# The Chilean pension system after the reform

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# 1 What's the challenge

- Three problems
  - Population ageing
    - Longer lives
    - Lower fertility
  - Uncertainty
  - Complexity: thus pensions are
    - Controversial in theory
    - Controversial in policy terms
    - Politically controversial
- Three questions
    - The macro question: what role do pensions play in increasing national output?
    - The micro question: what is the useful role of individual choice?
    - The political economy question: are pension rights better protected by people as part of the electorate or as owners of financial capital?

# Politics matters

(Atacama desert, January 2017; Chile is important in international debate)

# Responding to population ageing

- Rational response
  - More productive workers – more physical and human capital
  - Also more workers (will not discuss labour market agenda)
- More investment requires more saving
- Different ways of saving
  - Within the pension system – many ways (more below)
  - Outside the pension system

# 2 Some pension economics

(Barr and Diamond (2008, 2009, 2010, 2017, forthcoming)

- Multiple objectives
    - Consumption smoothing
    - Insurance
    - Poverty relief
- System, not plan
    - Important to distinguish between pension systems and the different elements of pension systems, i.e. pension plans
    - Since pensions have multiple objectives, a well-designed system generally comprises multiple plans
    - Example: risk is less important with a generous PGU and smaller individual accounts, and vice versa
    - For many purposes evaluation should be of the system as a whole

# No single best pension system for all countries

- Objectives: consumption smoothing; insurance; poverty relief; redistribution
- Constraints include: fiscal capacity; institutional capacity; empirical value of behavioural parameters; shape of the income distribution
- No single best pension system because
  - Policy makers attach different relative weights to the different objectives
  - The pattern of fiscal and institutional constraints differs across countries
- Thus
  - What is optimal will differ across countries and over time
  - Pension systems look different across countries; this is as it should be

# Don’t overestimate the usefulness of individual choice

- Theory
  - Information problems (Nobel prize 2001)
  - Behavioural problems (Nobel prize 2002 and 2017)
- Empirical evidence
  - Consumers often
    - Do not save enough
    - Retire too soon
    - Delay choice or make no choice (Sweden)
    - Choose an unsuitable portfolio
      - Active not passive
      - Inadequately diversified
      - Trading too much or at the wrong time
      - Holding equities too close to retirement
      - Taking insufficient account of family members
      - Not taking account of administrative charges

# In some ways an impossible problem even for someone who is financially literate

- Consider a financially literate 30-yr old
- Uncertainty about
  - Needs
    - How long they and their family will live
    - Duration of marriage
    - Number and experience of children
    - Medical expenses
  - Earnings: uncertainties about
    - Opportunities, influenced by personal factors and state of the economy
    - Not know in earlier years about earning opportunities in later years
  - Pensions: uncertainty about
    - Future asset returns
    - Future annuity prices
    - Future inflation
- Complexity of financial instruments
- Continuous process, not single-event like buying a car

# How much choice is useful

(Barr and Diamond 2017)

- People who wish to make choices about pensions and retirement should have room to do so.
- But
    - Some people will not make choices
    - Choice can be costly
    - Some people may make bad choices. Thus:
- Thus, the pension system should work well also for people who make no choice – and making no choice should be an acceptable option, e.g. default in Sweden, UK NEST pensions

# Is funding safer than PAYG?

- The political economy question: are pension rights better protected by people as part of the electorate or as owners of financial capital?
- Plenty of examples of badly-run PAYG plans (profligate promises, e.g. Greece)
- Plenty of examples of funded plans that have not stood the test of time (Argentina, Hungary)
- Bottom line: private property might well be safer, but not always, or necessarily, or everywhere
- What matters most
  - Not pension design, including whether private or public
  - What matters most is the quality of government

