CHILE’S EXPERIENCE WITH THE PRIVATIZATION OF SOCIAL SECURITY

Introduction

In 1981, Chile replaced its public defined benefit social insurance system with a private mandatory defined contribution scheme. Participants in the old system were given the choice of remaining with that system or transferring to the new, and most workers chose to move. As of 1983, the old system, which is being phased out, was closed to new labor force entrants.

Chile’s privatization of social security represents a radical transformation of a “traditional” social insurance system that has been described as the “shot. . . heard around the entire social security world” (Myers 1992: 41). Indeed, while only a handful of countries have in any way followed in Chile’s footsteps, many countries, faced with problems similar to those that led to reform in Chile, have been drawn to the Chilean experiment.

Chile in the 1970s: A Social Security System Under Stress

Introduced in 1924, Chile’s original social insurance system—the first such program in the Americas—actually evolved not as a single unified system but as a number of separate systems for workers in different occupations. Despite the fact that the scheme eventually consisted of over 30 funds varying in size, by the late 1970s, the large majority of contributors were covered by the three funds for government employees, salaried employees, and manual workers.

Both employers and employees contributed to social security through payroll taxes. As outgo began to exceed revenue, government subsidies were required as well. By the mid-1970s, the government payout for health, pensions, and social security contributions for government workers amounted to more than 20 percent of government expenditures (Diamond 1995).

Although a build-up of surplus funds was anticipated when the system was established, Chile’s social security system was essentially pay-as-you-go (Myers 1992). With time, the maturation of the system, coupled with an aging population, would result in an increase in the dependency burden such that further substantial increases in the payroll tax and/or government expenditures would be needed to keep the system afloat.

No single, centralized agency had responsibility for managing social insurance programs in Chile. Consequently, Chile’s social insurance system was plagued by high administrative costs and bureaucratic inefficiencies.

One of the major weaknesses of Chile’s social insurance scheme was the differential treatment of retirees in different systems. Benefits for some retirees, for example, amounted to 100 percent of salary over the final years of work, while others saw far less of their wages replaced. The indexing of the salaries used in calculating pensions differed among systems, which also affected benefit levels. In addition, service requirements and the age of eligibility for benefits sometimes varied. Inequities such as these were hardly conducive to generating and maintaining widespread satisfaction with or support for social security in Chile.

The 1981 Social Security Reform

The reform of Chile’s social insurance system, which was introduced during the military dictatorship of Augusto Pinochet, was designed to reduce public sector social...
insurance costs and eliminate the inequities endemic to the old system. Under the new scheme, private, profit-making, pension fund administrative companies, or AFPs (Administradoras de Fondos de Pensiones), invest and manage workers’ social security contributions. These companies, of which there were 22 in mid-1995, are government-approved and function under strict government regulation and the supervision of the Superintendancy of AFPs.

An individual annuity account is established for each worker, who “affiliates” with the AFP of his or her choice. Affiliation is mandatory for employees and voluntary for the self-employed. The military are excluded.

Mandatory payroll deductions amounting to 10 percent of earnings up to an indexed maximum are invested in the AFP fund the worker has chosen. Myers (1992: 46) reports that this maximum amounts to about 5.25 times the average salary of covered workers. Workers may also make voluntary deposits to the mandatory saving account. Both the mandatory and any voluntary deposits are tax-deferred. Employers contribute nothing toward old-age pensions under this new system.

To ensure that the savings employers would realize from reform were passed on to workers—who were presumed to have received lower wages in lieu of benefit contributions—employers were required to provide an 18-percent across-the-board wage increase to employees at the time of reform.

Workers may also contribute to a voluntary second savings account maintained by the AFP holding the mandatory account. Contributions to this second account are not exempt from taxes, although interest earned is tax-deferred (Diamond and Valdés-Prieto 1994: 268). Withdrawals from this account are allowed. Withdrawals from the basic annuity account are permitted only for pensions.

In addition to the 10-percent payroll deduction, workers are required to contribute a portion of their wages to purchase private life and disability insurance, as well as medical insurance. Total social security contributions amount to about 20 percent of taxable income.

