The Strengthening of The New Pension Systems: The Role of each Pillar in the Solution of Pension Problems

Presentations given at the International Seminar "How to strengthen the new pension systems in Latin America?: The role of each pillar for the solution of the pensions problem", organized by FIAP, May 19th and 20th 2005, held in Cartagena de Indias, Colombia.

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FUND ADMINISTRATORS

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REVIEW INTERNATIONAL FEDERATION OF PENSION FUND ADMINISTRATORS

The international Federation of Pension Fund Administrators (FIAP) came into being in the context of the II Latin American Congress of Private Pension System, held in May 1996.

The aim of this association is to propagate, promote, defend, publicize and facilitate in every way the development of social security systems based on saving and individual capitalization, channeled trough pension funds and managed by financial services companies or pension fund administration.

The members of the FIAP are associations, chambers or other similar institutions in those countries which already have legally established systems of pension fund administrators or their equivalents, whose members are institutions involved in the administration, coverage or provision of the entitlements benefits or services proper to such systems, as also institutions in those countries which have links whit the activities mentioned, even though they do not yet have associations, chambers or other institutions similar to those mentioned above.

The member countries of the FIAP currently number 20, in Latin America, Europe, Asia and Africa. They are: Argentina, Bolivia, Brazil, Colombia, Costa Rica, Chile, Ecuador, Dominican Republic, Dutch Antilles, El Salvador, Honduras, Kazakhstan, Mexico, Peru, Poland, Russian Federation, Spain, Ukraine, Uruguay and Venezuela.

From the year 2005,seven collaborating associates have been incorporated, represented by the main management committees of assets on a worldwide basis: Fidelity, BNP Paribas, Gartmore, Larraín Vial, Pictet, San Paolo Am Lux y Schroders. Besides representing a strengthening of our organization through the active incorporation of the International Mutual Funds, it permits us to include the contribute and the knowledge of these important businesses which enriches still more the exchange of experiences that is given in the breast of the FIAP.

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PRESENTATION

In mid-May 2005 in Cartagena de Indias, Colombia, FIAP organized the seminar "How to strengthen the new pension systems in Latin America?: The role of each pillar for the solution of the pensions problem", to analyze the reforms to the pensions systems so as to respond to the criticism and observations which are currently made as well as to define future improvements.

The reforms carried out on pension schemes in Latin America and Central Europe over the last two decades have substantially improved the situation of social security in this corner of the world. However and in spite of the great strides, the new systems are being questioned, and those countries which have not yet implemented them have some doubt as to following the footsteps of those before them.

Over the course of almost a quarter of a century, the contribution of individual mandatory saving systems to the improvement of pensions and the economic development of the countries has been manifested, especially when these reforms are within other processes of economic and institutional modernization

The success of the new pensions systems, however, is opposite to the periodical questioning on the different results that come out, including aspects that, as part of social security, are not the responsibility of contributory systems as is the case with coverage.

Since 1981, the year in which the first compulsory pension plan based on individual capitalization was implemented replacing pay-as-you-go systems worldwide, countries have been increasingly assuming that reforms on public policies in terms of social protection are a part of an integral whole in which new contributory systems must complement themselves, too, with schemes that serve the demands of the poorest sectors of the population through welfare pension schemes or by means of a minimum guarantee charged to the fiscal budget.

Those countries which are more orderly vis-à-vis their fiscal spending structure, might combine multiple pillars without affecting their economies, and allow for those sectors with less opportunities to have an equal access to protection schemes, as is the case of countries which have been capable of establishing a zero pillar for individuals who do not contribute regularly. These combinations will obviously depend on the resources that a particular government is able to allocate to the pensions relative to other priorities and its managing capability.

FIAP is cognizant of the need to permanently draw the attention towards the development of pensions systems since they represent the most important bond in the social security chain, and for the majority of the population, the only mechanism that provides a continuity of resources when they go into retirement.

Although our Federation gathers entities which represent pension funds administrators, we are well aware of the fact that we are part of an integral model. Therefore, together with governments, associations, labor unions and international organisms, must contribute to the constant development of pension funds models with individual savings as a fundamental mechanism.

Thus, FIAP will continue concentrating a relevant part of its analytical effort on strengthening the different pension pillars so that each one be developed under neutral and balanced economic conditions.

By presenting this book, FIAP wishes to express its thanks to the Colombian people, the President of the Republic Mr. Álvaro Uribe and the Colombian Association of Pensions and Unemployment Funds Administrators for having received specialists and speakers in such a beautiful city in order to analyze and deeply debate the situation and challenges of our pension systems. In this regard, FIAP reiterates its commitment to contributing towards perfecting and developing their instruments and systems, bearing in mind the importance they have and will have in the lives of millions of citizens in the world.

GUILLERMO ARTHUR
President

Inauguration

Alberto Carrasquilla
Treasury Minister, Colombia

I thank the kind invitation to participate in this forum, and I immensely regret not being able to be present. I regret it because it seems an extremely well-designed seminar, completely timely, and I am aware of the importance the deliberations that are about to begin will have in the Colombian pension discussion.

I would like to briefly give thought to two matters about the fiscal dimension of the pension issue in Colombia, and I would like to do so on two grounds: first, funding; second, the coverage issue of our system and its equity. Obviously, these issues will be deeply developed in the forum, but I wish to give some thoughts:

Fundingwise, it is of paramount importance to think about what has been done in Colombia. The different reforms, starting with Law 100 in the 90's; Law 797 and the debates that are currently taking place in Congress, allow us to think of the problem as comprised of three different populations: the current retirees; the population below 25 years of age which is just entering the labor force; and the population which although is not comprised of retirees, consists of people who are older than 25.

The first group is a population whose obligations are sacred, which represents a burden for the unavoidable national budget, and engages a substantial portion of the total tax collection in Colombia. These espenses are equivalent to roughly a third of the total Colombian tax collection and it is the first edge of the problem.

The second group represents the population of those who are older than 25 of age, not retired, and have a receivable account in their assets, so to speak, from the State as well as relatively considerable subsidized component as the grow older.

The sum of those two components, and the allowances whose accrual method is already created and the future allowances in their subsidized components represent an expense which will come from the national budget as well as from that of the Colombian taxpayers for the next decades.

And the third group represents the population who are those below 25 and entering the labor force, where the different reforms that have taken place in Colombia from the early 90's to the one which is currently under debate in Congress, not only has a relationship between the source where the resources come from because they are greatly supported by pension funds from the capitalization scheme, but also because the basic parameters are designed in order for the implicit subsidy to be equal to zero.

Therefore, financially speaking, we have a relatively important problem as part of the total contributions, but it is a burden that we are already assuming, and in any supposedly reasonable scenario in which Colombian public finances will be, it represents an accepted and defined burden. In that regard, I think that from a funding standpoint, this is a problem that has been properly tackled.

Second, there are the big pension challenges in Colombia which have to do with coverage and with intra and intergenerational equity. In Colombia we have a system in which coverage is extremely low: for example, the population which can retire and that gets no pension at all is over 70%. It is a widespread problem in many countries in Latin America as you will be able to see in the forum, and it is an extremely important challenge for the years to come.

The solution to this problem, of course, has to do with the formalization of our labor markets and with maintaining acceptable economic growth rates. It is the only way to solve this coverage problem in the mid term, we are cognizant of that and understand that the reforms targeted to formalize and grow are those which have a direct impact on the pivotal issue of coverage of our pension system.

I wanted to give thought to those two issues that concern the government and that, without a doubt, will be the issues that define the future of pension discussion. I will be attentive to the conclusions of the deliberations that begin because I am absolutely certain that in the very design of the program, by focusing it on the components by pillars which are part of the pension system, we will have very important conclusions for the pension future in Colombia. Thank you very much again and I wish this forum the best of success.

Ligia Elena Borrero
Delegate Superintendent of Colombian Pension Funds, Banking Superintendence

It is for me a great honor to represent the Government and the Colombian Superintendence of Banks and to welcome such a select group of speakers gathered here today in Cartagena de Indias for the FIAP seminar 2005.

I am very pleased to be here with you and perceive the environment of trust in my country and in its pension system.

The time has never been so favorable. On one hand, as you have just heard from the Treasury Secretary, our system has gone through some parametric adjustments which will allow for its long term sustainability. The legislative act under debate in Congress is close to become a legal and economic reality.

On the other hand, you know we are negotiating a Free Trade Agreement with the United States for which we had, as a starting point, the agreement signed with Chile.

All this opening process to the world, of the integration of the different economies as well as the growth and sophistication of the markets and their players, have forced us to rethink the dimension and scope of a supervision under a new vision based on risks. Hence, we are creating a sole supervisor integrated with the financial, insurance, pension, stock and capital markets.

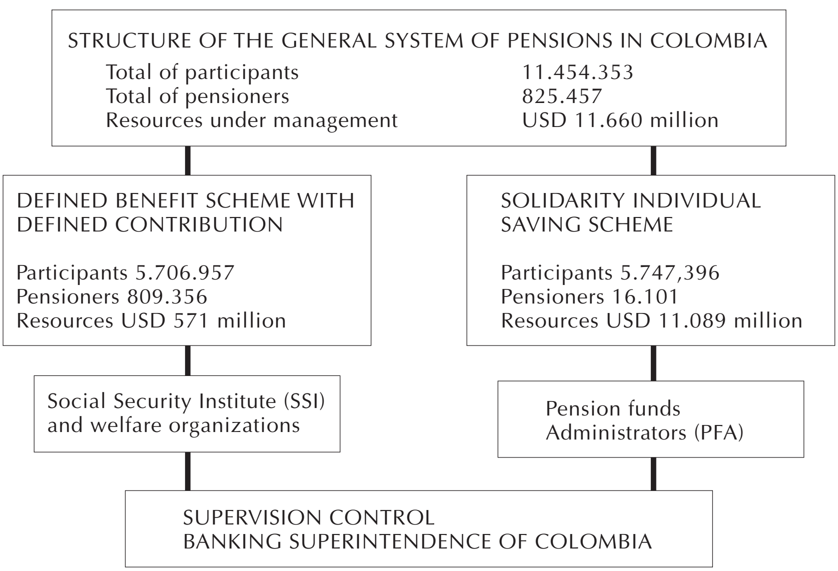
Colombia has undergone a consolidation process of its pension system. The reform of 1993 starts coming into fruition in a system that has reached considerable maturity, capable of arousing the interest in other latitudes. For those who study the subject in Latin America, in the OCDE, in the ILO, in the World Bank and in the IDB, the Colombian system, due to its structure, its size, perspectives and regulation, constitutes an important model of the stature of the Mexican or Peruvian system. All of us, are following the model of our Chilean brothers, represented by so many attendees and friendly faces by the Superintendent of PFA and the President of FIAP only to name a few.

The issue of pension systems reforms is present in the agenda of every country, regardless of their development. You know very well, the United States wants to implement as soon as possible a reform process of great magnitude as Eastern European countries had to do it before to become part of the European Union, and they have always turned to our continent to observe, measure and weight the results of our experience.

Nowadays, many turn towards Colombia. Hence, the importance of taking advantage of this wonderful opportunity with the backdrop of Cartagena, in order to analyze the way and convenience as to how to strengthen the new pension systems in Latin America, which is precisely the subject of this seminar (see Table Nº1).

Table Nº 1

STRUCTURE OF THE GENERAL SYSTEM OF PENSION IN COLOMBIA

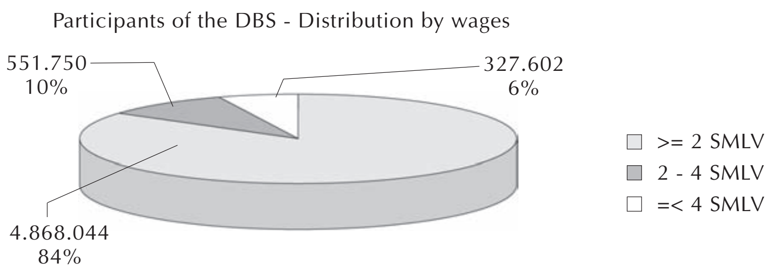


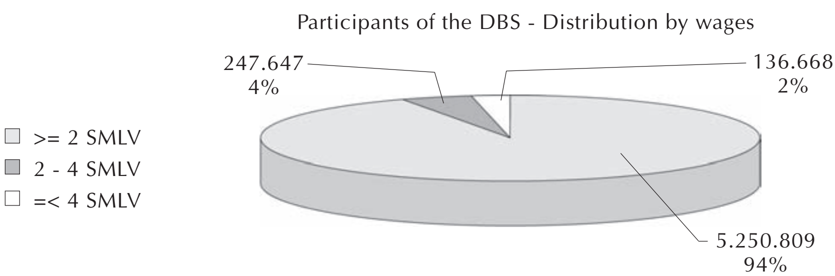
Figures as of December 2004

In the peculiar Colombian pension system coexist both the pay-as-you-go and the capitalization schemes, with 11.5 million participants distributed almost evenly between the two schemes, with resources in the individual saving scheme accounting for close to 11.090 million dollars managed by six administrators, all of them private, is now a mature system of a considerable size, and open to new investment options that allow for the diversification of the portfolios under State oversight to watch for the integrity, yield and liquidity of such resources (see Table Nº2 and Nº3).

Our pension system offers to us all –government, supervisor, managers and investors alike– big challenges because 84% of the participants of the individual saving scheme, and 94% of those affiliated to the pay-as-you-go scheme, are people who earn less than two minimum wages (that is, 320 dollars), 58,4% of the

Table Nº 2
DISTRIBUTION OF PARTICIPANTS BY WAGES

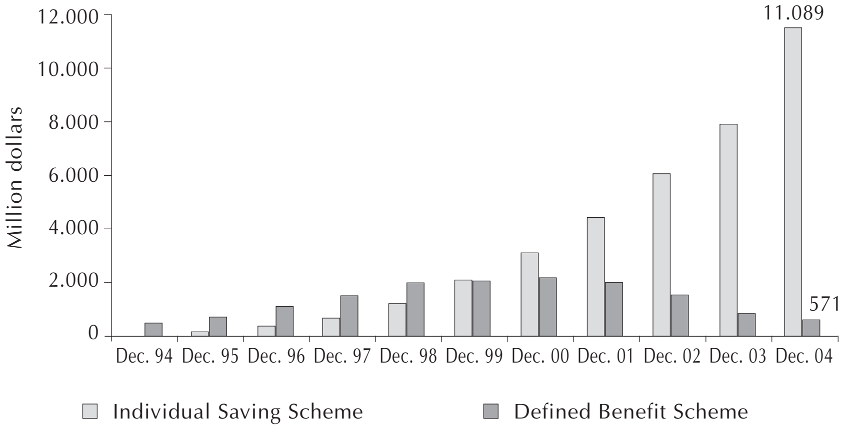




Note: The DBS table does not include participants of Cajanal nor Caprecom - Figure as of december 2004.

Note: 1 MLW is equivalent to US$ 160 - 2 MLWs are equivalent to US$ 320.

Table Nº 3
GENERAL PENSIONS SYSTEM
EVOLUTION OF RESOURCES UNDER MANAGEMENT



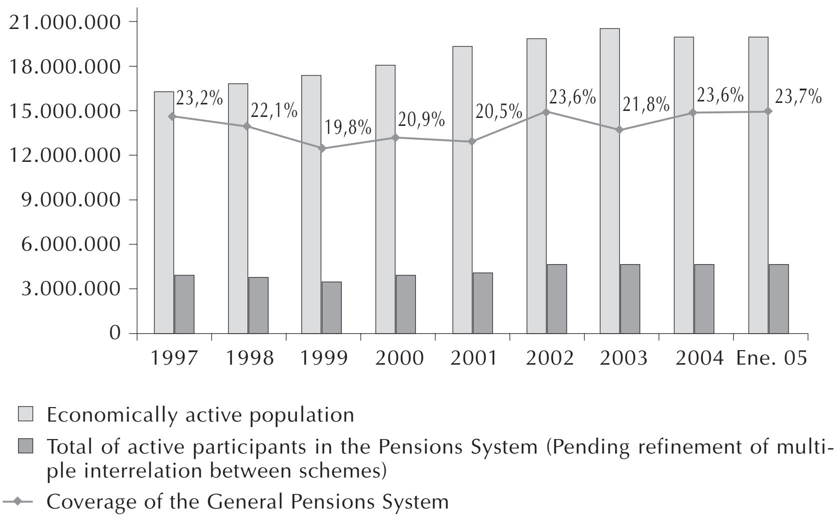
Exchange rate as of december 31st, 2004: $ 2.389,75.

participants who are in the pay-as-you-go system is older than 40, whereas in the capitalization system 57,6% is between 15 and 34 years old. However, almost half of the participants of one or the other scheme are inactive, that is, do not contribute, and the average contribution timeframe by member is quite short.

Colombia is still a country of young people, with a total population of a little more than 44 million inhabitants, where the economically active population is 20.161.000 inhabitants. The pension system then, covers only 25,92% of the entire population. All these challenges will be deeply discussed in these working sessions (see Table Nº 4 and Nº 5).

We, supervisors and regulators, and you, fund managers have a huge responsibility. In this two days we will talk about up-to-date and interesting issues from the academic and professional standpoint. Nevertheless, we cannot forget what the raw material of our work is, which goes far beyond the management of funds and resources. It is the future of Colombians that are not in the productive stage to take care of their basic needs. On our hands and management lies the legitimacy of the pension system of our country, the duty of loyalty, professionalism, information and responsibility of a good fiduciary is on probation and should go

Table Nº 4



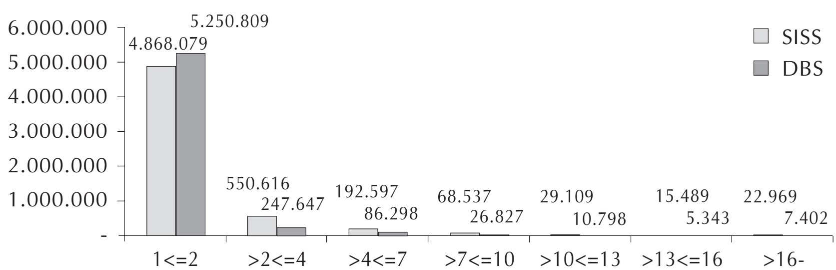
Source: Dane and supervised entities.

Table Nº 5
COVERAGE

Distribution of participants by income

NO. SMLV	1<=2	>2<=4	>4<=7	>7<=10	>10<=13	>13<=16	>16-	TOTAL
SISS	4.868.079	550.616	192.597	68.537	29.109	15.489	22.969	5.747.396
DBS	5.250.809	247.647	86.298	26.827	10.798	5.343	7.402	5.635.124
TOTAL	10.118.888	798.263	278.895	95.364	39.907	20.832	30.371	11.382.520

Distribution of participants by income



There is no information available for Cajanal and Fonprecon.

through the scrutiny of the participants. Neither the giant technological breakthroughs nor the good yields that funds obtain for their funds are useful if their job and role in the society are not legitimate. We have a big construction task ahead of us of a greater welfare for the participants and we must live up to the social function that the Constitution is asking from us. The training, advisory and informative tasks that lie ahead are huge. In that regard, the Superintendence is widening more and more the information available for the public, including a press release in English starting in May.

The superintendence will be open to suggestions, enquiries and ideas in order to improve our regulations and supervision. We want to diversify our portfolios, a greater security and yield that can be translated in better pensions for the members. We want you to help us build the pension system of our country on solid bases with political, economic and legal acceptance. It is a hard task but I think the time is right here, right now.

I wholeheartedly thank you. Welcome to Colombia and enjoy Cartagena.

Luis Fernando Restrepo
President of the Board, Association of Pension Funds Administrators and Unemployment, Colombia

Mrs. Ligia Elena Borrero, delegate superintendent of pension funds; Mr. Luis Fernando Alarcón, president of ASOFONDOS; Mr. Guillermo Arthur, president of FIAP; ladies and gentlemen.

On behalf of ASOFONDOS be warmly welcome to Cartagena de Indias on occasion of the traditional international seminar organized for the celebration of the IXth. FIAP assembly. We are very pleased to have here with us such a distinguished group of visitors, and I am sure that besides the use and importance of the conferences, you will enjoy your stay in Cartagena, a beloved city for all Colombians thanks to his beauty, history, Caribbean and joyful environment and, above all, the hospitality and congeniality of its inhabitants, by which UNESCO has declared it historical heritage of humanity.

This seminar will be of great interest for everyone in that it responds to the need of a better understanding of the language and scope of modern social security system, for which we can work to modify the reality and the future of millions of workers.

Over the last two years the criticism against pension system of individual capitalization has increased in most of the countries with reforms. We have been accused of not having increase the coverage, of charging exaggerated management commissions, of having caused the fiscal confusion of our countries, and many other things of similar caliber. Of course, most of such statements is based on partial analyses and the unknown of the very roots of the problems.

As a consequence, it is time for our new pension systems and for each one of their components or pillars, as they have been dubbed, to be thoroughly tested so as to completely comprehend the role each one of them plays in solving the gargantuan problems inherited from the old systems full of privileges and inequities, and to obtain appropriate pensions for future generations.

Of course, by better understanding the design of each element of the pension system, it will be possible to look for improvements in the face of the new economic and social conditions of each country. That is why, I would like to congratulate FIAP, and especially Mr. Guillermo Arthur for the magnificent conception of the seminar and for the extraordinary group of speakers he has gathered.

For us Colombians, this seminar sure is particularly transcendent because for about six years reforms for the defined benefits system has been discussed which, as most of you know, was an alternative for old and new workers of the structural reform approved eleven years ago through Law 100 of 1993. Such initiatives have sought to moderate, up to some extent, the huge privileges that benefit those who according to what has been established in that law can still obtain a better pension in accordance with the old rules. That is really onerous for the National Treasury, up to the extent that pension expenses represent the most expensive industry of the national budget, even greater than what is spent to maintain the social security system and fight against insurgency in Colombia, which is not an easy task, or than what is invested in forming human capital or public spending for health.

I am not going to bore you with the details of the pensions in Colombia, but it is worth mentioning that during the current administration of President Álvaro Uribe Vélez, political responsability has prevailed. In effect, two laws has been passed with substantial reforms in this direction. Unfortunately, they were partially but in significant aspects deemed inexequible in Constitutional Court.

Finally, last week after a sixth debate in Congress, a constitutional reform was passed -that must now go to Congress- through which the term to obtain privilege pensions in Colombia was shortened. With the transitional scheme, the form of payout and privilege schemes starting in 2010 with the exception of the military forces and the scheme of the President of the Republic, will undergo parametric adjustments.

In order to measure the importance of the debate, allow me to point out that, at present value, the future fiscal savings obtained through passed laws during this presidential period equal to approximately the total of the internal and external debt, but the liability that will have to be paid out in the future by the government is close to 150% of the Colombian GDP. Yet, during the legislative procedure of these laws, there are those who propose to continue with the status quo as to the defined benefit scheme, and that the solution be sought with the private pension funds, and that the government keeps the accumulated savings to date. They argue that fiscal problems can be solved this way, but they forget about the chaotic situation that might occur later on, and the tragedy that damaging public trust and the net worth of millions of workers affiliated to private pension funds might represent.

Likewise, it important to highlight the achievement obtained to date. Our private pension system has 10 million members with 15.542 million dollars under management, equal to 10% of the Colombian GDP, and this is contributing to the development and dynamism of the Colombian economy, assuring a dignified old age for the Colombians.

Dear friends, I have made these comments with the purpose of highlighting the importance of the seminar given the disturbed environment in which the pension debate in our countries unfolds. Of course, I am aware that what we have can be perfected and that, gradually, the regulation must evolve bearing always in mind that the our final objective is to improve the economic conditions for the retirement of our workers.

In that sense, We, Colombian PFA, are and will be attentive to participate in the debate, to present our points of view and to respect all of those initiatives that –in a prudent manner and respecting private ownership of more than ten million of Colombians that have trusted us with their savings, the entrepreneurial initiative and our rights as investors– seek the accomplishment of this objective. In other words, we thoroughly understand we are private companies participating in an activity of public interest. In fact, our interest is inline with that of our members and should be the objective that all of us should bear in mind.

According to the program, it is my turn to once again welcome you. We are very pleased to be able to cooperate with FIAP, and I am sure that we will hear to magnificent presentations, an active discussion and conclusions that allow to overcome the doubts of our oppositors. But I am also sure we will have the opportunity to enjoy pleasant moments of relaxation; that is the opportunity with which this city provides us and its kind inhabitants. Thanks.

Guillermo Arthur
President of the International Federation of Pension Fund Administrators, FIAP

Good morning. First of all, I would like to wholeheartedly welcome our partners, some of them from far away, to this beautiful and historical city of Cartagena. I would like to particularly welcome those funds that have partnered up as collaborators and are strengthening the work of our Federation as well as the representatives and the technical experts from international organisms, and all of the speakers who join us here in this seminar.

Yesterday, during the Federation Assembly, we were concerned as to how the modernization thrust has weakened in those countries which years ago started with the reform. Many of the things that allow the pension system to thoroughly fulfill its role of provider of good pensions are not getting done or being put off. The criticism towards pension systems based on the individual capitalization of the contributions and on private management is growing. Oftentimes, they are held accountable for issues that are far beyond their control, as coverage percentages which we all know are a consequence of the levels of unemployment and formality of the countries, and not of the functioning of the pension system. Sometimes, we are blamed for not improving the yields of the funds, whereas we can see that the investment portfolios of many PFA, due to an inadequate regulation, are fully invested in government bonds and fixed income securities.

We thought that in this seminar we should make an effort in order to win back that thrust so as to stress what is right and clearly define what the role of each one of the pillars that intervene within social security is. We, as PFA, are part of the second pillar; we believe we have acted adequately providing really good yields, with all the restrictions we have had, improving somewhat the coverage and making gigantic contributions to the economic development of countries. On that we want to take the test, and we are always willing to do so, but we also need to discuss what the role of the other pillars that intervene in the system must be.

That is why we have designed a program in which we are going to define the role of each one of the pillars within the social security system. Certainly, the population and the economic characteristics of our countries do not allow us to think about an unfounded first public pillar to serve the poorest and most informal sectors. And that is the objective of this seminar, trying to debate the role of each pillar in order for our pension system which is the second pillar can get rid of unfair criticism and resume both the right track and the thrust it once had, so as to have a wider investment diversification, a wider coverage, thus adequately complying with the promise to improve the pensions of the deprived workers for many years in this corner of the world. I am sure our system is adequate but for that reason we need the effort of our governments and that of the international organisms to support its modernization so that it can live up to its promise.

I would like to reiterate our welcome and I wish you the best in the debate of such a meticulous issue. Thank you very much.

Chapter I

The three –or four?– pillars of a social security system

The three –or four?– pillars of a social security system

Estelle James*

In the first place I would like to thank you very much for this invitation to speak. I am delighted to be here. I have spent the last ten or fifteen years of my life speaking and writing on this subject and when I speak in front of a knowledgeable group like this one, I always learn something new.

I am going to talk about the pillars of the mandatory old age security system to comment on what is working well and what problems still remain to be solved in the reformed systems that you are involved with. I hope we will have time to exchange views in the discussion afterwards.

Basically, an old age security system performs three functions. In the first place is the savings function: people must save a minimal amount for old age and the obligation of this system is to manage those mandatory savings.

In the second place is the redistributive function: Some people with lifetime low earnings are not going to be able to save enough

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* Consultant to the World Bank, the United States Agency for International Development and other organizations. She previously worked as lead economist in the Research Department of the World Bank and Director of the Pensions Course at the World Bank Institute. She was a member of the President's Commission to Strengthen Social Security in the United States and is currently on the Governing Board of the new Kosovo Pension Trust. Before joining the World Bank she was Professor of Economics and Provost of Social and Behavior Sciences at the State University of New York, Stony Brook. She is the main author of the book "Averting the Old Age Crisis" published by the World Bank and Oxford University Press, which provides an overall study of the economic problems associated with population ageing. She has given numerous lectures on this subject, advising the governments of China, Costa Rica, India and Thailand and publishing many papers in academic and policy journals. Her most recent research is focussed on social security reform, including the administrative costs of the individual accounts, how to manage payouts, and the gender impact of alternative systems.

to cover their old age, so there must be some type of arrangement for redistributing and giving these groups enough to live on, in accordance with society's judgment about what is "enough."

And in the third place is the insurance functions: to insure against risks associated with old age, such as disability and survivors' insurance, inflation insurance to ensure that income keeps pace with price increases, and longevity insurance to make sure old people don't run out of money before they die.

If we go back twenty or twenty-five years, in your countries and in most of the world, these functions were all combined in a single system pay-as-you-go system that paid defined benefits (DB) based on years of contributions and wages. As you know, those traditional systems encountered many problems. For example, instead of stimulating and rewarding saving, many systems discouraged saving. Redistributions were often perverse, from poor to rich. Payroll taxes were high and still did not cover total cost. Instead of having a sustainable, safe system, which is necessary to insure people's old age, those systems could no longer sustain themselves and people could not be sure that they would receive a reasonable benefit on retirement. Many of you are familiar with this situation and it is the background to the reforms that you are making today.

The multi-pillar system that many countries have been introducing separates these functions of savings, redistribution and insurance, and allows them to be more transparent in order to assure us that each pillar is doing what it is supposed to do. All of you here in the hall are part of the second pillar and as you know, this pillar manages mandatory savings. The essence of the second pillar is that it has funds and these funds are managed by private companies. Usually the plans are defined contribution (DC), although in Western Europe we find some defined benefit plans in the second pillar.

Now the public pillar, or pillar one, is responsible for managing redistribution. Later I will discuss whether this is redistribution only to people who are contributing or whether it includes people who are not contributing. This pillar is managed by the government, pays specified benefits that provide a social safety net, and is financed by contributions or general government revenues. In some countries, like Chile, it has a very limited safety net function, while in other countries, like Uruguay or Poland, which started with a large pension debt, the public pillar could not divest itself of this debt and continues to provide retirement income to the middle class as well . In both cases, the co-functioning of two pillars diversifies financing methods and thereby makes retirement income more secure.

Finally, pillar three deals with voluntary savings, but this is quite small in most countries, so I am going to focus on the mandatory parts of the system in this talk.

All three pillars participate in the provision of insurance. For example, in Chile disability and survivors insurance is provided through private pension funds and insurance companies, but with back-up from the public minimum pension guarantee. In Switzerland the public pillar provides disability and survivors benefits, but many employer plans do so as well. My recent work has concentrated on how longevity, survivors and disability insurance is provided in reformed systems, but I probably won't have time to discuss that today.

1. How have the multi-pillar reforms worked?

Over the past decade, many people have analyzed how the reforms have worked. I have been studying some aspects very thoroughly, especially the case of Chile, which has had this system for long enough to enable us to say something about the medium-term economic consequences.

Many of the things we can say are positive. In the first place, when workers were given the choice, most of them switched to the new systems, which showed that they did not have much faith in the sustainability of the old systems.

The new systems, in contrast, are fiscally sustainable. The obligations of pillar two do not exceed its assets. It makes no promises that it cannot keep and does not pass the responsibility on to future generations. In many countries the systems have produced high returns in the early years in part because they were often part of a package of market-oriented reforms that led to economic growth. In Chile, for example, the average annual rate of return exceeded inflation by 10% for the first twenty years. (After

2002 workers were offered a choice among portfolios with quite different risk and returns, so we cannot give a single average rate of return beyond that point).

We must, of course, be realistic and understand that all countries are part of a globalized capital market, so those kinds of returns will not continue indefinitely. But the new pension funds can be instrumental in helping countries become part of that global market. In Chile they have been credited with increasing national saving and enhancing financial market development, both of which are essential for economic growth. Recent research indicates the new system induced older Chilean workers to stay in the labor force longer, thereby increasing the supply of labor. And when they retire, most workers annuitize their accumulations, thereby obtaining lifetime income security.

But in addition to these positive results, we also observe problems and unresolved questions. How can multi-pillar systems keep administrative costs and fees under control? How can they reduce risk? What kind of safety net should be provided and what about the large number of people who do not contribute regularly to any pension scheme? While recognizing all the achievements, my talk today focuses on these controversial issues.

2. How pillar two is organized around the world?

Now, if we look at pillar two around the world, we see that it is organized in three different ways. The most common method in Latin America and in Central and Eastern Europe and is to use the "retail market" direct contact between the employee and the pension fund. This is the method with which most people in this room are very familiar.

However, when we look toward Australia or countries like Switzerland, Netherlands and Denmark in Western Europe, we see that pillar two is organized basically through employers or through the occupation or industry in other words, through a pre-formed group that makes a "wholesale" deal with an asset manager. For many years, employers in these countries have offered pension plans on a voluntary basis as part of their personnel policy or through collective agreements. During the past two decades, these governments concluded that it is almost impossible to cover more than 50% of the country's workers on the basis of voluntary plans. These countries wanted to avoid the pressures for greater public spending on retirement income, as their populations aged. So they decided to make the employer-sponsored plans mandatory or quasi-mandatory.

Generally these plans began as defined benefit plans, whose investment strategy was chosen by the employer and/or union. However, they are gradually shifting toward defined contribution, part of a world-wide trend. Indeed, it is difficult for private sector employers to credibly promise a long-term defined benefit in a globally competitive labor and product market. The shift to defined competition means fewer risks for the employer and greater portability for workers. As benefits depend on risk versus returns in DC plans, workers are likely to demand a greater role in choosing the investment strategy and manager, so we may see a partial reversion to the retail market in these countries.

The third method for organizing pillar two uses the institutional market. It is really an attempt to get the benefits of pre-formed groups for individual investors. The money in small accounts is aggregated in large blocs of money and a competitive bidding process is used to choose a limited number of asset managers among which workers can allocate their retirement funds. Bolivia started with this method; Panama has adopted it recently for public employees and it has also been adopted in Kosovo. The Thrift Savings Plan in the United States, which is part of the retirement plan for federal employees, is a defined contribution plan that uses the institutional approach. Proposals to reform social security in the United States also involve a competitive bidding process with limited choice mainly to control administrative costs and allow the system to benefit from scale economies and lower marketing costs. So this discussion of the organization of the second pillar leads naturally to my first implementation problem administrative costs and fees that may be to high.

3. Administrative costs. How to keep them low?

If commissions are 20% of the initial contribution or 1% per year of the assets in the account, they reduce the worker's final accumulation and pension by 20%, for a worker who contributes his entire lifetime. So this is obviously an important system parameter. In the current debate in the United States, critics of accounts often argue that fees will be high and will use up much of the investment returns.

Traditionally we depend in the market on price competition to depress costs. This apparently does not work very well in financial markets, possibly because inexperienced investors have a hard time comparing costs and fees for differentiated and volatile products. Therefore marketing through salespersons and advertising play an important role and drive up costs.

Commissions and other fees shouldn't surprise us, because substantial services are being offered in exchange. However, we must think of ways to keep those costs as low as possible, especially because this is a mandatory system and workers cannot choose whether to participate or not. They have to contribute, so the government and the system have an obligation to try to keep these fees low.

In thinking about administrative costs, we must realize that they are always high as a percentage of assets at the beginning of a new system. This is inevitable because at the beginning, before there are any assets, there are expenses. Then, when the assets start to arrive, they are small, but many of the expenses are large and fixed. You have to buy a new IT system, and that is a large expense; you have to hire staff to attract new affiliates; you have to maintain and track every account even if it has only a small amount of money in it; and you have to keep in contact with your members. When the assets are small, these costs will be a high percentage of those assets. Typically for the first few years costs will exceed fees charged, so it is not surprising that for several years thereafter fees must exceed costs by enough to repay this initial investment, with interest and risk premium. Taking all of this into account, the break-even point is not likely to come for at least 10 years.

Many of the figures that are used in the pension discussion are taken from the first few years of the system when the costs are inevitably very high by comparison with assets and contributions. However, if you look at what happens to those costs over time, you will see that they increase much slower than assets, which means that they decrease as a percentage of assets. As a corollary, costs will seem to be higher in countries with new systems and more reasonable in systems that have already grown and matured.

For example, in Chile administrative costs were initially over 10% of assets, but today they are only 0,7% of assets. This is less than fees charged by most mutual funds in the United States; it is less than charges in the United States for voluntary pension plans. But costs are much higher in most other Latin American and Eastern European countries with younger systems. How much the lower costs in mature systems will be passed on to workers in the form of lower fees depends on the perceived price-sensitivity of consumers. Regulators should be thinking hard about how to increase price sensitivity, especially in the retail market.

We can also see that countries that use group plans sponsored by employers tend to have lower administrative costs as a percentage of the assets. This is consistent with the fact that they have been in operation for longer and also that they choose asset managers for the whole volume of assets, rather than making each employee go and find his or her own pension fund. Marketing costs and therefore total cost are much lower in the group plans. These costs will increase in the future as more plans become defined contribution, workers make the investment choice and face greater options. For example, in Australia the retail funds charge fees that are three times as great, as a percentage of assets, as the wholesale funds in which the employer invests for the group as a whole.

But what can be done in countries that don’t have a tradition of employer-sponsored plans? How can they benefit from scale economies, reduce marketing costs and exploit the bargaining power that should exist in a mandatory scheme?

First, blind allocations can be used to cut marketing and commissions, as in Sweden. The system administrator aggregates the contributions of all workers who have chosen a particular asset manager, and hands the manager the money en bloc without the name of workers attached. Not knowing who are their affiliates, asset managers cannot pay a sales commission, thereby saving considerable money. But Sweden does not trust blind allocations to do the job, and therefore reinforces it with price controls. The government negotiates with each asset manager the net fee that he can charge. If a company charges more, it must rebate the difference to workers.

In general, price controls can get you into a lot of trouble, because no one really knows what the correct price should be. If the price is set too low, this may result in fewer asset managers being interested in participating, or they may offer a low level of quality. Regulatory pressures to keep fees down are another option, as in Chile. But this has many of the same disadvantages as price controls, plus the additional disadvantage of being non-transparent. I think we need to be very careful about going down that road.

Second, collecting contributions centrally to exploit scale economies in collection and record-keeping can also help to keep costs down providing the central mechanisms has an incentive to do this efficiently. One way to accomplish this is through out-sourcing by pension funds, just as many mutual funds in the US out-source this function. Another way is by government mandating a central clearinghouse of some sort. In Sweden tax authorities collect contributions and records are all handled centrally, by a public agency. This can work, providing the central agency has the capacity and incentive to do this efficiently. But in some countries this job has been turned over to the old social security institution, which was hostile toward the new system, and these conditions for efficiency were not satisfied.

A third method of controlling costs is to aggregate small contributions and choose a small number of investment managers in the institutional market. In Kosovo record-keeping is centralized and funds are invested in a global index fund and an international money market fund that were chosen in an international bidding process. Total fees for administrative costs have been kept very low (less than 1% of assets). The large size of the fund enabled it to negotiate very good terms. International investment allows it to use passive investment, which is much cheaper than active management yet, on average, produces higher net returns. These may be particularly useful techniques for small economies that are starting new systems. In effect, these countries can piggyback on the large size and experience of financial institutions that already exist in more advanced countries. I think that countries that reform over the next few years should seriously consider this approach. It is interesting to note that when Chile recently started its funded system of unemployment insurance it used competitive bidding to choose one asset manager and the winner was a consortium of PFA.

The competitive bidding process and the limitation on the number of asset managers are organized by government and this implies more government control. This opens the doors to another series of problems, including the danger of political manipulation, regulatory capture and conflicts of interest as indeed occurred to some extent in Bolivia. This is one reason this approach was not used initially in Chile. Moreover, as assets in the system grow, a small number of managers may end up controlling much of the investment in the country, which may not be healthy for the broader economy.. In other words, the solution to one problem may create others, which then have to be solved.

When Chile started its second pillar, there were virtually no local asset managers who would have been capable of investing the entire accumulation in the system, so Chile would have had to look abroad for managers of its retirement savings if it had used a competitive bidding process. These international managers would have wanted to invest most of the money abroad. This might have prevented the growth of financial markets in Chile, which was due in large part to the development of multiple PFA. Other countries followed the Chilean model, although they might not have been as well placed as Chile was in the 1980's to benefit from the increase in investment managers and investable capital.

Ironically, over the past decade these multiple PFA have merged, to better capture economies of scale, so the number is now down to six, with assets highly concentrated in the top three. In effect, the industry that invests workers' retirement saving has become a natural oligopoly. This does eventually reduce total costs it is barely 0,7% of assets right now and some but not all of this efficiency is shared with worker-affiliates.

Thus, one way or the other, a small number of managers is likely to end up controlling this industry, which means controlling a large proportion of the private assets in the country, in countries where pension assets are high relative to the country's GDP. In other words, this industry is likely to end up concentrated the question is whether we reach that concentration by contract at the beginning or by gradual market evolution from a less concentrated start. These two paths have different implications for the time pattern of costs and fees. We don't yet have a good way to think about the political implications of asset control that ends up concentrated as a result of market mechanisms, or how to impart market discipline to a natural oligopoly that provides a mandatory service. But inevitably, both political and economic issues will be raised. Meanwhile, for countries that started with decentralized retail markets and have gradually grown more concentrated, self-interested PFA might do well to keep their fees low on a voluntary basis to forestall regulatory action that requires this.

4. Financial market risk

Next I want to talk about financial market risk. This has not been a very serious problem in your systems in the past, but it might increase in the future. Initially, as you know, there were very few financial instruments in your countries, and at the beginning they were fixed financial instruments – investment was in bank deposits or government bonds. But as financial markets develop, pension funds face greater investment options and a greater variety of portfolios for workers to choose from. Multi-funds are the latest result initiated by Chile, they are being established in other Latin American countries as well. These permit varying amounts of equity investments, ranging from 0 to 80% of the total portfolio. On the one hand, this avoids the herding toward a single portfolio and absence of choice for workers with different risk-return trade-offs, for which the new systems have been rightly criticized. On the other hand, it opens the door to criticisms about increased volatility across time and disparities across individuals. I expect that in the future there will be more concern about financial market risk in your countries; the debate in the United States has concentrated a lot on these fears. I believe we still have to develop methods for giving workers investment alternatives and at the same time limiting the risk to which they are exposed.

The most basic method of reducing risk is to have wide diversification among instruments, sectors and countries. I want to emphasize the importance of international diversification, because many countries simply do not have enough of that. They want to keep their savings available for domestic investment and to avoid capital outflow. But there is a large hidden cost when this is done by regulatory constraint. First of all, international diversification allows you to avoid country-specific risks; if something disastrous happens in your country, you and your employees will be protected if some of your pension assets are invested outside, in another country, or at least in another currency. In Argentina, much of the pension fund assets were dollar denominated. These pension funds were not completely protected during Argentina's financial crisis, but they were protected much better than they would have been if they had all been invested in pesos. And they would have been even better protected if they had been invested outside Argentina, in the US or elsewhere. Secondly, investing internationally may reduce administrative costs because capital markets are more efficient and have lower transactions costs in more advanced industrialized countries. For example, PFA could invest in index funds in the US for 1 basis point much less than it costs to invest in Latin America.

Beyond the risk reduction that comes from diversification, we have a few simple rules to allow workers to handle the remaining risk better. Inexperienced investors have difficulty assessing risk and making risk-return trade-offs. Processing data that fluctuate widely through time is particularly difficult. Therefore, investment choices presented to workers must be carefully structured, to avoid mistakes. It is important to limit the number of options, to clearly define the risk and expected return implied by each option, and to think through the default option for those who do not make a choice of their own. For example, in Chile each PFA can offer five different portfolios, with different proportions of variable versus fixed income instruments. The default is in the middle, and it varies with the worker's age 60% in equities for workers under age 36, 40% for men up to age 55 and women up to 50, 20% for workers beyond that age and for pensioners. Moreover, the highest equity portfolio is ruled out for men and women over age 55 and 50, respectively, and the maximum for pensioners is 40%.

Sweden, on the other hand, has done the opposite of Chile. Sweden allows employees to choose whichever fund they prefer, from among 600 different mutual funds in the country. Some of these are highly specialized concentrating on tech stocks, or Russian stocks, for example; such narrow concentration greatly increase volatility, which is the most common definition of risk. The people who manage the Swedish system are now concerned about that volatility and are thinking about limiting the alternatives, grouping them into a smaller number of categories, with clearer risk-return combinations, to facilitate informed decision-making by workers. At the same time, one must remember that in Sweden the individual accounts are relatively small based on a 2,5% contribution rate and cushioned by a 16% contribution to the public pillar, which in turn is buttressed by a minimum pension financed by the government, that is about 40% of the average wage. The optimal amount of risk-taking is probably much higher in Sweden than in Chile, where the accounts are practically the entire source of retirement income for many workers.

Even when attempts are made to limit and structure choice there are problems, in part because it's not always clear which instruments are risky. Fixed income instruments may be risky when interest rates are low and may rise unexpectedly. International investment has been considered part of the "risky" portfolio, yet, as discussed above, this may decrease risk over-all. Similarly, derivatives can be used to reduce risk or to speculate. In some countries, derivatives are highly restricted for fear that they will be used for speculation, but that also limits their use for insurance.

Some economists argue that choices should be presented to workers, not in terms of composition of portfolio but rather in terms of privately guaranteed floors that go together with differentiated upside potential. For example, workers might be offered the choice between a floor that is slightly lower than the risk-free rate of return, together with a 20% participation in any upside gain by a specified benchmark; versus a floor that is considerably lower than the risk-free rate together with a 50% participation in any upside gain. These packages would be offered by private pension funds, who would then retain control over the portfolios, to avoid moral hazard. Different workers would make different choices among these alternative floors and upside potential, depending on their attitudes toward risk. This is an attractive way to structure choice, because it makes the risk-return trade-offs explicit. But the pension funds would have to be carefully regulated to ensure that the terms of trade are "fair" and understood by workers, and that the guarantors are able to keep their promises if the markets fall for a prolonged period.

5. Public guarantees

All countries with multi-pillar systems have some type of publicly financed minimum pension. This redistributes to low earners and it also reduces risk for the system as a whole by diversifying income sources and setting an income floor.

The minimum pension takes three different forms a minimum pension guarantee (MPG, as in Chile), a universal flat benefit (as in the Netherlands and the UK) or a means- and asset-tested benefit (as in Australia and Hong Kong). By definition, the MPG applies only to contributors, while flat or mean-tested benefits can more easily be extended to non-contributors as well (see below).

Here in Latin America you are most familiar with the minimum pension guarantee, where the government says, "If you have contributed for at least 20 or 25 years and your pension falls below a specified level, then we will raise it up to that level for you." In Chile, the MPG was initially price-indexed but it has risen with wage growth and is currently about 25% of the average wage at age 65, 27% at age 70 and 29% at 75.

This way of ensuring a minimum pension is relatively low cost and easy to manage but, like all guarantee programs, it may distort workers' behaviour. If, for example, one needs 20 years work in order to receive the guaranteed minimum pension, people who earn a low wage may decide to cease working or move into the informal sector once they reach 20 years, because any marginal contributions beyond that point will reduce their current consumption but will not increase their future consumption it will simply reduce the subsidy they get from the government. Or, such workers may invest in the riskiest portfolios allowable, because they may gain from upside growth but are protected from downside loss by the MPG. Another danger is that the MPG may distort their behavior during the payout stage. They may choose the most front-loaded payout since this gives them the highest standard of living if they die young, while the government picks up the bill if they live long.

When behavior is distorted in these ways, the cost of the MPG rises. And designing the system to avoid these distortions can then difficult and complicated. For example, the level of the MPG can be made proportional to years worked, so those who work less than 20 years get something while those who work longer are not penalized Chile is now considering this approach. Investment portfolios can be restricted to rule out very risky options. Chile already does this. Payouts that remain constant, or even rise through time, can be required, to eliminate front-loading. But in fact, in Chile workers can choose between a constant real payout stream through annuitization, versus a declining payout stream over the retirement period through programmed withdrawals. Retirees on programmed withdrawal may eventually run out of money, which creates problems for the individual as well as the treasury, which must then pick up the full bill. If Chile plans to continue the de facto linkage between MPG and wages, it might consider altering its formula for programmed withdrawals so that the time stream of private payouts starts lower but rises over time, to be more consistent with the rising MPG. At the very least, countries with the MPG should recognize that it poses a potentially large contingent liability, whose long term implications should be measured before policy decisions are made about the level and slope of public and private payout streams.

6. What kind of safety net for non-contributors?

The minimum pension guarantee, by definition, applies only to contributors. It tops up the pensions of those who have contributed but accumulated only small accounts. But what should be done about non-contributors? Should the redistributive pillar be for contributors only, or for everyone? This is becoming an extremely important political problem in many middle- and low-income countries. A public pillar for non-contributors is sometimes called "the 0 pillar."

In low and middle income countries a large portion of the adult population is self-employed or works in small firms in the informal sector. Those people are not going to be enrolled in any formal pension system, or if enrolled, they only contribute for a small number of years. In Chile, for example, the number of affiliates is greater than the total workforce, but their density of contributions is quite low, so many people will receive very small pensions in the end. And often they will not accumulate enough years of contributions to qualify for the guaranteed minimum pension. The lowest income groups are likely to have small private pensions while failing to qualify for a contributory public benefit. Very old widows, who have a high poverty rate in many countries, are a common example.

That is why some critics of the current systems argue that the public benefit should cover all residents who pass a specified age, such as 65. This is done in the Netherlands, for example, which gives a flat benefit that is about 38% of the average wage to all old people, or 54% to elderly couples. But if we do this we face another problem: This benefit is obviously going to be expensive and public resources may be better spent on other government activities such as health services and education. Most elderly people are not poor and the very poorest usually don't reach old age, given the strong relationship between wealth and longevity.

One money-saving method is to make the flat public benefit very small, say, 10-20% of the average wage, as in Nepal, Namibia and Kosovo, and have it kick in at a very old age, say, 70. Another approach is to use a two-tier, means-tested system or minimum pension guarantee. This would include, a higher level of protection for contributors, which serves as an inducement contribute, and a lower level for non-contributors to keep them out of poverty. For example, in Chile the guaranteed minimum pension for contributors is accompanied by a much lower social welfare pension for non-contributors. (Using a uniform means-tested benefit for contributors and non-contributors)

In general, the two-tier means-tested system means less expenditure on benefits but higher operating cost, because far greater administrative capacity is needed to implement the guaranteed minimum pension and the mean-tested pension for non-contributors. Moreover, this system involves moral hazard problems people may distort their behaviour to become eligible for the MPG or the means-tested benefit. In particular, means-testing may discourage voluntary saving that may make people fail the test. And, in some countries, it may lead to bribery costs. One study in India pointed to the bribes that must be paid to get the application form, to have it processed, to get a favorable decision, and to get the check delivered and cashed.

