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The Chilean Pension System: Favorable Results in International Comparison

The pension system has been questioned lately, because people's expectations are not being fulfilled in relation to their retirement standards. However, a deeper analysis allows showing that the retirement benefit is not explained by a problem in the system itself, but rather by labor market informality, life expectancy increase and growth of real wages in the last years.

Recently, the Chilean pension system has shown an increasing dissatisfaction level, which has even resulted in suggestions of retracing the steps taken and go back to the pay-as-you-go system, ignoring that this very system is partly responsible for the serious fiscal problems that several developed countries are facing. Up to a certain point, discontentedness is originated in the fact that workers who were affiliated to the system for 30 years are retiring now, and they are discovering that their retirement benefits are quite lower than their actual income levels. However, being affiliated for a relevant period of their working life does not mean that they have effectively contributed to the system, nor that they have contributed for their entire income and, therefore, with very scarce savings, it is evident that retirement benefits are low too.[i]

Certain data illustrate the above with great clarity: the number of affiliates to the system by the month of March was 9,375 millions, while contributors at that moment were 4,927 millions, that is, just 52.6% of the affiliates effectively contribute, since affiliates include anyone who has participated in the system at one time or another. On the other hand, contributors represent 64% of employed workers, and in terms of salaried workers they represent 85%, so there is close to 15% of dependent workers who are currently not contributing. Therefore, it is evident that the challenge is to improve the system's coverage. In any case, economic dynamism plays an important role in this objective, considering that in March 2010, contributors represented 60% of employed workers.

Total funds amount to US$164,962 millions, which correspond to approximately CLP$3,350,000 per contributor. With this average fund, it is hard to aspire to having retirement payments equivalent to the contributors' average wage level, which currently amounts to CLP$560,000. This perfectly illustrates the system's main problem: the low contribution density of the affiliates. The other relevant problem is excessive expectations regarding the relationship between the value of the pension and wages once retiring. As we will see later on, when comparing the so-called replacement rates with other OECD members, normally the pension covers just a fraction of the salary.

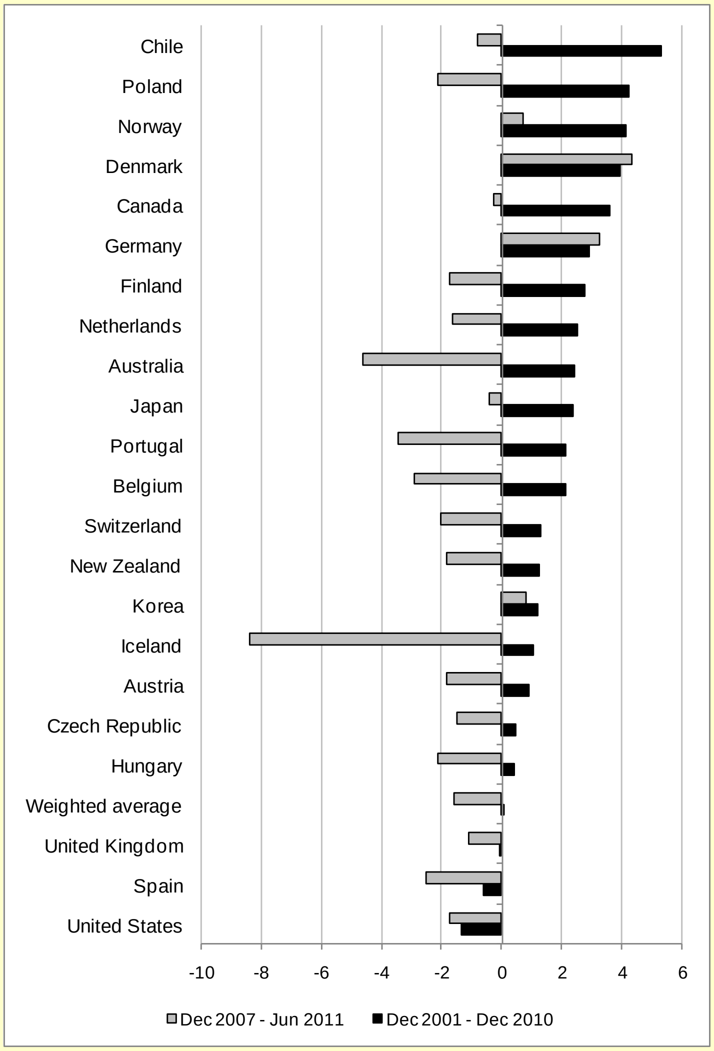
The low density results from labor market situations rather than from the system itself. There are basically three problems: the so-called pension gaps, periods without contributions originated in the labor informality which is still important; the fact that there are a high percentage of non-taxable incomes and the incentives for workers and employers to pay the legal minimum, a situation which is very frequent in lower income sectors. Since this is the main problem, future modifications should concentrate on this point. The reforms recently announced by the President aim partially in that direction, because they search to increase the contribution rate, encourage workers to effectively contribute and give incentives to extend their working life. However, the main announcement, which was to introduce more competition, does not aim at improving pensions, but at higher net wage in the present, and neither very significant, since the current commissions do not seem excessively high in relation to other pension fund administrators.

