

SOCIAL SECURITY REFORM PROGRAM

(UR-0108)

EXECUTIVE SUMMARY

BORROWER: Government of the Eastern Republic of Uruguay

EXECUTING AGENCY: Office of Planning and Budget (OPP)

AMOUNT AND SOURCE: IDB: US\$150 million

FINANCIAL TERMS AND CONDITIONS:

Amortization period:	20 years
Disbursement period:	36 years
Grace period:	5 years
Interest rate:	variable
Inspection and supervision:	1% of the loan
Credit fee:	0.75% per annum on the undisbursed loan balance

BACKGROUND: Over the last decade, Uruguay's real GDP has increased steadily, averaging 3.5% annually. Inflation was high, although it has fallen off considerably in recent years, from 112.5% in 1990 to 35.4% in 1995.

Fiscal imbalances are among the factors closely associated with that inflation and have largely been the result of increased public spending on the social security system. Uruguay's social security system is one of the most comprehensive in Latin America and presently accounts for over 50% of government expenditures. After increasing by more than 80% in real terms in the last five years, this expenditure now equals over 17% of GDP.

After several unsuccessful attempts to revamp the nation's social security programs, on September 3, 1995, the Executive Branch promulgated Law 16,713 reforming the existing social security system. The structural reform provided for in this law is the most ambitious that the present government plans to undertake. It is crucial to achieving long-term fiscal equilibrium, a lasting decline in inflation and a stimulus to sustained growth of the Uruguayan economy.

OBJECTIVES: The program's central objective is to assist the Government of Uruguay with social security reform, through the effective implementation of the social

through the effective implementation of the social security reform law (Law 16,713) and strengthening of the institutional framework within which the social security system operates.

The program's specific objectives are to: (i) establish a regulatory framework that allows for full implementation of the Law; (ii) improve the administrative efficiency of the Social Security Bank and the quality of its service; (iii) continue to support development of the capital market in Uruguay, and (iv) adapt pension plans that cover certain occupation groups (specifically professionals, bank employees, and notaries) to the new system.

DESCRIPTION:

Funding for the sector program will be disbursed in three tranches: the first for US\$30 million and the second and third for US\$60 million each, in tandem with the reform measures described below and summarized in the Conditionality Matrix that appears as Annex II-1 (see paragraph 3.15).

Legal and regulatory framework. The object here is to develop and properly implement the general regulations under the social security law and to draft any new legislation needed to adapt the separate occupational pension plans that cover specific occupation groups such as professionals, bank employees and notaries to the new general social security system, and rules and regulations for the operation of pension fund administrators [Administradoras de Fondos de Ahorro Previsional] (AFAPs).

Capital market. To reinforce the investment sector program (703/OC-UR) and given the importance that the creation of private pension plans will have for social security reform in Uruguay, the program will help the government identify long-term investment opportunities and policy measures that favor those funds' future growth. The possibility of according the AFAP oversight unit greater institutional autonomy will also be explored.

Institutional framework. The purpose of this component is threefold: (i) make the new social security system more efficient institutionally and administratively; (ii) ensure that the AFAPs and the authority charged with supervising them are set up; and (iii) reorganize the entitlements system for active contributors. The most crucial elements in this component are preparation and execution of a

plan to reorganize the Social Security Bank; support to the Central Bank of Uruguay to devise and set in motion the system for supervising the AFAPs; and the formation of a committee to evaluate and monitor the reform process, whose members will be high-ranking officials with the institutions participating in Uruguay's social security system.

Technical support. This component will finance consulting services and data-processing equipment for orderly execution of the above-mentioned measures through the following participating institutions: (i) the Office of Planning and Budget, to coordinate program execution; (ii) the Ministry of Labor and Social Security, for monitoring and evaluation of the system; (iii) the Social Security Bank, to prepare and carry out its strategic restructuring plan and create the first public AFAP; and (iv) the Central Bank, to organize and implement the AFAP oversight system.

**ENVIRONMENTAL
CLASSIFICATION:**

The Environment Committee, at its meeting of October 30, 1995, classified this as a Category II operation.

BENEFITS:

The program will further the government's efforts to implement social security reform and to introduce measures to make the new social security system more efficient. Hence, the program's benefits can be likened to the benefits to be gained from the reform.

The first benefit of the new social security system is an eventual savings in direct fiscal transfers to the system, as a result of an improved contributors-to-beneficiaries ratio and fewer years of benefit payments. The second benefit will come from measures introduced to reduce evasion and underreporting of earnings, by creating an employment history file [Registro de Historia Laboral], which is a unified system for recording employment, income and contributions for each member of the system. The third benefit is the creation of a savings "pillar" organized around AFAP-administered individual, personal savings accounts, establishing a clear link between contributions made and benefits received under the new social security system.

By the year 2000, the saving in total spending on the social security system is expected to be on the order of 0.5% of GDP; private savings accrued in the AFAPs could stand at 3% of GDP. Both sources of direct savings are indicative of the tangible benefits that

may ensue from the reform in the short run, provided it is properly carried out.

To make certain those benefits materialize, the Government of Uruguay has requested funding from the Bank to: (i) cover the short-term costs of the reform, without compromising the targets of the government's macroeconomic program and without drastically lowering the quality of the social security services delivered; (ii) provide the technical assistance needed to institute a plan for orderly institutional restructuring of the social security system; and (iii) allay the political risks inherent in the reform by building up confidence in the reform initiatives, thereby contributing to their success.

**POVERTY-
TARGETING:**

Because the program's benefits are macroeconomic and hence will accrue to Uruguay's population in general, this project cannot be classified under the poverty-targeted or "social equity and poverty reduction" category referred to in paragraphs 2.15 and 2.13 of document AB-1704 on the Eighth Increase in Resources of the Bank.

RISKS:

The presence of an emerging domestic capital market poses a considerable challenge to the AFAPs in their efforts to retain clients and offer an adequate return. Likewise, future returns on savings could be limited by the small size of the capital market. The investment sector program (703/OC-UR and 704/OC-UR) is taking on this challenge by establishing a new regulatory framework for the capital market and by deregulating and providing for oversight of the insurance industry, among other measures. For other ways to improve the AFAPs' future investment opportunities, the program will examine the operation of the domestic capital market, especially the present conditions for developing new long-term debt instruments.

Possibility that a low percentage of workers may opt to participate in the savings pillar. Workers will be more inclined to deposit a portion of their contributions in the future AFAPs if the latter show an acceptable return and are sufficiently publicized. The Uruguayan government has launched an ambitious program to inform the public about the alternatives available and the advantages and risks that each involves. Although there is some uncertainty as to future financial returns, once the public knows how the new system operates and what its scope is, a

considerable percentage may elect to participate in the individual savings pillar.

Political risks. This reform program is one of the most far-reaching social reform initiatives passed in Uruguay. Nevertheless, social security reform in any country is a politically sensitive issue, so it is not surprising that there is still opposition to the new system in Uruguay. There may be a referendum on some individual articles of the reform law or a plebiscite for their repeal in 1999, the latter procedure being possible only in a year of general elections. The various retiree associations are a politically powerful bloc, and if the new system should again come to be viewed negatively, the reform could be jeopardized. The technical support plan for the program, therefore, will include a component specifically targeted at ascertaining the opinions of the users of the system and at helping them to understand it (current pensions will not be affected). The component will also help remedy problems as they arise.

**THE BANK'S
COUNTRY AND
SECTOR STRATEGY:**

The Bank's strategy and its program of operations for Uruguay in the next three years are consistent with the Eighth Replenishment objective and with the government's medium-term strategy for dealing with the principal problems the country is facing. The Bank's assistance targets the following areas: (i) stimulating private investment; (ii) improving the economy's ability to compete on international markets; (iii) streamlining the public sector, and (iv) improving the quality and delivery of social services.

This is the first operation of its kind the Bank has considered and is consistent with the government's social security strategy, which is crucial to righting the current fiscal imbalances in the sector. The program is also the natural complement of a series of policy measures undertaken by the Uruguayan government with Bank support through the investment sector program (703/OC-UR) and its parallel technical cooperation (704/OC-UR), which are still in progress.

**SPECIAL
CONTRACTUAL
CONDITIONS:**

The program will be governed by a loan contract whose special conditions are explained in Annex III-1.

I. FRAME OF REFERENCE

A. Macroeconomic framework

1. Background

- 1.1 Uruguay's is a small, relatively open and diversified economy. Because of the nation's geographic location, its performance depends largely on the neighboring economies of Argentina and Brazil, Uruguay's chief trading partners. The services, business and manufacturing sectors together account for over 85% of GDP, the most important activities being financial services, tourism and real estate. This is the result of a set of policies dating back to the mid-1970s, which promote openness to external markets, integration of international and regional trade and financial liberalization.

2. Recent trends

- 1.2 The performance of the economy from 1990 to 1994 was mixed. During that period, GDP grew at an annual average rate of 3.9%; despite abundant inflows of foreign financing, the investment rate remained low, although it did increase from 11% to 13.9%; higher benefits to retirees and pensioners triggered increased consumption, which in turn adversely affected private savings, which dropped from 12.5% to 8.8% of GDP; (annualized) inflation, on the other hand, dropped from 128.9% to 44.1%. The current account of the balance of payments deteriorated because exports were sluggish until 1993 and imports increased rapidly as tariffs were lowered and the currency appreciated in real terms.
- 1.3 The public sector deficit dropped appreciably until 1992, but the downward trend was reversed in 1993 and 1994 owing to the deterioration of the central government's finances, which went from virtual equilibrium to a deficit of -1% and then -2.3% of GDP, respectively. The growing deficit was attributable primarily to a hefty increase in social security expenditures and termination of certain tax measures that had been instituted in 1989 to fund social security benefits. Uruguay's social security system is one of the most comprehensive in Latin America and presently accounts for over 50% of the government's total expenditures. In real terms, social security spending has increased by over 80% in the last five years and now equals over 17% of GDP. 1/

1/ This includes old-age, disability, and survivor's benefits, family allowances, and health and unemployment insurance. If health benefits are excluded, total social security spending stood at 12.7% of GDP in 1995.

- 1.4 This higher spending on the social security system is closely related to the country's demographics, with a rapidly aging population. This, coupled with a constitutionally mandated mechanism for indexing retirement benefits in effect since 1989, has driven up the system's costs, especially when inflation is high. Those costs have become an excessive drain on public revenues that the Uruguayan economy will be unable to afford.
- 1.5 To contend with the inflation and deficit problem, the new administration that took office in March 1995 launched a stabilization and fiscal adjustment program backed up by a surveillance arrangement with the International Monetary Fund. The targets of this agreement were satisfactorily achieved, even though the economy's performance in 1995 was affected by the Argentine financial crisis and by the political transition that accompanied the change of government. Preliminary data as of September 1995 indicate that GDP was 1.9% lower than at the same time the previous year; the public sector deficit had dropped to 2% of GDP, and inflation stood at 35.4% as of December 1995. Inflation remains relatively high in large part because of the persistent public sector deficit and because certain indexing mechanisms, like the one for retirement benefits, are still in place.

3. Policy framework

- 1.6 The new government's strategy puts the accent on maintaining fundamental macroeconomic equilibria in a regionally integrated economy open to foreign trade, emphasizing exports and constantly stimulating foreign and domestic private investment. Some of the government's chief priorities are to make exports competitive again, narrow the fiscal deficit, reform the State's political and administrative structure and overhaul the social security system. The last of these is critical to reducing the deficit and reconfiguring the State's political and administrative apparatus.
- 1.7 Incentives to export competitiveness. To make Uruguay's exports more competitive, the authorities took a variety of measures aimed at cutting the cost of producing tradable goods. These measures included extending drawbacks to exporters to December 1995, a reduction of up to six percentage points in the 14.5% of payroll that employers in the manufacturing sector presently pay to social security, and a reduction in energy tax rates paid by industrial consumers by replacing the specific internal tax (IMESI) with a value added tax (VAT).
- 1.8 Reduction of the fiscal deficit. On the fiscal policy front, in early April 1995, authorities announced a program to improve the nation's finances through measures that would increase revenues and cut spending, pursuant to the surveillance agreement that officials of the previous administration had concluded with the IMF. This program helped to accomplish the proposed target of narrowing the

fiscal deficit (nonfinancial public sector) from 2.5% of GDP in 1994 to 1.5% of GDP by the end of 1995.

- 1.9 A fiscal package took effect on May 1, 1995, that on the revenue side called for tax increases, some of them temporary. The following were among those increases: (i) the basic VAT rate was raised from 22% to 23%, the minimum rate from 12% to 14%, and the tax base was expanded to include previously exempt financial institutions; (ii) the graduated personal income tax rate was raised anywhere from two to six percentage points for taxpayers earning over three minimum wage equivalents; and (iii) the IMESI on automobiles was raised by five percentage points. On the expenditure side, the package included cuts in public investment, elimination of family allowances for workers earning more than six minimum wages, and enforcement of a strict wage policy.
- 1.10 State reform. A bill setting out general principles for preparing the five-year budget (1995-1999) was introduced on July 12, 1995. That budget, approved by Parliament on January 5, 1996, is consistent with the policy of programmed revenues, and contains over 100 articles that together constitute the legal foundation for reform of the State. The goal is to hold program expenditure at the same level over the five-year period, thus lowering its percentage share of GDP by as much as five percentage points. The reform's basic objective is to make the State more efficient by making certain that the emphasis given to its essential services, like education, does not increase the tax burden, which is already close to 35% of GDP.
- 1.11 State reform includes: (i) reorganization of ministries, partly by cutting the number of executing units; (ii) arrangements for eliminating redundant posts and personnel; (iii) a manpower adjustment program to help displaced civil servants, including contract employees, and including those attached to public education institutions; (iv) an incentives program to encourage civil servants to perform better, financed by reapportioning resources freed up after restructuring executing units; (v) financial reorganization of the State to avoid duplication of controls; (vi) deregulation of rates and prices of public services, and (vii) streamlining of public-sector infrastructure.
- 1.12 Social security reform is considered an integral part of State reform. After several unsuccessful attempts to revamp social security programs, on September 3, 1995, Law 16,713 reforming the existing social security system was enacted. The structural reform that this law proposes is the most ambitious that the present government has planned and is critical to achieving long-term fiscal equilibrium, lowering inflation once and for all, and fostering sustained economic growth in Uruguay. Uruguay's present social security system and its reform are described in the next section.

