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Uruguay Strategy Flash

The administration resolved the last roadblock to greenlight the pension reform

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Recently, the administration made some final concessions to the Colorado party, and with its support, the pension reform bill is headed for approval. This concludes several weeks of intense negotiations between the members of the ruling coalition, with both Cabildo Abierto and the Colorado Party conditioning their support to compliance with some modifications in the project. Having ironed out the details, now the bill will have to be voted by the Representatives Chamber in the coming weeks.

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The original project aimed to introduce several modifications to the current system, one of the fundamental changes prompted by the bill would be the increase of the retirement age to 65 years. Still, the requirement of years worked to retire will continue to stand at 30. The implementation of the reform would be very gradual, starting to take place five years after its approval, marking the start of a transition period. In addition, experts proposed a gradual increase in retirement age. Initially, those born before 1966 would not suffer any changes. Instead, for those born between 1967 and 1971 the age requirement would gradually increase (citizens born in 1967 would retire at 61, those from 1968 at 62, until the generation from 1971 would retire at 65). This was amended later, and the current project contemplates the retirement age to go up to 63 years in 2036 (for those born in 1973), to 64 in 2037, and 65 in 2038. Exemptions to these increases would apply only to the construction and rural sectors. In addition, the teachers would keep their current calculation system, which, every three years worked, four are computed. In turn, the police and the military who perform executive functions will have bonuses in the calculation as before, but not support services such as health or administrative roles.

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The reform also planned to consolidate all retirement regimes making them converge within 10 years in a single system. The bill would try to build a more just system, making the current sub-systems associated with occupations converge into a consolidated format. The pillars of the project would be threefold, based on (i) intergenerational transfers, (ii) mandatory individual savings, and (iii) complementary contributions such as voluntary savings funds. The project contemplates a long period of transition, with a gradual convergence. Ten years after the approval of the bill (2033, given the legislation is passed in 2023), the convergence would start, with the old pension system rules weighing 50% and the new ones 50%. In turn, the new system would gradually replace the old one, as the influence of the systems would be modified by 5% each year until the old system disappears. So, the new system would fully take effect by 2043. In addition, from that year onwards, pension calculation will contemplate the best 25 years of the person's professional career, unifying the varied social security subsystems currently applied. In addition, compatibility between retirement and paid activity will be promoted, so that workers can retire, but continue with a job.

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Taking a look at the long-term impact of the project, the new system would result in a deficit of -1.8% of GDP by 2070, while the current system would put said figure at -4.7% of GDP. In a shorter timespan, the results present more moderate trends but continue to reflect an improvement over the current system's sustainability metrics. For 2025 the reform's impact would be marginal, causing a 0.1pp drop in Soc. Sec outlays vs the non-reformed system, as the former

the proposed project would see them diminish to 9.7% of GDP, a 1.6% of GDP difference. Finally, for 2070, non-corrected Outlays would snowball to 12.6% of GDP, while the reformed Soc. Sec expenditure would remain stable, at 9.8% of GDP, ensuring the system's sustainability. On the side of Soc. Sec income, the trend is not expected to change significantly, as the reform does not address in any major way the number of contributions received by the system. These would amount to 7.4%-7.5% of GDP. In addition, the reform would include changes to the Police and Military Pensions Funds. The former could see its outlays increasing to 0.8% of GDP by 2070, alas the reform would avoid that, stabilizing them at 0.5% of GDP. In turn, the latter would experience a similar trim, as its outlays ex-reform would total 0.86% of GDP, whereas if the project is approved, they would hover around 0.51% of GDP by 2070.