In many aspects, the Chilean pension system obtains a positive evaluation, as derived from the international comparison. A first relevant feature refers to the profitability of pension funds. We should point out that this comparison does not include all countries, because in some pay-as-you-go systems there are no funds; contributions and payments operate through the tax system.

Chart 1 shows results for two periods of time: 2001-2010 and 2007-2011; therefore they include the 2008-2009 crisis. In the longest period, the Chilean pension fund is the most profitable of the sample, with an average yearly return of 5.3%, which is favorably compared with the countries' 1.9% average. For the shortest period, highly focused on the crisis, Chilean funds effectively register a loss, 0.8% annual average, but lower than the average of the sample, which is -1.5%. If we also consider that, from its very beginning, the average profitability of Chilean pension funds has been 8.7% real, it is evident that the system does not have a profitability problem; therefore, the criticism which argues that funds of Chilean workers are not being managed in their benefit cannot be empirically defended. On the contrary, regarding funds' management, on average the Chilean system is better than that of developed countries. In this perspective, the presidential announcement of flexibilizing the investment criteria, although it can be positive in itself, is not significant in terms of improving returns, which have been historically very good.

Chart 1

AVERAGE ANNUAL REAL RATES OF RETURN OF PENSION FUNDS

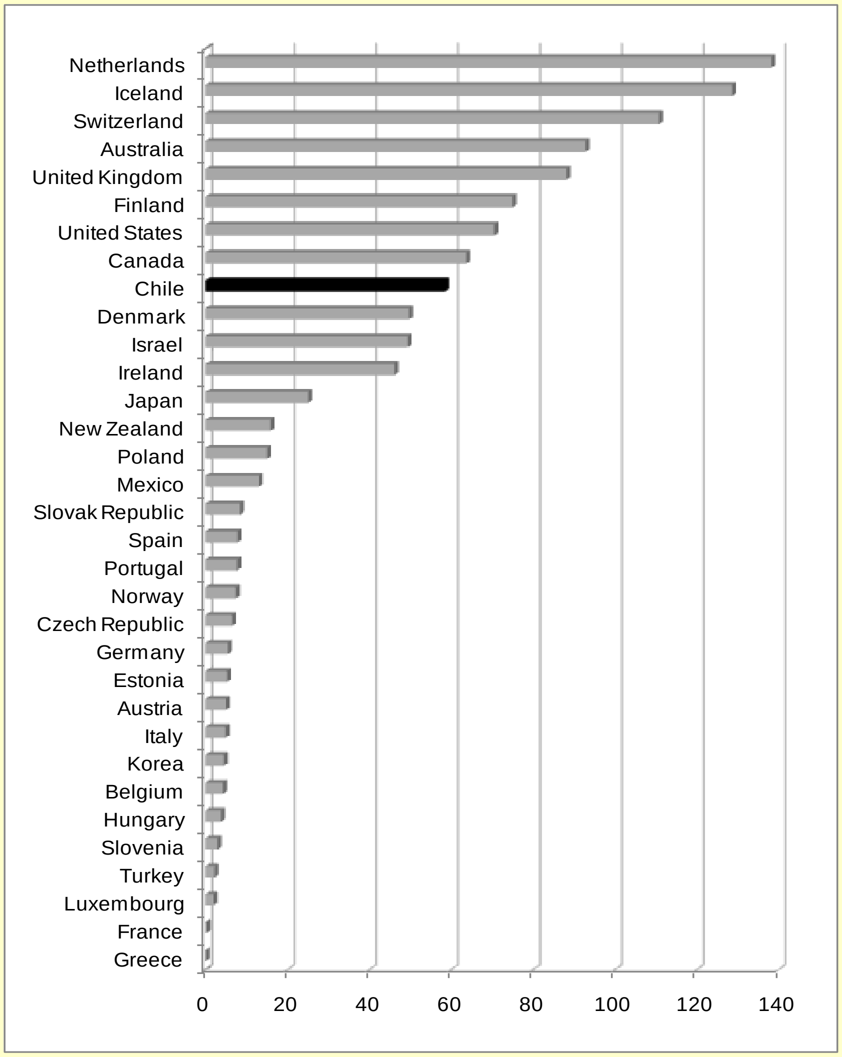


Source: OECD Pensions Outlook 2012

A second point of interest refers to the size of the pension fund in relation to the GDP, a comparison in which Chile holds the ninth place among 34 countries of the OECD, as shown in Chart 2.

Chart 2

SIZE OF THE PENSION FUND IN RELATION TO THE GDP (%)



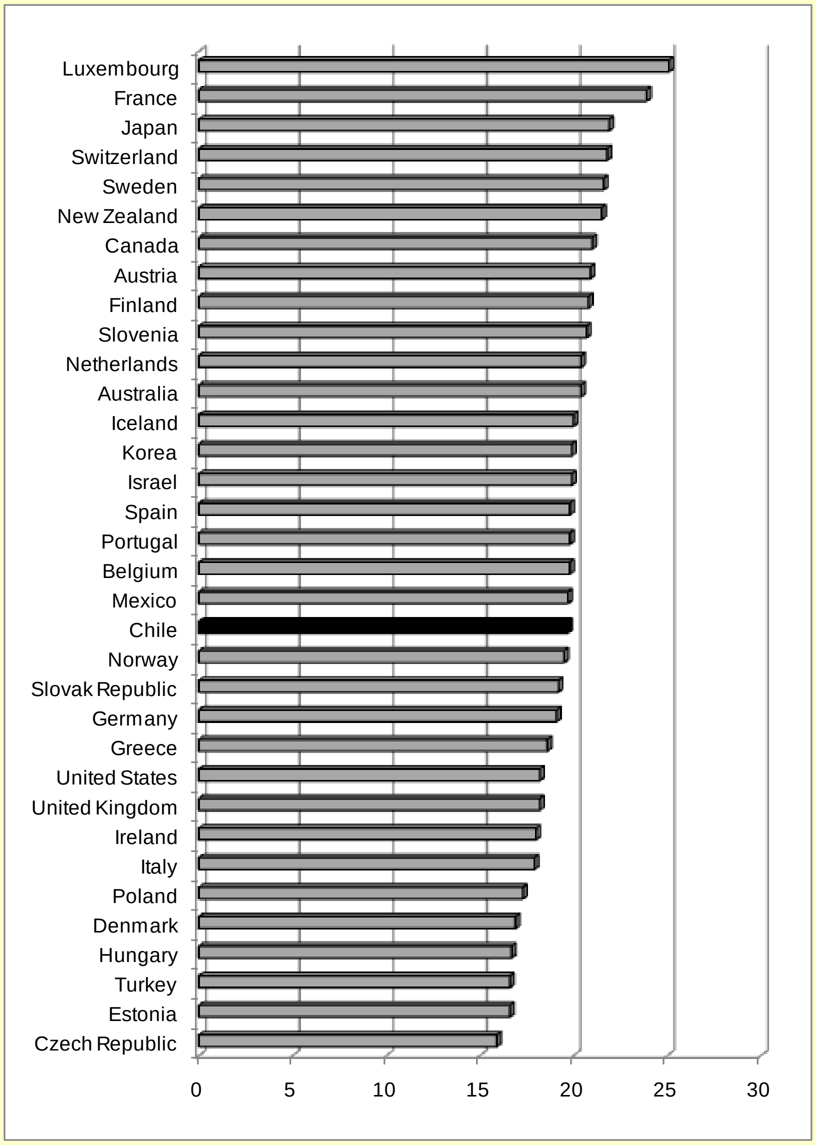
Source: OECD Pension Markets in Focus Nº 9, September 2012.

