RESHAPING RETIREMENT

Navigating Latin America's Pension Systems after COVID-19

EXECUTIVE SUMMARY

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In the wake of the global turmoil unleashed by COVID-19, Latin America and the Caribbean faces a glaring gap in understanding the impact of the pandemic on pension systems. Through a collaboration between research centers across the region and the Inter-American Development Bank, this book aims to fill that gap. Case studies focusing on Argentina, Chile, El Salvador, and Peru explore the pandemic's impact on pensioners' well-being and benefit accumulation, highlighting the resilience of pension systems in the face of adversity and the critical role of public policies in shaping their fate. Offering insights into navigating uncertainty and crafting policies to improve the quality of life of the elderly, this book calls on policymakers, academics, and advocates to join forces in designing equitable, sustainable, and resilient pension systems for future generations.

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The COVID-19 pandemic had an immediate effect on labor markets and, by extension pension funds, around the world. The depth and duration of these effects varied across countries, and some economies are still recovering from them.

The most noticeable impact was job losses, as economic activity stalled after countries imposed restrictions on mobility to stop the spread of the virus. Job losses were particularly strong in sectors such as hospitality, tourism, and retail, which in most countries saw either record unemployment or levels not seen in decades. In other cases, employers reduced the working hours of their employees in response to the pandemic, with the resulting reduction in incomes for workers.

The pandemic had an unequal impact on different groups of workers. For example, women, young people, and low-income workers were hit harder and were more likely to lose their jobs or have reduced working hours. In particular, jobs in the informal sector suffered a greater loss. Paradoxically, labor informality dropped in many countries during the pandemic, especially in countries with high informality rates such as those in Latin America and the Caribbean.[1]

There was also an increase in remote work, as companies adopted work-from-home policies to reduce the spread of the virus. This accelerated the process of teleworking that had started well before the pandemic, although at a slower pace. Today, more companies are relying on remote work and redirecting expenditures on old-fashioned office space to a greater dependence on

[1] The unemployment rate rose more among informal workers than formal workers. As informality is measured as a percentage of employees, the number of informal workers within total employment fell in several countries during the pandemic.

technology. Therefore, another challenge for the labor market in the aftermath of the pandemic is the expansion of a skill mismatch, with a group of workers lacking the skills needed for new jobs that emerged during and after the pandemic period.

Although its long-term effects on the labor market are yet to be fully understood, the pandemic has brought about significant changes in the world of work. For example, many countries have not been able to recover their pre-pandemic labor participation rates, something that might have a permanent effect on the income generation or families.

Pension Funds

This new situation in labor markets caused by the pandemic might also have effects on pension funds in terms of the status and wellbeing of pensioners and the buildup of pension benefits. The size of the impact on active workers and beneficiaries will largely depend on the pension scheme. For example, in pay-as-you-go (PAYGO) pension plans, pensioners should not suffer from market downturns because benefits are locked in once they are acquired. In the case of the pandemic, the future benefits of active workers contributing to a pension scheme will not change significantly given the relatively short duration of the crisis. However, benefits could change for individuals close to retirement who need to complete the vesting period in order to qualify for a pension benefit. In that case, workers will need to delay their retirement age in order to complete the required number of contributions.

A broader concern is that, since many pension schemes are not fully funded and require government transfers, it is likely that they will be affected given that governments have emerged from the COVID-19 crisis highly indebted, and with fiscal deficits that have not been fully closed. This implies that less resources will be available for transfers to pension systems. Consequently, countries will likely need to undertake fiscal reforms, pension reforms, and/or partial-inflation indexation of pension benefits to cover these imbalances.

Individual-account pension plan members face a different situation, as they bear investment market risk. Their pension balance is affected by both the lack of contributions during the unemployment period and the market downturn. In the short run, these factors decrease the amount of the benefit a soon-to-be pensioner might collect.

In general terms, the COVID-19 pandemic had a negative impact on pension funds globally. Initially, the pandemic caused significant market volatility that affected pension funds because they invest heavily in financial instruments and in the stock market. This led to a decrease in the value of many pension fund assets, resulting in lower returns for investors.

However, later, in response to the crisis, central banks made an effort to promote economic activity by reducing interest rates and enforcing quantitative-easing policies. This resulted in an appreciation in the price of bonds that were part of the assets under management of pension funds, partially undoing previous losses. But when inflation picked up, central banks had to increase interest rates, causing an opposite effect on the value of assets. These events attest to what has been a rollercoaster of returns experienced during the COVID-19 crisis and in its aftermath.

