Chapter 13

The Peruvian Pension Reform: Ailing or Failing?

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In 1992 Peru followed the example of Chile and implemented a fully funded pension scheme, becoming the second country in Latin America to reform its pension system. The Peruvian reform shows three notable characteristics: (*a*) the public pension system was not closed—it continues to operate alongside the private one; (*b*) coverage is limited; and (*c*) competition in the privatized system appears to be limited.

First, the decision to maintain rather than eliminate the public pension system introduced several distortions to the overall functioning of the new mandatory pillar. These distortions have been obstacles to the reform's success. Political demands to return to the old public scheme are common—each year legislative initiatives are introduced to revise the private pension system. Most of these proposed reforms are aimed at reducing profits for the private pension funds rather than enhancing the performance of the private system, improving the fiscal situation, or meeting the needs of workers.

Second, the original objective of the pension reform was to provide more secure coverage than the public pension system. However, this objective has been met for only a small fraction of the workforce. In this respect, the government could participate more actively to expand coverage to individuals in the informal sector.

Third, Congress has discussed many initiatives to reduce profits in the private pension system rather than addressing the more urgent policy question of how to both increase competition and guarantee a secure pension benefit without creating excess market distortion. These challenges present no easy solution, as the government has the upper hand in the regulation process and the pension system provides an easy way to finance the fiscal gap. Consequently, the government has an incentive to trade long-term stability for short-term objectives.

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This chapter analyzes the pension system as a whole, considering both the mandatory private and public systems,[1] provides a preliminary assessment of the reform thus far, and analyzes potential reforms for the pension system.

The Pension System before the Reform

Government pensions date back nearly to Peru's independence. In 1850 the government sanctioned the Ley de Goces, or the Benefits Law, which created special pension benefits for a select group of public officials and citizens that served in the wars of independence.[2]

The mandatory public pension system started in 1936. Over the following decades, the system has undergone numerous modifications. Initially designed exclusively for private-sector workers, it was partially financed by taxes and contributions from employers, employees, and the government. In 1962 the system was extended to public employees; by 1973 most of the existing pension systems were consolidated into a single PAYGO public pension system called the DL 19990 regime.[3] There were two main exceptions: the Caja de Pensiones Militar-Policial, which still covers all military and police personnel, and the so-called Cédula Viva, a privileged pension scheme for high-ranking officers, which the government attempted unsuccessfully to close in 1974 by DL 20530.[4] Despite their differences, all the pension systems suffered from public pension fund mismanagement. Their sustainability was jeopardized by fiscally irresponsible governments that borrowed from pension funds to cover current expenditures and infrastructure projects, while high inflation wiped out the real value of pension funds.

In 1985 DL 19990 pensions covered only 34 percent of the EAP. The combination of a severe economic crisis and the reform of public-sector enterprises dramatically changed the labor market, tilting the coverage balance even more. Whereas, in 1990 two-thirds of the labor force had permanent jobs, one decade later this figure was just one-third. (Workers in the informal sector of course do not contribute to pension plans.) Growth in the informal sector is one of the most salient characteristics of the Peruvian economy.[5] By 1992 coverage had fallen to barely 21 percent of the EAP (see Carranza and Morón 2003: 21).

According to Mesa-Lago (1985), before the trough of the economic crisis in 1985, the Peruvian public pension system was already characterized as one in which (*a*) coverage was low (only 38% of the EAP, compared to 61% for Latin America as a region); (*b*) noncompliance with contributions was widespread; (*c*) the age structure of the affiliates was young (Peru had only 3.6% of its population older than 65 years, compared to 4.2% in the

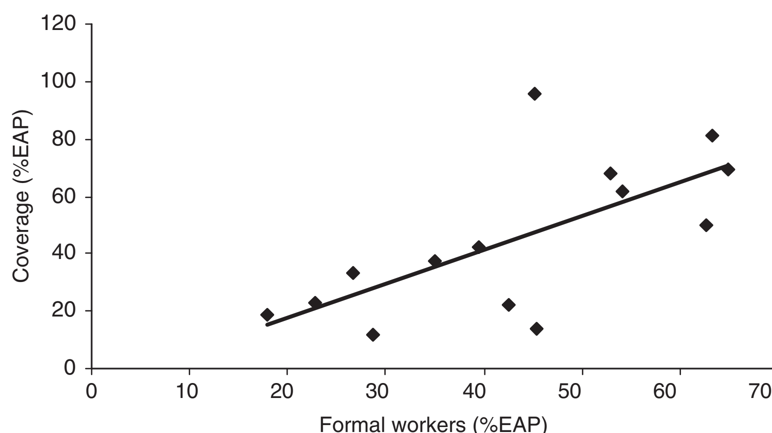

Figure 13-1. Coverage and informality in Latin America pre-reform (1985) (*Source*: Mesa-Lago 1985).

region); (*d*) pension benefit levels were not excessive—though this was not the case with the DL 20530 regime; (*e*) returns were significantly negative; and (*f*) recordkeeping was poor.