A means-tested program, whether one or two-tiered is more cost-effective only if countries have the capacity to limit moral hazard and avoid corruption. In contrast, a universal benefit is more immune to these dangers but requires higher total expenditures on benefits to achieve any specified minimum income level. In either case, it is clear that providing a safety net for non-contributors who are poor is important, it must be financed out of general revenues rather than contributions, and the long term fiscal consequences must be carefully evaluated before such a program is started. Most countries (including Chile) have not carried out such long-term simulations.

Still another approach would leave the informal sector to the informal family system, which doesn't function perfectly but in some cases functions better than the government. One of the first steps should be to take stock of what we know about living standards, family arrangements and poverty among the elderly compared with younger age groups, to determine where are the biggest holes and how can we avoid mis-targeting scarce public resources.

7. Conclusions

Pillar two, which is your industry, has been set up to manage people's mandatory retirement savings and it is now operating in over 30 countries. In most cases this industry did not exist 20 years ago but now it plays a large an important role. Key implementation issues currently are how to keep administrative costs and fees low and how to keep the amount of risk consistent with a program that is supposed to provide security to low and middle earners. These challenges have a political as well as an economic dimension, in a mandatory program. We don't yet know the best solution, but I have tried to outline some approaches.

Pillar one handles redistribution and also mitigates risk among contributors. The important remaining question is what to do about the informal sector. Should there be a pillar 0 that prevents poverty among non-contributors? Should the government establish a two-tier system consisting of an MPG for contributors and a means-tested benefit for non-contributors? Or should it have a universal flat benefit that covers everyone? Or, at the opposite extreme, should it rely on the family system to take care of those who do not have their own pensions? That depends on the government's priorities relative to its resources and its administrative capacity. In any case, general revenue funding is needed to cover non-contributors long term cost projections are essential and base-line studies of poverty and family structure should be carried out to determine the need for government intervention.

Finally, I would like to congratulate you all for having gotten your systems to where they are at this moment, because it has been a very good beginning. I believe that you have taken some very important steps during the last ten years; but as you know, there is always room for improvement and you have been constantly improving your systems. I believe that if I were to speak to you ten years from now, your industry and the environment in which it operates would be very different from what it is now and hopefully better. Thank you very much for this opportunity to share ideas.

Chapter II

The first pillar: non contributory and welfare pensions

First pillar schemes in Latin America

Fabio M. Bertranou*

First of all, I would like to thank the organizers of this seminar for the invitation to share in this panel discussion, and have the opportunity to exchange some ideas and mull over the problems of first pillar components in the pension systems.

It seems this debate is quite favorable. As it was mentioned before, there has been strong criticism against capitalization schemes vis-à-vis low coverage, the high cost that managing these systems represent, and the impact it has had on public finance as well as on the likely fiscal crises that have taken place in the region; which does not entail that the industry, *per se*, is guilty of these problems. Capitalization schemes are part of social protection systems, are part of pension systems, then, it seems highly appropriate to have an opportunity like this one to jointly think over as to where they belong to and what their role is for each one of the players in the system.

In this regard, it seems to me that the pension funds administration industry has a leading role to fulfill in the debate about what the future of these pension systems is because, evidently, the solution is global in scope, it is a comprehensive solution.

I will firstly focus my attention on some very specific issues. First of all, I would like to reflect on why we must go deeper into the

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discussion of the first pillar and in what context; later, I will make an evaluation on the Latin American experience with a kind of particular scheme which is part of the pension funds first pillar, and that refers to welfare and non contributory pensions. Later, we will check the characteristics of these schemes, and I will also show data of an assessment carried out a while ago at ILO and, finally, I will raise some questions and reflections.

Not so long ago, we published a book for the specific subject of non contributory and welfare pensions[1], as well as an article in the International Magazine of Social Security[2].

When we first started the research a couple of years ago I never imagined that I would be here making comments on its results. This is a study that is usually shared among public finance experts, government authorities, social development departments, and labor departments. But, I repeat, it seems to me that we have to take an integral look at the system. The different pillars of the pension systems are related, the different schemes are related, in which incentives and investment regulations have an impact on the system as a whole.

1. The labor market and low pension coverage

I would like to start by reflecting on the labor market in the region and later, argue about a more personal opinion regarding which the main priorities and weaknesses of the pension systems reforms have been in Latin America.

As for the labor market and coverage problems that unfortunately have been one of the main issues on the agenda, I think we have to start by analyzing the situation in the region. We have to remember that we live in a highly heterogeneous region where income distribution is quite uneven, and the labor market is one

1 BERTRANOU F., SOLORIO C. y VAN GINNEKEN W. (2002) *Pensiones no contributivas y asistenciales: Argentina, Brasil, Chile, Costa Rica y Uruguay*. Oficina Internacional del Trabajo, Santiago, Chile.

2 BERTRANOU F., VAN GINNEKEN W. and SOLORIO C. (2004) "The impact of tax-financed pensions on poverty reduction in Latin America: Evidence from Argentina, Brazil, Chile, Costa Rica and Uruguay", *International Social Security Review*, 57 (4), (también en español).

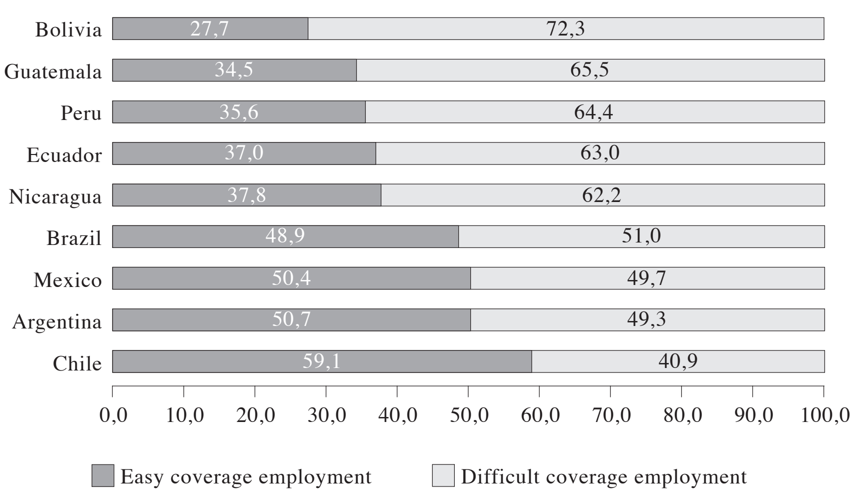
of the markets explaining this inequality. Therefore, also thinking about standardized and uniformed solutions to solve old age security constitutes an important challenge. We are not talking about a homogeneous labor force with low income dispersion, but on the contrary, about the fact that there is a wide heterogeneity.

In Graphic Nº 1 we can see the employment structure vis-à-vis the difficulty to be covered by social security. Easy coverage employment is that which can be reached through a contributory scheme in nature, organized as an insurance and funded with contributions. Difficult coverage employment is the one which is close to informality, unsalaried labor, unpaid employment, the employment in rural areas.

As you can see, there are important differences in the region. In countries like Bolivia and Guatemala, only 30% would have easy coverage employment, yet, in more socioeconomically developed countries like Mexico, Argentina and Chile, a good proportion accounts for that sector which is difficult to reach with a traditional scheme. Then, it holds water to later observe important coverage problems.

Graphic Nº 1

COMPOSITION OF EMPLOYMENT BY DEGREE OF COVERAGE DIFFICULTY

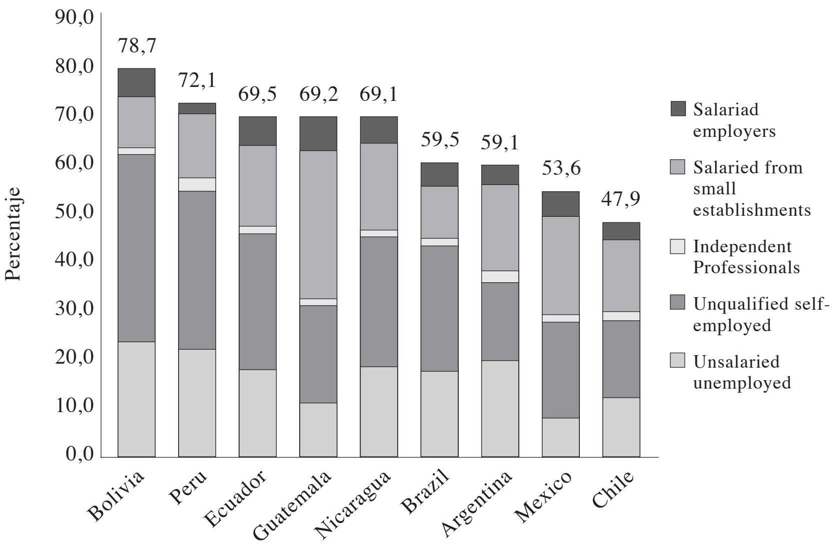


In Graphic Nº 2 we can see the same concept of difficult coverage population but adding up unemployed and unsalaried workers, that is, the economically active population which has difficult access to coverage. We can also see here a relevant heterogeneity in this sector across countries. In some of them, it is very important the proportion of, for example, unqualified self-employed workers whose coverage is even more difficult to attain by a contributory scheme; in other cases, the proportion of unqualified self-employed workers is lower. In summary, we can see an important heterogeneity in this cohort, that is, political proposals must also bear in mind this relevant heterogeneity.

Finally, Graphic Nº 3 shows why coverage is so uneven in the region. One of the important factors explaining this inequality is, as I just said, the structure of employment. On the horizontal axis we can observe the easy coverage economically active population –salaried workers in medium and large companies and salaried workers in the public sector-, and in the vertical axis, effective coverage of the systems, that is, the proportion of the EAP that contributes to social security either in a public scheme or in a program organized as a capitalization scheme. We can see a quite

Graphic Nº 2

EAP OF DIFFICULT COVERAGE



direct relation: countries with better performance labor wise in terms of having a more formal, salaried, and with a wider coverage EAP; as opposed to what occurs in other countries like Bolivia, Peru, Nicaragua, or Guatemala. In conclusion, an important part of the results in coverage performance are explained by the structure of the EAP.

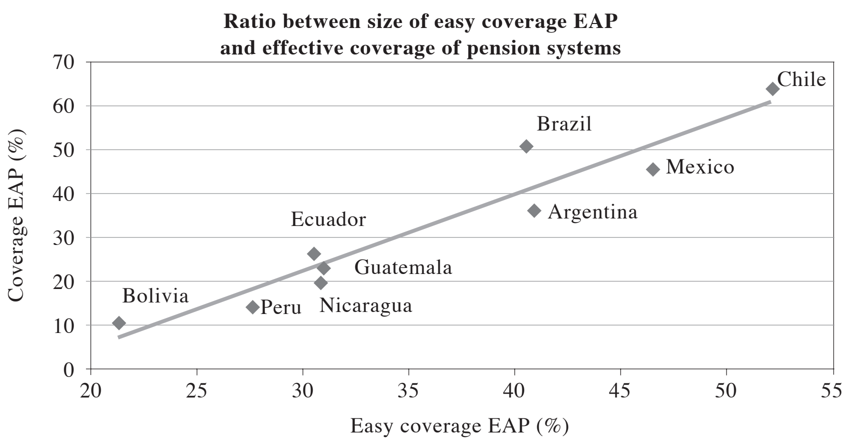
Thus, I would like to guide you towards the reflection of what would be the best strategy to close this coverage gaps, and here is where I believe the alternatives to try to identify solutions for different groups of workers play a key role and, obviously, it is also a matter of what the background of social protection schemes in the region is and in each country, where there is a blend of defined benefit , defined contributory and non contributory schemes.

In other words, in my mind, the strategy to widen coverage is a matter of policies of multiple tools, where a starting point is to expand contributory and non contributory schemes.

What is the role for each one of the schemes? In general, what we can see in the labor market is segmentation: low income workers with a scarce contributory capacity, irregular jobs, a high turnover rate and, on the other end, salaried workers with continuity, and long careers in the labor market.

Graphic Nº 3

COVERAGE AND STRUCTURE OF THE EAP



That is the traditional vision from a labor economy with dual labor markets. Nonetheless, in order to analyze pension and social protection systems on the whole, it seems timely to talk about three categories of workers:

– The first group is comprised of those who are informal and practically at any moment in their prior working life have been in the contributory scheme. They do not have a formal job and have practically never contributed in the social security system.

– At the other end are those workers with a full career and a backtrack record of contributions.

– There is a group of workers in between, that is very important. If we look at new studies being carried out on contribution backgrounds or density of contributions in social security, we can observe that a considerable number of workers has jobs with a lower or higher turnover rate but alternates formal with informal employment. We can see that many workers begin their working lives as self-employed, undergo a period of their labor backtrack record as salaried workers, and afterwards they come back to informality, probably when they are forced out of the labor market at the age of 50 for several reasons as the obsolescence of their human capital.

Therefore, there are irregular labor backgrounds and workers who have a portion of their labor backgrounds in their contributory system and another portion in the informality. Then, what is the strategy for these workers? I think that the core of the matter and the most important policy challenge is in this type of workers.

What is the role of tax financed pensions? Is this an alternative for coverage gaps? It is the motivation that emerges from the revision of Latin American experiences carried out at ILO. The experience in the region is rich but scarcely known.

The discussion as to whether a universal benefit is possible as a first pillar is also necessary. Several authors have elaborated proposals on fiscal implications, the cost it might possibly have, what the advantages are in terms of incentives and distortions in the labor market. However, in my opinion, it is somewhat difficult in the short run to come up with an alternative of this kind, there would be a few countries that would qualify to design a policy of this nature.

Only those countries with a more robust fiscal situation and a narrower coverage gap can propose this option. If we counted the number of countries which have this possibility in the region, I think we would get two or three at the most. So, arguing about the scope and financing of these first pillar schemes must be at the heart of the debate.

Regarding the reflection on the reforms and challenges carried out in the region over the last few years, I would like to state that, effectively, the design of these multipillar schemes is a paradigm already rooted in the region, and there is acceptable knowledge of the different experiences. Nevertheless, if we observe where the focus of public policy lies in these pension reforms, it seems to me that they were excessively stressed on the second pillar. At the end of the last session there was an interesting question concerning the size of the pillars as they were raised in the reform: do they have to be maintained or redefined? In other words, whether the second pillar has to be smaller and give way for the first pillar to grow.

I also think that this issue can be argued, but my commentary , has little to do with that objective but with the question of what has been the focus of public policy.

Public policy has been quite concentrated on how to design the second pillar, and how to improve, for example, the design of the annuities market, among others of paramount importance. Yet, the discussion about the first pillar lacked the relevance in the public agenda, that for me, should have had and must have from now on.

As far as public policy and design are concerned, the first pillar has been considered as a residual element. Most of the reports from international agencies and national experts have always been focused on the design and the role of the second pillar and, scarcely in a residual manner, on the role of the pillar seeking to alleviate poverty and maintain certain redistributive component in the system.

Another issue that has not been drawn the needed attention in this debate of the public agenda has been the disarticulation between the first and the second pillars as well as the inconsistencies that have emerged within the systems between the so called welfare pensions and minimum or basic pensions. On the cases I have been working the most, for example in cases like Uruguay, Argentina y

Chile, one can observe too many inconsistencies, and that there is a wide margin in public policy to perfect the schemes and the socio-laboral incentives that emerge.

Part of this lack of attention has also been due to a dearth of information as to how incentives work and what the concrete experience has been. In numerous cases, we, economists, mention the incentives problem, and whether or not 20 years of contributions in Chile, or 30 years in Argentina, or 35 in Uruguay generate a perverse incentive disencouraging contribution once workers have complied with these conditions of acquisitions. Honestly, I think that we have little evidence as to what the behavior of the workers is in the labor market. Furthermore, I would say that this likely moral hazard that might occur is not big enough; essentially because workers are not informed about this, and for them to be sensitive to making decisions, or for moral hazard to effectively take place, workers must know they will have a benefit if they contribute for 30 years, which will be just the same as if they had contributed for 31 years. And I think they ignore this. If you get anecdotal information about the ensured, you can realize that this does not take place.

2. Non contributory and welfare pension (NC&WP)

The five countries in the region which we did not included in our study were Argentina, Brazil, Chile, Costa Rica and Uruguay. They have schemes of some major importance relative to non contributive and welfare pensions.

According to the type of financing, there are schemes which are financed with taxes, others with contributions. On the other hand, according to the conditions of acquisition (a labor background with contributions to social security), there are the contributive and non contributive schemes. Then, I will now focus on the discussion of non contributory schemes, that is, the conditions of acquisitions are not related to the labor backtrack record and are mostly financed with taxes.

There is a little proportion of non contributory schemes that is financed with contributions. One of them is the case of Costa Rica, and another one is Brazil and residually Chile; a small portion of non contributory pension schemes, dubbed PASIS, is financed with the contribution of the workers that remain from the old system. There are practically quite a few crossed subsidies from the contributory scheme towards the non contributory.

So what do we understand by non contributory and welfare pensions? They are schemes that provide relatively uniformed monetary benefits which are granted either categorically or in a concentrated fashion, that is to say, for categories of workers or groups of workers that comply with a particular condition. They basically cover old age risks and disability, and are associated to situations of extreme poverty.

There are also schemes in the region within the general scheme of non contributory pensions but cover other contingencies and fulfill other objectives. In the case of Argentina, the non contributory pensions scheme also pays benefits for mothers, for instance, who have more than seven children or for veterans of the Fawkland Islands war. They are included within the general scheme of non contributory pensions, but the focus of the discussion now is welfare payments which cover those individuals who are in a situation of poverty and are elderly or disabled people.

Usually, non contributory pensions include the so called welfare pensions, the case of Argentina that I just mentioned is an example and, generally, we adopt this denomination in order to also include unconventional pensions because there also are schemes which we may call “semi contributory”, that is, they are almost completely tax financed, and cover a portion of the population which is in a situation of poverty. However, they have some requirements which resemble contributory schemes. This is the case of rural pensions in Brazil.

Out of the five countries in the region we will look at six cases, the Brazilian case is duplicated because we have considered both the welfare benefits scheme which is of major importance and also another scheme that has grown quite a bit over the last few years, and that has had a great impact: the rural pensions scheme. Brazil still has a considerable rural agrarian population. They still have cases of extreme poverty in the agricultural sector, and this scheme has been designed and expanded in order to cover these contingencies. Therefore, in the case of Brazil, there will be two entries: one for the case of rural pensions and another for the welfare pensions case. As I said earlier, the other cases are Costa Rica, Chile, Uruguay and Argentina.

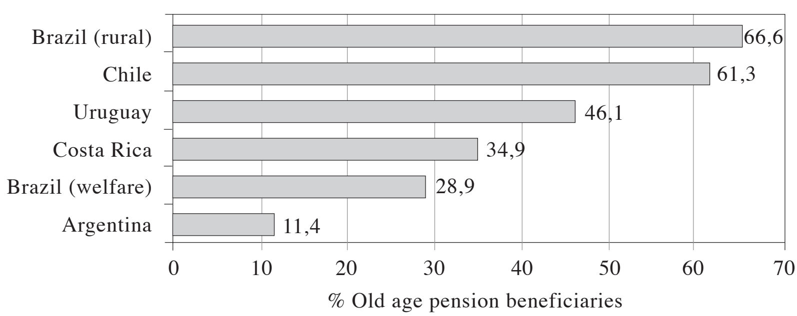
What is the proportion of the scheme that is targeted towards financing old age benefits? We can observe this information in Graphic Nº4. In the case of Brazil, most beneficiaries, 66%, receive an old age benefit, at the other extreme, there is the Argentine case where only 12% receives an old age benefit and the rest of the benefits are targeted towards other risks or has other objectives. This is an aspect in which there is considerable heterogeneity, not all schemes are specifically designed to cover old age risk.

What is the volume of public resources allocated to these schemes? The data are generally for year 2000, so this might have changed recently –especially in the case of Argentina after the fiscal crisis- but I would understand that the proportions are relatively stable. We will look here at three points: how much do these expenses represent in terms of total spending in retirement benefits and pensions in the country?, what proportion of the social spending it accounts for given that, as I mentioned before, these welfare benefits have a very important objective which is to reduce exclusion, destitution and poverty?, and lastly, what proportion of the GDP do they account for?

Graphic Nº 5 shows that in the Brazilian case we find the most relevant scheme which deals with rural pensions of a semicontributory nature, but if added to welfare benefits accounts for roughly 1,3% of the GDP. In the other countries, the relative importance of these schemes is small, however, it seems to me that this is important to be born in mind as fiscal possibilities of

Graphic Nº 4

NC&WP: % OF AGE PENSION BENEFICIARIES



second pillar schemes shrink, due to the fact that coverage of non contributory schemes will be increasing.

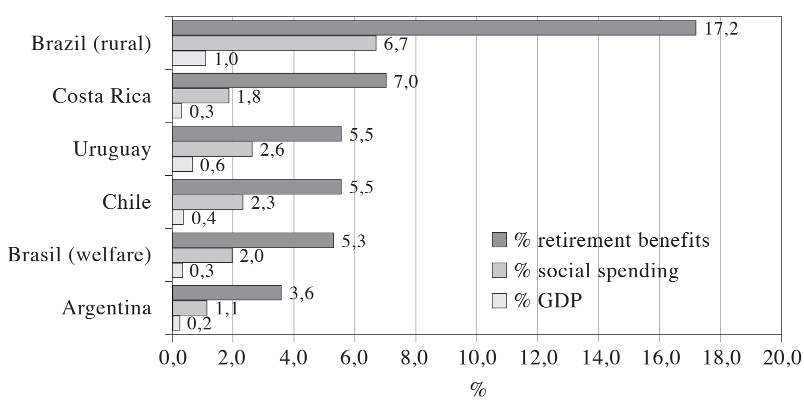
In fact, that is what we have observed in the Chilean case over the last years, where the coverage of the contributory scheme has been relatively stable and the growth in coverage for the elderly has been fundamentally explained by the growth in welfare pensions which has substantially increased, and today pays out around 400 thousand benefits. As I mentioned earlier, not all of them represent old age benefits but the scheme has gained a considerable proportion.

As for the characteristics of financing, I previously said that they are fundamentally financed with general incomes. In Costa Rica there is still a strong crossed subsidy from the contributory scheme to the non contributory scheme, which has also something to do with the way in which the scheme is structured: whether it is part of social security, managed by the social security administration as is the case in Costa Rica, or separated from the contributory pension system. In the Argentine case, for example, when the 1994 reform was carried out, the non contributory pensions scheme was separated from the social security administration and it is not even a part of the Labor Department but of another Department.

Then, there are still some schemes, as in Costa Rica, that have some kind of crossed subsidy component from the contributory

Graphic Nº 5

PUBLIC SPENDING IN NC&WP



scheme to the non contributory scheme; but the trend, as far as I am concerned, is that most of these systems will be tax financed and relatively separated from the contributory scheme.

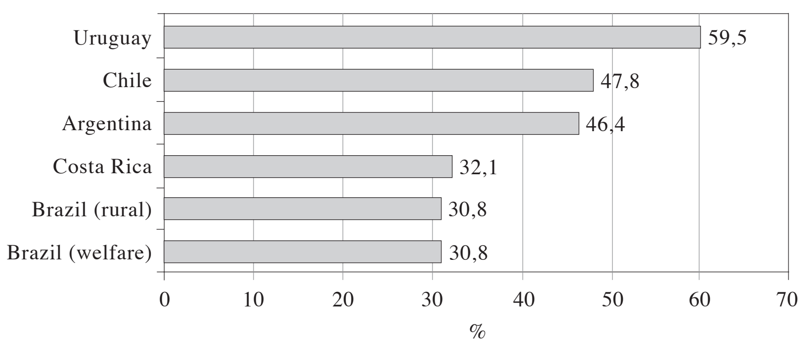
What has been the level of the benefits? This is an important issue for the discussion on incentives to contribute and remain in the contributory scheme, as well as the likely moral hazard these systems may pose. From the experience we observe at the time we carried out the study, we noticed that in general there are countries which pay modest benefits as might be the cases in Costa Rica and Brazil for both rural and welfare schemes, which account for a proximately 30% of the average of the contributory scheme benefit (See Graphic N°6). We must bear in mind that, regularly, the benefits of contributory schemes are quite low because they inherit those of the old public scheme which are very close to minimum benefits. This is quite noticeable in the Argentine case.

In the case of Uruguay, the non contributory benefit is very close to the average level of the contributory scheme. This means the incentive that a system may generate is under scrutiny, where many years of contribution are required to have access to a contributory benefit in case an individual has the possibility to obtain a similar non contributory benefit, though concentrated and with access requirements that deal with the level of assets and poverty.

There are too other inconsistencies which in some cases as in Argentina and Uruguay, deal with the fact that there are benefits

Graphic Nº 6

NC&WP: BENEFIT RELATIVE TO CONTRIBUTORY BENEFIT (IN %)



for the old age. In other words, individuals who do not qualify for the regular retirement age –65 years of age for men and 60 for women- have the possibility of having a reduced defined benefit at the age of 70. This sets another floor and parameters to be considered as far as incentives are concerned.

In terms of effectively reducing poverty, I think this is an important result because the fundamental objective of these schemes is to have an impact on the reduction of exclusion. What we have seen is that these schemes, in spite of many design problems as for decentralization and management, are quite effective in reducing poverty.

If we overcame all the problems in the schemes, I think we might substantially improve their impact on the reduction of poverty. In the case of Argentina, for instance, within the group of beneficiaries, poverty reaches 39%, if that benefit were taken away, poverty for this group of beneficiaries would go up to 56%. This is a partial analysis of the effect of these schemes, but it is an accurate estimate of the likely general effect of these kinds of schemes.

3. Final Comments

To close the debate, in the specific case of non contributory and welfare pensions, I can say that there has been a considerable impact on the reduction of poverty. From the fiscal standpoint, they have proved to be viable because benefit spending is noted and in a way, they are linked to a concentration criterion, which allows for the planification of what might be their growth relative to their fiscal burden- and in some cases too they are schemes that have been legitimized. In the case of Brazil, the rural pensions scheme is widely popular, benefits are greatly valued in rural areas, and in addition, they have fulfilled the objective of reducing rural migration in urban sectors that might go deeper into exclusion problems in urban zones.

As a final reflection, I would like to briefly state seven relevant aspects of the policy for these type of schemes which must also be linked to the general discussion, we might have regarding the other pillars of the pensions systems.

1. The definition of the level of benefits is not a trivial issue. Due to the incentives it generates, the definition of whom are eligible

and the criterion used to define that coverage must be transparent, explicit, it must be an issue of the social political agenda.

2. Fiscal cost and its financing is not a minor issue if we observe that these schemes will grow in time in order to close the coverage gap.

3. The kind of concentration and type of instrument used is also a sensitive issue relative to the efficiency of the scheme. In the Chilean case, an instrument of concentration is used which is generally for every social protection scheme; in the case of Uruguay and Argentina, for example, an specific instrument for the identification of the beneficiaries is used for this scheme which has advantages and disadvantages. It is an arguable issue.

4. Another important point is who manages this scheme and how integrated is the contributory scheme. There are those who argue that this must be separated so as not to affect the incentives so that, in turn, the insured does not get mixed up as to his/her contributory responsibility in the system in order to ensure a benefit in this scheme.

5. The kind of link with the rest of the social protection system. Many of the benefits that are greatly valued by the workers – beyond old age pensions- and that deal with health and labor risks coverage, have a considerable connection with the incentives that the contributory scheme may offer.

6. The connection issue with the rest of the welfare policy, and the fact that this scheme is so integrated with other benefits. There is a trend of conditioned transferences that involves not only the granting of the benefit to an individual in a family, but also meeting old age needs of the elderly in an integral way; the labor placement requirements that an individual in his/her active life might have, as well as the needs of children and adolescents.

7. Finally, how to protect these benefits against inflation. There has also been an experience of arbitrary criteria to adjust these benefits; sometimes they have lagged behind, and sometimes they have adjusted to levels that would be against this desirable differentiation that there must be of the benefit granted by the contributory scheme.

Thanks so much.

LABOR MARKET AND PENSION COVERAGE

AUGUSTO IGLESIAS*

1. Preliminary comments

Good morning. I would like to thank FIAP and ASOFONDOS for the invitation to participate in this Seminar that seems necessary and timely. The reforms of pension schemes in Latin America of the last decade have substantially improve the social security situation in this region of the world. Yet, in spite of the enormous improvements, the reforms are being questioned and countries that have still not implement them are seriously in doubt as to following in the footsteps of those who have implemented them before.

What has occurred? Up to a certain extent, it is evident there are some aspects of the individual capitalization programs that need to be perfected, in many cases, the scheme of pension funds investment must be modified, incentives must be created for a greater competition, the design of the benefits must be improved, etc. However, I think the critics are explained more by an important change in the political and economic environment in which the reforms to the pension systems in Latin America vis-à-vis ten years ago are being discussed. The winds are blowing today in a different direction. Therefore, I think that the main challenge the new pension systems face is to assure their future viability. The heart of the matter today is not the improvement of detailed design aspects of the capitalization programs (that, are

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also important and must not be forgotten about) but the need to convince a new generation of politicians and the public opinion regarding the benefits of the reforms and the importance to consolidate what has been done. This forces all of us who participate in the reform debate to, resume the discussion concerning the gain of introducing capitalization programs within the pension systems and, to clearly state the limits of the reforms and the problems that establishing individual capitalization programs does not help to solve.

The main objective of my presentation is to outline an analysis model that helps first understand the way in which the labor market interacts with the results of a pension system and then, how the best optimal structure of the pension system for a country depends closely on the characteristics of the labor market.

2. The problem

As Estelle James reminded us this morning, pension systems have three main objectives: they are mandatory saving tools for the old age; they are tools or instruments that provide economic protection against disability and death risks; and they are also a tool to provide protection for poor old and disabled people, who lose their ability to work without sufficient funds for them to finance a pension, and without having access to any other form of social protection.

There are two major categories of pension programs that permit to fulfill the objectives: unfounded programs that are financed with general budgetal resources; and funded programs –mandatory saving– that are mainly financed with the contributions of the workers themselves and their employers. If we use the pillar model of the Central Bank to classify the several pension programs, we could say that unfounded programs give birth to the "First Pillar" of the pension systems; and funded programs, to the "Second Pillar" of the pension systems; and contributory programs, to the "Second and Third Pillars", either for mandatory or voluntary programs.

In Latin America, contributory pension programs cover approximately 50% of the population (although the situation is different among countries (see Table N°1). This means that approximately 50% of the population that today is economically active in the region will not receive pensions neither from individual capitalization systems nor from traditional pay-as-you-go systems.

Table Nº 1
COVERAGE IN LATIN AMERICA AND THE CARIBBEAN

Country	Year	Covered wage bill/GDP %	Contributors/ Labor force %	Contributors /EAP %
Argentina	1995	23,0	53,0	39,0
Bolivia	1992	7,1	11,7	9,4
Brasil	1996	17,0	36,0	31,0
Chile	1995	40,0	61,7	43,0
Colombia	1995	9,8	33,0	27,0
Costa Rica	1996	30,3	47,0	35,0
Rep. Domin.	1988	—	11,5	9,0
Ecuador	1995	5,4	26,0	24,9
El Salvador	1996	12,6	26,2	25,0
Guatemala	1995	15,0	28,9	24,0
Honduras	1994	12,5	24,0	20,0
Jamaica	1989	—	39,0	33,0
Mexico	1997	12,1	30,0	31,0
Nicaragua	1996	25,0	13,6	13,0
Panama	1996	32,0	50,0	31,0
Paraguay	1997	4,4	31,0	29,0
Peru	1997	—	20,0	16,0
Uruguay	1995	23,1	78,0	78,0
Venezuela	1990	—	34,2	30,0

Source: Paredes and Iglesias, 2004.

However, at least a portion of the individuals that are "not covered" by funded programs also have "social protection", because they receive non contributory programs benefits that exist in many countries, they are women who are covered by the pension of their spouses (or by survivorship pensions in case the spouse dies). In fact, in the previous talk, Fabio Bertranou stated that in many countries in the region, the coverage of non contributory programs is relevant (See Table Nº 2) . For example, in the cases of Costa Rica and Chile, non contributory programs provide coverage for approximately 22% of the population. If we add up to this percentage the 50% coverage of contributory

Table Nº 2

POPULATION THAT DO RECEIVE NON CONTRIBUTORY PENSIONS (NCP 2000-2001(*)

Country	Total beneficiaries NCP (1)	Total beneficiaries NPC old age (2)	(2) / (1) %	Beneficiaries of NCS as a percentage of the total of pensioners (including contributory schemes)
Argentina	350.660	40.152	11,5	10,1
Chile	358.813	165.373	46,1	22,6
Costa Rica	76.009	46.597	61,3	31,2
Uruguay	64.053	18.515	28,9	9,0

(*) Argentina and Costa Rica: year 2000; Chile and Uruguay.
Source: Bertranou, Van Ginneken, Solorio (2004).

programs, we conclude that in this countries, social security covers approximately 75% of the population.

On the other side, included in the group of elderly and disabled people who are not covered by social security, are those individuals who do not need these programs because ,or they are not poor, or have access to other forms of "private" social protection –networks of family and district support– that are a substitute for programs regulated by the State.

However, we can hold that in many Latin American countries between a third and a fifth of the population faces old age or the inability to work with precarious economic means. It is clear then that we are in front of a problem that must be a matter of concern.

There are three main hypotheses to explain this result. First, the slow economic growth in many economies in the region during the last few years, would translate into high unemployment rates and, consequently, into a low contribution density. A second hypothesis draws the attention on the influence of certain characteristics of the labor market on coverage. A third hypothesis places emphasis on the influence that these pension system characteristics have on coverage levels. In the following sections I will focus my comments on these last two hypotheses.

3. Pension system and the labor market

The mandatory pension saving is not liquid. Individuals can only make use of it upon retirement, and generally only in the form of a pension. From the individual standpoint, this entails that with the same expected yield and the same tax treatment, mandatory pension saving will always be an inferior saving alternative compared to other more liquid forms of saving, even for the financing of a pension. Thus, for pension contribution collection to be effective, it is not enough to force people to contribute; at the same time, there must be a retention agent for such contributions. This role is par excellence played by the employer. As a consequence, the distribution between formal and informal employment is a principal determinant of the coverage of contributory and mandatory pension programs: the greater the formality of the employment in the economy, the higher the expected coverage of contributory programs; the more informal the employment, the lower the coverage of such programs. From this perspective, the working contract is a key determinant of pension coverage. In fact, in Latin America, the results of coverage observed for contributory pension programs are totally consistent with the distribution of employment between formal and informal sectors (See Table Nº 3).

There are also other series of variables, many of them relative to labor market characteristics which also have an impact on coverage levels (See Table Nº4), where the result of some studies for the Chilean case that have tried to measure the influence of different variables on the coverage level of contributory pension

Table Nº 3

LATIN AMERICA: STRUCTURE OF URBAN EMPLOYMENT (%)

	Informal sector	Formal sector
1990	42,8	57,2
1995	46,1	53,9
2000	46,9	53,1
2002	46,5	53,5
2003	46,7	53,3

Source: CEPAL, 2004.

Table Nº 4
VARIABLES THAT AFFECT DEMAND BY COVERAGE OF CONTRIBUTORY PENSION PROGRAMS

Environmental conditions		Characteristics of the pension system	
Income Level	: +++	Liquidity restrictions for pension saving	: +++
Formal employment	: +++	Contribution rate level	: ++
Minimum wage level	: +++	Commissions	: +
Employment and income stability	: ++	Transactional cost	: +
Credit restrictions	: ++	Minimum pensions	: +
Education	: ++	Yield rate	: N.A.
Interaction whit other social programs	: ++		
Income taxes	: +		
Age	: +		

Source: Paredes and Iglesias (2004), based on different studies.

programs is summarized. It is also indicated –quantitatively– in the table the force of the influence relative to each variable).

In particular, the income level of people appears as a main coverage factor of contributory systems: the greater the income level per capita, the greater the levels of coverage, and vice versa. The stability of income and employment also influence coverage: permanent employment and income allow an individual to better plan his/her consumption, and diminishes the costs of keeping saving in a not so liquid way, which, as we have said, is a pension saving characteristic. The level of minimum wage seems to have a negative impact on the coverage: the greater the level of the minimum wage, the lower the level of coverage; and the lower the level of minimum wage, the higher the levels of coverage. The existence –or nonexistence- of restrictions for credit has a relevant relation: the more difficult it is to have access to credit, the lower the demand for pension coverage, because people will prefer to save in liquid ways rather than those they can have access to in case of emergency in the pension saving.

The same way in which the labor market structure influences the levels of coverage of the different pension programs, the design of these programs can also have effects on the organization and performance of the labor market. Thus, the distribution of labor between formal and informal sectors of the economy is not completely independent from the characteristics of the pension system. The general rule is as follows: the higher the cost and lower benefits perceived by the contributory pension programs, the greater the incentive for labor informality because the demand for coverage goes down and the labor factor is more costly. In addition, the greater the benefits of the non contributory program, the greater the incentive for informality because demand for coverage goes down in contributory programs.

Once we recognize this relation, some proponents of the capitalization system have pointed out that the reforms would allow for a better pension coverage because the new programs with financial reserves and individual accounts could finance equal or better benefits at a lower cost; and, besides, by establishing a link between the contributions that are paid to social security and the benefits that are received, people do not completely perceive pension contributions as a labor tax and more as their own benefit.

In my opinion, available evidence shows that the creation of capitalization systems has effectively reduced the tax component of pension contributions, and stimulated a greater coverage. Thus, a couple of studies for the Chilean case (Torche and Wagner, 1997; and Edwards and Cox, 2002) argue that after the reform, at least 50% of the pension contribution would not be considered as a tax. In a study for the Argentine case, other authors (Colina, Ronconi and Tommasi, 2002) show that the credibility of the institutions depends on the probability that people assigned to receiving the pension. In that regard, after the pension reform, people assigned a greater probability to receiving the pension than in the old system.

Other studies for the Chilean case that directly measure the impact on the pension reform in the country on employment and salary levels, controlled by the effect of other variables that might have an effect at the same time on the results. It is suggested that all these studies concluded, without exception, that the creation of an individual capitalization system increased the levels of employment in the formal sector, and also increased wage levels in both the formal and informal sectors of the economy, which can be translated into a greater pension coverage (See Table Nº 5).

Table Nº 5

EFFECTS OF THE PENSION REFORM ON COVERAGE

- ***Holzmann (1995):*** results are consistent with the statement that the change of capitalization system as well as to establishing a direct link between contributions and benefits has a positive impact on labor markets.

- ***Packard (2001):*** individual accounts gradually increase the % of the AEP that contributes to pension systems.

- ***Edwards / Cox (2002, 2003):*** reform (including lower tax):

  – Drop in unemployment rates (Chile).
  – Increase of unemployment demand and participation (Chile).
  – More people remain as part of the labor force (Chile).

- ***Corbo / Schmidt-Hebbel (2003):*** associated with the reform in Chile:

  – Total employment grew between 1,3% and 3,7%.
  – Employment in the formal sector grew between 3,2% and 7,6%.
  – Employment in the informal sector fell between 1,1% and 1,3%.

Even though conceptual reasoning and empiric evidence allow for arguing then that the creation of capitalization systems should improve pension coverage, it is important to also point out that the magnitude of such an impact does not seem to be very significant. This would then be explained by the fact that, even though after the reform individuals no longer consider pension contributions entirely as tax, mandatory pension saving continues as an “inferior” alternative relative to other more liquid ways of saving, which maintains the incentive to evade the pension obligation. In addition, as we have just said, there are many factors, different from those of pension system characteristics, that have an effect on the demand by pension coverage.

Pension systems also have effects on the labor market through other mechanisms. For example, the existence of a mandatory retirement age; the possibility of receiving a pension and continue working; the incentives for early retirement; the differences in pension rules for workers from different sectors of the economy. All of these elements have an impact on the levels of employment and wages.

4. Results of the labor market and quality of the coverage of contributory pension programs

Now, I will make some comments regarding the impact that labor market performance has on the level of benefits offered by contributory pension programs.

In every contributory pension system, either of capitalization or pay-as-you-go nature, the labor record of the workers matters. In traditional pension systems in Latin America, the labor record mattered because the level of the pension depended on the number of years contributed and, in many cases, on the level of wages received during the last years of labor life of the worker. Thus, fewer years of contribution and fewer average wages in the years close to the date of the pension meant a lower pension. On the other hand, in the new capitalization systems the labor record also matters because the accumulated balance in the individual account depends on the number of years of contribution; on the distribution of the contributions through time; and on the level of wages on which contributions were paid.

As Fabio Bertranou said a few minutes ago, during the last years, important changes in the organization and functioning of the labor markets have been observed in Latin America. Particularly, the turnover rate between jobs in the formal sector, and between jobs in the informal sector has increased. For example, in the case of Chile, the turnover rate has gone up from 38,1 % between 1992 – 1994 to 42,5 between 2000 – 2002 (with a maximum of 44,5% between 1998 – 2000, see Table Nº6).

This phenomenon is accompanied by a lower job stability (the average duration of the contracts decreases) and by a longer duration of unemployment periods, which is translated into the fact that the number of pension gaps % periods during which people do not pay contributions to the pension systems- increases. At the same time, there is some evidence showing that people are entering the formal labor force at an increasingly old age, which decreases the years during which pension saving will be accumulated.

In the particular case of the new systems of individual capitalization, what is the impact of the pension "gaps" and the delay in the age at which contribution payments start?

Table Nº 6
CHILE: TOTAL TURNOVER RATE (PERCENTAGES)

Biennium	WAP turnover rate*
1992-1994	38,1
1994-1996	40,1
1996-1998	42,7
1998-2000	44,5
2000-2002	42,5

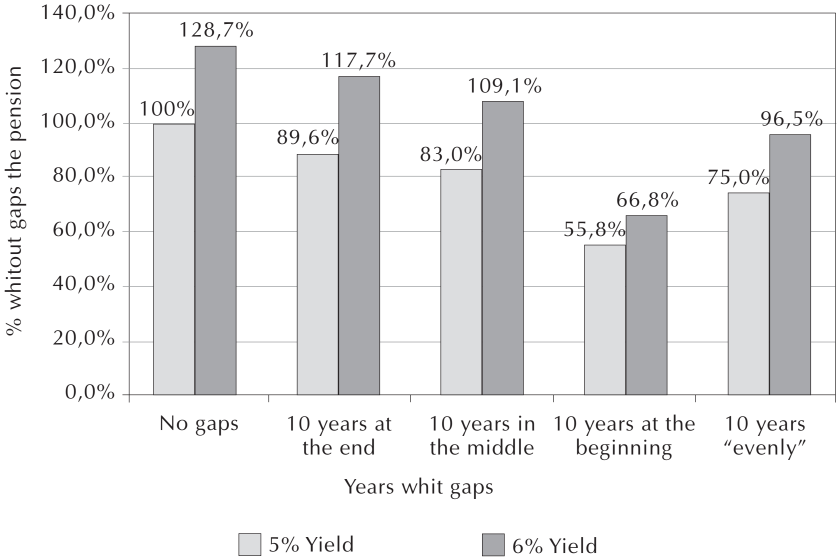
*Working age population.
Source: Quintanilla, 2004.

Graphic Nº 1 shows the pension level that a contributor with a lifetime pension saving would get, without "gaps", compared to that of an individual who stops contributing for the last years at the end of his/her labor life; and to that of an individual who contributes for ten years which are distributed evenly during his/her own life.

If there are no "contributory gaps", the shadow rate of the pension is 100. If the same individual stopped contributing in the last ten years, he/she would receive a pension of 89,6. If he/she would stop contributing halfway through a ten year period of labor life, his/her pension would be 83,0 If he/she stopped contributing ten years at the beginning of the labor life, the pension is 55,3 If he/she were, on average, 10 years unemployed during his/her whole life, and unemployment were distributed "evenly", the pension would be 75,0 (See Graphic Nº 1).

These results clearly illustrate the narrow relation between labor records and pension levels in the context of a capitalization system. Although higher yield rates of pension funds investment could partially compensate the impact of pension gaps, their influence on pension is very significant, especially at the beginning of the labor life. For example, in the case of a worker who starts contributing late, at 30 years of age, not even a higher point of greater yield rate accumulated during his active life is enough to compensate the negative impact of the pension gap at the beginning of his labor life (See Graphic Nº 1).

Graphic Nº 1
EFFECT OF PENSION GAPS
(CONTRIBUTOR WITH AVERAGE WAGE)



Assumptions: Member starts contributing at 25.
Pension age: 65 year men, spouse two years younger.
Discount rate CN: 3,5% (RV85).
Source: PrimAmerica Consultants.

Another exercise is useful in order to tell a similar story. Graphic Nº 2 shows the level of pensions that an individual would obtain depending on the age at which he/she starts contributing and the age at which he/she retires. We can see that the pension sharply decreases when postponing the age at which he/she starts contributing. Thus, the value for somebody who starts contributing at 35 is approximately 40% of the pension of someone who started contributing at 20. Of course, the pension also falls if the person takes early retirement.

On average, going into retirement at 60 instead of 65 means a 35% drop in the amount of the pension.

Pensions in a capitalization system are also affected by the way in which the wage that a person receives changes through time. For example, an individual whose salary grows constantly in

Graphic Nº 2

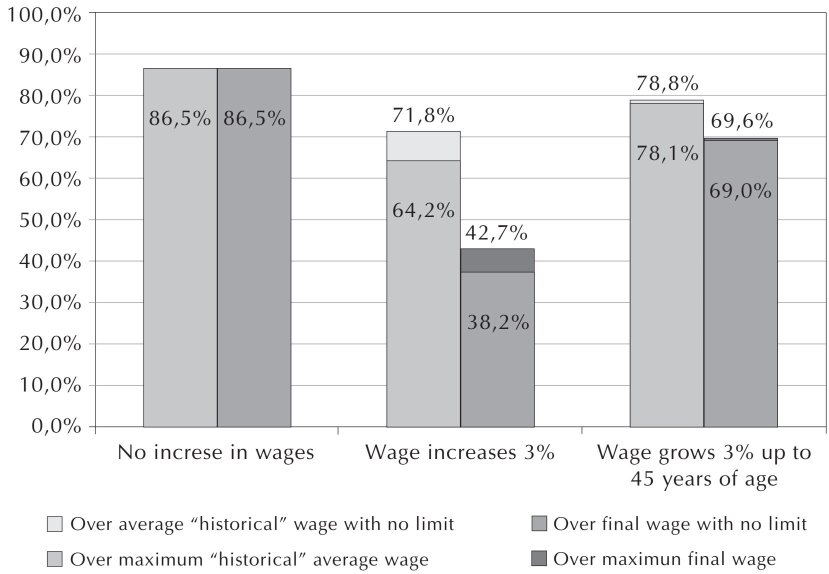
PENSIONS IN DIFFERENT YEARS OF CONTRIBUTION STARTING DATE

Assumptions: Base Pension=100, corresponds to a member who contributes from 20 to 65 years of age.
Male contributor, spouse is two years younger.
Real Annual yield of funds 5%.
Discount rate CN: 3,5% (RV85).
Source: PrimAmerica Consultants.

time (with no voluntary savings) will be able to finance a pension that, as a percentage of his/her last salaries, is relatively low compared to an individual whose wage does not grow, or to that of idual whose an individual whose salary only grows during part of his working life. This differences are even worse if the worker contributes only on part of the salary, see Graphic Nº 3.

As a consequence, youth unemployment, long periods of pension gaps, early retirement from the labor force, and the profile of gross income through time, are conditions that have a significant influence in the results of a capitalization system.

Graphic Nº 3
REPLACEMENT RATES
(CONTRIBUTOR WITH A 58,3% WAGE OF MAXIMUM WAGE)



Assumptions: Member stars contributing at 25.
Pension age: Men of 65, spouse is two years younger.
Real annual yield of funds 5%.
Discount rate CN: 3,5% (RV85).
Source: PrimAmerica Consultants.

5. Labor market and coverage of non contributory programs

As a result of the performance and characteristic of the labor market –which we commented a few minutes ago–, it is possible that in many Latin American countries, the pensions obtained by some groups of contributory systems are insufficient to protect them from poverty. This will mean that the demand for non contributory pension programs increases in time.

In the face of this, it is critical to carefully assess the design and operation of non contributory pension programs. It is evident that assuring a good pension coverage for the poorest must be the priority of the social security systems. To that end, non contributory programs must be designed in such a way that fiscal resources targeted towards their financing should precisely support the elderly and disabled people, without wasting them in subsidizing individuals that can finance their own pensions or that have access to other forms of pension protection.

In that regard, it is worthwhile making some general observations. First of all, there is much evidence in the sense that informal workers have pension saving, although it is somewhat different from the mandatory pension saving that we have commented earlier. Therefore, a careless expansion of non contributory pension programs could induce the substitution of other social protection alternatives, without increasing the welfare of the participants, but at a significant fiscal cost.

Second of all, there is some evidence that in Latin America, old people are less poor than the younger population. In other words, the proportion of poor people among the elderly is lower in almost every country in Latin America than the proportion of poor in the rest of the population. Given the considerable fiscal restrictions in every country and the fierce competition for public resources for different social programs, this reality forces to be extremely careful in the design of non contributory pension plans. In particular, efforts must be made in order to concentrate the respective spending on the elderly and disabled who besides of not being covered by contributory programs, are really poor and are in a true social abandonment situation. From this perspective, I think that universal non contributory pension programs, benefiting the whole elderly and disabled population by guaranteeing them a minimum income floor, are a less convenient solution than non contributory pension programs with an “income test” that benefits only those who can demonstrate that are poor.

6. Conclusions for pension policy

Even though the reforms that established individual capitalization systems in Latin America have had a positive impact on pension coverage, there is still a long way to go so as to provide effective social protection to all of those for whom is needed. In particular, neither pension problems of at least a portion of informal workers nor pension problems caused by more unstable and imperfect labor markets have been solved.

Reversing or stopping the process of contributory pension programs reforms does not help at all to solve this problem, whose origin, as we have pointed out many times over, lies mainly on the economic conditions of the country and the labor market and not on the characteristics of the pension system. By the same token, it seems to me that the proposals intended to solve coverage problems weakening the new capitalization systems are mistaken.

What to do then? In the remaining minutes I will briefly mentioned different proposals that might contribute to increase the coverage of the pension systems in Latin America.

Economic growth is a primary factor of coverage. A sustained growth means a greater income, more employment and income stability, more labor formality, and expansion in the access to credit, all of them, changes contributing to the improvement of coverage. Consequently, adopting policies that promote the economic growth is the first ingredient to solve the pension coverage problem.