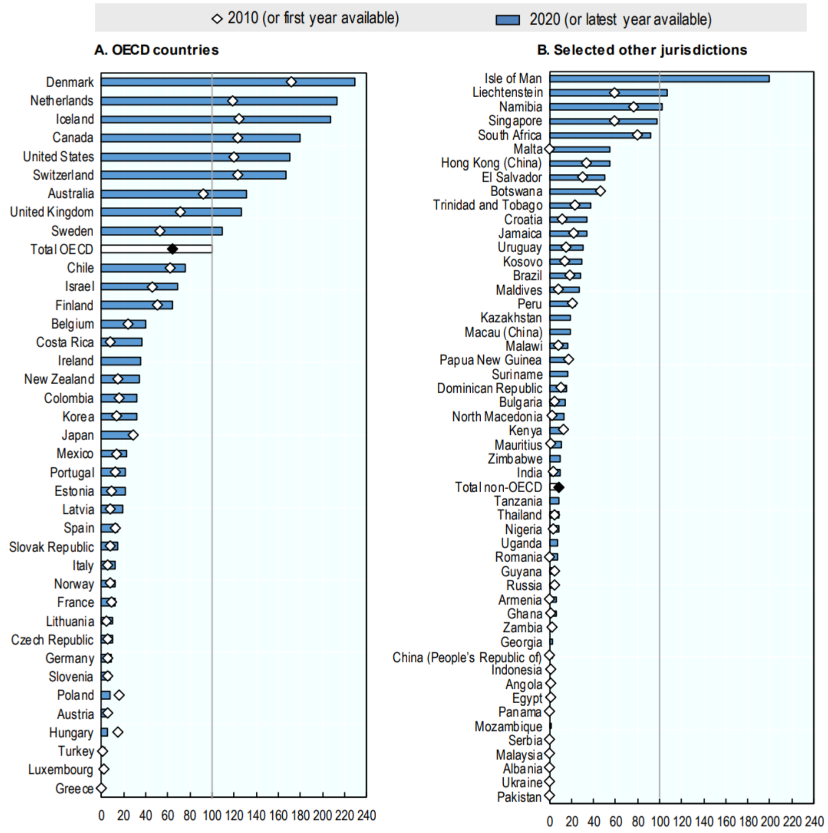
# 3 Pensions internationally

# All (repeat, all) pensions systems have a PAYG element

- The 1981 Chile design provided a guaranteed pension after 20 years of contributions, replaced by the solidarity pension in 2008 and in 2022 by the PGU
- Different countries make different choices
  – About  the balance between PAYG and funding
    - Chile and Australia: substantial reliance on funding
    - Canada and Sweden have partially funded national plans
    - Germany has a mainly PAYG system
  – About the way any funding is organised, e.g. individual accounts (Chile, Australia) or aggregate (Netherlands industry plans)

# Total assets in retirement savings plans, in 2010 and 2020, % of GDP

(OECD Pension Markets in Focus 2021, Fig. 1.3)



# Internationally, countries organise saving in different ways

- Some good but very different pension systems
- Saving within the pension system: options include
    - Fully-funded individual accounts from multiple competing providers (Chile, Australia)
    - Simpler, cheaper individual accounts with less choice (US Thrift Savings Plan, UK NEST pensions)
    - Fully-funded industry plans (Netherlands)
    - Partially-funded NDC (Sweden)
    - Partially-funded DB (Canada)
    - Partially-funded DB with risk sharing (New Brunswick)
- Saving outside the pension system: Government Pension Fund of Norway

# 4 The Chile evolution

- 1981: Individual funded accounts – the AFP system
    - Based on a 10% contribution by workers
    - Reformed over the years
- 2008: President Bachelet, following the Marcel Commission
    - A non-contributory pension (the Solidarity Pension), introduced in 2008, was paid to the bottom 40% of pensioners, over time expanded to bottom 60%
    - Introduction of auction mechanism for new APF affiliates to strengthen competition
- 2022: President Piñera
    - The Universal Guaranteed Pension (PGU) replaced the solidarity pension which goes to the bottom 90% of pensioners
- 2025:
    - A new 7% employer contribution
    - Strengthening competition between AFPs

# The background

- Desire to increase the replacement rate
  - In the medium term by increasing contributions to workers' AFP accumulation
  - In the short term
- Desire to improve gender equity in pensions