B. The social security sector

1. Principal features

- 1.13 All Uruguayan citizens and resident aliens who have lived in the country for at least 15 years are eligible to receive a noncontributory pension under the social security system. The social security system is financed by (i) payroll taxes paid by employers and employees, (ii) a share of VAT revenues, and (iii) additional transfers from the Treasury to make up the system's deficit. The Social Security Bank [Banco de Previsión Social] (BPS), a public institution, administers and coordinates the social security system. It arranges payment of benefits to 81% of all Uruguayan retirees and pensioners and receives 89% of the social security contributions paid nationwide. The BPS is also in charge of paying family allowances, medical benefits, disability and unemployment-insurance benefits to current employees and their dependents. The remaining 19% of the nation's pensioners and retirees are enrolled in separate, occupational pension plans (institutions set up under public law and providing pension and health-insurance services to specific occupation groups, such as bank employees, notaries and their employees, and professionals). Special State plans administer pension funds for the police and armed forces. Taken together, the social security system covers approximately 64% of the economically active population.
- 1.14 Uruguay's social security system is one of the main obstacles to sustainable fiscal equilibrium. The BPS's deficit jumped from 2.5% of GDP in 1991 to 5.2% of GDP in 1994. The Treasury covered this deficit by tapping two main sources: (i) 7% of the 23% VAT that by law is earmarked for the social security system, and (ii) direct fiscal transfers to make up the deficit between total outlays and total proceeds from contributions plus the share of the VAT. Whereas in 1991 direct central government transfers made up 40% of the deficit, by 1994 they had to cover 60%.
- 1.15 The underlying causes of the social security system's deficit can be briefly described as follows: (i) a steady decline in the ratio of contributors to beneficiaries, which went from 3.4:1 in the early 1970s to close to 2:1 at the start of the 1990s for the system as a whole, and 2.1:1 for the BPS. ^{2/} This decline is due to demographic factors (in which the retirement-age population accounts for an ever larger share of total population). However, it is also associated with generous and often discretionary rules for allocating benefits under which it is feasible to receive a pension without ever having contributed to the system; (ii) a relatively high level of benefits combined with young retirement

^{2/} The ratio of contributors to beneficiaries is 5:1 for Latin America and 2.6:1 for OECD countries.

ages; and (iii) a severe problem with evasion and underreporting of earnings as a means for avoiding high contribution rates (which vary from 27.5% of payroll in the case of industry and commerce to 94% in the case of the construction industry). Although evasion and underreporting are typical of defined-benefit plans, the Uruguayan case is extreme in some respects; likewise, 28% of all pensions have been granted on the basis of evidence elicited from witnesses, in lieu of documentary proof of contributions.

- 1.16 Although the demographic pattern is a variable that government policy cannot affect and, according to population forecasts, will continue to strain the system (particularly after the year 2015), something can be done about benefit levels and the serious evasion problem. These are the main targets of the government measures with which the proposed operation will assist.

2. The reform

- 1.17 The new social security reform legislation introduces measures that will reduce and rationalize the public sector's financial support of the system, thereby easing the inflationary pressures associated with large and sustained fiscal deficits. The approved reform, described in some detail in Annex I-1, basically affects regular retirement, old-age, disability and survivor's pensions.
- 1.18 The reform consists of three basic elements. The first is a lowering of the wage-replacement ratio 3/ from a simple mean of 72.9% to an average of 62% (see Table 3 in Annex I-1); raising the retirement age for women (making it the same as the minimum retirement age for men), and offering deferred- retirement incentives in the form of higher replacement ratios. The second is the introduction of measures aimed at reducing evasion and underreporting of earnings by, for example, increasing the number of years used to compute the pensionable base salary and creating an employment history file that records employment, income and contributions. The third is creation of a savings pillar organized around the establishment of individual, personal savings accounts administered by AFAPs (pension fund administrators).
- 1.19 Initially, only workers under the age of 40 with monthly incomes over Ur\$5,000 (approximately US\$728) are required by the Law to put 15% of their monthly earnings over Ur\$5,000 toward this savings pillar. Workers whose monthly income is under Ur\$5,000 have the option of putting up to half their personal contributions (7.5% of earnings) into the individual savings system, and are encouraged (article 28 of the Law) to do so by a new incentive that adds another 50% when computing the pensionable base earnings of workers who so elect. The AFAPs are specialized financial institutions

3/ The ratio of the monthly pension to final earnings.

with assets of their own, segregated from those of the pension fund they administer. Their functions include: (i) managing and investing the accounts of the pension plan's members and (ii) contracting life and disability insurance for their members. The Law is very specific about the composition of the investment portfolio that the AFAPs can put together and stipulates the minimum return ^{4/} that the AFAPs must realize to avoid fines levied against their net worth.

- 1.20 The most positive feature of the new reformed system is that benefits, and therefore total expenditure, will increase more slowly than they did under the old system. Short-term projections show that had the system remained as it was, by the year 2005 its total outlays (health and maternity benefits not included) would have equaled 11.4% of GDP. The reform reduces total system expenditure to the equivalent of 10.9% of GDP by 2005 (see Annex I-2). Over the longer term, the effects are even more appreciable: had the system not been revamped, total expenditure by the year 2040 would have been 10.7% of GDP; with the reform, expenditures drop to 7.8% of GDP. At the same time, the reform preserves a minimum pension in real terms that protects low-income retirees.
- 1.21 Another attractive element of the reform is that it creates the conditions for operating a pension plan based on individual, personal savings accounts, which will have a positive impact on the capital market. Depending on what percentage of workers elect to contribute to the savings pillar, estimates are that by 2005 accruals in the AFAPs' portfolio could be anywhere from US\$747 million to US\$1.243 billion. That year, these private savings would be roughly equivalent to 3.7% and 6.5% of GDP, respectively.
- 1.22 Lastly, the reform creates an opportunity for institutional reorganization of the BPS, for more effective monitoring of contributions, better cost accounting, better quality service and closer supervision of the funds earmarked for individual programs run by the BPS. The measures the government will have to take for this operation are intended to ease the transition in these areas and to develop a customer-oriented BPS.
- 1.23 These positive aspects notwithstanding, in the long run the reform does not ensure the system's financial equilibrium. In fact, forecasts for the year 2040 indicate that direct fiscal transfers

^{4/} The law stipulates that the annual real return rate of any AFAP must be no less than the system's annual real minimum return rate, the latter being defined as either an annual real rate of 2% or the system's average real return rate less two percentage points, whichever is lower, to avoid being fined and eventually shut down by the authorities.

to the system (including its share of the VAT) would equal about 1.8% of GDP. This suggests that further reform measures will be needed ahead to assure the system's long-term financial stability.

C. The capital market

- 1.24 Trading on the Montevideo Securities Exchange, in operation since 1867, has averaged US\$51 million a month for the last eight years, for a daily average of US\$2.3 million, with seasonal trends. What is most unique about the Uruguayan exchange is the predominance of government securities. After monopolizing over 95% of market trading in the 1980s, government securities accounted for 2/3 of the value of 1995 trading. Of that amount, 55% was in treasury bonds, which are now 10-year dollar-denominated bonds paying a fixed return equivalent to the 6-month LIBOR plus 150 basis points; 40% are 180- and 360-day dollar treasury notes yielding slightly less than bonds; and the remaining 5% are medium- and long-term securities and certificates issued by the Banco Hipotecario del Uruguay [Uruguayan Mortgage Bank] (BHU) and pegged to either the consumer price index or the mean wage index.
- 1.25 Transactions involving private funds account for the other 33% of the exchange's activity at the present time. More than 70% of that 33% are private investors' participations in fixed-term bank certificates of deposit paying interest slightly higher than the market average and packaged by the Montevideo exchange. Another 25% of the private securities market are negotiable dollar-denominated corporate notes, from one to five years, paying interest from 3 to 4 points higher than the six-month LIBOR. The remaining 5% is trading in corporate stocks. Of the 20 corporations listed on the exchange, four account for over 95% of total corporate equity trading.
- 1.26 Government securities (bonds, notes, BHU certificates) are popular with the local public and in neighboring countries because the Uruguayan government has been selling them since the last century and has never defaulted on its obligations. Investor confidence in this paper makes it attractive even at interest rates comparable to those on the international market; in fact, the government is largely financed with public debt paper sold on the local market, because it is less costly than borrowings on international markets. The Central Bank's prudential regulations require that the financial brokers it regulates have 11.5% of their dollar-denominated public deposits in reserves in treasury notes. Finally, government securities offer a tax incentive in that they are tax exempt for the holder. Also, the brokerage commission on government securities traded on the exchange is exempt from the VAT.
- 1.27 The emerging capital market for private securities in Uruguay was helped with passage of the law on commercial companies in 1990. This law updated the century-old legislation in effect until that

time and, among other things, required corporations to convert retained earnings to capital when those earnings reserves represented over 50% of the corporation's net worth, and to pay dividends of at least 20% of their profits. The law also afforded minority investors certain guarantees. Starting in 1996, this means of raising capital through the Montevideo exchange will be even more dynamic since the cap that had heretofore limited the negotiable instruments that a company could issue to 50% of its capital and retained earnings was eliminated under the national 1996-1999 budget law.

- 1.28 At the present time, the securities exchange law, the investment funds law and the amendments to the commercial companies law, whose submission to Parliament was a condition for the second tranche of the Bank's investment sector program (703/OC-UR), are moving through the legislature headed for passage. The Central Bank is preparing a bill on securitization of assets, which will round out the set of legal instruments that the government is presently drafting to spur development of Uruguay's capital market. These rules and regulations, however, do not include any provisions that, for example, would require listed companies to publish their balance sheets or would foster the creation of listed-security rating agencies, could reinforce the transparency of and confidence in the private securities market, or provisions for producing regulations governing its workings.

D. Institutional framework

- 1.29 The social security system is comprised of institutions with policy-making, regulatory and oversight functions, and agencies with operations-related functions like the intake and collection of contributions and the delivery of services.

1. Policy-making, regulatory and oversight institutions

- 1.30 The system's policy-making, regulatory and oversight institutions are the Ministry of Labor and Social Security (MTSS), the Central Bank of Uruguay (BCU), the Office of Planning and Budget (OPP), the National Internal Audit Bureau, and the National Audit Office. These institutions' specific functions are as follows: (i) the MTSS develops social security policies, appoints the directors of the BPS (the president and three directors), approves the budget of the BPS with the OPP, and appoints the president of occupational pension plans and, in the case of the professionals' pension fund, a second director as well; (ii) the OPP, whose director has ministerial rank, approves the budget of the BPS jointly with the MTSS and puts together the budgets of all ministries in the central government, including the budget for the police and armed forces retirement and pension plans, for transmittal to Parliament; the OPP does not have formal relations with the occupational pension plans; (iii) the National Audit Office preaudits and audits the

expenditures of all ministries and decentralized agencies in the executive branch of government, among them the BPS and the police and military retirement and pension plans. The bank employees' and notaries' retirement and pension funds do not come under its jurisdiction, but the professionals' fund does; (iv) the **National Internal Audit Bureau** audits the bank employees' retirement and pension fund and the professionals' fund; it has no jurisdiction over the BPS or the police and military retirement and pension plans; and (v) the **Central Bank of Uruguay** has oversight functions vis-à-vis the AFAPs and insurance institutions.

2. Operations-related institutions

- 1.31 The BPS is the main operational institution in the social security system, since 81% of all retirement and pension benefits are paid through it to over 697,000 retired plan members, as are benefits to approximately 510,000 contributing plan members, which include health insurance, family allowances and unemployment insurance. Its board of directors has seven members (four appointed by the Executive, one representative of beneficiaries drawing pensions, one representative of employees and one representative of employers). The objectives and authorities of the BPS are: (i) advisory and supervisory, which includes organizing social security and coordinating the State social security services mandated in the Constitution; and (ii) operational, which includes the delivery of pension, assistance and social welfare benefits on the one hand, and the collection and control of taxes on the other, which means keeping records like the employment history file. Under the new law, the BPS is also to set up and organize an administrator for the pension savings funds (a public AFAP).
- 1.32 Other operating institutions include the various retirement and pension plans: the Armed Forces Retirement and Pension Plan and the Police Retirement and Pension Plan; occupational pension plans: Bank Employees' Retirement and Pension Plan, Notaries' Retirement and Pension Plan, and Professionals' Retirement and Pension Plan, and, as of April 1, 1996, the AFAPs. Some of these institutions, like the BPS and the military and police pension funds, are public entities with State representation; others are private entities established under public law, like the occupational pension plans.

3. Occupational pension plans

- 1.33 A number of occupational plans provide retirement pensions and other benefits to groups specifically defined in their charters. The Notaries' Plan receives contributions from and dispenses pensions to notaries and employees of notary firms, the Bank Employees' Plan to employees of banking institutions, and the Professionals' Plan to professionals (with the exception of notaries) on the income earned from their professional practice (salaried employees are, as a rule, covered by the BPS system,

although they may voluntarily opt to pay into the Professionals' Plan). The group affiliated with the Bank Employees' Plan has recently been expanded to include the bank credit card issuers previously covered by the BPS. In all, in 1994 occupational plans had approximately 55,000 contributing plan members and around 22,000 retired members. In 1994 total receipts of the three plans equaled 1.1% of GDP.

- 1.34 The three occupational pension plans have two basic sources of revenue: employers' and employees' contributions and the return on their investments. In the case of the Bank Employees' Plan, members are in salaried jobs so their contributions are a percentage of their earnings. In the case of notaries, the contributions are a percentage of the value of the transactions in which they are involved, whereas in the Professionals' Pension Plan the contributions are a percentage of an income that varies with the number of years in practice.
- 1.35 The Professionals' Plan is also funded by specific taxes established under article 23 of Law 12,997. These are of two types: the first, similar to the notary's levy, is a percentage of the value of the object of the professional service (for example, a percentage of the cost of construction in the case of architectural plans). The second are direct consumption taxes, such as a percentage of the value of medicines purchased.
- 1.36 The impact of the above-described contributions on the level of business and on the prices of the corresponding product or service varies according to the nature of the contribution and the structure of the market for the business. In the case of the Bank Employees' Plan, the contribution is similar to the contribution made under the BPS's general pension plan, except that its level is 59.1% higher (45% of earnings). In the case of the Notaries' Plan, since the market for notary services is competitive and the supply of notary services elastic (there are no restrictions limiting entry into the notary program in the university, and graduate notaries may work anywhere in the country, with no geographic exclusivity), the contribution rate impacts heaviest on the income of the practicing notaries. The same is largely true of the contributory earnings for the Professionals' Pension Plan. However, some of the contributions required under article 23 of Law 12,997, which in 1994 represented over 37% of that Plan's total income, are indirect consumption taxes levied on the price of the taxed articles, which directly affect consumers, who end up funding the pensions of professionals.
- 1.37 Although in 1994 these occupational plans were operating in the black, each had its own problems that eventually will generate large actuarial deficits if no corrective measures are taken in the short term. The Bank Employees' Plan operates in a sector being downsized, and its contribution rates are sufficiently high to give a competitive edge to banking institutions that are able to put

together alternative pension plans or avoid their employees' joining the ranks of the bank workers union. In the Notaries' Plan, the contributions structure is such that a very small percentage of its members generate the bulk of the Plan's receipts. Among the Plan's members is a large group of young notaries whose income is low and whose contributions, therefore, do not cover the actuarial cost of their future pensions, raising serious questions about that fund's future financial solvency. In the case of the Professionals' Plan, the basic question is whether or not the set of indirect taxes prescribed by article 23 of Law 12,997 can and should be preserved. Without the proceeds from those taxes the Plan would already be showing considerable current deficits.