Moreover, it is important to move forward in reducing the costs of formalization of the economic activity and labor contracts. In most of the countries of our region the lack of incentive for the creation of companies is due to an abundant variety of regulations, tax demands, and bureaucratic errands. At the same time, labor law frequently raises hiring costs because of hurdles concerning the termination of contracts, inefficient regulations of collective bargaining, the obligation to adopt wage schemes that are not associated with productivity, and fixed minimum wages to levels that have nothing to do with labor market conditions. All of these “incentives” for labor formality makes it difficult for the extension of pension coverage. At the same time, it is necessary to eliminate the distortions that hinder the incentive for old age employment as well as the employment of younger people in the formal sector of the economy.

It is also absolutely necessary to improve the design of non contributory pension programs (the so called “first pillar” of the pension systems) and in some cases, extend its coverage. In that regard, I totally share Fabio Bertranou’s comment: it is hard to understand why, if a fourth of the population of our continent depends on non contributory pension programs to face disability or old age, during the last few years, so little has been done to perfect and develop them. However, the strengthening of first pillar programs must go hand in hand with the strengthening of new individual capitalization programs. In order to avoid that those who can have pension saving during their active life end up requesting fiscal help upon retirement, it is important to consolidate and perfect the reforms that created the capitalization programs.

There also are some ways of fostering pension saving among the poorest and independent workers. First, I suggest the analysis of the possibility to establish subsidies for pension contributions of low income workers (who do not benefit from tax incentives on contributions). The cost of a program of this kind may be lower than the cost of universal non contributory pension programs. Furthermore, tax incentive for the pension contributions of self employed workers (not working under contract) need to be perfected. In fact, in many countries in Latin America, self employed workers are not authorized to deduct the pension contributions from their gross income which, together with pension saving liquidity, are sufficiently strong reasons to explain their low contribution density.

Finally, ways to provide liquidity to the unfounded saving accumulated by pensioners. For example, it is likely that most of an old age worker's net worth is in the form of a property; through a system dubbed "reverse mortgage" the worker can open up to the possibility of liquidating this asset and obtaining a flow of income, but preserving the use of the property, representing a very appealing alternative for this group of the population.

In summary, in order to extend the pension coverage, it is necessary to strengthen economic growth and employment in the formal sector of the economy, as well as the quality of social protection in our countries by means of perfecting and strengthening non contributory pension programs ("first pillar") as well as creating better incentives for pension saving. Thank you very much.

How to finance first pillar schemes?

Olga Lucía Acosta*

The recent evaluations of the reforms of pension systems in several countries in Latin America have stressed the need for greater attention to old age risk protection of the poorest. The implementation of capitalization pension systems, and the heavy burden derived from defined benefits systems has brought about a revision of protection systems in countries in which old age risk is still deficiently protected.

The fragility of old age protection results primarily from an unfavorable labor market performance and the scarce flexibility of the social protection systems of the countries. The design of a financing strategy is critical for the task of strengthening both the mechanisms that promote membership to pension systems, and the accomplishment of a better design of old age protection schemes, in order to face the strong growth of old people and their increasing longevity.

I will start this reflection by showing some traits of benefit financing for the elderly in developed and underdeveloped countries. Likewise, the questions stated by the authors on the

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issue in Latin America are pinpointed. Old age risk protection is particularly important because in poor countries with high levels of informal work such as in Latin American countries, it is not possible to think about a solution, exclusively by increasing the membership to pension systems.

Second, this is specifically for the Colombian case. Only 25% of people who are 60 years of age has a pension, and there is a caveat as to the possibility that this percentage is reduced due to the difficult conditions to reach this benefit according to the trends of the Colombian labor market. The different instruments introduced with the reform of the system in 1993, and their recent adjustments are reviewed in order to broaden the coverage and protect older people. Finally, it is concluded with the impossibility to get a better pension without involving the redesign of social and fiscal institutions.

1. Social protection of old poor people

Social policy towards old poor people does not exclusively cover the allowance of a old age pension, there are many other benefits linked to that, such as health insurances or old people care programs. On the other hand, strictly speaking, within old age risk protection there are different forms of pension that depend on the characteristics of protection schemes in different countries, among them, welfare pension, universal pension funded with contributions, and universal pension funded with taxes. One of the most important elements that differentiate these types of pensions is the source of the resources used to finance them, Either fiscal resources (taxes) or mandatory contributions, a part of which can take the form of payroll taxes.

On the other hand, the differences also come from the level of development of a country. In developed countries, social protection is financed primarily with global contributions and general taxes, and the financing of health and old age expenses accounts for more than 50% of the resources. There are considerable differences in the institutional organization of the services devoted to protection schemes for the population, but the public provision of the services with a low participation of resources from local authorities is predominant. The main problems faced by these systems refer to: (i) changes in the structure of the population, (ii) increase in female labor participation, (iii) early retirement and the persistence of long term unemployment as well as (iv) changes in the household structure.

In the same order, the previous situations push protection systems in that: (i) the aging phenomenon increases the pressure on pension systems and broadens the demand for long term care. In that sense, by 2040, the coefficient of old age dependence is estimated to be 2: one person older than 65 per two in their working age; (ii) women working part-time are, in many cases, exempt from contributions and not granted benefits, (iii) by 1998, about 5 million people were unemployed for more than two years, greatly limiting the contribution capacity and (iv) the reduction in the average household size implies a demand of social services, since it is more difficult for families to provide themselves with the help and care they need[1].

Other characteristics of protection systems of developed countries are as follows: i) they revolve fundamentally around social insurance, and those who are not insurers are responsible for welfare schemes, mainly through universal benefit schemes; ii) in accordance with the integrated European system on social protection, these countries allocate an average close to 43% of social spending (12% of the GDP) to retirement pensions; iii) in some countries (Australia, Denmark and Switzerland) fiscal resources are used, but recently they have been complemented with funded pillars; iv) 63% of the financing of that spending comes from contributions on wages, with wide differences. While in France two thirds of the financing is obtained by contributions, in Denmark this accounts only for a fourth of the total financing.

On the contrary, in low income countries, especially in Latin America, the characteristics differ primarily due to labor market characteristics[2]. Among the most common traits, the following are highlighted:

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1 Acosta OL, Gamboa LF (2005) "Elements of the Funding Strategy for the Social Protection System" First research draft No 69. Economics Faculty Universidad del Rosario. Bogotá Colombia.

2 James, Estelle (1999). Coverage under old age security programs and the protection for the uninsured, what are the issues?, World Bank. Document presented for the Social protection conference of IADB. February 4 to 5 of 1999.

- Funding based on contributions is not an option nor desirable. The low income level of informal jobs works in favor of consumption if the cost of the opportunity to invest in human resources for the offsprings, for example, is present, as opposed to the saving for an old age pension in the future. On this issue, professor Estelle James has highlighted in different studies the inconvenience, in some cases, of mandatory pensions systems for informal workers.

- On the other hand, small businesses, not only in a few unipersonal cases, require labor capital that rivals the one that is necessary to save for a pension.

- Mandatory contributions must have undesirable effects in employment because of the incidence of the contributory part that falls into small business owners.

- Experts have generally recommended to aim old age care schemes towards non universal welfare schemes, granted through means testing systems and financed through taxes on a wide base. Likewise, it is recommended that welfare pensions be lower than that lower income contributors receive in order to avoid moral risk issues.

- Argentina, Brazil, Chile and Uruguay have unfounded welfare pension. Colombia has recently, as we will see later, finished with the design of a benefit, that, although it is not dubbed pension so as to avoid reaching the value of a minimum wage, represents the concept of non universal welfare pension.

To focus on this issue, Table Nº 1 is presented, which was adapted from a working paper by the World Bank, where the main elements of the different coverages of old age risk are described, grouping the functions in pillars. Pillar zero ensures against poverty of those who contribute, but its condition does not suffice to save the necessary amount for a pension. In both cases, the government takes the risk and it is financed through general or payroll taxes. On the contrary, in pillars 2 and 3 the main function is the redistribution of consumption during the life cycle. In the second pillar, the government defines the characteristics of the contributions and in the third pillar the incentives, generally of a tax nature in order to foster a greater

Table Nº 1
PROTECTION OF OLD AGE RISK, PILLARS 0, 1, 2 AND 3

Name	Pillar 0	Pillar 1	Pillar 2	Pillar 3
Function	Ensures non contributors against poverty	Ensures contributors against poverty	Distributes consumption during life cycle	Distributes consumpti during life cycle
Government	Defines benefits allocate resources	Defines benefits allocate resources	Defines contributions	Defines incentives
Risk taking	Government	Government	Worker	Worker
Financial instrument	General or Payroll taxes	General or Payroll taxes	Mandatory individual saving	Voluntary individual saving

Source: Presentation of Luis Fernando Alarcón, ASOFONDOS "The pension reform Colombia needs" October 2004[3].

saving. The risks in these last two pillars are assumed by the worker, and the financial instrument is the mandatory individual saving or the voluntary individual saving.

As we will see, particularly in the case of Colombia, public funding pillars suffered modifications with the General Pensions Reform and adjustments have recently been carried out. At the same time, improvements have been made in order to articulate social security with social welfare through the design of mechanisms that strengthen saving and avoid the promotion of protection based exclusively on social welfare.

2. Old age risk protection of old poor people in Colombia

In addition to the purpose of improving coverage and reducing high fiscal costs of the traditional pensions system in Colombia, another argument in favor of the 1993 pensions system reform was the search for mechanisms to better protect the elderly.

[3] World Bank. (2004) "Keeping the Promise of Social Security in Latin America" Indermit Gill, Truman Packard and Juan Yermo.

2.1. Some results of the Colombian reform of 1993

In 1993, Colombia reformed its entire Social Security System: pensions (disability, old age and death), health and protection against professional risks. In terms of pensions, the 1993 reform opened up the option for individual capitalization thus ensuring pensions independent from the National Treasury. Likewise, the reform reduced long term fiscal costs for the Social Insurance Institute (SII) and committed to integrate multiple pensions systems of the public sector with those of the private sector. Another one of the characteristics of the 1993 reform, was the adoption of distributive mechanisms such as minimum pension guarantees, a contribution percentage aiming at solidarity and welfare pensions[4].

The reform has consolidated primarily the individual saving scheme. At the end of 2003, the system had 11.6 million members, but with only 5.1 million active contributors which represents an effective coverage with regard the economically active population, slightly above 25%. Pensioners reach 1 million (See Table Nº 2).

As we can see in Graphic Nº 1, the capitalization system managed by the PFA has today the same number of participants as the SII does, but in the latter, the average age of the participants is higher, because young people are members of the capitalization system created with the reform, while the SII concentrates older participants.

From the competition between these two subsystems approved by the reform of 1993, a generational segmentation is recorded by which young people are concentrated on the capitalization scheme and old people as well as public officials on the defined benefit system, due to the wide benefits of the generous transition approved, which deemed the scheme in force for 20 years until 2014 (see Graphic Nº 2).

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[4] A detailed description of the reform is found in Acosta and Ayala (2001), Acosta OL, Ayala U (2001). Pension reforms and fiscal costs in Colombia. Financing Development Series. Nº 116. Economic Commission for Latin America (ECLAC). Special Research Unit. October.

Table Nº 2

PARTICIPANTS, CONTRIBUTORS AND PENSIONERS OF THE COLOMBIAN PENSIONS SYSTEM. DEC. 2003

	Individual saving P.F.A.	Defing benefit I.S.S. 1/	Public sector		Total
			Reformed	Not reformed 2/	
1 Total participants	5.213.023	5.670.077	200.000	529.000	11.612.100
% with respect to total	44,9	48,8	1,72	4,56	
2 Contributors	2.538.688	2.234.227	200.000	220.000	5.192.915
% of active participants (2)/(1)	48,7	39,4			
3 Pensioners	14.908	490.000	265.310	238.155	1.008.373
% with respect to total	1,5	48,6	26,3	23,6	
Nominal coverage with respect E.A.P. %					56,18%
Nominal coverage with respect E.A.P. %					25,12%

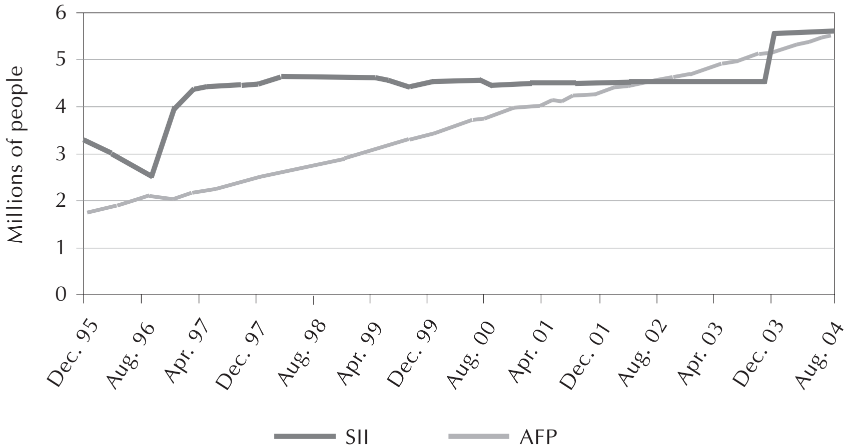
Source: Calculations of the author based on Statistics of the Superintendency of Banks, Treasury Departament and Household Surveys.
1/ Data from participants and pensions of SII, as of june 2002 in the official statistics of the Banking Superintendency.
2/ The unreformed sector represents the Armed forces, Teachers and Ecopetrol: The unreformed sector pays contributions different than those or does not pay for conventional benefits.
Economically active population as of december 2003: 20.6669.276.

In spite of the mechanisms introduced by the reform to widen the coverage, there is no considerable breakthrough in this regard, which seems to be more the results of a strong recession the Colombian economy is going through which has increased unemployment from 10% to 21% between 1995 and 2000; and the growth of the informal sector that today accounts for 60% of the unemployment and is precisely characterized by not providing their workers with coverage in terms of social security.

2.2. Poverty and coverage of pensions in Colombia

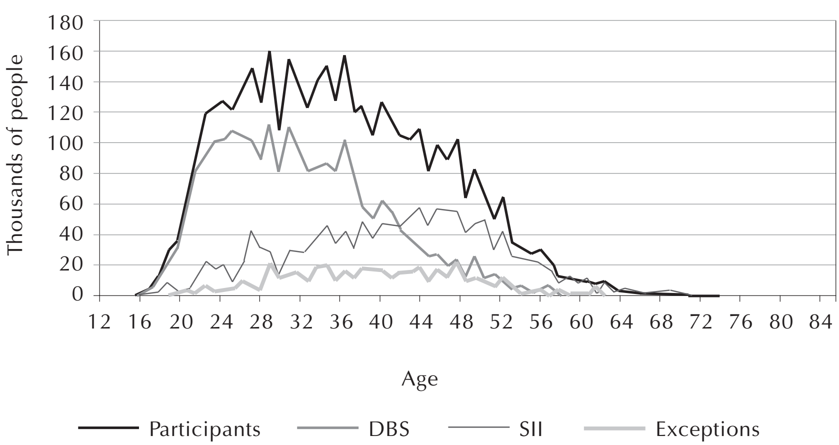
Based on a survey on quality of life carried out in 2003, it is possible to examine more thoroughly the reach of old age risk

Graphic Nº 1
EVOLUTION OF THE PFA AND SII MEMBERS 1995-2004



Source: Superintendency of Banks, and Asofondos. The SII statistics in recent months is an estimate of the economic management of Asofondos.

Graphic Nº 2
MEMBERSHIP BY PENSION SCHEME AND AGE OF THE POPULATION 2003



Source: ECV 1997-2003 Authors' estimates.

coverage in Colombia. As you may know, if poverty is examined by age groups, there is a higher incidence in kids. By entering the labor market at an early age, poverty incidence decreases both in urban and rural areas, however, it increases again during old age. (see Graphic Nº3).

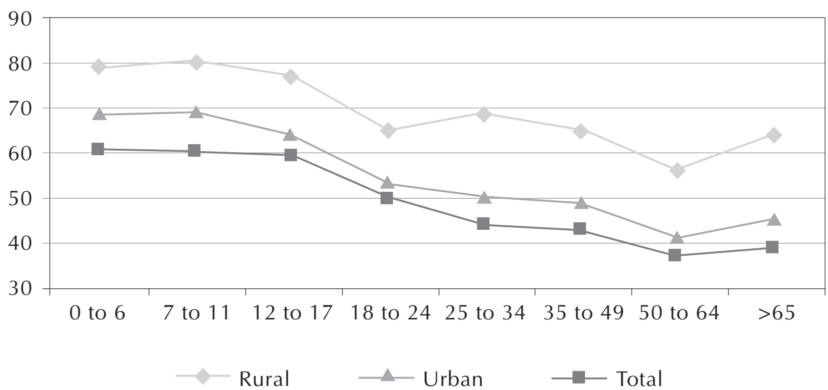
This situation shows the need to work in the design of welfare pensions and other old age protection mechanisms, especially to get ahead of the strong pressure that will result from the higher participation of people older than 65 years old in the total of the population and their life expectancy.

Another way to see those who are covered against old age risk is by examining pension membership of the working population of formal and informal sectors, and there is also a striking difference between poor and non poor population. Close to 68% of the population who has access to formal labor markets is a beneficiary, as opposed to 8.1% of whom works in the informal sector. Likewise, 51% of poor people who work in the formal sector are beneficiaries as opposed to 2.9% of the informal poor. So, the percentage of pensioners increase in the non poor population. (see Table Nº 3).

Graphic Nº 3

POVERTY INCIDENCE BY LIFE CYCLE

(% OF POOR PEOPLE BY AGE GROUPS)



Source: Calculations of Poverty Mission, 2005 based on Life quality survey carried out in 2003 by DANE, Colombia.

Table Nº 3

PARTICIPANTS, CONTRIBUTORS TO THE PENSION SYSTEM AND PENSIONERS OF FORMAL AND INFORMAL SECTOR, POOR AND NON POOR POPULATION, 2003

TOTAL	MEMBER %	NOT A MEMBER %	PENSIONER %	TOTAL %
Formal	68,1	30,9	1,0	100,0
Informal	8,1	90,9	9,0	100,0
POOR				
Formal	51,0	49,0	0,1	100,0
Informal	2,9	96,9	0,2	100,0
NON POOR				
Formal	72,0	26,8	1,3	100,0
Informal	12,3	86,1	1,5	100,0

Source: Calculations of Poverty Mission based on LQS 2003.

The next section presents a quantification of the high increase in pensions, public resources that benefit those who are not poor in greater proportion.

2.3. The Colombian protection system, sources and uses of the pension system

The different schemes of the Social Protection System or SPS in Colombia, can be grouped into what we know as i) Health Social Security System, HSSS, in force after a reform carried out in 1993 which also includes professional risks; ii) the Pensions System which covers old age risks, reorganized jointly with the health system through law 100 of 1993; iii) labor protection schemes, among them, the traditional unemployment Colombian system, schemes oriented towards training, social security network schemes intended to respond against the crisis of the last decade, and others oriented to granting unemployment subsidies that are currently in process of implementation; iv) and finally, a series of schemes of a welfare nature provided mainly by the Colombian Institute of Family welfare (ICBF), Welfare Organizations, local governments and a group of social and community organizations dubbed private network.

According to this grouping, Table Nº4 shows the resources allocated to the SPS, which in 2003 amounted to USD$31.2 billion, equivalent to 14% of the GDP. 33,65% of the resources correspond to a health and professional risks component, 53,7% to the pensions system; 6% to the labor component and 6,7% to the welfare scheme altogether. A first reading shows then that close to 88% of the resources of the SPS are mainly oriented towards health and old age risks. On the contrary, labor protection programs both in their training component and unemployment subsidy account for a slight 0,7% of the GDP. The countries with more consolidated labor protection systems devote close to 1,5% of the GDP to such purposes (Acosta and Ramírez, 2004).

Table Nº 4

ALLOCATED RESOURCES TO THE SPS IN 2003

Component	USD$ Billion	Part. %	% of GDP
Health and Professional Risks	10.510	33,6	4,7
Pensions	16.793	53,7	7,7
Labor Protection	1.880	6,0	0,7
Welfare	2.082	6,7	0,9
TOTAL	31.265	100	14,0

Source: Acosta O.L and Gamboa L.F (2005) "An estimate of the funding of the Colombian Social Protection System. Research draft No. 69. Faculty of Economics, Universidad del Rosario.

Out of the 31 billion allocated to the SPS in 2003, 43,6% comes from contributions of both workers and employers or companies; 42,8% comes directly from general taxes; 2,8% from local taxes; 3,4% from solidarity resources; 10,6% from government controlled income; and –3,9% accounts for the net result of adding up the constitution and redemption of reserves, as well as financial performance and other income (see Table Nº 5)

The pensions component is the one that accounts for the greater proportion of the resources, $16,79 billion in 2003 equivalent to 7,7% of the GDP. Out of these, 43,8% comes from the contribution of workers and employers, and 61,1% from government contributions to mainly finance the funding deficit of pension liabilities. Solidarity resources, close to 110 million, are oriented to finance the pension solidarity fund, contribute 0,7%, and to others, equivalent to –5,6%. The net of constitution minus the redemption reserves are added, as well as the yields and financial surpluses of the accounts through which these funds are managed. These resources allow for the payment of slightly more than 1 million pensioners in 2003, as opposed to a total of slightly more than 4,1 million of people older than 60 who do not have this protection.

Table Nº 5

FINANCING SOURCES OF THE SPS IN COLOMBIA, 2003

Service	Contri-butions	General taxes		Soli-darity	Government controlled income	Others	Total
		Domestic	Local				
			Billion of pesos				
Health & Risks	5.534	3.001	891	590	102	392	10.510
Pensions	7.351	10.268	—	110	—	-936	16.793
Labor Protec.	758	—	—	—	619	503	1.880
Welfare	0	103	0	350	2,599	-970	2.082
Total	**13.843**	**13.372**	**891**	**1.050**	**3.320**	**-1.012**	**31.265**
%	43,6	42,8	2,8	3,4	10,6	-3,9	100,0
			In % of GDP				
Health & Risks	2,5	1,3	0,4	0,3	0,0	0,2	4,7
Pensions	3,3	4,6	—	0,0	—	-0,4	7,7
Labor Protec.	0,3	0,0	—	—	0,3	0,1	0,7
Welfare	0,0	0,0	—	0,2	1,1	-0,4	0,9
Total %	**6,1**	**6,0**	**0,4**	**0,5**	**1,5**	**-0,5**	**14,0**
			Proportions				
Health & Risks	40,6	22,4	100	56,2	3,1	-38,7	33,6
Pensions	53,9	76,8	—	10,5	—	92,5	53,7
Labor Protec,	5,6	—	—	—	18,7	-49,6	6,0
Welfare	—	0,8	—	33,3	78,3	95,9	6,7
Total %	**100**	**100**	**100**	**100**	**100**	**100**	**100**
Health & Risks	52,7	28,6	8,5	5,6	1,0	3,7	**100,0**
Pensions	43,8	61,1	—	0,7	—	-5,6	**100,0**
Labor Protec,	40,3	—	—	—	32,9	26,7	**100,0**
Welfare	—	5,0	—	16,8	124,8	-46,6	**100,0**

Source: Acosta O.L and Gamboa L.F (2005) “An estimate for the financing of a Social Protection System in Colombia. Research draft No. 69. Economics Faculty, Universidad del Rosario.

2.4. The redistribution mechanisms of the Colombian Pension reform (1993) and recent modifications

The reform of 1993, introduced a group of redistributive measures, financed primarily by the National Treasury, and oriented towards widening the coverage of social protection: (i) Old age minimum pension guarantee or basic pension granted with State resources (national and local) to whom has not been able to save the necessary capital but has contributed for a sufficient period of time; ii) the FSP, created to temporarily subsidize the contributions of the least affluent, and (iii) the new welfare pension of half a minimum wage for people of 65 and up who have not complied with requirements for minimum pensions nor had access to contributive social security. Table Nº6 points out the main characteristics of these mechanisms that were recently reformed[5].

In effect, the unfavorable results in terms of coverage, and the declining excessive pension expenses mentioned above, which are manifested in the financial insolvency for welfare pensions and temporary subsidies on contributions, motivated the presentation of a new reform project whose approval was estipulated in Law 797 of 2003, and among the advancements is the introduction of new equality tools. The proposed new legislation was oriented to restrict the requirements for the beneficiaries of contributory subsidies, and implement the resources for a direct service for old people. (See Conpes Social 70). Among the modifications are: i) the increase of contributions for the highest wages and the modification of its saving, commissions and insurance application; ii) the creation of a new payroll tax to fund the MPG; iii) the reduction of subsidies for higher incomes whose saving in terms of liabilities was estimated to be close to 50% of the GDP. Next, the redistributive mechanisms and their modifications are further explained.

[5] Further details on these mechanisms are found in Ayala and Acosta (2002)

Table Nº 6

THE MAIN MECHANISMS OF THE COLOMBIAN PENSION SYSTEM TO PROMOTE OLD AGE RISK COVERAGE

Mechanisms:	Old age Minimum Pension Guarantee or Basic Pension	Solidarity Pension Fund	Welfare Pensions
Objective	Granted with State resources (national and local) to whom could not save the necessary amount, but had an established number of weeks of contributions	Targeted to temporarily subsidize the contributions of the least affluent	For poor people of 65 years of age or older who do not comply with the requirements for the minimum pension, or had not access to contributory social security
Main Characteristics	Law 100 established that the level of minimum pensions would be equal to that of the minimum wage and that it would be updated subject to CPI variation The Constitutional Court determined the possibility to adjust it according to the higher variation between the CPI and the minimum wage	Financed with a payroll tax of 1% of the wages over four minimum wages	In 1993, Law 100 created a monthly monetary subsidy (50% MMS) for old poor people Financing: Fiscal resources: National and Local Govs. Starting Goal: To cover 240 thousand elderly people with the subsidy in cash and means of payment (health, housing, food)
Requirements	ISS Participants who are 62 in the case of men and 57 in the case of women, and have contributed at least 1.150 weeks without reaching the current minimum wage	*Beneficiaries*: Workers that accrue up to 1 MLW (special groups: community mothers, disabled, workers of the rural and urban informal sector)*Some results*: 318,302 participants (2002), more than 50% with 4 months of past due contributions; total coverage of only 5% of the potential population in 8 years; 1.500 pensioners a year	Benefits for old poor people
Main problems	The high cost with respect to the average income on which it is contributed: A great number of participants will only be able to reach a minimum pension	i) Wrong institutional design, inadequate incentives for both the management consortium and the SII ii) Lack of clarity in the objective: foster new contributors, or complete requirements to obtain the pension	In 1998 (the year with the highest investment), 88 thousand subsidies were granted (37% of the goal and 25% of the target population), after that, it was not implemented Recommendations of the reform: Increase tax financing and improve its design

	Substantial subsidies: minimum pension reaches 50% of the average wage of contribution to the SII versus 25% to 35% in other countries in Latam	iii) Restricted access only to those who are participants of the MPS iv) Focus problems v) Flow of information problems between the receptor of the subsidy (SII) and the issuer (SPF)	
Estimated Cost	8% of the GDP		
Recent adjustments (Laws 797 and 860 of 2003)	– State guarantee remains – The minimum pension guarantee fund was created, MPGF, of the Individual Saving Scheme, ISS, through which guarantees would be "firstly" paid – The MPGF is funded with 1,5% of the contribution, a percentage that will be subject to revision every five years – Beneficiaries: Participants of the ISS (Women: 57 years, men: 62) who have contributed for 1.150 weeks until 2008, and from 2009 it increases in 25 weeks up to 1.325 by 2015	– Additional contributions of the participants were created according to their Gross Income Contribution: between 16 and 17 MLW: 0,2%; between 17 and 18 MLW: 0,4%; between 18 and 19 MLW: 0,6%; between 19 and 29 MLW: 0,8%; equal or above 20 MLW: 1,0% – Two independent accounts were created: the solidarity account and the survivorship account which is being examined as part of welfare pensions (following column) **Solidarity account** *Resources:* 50% of the 1% contribution of wages higher than 4 MLW, their yields, plus the contributions of domestic entities. *Target population*: estimated potential population: 1.2 million. *Requirements*: Minimum of 650 weeks prior to receiving the subsidy on the contribution To be older than 55 if he/she is a member of the SII, or older than 58 if he/she is a member of the ISS To be part of the health system *Amount of the subsidy* 70% of the total contribution for the urban sector 80% of the total of the contributions for community mothers 90% of the contribution for the rural sector 95% for disabled workers *Goal*: 14%: 125 thousand people	**Survivorship account:** *Resources:* the remaining 50% of the 1% contribution of wages higher than 4MMS; additional contributions to incomes higher than 16 MMS, plus the contributions on pensions higher than 10 MMS and contributions from the National Budget *Target population:* indigent or extremely poor people *Estimated potential population*: 900 thousand people *Requisites:* 3 years less than the minimum age to be granted the right to old age pension: 52 years or more in the case women, and 57 years old or more in the case of men *Amount of the subsidy:* 32% of the MMS

2.4.1. Minimum Pension Guarantee

As stipulated in Law N° 100 of 1993, the new pension system was comprised of a contributive mandatory system of individual capitalization publicly regulated, with state guarantees for minimum pensions, complemented by the welfare system for the poorest who could not contribute at all. The minimum pension would be provided to the participants of the individual saving system who, at the age of 62 in the case of men and 57 in the case of women, have not reached the minimum current pension[6]; and have contributed for at least 1.150 weeks. The minimum pension guarantee was excessive due to the high level of average incomes on which it is contributed, which implied that only a relatively high number of participants was granted the minimum pension, and that substantial subsidies were required towards that goal.

Among the most important proposals for the reform of this mechanism, pointed out by different analysts, it is worth mentioning, first of all, the one that maintains purchasing power at a constant level by the time pensions are granted, isolating them from the level of minimum wage. Likewise, the flexibilization of the requirements to obtain them has been suggested in order to cover a greater number of people. In the 2003 reform, the state guarantee remained linked to the minimum wage; the Minimum Pension Guarantee Fund or MPGF was created, and the conditions to take advantage of this benefit were hardened.

As for the MPGF, it was established as the mechanism against which these obligations would be paid out, funded with 1,5% of the contribution. In 2004, with a mandatory contribution of 14,5 point of the wage paid by the employer (75%) and the employee (25%), 10 points would for the individual account, 1,5 for management, and 1,5 for the payment of insurance premiums. Afterwards, the increase in the percentages of the wage contribution made to finance this guarantee is shown. The beneficiaries of this benefit will be all of those who contribute for

6 The minimum pension remained as the minimum wage to the date of recognition of the government proposal on pension reform, keeping its annual value to the CPI, Ayala U, Acosta OL (1998). Evaluation of the Colombian pension System and proposals for the consolidation and modernization. Final Report. Fedesarrollo. Bogotá. June

1.150 weeks; women of 57 or men of 62, but the number of weeks increases up to 1.300 weeks.

In that regard, the concern is the low likelihood workers would have to reach the number of weeks needed, if low contributions due to unemployment are factored in. The relatively high cost of this guarantee demands farfetched requirements in terms of weeks contributed by Colombian workers. That is why, it is not an accessible mechanism, and it would be preferable to grade it in such a way that it provided for a lower percentage than that of the minimum wage, for example, 50% for 800 weeks of contribution, and from that, it were gradually reaching the total minimum value at the end of the 1.200 weeks of contribution. That would allow for a wider distribution of this subsidy.

2.4.2. The Solidarity Pension Fund, SPF

The Solidarity Pension Fund has been financed since 1993 with the additional 1% of the contribution of wages higher than four minimum legal wages. The beneficiaries would be workers who had lower incomes or up to one minimum wage, of specially vulnerable categories, or subject to government attention. However, since it was in force in 1994, the results have been very modest. In the year 2002, 318 thousand participants were counted, but many of them were in arrears, their coverage only reached 15% of the potential population, and of those who have received the subsidy, only close to 1.500 people a year have been able to obtain a pension.

Several analysis of the problems of this mechanism have been carried out which seems to be a good instrument to promote coverage, in a system lacking income protection systems. The evaluations carried out on the SPF revealed both institutional and design problems, among them: (i) the dearth of precision in subsidy orientation if we are trying to induce new contributors (community mothers). The objective was to complement the requirement for a pension of a person who is close to reach the conditions to obtain a pension (for example, informal workers who have contributed for a long time as salaried workers and have lost their jobs); (ii) the defined benefit scheme was favored by demanding the membership to the SII, main administrator of the defined benefit scheme, to be in charge of the subsidy; (iii) the contract with the operator did not specify the focus of the system, the incentives, oversight, and the sufficient control to ensure a good performance, and finally, (iv) nor it generated a flow of information between the recipient (SSI) and the issuer of the subsidy (SPF), in order to control who maintain or lost the conditions of the subsidy.

With the adjustments that took place in 2003, two independent accounts were created in the SPF: solidarity and survivorship. The first one has the original functions of the SPF, that is, to grant subsidies for the contributions. Nevertheless, it was established that it would only cover people who are older than 55, and members of the SSI, or older than 58, and participants of the Pension Funds, trying to improve the loyalty to the system. The source of the resources for these subsidies will account for 50% of the contributions on account of i) the additional contribution of 1 point of contributors to the system with incomes higher than 4 MLW, ii) contributions of domestic entities, iii) financial yields, and iv) penalty fees. The survivorship account is talked about in the next section.

2.4.3. Welfare payments

Law N° 100 of 1993 created this scheme in article 258 for old poor people so as to provide a monetary subsidy equivalent to 50% of the minimum legal wage currently in force. This subsidy which was not approved for all of those who complied with the established requirements, would be cofinanced with subnational governments. The objective was to cover 240 thousand elderly people, but in the year of the highest investment, 1998, only 88 thousand subsidies were able to be granted or slightly less than 25% of the target population.

With the recent adjustments, and particularly with the survivorship account of the Solidarity Pension Fund, the protection of the destituted or poor older population through an economic subsidy was sought after. This account is financed with: i) the other 50% of the contributions on account of the aforementioned concepts of the solidarity account, ii) additional contributions of those contributors with incomes higher than 16 MLW, iii) contributions for pensions higher than 10 MLW and iv) contributions from the National Budget.

An illustration of the redistributive mechanism derived from the adjustment of 2003 is presented in Table Nº7. As we can see, a scheme of different contributions was introduced depending on the number of minimum wages on which the person is contributing. 1,5% of the 14,5% would go to fund the minimum pension guarantee. The differential increase of the contribution according to the number of minimum wages is applied in the defined proportions of the solidarity account and the survivorship account of the Solidarity Pension Fund.

Table Nº 7

DIFFERENTIAL CONTRIBUTIONS AND THEIR SUPPORT FOR REDISTRIBUTIVE MECHANISMS

	Contribution in 2004: 14.5% [1/]						
IBC in minimum wages	Individual account %	Mana-gement %	Insurances %	Minimum Pension Guarantee Fund MPGF [2/] %	Solidarity Pension Fund SPF [3/] %	Solidarity Pension Fund SPF [4/] %	TOTAL %
1 a 4	10	1,5	1,5	1,5			14,5
4 a 16	10	1,5	1,5	1,5	0,5	0,5	15,5
16 a 17	10	1,5	1,5	1,5	0,5	0,5	15,5
17 a 18	10	1,5	1,5	1,5	0,5	0,9	15,9
18 a 19	10	1,5	1,5	1,5	0,5	1,1	16,1
19 a 20	10	1,5	1,5	1,5	0,5	1,3	16,3
>20	10	1,5	1,5	1,5	0,5	1,5	16,5

Source: Presentation Luis Fernando Alarcón, ASOFONDOS "The Pension Reform Colombia needs" October 2004.

[1/] 75% of the contribution is paid out by the employer and 25% by the worker. This contribution rises to 15% in 2005 and 15,5% in 2006. Starting in 2008, it could rise to 16.5% if some goals in terms of economic growth are reached.

[2/] Finances the Minimum Pension Guarantee (PILLAR 1).

[3/] Subsidizes contributions over 1 minimum wage for those who are close to complying with the requirements: It goes to the solidarity account of the SPF.

[4/] Finances welfare payment (PILLAR 0).

With these adjustments it is expected to reach a higher coverage both in pensions and protection for the elderly. The evaluations of the impact of these adjustments are not yet available due to the short period since Law 797 of 2003 was passed.

3. Different instruments to finance old age risk protection schemes in Colombia

The successive reforms that have been carried out in the pension system will not suffice to offer an integral answer for the challenge that the current protection for the population older than 65 years of age presents, let alone the high percentage they will represent in the near future. It is necessary to move forward in the reform of other instruments as well as social and fiscal institutions.

It is not likely either to adequately finance pillar 0 and 1 exclusively, starting from the increasing payroll taxes that have recently been approved. It is necessary to integrate the design and financing of the protection of people who are not able to contribute to the reorganization process of the social protection system (SPS) of the country.

The design of the financial strategy of the SPS requires considerations of at least three main interdependent aspects: 1) the definition of the package of protection services that the population is likely to provided with, 2) the changes in the population and the economic cycle which determines the structural and short term factors of such package; and 3) the possible source of the resources to achieve this. Over the last two years, the Social Protection Department has specified the composition of the basic package of services for the SPS. Research points out the need for a deeper analysis of labor protection schemes[7] of both training and unemployment benefits as the pivotal point of the strategy. Likewise, the need to reorganize and focus the welfare component in a set of far-flung impact schemes[8]. The components that account for close to 90% of the resources, health and pensions, have been reformed in the nineties and are currently undergoing adjustments projects.

The demographic transformations whose most relevant manifestations are a lower growth of younger groups of the

7 Barrera Felipe (2004) "Labor Elements in a Social Protection Scheme". Recommendations document on economic policy. Document for the Implementation Scheme of the Social Protection System. Second Version. November.

8 Nunez Jairo y Silvia Espinosa (2004) "Social Welfare in Colombia: Diagnosis and Proposals". Document for the Implementation Scheme of the Social Protection System. Comments Draft. November

population, the sustained trend to a higher life expectancy, and, as a consequence, the growth of older age population have deep repercussions in the composition of the social services offer, which will require considerable adjustments in order to finance a higher service and health expenses of an ever increasing older population. Our SPS will have to take a turn towards protecting the elderly. In the year 2000, the population of people older than 65 years of age accounted for 7%, and it will be near 10% by 2015 and growing. The pension component of our SPS is too fragile for the percentage of old people we have at present, and more resources and schemes will be needed.

The revision of the allocated resources and their uses in different social protection schemes presented above, as well as the conclusions of several of the simultaneous studies carried out on different components of the SPS for its implementation, indicate the need to concentrate the financial strategy on the achievements of the following objectives:

- *Protect the income of people through employability schemes and temporary unemployment benefits (Barrera, 2004), and strengthen contributory protection schemes*. Recent evaluations show that need to strengthen the labor protection component. An important percentage of workers might comply with the necessary weeks and contributions for their pensions on condition that there was a network that protect them during unemployment periods. That has been persistently talked about, and the possibility to reallocate fiscal resources in order to strengthen the schemes of such component is under studied. As regard contributory protection schemes, they would have to consider unemployment schemes which has been the form of unemployment insurance the country has relied upon.

- *Articulate a welfare network with far-flung schemes* (Nunez and Espinosa, 2004). There is a wide variety of welfare schemes, not only in the national public sector but in local public sectors as well, and not only in the public sector but also in the private sector, that might be efficient protection mechanisms considering the pensions to which we are referring.

- *Have a deeper analysis of the decentralization* of labor and welfare protection schemes as well as the design and financing

- *Redirect the resources that* nowadays are allocated to schemes of the global protection strategy that are not articulated nor a top priority, and financed with government controlled incomes,

- Strengthen the system with *new resources* coming from anticyclical schemes.

- *Have a deeper analysis of the pension reform* in order to reduce steep liabilities and strengthen protection schemes of the older population from the standpoint of the aforementioned demographic trends.

In the fiscal arena, a structural reform of the tax system has been proposed over the last couple of years. It was stated that the Mission of Public Income goes beyond fiscal stability. The reforms for the tax structure must seek the conditions that facilitate economic growth and help diminish poverty and that, as the final goal, allow for the increase of the welfare of the population[9] . It is considered necessary to cite these principles outlined by the representatives of different sectors of society and the group of technical experts who worked together with them, because the financial strategy of the SPS must be defined jointly with an important reform of the tax structure in the country. There is no doubt that more resources will be required, and towards that goal, it is useful to mention the possibilities presented in the works carried out by the Mission.

In a more concrete manner of speaking, besides a set of specific proposals, possibilities for a higher fiscal collection, particularly in the most populated 43 cities with a population of over 100 thousand inhabitants. Likewise, contributors were better disposed towards paying local taxes. For this reason, the proposal to strengthen the resources of the SPS is based on the deeper analysis of the local fiscal structure. The structural tax reform as well as the revision of the transfers system that must be approved by 2008, would have to stipulate the need to strengthen the SPS, together with the programs of old age protection. Payroll taxes would have to be trimmed. Colombia is a country with high payroll taxes, considering the extremely high percentage of poor population that cannot comply with them. Likewise, the reorientation of the income to finance long term liabilities has been proposed.

[9] Public Income Mission (2002) Final Report. Books from Fedesarrollo.

Definitively, the demographic changes will demand a sustained increase of the resources, and it is a challenge that we have to face now; it will not only be an increase in the resource allocation but also a reduction of the costs which nowadays means improving the focus, more general fiscal resources, avoiding the conversion of these benefits in universal rights because they are unsustainable for a country like Colombia.

Between the most specific reforms which unfortunately have not reached a consensus yet is the authorization for a lower minimum pension following the experience of other countries.

Finally, it is necessary to coordinate governmental efforts with other forms of protection used by families and their organizations. Professor Estelle James has drawn the attention on the need for implementing family strategies in the design and financing of the protection system of those who cannot generate the necessary saving for self protection.

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Chapter III

The second pillar: mandatory contribution programs

Part I

The challenge of the pension funds investment

PENSION FUNDS INVESTMENT: RESULTS AND REFORMS OF THE REGULATION

FRANCISCO ZAMARRIEGO*

The title is a little pretentious so I am going to try to be straightforward and avoid getting in too deep because what is interesting here is to simply highlight the concepts that perhaps we will have to remember.

1. Results

I think that regarding results we have to be quite clear; after all the experience the system has in many countries we must recognize that a **high yield** has been reached, that within certain boundaries there is a **diversification** of the portfolio –I say within certain boundaries because in that regard the regulation has been quite strict– and the funds have been managed with absolute **transparency** and **honesty.**

There is no doubt that if something sets the System of Private Pensions apart, with respect to the administration of the second pillar, is the absolute transparency with which we have operated. The fact individual accounts which participants own have been adequately protected, and that in fact there are funds, is the first

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value we must recognize in the private pensions system vis-à-vis the former existing systems in the region, where we frequently see how the old pensioners or governments complain about the lack of resources for the payment of pensions.

1.1 High yield of the funds under management

The yield obtained by the participants during the lifetime of the capitalization system is described in the following table (See Table Nº1). The source comes from figures of our distinguished colleague Augusto Iglesias. All in all, we see that the numbers are fairly good. On average, we can talk about an 8% to 9% yield in real terms in the sum of the countries, a yield that is above the average increases of real wages in the economies of the same countries. Therefore, if we eventually compare the increases in the pensions that pay-as-you-go system had had in those countries –on condition this yield is above the increases in real economies- we can say that we have had a better result yield wise and better improvements of the base of the pensions, than the ones the other systems would have had.

Table Nº 1

REAL YIELD OBTAINED BY PARTICIPANTS LIFE OF INDIVIDUAL CAPITALIZATION SYSTEM*
(ANNUAL AVERAGE)

Country	%
Argentina	10,20
Bolivia	9,40
Chile	10,30
Colombia	11,00
Mexico	7,20
Peru	7,60
Uruguay	16,00

*The calculation corresponds to the real yield obtained by a member of the individual capitalization system during the effective date in the respective country.
Source: Augusto Iglesias (2004).

1.2 Development of the capital market, attracting new issuers, and the creation of new instruments

The system has contributed to the development of the domestic capital markets and we believe we have to continue doing so, we have the mission of attracting new issuers and the obligation of having new instruments. Administrators must be particularly proactive, work together with the providers of the system in this regard (funds, investment banks), and that is why I am happy that more providers of the industry attend this kind of meetings. The presence of a number of foreign funds is very positive. It is an issue on which we have to work together in each one of the countries, with the regulators, with investment managers so as to propose new instruments to offer to the funds. In that sense, we are willing to work together with each one of the providers of the industry, and to invite funds and investment banks to come closer to our companies and also work together with them.

1.3 Investment promotion in the real sector of the economy

We have to be particularly responsible and proactive in promoting the real sectors of the economies. There is a wide field that we need to work on, especially in issues like real assets, the development of real estate products, concessions, etc. An we must also reinforce the area of Risk Control

Within our administrators I think there is still an issue we have to work on which is the need to reinforce the risk areas, the issue of market risks control, credit risks control, and together with the regulators develop a regulation in order to homogenize the standards of the administrators.

2. Current challenges

Increase the diversification of the portfolio, improve the risk/ return relation, and provide the participant with a greater possibility from which to choose.

Next, I would like to focus on three points. The need **to improve the risk/return relation** concerning our portfolios, and especially the challenge regarding the need **to increase the**

diversification of our portfolios. On one hand, that will obviously improve the risk/return relation; and there is also another important point: **we have to provide the participant with a greater possibility to choose** from the variety of products under management. After many years, the administrators have shown to be efficient in managing our resources, we have provided a good yield, and we have the capacity that allows us to offer products with more added value. In addition, that is going to allow participants –we have seen this with regard to the third pillar in the previous presentation- to better identify with their pension products and, obviously, that should contribute to lessen the risk of net worth loss that different generation of participants face.

Therefore, we will go into detail in each one of these points as quickly as we can, especially in what we are proposing to delve into.

There are five points I think we must highlight to focus the improvement proposals:

2.1 The offer of different funds, a very important point

With respect to the different funds of different risk, the proposal is that pension funds administrators can offer different funds for mandatory contributions. The participant must have the possibility to choose the kind of risk/return combination according to his/her risk and age profile. We do not see why that issue should not move forward in different countries. The Chilean experience shows that there is a bigger closeness between the participant and the fund. Besides, it will contribute to the structure of differentiated portfolios and to provide products with more added value.

Perhaps, the regulatory paradigm in that regard is Peru. The regulation in this country will allow pension funds to offer different voluntary saving products, for pension and non pension purposes, not only regarding fixed stereotypes –in the case of Chile we have seen five funds– but pension funds administrators will have the leeway to create funds according to the needs of their clients. There is complete freedom on this issue. And perhaps it is important to highlight the Peruvian regulation.

2.2 Limit the concentration of the portfolio in public securities and increase investment abroad

We have to be especially careful with public debt investment, the excess in public debt concentration; we have to be able to generate a greater investment abroad, and when I say abroad I speak in general terms and taking the appropriate risk, etc. This will not only contribute to provide a wider diversification in the portfolios but also a greater interrelation among pension industries in the continent.

As we mutually invest in our countries, there will be bigger economic links, there will be in time –as participants identify with investments- a greater interest in the evolution of the addressees of our investments, and thinking big, this will obviously contribute to a bigger economic "brotherhood" among our countries. As a worker in Chile has investments in a company in Brazil, or a worker in Brazil has investments in Argentina, we are, up to a certain extent, also conditioning the several commercial and economic scenarios among us. Perhaps today that is daydreaming, but it is a scenario that should be plausible.

2.2.1 Limiting the concentration of the public securities portfolio

This is a delicate issue. In fact, excessive concentration in public securities is equal to nationalizing the individual capitalization system. Obviously, this way we are changing the mandate given to us by the participant, through which he/she is paying us to have a more active management of the funds.

Peru and Chile are the countries with the lowest concentration in public debt securities, and the countries with the highest concentration are Mexico, El Salvador, Argentina and Bolivia, reaching up to 70 or 80% of the portfolio (See Table Nº2), which is clearly a limitation for the management capacity of our portfolios.

Furthermore, recent experiences show that in moments of crisis, governments induce to a greater buying of public debt, so the system will be more protected the less it holds before the crisis. During renegotiation scenarios, the State has given no preferential treatment to participants relative to other creditors.

Table Nº 2
INVESTMENT OF PENSION FUNDS IN LATIN AMERICA
(JUNE 2004)

Sector	Argentina %	Bolivia %	Chile %	Colombia %	El Salvador %	Mexico %	Peru %
Government sector	68,48	65,08	21,17	47,79	84,18	80,70	19,09
Term deposits	4,20	6,41	18,18	8,66	10,22	4,27	18,03
Mortgage bonds	0,02		8,25	0,09			0,08
Corporate bonds (ST & LT)	1,52	17,35	7,07	13,64	0,35	14,26	11,68
Stocks	10,38	7,94	14,35	5,13	0,27		33,80
Investment funds			2,47				0,62
Foreign sector	9,51	0,00	27,54	8,66	4,98		8,25
Others	5,91	3,22	9,21	16,12	0,00	0,78	8,53
Thousands of US$	16.101.260	1.613.251	48.991.810	8.327.413	1.819.419	38.337.018	18.431.411

Source: FIAP.

I think we must try to be cautious in this sense and, therefore, the regulations propose the existence of concrete limits that hinder the modifications on the part of one government. Again, this is an issue that may be difficult to overcome but it is what I think needs to be passed on and talked about in every country.

2.2.2 Foreign investment, a diversification issue

So far, regulators have leaned toward strengthening domestic investment with the argument (which is justifiable up to a point) that private pension systems have to contribute to the development of domestic markets, they must be a source of financing domestic economies –which is absolutely reasonable- but with limits that do not create distortions. In that sense, the country with the most foreign investment is Chile, but it is not more than twenty-odd percent. Anyway, it is a very restrictive regulation, and it is a fact that this excess of available funds in the domestic market is already creating an excess of liquidity and inflation in the price of some assets.

The main objective of the private pension system is to guarantee good pensions, the best pensions possible, so this objective should not be passed onto others. The issue of price inflation benefits those who ask for loans that given the current regulatory restrictions are the main economic groups of the countries and the government. It is an issue in which administrators must be particularly incisive, talk to the regulators and have the public opinion at large see the convenience of diversifying in securities abroad. This issue should not be raised in ideological or nationalistic terms but we must be absolutely rational in the debate. Diversification generates a better risk/return relation and avoids distortions such as the ones described.

In some cases, diversification with assets abroad is nowadays being carried out in a direct way. But in this sense, the participant is the one who is truly interested; then, linking this subject with that of the multifunds, a good solution might be to come up with a fund that exclusively invest in the domestic market within the multifunds scheme, and let participants decide whether to be in it or not; and to create other funds which can invest abroad with degrees of foreign investment as we see liquidity excesses in domestic markets that generate price distortions. To that end, the ones who must choose the destiny of their funds are the participants.

