CENTER FOR ECONOMIC AND POLICY RESEARCH

THE ROLE OF SOCIAL SECURITY PRIVATIZATION IN ARGENTINA'S ECONOMIC CRISIS

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In July of 1994, with the strong support of the World Bank, Argentina partially privatized its Social Security system.[2] In December of last year, Argentina finally removed its currency from its peg with the dollar, and halted payments on its debt, after four years of recession. These moves came in response to a situation that had clearly become untenable. The nation was paying ever higher interest rates to finance a debt that was continually growing, due to the country's extraordinary interest burden.[3] By December it was clear that there was no way out of this vicious circle without both a devaluation of the currency and some reduction of the interest burden. Argentina is currently negotiating with the IMF to allow for a resumption of normal credit relations, but regardless of the outcome of these negotiations, it is generally expected that Argentina will see a further large decline in its GDP.

While the decision to peg its currency to the dollar would have created problems in any case, the decision to privatize Social Security made Argentina's situation more precarious. The reason is simple—Social Security privatization deprived the government of a large amount of tax revenue. Payroll taxes that had gone to the government to support the old pay-as-you-go Social Security system were instead diverted to private accounts. As a result, the government lost an amount of revenue that has been estimated at 1.0 percent of annual GDP (the equivalent of $100 billion a year in the United States) (International Monetary Fund, 1998, p 9).

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[2] See World Bank 1996 and Holzmann 2000.
[3] It is important to note that Argentina's deficits were entirely attributable to interest payments. It had a surplus on its primary budget (revenue minus non-interest expenditures) in 2001, as it did virtually throughout the nineties. See CEPR publications, "What Happened to Argentina" and "When Good Parents Go Bad: The IMF in Argentina," on www.cepr.net.

Argentina's government had to borrow to make up for this lost revenue.[4] Argentina was forced to pay a very high interest rate on its new debt, as a result of a series of external events beginning with the US Federal Reserve's interest rate hikes in February of 1994, and the series of emerging market financial crises (Mexico, East Asia, Russia, Brazil) that followed**.** Therefore, the borrowing that was needed to finance Social Security privatization came at a very high cost. This cost quickly grew, as higher debt led to higher interest payments. Table 1 shows the impact that Social Security privatization had on Argentina's deficits and debt in the years from 1994 to 2001. These calculations assume that no offsetting adjustments were made to Argentina's budget to compensate for these deficits. As can be seen, the deficits created by the lost Social Security tax revenue and resulting interest payments grew rapidly, so that by 2001 they were nearly equal to 3.0 percent of GDP.

Table 1: The Impact of Social Security Privatization on Argentina's Budget
(percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001
Lost Soc. Sec. Rev	-0.5	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Interest Rate (percent)	10.0%	10.0%	10.0%	10.0%	14.0%	14.0%	20.0%	20.0%
Interest Costs	-0.01	-0.10	-0.20	-0.30	-0.60	-0.86	-1.59	-2.16
Additional Deficit	-0.51	-1.10	-1.20	-1.30	-1.59	-1.86	-2.59	-3.16
Cumulative Debt	-0.51	-1.62	-2.72	-3.83	-5.35	-7.50	-10.05	-13.49

Source: IMF 1998, IMF 2001 and author's calculations. See appendix.

In fact, the deficit created by Social Security privatization is almost exactly equal to the government budget deficits that Argentina ran in these years. Table 2 shows Argentina's revenue, non-interest spending, total spending, and deficit or surplus in each of the years from 1994 to 2001, measured as a share of GDP. The last row in table 2 shows the deficit assuming that Argentina had not chosen to privatize Social Security. This is calculated by deducting the additional deficit calculated in Table 1 from the actual deficit. The table shows that budget would have been very close to balanced in each of the last five years, if it had not been for the tax revenues that were lost as a result of Social Security privatization. In short, the country would have had little difficulty covering its bills, and there is no reason to believe that it would be facing the same sort of crisis and loss of confidence that it has at present.

[4] Argentina did sell several state owned companies and other assets to help finance its transition to a privatized Social Security system, but it had the option to sell these assets in any case.

Table 2: National Government Spending and Deficits in Argentina
(percent of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001
Revenue	19.84	19.49	17.52	18.91	18.98	20.61	19.90	19.10
Non-interest spending	18.73	18.44	17.76	18.41	18.11	19.40	18.90	18.54
Total Spending	19.95	20.07	19.45	20.37	20.34	22.30	22.29	22.12
Deficit	-0.11	-0.53	-1.93	-1.46	-1.36	-1.68	-2.39	-3.02
Deficit W/O SS Priv	-0.60	0.57	-0.73	-0.16	0.23	0.18	0.20	0.14

This set of calculations is based on the important assumption that everything else is held constant. Clearly this is not likely to have been the case: as a result of its deficits, Argentina made cutbacks in other spending and raised taxes, which it would not have done if its deficit was not posing a large problem. Nonetheless, it is reasonable to ask what Argentina's budget would have looked like, if everything else had been the same, but the government had not privatized Social Security.[5]

The economic collapse that resulted from Argentina's inability to continue to finance its deficits ultimately affected Argentina's Social Security program. As part of a loan agreement with the IMF, Argentina cut the benefits in its traditional Social Security program by 13 percent in September of 2001 (IMF 2001, p 3).[6]

The irony of this action is that Argentina's decision to privatize Social Security in 1994 helped to touch off a financial crisis, which ultimately forced much more draconian cuts in Social Security than ever would have been contemplated in 1994. While no one could have foreseen the exact path of subsequent events in 1994, it should have been obvious that the additional deficits created by the privatization of Social Security would lead to serious pressures on the budget. The risks were made even greater due to the constraints imposed by the peg of Argentina's currency to the dollar. The fact that the government and international financial institutions apparently did not take these risks into account in promoting Social Security privatization was a serious and costly error.

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[5] It is worth noting that Argentina's interest rate on all its debt probably would have been considerably lower, if it did not have the deficits that resulted from Social Security privatization. In this way, the calculations in Tables 1 and 2 may understate the impact of Social Security privatization on Argentina's deficits.

[6] Some proponents of privatization argue that the government debt created by privatizing Social Security programs should not be viewed as new debt, since it is just replacing implicit debt -- in the form of pension obligations to future retirees -- with explicit debt. It seems clear that the financial markets did not take this view, nor did the IMF. The IMF insisted that Argentina balance its budget as a condition of new loans. Had it accepted that the explicit debt and implicit debt of the pension fund were equivalent, it would have allowed for a deficit equal to the amount of lost revenue from privatizing its Social Security system.

Appendix

The calculations in table 1 assume that the tax revenue lost to Social Security privatization was equal to 1.0 percent of GDP based on the IMF's estimate (IMF, 1998). Since the privatization began in the middle of 1994, the lost revenue for the year is assumed to be 0.5 percent of GDP. The interest rates shown in the second row are estimates of Argentina's nominal cost of borrowing at the time. The third row shows the additional interest costs accrued each year due to the loss of current tax revenue plus the accumulated debt from prior years. It is assumed that the government must pay interest on half of the lost revenue for the year, since the losses are spread out over the full year. The fourth row shows the additional deficit, measured as a share of GDP, that is attributable to the combination of lost tax revenue and additional interest costs. The last row shows the cumulative increase in the debt as a result of the interest cost.

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