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The Politics of Postponement: Political Incentives and the Sequencing of Social Security Reforms in Argentina and Uruguay

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Summary: Pension reform in the Southern Cone of South America contains two basic components: reform of the state-run PAYG system, and the implementation of a new system based on individual savings accounts. While PAYG reform requires governments to impose costs on specific constituencies, the distributional impact of instituting individual accounts is less immediate, which allows governments to postpone the political costs and enables political actors to claim credit for policy outcomes that will not be known for decades. The divergent political consequences of PAYG reform and instituting individual accounts is reflected in the sequence of pension reform measures in the region. Given intense political opposition to key PAYG reforms, governments have postponed such measures as reducing benefits for privileged beneficiaries in order to make the adoption of individual investment accounts more politically viable.

Introduction

Latin America is at the forefront of a global trend toward social security privatization. Several Latin American countries have begun replacing or supplementing defined-benefit, state-sponsored pay-as-you-go (PAYG) social security programs with defined-contribution individual savings accounts, where pensions will ultimately depend upon individual capital accumulation. Chile's military dictatorship initiated the world's first privatization in 1981, while many of its neighbors introduced individual savings accounts after the region's return to democracy in the 1990s. Social security reform remains a top priority in the region, as countries continue to initiate major reforms, or introduce measures that supplement or modify earlier reforms.

The process of privatization in the region is a radical policy innovation in that it represents a break with the past pattern of defined-benefit PAYG systems, and these reforms have inspired like-minded reforms throughout the globe. It is also a controversial policy that has led to intense political conflict. Most political analyses of the process of pension reform in the region have tended to concentrate on explaining the political factors which led to the establishment of defined-contribution individual accounts (Kay 1999, Madrid 1999).[1] However the process of reform in Latin America does not begin and end with individual accounts, as state-run public PAYG systems were also targeted for reform.

Rather than being a one-time event, the process of reform in the region is a multi-staged, politically-driven process. In the face of intense political opposition to reform, governments have tended to prioritize the establishment of systems of individual accounts, while postponing more controversial companion reforms to the public PAYG systems. In some cases, these "follow-up" reforms, which could include lowering the state-provided flat-rate benefit, raising the retirement age, or eliminating preferential treatment for certain occupational groups occurred within a few months or years of the original reform. In other cases, these measures have been postponed indefinitely. The common denominator for all of these measures is that they tend to threaten politically

[1] Of course there are a range of policy outcomes possible, including as Huber and Stephens point out, the possibility of introducing funding without costly individual accounts (Huber and Stephens 2000). However political factors, including the support from international financial institutions, and the influence of the Chilean model precluded the possibility of alternative reforms (see Kay 1999, Huber and Stephens 2000).

powerful constituencies, and thus impose a political cost on governments pursuing such reforms. This paper seeks to describe how the sequence of reform in the region is driven by two distinct political processes with differing according to distributional time horizons. In the case of individual accounts, future benefits are promised, while in the case of PAYG reform, current benefits are cut. As Paul Pierson (1994 p.8) described, in the former, politicians engage in a process of "credit-claiming" as they take credit for the promise of improved future benefits of individual savings accounts. Regardless of the veracity of these claims, the benefit will not be realized until some point in the future. In the case of reforming the public PAYG system, politicians seek to avoid imposing political costs during the relatively transparent process of cutting benefits.

The result is a process where reforms take place in a piecemeal fashion. The postponement of critical PAYG reform combined with the implementation of private individual accounts has significant distributional consequences. A thorough explanation of the process of social security reform in the region thus requires a long-term perspective, and close examination of subsequent measures that in essence constitute the "reform of the reform." This paper focuses on the sequence of reform in Argentina and Uruguay, which were the oldest systems with the greatest rates of coverage in the region, as they followed Chile in instituting individual accounts. This is only a "first take" on the topic, and given the fact that reforms took place so recently, there is little data (certainly much could be gained by expanding the set of cases to other countries engaged in reform). Nevertheless, studying the process of the "reform of the reform" in the years since defined-contribution accounts have been introduced may explain how the sequence of reform is determined.

The first section of this paper describes the general process of social security reform in the region, and describes how countries intent on introducing systems of individual accounts have also sought to introduce greater efficiency and equity into their public PAYG systems. However, as discussed in the second section, governments reforming state-sponsored PAYG systems must impose, or at least attempt to impose, political costs on politically powerful constituencies. Given the political liabilities of such a move, governments seeking to privatize have an incentive to prioritize the establishment of a new system of individual accounts prior to reforming the public PAYG system. The third and final section describes the link between imposing costs, credit-claiming, and the sequence of reform.

1. Disaggregating the Regional Social Security Privatization Trend

Throughout Latin America, governments have initiated social security reforms that introduce defined-contribution individual savings accounts that are designed to complement, and in some cases replace, state-sponsored PAYG social security plans. The world's first social security privatization took place in Chile in 1981 under the Pinochet dictatorship. After the countries of the region returned to democracy in the 1980s, privatization became the policy of choice in the 1990s as Peru, Colombia, Argentina, Bolivia, Mexico, and El Salvador all introduced some type of individual savings accounts (see Table 1).