Low coverage is explained by the size of the formal sector: only 45 percent of the EAP were wage earners (Mesa-Lago 1985). The same pattern was true for the rest of Latin America (see Figure 13-1).

In sum, the public pension system suffered a severe mismanagement problem as the pension funds were subject to imprudent government policies. These problems were compounded when the demographic boom receded and a large share of younger workers migrated to other countries. Finally, government intervention in the market was biased toward the shrinking urban and formal labor market, which constitutes a minority of the workforce.

The Reform[6]

From a political economy perspective, some conditions are more conducive to reform than others. For example, it is easier to pass a reform if (*a*) the leader has an ample majority in Congress; (*b*) the president has recently been elected and is enjoying a honeymoon effect; (*c*) the group of beneficiaries will receive its benefits in the short run, whereas the costs are lumped in the long run; or (*d*) there is a clear consensus (see Brooks and James 2001). None of these four conditions were true in 1992.

Alberto Fujimori was elected president in July 1990 amid an economic crisis and the threat of increasing political violence. Given the desperate situation, he received political support for most of his political initiatives. However, Fujimori did not engage in dialogue with the legislature, nor did he pursue political alliances. He instead asked for special legislative powers to pass reforms, only explaining his decisions afterwards. Fujimori received ample legislative powers to pass a long list of reforms in the second half of 1991. In one week, the government issued more than fifty legislative decrees promoting private-sector participation in several sectors in the economy, including the pension reform (DL 724).

The early months of Fujimori's presidency were a time of major confrontation between the president and the Congress. Several decrees were changed or repealed.[7] One minister was censured and a motion to declare the presidency vacant was almost passed. These conflicts ultimately led to the April 1992 'self-coup', when Fujimori dismissed the Congress. In this complex political environment, the first attempt to reform the pension system did not succeed.

Mounting international pressure for a swift return to democracy forced the government to call for congressional elections. This put the pension reform in peril, as the issue lost importance in the political agenda. It was not until late 1992 that new legislation (DL 25897) was enacted to replace the first initiative.

The urgency of pension reform was justified in terms of the overall fiscal situation and the history of mismanagement of the public pension system. These two factors implied an inability to finance public pensions, and the pension reform was viewed as a way to avoid deeper fiscal problems. In this sense, replacing the PAYGO system with a system of individual accounts constituted one key element of the reform. Up to then, pensions were not linked to contributions and instead depended on the fortunes (or misfortunes) of the national treasury.

The reform did not bar workers from entering the public pension system, as in Chile,[8] due to mounting public opposition. The campaign to maintain the public system was assisted by favorable public opinion of Luis Castañeda, the manager of the agency running public pension and health programs (the Instituto Peruano de Seguridad Social, or IPSS, now called EsSalud). His managerial success undermined critics of the government's management of the pension system (although IPSS performance during his tenure was not representative of its past).

The manager's popularity explains why at that time it was considered positive to continue the operations of the public pension system. IPSS's coexistence with the AFPs or private pension fund managers was justified as a source of competition and as a way of disciplining the market.[9] Workers would voluntarily choose to join an AFP or the public pension system (El

Sistema Nacional de Pensiones, or SNP), but those who joined an AFP would also have to pay a solidarity contribution to the SNP to guarantee its financial sustainability.

One of the most significant design problems of the initial reform proposal was that workers had an incentive to stay at the SNP. The SNP offered several advantages, including a lower contribution rate, a lower retirement age, and an MPG—all of which the new system lacked. Meanwhile, recognition bonds to compensate those joining the new system for contributions made to the old public system were not implemented swiftly.[10] Additionally, workers who had chosen an AFP retained the option to move back to the SNP. Hence, the growth of the new system was slow (see Arce 2001). By the end of 1993, only 30 percent of workers with pension coverage were affiliated with the private pension system.

In 1995 most of the initial deficiencies were corrected. Under DL 26504 the contribution rate of the SNP was raised to match that of the Sistema Privado de Pensiones (SPP, or Private Pension System), the solidarity contribution was eliminated, and the retirement age was standardized for both men and women at 65 years. Also, the Oficina de Normalización Previsional (ONP, or Office of Social Security Normalization) was created to manage the SNP (replacing IPSS) and to expedite the recognition bonds process. Moreover, to tilt the balance toward the SPP, new employees had to select their affiliation preferences (SNP or a particular AFP) within a certain period; otherwise, they were automatically enrolled in an AFP.