2.3 Market valuation with exceptions of portfolios

Obviously, the valuation of the portfolio that must prevail is the market price valuation. However, we all know that in some of our markets there are a few inconvenients in that regard, due to size, dearth of depth, or lack of liquidity. We have to improve the regulations given that the size of the funds today is critical for these kind of securities, and that a big price distortion might occur. Therefore, what is being proposed is to continue the valuation at market prices but with a few exceptions. The fund of participants close to retirement within the aforementioned context of multifunds, must be valued at yield rate which will reduce unwanted volatility of the unit share.

And we have to be able to identify other eligible fixed income instruments whose lack of liquidity makes it more relevant to apply private valuations of the company instead of market prices. So, the issue of private valuations must also be developed for us to have a wider spectrum of eligible variable income securities.

2.4 The elimination of the minimum yield

The existence of the minimum yield induces to the well known herd mentality effect because the punishment for deviating is too high, and also restricts product diversification and reduces the possibility for the participant to choose. Therefore, we propose to establish wider limits for the valuation of the unit share, through limits to the value at risk. This measure will provide managers with a wider room so as to reach a greater variety of products. Combining the different proposals (See Table Nº 3), we have here a conspectus of the main countries which have a pensions scheme, and where we can still delve into some subjects:

Table Nº 3

CHANGES PROPOSED FOR THE REGULATION BY COUNTRY

	Argentina	Chile	Colombia	Mexico	Peru	Uruguay
The offer of several funds	×	√	√	√	√	×
Lower public debt	×	√	×	×	√	×
Higher investment abroad	×	×	√2/	×	×	×
Market valuation with exceptions	√1/	×	×	×	×	×
Eliminate minumum yield	×	×	×	×	×	×

√ = already present 1/ the renegotiation of the debt will generate accrrual to the IRR of 50% of the portfolio.
× = it is needed 2/ current limit is still wide.

In Argentina we must delve into the possibility that various funds coexist, the public debt issue, concentration and foreign investment. In the case of Chile, we have a country with several funds and where there is less public debt investment, but there is still much more to do in terms of foreign investment and minimum yield, and so on and so forth. Everything the table you all have shows, I will not refer to due to lack of time.

Anyway, we can see there are many things that still need to be done.

We, the administrators, will be permanently requesting, talking and delving into these issues in order to reach those objectives.

3. Conclusions

The system of individual capitalization shows encouraging results in Latin America from the yield standpoint, but there are other challenges that we must still face; especially, the offer of several funds, the limit of the percentage of the portfolio invested in the public sector in order to avoid populists temptations to the detriment of the participant. A couple of exceptions for the valuation of market prices are proposed as well as the substitution of the minimum yield for more flexible mechanisms, and most importantly, -what I expressly left to the end so we can take it into consideration- we have to be more generous when increasing investment limits abroad so as to allow a wider diversification and, therefore, a lower risk for the participant.

Fixed income management of the pension funds, and volatility risk control

Jaime Arguello*

Pictet Bank is a Swiss bank that manages 180.000 million dollars from institutional and private clients, out of which 25 thousand are in fixed income. Today, I would like to talk to you about fixed management, first, with the different kinds of assets; followed by what we consider the basic principles for an effective management in fixed income; finally, I will also cover the management of risk and volatility in fixed income.

Firstly, I will provide an illustration of the different categories of fixed income (see Graphic Nº 1), classified in two types: from cash and mid term, etc., to the riskiest kinds of assets. Another fixed classification is by the level of active risk that can be taken in the different types, passive management, semi passive management in the types of assets with lower risk, and a much more active management in those of higher risk. Finally, there is a fixed income management category with lower market risk, but a high active risk which represents absolute returns.

Once the different categories and types of fixed income management are pointed out, we will go back to the pension funds. The classic asset allocation model in a pension fund is comprised of analysis of the fund, asset and risk allocation (see Diagram Nº 1). That is, the pension fund chooses either a passive management, which is just Beta, or an active management, which is Beta plus the potential Alpha that a manager can generate.

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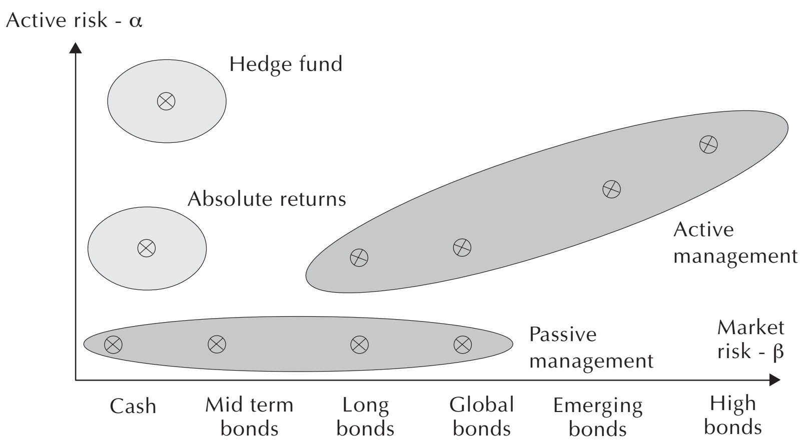
Graphic Nº 1

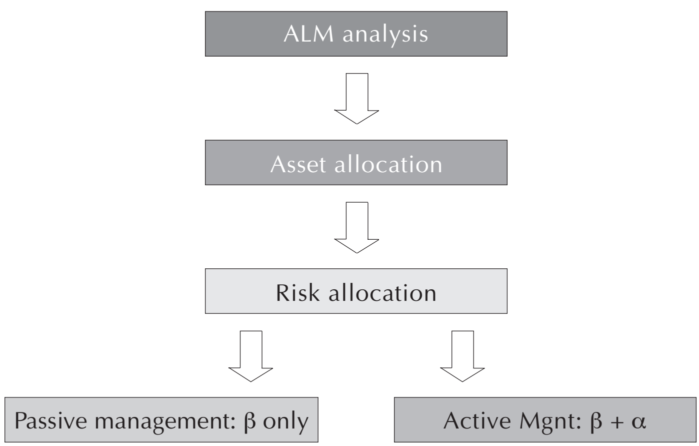
FIXED INCOME: CATEGORIES AND TYPES OF MANAGEMENT



In the fixed income context there are different dimensions in which we can take bets relative to the index represented by market risk, the Beta, which are as follows:

Diagram Nº 1

CLASSIC MODEL OF ASSET ALLOCATION

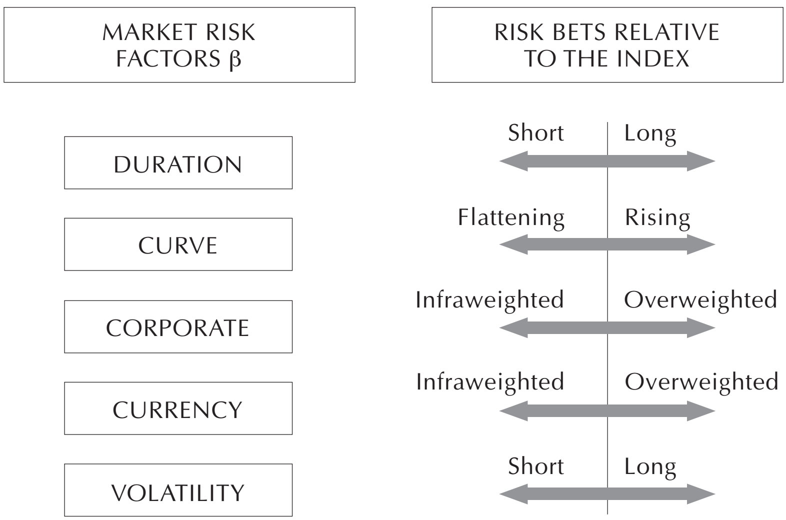


- Duration risk, exposure to ups and downs of types;
- Risk type curve, exposure to the change in the type curve;
- Corporate debt risk, amount we can have in corporate debt risk;
- Currency risk
- Volatility risk, risk that can be taken mainly by derivatives.

An active fixed income manager can deviate or take bets against the benchmark, that can be weighted or overweighted figures in each one of these risk categories (see Diagram Nº 2).

Diagram Nº 2

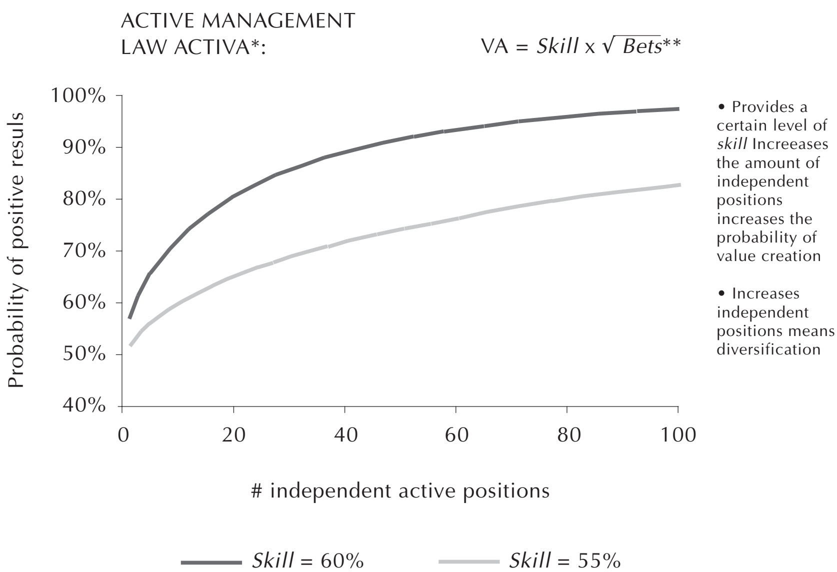
ACTIVE FIXED INCOME



There are different styles of active management of fixed income, and the one that is more efficient and interesting for us is commonly known as Active Management Law, defined in 2000, which says that the added value an active manager can contribute is a factor of his *skill* to make bets that provide gains, multiplied by the square root of the number of independent bets that the manager will take (see Graphic Nº 2). What this principle shows is that a manager who has a certain *skill* has an interest in increasing the amount of independent bets that he is going to take instead of increasing the size of each one of them.

Graphic Nº 2

EFFICIENT ACTIVE MANAGEMENT: DIVERSIFICATION



*: Grinold and Khan (200), Active Portfolio Management, 2nd ed., New York: McGraw-Hill
**: Added Value / Independent active positions

This active management principle is the one that Pictet applies in its investment process, which I will illustrate next. But before I want to pinpoint three essential investment principles for us.

The first one of these principles is diversification; in the context of fixed income management we believe it is critical to diversify the bets which are taken in a very opportunistic manner.

Second, risk management is very important when allocating a risk budget to each one of the types of bets we saw before, in addition to controlling and measuring the contribution of each one of the active bets to the yield of the portfolio.

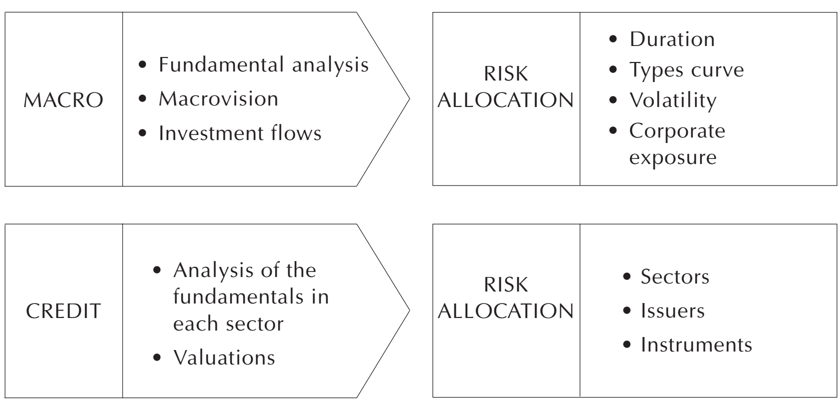
Finally, it is essential, considering the complexity of fixed income management, to have specialists in each risk type zone described earlier.

The principles described here are applied particularly to two kinds of factors to take a position in the market that we will analyze: macroeconomic factors and the credit factors of corporate debt (see Diagram Nº 3), which lead to a part of fundamental macroeconomic analysis and another one of fundamental credit analysis, yet, it is always important to face and analyze what the most technical factors of the market are: flow factors that can have a great impact on the evolution of the types of interests or credit *spreads*. Well known examples are the *flight to quality* that happens when the market moves, for example, towards American Treasury Bonds, or contagion effects like the ones undergone in the credit market with the derating of General Motors and Ford, which affects the entire corporate debt market in the United States and also in Europe, in spite of the fact there is no change in the credit fundamentals of most companies. That explains the importance in an active management process of taking into consideration the fundamental factors, the technical factors, and the valuation.

Once the different types of bets we wish to take are defined, it is important to define the objective we have in each one of the bets, as well as the maximum loss we can take in each one of them, This kind of disciplined approach in each one of the assets positions is necessary in order to avoid that our clients take risks due to vision and market anticipation mistakes.

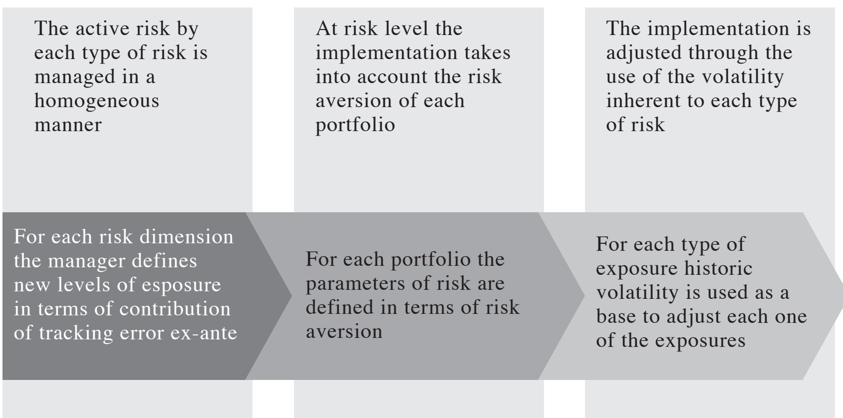
Diagram Nº 3

FACTORS OF ACTIVE MANAGEMENT ANALYSIS



Once we have defined the type of position, the objective and the stop loss of each one of the positions, we will implement our own active bets (See Diagram Nº 4). And to that end, there are two important stages: the first one is to adjust the size of our positions in active bets by risk the aversion of each client. Of course, there are many institutional clients, pension funds, that want little risk, and others that want much more, then, we have to adjust this in a precise way. And also, that a relation with volatility control means to bear in mind the volatility of each kind of bet to define the size of the position.

Diagram Nº 4
IMPLEMENTATION



1) Volatilities management 2) Interest rate
3) Cross country 4) Credit currency

	CHF	EUR	GBP	JPY	USD
2y	50	65	60	15	100
5y	50	70	60	50	115
10y	50	55	60	55	100
30y	30	40	50	60	75

	CHF	EUR	GBP	JPY	USD
2-5y	25	25	30	35	40
2-10y	30	25	40	45	40
2-30y	45	40	45	55	50
5-10y	20	25	15	25	30
5-30y	45	40	30	45	50
10-30y	45	20	20	35	30

That part of the implementation is the first one in the risk process which also has an element of risk measure and analysis and control. I do not comment on every point but you can see them in your papers. We think they are the most important points to be measured as well as having a risk control process of a portfolio in fixed income or any other kinds of assets. We have to know where the risks are and what the ex ante of the portfolio is compared to its index, and also the control, as I said before, of the contribution of each active bet to the yield of the portfolio.

Another important element is risk analysis and control. What has occurred in managing fixed income over the last three or four years is the relevant increase in the complexity of the products that we use to manage the portfolios. Here, there is a considerable evolution in credit derivatives, especially in the dollar and euro market, which now has a size of five thousand billion dollars and is much more liquid than corporate bonds per se. That is, every time we take a position in the credit market, it is done through credit derivatives of each issuer or through credit derivatives baskets.

All of that makes the risk analysis of a fixed income portfolio today much more complex than five or ten years ago, therefore it is important to have risk systems that are more and more sophisticated, so in our case for example, we use a system designed by fixed income risk specialists.

Here I will show you the example of the evolution of the ex ante Tracking Error of a European fixed income portfolio where we can see that the active risk we take, as I said before, is very opportunistic, we get in and out of the positions, and it is also very diversified. Here we can see the breaking down of this volatility by risk factors (see Graphic Nº 3). Of course, the ex ante volatility measure of a portfolio is an interesting measure, but it is not enough. What happens in the last part, for example, back to twelve or eighteen months ago, is that the volatility of the market itself has gone down quite considerably, so it may seem as though we are taking less risk, but what really happens is that the volatility of the market itself has decreased a lot.

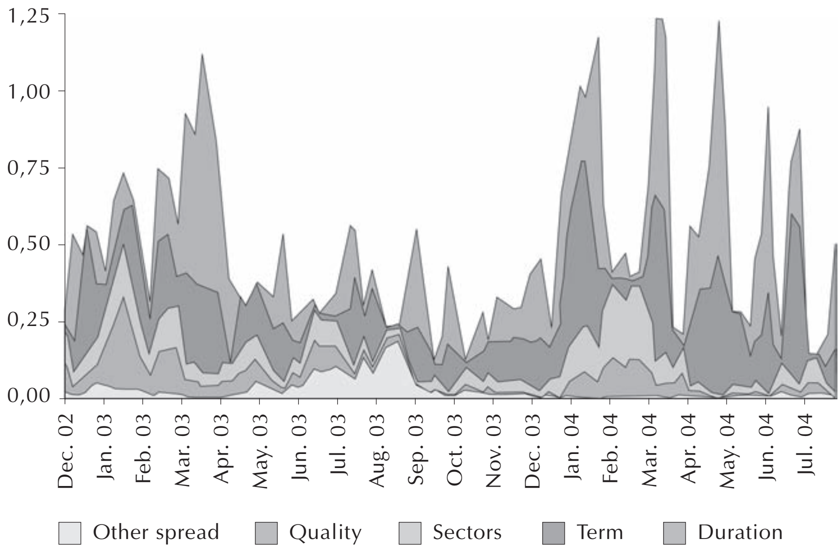
Speaking of risk systems, I have also illustrated here what a system produces: a breakdown of the volatility of a fixed income portfolio against its index. This looks more like an eye exam but you will see in your papers (see Table Nº 1).

What is interesting is that these systems also allow us to measure where the Alfa that we create comes from, and matching that Alpha measurement, is a breakdown of the contribution by risk

Graphic Nº 3

VOLATILY CONTROL AND RISK BUDGETING

PICTET EUR BONDS ALLOCATION



category; and to prove it with the definition of our investment process. Thus, we verify that the Alfa that comes from the active management is diversified by categories of risk, and also what we see here is that in cases where we have a year a little bit more difficult, we can control with the stop loss system, the loss that we can generate against the index (see Graphic Nº 4).

As a conclusion, I repeat that diversification seems essential to us in a modern fixed income management. I am talking particularly about global fixed income. It is important to diversify by risk category and also to measure, in the risk process, the global risk of the ex ante and ex post portfolio, and also to measure the contribution of each bet to know where the Alfa comes from. It is necessary and essential to invest in external risk systems because it is very difficult to develop them internally.

Perhaps the last element I did not mention earlier is the importance of providing managers with a margin for their investment process to be completely developed.

Table Nº 1
RISK MANAGEMENT
ANALYSIS TOOLS

Global credit model – Global risk summary
PFIF EUR TURBO INCOME vs. Citi EUR 3 months Index on 27.07.2004
Base currency: Europe - Euro

Portfolio Annual Total Risk Contribution

	Duration	Term	Sectors	Quality	Other spread	Currency	Covariance	Totals	1 Day VaR (95*)
Asia Pacific	0.0121	0.0664	0.0000	0.0000	0.0000	0.0015	-0.0381	0.0558	18
Europe	0.0678	0.4260	0.1924	0.1149	0.0089	0.0002	-0.1861	0.4492	142
North America	0.2613	0.3489	0.0010	0.0005	0.0041	0.0014	0.1649	0.4661	147
Covariance	-0.1194	0.2472	0.0068	0.0027	-0.0023	0.0016	0.3342	0.3983	126
Totals	0.2425	0.6072	0.1928	0.1149	0.0035	0.0028	0.3206	0.7620	241
1 Day VaR (95*)	77	192	61	36	3	1	101	241	

Benchmarck Annual Total Risk Contribution

	Duration	Tera	Sectors	Quality	Other spread	Currency	Covariance	Totals	1 Day VaR (95*)
Asia Pacific	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0
Europe	0.1120	0.0052	0.0000	0.0000	0.0000	0.0000	-0.0040	0.1121	35
North America	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0
Covariance	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0
Totals	0.1120	0.0052	0.0000	0.0000	0.0000	0.0000	-0.0040	0.1121	35
1 Day VaR (95*)	35	2	0	0	0	0	-1	35	

Annual Tracking Error Contribution

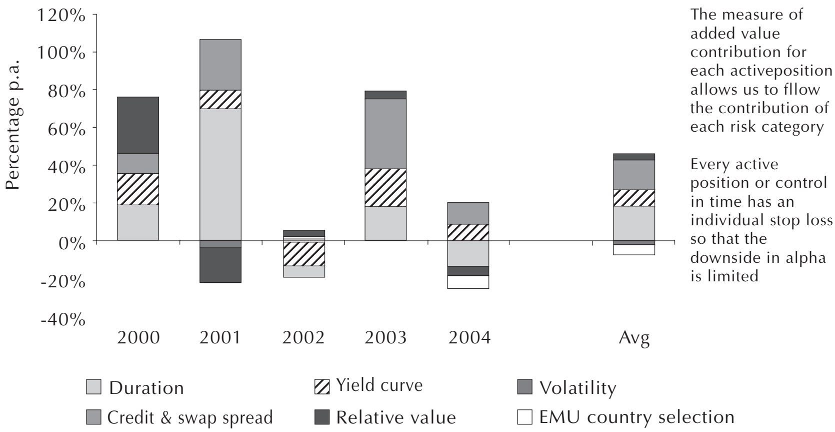
	Duration	Tera	Sectors	Quality	Other spread	Currency	Covariance	Totals	1 Day VaR (95*)
Asia Pacific	0.0121	0.0664	0.0000	0.0000	0.0000	0.0015	-0.0381	0.0558	18
Europe	0.0442	0.4268	0.1924	0.1149	0.0089	0.0002	0.2285	0.5354	169
North America	0.2613	0.3489	0.0010	0.0005	0.0041	0.0014	0.1649	0.4661	147
Covariance	0.0909	0.2508	0.0068	0.0027	-0.0023	0.0016	0.3637	0.4511	143
Totals	0.2805	0.6092	0.1926	0.1149	0.0095	0.0026	0.4585	0.8429	267
1 Day VaR (95*)	89	193	61	36	3	1	145	267	

*Note: VaR values are displayed in 1000's.

Graphic Nº 4

ANALYSIS OF ADDED VALUE BY RISK CATEGORY

PICTET EUR BONDS ALLOCATION



What often occurs –and these are discussions we have with our clients from European pension funds– is that usually pension funds do not want to take much credit risk or they do not want us to use futures or derivatives which naturally has an impact on our capacity to generate Alpha, which we measure very easily. The difference in yield between the portfolios that can use all instruments, with a well defined risk process, and those that can use derivatives is very clear. Derivatives, especially in the European and American markets, are very liquid which makes them very convenient to use for a fixed income active management.

Part II

Perfecting the second pillar

Performance of reformed second pillars in Latin America: response to criticism

Daniel Artana*

First of all, I would like to thank FIAP and ASOFONDOS for the invitation to share the results of the working paper carried out together with two collegues, Juan Luis Bour and Santiago Urbiztondo.

Second of all, I would like to thank FIAP for commissioning the task of critically reviewing the report the World Bank wrote last year on the pension issue, and straighten out two things: the report of the World Bank is a very vast report of more than 200 pages; obviously, there are things that in my mind are quite right, but what I am going to do is, given the restricted amount of time we have, to concentrate on the analysis of the criticism that I believe is not based on correct grounds and, therefore, I might appear in my review as criticizing the report more than it deserves.

It is also true that this is not an official report from the World Bank. As far as I know, there are differences of opinion within the Bank because that is the way in which the media has understood this issue in Latin American countries, and up to a certain extent it is easier to refer to it as the report of the World Bank.

I am going to try to synthesize the criticism that emerges with the report: the move towards capitalization systems for the second

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pillar did not contribute to increase coverage, it did not protect contributors from the confiscatory opportunism of the public administration, it had worse than expected fiscal results and distributive impact and led to a concentrated market of PFA or AFJ that charge high commissions when disability or life insurances are deducted and that, therefore, much harm is done to consumers, in this case, the workers.

What I am going to try to do is to cover each one of the issues and try to show where some of the weaknesses lie, in our judgment, in the report.

The first issue is coverage, an issue that was already talked about yesterday, during the morning session. Coverage depends on a number of factors, indeed, it was expected that a better alignment of the incentives, the fact that pensions were linked to what a person contributes, improved coverage; but there are other issues in between that have changed, as the obligation to work, the levels of poverty, issues relative to unemployment, the composition of labor demand, the increase of the retirement age, etcetera. That is, part of the reforms toughened the pay-as-you-go systems and up to a certain extent we can say that a subsidy was removed and that, ceteris paribus, it must have led to a fall in the coverage as opposed to a rise. For example, labor demand in some countries moved towards small businesses which was highlighted by the very report; and that must have led to a reduction in coverage due to the reasons mentioned yesterday morning.

In reality, then, we would have to have carried out a working paper in which those factors were isolated; and what the report basically does in one of the background papers is to basically correct by the level of income per capita of the countries and by the economic cycle, which records the highest or lowest unemployment of the countries, but it did not correct by the observed changes in the remaining factors I previously mentioned.

In spite of that, the econometric result in this background paper shows there has been a modest improvement in coverage. That is why the criticism of the World Bank's report seems somewhat disproportionate, regardless of the fact that something different was stated yesterday: one must trust in the second pillar reform in order to improve the coverage. This is another discussion and from which we might have analyzed the problem before.

So, the first issue is that the own evidence of the report, even without correcting other issues that might have harmed the increase in coverage, shows that coverage improved, and that is not what it is highlighted when analyzing the whole report.

On the flip side, there is a contradiction between whether or not an increase in coverage is really valued, because in another part of the report, when surveys carried out in Chile and Peru are analyzed -actually questioning the size of pillar number two, the mandatory saving pillar-, the report reads that workers reveal that, when given the opportunity, they do not opt to contribute more – i.e. voluntary contribution- or that they try to escape from the system when they are able to. Now, if that is the case, what the report is showing is that workers do not value the increase in coverage and prefer to save on their own, which shows a contradiction between both parts of the working paper.

The following point that can be seen is that there was a long held coverage problem in the region. The critical question is: what is the benchmark?, because there is obviously a coverage problem which is a concern for us all. And it is well and good to say that coverage needs to undergo some improvements, but the question is: what is the alternative? And the alternative was to remain in the pay-as-you-go-system.

Now, we can come up with a contrafactual analysis or look at those cases where the pay-as-you-go system and the capitalization system coexisted, and people could choose to stay in the pay-as-you-go system, and one of those countries was Argentina. If we analyze the contribution/participant relation against a coverage proxy, what we can find is that there effectively was a coverage decrease in the capitalization system, but if we look at the pay-as-you-go system, we will see that this decrease was much steeper. This means that, first, there are other issues affecting coverage. Now in the same country, facing the same conditions and despite the composition of the population contributing to the pay-as-you-go system in Argentina that is more concentrated in public officials, that must have led to a downturn in lower coverage. What data show is that coverage fell more in the pay-as-you-go system rather than in the capitalization system.

The second criticism, which more than anything is related to the Argentinean crisis, is that the reform did not protect contributors from fiscal opportunism. First, and remember this for something I will point out later, you know that in design terms it can be argued that when a pay-as-you-go system undergoes a reform towards a capitalization system, what is really being done is to make a debt that was hidden in the system explicit, and as that move is fiscally neutral, there should not be a negative impact in the vision people have of the fiscal problem, because this causes that the problem is brought forward, with which the issue of transition costs is no longer a problem. It can be argued in the opposite direction, in the sense that we do not have this perfect rationality (from a theoretical standpoint, the "Ricardian Equivalency").

The report argues the opposite, that is, it does not believe in the Ricardian Equivalency, and I think this point is reasonable because people do not see the future clearly. There is a perception when transitional costs are explicit, fiscal solvency deteriorates, and I think that can be accepted. But the point is that the only evidence cited in the working paper is that there is no evidence the reform has increased the country risk of the bonds. Therefore, it is more an argument of concept rather than an empirical one.

The next point which is extendedly highlighted in the report, is that the Argentinean crisis justifies the concern for transitional costs. Actually, the reform (and this is also highlighted in a background paper in the report), the Argentinian pension reform aforementioned explains solely four points out of the 18 points of the Argentine Product in which the debt increased between 1994 and 2001 when the fiscal crisis finished in Argentina. The rest of the increase in the pension deficit is explained by decisions that are not due to the pension reform; most of this rise in pension deficit is explained by a decrease in working contributions which has nothing to do with a pension reform. In fact, this could have perfectly been applied to the pay-as-you-go system and the objective was the increase of employment formality for better or worse. It is not the point of this debate to discuss whether it was a good or a bad decision, since it is not about transforming the pension system into a capitalization system. The same may be said about the decision of the Argentine national government as to take care of the provincial pay-as-you-go schemes deficit that was carried out to make an incentive for provinces to support specific reforms of the national government.

Therefore, when we see the specific cost of the pension reform, going from a pay-as-you-go scheme to a capitalization system, the impact on public debt is relevant so as to explain the debt crisis Argentina went through. Moreover, and this was presented last year in Lima, the Argentine crisis also took a stab at the pay-as-you-go system. When we compare the two systems, the impact was bigger for the pay-as-you-go system rather than the capitalization system. That is, even after we see the debt exchange that meant a present value remission of public bonds of about 70%, the accumulated yield of capitalization funds in Argentina, net of commission, accounts for roughly 5% a year; a figure that does not seem bad at all in virtue of the magnituded of the crisis.

Obviously, I am going to add up to this point that it is more prudent to finance the transitional costs of the pension reform with fiscal savings of another kind as was the Chilean case. But we do not have to overreact by saying that when the hidden debt of the pay-as-you-go system is made explicit, the fiscal crisis is inevitable. I think this is an exaggeration and the figures in Argentina do not support the argument that the pension reform is the culprit of the macroeconomic crisis in Argentina, even though there has been renowned American professors who have wrongly looked at these figures and supported this point as is the case with Mr. Stiglitz who looks at the aggregate figure without looking at the details.

When the aforementioned fiscal deficit is analyzed, the reports makes projections regarding the idea that reform should have improved fiscal solvency basically for two reasons: because it reduces the hidden actuarial debt in the pay-as-you-go systems, and because the reforms that have toughened up the pay-as-you-go system are also translated into lower payouts into the future. Now, the very report supports this point by saying that during the implementation of the systems, there appeared issues that led to higher expenses than the ones foreseen when the fiscal projections were made; and it also cites examples of fraud in Bolivia and some other countries.

The problem with this interpretation is that it does not mention the fact that these things might have equally occurred in the pay-as-you-go systems, therefore, the fraud issue is a problem that goes beyond the reform. In fact, we do not mention this point but one of the background papers written by Fiess, who is an economist with the World Bank, in which he mentions practically verbatim that everything that can be said about the Bolivian reform might have actually occurred in the pay-as-you-go system as well. It is curious that in the main text of the report this interpretation has not been a bit more balanced. Obviously, we are not justifying fraud, but actually frauds are determined by political issues which might happen either in one system or the other, and a priori we can say that the capitalization system should be better protected.

The next point was whether or not the pension reform helped the perspectives of economic growth of the countries, this and all that has been said leads anyhow to improve fiscal solvency because there is a higher growth, more contribution and better figures.

What the working paper states is that the impact of the reform on growth does not have clear empirical basis. It is argued there is a scarce empiric evidence, related more than anything else to the working paper by Corbo and Schmidt-Hebbel for the Chilean case, and citing a paper by Barr, which reads that different steps ought to be taken for the reform to improve economic growth: saving must increase which in turn must lead to an investment rise, and third, to economic growth.

Actually, in one of the background papers of the report four working papers are cited, in addition to that of Corbo and Schmidt-Hebbel, which empirically favors the impact of the reform on growth. Again, it is curious to note that the own evidence provided by the background papers of the report has been overlooked.

But there is here a big contradiction regarding what was said earlier. And this is a contradiction that appears two pages apart, that is, it does appear in the first chapter and then it is revealed in the last one but in the same report between two pages. For the reform not to increase saving we have to believe in the Ricardian Equivalency. Basically, the argument is that people are saving before the reform in other alternatives, and when they have a credible saving through the PFA, decide to save less in the rest and, therefore, everything that raises PFA saving takes away from somewhere else and the impact on private saving is null. There is an old discussion in the United States between Robert Barro and Martin Feldstein on this point that, definitely, is an empiric issue. But what we cannot do, in my mind, is to criticize the reform assuming it will provide the Ricardian Equivalency whereas before (two pages above) the report uses an argument of fiscal illusion with respect to the transition issues: if we believe in the Ricardian Equivalency, we automatically know the debt was hidden in the pay-as-you-go systems and the only thing that was done was to make it explicit, so, there was no room for fiscal illusion. It cannot be argued that the same people have fiscal illusion when the weight of the reform on public accounts is being evaluated, and do not have fiscal illusion when deciding their saving."

Then, arguing that saving does not rise by means of a conceptual argument based on the Ricardian Equivalency is contradictory and used to criticize the transitional costs mentioned above.

Nor the reform reviews empirical evidence on saving behavior in Latin America. The reading is a book by the IDB of 1997, ignored by the authors of the report, in which the movement of saving is analyzed, and the numbers do not suggest there that the Ricardian Equivalency takes place and, therefore, one should expect an increase in global saving.

The fact that saving increases investment and in turn investment increases growth is a general criticism to any increase in saving. Besides, the report does not mention that if there is a rise in saving, that is in itself positive because it lowers the vulnerability of the economies against the capital restrains that have made Guillermo Calvo so popular. In addition, in order for the investment not to improve growth, we must make low quality investment which can be the case but is beyond the scope of pension reform. So in this point I thought criticism was once again exaggerated.

Afterwards, there appears the issue of distributive problems, and the main criticism of the report is that commissions, as a percentage of the wage, are declining. And this I believe is a big mistake because when we look at the progression of a service such as the one provided by a financial intermediary, as is the case of the PFA, we must refer to the costs and the costs of the PFA do not depend on wages but up to a great extent on the number of participants; so a scheme which had been distributively neutral, would have been based on fixed commissions. Now, we might argue that if we look at it from an income distribution standpoint, a fixed commission obviously has an greater effect on poor people, but it is the same that occurs when we eat bananas: the price of the banana is the same for the rich or the poor; and there are not hundreds of report from multilateral organisms worrying about that but, at most, we can see how it is corrected after the fact. In other words, a reference to the costs must be made, and when that is done, actually variable commissions, fixed as a percentage of the wage or the contribution, are progressive and not declining.

After, it is argued that the cost of the PFA was higher for the first generations based on the Chilean experience. Actually, there is here a mistake in the account (dubbed accumulated charge) recognized later by the own authors of the report. Besides, they do not correct the accumulated charge which is a weighted average of the commissions, weighted by the yield, and by the fact that the yield in Chile was higher in the first years; it compensates the fact the first generations had a higher commission, which is stated in a footnote but not recognized in the main text.

I would like to concentrate now on the most critical issue of the report where mistakes are even bigger, which is to argue that PFAs charge high commissions because they are an oligopoly.

First, the report assumes that PFA are an oligopoly. There is not one study from the Offices of Competition Defense in the region that worries about this issue. It is interesting that those who are responsible for overseeing competition have not realized that there is a PFA oligopoly but the authors have.

Second, in the working paper there is no reference to any of the traditional tests an office of competition defense would have taken to check whether there is an oligopoly or not. Only the concentration of the two biggest PFA is mentioned in the report. To conclude from that evidence alone that there are anticompetitive prices is something that in competition defense has not been done for about thirty years. That is, they are applying a methodology that has been discarded many years ago by experts in competition defense.

As a matter of fact, we have many elements to explain the reason the PFA market has the characteristics of a highly competitive market; later we can say that part of that competition is dissipated in marketing expenses which are not the best for consumers (I believe this is quite arguable as well), yet that is not the point of the report but the fact that commissions are too high.

Hence, the report suggests, for example, it might be better to have centralized system as the accounts in Bolivia. In reality, on that the report is clearly wrong, makes a mistake, because in Table 7-3 which shows compared commissions, Bolivia is shown with a commission of 5% of the wage, and on the note in the table also reads that there is a contribution on accumulated funds of 0.2%; and in a previous working paper by the World Bank, Estelle James says that in addition, banks charge an additional 0.2% which is held from accumulated funds due to investment decisions. When we sum up these three factors and make a projection in time, then the Bolivian commission is equivalent to the commission in Chile which cancels the point out. Had they done the math correctly, they would have supported the Bolivian scheme which has a sort of centralized management.

Afterwards, the other alternative under discussion in the report is the issue of blind accounts (the PFA does not know the worker) that are intended to avoid marketing costs and are applied in Sweden. In Sweden, the commission accounts for 0.4% of accumulated funds, lower that in the Chilean case, which ranges from 0.7% to 0.8% with a 30 year projection, but what is not mentioned in the report %which is mentioned in a later working paper carried out by a Swedish economist% is the fact that actually the State is in charge of many of the expenses PFA or AFJP incur in the Latin American market, therefore, the problem here is that when we compare at an international level we must try to, at least, compare red apples with green apples, but what it is being done here is compare apples with tomatoes which results in an unreliable comparison; and above all, to get political recommendations out of this.

Another point that seems important to highlight is that in many parts within the report it is pointed out that commissions are high relative to mutual funds, and now, when we look at the evidence of the mutual fund market in Brazil or Chile, PFA commissions are in fact much cheaper, so we do not understand the foundation of the criticism. Besides, by recognizing a cost difference favorable to the PFA, the report assumes that the market of the mutual funds is also an oligopoly.

The issue of old age poverty prevention is a critical subject, and as we saw, there are other issues as well. I would add up that there are other schemes that cover poverty and oftentimes are managed by local governments, so, to rely on the pension system is not necessarily the best for the issue, but is a discussion that perhaps is beyond the objective of the World Bank's report or what we can argue in this panel for that matter.

There are conclusions I share, for example, in order to suggest that we must reduce the mandatory pillar, the report reads that we can rely; in other words, that the obligation to contribute is to rely on the fact that the State can choose better than the people, and actually that is to trust too much in the government, but at the same time they are suggesting that everything should be centralized on the government. So this is another contradiction.

Finally, I would say that unlike other reports of the World Bank which are regularly used as a reference for many issues, this report is not even balanced, because every time there is comparative empiric evidence, the conclusions are always negative towards the reform (it is systematic throughout the report). And it does not mention all the relevant information, whereas in general the reports of the World Bank are thorough (in this report, relevant working papers are ignored that might be useful to evaluate the pension reform in the region). Lastly, it is not even realistic because many times the alternative offered by the authors is an ideal Governmental solution, and the pay-as-you-go system is exactly a Governmental solution that failed; then, to think we can solve the problems that might have existed with a reform towards a capitalization system through a State reform that works ideally, seems to me naïve and exaggerated.

As a conclusion, it appears the World Bank goes form a pro-reform euphoria in the report of 1994 to a certain depression anti-reform in the current report. That is not what we expected from a working paper that it was known to have big repercussions. Thanks for your attention.

THE REMAINING AGENDA IN PAYG REFORMS

ANITA SCHWARZ*

Good morning, I'm sorry that I'm having to speak in English, but I think that you would suffer more with my Spanish, than you would with translation.

It is a pleasure to be invited here to speak to such a distinguished audience.

I am currently working in the World Bank, in the countries of Europe and Central Asia, and as you probably know, many of these countries have taken on the Latin American model and introduced fully funded, privately managed individual accounts within their pension systems.

I had previously worked in a number of Latin American countries and am delighted to be back here. Since I come from the World Bank, I feel that I should comment a bit, on Mr. Artana's presentation. The only thing that I want to emphasize is that the World Bank is a large organization and there are many different views within the organization.

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In a group like this, one might ask, “Why are we concerned about the Pay As You Go system?”

There are countries of course, that continue to rely simply on the Pay As You Go system, such countries as: Brazil, Paraguay, the US, and many in continental Europe.

There are also countries that have introduced funded systems that continue to have some element of a Pay As You Go system, such as: Argentina, Uruguay, Columbia, Peru, Costa Rica, the Slovak Republic, Hungary, Poland, Latvia, but even in countries that have moved almost exclusively to funded systems, the Pay As You Go system has some importance.

These countries include Mexico, Nicaragua, Ecuador, El Salvador, Chile, Bolivia.

1. Demographic Issues

All “PAYG” systems face pressure from an aging population. The aging of the population comes from both increases in life expectancy and decreases in the birth rate. This leads to higher dependency rates, with fewer workers being asked to support more and more pensioners.

Even PAYG systems that were completely balanced, with the aging of the population, become unsustainable and unaffordable and lead to pressures to raise retirement ages, reduce benefits and raise contribution rates.

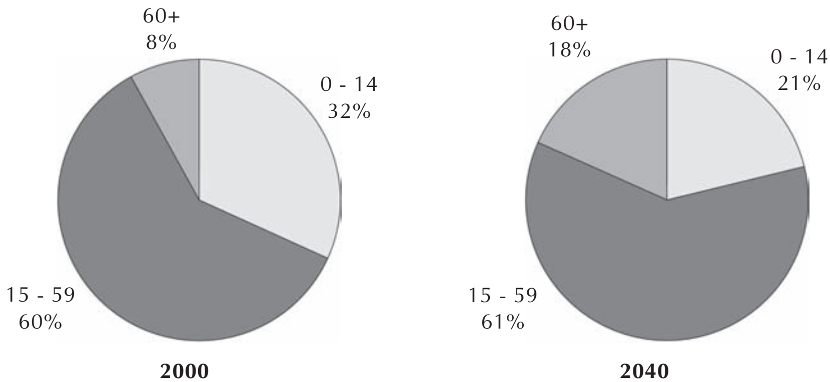
Graphic Nº 1 shows the situation in Latin America overall, where only eight percent of the population of Latin America, in the year 2000, were over sixty, but by 2040, we expect to see a more than doubling, to eighteen percent of the population being over sixty. And this figure looks at Latin America as a whole.

There are already countries like Uruguay which are considerably older and facing pressures from the aging of the population.

Several countries have tried to introduce automatic adjustments that will adjust the pension system to changes in life expectancy.

Graphic Nº 1

DEMOGRAPHIC CHANGE IN LATIN AMERICA



One popular measure has been to introduce the system of Notional Accounts, where contributions are still made on a Pay As You Go basis, but the contributions are recorded and interest is accumulated on the contributions with the amount that is in the notional individual account then divided by life expectancy to determine the amount of the pension.

This is increasingly common in the Europe/Central Asia region, with Poland, Latvia, Sweden and Italy having taken this approach.

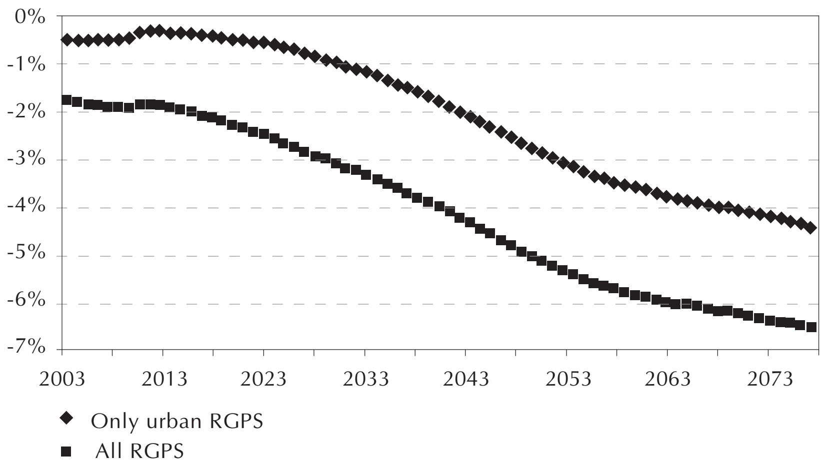
Another approach that has been chosen is that of the Brazilians, where the both the retirement age and the life expectancy at that age are included in the defined benefit formula for calculating the pension.

Another example is the Ecuadorian Law which automatically allows adjustments in the retirement age as life expectancy changes, with adjustments every five years, but this law was never implemented, so this has not gone into effect.

All of these efforts only deal with half of the aging problem, the changes in life expectancy, but they do not deal with the changes in fertility rates which are also occurring in these countries. For example, after Brazil introduced life expectancy into its benefit formula, there has been an improvement and there will be a period of about twenty years where the fiscal accounts are in balance, but after that, the deficits will become unsustainable again. Since the aging of the population arises from both changes in life expectancy and changes in fertility, accounting for the changes in life expectancy alone will not be sufficient to keep the systems balanced. Graphic Nº 2 shows the Brazilian case.

Graphic Nº 2

EXAMPLE OF COUNTRY WHICH TRIED TO INCLUDE LIFE EXPECTANCY



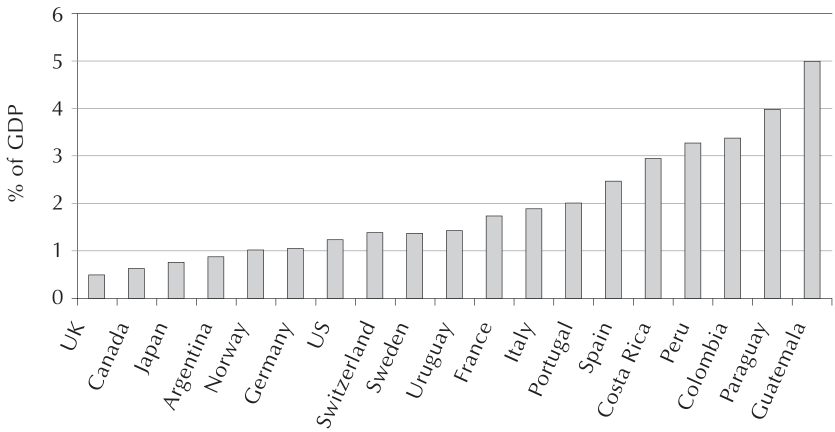
2. Generosity of the PAYG System

In addition, in most cases, the systems were not balanced to begin with; they were too generous. The systems were generous, partly because many categories of workers had gotten special kinds of benefits.

They were also generous because the minimum pension is often very high. For example, in Uruguay, the minimum pension is higher than the minimum gross wage. In many other countries the minimum pension is equal to minimum wage.

If you look at the amount of benefits per year of service in Latin America compared with the Pay As You Go systems in other richer countries, what you find is that the Latin American countries systems are generally more generous than other countries (see Graphic Nº3).

Graphic Nº 3
ACCRUAL RATES IN LATIN AMERICA VS. OECD
BENEFIT RATE PER YEAR OF SERVICE



The ones that have not reformed are the most generous of all. Exceptions are Uruguay and Argentina because their benefit rates are on par with the richer countries, but these graphs only show the pensions that come from the Pay As You Go system. The pension that comes from the funded system is on top of this, which might make the overall benefits in Uruguay and Argentina higher than in many of the richer countries. Since we know that the richer countries cannot afford the systems that they have, and are constantly proposing reforms, we have to ask the question, how can Latin America afford an even more generous system than the richer countries?

3. Political Economy Issues

Aside from the demographics and generosity which led to unsustainability of the PAYG systems, in some cases there was a recognition at the time of reform that the remaining PAYG system was still unsustainable, but political economy issues led policymakers to avoid further changes in the PAYG systems at that time. In most countries, which adopted funded systems, there was a package of reforms introduced which included both the introduction of the funded accounts and reforms to the PAYG system.

The benefit rates in the PAYG system were generally kept fairly similar to the old levels since there was a fear that the public was not used to depending on financial markets for pensions and would reject the entire package if an option for a relatively unchanged pension did not exist. There had not been a tradition of depending on financial markets for pensions, and the idea was that later, when people had become accustomed to private pensions and felt more comfortable, it would be easier to go back and reduce the Pay As You Go benefits.

As a result, even in countries that have introduced multi pillar systems, there are often sizeable deficits left in the remaining public systems that will need to be addressed.

I can give you some examples from my current region. In Poland, the PAYG system was moved to a notional accounts basis, but pensions were indexed 50% to wage growth and 50% to inflation. In just January of this year, the Poles decided to move to 100% inflation indexation because their previous policy was just unaffordable.

Similarly, in Slovakia, you can see from the figure that prior to reform, the system was completely unsustainable, even with the reform and adding the funded pillar, that just began in January of this year, the system is not going to be sustainable in the long term.

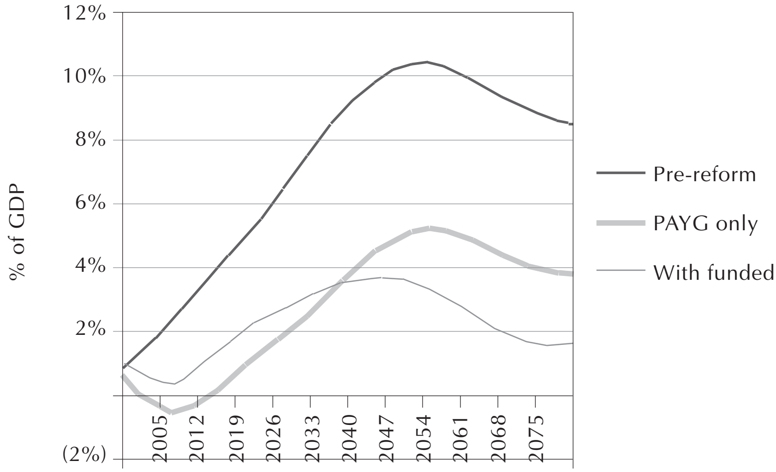
A long run deficit of 2% of GDP in the pension system is completely unacceptable to these countries since are of course interested in joining the European Monetary System. They are concerned about meeting the Maastricht Criteria of deficits no higher than 3% of GDP with a pension system deficit of at least 2% of GDP.