# 4.1 A new contribution and new institution

- A new 7% employer contribution, of which
  - Permanent contributions
    - 4.5% goes to each worker’s AFP, addressing the desire to increase replacement rates in the medium term
    - 1% subsidises the pensions of women who retire at 65, such that a woman retiring at 65 receives the same monthly pension as a 65-year old man with the same accumulation, addressing the desire to improve gender equity. The additional benefit is tapered between age 60 and 65
  - A 1.5% contribution that changes use
    - 2025-2044: a ‘contribution with protected returns’ (Cotizacion con Rentabilidad Protegida) goes into a new Autonomous State Protection Fund (Fondo Autonomo de Protección Previsional). The contribution is 0.9% from 2025-2027, then 1.5%. This contribution acts to increase replacement rates in the short term
    - Between 2044 and 2054, the 1.5% contribution will increasingly be diverted from the Autonomous fund to each worker’s chosen AFP, so that by 2054 the entire 1.5% will go to each worker’s AFP
    - Thus in the medium term the new employer 7% contribution will go 6% to each worker’s AFP and 1% for gender equalisation

# A new institution

- A new social security institution (Seguro Social Previsional) will manage the new Autonomous fund
- The income of the fund is made up of
    - The sum of the 1.5% contribution, plus the 1% gender equalisation contribution, plus the pre-existing 1% contribution that provides disability and survivors insurance
    - Some taxpayer support
- The Autonomous fund is managed by private fund managers to prevent political influence. The idea is to emphasise private fund management and that the contributions will be returned to individual accounts
- The contribution is presented as a loan from workers to the pension system, but a loan that will be repaid at age 65 in the form of a guaranteed new benefit

# 4.2 Two new benefits

- One is paid on the basis of a worker's entire history of contributions, including those made before the current reform, hence will increase replacement rates immediately
- One is paid on the basis of a worker's history of contributions to the new Autonomous fund, hence will grow over time

# Benefit based on past contributions

- This benefit, paid from the Autonomous fund, is based on a worker's entire history of contributions, including those made before the current reform
- At age 65 a worker receives a sum equivalent to 0.1 UF for each year of contribution
  - For women with at least 10 years of contributions (rising in stages to 15 years after the first 10 years)
  - For men with at least 20 years of contributions, up to a maximum of 25 contribution years
  - [A UF is an indexed amount, currently 1 UF is worth about 40 USD]
- Thus a worker with 20 years of contributions who retires in 2026 will receive an additional benefit equivalent to 2.5 UF (approximately USD100) per month, giving an immediate boost to replacement rates

# Benefit based on the history of contributions to the Autonomous fund

- At age 65, each worker receives a bond with a face value equivalent to 240 equal monthly payments, reflecting the worker's history of contributions to the Autonomous fund
- The bond is transferred to the individual through their AFP or insurance company and can be used in the same way as an AFP accumulation, i.e. for programmed drawdown or for a fixed-term or life annuity
- The arrangement can be thought of as a recognition bond
- The political point is that the bond belongs to the worker, hence goes to the worker's family if they die before reaching pension age
- The 1.5% contribution and corresponding benefits will be phased out between 2044 and 2054 on the grounds that by that time replacement rates will be boosted by the 4.5% additional contribution to each worker's AFP

# 4.3 Other changes in benefits

- Gender equalisation
    - The new 1% employer contribution finances a transfer, such that a woman retiring at 65 receives the same monthly pension as a 65-year old man with the same accumulation
    - The contribution entitles a woman at age 65 to a benefit of approximately 0.25 UF per month (around USD 10) paid through a type of recognition bond
    - The benefit is paid to current as well as future pensioners, increasing replacement rates immediately
- The Universal Guaranteed Pension ((Pensión Garantizada Universal – PGU) will increase to CLP 250,000 (approx. USD 255)/month
    - After 6 months for pensioners aged 82 and older
    - After 18 months for pensioners aged 75 and older
    - After 30 months for pensioners aged 65 and older