Workers may shift their contributions from one fund to another, but they are not allowed to have more than one annuity account at a time. Likewise, AFP managers are allowed to manage only one fund. Intended to protect workers and their investments, these restrictions have been criticized for limiting workers’ ability to spread their risks and managers’ ability to broaden their investment expertise (World Bank 1994).

Under the privatized system, old-age pensions are payable to men at age 65 and to women at age 60. (Under some circumstances, earlier retirement is possible.) Ultimately, a worker’s pension will depend solely on accumulated investments and the returns to those investments. However, in the early years of the new privatized system, many workers will reach retirement age with substantial work records under the old public system.

To protect earlier contributions, the government guarantees a “transfer voucher” or “recognition bond” that takes those earlier contributions into consideration. Upon retirement, the bond amount, indexed and interest-paying, is transferred to a worker’s individual annuity account. Benefits for workers with time under both schemes are based on the transferred contributions plus accumulated contributions (mandatory and voluntary) to the new scheme.

A distinguishing feature of the new Chilean pension system is a government-guaranteed minimum pension for insured workers who have contributed to the system for at least 20 years, but whose AFP pension falls below a certain level. Unindexed, the minimum benefit is adjusted from time to time. The non-insured may be entitled to a public assistance pension.
from the state. Both the minimum pension (or, more precisely, the difference between what the worker’s contributions provide in the way of a benefit and the minimum amount, if that is higher) and the public assistance pension are financed from general revenues.

Upon retirement, Chilean workers select a benefit payment structure. A retiree may contract with an insurance company, which disperses a fixed, inflation-adjusted lifetime benefit to the retired worker and survivors’ benefits to dependents. Alternatively, a worker may make phased withdrawals that are recalculated each year according to the balance in the account and the life expectancy of the retiree’s family group. At any time, the retiree selecting this option may convert to a lifetime fixed annuity.

**Fund Investments**

AFPs can engage only in fund investment and management. Government restrictions are placed on investments to limit risk and ensure diversification; however, some initial investment restrictions have been eased. Government guarantees also help insure against investment loss. Within limits, funds may invest in government obligations, as well as in mortgage securities, bank term deposits, corporate stocks, bonds, and foreign securities.

Initial returns to investments have been high. Gross annual real returns averaged 13 percent and average net yield to affiliates was 9.2 percent during the first ten years of the new system (World Bank, 1994: 213), well above original projections; however, the returns have not been consistently high. In 1992, the annual average return plummeted to 1.1 percent before rebounding to 15 percent in the first nine months of 1993 (“Privatization of Pensions in Latin America” 1994: 136). Over any short period of time, extreme fluctuations in returns cannot be discounted.

By law, funds are required to show a profit, the amount of which is related to average investment returns for the entire system over the previous 12 months. Any shortfall must be made up from an AFP’s profit or investment reserves. If reserves are insufficient, the state guarantees the difference; the fund is dissolved, and accounts are transferred to another fund of a worker’s choosing.

In part due to government regulation, variation in return among funds appears to have been relatively narrow, at least during the first ten years. Myers (1992: 51) presents data showing that the 1981-90 average annual real rate of return across funds ranged from 12.5 percent to 14 percent.

**Benefits**

The architects of the reform anticipated that the new system would yield retirement benefits above what the old system has provided, especially to the extent that they were supplemented by voluntary contributions. Some supporters of the new private system believe that over the long-run, pension levels could amount to 70 percent of earnings in the last years of work (Scarpaci and Miranda-Radic 1991), far more than the 20 percent that the old scheme was paying many workers in the 1970s (see Williamson and Hochman 1994: 9). However, not all observers are convinced that the high rates of return necessary to achieve this replacement rate can be sustained over the long run (Gillion and Bonillo 1992; Tamburi 1993; World Bank 1994).