As a result, Slovakia plans to change its indexation from a fifty/ fifty mix of wage growth and inflation, to pure inflation indexation by 2010. They also intend to raise the pension age from sixty two to sixty five and they plan to reduce benefits by 2050 by about twenty percent (see Graphic Nº 4).

The same situation exists in Latin America, in the countries that have the multi pillar system. If you look at the deficits projected

Graphic Nº 4

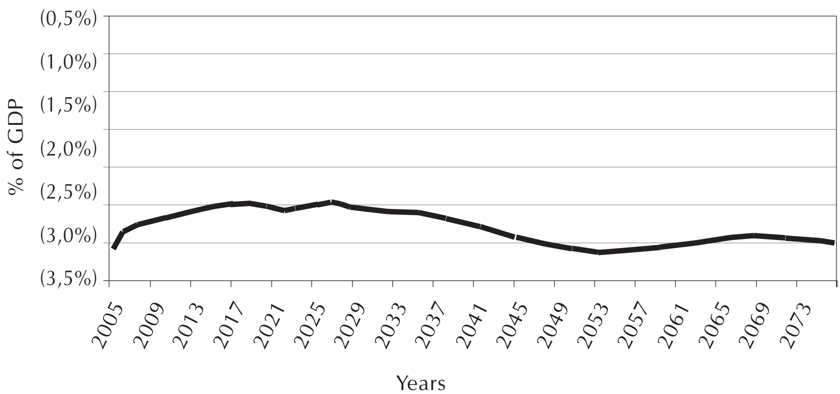
COMPANING PENSION DEFICITS WITH AND WITHOUT REFORM IN SLOVAQUIA



in the first pillar in the Pay As You Go system, you find that the deficit is around three percent and this will continue in the short term, medium term and long term. While Uruguay is not constrained by the Maastricht Criteria, it will find that a 3% pension deficit will constrain its growth opportunities (see Graphic Nº 5).

Graphic Nº 5

DEFICITS LEFT IN URUGUAYAN PAYG SYSTEM



4. Transition Costs

One of the other reasons why countries were reluctant at the very beginning to cut the Pay As You Go system drastically was the concern with high transition costs.

If everyone changed to the new funded system, just like in Mexico, the government would lose all the revenue going to the Pay As You Go system, but the government still had liabilities would still have pension expenditures to pay. The government still had to pay the pensions to the already retired and the bulk of the pensions to those that were very near retirement, because of the acquired rights of workers.

As a result, many governments preferred to keep some workers, particularly older workers in the old Pay As You Go system to continue generating revenue to improve the short term cash flow. They could not encourage or even force older workers to stay in the old system and reduce their benefits drastically at the same time, so they had to maintain a fairly constant level of old benefits in the old system to encourage people to stay in it. This applies more in older countries, like those of Central Europe but also in Uruguay and Argentina.

5. The impact that comes from the old pay as you go system in the countries that have moved towards the funded systems

Even in the countries that have moved more definitively towards the funded systems, there's an impact that comes from the old pay as you go system. In some cases, the level of the minimum pension has been set to be equal or similar to the minimum pension that has been guaranteed by the old system. The minimum pension was frequently already too generous, and now the high minimum pension affects the incentives for people to contribute to the funded system. If people are guaranteed a high minimum pension no matter how many years they contribute, they have an incentive to contribute only for the minimum number of years required to qualify for the minimum pension. There are also more extreme example like that of Nicaragua where there were such large increases in the levels of the minimum pension that the transition costs rose so dramatically that the government had to postpone the introduction of the funded pillar.

Transition costs are also affected by the other parameters in the old PAYG system. Since current pensioners and those soon to be retired receive benefits based on the old system, it is the old system parameters which affect the transition costs. If there is less reform in the PAYG system, the costs of transition will invariably be higher. When the costs of transition are high, governments are often tempted to force the private pension funds to buy more and more government bonds to easily finance their transition costs. So there is a direct impact from the parameters of the Pay As You Go system, even when it is closed to new entrants, to the functioning of the funded system, to the private pension funds, and to the interest rates that people will actually get in their funded accounts.

Finally, there is also the option, which some countries have, of being able to return to the old Pay As You Go system.

We can interpret the Mexican system as one which falls in this category, because workers who contributed to the old system have the right to have their pension calculated under the old system rules. If the old system rules result in a higher pension than what the worker would receive under the new system, the government will increase the worker's pension to match the old system pension. Obviously, the old system rules make a difference in how many pensions the government will have to increase.

In countries like Colombia, workers also have the option of returning to the old system throughout their career, and of course, the more generous that the old system is, the more people are willing to switch back and forth, and this makes it very difficult for the funded system to operate efficiently. In Colombia, this option is available for new entrants as well as workers who had contributed to the old system.

6. A Need to Re-Evaluate the Old Systems

So, there definitely is a need to re-evaluate the old Pay As You Go systems. People now have become accustomed to the individual accounts and generally like them. In every country around the world, many, many, many more people, often double, triple, quadruple the number of people, change to the new systems than were predicted before the new systems got started, and as the old contributors from the old system reach retirement age, there is little reason to continue paying more generous benefits than affordable in the PAYG systems just to induce people to stay in the Pay As You Go systems.

Even in countries where there is an opposition to the funded system, and where governments and some people are interested in trying to reverse some of the reforms, when people really realize that the choice is not between the generous Pay As You Go system of the past and the new funded system, but between a much, much, less generous PAYG and a funded system, the PAYG option may not look so attractive.

But the timing of when these changes are most appropriate will depend on individual country circumstances. In some cases, they can happen right away; in others, it might be more appropriate to wait. But ultimately, countries will not be able to avoid further changes to PAYG systems if they are part of the permanent pension system.

Thank you

The reformed pension systems in Latin America: some macroeconomic considerations

David Taguas*

Thank you and good morning. My presentation will cover some macroeconomic considerations on reformed pension systems in Latin America.

In principle, the need for reformed systems was demographic. According to UN projections, the dependency rate in Latin America will increase until it reaches 40% by 2050, close to the worldwide average. Also, a negative growth of the population in their working age is foreseen for the next decades, probably in the 30s; and logically, these individual capitalization systems introduced a greater technical and political ease for future pensioners to be able to cofinance their increase in life expectancy. You are well aware that the most effective way there existed to face these demographic changes was diversification. That is why, the scheme was articulated around the second pillar of individual capitalization and private management which will be the center of my presentation.

Latin America has led this introductory process of multipillar systems, although as we have seen across the region in the sessions held these days, there are several models: the substitute model, currently existing in Chile, the parallel model that exists in Colombia, and the mixed model in force in Argentina in which public and private systems coexist.

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During the previous sessions, the issue of economic impact that this system may have was covered, concluding that the evidence is not so robust. The development of reformed pension systems should increase the domestic saving rate, it should assume a rise in efficiency to allocate the resources and also an increase in economic activity rates and, of course, a rise in labor market formality. All of this should lead to a greater potential growth of the economies.

In the end, this will contribute to get the essential objectives of the social protection systems: the increase of substitutive wages and the rise in the coverage rate. In this sense, it cannot be forgotten that of all these are endogenous effects: all of them are obtained at the same time or none of them will ever be obtained by itself.

The debate on saving far exceeds the scope of this intervention. Nonetheless, it is usual to start from the assumption that funded benefits in pay-as-you-go systems reduce private saving, because if individuals want to maintain a "permanent consumption" during their life cycle, they need to save less. That was the discussion as it was stated in the 70s[1] and that is still currently in force. However, the results of a possible increase in saving thanks to the transition towards a funded system through capitalization techniques will depend on other issues: if there is an early retirement effect, heritage effects, and a transitional deficit financing, all of which are complex and controversial issues.

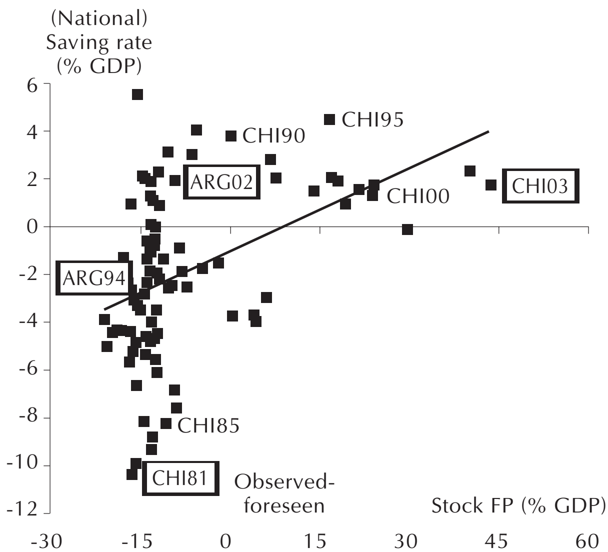
When we analyze the preliminary evidence of the economies in which there are pension systems with the second pillar of mandatory capitalization, we can find some kind of positive correlation between the development of these pension funds and the saving rate of the economy, the domestic saving rate. As an illustration, we can see in Graphic N° 1 the correlation between the accumulated *stock* in the pension funds above the GDP and the domestic rate of saving, controlled by the dependency rate and headcount in Latin American economies, with Chile and Argentina standing out as paradigms. A 10 point increase in pension funds will contribute to an increase of 0,5 basis points in the saving rate of the economy in the long term. Empiric evidence in Chile shows

[1] Martin Feldstein,"Social Security, Induced Retirement and Aggregate Capital Accumulation", *Journal of Political Economy*, vol. 82, n° 5, pp. 905-926, September-October 1974.

that the saving rate of the economy has gone up between 1% and 5% of the GDP[2].

Graphic Nº 1

CORRELATION BETWEEN ACCUMULATED STOCK IN THE PENSION FUNDS OVER GDP AND THE NATIONAL SAVING RATE



* Variables orthogonal to the rate of demographic dependency and the level of education.
Source: AIOS, World Bank and own elaboration.

The positive impacts that might be present on labor markets are based on an increase of labor supply and demand, due to the fiscal rebate that imposes a levy on the labor factor (both on the entrepreneur and the employee). Most importantly, however, is the impact on the level of formality. Literature does not seem to agree on the fact that formal employment has increased significantly as a proportion of the total employment in the economy. In Graphic Nº 2, the evolution of this formality rate in the labor market is represented, and that of per capita income for different economies in Latin America. Only in the case of Chile, effects can be found that over the last few years can be significant.

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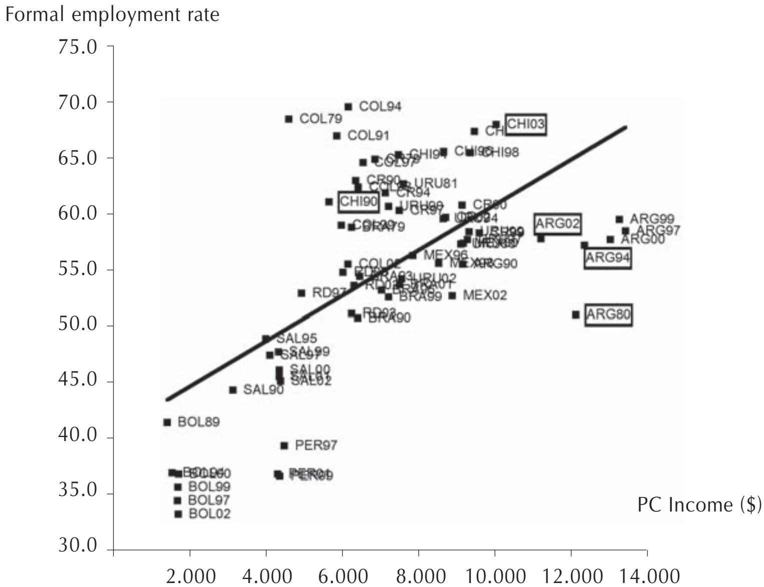
2 Vittorio Corbo and Klaus Schmidt-Hebbel,"Macroeconomic effects of the pensions reform in Chile", in *Results and Challenges of the Pensions Reform*, pp. 259-351, FIAP 2003.

Graphic Nº 2
FORMALITY, COVERAGE AND INCOME PER CAPITA



Source: ECLAC, World Bank and own elaboration.

Even though the fact that coverage is closely related to labor market formality is verified, and that this formality depends on the income level of the economies, there are other factors contributing to its extension. The trust in new institutions, the socio-economic characteristics (autonomous, agrarian sector) and learning can explain that in economies like the Chilean one, the level of formality exceeds the Latin American pattern for the per capita income level.

In fact, there is empirical evidence in the literature showing that sometimes prolonged periods are necessary for reform systems to start fostering contribution. Packard[3] establishes, for 18 Latin American economies, that participation only increases ten years

[3] Truman G. Packard,"Is There a Positive Incentive Effect from Privatizing Social Security? Evidence from Latin America", *Background Paper for Regional Study on Social Security Reform*, 2001. World Bank.

after the introduction of individual capitalization systems. That is, we have a transitional period that in some cases spans for a decade and that, therefore, in some economies is still not over yet.

Without regulatory changes, it seems feasible that a significant proportion of the participants requires minimum and welfare pensions; which advises to tackle the situation of the public sector, given the attainment of the objectives of social protection, and regulate the combination of private and public policies. The expectations in this regard were of fiscal consolidation and margin openness in order to carry out stabilization fiscal policies. Likewise, the explicit debt and transitional costs would be limited, reducing simultaneously the implicit debt of the system.

Public deficits in Latin America at large have been reduced from the 80s until today. Is that the result of a better macroeconomic performance or is there structural advances? For that, a simple method is implied so as to be able to evaluate whether there is a decrease in structural deficit in each one of the economies (van den Noord (2000)[4] and Corrales et al (2002)[5]), consisting in estimating the following expression:

$$\Delta sp_t = \beta\left((1-\gamma) + \gamma \frac{G_t}{PIB_t}\right)\Delta y^c{}_t + \varepsilon_t$$

sp=public balance - Yc= output gap - G=public spending level - PIB=GDP

where sp is the public balance and y_c represents the *output gap* – both expressed in variation - and g is the level of public spending and GDP is the Gross Domestic Income. The estimate of the parameters b and g allows for the direct quantification of the impact on budgetary changes of the economic cycle. In addition, under the assumption that g is different from zero, the expression reflects that the bigger the size of the public sector, the greater the response of public accounts to the economic cycle.

4 Paul van den Noord,"The Size and Role of Automatic Fiscal Stabilizers in the 1990s and Beyond", OECD Economic Department*Working Papers* nº 230, 2000.

5 Francisco Corrales, Rafael Doménech and Juan Varela,"Cyclical and Structural Budgetary Balances of the Spanish Economy", *Spanish Public Treasury / Spanish Economic Magazine*, nº 162, 3/2002, pp. 9-33.

In Table Nº 1, preliminary estimates are gathered for extreme cases of g=0 and g=1, in the main economies in Latin America for which public deficit was used excluding expenses due to interests

Table Nº 1
ECONOMIC CYCLE AND PUBLIC SURPLUS
(SEMIELASTICITY, ESTIMATED IN DIFFERENCES)

	Public sector (*)	Public spending (% GDP) 1990 (**)	2003 (***)	Semielasticity (****) Gamma = 0	Gamma = 1
Argentin	GG	0,21	0,24	0,09	0,46
Chile	SPNF	0,38	0,37	0,25	0,77
Colombia	SPNF	0,21	0,39	0,62	1,58
Mexico	SPNF	0,28	0,24	0,45	1,81
Peru	GG	0,19	0,19	0,17	0,86
Uruguay	GC	0,16	0,26	0,24	0,94
Venezuela	SPNF	0,35	0,31	0,74	2,54

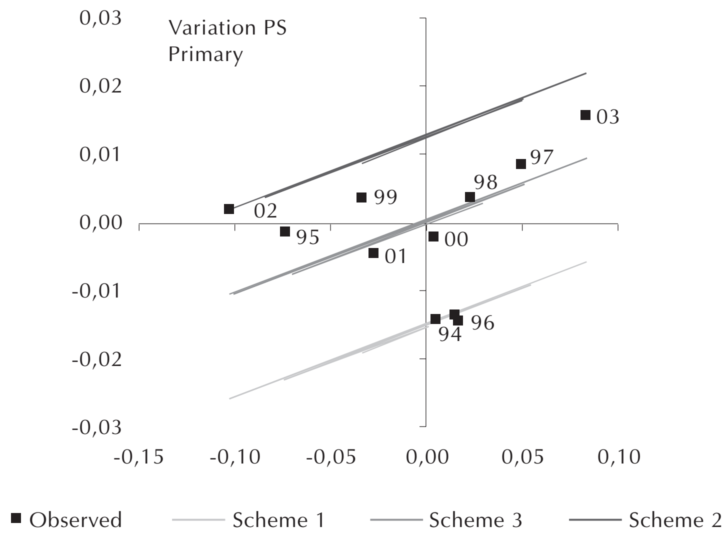
(*) SPNF: Non Financial Public Sector, GG: General Government, CG: Central Government.
(**) 1993 for the argentine case.
(***) 2002 for the chilean case.
(****) All estimates are significan to 99%.
Source: ECLAC and own elaboration.

As an example, in Venezuela the semielasticity of the public sector to the cycle is 2,5, significantly higher than that of Argentina (0,5). That is, public accounts in Argentina react slower before changes in the current economic conditions than in Venezuela. And on top of that, the size of the public sector is shown as an interesting variable to evaluate the results in the case of the economies of a bigger size in Latin America.

On this assumption, the different schemes of fiscal policy in the economies of the region are identified. For example, graphic Nº3 represent the Argentine case. The middle line represents the general scheme in which the deviation of the primary public surplus vis-à-vis the equilibrium are integrally explained by the contribution of the economic cycle (Scheme 1). On the other hand, the down line which spans the fiscal years of the period 1994 and 1996, represents an expansive case of fiscal policy (Scheme 3); whereas in 2002 (line of above, Scheme 2), there was a relevant fiscal restriction, that is, a very restrictive fiscal policy took place in the middle of the crisis.

Graphic Nº 3

PRIMARY SURPLUS OF THE FEDERAL GOVERNMENT OF ARGENTINA



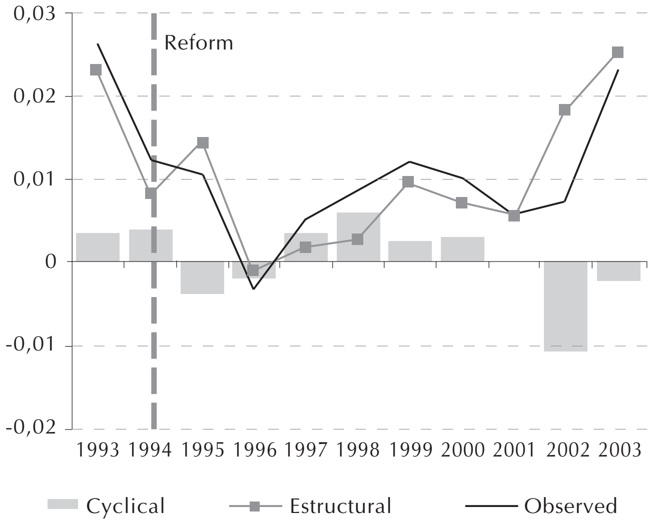
Soruce: ECLAC and own elaboration.
Scheme 1 goes by the intersection between axis X and axis Y.
Scheme 2 goes above
Scheme 3 goes below

Using these results, the primary structural public surplus can be estimated as the difference between the observed surplus which is explained by the contribution of the economic cycle and the size of the public sector according to the expression, for the case g=1:

$$sp^*_t = sp_t - \hat{\beta}\left(\frac{G_t}{PIB_t}\right)\Delta y^c{}_t$$

In Graphic Nº4 the breakdown of the public surplus is represented without interests in structural and cyclical components, supporting the fact that recent fiscal consolidation has been structurally eminent.

Graphic Nº 4
PRIMARY SURPLUS OF THE FEDERAL GOVERNMENT OF ARGENTINA
(% GDP)



Source: ECLAC and own elaboration.

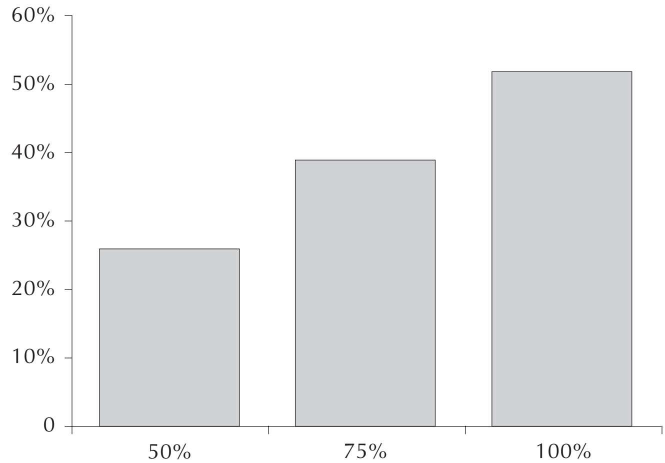
The conclusion obtained by applying this exercise for the whole region is that, in general terms, consolidation policies have been carried out, and in some cases, the years prior to the implementation of the reformed systems coincide. Likewise, the transitional costs are persistent but transitory. Finally, there is plenty of evidence showing that the explicit debt has presented a sharp reduction, with benefits in the long term, by endowing fiscal policy with room to maneuver in the future.

Every intervention on pension reform in Latin America must cover the challenges. As regards the percentage of participants belonging to the population of working age individuals as well as pensioners of 65 years of age or more, we must not forget that collective pension structures must be adapted, for which it is necessary to bear in mind their characteristics as they can be either autonomous workers or workers from the primary sector.

As far as the challenge of substitutive wages is concerned, Graphic Nº5 shows simulations for an average Chilean pensioner who will retire by 2025 after 40 years of contributions in the capitalization system, and taking into consideration a real wage growth of 2%. The substitutive wage will considerably depend on the density of the contributions and, logically, in order to analyze whether this level of contributions is appropriate, it is necessary to additionally evaluate the financing of coverage for contingencies, the commissions and the management.

Graphic Nº 5

SUBSTITUTIVE WAGE BY DENSITY

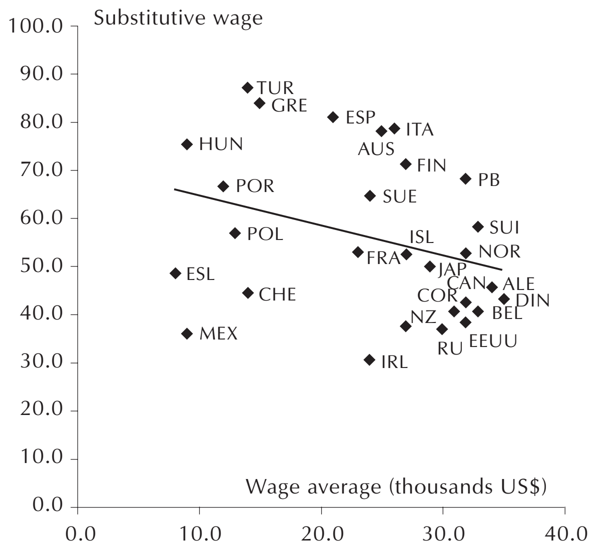


Chilean pensioner with 40 years of contributions in the capitalization system. Contributions 10%, real wage growth 2%, retirement 2025, real yield 5%.

Source: Own Elaboration.

Finally, it is worth highlighting that in the next decades real wage in Latin America will grow substantially. That is why, substitutive wages in the future will roughly be at the levels observed in most of the advanced economies in the world today. An important number of them are represented in Graphic Nº6, in which we can see substitutive wages relative to the average wage in thousands of dollars adjusted to purchasing power parity, and we can see that they account for roughly 40% to 50%.

Graphic Nº 6
SUBSTITUTIVE WAGE INCREASE



Source: OCDE.

TUR =Turkey; GRE= Greece; HUN=Hungary; POR=Portugal; POL=Poland; ESL=Eslovaquia; CHE=Czech Republic; MEX=Mexico; ESP=Spain; ITA=Italy; AUS= Austria; FIN= Finland; SUE=Sweden; SUI= Switzerland; FRA=France; JAP=Japan; NDR= The Netherlands; CAN= Canada; ALE=Germany; DEN=Denmark; BEL=Belgium; NZ=New Zealand; EEUU=USA; RUS=Russia; IRL=Ireland

In conclusion, systems have contributed –and they will continue to do so– to the development and economic stability in Latin America. The main current challenges are the increase in substitutive wages and the expansion of coverage to a wider population. The new system that is to be implemented must be of a global nature, must be a combination between public and private commitment. The welfare pillar must be reinforced and the basic pillar must continue to be mandatory. The lines on which we must work will have to be, without a doubt, the types of contribution, the financing of coverage of contingencies and investment management. The development of the third pillar during the next decades. Thanks for your attention. It has been a pleasure.

Chapter IV

The third pillar: voluntary saving plans

VOLUNTARY PENSION SAVING: THE EXPERIENCE IN LATIN AMERICA

GUSTAVO ALCALDE*

1. Introduction

When we talk about a voluntary saving plan, we refer to a saving mechanism that allows for a contribution above the compulsory rate for some of the following purposes: increase the amount of the pension, take early retirement (either voluntarily or forced by labor conditions); cover some pension gaps and, in the case of some countries in which these savings are liquid, use them for different purposes. The incentive around which this incentive is articulated is usually a tax incentive.

In option terms, there are basically two: first of all, individual pension plans, in which each worker, by taking advantage of the existing incentives of their Pension System, is building their own voluntary saving; second of all, collective pension plans, in which the linchpin is the employer as a promoter. The objective the employer seeks is to offer its workers an additional benefit that can help design an optimal turnover rate for the company. As examples of this last case are, as you may well know, the 401(k) plan in the United States and another one which is less known in our region, the Employment Plan in Spain that also has interesting elements.

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2. The current reality in Latin America

The analysis that I would like to carry out is a look at what is going on with this third pillar in most of the countries of the region where there is a Private Pension System. The most difficult part in developing this issue lay in the fact that there is very little added information on the third pillar. In fact, getting what we will look at was fundamentally carried out through personal contacts and by obtaining some figures from the AIOS website.

Commonly in every country, voluntary pension saving (VPS) is very peculiar and in some cases I might have not gotten completely certain aspects of it, therefore, I want to apologize beforehand if there is any mistake in the details described afterwards.

- **ARGENTINA**

– There are three alternatives in the Voluntary Pension System:

1. If the worker is a member of a AFJP, beside his/her voluntary saving, he/she can make voluntary contributions (Agreed Deposits).

2. Individual withdrawal Insurance, with companies that only operate with this risk and in which the yield and contributions accumulate so as to receive a life annuity in the future.

3. Collective withdrawal insurance, similar to the previous one but with a company in favor of its employees.

– These instruments have tax benefits and can be totally or partially withdrawn before retirement but subject to deductions that will decrease during the period they are in force.

– Funds of voluntary contributions represent approximately 1,0% of the total managed by the AFJP.

– The yield of voluntary funds is the same as that of compulsory funds, and the historical average is a real 9,9%

– Currently, there are no legal initiatives for the incentive of voluntary pension saving.

- **BOLIVIA**

– There are no Voluntary Pension Saving mechanisms, only Mandatory Pension Saving has been implemented.

– Currently, there are no legal initiatives under debate in order to implement voluntary pension saving.

- **CHILE**

– You will be able to see their main characteristics in greater detail in point three of this publication.

– There are two alternatives for the Voluntary Pension Saving:

1. Voluntary contributions.
2. Agreed Deposits.

– These options have tax benefits, they can be invested in different financial institutions (PFA, Bank, Insurance Co., Mutual Funds, etc.) and both self-employed workers, dependent workers as well as contributors to the INP can do this. Unlike agreed withdrawals which can only be withdrawn upon retirement, voluntary contributions can be withdrawn at any moment.

– Voluntary pension saving funds represent approximately 2,1% of the total managed by the PFA (USD$ 1,297 billion as of December,2004).

– The yield of the voluntary funds is the same as those of the mandatory funds, and the historical average is a real 10,2%).

– Currently, there are no legal initiatives for the incentive of voluntary pension saving.

- **COLOMBIA**

– There are two alternatives of Voluntary Pension Saving:

1. Individuals.
2. Employers.

– Individuals and employers plans have tax benefits, management fees differentiated by amount and seniority, different portfolio alternatives and withdrawal commissions according to the tenure, even though they do not normally apply for employers plans

– Participants of voluntary funds represent until dec/04, 4,0% of the total of participants of the mandatory system, and the fund accumulated by voluntary contributions represent roughly 13,9% of the mandatory fund.

– The average yield of voluntary funds as of dec/04 reached 9,1% nominal, whereas the yield of mandatory funds as of the same date was 17,2% nominal.

– Currently, there are no legal initiatives to foster voluntary pension savings.

• **EL SALVADOR**

– There exist but scarcely developed.

– Voluntary pension saving does not have fiscal benefits with detriment to its growth.

– The voluntary saving fund is not over 1,0% of the total mandatory saving fund

– Currently, there are no legal initiatives for the incentive of voluntary pension saving.

• **MEXICO**

– There are two alternatives of Voluntary Pension Saving:

1. Voluntary retirement contributions.
2. Complementary retirement contributions.

– Both plans have tax benefits on condition that contributions comply with the established tenure requirements.

– Voluntary Contribution plans are available for withdrawal at least once every semester, whereas Complementary

Contribution plans will only be available for withdrawal when the participant has the right on compulsory contributions, either to complement his/her pension or to get them in a lump sum payment.

– Historical yield of voluntary funds reaches a real 7,3%, whereas historical yield of compulsory funds reaches a real 7,5%.

– Currently, mechanisms that foster saving are being sought after in individuals who are neither part of the public system nor of the private system in order to provide them with a dignified pension.

- **PERU**

– There are two Voluntary Pension Saving alternatives:

1. Pension Voluntary Contributions offer the participant to increase the amount of hi/her pension upon retirement and even the possibility to take early retirement.

2. Non pension voluntary contributions offer a saving alternative for the participant.

– Voluntary Pension Saving is not well developed due to two fundamental factors:

a) It does not offer fiscal benefits. Currently, the contributions to these instruments are not tax deductible.

b) There is no limit for the contribution to the mandatory system on gross income which gives little room for voluntary saving.

– Since the voluntary system is not well developed, participants and the managed fund account for only 0,3% of the compulsory system .

– The yield of voluntary funds is the same as that of mandatory funds, and the historical yield is a real 7,7%.

– Currently, there are no legal initiatives for the incentive of voluntary pension saving.

- **DOMINICAN REPUBLIC**

– There are two alternatives of Voluntary Pension Saving:

1. Voluntary Pension Saving within the same mandatory scheme.

2. Private companies pension plans operate under the same law as that of the compulsory system and complementary in its nature.

– Voluntary pension saving has fiscal benefit only in favor of the participants who at the time the benefit was in force (May 2001) were 45 and up.

– The voluntary contributions fund accounts for approximately 3,1% of the total mandatory fund

– The yield of voluntary funds is the same as that of mandatory funds, and the historical yield is a nominal 22,0%.

– Currently, there are no legal initiatives to foster voluntary pension saving.

As you can see, countries like Uruguay and Costa Rica are not part of this analysis given the difficulty I came across to obtain this information.

As a matter of fact, conclusions flow easily and are somehow obvious. There is a low level of development of the voluntary pillar in the region; this quick revision makes it very clear. In addition, what is more worrisome, is the fact that there is an absolute absence of legal initiatives towards the strengthening of the future. The truth is, we think as an industry that there is a clear challenge ahead of us.

3. The Chilean experience

When we analyze those countries that in terms of the VPS have greater volumes or have been making greater efforts in promoting it, we realize that in Colombia there is a reality which has some interesting aspects, without a doubt; and another reality is that of Chile since a series of legal modifications took place in 2002 which have meant a relevant dynamism in the third pillar, even though it is not widespread for the whole population.

In Chile, voluntary pension saving is carried out individually, there are, therefore, mechanisms for each member, in his/her individual capitalization account, to be able to save above mandatory contribution thus having the opportunity to design their own pension plan. The objectives are those which we analyzed earlier: increase the amount of the pension, take early retirement, cover some gaps, save for different purposes, and also, for many people, it is a good unemployment benefit mechanism, especially for high and medium income. The incentive is provided directly by rebates on the gross tax return base.

VPS in Chile has been in existence since the individual capitalization system started back in 1981, but it actually took off in March 2002 when several legal modifications were implemented which are summarized in Table Nº1.

The two existing alternatives to build a VPS (see Table Nº 2) are voluntary contributions and agreed deposits whose characteristics are:

Table Nº 1

VPS started with the Individual Capitalization system, but it took off in March 2002
Before: – Tax benefit that allowed for the discount of the VPS from the income tax – Resources went to the only straight existing fund, the Mandatory Contribution Fund. – VPS was not liquid. It could only be withdrawn as a grant at retirement. or in the case of agreed deposits with the pension. – It could only be invested in PFA which could not charge for the service. – Only dependent workers.
March 2002: – The tax benefit cap was marginally widened (from 48 UF a month to 50 UF) – It was open to other financial institutions (Banks, mutual Funds and Insurance companies among others) and both these institutions and the PFA can charge for this service. – This reform coincided with the implementation of the multifunds which permitted to invest in funds different from those of the Mandatory Contribution – The VPS through the Voluntary Contribution is always liquid, and the Agreed Withdrawals can be withdrawn as part of the freely disposable surplus at retirement· – It was open to self-employed workers and contributors of the INP

Table Nº 2

Two types of VPS
Voluntary contributions – Contribution with a tax benefit up to 50 UF a month since they are deducted from the gross income – For self-employed workers as well as dependet workes – They are liquid before retirement
Agreed deposits – Deposits whose amount is agreed between the worker and the employer – They have no limit in the amount – They can only be withdrawn at retirement or with the pension
Both types require the mandatory saving contribution whose amount limits the tax benefit

As I mentioned before, incentives are mainly of a tax nature (see Table Nº 3).

Table Nº 3

Tax benefit of the VPS: permits to defer and rebate gross income payment
– VPS is deducted from the gross income tax base with a cap of 50 UF a month or 600 UF a year – When withdrawing the VPS, it is added to the gross income – The advantages are twofold: Defer the income payment without financial costs and take advantage of the high progression on the gross income scale to save during high income periods and consume during low income and tax rates periods

INCOME TAX TABLE (APRIL 2005)

Income bracket (US$ a month)	Marginal rate %
0 - 700	Free
701 - 1.570	5
1.571 - 2.600	10
2.601 - 3.640	15
3.641 - 4.679	25
4.680 - 6.239	32
6.240 - 7.799	37
7.800 o +	40

One of the relevant sale arguments to promote the development of the VPS is make participants see the favorable impact it has on their pension (see Table Nº4 and Table Nº5). An effect that we can observe in the following tables. In the case of Chile, it is important to remember that mandatory contribution has a maximum limit of 60 UF a month

Table Nº 4

IMPACT OF VPS IN PENSION VALUE: THE CASE OF MEN (APRIL 2005)

Gross income (US$ a month)	Gross income (UF/month)	Starting age VPS	Only mandatory pension	with contribution pension M.C. & VPS	Replacement rates W/O VPS %	Replacement rates W/VPS %
862	30	30	863	1.583	100	184
		45	863	1.294	100	150
1.724	60	30	1.733	3.173	101	184
		45	1.733	2.596	101	151
3.448	120	30	1.733	5.100	50	148
		45	1.733	4.741	50	138

Mandatory contribution: 10% of gross income
Voluntary contribution: 10% of gross income
Yield rate: real 5% annually
Retirement age: 65 years
Contribution density: 95%

Table Nº 5

IMPACT OF VPS IN VALUE OF PENSIONS: THE CASE OF WOMEN (ABRIL 2005)

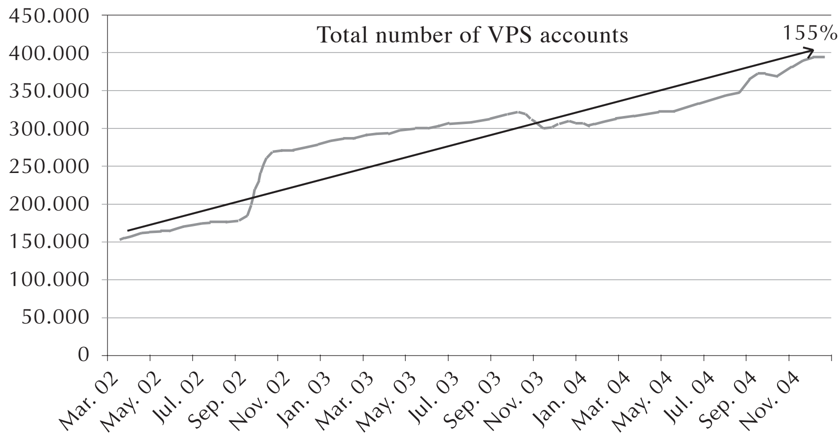
Gross income (US$ a month)	Gross income (UF/month)	Starting age VPS	Only mandatory pension	with contribution pension M.C. & VPS	Replacement rates W/O VPS %	Replacement rates W/VPS %
862	30	30	485	886	56	103
		45	485	716	56	83
1.724	60	30	975	1.776	57	103
		45	975	1.436	57	83
3.448	120	30	975	2.863	28	83
		45	975	2.652	28	77

Mandatory contribution: 10% of gross income
Voluntary contribution: 10% of gross income
Yield rate: real 5% annualy
Retirement age: 60 years
Contribution density: 95%

What has occurred since March 2002 with the changes that were introduced? As I said, a fairly significant dynamism has been produced as shown in Graphic Nº 1 and Graphic Nº 2. A steep increase in the number of VPS participants has taken place after the changes and the accumulated balance has gone up 139% since the VPS regulation was in force (Figure Nº 2)

Graphic Nº 1

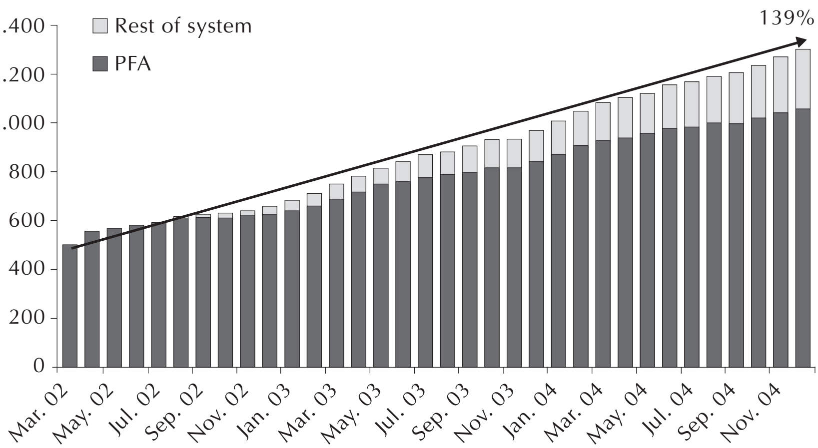
TOTAL VPS ACCOUNTS



Source: SAFP.

Graphic Nº 2

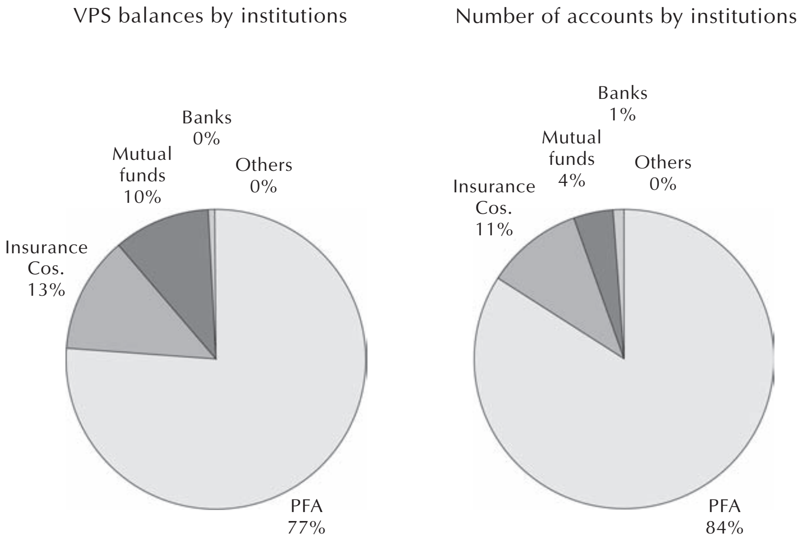
TOTAL ACCUMULATED BALANCE (MM US$)



Source: SAFP.

In managing the VPS, as mentioned before, the participation of several financial institutions was also allowed. Industry market share as of December 2004 was as follows (see Graphic Nº 3):

Graphic Nº 3
MARKET SHARE BY TYPE OF ADMINISTRATOR



Accumulated amount in VPS as of dec. 2004: US$ 1.297 millions

An essential complement for the voluntary pension saving was its launching, around the same time, of the so called multifunds (see Table Nº6). In Chile, we previously managed one fund. There was a second fund but it was for a restricted segment of participants. Five funds were authorized so as to be in condition to make a wider offer to our clients. And when it comes to voluntary pension saving, participants unquestionably demand several investment alternatives from which to choose.

The figures show that the greater proportion of VPS accounts belong to contributors with greater gross income, because the tax benefit aims in that direction (see Graphic Nº4). Nevertheless, at

Table Nº 6

VPS & Multifunds: an essential complement

Objective: Increase the expected value of the pension

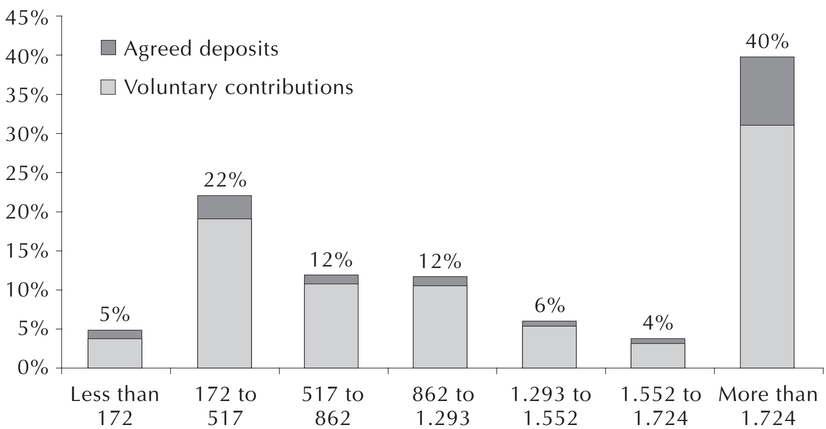
- 5 pension funds are created, differentiated by the invested proportion in variable income
- Allows participants to exercise their preferences with regard to yield, risk and investment horizon
- The VPS can be invested in a fund different than that of the mandatory saving
- The VPS can be invested in any fund and it can even be distributed in 2 of them

Limits of variable income investment

	Maximum permitted %	Minimum permitted %
Fund A	80	40
Fund B	60	25
Fund C	40	15
Fund D	20	5
Fund E	Unauthorized	Unauthorized

Graphic Nº 4

PROPORTION OF CONTRIBUTORS BY GROSS INCOME BRACKET
(APRIL 2005)

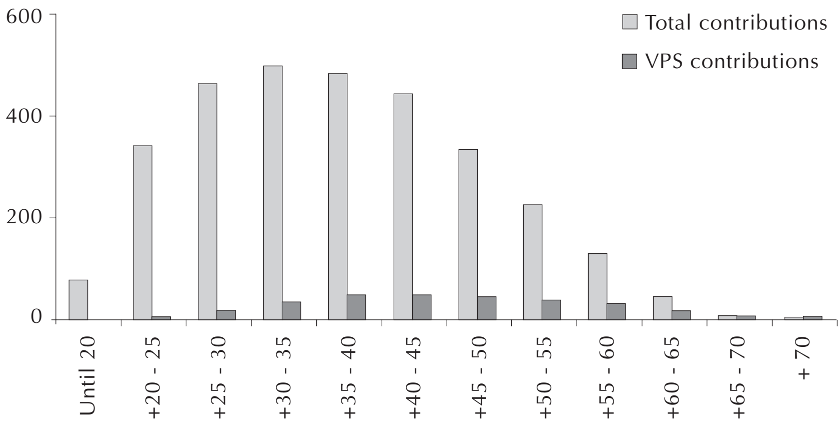


Figures in US$
Source: SAFP.

the lowest levels, especially in the second bracket, there appears an interesting percentage of participants who do not have a tax benefit but who are also saving.

But in spite of the interesting growth the VPS has undergone during the analyzed period, it only reaches 11% of the contributors and, additionally, it is concentrated on intermediate ages: a few young people, a few old people. (see Graphic Nº5)

Graphic Nº 5
LOW VPS COVERAGE



What are still the reasons for this low coverage? Mainly, the incentive, as we have seen, revolves around the tax system, then it only benefits taxable incomes. According to the tax table seen before the greater the benefit, the greater the gross income, and low and medium income contributors who are exempt form income tax do not have special incentives.

Therefore, I would like to briefly comment on two pending challenges in order to increase Third Pillar coverage. One of them aims to a direct subsidy for low and medium income contributors which to a certain extent helps balance the incentive high income contributors receive. In Chile, contributors with a monthly income below 700 dollars (April 2005) do not pay taxes, so it would be necessary to look for an incentive formula for them to eventually find saving more appealing.

Another pending challenge in terms of voluntary pension saving is that of self-employed workers who account for 30% approximately of the labor force.

The problem, in fact, is much wider. It is not compulsory for self-employed workers to contribute in the pension system and, therefore, an important part of the current coverage deficit is due to this issue.

In conclusion, we can see that the VPS has a number of benefits for the pension system as a whole. First of all, the person who contributes in the VPS has a strong stimulus to play an active role in managing his/her pension funds, which makes him/her greatly increase the sense of ownership. A participant who contributes in a VPS is concerned as to whether he has received the information sent by his/her PFA with the balance and yield of the savings he/she has gained in his/her funds, is attentive as to shifting his/her savings to another fund if the market is expected to move in such and such direction and, additionally, is also worried about the commission charged by the administrator for managing his/her account.

The VPS motivates workers and imposes the Administrators the challenge of playing the role of advisors that allows the participant to plan their future pension. This positive vision is also contagious for the perception on mandatory funds. They are no longer perceived as taxes but as something much more tangible. Everything that was mentioned before, in turn, has a positive impact on the formality of the labor market.

After more than three years the analyzed modifications were implemented, it can be surely said that the voluntary pension saving in our case is a fundamental complement for the compulsory saving that is built through the Second Pillar.

Promoting personal saving. The power of inertia

Andrea Repetto*

I would like to greatly thank FIAP and ASOFONDOS for the invitation to participate in this seminar and for giving me the opportunity to share the issues on which I have worked, as well as to present you an alternative vision of the voluntary savings problem.

What I would like to show you today are some ideas and evidence on what makes people tick on some level, and what gets people to voluntarily save on a second level. The main idea of my presentation is found in the title I chose for it: the power of inertia. What I am about to show you is evidence relative to the passivity of people with respect to saving, in order to later debate which are the sources and consequences for the saving policies of that inertia.

Many of you have studied economics, and if you remember, economic theory is based on a series of axioms on how people behave. These axioms are summarized in the word rationality, which means that people know what they want, know how to get it, have stable preferences, use information objectively, understand the law of great numbers, and apply sophisticated laws of probability in their daily behavior.

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Saving and consumption are covered in theory as a problem of intertemporal optimization: I know that in 20 or 30 more years I will retire and, therefore, it is necessary to do some planning now. Likewise, there are other reasons for saving such as sickness and unemployment, for which is useful to have insurance. In other words, economic theory predicts that people wish to soften their consumption throughout their lives, to have a somewhat stable consumption with no ups and downs, or big drops, and that saving allows for the reduction of this variability. Finally, on this tone, the theory indicates that the relevant price to motivate saving is the interest rate, although it is not clear regarding the sign of this relationship.

Yet, traditional theory forgets the fact that we are very human; it forgets the fact that we are neither *supermen* nor *superwomen* and that we do not come from *Krypton*. In reality, we have limitations that make it difficult to do tasks we know are good for us, and the savings area is particularly special to think these problems through.

First of all, the decision of how and how much to save is complex. What is the best?: 5%, 6%, or 10% of the income? For how long? In what instrument to save: mutual fund, a fixed interest rate account or equity? If so, in what stock? Uncertainty is also an issue (life expectancy, health, the number of family members, employment, etc). Anyhow, for most people, it is not easy to elaborate an optimal plan that takes every variable into consideration.

Secondly, a vision of the future is required: knowing when the saving will be needed and understand that we are vulnerable and many things can happen to us. So, it is necessary to be able to think about the future objectively.

Thirdly, even though we can outline a plan and also carry it out, a strong will is required to do so, and we must avoid the temptation to spend all we have.

Lastly, there are a few possibilities to "practice" saving and amend the mistakes. Traditional theory predicts that people are not systematically wrong. This is true in repetitive tasks. If I go to the stadium to watch a soccer game and I want to buy a soda, I will buy the cheapest. Everybody would surely do the same. We have bought so many times over, that for the same quality, we have learned how to choose the cheapest. But we have not learned how to save because we cannot observe what occurs when we are wrong. We retire only once, and if we get to retirement with no savings, there is no other choice to go back and start again. It is not easy to anticipate to the consequences of not having been able to save enough, and we realize that a bit too late.

There is a new research field in economics -actually it is not that new, it goes back to the 50's- dubbed *Behavioral Economics*, which analyzes the implications, in the workings of the markets, of human limitations as I have just described them. As regards saving, we have learned that people are passive in their decisions. This passivity of the savings plan design and not the tax incentives make people save much, less or simply nothing.

In the remaining moments of my talk I would like to show you the following ideas: First, I want to discuss the elements of human psychology that make people act passively. Afterwards, I will illustrate this inertia using evidence from the 401(k) plans in the United States. I will show you how small details of the design affect the participation, contribution, and the workers' portfolios. Finally, I will propose some lessons as to how to motivate the voluntary saving.

We will talk first of the basic principles. Three concepts in the literature predict that people act with inertia: limited rationality, temporary inconsistencies and loss aversion.

Limited rationality recognizes that we lack the cognitive abilities to solve difficult problems, particularly optimum saving. People understand that saving is good and useful, but it is so complicated to decide what is optimum, that is preferable not to think about it. In general, we avoid facing difficulties, we are paralyzed before things we do not perform well. Saving for retirement is difficult, and if we add the fact that old age has a negative connotation in our societies, people then choose not to think about it, and therefore, not to do anything about it.

