely elderly people) impedes any serious evaluation of these schemes (MTSS 1989; Casares 1990; Lacurcia 1991).

Despite an apparent consensus developed over one year of public debate and consultation, the draft was voted down by Congress in 1992. At the time this paper was finished, the legal draft was being revised for resubmission.

### III. LESSONS AND FUTURE OUTLOOK

Although there is an apparent wave of social security privatization in Latin America, the fact is, that by the end of 1992, only two countries had enacted a law creating a substitutive private pension scheme: Chile and Peru. The latter's law however was only passed in July 1992, hence, only Chile has lengthy experience (about a dozen years) with this type of reform. Privatization of health care is even less important as the leading country, Chile, only has one-fourth of its

population insured in private HMOs. In a few other countries there has been either marginal privatization (of non-medical services as in Jamaica) or collaboration of a public scheme with the private sector (as in Costa Rica and Colombia). Two legal drafts under consideration (in Argentina and Uruguay) follow a mixed-scheme approach. Several countries are studying reforms, but it is still premature to know what their style will be. The overwhelming majority of Latin America and the Caribbean therefore retains a public pension scheme, although reformed in some countries. But there is talk that toward the end of the century, a privatization wave may become a major threat to social security. Some countries see the Chilean model as a panacea, without sufficient knowledge of its feasibility in and implications for their own societies.

A. Is the Chilean Model Replicable in Latin America?

Divergent political economic and social security factors to those of Chile can make the adoption of its privatization model much more difficult in other countries. The drastic Chilean reform was made feasible by an authoritarian government that banned political parties and controlled unions and the newsmedia. Under such conditions any opposition to the reform was either eliminated or very weak. Conversely, in the 1980s and the beginning of the 1990s, there was a democratization trend in Latin America. Even with authoritarian regimes installed in Argentina, Brazil and Uruguay (but not as radical and repressive as Chile's), a full-fledged reform was not possible. In an international seminar held in Santiago in October 1992, I questioned José Piñera, author of the Chilean reform, if such divergent political conditions made its model not replicable in other countries. He answered saying that it was as difficult to convince a group of generals as a group of congressmen. And yet, he actually did not have any experience with the latter and basically had to convince one single general. It is symptomatic that the only other country that so far has passed a substitutive private pension scheme, Peru, did so after a coup d'etat and under suspension of constitutional rule. The attempt of Colombia's president to pass a similar



reform failed because of strong opposition in congress. and by political parties, other government agencies and experts who were freely able to disseminate their criticisms. Even moderate mixed-scheme proposed reforms in Argentina and Uruguay, preceded by careful study and public discussion (at least in the second country), were voted down by congress, and important modifications had to be introduced. Finally, the Constitutions of several countries (e.g., Colombia, Peru) enthrone the state's predominant role in social security and/or the principles of solidarity and universality, all of which conflict with a substitutive private scheme.

Socio-economic conditions may also be different. In 1980 Chile was experiencing a four-year economic boom, which provided a comfortable base to the reform; and yet, the severe crisis of 1982 forced direct government intervention to save the reform from bankruptcy. Economies like those of Peru are suffering a severe crisis, while others are just emerging from the terrible recession of the 1980s. Capital markets in countries such as Colombia and Uruguay are considerably less developed than that of Chile at the time of the reform, and hence less capable of properly absorbing a sudden huge flow of funds.

Last but not least, social security conditions in many Latin American countries are less propitious than in Chile. In less developed countries such as Bolivia, Colombia, Ecuador, Peru, and most of Central America and the Latin Caribbean, less than one-fourth of the population is covered by social security; furthermore, poverty incidence, the informal sector, self-employment and the marginal peasant sector are much more extended than was the case of Chile. If public schemes have been unable to significantly expand population coverage with a Bismarckian model, a private scheme will certainly be an unsurmountable barrier to coverage, as the majority of the population (non-formal, non-salaried, rural) will not have access to the private scheme. Scarce public funds will be committed to consolidate the social security system of a minority at the expense of desperately needed resources for the majority, such as public assistance, primary health

care and so forth. In the most developed countries of the region, pioneers, such as Argentina and Uruguay, currently face a pension disequilibrium much worse than Chile's in 1980, the cost of the reform therefore would be higher. Demographic and other factors are equally more adverse, for instance, the ratio of contributors to pensioners was two to one in Chile but is one to one in Uruguay. Even less developed countries like Colombia suffer a worse disequilibrium (particularly in the civil-service sector) than was the case in Chile.

#### B. Lessons of and Apprenticeship from the Chilean Experience

The Chilean pension reform has brought important advantages such as: (i) reduction of insured's payroll contributions; (ii) higher benefits (so far) and easier and faster granting of pensions; (iii) eradication of privileged regimes (except for the armed forces); (iv) recognition of previous contributions to the old scheme; (v) state guarantees to the insured; (vi) very high investment yields; and (vii) eventual disappearance of the costly old scheme. But contrary to the founders' expectations, there are obvious disadvantages and unanswered questions on the reform: (i) About half of those registered do not contribute to the private scheme, and overall effective population coverage has declined. (ii) Coverage of non-formal groups of the labor force is minimal, e.g., 42% of employees in microenterprises, 29% of the self-employed and 8% of unpaid family workers (these groups make up the majority of the labor force in many Latin American countries). (iii) The number of AFPs has increased very little in twelve years, and high concentration in coverage by the major three AFPs has grown from 60% to 68%; furthermore, selection of the AFP by the insured is more a result of seller's activity and publicity than the AFPs higher yields and lower commissions, implying that the insured does not have adequate knowledge to make decisions and, hence, the system is not competitive as claimed. (iv) It is not clear whether administrative costs in the private scheme are higher or lower than in the old system. (v) There are contradictory projections of future salary replacement rates, which range from 80% to 86% for