Another effect of the pandemic is that some liabilities of pension funds were brought forward in time. This is because the increase in mortality rates caused by the pandemic could have brought forward the number of beneficiaries eligible for pension benefits. This increase in mortality is likely a one-shot effect because life expectancy should return to its previous level when the pandemic is over. Therefore, these mortality effects should not have a perceivable persistent impact on pension funds.

Ironically, the most important effects of the pandemic on pension funds are not to be found in labor or financial market dynamics, but in the political arena. In many countries with individual-account pension funds, governments pushed forward laws allowing active workers to collect benefits in advance. These cash advances were more significant among low-income workers. In countries like Chile and Peru, cash withdrawals left a significant percentage of workers with a zero balance in their pension accounts. This constitutes a potential challenge to fiscal accounts, as governments may need to provide some minimum pension assurance to workers in the future.

Country Studies

To date, there has been very little research in Latin America and the Caribbean exploring the impact of COVID-19 on pension systems, including reductions in pension savings, lower replacement rates (the adequacy of retirement income), changes in intergenerational equity, problems in financial sustainability, and higher fiscal costs. This book tries to fill that void by presenting a set of studies by several research centers in the region in collaboration with the Research Department and the Labor Markets Division of the Inter-American Development Bank (IDB). The studies cover the impact of the pandemic on Argentina, Chile, El Salvador, and Peru.

These studies were commissioned based on the concern that the economic recession caused by the COVID-19 crisis would most likely imply a decrease in labor demand that, despite the efforts of governments to preserve employment, would not only translate into lower employment rates, but also into lower contribution densities of pension systems and lower rates of future pension coverage. Additionally, the passing of laws allowing early pension fund withdrawals in many countries in the region could significantly affect retirement funds used to finance future pensions and, therefore, the adequacy of retirement income.

A key benefit of these studies is that they all share a common framework for analysis of the impact of COVID-19 on pension systems in the region. In 2015, the IDB created the Network for Pensions in Latin America and the Caribbean, known as the PLAC Network.[2] This network created a standard pension projection model to evaluate the financial and social sustainability of pension systems.[3] The model was used by all studies presented in this book, making it possible to conduct a standardized analysis across countries on the impact of the crisis on both public PAYGO and private individual accounts systems.

Each study first presents country-specific evidence on the impact of COVID-19 on pension systems. The analysis examines the effect on key indicators such as density of contributions, pension coverage rates, replacement rates, changes in intergenerational equity, gender-specific effects, and financial and fiscal sustainability, among others. Second, the studies evaluate the short- and long-term fiscal pressures stemming from the crisis. Third, the studies evaluate political implications in each country and make policy recommendations for the region.

Argentina

Argentina has one of the most fragmented pension systems in the region, all based on PAYGO public schemes. Given the country's federal nature, there is a myriad of pension programs, leading in some cases to duplicate benefits for some people. The pension system is so complex that it is challenging even to decipher basic statistics such as the number of beneficiaries and coverage of the hundreds of pension programs that coexist across the country.

Nevertheless, Argentina is among the countries with the highest pension coverage in the region, thanks to the relatively

2 The objective of this network is to support regional efforts to improve the institutional and technical capacity of pension systems.

3 This model is freely available on the network webpage at https://www.iadb.org/en/who-we-are/topics-and-sectors/labor-markets/plac-network-projects.

low informality rate and to the existence of the Universal Pension for Older Adults (*Pensión Universal para Adulto Mayor* - PUAM). These schemes offer a basic benefit to practically every citizen in the country. Therefore, the big challenge is whether this high coverage will provide a pension benefit that is adequate and sustainable in the future, especially after the COVID-19 pandemic.

In Argentina, the public pension indexation formula is based on past inflation, which, in a context of increasing inflation, means that the real value of pensions is often rapidly depleted. Despite this fact, in 2020, pension spending reached more than 12 percent of GDP.

The impact of the COVID-19 pandemic on the labor market in Argentina was temporary, and by 2021 employment rates were already similar to those in 2019. Therefore, the pandemic had very limited effects on the pension rights of most current workers. The impact on the labor market was more severe among informal workers, even more so considering that governmental aid was aimed at protecting salaried formal jobs.