Despite all the changes, some important issues still needed to be addressed, such as the implementation of a cap on mandatory contributions in the form of a taxable-wage ceiling, the possible phasing out of the SNP, and the introduction of an MPG for the SPP. Though included in the 1995 law, the MPG was not implemented until 2001. The reduction in the contribution rate from 10 to 8 percent that was intended as a temporary measure to attract more affiliates to the SPP became more of a permanent policy. Proposals to raise the contribution rate have been deferred year after year.

In summary, the initial reform introduced a fully funded DC system alongside an unfunded, fiscally unsustainable public system. The reform was incomplete, and there has been space for continuous revisions of the system. The politics of the reform have imposed great costs on the SPP: (*a*) the SPP has to invest significant resources in defending its existence; (*b*) its performance has been affected by changing the rules of the game; and (*c*) the SPP had to compete with the SNP to attract the same pool of workers but under unequal conditions and regulations. The experience of the past ten years suggests that a better strategy for the government would have been to complement the services provided by the private sector by extending coverage to sectors difficult to reach.

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Evaluation of the Reforms

This section offers a preliminary evaluation of the pension system. A full evaluation is problematic given the fact that the system is still in a transition phase and is constantly changing.

Tables 13-1 and 13-2 provide a quick overview of the pension system as a whole. The most significant accomplishment of the reform is simply that it has endured, given the fact that policymaking in Peru is characterized by constant reversals (see Morón and Sanborn 2006). New governments have been prone to redo entire reforms regardless of the costs.[11] However, despite a strong and vocal group of opponents, the private pension system endures.

This resilience is notable. After a natural consolidation process that reduced the number of participants from eight AFPs to four, there was no effect on the affiliates (see Figure 13-2). Moreover, the pension fund has grown despite being tested by a series of major international economic crises during the late 1990s as well as a domestic political crisis following Fujimori's abrupt departure in 2000.

Evidence of the reform's progress can be found in the size of the funds managed by the private pension system: US$9 billion (more than 12% of the GDP). The rapid growth of pension fund assets has completely transformed the financial system. Banks have been displaced as the main providers of funding to the corporate sector. The government—after fixing major macroeconomic imbalances—was able to introduce a domestic bond market long awaited by the AFPs. Yet, in comparison with other reformed private pension systems, the Peruvian system has a much lower concentration in government bonds (see Table 13-3). Whereas the average in the region is close to 60 percent (in some countries, more than 80%), in Peru only 25 percent of the portfolio is in government bonds.

The excessive dependence on government bonds that characterize the rest of the reformed systems in the region highlights the fact that 'privateness' of the pension funds is relative. The only difference between those private systems and the old PAYGO systems is that now the workers' contributions go to their individual accounts instead of a common pool. However, the pension funds are still subject to regulatory capture and exposed to government whims. The limited investment in government bonds is one of the strengths of Peru's reformed system.

Of the main failures of the reform, the most pressing is the low coverage (see Table 13-4 for numbers on the region's coverage). In a recent World Bank study, Rofman and Carranza (2005) compute comparable coverage figures using Latin-American household surveys. The low coverage figures in Peru merit some explanation. First, Peru (along with Bolivia) is among the countries with the largest shares of informal workers in its labor force,

TABLE 13-1 The Peruvian Pension System after the 1992 Reform

	National Pension System	*Private Pension System*
Nature of the system	PAYGO	Individual capitalization account
Administration	National pension office (ONP)	Pension funds administration (AFP)
Mandatory contribution	13%	8%
Voluntary contributions	No voluntary contributions	Voluntary contribution up to 20% of the wage are deposited in the mandatory CIC
	—	Those in excess of 20% of the wage are deposited in separate voluntary retirement savings account
Fees as % of wage	None, but it is not clear how the 13% is distributed between retirement savings and administration costs.	Administration fee: 2.27%
	—	Insurance prime: 0.95%
	—	—
Maximum taxable wage	No ceiling	No ceiling
Maximum pension benefit	US$261	No ceiling
Minimum pension benefit	For all workers, according to the years of contribution:	Since 2002, only for workers that were born before 1945
	US$81.14 if less than 5 years	A benefit of US$125 is provided conditional on 20 years of contributions to any of the pension system
	US$92.55 if less than 10 years	—
	US$104 if less than 20 years	—
	US$125 if 20 years or more	—
Retirement pensions	According to the rules that consider the number and amount of contributions registered by the worker	As an annuity of the resources accumulated in the CIC: contributions and returns to the pension fund.

Source: MEF (2004).

