

Zabkowicz, Anna

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Pension Funds in Chile: Bringing the State Back In

Anna Ząbkowicz

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Anna Ząbkowicz
anna.zabkowicz@uj.edu.pl
Pension Funds in Chile: Bringing the State Back In

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Abstract

Research background: The privatized and capitalized old-age insurance in Chile has recently witnessed reforms under President Bachelet which extended the social safety net as well as re-introduced publicly-administered programs on behalf of retirees.

Purpose of the article: The article reviews the performance of the system up to the most recent reform and presents results of pension engineering in a systematic way in attempt to estimate the scope of change.

Methodology/methods: The method relies on orderly analysis which is founded on review of the literature relevant to the subject.

Findings: Bringing the state back into Chile's pension system can be viewed as a plan to subsidize total retirement benefits in order to improve the distressing rates of replacement and, in such indirect way, to support the longevity of privately-managed pension funds.

Introduction

The Chilean reform pioneered a shift in old-age security systems away from public pension schemes on the pay-as-you-go (PAYG) basis towards individual pension schemes on capital basis and found followers in the 1990s, mostly among other Latin American countries and in Central and Eastern Europe¹. However, nowhere was the change so embracing as in Chile. The early 21st century saw retreat from the pension funds created on mandatory basis. Also in Chile the 2008 crisis echoed with reforms of 2008 and 2015 under the socialist president, Michelle Bachelet which extend the social safety net as well as re-introduce publicly-administered programmes. The change seems to be internationally meaningful, also for Poland being one of the follower-countries.

The article poses the question whether a drive in such direction in the country of vast evidence on mandatory, funded, defined-contribution pensions means a downturn of the scheme? Recent reforms are reconstructed and analyzed in aim to evaluate the weight of the change and, consequently, to form view on sustainability of such pension system design. The research was inspired by Polish re-reform to be implemented in 2018 under which capital-based funds in a new shape constitute one of the pivotal issues².

Recent years in Chile witnessed protests involving hundreds of thousands of people throughout the country against the private pension system (so called AFP system after Administradoras de fondos de pensiones - pension-fund management companies) and under slogans for return to the status quo before the structural reform, initiated in 1980 which privatized publicly-administered pensions. Protests were organized by students, indigenous organizations and citizens who feel their demands are not being met. In the context of the growing street protest the Concertación leftist political alliance won the 2013 elections (with abstention rate exceeding 50%), acquired majority in both houses of parliament and guaranteed the return of Michelle Bachelet to government. President Bachelet, in her first term already, appointed an Advisory Pension Commission (so called Marcel Commission), and 90 per cent of that commission's recommendations were incorporated in the law enacted in 2008. In 2014, directly after her re-election, she appointed international pension commission (so called Bravo Commission) who after 16 months of work elaborated three re-reform proposals. Bravo Commission reported: "A high percentage of the population believe that only a complete change in the AFP system would help improve pensions (72%) and believe that most of the responsibility for low pensions lies with the AFPs (66%)" (Executive... 2015, p. 17).

Research methodology

In the research the approach of institutionalist political economy has been applied. The leading question is for whose sake were the reforms introduced and which vested interests were protected. The method relies on orderly analysis which is founded on review of the literature relevant to the subject and is carried on in order

¹ The causes and circumstances of this change are not fully examined yet (Barr, 2001; Singh, 1996) and the arguments put forward by the government to justify the partial pension privatisation are still subject to scientific as well as political dispute (Wehlau, 2007; Ząbkowicz, 2016; Ząbkowicz, 2014).

² Both pension funds on mandatory basis introduced under 1999 reform (OFEs) and new quasi-mandatory pension plans based on automatic enrollment (PPEs) are at stake.

as follows. We start with an observation that Chile's pension reforms of 2008 and 2015 open space for renewed role of the state. Next, basics of the change are presented in a systematic way. The question is posed whether the scope of reforms challenges the shift to the funded-pensions system (the AFP-system) made in 1981.