Another interesting aspect refers to the retirement age, compared with the population's life expectancy, or longevity rate, which must be taken care of by the pension system. It should be mentioned that life expectancy in Chile is equivalent to that of developed countries, which in some way disproves the idea that the public health system, who assists more than 85% of the population, is deficient, because if it were, we would not have such comparatively good results. In terms of men's retirement age (65 years in Chile), among 34 OECD member countries, only four have a lower retirement age than our country. In relation to women, Chile is the country who has the lowest retirement age (60 years), together with Luxembourg and Poland. This puts our country in the highest rank of the OECD in terms of the longevity risk that must be taken care of by the pension system.

The following charts show the longevity risk which the system has to cover.

Chart 3

OECD: LIFE EXPECTANCY AT THE MOMENT OF RETIREMENT, MEN

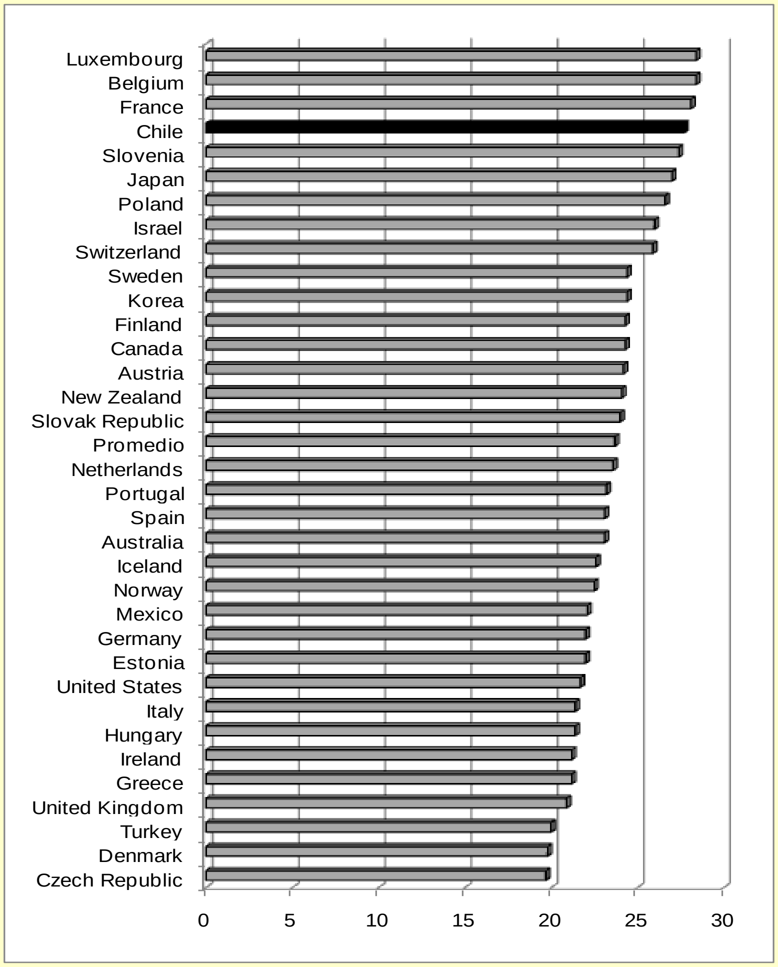


Source: OECD: Funded Pension Statistics

The charts show that the Chilean pension system has to cover a quite long life expectancy in relation to the rest of the OECD, especially in the case of women. This demonstrates the importance of incentives to extend the working life, since financing almost 20 years of retirement for men and nearly 28 years for women is highly complex for any system. On the other side, it seems almost common sense to believe that if we have greatly succeeded in extending the lives of the citizens, it is equally necessary to extend their active life. In fact, many OECD countries have increased retirement ages, while Chile has kept behind in this matter.

Chart 4

OECD: LIFE EXPECTANCY AT THE MOMENT OF RETIREMENT, WOMEN



Source: OECD: Funded Pension Statistics