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Table 13-2 Pension System Indicators (December 2005)

	SNP		
	DL 19990	*DL 20530*[a]	*SPP*
Affiliates (in thousands)	1,154	60	3,637
Contributors (% affiliates)	41	—	36
Pensioners (in thousands)	4,133	262	27
Annual pension payment (in millions $)	1,050	1,318	86
Receive minimum pension (% pensioners)	27	—	3.5
Annual contribution collection (in millions $)	217	—	1,058
Pension Fund (in millions $)	—	—	9,931

Sources: Authors' own calculations based on data from ONP (n.d.), SBS (n.d.), and MEF (2004).

[a] The figures in this column are from December 2004.

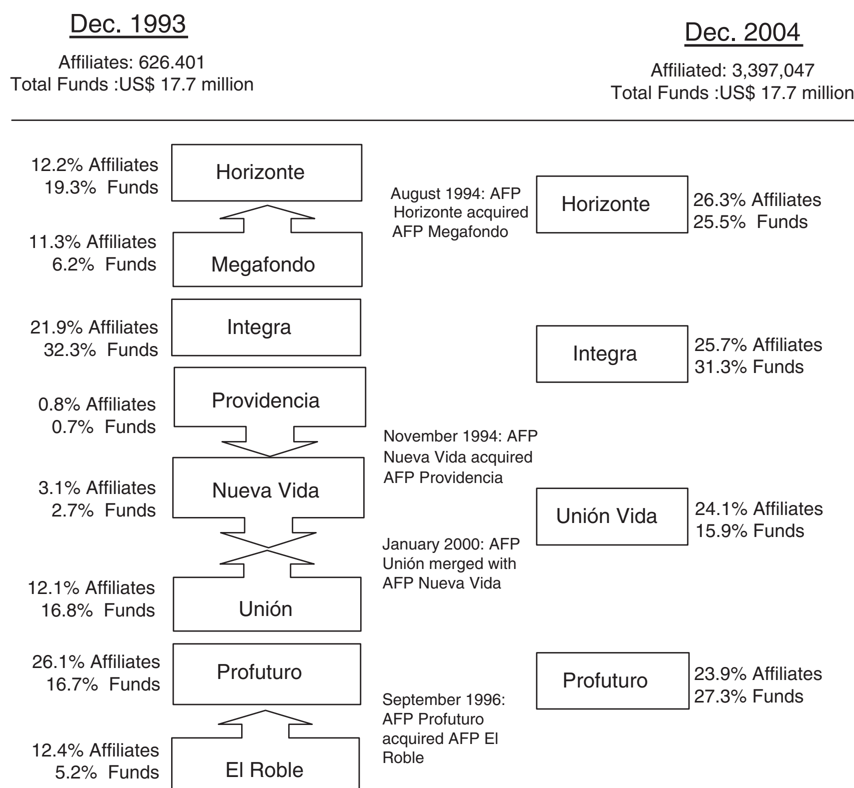

Figure 13-2. AFP mergers and acquisitions.

TABLE 13-3 Investment of Pension Funds (as of December 2004)

	Government Sector	*Corporate Sector*	*Financial Sector*	*Foreign Sector*	*Others*
Argentina	62.3	14.7	11.1	10.3	1.7
Bolivia	67.5	24.4	5.6	1.5	1.1
Chile	18.7	24.4	29.5	27.3	0.1
Colombia[a]	48.5	19.6	21.1	9.7	1.1
Costa Rica	77.2	11.4	11.5	—	—
El Salvador	83.5	0.3	10.5	5.5	—
Mexico	84.5	14.4	0.4	—	—
Peru	24.5	45.2	20	10.3	0.1
Uruguay	79	5.2	7.5	—	8.3
Average	60.6	17.7	13	10.8	2.1

Source: Author's own calculations based on FIAP (2005).

[a] The Colombian information includes only the mandatory pension system figures.

so the potential pension market is one of the narrowest.[12] Second, the reform law did not include incentives to increase coverage. For instance, Peru was one of the last countries to extend the MPG to the private pillar, and even then the guarantee is limited to affiliates born before 1945 with 20 years of contributions. Furthermore, contributions to the pension fund are still taxable in Peru.

By some measurements, pension system coverage has diminished since the introduction of the reform. However, measurements of coverage have a serious limitation: they do not control for the level or the certainty of

TABLE 13-4 Coverage Rates

	Contributors/ EAP	*Contributors/ Employed Persons*	*Contributors/ Wage-Earners*	*Beneficiaries/ Population Age 65+*
Argentina (2003)	34.6	40.3	54.7	68.3
Bolivia (2002)	9.9	10.9	29.0	14.7
Chile (2003)	58.2	63.4	77.3	63.8
Colombia (2002)	n.d.	n.d.	n.d.	18.6
Costa Rica (2000)	50.1	52.1	70.8	36.6
El Salvador (2000)	29.7	31.6	52.9	14.5
Mexico (2000)	38.5	39.3	62.2	19.2
Peru (2002)	13.9	14.4	31.3	23.7
Uruguay (2002)	55.3	65.0	78.6	87.1

Source: Rofman and Carranza (2005).

the pension provided.[13] In the past, the protection offered by the pension system was poor. The level of the pensions and the replacement rates were low and uncertain. In this sense, it is possible to argue that the law increased the cost of not participating in the system. However, the effects of these benefits were not extended to a larger group.

