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IS IT A GOOD IDEA TO RETURN TO THE PAY-AS-YOU-GO SYSTEM?

- When pensions paid by both systems are made comparable, we can conclude that pensions given by the old system are at least 45% lower than those of the individual capitalization system.
- The problems that the individual capitalization system is undergoing today will also impair a pay-as-you-go system. The difference is that a pay-as-you-go system can cover these risks with a higher fiscal deficit, as it occurred until 1981.
- If we were to return to a pay-as-you-go scheme as the old one, more than half (53%) of the affiliates of the individual capitalization system would have no right to any pension whatsoever and would lose all the savings made during their active life.

FURTHER INFORMATION

http://www.lyd.com/centro-de-prensa/noticias/2014/06/expertas-de-lyd-hacen-propuesta-de-perfeccionamiento-del-sistema-previsional-en-comision-de-pensiones/

http://www.lyd.com/wp-content/uploads/2014/06/PPT-comision-pensiones-LyD-CC-AC-2.pdf

At the end of April, and keeping a campaign promise, President Bachelet created the Presidential Advisory Committee concerning the Pension System, with the purpose of making a diagnosis and preparing proposals about the current social insurance system in Chile. This body has opened a big debate about the alleged deficiencies of the current system and if it should be modified or replaced. The present document seeks to briefly show why it is not a good idea for our country to return to a pay-as-you-go system like the one we had until 1981.

I. The old pay-as-you-go system failed, and the current individual capitalization system was created with the aim of replacing a host of existing inefficiencies.

The first pension system aimed at Chilean workers was created in the middle of the twenties, representing a pioneer social security program in Latin America. It was a pay-as-you-go system in charge of what is known as Social Security Funds to date, which started to multiply as time went by.

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At the beginning of the 70's, the prevailing pension system was strongly questioned. It was an atomized system, operated by more than 30 funds, each one with its own regulations. Unlike today, the employee could not choose where he wanted to contribute, and both the contribution level and the benefits when retiring (retirement age and pension level) depended on the economic sector in which he worked and the pressure exercised. There was no clear relationship between contributions made during the active life and how much the worker received when retiring.

As a consequence thereof, the social security system evidenced strong inefficiency symptoms. 13% of the social security budget was spent on its administration. On the other hand, the payment of pensions at the beginning of the 70's registered an important deficit, since it was financed, by close to 60%, with contributions from the employee and the employer, and 40% with public contributions.[i] At the beginning of the 80's, the options were to increase fiscal funding or social security contributions still further, which even exceeded 50% of the taxable wage, after being 5% originally. Likewise, the old social security system represented more than half of the expenditure on social security in Chile, and there was evidence that it would keep growing exponentially.[ii] In this context, the individual capitalization system was created in 1981, through Decree Law Nr 3,500, which stipulated property rights for the contributions made during the contributors' work life. It also related the contributions directly with the benefits to be received, thus eliminating special privileges, creating the adequate incentives and generating a financial structure that would contribute to the long-run macroeconomic sustainability of both the system and the country.

II. The pay-as-you-go system does not give higher pensions than the individual capitalization system.

Usually, it is argued that a good reason to go back to the old system is that the pension level is higher than the one obtained under the individual capitalization regime. Except for disability pensions, this is what aggregate statistics of the Superintendence of Pensions show for self-financed pensions by April 30, 2014.[iii] More specifically, if we compare the average old-age pension amount in both systems, the pension given by the Institute of Social Security (IPS, in Spanish) is close to 11% higher than that of private pension fund managers (AFP). This difference accounts for 38% and 21% in favor of anticipated old-age pensions and survivor pensions paid by the old system, respectively.

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PENSIONS OF THE OLD SYSTEM SUPPOSEDLY EXCEED PENSIONS OF THE INDIVIDUAL CAPITALIZATION SYSTEM

Table N°1: Paid Self-financed Pensions

System / Organism	Nr and Average Amount	By Type of Pension (by April 30th, 2014)				
		Old-age	**Anticipated Old-age**	**Disability**	**Survivor**	**Total**
AFP and Insurance Companies	Nr of pensions	403,834	242,825	106,226	223,941	976,826
	Amount (CLP$)	177,160	273,534	210,341	126,942	193,213
IPS (old system)	Nr of pensions	311,117	35,013	101,764	252,215	700,109
	Amount (CLP$)	196,457	378,174	195,061	153,481	189,860

Source: Superintendence of Pensions

However, these averages are not directly comparable. In the first place, those who state that the old system pays better pensions than the individual capitalization system forget that, under the old pay-as-you-go system, only people complying with a minimum number of contributions received a pension.[iv]

According to data from the IPS, the number of contributors without a pension in the old Social Security Funds, for not complying with the contribution intensity, is close to 50% of the total. Considering that the above table only shows the total number of people who receive a pension in both systems, and therefore leave out those who did not receive a pension because they did not meet the necessary requirements, we can affirm that the real average old-age pension of the old system is not CLP$196,457, but CLP$196,457/2 = CLP$98,228.5. Consequently, old-age pensions of the former system are 45% lower than those from the individual capitalization system. The same exercise can be repeated for all types of pensions.

