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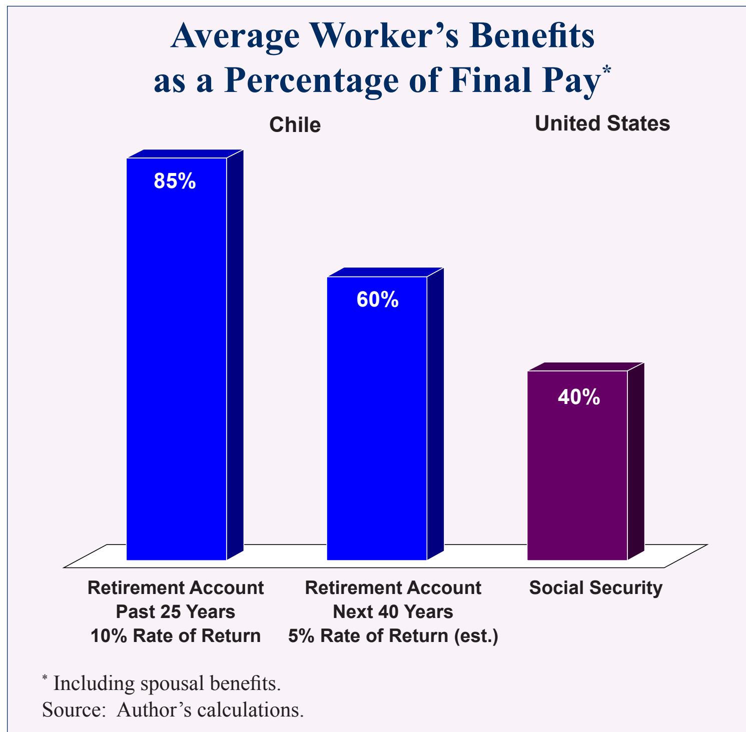
Pension Reform in Chile: Closing the Gap, Not Scrapping the System

by Estelle James

A quarter-century ago, Chile replaced its traditional social security system with personal retirement accounts funded by workers and invested in stocks and bonds. Chile's president recently proposed several modifications to its pension system, including a new retirement benefit funded by general government revenues. Long-time critics of Chile's pension system have been quick to claim the proposed reforms are proof of the system's failure. Unfortunately, the critics fail to distinguish between a system that functions well for contributors versus one that is designed to give benefits to noncontributors.

How the System Works. Chile's pension system features privately managed individual accounts. Chilean workers are required to contribute 10 percent of their wages to their personal pension accounts — plus another 2.5 percent to 3 percent for administrative expenses and survivors and disability insurance.

The accounts are managed by pension funds that must invest according to very strict guidelines. Payouts are also tightly circumscribed: Workers can choose between annuities and programmed withdrawals. For annuities, workers turn their accounts over to an insurance company and receive a guaranteed income for life, indexed for inflation. For programmed withdrawals, the account is left with a pension fund administrator and retirees annually withdraw an amount determined by a preset formula. Regardless of the option chosen, the government guarantees a minimum pension amount to all workers who contributed for 20 years.



* Including spousal benefits.
Source: Author's calculations.

The Current System Is Working. The Chilean system functions very well for workers who contribute regularly:

- An average Chilean worker who contributes for all 40 years of his working life and retires at age 65 will get a price-indexed pension that is 60 percent of his final wage, assuming his account earned a 5 percent rate of return; the pension will also cover his wife after he dies.
- Even if he contributed for only half his working life, he would still get 30 percent of his final wage.
- If he began contributing 25 years ago when the system began and earned the 10 percent average rate of return it has yielded since inception, his pension would be 85 percent of his final wage.

These numbers are much higher than the replacement rate an average full-career, middle-income worker gets from Social Security in the United States — about 40 percent of final wages.

The Problem of Noncontributors. Most criticism of the Chilean system focuses on individuals who do not contribute regularly or at all. Noncontributors are very common in low- and middle-income countries because governments do not have the capacity to enforce contribution collections on small firms, self-employed individuals or agricultural and other rural workers who form a large portion of the labor force. This is why Chile has not required contributions from the self-employed or independent contractors until now.