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However, for the project to be greenlighted, some of the minor members of the ruling coalition forced the administration's hand into agreeing to some concessions. Cabildo Abierto was the party that expressed their discontent the loudest, stopping the project on its tracks, as their votes are crucial for the approval of the new system in the Representatives Chamber. Their figurehead, Mr. Manini Rios, presented several changes to the original project and tied his party's votes to the inclusion of said modifications. While the initial list of demands was extensive, including nearly ten points, the administration finally had to grant only two concessions, albeit important ones. The first changes the number of years which are considered for the calculation of each citizen's monthly pension. The initial reform took the last 25 years into account, while Cabildo Abierto demanded a reduction to the last 20 years, arguing it would benefit middle-class workers, as salaries tend to increase with experience, considering only the last 20 years would increase the worker's pension. According to government officials, this could result in a 0.3% of GDP increase in Soc. Sec expenditures, watering down the proposal's saving capabilities. The second point came regarding an article on the pension reform, which would allow pension funds to invest in external assets. Mr. Manini Rios requested this article be separated from the general pension fund reform and discussed autonomously. He pointed out that allowing pension funds to deploy monies into external securities would present extra risks that could compromise the savings of the Uruguayans. He instead proposed to discuss the issue in the next Budget Review, scheduled for Jul-23. This could affect the newly created Growth fund, which is designed to manage the funds of younger workers, providing them with higher yields, albeit with higher risks. This petition was also granted by the administration, which secured the party's votes with this maneuver, at the cost of a slightly watered-down version of the pension system reform.

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This triggered another key member of the ruling coalition, the Colorado party, to pitch its own demands to support the project. These negotiations with the administration also succeeded, as yesterday both parties agreed to include three further modifications to the project. The concerns of the Colorado party congressmen came on the back of three issues. The first instated a reward mechanism for those workers who entered more years of contributions than necessary, allowing them to retire early. The change would allow persons who contributed to social security for 38 or 35 years to retire at 63 and 64 respectively, with the minimum threshold being 30 years. On another topic, the Colorado party asked the administration to solve the "discrete jump" that existed between the 1972 and 1973 generations regarding retirement age. The current project would see anyone born in 1972 retire at 60, while any person born on the 1st of January 1973 would retire at 63. Their solution would make this change less abrupt, sliding the retirement by a year, as initially envisaged, but for posterior generations. So, those born in 1973 would retire at 61, those born in 1974 at 62, and so on until those born in 1977 would retire at 65. And finally, the third proposal has to do with phasing out the IASS tax, which the administration did reduce slightly in March. Said instrument taxes pensioners who earn a pension that exceeds said fixed monthly amount. It currently contributes roughly USD400mn yearly, and the planned reduction would amount to 20% (USD80mn), in two symmetric phases, 10% in 2024 and 10% in 2025. The total cost of the measures would total between USD50mn and USD300mn, albeit generally computed near the USD100mn (0.15pp of GDP) mark.

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In our view, even if the concessions do water down the proposal slightly, they do not defeat its main intent and should prove key to stabilizing public finances. With the reform poised to trim the pension system deficit substantially as time advances, these concessions made to the minor members of the coalition do dampen the deficit compression prospects, but still result in a more sustainable system that the one currently in place. However, on the political front, the reform might prove short-lived, as the FA already voiced its discontent regarding the new law and plans to reform the pension system again if it manages to defeat the government coalition in the next presidential elections. So, even if the reform's approval is good news for the administration, the question of how long it will remain in place stands. As the main effects of the reform are poised to take place from 2033 onwards (and very gradually), this means impact in the short run is limited. This compounds with the fact that the FA, which currently has a slight advantage over the government coalition in voting metrics, is considering revising the pension reform if they manage to win the 2024 elections. They would indeed need a majority in both houses of Congress to do so, but in the event of said scenario occurring, the impact of the current reform would be negligible, as it would not have enough time to bear fruit. On the other hand, Mr. Pereira, a FA figurehead recently stated that the need to ensure the system's sustainability does exist, but that the plan is to present an alternative reform after the elections in case the FA returns to power. So, even if the FA presents another system reform, it might include some of the issues tackled by this proposal. Still, the main threat to the current reform comes not from the impromptu modifications it can harbor, but from its durability in time, which will directly determine its impact on fiscal dynamics.

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