Second, the above table hides another relevant aspect referred to comparisons: while the contribution rate of the individual capitalization system is close to 13% (including the commission of the private pension fund manager and the disability and survivor insurance charged to the employer)[v], the current contribution rate for those who still contribute to the old system is approximately 20.7% (excluding health, in order to make both figures comparable)[vi]. With this contribution, 7.7 percentage points above the contribution to the AFP system, the average pensions of the individual capitalization system would still be higher than that shown by the system today.

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There is a third aspect that should be highlighted from the previous table, which increases the pensions' gap in favor of the individual capitalization system: the individual capitalization scheme gives a pension to its affiliates regardless of the worker's contribution intensity. Thus, the old-age pension average of CLP$177,160 represents the average old-age pension obtained by those who show a high contribution intensity variance. For example, it includes the pension of women who only contributed once in order to get the Allowance per Child created in the Social Security Reform of 2008. Considering that the average intensity of AFP contributors in the last twelve months is 52.1% (which means that, on average, contributions were made for 6.25 months last year), the pension averages shown in the table for the individual capitalization system are not comparable with those of the old system.

Furthermore, that average does not reflect the pension that the individual capitalization system would give to the members who actually contributed to the system for a reasonable time and in a sustained manner. With this objective in mind, we present the following exercise, made by the Superintendence of Pensions, which shows average pensions by gender of the pensioners between January 2012 and May 2013, excluding those who joined the system after the approval of the Social Security Reform (so as to exclude those who were affiliated with the sole purpose of obtaining benefits) and including only those who joined the system with 35 years or less.

As we can appreciate, the average pensions obtained when applying the indicated filters are higher than the global average, even considering the fact that they are prior to April 2014. Moreover, the exercise clearly shows that pensions strongly increase inasmuch as the number of contribution years increase. It should be noted that the previous exercise does not envisage the contributions of the Solidarity Pillar. If we were to include what pensioners receive by concept of the Solidary Social Security Contribution, the final pension (which is the one effectively received) would be still higher.

PENSIONS OF THE AFP SYSTEM GROW AS THE NUMBER OF CONTRIBUTION YEARS INCREASE

Table N°2: Average Pension by Gender and Years Contributed to the Individual Capitalization System. Pensioners between January 2012 and May 2013

	Average Amount (CLP$)			
Contribution years	**Total (CLP$)**	**+10 years**	**+20 years**	**+30 years**
Women	198,292	220,074	253,496	312,002
Men	235,227	268,128	310,984	439,985
Total	216,000	243,514	281,489	375,038

Source: Superintendence of Pensions[vii]

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In short, when making both systems comparable, we can conclude that the old system does not give higher pensions than the individual capitalization system, but quite the opposite.

III. The pay-as-you-go system undergoes the same problems that impair the pension level today in the individual capitalization system

The main reasons why the individual capitalization system does not give higher pensions can be briefly described in the following list:

- Low contribution intensity due to social security gaps.
- Not contributing for the total wage (because of informality or non-taxable allowances).
- Growing life expectancy (which entails that accumulated funds have to last for a greater number of years).
- Reduced rate of return of long-term assets.

Is a pay-as-you-go system the solution for these problems? Or, if subject to the existence of these problems, would a pay-as-you-go scheme give a better pension than the individual capitalization system? For the reasons described below, we believe the answer is no.

First, the right to obtain a pension in the former pay-as-you-go scheme requires to make contributions to the system for at least 10 years. As a result of the low contribution intensity during the active life of Chileans, it is estimated that only 47% of AFP contributors achieve this number of years.[viii] This means that, if we went back to a pay-as-you-go system like the old one, more than half (53%) of the contributors to the individual capitalization system would have no right to receive a pension and would lose all the savings made during their active life. Since they would not receive any pension whatsoever, only those complying with the focalization requirements could opt for the Solidarity Pillar (that is, a Basic Solidarity Pension).