# 4.4 Strengthening competition

- An enhanced auction mechanism: the previous auction mechanism will be replaced by
    - 10% of affiliates, randomly selected, will be auctioned every 2 years
    - Only AFPs with less than 25% of affiliates may bid
    - The winning bid must maintain the winning administrative charge for 5 years
    - Affiliates who are auctioned can choose not to be reallocated
- Reduced entry barriers (next slide)

# Reduced entry barriers for new APFs

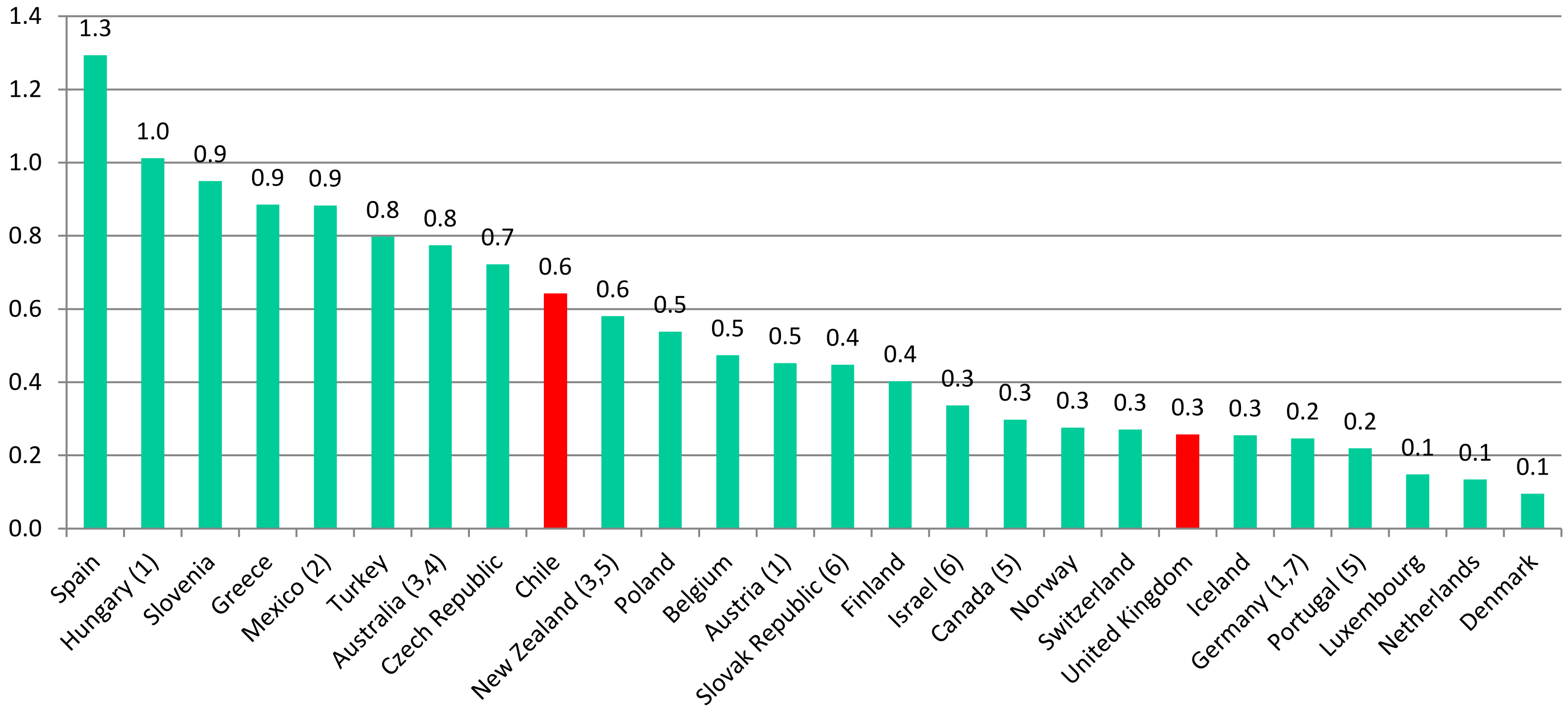
- Lower reserve requirement for APFs
  - Previously AFPs had to keep 1% of their total pension fund (i.e. the stock) in a separate account (the Encaje), though the reserve can be invested in the same way as the other 99% of the AFP's funds
  - This requirement proved to be a significant entry barrier
  - The reform reduces the requirement to 30% of annual contributions (i.e. the flow), reducing the total funds in the Encaje from around USD 2 bn to approximately USD 200-300 mn
- Account administration services
  - The Social Security Institute (Instituto de Previsión Social – the office that administers the PGU – will be allowed to offer account administration services (i.e. record keeping), again easing entry by new AFPs who therefore do not have to manage the upfront costs of setting up a new administration