Table 1. **Selected Features of Recent Pension Reforms in Latin America**

Reform	Chile	Argentina	Uruguay	Peru	Colombia
Year Implemented	1981	1994	1996	1993	1994
Private System Mandatory?	Yes	No	Yes[2]	No	No
Basic Public PAYG Benefit?	No	Yes	Yes	Yes	Yes
Contribution Rate for Savings as % of wage	10	7.5	7.5	8[3]	10
Commission Costs + Insurance as % of wage	2.94	3.45	2.62	3.72	3.49

Source: Monika Quiesser, "The Second-Generation Pension Reforms in Latin America, Working Paper AWP 5.4, OECD, 1998.

While regional reforms vary to the extent that individual accounts complement or replace PAYG systems (see Table 2 below), social security legislation in the 1990s in Argentina, Colombia, El Salvador, Mexico, Peru, and Uruguay consisted of two distinct phases of reform. Governments had to confront the financially ailing public PAYG systems which generally suffered from expensive preferential regimes, low retirement ages, loose disability qualification, poor investment policies, weak administrative capacity, high evasion rates, and high salary replacement rates (for a more complete description see Cruz-Saco and Mesa-Lago 1998). Restoring financial equilibrium to the state-sponsored system was thus the logical starting point of any reform effort. The second major component, and indeed the cornerstone of reform in the region has been the establishment of defined-contribution individual savings accounts. Individual savings accounts which either complement or replace public PAYG systems were established in Argentine, El Salvador, Uruguay, Mexico, Columbia, and Peru in the past decade. At its most basic level then, pension reform in the region has consisted of reform of the public PAYG system, while at the same time establishing new individual savings accounts.

[2] Mandatory for earnings between $800 and $2400.
[3] Contribution rate will gradually be increased to 10%.

Table 2. Various Regional Reforms

Reform Option	Country – Year Implemented
Reform PAYG - optional complementary individual account	Brazil, 1998
Privatize – PAYG as option or basic pillar	Colombia, 1994 Argentina, 1994 Peru, 1993 Uruguay, 1996
Privatize- eventually end PAYG	Chile, 1981 El Salvador, 1998 Mexico, 1997

As Vittas notes, the sequence of reform will vary from country to country depending upon local political conditions (1995 p.11). However he adds, "the potential benefits of a reform program will not be fully realized until the program is completed, while doing things in a suboptimal order may increase the costs of transition and may delay considerably the attainment of the full benefits of reform" (p.12). In other words, he argues that for such reforms to have their intended impact, all of their component parts must be implemented. Vittas goes on to outline four sets of actions, with an implied optimal order of first restructuring the public pension plan, then setting up a defined-contribution individual-account scheme, followed by the streamlining of the regulatory framework, and setting up a long-term transition plan. Vittas notes that in many countries, setting up the new system and regulating it may precede the initial step of restructuring the public system. As shall be described below, this scenario has been common in Latin America, where, with the exception of Chile's reform, there have been significant lags and delays in restructuring the public system. Below is a table (modeled after Vittas 1995), which divides the reform into two, rather than four distinct stages.

Table 3. Introducing Individual Accounts – Selected Reform Measures

I. Restructure Public PAYG System

1. *Raise retirement age*
2. *Eliminate preferential treatment for specific occupations*
3. Tighten disability and early retirement requirement
4. Factor in years of contributions and use longer averaging period for determining pensions (not wages from last three years)
5. *Lower targeted replacement rate to more realistic levels*
6. *Reduce inequality of pension levels*
7. Fight evasion
8. Improve administrative capacity

II. A. Establish a System of Individual Accounts

1. Establish role for public pillar (flat-rate, means-tested etc.?)
2. Create mandatory or voluntary accounts
3. Set contribution rates
4. Institute life and disability insurance
5. Establish rules (and markets) for annuities and withdrawal of funds

B. Establish a Regulatory Framework

1. Create or reorganize regulatory agencies (new or existing agency)
2. Establish competent supervision and regulation powers
3. Establish entry/exit requirements for pension funds
4. Solvency rules
5. Investment rules
6. Establish reporting and disclosure rules
7. Establish state guarantees (protection against insolvency)

C. Transition Plan and Actuarial Model to Estimate Costs

1. Compensation for vested pension rights (recognition bonds, other compensation)
2. Periodic review of regulations for insurance plans, pensions, training for staff
3. Train regulators, fund managers, actuaries, accountants, and auditors
4. Public relations campaign

Note: Reforms noted in italics were postponed in Argentina.

Source: Adapted from Vittas 1995.

As table 3 demonstrates, shifting toward private funded pensions requires two distinct sets of reforms. Vittas' argument that reform of the public PAYG system should precede the establishment of a system of individual accounts is quite sensible given deficiencies in both efficiency and equity in the region's social security systems. Introducing individual accounts without addressing fundamental problems in the PAYG system would reduce the effectiveness of the reform.

One PAYG reform at the top of the policy agenda in Latin America was raising the retirement age. Retirement ages in the region had not been raised in decades despite increased longevity (for example, Argentina's minimum retirement age was raised from 60 for men and 55 for women to 65/60). Also, pension benefit levels varied drastically according to profession, and in some cases workers could retire after as little as 15 or 20 years on the job. Worker pensions were based upon the last three years on the job, giving workers an incentive to under-declare wages until nearing retirement. This meant that a worker making full contributions for an entire career could easily receive a lower pension than a worker who only made full contributions during the final three years of work. In general, evasion was a tremendous problem with the old PAYG systems, due to large informal sectors and lax enforcement. Pension programs were not well-administered, with poor record-keeping and long delays for those waiting to receive pensions. Meanwhile payroll taxes were as high as in many European countries, providing a strong incentive for the growth of the informal sector[4] (see Schulthess and Demarco 1993, World Bank 1994).