Projected benefits depend greatly on the assumptions underlying the projections, and, assert Marcel and Arenas (1992: 45) in a report for the Inter-American Development Bank, “the estimates concerning pensions to be paid in the future... are based on simulations whose assumptions do not necessarily reflect the reality of the entire system.” Thus, benefits could turn out to be at or below subsistence for a large proportion of future retirees.
While warning that averages can be misleading, Myers (1992) notes that average old-age benefits under the new and old systems were comparable in 1990. Mesa-Lago (1994) simply reports that benefits for the initial retirees have been higher. If Codevilla (1993: 135), is correct, benefits are, on average, about “40 percent more than [those of] retirees in the state system. . .”, but that only indicates that retirees are better off than they would have been, not that they are well off.

In fact, the International Center for Pension Reform (1995: 7), an advocate for expanding a Chilean-type system beyond Chile, contends only that “at present, six out of seven workers who reach retirement age have AFP savings that yield pensions in excess of the government-subsidized minimum.” At about 22 percent of average wages in 1991 (Gillion and Bonilla 1992: 178), that minimum hardly appears overly generous. Still, it represents some 80 percent or more of the minimum wage, so the pension is not low when compared to the earnings of many Chilean workers.

Too high a minimum risks becoming a work or contribution disincentive. Moreover, raising the minimum benefit under the new system must be considered in the context of several hundred thousand retirees under the old system who currently receive comparable benefits. An increase in the minimum for retirees in the new system would put pressure on the government to raise benefits for retirees under the old one.

Evaluation of the New System

Although little more than a decade old, the new Chilean system receives praise on a number of fronts. Myers (1992: 45) concludes that the reformed system “both as to its design and as to its performance--is excellent.” Nonetheless, for reasons discussed below, he does not recommend similar reform for the U.S. Social Security system.

Among the virtues of Chile’s new system, according to Scarpaci and Miranda-Radic (1991), are greater accountability than under the old system and, at least to date, the greater yield on investments. Benefits are adjusted for inflation, and workers are guaranteed a minimum benefit. Survivors’ benefits and disability benefits (which are not the subject of this overview) are higher under the new system. The Chilean system is now fully funded and portable, with all the benefits those two features entail. Deteriorating support ratios should be far less cause for concern under this defined contribution system than they were under the pay-as-you-go system it replaced.

Diamond (1995: 2) applauds the Chilean approach for “defending the system from political risk” and for its impact on capital formation. Mesa-Lago (1994: 131), however, argues that “there is no evidence that the capitalization system has generated higher national savings” (see also Marcel and Arenas 1992).

It is by no means the case that privatization of Chile’s social security system has led to greater administrative efficiency or lower costs. Administrative costs have, in fact, been high (but falling), and some fault the regressivity of flat commission fees paid by contributors.

Contributing to the high administrative costs of the Chilean system has, apparently, been a high degree of shifting among funds on the part of AFP participants. Efforts have been undertaken to discourage too frequent shifting—and so modify what has been touted as one of the most desirable features of the new system, ability to transfer among funds—by increasing the costs of fund transfers.

Marketing costs to attract new members to the AFPs can also be substantial, as membership volume is critical to profitability. Some funds have substantially more employees devoted to sales than to fund administration and management (Hansell 1992: 81). In
centralized government-run systems, marketing and sales costs are non-existent.

The new system has introduced uniform norms and standards, according to which all contributors and retirees are treated alike. Equity, however, can be at odds with adequacy and is not necessarily the most significant objective of social security systems. Diamond gives the new Chilean system low marks when it comes to the provision of insurance, a fact that others deplore as well. Schulz (1993: 72) argues that the new system “contains no elements of mutual protection (i.e., insurance) between members of the labor force,” since workers’ benefits depend on their own contributions to the system.

To be sure, the new system’s minimum benefit is aimed at providing a floor of protection, even though that benefit alone may be far from adequate in meeting a recipient’s basic needs. Overall, however, an important element of social insurance schemes, namely its redistributive function, is largely missing in the new defined contribution Chilean system. Indeed, not only are the benefits of lower wage earners not subsidized by higher earners, but higher wage earners gain more from the tax deferral of their AFP investments.