Another serious criticism of the reform is related to the level of competition in the private pension system. The perception in recent years has been that the four AFPs have behaved as an oligopoly and earned noncompetitive profits due to price agreements. The high return over equity (ROE) and concentration indices as well as the high and unchanging fees have been the fuel for dozens of legislative initiatives ranging from closing the private pension system to arbitrarily setting administration charges. They have also been the base of antitrust demands against each of the AFPs at INDECOPI (Instituto Nacional para la Defensa de la Competencia y de la Protección de la Propiedad Intelectual, or National Institute for the Defense of Competition and Protection of Intellectual Property), the competition watchdog. Nevertheless, all the demands were dismissed.

Typically, market concentration is measured by the Herfindahl-Hirschmann index (HHI). A first inspection of this indicator appears to support the position of the critics (see Figure 13-3), but the figures are deceiving as the number of firms is very small and not constant in the sample. To correct the problem, we compute an alternative indicator comparing the computed HHI with the lowest possible value it can take given a particular numbers of firms in the industry. The results in Figure 13-4 are the opposite of what Figure 13-3 shows. As the smaller firms were absorbed, the adjusted HHI of the remaining firms declined systematically. Given the number of AFPs, the market could not be less concentrated: the market shares of each AFP are almost 25 percent.

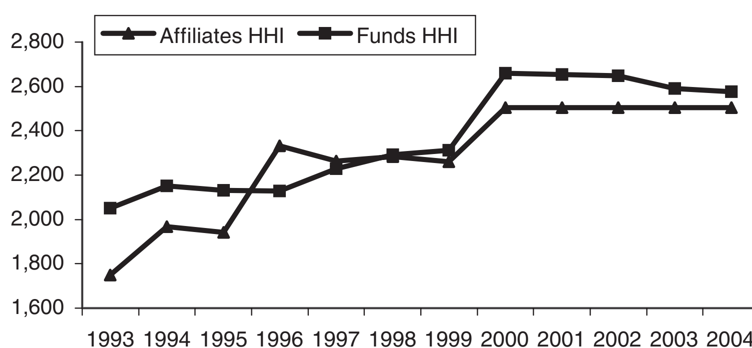

Figure 13-3. Herfindahl-Hirschman concentration indexes. (*Source*: Authors' computations based on SBS data n.d.)

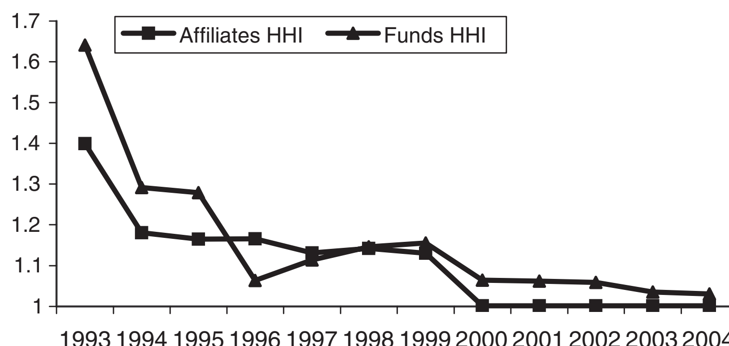

Figure 13-4. Herfindahl-Hirschman alternative indexes. (*Source*: Authors' computations based on SBS data n.d.)

Critics also frequently argue that the administrative fees charged by the AFPs reveal a lack of competition. Comparing Peru with other countries in the region, critics such as Campodónico (2005) claim that the Peruvian system is the second most expensive, just after the Argentine AFPs (see Table 13-5). However, a rapid inspection reveals that this conclusion is wrong. To rank the systems, the critics use the ratio of the administrative fee to the mandatory contribution rate. This indicator is flawed for two reasons. First, the ratio will be higher in those countries where the mandatory contribution to individual accounts is lower. In Peru, the level of this contribution is set by Congress, not by the AFPs. When Congress 'temporarily' reduced

Table 13-5 Contribution and Administrative Fee Rates (December 31, 2004)

Country	*Contribution Rate to Individual Account (1)*	*Administrative Fee [a] (2)*	*(2)/(1) (%)*
Argentina	4.47	2.53	56.8
Bolivia	10.00	2.21	22.1
Colombia	10.00	3.00	30.0
Chile	10.00	2.26	24.2
El Salvador	10.00	2.98	29.7
Mexico	4.88	1.38	28.9
Peru	8.00	3.19	39.9
Uruguay	11.95	2.90	24.7
Average	8.66	2.59	29.9

Source: Author's own calculations based on FIAP (2005).

