

# **Pension system reform in Argentina**

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## **I. Introduction**

Pension systems of most countries of the world, independently of their degree of development, geographical location, ethnic characteristics, etc., have had many changes in the last two decades, or at least governments afford demands from society to introduce transformations.

In Argentina there were at the beginning of the 90's many reasons for introducing changes. Namely a low contributors/pensioners ratio which had driven to a huge financial deficit of around 4% of GDP at the end of the 80s, high inequalities -high pensions were more than 100 times the low ones-, privileges for public officers (they could get their retirement being younger than the rest of workers), etc. The reform was performed after a long public debate with the participation of political and social groups, Labor Unions, entrepreneurs, etc.

The aim of this talk is firstly to examine which were the changes politically feasible. And secondly to explain central characteristics of the new model which as was put into practice by means of the Law 24241/94 which gave place to the so called "Sistema Integrado de Jubilaciones y Pensiones (SIJP)".

The presentation has four sections. The first one is a brief analysis on the two more relevant methods for conceding retirement benefits that, at this time, were feasible in consideration of historical practice not only in Argentina but also in other countries of the region. The second section, we show the main elements for justifying the decision of changing the regime (which had operated for around 50 years). Third, the SIJP is briefly presented. Finally, we list the main comments and critics on the SIJP after eight years of being enacted.

In Argentina, as in the rest of Latin America, the pay-as-you-go system was applied. This system had many inconveniences as was previously mentioned.

The main structural problem was the low contributors/pensioners ratio, which provoked a huge financial deficit with negative economic implications.

## **II. Alternatives of Social Security regimes**

The choice of a social security system was basically restricted to two possibilities: one of them was just to continue with the pay-as-you-go system, and the other one was to enact a capitalization system.

Both alternatives were carefully evaluated, analyzing the pros and cons of each method, to take a decision for organizing the new regime. Two main positive aspects of the pay-as-you-go system are. Firstly, the possibility of implementing personal-income distribution policies. Secondly, the value of the pension can be accurately determined, using a defined benefit plan, where the pensions are based on a prescribed formula (e.g. the number of years in service, de final salary), providing a guaranty of replacement ratios (pension/salary).

Negative aspects in the implementation of the pay-as-you-go system translated into serious financial deficit.

a) The change on the parameters that integrate the formula for the calculation of the pension (the minimum age for getting the benefit, the minimum number of contributors), were not included at the just time. The consequence was that the financial equilibrium of the pension system was affected.

b) The second problem was the high evasion; workers evaded and entrepreneurs evaded as well; there were also huge abuses coming from the use of political power to generate extraordinary or what was in popular talk called "privileged" benefits.

Generally speaking, this regime generated an income distribution that was running in precisely the opposite direction as desirable, which is to give more to those who had less.

The alternative to the pay-as-you-go system was a capitalization system (with definite contributions), whose positive aspects were the equity principle (this means, pay out pensions according to the size of accumulated pension contributions plus the investment returns yielded by them over many years).

It was thought that the capitalization system would generate the incentives for people to pay the social security contributions, helping to diminish evasion. The main expected difficulties were related to the risk and uncertainty concerning the accumulated funds, particularly regarding the unduly appropriation of these funds by the Government. Besides, a system of this type could be considerably more expensive to administer than the pay-as-you-go system.

### **III. The basis for the reforms**

Considering the alternatives, as was explained above, an appropriate, practical, and useful solution was a mixed system. The character of "mixed" means that workers have the choice either to stay in the State-managed pay-as-you-go system, or to accumulate their personalized contributions in privately managed Funds (the so called "Administradoras de Fondos de Jubilaciones y Pensiones" -AFJP-) which exclusive task was to manage those funds. In this case, the amount of the pension received on retirement depends exclusively on the accumulated individual contribution to the own personal fund, and on the return earned by the AFJP.

A hard discussion took place to reach a political agreement in the structure of the system as was finally implemented. This discussion between the Public Officers of the Executive Power and the political parties represented in Parliament lasted 16 months. Institution representing workers, entrepreneurs, pensioners, etc., were also involved in the process. A final consensus was reached of adopting the mixed regime, as it is presented in the next section.

