The Peruvian Pension Reform

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DOCUMENTO DE DISCUSIÓN

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Resumen

This short note was written for the OSI/Center for Global Development Taskforce on Helping Reforms Deliver Growth in Latin America. Applies the framework proposed in that project to analyze the Peruvian pension reform.

Palabras claves: Pension reform, Peru

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Objectives of the reform

Every pension reform creates a tension between -at least- two main objectives: (i) increase pensions of those already affiliated and coverage among workers, and (ii) the fiscal cost of running the pension system. From an optimal policy design, the reform should maximize the first objective minimizing the second objective. Along with that, a pension reform might reshape the financial system fostering the development of bond markets, including both the corporate sector and the government as well.

In the case of Peru, the pension reform was done in 1993 under very special circumstances. First, it was done the year after President Fujimori dissolved the Congress and amid a fiscal crisis. Second, it was the first country which reformed its pension system using the Chilean reform blueprint. Given those circumstances it is hard to argue which objective was at the heart of the reformers, but the end result was one in which the fiscal stance worked as a severe constraint in the design of the new pension system. Even though the initial idea was to increase the role of the private sector as much as possible, the strong opposition to this reform created a parallel system in which both the private and the public pension system serve the same market. This was in some sense a contradiction of one of the objectives of the reform. There was a huge need to stay away from the poor track record of the government as a pension fund administrator but the reform did not remove the government from its role as pension manager.

It is important to mention that in every pension reform, even in those in which the former public pension system is closed to new entrants, the government keeps playing a role and therefore paying a transition cost. This cost will be given by the sum of (i) those pensions already generated, (ii) the value of recognition bonds that represent the stock of contributions made to the public pension system by those switching to the

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private pension system, (iii) any other pension guarantee offered (i.e. non-contributory but means-tested universal pension, or minimum pension). All these items represent the fiscal cost of the reform.

How successful was the Peruvian pension reform? First, the reform did create a mechanism to escape –though partially- from government intervention. This has opened up a window of opportunity to increase the level of pensions to those workers affiliated with the private pension system. Second, the reform did limit the fiscal cost associated with the transition to a parallel system although opened up other potential sources to additional fiscal costs. Third, the reform was unable to increase coverage among those workers that were not affiliated. As a consequence more than 80 percent of the workforce remains uncovered either by the public or the private pension system. The priorities of a pension system should be to (i) avoid poverty in old-age and (ii) allow individuals to smooth their consumption through their life cycle. As far as the first is far more important than the second, coverage should be the key criteria to judge the performance of the reformed systems and universal coverage should be the target to achieve.

Just reforming the second pillar and forcing individuals to contribute into their own accounts is not enough to increase coverage. Something else should be done to increase the group willing to participate in the reform modifying tax and labor codes that reduce the size of the formal sector within an economy. The complementary of these three reforms is clear. Therefore, seems to be crucial both towards achieving better coverage ratios and achieving higher growth impacts as well to implement reforms in all fronts.

The reasons why the government was able to contain the fiscal cost of the reform lie on three main factors. The policy decisions were to replace –partially- the PAYG system with a fully funded individual capitalization system managed privately with many constraints. Along with that, the government (i) instead of closing the public system only restricted the possibility of going back and forth from the public to the private system, (ii) put a ceiling on the transition costs introducing recognition bonds with many restrictions and (iii) did not introduce a minimum pension guarantee for the private pension system (it was introduced with strict limits in 2002).

**How can pension reform affect the foundations for growth**

The economic impact of a pension reform must be addressed with a long-term perspective. Its potential effects are focused on fiscal stability, the gains in efficiency as
the government relies on the private sector to deliver pensions, and the increase in financial deepening that might lead to a wider access to financing. However, the gains of the reform are not only easily reaped but also it entails several risks. For instance, the reform makes explicit the value of the contingent debt related to pension provision. The management of fiscal accounts could be forced to improve as the government is left without an easy source of funding. But there is a huge risk expressed in the transition cost of the reform. If the government does not reduce the future outlays it might be also reducing the growth prospects. In what follows we discuss five areas in which the pension reform might enhance the foundations for growth in the case of Peru.