The second issue is temporary inconsistency, or the inability to carry out tasks with present costs and future benefits. We plan to go on a diet, go to the gym, quit smoking....but tomorrow. Procrastination is a will problem: we know there are long term tasks that are good for our own welfare, but we lack the ability to start with them immediately. This inability is colluded with our excess of confidence. When we promise ourselves that tomorrow we will start with our diet, go to the gym and quit smoking, we do this honestly believing in our future action capacity. But come tomorrow we do not do it because we do not have the necessary will. The problem lies in that in spite of the fact that we have failed in our commitments of behaving better, we keep on believing we will do better in the future. A real life example: I have purchased a mobile phone plan which provides a fixed amount of minutes at a low cost, and a high cost for every minute that is not covered by the plan. I systematically use more minutes than those I originally purchased, and when the bill arrives I promise myself to speak less next month, which I never do. The rational thing to do would be to change my plan, given my inability to speak less on the phone. But I do not do so because I still expect to spend less in the future.

The third concept is loss aversion: we like winning and get hurt when we lose, but the sense of losing is twice as the pleasure we get from the former. Therefore, in an uncertain context, we stick to our behavior and past options so as to avoid eventual losses.

What I would like to show now, using what we have learned from the American experience in the 401(k)s, is that this inertia can get savings. If the design is correct, passiveness can generate substantial savings. The importance of the design is in the details. In the traditional theory, details do not matter; if someone wants something and knows it is good, he/she takes it regardless of how it is presented. Nevertheless, the presentation does matter in practice. For example, in Chile every product in the shelves of a supermarket is at 1.60 mt. of height, how tall women are in Chile. The same product, but from brands that generate less earnings for the seller, are at a lower height. If the theory is correct, and the person knows he/she wants something cheaper, he/she only needs to bend. But it turns out we do not make that little effort and tend to buy what is in front of us, which is exactly what I want to show you using saving data of 401(k)s: people's behavior depends much on how products are presented.

I know you are familiar with the 401(k) plans and Dennis Duffi will talk about them in more detail, but, in general terms, a 401(k) plan is a saving vehicle offered by American employers to their workers. They voluntarily save a fraction of their salary in an individual account and obtain a subsidy from the employer up to a percentage of the saved income. They can save more than that, but that extra money does not grant a subsidy.

Income flows are tax deducted so long as the funds are not withdrawn; there is a withdrawal penalty before 59 and a half years of age. If the worker changes employer, the funds can be transferred to another 401(k) account or to an individual account. Different investment alternatives are offered, and some plans even permit to ask for loans. Finally, companies must comply with certain anti discrimination regulations in order not to disproportionately give away these subsidies to the *management*.

What does traditional theory predict? It predicts that people should take a 401(k) plan when convenient and that it should not be taken in case it is not convenient. There is heterogeneity in likes and needs, which cannot be good for everybody. However, there are many circumstances in which this is evidently good, but people do not enroll. And what is more, the way in which the plan is presented makes people decide to either enroll or not, or to invest in certain assets or not, regardless of the personal convenience. This is the kind of evidence that I would like to show next.

Let us talk about participation. There are three ways of enrolling into a 401(k) plan. First of all, there are companies that offer what is called standard enrollment: when a person is hired by a company that offers 401(k)s, the person must voluntarily choose whether to participate or not. If the person wants to participate, he/she must call a toll free 800 number. If he/she does not call, this person is not enrolled.

The second case is automatic enrollment. Here, the worker does nothing and he/she is automatically enrolled in a base plan. If he/she does not want to participate, this person must call the toll free 800 number to cancel his/her enrollment. In summary, in the case of standard enrollment, the *default* is to not be enrolled; in the automatic enrollment, the *default* is to actually be enrolled. In both cases, the cost of getting out of the *default* is trivial.

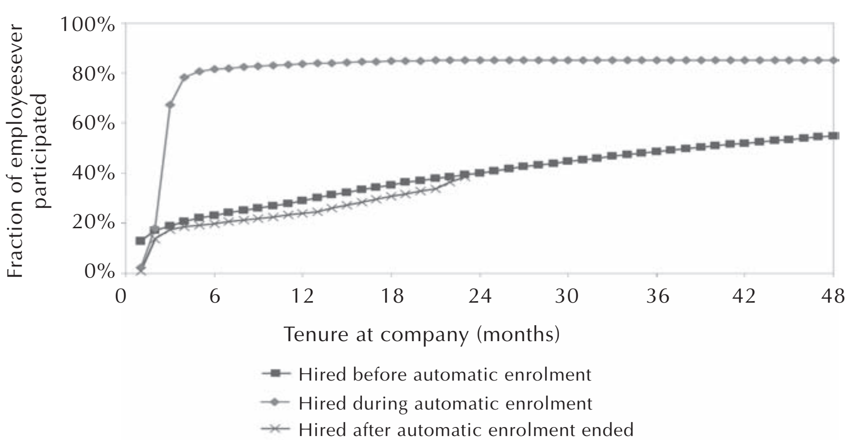
The third alternative, which is an intermediate alternative, is called active enrollment. Once a person is hired by the company, he/she has a deadline (typically 30 days) to indicate if he/she wants to participate or not. In this option the person is implicitly being asked to sit down and mull over the decision. Since there is no *default,* a base plan, the decision is not delegated onto the employer.

These three options create very different participation rates. The first graph, taken from choi el al.(2001), shows a company with a standard participation plan which then was substituted for an automatic enrollment rule. After a while, the company went back to the original standard enrollment. In the horizontal axis, the number of months a person has been working for the company is shown. In the vertical axis, the percentage of workers participating in the 401(k) plan is shown. The middle line shows those who enter by the standard enrollment system, in which one has to call to be enrolled. the line of above shows those who were hired at the time the participation was automatic, where it is necessary to call in order not to be enrolled. Lastly, the line of down shows the period in which the company went back to the original standard enrollment. It is the same company through time.

As you can see, participation rates under different options are dramatically different. In the first months of employment, standard enrollment is associated with the participation of 20%, whereas automatic enrollment makes up for 80% of the participation

Graphic Nº 1

401(K) PARTICIPATION BY TENURE AT FIRM: COMPANY B

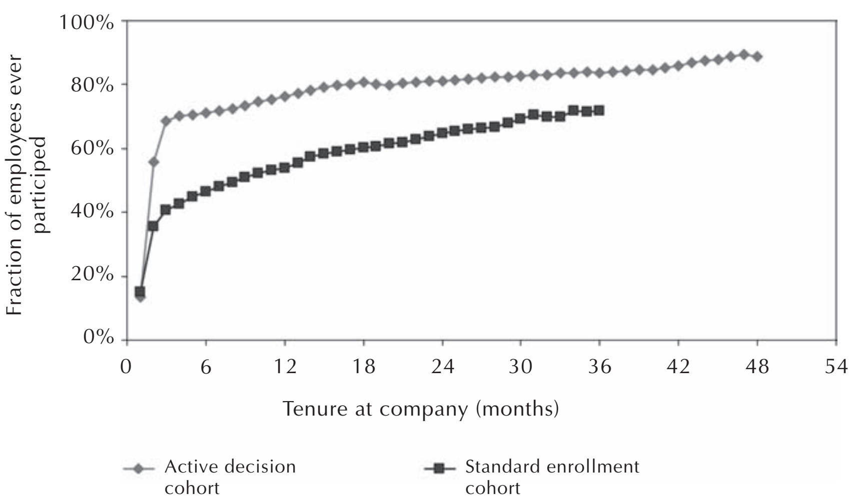


probability. What is the difference? In both cases one must call a toll free number, but in one case you call to enroll, and in the other, to get out of the plan. In other words, inaction (to not make the phone call) increases the relevance of the *default*. We can also observe that the probability of getting out is low once we are enrolled: the orange line is practically flat. Once a person is enrolled, the worker stays there forever. Again, this is due to passivity. Getting out is voluntary and free, you just have to call the 800 number. But in general, workers do not do so and stay, passively, enrolled forever.

The second graph, taken too from choi el al.(2001), shows the data of a company with the standard enrollment format that was changed to the active method, the one in which the worker is asked to make explicit whether or not he/she wants to participate in the plan. The participation rate also increases steeply from roughly 40% to about 70%. The effect is less dramatic than shifting to automatic enrollment. However, this method is less fatherly because it allows people to decide based on their preferences and needs. The difference in the former case is that people were passive and the employer made the decision for them; in this case people are active, but they were forced to make a decision. Without fixed terms, decisions are protracted indefinitely.

Graphic Nº 2

401(K) PARTICIPATION BY TENURE: COMPANY E



What do we learn? Those tiny details in the design can create dramatic changes in the participation of the people. Automatic enrollment is the one that generates more participation; active enrollment does not create much, but probably represents better

the real needs of people. Likewise, once people are enrolled, it not likely that they quit. In every case, people are taking the path of least resistance: they leave the decision to somebody else, and only make active decisions if they do not have a choice.

What happens with the contribution rates? Once enrolled, workers must decide how much to save. In the case of the automatic enrollment, people choose the

default. Since they are enrolled because they forgot to call the 800 number, they are automatically tied to the base plan chosen by the employer. This kind of *default* is very slow, in the order of 2 to 3%. Thus, in this case, design makes people participate but contributing a fairly small fraction of their income.

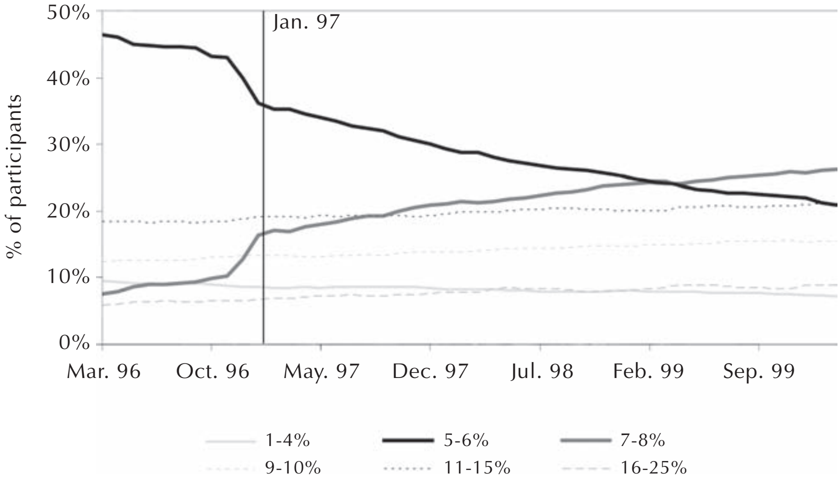
In the case of the active decision, there is no *default* but people look for focal points to make their decisions. Evidence shows that two elements are used: the date on which the employer's subsidy expires, and the legal maximum that can be saved.

In order to illustrate these ideas, Graphic Nº3, taken too from choi el al.(2001), shows the contributions decisions in a company, company G, which had a subsidy of 50% of up to 5% to 6% of the income contributed to the individual account. The 5 or 6% rate depends on whether or not it refers to unionized workers or about the *management*. This company changed that cap to 7% or 8%. People always had the option to save 7% or 8%, 5% or 6%, and any other alternative. the line of above shows the number of participants who chose 5% or 6%. When the cap changed, people moved slowly to this new rate. This rate is a focal point: workers take the implicit advice of the employer as to how much to save.

Thus, people look for help on how much to save. Since it is difficult to determine how much it is reasonable, they go for the employer's "opinion". If the employer rewards saving up to a certain amount, then, it is understood that is a reasonable amount.

Graphic Nº 3

401(K) CONTRIBUTION RATE RESPONSE TO MATCH THRESHOLD CHANGE:
COMPANY G



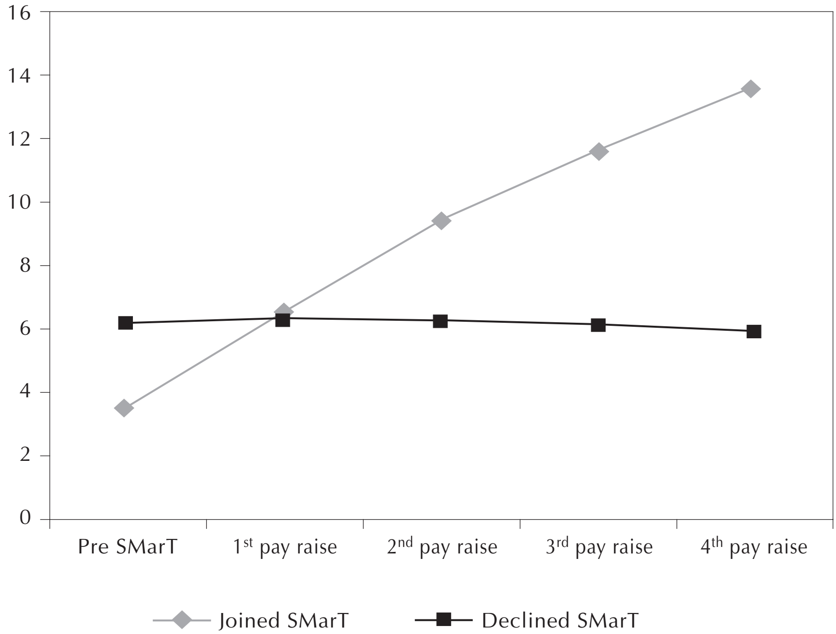
Another interesting program is SMarT plan, created by two renowned professors, one from Chicago University and the other one from UCLA. The program consists of offering workers who already have 401(k) plans, the option to make a commitment to saving a considerable portion of their future wage adjustment. In the companies under study, the adjustment were around 3,5%. The plans consisted in committed 3 of the 3.5 percentage points of readjustment, until a preestablished saving rate is obtained. This plan also creates significant increases in the contributions.

In Graphic Nº4, taken from Bernartzi and Thaler, the line of down represents the average contribution of those who chose not to be in this program. The line of above follows the contributions of those who did accept. The figure shows that after four cycles of wage increases, the contribution rate went from 3,6% to almost 14%. The option to contribute an increasing rate was always open, but it was only taken after it was explicit. Likewise, the contribution decision was made far before it was made effective. The passivity allowed them to comply with the plan.

What happens with the investment portfolio? Again, workers make passive decisions. The plans offer a menu of options and

Graphic Nº 4

Average savings rate (%)



we observe that people follow naïve investment strategies. The usual thing to do is to go for the default, because it is taken as an implicit advice from the employer. Another typical strategy is the 1/N rule: if there is a number (N) of funds, then an umpteenth time of the total is saved in each one of them; that is, if two funds are offered, one in fixed income bonds and the other in variable income, people invest half and half; if three are offered, one in fixed income and two in variable income, people end up with a portfolio which has a third in fixed income and two thirds in variable income. Again, the way in which what is offered is designed has a great impact in the options people take.

Likewise, once they take an investment option, they will not change their portfolio, even if it is in long terms. A classic example in the literature is related to one of the biggest private pension programs in the united States, the TIAA-CREF that groups those who are employed in the higher education. Harvard professors as well as the most brilliant people in this world have funds there. Data show that these people for as long as ten years never change their portfolios, not even once. They enroll and they never think about the issue ever again. In addition, they typically enroll using the 1/N strategy with half of their flows in fixed income and the rest in variable income. This strategy has consequences since assets yield different rates, the ex post portfolio is far different than the ex ante portfolio.

In summary, what is observed regarding contribution and investment? People try to save the costs of making tough decisions. To that end, they are supported by information that is easy to get. This is just what employers do when they design their 401(k)s: they provide implicit advice as to saving to their workers. Perhaps they do not do so with that in mind, but people understand it this way.

Another relevant element of the design, lies in that in a program like Smart, future wage readjustments are saved. First, this saving is perceived as a future sacrifice, a cost we are all more inclined to accept. Second, it refers to the loss aversion problem: since not all the adjustment is saved, people are left with the feeling of winning, because their net income also rises together with the saving. In other words, there are no losses.

What do we learn from these experiences? The main lesson is that people are passive and try to minimize the effort, which may lead them not to participate in spite of the fact that it can be very beneficial to do so. To not participate in a 401(k) plan means oftentimes to throw money down the drain. A worker of 59.5 years of age, close to retirement and who is not penalized if he/she withdraws the funds, can only lose by not participating in a 401(k) plan.

Measuring the value of the usual subsidy give by employers, these workers lose in the order of 460 dollars a year if they do not participate. It is a gift they are not accepting.

Another important lesson is that it is possible to design appealing issues which may motivate people to save and carry out their plans. First, they have to be motivated as to thinking about the problem. People by themselves, choose not to do anything, not because they are not intelligent enough or because they are blind, simply because it is easier not to do so.

The second element of a good design is that it avoids delay. Active enrollment does that by giving a deadline for making the decision. Deadlines creates the feeling of urgency, forcing people to think and solve the problem immediately.

Third, plans must be easy to understand and apply. For example, automatic plans which require only to think once about the saving issue, generate high participation.

A fourth element is to reiterate the offers to whom do not participate. Often, 401(k) plans are offered only upon hiring. If every year they are reminded of the possibility to use these saving instruments, the chance that people do not participate increases.

Once our human limitations are recognized, it is worth noting that the government and the institutions have much power, the power of inertia. We know we can greatly affect savings by just changing small details in the design. On the other hand, regular promotion instruments such as subsidies and tax reductions are expensive and might be a little inefficient. They are expensive because they have to be provided to everyone, whereas it is much cheaper to generate saving by simply filling out a well designed form. For example, automatic participation is efficient and cheap.

However in automatic participation, heterogeneity is not factored in the saving needs of the people. A person who is close to retirement, and another one who is just raising a family have different saving needs. But automatic enrollment packages in case of *default,* offer the same plan for everyone.

On the other side, financial education as well as the delivery of information are not necessarily a good solution. Without a doubt, they help because the lesser the unknown about the issue, the better. But that is not enough to get people to do something. Understanding is one level, doing is another one. I understand I have to go on a diet, go to the gym or quit smoking but that does not mean I will actually do it.

As regards information delivery, not so long ago in Chile, University of Chile and the Undersecretariat of Social Security elaborated a poll in which people were asked about the balance statements sent by their PFA. The statement contains information not only on accumulated balances, but also on the commission paid to the PFA, the commission charged by the other PFA, the yield of the fund owned and on that of the competition, and a number of other details. 70% of the people recognized having received a statement; out of that 70%, about 60% said they read it; 50% out of this 70% said they understood, and only 16% of the 70% said it used it to make a pension decision. This evidence reveals that the problem is not necessarily solved by giving free information because by itself it does not make people do something.

To finish, another additional issue for governments and regulators: competition in private management industry of individual capital. The big debate as to whether or not this system is expensive. The answer has much to do with people's passivity; people do not shift to another PFA because they do not think about retirement thus reducing effective competition. It is very cheap to shift into another PFA, people can go to an office and sign a paper, yet, we observe a small number of transfers. People shift only when they are approached by a salesperson. The rest of the time there is no sense of urgency about the problem.

In Chile, people do not think about retirement because of the way in which the system is designed. Participants must not make decisions as to the amount to be saved: we must all contribute 10% of our income every month. It cannot be 8%, it cannot be 11%, it is 10%. In which PFA? Usually, it is the first employer who decides, and in doing so, the employer simply tries to minimize the management costs. In what instruments to invest? Only recently, Chileans have the possibility to choose a fund : stocks, fixed income or a mix in a variety of proportions. In summary, there are a few instances today for people to think about retirement and, therefore, the system is not designed to motivate workers so as to make active decisions.

To wrap things up, and this is a message for both regulators and those who work in the industry: the design of the plans you offer can create much or little saving. It is in your own hands. Thank you.

EXPERIENCE WITH VOLUNTARY PENSION PLANS IN THE UNITED STATES

DENNIS DUFFY*

Good afternoon and thank you for asking Vanguard to share our perspective on the state of voluntary pension savings plan in the United States. I will share with you today some of the successes that employers and workers have achieved with our help, as well as the challenged that lie ahead of us. Overall the measures for voluntary pension savings in the United States are positive and the news is good. However, an interesting picture emerges when you look "beneath the averages" – drilling down to see what is really happening, and where some of the challenged and opportunities remain.

In my remarks today I will start with an overview of retirement plans in the United States. Then I'll turn to a survey of high-level statistics –participation rates, savings rates, etc.– and we'll look "beneath the averages". In the second part, I'll be using a myth/fact framework to look at issues such as investment fund choices. I am also going to speak about the issue of savings adequacy –are workers saving enough? Yes, many workers will accumulate a meaningful retirement benefit in their voluntary pension savings plan. However, it is the non-participating workers and those who save very little who present the greatest challenges today.

In the U.S. we often refer to the retirement savings system as a "three-legged stool". Social security is the core benefit, a public

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system that is funded from a payroll tax. One-third of retirees in the United States rely almost exclusively on social security for retirement income. Employers may voluntarily sponsor a defined benefit pension plan or a defined contribution pension plan – the second leg of the stool. The third leg is private savings.

Today I will focus on the voluntary defined contribution pension plan commonly referred to by its Internal Revenue Service tax code cite – the 401(k) plan. In a 401(k) plan, the worker, or plan participant, makes all of the key decisions, including how much to save and how and how to invest.

About half of all workers in the United States are working for employers that voluntarily sponsor a pension plan. This level of coverage has remained fairly consistent for several decades.

We have seen a shift from traditional defined benefit pension plan coverage to the 401(k)-type coverage. This represents a shift from a system where the employer made all of the key decisions around investment strategy and sufficient income replacement ratios to a system where all the key decisions are now made by the individual worker.

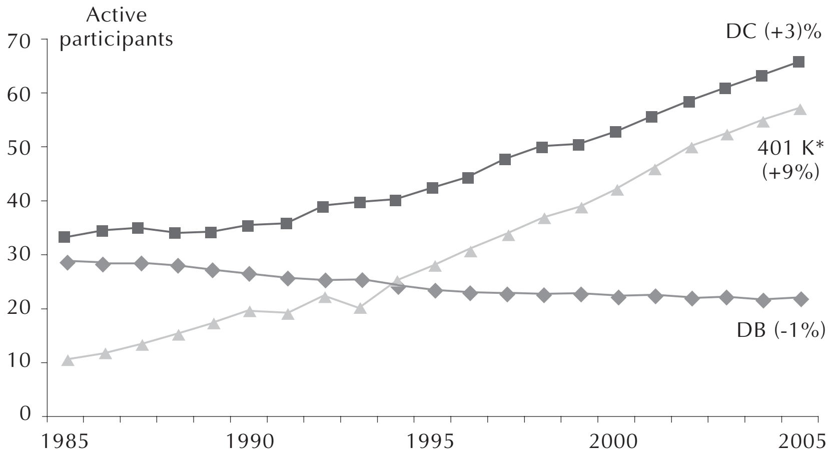
We have also seen participation rates that have risen at a rate of 9% over the past 20 years. In other words, the 401(k) option has been popular in the United States (see Graphic Nº1).

As I mentioned, employer pension schemes are just one leg of our three-legged stool. Graphic Nº2 shows the percentage of workers who are saving for their own retirement, either through 401(k) plans or in individual accounts. About six of every 10 workers report that they are currently saving for retirement.

Now let's take a closer look at behaviors within the voluntary 401(k) savings plans. The data that I will share with you is from Vanguard's defined contribution recordkeeping system. We have records for 1,500 plan sponsors and more than 2.5 million plan participants. The data is published in our book-length report, "*How America Saves: A Report on Vanguard Defined Contribution Plans*" and in our periodic Vanguard Center for Retirement Research Reports. These publications are available on our website, www. vanguard.com.

Gráfico Nº 1

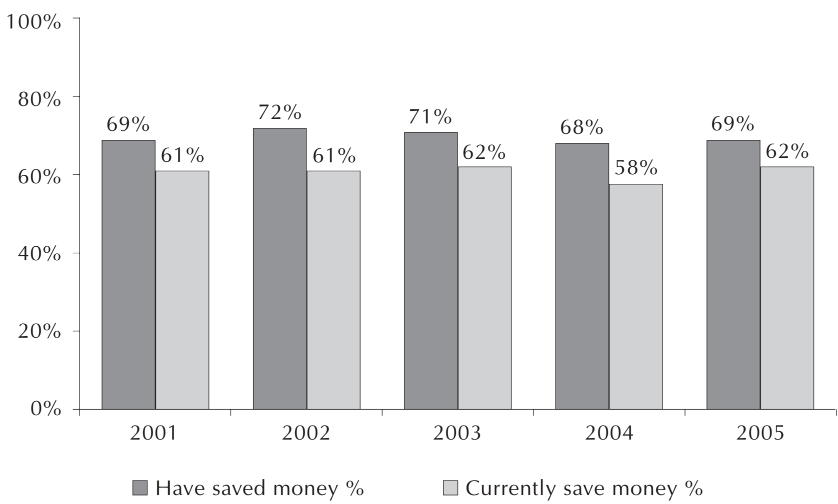
PLAN PARTICIPANTS 1985 TO 2005



* 401K is subset of defined contribution figure.
Source: DOL through 1998; Vanguard estimates thereafter.

Gráfico Nº 2

PERCENTAGE OF WORKERS WHO ARE SAVING OR HAVE SAVED



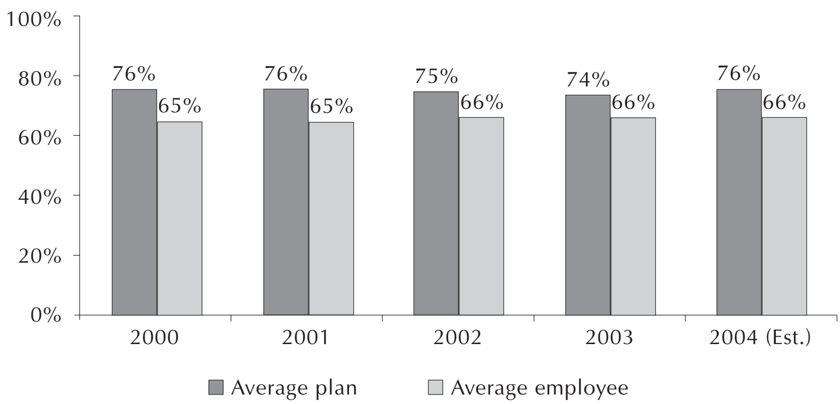
Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2005 Retirement Confidence Survey

The good news is that plan participation rates remained strong and steady (see Graphic Nº3), despite the bear market of 2000 to 2002, and the accompanying recession. What kept participants in the plan while the market and economic news was so poor? Certainly one reason is the discipline of automatic payroll deductions through 401(k) plans. A second is inertia maybe some participants were planning to quit, but they never got around to it. In general, this is very good news.

Now let's look beyond those top line numbers and move beneath the averages. On closer inspection, not everything looks as good. Of workers under age 5, only 26% join their plan. Of those earning less that $30.000, only 41% join. Across all plan, one-third of eligible workers never join.

Graphic Nº 3

PARTICIPATION RATES



Source: The Vanguard Group, 2005

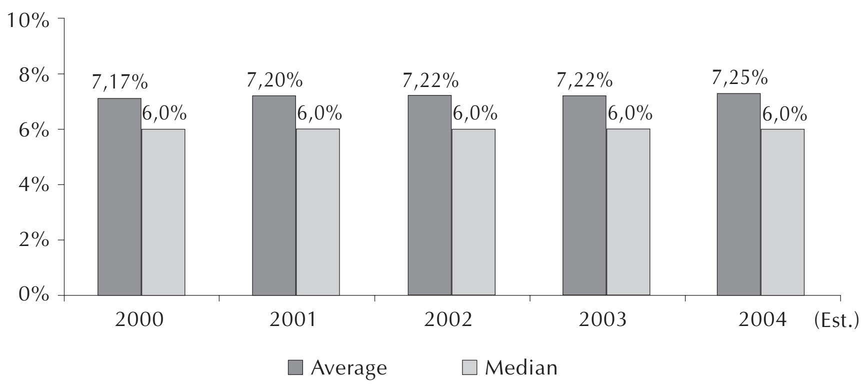
Now let's look at savings rates (see Graphic Nº 4). Like participation, savings rates also remained essentially unchanged despite adverse market and economic conditions. Again, we attribute it to the power of payroll deductions, along with inertia. With a median savings rate of 6% and a typical employer matching contribution of 3%, the typical worker is contributing 9% to their employer's plan. As I'll discuss later, for the typical participant, with a 9% contribution, that's positive news.

A look beneath the average shows is some interesting extremes in behavior. There are some strong savers among participants. For example, 25% of participants saved 10% or more and 10% of participants save the maximum allowed $13.000 IN 2004. However, 23% of participants saved 4% or less, not nearly enough for their retirement. Saving 3% or 4% in the savings plan, given everything we know, is clearly not enough.

Now I'll shift from savings to investment decisions. Graphic Nº5 shows the total amount invested in equities, both in terms of asset balances and annual contributions. On average, equity holdings look very positive. They are down slightly from 77% in 2000 to 71% in 2004.At vanguard we take this shift as good news a return to more sensibly balanced investment programs, and a gradual retreat from the excessive enthusiasm for equities we saw in the late 1990s. We've calculated that half of this shift is the result of workers moving among investment options during the bear market. Even after the shift, portfolio strategies remain appropriately equity-oriented, and better balanced than before.

Again, a look beneath the averages shows the opportunities and challenges. Among all participants, 13% have all their assets in fixed income investments it's hard to argue that this is the right portfolio strategy except for the most risk-averse participants. On the other hand, 20% of participants have all of their assets in equities this is

Graphic Nº 4
SAVING RATES

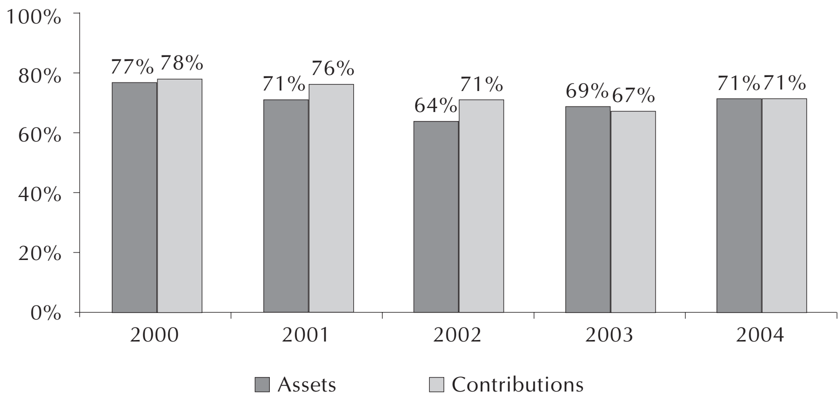


Source: The Vanguard Group, 2005

certainly right for some investors, those who have a large defined benefit plan, or perhaps those who have long time horizons or higher levels of risk tolerance. But some portion of these participants are 100% in stocks simply because of the late 1990s bandwagon effect. More worrisome, even after the Enron situation, is that 17% of participants have more than 20% of their assets in company stock a dangerously high level to be invested in a single equity.

Graphic Nº 5

EQUITY HOLDINGS



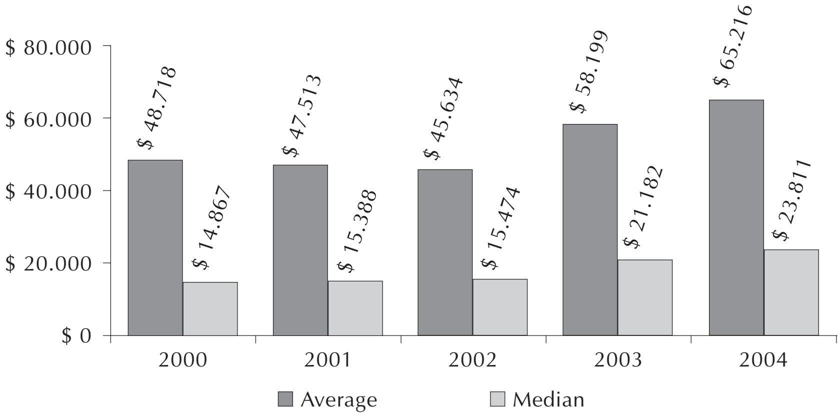
Source: The Vanguard Group, 2005

Account balances are growing (see Graphic Nº6). The average account balance rose 34% from 2000 to 2004 to over $65.000. However, median account balances are really more representative of the typical participant, since they reflect the balance of middle or 50th percentile participants. And since the end of 2000, median account balances have grown by 60% to about $24.000.

Again, a look beneath the averages is a telling story. About 18% of participants have account balances greater than $100.000 many of these are older workers, they are long-tenured with their companies, or they are higher income participants. On the other side, 36% of participants had account balances under $10.000. Not all of these participants are in trouble. A lot of small balance participants are new to the job, or just have lower incomes to start with. The real challenge is the low balance participants aged 40 to 60 who started late, and are still contributing too little.

Graphic Nº 6

ACCOUNT BALANCES (US$)



Source: The Vanguard Group, 2005.

I'd like to continue looking at trends in 401(k) plans now but with a bit of a twist. Here I'll present a number of myths about defined contribution plans and then contrast that myth with the reality.

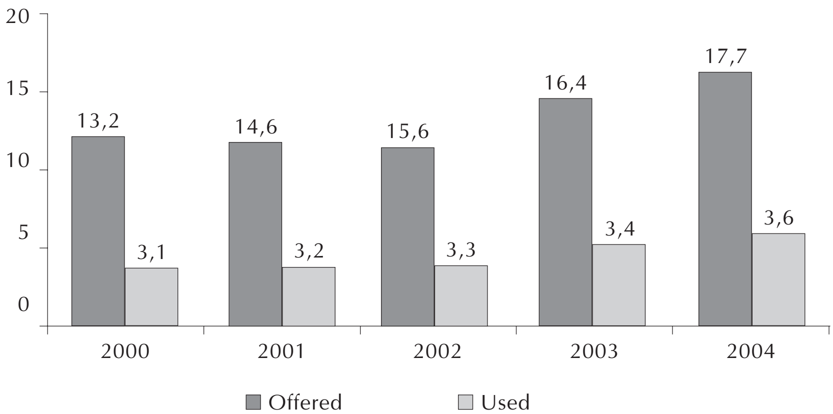
The first myth is that plan participants want more investment fund choice and that plan sponsors feel they should offer more investment options.

- In fact, it is clear from the data above that only *some* participants want more choice. Today, the typical plan offers over 17 investment options, up 34% from 13 investment options in 2000. However, the typical participants only uses 3.6 funds. Many workers struggle with understanding the expanded number of investment choices (see Graphic Nº 7). In fact, 40% of participants use only one or two investment options

- Another myth suggests that the widely publicized Enron situation increased awareness of the dangers of owning too much company stock. The general perception seems to be that we've been making small but steady improvements here that employers have been easing restrictions, and risk disclosure has improved.The fact is, the Enron melt down seems to have had no noticable effect on either plan-level or participant-level

Graphic Nº 7

INVESTMENT OPTIONS OFFERED VERSUS THOSE USED



Source: The Vanguard Group, 2005.

concentration in company stock. its important to keep in mind that enron workers *chose* to hold Enron stock in high concentrations in their 401(k) plan. At the participant level, from 2000 through 2004, ownership of company stock has remained remarkably unchanged. In plans offering company stock, about 44% to 45% of participants have 20% or more of their balances in company stock. At the other extreme, the percent of participants offered company stock and investing 0% in it has also remained the same.

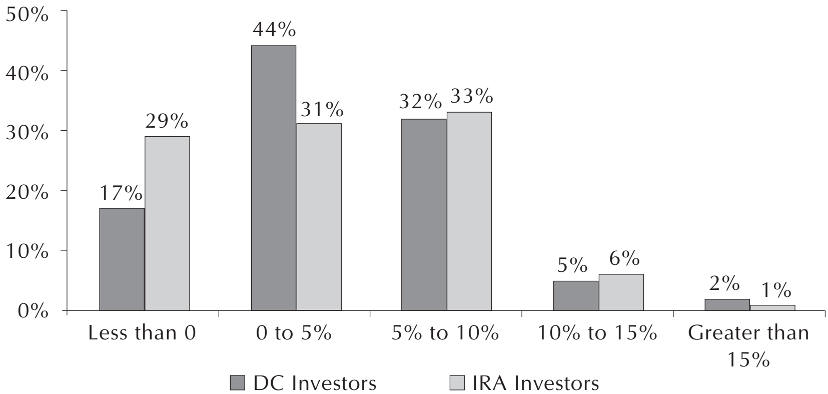
- Yet another myth suggests that the individual mutual fund investor has experienced negative returns since the market reversal that began in 2000 (see Graphic Nº 8).

Once again, looking beneath the averages, most vanguard 401(k) participants see relatively good personal performance. Over 80% of 401(k) participants have positive returns over the 5-year period that included the bear market of 2000-2002.

Now I'd like to turn to the issue of savings adequacy. I believe that this is the most pressing issue facing employers and workers today. In the United States, our collective challenge is to get our workers to increase savings rates today.

Graphic Nº 8

DISTRIBUTION OF 5-YEAR PERSONALIZED RETURNS, 2000–2004



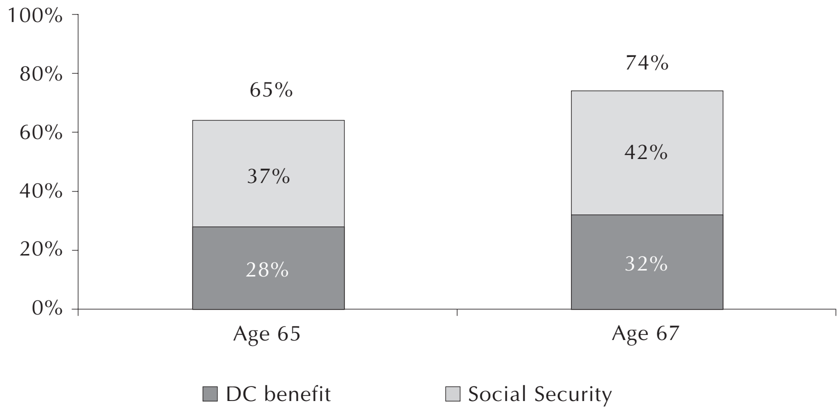
Source: The Vanguard Group, 2005.

Like everything you've heard from me today, however, it is a question of "beneath the averages." The median vanguard participant today is 44-years old, has a household income of $69.000, and is saving about 9% of income each year. A median worker contributes 6%, and a typical employer match is 50 cents on the dollar, or 3%. These contributions are being invested into a diversified equity-oriented portfolio. The median participant at this age has a balance of $24.000.

At first glance, these numbers do not look good. An age-65 annuity would translate to only $164 per month for life. But of course, the median participant, as i mentioned, is 44 years old and has at least 20 more years to work before being eligible for social security benefits (see Graphic Nº 9).

How does our median participant look if we project forward? Above are our estimates for that same participant at age 65 and age 67. The figures shown are income replacement ratios. These figures tell a positive story. If the typical participant stays in his or her retirement plan, and continues to contribute at a steady rate, if the participant retires at 65, the combination of social security and her 401(k) plan benefits replaces about 65% of the participant's income. At age 67, the figure reaches more than 70%.

Graphic Nº 9
REPLACEMENT RATES



Assumptions: 3% inflation; 4% real return after costs; volatility of 16,5% on asset returns; single-life annuity for male participant at current market rates.
Source: The Vanguard Group, 2005.

The real challenge is not with the savers it's the non-savers. By our calculations, roughly half of all workers are under-saving. Roughly a third doesn't join their plan or save at all, and about 25% of participants save only 4% or less each year. So our principal challenge is with this population taking action to get them saving today, and saving at adequate rates.We must take our savings message not only to the non-participants and the low-savers but even to the participants saving 7% or 8% and who think they are on track.

Of course, there are other strategies that can help to close the savings gap. Participants might work later in life, as some are already doing (see Table Nº 1). Higher equity returns could help to boost participant accounts, but most participants are already taking significant equity risk.

Above are some of the strategies that are used to impact participant behaviour. One successful approach has been the introduction of education plans for workers, which include meetings to on the benefits of the 401-k plan and printed investment information.

Table Nº 1
PARTICIPANT BEHAVIOUR

Traditional strategies	Participation rate %	Plan contributions %
Introducing a match	+10 → 25	+10 → +25
Increasing existing match	0 → +15	0 → +15
Introducing plan education	+10 → +20	+10 → +20
Loan within 401(k) plan	0 → +5	+10 → +20
New strategies		
Autopilot	+10 → 25	+10 → +25
Personalized communications*	+3 → 25	+4 → +15

Note: Change in participation is measured in absolute percetage terms and plan contributions in dollar terms
*Changes resulting from personalized communications are measured based on response rates for individuals receiving.
Source: Vanguard estimates based on Andrews, 1992, Papke, 1995, Papke and Poterba, 1995, Clark ans Schieber, 1998, Bernheim, 1998, GAO, 1997, Munnell, Sunden and Taylor, 2000, Huberman, Iyengar and Wei, 2002, and Choi et al., 2004.

At vanguard we are finding that there are groups or workers that are difficult to reach with education strategies. Vanguard research indicates that about half of workers can be categorized as *reluctant savers*.

And it is not simply a matter of educating this group – research has found that even when people know they should be saving more, sometimes they just don't get around to taking action.

At vanguard we believe that in order to really move the dial on savings rates employers need to rethink the default decisions in their plan designs. Instead of telling workers that if they want to save – call vanguard; tell workers that they are automatically signed up for the 401(k) plan and to call vanguard if they don't want to save.

Instead of telling workers that if they want to increase their savings rate – call vanguard; tell workers that their savings rate will automatically be increased and to call vanguard if they don't want to save more.

Instead of telling workers that they need to sort through and select from over 17 investment options, and call vanguard to make their investment elections; tell workers that they will be defaulted to an age based lifecycle fund and to call vanguard if they want to make another choice.

Of course when these design changes are successful and lead to increased savings, we will have a whole new set of problems, but good problems to have – more workers will want custom advice and help in managing their retirement assets during retirement.

As I mentioned when we started, the top line figures for defined contribution plans look compelling. Participation rates, savings rates, investment decisions, balances all look attractive at a summary level. However, when we look beneath the averages, we can see where the challenges and opportunities lie.

As I hope I have made clear, for the typical participant who saves and saves steadily, the future looks fine. Our challenge is to refocus our attention on savings adequacy for the other half those who are under-saving, or who aren't saving at all.

I think it's our collective challenge in the u.s. and elsewhere to help get workers to the right place. Twenty years from now, how many will complain that they've saved *too* much, if they've made the right decisions. That would be a real accomplishment for us, but it's one i have every confidence we can help workers archive.

Thank you for your attention. if you have any questions, I'd be happy to answer them.

VOLUNTARY PENSION SAVING ON PENSION FINANCING

ANDRÉS CASTRO*

Good afternoon, in my presentation I would like to talk about VPS from a business perspective, from the viewpoint of market opportunity. I want to talk about satisfying the client and compete productively. I would also like to visualize the synergy perspective and the conception of the virtuous cycle that is produced by developing voluntary saving together with the mandatory saving offer.

Then, it is worth mentioning:

1. Why the VPS? From the standpoint of analyzing whether or not there is an important need for the coverage of clients

2. Development of the VPS industry and competition in three years of history in the Chilean case

3. How has the perception of the clients affected this new offer?

4. A look at the future development of VPS in the pension industry.

1. Why the VPS?

1.1 There is a mandatory contribution cap (USD $1800), that generates insufficient pensions for those who are above this limit.

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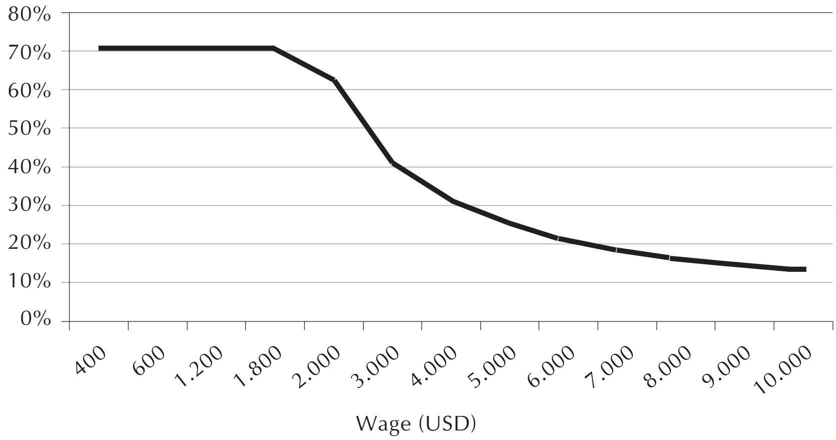
* CEO of Santander PFA, Chile. During 16 years he has held several positions within Santander Group. Among them, it is worth mentioning his active participation in the development of the Pension Fund Administrator of the Group, as well as his position as CEO of Bansander International. As such, he participated in developing pension and insurance businesses for Santander Group in the southern cone.

Graphic Nº 1

PENSION AT 65 AS A % OF THE CURRENT WAGE

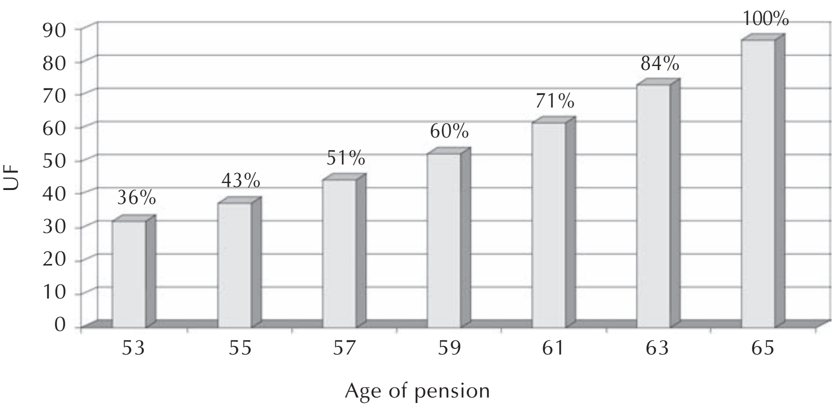


In Graphic Nº 1 we can see how the pension falls in the case of incomes over USD $1800, where, for example, in the case of a person who makes USD $ 5000, his/her pension would be 30% at 65 years of age.

1.2 Early withdrawal of the pension due to labor market conditions is also a problem, in Graphic Nº1 we can see how early pension withdrawal falls by retirement age.

Graphic Nº 2

DIFFERENT TERMS EXPECTATIONS, LONGEVITY



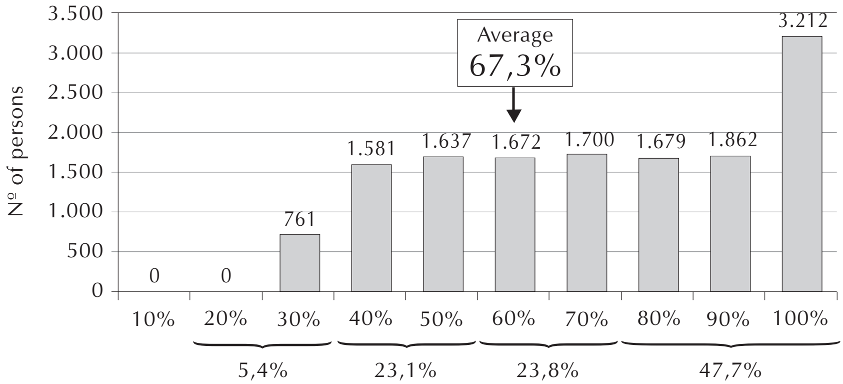
Cap, 25 years, 2-year younger spouse, yield 6%

1.3 Low density of contributions, especially at the beginning due to labor market conditions, as we can see in Graphic Nº 3.

Graphic Nº 3

CONTRIBUTIONS DENSITY

(REFINED SMPLES)



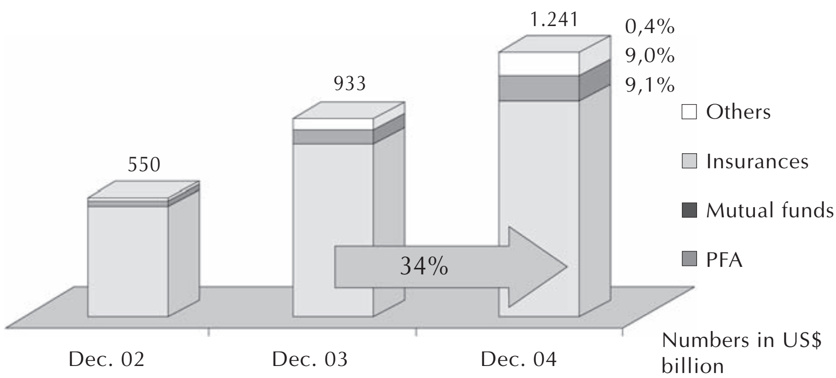
Therefore, we face a garden variety of realities farther apart from the theoretical plan, which proposed 35 years of continuous contributions and a retirement age of 65.

2. Developing the VPS industry

The industry has had an explosive growth during 2003 and 2004, with a multiplicity of suppliers in the neighborhood of 45 companies, among them PFA, life insurance companies, mutual funds managers, etc., which accumulate volumes of USD $1.241 billion, with an annual growth of over 35% and more than 400.000 VPS accounts (see Graphic Nº 4)

The competition has supplied an important number of offers in the neighborhood of 201 available products, narrowing the margins, especially in products such as Investment Funds with a reduction in commissions of 5% to 1,5% annually of the managed fund, and diversifying the participant companies of the pension industry. There has also been an increase in the pension

Graphic Nº 4
NEW PENSION PROVIDERS AND HIGH GROWTH



awareness of the clients. A very positive external factor for mandatory savers.

2.1 What elements have we seen in successful strategies?

First, the pension approach, the opportunity to help clients solve their variety problem. A common element for all strategies has been to emphasize the pension issue.

Second, the advisory and non transactional approach. An explanation of the reason why mutual funds and banks do not participate.

Third, profit from the strengths. In the case of the PFA the offer of balanced funds, the security with regard investment management and the relation with the portfolio of clients. In the case of mutual funds which start developing late, it is convenient to focus on client segmentation which has high balances that demand more sophisticated investment alternatives.

Insurance companies create yield out of their portfolio of clients in terms of their protection and saving products with the advantage that it is the only product that allows for the protection of the risk of death during the saving stage.

3. What has been the perception of the clients?

In Table Nº1, we can see the vision of the clients who wish to contribute to the VPS and in which institution, where banks take the lead, followed by PFA, then mutual funds, and finally insurance companies.

However, we see that in time the perception of the clients who contribute to the VPS in a PFA improve, equaling the vision of banks and PFA among their preferences.

