Emerging Markets

Pension Watch

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Economic Analisys

Jasmina Bjeletic
jbjeletic@grupobbva.com.pe

A review of the non-contributory pension pillars in Latin America: first steps in Peru

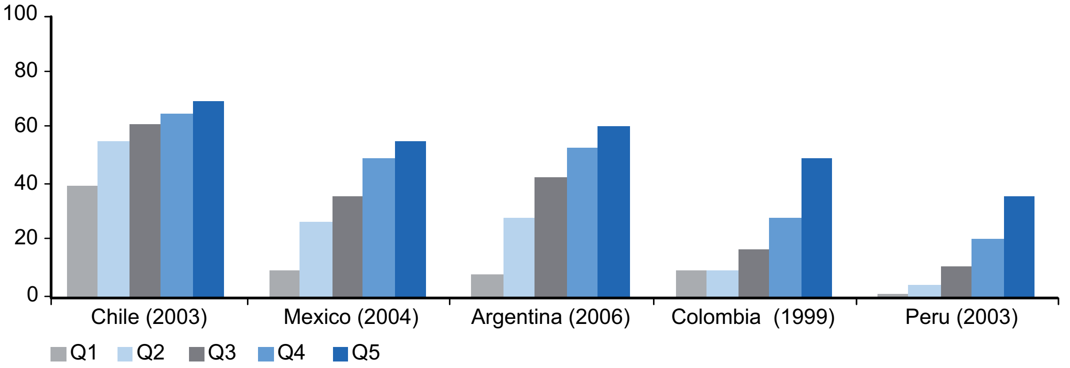
- **On the back of improving economic conditions in Latin America,** governments have in the last decade made progress towards increasing the quality and quantity of their social protection programs. These policies have included the decision to expand the coverage of the pension systems. A number of studies such as Favre et al (2006), Albo et al (2007), Bernal et al (2008) and Muñoz et al (2009), have dealt with the problem of low pension coverage and the need to construct a solidarity pillar.

- **This solidarity pillar should in general focus its attention on those segments of the population that receive no assistance in old age**
Attention should also be paid to the capacity of people who, while active in the labor force, do not have sufficient capacity to save for a pension. A solidarity pillar for pensions, according to 2009 BBVA report, should be founded on four columns: (i) it must not create disincentives for saving; (ii) it must focus resources; (iii) it must be responsible in terms of fiscal resources; and (iv) it must be manageable.

- **The importance of the solidarity pillar has been studied in a number of publications**
Two World Bank reports, "Keeping the promise of social security in Latin America" and "Old age income support in the 21st Century", emphasize the importance of the solidarity pillar in preventing poverty in old age and also point out that if the reforms of the pension systems only focus on the contributory pillar a significant part of the elderly population could be excluded from access to a pension. They also recommend that governments in the region should place more importance on the low coverage of the pension systems in order to enhance the role of social security in reducing poverty. To achieve this aim, some of the suggested proposals are based on designing a social safety net for the elderly population financed through taxation and also on constructing optional schemes that help those excluded.

The fact is the problem of neglect is extensive. For example, a study by Rofman y Lucchetti (2006), based on an analysis of survey data, points to the enormous lack of protection in Latin America, above in population segments with lower resources. The case of Peru is particularly striking according to this research, with particularly low levels of coverage even among the high-income population (under 40%).

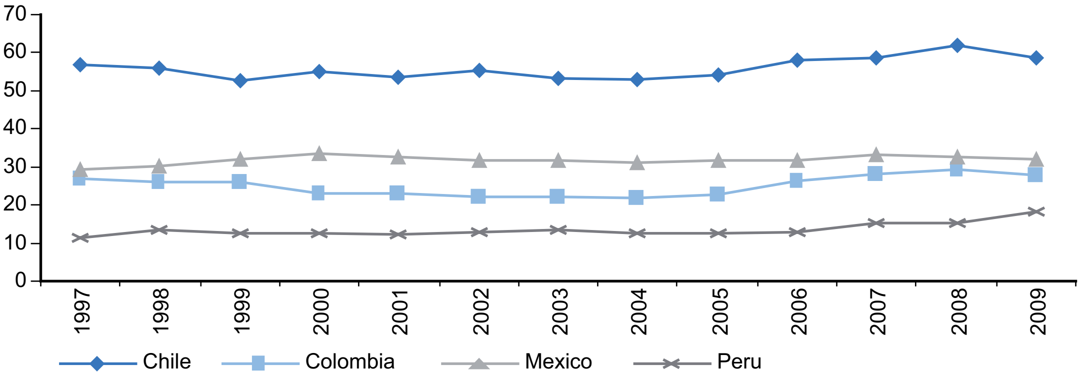
Chart 1
Coverage of the EAP by quintiles (Q1=poorest, Q5=richest)



Source: BBVA, FIAP, AIOS, Rofman and Lucchetti (2006)

In its studies on Chile, Colombia, Mexico and Peru, BBVA came to similar conclusions with respect to the coverage problems of pension systems. As can be seen in the chart below, the coverage levels in countries in the region have not changed significantly and are currently at very precarious rates, except for Chile. Even more alarming is the case of Peru, where coverage is not over 20%. This could be attributed to characteristics of the Peruvian economy such as the high level of informality and the high dispersion in wealth distribution, in addition to the country's low level of pension culture.