### **IV. The new regime since 1994**

The new regime, as the previous one, is universal, meaning that every working person, either independent or employees, must participate of the system.

This mandatory regime covers old age (retirement) obligatory insurance of disability and death.

In the case of employees, the SIJP is financed by a personal contribution of the worker of 11% of her salary, and an employer's contribution of 16%, adding up to 27% of the salary.

In the case that the worker chooses to stay in the pay-as-you-go system, the whole 27% is deposited at the Treasury. If in the other hand the worker has decided to participate in the individual capitalization system, her personal contribution (11%) is accumulated in

her personal account at the AFJP that she has chosen. The 16% portion in all cases is channeled to the financing of the State.

The different kinds of payments to the retirees are the following: an amount called "Prestación Básica Universal" (Basic Universal Payment) that is always afforded by the State, independently of the fact that the worker is in the pay-as-you-go or in the capitalization system. This amount is approximately the same for all beneficiaries. Consequently, it represents a basic minimum, which has an income distribution effect. This is a solidarity feature of the mixed system.

If the worker chooses to stay in the pay-as-you-go system, an amount additional to the Basic Universal Payment is included. This "Prestación Adicional por Permanencia" (an additional payment for permanence in the pay-as-you-go system) is a function of the contributions made after 1994. In turn, as a function of the contributions made before 1994, there is another amount called "Prestación Complementaria" (Complementary Payment).

Both, the "Prestación Básica Universal" and the "Prestación Complementaria", are paid by the State.

If the worker chooses the capitalization system, she receives these two payments to which the accumulated funds at the AFJP are added.

## **V. The main effects of the SIJP**

Despite the fact that 8 years are not enough to firmly evaluate the effects of the implementation of the SIJP, a preliminary evaluation can be done.

Firstly, at the very beginning of the system, almost 80% of the workers had chosen the pay-as-you-go system. In 2002, the percentages had turned around such that 80% or more workers have adopted the capitalization system. This is mainly explained by the great lack of confidence among the workers, as regards the fulfillment of the State commitments.

Secondly, and contrary to what was expected, the coverage degree tendency is not increasing; rather, it is decreasing. It should be said that is very difficult to get a conclusion about this situation because of the current conditions of the labor market, where a high unemployment rate never seen before is observed.

There is a generalized opinion that the administrative cost of the new capitalization system is extremely high. It is around 2% of the wage bulk plus 1% as a compulsory premium in order to cover the mandatory insurance of disability and death. Up to now the Government efforts for diminishing those costs were unsuccessful. Above all, "Nación AFJP" (the State-owned AFJP) practically has the same fee as the rest of the private AFJPs.

A further critic that has been made to the new system is the deficit it provoked to the Treasury, mainly as a consequence of the reduction in the funds coming from the contributors who chose the capitalization regime. This cost is motivated by the transition from the old system to the new one.

The mentioned deficit that has been anticipated at the time of the reform will be even higher, perhaps with a trend to decline in 2005 or 2006.

An additional critic to the new regime is related to the risk of the accumulated funds in the AFJP. Actually, from the point of view of these firms, everything was developing normally. It should be remembered that the AFJP only manage those funds, being the workers the real owners.

There had been in fact problems with those funds, but as a result of the financial difficulties of the National Government. Since these problems are a consequence of political uncertainty, the blame cannot be put on the risks assumed by the AFJPs in the choice of their portfolios.

Finally, we can mention three further topics regarding the reform of the social security system. Firstly, there exist a trend to bettering the payments off. While the average of this payments was about \$350 before 1995, after that year the amount rose to \$550. Secondly, the system has won in transparency. Despite the lack of precision in calculating the amount of the benefit every contribution regime has, in the Argentine case the pay-as-you-go system has always been a mess, particularly as a consequence of bad managing of the system. The acute inflationary problem worsened the situation because of the difficulty in calculating the average wage -the base for the calculation of the benefit. Thirdly, the capitalization regime buries the possibilities of abuse that was a current practice in the past.

It should be recognized that it could be useful to introduce changes in the regime in order to adjust the new system to the current situation of Argentina. But it should also be recognized that the most important step in the reform of the Argentine social security system has already been done.