4. Benefits to contributing plan members

- 1.38 The BPS-administered benefits that the social security system pays to contributing workers represent approximately 16% of its expenditures. These benefits include payment of: (i) medical care and related allowances; (ii) family benefits that include family allowances, medical benefits, and maternity grants; and (iii) unemployment insurance. With the exception of the health benefits, which are financed by an 8% payroll tax (3% from the worker and 5% from the employer), the other benefits are entirely subsidized through direct transfers from the Treasury.
- 1.39 **Unemployment insurance.** This insurance accounts for over 2% of BPS outlays and in 1994 paid benefits to over 20,000 people. The amount of the unemployment allowance paid needs to be compared to the other benefits, because in some cases it is actually higher than others, such as illness benefits, and thus discourages employment. The MTSS is considering the idea of creating an additional eligibility requirement whereby claimants of unemployment benefits would have to undergo a period of training or retraining.
- 1.40 **Family benefits.** In 1994, the 409,713 beneficiaries of this program accounted for approximately 3% of BPS outlays and half of its administrative work involving benefit recipients. The **family allowance** is a payment for each child or dependent minor and is equivalent to 8% of the national minimum wage. It is payable as from the certification of pregnancy. The **medical benefit** refers mainly to mother and child care, while the maternity grants are limited to the six-week periods before and after delivery. To qualify for this benefit, applicants must show that they are not covered under health insurance or are not privately enrolled with a group health provider (IAMC).
- 1.41 **Medical care.** This service is funded with the contributions made to the health insurance program, and accounts for 11% of BPS expenditures. It benefits current employees, unemployed workers receiving unemployment insurance, retirees, pre-retirees who are

themselves making the necessary contribution, and the immediate family of the insured. In 1994, over 520,000 people filed for medical benefits, which are provided by IAMCs under contract to the BPS. The latter pays members' contributions directly to the IAMC and every month sends the worker, by way of his or her employer, the group plan receipt that will entitle the worker to seek medical care.

Table 1.1. Restructuring of health services	
<p>During the discussions of State reform, the Ministry of Public Health (MSP) introduced a proposal that would transfer the BPS-administered health services to the MSP. A committee was formed whose members included representatives from the Ministry of Labor and Social Security, the MSP, the Office of Planning and Budget, and the BPS. The work of the committee was held up, in part because of political opposition to the transfer, which became apparent when the five-year budget bill was being discussed in Parliament. The proposal was withdrawn and will now be attached to a different bill. The opposition is due to the widely held view that the quality of the delivery of these benefits would suffer considerably were they transferred to the MSP.</p> <p>Over and above the political opposition, little information is available to determine whether or not such a transfer is viable. The BPS has begun arrangements to hire an auditing firm to evaluate the efficacy and efficiency of the health and logistical services it is responsible for in this area. The findings of this study will be crucial to helping the BPS function well and will be additional information to consider in the State reform program, one component of which will involve the health sector, including BPS-administered programs.</p>	

1.42

Children who are the beneficiaries of the family allowance are entitled to the primary health care that the BPS provides at its mother and child care centers (five in Montevideo and one in Pando) or at IAMCs under contract to the BPS elsewhere in the country. These services cover pediatric care from birth to age 6, dental and orthodontic care up to age 9 and age 14, and, with no age cap, specialists' care and treatment of congenital disorders at the Policlínica Pediatra Especializada [Specialized Pediatric Care Clinic]. The latter is known worldwide for the excellence of its services.

E.

The Bank's strategy in the country and rationale for its participation

1. The Bank's lending strategy in Uruguay

1.43

The Bank's strategy and its program of operations for Uruguay in the next three years are consistent with the objective of its Eighth Replenishment and with the government's medium-term strategy for dealing with the major problems the country faces. The Bank's assistance focuses on: (i) stimulating private investment; (ii) improving the economy's competitiveness on international markets; (iii) streamlining the public sector, and (iv) upgrading the quality of social services.

1.44

This operation is justified in that it is consistent both with the Bank's strategy as described above and with the government's strategy for the social security sector. It will further the government's efforts to modernize Uruguay's public sector and make

assistance under its investment sector program (SIP) (703/OC-UR) and its parallel technical cooperation (704/OC-UR), which are still in progress (see paragraph 1.28). The main objective of these operations is to promote greater private-sector participation in the Uruguayan economy by reforming and strengthening the investment sector's institutions and regulations, to open the way to more diversified and efficient channeling of the various sources of private savings into new investment instruments, such as pension funds, insurance reserve funds, and the stock and bond markets. In preparation for this operation, SIP funds were used to finance a comprehensive study of the social security sector in Uruguay.

- 1.46 Also, for eight years the Bank has been assisting Uruguayan authorities through technical assistance programs to consolidate the nation's tax administration, strengthen its collection mechanisms and thereby reduce tax evasion. The most recent assistance was ATN/JF-4561-UR, which is still in progress. These programs have clearly helped to harmonize the tax collection methods used by the BPS and the General Tax Directorate of the Ministry of Economic Affairs and Finance.

3. Relations with other multilateral organizations

- 1.47 The Uruguayan government's economic program will be monitored by the IMF under a new precautionary standby arrangement for the equivalent of US\$150 million. The agreement, which could be concluded in March 1996, will be for twelve months. Monitoring of the macroeconomic targets agreed upon with the IMF is an integral part of the conditionality for the operation proposed herein. Those targets are described in the next section.

II. THE PROGRAM

A. The program's objectives

- 2.1 The program's main objective is to assist the Uruguayan government with the social security reform it plans to achieve by effectively implementing the social security reform law (Law 16,713) and strengthening the institutional framework within which the system operates.
- 2.2 The program's specific objectives are to: (i) establish a regulatory framework for full implementation of the Law; (ii) improve the BPS's administrative efficiency and the quality of its service; (iii) continue to support development of the capital market in Uruguay; and (iv) adapt pension plans that cover certain occupation groups (professionals, bank employees, notaries) to conform to the new system.

B. Description and elements of the program

- 2.3 The program is a quick-disbursing sector loan with activities in four policy areas and a technical assistance component, as shown in the Conditionality Matrix in Annex II-1.

1. Macroeconomic policy framework

- 2.4 To monitor implementation of its stabilization strategy, the government has requested a new precautionary arrangement with the IMF in February 1996 for SDR 100 million (roughly US\$150 million). The agreement, which could be signed in March 1996, would be for 13 months. Under that agreement, the principal targets for 1996 are: (i) **growth** of 1% in real GDP and a **drop in inflation** from 35.4% to 20%, assuming low wage pressure and zero imported inflation; (ii) **fiscal policy**: reduction of the public sector's overall deficit from 2% to 0.5%, excluding the net effect of higher transfers to the AFAPs; (iii) **exchange policy**: correction of the devaluation of the nominal rate consistent with a 20% anticipated inflation rate; and (iv) **external sector**: reduction of the current account deficit from 2% to 1.5% of GDP and a change in the maturity profile of the domestic foreign currency debt, shifting it from short to long term as a hedge against external risks.
- 2.5 Of these short-term measures, the one with a direct bearing on the objectives of this operation is that of the fiscal deficit, since in accomplishing that target the fiscal cost of the reform will have to be factored in. During the first four years of the reform (1996-1999) this cost is not expected to average more than 0.3% of GDP. The anti-inflationary targets are important to the success of social security reform given the negative consequences that inflation could have: because benefits are indexed, inflation could mean higher pensions, which would widen the social security

deficit. For that reason, the government is pledging to fulfill those goals, which is one of the conditions for release of this operation's three tranches.

2. Legal and regulatory framework

a. General social security system

- 2.6 The Social Security Reform Law requires that the new system's regulatory framework take effect on April 1, 1996. This means that the fundamental rules for the new retirement system will have to be defined, occupational pension plans will have to be adapted to conform to the new system, the employment history file system will have to be instituted, and public and private pension funds will have to be set up and operational. To that end, a committee to draft the regulatory decrees and corresponding legislative bills has been formed, coordinated by the OPP and the MTSS in close cooperation with the BPS and the Central Bank (BCU).
- 2.7 The general rules and regulations needed to put the Law into effect will have to include decrees pertaining to the following: (i) a survivor's pension system; (ii) the two pillars of retirement income security (pay-as-you-go and savings plans); (iii) taxable items for special social security levies; (iv) formation, start-up and supervision of AFAPs; (v) regulations on advertising, promotion and disclosure by AFAPs, and (vi) disability and survivor's insurance contracts.
- 2.8 To put into effect the decrees on AFAP operations, the BCU will prepare a series of directives that together will form the basic regulations. These basic rules and regulations must be ready before the operation's first tranche is disbursed. They will entail the following. **Financial control directives:** (i) design of the individual accounts management plan, (ii) regulations on the fund's investment ceilings and the reserve required by law, (iii) procedures for investment valuation, (iv) rules on the temporary availability of contributions, (v) institutional financial-control procedures, (vi) rules on fees and commissions, and (vii) disclosure requirements. **Institutional control directives:** (i) rules to govern agency operations, (ii) rules for creating and managing records and personal accounts, (iii) enrollment procedures, and (iv) procedures for effecting transfers from one AFAP to another. **Directives on insurance and reinsurance:** (i) awarding of disability insurance and survivor's benefits under the individual savings system, (ii) contracts with and operation of insurance companies for payment of benefits under the individual savings system, (iii) the reserve for payment of pensions and annuities, and (iv) a formula for computing the benefits prescribed in the Law. A more detailed description of the rules on disability insurance and survivor's benefits and the rules on AFAP advertising, promotion and disclosure appear in Annex II-3.

- 2.9 One of the conditions precedent to disbursement of the operation's first tranche is that evidence of these general regulations, duly prepared and approved by the executive branch, be presented. For release of the second and third tranches, the Law and regulations thereunder will have to be put into force and remain in effect.

b. Adapting the occupational pension plans

- 2.10 Although the finances and demographics of the occupational pension plans vary from one to another, when they are adapted to the new social security system their conditions as to retirement age and length of service will be the same as those prescribed in the law governing the general system. By mutual agreement with the government, the program will make certain that bills drafted to adapt the occupational plans to the general system take into account the plans' financing structure and mode of operation. The goal is to ensure that the social security system's fiscal situation is not compromised if, as a result of the adaptation process, funds have to be transferred to the occupational plans to make up their operating or actuarial deficits, pursuant to article 1 of the Law.
- 2.11 The basic problem areas identified are as follows: (i) the adjustments that need to be made in contribution rates and in replacement ratios to keep the occupational plans financially solvent without jeopardizing the activities in question; and (ii) elimination of indirect taxes paid directly by consumers, particularly in the case of the Professionals' Plan.
- 2.12 The program will make certain that the first two problem areas are taken into account in the bills that have to be drafted to adapt the occupational plans to the new general social security system by January 1, 1997, as required under the new law. The program's technical support will help create conditions for the occupational plans that so elect to form one or more AFAPs. In the adaptation process the plans will become stronger institutions and adopt efficiency ratio requirements similar to those agreed upon for the BPS and shown in Annex II-2.
- 2.13 Under the new social security reform law, the draft legislation to adapt the occupational pension plans (professionals, bank employees and notaries) is to be presented before January 1, 1997. The idea is for benefits under these plans to match those of the general social security system established under the new law, moderating certain preferential conditions while respecting the occupational plans' institutional and financial autonomy. Presentation of the draft legislation will be one of the conditions precedent to release of the program's second tranche; evidence that these new laws are in force must be submitted as a condition precedent to the third tranche.

3. Capital market

- 2.14 Under the Bank's investment sector program (703/OC-UR and 704/OC-UR), the government has made significant progress toward shaping a new regulatory framework for the capital market and deregulating the insurance industry and creating an insurance-industry oversight agency. Building on this progress and in order to identify additional policy measures to improve the AFAPs' future investment opportunities, under this program the government will do a study on the workings of the domestic capital market, focusing on current prospects for developing new private long-term debt instruments.
- 2.15 The following are among the issues the study might consider: (i) the structure of supply and demand for short- and long-term credit and opportunities for heightened private sector participation in the capital market; (ii) stock market investment opportunities for AFAPs; (iii) as emerging capital markets develop, opportunities for creating rating agencies; and (iv) the lack of corporate disclosure such as would be needed to ensure the transparency of the domestic capital market; and (v) greater institutional autonomy of the AFAP oversight unit. One of the conditions precedent to disbursement of this operation's third tranche is that the findings of that study be presented. It should be noted that the aforesaid conditions, in regard to the approval of legislation by the legislature, fall outside the purview of the Executive Branch.