Mandatory public pension systems were started, in large part, because people will not save enough for old age voluntarily and will not contribute unless the mandate is strongly enforced. Even in the United States and Japan, two highly developed economies, government has trouble collecting correct contributions from the self-employed. Because of the administrative difficulties,

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farm workers in the United States were not originally covered by Social Security.

Due to the limited ability of low- and middle-income countries to enforce mandatory contributions, when social security benefits are closely tied to contributions many people (both rich and poor) accumulate only small pension rights.

How Some Countries Handle Noncontributors. Countries have handled the problem of noncontributors and enforcement in several different ways. Some countries do nothing and leave the noncontributors to rely on their own savings and families. Some Latin American countries traditionally offered benefits that were only loosely tied to contributions. Some low contributors (including rich people) got much more than their contributions. These systems ran large deficits, which caused major fiscal problems for the government's general budget. This is the reason why many of these countries have switched to fully funded defined contribution plans, as in Chile. In doing so, they avoid creating a huge fiscal burden and making promises they ultimately cannot keep.

Some European countries take another approach. They pay every person over age 65 a flat (uniform) benefit, financed out of general revenues, regardless of whether or not they have contributed. The high and increasing cost of these programs is leading these countries to shift toward means-testing these benefits.

In the United States, individuals who have not worked full careers, and therefore have low lifetime earnings, receive a higher rate of return for their Social Security taxes. This includes married women with limited contribution histories, some with rich husbands and some with poor ones.

Compensating for Noncontributors. Chile has handled the problem of low contributors in several ways:

- Because many of the low contributors are married women who retired from the labor market when they had children, husbands in Chile are required to purchase joint pensions when they retire; this covers their widows (at 60 percent of the primary benefit) as well as themselves, without imposing a cost on the general treasury.
- Workers with 20 years of contributions are guaranteed a minimum pension by the government, financed out of general revenues.
- Workers with less than 20 years of contributions are eligible for the smaller means-tested benefit (PASIS), also financed out of general revenues.

However, these arrangements left several gaps. The PASIS benefit was small and the general funds appropriated for it were not large enough to cover all eligible individuals. Workers with less than 20 years of contributions were not eligible for the minimum pension guarantee and many also did not receive PASIS. Widows of husbands with small pensions were even worse off, since they lived longer and got an even smaller widow's pension.

Closing the Gaps. To remedy these deficiencies, the government is now proposing to replace the minimum pension guarantee and PASIS with a new public benefit, financed by general tax revenues and targeted toward lower-income households — the bottom 60 percent of the income distribution. This will ensure that all low- and middle-income seniors get some benefit, even if they have not contributed.

Unfortunately, the amount of the new benefit will be reduced for those workers who have made some contributions to their pension account. The public benefit gradually phases out as the worker's own pension grows. This offset implicitly imposes a 37.5 percent tax on pensions from contributions until the public benefit is completely gone. This may further discourage such workers from making the mandatory contributions to their accounts. A flat benefit that is not phased out, as in some European countries, would avoid this disincentive but would cost more. The government also proposed strengthening the retirement account system by requiring the self-employed to contribute and by subsidizing the contributions of younger workers to encourage their participation.

> ***"The pension account of an average Chilean worker who contributes for all his working life will be 60 percent of his final wage and will cover his wife after he dies."***

Conclusion. The Chilean government is not getting rid of its funded retirement system. President Michelle Bachelet began as a skeptic of Chile's personal accounts, but acknowledged to Parliament that the evidence shows "it will pay good pensions to those who contribute on a regular basis." She has suggested ways to fill in the gaps left by people who do not contribute regularly. Every contributory scheme has these gaps, including the United States, and they are especially large in low- and middle-income countries like Chile. Chile is now in the process of rethinking its arrangements for filling these gaps, while retaining its successful system of personal accounts as its main pension plan for contributors.

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