i. **Property rights.** This is probably the foundation that has been more affected by this reform. One of the key aspects of the reform was to protect the workers right to a pension given the fact that he has contributed during his years prior to reach retirement age. The pension within a PAYG system depends substantially on a government decision. The level of the pension is not necessarily linked to the amount of contributions made to the system. Given that the PAYG system is based on a solidarity principle in which everyone contributes to a single pool of funds, the property rights are vaguely defined. In contrast, in a fully-funded system of individual capitalization accounts property rights are tightly defined. However, as the system remains under government supervision and more importantly under government regulation, there is plenty of room for government policies that might limit the *privateness* of the allegedly private pension system. For example, investment policies that impose a minimum share of government debt in pension fund portfolios are imposing risk and return conditions that might not be consistent with affiliates’ preferences. Some regulatory policies limiting risk diversification could be seen as taxes on pension funds.\(^2\) Securing the property right of future pension holders is a first stepping-stone but if investment policies of those funds are not market-based the growth effect of those funds might be lessen.

\(^2\) Uruguay imposes a 40 percent minimum share of government bonds in pension funds. Berstein and Chumacero (2005) have calculated the tax equivalent of imposing a ceiling on investment pension funds abroad for the Chilean pension system. A similar exercise was done by Gómez, Morón and Vega (2005) for the Peruvian case.
ii. **Equal opportunity**: One of the preconditions for growth is the existence of funding available to the best investment projects. The absence of available funds will incentive the existence of non-market-based methods to allocate those funds. The reform has generated a new source of funding opportunities across the financial market. The rapid growth of the pension funds has created the possibility for a new set of firms to move out of the standard bank loan as their typical financing decision.\(^3\) The corporate bonds market has developed rapidly although still limited to medium to large companies. In that sense, this reform has a lot of potential to address one of the main obstacles to growth in these economies: the access to financing.

iii. **Increased competition**: Compared with the pre-reform situation the introduction of privately-managed pension fund managers has increased the level of competition. This comes both from domestic firms and foreign firms as well. However, there is a generalized perception that this level is not very high compared across the board of other sectors in the economy. Even though the ROE of the pension fund managers has hovered around double digits in the last ten years there has been little action to contest the market share. The main problem faced by entry firms is that the private pension market is not highly contestable as affiliates do not seem to care much about the price they pay. In Berstein and Ruiz (2005) study on the individual decisions of Chilean affiliates the evidence supports zero price elasticity. This has lead to many proposals to reduce transaction costs associated with moving from one pension fund manager (AFP) to another. In many countries now this procedure is done over the internet, without paying a fee and reducing the time interval between transfers. Inasmuch as more competition has not been key to lure more affiliates, the growth effect has been minimized.

iv. **Broad participation**: As mentioned before the reform has not increased pension coverage in those sectors previously not covered. However, it has opened the access to equity to a larger share of the population that did not

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\(^3\) The current size of the average pension fund in the region amounts to 10 percent of GDP. By 2015, this figure will reach 30 percent of GDP. See CLAAF (2005) Statement # 13.
participate in the financial market holding those kinds of assets. In that sense, there is a larger set of the population that might feel more directly the potential impact of policies that harm the profitability of firms. But the main point here is that the decision of containing the fiscal cost of the reform has put the whole reform in danger as it is seen as that a more generous pension system has been replaced by a system in which only a thin minority receives handsome pensions.

v. **Macro stability:** The pension reform was designed to contain the fiscal contingencies. In that sense the reform has served the purpose to avoid fiscal surprises. The reform has helped to clarify the real value of the contingencies already assumed by the government. The rapid grow of the private pension fund has also served as a relatively cheap source of funds for the government.