4. Institutional framework

a. Social Security Bank

- 2.16 To help the Social Security Bank (BPS) become more efficient in performing its multiple functions, the program will devise a comprehensive strategic plan for the BPS's reorganization. The general lines of the plan were put together in conjunction with the BPS while this operation was being prepared. In the process a preliminary determination of priorities was made, which will steer the reorganization process and be the fundamental input when the details of the strategic plan are filled in.
- 2.17 The following are among the areas identified as being central to the BPS's reorganization: (i) computerization of contribution intake systems; (ii) establishment of a system for transferring funds to individual accounts; (iii) the employment history file system, which is being developed and will be ready by April 1, 1996; (iv) improvement of human resources management; (v) improvement of the quality of benefit services, especially to pensioners, and (vi) improving financial management gradually, to achieve financial independence.
- 2.18 Pursuant to one of the conditions precedent to disbursement of the first tranche, the general lines of the strategy for reorganizing

the BPS have already been established. Efficiency ratios for monitoring the BPS's performance appear in Annex II-2. The strategy plan itself, which is to set out what the program's targets will be at each stage, will be one of the conditions precedent to release of the second tranche. Accomplishment of the agreed targets will be a condition precedent to disbursement of the third tranche.

b. Creation of AFAPs

- 2.19 Under the new social security reform law, a public AFAP is to be in operation by April 1, 1996, so that the new individual savings system and, by extension, the private AFAPs can then get under way. To that end, through the BPS, the government will see that the first public AFAP is set up, while the BCU will set up a unit in charge of prudential supervision of the public and private AFAPs. This unit will be part of the BCU's institutional structure.
- 2.20 As a condition precedent to disbursement of the program's first tranche, evidence will have to be presented to show that both the public AFAP and the unit that will oversee the AFAPs have been established and are operating properly. Annex II-3 describes the basic organization structure proposed for that oversight unit and the functions of each of its departments (legal, institutional oversight, financial, studies, computer services and benefits and insurance).

c. Benefits paid to current employees

- 2.21 Shortcomings in the present records and reporting systems for benefits paid to current employees has made it difficult to get a thorough, systematic grasp of the administrative side of processing these benefits and how much fraud and misuse there is of benefit entitlements. For these reasons, and to make the administration of the benefits more efficient but less costly, the program will study how the entitlements system operates with a view to focusing it better, creating better records and qualification procedures. The criteria used to determine the present level of benefits will have to be reviewed first, as will the conditions required to qualify, to establish efficiency benchmarks against which the procedures can be compared.
- 2.22 Based on that review, the study will recommend measures to reorganize the way the system of benefits to current employees operates. The main activities to consider would be the following: (i) establishing records and a history of benefits paid that is cross-referenced to the employment history file; (ii) developing systems to track contributions paid and the operating costs of delivering benefits; and (iii) designing less bureaucratic (computerized) procedures to simplify benefit payment systems. The study's findings and recommendations will have to be presented as a condition precedent to disbursement of the second tranche of the

proposed loan. Implementation of those recommendations is a condition precedent to release of the third tranche.

d. Evaluation and monitoring committee

- 2.23 To evaluate and monitor social security reform, it was agreed that the government would form a committee composed of senior officials. This body will propose the measures needed for the new social security system to function smoothly and will report periodically thereon. The new system will be examined for improvements in efficiency and, to the extent that the available information allows, the reform's distributive impact will begin to be measured.
- 2.24 This committee will be made up of (i) the director of the OPP, who will coordinate its work; (ii) the Minister of Labor and Social Security; (iii) the president of the Central Bank; (iv) the president of the BPS, and (v) the program's general coordinator.
- 2.25 Given its importance, the committee should be established by the time the new social security system takes effect; in other words, it should be a condition precedent to the first disbursement. Prior to release of the second and third tranches, the committee will present, respectively, a mid-term and a final report tracking implementation of the reform. It will make its final report available to the public, and will help disseminate its findings through workshops, seminars, and other forums assembling eminent experts in this field and representatives of civil society organizations. Annex II-5 outlines criteria to be followed in producing the study on the operation of the new system; the committee will use these criteria as an input in drawing up its reports.

5. Technical support

- 2.26 The program's technical support component will finance consulting services and data-processing equipment for the program's different components. This component will assist the various participating institutions: (i) the OPP, to coordinate the program; (ii) the MTSS, for monitoring and evaluation of the system; (iii) the BPS, to prepare and carry out its strategic reorganization plan and create the first public AFAP; and (iv) the BCU, to organize and implement the AFAP-oversight system.
- 2.27 The technical support component is needed for the methodical implementation of the program as a whole through these institutions and will be based on a plan that targets the technical support needs of the other program components as the program progresses (see Annex II-6). Therefore, evidence that those goals have been satisfactorily achieved will be a condition precedent to disbursement of the second and third tranches. The plan will concentrate on four areas: (i) personnel training and development, primarily in the new procedures instituted as a result of the reform and in data-processing systems in those cases where existing

processing systems are upgraded; (ii) studies related to the social security system, including those already agreed upon with the Bank concerning the efficiency of the revamped system, expansion of the AFAPs' long-term investment opportunities, streamlining of the system of benefits to contributing members, and the quality of client service; (iii) equipment, chiefly for modernization of the BPS's data-processing system, which ties in with plans to improve client service, harmonize collection systems and streamline human resources to make the new system more efficient; and (iv) the consulting services needed to strengthen the system and adapt it to the new law and regulations. The consulting services will be in differing areas of specialization, described in Annex II-6.

III. PROGRAM FINANCING AND EXECUTION

A. The borrower and the executing agency

- 3.1 The Government of Uruguay will be the borrower and the Office of Planning and Budget of the Office of the President of the Republic the executing agency. Other institutions that will take part in the program are: (i) the Central Bank of Uruguay (BCU), which will supervise and regulate pension fund administrators (AFAPs) and insurance companies; (ii) the Social Security Bank (BPS), and (iii) the Ministry of Labor and Social Security (MTSS), responsible for social security policy.

B. Program execution

- 3.2 For general coordination, management, monitoring and evaluation of the program, a coordinating unit will be set up under the Office of Planning and Budget of the Office of the President. The Bank's standard procedures will be followed for consultant selection and procurement of goods. The United Nations Development Programme (UNDP) is to be engaged to provide technical and administrative support to expedite the contracting process, as outlined in Annex II-6.
- 3.3 The program's coordinating unit will ensure that all program components are functioning smoothly and will have the following functions, among others: (i) compile and present to the Bank the information required for disbursement of each tranche; (ii) coordinate and monitor the activities carried out by the other institutions participating in the program; (iii) implement the technical support component, seeing to it that elements agreed on with the Bank are carried out; (iv) serve as the government's technical interlocutor with the Bank; (v) administer the program's finances according to Bank requirements; (vi) see that the approved reforms are duly carried out, as are the recommendations of studies and consultants; (vii) determine the manner and timing of the occupational pension plans' participation in the program, through the pertinent agreements; (viii) see to it that the timetable for hiring consultants and completing the planned studies is adhered to; and (ix) prepare the six-month progress reports and other reports agreed upon with the Bank or requested by the evaluation and monitoring committee.
- 3.4 The units in charge of the program's execution in the participating institutions will be: (i) in the BPS, economic advisory services, actuarial unit and institutional planning; (ii) in the BCU, the executive office, and (iii) in the MTSS, the office of the minister.

- 3.5 The following are some of these units' basic responsibilities: (i) draft and propose the terms of reference for the studies and consulting services; (ii) see that the approved reforms and the recommendations of studies and consultants are carried out; and (iii) provide the coordinating unit with the information needed to execute the program efficiently.
- 3.6 To discharge its functions, the coordinating unit will be organized as follows: a general coordinator (local), the international technical coordinator of the UCTA; two specialists in social security to provide advisory services and monitor the program's components; an international consultant for periodic advisory assistance, and an administrative officer. This team will be assisted by one sector specialist in each of the participating institutions, in charge of executing the institutional component.
- 3.7 The coordinating unit's organizational structure, its responsibilities vis-à-vis the other executing units, and the terms and conditions for carrying out the institution-strengthening components, and the studies and introduction of the reforms will be set out in agreements to be worked out in negotiations on the operation.
- 3.8 **Evaluation and monitoring committee.** This committee will be created for interagency coordination and to see to it that all parts of the project fit together to make the program a success. Its mandate will include monitoring and evaluating the impact of the reform, according to the agreed-upon criteria which appear in Annex II-5.

C. Technical support

- 3.9 The government will support the reforms contained in the program by earmarking US\$15 million in technical support for it. The plan for this technical support and the specific activities that will be carried out are described in detail in Annex II-6. As the program advances, the coordinating unit may suggest to the Bank any changes in the technical support plan deemed necessary for the program to function well.
- 3.10 The coordinating unit will be in charge of executing the technical support component and will confer with the Bank on the terms of reference of the studies and consulting services and on the equipment to be financed under the program. Before hiring consultants, the government will draw up a short-list of candidates and submit it to the Bank for approval, pursuant to standard Bank procedures.

D. Financing and disbursements

- 3.11 The program will be financed with a loan from the Bank's ordinary capital in the amount of US\$150 million. The loan would be disbursed over a 36-month period as of the effective date of the loan contract and would be repaid over 20 years, with a five-year grace period. Loan proceeds would be disbursed in three tranches, the first for US\$30 million and the other two for up to US\$60 million each.
- 3.12 The project team and Uruguayan authorities discussed three scenarios for the financing that the social security system would require in the 1996-2005 period, once the reform takes effect on April 1, 1996:

Table III-1
Projected additional financing requirements
(after investments in AFAPs)
(millions of US\$) 1/

YEAR	Low		Intermediate		High	
	%	Amount	%	Amount	%	Amount
1996	20%	\$(16.5)	40%	\$(4.9)	60%	\$6.8
1997	30%	\$(0.7)	50%	\$16.5	70%	\$33.7
1998	40%	\$16.4	60%	\$39.8	80%	\$63.1
1999	45%	\$36.6	70%	\$72.3	85%	\$96.7
TOTAL		\$53.0		\$128.6		\$200.3

1/ The % in the table is the percent of eligible contributors who opt for the individual savings pillar.

- 3.13 The Uruguayan authorities see the program with the Bank as a "precautionary" program to have the maximum necessary resources available should large numbers of contributors elect to move to the individual savings pillar. The authorities would use the agreement with the Bank to allay the "high risk" associated with the political climate, which requires that confidence in the new social security system be maintained. Based on this reasoning, the program must be scaled to provide for the maximum need, in other words the "high" scenario in the preceding table.
- 3.14 After early discussions the government requested that, solely for purposes of scaling the program, the most optimistic projected scenario for the reform (high projection) be considered. Under

that scenario, the capital market would undergo rapid development, and high percentages of workers would opt to put a portion of their contributions into the pension funds. The team proposed that the loan be disbursed over a three-year period, since this is considered sufficient to see the short-term effects of the reform and of the strategic plan for reorganization of the Social Security Bank, notably as regards creation of the employment history file system and individual records for each worker contributing to the government plan. The financing needs from April 1996 to April 1999 total US\$135 million (\$6.8 + \$33.7 + \$63.1 + \$31.4, proportionally).

- 3.15 In line with the authorities' approach, the project team is proposing that the program be for US\$150 million (US\$135 million plus US\$15 million for the program's technical support component). The operation's disbursements would be contingent upon the compliance with the conditionality matrix (Annex II-1), and a coefficient that reflects the success the reform has in creating and building up the savings pillar. To this end, the following disbursement arrangement was worked out during the negotiations: (i) a first tranche in a fixed amount of US\$30 million, \$15 million of which would go to fund the program's technical support component; (ii) a fixed amount of US\$30 million for the second and third tranches, tied to compliance with the conditionality matrix; and (iii) a variable amount of up to US\$30 million for each of the second and third tranches. The variable portion would be disbursed according to the percentage of the universe of plan members who elect to join the individual savings scheme, equivalent to 30% for the second tranche and an additional 40% for the third tranche. These percentages would be calculated on the number of plan members under age 40 on the effective date of the law who earn less than Ur\$5,000.

E. Procurement

- 3.16 Proceeds from the loan will finance the FOB cost of eligible imports and the CIF cost when the freight is eligible. The tranches will be disbursed as the executing agency presents importation documentation. In keeping with Bank policy, the usual restrictions set out in a negative list will apply. Among the items not allowed are local-currency outlays, firearms and other material used by the armed forces, luxury items and imports financed with medium- and long-term loans.
- 3.17 Procurement with loan proceeds will be done according to the Bank's standard procedures. When the amount involved is over US\$5 million, international bidding will be required. Bank procedures are not necessarily applied to the letter in the case of imports of petroleum and petroleum products worth over US\$5 million from a single supplier. However, if acceptable commercial practices are used and the transactions are at market prices, the Bank will regard these as acceptable procedures, as it has done with other sector adjustment operations.

- 3.18 When the amount is less than US\$5 million, the procurement for which the public sector is responsible will be done according to established local procedures, provided those procedures are compatible with the Bank's procurement policy. Private sector purchases for small amounts will be transacted in keeping with accepted commercial practices and, wherever possible, with quotations from suppliers in at least two member countries of the Bank.

F. Records, auditing and control

- 3.19 For each disbursement, the executing agency will supply documentation showing the goods imported during each period, the country of origin, and the date and value of the transaction. For accounting and control of those transactions, the borrower will open a special account with the Central Bank, keep accounting records on the project, prepare and remit disbursement requests, present lists of the transactions considered eligible and keep all relevant supporting documentation. Within 90 days following disbursement of each tranche, the borrower will present to the Bank a statement of account for that tranche, prepared according to the terms of reference agreed upon with the Bank and certified by a firm of independent public accountants appointed by the borrower and cleared by the Bank.
- 3.20 The funds earmarked for the technical assistance component will be deposited in a special U.S. dollar account set up in the Central Bank of Uruguay, and will be used to pay for goods and services in accordance with Annex C to the loan contract. The six-month evaluations will be done by the Bank and the program's coordinating unit, which will prepare a six-month progress report to be approved by the evaluation and monitoring committee and then submitted to the Bank.

G. Environmental effects of the operation

- 3.21 The Environment Committee examined the environmental summary for this operation on October 30, 1995, and classified it in Category II. No specific recommendations were made.

H. Program status: fulfillment of first conditions

- 3.22 The government has made headway on most of the activities associated with the conditions precedent to disbursement of the first tranche. A brief status report is given in the next paragraphs.
- 3.23 The guidelines that will serve as the terms of reference for preparing the BPS's strategic plan have been devised. Efficiency indicators have been established and are shown in Annex II-2. The BPS is working to have the employment history file system and the information system needed for the public AFAP in place by

April 1, 1996. The president and board of this AFAP have already been named.

- 3.24 The coordinating unit's activities are under way, and the program's general coordinator is on the job. The institutions participating in the program have appointed their units and staff, who are already preparing the activities that have to be ready by April 1, 1996. The program coordinating unit and the participating institutions jointly drew up the technical support plan that appears in Annex II-6.

I. Special conditions

- 3.25 The special contractual conditions to ensure that the program and each of its components are carried through effectively and efficiently appear in Annex III-1.

IV. RISKS AND BENEFITS

A. Risks

- 4.1 The emerging domestic capital market poses a considerable challenge for the AFAPs in their efforts to retain clients and offer an adequate return. Future returns on savings could be limited by the fact that the capital market is itself small. The investment sector program (703/OC-UR and 704/OC-UR) is responding to this challenge by, among other things, creating a new regulatory framework for the capital market, strengthening its oversight agency, and deregulating and supervising the insurance industry. To find other ways to improve the AFAPs' future investment opportunities, the program will study how the domestic capital market operates and be particularly attentive to the existing conditions for developing new long-term debt instruments.
- 4.2 Possibility that a low percentage of workers will elect to participate in the savings pillar. Whether workers can be persuaded to put a portion of their contributions in to the future AFAPs will depend on the returns the latter afford and the amount of information available on the new system. Recently, the Uruguayan government launched an ambitious campaign to inform the public of the options available and of the benefits and risks that each option involves. Although there is some uncertainty as to future financial returns, the view is that once the public understands how the new system operates and what it entails, a considerable percentage might opt to participate in the individual savings pillar.
- 4.3 Political risks. This reform is one of the most sweeping reform programs ever essayed in Uruguay. Since reform of the social security system in any country is a politically sensitive issue, it is not surprising that there is still some opposition to the new system in Uruguay. In fact, there could be a referendum on some individual articles of the reform law or a plebiscite for their repeal in 1999, the latter procedure being possible only in a year of general elections. The various associations of retirees together form a powerful political bloc; should the new system again come to be viewed negatively, the reform could be jeopardized. Given that fact, the program's technical assistance plan will include a component specifically to ascertain the views of the users of the system, to promote a better understanding of it. The new system will have no effect at all on those already drawing a pension. The technical assistance component will also help remedy problems as they arise.

