Chile: Private Pensions A Quarter Century On

by Manuel Riesco

The author is a member of the board of CENDA (Center of National Studies of Alternative Development), of Santiago, Chile, www.cep.cl. Riesco is also External Research Coordinator (on social policy matters) for the United Nations Research Institute for Social Development (UNRISD). He can be reached at mriesco@cep.cl.

December 2004: The privatization of pensions in Chile during the Pinochet dictatorship has been hailed worldwide as a success story, and President Bush recently said that it was "a great example" for Social Security reform in the United States. Its champions continue to repeat the arguments on which it has been presented since its inception. Some of these arguments are strictly ideological: It is a better system because it depends on property, free choice, and personal responsibility; and it links individual contributions with benefits, personal effort with their reward. Other arguments were based in financial and actuarial calculations, which proved that, at 4% yearly rates of return, saving 10% of salaries throughout an active lifetime would afford pensions in the order of 70% of salaries at retirement. The cost of transition—due to the fact that social security contributions are funnelled into the new system, while the state continues to provide financing for the old pay-as-you-go system—was to be financed by privatizations, long-term public debt, extra economic growth due to the optimized investment of pension funds by the private administrators, and a "residual" tax on wages. Recent arguments have been added, that seem tailored specifically for U.S. consumption, such as the fact that the new system entitles the worker to his pension savings, even though he may be an immigrant who returns home at retirement. Nevertheless, the Chilean private pension system has not been able to keep these bright promises, a quarter century on.

In Chile today there is a broad consensus among experts that the Chilean private pension system will provide pensions on its own only to the upper income minority of the enrollees to the system. Even for them, it seems highly unsatisfactory, mainly because of the high fees charged by private pension administrators. These, in turn, are six companies that have become the most profitable Chilean industry, one that is immune to recessions, with average return on equity of over 50% a year since 1997.

Meanwhile, a sizable majority of the workforce will not receive minimum pensions out of their savings in the system, and are not entitled to the complementary public social security "safety net" either. Recent studies by the State regulator of the private pension administrators, Superintendencia de Administradoras de Fondos de Pensiones (AFP) have concluded that over half of the enrollees in the new system will never be able to save enough in their pension accounts by retirement, to fund even the "minimum pension," which is set presently on the order of $100 a month. A parallel study by the AFP Association—that is, the private pension administration industry—came to exactly the same conclusion. In the latter case, though, those who will never save enough funds are divided in two groups, one of which comprises fully one-third of enrollees and is simply left out of the calculation, on the grounds that they will never contribute more than ten years into the system. Two different studies by the State administrator of the public pension system, Instituto de Normalización Previsional, concluded that those who would be unable to save enough for the minimum pension, amount to about two-thirds of the enrollees.

All of the above studies agree as well that the State guarantee of "minimum pension" is almost completely ineffective, because very few enrollees in need of that guarantee will comply with its pre-requisite of 20 years of contributions into the system. On the other hand, most enrollees do not apply for the non-contributive "assistance pension" offered by the State, which presently amounts to about $50 a month, because it is subject to quotas, and targetted to the extremely poor. The above leaves most of the Chilean workforce with no entitlement at all regarding pensions—except withdrawing the meager funds accumulated in their individual pension accounts.

These results have been confirmed by none other than the World Bank itself, an institution that during the past decades championed Chilean-style pension reforms all over the world. In a recent book, suggestively entitled *Keeping the Promise,* the Bank acknowledges that private pension systems are not able to provide income security for old age for sizable portions of the workforce, and suggests that the State should provide some kind of basic pension entitlement that is not subject to any sort of quotas.

In the Chilean case, the above-described situation is not an eventuality for the future, but the crude reality that most enrollees to the new system who are reaching retirement age are confronting today. They have very little money in their individual accounts; they are not entitled to the State guarantee of a minimum pension because they have contributed less than 20 years, and they are not extremely poor, for which reason they are not entitled, either, to the State-provided, non-contributive "assistance pensions." In their case, however, they have been subject, as well, to what is widely known in Chile today as "pension damage." "Pension damage" affects the cohort who joined in 1981—that is, all those who were working at the time the pension reform was implemented, and changed to the new system, and who comprise about one-sixth of all enrollees.