Table Nº 1

EVOLUTION OF THE OPINION OF VPS

	PFA		Banks	
	Has	Does not have	Has	Does not have
Prestige	62,5	30,9	62,5	45,5
Trust, security	62,5	40,0	72,5	67,3
Advisory services provided on the issue	45,0	38,2	42,5	38,2
General opinion	50,0	29,1	50,0	52,7

Assessment of institutions to have a VPS, scale 1 to 7; % 6 and 7

4. A look at the future development of the VPS in the pension industry

What is the projection of this industry and where the benefits and opportunities of this business lie?

Our projection of the industry over the next ten years indicates that it will accumulate 22 billion dollars, in the neighborhood of 14% of the GDP, 23% of the mandatory pension fund which will account for roughly USD $250 billion in commissions for the managers (see Table Nº 2).

The competitive development will imply a diversification in the players of the pension industry, giving way for investment funds and insurance companies to manage pension funds.

Table Nº 2
PROJECTIONS OF THE VPS INDUSTRY

VPS Industry	2004	2010	2015	Projected annual gowth (%)
PFA	1.011	5.041	10.140	21,2
Mutual funds	113	1.655	5.658	38,5
Insurances	112	1.846	6.311	40,0
Others	5	48	257	38,1
Total billion USD$	1.241	8.591	22.366	27,2
% GDP	1,4	7,0	14,0	
% VPS/MPS	2,4	11,7	23,0	

The penetration of the VPS product will have a positive impact on the perception of clients regarding the pension industry as a whole, especially the mandatory system.

Chapter V

Perspectives of the World Bank on pension reforms

Old-age income support in the 21st century: an international perspective on pension systems and reform

ROBERT HOLZMANN*
Director of the Security
Department of the World Bank

1. Introduction

Thank you very much for the invitation. I feel privileged to be at this conference and I am very happy to be able to present to you the Bank's thinking about pension systems and reform. As you may know a regional publication has recently created some uncertainties and I am happy to help clarifying the Bank's position in this area.

To this end, let me start with some background information about this recent Bank publication. It was the then Chief Economist, now Sir Nicolas Stern and second person in the British Treasury, who asked me to lead this work. "Robert, on the one hand I hear from some people that the Bank is selling a Chilean-type pension system all over the world, on the other hand I hear a very reasonable position from you and your team, so why don't you sit down with Bank staff working on pensions to produce a report on the Bank's thinking and operational practice." When I asked him, "OK Nick, what is the charge code?" he said there is none. Hence what you have is a report produced over more then 3 years by highly motivated team of Bank staff doing most of the work in

* Director of the Social Security Department of the World Bank which is responsible for conceptual and strategic work in the field of social risk management, he carried out the work on systems and pension reforms of the World Bank. He is the author of the recent *paper* about the position of the World Bank on systems and pensions reforms. He was Professor of Economics and Director of the European Institute at the University of Saarland in Germany (1992-97); he was a Professor of Economics at the University of Vienna, Austria (1983-92); Senior Economist at the IMF, Washington, D.C. (1988-90), and main administrator of the OECD in Paris. His research on pension reforms spans across all regions in the world. He has published 24 books and more than 100 articles on political, social, fiscal, and financial issues.

their free time. Despite that, the report went through a formal review process as other knowledge and policy products at the Bank. And it was written and endorsed to reflect the current Bank position on pension systems and reforms.

So what you have here is the position by the Bank on pension reform and I hope that you stay with me through the presentation, and I am looking forward to answer the good questions afterwards. Of course, I will not be able to cover the full two hundred and fifty pages within the allocated 30 minutes or so. What I will present here are the highlights of the Bank's thinking - a distillation of what we are thinking in this area and for what reason.

On the conceptual side, when we started to reflect on pension reform three issues emerged:

First, we saw a need to not only discuss the structures of the pension system, i.e. the different kinds of pillars, but more importantly to think about the objectives of pension systems and the criteria applied for their assessment and proposed reforms.

Second, when we reviewed our pension thinking and operational interventions we discovered that the poverty aspect of the pension systems had not received sufficient attention and as a result we started to give a lot of emphasis to a basic pillar (call it zero or first pillar).

Third, based on our conceptual and operational experience we reaffirmed the importance of strong funded pillars (second or third pillar) as part of our system design, if the conditions are appropriate. But they form part of our benchmark, not part of a blueprint.

When you read through the report you will see that we covered many issues, including a comprehensive discussion of the main reform options, an innovative section about the political economy of reform, but also a full chapter about regional experiences – of Latin America and also the other regions of the world. But a major emphasis of the report is about areas where we feel pretty sure that we have a grasp on issues and good or even best practices. Perhaps more importantly, we also to address very openly the areas where we feel that we have a very long way to go in order to find good solutions, and many of these questions were raised yesterday and today, and some of them I will raise in this short presentation.

I think the main message I want to convey to you is the following: Funded pillars can and should have an important position in any pension system in the world. But in order this to happen and the financial sector to stay in business in twenty, thirty or fifty years time, you have to participate in making improvements in the system, in helping out that the issues that we have discussed at this conference get solved. To this end, with this conference a great start was done but much more is needed.

After these introductory remarks, let me enter now into the slide presentation and highlight a selected set of issues from the report. Hence, please fasten your seat belts and let me start out with some conceptual underpinnings of the report.

2. Conceptual Underpinnings

The first conclusion from our review of country's experiences states that it is not only fiscal issues that pressure a country to reform; there are many reform needs beyond the short-term fiscal crisis.

Of course, a review of our experience clearly confirmed that everywhere it is the emerging large deficit of the pension scheme what makes the government/the minister of finance move. And the pressure for action goes beyond the mere budget issues as deficits are likely to create macroeconomic instability in an already volatile and vulnerable environment. The most drastic recent example so far is still Brazil, where the country' financial crisis of 1998 was triggered by a budget deficit of six percent of GDP which in turn was created by a deficit of the pension system in the order of four percent of GDP. This morning we heard from Anita Schwarz that Serbia has a deficit in their pension system in the order of seven percent of GDP. This may be dwarfed by the recent developments in the Ukraine. There, in the preparation of last year's presidential election the government had promised and quadrupled the minimum pension as a result that –without further corrections– the pension expenditures is projected to increase from ten percent in 2004 to seventeen percent this year.

Thus fiscal pressure remains a major reform trigger, even if it is not so much the mere size of the fiscal deficit. What we see increasingly in our client countries is that expenditure pressure in the pension system leads to a crowding out of other social expenditures; such as education and health. Quite often, the spending of countries on these programs is a fixed part of the overall budget. But if you have to pay the pensions for an increasing number of retired teachers and health care workers out of a fixed budget, it means that you can employer only a smaller number of active workers in these areas.

Of course, there is also the long-term pressure of an aging population world-wide, but with an important difference between the North and the South. The North became rich before it became old, whereas the South risks becoming old before becoming rich. This creates a special reason for the South to implement a well structured and cost-efficient pension system.

A second conclusion from our report states that – as over 10 years ago when "Averting" was written – the current pension schemes – the unreformed but also some reformed one's – continue to over-promise, are financially unsound, are unfair, and continue to have low coverage, even the recently well-reformed one's. It is that last failure which creates particular attention and challenge to an institution such as the World Bank which has the fight against poverty as its core mission. Helping to create a financially sound pension system with moderate contribution requirements is, of course, a necessary condition to free financial resources for the vulnerable elderly in a low budget environment. You can only distribute money once you have it, and the reform of the unfunded and financially unsound system is an important step to make this happen. But with a rising number of elderly poor the reform focus has to move in parallel.

In addition to short and long-term fiscal issues, and the under-delivery of current pension schemes, there are also two further central issues which require reforms worldwide. The first has to do with the needed alignment of the pension system to socio-economic changes.

A first main socio-economic change has to do with aging population. You need to have a pension system which accommodates increased life-expectancy, which supports life long learning and which keeps people longer on the labor force and as participant of the pension system. But the increase in life expectancy requires also rethinking the disability provisions. In the past both old-age pension and disability pension were closely linked and both quite often had the same formula as the old-age pension was a kind of generalized disability pension. But with rising life expectancy they increasing cover completely different risks (uncertainty of death versus inability to work), and thus breaking them apart becomes crucial, and in those countries in Latin America, that have reformed their system this has mostly been done. In most countries of the world, this is being debated.

Another socio-economic change which requires rethinking pension provisions has to do with the increase in female labor force participation. When the systems were conceptualized fifty or even hundred years ago they reflected very much the world of a man providing the living for his family, with his wife staying at home and taking care of the children. Well, this is the past. Nowadays, you have an increasing number of working women with a female labor force that approaches in some countries also that of men. This raises the question what to do with the traditional widows pensions. In addition, in many countries you have the issue of high and rising divorce rates –in some countries fifty percent of marriages do not survive– an additional reason for rethinking current pension provisions for spouses. Individualization with defined contribution systems may be a solution in this respect as they allow to establish independent pension rights which thus become portable.

Another major change in addition to socio-economic changes has to do with globalization and how to accommodate it.

In order to profit from globalization, it is claimed that those countries will profit most for it which are the most flexible to adjust: Not the strongest nor the most intelligent but the most flexible will win (and survive). As a result of it, what must happen is to move quickly resources from declining to expanding sectors, but this requires, inter alia, labor mobility across sectors, professions, and countries.

Pension reforms in Latin America have in many but not all cases brought this flexibility through full benefit portability between the public sector and the private sector. Columbia and Mexico are still struggling with a more coordinated pension scheme between the sectors. Solving these portability and flexibility issues are crucial as otherwise the benefits of globalization risk to be low.

Last but not least, if you want to fully profit from globalization, you have to be integrated in the world economy, you have to be integrated in the worlds' financial market, and a well diversified pension system can importantly contribute to this.

Against this background of a multiplicity of reform pressures beyond fiscal stress, and the intensive hands-on reform experience in over 80 countries and lending in over 60 countries, how has this led to an adjustment of our pension reform perspective since the early 1990s? Let me state the most important ones.

3. Extension of original concept

First, I think nowadays we have a much better understanding of the possibilities but also the limitations of formal and mandated systems. On the one hand this leads to confirmation of the importance of pre funded pillars within a multi-pillar pension structure. On the other hand we see also much clearer the limitations and conditions under which this can happen.

Second, and I will come back to this with a little text table, we expanded the three pillar structure toward a five pillar concept in order to get a bit more clarity for some of the issues which otherwise may get blurred.

Third, and as part of country experience but also out of simple logic introspection, there are many ways in which pillars can be formulated and also not all pillars need and will exist in a country at all times. Take South Africa, which has a zero (basic) pillar and a voluntary funded pillar. Should they introduce a mandated unfunded/funded i.e. first or second pillar? When asked by the government my answer was that currently I see no need for it, just improve the system as it is. But under the same circumstances to do away with a second pillar, once you have it, it would not make much sense either.

A fourth point which emerged quite clearly from our country work is that country conditions matter for the future pension system the country wants to reform toward. It matters what are the specific reform pressures, what is the system that the country has inherited, and what is the (enabling and not enabling) environment in which the reform proposal is to be implemented.

The last, but not least important point concerns the many innovations introduced by our client countries but also some industrialized countries. We are closely inspecting many of these innovations to see if they are working, and under what circumstances and how they can be applied in other countries. Such innovations include the non-financial or notional defined contribution system (a system which imitates the logic of a DC system but remains except a buffer fund essentially unfunded); the clearing house concept to centralize information and money flows to keep administrative costs but keep asset management decentralized; and the changes in governance structures in centralized funds to improve investment performance and to allow for pre-funding of basic and tax financed schemes. All these and other innovations are still under close scrutiny, and some are looking quite promising.

Let me take a pause and return to the proposed new multi-pillar structure and why we have moved beyond the three pillars. While this may have created a bit of confusion, the answers are quite straight forward.

The first thing to note is that the concept of pillars differs importantly across regions, countries and international institutions. In some, the second pillar is there for consumption smoothing independently if funded or unfunded, and the first pillar there for poverty alleviation, independently whether financed by general taxes or ear-marked contributions. In others, the first pillar is the publicly managed and unfunded pillar (whether tax or contribution financed, and poverty or consumption smoothing oriented) and the second pillar is the funded but mandated one (whether based on employer or individual design). Differentiating between zero and first pillar makes this clear distinction between objectives and financing.

Hence, we introduced the concept of the zero pillar (or basic pillar) to take care of the poverty aspect of pension systems, in particular of those without access to formal systems (see Table Nº 1). On the other side we added also a forth pillar which captures existing formal and informal arrangements to support people in old-age: health care systems or housing support, or family or community based income support and services. Their existence and strength has a major bearing on the design on the other pillars.

The focus on the pillars beyond 1 and 2 – i.e. the ones which mandate participation for formal sector workers – was also driven by the realities of our client countries beyond middle income countries. Take the example of India where the coverage under the formal pillars 1 and 2 is below 9 percent of total labor force. Some

Table Nº 1
MULTIPILLAR PENSION TAXONOMY

	Target groups			*Main criteria*		
Pillar	Lifetime poor	Informal sector	Formal sector	Characteristics	Participation	Funding/ collateral
0	**X**	X	x	"Basic" or "social pension," at least social assistance, universal or means-tested	Universal or residual	Budget/general revenues
1			**X**	Public pension plan, publicly managed, defined benefit or notional defined contribution	Mandatory	Contributions, perhaps with some financial reserves
2			**X**	Occupational or personal pension plans, fully funded defined benefit or fully funded defined contribution	Mandatory	Financial assets
3	X	x, **X**	**X**	Occupational or personal pension plans, partially or fully funded defined benefit or funded defined contribution	Voluntary	Financial assets
4	X	**X**	X	Access to informal (e.g. family support), other formal social programs (e.g. health care) and other individual financial and nonfinancial assets (e.g. homeownership)	Voluntary	Financial and non-financial assets

Note: The size of x or **X,** normal or bold, characterizes the importance of each pillar for each target group.

thirty percent of the population form the “life-time poor”, i.e. those always living below the poverty line. This leaves 60 percent of informal sector workers (including self-employed), of which some are sometimes but not always poor.

For the life-time poor, formal systems and voluntary retirement products are beyond the reach. For them access to a zero pillar and the availability of 4^{th} pillar arrangements matter to keep them from destitution. For informal sector workers having a zero pillar in case things go terrible wrong is important; what matters most for them is access to voluntary retirement income products to move resources (financed savings) towards the future (and beyond the own housing or small enterprise assets).

Hence, while first and second pillar reforms are important for fiscal and other reasons, for the majority of the words population the structure and functioning of the other pillars matters most. Here I would like to mention that I very much enjoyed yesterdays’ presentation about the third pillar. It was really first class.

After this explanation about the pillars which I hope reduced confusion but did not add to it, let me return to the main messages of the Bank’s new position paper and reduce it to three key principals.

(1) All pension systems should, in principle, have elements that provide basic income security and poverty alleviation across the full breadth of the income distribution. This may take the form of a social assistance program, a small means-tested social pension, or a universal demogrant available at higher ages (for example, age 70 and up). Whether this is viable—and the specifics of benefit forms, levels, eligibility, and disbursement—will depend on the prevalence of other vulnerable groups, availability of budgetary resources, and design of the complementary elements of the pension system.

(2) If the conditions are right, prefunding for future pension commitments is advantageous for both economic and political reasons and may, in principle, be undertaken for any pillar. The decision to prefund, however, requires a careful consideration of benefits and costs as net benefits are not automatically assured, and awareness that political manipulation can make prefunding illusory. This decision also requires a close look into the implementation capacity of a country.

(3) In countries where prefunding promises to be beneficial, a mandated and fully funded second pillar provides a useful benchmark (but not a blueprint) against which the design of a reform should be evaluated. As a benchmark, it serves as a reference point for the policy discussion and, as such, a means to evaluate crucial questions with regard to welfare improvement and the capacity to finance a transition from pay-as-you-go to funded regimes.

These key principles of pension systems and reform distil the position of the Bank. In the development of this position we also attempted to pin-point better the objectives of pension systems beyond poverty alleviation and consumption. As such, it moves the discussion about pillars and structural issues towards objectives of pension systems and reform criteria against which a proposed reform should be evaluated.

The *primary goals* of a pension system should be to efficiently provide adequate, affordable, sustainable, and robust retirement income, while seeking to implement welfare-improving schemes in a manner appropriate to the individual country:

- An adequate system is one that provides benefits to the full breadth of the population that are sufficient to prevent old-age poverty on a country-specific absolute level in addition to providing a reliable means to smooth lifetime consumption for the vast majority of the population.

- An affordable system is one that is within the financing capacity of individuals and the society, one that will not unduly displace other social or economic imperatives or lead to untenable fiscal consequences.

- Sustainable refers to the financial soundness of a pension system and its capacity to be maintained over a foreseeable horizon under a broad set of reasonable assumptions.

- Robust refers to the capacity to withstand major shocks, including those coming from economic, demographic, and political volatility.

The design of a pension system or its reform must explicitly recognize that pension benefits are claims against future economic output. A main ingredient for pension systems to fulfilled their primary goals is their contribution to future economic output. Reforms should, therefore, be designed and implemented in a manner that supports growth and development and diminishes possible distortions in capital and labor markets. This requires the inclusion of *secondary developmental goals* which are to create positive developmental outcomes by minimizing the potential negative impacts pension systems may have on labor markets and macroeconomic stability while leveraging positive impacts through increased national saving and promoting financial market development.

The application of a goal-oriented and context-specific flexible policy framework also necessitates the formulation of criteria against which a reform proposal is evaluated in comparison to the existing arrangements. These include criteria directed to the content of the reform and others directed to the reform process.

The Bank uses four primary content criteria to judge the soundness of a proposal:

- Does the reform make sufficient progress toward the goals of a pension system? Will the reform provide reasonable protections against the risks of poverty in old age by efficiently allocating resources to the elderly? Does it provide the capacity to sustain consumption levels and provide social stability across the full range of socio-economic conditions that are prevalent in the country? Does the reform meet distributive concerns? Will it offer access to retirement savings and poverty protection on an equivalent basis to all people with significant economic participation including informal sector workers and those performing mainly non-economic work? Is the burden of transition financing equitably distributed between and within generations?

- Is the macro and fiscal environment capable of supporting the reform? Have financial projections been thoroughly evaluated over the long-term periods appropriate to pension systems and rigorously tested across the range of likely variations in economic conditions over these time periods? Is the proposed financing of the reform within the limits reasonably imposed on both public and private sources? Is the reform consistent with the macroeconomic objectives and available instruments of government?

- Can the public and private structure operate the new (multipillar) pension scheme efficiently? Does the government have the institutional infrastructure and capacity to implement and operate publicly managed elements of the reform? Is the private sector sufficiently developed to operate the financial institutions required for any privately managed elements?

- Are regulatory and supervisory arrangements and institutions established and prepared to operate the funded pillar(s) with acceptable risks? Is the government able to put in place sustainable and effective regulatory and supervisory systems to oversee and control the governance, accountability, and investment practices of publicly and privately managed components?

Experience also dictates that major emphasis must be given to the process of pension reform. Three process criteria are therefore also relevant:

- Is there a long-term, credible commitment by the government? Is the reform effectively aligned with the political economy of the country? Are the political conditions under which the reform will be implemented sufficiently stable to provide a reasonable likelihood for a full implementation and maturation of the reform?

- Is there local buy-in and leadership? Even the best technically prepared pension reform is bound to fail if it does not reflect the preferences of a country and is not credible to the population at large. To achieve this goal the preparation of a pension reform has to be primarily undertaken by the country itself, by its politicians and technicians, and be effectively communicated to, and accepted by, the population. Outsiders, such as the Bank, can assist with advice and technical support, but ownership and public support must come from the client country.

- Does it include sufficient capacity building and implementation? Pension reform is not simply a change of laws, but a change in how retirement income is provided. Accomplishing this typically requires major reforms in governance, contribution collection, record-keeping, client information, asset management, regulation and supervision, and benefit disbursement. With the passage of legislation providing for reform, only a small part of the task has been achieved. A major emphasis and investment in local capacity building and implementation and continued work with the client and other international and bilateral institutions beyond reform projects or adjustment loans is required.

4. Design and Implementation Issues

The preparation of the report has helped us rethinking some of the basic questions of income support for old age and be more specific in our work with clients of what to expect from a reformed pension system. Through its pension reform activities in client countries and the work of other institutions and analysts, the World Bank has also developed a clear understanding of good and best practices—of what works and what does not—in an increasing number of design and implementation areas. In a variety of other areas, however, open issues remain, and the search for good solutions continues. The areas range from design issues of the various pillars, and their relative weight, to issues of financial sustainability, administration and implementation, political economy, to lessons from multipilar pension reforms in the world's regions. In the remainder of this presentation I want to briefly highlight best practices and open issues in three areas of major interest related to fully funded pensions: When is the financial sector ready for fully funded pensions and how should it be regulated and supervised? How to contain fees and costs of funded individual accounts? Can the private market deliver the required annuities once contributors to fully funded systems retire an often overlooked issue, but one of increasing relevance as population and fully funded pension systems age.

5. Financial market readiness, regulatory and supervisory issues

The question of what conditions are required for the introduction of a mandatory funded pension pillar has given rise to considerable debate that will take a few more years to resolve. Five issues are at the core of the debate: (1) Can funded pensions be introduced in a rudimentary financial market environment? (2) What are the regulatory standards and practices needed to ensure effective operation and security? (3) What supervisory practices and institutions need to be developed? (4) What level of costs are acceptable in the operation of a system, and at what threshold do operating costs mitigate the potential advantages of funding? and (5) What are the options for countries with small open systems?

Not all countries are ready to introduce a funded pillar, and consequently some should not do so. However, the introduction of a funded pillar does not require perfect conditions, with all financial institutions and products available from the outset. Funded pillars should ideally be introduced gradually to enable them to facilitate financial market development. There are, nevertheless, minimum conditions that need to be satisfied for the successful introduction of a funded pillar, including: (a) a solid core of sound banks and other financial institutions capable of offering reliable administrative and asset management services; (b) a long-term commitment by government to pursue sound macroeconomic policies and related financial sector reforms; and (c) the establishment of core regulatory and supervisory systems concurrent with the implementation of a funded system and a long-term commitment for the support and continued development of a sound regulatory framework.

The extensive recent experience with pension reforms in Latin America and Central and Eastern Europe in addition to the much longer experience in OECD economies has advanced the understanding of issues of financial market regulation. This experience indicates that there are certain basic (and less controversial) regulations that should be applied for mandated, funded schemes from the very beginning. These include appropriate licensing and capital requirements for providers, full segregation of pension assets from the other activities of sponsors and management firms, the use of external custodians, and the required application of broadly accepted and transparent asset valuation rules and rate-of-return calculations. There are a number of more controversial regulations, for which there remains uncertainty regarding how and when they should be applied. These include controls on market structure and portfolio choice by members, minimum funding standards for defined benefits, investment requirements or specific limitations on particular asset categories, portability rules, profitability or minimum rate of return requirements, and guarantees.

Similarly, in financial market supervision, many rules are not controversial and should be applied early on. The less controversial rules and tasks for the supervisory body include the need for an operationally independent, proactive, well-financed, and professional staff; the vetting of the application for licensing; and collaboration with other regulators. The more controversial rules and questions for supervision include the choice between a single-purpose or dedicated supervisory agency (such as pioneered in Chile with the superintendence) or integration of supervising bodies (such as insurance, securities markets, banking or mutual funds); decisions about the range of institutions permitted to offer retirement-income products; establishing effective collaboration among regulators and supervisors; and creating effective oversight and accountability of the supervisor.

Various small and open economies, such as in Central Europe and Central America, but also Africa (Mauritius and Senegal), are starting pension reforms that include the development of a funded pillar. Undertaking such a reform in an environment with a limited financial sector creates both opportunities and challenges. The challenges include the resource-intensive development of country-specific regulations and the buildup of supervisory capacity; a potentially small number of pension funds given the small size of the country and the existence of significant economies of scale; and a limited range of financial instruments through which investment portfolios can be diversified. The opportunities include full integration into the world economy, with much better opportunities to share and manage risks for retirees and the economy as a whole. The way forward is not easy, and the potential options include regional development of funded pension systems (promising but so far never done), the application of practices of other countries, such as centralized public management (possible but not fully convincing), and a mixture of knowledge import through opening the financial sector to foreign investment, keeping the government out of investment decisions while undertaking cost-intensive buildup of institutions, regulation, and supervision. This capacity building may have positive overall developmental effects because reliable domestic financial markets are needed in any economy that wants to participate in, and profit from, globalization.

6. Fees and Costs: How to contain?

The amount of fees or charges levied on financial retirement products is an area of considerable debate and research. For critics of a funded pillar, these fees are much too high, in particular compared with the (best) unfunded and public benchmark; they reduce the net rate of return to sometimes unacceptably low levels and thus eliminate the potential return advantage of a funded pillar; and the structure of fees is often non transparent and anti-poor, which prevents a broader pension coverage of lower-income groups. Supporters of a funded pillar (including the Bank) also recognize the need to bring fee levels down and to rework fee structures. But they see the problem as much more manageable, with fee levels in client countries much more in line with those of popular financial services in developed countries and falling after start-up costs have been covered. Still various areas require closer investigation in and across countries and regions

6.1 Measuring and Comparing Fee Levels

Across countries, charges or fees (administrative charges and management fees) on long-term financial products, such as pensions, are levied in many different ways. Some are one-off fees, usually a fixed sum payable either up-front or at maturity. Others are ongoing and can take the form of a fixed fee per period, a percentage of contributions or premiums, or a percentage of assets. One main problem with international comparisons is that products offer different services and pension systems have different structures. For example, some plans have guaranteed minimum returns or guaranteed minimum pensions, while others do not. Obviously, everything else being equal, guaranteed products should have higher fees. Also, some plans provide better services, such as higher rates of return and immediate benefits to plan members, and could justify being more expensive. Finally, funded pillars that rely on the public pillar to collect contributions (for example, Argentina) should have lower administrative costs than those that are independent of government.

A national and international comparison of fee levels requires a comprehensive and life-cycle-type approach in which all types of charges for, say, a full working life are considered and, for example, the gross amount and the net accumulated amount are compared at retirement. Time-specific comparison of fees on flows (contributions) and stocks (assets) alone are of little value.

6.2 Fee-Level Limitation via Regulation of Structure

Countries have taken different approaches to regulating the fee structure of pension funds. For example, Australia, Hong Kong (China), the United Kingdom, and the United States have few, if any, explicit restrictions on charges and instead regulate charges under the broader

"prudence" or "reasonableness" standards. This is partly explained by the fact that private pensions in the United States are largely voluntary, while in other countries they are built on pre-existing voluntary systems. Most World Bank client countries limit the structure of charges, and quite a few have restrictive regimes in that companies are limited to two charges (an asset-based and a contribution-based charge), one of which is subject to a ceiling (asset-based charge), while the other can take any value.

It is still unclear to what extent these limitations on the structure lead to effective lower fee levels or what they imply for the longer supply structure (number of funds) or demand structure (scope of coverage). It appears that these limitations may be of lesser relevance than other elements of the second-pillar design and implementation A simple and transparent fee structure with well-thought-through price caps is probably a useful approach when such a new pillar is introduced. But these limitations need to be reviewed regularly and adjusted with other pillar characteristics if deemed necessary; it is quite likely that they will be relaxed as time progresses and individuals become more familiar with the system.

6.3 Fee-Level Limitation via Special Organization of Providers

Several models of pension fund management are aimed at reducing fees by reducing costs. The basic idea is that, in competitive markets, costs are the major determinant of fees. Moreover, reformers should be concerned with the real cost of producing the services. International experience indicates that close-end funds (those limiting membership to employees of a firm, industry, or profession) have lower fees than open-end funds, perhaps because they incur lower marketing costs. Some countries use a centralized competitive-bidding process to outsource fund management (Bolivia, Kosovo, and Latvia, but not Sweden). These systems have resulted in lower fees, although it is not clear whether the related reduction in worker choice is sustainable. In this regard, the experience of the Federal Thrift Savings Plan in the United States (covering only federal government workers) is encouraging. Its gross expense ratio has declined steadily as the fund assets have grown, from an average of 0,67 percent of funds in 1988 to 0,07 percent in 1999. It is by far the lowest fee structure in the industry. Another important case for reducing fees while providing almost unlimited investment choices to plan members is the Swedish scheme. The majority of Latin American and some Eastern European countries adopted a model of open-end and specialized fund managers, with countries differing in terms of centralization or decentralization of collection and record-keeping systems. These models have produced relatively high management fees, especially in their early years. Although their fees are not higher, and in some cases are lower, than those of personal and stakeholder plans in the United Kingdom, there is still room for reducing them by addressing the issue of industry concentration.

Deregulation of fees and market contestability (for example, providing options to plan members) promote competition but require stronger disclosure of information. Fund managers have to provide affiliates with statements of their accounts. In addition, at least once a year they need to provide affiliates with basic information about the pension fund management company (ownership, managers, directors, and audited financial statements, including the auditor's report) as well as information on the fee structure and rate of return relative to the respective system's average, taking into account the long-term view.

The greater the choice and contestability, the greater the incentive of fund managers to spend money on public relations and marketing—costs that eventually are passed on to worker-affiliates.

Again, it is too early to make strong recommendations, but the experience, so far, suggests three promising approaches. First, limit costs by saving on the administrative costs of contribution collection, account administration, and so forth (that is, adopt the clearinghouse approach). Second, limit the incentives for marketing expenditures by pension funds through blind accounts or constraints on the ability of individuals to change funds as a result of laws or exit fees. Last, but not least, limit asset management fees by such means as the use of passive investment options, employers' choice of financial provider, or competitive bidding for a restricted number of service suppliers.

7. Can the Private Annuity Market Deliver?

A privately managed, funded pillar (mandated or voluntary) requires the provision of annuities that transform at retirement an accumulated amount into a lifelong income stream (that is, until death). This requirement has often been neglected when fully funded pillars are set up, but it raises a number of issues for which good answers are not always available. For example, how much annuitization is required, in what form, and at what age (or ages if plan members are given the option of purchasing annuities through time) in order to improve risk management? What type of providers should offer what products? To what extent can and should unisex life tables be applied? What prudential and business regulations should be applied? What risk-sharing arrangements can or need to be put in place between providers and annuitants? What is the appropriate allocation of the risk of future changes in mortality among public and private sources? What role is there for governments in ensuring that appropriate financial products are available to back indexed annuity contracts? This subsection concentrates on five issues: (a) What type of providers should be allowed to offer annuities? (b) What kinds of products should be allowed? (c) When must a private annuity market be ready? (d) Should there be price indexation of annuities? (e) How should we deal with the main challenge: risk bearing ?

7.1 What Type of Providers Should Be Allowed to Offer Annuities?

Because of the insurance nature of annuity products, the insurance sector is bound to represent the largest set of annuity providers in any country. Pension funds (occupational and individual) may also provide annuities, especially if they provide defined benefits. Among insurance companies, there is an issue whether general life insurance companies should be allowed to sell annuities or whether specialized annuity companies should be licensed under the regulation (as in Mexico, for instance). On the one hand, life insurance companies may "hedge" the longevity and mortality risks when selling annuities and (say) term life products. On the other hand, information disclosure in the insurance industry is poor in practically all jurisdictions. Accounting standards are mostly opaque, and, from the point of view of consumer protection and transparency, an argument can be made for specialized annuity companies, especially to provide annuities from mandatory schemes.

7.2 What Kinds of Products Should Be Allowed?

Annuity markets are characterized by large asymmetric information between suppliers and demanders. This results in adverse selection and a difference between an actuarially fair price for an average individual and the typically insured of some 10 to 15 percent even in well-developed markets. This also results in complex products that compete on price as well as many other characteristics. It also results in differences in prices between deferred annuities (for example, where individuals pay premiums periodically through their active life) and annuities bought at retirement. Last, but not least, it results in price differences between individual and group insurance. To address the issue from a public policy perspective, a few needs stand out: (a) the need for comprehensive consumer information and protection for all products, (b) the need for standardized products as benchmarks for consumers, (c) the need for employers to be included in the selection of products, and (d) the need to pilot innovative solutions (such as the auctioning of whole pension cohorts in a mandated pillar).

7.3 When Must a Private Annuity Market Be Ready?

At the inception of pension reform in client countries, a functioning life insurance sector typically is not available and need not be so. These reforms concentrate initially on the accumulation phase, with the payout phase some 10 or more years away. But can a reform be launched without a view to the insurance sector? For example, the choice of individuals to join the second pillar may depend on available products and their characteristics (such as indexation and joint annuities). It is probably the case that if a financial sector fulfils the minimum requirements for launching such a reform, the insurance sector can (and must) be built over a period of five or so years. Major contributions to its development would be the adoption of a modern law establishing an operationally independent regulatory and supervisory authority, encouraging actuarial training, promoting reinsurance arrangements with highly reputable reinsures, and opening up to well-established foreign life insurance companies from reputable jurisdictions, either in the form of joint ventures or the privatization of existing public institutions. For very small jurisdictions, considerations need to be made about unification or integration of several supervisory authorities, especially securities, insurance, and pensions.

7.4 Should There Be Price Indexation of Annuities?

For annuities to provide real consumption smoothing to individuals, they need to be price indexed; otherwise, even moderate inflation over a lengthy period of retirement will lead to a major fall in the real value of the annuity. For insurance companies to provide indexed annuities at reasonable prices (if at all) requires access to price-indexed assets, preferably in the form of price-indexed government bonds. Various countries have started to provide such bonds (Chile, Sweden, the United Kingdom, and the United States), but they are far from universal and often not long term. Even if indexed government bonds are available, insurance companies offering indexed annuities must forgo other more profitable investments and must therefore charge a higher price to annuitants than they would for nominal annuities. Therefore, indexation involves a difficult tradeoff between the higher financial security of older pensioners and the lower payouts they will receive when young. This trade-off needs to be taken into account by governments when projecting the replacement rates that the new system will generate. Moreover, if governments want to ensure (or mandate) the availability of price-indexed annuities, they will need to issue the appropriate inflation-indexed or other specialized instruments to enable this market to develop. This, however, potentially imposes significant distributional tradeoffs because in nearly all developing (and many developed) countries the beneficiaries of indexed annuities are higher-income groups, while all will bear the costs of providing the financial instruments to enable them to develop.

7.5 How Should We Deal with the Main Challenges?

Two issues are addressed around the question of who should bear the risk. The first concerns rating or differential underwriting of survival probabilities (such as genetic testing, for instance). One of the disadvantages of pooling risks is that good types (in the case of annuities, those who die early) subsidize bad types, giving rise to the pooling premium. For some groups of pensioners –for example, those with health impairments or those with poorer socioeconomic backgrounds– the terms on which pooling takes place may mean a high probability of subsidizing other parties to the pool because of the lack of homogeneity of lives.

Disallowing access by insurance companies to this information increases asymmetric information, adverse selection, and the danger of a breakdown of the market. Providing this information for both sides of the market leads to segmented risk pooling and the exclusion of some groups (those with identified high survival rates), for which public provisions may have to be established. The introduction of rating would eliminate the non-stochastic component (that is, those elements that would induce strong adverse selection) from the pooling equilibrium. In other words, types systematically better than the average (that is, who die earlier) would be better off, while types systematically worse than the average would be worse off.

The other main issue concerns the question of who should bear the risk of rising life expectancy and uncertain future investment income. Some demographers have been predicting large increases in life expectancy due to scientific breakthroughs. Some economists have been predicting prolonged drops in stock prices or bond interest rates due to aging populations who cash in their stocks and use them to buy more stable bonds. Evidence from many countries indicates that these companies now return the government bond rate to annuitants over their expected lifetime; that is, the "money's worth ratio," discounted at the government term structure, is close to 100 percent. A large increase in longevity or a decrease in investment income may bring losses to these companies, including the possibility of insolvency and failure to keep their promises to annuitants.

How should we deal with these risks? Who is best equipped to deal with them? At least three approaches are relevant here. In the first approach, insurance companies continue to bear the risks, but with careful government regulation to ensure that their reserves are large enough to cover unexpected shocks. Such reserves and regulations have significant costs, so we would expect them to be factored into the prices (or money's worth ratios) offered annuitants.

The second method explicitly shares these risks with annuitants by allowing and possibly encouraging variable annuities whose value varies annually depending on actual longevity and investment outcomes. Annuitants get a higher expected return than they would under fixed-rate annuities, but they also bear some of the risk, which may be difficult for low-income pensioners. Also, they may not understand the complex terms of the variable annuity, and companies may take advantage of their lack of information. Obviously, if this approach is taken, government has a large responsibility for providing consumer information and for standardizing the terms of payout variation to facilitate comprehension and comparability.

The third method of assigning risk places a heavier burden on government, which might offer a minimum pension guarantee, sell longevity-indexed bonds, or provide the annuities directly. This enables the broadest possible intergenerational risk sharing, but it also creates the danger that government will be faced with a large contingent liability many years in the future. The "best" solution for the annuity dilemma remains an unresolved and controversial issue.

With this, I will finish. I hope that I gave you some glimpse into the banks' thinking about pension systems and reform. I hope that you got the message and understood that we are, in general, supportive strong funded pillars. But I hope I could also convey to you that in order to deliver fully on their social policy objectives funded provisions have to improve. In order to do so, I see areas of common interest and possibilities to address them together. Quite definitely, the conference yesterday and today was a great start for such a discussion.

REFERENCE

HOLZMANN R., RICHARD H. and WORLDBANK team (2002). Old-age income support in 21st century: an international perspective on pension systems and reform, Washington, DC, World Bank.

Commentaries

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When Guillermo Arthur first asked me to comment on this working paper, I gladly accepted before even looking at it. When I saw the 250-page long document, I hesitated for a while. But I think that it finally resulted in a very useful effort, because the World Bank is an institution that has been playing a key role lately, and because I think the buzz that -from the World Bank itself- over the last couple of years has been around on pension issues, called for an effort to clarify its position in this regard. I consider that from this standpoint, the document is extraordinarily well received for all.

I would like to make some general comments before actually analyzing the document. We all know that pension systems of individual capitalization are relatively new. If we set aside the Chilean case, the country with more experience is Peru, and only 12 years operating in the system which is not much.

It is important to highlight that the system is one of the few socioeconomic institutions that has been exported from developed countries and that is being applied in a developed country such as Sweden. Apart from being a matter of discussion in the United States as the main issue of political debate.

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The main implication of this original nature is that there is no country in the OECD that can be authorized to either compare or suggest how to improve, how to perfect our pension systems based on individual capitalization.

There is no public asset as a benchmark as is the case with Basle agreements among rich countries that we have somehow adopted in the banking sector, or behavior standards of the IAIS (International Association of Insurance Supervisors) for the insurance sector, and so many other international standards that are considered public assets and that we, developing countries, simply take and practically copy in our legislations.

As regards the pension system based on individual capitalization this is not the case. This is a reform that was born here and, therefore, we have to take the challenge into our own hands to mull over, to adapt the model to make it coherent with the principles of social security.

I think that Latin America in particular –I do not deeply know the specific case of Eastern Europe–, but I think that in Latin America this is far from what it should be. We are not making the necessary effort in the region to develop the mindset, data bases, nor the critical reflection as to how to improve our model.

Therefore, we rest on the support the World Bank provides with on these issues. Thus, we see that much of the intellectual effort that is being made nowadays on these issues is born precisely out of the World Bank. So, to clarify its position is quite fundamental.

This document is not a research report, even though it well describes the criteria used in the Bank in the reforms it proposes. It is not an easy reading. Actually, it is too literate, there is a lack of data and graphs which makes the life of economists far easier. However, once we reach the ending of the text, we are under the impression that the global focus of the World Bank is far more complex and with much more nuances than what it is actually seen from the outside.

In particular, and now I will talk about the issues that are of our interest, there is not a unilateral, fanatic argument, in favor of capitalization systems in the sense that the second pillar must constitute, per se, the main component of pension systems and that, as mentioned yesterday, pillars zero and one are residual. That argument is not applicable. There is more a sense that countries are different and they deserve a combination of these pillars which is specific for each one. I think that is a serious approach and I think it is fine that the World Bank has such an approach.

In fact, the report begins by increasing the number of necessary pillars that there originally were basically three. Here, they increased them to five as Robert Holzmann just said, and this somewhat sides with those who have said that there effectively is a coverage problem that should be seen outside pillar two.

But just as Robert has mentioned here, there are many areas in which pillar two can be improved and, therefore, it also sides with those of us who believe that it is possible to perfect the second pillar and do it much more efficiently, in a much more compatible way with the most advanced social security systems.

In particular, in the report that Robert Holzmann has presented, nothing is mentioned as to perfecting or strengthening pillar one at the expense of the second pillar. That conclusion is not part of the report.

From the reading of this working paper- whose extension does not make it easy to make specific references- I was suggested to come up with six questions, which are questions that I certainly ask the World Bank, despite the fact that I think this entity is aware of them.

The World Bank places a global emphasis on all its policies whose objectives are the prevention of poverty. This is all well and good, but in the case of pension systems I would like to come up with a caveat because in old age issues, poverty seems not to be the main concern, and I will show you this later.

Then, perhaps (and this is something that Fabio Bertranou mentioned yesterday), little time has been devoted %and not only the World Bank is to be blamed for this because it is actually everybody's fault% to promote a better first pillar. But when we see what is happening –and I will particularly show the investment portfolios of the PFA–, it is fair to wonder if we have made the relevant strides to improve pillar two. I think that, even though we have spent plenty of time in pillar two, there is still much left to do.

Third, there is the issue mentioned by Robert in the last part of his presentation: in the long haul, what is good about managing accumulating resources for the pension is to spend it and not accummulate it just for the sake of it. The truth is that we have allocated little resources to improve the deaccumulation phase. In fact, I am under the impression that here today there are no life insurance companies present. Certainly, the big financial groups have life insurance companies but they are not, as an industry, represented here. And there is a certain mystic in the pensions that PFA industry is gradually taken. Quite frankly, my impression is that this mystic is not shared in the sector of life insurance companies which are important agents for the development of the system.

The fourth point is that when we move towards a capitalization system, people are allegedly responsible for their future. In fact, this is part of the ideology with which President Bush is selling this reform; that is to say, we must be responsible for our own future. But first of all, and as Andrea Repetto said yesterday, if we are wrong after 20 years we cannot go back and correct, and on top of that there are information problems. The question is whether or not people are able to be responsible of the risks we have assigned them. How is risk being allocated among much more sophisticated players than the average Bill Smith in the street? This is something I will also talk about afterwards.

On the other hand, there are transition issues. Much of our focus is on these issues: fiscal deficit, which is right, but social security is always much more complicated than just one variable and usually there are people who are likely “to be the goat” of the necessary fiscal adjustment to validate the reform, and unresolved transition problems are generated that greatly affect the economic policy of the future improvement of the reform which I think are issues that can be timely solved.

Lastly, the issue of competition. I think it is critical to improve and increase the competitive conditions of this industry which can be derived from the fact that it manages compulsory saving. It makes no sense to force people to contribute money so it can be managed by some people, if in the long run the competitive scenario in which this takes place is not so clear.

I am against the idea that the regulators be the ones who, by political negotiation, make prices fall. I think that the challenge here is to search for a sustainable solution to improve competition. Augusto Iglesias suggested yesterday to provide a subsidy to strengthen pillar three, but we wonder how we can show up in Congress and ask for money to subsidize the development of the third pillar on the basis of an industry about which it is said to have high costs.

I will talk then about each one of these six points, and I will show some figures based on the Chilean experience.

1. The issue of poverty. For the Chilean case, this figure shows, by age, extreme poverty, poverty and non poverty groups. In the population older than 61 or more, those who are extremely poor account for 1,4% of these group in particular and 8,3% of the poor. Compare that to the situation of poor children, where we can see that the figure is six times higher, that is, 7,7% of the children are extremely poor compared to 1,4% of the persons who are 61 years of age or older. The same is true for poverty figures (see Table Nº 1).

This means there is a very significant opportunity cost for the idea of relieving poverty in the old age and it is, precisely the poverty of the children.

Secondly, a point related to what was said before: the emphasis on the prevention of poverty. If we allocated all the resources to

Table Nº 1

SITUATION OF POVERTY

Age	Extremely poor	Poor	Not poor	Total
0-10	7,7	19,9	72,4	100
11-20	6,2	18,0	75,7	100
21-30	3,8	12,0	84,3	100
31-40	4,5	14,2	81,4	100
41-50	3,8	11,4	84,8	100
51-60	2,8	8,6	88,6	100
61 or more	1,4	8,3	90,3	100
Total	4,7	14,1	81,2	100

Source: Mideplan, Social Division, Mideplan, Casen 2003.

prevent poverty (the first pillar), and it is proposed that the importance of the second pillar dimished; or that pillars one and three must be strengthened, we are actually assuming there would be some degree of awareness, of time distance, of high planning on the part of people. Nothing can be further from the truth.

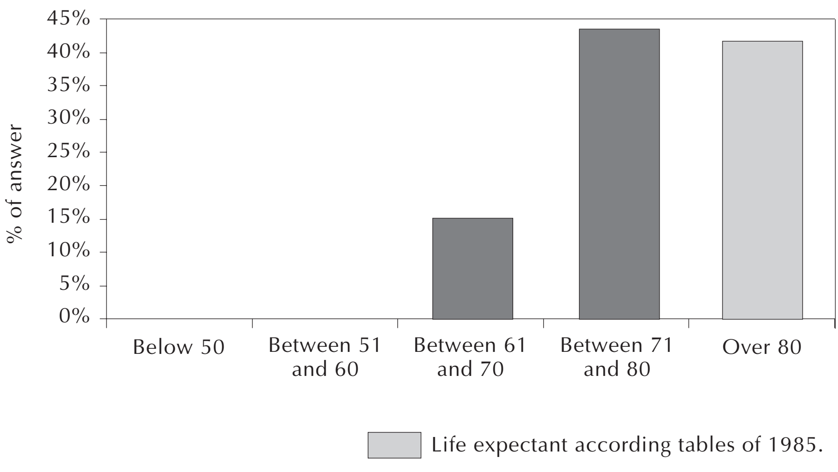
The social pension survey to which Andrea Repetto referred yesterday and that covered the Chilean case, asked the following question: what age do you think you will die? And what I am showing in Graphic Nº1 is the answer, the distribution of the answers of individuals who are rather between 15 and 35 years of age; and look at the figure and the way that distribution changes when we go to the next group: it will not budge, the distribution remains practically the same. When people who are 60 are asked this question, the answer changes quite substantially.

What I want to say is that people realize much too late that they are going to live far longer. And probably those are going to be the kind of surprises that we will systematically see in the future.

This means it is not possible, in my mind, to think of a social security system where there is no compulsory pillar in charge of softening consumption and not just aliviate poverty.

Graphic Nº 1

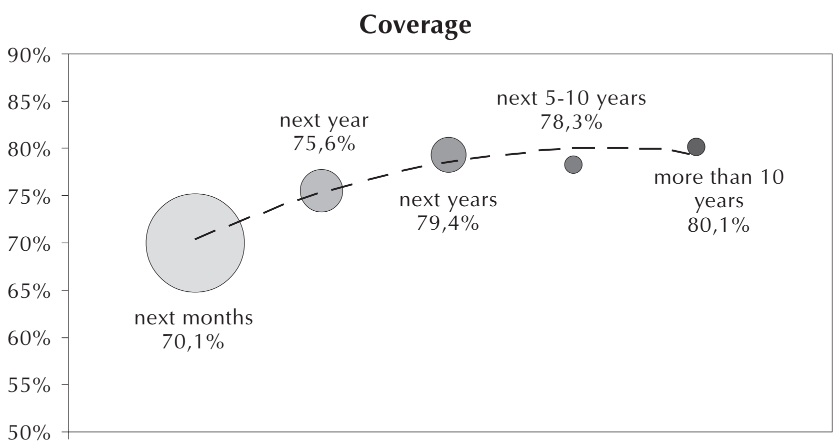
LIFE EXPECTANCY FOR INDIVIDUATE OLDER THAN 60 YEAR



The same happens here when asking the question as to how distant into the future you organize your expenses. The size of each sphere shows the number of people who answered, and truth be told, most of the individuals live on a daily basis, even more so in the case of self-employed workers rather than dependent workers, but the greater number is comprised of workers who think in terms of the next few months (See Diagram Nº1).

Diagram Nº 1

QUESTION: WHAT IS THE HORIZONT WITH WHICH YOU ORGANIZE YOUR EXPENSES?



Note: the size of the spheres shows the percentage of response, whereas the figures deal with coverage.

2. Complementary reforms. We have spent too much time in the second pillar. We look at pension funds investment portfolios in Latin America, and with the exception of Chile and Peru, and the Dominican case up to a certain extent, the concentration in State assets which is shown in the first column of the figure is truly remarkable (see Table Nº 2). The Argentine case accounts for 68,1%; the Mexican case for 85,6%. There are improvements through time, but clearly there is an extremely bad diversification and we wonder why. The question is, for example, if you, those who are in this very room, are incompetent. I do not think so. There are other reasons that explain this bad diversification of the assets.

Table Nº 2

IN THE FINANCIAL MARKETS: WHY DIVERSIFICATION IS SO POOR?

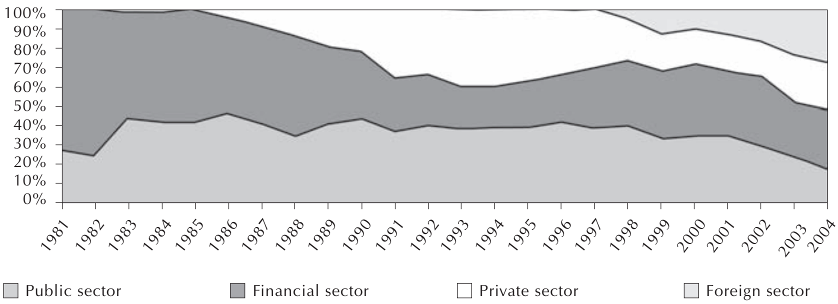
Country	Total (millions of US$)	Govern-ment debt	Financial institu-tions	Non financial institu-tions	Stocks	Mutual & investments	Foreigner issues	Others
					(porcentaje respecto al fondo total)			
Argentina	16.222	68,1	4,5	2,1	10,4	2,9	9,4	2,5
Bolivia	1.617	64,9	6,5	18,2	7,9		1,6	0,9
Chile	48.992	21,2	28,3	7,1	13,3	2,5	27,5	0,1
Costa Rica	378	74,1	10,8	9,4		1,5		4,2
El Salvador	1.819	84,2	10,2	5,3	0,3			
Mexico	37.930	85,6	4,3	10,				
Peru	6.699	21,2	16,2	11,0	36,9	1,6	9,5	3,5
R. Dominicana*	245	24,4	66,5	2,	6,5			0,2
Uruguay	1.323	55,5	37,7	5,4				1,4
Total	**115.224**	**51,2**	**15,9**	**7,7**	**9,4**	**1,6**	**13,6**	**0,7**
Total w/o Chile	66.232	73,4	6,7	8,1	6,5	0,9	3,3	1,1
Total w/o Chile and Peru	**59.533**	**79,3**	**5,7**	**7,8**	**3,1**	**0,9**	**2,6**	**0,9**

In Graphic Nº2 we can see the history of the Chilean diversification, and we can identify two kinds of assets; gradually a third one shows up, then a fourth one within 25 years. What I want to point out is that the diversification process requires more tenacity and a certain number of requirements so they can be developed adequately in fixed income markets.