B. Benefits

- 4.4 The program will afford support for government efforts toward the effective implementation of social security reform and the introduction of measures to make the new social security system more efficient. The benefits of the program can therefore be likened to the benefits of the reform.
- 4.5 The first benefit of the new social security system is a future saving in direct fiscal transfers to the system stemming from a better contributors-to-beneficiaries ratio and fewer years of benefit payments. The second benefit concerns the introduction of measures to reduce evasion and underreporting of income, by creating an employment history file, which is a unified system to record employment, earnings and contributions for every individual enrolled in the plan. The third benefit is creation of a savings pillar organized around individual, personal savings accounts administered by AFAPs, which will make for a clear link between contributions made and benefits received under the new social security system.
- 4.6 By the year 2000, the savings on total social security expenditure would be around 0.5% of GDP and private savings built up in the AFAPs could equal as much as 3% of GDP. Both sources of direct savings illustrate the tangible benefits that the reform could realize in the near term, provided it is properly carried out.
- 4.7 To make certain those benefits materialize, the Uruguayan government has requested funding from the Bank to: (i) cover the short-term costs of implementing the reform, without compromising the targets of the government's macroeconomic program and without drastically eroding the quality of social security services; (ii) provide the technical assistance needed to begin an orderly plan for institutional reorganization of the social security system, and (iii) allay the political risks generated by the reform by increasing confidence in it and thereby contribute to its success.

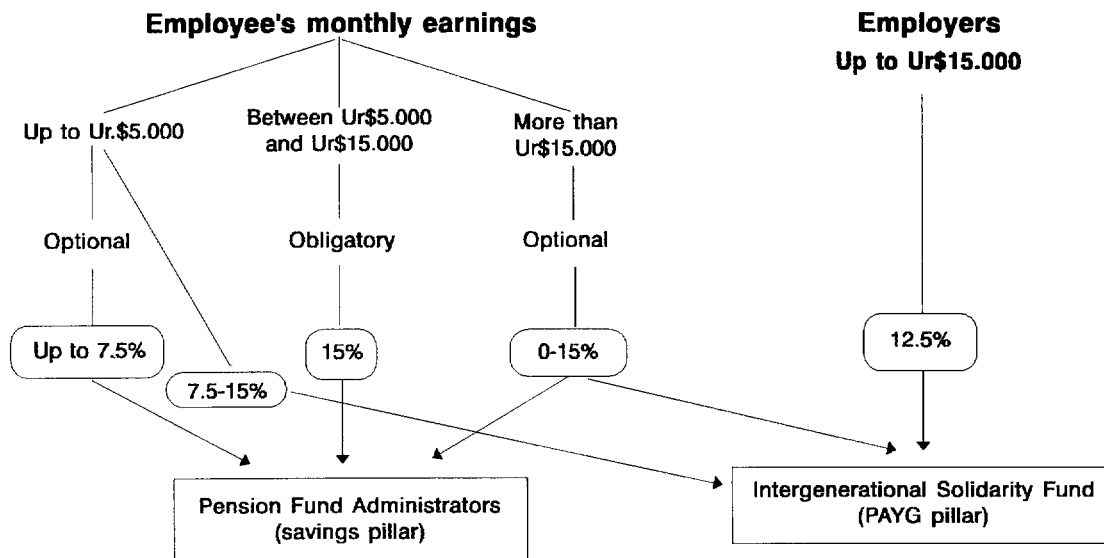
THE URUGUAYAN SOCIAL SECURITY SYSTEM

- Under Uruguay's revamped social security system, benefits and contributions will be payable under two pillars, an intergenerational "solidarity" pillar administered by the BPS and a system of individual, personal savings accounts administered by pension fund administrators (AFAPs). The first pillar covers all workers for their first Ur\$5,000 of earnings in May 1995 pesos and pays benefits comparable to those afforded by the present system, although retirement conditions have been made somewhat more stringent and wage-replacement ratios have been lowered. The first pillar provides a retirement annuity and survivor pension, the amount of which will depend on the worker's age at retirement, years of service, and contributory earnings; the rules specify both minimum and maximum pension amounts (see Table 2).

Table 1
Changes in contribution rates for the social security system

PRESENT SYSTEM	REFORM	
Contribution to the BPS	Contribution to the BPS	Deposit in individual personal accounts
Industry and commerce: Employer: 14.5% of payroll Employee: 13% of earnings Contributory earnings include overtime, tips, meals and lodging, year-end bonus. Contribution rates are different for other sectors.	Industry and commerce: Employer: 12.5% of payroll, reduced to 6.5% for the manufacturing industry Employee: <u>For portion of earnings up to Ur\$5,000 (first level)</u> No capitalization option: 15% of earnings With capitalization option: 7.5% of earnings. Basic retirement salary is computed as 1.5 times the basis of contributions, to a maximum of Ur\$5,000. <u>For earnings over Ur\$5,000 (second and third level)</u> Does not contribute. Contribution rates are different for other sectors.	Industry and commerce: Employer: does not contribute. Employee: <u>For portion of earnings up to Ur\$5,000 (first level):</u> does not contribute. With capitalization option: 7.5% of earnings <u>For earnings between Ur\$5,000 and Ur\$15,000 (second level)</u> 15% of earnings <u>For earnings over Ur\$15,000 (third level)</u> 15% of the first Ur\$15,000; voluntary for the rest

URUGUAY: Employee and Employer Payroll Contribution rates under the Reformed System



2. The second pillar is a new system that will take the form of contributions deposited in individual, personal accounts administered by AFAPs. This pillar covers all workers earning between Ur\$5,000 and Ur\$15,000 a month in May 1995 pesos. Workers earning less than Ur\$5,000 may elect to participate voluntarily in this system, putting in half of their total individual contributions up to a maximum of Ur\$2,500 (see Figure 1). For those who so elect, the base earnings used to compute pension benefits under the first pillar will be increased by a factor of 1.5 to a maximum of Ur\$5,000, which creates a significant premium over the first-pillar pension.
3. At retirement, the BPS will pay pensions corresponding to the first pillar, and funds accrued in the capitalization account under the second pillar will be used to draw a pension from an insurance company.
4. The reform has considerably changed the size of benefits and eligibility requirements. Minimum retirement age for women was raised to 60 (from 55), making it the same as the retirement age for men. Now, workers must be at least 60 years of age and have 35 years of service to qualify for a retirement pension, and an employment history file system has been set up to record and certify length of service and contributions paid. Wage-replacement ratios have been reduced to 50% of average adjusted remuneration in the last 10 years of service, not to exceed the average of the highest 20 years plus 5%, or in the highest 20 years if such were to the worker's advantage. In addition, a number of incentives to defer retirement beyond the minimum age have been introduced (income-replacement ratios increase 3% for each year beyond age 60 once the worker becomes entitled to a pension, to a maximum of 30%, and 0.5% for each additional year of service beyond 35 years until the worker is eligible for a pension, to a maximum of 2.5%). The benefits under the second pillar can be drawn by insured workers when they attain age 65, if they have at least 35 years of service, even if they remain employed.
5. A summary of eligibility requirements and benefit levels before and after the reform appears in Table 2. To give an idea of how workers with typical income flows would fare after the reform, Table 3 shows wage-replacement ratios at various ages and for varying lengths of service.

Table 2
Uruguay's social security system: old versus new

PRESENT SYSTEM		REFORM	
RETIREMENT PENSION			
Eligibility	Benefits	Eligibility	Benefits
Retirement age: 55 for women, 60 for men Years of service: 30 A record of contributions is required, but evidence from witnesses may be accepted in lieu of same.	55%-75% of average earnings in last three years of service prior to retirement Minimum pension: 85% of minimum wage Maximum pension: 7-15 minimum wages Benefits are pegged to the mean wage and salary index (a weighted average of private and public sector wages).	Retirement age: 60 for men and women Years of service: 35 Contributions must be logged in the employment history file.	50% of average contributory earnings, to a maximum of Ur\$5,000 (May 1995), in last 10 years of service preceding retirement or highest 20 years of earnings (pensionable base earnings), plus 3% for each year of age over 60 with entitlement (maximum 30%), plus 0.5% per year of service beyond 35 years (maximum 2.5%). Pensionable base earnings are increased by 50% for those who opt for the capitalization system. Minimum pension: Ur\$550 Maximum pension: Ur\$4,125
Disability Permanently incapacitated for all types of work: permanent pension Permanently incapacitated for worker's trade or profession: temporary pension for five years	70% of average earnings Minimum pension: 85% of minimum wage Maximum pension: 7 minimum wages Benefits are pegged to the mean wage and salary index (a weighted average of private and public sector wages).	Permanently incapacitated for all types of work: permanent pension Permanently incapacitated for worker's trade or profession: temporary pension for three years	65% of pensionable base earnings Minimum pension: Ur\$950 Maximum pension: Ur\$4,125 Benefits are pegged to the mean wage and salary index.
Advanced age Retirement age: 65 for women, 70 for men. Length of service: 10 years	40% of pensionable base earnings plus 0.1% for each year of service (maximum 30%). May not be drawn by persons receiving any other retirement or pension benefits.	Advanced age Retirement age: 70 (men and women) Length of service: 15 years	50% of pensionable base earnings plus 0.1% for each year of service over 15 (maximum 14%). May not be drawn by any person receiving retirement or pension benefits other than savings-plan retirement.
SURVIVOR'S BENEFITS			
Upon death of worker or pensioner, benefits are payable to surviving spouse, children under 21, disabled children over 21, disabled parents, and unmarried daughters over age 45.	Surviving spouse or child: 66% of average earnings Surviving spouse with minor or disabled children: 75% of average earnings Other cases: 50%-75% of average earnings	Idem	Surviving spouse or former spouse or children: 66% of pension to which insured would have been entitled. Surviving spouse or former spouse with minor or disabled children: 75% of same Other cases: 50%-75% of same. Pensions are paid for varying terms depending on beneficiary's age.

PRESENT SYSTEM		REFORM	
OLD-AGE ASSISTANCE			
Eligibility	Benefits	Eligibility	Benefits
Payable from age 65 Personal income of claimant and family members cannot exceed value of the old-age assistance pension.	Pegged to mean wage index.	Payable from age 70	Idem

Table 3
Wage-replacement ratios before and after the reform

	PERCENT OF PENSIONABLE BASE	
	YEARS OF SERVICE	
	35	40
I. At age 60		
Men	65%	70%
Women	70%	75%
New system (men and women)	50%	52.5%
II. At age 65		
Men	65%	70%
Women	80%	80%
New system (men and women)	60%	65%
III. At age 70		
Men	67.5%	75%
Women	77.5%	80%
New system (men and women)	70%	75%

PROJECTED IMPACT OF SOCIAL SECURITY REFORM

1. Additional financing requirements

- a. The additional financing that the BPS will require for the revamped social security system does not all need to come from the public sector, since a portion of the funds deposited with AFAPs can be invested in government securities, making them an additional source of financing. Hence, the net additional public sector financing requirement will depend on: (i) how fast the minimum percentage of government securities required in AFAP portfolios is lowered, and (ii) the pace at which the capital market develops. If the required percentage drops slowly and capital markets are slow to develop, then the percent of government securities in the AFAPs' portfolio will likely be very high and the "upper limit" stipulated in article 123, paragraph 3, of the Law would apply. The more optimistic scenario would be one in which the required percentage share drops rapidly and the capital market develops more vigorously, in which case the "lower limit" described in article 123, paragraph 4, of the Law might apply. The projections posit two scenarios for government securities as a percentage of the AFAPs' portfolio, as shown in the following table.

Table 1
Scenarios for the percentage of government securities
in the AFAPs' portfolio

	Lower limit	Upper limit
1996	80	100
1997	70	90
1998	60	80
1999	50	70
2000	40	60
2001-2005	30	60

- b. The additional financing needs are shown in Table 2 below. Line 1 reports the deficit attributable to the BPS pension system without the reform, while lines 2 through 4 report the

"with reform" deficit with differing option scenarios for the mandatory individual savings system 1/. Lines 5 to 7 show the additional deficit that each option would generate over the base without-reform scenario. Lines 8 to 10 indicate the net increase in the AFAPs' portfolio (fees and insurance excluded) under each scenario. These figures are lower than the figures given as the AFAPs' receipts, since they do not include the fees and insurance that members will be required to pay. Lines 11 to 13 are the accruals in the AFAPs' portfolio under each option scenario. Lines 14 and 15 reproduce the preceding table and are used to compute, on lines 16 to 21, aggregate government securities in the AFAPs' portfolio. With that information, lines 22 to 27 report the additional public sector financing needed, as the difference between the increase in the BPS deficit under each reform scenario and the net increase in government securities in the AFAPs' portfolio.

1/ Assumed option scenario percentages:

	1996	1997	1998	1999	2000 to 2005
High	60	70	80	85	85
Intermediate	40	50	60	70	75 to 84
Low	20	30	40	45	50 to 59

Table 2
Deficit to be made up by the Treasury under alternative scenarios
(in millions of US\$)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total deficit									
- Without reform	442.2	452.6	451.8	439.2	410.8	381.6	351.8	321.3	290.3
- Reform with high option	518.5	548.2	565.9	568.8	539.4	507.1	481.1	444.8	416.0
- Reform with intermediate option	488.6	516.0	531.5	541.2	520.0	496.9	472.5	438.0	411.3
- Reform with low option	458.6	483.9	497.1	495.3	471.5	445.7	418.6	381.4	352.0
Increase in total deficit associated with the reform under the ...									
- high option	76.3	95.5	114.1	129.6	128.6	125.5	129.3	123.4	125.7
- intermediate option	46.3	63.4	79.7	102.1	109.2	115.3	120.7	116.6	120.9
- low option	16.4	31.3	45.3	56.2	60.7	64.1	66.9	60.1	61.7
Net increase in the AFAPs' portfolio									
- high option	86.8	100.7	116.2	126.5	129.2	131.8	134.5	137.0	139.2
- intermediate option	64.0	76.1	90.0	105.5	114.4	124.0	127.9	131.8	135.6
- low option	41.1	51.6	63.7	70.5	77.4	85.0	86.8	88.6	90.4
Accumulated AFAP portfolio									
- high option	86.8	187.5	303.7	430.3	559.5	691.3	825.8	962.8	1,102.0
- intermediate option	64.0	140.1	230.1	335.6	450.0	574.1	702.0	833.8	969.4
- low option	41.1	92.8	156.5	227.0	304.4	389.3	476.2	564.8	655.1
Scenarios for percentage of government bonds in the AFAPs' portfolio									
- lower limit	80%	70%	60%	50%	40%	30%	30%	30%	30%
- upper limit	100%	90%	80%	70%	60%	60%	60%	60%	60%

Government securities in the AFAPs' portfolio									
- high option									
- lower limit	69.5	131.2	182.2	215.1	223.8	207.4	247.8	288.8	330.6
- upper limit	86.8	168.7	243.0	301.2	335.7	414.8	495.5	577.7	661.2
- intermediate option									
- lower limit	51.2	98.1	138.1	167.8	180.0	172.2	210.6	250.1	290.8
- upper limit	64.0	126.1	184.1	234.9	270.0	344.4	421.2	500.3	581.6
- low option									
- lower limit	32.9	64.9	93.9	113.5	121.7	116.8	142.8	169.4	196.5
- upper limit	41.1	83.5	125.2	158.9	182.6	233.6	285.7	338.9	393.1
Additional financing needs after AFAP investments									
- high option									
1) - lower limit	6.8	33.7	63.1	96.7	120.0	141.9	89.0	82.3	83.9
1) - upper limit	(10.6)	13.6	39.9	71.4	94.1	46.4	48.6	41.3	42.2
- intermediate option									
1) - lower limit	(4.9)	16.5	39.8	72.3	97.0	123.1	82.3	77.1	80.3
1) - upper limit	(17.7)	1.3	21.8	51.2	74.1	40.9	44.0	37.6	39.6
-low option									
1) - lower limit	(16.5)	(0.7)	16.4	36.6	52.4	69.1	40.8	33.5	34.6
1) - upper limit	(24.8)	(11.1)	3.6	22.5	37.0	13.1	14.8	6.9	7.5

2. Medium-range financial projections of the reform

- a. Using the intermediate option scenario, the reform's financial impact was projected up to the year 2040. The most significant finding is that the BPS pension system's total expenditure drops from 12.2% of GDP in 1995 to 7.4% by the year 2035. The findings appear in the following table.