Clearly addressing these faults in the state-run systems was and is fundamental to achieving progress toward reform. However reforming the PAYG system was only part of the policy-reform agenda in Latin America. With the World Bank's support for individual accounts (articulated in the landmark 1994 study, Averting the Old-Age Crisis), reforming the state system was just the first stage of a process that would introduce a fundamentally different social security model based upon the establishment of private individual accounts. The ILO lost its former hegemony over international pension policy advice, as the World Bank and Inter-American Development Bank became powerful proponents of individual accounts in Latin America.

Moving from a public PAYG system to a funded system entails significant transition costs, as governments must continue to provide pensions to the retired even as workers divert contributions to their individual accounts. While advocates of individual accounts argue that they are designed to lower the pension burden, if this is to occur, it will only take place in the long-run, as new fiscal obligations are generated by the shortfall in revenue to the public system. As Bravo and Uthoff (1999 p.18) point out, when these fiscal obligations "are added onto insufficiently solvent or stable government budgets there is a substantial risk of government default on parts of the pension rights owed to workers and retirees." This is precisely what occurred in Argentina, as obligations to pensioners maintained in the original 1994 reform were scaled back in 1995, 1997 and 2000.

The next three sections described in Table 3 concern the sets of reforms necessary to establish, regulate, and finance the transition to private accounts. As Table 4 below demonstrates, there is a considerable degree of variation among the new defined-contribution systems in the region (for more detail, see Cruz-Saco and Mesa-Lago 1998 p.390-407). Two fundamental areas in which pensions diverge have to do with whether or not joining the new system is optional or mandatory, and whether or not the public PAYG system will continue to pay a universal benefit. In Chile, joining the new private system is mandatory for all workers entering the workforce since 1981, while for workers in Argentina and most workers in Uruguay, it remains optional. The fate of the public PAYG system is another important factor that varies. Chile's public system will eventually wither away, while Argentina and Uruguay's public systems continue to provide a universal benefit.

[4] In Latin America 57 percent of the workforce is estimated to be in the informal sector (Lora and Olivera 1998 p7-8). A recent study in Argentina estimated that 72 percent of new jobs created in the 1990s were in the informal sector, a figure that approximates the region-wide trend of 8 out of 10 new jobs (Clarín, 6-29-00).

In establishing a system of individual accounts governments must develop legislation and institutional mechanisms to establish, regulate, and finance the new system. Step II of the reform – establishing individual defined-contribution accounts – is of course intertwined with Step I (PAYG reform), and most of these measures need to be initiated in close proximity to one another. An effective regulatory framework for the new individual accounts is essential from the start, as are rules which govern the transition. A set of actuarial forecasts is essential for determining contribution rates and projecting the adequacy of future pensions, although market risk is part of the new system, and financial forecasts decades into the future are inherently problematic. Fulfilling the regulatory requirements requires the establishment of new institutions or modification of existing institutions which can provide competent regulation. Given the often ineffective administration of the old state-run pension systems, effective supervision and regulation of the new system is essential.

The process of pension reform in the region is thus typically divided into two distinct parts: reforming the old system, and establishing a new system of individual accounts. The policy coherence of the reform - which pair reform of the public system with the introduction of individual accounts – is undermined by the fact that fundamental PAYG reforms are often not undertaken due to intense political opposition. Each component part will vary in its political salience and the degree to which it imposes a political cost or benefit for political actors. In general, reforming the public PAYG system, to the extent that it requires transparent cuts to key political constituencies, will tend to impose greater costs than will the establishment of the new system, which allows greater opportunities for credit-claiming. The following section explains how specific reform features varied in terms of political costs and benefits, and the sets of political incentives that they created shaped the sequence of reforms in Argentina and Uruguay.

Argentina and Uruguay are selected as cases for this paper for the simple reason that along with Chile, they lead the region in rates of social security coverage. Rates of coverage in the Southern Cone are closer to those in the industrialized countries than those in other Latin American countries. From 1985-88 (prior to the reforms) 80% of the Argentine workforce and 73% of the Uruguayan workforce received social security coverage (Mesa-Lago 1994, p.22). Furthermore, since the 1993 Argentine reform and the 1995 Uruguayan reform, governments have already engaged in follow-up reforms. By way of contrast, Peru and Colombia, which also reformed their social security systems in the early and mid-1990s had far lower rates (32 and 30 percent, respectively) of their populations covered by social security during the same pre-reform period (Ibid).

Chile's 1981 reform, which has become a global reference for pension privatization, occurred under a repressive military dictatorship. Consequently the political factors which shape the process of reform in democratic regimes did not apply as opponents of government policy were clearly not in a position to influence outcomes. The sequence of policy reform in Chile closely matched Table 3: the PAYG system was reformed (step I) prior to the introduction of the new system of individual accounts (step II). In 1979, Decree Law 2448 equalized benefits, eliminated pensions based on years of service, and established a uniform system where pension adjustments would be linked to the consumer price index. It also eliminated special "perseguidora" pensions awarded to top civil servants where pensions were tied to the actual salaries of active civil servants.

In 1980, the new system of defined-contribution individual accounts was decreed and was implemented the following year.