# The ‘So what?’ question: Why do administrative charges matter

- Over a full career an annual management charge of 1% of a worker’s accumulation reduces the accumulation (and hence the pension) by 20%
- Less relevant in Chile because charges come directly from worker’s pay rather than from their individual account

# Pension funds' operating expenses in selected OECD countries, 2011

(Pensions at a Glance 2023, Table 8.11)



# 5 Some thoughts on the reform

- A sensible evolution of the pension system
  - The 1981 system
    - Focussed heavily on consumption smoothing, hence was not a pension system but only part of a system
    - Was based on first-best economics; have learned much since then
  - The 2008 reform
    - Made the system more complete introducing the solidarity pension
    - Introduced an auction mechanism to reduce administrative charges
  - The 2025 reforms
    - Strengthen consumption smoothing
      - In the short term; the effect is strongest for lower-paid workers with incomplete contribution records
      - In the medium term, both directly and by strengthening competition
    - Very cleverly combine good economic design and political acceptability

# 5.1 The new benefit Desirable design features: Economic

- Increases replacement rates immediately and in the medium term
  - Desirable in economic terms to increase replacement rates that are low by OECD standards
- Preserves the saving element in the system
- Moves the total contribution rate in Chile closer to the OECD average (2022 figures: *OECD Pensions at a Glance 2023*, Table 8.1)
    - OECD average at average wage 18.2%
    - Chile before the reform 12.7%
- Avoids workers having to make choices about portfolio during accumulation. Seems desirable, since workers have choice within the AFP part of their pension
- 2022: the Universal Guaranteed Pension increases the role of the solidarity pension, helping to ameliorate the damage to savings from withdrawals of about USD50 billion

# Desirable design features: Political

- Addresses one of the major discontents that led to the Bravo Commission
- Increases replacement rates
  - Immediately
  - And in a way that preserves the character of individual rights embedded in the Chile system
    - The Fondo Autonomo de Proteccion Social is established as an autonomous institution
    - Each month workers can see their individual account record including the new element

# Fiscal cost

- 1.7% of GDP, in part because of the state’s role as employer (approx. 13% of total employment is in the public sector)

# Effects on employment

- Some commentators have argued that the additional employer contribution would reduce employment (‘tax on jobs’)
- Counter-argument 1: the incidence of a tax or contribution is shared, depending on relative demand and supply elasticities
- Counter-argument 2 (Mario Marcel): the extra saving will lead to extra investment, boosting growth and employment prospects
- As noted, the contribution rate in Chile is below the OECD average

# Gender aspects

- Equalising monthly benefits for men and women at age 65
    - Brings Chile into line with the OECD mainstream
    - Note that such equalisation applies only to women who retire at 65 or later, thus encouraging later retirement.
- Earliest pension age remains 65 for men and 60 for women, an outlier in the OECD

# 5.2 Stronger competition

- As noted, the reforms
  - Introduce a stronger auction mechanism
  - Reduce entry barriers
- Both directions are desirable in that they exert downward pressure on charges
- A more radical approach: NEST pensions in the UK
  - Automatic enrolment
  - Limited choice
  - Centralised account administration
  - Wholesale fund management
  - Long-run administrative costs about 0.3%

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