Bringing the state back in?

This short review provides evidence that two portions of reforms under President Bachelet improved performance of the system in terms of social security due to increased engagement of the state in the country where 98 per cent of the insured are in the private pension system. Before presenting where the system has arrived at the end of the day a short characteristic of structural change initiated in 1979-1980 is required. In 1981, Chile implemented mandatory individual retirement account system, managed by private AFPs and financed on the capital basis. The previous public system financed on PAYG-basis is being phased out since new entrants to the labor force have had to join the capitalization system, starting from December 31, 1982 on. The insured who chose to switch from the public PAYG to the individual account system received a recognition bond at retirement that represents the value of their accrued rights under the old public system. The bond is to be redeemed and added to the mandatory individual account when the worker retires, becomes permanently disabled or dies. If pension from an individual account plus other source of income was below the minimum level set by the government, the guaranteed minimum pension (MPG) was paid which implies state subsidy. If a person over the age of 65 did not qualify for any type of pension (or was disabled), a means-tested benefit (PISIS) was paid out, funded from general fiscal revenues (Kritzer, 2008, pp. 69-70). In sum, the Chilean retirement system between 1981 and 2008 was comprised of two pillars, the privately-administered second pillar and the first pillar, administered by the state. The latter contained the closing PAYG system and the tax-financed military-force and police-force schemes as well as retirement income safety-net. The first pillar was practically non-contributory while the second pillar constituted of mandatory contributions under the AFPs' management.

Year of 2008 saw minor change in contributory component and more significant change in the non-contributory pillar. The modified structure of the pension system is displayed in diagram 1 beneath.

Diagram 1. Pension benefits under 2008 reform

Pillar		Non-contributory	Contributory (only fully funded capital accounts)
Administration		Social Security Administration (a)	Pension management companies (b) and insurance companies
Financing		General tax revenues	Workers contributions according to taxable wage
Benefits	Poorest 60%, no contributions required	Basic pension benefit, PBS (c)	-
	Poorest 60%, some contributions required	Supplementary or additional pension benefit, APS (d)	"self-financed pension benefit", PCI (e)
	Fully contributory	-	"self-financed pension benefit", PCI

(a) Instituto de Prevision Social

(b) AFPs - administradoras de fondos de pensiones

(c) PBS - pension basica solidaria

(d) APS - aporte provisional solidario

(e) PCI - pension autofinanciada; pension benefit derived from individual pension savings

Source: Based on Bertranou (2016, p. 14), annex 2

In the second contributory pillar the rules concerning mandatory pension funds remained basically the same. This is, AFPs collect workers' contributions, credit them to workers' accounts, and invest these monies according to regulations set by the government. They also contract with insurance company to provide survivors and disability insurance to their fund members. Workers contribute on obligatory basis to one of the AFP-managed funds 10 per cent of their salary, and in addition 1.15 per-cent contribution is required to finance disability and survivorship insurance. The AFP charges an administrative commission and a premium on own behalf and on behalf of the insurance company, which is deducted from wages as well. Employees cannot withdraw their funds until they retire, but they can choose the type of instrument they want to invest in. At retirement, workers can buy inflation-indexed annuities purchased from insurance companies, or pull out their accumulation as phased withdrawals from the pension funds which remain with the AFPs. Pension benefit is derived from individual pension savings (PCI) then.

Two changes in the contributory pillar are worth mentioning. First, voluntary collective savings accounts on top of the mandatory individual pension savings accounts were introduced in aim to allow workers to save beyond the compulsory wage contribution. However, eight years after the change such accounts have been

reported to be still heavily under-developed (Bertranou, 2016 , p. 16)³. Another change was a mechanism of auctioning the entrants to the pension system, as described before.