In general, application of the IDB projection model reinforces the conclusion that the COVID-19 pandemic had a short-lived effect on main pension indicators in Argentina. The model predicts that coverage of the main pension schemes (salaried workers and the *monotributo*) will remain stable over time, with the exception of coverage for women, who will rely more on non-contributory schemes and PUAM. The model also anticipates that the adequacy of pension benefits will also remain stable over time, as will pension replacement rates.

Finally, the model shows a deterioration in the financial sustainability of Argentina's pension system in the future, as expenses increase more rapidly than contributions. However, it is not the pandemic that is responsible for this growing deficit, but rather the structure of the pension schemes. In fact, it is expected that a greater coverage of PUAM benefits for women will have a greater toll on sustainability indicators. This is explained by a greater participation rate of females in the labor market and by the gender salary gap, which results in a higher proportion of women benefitting from minimum pensions as compared to men. These pensions have a greater toll on public finances as they are heavily subsidized given their non-contributory nature.

Chile

Chile is the pioneer in the world in implementing a compulsory pension system based on individual accounts, dating to the creation of the system in 1980. Along the way, the country's pension system has managed to attain high coverage while its retirement income adequacy received an important boost among lower-income formal workers with the 2008 reform that introduced a solidary non-contributory pillar, that is, a minimum pension paid to workers meeting the vesting requirements and financed with public expenditure. The 2022 reform substituted this non-contributory pillar with a universal pension for most of the elderly.

The effects of the COVID-19 pandemic on labor markets and contributions to pension funds in Chile were similar to those in most countries in the region. Like Argentina, shocks to the labor market in Chile were small and temporary. However, during the pandemic, pension assets were hit hard, as Congress approved three sequential laws allowing early withdrawals, each equal to 10 percent of the balance accumulated in individual pension accounts. In the aftermath of the pandemic, pension assets dropped by 25 percent compared to 2019, a figure representing 22 percent of GDP. Between 97 and 99 percent of workers chose to withdraw the complete allowance (10 percent each time) from their pension accounts.

The early withdrawal of pension funds was not heterogeneous among workers across different income levels. Since there was a voluntary minimum amount to opt in for the early withdrawal and a compulsory maximum withdrawal amount, the balance of lower-income workers suffered the most. In fact, most workers in the lower income distribution deciles ended up with a zero balance in their pension accounts. In total, around 32 percent of individual accounts were emptied. To compensate for this loss of future income, the government promoted an increase in non-contributory pensions, not only in size but also in coverage. The government made a flat minimum pension almost universal for all senior citizens, except for those in the richest income decile and those with self-financed pensions greater than three minimum wages.

The IDB projection model shows that the COVID-19 pandemic did not have a permanent effect on the contributory wage, participation rate, employment rate, or formality rate. These effects are very similar across income groups and gender, though somewhat biased against women. Most of the impact of the pandemic on labor markets dissipated by early 2022.

By contrast, the model predicts a permanent effect of early withdrawals on future pension benefits. These effects intensify with the age of the worker, since younger people had lower balances to withdraw and a longer horizon to compensate for this withdrawal with new contributions. Even without early withdrawals, the model predicts an average self-financed pension lower than the minimum wage, making most individuals candidates eligible to receive the universal pension approved in 2022. Therefore, most workers will improve their replacement rate after this reform since, according to the model, for 9 out of 10 workers in Chile the decline in the pension benefit caused by the withdrawal is more than offset by the new universal pension arrangement. However, this improvement comes at a cost for public finances, estimated at around 2 percent of GDP in 2023 and projected to increase to 6.5 percent by 2100.

El Salvador

Like Chile, El Salvador reformed its pension system in 1996 to transform the PAYGO scheme into an individual accounts scheme. Unlike Chile and Argentina, the Salvadoran economy has a high informality rate that is above the Latin American average. Consequently, the destruction of jobs and the suspension of labor contracts caused by the paralysis of the COVID-19 pandemic more severely affected the informal labor market, with milder effects on formal jobs contributing to pension funds.

Nonetheless, these latter effects were not small on impact. The already low coverage of the pension system decreased 1.3 percent during the pandemic (pension coverage is around 24 percent nationwide) and monthly contributions to pension funds dropped by 14 percent. As in other countries analyzed in this volume, however, these negative shocks were short in duration and, by the end of 2020, assets under management by pension administrators exceeded those seen before the pandemic.