Table 3
Medium-range projection of the BPS
(in millions of US\$)

Intermediate option scenario										
	1995	2000	2005	2010	2015	2020	2025	2030	2035	2040
Total expenditure	2,196.8	2,332.2	2,289.7	2,252.5	2,229.8	2,252.6	2,331.7	2,472.3	2,688.8	2,972.5
(includes retirement annuities, pensions, family benefits, unemployment insurance and operating expenses)										
Employer contributions	703.1	718.6	781.7	850.5	925.3	1,006.6	1,095.2	1,191.5	1,296.3	1,410.2
Employee contributions	601.0	591.2	580.1	588.4	606.6	635.7	678.7	734.0	797.0	866.4
Other revenues	55.3	55.5	57.8	61.0	65.0	69.7	75.2	81.7	88.8	96.6
Share of VAT	402.1	447.0	486.3	529.0	575.5	626.2	681.2	741.1	806.3	877.2
Deficit to be made up by the Treasury	435.3	520.0	383.8	223.6	57.4	(85.6)	(198.6)	(276.0)	(299.6)	(277.9)

- b. While the BPS's total expenditure declines, there is a significant increase in the AFAPs' portfolio, which by the year 2040 is equal to 48.8% of aggregate GDP. This opens up a major capital market in long-term investments that, with sustained development of the capital market, can have significant effects on the country's financing capacity. The evolution of the AFAPs' portfolio is shown in the following table.

Table 4
Evolution of the AFAPs' portfolio and cumulative holdings
(in millions of US\$)

	1995	2000	2005	2010	2015	2020	2025	2030	2035	2040
Annual additions to portfolio	0.0	114.4	139.4	186.4	215.1	240.3	260.9	278.3	295.2	312.8
Portfolio accruals (with capitalization)										
In millions of US\$	0.0	475.5	1,257.5	2,398.0	3,891.8	5,782.8	8,116.5	10,946.6	14,350.0	18,426.3
As a % of GDP	0.0%	2.5%	6.0%	10.5%	15.7%	21.4%	27.6%	34.2%	41.2%	48.6%

CONDITIONALITY MATRIX

POLICIES	MEASURES TAKEN TO DATE	MEASURES REQUIRED PRIOR TO:		
		First tranche release	Second tranche release	Third tranche release
ECONOMIC CONTEXT				
program objectives consistent with the short- and medium-term macroeconomic work.	Letter of Agreement concluded with the International Monetary Fund.	Macroeconomic performance consistent with the program's objectives.		
LEGAL AND REGULATORY FRAMEWORK				
Review of the present pay-as-you-go social security system in favor of a system of individual savings.	Institutional legal framework of the new social security system approved and enacted.	Presentation of regulations under Social Security Reform Law 16,713.	Entry into force of the Law and regulations thereunder. <u>1/</u>	New legal framework in effect.
Review of the system of occupa- tional pension plans (bank employees, professionals and public) to the new social security system.	Interagency team that is to decide on conditions and guidelines for adapting occupational pension plans and police and military public pension plans to the Law has been set up, and tentative timetable for same has been drawn up.		Presentation of draft legislation to adapt occupational pension plans to the new social security system.	Entry into force of the enabling regulations.
FINANCIAL MARKET				
Investment opportunities and administrators	Definition of a new regulatory framework for the capital market; deregulation of the insurance industry; creation of an oversight body for that industry.	Agreement on terms of reference for the study on the domestic capital market, to identify long- term investment opportunities.	Start-up of the study.	Presentation of the study findings and recommendations.
INSTITUTIONAL FRAMEWORK				

and its regulations are to enter into force by April 1, 1996.

POLICIES Objective	MEASURES TAKEN TO DATE	MEASURES REQUIRED PRIOR TO:		
		First tranche release	Second tranche release	Third tranche release
the institutional and administrative efficiency of the social security system.	General lines of a strategy to improve the institutional and administrative efficiency of the Social Security Bank (BPS) have been devised.	Agreement on efficiency indicators for a base year, for purposes of implementing the BPS strategic plan (see Annex II-1).	Development of a strategic plan for the BPS, including a review of the agreed-upon efficiency indicators, their value for the base year, publication thereof, and setting of performance targets. Satisfactory progress made in implementing the BPS strategic plan.	Satisfactory progress made in implementation of the strategic plan.
the AFAPs.	President and board of directors of a public AFAP appointed.	Establishment of a public AFAP and organization of the unit in the Central Bank of Uruguay that will supervise the public and private AFAPs.	AFAPs' new institutional framework remains intact.	AFAPs' new institutional framework remains intact.
the system of paid to working plan seeking enhanced and equity.		Agreement on terms of reference for a study on streamlining working plan member entitlements (medical, family benefits, unemployment insurance).	Presentation of the study's findings and recommendations.	Implementation of appropriate recommendations of the study.
evaluation and monitoring committee of senior officials, to the program and measures as needed to ensure social security system function well.		Set-up of the committee. Agreement on terms of reference for studies on (i) the impact of the new social security system and (ii) the quality of client services.	Presentation of the committee's mid-term report. <u>2</u> / Inclusion of the studies' main findings and recommendations in the mid-term report.	Presentation of the committee's final report and proof thereof available to the public. Inclusion of the studies' findings and recommendations in the final report.
AL SUPPORT COMPONENT				

arts will consider the findings and recommendations resulting from the studies on the impact and quality of the new social security system.

POLICIES	MEASURES TAKEN TO DATE	MEASURES REQUIRED PRIOR TO:		
Objective		First tranche release	Second tranche release	Third tranche release
Executive branch with support needed to the program's	<p>Identification of needs of the following institutions to perform the tasks shown in each case:</p> <ul style="list-style-type: none"> - OPP: Coordinate program execution - BPS: Reorganize and modernize the institution - BCU: Organize and institute the AFAP oversight system - Occupational pension plans: Improve their administrative efficiency - Other adjustments pursuant to article 1 of Law 16,713. 	Preparation of a technical support plan for coordinated execution of the program (see Annex II-6).	Satisfactory implementation of the technical support plan according to the timetable.	Satisfactory implementation of the technical support plan according to the timetable.

EFFICIENCY RATIOS FOR THE SOCIAL SECURITY BANK
(measured and published quarterly with the funds flow statement)

The following are the efficiency ratios and other indicators that are to be used to gauge progress on the strategic plan:

1. Number of pension claims filed/number of staff in claims area.
Number of pension benefits paid/number of staff in payments area.
2. Contribution monies received/benefits paid out. BPS current assets/BPS current liabilities. Fiscal-year operating income/total income (operating income being contributions received net of benefits paid out and administrative expenses).
3. Evasion (expressed in contributory job positions). Change in intake per 1% of contribution.
4. Total administrative expenses in constant currency/number of beneficiaries and contributors.
5. The first ratio below compares the covered population and the target population, the latter being all persons who could be entitled to the benefit by virtue of status, age or objective circumstances. The second ratio illustrates the dispersion of benefits-in-pay.
 - a. **Coverage:** number of beneficiaries/target population (beneficiaries and target population broken down by type of benefit).
 - b. **Amount:** average benefit amount/minimum benefit amount (for retirement security and pensions).
6. Number of inspections performed. Contributions found to be owing/number of inspections performed.
7. Number of contributing members enrolled/number of staff in contributing member area. Number of benefits paid to contributing members/number of staff in payments area.
8. Administrative costs associated with dispensing of benefits/total amount of benefits paid out. Administrative costs associated with intake and collection of contributions/total contribution receipts.
9. Processing time for each retirement or pension benefit (time elapsed between date of receipt of the claim application and date of awarding of the benefit), with a breakdown by type of benefit. Response time for complaints of errors in benefit payments (time elapsed between receipt of the complaint and date of reply). Calculate also the percentage of replies that are favorable.

Time elapsed between date of pension benefit award and effective date of payment.

10. Number of employees contributing in the month/number of employees registered as contributing members. Number of businesses contributing in the month/number of contributing businesses.
11. Administrative expenses, not including collection costs/total amount of benefits paid. Collection costs/total amount of benefits paid.
12. Number of contributors/universe of workers required to contribute, by type of contribution (contributions to the plan and to the health insurance program).
13. Availability of telephone assistance; number of calls received. Bureau for complaints and evasion reporting: (i) number of reports of evasion received; (ii) number of complaints received.
14. Benefits awarded/benefits programmed. Paying contributors/programmed contributors.

**AFAP INSURANCE CONTRACTING, PUBLICITY, AND OTHER RULES, AND ORGANIZATION
OF THE AFAP OVERSIGHT UNIT**

A. Disability and survivor's insurance

1. Requirements as to the object of disability and survivor's insurance contracts, regarding the 100% of the additional contribution that the AFAP must credit to the account of the deceased or disabled insured.
2. Requirements for eligibility for the additional contribution, where
 - (i) the plan member worked during the month when he or she died or was declared disabled;
 - (ii) the plan member stopped working as of a given date, within a prescribed interval, because of death or declared disability.
3. Rules for purchasing and renewing insurance contracts, including
 - (i) features of the call for bids
 - (ii) the number of insurance companies that qualify
 - (iii) insurance renewal rules
 - (iv) features of the opening of bids
 - (v) deadline for awarding a bid or voiding the bidding
4. Bidding conditions, which must include
 - (i) a statement of the object of the call for proposals
 - (ii) a definition of the participants
 - (iii) place and date for clarifying questions
 - (iv) deadline and procedure for bid submittal and opening of bids
 - (v) qualification method
 - (vi) technical bidding conditions
5. Type of insurance contract, with term evidenced by registered public instrument.
6. Instructions for transmittal of copies of the contract to the AFAP oversight unit.
7. Instructions for payment of the insurance premium, specifying date of payment, possibility of prepayment, and certification of receipts required of the insurance companies.

8. Instructions for transmittal of insurance payment information to the AFAP oversight unit.
9. Terminology to use when reporting the following to the AFAP oversight unit:
 - (i) current contributions
 - (ii) past due contributions
 - (iii) contributions in arrears
 - (iv) contributions through transfers
 - (v) premium payable

B. Rules on advertising, promotion and reporting

The object of these requirements is to:

- (i) determine the types of advertising, promotion or reporting to which these rules apply;
- (ii) specify the date on which advertising is permissible;
- (iii) clarify what advertising may and may not contain;
- (iv) clarify stockholder equity interests and limitation of liability;
- (v) specify the physical place where advertising is permitted;
- (vi) compare AFAPs;
- (vii) define "return" and "return period" to be publicized;
- (viii) determine fees to be publicized;
- (ix) determine rules for AFAPs starting operations;

- (x) provide for transmittal of advertising and promotional materials to the AFAP oversight unit;
- (xi) specify the content of the public notice-board at AFAP head office and branch offices;
- (xii) specify the content of the brochures available for members at the AFAP head office and branch offices.

C. Proposed organization of the AFAP oversight unit

This section outlines a proposal for the internal organization of the AFAP oversight unit.

This unit should have the following offices or departments to perform the functions that Law 16,713 prescribes:

- (i) Legal
- (ii) Institutional oversight
- (iii) Finance
- (iv) Studies
- (v) Data-processing
- (vi) Benefits and insurance (Office of the Superintendent of Insurance and Reinsurance)

The functions of the various offices or departments would be as follows:

1. Legal department

- (i) Study, analyze and resolve all legal matters that come under the authority of the oversight unit.
- (ii) Help draft the rules, directives and circulars distributed to the individuals and institutions being supervised.
- (iii) Propose legal and regulatory reforms deemed necessary.
- (iv) Conduct summary investigations of supervised institutions.
- (v) When appropriate, levy fines on the institutions being supervised and notify them of same.
- (vi) Advise institutions being supervised on legal action against third parties and represent the oversight unit

when the latter is a party to legal proceedings in which the institutions under its supervision have an interest.

2. Institutional oversight department

- (i) Prepare rules, directives and circulars for distribution to the institutions being supervised on matters that are the unit's responsibility.
- (ii) Supervise the AFAPs.
- (iii) Keep records of AFAPs and vendors.
- (iv) Make certain that AFAPs provide members with information on the matters specified in the Law and in directives from the oversight unit.
- (v) Inspect the head offices of the AFAPs once operations are authorized.
- (vi) Participate in the dissolution and liquidation of AFAPs, ensuring that all relevant laws, regulations and directives are observed.
- (vii) Make certain that the AFAPs require contributing members to make their contributions, and deduct the fees prescribed in the Law.

3. Finance department

- (i) Issue rules on presentation and controls of balance sheets and charts of accounts of pension fund administrators and pension funds, valuation allowances and reserves, reserve requirements, and other matters for which it is accountable.
- (ii) Develop formulas for computing the return on the fund and on the individual savings account, a method for valuating the pension plans' investment portfolios, and other matters within its purview.
- (iii) See to it that financial and oversight rules in areas over which it has authority are observed.
- (iv) Examine and monitor the balance sheet of AFAPs and the pension fund, investment caps, legal reserve requirement, valuation allowances and reserves, and other matters for which it is responsible.

- (v) Assess prospects for creation of pension fund administrators, examine authorizations for their establishment, and evaluate their operations.

