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Commentary

Uruguay's Pension Reform Supports Long-Term Sustainability of Public Finances

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Key Highlights

- Uruguay's rapidly ageing population could put upward pressure on pension spending over time.
- Passage of pension reform in Uruguay will improve fiscal sustainability, though recent changes to accommodate the government's coalition partners have watered down the fiscal savings.
- Pension reform will likely be the last big legislative push of this government, given the electoral calendar and tensions within the coalition.

Yolanda Ngo
Assistant Vice President, Credit Ratings
+1 212 806- 3276
yolanda.ngo@dbrsmorningstar.com

Michael Heydt
Senior Vice President, Credit Ratings
+1 212 806-3210
michael.heydt@dbrsmorningstar.com

Thomas Torgerson
Managing Director, Co-Head of Sovereign Ratings
+1 212 806-3218
thomas.torgerson@dbrsmorningstar.com

President Lacalle Pou signed a pension reform bill into law on May 3 after approval in Congress along party lines. Key measures of the reform include raising the retirement age, increasing the number of years workers need to contribute, and harmonizing pension regimes across different professions. Since taking office in March 2020, the government has introduced a new fiscal framework and taken substantial cost-cutting measures. Pension reform — even though it was watered down from the initial proposal — represents the next step in the government's objective to strengthen the sustainability of Uruguay's public finances.

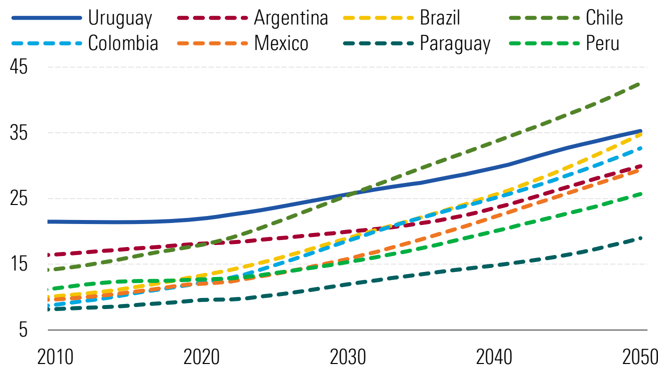
Pension reform is necessary to ensure fiscal sustainability due to the country's demographics. The Uruguayan population, already one of the oldest in the region, is rapidly aging even as the birthrate is falling. According to Uruguay's national statistical office (INE), the old-age dependency ratio (ratio of people aged 65+ relative to the working age population) will steadily rise from 23% in 2023 to 35% in 2050 (Exhibit 1). Without reform, government projections indicate that pension spending would rise from 9.4% of GDP to 10.5% by 2050 and 11.8% by 2090. Upward pressures on pension spending — as well as healthcare-related expenditures — could eventually crowd out spending on other government priorities or contribute to higher deficits.

We view passage of the pension reform positively, even though the cost savings may not be evident for years or decades. The main parametric change of the reform raises the retirement age to 65 from 60 for those who have contributed for 30 years. The reform gradually harmonizes contributions and benefits across different profession categories (including notaries, banking personnel, university professionals, the military, and the police). In addition, the reform grants retirees the right to work even when receiving retirement benefits and includes a solidarity supplement to top up workers with smaller pensions.

Concessions made to secure passage of the reform have reduced the fiscal savings relative to the government's initial proposal, although the extent of the impact is still unclear. Following last-minute negotiations, President Lacalle Pou and the Cabildo Abierto party agreed to increase the benefit calculation to the highest 20 years of earnings, instead of the initial proposal of the highest 25 years. The compromise still represents cost savings relative to current law, which is based on the highest 15 years of earnings. Similarly, President Lacalle Pou agreed to some amendments sought by the Colorado party, including allowing workers to retire at the age of 63 if they have completed a greater number of years of contributions; reducing the tax on social security transfers (including retirement benefits) by 20% over the next 3 years; and introducing a more gradual increase in the retirement age, rather than a step-change for those born in 1973.

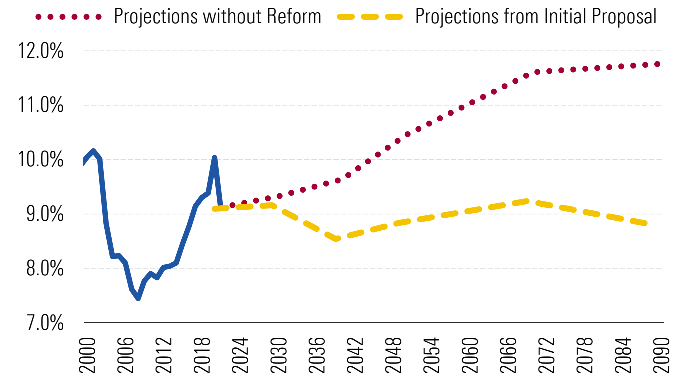
Under the original reform proposal, pension payments were expected to stabilize around 8-9% of GDP (Exhibit 2). The primary difference between the final reform and the original proposal was the reduction of benefits calculation. The lower tax on social security transfers will also reduce social security revenues. Although the cumulative impact of the concessions will likely be material, the modified reform should still generate significant savings relative to a no-reform scenario.

Exhibit 1 Old Age Dependency Ratios Across Latin America (per 100)



Source: Instituto Nacional de Estadística (UY); United Nations; Haver Analytics; DBRS Morningstar.

Exhibit 2 Pension Payments (% GDP)



Source: Ministerio de Economía y Finanzas (UY); Banco Central del Uruguay; Haver Analytics, DBRS Morningstar.

The pension reform appears likely to be the last major legislative initiative by the Lacalle Pou administration. With general elections approaching in October 2024, the political environment will likely become less conducive to substantive legislative dealmaking by the second half of this year. Furthermore, growing tensions within the government's Multicolor Coalition, which currently holds majorities in both houses, could limit cooperation and potentially lead to a split in the coalition prior to the election. Nonetheless, the Lacalle Pou administration looks set to leave Uruguay's public finances in a better position for future governments.

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