Non-contributory pensions are almost non-existent in El Salvador. There is a "universal basic pension" covering only the elderly in extreme poverty, which costs around 0.08 percent of GDP. These expenditures did not increase during the pandemic.

As in Chile, in El Salvador the pandemic brought about a relaxation of requisites allowing for early withdrawal of pension funds. Most formal active workers responded accordingly, retiring most of the allowance to finance short-term consumption in a time of income loss. Given the Salvadoran government's limited fiscal space, these early withdrawals helped people offset income losses caused by the pandemic. This was the case at least for formal workers, who, on average, correspond to the higher income distribution deciles.

Besides the obvious effects of these withdrawals on individual account balances and the future value of pensions, another element to consider in the case of El Salvador is the fact that, by law, most pension assets are invested in local government bonds. Therefore, the decrease of assets under management of pension funds caused by early withdrawals could translate into a financing problem for the government. This may jeopardize the sustainability of pension funds as the government finds it harder to finance its fiscal deficit, some of which is caused by pending obligations of the closed PAYGO pension regime. In the recent past, the government entered into a selective default, precisely for not complying with scheduled payments to private pension funds.

The IDB projection model shows that the COVID-19 pandemic uncovered and exacerbated the vulnerabilities of the Salvadoran pension system in terms of low coverage, low densities of contributions, insufficient replacement rates, and poor sustainability of the pension funds, as the government is still financing the transition from the PAYGO system to the individual accounts regime. The model also predicts a drop in passive coverage of up to 2 percent, a decrease in assets under management by pension funds of up to 1.5 percent, an increase of pension disbursements of up to 10.6 percent, and an advance of the date when pension payments become higher than contribution collections. In addition, the model shows an increase in the fiscal cost to finance private pension commitments, since early withdrawals will increase the number of people eligible to receive a minimum pension under the private scheme. This effect is calculated at 5.5 percent of GDP. Finally, according to the model, the replacement rate will be reduced by as much as 28 percent, regardless of gender, due to early withdrawals and no obligation to reimburse them.

Peru

Colombia and Peru are the two Latin American countries that have what is called a parallel pension system. Under this configuration, a worker entering the formal labor market for the first time selects between the PAYGO pension scheme, managed by the government, or the individual accounts scheme managed by private administrators. After selecting the scheme, the worker can opt at any time to change from the private to the public scheme, but not inversely. Only around 28 percent of the labor force contributes regularly to a pension scheme, making labor informality in Peru high, even by Latin American standards.

After the lockdown to contain the spread of COVID-19, the government implemented a series of measures to preserve jobs and reactivate the economy. Many of these measures were in-kind assistance and lump-sum cash subsidies to poor households. The government also offered payroll subsidies as a way to incentivize economic activity and limit the destruction of jobs.

Moreover, as in Chile and El Salvador, the Peruvian Congress approved three laws to allow early withdrawals from pension funds. These laws were on top of two additional administrative measures designed by the government in 2020 to extend early withdrawals from individual pension accounts. In total, these five allowances will reduce the pension assets of an average worker by about 40 percent, jeopardizing the financing of old-age expenses, especially in a country where there is no guaranteed minimum pension. Peru has a non-contributory pension scheme covering 19 percent of the elderly at a cost of 0.1 percent of GDP.

This is not the first time that the Peruvian Congress has allowed advance withdrawals from pension funds. In 2016, a law was approved to permit pensioners to retire a lump sum payment of up to 95.5 percent of accumulated assets in individual pension accounts. The other 4.5 percent of the balance is transferred to finance the health insurance of pensioners. The evidence shows that a vast majority of pensioners preferred the lump sum instead of purchasing an annuity, affecting the market of such financial products.

As in the other countries examined in this volume, labor market figures in Peru show that most of the shocks caused by the economic paralysis due to the pandemic were short-lived. By 2021, the number of jobs was higher than in 2019, with an increase in the informality rate, especially in urban areas. This means that the recession would not have had an important impact on pension funds if early withdrawals had not been approved. Nonetheless, by 2021, these early withdrawals amounted to an equivalent of 7.6 percent of GDP, and 30 percent of active formal workers ended up with a zero balance in their pension pot.

As mentioned, the average reduction in the future pension is 40 percent. However, it is estimated that the reduction is a little higher among men than women, among older ages because younger workers will have more time to capitalize future contributions, and among the lower income deciles given the maximum cap set for the early withdrawals. In sum, the simulations show that after the early withdrawals, the poorest decile will lose an average of 60 percent of the pension pot, while the richest decile will only lose 15 percent.