The major change occurred in the first non-contributory pillar with regard to its structure, and, the more so, to its dimension. The MPG which was guaranteed exclusively to contributors to the second pillar as a minimum benefit was replaced with supplementary pension benefit paid out to contributors (APS) and funded from general fiscal revenues as well. The PASIS poverty relief component was replaced with other non-contributory benefit PBS. However, the real change is to be seen in the scope. The two new arrangements benefit majority of population below certain poverty line whereas social assistance under 1981 reform was extremely modest, namely, eligible workers for a minimum benefit (MPG), according to the 2006 estimations, would have constituted only five per cent of the affiliates. The second poverty relief component (PASIS) had been administered at the municipal level with quotas and queuing mechanism (Bertranou, 2016 , p. 4). The state's role had been mostly subsidiary due to low coverage of this retirement-income safety net. The 2008 reform meant funding or co-funding of benefits from tax revenues being extended from a very small fraction of population to 60 per cent of the poorest. Thus, a social protection floor was established which is regarded one of major accomplishments of the reform.

As a matter of fact, the re-reforming pensions in 2008 reinforced role of the state in many respects. Apart of transforming the modest social assistance into increased tax-financed coverage of the poorest, an attempt was made to use the state's compulsory power in aim to increase coverage through the mandatory contribution tier. Namely, it was designed to reach the segment of self-employed workers in certain tax categories and with higher contributor capacity. This measure was postponed until 2018 however. Moreover, institutional innovations such as the set up of Social Security Administration bring back "the idea of having a public long-lasting institutions which administered public pension benefits (i.e., PBS, APS and benefits from the pre-1980 system)" (Bertranou, 2016 , p. 7)

Although the 2008 reform meant progress in terms of social security, it left numerous flaws of Chile's pension system in place, as the former section informed. These, and low benefits in particular, possibly added to surge of social discontent. The social conflict has been also reflected in important conceptual differences among the experts of the 2014-nominated Bravo Commission. Both the Commission hearings and meetings for citizen participation showed majority's preferences for elimination or limiting the private savings component of the pension system, and restoring a reformed system based on social security principles. On the other hand, pension management companies and conservative think tanks with support of foreign experts and international organizations highlighted the need to maintain the status quo with some reforms in the volume of financing and parametric changes (Bertranou, 2016 , p.3). Consequently, the Commission's report presented in 2015 to the President Bachelet has revealed its members divided, basically, between two global proposals⁴. In a nutshell (for more technical details see Barr & Diamond, 2016), proposal "A" is to keep the status quo of the current system with increases in tax financed benefits. This is to say, individual pension savings accounts with mandatory and voluntary contributions remain the core of the system; however, in the non-contributory component loosening the qualifying conditions for pensions is proposed (Garcia-Huitron & van Leuvenstejn, 2015, p. 199). Proposal "B" introduces a social insurance component thus reducing the size of individual savings component. The Commission agreed that the increment in the contribution rate is needed and that it should reach an additional four percentage points which implies an increment from 10 to 14 per cent. However, while proposal "A" proposed to use these resources mostly for individual pension savings, proposal "B" recommended allocating them to fund a new social insurance scheme.

Option "B" is presented systematically in diagram 2. It displays a new social-insurance pillar in the contributory component and, consequently, an expanded competence of the public supervisory agency, Social Security Administration.

Diagram 2. Proposed structure for the Chilean pension system, the Advisory Pension Commission ("Bravo Commission"), proposal "B"

	Non-contributory	Contributory	
		Social insurance	Fully-funded individual accounts
Financing	General tax revenues	Worker and employer contributions; state contributions from general tax revenues	Worker and employer contributions
Administration	Social Security Administration	Social Security Administration; social security fund	Social Security Administration; pension management companies (AFPs) and

³ This tax-incentivized arrangement is analogical to Polish funded voluntary pension plans (PPE and PPK) which are lately officially and intensively promoted under the governmental Morawiecki Plan.