4. Studies

- (i) Evaluate, analyze, and forecast the operation of the system and perform financial, economic, actuarial or other studies to ensure it functions properly.
- (ii) Assess prospects for creation of pension fund administrators, examine authorizations for their establishment, and evaluate their operations.
- (iii) Produce rules, directives, and circulars to be distributed to the institutions being supervised.
- (iv) Coordinate the work of the oversight unit with other social security regulatory bodies, such as the Office of the Superintendent of Insurance and Reinsurance and the Social Security Bank.

5. Data-processing service

- (i) Acquire and maintain hardware and software to enable the oversight unit to function well.
- (ii) Set up data-sharing networks within the oversight unit and with the institutions being supervised and make certain those networks function properly.

6. Benefits and insurance department (Office of the Superintendent of Insurance and Reinsurance)

- (i) Make certain that the benefits prescribed in the Law are dispensed promptly.
- (ii) Establish rules for contracting disability and survivor's insurance.
- (iii) Establish rules for awarding the retirement and pension benefits prescribed by law.

Eastern Republic of Uruguay
Office of the President of the Republic
Office of Planning and Budget

Montevideo, February 16, 1996

Mr. Enrique V. Iglesias
President
Inter-American Development Bank
Washington, D.C.

Dear Mr. Iglesias:

1. The Government of Uruguay is requesting a sector loan from the Inter-American Development Bank to further a program of reforms and policies to make the nation's social security system more efficient and transparent. The government is already introducing the necessary changes in the laws, decrees, administrative procedures, institutional structure and operating rules in the social security sector and in the institutions that comprise it.
2. The social security reform program complements other reforms and policies that have been and continue to be carried out with support from the Bank and other multilateral institutions. This program builds upon the progress made under the investment sector program (703/OC-UR) by helping to create and develop pension funds.
3. A top priority of the government's economic strategy is to maintain fundamental macroeconomic equilibria in a regionally integrated economy open to the global marketplace, while accenting exports and fostering continuing domestic and foreign private investment. Accordingly, the government has instituted a stabilization program and certain structural reforms, mainly in the public sector. These initiatives are crucial to build a dynamic export sector and make areas reserved to the public sector more efficient; to free up resources for better use in social investments (education and health) and to improve the quality of spending. The structural adjustment policies, for their part, seek to clear away obstacles to economic growth such as the heavy burden of the social security system and inefficient workings of the State apparatus, in order to create an environment more conducive to Uruguay's socioeconomic development.
4. The reforms are to make the State more efficient by ensuring that priority attention to its essential services, such as education, does not drive up the tax burden, which already hovers at 35 percent of GDP. The reform in central government, which was approved along with the five-year budget, includes: (i) a cut in the number of executing units, to eliminate overlapping functions

and costs; (ii) decentralization of services associated with nonessential activities or services that can be delivered more effectively in the form of enterprises, such as postal and agricultural extension services; (iii) fundamental changes in personnel management that would do away with redundancies and introduce a performance-based remuneration system; and (iv) a study of prices and rates the State charges for its services.

5. Social security reform is an integral part of the aforementioned State reform. At the present time, social security outlays in Uruguay account for over 50 percent of total government expenditures and have risen more than 80 percent in real terms in the last five years, now equaling over 17 percent of GDP. To counteract the negative effects of this situation on employment, inflation, wage costs, income distribution and the efficiency of the productive apparatus, the Uruguayan government has launched reforms of enormous consequence to the country's sustainable development. Social Security Reform Law 16,713, passed in early September 1995, radically reconfigures Uruguay's social security system. The social security reform first addressed the largest plan, the one administered by the Social Security Bank (BPS). The measures to tackle the most pressing problem, which is the BPS's finances, include: (i) increasing the number of years used to compute pension annuities; (ii) eliminating in future the acceptability of testimonial evidence in lieu of a demonstrated contribution record; (iii) introducing a system of individual accounts to record retirement contributions (employment history), and (iv) revising wage-replacement ratios. The reform also plans to adapt the country's other social security plans (occupation-specific pension plans and the military and police retirement and pension plans). Draft legislation to that end is to be introduced no later than December 31, 1996, as the Law prescribes. Areas of the social security system that involve benefits to contributing members will also be evaluated.

THE SECTOR PROGRAM

6. The Government of Uruguay is requesting the Bank's assistance to help it revamp the country's social security system by effectively implementing the new Law and strengthening the institutional framework within which the system operates. The support will focus mainly on the following areas: (i) establishing a regulatory framework that makes full implementation of the Law possible; (ii) improving the BPS's administrative efficiency and the quality of its service; (iii) developing Uruguay's capital market; and (iv) adapting occupation-specific pension plans (professionals, bank employees, notaries) to conform to the new system.

7. **Macroeconomic framework.** The policy measures taken under the government's stabilization program have significantly reduced inflation and the external debt, have opened the economy to more international and regional trade, and have liberalized the financial market. To monitor implementation of its stabilization strategy, the government has presented a request to the IMF for a new precautionary arrangement for the equivalent of SDR 100 million (approximately US\$150 million). This agreement, which is now before the IMF Board, would take effect in March 1996 and last thirteen months. The main targets under that agreement for 1996 are: (i) **growth** of 1 percent in real GDP and a **drop in inflation** from 35.4 percent to 20 percent, assuming low wage pressure and zero imported inflation; (ii) **fiscal policy**: a reduction of the public sector's overall deficit from 2 percent to 0.5 percent, excluding the net effect of increased transfers to the social security system as payments to AFAPs; (iii) **monetary policy**: sterilization of excess liquidity stemming from the surplus of public enterprises; (iv) **exchange-rate policy**: adjustment of the devaluation of the nominal rate in accordance with anticipated 20 percent inflation; and (v) **external sector**: reduction of the deficit on current account from 2 percent to 1.5 percent of GDP, and a shift in the maturity profile of foreign-currency domestic debt from short to long term, as a hedge against external risks. Considering how important these targets are to successful social security reform, the government pledges to see that they are achieved.
8. **Legal and regulatory framework.** The Social Security Reform Law stipulates that the regulatory framework to govern the new system must be in place before April 1996. This will require a determination of basic rules to give effect to the new retirement system, adapt the other pension systems (occupation-specific plans and police and military retirement and pension plans), create the employment history file system, and set up the public and private pension funds and put them into operation. A committee to draft the required regulatory decrees and legislation has been formed in close cooperation with the BPS and the Central Bank of Uruguay. The following are among the areas that those regulations and draft legislation will address: (i) the survivor's pension system; (ii) formation, start-up and supervision of pension fund administrators (AFAPs) and delimitation of the various levels and options that the Law provides; (iii) the first- and second-pillar pension system (pay-as-you-go and savings, respectively); (iv) taxable items for purposes of special social security levies; (v) regulations on advertising, promotion, and reporting by AFAPs; (vi) the formula for computing the return on individual AFAP accounts; (vii) disability and survivor's insurance contracts, and (viii) draft legislation to adapt the occupation-specific plans to the new social security system.

9. **The domestic capital market.** Under the investment sector program (703/OC-UR and 704/OC-UR), the government has made significant progress toward shaping a new regulatory framework for the country's capital market and strengthening its oversight agency, and toward deregulating the insurance industry and creating an insurance-industry oversight body. To identify additional policy measures to improve the AFAPs' investment opportunities in the future, the government will conduct a study on the domestic capital market, focusing especially on the existing conditions for developing new private long-term debt instruments.

INSTITUTIONAL FRAMEWORK

10. **Social Security Bank.** Reorganization of the existing institutional framework is one of the keys to the success of the social security reform. The government is developing a comprehensive strategic plan to adapt the BPS to the new social security system's needs, particularly in the following areas: (i) mechanisms for contribution collection, transfers, and crediting of individual accounts; (ii) an employment history file system; (iii) harmonization of collection arrangements; (iv) outsourcing of services; (v) human resources management, and (vi) quality of client services.
11. **Creation of the AFAPs.** The Law stipulates that a public AFAP is to be in place and operating by April 1, 1996, so that the new individual savings system can be instituted, whereupon private AFAPs can be created. To that end, through the BPS, BROU, and BSE the government has created the first public AFAP, and the BPS, working with the Central Bank of Uruguay, is to set up a unit in charge of prudential supervision of public and private AFAPs.
12. **Benefits to contributing workers.** The benefits paid to contributing workers under the social security system represent around 16 percent of total BPS expenditures. These include health benefits, family allowances, and unemployment insurance. Health benefits are financed by an 8 percent payroll contribution; there are no earmarked contributions for other benefits. Under the strategic plan for the BPS, which manages these benefits, the system used to award and administer benefits will have to be streamlined. Once the system's operations have been analyzed, the government will take steps to that end.
13. **Evaluation and monitoring committee.** The government will form a committee composed of senior officials to monitor the social security reform. This committee will propose measures needed for the new social security system to function smoothly and will report periodically thereon.

PROGRAM EXECUTION

14. **Technical support plan.** The government will carry out a technical support plan (Annex D to the loan contract), which will include a number of studies, advisory assistance and activities for the effective implementation of the social security reform program. The main institutions that will benefit directly are: (i) the Office of Planning and Budget, to coordinate the program; (ii) the BPS, to carry out its aforementioned restructuring and modernization plan; (iii) the Central Bank of Uruguay, to organize and implement the AFAP-oversight system; and (iv) the occupational pension plans and other State social security services, to make them more efficient administratively.

Luis Mosca
Minister of Economic Affairs
and Finance

Ariel Davrieux
Director

GENERAL CRITERIA FOR EVALUATING THE IMPACT OF THE NEW URUGUAYAN SOCIAL SECURITY SYSTEM

The purpose of these guidelines is to define the basic criteria for evaluating the efficiency and equity effects of Uruguay's social security reform process currently underway.

I. Introduction

The Uruguayan social security reform program is in its very early stages, and many important programmatic and structural details have yet to be decided and implemented. In addition, an adequate assessment of the system's performance will be feasible only after several years of functioning, since time must pass in order to determine how well the AFAP investments perform, how streamlined the bureaucracy will become, and how well labor history data and contributions will be collected. For this reason, it is obviously premature to conduct a full-fledged evaluation of a system very much in evolution.

Nevertheless, it is reasonable to structure a series of questions which will be used to put in place mechanisms with which to inform evaluators interested in assessing the reforms in the future. Generally, reforms of social security systems are assessed using a number of different criteria, typically grouped under the headings of equity and efficiency. A panel of social security experts ^{1/} recently formulated a set of six criteria recommended for use in evaluating the effects of social security reforms. How each of these criteria will be applied to the Uruguayan case is discussed below.

II. Evaluation Criteria for Social Security Reform

A. *Criterion 1: Adequacy of Retirement Income*

A social security system should contribute to an adequate retirement income for older citizens. Defining "adequacy" obviously requires a value judgment; some focus on whether retirement income attains a certain replacement level as compared to earned income, while others use an absolute income or consumption standard. There are also many reasons that retirees can end up with inadequate retirement resources. Some people attain old age facing poverty because they myopically saved too little, while others confront poverty because they were poor all their

^{1/} Final Report: 1994-95 Advisory Council on Social Security Technical Panel on Trends and Issues in Retirement Saving, Washington, D.C. 1995.

lives. Still others may have lost earnings capacity due to disability, for which they made inadequate provision. In any event, a social security reform which increases retirement income adequacy would be judged positively.

In order to evaluate this criterion, it will be necessary to develop measures of adequacy, against which the evidence can be assessed. Additionally it will be necessary to collect data on retirement resources, perhaps using a household survey to which income and consumption questions could be attached. Since it will take a number of years until this new system is fully mature, simulation analysis will be conducted in the interim, varying assumptions on pay levels, contribution patterns, rates of return, for hypothetical workers by age and sex.

B. Criterion 2: Insurance against Income Shocks

A social security system seeks to afford some degree of income protection, insuring against shocks which reduce a worker's earnings potential including death and disability. This insurance is provided by risk pooling across the workforce. Research shows that insurance has incentive effects on work and savings behavior: for example, making benefits available at an early age increases the tendency to retire earlier, and providing benefits for disabled workers provides incentives for workers to file as disabled. A reform would be judged favorably if the behavioral inefficiencies generated by the program were offset by the gains from having the insurance.

To address this issue, it will be necessary to explore the factors generating peoples' filing for benefits. For example, workers must meet certain criteria before becoming eligible for social security benefits. It will be determined if meeting these criteria poses undue hardship on workers, in a way that private insurance failed to protect against. Thus data will be gathered on patterns of well-being and private insurance for those who stopped working prior to the retirement age. Similarly, data will be collected on the well-being of those workers in poor health who failed to qualify for social security disability insurance, to determine whether the eligibility criteria are unduly restrictive.

C. Criterion 3: Avoidance or Reduction of Inefficiencies

Social security has been shown to influence economic decisions regarding the labor-leisure choice and the savings-consumption choice. Hence according to this criterion, a social security reform which limits or reduces labor market and savings distortions would be a desirable outcome. In addition, a reform which increases the system's administrative efficiency would be judged positively.

To determine how the program is affecting market efficiency, it will be necessary to assess work/retirement patterns as well as savings/consumption patterns among both young and older workers. If available, a before/after data set will be constructed, comparing the labor supply

patterns of workers covered by the program prior to and after the reform. Perhaps household surveys conducted in the past could be repeated in future years, to assess saving and work effort by age and income group. In order to assess administrative efficiencies, a time path of administrative data on the types and quality of services delivered by the various existing and newly formed social security agencies will be analyzed. ^{2/}

D. Criterion 4: Equity of Lifetime Social Security Taxes and Benefits

Government-provided social insurance usually embodies more redistribution than would a privately-supplied insurance program. These transfers take place both within and across generations in the social security context. Any social security reform should be examined in terms of how it alters the distribution of lifetime benefits and taxes both between and within generations of taxpayers and workers.

Again, a simulation analysis will be carried out to assess this criterion. The exercise will involve inputting a range of hypothetical workers differing by earnings/sex/contribution options, and simulating their lifetime taxes and benefits. Cohort analysis will compare outcomes for current workers, many of whom have earned accruals under the old system, with new market entrants in years to come. If possible, data on differential mortality patterns by income and sex will be collected.

E. Criterion 5: Encouragement of National Saving

Social security programs can and do influence national saving rates. Hence social security reform proposals should be evaluated in terms of their expected effects on aggregate national saving.

This criterion is often the most difficult to evaluate because of the inherent problems encountered in measuring saving. That is, it might be possible to assess workers' accumulations in the AFAPs, but it is far more difficult to determine whether these represent net new saving or simply transfers from other asset classes. While no simple survey can supply all the needed answers, it will be necessary to collect baseline data on household assets and debt, across a range of holdings. Then as time passes, the analysis will be repeated, ideally using panel or longitudinal surveys (as in the US Health and Retirement Survey).