2. Certainty, Imposing Costs, and PAYG Reform

As Pierson (1994 p.18) notes in his discussion of "retrenchment politics," the costs of cutbacks are concentrated upon specific groups, while the benefits are often diffuse. In the case of reforming the state-run public PAYG systems, politicians were engaged in a process of blame avoidance, rather than the credit-claiming that would take place with the implementation of a new social program. Where possible, politicians engage in political strategies to minimize the political damage (Pierson labels such strategies obfuscation, division, and compensation – 1994 p.19). In the case of reforming the region's public PAYG systems, the most politically costly reforms were transparent cuts that reduced privileges for interest group actors. While the costs and benefits of the future of individual accounts were essentially uncertain, the transparent cuts accompanying PAYG reform were all too certain. Specifically, reforms that reduced preferential treatment and reduced the wide disparity in benefits along occupational lines were (and continue to be) the most politically controversial reforms in the region. Raising the retirement age and lowering the replacement rate were also politically sensitive issues, but governments were more successful in imposing these costs (although raising the retirement age for women continues to be a salient topic of debate in Argentina). Other steps, including improving administrative capacity, changing the benefit-calculation formula, lowering evasion, and tightening disability requirements were generally less controversial.

Table 4. Pension Reform: Examples of Imposing Costs vs. Claiming Credit

Imposing Costs	Claiming Credit
Cut Special Pensions (early retirement)	Create System of Individual Accounts
Lower the Replacement Rate	Establish Regulatory Framework
Reduce Inequality (cut top pensions)	Set up Transition Plan
Raise the Retirement Age	

Of course politicians could (and did) ameliorate some of the political costs by introducing reforms over a prolonged period of time (for example through gradually raising the retirement age, or introducing a two-tier system that would not alter benefits for current workers). However in general, governments were faced with tradeoffs over taking politically costly steps that would have an immediate fiscal impact, and reforms which could be postponed. Alternatively, as discussed below, at times governments were forced to compromise and adopt measures which compromised fiscal goals (as was the case in Argentina with the formula for determining the basic universal pension, or the establishment of a minimum pension guarantee for the Banco de la Nación). However governments could always make these compromises, and later take steps to undo them (as took place in Argentina).

Improving administrative efficiency, reducing evasion, and tightening disability requirements were generally less controversial since they did not threaten the interests of specific interest groups. There was little disagreement that improved systems for determining and awarding disability claims were considered necessary. Likewise, there was little opposition to improving efficiency in social security. However when such reforms became politicized, they could be subject to political veto. This occurred in Uruguay in the early 1990s when labor and pensioner groups saw efficiency improvements (strict monitoring of individuals' payroll tax contributions) as a prelude to private individual accounts. The reforms were defeated.

Highly Contested Reforms: Privileged Pensions

Pension systems in the Southern Cone and Brazil were traditionally stratified along occupational lines, leading to large disparities among occupational groups (see Mesa-Lago 1978). In the 1960s and 1970s, Argentina's various occupational pension funds were standardized and consolidated into three main funds for independent workers, salaried employees, and government workers. As of February, 2000 approximately 73,000 pensioners in Argentina receive "privileged pensions," which are pensions granted to individuals before retirement age at a costs of 1 billion dollars a year. Of the 73,000 privileged pensions, 4822 go to former federal employees and average $3421 per month, while 68,000 were formerly privileged beneficiaries of former provincial pension funds, and average $900 per month. The average beneficiary of the state-run system receives $321 per month, while 38 percent of beneficiaries receive the minimum $150 per month. 24 percent of all pensioners receive an additional means-tested $70 per month benefit (see *La Nación*, 2-8-00). In addition, the military has its own separate pension fund.

Uruguay's pension system is also stratified. Around 20 percent of benefits (representing around 10 percent of the workforce) go to three "para-statal" pension funds and the military and police pension funds, while the rest of the workforce belongs to the *Banco de Previsión Social* (*BPS*). With 633,700 beneficiaries, the pre-reform *BPS* deficit was $332 million dollars on the eve of reform in 1994, while the police and military pension fund deficit was $223 million for only 69,500 retirees (*La Mañana* 4-27-95). Notaries, professionals, and bank workers belong to the para-statal plans, which deliver higher benefits. Given intense political protest from these professional groups, these plans were not included in the initial 1995 reform, but the legislation did require that the three para-statal plans be incorporated into the new multipillar system by the end of 1996. As of June 2000, neither the para-statal plans none the military plan had been incorporated into the new pension system.

Clearly any equity-enhancing reform must take into account the distortionary impact of privileged pension plans on both the equity and finances of social security. Yet such privileged pensions appeared to be politically untouchable, even as the rest of the state-run pension systems underwent extensive reforms. No government in Latin America has dared touch the military's privileged pension structure, and Uruguay's para-statal plans appear to be safe despite legislation that calls for their demise. However the current economic and fiscal crisis in Argentina appears to have provided the government with sufficient political cover to reduce the value of privileged pensions. When faced with pressure from global financial markets and international financial institutions to reduce fiscal deficits in May 2000, President de la Rua issued an emergency decree that cut 61,000 privileged pensions in half for workers under 50, and by a third for workers between 50 and 60, for an annual savings of $240 million (*Clarín*, 6-8-00). The government reportedly also seeks to eliminate special retirement pension for the military and judiciary (*Clarín* 5-9-00), but has yet taken any action. At this point it is unclear whether or not these cuts will withstand political challenge, but they are politically significant because they represent the first-ever concrete attempt to cut seemingly untouchable privileged pension benefits.