In the public pension scheme, the government and Congress attempted to approve policies to allow past contribution withdrawals in the PAYGO scheme. However, while a law was approved, it was declared unconstitutional. In the meantime, the government relaxed the conditions to qualify for a pension benefit in the public scheme. These more favorable rules benefitted almost 10 percent of the participants, but the cost runs counter to the sustainability of this scheme.

Main Findings

In general terms, the COVID-19 crisis affected pension schemes in the region through several channels. First, unemployment obviously generates pension gaps in the savings of many workers, and this lack of contributions will undoubtedly harm the pension savings of millions of contributors. Second, the pandemic affected the financial position of pension systems, regardless of whether they are defined-benefit or defined-contribution systems. In the case of defined-contribution systems, the most immediate effect is the reduction of income from contributions due to the decline in formal employment. This caused a deterioration of the financial balance of systems and an increase in implicit debt. Third, assets price shocks and falling financial markets impacted the investment rate of return of pension funds. In defined-benefit systems, the value of pension reserves was reduced, negatively impacting systems' financial sustainability. In defined-contribution systems, the lower rates of return mainly affected persons about to reach legal retirement age, since younger workers still have a long investment horizon for their savings to recover.

Pension systems in each country had their own issues in coping with the COVID-19 pandemic, and the path followed by countries examined in this volume depended on several variables such as the maturity of the system, the political stance, and the structure of the pension system. However, there are common findings that convey three general conclusions that are important to consider in terms of future public policy design.

Structural Challenges

The COVID-19 pandemic exacerbated some of the structural challenges of pension systems in the region, such as low coverage, poor retirement income adequacy, and fiscal sustainability. In theory, a pension system should provide beneficiaries with a decent retirement pension. However, most pension systems in the region suffer from low old-age coverage. In some of the countries analyzed, it is common to find very expensive and fragmented schemes comprised of many different and special regimes, which may result in the duplication of benefits. This also represents a serious structural challenge in terms of fiscal and social policy.

Some countries will require a comprehensive reform of their pension system focused on the objectives of coverage, adequacy of benefits and sustainability. Such reforms go beyond partial and short-run solutions and instead require that all political and economic actors with an interest find a comprehensive and long-run solution to pension system deficiencies. In addition, pension overhaul requires a set of reforms in several areas with an integrated vision. Reforms to labor markets, protection mechanisms, and fiscal positions must be framed within this vision. In some cases, improving the pension system requires an increase in public expenditure, so it is essential to include sustainable financing sources. In this regard, the introduction of mechanisms to increase tax collection for the financing of contributory and non-contributory pension systems needs to be discussed.

Early Withdrawals

Policies allowing early withdrawals from pension balances implied a significant reduction in expected pension wealth, and the distribution of pension wealth losses varied substantially among active formal workers. Losses were larger for workers at the bottom of the income distribution or pension wealth. Furthermore, older people experienced larger losses than younger people, as they have less time to rebuild their pension pots. This could negatively affect the coverage rate and replacement rates (retirement income adequacy), among other variables, putting pressure on future fiscal spending.

In some countries, governments introduced an ambitious expansion of non-contributory pensions, increasing their size and scope. This change more than offset the effect of early withdrawals. However, new non-contributory pensions imply a sizable fiscal cost. Other countries do not have the fiscal space to offer a universal social pension that could attenuate the risk of falling into poverty in old age. In those cases, withdrawals will compromise the economic security of the elderly.

Social validation of a pension scheme is important. If the public is not at ease with its pension system, the stage is set for future issues of unknown costs. Early withdrawal policies in different countries did not follow a principle of focalized emergency relief, as a large share of withdrawals went to formal workers belonging to upper-income groups, without any technical framework to support this policy. Eligibility conditions were very loose, so practically any active workers could cash out funds, regardless of the size of pension balances and income levels.

Impact on the Labor Market

The impact of COVID-19 on the labor market in most countries was limited and of short duration, with labor markets recovering to a substantial degree by 2021–2022. This occurred partly as a result of several measures adopted to mitigate the consequences of the pandemic (focused on the productive system, social protection, and public health, including strengthening health systems and national vaccination campaigns). Rather than the density of contributions, the variable that is still struggling to recover is real wage growth, possibly due to high inflation and low productivity growth.

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