^{2/} Suggested criteria might include those mentioned in "Social Security Reform in Uruguay: An Economic Assessment," prepared by Olivia Mitchell for the Inter-American Development Bank, RE1/S01, Division of Social Programs, November 1995.

F. *Criterion 6: Strengthening the Financial Integrity of Retirement Income Institutions*

Because many different institutions help protect retirement well-being, any given social security reform should be examined to determine whether it would weaken or strengthen the integrity of these other institutions as well. For example, social security reforms may encourage or retard the growth of private individual, group, and employer retirement saving plans.

Therefore, how well the AFAPs are functioning, what investment returns they have generated, what their portfolio risk appears to be, and what successes or problems they have confronted will be assessed. Of related interest is how well the insurance companies have managed the transition to paying retirement annuities on a large scale, how well diversified they are, what reserves they hold, and how well the annuity market is working. In addition, whether the new system is substituting for, or strengthening, other private mechanisms for retirement support (including family support, employer-provided pensions, private charity, etc.) will be determined.

TECHNICAL SUPPORT PLAN FOR THE SOCIAL SECURITY PROGRAM

I. Introduction

As it implements the social security program, the government will need technical support to accomplish the operation's objectives in an amount estimated at US\$15 million, to finance consulting services, training, studies and equipment. The Office of Planning and Budget will serve as executing agency of the technical support plan.

II. Description

The technical support will concentrate on four areas: (i) personnel training and development in the areas of specialization described below, primarily for the new procedures instituted with the reform and for data-processing systems where existing systems are being modernized; (ii) specific studies on the social security system, including those already agreed upon with the Bank on the reformed system's efficiency, how to increase the AFAPs' long-term investment opportunities, streamline the system of contributing-member benefits, and improve the quality of client services; (iii) equipment, largely to upgrade the BPS's computer system, which ties in with efforts to improve service to users, harmonize contribution intake and collection systems and streamline human resources to make the new system more efficient, and (iv) the consulting services needed to strengthen the system while adapting it to conform to the new rules in force, which will focus on the areas of specialization described below.

Table 1 of this annex shows the technical specialties that the training and consulting will target and gives a preliminary estimate of the person-months that each institution will require. These are:

- a. Strategic and financial management. To adjust the strategic and financial management mechanisms of the Social Security Bank and the occupational pension plans so that they conform to the new system set out in the recently enacted social security reform law, this area will include strategic planning, actuarial economic projections and analyses, cost accounting to determine administrative costs and by type of insurance, management of procurement and efficient use of facilities, preparation and evaluation of budgets and intra-agency management information systems.
- b. Human resources. The purpose of this component is to examine the size and nature of present staffing to come up with streamlining plans, propose realistic reassignment

alternatives, make staffing flexible and provide incentives, training and retraining.

- c. Core social security functions. The purpose here is to make the systems for contribution intake and collections, benefits and members' accounts more efficient and adapt them to the new rules and regulations in force.
- d. Systems. The strengthening measures under the program require that information systems be developed and introduced that fit the new structures, particularly in the case of the BPS. The computer services infrastructure will be upgraded and staff will be taught how to operate the new systems.
- e. Dissemination and public information. The new social security reform law necessitates major changes in the rules and regulations previously in force. Therefore, the law and its features have to be publicized among the general public and among the staff of the various institutions. This is the focus of this component.
- f. Legal regulatory aspects. This component includes a range of activities, from a review of the rules and jurisprudence in the area of social security in light of the new law to drafting of resolutions and their implementation at the various levels of the social security system in order to adapt the rules and regulations to the newly configured system.
- g. Coordination, monitoring and evaluation of the program. Because the program will address a variety of aspects and a number of institutions will participate, the activities will have to be coordinated and monitored, and outputs and performance evaluated. These functions will be performed, as noted earlier, by the Office of Planning and Budget.

III. Execution of the technical support plan

Funds for this component will be transferred to the government once the first tranche is disbursed. These sums will be deposited in a special account in U.S. dollars, set up in the Central Bank of Uruguay, for the sole purpose of paying for the goods and services called for in the technical support plan.

The coordinating unit will carry out the technical support component, with administrative support from the OPP's Technical-Administrative Coordination Unit (UCTA). It will engage the UNDP for procurement of goods and services, and will operate according to the procedures agreed upon with the Bank, which are being used for the program to strengthen social areas (loan 811/OC-UR) now under way. These goods and services will be financed for the institutions participating in the program, as part of the

institution-strengthening plan. This plan will be the first activity to be financed for the institutions.

The plan will begin by hiring the following: (a) staff for the coordinating unit; (b) consulting services to organize the public AFAP that will begin business on April 1, 1996; and (c) consulting services to prepare the legislation and regulations to adapt the occupational pension plans to the new social security law. For the contracting process the coordinating unit will adhere to the procedures set out in Annex C to the loan contract.

As for the other activities under this component, the coordinating unit will begin by financing the consulting services needed to prepare diagnostic studies and institutional strategic plans, including that of the coordinating unit itself. Those studies and plans will be used to draw up an institution-strengthening plan, specifying the staff training and development and consulting support and equipment that the institution will need to perform its new role in the social security system. These plans will refine the estimates presented in Table 1 of this annex and will set out the timetables for execution.

The consulting services will begin in the first half of 1996 to prepare the strategic plans of the BPS (which will be the major user of these resources), the MTSS, the coordinating unit and the Central Bank. The services pertaining to the strategic plans for the occupational pension plans will not begin until the specifics of how they will be adapted to the new system have been determined, which will not be until January 1, 1997. Likewise, the technical support that the public AFAP will require cannot be determined until it is in operation (April 1, 1996).

Preliminary studies will be needed for the equipment to determine the best specifications for the functions to be performed. The procedure described above will be used to finance these studies also. To procure the equipment thus selected, the procedures followed will be those agreed upon with the Bank, which is using the UCTA to purchase goods for the program for strengthening of social areas (loan 811/OC-UR) now under way.

The following table gives a preliminary estimate for the activities to be financed under this component.

Table 1
Technical support
(consulting services expressed in person-months [P/M] for the project's three years)

PRINCIPAL CONSULTING SERVICES	SPECIFIC CONSULTING SERVICES	MTSS	C	BPS	AIN/TC* BCU♦ AFAP♣	Cs.P.E.○	TOTAL P/M	TOTAL 1/ US\$000
I. Strategic and financial management	Strategic management: Plan			48	60	90	198	594
	Actuarial economic studies: models			6		100	106	318
	Admin. costs			36			36	108
	Administration of procurement			12			12	36
	Rational use of facilities			6		10	16	48
	Budgeting			12	6	10	28	84
	Management information system	12	24	12	12	20	80	240
II. Human resources	Reassignment and incentives			30		50	80	240
III. Core functions (SOCIAL SECURITY)	Collections			9	5	10	24	72
	Benefits:					10	10	30
	Contributing members			32	3		35	105
	Retirees and pensioners			32	3		35	105
	Members' account			18	5	10	33	99
IV. Systems (data- processing infrastructure, networks, software)			40	106	15	60	221	663
V. Dissemination and public information (internal and external)						30	30	90
VI. Legal regulatory aspects		36	40	36		30	142	426
	Implementation and supervision		30				30	90
VII. Coordination, monitoring and evaluation of the program	Management control and auditing	36	50	36	9	30	161	483
	Central government				40		40	120
	Autonomous agencies				20		20	60
	Occupational pension plans				40		40	120
	Program coordination		98				98	294
	Monitoring and administration		90				90	270
	Evaluation		40				40	120
	External advisory assistance		50				50	150
TOTAL		84	462	431	218	460	1,655	4,965
Training and development	In the same consulting areas, all institutions							1,000
Equipment	Mainly for the BPS							7,435
Specific studies	Mainly those already agreed upon with the Bank							1,000
UNDP administration	Procurement of goods and services							600

- * Auditoría Interna de la Nación/Tribunal de Cuentas [National Bureau of Internal Auditing/National Audit Office]
♦ Central Bank of Uruguay
♣ Pension fund administrators
○ Occupational pension plans
1/ Figured at US\$3,000 per consultant-month

SPECIAL CONTRACTUAL CONDITIONS

1. Special conditions precedent to all disbursements of the loan proceeds. In addition to the conditions precedent stipulated in Article 4.01 of the General Conditions, disbursements from the loan will be conditional upon the Bank's satisfaction with: (a) the progress the borrower has made with program execution and the measures agreed upon, and (b) the consistency between the borrower's macroeconomic policy framework and the program. (Clause 3.03)
2. As policy conditions precedent to disbursement of the first tranche, the borrower must present the following to the Bank's satisfaction: (Clause 3.04)
 - a. A copy of any legal undertakings whereby the MTSS, the BPS, and the BCU pledge to honor all their obligations vis-à-vis the program's execution.
 - b. General regulations under Law 16,713 governing the new social security system. These regulations shall address, among others, the following elements: (i) the survivor's pension system; (ii) formation, start-up and control of AFAPs, and delimitation of the various levels and options that the Law provides; (iii) the first- and second-pillar pension system (pay-as-you-go and savings, respectively); (iv) taxable items for purposes of special social security levies; (v) rules on advertising, promotion and disclosure by AFAPs; (vi) the formula for computing the return on the mandatory individual savings system, and (vii) disability and survivor's insurance contracts.
 - c. A report defining the institutional and administrative efficiency indicators previously agreed upon with the Bank for implementation of the BPS's strategic plan for a base year, referred to in Annex II-2 to the loan document.
 - d. Evidence that the following are in place and operating: (i) the first AFAP, which will be a public-sector agency; (ii) the BCU unit in charge of overseeing AFAPs, both public and private; (iii) the technical staff within the OPP, MTSS, BPS and BCU who will be in charge of the program's execution, and (iv) the evaluation and monitoring committee (hereinafter the "Committee") composed of senior officials of the principal institutions involved in Uruguay's social security system, whose mandate will be to monitor the program and propose any measures necessary for the new social security system to function smoothly, as practical experience is gained in its workings.

- e. A plan, with a timetable, for implementation of the technical support plan referred to in Annex II-6 to the loan document, to ensure the coordinated execution of the program. The procedures set out in Annex C to the contract are to be followed in selecting and hiring consultants for the technical support plan. The United Nations Development Programme, which will be hired directly, will arrange for these contracts on behalf of the Republic.
 - f. The terms of reference of the following studies: (i) impact of the new social security system; (ii) operation of the domestic capital market, identifying long-term investment opportunities for AFAPs; (iii) streamlining of the benefit system for contributing members, and (iv) the quality of client services.
3. As policy conditions precedent to disbursement of the second tranche, the borrower shall present the following to the Bank's satisfaction: (Clause 3.05)
- a. Evidence that the Law and its general regulations, mentioned in subparagraph (b) of clause 3.04, have entered into force.
 - b. Drafts of the bills to adapt the occupational pension plans to the new social security system.
 - c. Evidence that the BPS's strategic plan, referred to in subparagraph (c) of Clause 3.04, has been prepared and that satisfactory progress has been made on the plan's implementation, including a review of the indicators agreed upon for the base year, publication thereof, and establishment of performance targets for the BPS. The borrower or executing agency must show that consultants specializing in strategic-administrative-institutional planning have been hired to help carry out the plan.
 - d. Evidence that the institutional framework of the AFAPs to which subparagraph (d)(i) and (ii) of Clause 3.04 refers has not been changed in any way that, in the Bank's judgment, might adversely affect the workings of the new social security system.
 - e. Evidence of the commencement of the study on the workings of the domestic capital market referred to in subparagraph (f)(ii) of Clause 3.04.
 - f. The study on streamlining the system of benefits for contributing members referred to in subparagraph (f)(iii) of Clause 3.04.

- g. Through the Committee, a mid-term report on the new social security system, adhering to the terms of reference specified in subparagraphs (f)(i) and (iv) of Clause 3.04.
 - h. Evidence that the technical support plan is under way, following the timetable referred to in subparagraph (e) of Clause 3.04.
 - i. A report showing the percentage of contributors not required to join the individual savings plan who have elected to do so (regardless of their age on the effective date of the Law or their earnings). The percentage shall be calculated in regard to members under age 40 on the effective date of Law 16,713 who earn less than Ur\$5,000 a month (May 1995 pesos).
4. As policy conditions precedent to disbursement of the third tranche, the borrower shall present the following to the Bank's satisfaction: (Clause 3.06)
- a. Evidence that the Law and regulations referred to in subparagraph (a) of Clause 3.05 have not been amended in any way that, in the Bank's judgment, could adversely affect the workings of the new social security system.
 - b. Evidence that the laws and enabling regulations to adapt the occupational pension plans referred to in subparagraph (b) of Clause 3.05 have entered into effect.
 - c. The study on the workings of the domestic capital market referred to in subparagraph (f)(ii) of Clause 3.04.
 - d. Evidence that further satisfactory progress has been made on implementation of the BPS's strategic plan, as stipulated in subparagraph (c) of Clause 3.05.
 - e. Evidence that the AFAPs' institutional framework, to which subparagraphs (d)(i) and (ii) of Clause 3.04 refer, has not been modified in any way that, in the Bank's judgment, would adversely affect the workings of the new social security system.
 - f. Evidence that recommendations of the study on streamlining the system of benefits for contributing workers that have been approved by the parties to the loan contract, referred to in subparagraph (f) of Clause 3.05, have been implemented.
 - g. Presentation by the Committee of a final report on the impact of the new social security system, and proof that it has been made available to the public, pursuant to the terms of reference stipulated in subparagraphs (f)(i) and (iv) of Clause 3.04.

- h. Evidence that the program's technical support plan has been carried through in accordance with the timetable to which subparagraph (e) of Clause 3.04 refers.
- i. A report showing the percentage of contributors not required to join the individual savings plan who have elected to do so (regardless of their age on the effective date of the Law or their earnings). The percentage shall be calculated in regard to members under age 40 on the effective date of Law 16,713 who earn less than Ur\$5,000 a month (May 1995 pesos).

UR-0108
LEGI/UR-0477
Original: Spanish
Appendix

PROPOSED RESOLUTION

URUGUAY. LOAN ____/OC-UR. TO THE REPUBLICA
ORIENTAL DEL URUGUAY
(Social Security Reform Program)

The Board of Executive Directors

RESOLVES:

That the President of the Bank, or such representative as he shall designate, is authorized, in the name and on behalf of the Bank, to enter into such contract or contracts as may be necessary with the República Oriental del Uruguay, as Borrower, for the purpose of granting it a financing to cooperate in the execution of a sectoral social security reform program. Such financing will be for the amount of up to US\$150,000,000, or its equivalent in other currencies, except that of Uruguay, which are part of the ordinary capital resources of the Bank, and will be subject to the "Terms and Financial Conditions" and the "Special Contractual Conditions" of the Executive Summary of the Loan Proposal.