Other Controversial Reforms: Raising the Retirement Age and Lowering the Replacement Rate

Raising the retirement age and lowering the replacement rate have been two fundamental elements of reforms aimed at restoring financial stability to the region's social security systems. Prior to the reform, both Argentina and Uruguay's minimum retirement age was 60 for men and 55 for women. With the new reforms, Argentina's retirement age gradually went up to 65/60, while the retirement age for women in Uruguay was raised to 60 over five years. In Argentina, the government had sought a retirement age of 65 for both men and women, but on the evening of the floor vote, the women's caucus threatened to leave the chamber and deny a quorum if the retirement age was not set at 60. Setting the minimum retirement age for women five years earlier than that for men will have serious distributional consequences because under the defined-contribution system, pension levels depend directly on a worker's contributions and investment performance. Since women will have contributed fewer years, and have greater longevity than men, a woman purchasing an annuity will receive a lower benefit than a man will. Supporters of the reform argued in vain that earlier retirement would actually harm the interests of women, who would have less years to accumulate funds in their individual accounts, but the women's caucus prevailed (interview with Posadas). During the current economic crisis in Argentina, raising the retirement for women has once again become a salient topic. While it is unclear what the final outcome will be, the Finance Ministry, with the support of the IMF, has indicated that it wants to raise the retirement age for women to 65.

In Argentina, the old system promised a salary replacement rate of between 70 and 82 percent, while Uruguay promised 60 percent. In practice, Argentina failed to deliver such high promised replacement rates, which was originally granted during the Perón era. This led pensioners to sue the government, and as judicial claims mounted, the government declared a state of social security emergency in 1986. The government issued bonds to pay off its defaulted pension debt, but the fiscal situation continued to deteriorate until the new system was inaugurated. Lowering the replacement rate was a critical element of the pension reform. In Uruguay, the replacement rate in the reformed public system was lowered from 60 to 50 percent.

Unlike Uruguay, Argentina eliminated the statutory defined-benefit replacement rate, replacing it with a combination of benefits. For workers who choose to contribute to the reformed public system rather than to an individual account, benefits are based upon the Basic Universal Benefit (the *PBU*), the compensatory benefit (the *PC*) for contributions to the old public system, and a formula that provides 0.85 percent per year of an individual's average salary during a worker's last ten years in the workforce for each year of contributions (the *PAP*). The terms of the benefit formula was a controversial point of debate in Argentina. The dissident labor wing of the Peronist party demanded and received a much higher Basic Universal Pension than the government was initially willing to offer (interview with Gonzalez Gaviola). The result was a *PBU* calculated at 2.5 times of the average worker's social security contribution (the *AMPO*).

Postponing PAYG Reform: The Social Security Solidarity Law in Argentina

However the Basic Universal Pension formula which the dissident labor-wing of the Peronist party negotiated in the legislature did not endure. The original Argentine social security reform was passed in September 1993. Just over one year later, in October 1994, the government announced that the public PAYG social security system had incurred a $1.3 billion deficit. Reduced worker contributions to the new private system led to a revenue shortfall in the public system, and revenue was further reduced by cuts in employer contributions in select industries and regions. The government also withheld provincial "co-participation funds" for the provinces that were earmarked for social security, transferred the responsibility for military pensions to the national social security system without providing additional funding, and transferred some financially-troubled provincial pension funds to the national system. Given the reduction in revenue, the financial imbalance was not surprising (and in a sense, pre-ordained). The December 1994 peso crisis in Mexico caused panic in financial markets, and sending positive signals to the international financial markets provided further justification for correcting the growing fiscal imbalances in the PAYG system.

In February 1995, the government passed the "Social Security Solidarity" law, which finally legally abolished the legally-defined 70-82% replacement rate. This meant that individuals who were already retired could no longer sue the government for underpayment of benefits (in practice the replacement rate had rarely surpassed 55% since the mid-1980s - see Isuani and San Martino 1995b). The law also eliminated the linkage of certain civil service pensions to the salaries of active workers. The basic universal benefit (the *Prestación Basica Universal (PBU)*), which had in the original reform been indexed to the average social security contribution (*Aporte Medio Previsional (AMPO)*), was no longer indexed, and benefit increases were only permitted if there was sufficient tax revenue. The *AMPO* was still used to determine new pensions. However, in 1997 a presidential decree eliminated the link between the *AMPO* and new pensions, and henceforth the Basic Universal Pension would be defined by the *Mopre* (*Módulo Previsional*), which was to be set by the executive. In short, pensions were de-indexed and left at the discretion of the executive branch.

The "Social Security Solidarity law" also prohibited social security expenditures from exceeding revenue, and directed any surpluses in the system toward raising benefits for those receiving less than $450 a month. It also placed a maximum limit of $3000 per month on pensions, and froze future court settlements (there had been 90,000 legal settlements and numerous cases pending against the government due to failure to pay legally mandated social security benefits of 70 to 82 percent of wages at retirement). The Minister of the Economy at the time, Domingo Cavallo, issued a dire warning that if the Social Security Solidarity law did not pass, the financial burden of the pension system could lead to the unraveling of the "Convertibility plan" (which set the value of the peso at one U.S. dollar), and would bring back hyper-inflation. In an atmosphere of economic crisis, Cavallo's ominous warning helped persuade legislators to support the bill.