⁴The third proposal of coming back to the PAYG-system won only one vote which may be puzzling so far as Chile's popular voice concerned. The only vote came from the expert from Poland, Professor Leokadia Oręziak (see Oręziak, 2016).

				insurance companies
Benefits	No contributions required	PBS	-	-
	Workers with wages up to the median earnings distribution (a)	PBS	PSS (b)	-
	Workers with wages above the median earnings distribution	PBS (affluence test to exclude richest 20%)	PSS	PCI

(a) This is \$ 350.000

(b) PSS: social insurance benefit

Source: Bertranou (2016 , p.15), annex 2.2

Rebuilding social security solidarity mechanism is a novelty in the 2015 package of reforms. Workers with wages up to the median earnings distribution contribute solely to the social security fund. Workers with wages above the median are both comprised by social insurance and by the AFP-system, and thus they become beneficiaries of social insurance benefit (PSS) and pension benefit derived from individual pension savings (PCI) as well. Thanks to this novel arrangement low-income workers are going to get a minimum of economic security guaranteed and, possibly, be not subject to excessive risk neither to complicated decision-making (portfolio investment options, choice of fund administrators, etc.) to such extent as under the current system. Only those with income above certain level would contribute to the fully-funded individual saving accounts scheme and take the full risk.

The 2008 reform reinforced the role of the state in Chile's pension system. The Bravo Commission presented its report to President Bachelet in September 2015, proposing either higher tax financing or structural change by introducing social insurance. Whether this package of reforms wins political acceptance to become a continuation of bringing the state back in remains an open question. In aim to consider how to take things forward, the President established a Committee of Ministers, including the Ministers of Labour, Finance, Social Development, Economy and Women. At the end of 2016 Michelle Bachelet announced her government plans to send a bill to Congress seeking to overhaul the pension system. Her administration proposed increasing workers' contribution to the pension fund, thus, sparking widespread street action (*Business...*,2016). Most probably, the Government and the Congress will make attempts to implement some of the specific proposals but may leave decisions about the global proposals (status quo or social security) till 2017.

Conclusion

The 2008 reform meant funding or co-funding of benefits from tax revenues to be extended from a very small fraction of population to 60 per cent of the poorest. Thus, a social protection floor was established which is regarded the major accomplishment of the reform. Although it meant progress in terms of social security, it left numerous flaws of Chile's pension system in place. The recent re-reform, at least as seen in the light of 2015 report by Bravo Commission, intends to reinforce the role of the state in Chile's pension system even more, proposing either higher tax financing or structural change by introducing social insurance.

Nevertheless, as far as now the reforms left the foundations of the system intact. Year of 2008 saw minor change in the AFP's component of the system and the rules concerning mandatory pension funds remained basically the same. Recent proposals tend either to supply the AFP-managed funds with additional capital thanks to increase in mandatory workers' contribution (proposal "A") or to subsidize benefits paid out by AFP contributory pillar via the rebuilt social security mechanism (proposal "B"). The latter arrangement, i.e. the social security component, is supposed to draw from increased mandatory workers' contributions as well.

Thus, bringing the state back into Chile's pension system, in spite of the leftist provenience of the change, can be rather viewed as a plan to subsidize total retirement benefits in order to improve the distressing rates of replacement and, in such indirect way, to support the AFP-pillar longevity⁵. However, the alarming performance of mandatory privatized fully-funded pensions in Chile and the radical retreat from this scheme in some follower-countries (Argentina, Peru, Hungary, etc.) offer a lesson that a "there-is-no-alternative" thinking is not necessarily applicable to pension-system design.

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⁵ This view corresponds with panorama of social change under democracy in Chile as evaluated by an insider and a sociologist, Manuel Antonio Garreton in his book on improved neo-liberalism and moderate progress (Garreton, 2012). In the period this article refers to the fourth Concertación government (2006-2010) led by socialist Michelle Bachelet initiated major reforms to the social security and pension systems. When in 2009 the political right won the presidency in an electoral process for the first time since 1958 with its candidate Sebastián Piñera, the new government largely maintained the generally business-friendly policies of the Concertación, and also continued social policies promoted by Bachelet (BTI, 2016).

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