[a] Only includes administrative fee charged as a percentage of wage.

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TABLE 13-6 Average Commissions in Private Pension Systems (December 31, 2004)

Country	*Fixed Fee US$*	*Var. Comm. (% Wage)*	*Var. Comm. (% Wage)*		*Var. Comm. (% Pension Fund)*	*Var. Comm. (% RR)*
			AFP	*Ins. co.*		
Argentina	n/a	2.53	1.12	1.41	—	—
Bolivia	n/a	2.21	0.50	1.71	— [a]	—
Colombia	n/a	3.00	1.55	1.45	—	4.50
Costa Rica	n/a	—	—	—	—	7.25
Chile	0.95	2.26	1.27	0.99	—	—
El Salvador	n/a	2.98	1.78	1.20	—	—
Mexico	n/a	1.38	1.38	—	0.33	—
Panama	n/a	—	—	—	1.26	—
Peru	n/a	3.19	2.27	0.92	—	—
Dominican Rep.	n/a	1.50	0.50	1.00	—	28.75
Uruguay	0.43	2.90	1.94	0.96	0.002	—

Source: FIAP (2005).

[a] 0.2285 if the pension fund is less than US$1,000; 0.14 if the pension fund is more than US$1,000 but less than US$1,200; 0.067 if the pension fund is more than US$1,200 but less than US$1,500.

the rate of contribution from 10 to 8 percent in 1995, they made the system more expensive. Following this reasoning, by restoring the original rate, Peru would come close to the regional average.[14]

Second, the indicator is misleading, as it takes only the variable commission into account —that is, the fee charged as a percentage of a worker's wage. However, the AFPs across Latin America have differing administrative charges. Some also include a fixed fee, while others apply a fee on the size of the funds or on the return obtained by the funds (see Table 13-6). Consequently, this indicator underestimates fees on systems that depend less on the variable fees.

Carranza and Morón (2004) offer a better measure that allows comparisons among systems with different pricing schedules. Following James, Smalhout, and Vittas (2001), we compute equivalent annual fees, or the annualized value of all fee payments as a percentage of the workers' wages. The figures assume that the return on the funds and the mandatory contribution are the same across systems and over time. The results, in Table 13-7, show that while the cost of Peru's pension system was above the regional average, the discrepancy is not as high as previous studies have indicated. Furthermore, with the recent reductions in fees, the Peruvian system is among the less expensive ones in the region.

TABLE 13-7 Equivalent Annual Fees (% of the Individual Pension Fund) (December 31, 2004)

Country	*With Official Contribution Rate (1)*	*Assuming 8% as Contribution Rate (2)*
Argentina	0.760	0.424
Bolivia	0.523	0.597
Colombia	0.484	0.494
Chile	0.304	0.380
El Salvador	0.398	0.497
Mexico	0.707	0.560
Peru	0.532	0.532
Uruguay	0.390	0.487
Average	0.512	0.496
Memo: Peru (2006)	0.374	0.467

Source: Author's own calculations based on FIAP (2005).

Finally, pension fund firms have been criticized for excessively high ROE. According to a report prepared by Gerens (2005), the private pension industry has the highest ROE displayed in the past 10 years by any industry.[15] Furthermore, by that measurement, two of the AFPs rank as first and third best performers of the past decade.

Surprisingly, such a profitable market has not seen new entrants until this year. A typical explanation is that high barriers deter potential competitors, but the capital requirements for entry are not extremely large. Rather, other local factors hinder investor participation in this market. First, high uncertainty exists regarding the basic rules governing the system. Second, substantial limitations are imposed by the informal sector on the size of the potential market. Third, there is low price elasticity of affiliation and contribution. Fourth, switching from one AFP to other was an involved process in which the affiliate had to bear high transaction costs.[16] In such an environment, the most convenient method of entry was to buy an existing firm.

A weakness in the system is the effect of the temporary reduction of the contribution rate. Back in 1995, legislators were convinced that a reasonable way to attract more affiliates into the system was to reduce temporarily the contribution rate from 10 to 8 percent. However, they did not take the possible effects on replacement rates into account. Moreover, the temporary change has become a permanent one that has reduced projections of future pensions. A paper by Berstein and Ruiz (2004) suggests that frequency of contributions does not depend on the rate of contribution. If this is the case, then lowering the contribution rate will lead to lower replacement rates but not to greater compliance.