Table 5. Selected Chronology of Argentine Reform of the PAYG System

1993	Legislation to reform PAYG and introduce individual accounts passes
1994	Reform instituted, Minimum guarantee for Banco de la Nación fund abolished
1995	Solidarity Law – Pension adjustments delinked from median contribution (Ampo)
1997	Ampo linkage to new pensions ends, President sets universal basic pension
2000	Privileged pensions cut, Renewed effort to raise female retirement age

In short, in 1993 the Argentine government pursued reform legislation that privatized social security, while legislation that cut select PAYG benefits was not passed until later in the decade. As could be projected after the original reform, deficits began to rise, and amidst an economic crisis that began with the Mexican peso crisis and a looming recession, the government issued spending cuts in social security that would have endangered passage of the reform had they been introduced in 1993. Reform measures were sequenced so that the government could take political credit for introducing the new individually-capitalized pension funds, while cutbacks which threatened key interest groups were postponed until they were more politically viable.

3. Reforming Public PAYG Systems: Political Costs and Policy Sequence

The brief description of reforms of the public PAYG systems in Argentina and Uruguay reflects a few basic patterns. First of all, imposing costs on key political constituencies was not a politically viable strategy when the governments were trying to obtain legislative approval for introducing individual savings accounts. The most transparent of these measures involved cuts to privileged pension programs. While the Uruguayan law called for their demise within a year, this provision was, and continues to be ignored. The Argentine government later cut benefits in 1995, 1997, and 2000 during economic crises, but such pensions remain untouched in Uruguay.[5] Another very transparent cost that the Argentine government found difficult to impose was raising the retirement age for women after having agreed to an earlier retirement age during just prior to the legislative vote. The government, with support of the IMF, continues to seek opportunities to raise the retirement age for women.

[5] In Argentina, the vast majority of cuts in privileged benefits were to individuals who obtained their pensions as part of a provincial pension plan that was later transferred to the federal government. The relative percentage of individuals receiving privileged pensions in Uruguay was higher, and concentrated in politically vocal professional groups, rather than consisting largely of former provincial state employees, as in Argentina. Hence cutting such benefits was politically more problematic in Uruguay than in Argentina.

Other reforms, like lowering the statutory replacement rate, or deindexing pensions from salaries were also unpopular, but governments have been more successful at implementing these reforms either within the initial reform package, as in Uruguay, or in the months and years after the initial reform. During the economic crisis in Argentina following the Mexican "peso crisis," the Social Security Solidarity law removed the 70 to 82 percent replacement rate from the books, and linked future pension levels to budgetary capacity. These costs were easier to impose because they did not attack the interests of a specific interest group or privileged pension program, but instead were cutbacks aimed at the entire public social security system (besides, the 70-82 percent replacement rate was no longer provided in practice). Furthermore, the cutbacks were undertaken in an atmosphere of political crisis, which put government in a more favorable position than had there not been a crisis. Also, because the centerpiece of the reform – the system of individual accounts – had already been accomplished, these measures were less politically salient than they would have been had they been included in the original reform project.

Finally, it may be useful to conceive of these postponed reforms as acts of omission and acts of commission. The acts of omission include preserving the privileged pension plans, and not raising the retirement age. Despite these cuts to the public PAYG system that are necessary to restore financial equilibrium to the PAYG system and finance the transition to a system of individual accounts, the political costs can be prohibitive. Other reforms were acts of commission in the sense that governments were abolishing measures that had originally been conceded in legislative bargaining. For example, the government was under severe fiscal pressure when it indexed the basic universal pension based on the average pension contribution (the *AMPO*), and it abolished the formula only two years after it was implemented. The statutory PAYG replacement rate was not touched in the original reform in order to reduce political controversy that would arise from removing "acquired rights," but was later abolished with the Social Security Solidarity law.

Uncertainty, Claiming Credit, and the Creation of Individual Accounts

While reforming the public PAYG system is largely an exercise in imposing costs, the establishment of a system of individual accounts is largely an exercise in credit-claiming. Interest groups which were opposed to government pension reform initiatives in Argentina, Brazil, and Uruguay tended to emphasize in their rhetoric the necessity of preserving pension rights under the PAYG system, rather than opposing individual accounts per se. This is not to say that the "privatization" was popular. A 1995 poll of 10 Latin American countries found that 73 percent of respondents said that pensions should be the responsibility of the government (Basáñez 1997, p. 10). Labor Unions, professional organizations, and pensioners groups were vocal, if not always effective critics of social security privatization in Argentina and Uruguay (Kay 1999). However these interest groups were first and foremost concerned with preserving current benefits levels, which were threatened by the proposed establishment of individual accounts. The rhetoric of prominent opponents of reform emphasized opposition to ending occupationally-based pensions, the recognition of current government pension obligations, opposition to raising the retirement age, arguments for greater gender equity, and opposition to the procedural means used by governments to secure pension reform (Kay 1998 p.183-193). Opposition to individual accounts was just one of several elements of interest group opposition to reform.

In debates over reform, advocates of individual accounts who chose to cite the Chilean case emphasized its high returns, and Chile's impressive rates of economic growth as reasons to support the reform. With regard to the Chilean case, proponents of individual accounts benefited from the perception that Chile's pension system and economy were flourishing. Prior to the return to democracy in Chile, politicians were reluctant to advocate individual accounts because of their association with the Pinochet dictatorship. The current Uruguayan president Jorge Battle (elected in 1999) blamed his 1989 electoral defeat on his unpopular position of calling for a Chilean-style system (interview with Jorge Battle). However with the reemergence of democracy in the region, Chile's private pension system became a politically viable model.