Replacement rates of the pension system are another interesting aspect. Comparisons are complex, inasmuch as there is not a single way of determining the replacement rate. First, it must be established if they are calculated independently of the number of contribution years or not.

Second, if it is determined in terms of the wage at the moment of retiring or of the working life's average wage; third, which is the income level that the calculation considers, since replacement rates are generally higher for lower income sectors (due to subsidies that can be added up in this segment). Table 1 shows the replacement rates (net from tax) by country for different income levels related to the workers' mean income.

Table 1

NET REPLACEMENT RATES BY INCOME LEVEL

	Individual earnings, multiple of mean for men (women where different)			
	Median earner	0,5	1	1,5
OECD members				
Australia	65,9 (63.2)	82,5 (79.7)	58,9 (56.9)	47,1 (45.3)
Austria	89,9	91,3	89,9	84,6
Belgium	66,0	81,8	64,1	52,0
Canada	61,5	88,7	57,3	39,7
Chile	66,0 (52.4)	74,4 (61.7)	64,3 (49.9)	62,7 (46.3)
Czech Republic	72,5	94,0	64,4	48,9
Denmark	94,5	131,9	89,8	80,8
Estonia	63,1	73,4	58,3	51,4
Finland	64,8	72,0	65,2	64,4
France	60,8	69,4	60,4	53,1
Germany	58,4	55,6	57,9	57,2
Greece	110,3	113,6	111,2	106,8
Hungary	99,5	96,3	106,0	103,2
Iceland	111,7	139,0	101,1	91,7
Ireland	40,8	60,8	35,8	26,8
Israel	92,2 (82.3)	103,0 (93.6)	78,2 (69.8)	56,7 (50.6)
Italy	76,2 (63.0)	78,2 (63.4)	75,3 (62.1)	76,7 (62.1)
Japan	41,4	52,7	39,7	34,9
Korea	51,8	69,8	47,5	37,3
Luxembourg	96,2	103,1	94,0	90,9
Mexico	46,9 (46.9)	58,2 (58.2)	32,2 (29.9)	33,3 (29.7)
Netherlands	103,3	104,5	99,8	96,4
New Zealand	49,6	79,4	41,5	29,4
Norway	62,3	81,7	62,2	51,4
Poland	68,2 (50.7)	68,1 (53.4)	68,2 (50.6)	68,3 (50.4)
Portugal	65,5	73,4	69,2	70,5
Slovak Republic	72,9	68,3	74,5	76,7
Slovenia	90,2	82,5	85,4	86,2
Spain	84,5	82,3	84,9	85,4
Sweden	57,4	71,1	57,7	75,2
Switzerland	66,4 (65.5)	78,6 (78.1)	64,1 (63.2)	46,2 (45.5)
Turkey	98,0	107,3	93,1	96,0
United Kingdom	48,0	67,5	41,5	30,5
United States	53,4	63,8	50,0	46,6
OECD34	***72,1***	***82,9***	***68,9***	***63,5***