Another weakness is the inability to offer a response to the problem of the lack of compliance in contributions. More than half of the affiliates do not contribute regularly to their individual accounts. However, it is unclear whether this is because the worker is no longer employed or because the firm is not depositing the corresponding contribution. Both the SBS and the Ministry of Labor have a very limited ability to enforce compliance. Moreover, workers do not have the incentive to complain to their employers out of fear they might be laid off.

The Pending Reforms

As discussed above, the common view is that the reform failed to increase coverage, reduce administrative costs, or promote competition. The section that follows discusses proposals that tackle those issues.

Refocus Government Intervention[17]

The most pressing question for a country reforming its pension system is perhaps whether to close the old public system. This is a very difficult political decision, because the workers in the transition period are significantly affected. Compensating them increases the fiscal cost of reform but avoiding a complete phaseout of the public system reduces the efficiency of the private system and lessens the potential for reductions in administrative costs. The tradeoff is clear, because in essence the public and the private systems are serving the same clients.

In Peru, according to the most recent household survey, 77.5 percent of the population older than 60 years does not have pension coverage. Even if we include such informal social protection networks as retirees living with their children, 46.5 percent of people older than 60 years are still not covered against an income shock. This situation calls for a redefinition of the role and commitment of the government in the postreform period. Currently, its role is limited to supervising the private pension system and offering pensions to those affiliated with the public system. There is no effective universal MPG for the elderly. A World Bank report argues that current government programs should cover only those that comply with requisites of contributions and years of enrollment (WB 2004). Currently, the public provider duplicates efforts in that the SNP and SPP serve the same market in a situation in which the government is resource constrained and in which a large part of the population has no benefits whatsoever.

According to the report, pension system objectives require clarification. These systems should prevent poverty in old age and smooth consumption

in old age. Those objectives could be achieved by: introducing a universal noncontributory means-tested pension; redefining pillar one as a mandatory pooling system with a crosssubsidized minimum pension; and creating individual capitalization accounts that provide affiliates with pensions consistent with their earnings. The report concludes that it is preferable that the government focus its attention and resources to meet the poverty-reduction objective through a collective system, whereas the private pension system takes care of consumption-smoothing through individual accounts. In this way, the pillars are clearly defined and complement each other.

Recently, Carranza (2005) and Morón, Ponce, and Tejada (2005) estimated the feasibility of adopting the World Bank proposal. Carranza finds that setting up a universal pension system will increase coverage from 15 to 40 percent, with the less expensive alternative costing around 0.6 percent of GDP annually. This does not take into account the administrative cost of running a pillar-zero program and the possibility of targeting problems that have swamped other social programs.[18] Both papers find that setting up an MPG in which the government fills only the gap not provided by individual contributions and the profitability of the funds managed by AFPs is fiscally feasible (costing around 0.05% of GDP annually). According to Morón, Ponce, and Tejada (2005), a restructured MPG program could be used as a source of additional funding to increase coverage for at least half a million workers. Asking individuals to fund at least a part of their future pensions will potentially free up government resources. However, phasing out the SNP will prove difficult for political reasons.

In our opinion, there is room for private-sector involvement in each of the pillars. The private pension providers could pay the universal benefits, manage the collective insurance, and administer the capitalization accounts. In this scenario, the role of the government would be restricted to providing funds for the universal pension, offering guarantees for a less restrictive MPG, improving the supervision and regulation of the AFP industry, and isolating the system from political risks.

Promote Competition with More Flexible Rules

Under the current regulatory framework and until the system matures, the dimension on which AFPs most often compete is price. Contrary to what happens in any other industry, the AFPs have not been able to differentiate their product by altering characteristics such as the liquidity of the retirement savings, the portfolio composition, or the returns on the pension fund. The administrative fee is the main differentiating factor, but this also has its limitations. The AFPs were not allowed to offer price

incentives to loyal affiliates until 2004, and even in that case the elasticity of fee reductions is so low that this tool is ineffective.

Much of the current regulation was written during the early 1990s, when the only reference was Chile's groundbreaking experience. It was understandable that regulators were extremely cautious. For example, AFPs were required to invest only in investment-grade securities, and they had to attain a return similar to the average of the system. These restrictions promoted a copycat strategy among AFPs that was exacerbated in the context of a rather illiquid and underdeveloped financial market. In general, the strict limits on portfolio management have created a situation in which differences in the returns accumulated by the AFPs have to be measured using two decimal points.