The point is that the agenda of reforms that triggers the pension reform is quite long, is extremely long; it requires from all of us a huge amount of effort and patience. Among other things, because there are many groups of interest that try to block these reforms, groups of interest that are embedded in the financial market and are underdeveloped, groups of interest that do not want transparency, that do not want accountability.

That happens everywhere and I think that here there is arole we might ask the PFA to play: help remove the hurdle of political

Graphic Nº 2
EVOLUTION OF ASSET DIVERSIFICATION IN CHILE



economy that hinders these markets from development and that goes in the own interest of the pension funds.

The case of labor markets is another complementary reform, we say there is a problem with female retirement, but the truth is that we have done very lttle to improve the female labor market. In Chile, it is nowadays quite common to say that there is a contractual issue, that there is little contractual flexibility. It is possible. And that childcare is also an issue that must be subsidized and, besides, a much more complicated issue which is male chauvinism.

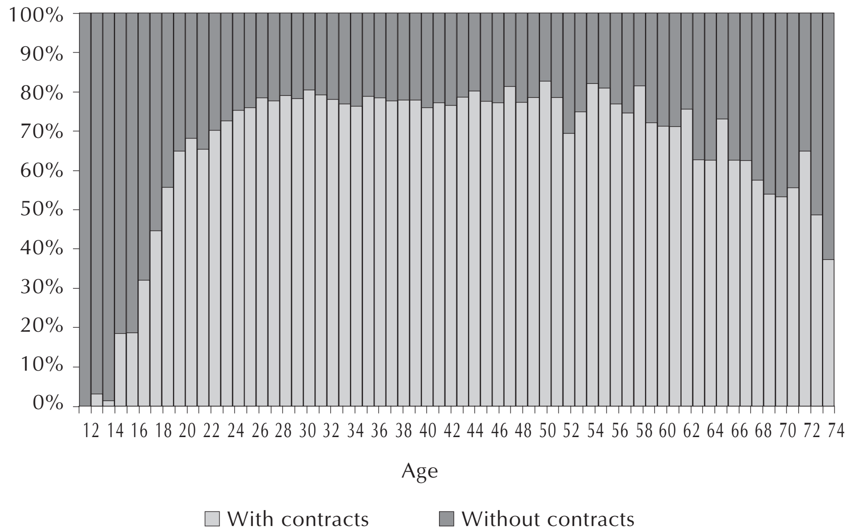
But those are three answers that arise quite evidently and not always true solutions are evident. I think we have to give it much more thought as to what we are coming to with these issues

3. Informality in the labor market. Today, Latin America, according to the ILO has 46,7% of the employment in the informal sector and the truth is that we are not so clear as to how we make strides in this sector, particularly when we see that informality is relevant because it is much more focused on low income sectors; if those individuals might have access to coverage we would have a different situation in the labor market.

In addition, informality is much stronger among young people. See Graphic Nº 3, there is the distribution by age and the percentage of informality for each age bracket in the Chilean case. The dark bars represent the workers that operate without a contract, and we can see that young people account for a big share of informal contracts. But remember that in a capitalization system, being informal when we are young, not contributing when we are young has an spectacular cost in terms of the pension down the road. Later on, this issue becomes crucial.

Graphic Nº 3

INFORMALITY OF UNEMPLOYMENT

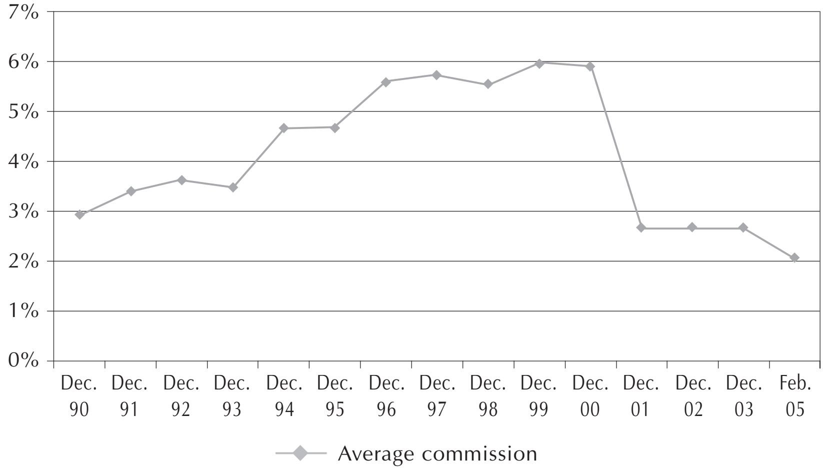


Source: Survey CASEN 2000.

4. The desaccumulation phase. In Chile –here I show the table with transactional costs of a life annuity in the Chilean case-, costs were going up in the 90s from 3% of the pension fund up to 6% (see Graphic Nº 4). This is extremely expensive. The government sent a reform in 1994 which took 10 years to be passed, and everybody who retired in between, did so paying too high commissions under extremely lax early retirement conditions, and today they complain because the pensions are low.

This, for example, is the kind of political influence that I think pension funds might have had in order to unblock a reform that lasted for 10 years in the Chilean case, and that could have taken place much earlier.

Gráfico Nº 4

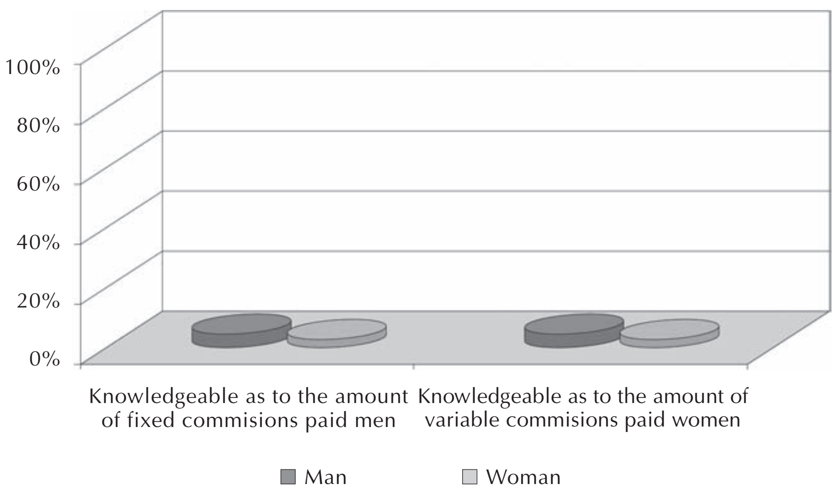


And the same happens with early retirement. Nowadays, 67% of men are taking early retirement in Chile, at age 56; that is, it is quite obvious they complain if the pensions are low. But this situation ocurred because there was a law that was not passed in Congress because of a political issue. Then, pension funds have to act according to these problems, and I do not even want to mention the case for women because it is even sadder.

5. The risk issue. The regular people in the street have extremely limited knowledge on the pension system. We came up with some sort of test and to be honest they did not get a passing grade. Graphic Nº5 shows the distribution of two results, of the test out of a total of 36 questions, and you can see that the average of correct answers is around 5 or 6. People do not know about the amount of the fixed commissions they pay, they do not know about the amount of variable commissions, then it is very difficult to tell them to be responsible and take risks.

On the other hand, what kind of risk is the State taking? The risk of the minimum pension, no doubt, but minimum pension is not well defined in the Chilean case because, according to our projections –in a working paper I elaborated together with two colleagues from the Superintendency-, the amount of people who will definitely have access to the minimum pension in Chile represents an average that ranges between 10% and 15%, with a yield rate of 5%. If for some reason we managed that the yield were 7%, the individuals who have access to the minimum pension vanish (see Graphic Nº 6); which means that we have not been successful in defining the requirements to have access to the minimum pension, then, the State is not taking a significant risk, either.

Graphic Nº 5



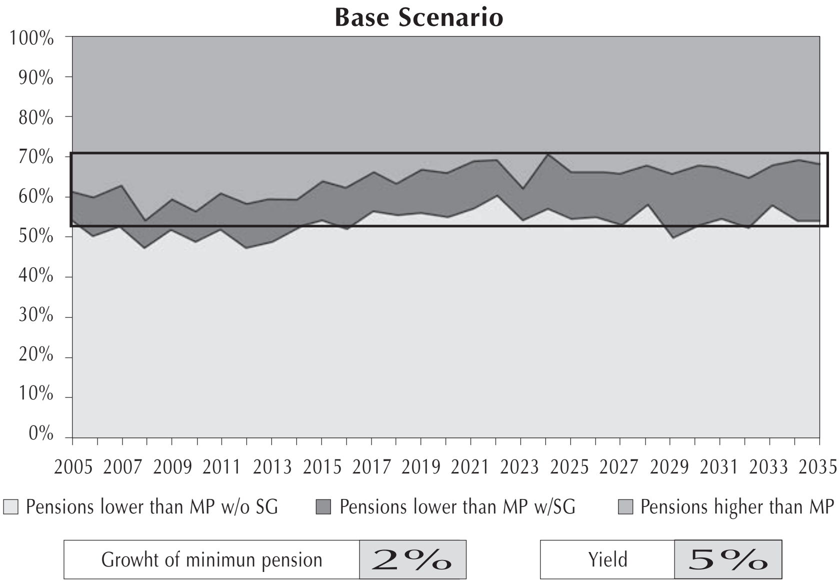
On the other hand, the fundamental role of the PFAs is to worry more about the risk of falling into the minimum yield rather than the definitive risk of the pension. Then, I think there is a global risk allocation that we have to think about which is quite relevant.

The graphs correspond to a preliminary version. The working paper is available at www.safp.cl

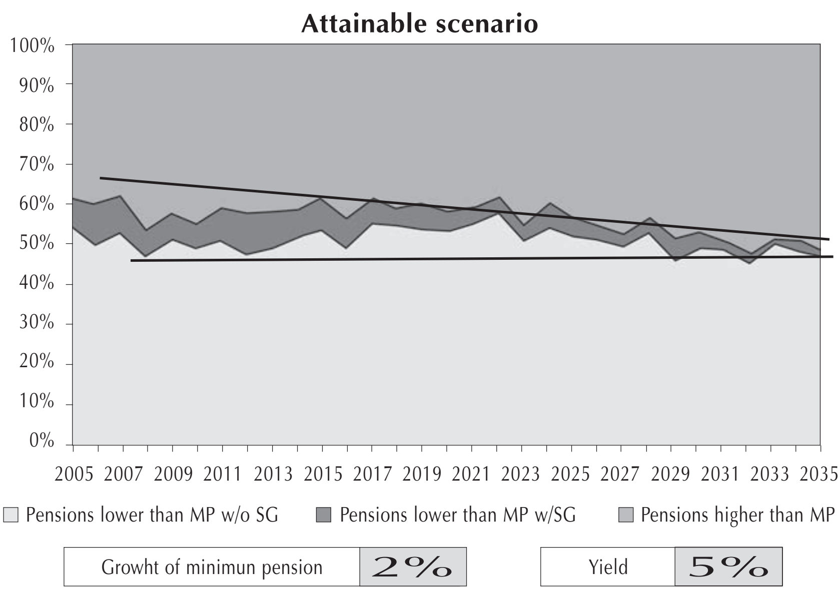
6. Transition issues. In the Chilean case, transition is quite an issue. I would like to mention only one, which is what we call "pension damage". This damage has to do with the way in which the fiscal adjustment was carried out and that today it is thought to have helped the reform. This fiscal adjustment was made on the basis of not contributing the total of the wage of civil servants, who are the most organized and, politically speaking, greatly oppose the system. Then, transition issues are important.

Graphic Nº 6

ACCESS TO MINIMUM PENSION



Source: Berstein, Larraín and Pino (2005).



Source: Berstein, Larraín and Pino (2005).

Note: The graphs correspond to a preliminary version. The working paper is available at www.safp.cl

Finally, I will talk about the industrial organization issues we have already covered. I do not think it is only a matter of the level of the commission. I believe that if we think the problem lies in that commissions are too high, we are making a mistake. In effect, we can push the industry enough as to lower the commissions. Competition goes beyond a low commission, it is an attitude towards customer service, quality of service, technological innovation that it is precisely triggered by the competition. Price is an example of that, but if we concentrate the industrial organization issue solely on the fact that the price must be low, I think we will make a mistake. Thank you very much.

Closing remarks

The future of the pension system in Colombia

Luis Fernando Alarcón*

Doctor Álvaro Uribe Vélez, President of the Republic; Doctor Diego Palacios, Minister of Social Protection; Mr. Guillermo Arthur, President of FIAP; Doctor Libardo Simanca, Governor of the District of Bolivar; Doctor Alberto Barbosa, Mayor of Cartagena; Mr. President of the Colombian Association of Pension and Unemployment Funds Administrators; Mrs. Superintendent Delegate for Pensions and Unemployment, Doctor Ligia Elena Borrero. Delegates of the FIAP assembly; Doctor Patricia Cárdenas, President of the Banking Association of Colombia.

First of all, I would like to thank FIAP for giving us the opportunity to receive them in our beloved Cartagena de Indias.

To the lecturers, thanks for your dedication and generosity in sharing your valuable reflections with us.

Thanks to the numerous audience coming from all latitudes for having trusted in the country. To the natives of Cartagena for your hospitality.

To the Banking Association; to Doctor Patricia Cárdenas and very especially to Pamela Barberi for their logistics support in the organization of this event.

To our sponsors, for their contribution to this cause.

And very especially to you Mr. President, thank you for honoring us with your presence.

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* President of the Colombian Association of Pension and Unemployment Funds Administrators, ASOFONDOS, Colombia.a

In the name of ASOFONDOS and its member entities, thank you very much to you all.

Allow me, in this session, to take a few minutes to share with you some reflections on the evolution of the pension system in Colombia and the main challenges that, in my opinion, it will face going forward to offer the workers, specially the poorest ones, a better adapted scheme to attend the contingencies of old age.

In only two minutes I will synthesize the history of our pension system.

In the middle of the 20th century, the law imposed employers with the obligation to entirely assume their workers pensions. Based on this mandate, in the public sector as employers, multiple institutions in charge of attending such a commitment arose, and under their protection different pension schemes were designed whose common characteristic was to grant wide benefits.

As for the private sector, which included many industrial and commercial companies of the State, a pension scheme was established that progressively became more and more onerous as a result of collective bargaining labor negotiations.

In 1968, when we understood that the increasing pension asset in charge of the companies would soon become unmanageable, the reformist government of Carlos Lleras Restrepo created the Mandatory Social Security System, especially the scheme of disability, old age and death, (also known in Colombia as IVM), in charge of the Colombian Institute of Social Security.

The original design of the IVM, in hindsight, was very ambitious and followed the parameters of the very design implemented at the time: defined benefits calculated on the basis of the last accrued wage; ages were in accordance with the prevalent life expectancies at the moment, and a chronogram of contribution increase that gradually adjusted it from 6 % back then up to 23 % in 1991.

However, in the early nineties, when the crisis became evident, the contribution was scarcely 8,5 % of the wages and the country's demographic conditions were totally different from those initially foreseen.

The seriousness and imminence of this crisis led the administration of César Gaviria together with Senator Álvaro Uribe Vélez, to foster Congress to come up with a structural reform that gave the country a financially sustainable pensions system, and, above all, fair and equitable, up to the extent that welfare benefits were actually focused on the most economically vulnerable population. Law 100 of 1993 represented a big step ahead, but it failed in several aspects due to necessary political transactions.

It is necessary to underline the following points of the structural reform. An individual saving scheme with a design very similar to that of Chile was created, but the possibility to continue being part of the former defined benefits system was still open, even for new workers. Simultaneously, an important parametric reform was carried out which was completed during the current administration. Because of that, new participants who will be granted their pensions within the adjusted parameters will not represent an onerous burden for the National Treasury, with the exception of minimum pensions to which I will refer hereinafter. Furthermore, since the workers have understood that the advantages of the pay-as-you-go system are not clear and that it is likely to undergo further changes, they have massively preferred to participate in the capitalization scheme.

What has actually been disastrous for public finances is the so called transitional period to which 40-year-old men and 35-year-old women belonged at the time Law 100 was passed; since they have the right to be granted a pension under the old conditions. The previous situation implied that the parametric reforms of the so called Defined Benefit Scheme were approved in order to be applied 20 years later.

For example. There are still social security participants who enjoy the transitional period and that can get a pension with 500 weeks of contributions, with a replacement rate of 45 % of the average wage of the last 10 years, but if they can contribute 1000 weeks, they could obtain a pension equivalent to 90%. Let alone, certainly, the cases in which such a transitional period applies to the privileged conditions of Congress, High Courts of the legal system, and other entities of the public sector.

The issue of how long the transitional period remains in force is one of the aspects that have to be corrected, by reducing the permanence in the constitutional reform on pensions that is currently under debate in Congress and whose legislative process must end next month.

Unfortunately, Congress has been taking away substance from the proposal originally made by the government.

Once the constitutional reform is passed, the possibility to perform new reductions to the pension liability in force will

have been practically over, because society will be forced to honor the payment of the allowances of current pensioners and of those who acquired the right in the defined benefits scheme until the year 2014, when all the pension advantages and privileges are concluded. Since it is a substantial debt and the law stipulates that the remaining participants be covered with charge to the national budget, it will be necessary to incur in significant fiscal expenses.

Let us revise some figures that synthesize this situation.

At the turn of this decade, the flow of pension expenses charged to the National Treasury was calculated to be approximately 200% of the gross domestic product at present value; amount that has to be paid out almost completely during the next 50 years. After Congress passed the reforms during the first two years of government, this amount dropped roughly 40 points, and if the constitutional reform is passed – as we hope it to be- an additional drop of 20 points will be achieved, and during the next five decades it will be necessary that the National Treasury pays out a pension debt of close to 140% of the gross domestic product.

The previous situation will imply an enormous efforton the part of public finances and an increase of the explicit national debt; such an increase will certainly have to be carried out with extreme caution. But we must not forget a few things that come along with this process and that make finance and public indebtedness incapable of being analyzed as though anything had occurred: the existence of a pension saving accumulated in pension funds which directly or indirectly helps finance an important part of the biggest indebtedness, and that implicit debt is being paid out to a pace particularly accelerated during the next two decades, as budget transferences of pensions payment will fluctuate approximately between 4 % and 5,5 % of the gross domestic product per year.

But now Mr. President, let us take a look into the future. The culmination of the first stage of the reform process does not entail that the agenda is covered and that there are no changes to make. On the contrary, there are still several and very important changes that need to be made. The difference lies in the fact while the reforms of the last ten years were oriented to moderate and cut privileges, the following ones will have to be oriented towards creating better conditions for those workers who will be granted a pension starting in 2015, most of them as part of the individual saving scheme.

I would like to talk about those necessary changes during the rest of this intervention.

The first issue is coverage. Part of this issue is the widening of the non-contributory or welfare pensions directed to poverty-stricken elders who have never contributed to the system and who depend critically on available fiscal resources. Until now, their pensions had been possible courtesy of what has been collected for the Pension Solidarity Fund, but an ambitious policy in this field cannot depend exclusively on salaried labor taxed financing. This cannot be improved by means of pension system reforms; it is rather an issue of fiscal policy and priorities in public spending.

Another coverage challenge is how to increase the number of workers participating in the system and the number of active participants. The studies clearly show that the problem here is mainly related to economic growth, employment in general, and its quality in particular. Certainly, we have to think over some aspects. For example: the heavy burden of payroll taxes existing in Colombia definitively does not contribute to the formalization of employment.

As for coverage, the issue that I want to specifically draw attention to is the access to a minimum pension for participants with lower means of support –which in Colombia is not a small number- since the design of the system has much to do whit this issue. From 2015, 62-year-old men and 57-year-old women who had contributed during 1.300 weeks to the defined benefit scheme, or 1.325 weeks to the individual saving scheme, will have the right to a guaranteed pension equivalent to a minimum wage.

In the last scheme, that of pension funds, the reserves for this purpose had already started to be set up, with contributions of the very participants since 1,5 % of the 15 % base wage contribution that they contribute today, is allocated to the minimum pension guarantee fund of the individual saving scheme.

The question is how many lower income workers will manage to accomplish the density of contributions implied in the number of required weeks.

After a heated debate in Congress, we have come to the aforementioned combination of age, amount of minimum pension and density of contributions.The political preference is that the amount of the minimum pension and the age cannot be modified, therefore, the adjustment to

keep fiscal spending of the guarantee in the defined benefit scheme under control, is given within the number of contributed weeks.

Recent analyses from the National Planning Department draw attention towards the fact that, given the historical pattern of Colombian workers' contributions, the number of beneficiaries from the aforementioned guarantee is going to be small, and the guarantee fund of the individual saving scheme will accumulate increasing resources -which will not be a minor amount- failing to adequately fulfil the purposes for which it was created in the first place.

In other words, the fact of having anchored minimum pension to minimum wage will represent a threat instead of a lifesaver, since the only way of financing such a high goal in the defined benefit scheme is by hardening other parameters of the equation and specially the required weeks.

Under such circumstances we have asked ourselves whether poorest workers would be better off with a guaranteed scheme, with a pension goal slightly lower, an age limit slightly higher; for example, the 65 years proposed by the government in several opportunities in exchange of being able to guarantee pensions within a lower number of contributed weeks.

This is far from being a simple issue. I am aware of the sensibilities it entails, but the matter must be approached objectively and supported by actuarial calculations as well as with a clear political decision that seeks to extend the minumum pension guarantee to the highest possible number of lower income workers.

Pension funds participants and their employers have already assumed that a not too insignificant part of their contributions are allocated for a purpose that is definitely distributive in nature. It would be very frustrating if the future surprised us with the reality that the individual sacrifice, which is also solidary and collective, would not live up to the task, and thousands of elders ended up deprived of a pension because the system followed a design that was not based on reality.

The second set of issues where it is possible to make beneficial changes, deals with the need to stimulate the virtuous circle of better accumulated yield for the participants, which is a source of better pensions and at the same time has a greater impact on capital market development, and therefore on general growth and welfare.

World Bank's Dimitri Vitas's working paper æ*Pension Reform and Capital Market Development*æ summarized the conditions needed in order for pension reforms, which create capitalization systems, to generate the desired impact on the capital market as the amount of managed resources of a critical mass -Vitas quantifies this mass as being close to 20% of the Gross Domestic Product-, the suitable regulations that must be adopted, and the portfolio optimization policies that have to be complied with by managers.

In my opinion, the first condition has already been accomplished, since PFA manage resources in their three activities which are equivalent today to approximately 15 % of the GDP. And as for the others, though it is necessary to admit that our investments regulation has favorably evolved and the authorities, especially the banking superintendence, have been receptive to make the required changes, there is also clear consensus as to the need to make some legal adjustments which should lead to a better portfolio diversification and to a higher demand for risk assets, including those of variable income.

When the scheme was created in accordance with Law 100, there was a legitimate concern about the yield that participants should obtain, especially those close to obtaining the pension, which in case of a reactive situation on the value of the portfolios, could see the amount of their pension affected. For this reason, the minimum yield was established with severe penalties for managers who do not comply with it. Experience has demonstrated that this rule stimulates conservative portfolio management, which in the long term can represent a lower yield and, therefore lower pensions.

Conversely, having to put 20-year-old participants together with 57-year-old participants in the one and only portfolio, and at the same time risking the manager's net worth to guarantee a short term yield, is not a healthy way of seeking portfolio optimization, which is one of the conditions appointed by Vitas.

Recently, Mr. President, about three years ago, a more intelligent way of satisfying these different objectives was adopted in Chile, and the multifunds scheme was designed. By this means the worker can assume higher or lower risks depending on the age. Certain minimum yield measures for each type of portfolio remained, though I think this restriction should disappear, being the worker the main beneficiary.

In ASOFONDOS we think that the time has come for Colombia to take the leap forwards towards multifunds.

In order to achieve a better yield, besides changes in the regulation, it is important to increase the offer of assets in which funds resources can be invested. That is why I cannot let the opportunity pass by to ask you Mr. President to consider, within the government's divestment processes, the possibility of following a similar path than that implemented in the ISA case.

This has been internationally recognized and its equity capital was democratized, not privatized since the nation continues to be the majority stockholder, and it is recognized as the company with the highest standards of corporate governance in Colombia having more than 50 thousand shareholders, among them, pension funds. I believe, Mr. President, this is the model we have to follow in an attempt to make of Colombia a country of stockholders.

The issues I have referred to, coverage and risk management to improve yields, are of great significance and in need for a wide political and technical consensus, which is the reason we invited the government to share a process of reflection that allows for the design of adequate schemes.

On the other hand and to finish, Mr. President, we also want to call your attention on the need to be careful and wary in implementing the integrated pay-out system of social security which we have proactively supported.

Undoubtedly, such a mechanism has great advantages in fighting against the evasion of contributions within the social protection system; however, and due to implications in recognizing the benefits granted to workers by the system, it demands a thorough process of planning and assurance. As the Minister already knows, ASOFONDOS is interested in its development and in the consolidation of a civil and managerial culture on the issue.

Mister President, distinguished lecturers and authorities, respected friends. We reiterate our thanks for attending this academic event whose importance and scope become evident in the numerous audience and participation.

We hope, especially for our foreign friends, that your stay in Corralito de Piedra has been pleasant, and that you come back very soon to our dear Colombia.

Thank you very much.

Guillermo Arthur
President of the International Federation of Pension Fund Administrators, FIAP

Your Excellence, Mr. President of the Colombian Republic, Doctor Álvaro Uribe Vélez. On behalf of the delegates who have come from 22 Latin American and Eastern European countries, allow me, first of all, to especially thank you for your presence at the end of our debates, which gives luster to this gathering. Your presence, Mr. President, is especially significant for us because we know well that you were one of the promoters of the pension reform in Colombia by being the informant senator of Law 100 which put in force the pension regulations based on the individual capitalization of the contributions and their private management.

During this gathering, Mr. President, we have tested the development of these systems in those countries which have adopted a similar reform to that of Colombia. We believe that the result is totally positive. We feel that this reform is gradually fulfilling its objective to offer workers better pensions than those a pay-as-you-go system can offer, thanks to investments that allow for high yield rates, good yields that, ultimately, will have to be translated into good pensions.

We also feel that we have been particularly successful in contributing to the economic development of our countries when the regulations have allowed us to invest in the sectors that offer a higher yield for the workers' money and collaborate more with the development of our countries.

However, Mr. President, certain characteristics of our countries, completely alien to the pension system situation, have somehow hindered this initially modernizing thrust. In effect, in most of the countries that are represented here, high unemployment rates and high levels of informality still persist, which have very negative repercussion within the pension coverage. We think that this loss of thrust should lead us to deeply mull over which are the corrections that we should introduce within the system.

That is the reason this seminar has been focused on studying which the role corresponding to each one of the pillars is within the general system of social security. We work and belong to the second pillar which is a funded pillar with fund capitalization, but we cannot stop recognizing the necessity to also strengthen an unfunded first pillar, targeted towards solving the situation of the sectors that due to poverty, informality or employment have not been able to contribute to finance their pensions.

We are sure that the debates and working papers prepared by the most important specialists will allow us to make advantageous conclusions for the development of these systems, and they will also allow for the recovery of the necessary serenity to argue about the transformations that this second pillar requires; that is, to foster the improvement of the coverage through a greater trust in the system that must be delivered from the governments themselves, and be inclined towards a wider investment diversification that allows for a higher yield as well as greater support for the economic development of our countries.

I would like to end these words, Mr. President, by reiterating our thanks and asking you as one of the promoters of this system to also collaborate with us to become again the promoter of this huge modernizing crusade of our social security for the welfare of our workers across the region.

Thanks again so much for your presence, Mr. President.

Álvaro Uribe

President of the Republic of Colombia

Mr. Diego Palacio Betancourt, Minister of Social Protection; Mr. Guillermo Arthur Errázuriz, President of the International Federation of Pension Funds Administrators; Mr. Former Secretary of the Treasury and Mr. Former Minister of State and President of the Colombian Association of Pension and Unemployment Funds Administrators, Luis Fernando Alarcón Mantilla; Mr. Governor of Bolivar, Libardo Simancas Torres; Mr. Mayor of Cartagena, Alberto Barbosa Sinior; Mr. president of the Directive Board of ASOFONDOS, Luis Fernando Restrepo Jaramillo; esteemed vice-ministers; fellow men of the National Government; highly distinguished members from different companies of funds and unemployment funds; Mrs. Delegate Superintendent of Pension Funds of the Banking Superintendency, Patricia Cárdenas Santamaría, President of ASOBANCARIA. Friends from the media; fellow countrymen.

I would like to warmly greet you all and specially the distinguished citizens who are with us today, coming from so many nearby countries, from European countries and even from the Russian Federation. I can see we have a very important delegation from the Netherlands Antilles, Argentina, Bolivia, Brazil, Costa Rica, Chile, Ecuador, El Salvador, Spain, Russia, Honduras, Mexico, Peru, Ukraine, Uruguay, Venezuela, Panama, Poland. To all, a greeting full of affection.

You are visiting a country with great difficulties, which is making all the efforts to move on. Doctor Patricia Cárdenas Santamaría knows by rote the speech she has heard me repeat often this week, about my elementary vision of Latin America.

I believe it is a big mistake to try to divide Latin America into countries with governments form the right wing and left wing of the political spectrum. This is an obsolete division that corresponds to a period of dictatorships; it is also inconvenient and the only thing it has caused is polarization.

A foreign journalist asked me this week what my opinion was about the governments from the left wing and the governments from the right wing in Latin America. And I expressed her this theory: she insisted and I said to her: Tell me the reason you believe that government X belongs to the right wing or that government Y is from the left wing, and she was not capable of giving me an answer. I believe that we are simply attending to a provocation based on a speech that is starting to have no basis on reality.

In my opinion, once adopted the democratic rule, these democracies have to de measured depending on five elements to define if they are caciquisms or institutional democracies, if they are democracies in which there's a rigorous submission from the elected to legal regulation or not; if they are progressive democracies or laggards. In my opinion, these five elements, should be: safety, public freedoms, social cohesion, transparency and institutionality.

Colombia has been working on these five elements. I am not going to go explain them in detail, but when an evaluation is carried out, a progressive democracy is found, which progresses in all these factors; where we are all submitted rigorously to the independence of the institutions and the compliance of legal regulations, starting with the top government led by the President of the Republic. This should be generating better understanding conditions across the Latin American region and increasing the number of investors and general citizenship confidence.

The pension issue is critical for each one of the five elements, in the social cohesion.

The first relevant information is that in these almost three years of government, the number of members of the pensions system has increased nearly in 1.000.600. Nevertheless, the same 50% rate of inactive individuals has remained. If we add up the assets of one scheme or the other, we find approximately 6 million members which are protected in an effective way by the system. This information has been used for many critics to say that the capitalization system has failed in Colombia, because there have not been noticeable strides in coverage.

I believe it is necessary to answer it in the following way. What affects coverage is not the system, but the general behavior of the economy. From 1994 when the system began, the Colombian economy had experienced really hard times, of very slow growth or even a decrease in growth; in 1994 unemployment jumped from 7,5% % to a rate of roughly 20% during the year 2000; in the same period, between 1994 and 2000, unemployment among heads of household raised from 4% to 10%; poverty grew enormously. The investment participation rate of the private sector that is currently again near 12% of the GDP, managed to be 6%, which I believe is the lowest over the last five decades. That is what we have to bear in mind.

From another angle, I see great benefits in the new pensions system. Firstly because there has not been a major increase in coverage, not for the system but for the general behavior of the economy. However, over the last two years and ten months a growth of 1.000.600 members has been shown.

Let us check another subject of great importance: the district attorney. Some attribute a good part of Colombia's fiscal deficit to the pension reform and, particularly, to having adopted the system of pension funds of individual capitalization.

Allow me to comment on this: when the government of President Barco finished, which had two Ministers - next President Gaviria and, you, doctor Alarcón-, public finances in Colombia were balanced and the public indebtedness of the Nation was not over 10% or 12% of the GDP. I refer to 1990. Twelve years later, when this administration began, public indebtedness jumped to 54% or 56% of the GDP and we had gone from a balanced financial situation to a 4,2% deficit recorded when this government started back in August 2002. We ended 2002 with a 3,6%, but after making two decisions: the adoption of the net worth tax for democratic safety and a freezing of public expenses near to a trillion of Colombian pesos.

Then, let us see two realities to judge the pension system well. First, an economy with a quite complicated behavior, in terms of growth and employment, and also, that fact that the same economy experienced some serious changes as for indebtedness and fiscal deficit.

What has happened in that same period? A huge dissaving in the private sector, accompanied with an unprecedented population exodus: four million Colombians migrated resulting in an internal movement of two million people that really aggravated the situation.

My question is: in this economic context, in that fiscal context, in that distrust and dissaving context, what would have happened to this country, if the mechanisms of capital construction, of reserves construction, of savings accumulation, that constitute the pensions individual capitalization system had not been created,?

I will ask you to think over this element. A country in stampede, the investment in drill, added to the fiscal deficit, the indebtedness and the increased unemployment, with negative rates of private saving. With this increasing and high fiscal deficit, what would have happened to us if we hadn't had this saving system, if the country hadn't implemented it in 1993?

This saving system has brought, in my opinion, a great benefit for the Colombian economy. Today, the country has the lowest inflation of the last 40 years; I am going to be 53 years old next 4th of July and I do not remember interest rates like the ones we have in the Colombian economy today. Of course, they will have to lower some more for the medium and small debtor, but the DTF in 7,17%, has an historical record.

I believe this sketch has contributed enormously to Colombia's decreasing inflation process and reduction of the interest rate.

And I wonder, if with such growth in public indebtedness, with the weight of the service of national debt in the national budget that accounts for 32% or 34% of the total budget, what would it be of the interest rate in Colombia if we had not 28.5 trillions saved in the pension funds?

I believe that this country should think about the benefits of the system.

Some people have said that the system has been perverse, because it increased fiscal deficit; I believe that it has had, among many –contrary to what opponents had said- two fiscal benefits that I want to emphasize. First, it brought us back to reality, forced us to introduce corrections and, second, it has financed us. Had we continued with the defined benefit system, we wouldn't have seen the arrival to the budget reality of that liability that still in many places doesn't want to be assessed, that is treated as an implicit liability, which supposedly would never be paid, and that is the pensional debt.

I believe that having expressed the issue is an attribute. Having taken the step towards creating the capitalization system in 1993 was a good choice. If introducing corrections has been so difficult, in spite of the confidence gained over the problem, what would have happen if we hadn't created the mechanism that has made us see the reality of the problem?

I think that we would not have introduced corrections; that the country would have remained fascinated by social service reserves; that the country would have continued paying privileged pensions, and that adjustments wouldn't have been carried out at all.

And yet another great fiscal benefit... what would we have done to finance the Colombian State? The point of this system is that it has helped to obtain a very low interest rate, in spite of the high requirements that the Colombian State has received to finance its own expenses and investments. Pension funds have turned into the great financing source of the Colombian State, generating a double virtue: financing the State and, simultaneously, something that seems to be a contradiction, inducing the low interest rates trend.

As for the adopted corrections, the President of Asofondos has said it. This government begins with an implicit pension deficit of 200% of the GDP and we aspire to end it with a deficit lower than 72 points. Why do accounts give me a more optimistic result than that of Doctor Luis Fernando Alarcón? Because he is assessing the legal reform we proposed and that the Congress of the Republic passed in December, 2002, as well as the effects of the constitutional reform that is in under scrutiny, which needs eight debates and has been approved in six of them to date, and I am adding, also, the administrative reform. This government has reformed 152 State entities, eliminating, in all of them, the privilege pensions, which has to be borne in mind.

And politically speaking, how have we defended these administrative reforms? We have said that it is not a question of privatizing everything, since some people have argued that this was already tried in Latin America back in the nineties. The purpose is to create a sustainable, efficient, transparent State. This has been the connecting thread in the reform of the 152 State entities.

Then, I believe that it is necessary to assess the effects of the administrative reform. Thus, the country is going to gain approximately 12, 14 or 15 more points of the GDP, in the clearing of privileged pension schemes on all these entities. I warn, however, that we lack many.

I trust that with the administrative and constitutional reforms, the country will make the necessary improvements.

Allow me to add a few references to the second chapter of the agenda which the President of Asofondos has raised.

I am in favor that this government, in what still rest of it, deal with this second chapter. The commitment that I would like to assume with you today is that using the help of the Minister of Social Protection and the private sector, we come to an agreement to present in the Congress of the Republic, a project that goes in that direction.

Allow me to make some references.

First, the transitional period. It is very difficult to move it more. I will go back to 1993. I had begun to struggle for this reform in 1986 and we achieved to process it successfully during the Gaviria administration in 1993. I remember that one of the transaction points was to postpone the transition until 2014 based on one reason: it was necessary to yield in favor of those who were saying, well, here a person who contributes, retires after 20 years, let us postpone an equal period. We passed the law when I was appointed Senator of the Republic in December, 1993 and we started the application on 1st of April, 1994, then it was agreed to extend the 20-year transition until 2014.

In the 2002 reform, I proposed to accelerate the transitional period being received by the Congress of the Republic togheter with the predecessor of Diego Palacios, Doctor Juan Luis Londoño, (may he rest in peace), one of the most important leaders of this country. However, the Constitutional Court deemed this regulation inaccesible. When the judgment is read, one finds arguments to proceed as the Greek sofist: as the judgment is defended, it is attacked.

If you invite me to attack the judgment I would say how is it that they assimilated a correct expectation as an acquired right. And what the judgment did to modify this rule. In this way, then, it is thought that to accelerate the period of transition is a violation of an acquired right.

And someone might answer: according to that, it can be considered that the pension rules are immovable. It is true, we take that risk with this interpretation. It is an interpretation risk that, under the excuse that is not possible to affect the rule because it is assimilated by the acquired right, then there is no chance of introducing modifications to a pension system.

However, the Constitutional Court also set out some limits, more pragmatic than legal, when indicating that «the transition period» is the one defined in Law 100, which means that a transition was established for us, the Court assimilated it to an acquired right but didn't come to the point that it could come by saying that any pensional rule has to be assimilated to the acquire right for the person who, at the time, is working and that any modification to that rule has to be for new workers. The Court didn't go that far.

But it is a reality, we are facing a Court sentence. And some people have told me: but why don't you modify it now that you are in a constitutional reform? First, we have appealed to this constitutional reform because we couldn't carry out the regulation we proposed in the referendum.

I believe that this government has fought an enormous battle by adjusting the pension system to reality: law 797 was passed in December, 2002, and law 860 in 2003 to rescue one of the points that the Court declared inaccesable. In addition, everything that has been done in the administrative reform in 152 State companies, the effort of the referendum; the reform to the pensions for people who deal with «high risk» activities, the pensional law for the military and police forces; the adjustments made by the Development Plan to the teaching regime, where corrections had great importance since sixty thousand new teachers are entering now to the official list, all selected through tender, will do it with the general pension system and not with the prior privileges regime. I am convinced that these reforms will start having less weight in the National Budget.

So, we must respect and work with the criterion adopted by the Constitutional Court. And we, what have we answered to those who say to us: «you have to respect the jurisprudence of the Court regarding to the laws «, but not apply it when a constitutional reform is under debate? Both in the referendum and in this constitutional reform, we have said: it is not suitable as precedent, that the country uses constitutional reforms to violate acquired rights.

A constant of the referendum was, in spite of the fact that it was a proposal of the constitutional level, not to use it to affect acquired rights, because a very serious precedent is created. Tomorrow or the day after tomorrow if someone gots into its mind affecting an acquired right, might say: since I cannot affect it by law, I affect it by constitutional norm; and the acquire right, in my opinion, has to be considered as intangible, untouchable, not in the light of the law but in the light of the whole juridical classification. And when one examines the concept of acquired right as an intangible one in front of the whole juridical classification it cannot gives a free way to the idea of using the constitutional level to affect them. This is one reason.

And the discussion with the Congress comes, where I have the whole solidarity with the Minister because I know what that is. I say that this hair haven't been turnerd white by the FARC, I've been fighting against these bandits thirty years. This hair has been tuerned white by the fiscal problems and the pension problems of this country. I know what it is to be fighting that battle in the Congress. Then, I trust that the way the Minister has been clearing away, comes to good end. It is not going to be the ideal one, but I believe that it is a good step for the country.

When we were in the reform of the year 1993, I was asked a lot: why are you having such a long transitional period? I already gave you a reason. And why are you going to leave the mixed system? The law was a great step, as doctor Luis Fernando Alarcón says, but the political negotiation demanded to do some grants. And I was remembering, for example, that in Chile the system had been adopted by decree of the government of the general Pinochet. Our system was introduced by a pluralist Congress, post constituent, with the participation of a group of citizens that came for the first time to the Congress with a strong speech in these matters. So we also have to consider the historical moment in which this happened, and the political circumstances in which these processes developed.

The topic of the new agenda. I share fullly the elderly matter, it is an expression of solidarity. This year we are going to make progress because using fiscal resources we are paying 170.000 elders and the Institute of Family Well being is opening a tender to incorporate 400.000 elders to a program that will offer them one daily food. The country will end, in July - August, with 570.000 subsidized elders, but I believe that the goal has to be a million. Anyhow, when this government began, a financial subsidy was paid to 60.000 elders of an intermittent way. We are going to continue making this effort, doctor Luis Fernando, I have nothing to discuss wiyh you about it.

The topic of payroll taxes. That's a complicated topic. I have told that Chile eliminated one of these taxes but, for example, the compensation funds were assumed by the treasury. If today we eliminate the SENA, the Compensation Funds, the Institute of Family Well-being, would imply to us a four trillions saving on payroll taxes, but the State doesn't have a way to replace those four trillions. That is 2.5 of the GDP. So, that's what I fear. And in the social conditions of Colombia, where we have 52% of the population in poverty. To say that we are going to finance the Family Well-being and the Compensation Fund with contributions from the State and that we are going to remove the parafiscality, I believe the people would have doubts, they would say: the State keeps it promise the first year, but it doesn't keep it later. However, the country will have to continue having this debate.

What have we done about the taxes? The deficit forced us to raise the taxes, but to tinge them we have created very important incentives. For example: year 2004, 2005 and 2006, all the revenue generating investments carried out in Colombia have a deduction of 30%. Last year we had again a great private investment growth in the country, the unions state that the private investment in Colombia grew 30%, it is already between 11 or 12 of the GDP, and we expect this to keep on rising. I think that the tax deduction and other incentives have really helped.

The second incentive: we eliminate the VAT for the acquisition of capital goods of highly exporting companies. Before, in order to a company classified as highly exporting had to export a 50%, we reduced this demand to a 30%. It was also decided to return the VAT of capital goods to the group of companies, and until December we had another incentive: the elimination of the capital goods duty. We had to restore it in December because of the fiscal situation and because when we introduced it the dollar exchange rate was in 2.800 or 2.900 pesos per dollar; now is in 2.350 pesos. Then, the revaluation helps the importers of capital goods better than the elimination of the duty. We made a small reflection: in this moment, with this revaluation, it is not necessary to stimulate the acquisition of capital goods with the elimination of the duty. The revaluation stimulates the growth in capital goods enough, however, you already know, how I fear the revaluation and the headaches that it is causing to the exporting sectors. I think that what we must consider is to answer the following question. When these incentives stop, since they are temporary, what must Colombia do about taxes? That no longer concerns this government. It is very difficult, in this government period, to perform a new tax reform, but this government do has the political responsibility of creating conscience. The proposal this government wants to launch as civil reflection motive, is that a substantially lower revenue tariff has to be adopted. It has to be defined, that in the moment when the incentives have to be eliminated, a substantially lower general revenue tariff exists; which is not capricious. To be competitive we need the significantly lower revenue tariff, besides there is an element that helps to acclimate this thesis: the struggle against the evasion, the expansion of the contributors' base.

When this government began there were 300.000 income contributors, last year we end with 715.000, we trust we are going to end this year with one million and a half revenue contributors, and we are preparing ourselves in taxes administration, in order to next year the country has two million income contributors. This base extension also gives arguments to say, in absence of incentives, we shouldn't be afraid to lower the revenue rate. That is the proposal of tax politics we want to be acclimating in the conscience of our compatriots.

Many people ask me about the VAT, and I am afraid to speak about that subject because when I do speak about it is the only thing that generates news, and that's really complicated. But yes, I want to remember something. When this government began, the amount of goods and services levied with VAT didn't represent the 37% or 38%, today we are levying with VAT between 50% and 52%. That is to say, we had an expansion base of 12 or 15 points. We made a very important legal decision at the beginning of the government: for this exempt or excluded percentage, a general VAT rate of 2%, antitechnology, but I proposed it and defended it because I said that it was necessary to look for what was politically viable, socially equitable and presentable. Then, we design a system that many technicians don't like, but that finally works, which is a diminishing VAT rate as it gets even more into the core of the welfare benefit. Unfortunately this 2% VAT general rate was declared innaccessible by the Constitutional Court. The country has here a precedent that must not be lost of sight.

As for facilitating the access to the minimal pension topic, it is very complicated because if the President or some of the Ministers says that the minimal pension is going to be reduced, an enormous social conflict is created in the country. I believe that we must look for options. On one hand, we have to guarantee the minimal pension as it is right now, to the people who can have access to it, on the other hand, let's think about the great mass of Colombians that don't have the possibility to access the minimal pension, let's create for them a kind of popular voluntary pension, without the inflexibilities of the minimal pension -I offer you the idea-, facilitating contribution, age, weeks. A well impelled popular voluntary pension, well stimulated for the sectors that don't have the possibility to access the minimal pension and without the requirements of the minimal pension.

To introduce the topic, we are not going to use a regressive vocabulary or proposal outline, but a positive, progressive attitude. Instead of saying: we are going to affect the right of the minimal pension; let's look for another way: we are going to extend the coverage creating an outline of popular voluntary pension. Here I have some ideas in draft, but I prefer that, hopefully for July 20th -with the help of doctor Luis Fernando-, the Minister and his team could have a project on this. I believe this is very important for the country.

As for the topic of the multifunds, I invite the Minister, his team and you, lead by doctor Luis Fernando, to help us have a project that starts the The Second Stage of Reforms, for July 20th.

Let's not make mistakes in the social presentation of this project, in order to fill with enthusiasm the Colombian majorities and the Congress of the Republic, with this project. And we must know what is possible to do with the system. We have a problem: the great mass of Colombians without the possibility of having a pension; so, they are our target. I am not against studying this and put all our judgment into it, specially if so many people have entered the multifunds system.

This it is a very important topic, that the people at least be sure of the continuity of this institution. Because the system is still very young in Colombia and the people look at it fondly, but one has to give everyday even more confidence to the people and not let them to be frighten.

And the final topic is the ISA model. I am ging to speak to the Mining Minister about some ideas he has.

And the integrated system of payments. Any Colombian businessman has to do nowadays multiple tax returns and payments for each one of the risks protected by the Social Protection System. A different form has to be created for each one of them. Reason enough. This implies a lot of procedures, is really expensive, and facilitates evasion, specially in health. Why? Because today the worker is been taken care in order to there is no evasion when is affiliated to pension funds, because he knows very well the proportionality between what he contributes and the pension amount he'll obtain, but is not careful when it is a question of affiliating to the social service or when it is a question of affiliating to health.

Because the health system, in the name of solidarity, allows that whatever the level of the participant be, minimal contribution or maximum contribution, it would give the same benefits plan. So, the people tend to declare a salary to contribute from the average down.

We believe that this integrated system is going to simplify a lot the businessman life and will avoid the evasive practices. We extract it with the whole judgment. I know that the Department of Social Protection has been working with you, and I hope that it is in full functioning before this government ends.

I am very grateful and I think it is very rude of my to continue stretching the time at this lunch hour.

Enjoy Cartagena very much and that our international guests be as ambassadors of our Colombian mother land in their countries. Thank you very much.

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CLOSING REMARKS

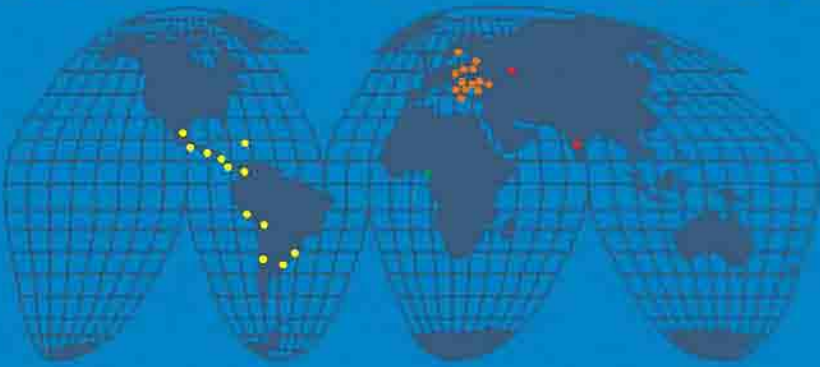
Publications

Publications by FIAP

- Results and Challenges of the pension reforms, 2003(*).
- Pension Reform in Eastern Europe: Experiences and perspectives, 2004(*).
- Pension Funds Investment, 2005(*).

(*) Books elaborated on the basis of the presentations that many authors gave in the seminars that FIAP organized to cover the same issue.

C O U N T R I E S   W I T H   R E F O R M S



AMERICA | CENTRAL AND EASTERN EUROPE | ASIA | AFRICA

Chile	1981	Hungary	1998	Kazakhstan	1998	Nigeria	2005
Peru	1993	Sweden	1999	India	(**) 2004		
Argentina	1994	Poland	1999				
Colombia	1994	Latvia	2001				
Uruguay	1996	Bulgaria	2002				
Bolivia	1997	Croatia	2002				
Mexico	1997	Estonia	2002				
El Salvador	1998	Kosovo	2002				
Costa Rica	2000	Russian Fed.	2003				
Panama	(**) 2002	Lithuania	2004				
Dominican Rep.	2003	Slovak Rep.	2005				
Nicaragua (*)		Macedonia	2006				
		Ukraine (*)					

The year given correspond in each case to the beginning of operations of the mandatory pension system.

* Aproved reforms yet not implemented.
** Reform for Civil Servants.

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