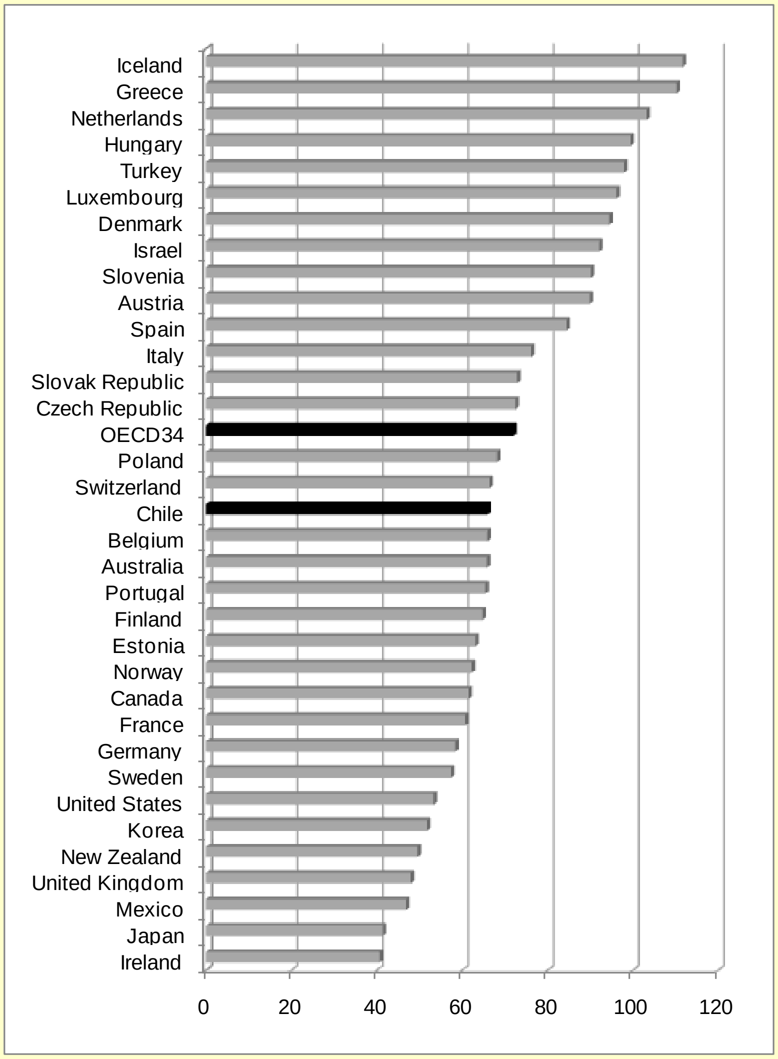
Source: OECD, Pension Models, data for women are expressed in brackets.

We can see that the replacement rates for Chile are slightly below the OECD average, but many of the countries having higher replacement rates have currently serious financing problems in their pay-as-you-go systems, and they are in the process of reducing the benefits. It is interesting to note that several high income countries have quite lower replacement rates than

Chilean ones: United Kingdom, United States, Canada, France, Germany, Ireland, Japan, Korea, Sweden and New Zealand, as shown in Chart 5.