males (but only 53% to 56% for females) down to 30% to 40%, depending on whether optimistic or pessimistic assumptions are used for those calculations. (vi) There are doubts about the ability of the domestic capital market to absorb the growing funds (currently equal to about 35% of GDP); high enterprise-share yields appear artificially inflated by the insufficient number of those that qualify in the stock market; the opening to investment in foreign instruments could be an indication of poor availability of domestic investment opportunities; and there is no evidence that the system has had any beneficial impact on national savings. (vii) We lack an overall actuarial balance for the whole system, and projections of future costs vary widely due to incomplete data. Followers of the reform pinpoint its positive effects, while critics stress the negative outcomes. Countries that are considering a reform should be aware of both results.

Several lessons can be learned from the Chilean experience. One is that the cost of the transition must be very carefully evaluated. The maintenance of part of the old entitlement, the recognition bonds and the minimum pensions are humane elements of the reform but extremely costly, hence, they must be balanced with an accurate assessment of the future burden on society and alternative costs to other public programs for lower-income groups. Another lesson is that the market and private administrators do not necessarily assure competition, control of evasion and payment delays, and other efficiency improvements. Huge collective savings have not led to a corresponding expansion of the domestic capital market either. Finally, the exclusion of part of the population (e.g., the armed forces) from the reform, and the maintenance of its privileged entitlement conditions and benefits can be forced by political reasons but eventually become a salient inequality that must be eradicated

The analysis of two enacted laws (in 1991 and 1992 in Peru), three legal drafts (in Argentina, Colombia and Uruguay in 1992) and several proposals (in Colombia in 1991) concerning pension reform shows that they have learned some of the above noted lessons and

attempted to correct several disadvantages of the Chilean model. The legal proposals of Argentina and Uruguay (as well as the 1991 law in Peru, and Colombian proposals) discarded the substitutive private scheme and followed mixed schemes. To reduce costs of the reform, some proposals divide the population of insured in the old scheme by age, restricting the right to move to the new scheme to those who are below that age (e.g., 55/50 in Colombia, and 45 in an early legal draft in Argentina). In Peru a ceiling is placed on the value of the recognition bond, and no interest is accrued to it, and no minimum pension is guaranteed. Tougher entitlement conditions are established, for instance, five more years for women to retire and ten more years of contributions for both sexes in Argentina and Colombia (this is particularly important to the latter, whose life expectancy is shorter than Chile's). To increase revenue and infuse some solidarity into the system, the employers' contribution is not eliminated in Colombia (actually increased substantially), Argentina and Uruguay (where the employers' contribution goes in solidarity to the old scheme); Peru maintained such contribution in its 1991 law but eliminated it in the 1992 law. The insured's contribution is not reduced as in Chile, but maintained unchanged (in Argentina) or increased (in Colombia's and Peru's 1992 laws).

The administration of private pension schemes is not only entrusted to AFPs (corporaciones anónimas) but also to savings associations and public financing agencies (in Colombia), and banks, cooperatives, unions and employers or professional associations (in Argentina). The supplementary pension scheme of Uruguay is voluntary and is exclusively administered by the social security institutes or by non-profit private organizations. In Argentina a unified state collection solves the problem of multiple forms to be filled by the employer to different social security institutions. Changes of AFP are legally limited to two annually (Argentina, Colombia), and no publicity is allowed until the AFP is approved: the state sets norms and supervises all publicity (in Argentina). Chile's early bad experience of excessive concentration of AFP investment in state and debt

instruments—which led to eventual portfolio diversification—appears to be ignored by Argentina (where 100% of investment can go to public debt instruments) but learned by Colombia (which fixed a ceiling of 45% for such instruments, the same as currently in Chile).

Barriers to coverage extension are not considered in Peru and Colombia but, in the latter, criticism to that flaw was one of the reasons for withdrawing the government legal draft (modifications now proposed attempt to correct such flaw). Finally, exclusion of the armed forces from the reform seems to be universal (Argentina, Colombia, Peru, Uruguay), an indication of the limits of democratization in all those countries; furthermore, privileged regimes of civil servants were left untouched in the Colombian legal draft.

The urgent need for profound reform of social security in most of Latin America can not be denied, even by those apologists, who in ostrich fashion, refused to see the dangerous signs of the crisis that began unfolding a decade ago. Democratization in the region is a welcome trend, which has allowed ample debate of proposed reforms by many segments in society. But in some countries the political opening has become an obstacle in the path of reform or led to a perpetual watering down of proposals studied and debated for years. Paradoxically, Chilean democratization has transformed a pariah model of reform into one politically correct or at least palatable in Latin America. And yet, there is the danger of advocating the Chilean approach as the only valid one for the region. The executives, political parties, the congress, unions, employers' associations and other groups must put aside their narrow interests and responsibly reach a consensus to adapt and implement the type of social security reform best suited to national peculiarities and needs.

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