Even so, at least to now, contributors overall seem to have benefited from lower contribution rates, what appears to be for Chile a sounder pension system with state guarantees, freedom of choice among AFPs, and, as noted above, strong returns on investment (Mesa-Lago 1994). Mesa-Lago cites as disadvantages the lack of employer contributions, worker inability to use accumulated funds until retirement (which not everyone would view as such a bad idea), commissions, and problems with coverage and contribution compliance.

Adversely affecting coverage are the high proportion of self-employed workers, growth of the nonpermanent workforce, and plain evasion. Contribution evasion was widespread in the old system. Greater contribution compliance had been predicted under the new system than under the old, since workers would “own” their annuity accounts, contributions would be safe from political manipulation, and employers would no longer be required to contribute.

Reasons for noncompliance include the high contribution rates, which can be onerous for low-wage workers and many self-employed, and the lack of adequate controls for ensuring compliance, especially in the informal sector. Success in enticing the self-employed into the system has been extremely limited (Mesa-Lago 1994: 118). It seems that as much as 20 to 40 percent of the workforce is not contributing to an AFP at any one time.

Of particular concern is the extent to which future retirees may come to depend too heavily on the guaranteed minimum benefit and begin to work the system to their advantage. Contributors who estimate that their investments will not yield a pension much above the minimum might decide to contribute only long enough to qualify for the minimum and attempt to avoid subsequent contributions.

It is well to keep in mind the World Bank’s crucial observation about decentralized mandatory savings schemes such as that in Chile, namely, that they “will function best in middle- or high-income countries with a population well enough informed to make intelligent investment decisions” (World Bank 1994: 231, emphasis added). Workers’ ability to make the wisest investment decisions, to say nothing of their interest in keeping abreast of all that they need to in order to make wise decisions, is questioned in Chile as well as in the United States. Workers under the new Chilean system, aside from the minimum benefit, are not insured against poor decisions; nor can the system guarantee a particular rate of return.

The new system retains substantial continued government involvement in the form
of guarantees, subsidies, and oversight. State financial commitments to current retirees receiving payments under the old system and to future retirees who will require transfer vouchers—which must be paid with general revenues—are currently substantial. The government also retains an unknown obligation for the promised minimum benefit, as well as the obligation to ensure against the financial losses of an AFP.

At present, there are more than one million beneficiaries under the old system whose benefits are the government’s responsibility. Naturally, this commitment will decline as these pensioners die, but the 1995 state share for financing pensions is expected to amount to six percent of GNP. Mesa-Lago (1994), long a student of social insurance in Latin America, maintains that, in fact, the state has been a loser when it comes to social insurance in Chile.

Another question involves how the poor have been faring since reform. Williamson and Hochman (1994: 14) report that the financial burden to the state of guaranteeing benefits under the old system and promoting the new system means that “there are generally not enough funds to increase assistance pensions and health services to the poor.” Chile places a limit of 300,000 on the number of persons who may receive the public assistance pension at any one time; eligibility requirements are reportedly very stringent, and there is a waiting list for benefits.

The private sector investment decisionmaking and management features notwithstanding, Chile’s social insurance system remains in many respects very much a public program with its government oversight, controls, and guarantees. The same, of course, might be argued of the U.S. private pension system, which is heavily regulated under the Employee Retirement Income Security Act (ERISA); however, government involvement in the Chilean system goes beyond the establishment of minimum standards for pension plans and insuring that pensions will be paid in the event of plan termination. ERISA does not, for example, guarantee a minimum benefit or mandate a profit on investments. It should also be noted that while the United States has both an advanced social security system and a well-developed private pension system, Chile has no comparable private pension system beyond the AFPs.

The magnitude of government guarantees in the Chilean system could be considerably above what is currently projected, especially if inflation, hovering about 20 percent in the 1980s, were to return unexpectedly to some of the triple-digit levels of the not-so-distant past. As MacKenzie (1995: 13) observes, “the effect of unexpected inflation would not be reversible as under a pay-as-you-go system”; sustained high rates of inflation might well put pressure on government to make up any losses.