Chart 5

NET REPLACEMENT RATES IN THE OECD

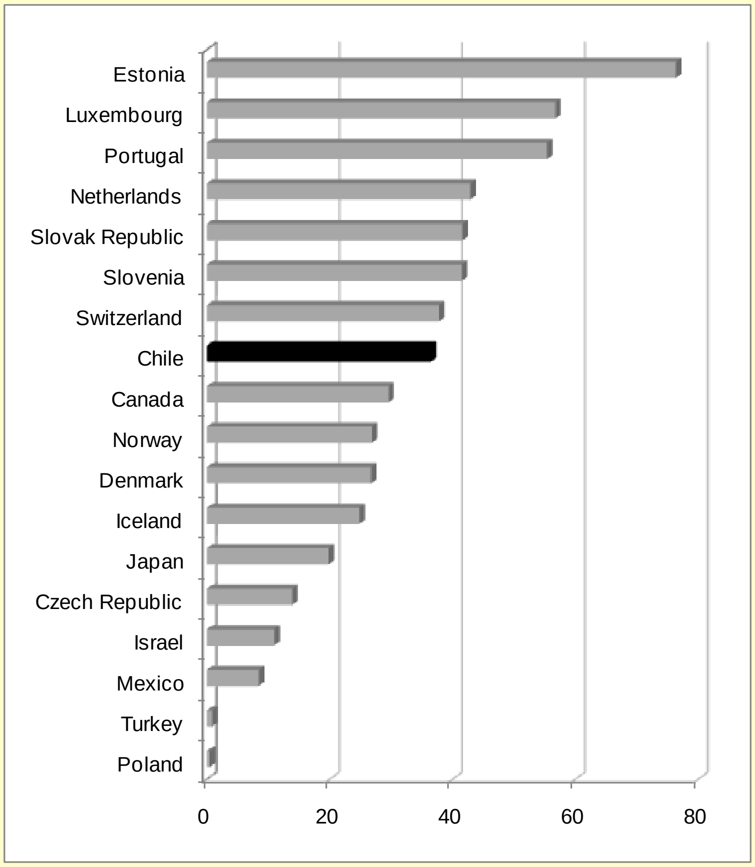


Source: OECD Pension Models

It is also interesting to compare the funds' diversification degree in external assets, where the Chilean pension fund is in an intermediate range. Since there are arguments in favor and against increasing the allowed percentage of foreign investment, the current position seems reasonable. On the other side, a greater diversification can improve the risk position and probably, in a lesser measure, the expected return.

Chart 6

PENSION FUND FOREIGN INVESTMENT % OF TOTAL ASSETS



Source: OECD Pension Markets in Focus Nº 9, September 2012.

Conclusions

The pension system has been questioned lately, because people's expectations are not being fulfilled in relation to their retirement standards. However, a deeper analysis allows showing that the retirement benefit is not explained by a problem in the system itself, but rather by labor market informality, life expectancy increase and growth of real wages in the last years.

As a starting point in the analysis of the Chilean pension system, it is useful to compare some features with other OECD countries, which allows concluding the following:

- Retirement funds of Chilean workers are being adequately managed by the administrators and, in fact, Chile is ranked in the first place of the OECD in terms of fund profitability.

- The Chilean system has to cover a relatively high longevity rate in the case of men, and definitely very high in the case of women, which evidences the need to extend their active working life, either in a mandatory and/or voluntary manner.
- In spite of this high longevity, the replacement rates of the Chilean system do not differ much from the OECD average, and the real problem for countries all around the world is that it has turned very difficult and expensive to keep retirement benefit levels in the range of the worker's last wage. In the end, it is a common sense problem: if in recent years economic development has allowed men and women to live longer and with higher labor incomes, it is strictly necessary to save more to keep the quality of life in the passive stage. The substantial problem is not solved by simply saying that "workers have the right to dignified pensions", because somebody has to finance them.

In brief…

- The Chilean pension system has been questioned lately, because expectations are not being fulfilled in relation to their retirement standards.
- Retirement funds of Chilean workers are being adequately managed by the administrators. In fact, Chile is ranked in the first place of the OECD in terms of fund profitability.
- The Chilean system has to cover a relatively high longevity rate in the case of men, and definitely very high in the case of women, which evidences the need to extend their active working life.
- Replacement rates of the Chilean system do not differ much from the OECD average, and the real problem for countries all around the world is that it has turned very difficult and expensive to keep retirement benefit levels in the range of the worker's last wage.

[i] In this context, an unusual case is constituted by women who contributed a single time in their lives in order to receive the child bonus, and who are currently included in the pension system.