

## PRIVATE ACCOUNTS IN CHILE

### Background

In 1924, Chile was a pioneer in the development of social security, becoming the first country in the Americas to establish a social security program. In 1981, Chile was again a pioneer, ending that program and requiring that all new private sector employees participate in a private account system.

The Chilean system mandates that each employee contribute 10 percent of pay to a private account that he or she selects. Each month, the employer sends that amount to the worker's pension fund provider.

Chile has continued to be a pension innovator, making a number of reforms since its private account system started in order to strengthen the system.

### Portfolio choice

When the system was started in 1981, each pension fund provider could provide only one fund, and all the providers maintained similar investment portfolios. Now each provider may provide up to five different funds, varying in level of risk.

### Default fund varies by age

One of the Chilean innovations is that the default fund, into which workers who do not choose an investment fund have their contributions placed, varies by age, having lower risk for older workers.

### Fees

Fees have been high in the Chilean system. Cumulated over the working life, 28 percent to 33 percent of the contributions of the average Chilean worker who retired in 2000 went to fees,

according to one study (Gill, Packard, and Yermo 2005). A different study has calculated a lower but still substantial figure of 16 percent (James, Smalhout and Vittas 2001).

### Workers have avoided participating in the private account system

The proponents of the Chilean private account system thought it would be popular with workers (World Bank 1994). However, low worker participation through contribution evasion has been a problem, even though the system is mandatory. Only 63 percent of Chilean workers participate in the system (Gill, Packard, and Yermo 2005).

### Low benefits for some workers

While providing high real rates of return in its early years, the Chilean pension system has failed to provide adequate benefits for many workers, in part because of workers under-reporting their wages and under-paying their required contributions. A majority of workers surviving to their mid-80s are expected to receive at least some of their retirement income from anti-poverty benefits (James, Martinez, and Iglesias 2004).

### Flexible retirement age

The normal retirement age is 65 for men and 60 for women. However, there is flexibility in the retirement ages in that workers can retire earlier if they have accumulated a sufficient amount in their private account to provide benefits that will keep them above the poverty line.

### Inequities across birth cohorts

Because of differences over time in the rates of return in financial markets, there

have been large differences in rates of return received by people born in different years. The cumulative average rates of return have ranged from 4 percent to 11 percent for different birth cohorts (Gill, Packard, and Yermo 2005).

### **Reduced influence of demographic changes**

The Chilean pension reform has reduced the influence of demographic changes. While changes in life expectancy affect the benefit levels that the private accounts can provide, changes in the old-age dependency ratio do not affect benefit levels.

### **Voluntary savings discouraged**

The high ceiling on covered earnings in Chile has discouraged workers from saving voluntarily because, even at relatively high income levels, they are required to contribute to the mandatory program (Gill, Packard, and Yermo 2005).

### **Expensive and Lengthy Transition Period**

A transition cost to the government resulted from ending the previous social security system but still needing to pay benefits to workers who had accrued benefits in that system. That cost peaked in the first decade of the reform at about 5 percent of GDP. The cost is projected to continue at a high level for many

years, still exceeding 1 percent of GDP after more than 40 years (Edwards 1998).

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