Advocating individual accounts was a process of credit-claiming because political actors could make claims about the costs and benefits of systems of individual accounts without being accountable for such claims. No one can state with any certainty what the long-term returns of these new systems will be, and benefits are of course highly contingent on returns.[6] Claims about the macroeconomic impact of moving to a new system are also impossible to evaluate *a priori*. To cite just one example, the Argentine Undersecretary of the Economy Juan Llach stated that the new system would generate savings, improve the distribution of income, improve productivity and growth, and assure public and private investment (cited in Camara de Senadores 1993, p.3394). Whether or not all of these projections will transpire will take years if not decades given the long generational transition period from a purely PAYG system to a system of individual accounts. It is safe to say that no political actor involved in initiating a new system will still be in office and face accountability for the new system 40 years after a switch to individual accounts, when the true economic impact of the new system and its impact on benefit levels will be apparent. Consequently making such bold claims about the impact of the new system was a fairly safe political bet.

A glance at the basic policy decisions and tasks necessary to initiate a system of individual accounts (see Table 3) suggests that there are far fewer political costs attached, and indeed greater opportunities to claim credit. For example, the most politically salient step in establishing a system of individual accounts is whether or not to make the system optional or mandatory. An early (1992) version of the Argentine reform legislation that made contributions to individual accounts mandatory for all workers under the age of 45 was withdrawn from consideration in the face of widespread opposition led by the labor wing of the Peronist party (see Isuani and San Martino 1995a p.48-50). The bill that was eventually introduced in 1993 made the system optional rather than mandatory, which contributed to depoliticizing the introduction of individual accounts. The new Uruguayan system is optional for the vast majority of Uruguay's workforce (those earning less than $800 per month). As discussed earlier, workers in the privileged para-statal systems were and are vehemently opposed to being forced to contribute to the new system, and have

[6] Gillión and Bonilla (1992) cite the range of projections of the real annual return in the Chilean case (from around 3 to 5 percent), and demonstrate how even a slight variation in the rate of return will have a drastic impact on benefit levels.

succeeded in postponing any such attempt despite a legislative mandate to incorporate them.

Overall contribution rates themselves were not controversial since they generally remained the same. Clearly any attempt to raise them to raise payroll taxes to pay for the transition costs would not be well-received. The long-term policy goal of pension reform was to lower payroll taxes and labor costs despite the fact that the transition costs raised the costs of pension programs in the short and medium term. Argentina had already lowered employer payroll taxes in targeted regions and industries, and Uruguay planned similar moves. However in the interim, as the chart below shows, overall payroll tax rates were held steady.

Table 6. Payroll Taxes in the New and Old Systems as a Percentage of Salary

	Argentina	Chile	Uruguay
Total: New System Employer	27% 16% to PAYG (less in some cases)	13% No Contribution	28.5% 13.5% to PAYG
Worker	11% to individual account or PAYG (includes approx. .75% disability ins., 2.75 commission fee)	10% to individual account, 3% to disability ins. And commission fee	15% to PAYG on first US$800, and to individual account on earnings between $800 - $2400 (less 2.6% disability ins. and commission)
Total: Old System	27% to PAYG	22.95% (for main system – SSS)	28.5% to PAYG
Employer	16% to PAYG	15.7%	15.5%
Worker	11% to PAYG	7.25%	13%

One facet of contribution rates that received little attention has been commission fees. In the new systems of individual accounts, disability insurance and commission fees are bundled together into one fee. The cost of disability insurance has dropped significantly in Argentina since its introduction, from over 2 percent in 1994 to around .75 percent in 2000, yet commissions have held steady at 3.5 percent. Commission fees and insurance premiums eat up around almost 25 percent of a worker's contributions in Argentina, and around 14 percent of worker contributions in Uruguay, yet the issue has not generated much political controversy. This is not to say that regulators are not aware of the problem. A 1999 report by the Chilean brokerage firm CB Capitales presented data which demonstrated the devastating impact of commission charges on worker returns. The average worker contributing from 1982 through 1998 would have received an average real return of 5.1 percent (rather than the much cited figure of 11 percent, which did not factor in commissions). Furthermore, a worker contributing from 1991 through 1998 would have had a negative average annual return of 1.09 percent (CB Capitales 1999). In both Argentina and Chile, regulatory agencies have made lowering expenses and commission fees a top priority. However thus far, high commission charges have not become a salient political issue.

Arguably the most politicized regulatory issue surrounding the creation of a system of individual accounts concerns the extent to which governments will guarantee investment returns. In Chile, returns are guaranteed relative to the average pension fund return, so a firm that consistently underperforms the market can eventually be taken over by regulators. In Argentina, the labor wing of the Peronist party demanded an absolute minimum guarantee for individuals contributing to the state-run Banco de la Nación pension fund. The government gave in to labor demands during legislative negotiations, but the guarantee was later eliminated by an emergency presidential decree from President Menem (the Argentine system has a relative guarantee like Chile's). While the minimum rate of return was never implemented in Argentina, it is in effect in Uruguay (making it the only such system in the region to have an absolute guarantee). There is a minimum guarantee of the lesser of either 2 percent real, or the pension fund industry average less 200 basis points. Funds underperforming the benchmark must make up for the difference from their reserves.