Finally, even though the system may now be healthy, its longer term “fiscal soundness,” as Scarpaci and Miranda-Radic (1991: 40) point out, “remains to be tested.” The ultimate “proof” of the new system’s success won’t be apparent for many years, when the first workers to have been employed solely under that system reach retirement age. Until then, the extent to which workers’ annuity accounts will provide them with adequate retirement income--and the extent to which the government may be required to augment inadequate annuities for large numbers of workers--will remain an unknown.

If the optimistic scenarios prevail, and the large majority of workers are able to provide for their own retirement in a mature system, then the government and retirees themselves could end up winners. It is too early to tell.

The Relevance of Chile’s Experience to Other Countries

While interest in adopting or adapting the Chilean model has been most evident in other Latin American countries (e.g., Peru and
Argentina), Chile’s privatized system has caught the eye of politicians and government officials elsewhere as well. The World Bank (1994) advocates a mandatory private savings retirement pillar along the lines of Chile’s for both developing and developed nations. Nonetheless, such a radical overhaul of other social security systems hardly seems justified based on the still very limited experience of one developing country.

Even Robert Myers, who has high praise for the Chilean reform, reserves his praise for Chile. He by no means recommends comparable reform for the United States (Myers 1992), in large part because the situation of Chile in the late 1970s is in no way comparable to that of the United States in 1995.

Chile’s social security system was on the verge of bankruptcy in the late 1970s; the payment of benefits already required substantial government financing, and substantially more would be needed from the state as the years went by. Myers (1992: 54) feels any reliance on general revenues is “highly undesirable.” Any shift to a system like Chile’s would require, as in Chile, a huge infusion of general revenues to finance the transfer obligations to beneficiaries under the current system.

In contrast to Chile’s social security system, the Old-Age, Survivors, and Disability Insurance program in the United States does not depend on general revenues for financing. This pay-as-you-go system has managed to build up a sizable reserve in the Old-Age and Survivors Insurance trust fund, and while that fund will eventually be drawn down under current law, Myers observes that the system now appears adequately funded. Less radical tinkering should suffice to keep the system solvent well into the next century.

Although both workers and employers have responded favorably to the new Chilean system (Williamson and Hochman 1994), much of that satisfaction is, for workers, tied to the lack of trust they had in the old system, as well as in the government in general, and the high rates of return they have thus far typically seen in the new one. Employers, of course, make no contributions under the new system, so their satisfaction is also understandable, even in the face of a heavy administrative burden.

Ultimate worker satisfaction will depend upon the adequacy of the retirement benefits, which in turn will ultimately depend solely on workers’ investments relative to their contributions. Even for life-long investors, the adequacy of future benefits cannot be guaranteed. Given their intermittent work histories, women are a particular cause for concern.

Workers who evade compliance, who voluntarily opt not to contribute because they are self-employed, or who experience bouts of unemployment, may find themselves less than adequately equipped for retirement. The lack of an occupational pension system in Chile means that most retirees will be heavily dependent on their AFP pensions, so who invests what and how the funds do over the long run are what counts.

Notes

1 The legislative degree for the new system was enacted in November 1980 but did not go into effect until 1981.

2 The comparable multiple for the Old-Age, Survivors, and Disability Insurance program in the United States is 2.4, according to Myers (1992: 55).

3 A worker can retire early (1) if his/her account has accumulated funds that will provide a pension at least equal to 110 percent of the minimum pension and (2) when the “fund represents at least 50 percent of the taxable wages [the worker] has earned during
the preceding 10 years” (Marcel and Arenas 1992: 15).

4 For example, Diamond (1994: 5) cites administrative charge estimates of U.S. $89.10 per year per active affiliate in 1991 in Chile vs. U.S. $18.70 per person in the U.S. Social Security system.

References


Written by Sara E. Rix
Public Policy Institute
August 1995

© 1995, American Association of Retired Persons.
Reprinting with permission only.
AARP, 601 E Street, N.W., Washington, DC 20049