Chart 2
Contributors as percentage of the EAP



Source: BBVA Research

The Peruvian case

In fact, the most recent reform initiative has been taken in Peru, where the government announced the introduction of a welfare pension for the elderly. At the end of August 2010, Urgent Decree No. 059-2010 approved the creation of a pilot program called Asistencia Solidaria: Gratitud (Welfare Assistance: Gratitude), thus establishing the framework for the provision of this pension. Initially, the measure will be focused on adults over the age of 75 who live in extreme poverty[1] and who form part of the homes benefiting from Juntos, the National Direct Support Program for the Very Poor, in three of the poorest departments of the country[2] as well as the Metropolitan Lima area. The monthly subsidy will amount to PEN 100 (about 25 euros) and the Ministry of the Economy has allocated PEN 2 million (about 510,000 euros) to this program in the budget for the public sector this year (2010). This amount is planned to increase as the scheme is implemented more extensively, other departments of the country are included and the scheme's impact is evaluated.

In Peru, a study carried out by la Mesa para la Concertación de la Lucha contra la Pobreza (the Board for Organizing the Fight against Poverty) quantified the potential impact that a scheme of welfare pensions of PEN 100 would have on the level of poverty among elderly adults and the poverty gap in this group. The different scenarios presented by the authors suggest that poverty in this age group could be reduced from the current 30.3% to 12% or 8%, depending on the level of coverage provided by the program. Scenarios that consider more universal coverage could end up costing between 0.6% of GDP in 2008 to close to 3% for projections up to 2050. The base scenario considered in the study could cost 0.08% of GDP at the start and reach 0.1% of GDP by 2050. The key elements in these projections are the expected gradual implementation of the program, the socioeconomic assumptions, the management of the program (which limits "filtrations" to non-target groups) and the behavior of pension systems in the future.

At the same time, care should be taken to implement fully the additional measures designed to extend pension coverage in the country (in the private system the ratio of members to the urban economically active population (EAP) is 44% and the ratio of contributors to the urban EAP is only 20%). These include the Social Pension System (SPS), which targets workers in micro enterprises. Although it was created in 2008, it has still not been implemented, despite its importance.

Bernal *et al* (2008) also propose the application of a variety of proposals to help extend the coverage of the pension system. Among these are pension plans through contributions of PEN 1 or 2 per day, which give workers a percentage of the pension after fifteen years. It is important to note that each year of additional contribution would imply a higher subsidy and thus guarantee a greater percentage of the minimum pension, as can be seen from the table below.

Table 1

Pension guarantee schemes by years of contribution
(Pension in PEN and as a percentage of the minimum pension)

Year	P1	P2
15	218 (45%)	348 (72%)
16	230 (48%)	373 (77%)
17	242 (50%)	398 (82%)
18	256 (53%)	425 (88%)
19	270 (56%)	450 (93%)
20	289 (60%)	484 (100%)

Note: P1 refers to the program "Pension for PEN 1" and P2 to "Pension for PEN 2".
Source: BBVA Research Peru

In assessing the impact of these programs on the level of pension according to the period of contribution, it is worth noting that the workers newly covered by the Pension for PEN 1 and Pension for PEN 2 programs can receive an income in old age that at least ensures them minimum levels of consumption. Thus, for example, in 2050 low-income workers (beneficiaries of the Pension for PEN 1 program) would receive a pension that would allow them to acquire 1.5 times the minimum basket; these pensions are equivalent on average to 50% of the minimum pension, or 60% of the minimum wage. Something similar can be seen in the case of pensions under the Pension for PEN 2 program.

1: Estimates by the National Institute of Statistics and Computing (INEI) and information from the latest National Survey of Households (ENAHO 2009) indicate that of the 624,390 people over the age of 75, 12.5% (around 80,000) live in extreme poverty.
2: Huancavelica, Apurímac y Ayacucho show poverty ratios of 77.2%, 70.3% y 62.6%, respectively.

Other experiences

The study by Melguizo *et al* (2009) review the solidarity systems in various countries. They cover Mexico, Colombia and Peru, with particular emphasis on the system in Chile and on the recent comprehensive reform introduced by the government in 2008 which has given the country one of the soundest Solidarity Pension Systems (SPS) in the region. The creation of a improved solidarity system in Chile mainly benefits: (i) those who do not have pension savings; and (ii) those who only have very scarce funds. To access the benefits, each of these groups has to form part of the lowest-income population (the poorest 60 per cent of the country`s population). Products have been designed for them that will increase the benefits and amounts granted steadily until 2012.