Another regulatory issue that became more politicized in Uruguay than in Argentina was the extent to which pension funds could be invested in foreign countries. In Uruguay there was widespread sentiment against investing pension funds in foreign securities despite the obvious benefits of diversification in a small country with a small capital market. The general argument is that worker's capital should be invested toward the development of the Uruguayan economy rather than sent overseas. Consequently, Uruguay's system does not allow pension funds to be invested abroad. In Argentina, up to 10 percent of pension funds can be invested in foreign sovereign bonds, and 7 percent can be invested in foreign corporate bonds. In practice, at the end of 1999, only 0.4 percent of pension fund investment in Argentina was in foreign instruments (SAFJP 2000).

Finally, the transition costs of moving from an unfunded PAYG system to a system with funded individual accounts is one of the most fundamental policy challenges. While governments switching to a funded system seek to alleviate costs associated with PAYG systems, stimulate efficiency, and generate savings and investment, and develop financial markets, the evidence thus far is mixed[7] (see Kay 2000, Bravo and Uthoff 1999). Governments can only cope with the liabilities associated with the transition through some combination of raising taxes, cutting spending, or debt. The size of the implicit debt associated with the transition can in fact make a Chilean-style privatization (which eliminates PAYG completely) prohibitively expensive (Bravo and Uthoff 1999 p.18). As we observed earlier with the Social Security Solidarity Law in Argentina, the transition costs can become apparent shortly after the reform, and are ongoing for decades as the government copes with liabilities associated with the old system.[8] Yet discussion of

[7] While governments instituting individual accounts sought to boost savings rates (Madrid 1999), several recent studies suggest that Chile's savings rates improved because of changes in corporate tax laws rather than the new system of individual savings accounts (see Uthoff 1997 or for a summary see Kay 2000).

[8] For example, total transition costs in Chile averaged 4.3 percent of GDP during the 1980s and 4 percent between 1990 and 1998. Total transition costs are projected to rise to 4.6 percent of GDP from 1999-2008 before dropping to 3.3 percent in 2009-2018 and 1.9 percent in 2029-2037 (Arenas de Mesa 1999).

transition costs and their potential fiscal impact on other areas of public spending was absent from the greater political debate over reform.

The Other Sequence – PAYG-only Reform (so far) in Brazil

Brazil stands in marked contrast to other Latin American countries in that there is no initiative at the present time to incorporate mandatory individual pension savings accounts into their social security systems. The proposal to move toward a system with private accounts was met with widespread political opposition when President Cardoso broached the subject in 1995, and was withdrawn from debate (Brazil subsequently introduced voluntary supplementary private accounts). However like the rest of its neighbors, the Cardoso administrations encountered tremendous political obstacles in its effort to reform the public PAYG systems for private sector and government employees. Ultimately the financial emergency in late 1998 and early 1999 created pressure that forced President Cardoso's normally undisciplined legislative allies to approve reforms that essentially lowered benefits and raised taxes for the most privileged beneficiaries. The Fiscal Responsibility law approved in 2000 created actuarial and financial targets for social security which are included in caps on personnel expenditures. The introduction of a new formula to calculate pensions which directly links pensions to years of contributions, age, and life expectancy is expected to improve the accounts of the social security system for private employees (the *INSS*) in the medium and long-term. The Brazilian case demonstrates that countries in the region can engage in dramatic social security reform without making a radical break with the past in the form of introducing individual savings accounts. However it also demonstrates that initiating such reforms can be a long and arduous political challenge that requires significant political resources in order for governments to bear the political costs of reducing privileges for key constituencies. Mandatory individual savings accounts may once again appear on the political agenda once the current wave of PAYG reforms are completed - President Cardoso continues to express personal support for individual accounts – but such reforms are unlikely to occur under the current administration.

Conclusions

The recent wave of pension reforms in the Southern Cone of South America contain two basic components: reform of the state-run PAYG system, and the implementation of a new system based on private individual savings accounts. While PAYG reform includes transparent measures which require governments to impose costs on specific constituencies, the distributional impact of instituting individual accounts is less immediate, which allows political actors to postpone the political costs and claim credit for policy outcomes that will not occur until a future date, usually after they have left office. The divergent political implications of these two aspects of policy reform are reflected in the sequence of pension reform measures in the region. Given intense political opposition to key PAYG reforms, governments have postponed some vital aspects of the reform – such as reducing benefits for privileged beneficiaries or raising the retirement age - until a more politically opportune moment, an action which makes the adoption of new pension systems more politically viable, but adds significantly to the costs of the reform.

For example, the policy goals of reducing drastic inequality in benefits and restoring financial equilibrium are undermined by systems which preserve special generous programs for the military, civil servants, or other professional groups. Raising the retirement age for women from 60 to 65 has been a policy goal for the Argentine government since the original reform was passed, but despite the urging of the IMF, the government has not yet attempted such a politically unpopular measure. In short, the political process dictates a sequence where the new systems of individual accounts are introduced first, while more politically sensitive distributional aspects of PAYG reform are postponed, sometimes indefinitely.

While the new systems of defined-contribution individual accounts were opposed by the same set of professional, labor, and pensioner groups that opposed PAYG reform, the fact that benefit levels (not to mention costs) would not be apparent until far into the future meant that the new defined-contribution systems offered far more opportunities for credit-claiming. As described above, several specific provisions of the new systems generated political opposition, including whether or not joining the new systems would be mandatory, the extent to which governments would guarantee a minimum return, and the extent to which foreign investment of pension funds would be permitted. Just as notable is the set of issues surrounding privatization which were not very politically salient, including the significant transition costs, administrative fees, and contribution rates. The resulting sequence is one where individual accounts were introduced rapidly while key elements of PAYG reform were postponed.

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