Only since 2005 has the SBS changed its pricing policies. AFPs can now offer discounted fees to affiliates who sign contracts committing to stay with the same provider for a fixed term (1–3 years). Along the same lines, the SBS approved and regulated the creation of multifunds. In October 2005, the AFPs started offering three types of pension funds that may better meet the risk-return preferences of their affiliates. The previous scheme imposed too much risk on the old affiliates and offered moderate returns to the young. The new regulations allow individuals to invest voluntarily in an AFP other than the one in which they have their mandatory account. Nonetheless, if this initiative is not complemented with more flexible investment limits, the system will end up with three similar funds. Unfortunately, the Central Bank—which has the last word on portfolio regulation—has blocked the SBS proposal to raise the limit on investments in foreign markets.

Another way to introduce more competition is to promote the voluntary third pillar. For this, the SBS will have to introduce caps on contributions to the mandatory second pillar. The potential problem with this proposal is that if the ceiling is set too low, replacement rates may fall beyond reasonable amounts. On the contrary, if the ceiling is too high, the market for voluntary savings will be too thin to attract competitors beyond the AFPs such as mutual funds or banks.

Conclusions

In summary, the pension reform in Peru has been a partial success. The qualification is needed because the initial reforms were not as bold as they should have been. Could we say emphatically that the private pension system is safe from political interference in the near future? Unfortunately, the answer is a resounding *no*—it is a government-mandated, privately run system, not a private one. Sound policy requires taking a long-term

perspective, an exercise that has never been an easy task for a government in which competing pressing needs and an unpredictable political scenario force policymakers to think myopically. Perhaps the size of the pension fund and its considerable influence on the financial system will be enough incentive to shift the policy debate toward long-term issues. Hopefully, as the pension system matures and grows exponentially, politicians will change their perspective.

The challenges ahead might seem insurmountable, especially regarding increasing coverage, which is clearly linked to the formalization of the economy and luring independent workers into the system. The system is vulnerable to multiple risks given that Peru is a developing country with a developing pension system. Nonetheless, the need for additional reforms is clear. For that to happen, it will require political will to lead a pension reform.

Notes

[1] Not included in this chapter is a discussion of possible reforms of the military and police pension systems.

[2] In fact, this legislation only rephrased older Spanish legislation (Real Cédula of February 8, 1803).

[3] DL is short for *decreto ley* (literally, 'law decree').

[4] There were attempts to end this system in both 1962 and 1974. This regime was to be restricted to employees who had entered the public sector before 1962. However, workers entered via special legislation in the 1980s (discussed below).

[5] According to Schneider (2005), Peru ranks among the world's top ten informal economies.

[6] An early but balanced account of the reform is found in Ortiz de Zevallos et al. (1999). A more personal and passionate account of the reform can be found in Roggero (1993). Roggero was a member of Congress until 1992 and the main proponent of the pension reform during the early stages of the process.

[7] Another set of legislative decrees were blocked by the constitutional court, which by all accounts was controlled by the Alianza Popular Revolucionaria Americana (APRA), the major opposition party. The pension reform (DL 724) was under review by this court when it was dismissed after the 1992 coup.

[8] A provision making the new system compulsory was part of the original executive proposal but President Fujimori removed it from the final bill. A proposal to charge higher fees in the public system (as an incentive for workers to join the private system) was also scrapped, as was a later 1995 attempt to require new workers to affiliate with the private system.

[9] In 1995 the World Bank proposed to unify both systems but the proposal was dismissed. See Kane (1995).

[10] Moreover, recognition bonds faced two problems: (*a*) reliable contribution records were absent and, (*b*) in most cases, actual salary records were also unavailable.

[11] For example, President García's regionalization process was completely dismantled by President Fujimori, only to be revived by President Toledo. All these changes happened in less than fifteen years.
[12] According to the ILO (2005), in 2004 58% of Peru's nonagricultural labor force was in the informal sector, compared to 66.7% in Bolivia and 47.4% in Latin America overall.
[13] Mesa-Lago (2001) discusses the pros and cons of alternative coverage measures.
[14] On the last day of the 2005 legislative session, Congress voted to return to the original 10% contribution rate.
[15] According to that report, the private pension system had an average 30.6% return over equity compared to a financial sector average of only 7.7% in nominal terms.
[16] This was changed in 2005 to allow affiliates to switch AFPs via the Internet and without having to wait six months to make a new switch. The new procedure has reduced the duration of the process from ten to two months.
[17] This section is based on Carranza and Morón (2004).
[18] Carranza (2005) simulates the cost of this program under two alternative targeting rules. In one case, the beneficiaries are all elderly people living alone in extreme poverty or in poverty and not receiving a pension benefit. In the other case, the restriction of living alone is lifted. In the less expensive case, the pension benefit is equivalent to 2/9 of the current minimum wage.

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