Estimates in the study suggest that annual public spending on the solidarity pillar in Chile will be between 0.8% and 0.9% of GDP in 2010 (0.9% under scenario A, which follows historical trends, and 0.9% under B, which includes the negative effects of the recent crisis). It will reach a maximum of 1.0% by 2016 and then fall off steadily to 0.7-0.8% in 2022. This would involve a permanent increase in spending of around 0.7-0.8 pp of GDP per year compared to the previous solidarity pillar (the sum of spending under the SEPM and PASIS schemes).

In Mexico, under the reform of 1997 the state added a social contribution of 5.5% of the minimum wage in the Federal District into each worker's individual account for each day of contribution. This was in force until 2009. With the Social Security Law of 2009, the payment of the social contribution was authorized only for workers who earned less than 15 times the minimum wage and a scheme was designed to ensure that the social contribution should as far as possible benefit those on lowest incomes. Thus, their pension would increase by approximately 17% as a percentage of salary contribution.

In Colombia, the approval of Law 1328 on Financial Reform provided some guidelines for the Regular Economic Benefits Program (BEPS) created through Legislative Act 01 of 2005, although the regulation required to make them operative is still not in place. Article 87 of this Law states that the BEPS are aimed at "people with low levels of resources who have made regular or occasional contributions or savings through such means or mechanisms as may be determined by the national government." Thus, among the aims of this scheme is to create incentives for saving through mechanisms that encourage loyalty. These include making regular benefits depend on individual savings, loyalty and the total saved; and allowing the funds in the accounts to serve as collateral for loans to be used to cover unexpected events in the lives of savers or their families.

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This report has been produced by the Pensions

Emergings Markets Chief Economist
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Pensions Chief Economist
David Tuesta
david.tuesta@grupobbva.com

Soledad Hormazábal
shormazabal@grupobbva.cl

María Claudia Llanes
maria.llanes@bbva.com.co

Ivonne Ordoñez
ivonne.ordonez@grupobbva.com

Jasmina Bjeletic
jbjeletic@grupobbva.com.pe

Javier Alonso
javier.alonso.meseguer@grupobbva.com

BBVA Research

Group Chief Economist
José Luis Escrivá

Chief Economists & Chief Strategists:

Regulatory Affairs, Financial and Economic Scenarios:
Mayte Ledo
teresa.ledo@grupobbva.com

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com

Financial Systems
Ana Rubio
arubiog@grupobbva.com

Economic Scenarios
Juan Ruiz
juan.ruiz@grupobbva.com

Regulatory Affairs
María Abascal
maria.abascal@grupobbva.com

Market & Client Strategy:
Antonio Pulido
ant.pulido@grupobbva.com

Equity and Credit
Ana Munera
ana.munera@grupobbva.com

Interest Rates, Currencies and Commodities
Luis Enrique Rodríguez
luisen.rodriguez@grupobbva.com

Asset Management
Henrik Lumholdt
henrik.lumholdt@grupobbva.com

Spain and Europe:
Rafael Doménech
r.domenech@grupobbva.com

Spain
Miguel Cardoso
miguel.cardoso@grupobbva.com

Europe
Miguel Jiménez
mjimenezg@grupobbva.com

United States and Mexico:
Jorge Sicilia
j.sicilia@bbva.bancomer.com

United States
Nathaniel Karp
nathaniel.karp@bbvacompass.com

Mexico
Adolfo Albo
a.albo@bbva.bancomer.com

Macro Analysis Mexico
Julián Cubero
juan.cubero@bbva.bancomer.com

Emerging Markets:
Alicia García-Herrero
alicia.garcia-herrero@bbva.com.hk

Cross-Country *Emerging Markets* Analysis
Daniel Navia
daniel.navia@grupobbva.com

Pensions
David Tuesta
david.tuesta@grupobbva.com

Asia
Stephen Schwartz
stephen.schwartz@bbva.com.hk

South America
Joaquín Vial
jvial@bbvaprovida.cl

Argentina
Gloria Sorensen
gsorensen@bancofrances.com.ar

Chile
Alejandro Puente
apuente@grupobbva.cl

Colombia
Juana Téllez
juana.tellez@bbva.com.co

Peru
Hugo Perea
hperea@grupobbva.com.pe

Venezuela
Oswaldo López
oswaldo_lopez@provincial.com

Contact details

BBVA Research
Paseo Castellana, 81 - 7th floor
28046 Madrid (Spain)
Tel.: +34 91 374 60 00 and +34 91 537 70 00
Fax: +34 91 374 30 25
bbvaresearch@grupobbva.com
www.bbvaresearch.com