Most of the Chilean workforce was, in fact, forced to join the new system, including all those workers hired since 1981, who were given no choice at all. Those who were working under a formal contract at the time were given the one-time choice to change or stay in the old pay-as-you-go system. In practice, however, most were forcibly induced to change to the new system by their employers, and by a huge propaganda campaign implemented by the dictatorship that promised better wages today and better pensions tomorrow for those who changed. Transition arrangements for those who changed to the new system specified that the State would contribute to their new pension accounts with an amount called "recognition bond," with the equivalent of their past contributions to the old system.

Nevertheless, the amount of "recognition bonds" was calculated as the average of wages earned in 1978, 1979, and 1980, which happened to be years when wages were still very depressed, after the slashing of roughly half their buying power in the wake of the 1973 coup. Furthermore, contributions into the system during the 1980s were also meager, because wages were again depressed, and unemployment reached levels of 30% of the workforce, during the severe economic crisis that affected Chile in 1982 and lasted four or five years. In addition, for State employees, contributions into the pension accounts were further depressed during the 1980s, because they were calculated over only a part of their salaries.

Pensions Cut in Half

As a result, if two work colleagues reach retirement age in Chile today, both with the same salary and the same number of years contributing to social security, one of them who remained in the old pay-as-you-go and the other who changed to the AFP system back in 1981, the latter will receive less than one-half of the pension of the former. This huge difference has been documented in hundreds of thousands of individual cases by the Association of Employees with Previsional Damage, and their demand for a reparation has been heard by parliament, where a group of members of Congress belonging to all political parties presented the problem to the government, which has since started negotiations with the affected workers.

The above not withstanding, the privatization of pensions may have been a mixed blessing for the Chilean workforce. On the one hand, as all Chilean workers own individual pension accounts that are reviewed monthly, they provide excellent statistics of their crude labor reality. The numbers indicate that the modern Chilean workforce is composed mainly of a huge mass of persons who permanently move in and out of short-term salaried jobs, half of which last less than four months, and in most cases less than a year. While they are not working for a salary, Chileans survive working on their own—when they are able to do so; because at present, for example, around 10% of the workforce is unemployed, even according to government figures that are widely considered underestimating the real joblessness rate. As a result, 70% of the workforce contributes less than six months each year into their pension accounts, and over half of the workforce contributes less than four months each year. These figures show a huge bias for the worse, in the case of women and the poorest.

On the other hand, in their enthusiasm to grab pension contributions, the promoters of the system did not pay much attention to the public purse. To their personal benefit as well, as the boards of AFP companies are full of ex-cabinet members of the Pinochet government. While the old pay-as-you-go system produced a yearly surplus—as is the case with the present U.S. system, for example—the fiscal consequence of the Chilean pension reform was, on the contrary, a huge pension deficit, which has been paid out of regular government revenues. The public expenditure in pensions has remained consistently in the order of 6% of Chilean GDP since 1981. It has absorbed almost one-third of the overall government budget, and over 42% of public social expenditures.

Chile spends more public funds in the pension deficit than it does in education and health, put together.

The current pension deficit, naturally, is occasioned mostly by the fact that most social security contributions are funnelled to the new system, while the current pensions continued to be paid by the State. Almost three-fifths of the public expenditures in social security are dedicated to pay for the remaining pay-as-you-go system, and for the "recognition bonds" transferred to the new system. Another fifth is to dedicated to pay the pensions of the military, who took good care of avoiding, themselves, the system they imposed on the rest of the citizenry. As both these expenditures end up in a large portion in the pockets of the upper income segment of the Chilean population, they manage to upset the redistributive effect of all the rest of public social expense, even though it is highly targetted to the poor. An additional fifth of public expenditures in pensions go to the non-contributive "assistance pensions."

Nevertheless, on the other hand, public expenditure is so high—it is the equivalent of about $250 a month for each Chilean over retirement age, which is 60 years for women and 65 for men—that just keeping it at present levels as a proportion of GDP may well finance a decent universal basic pension for retirees. Of course, most of the above-listed expense items will diminish in time, and even the military should sometime be made to join the rest of Chileans in a universal system. On the other hand, Chilean GDP is growing much faster than the population over retirement age. The savings in the AFP system—duly reformed to impose serious competition and lower costs—may conform to a good, complementary, second tier in a Chilean pension system that in the end will be recognized not as a private one, but a mixed public-private one.

Most certainly, in the future as it is today, most Chileans will continue to receive most of their pensions out of the public pension system.