**What local features can constraint the effectiveness of the reform in delivering growth**

i. **Problems of design:**

a. The public pension system was not closed as part of the pension reform. In contrast to what Chile did, in Peru new workers could choose to enroll in the public pension system. This has had the effect of reducing the size of the market for the private pension fund administrators and perhaps more importantly to keep the idea that the government could provide better pensions through its own system. Regulations related to contributions or investment policies are not symmetric across the public and the private pension system. The reform of the pension system for military and police forces is still pending.

b. There are complementary reforms that need to be done to get the most out of this reform. A major problem in all countries has been to adopt investment regulations that are consistent with the corporate structure in Latin America. The regulatory framework has ignored this fact and has stayed its focus on government bonds, large corporate firms’ equity and bonds, and bank deposits. This has left out of the picture most of firms
which are smaller, family-owned and somehow reluctant to open to public scrutiny.

c. Along the same line, given the limited size of the financial market and the relatively small set of financial assets available to pension fund administrators the rapid growth of the pension fund might end up forcing managers to invest in low-yield assets or concentrating their investments in the domestic market. The relative size of the transactions in any particular asset should be small enough to avoid generating larger fluctuations as a result of an investment decision.

ii. Obstacles from the local environment:

a. Given the structure of the labor market characterized by two thirds of the labor force holding an informal sector job, the size of the potential market is limited. The pension reform introduced a government mandate to force contributions coming out of the workers’ pocket. For that mandate to be enforced contribution to the pension fund should be the default option. However, that only happens in the case of dependent workers. For the case of independent workers, such as self-employed the default option is not to contribute. The Peruvian workforce is comprised by 20 percent of formal workers, 50 percent of independent and informal workers, 22 percent of dependent but informal workers and 8 percent of unemployed workers. Only the first segment could participate in the pension system as it has been designed. In contrast Chile has two thirds of dependent workers. That is why the lack of coverage is intertwined with the characteristics of the labor market and it is not a flaw of the pension fund administrators.

b. The initial design of the system was not aimed to enhance pension coverage. The degree of social exclusion has fueled along with the coexistence of the public pension system a constant political pressure to undo this reform. In the last five years more than 800 initiatives have been tabled in the Peruvian Congress aimed to change pension legislation. In contrast to other countries experiences, in Peru the design of the initial reform was tilted against those who transferred to the private system. For example, rather strict rules for accessing the
minimum pension guarantee in the private pension system, problems granting recognition bonds or generous increases in the minimum pension of the public pension.

**How can obstacles be by-passed (or resolved if possible)?**

i. **Dealing with problems of design:**
   a. The government has been hesitant to introduce reforms in this area. This has increased the fiscal cost and it has also increased the administrative cost faced by workers affiliated to the private pension system as economies or scale are being limited.
   b. In some countries, including Peru, the regulators are shaking off its concerns about pension funds investing in a larger set of assets. For example, rules have been changed to allow AFPs to invest in infrastructure bonds in Chile or in long-term projects as the gas pipeline for Camisea in Peru. But more could be done. Among the ideas suggested to broaden the base of assets are: securitized bonds, mortgage securities, and collateralized loan obligations (see CLAAF Statement 13 for further discussion of the relevance of this set of financial assets).
   c. The most sensible way to avoid this problem is to increase the current ceiling to invest abroad. It is true that the existence of the pension funds has been the force behind the rapid development of new markets as the corporate bond market or the domestic government debt market. However, the growing size of the pension funds will continue its way whether the domestic financial market is ready or not.

ii. **By-passing obstacles from the local environment:**
   a. There have been private attempts to tap the self-employed segment of the market with not so good results so far. One possibility is to create an incentive to participate in the system or as it is being discussed in Chile make that contributing to the pension system be the default option for independent workers. In other countries there are tax incentives to contribute to save for your own pension. Although, all of these schemes based on fiscal incentives have had limited success in other countries.
b. In order to reduce social exclusion and broaden the pool of beneficiaries of reform, the government could introduce non-contributory pensions for old-age workers—currently not covered—that are in poverty or extreme poverty. The potential cost of this reform could be around 0.3 percent of the GDP according to Carranza (2005)—which is a small fraction of the total amount currently spent in pensions (3.0 percent of GDP). The coverage among old-age people could increase from 14 percent to 40 percent. In addition, the minimum pension guarantee in the private pension system should be reformed to match what it is offered in the public system. Even though this might be seen as increasing the fiscal cost of the transition it also be considered as a preemptive measure to bolster the political sustainability of the reform.

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