The pension level given by the old scheme also depends on how many years the worker contributed to the system. That is, when complying with the number of years in which contributions are made, the pension level will depend on the contribution intensity achieved by the worker during his active life. Thus, the low contribution intensity registered by employees today would also impact future pensions of the contributors to a pay-as-you-go scheme, like the one existing in Chile in the past.

Moreover, the pension to be received in the old system also depends on the taxable wage for which workers contributed. Accordingly, the current problems associated to sub declaration (contributing for less), such as informality and social security elusion originated in non-taxable allowances, also reduce the pension to be received in the pay-as-you-go system.

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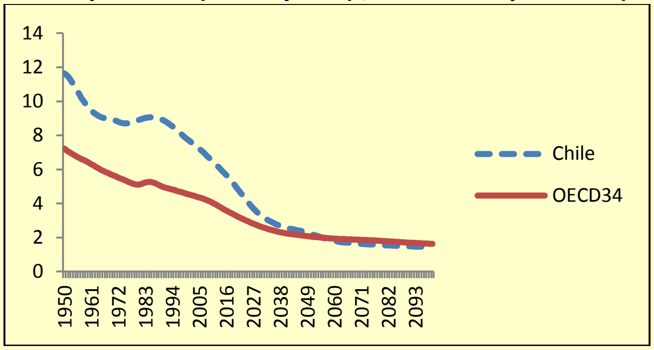
Consequently, under a pay-as-you-go system, as in the individual capitalization system, the person who contributes for less money or time will also receive less pension. Furthermore, according to the rules of the old pay-as-you-go system, a low contribution intensity could even take the affiliate to not receiving any pension whatsoever when retiring, thereby losing all his accumulated savings.

Finally, while the individual capitalization system is hit by people's higher life expectancy (since the same person has to finance a pension, during his active life, for a greater number of years), the pay-as-you-go system is hit by both greater life expectancy and lower birth rate in our country today, due to the aging of the population as a whole. Because, financing of a pay-as-you-go system depends on the active population and its ratio with the passive population. As a result of the noticeable aging of the Chilean population, this ratio is increasingly lower for our country, decreasing even more rapidly than the average of developed countries, as shown in the following chart. This could have an impact on the financial balance of a pay-as-you-go system.

STRONG IMPACT OF POPULATION'S AGING IN CHILE
Chart 1: Dependency Rate
(Active Population (20-64 years) / Passive Population (65+))



Source: OECD[ix]

With the purpose of illustrating the described situation, and using the simile of going back to the pay-as-you-go system, we observe the following: if we take the current scenario of the total number of contributors and pensioners from both systems, a contribution rate of 10% of the average taxable wage would be enough to cover a pension of approximately CLP$160,000 for today's pensioners. In 10 years more, given the increased aging of the population of our country, this pension would drop by more than 30%.

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CONCLUSIONS

There are several reasons why it would not be a good idea to change our individual capitalization system for a pay-as-you-go scheme. In the first place, when comparing both systems, we can conclude that the old system gives, on average, considerably lower pensions than those than an average pensioner can get from the AFP system; especially, when comparing with workers who contributed for a reasonable time in the individual capitalization system.

Likewise, and according to our analysis, the threats that the individual capitalization system is undergoing today also impair a pay-as-you-go system. The difference is that a pay-as-you-go system can cover these risks with a higher fiscal deficit, as it occurred until 1981. This greater deficit generates among its affiliates a false security feeling in relation to the benefits that could be obtained under a pay-as-you-go system. The deficit in which the State has to incur has an alternative cost, both in relation to public policies that must be set aside in other areas (for example, in health or education) and to lesser public savings that can entail lower economic growth.

Once the system collapses, as in European countries, the pay-as-you-go system is forced to either adjust its benefits (reduce the pension), increase the requirements to receive benefits (demand, for example, a higher number of contribution years) or increase the affiliates' contribution rate, so as to ensure its budgetary stability. The latter, with the risk of increasing informality or social security gaps which would lead to more deficit, thus generating a vicious circle that is hard to break.

Considering the system's great deficit before 1981, we decided to change to the current system, which was complemented later on with the Reform of 2008, through a Solidarity Pillar which allows giving access to a pension, or increasing self-financed pensions to all the people who comply with the focalization requirements. It is clear that going back is not the option we should take. However, improvements can be introduced both to the social security system and the labor market, which lead to better pensions and more opportunities while being active, which in turn will result in less social security gaps and informality.

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[i] Gaete, M.E., & Matthei E. (1988). *La privatización de la previsión social en Chile*. Puntos de Referencia, 32.
[ii] Piñera, José (1991), *El cascabel al gato. La batalla por la reforma previsional*. Editorial Zig-Zag, Santiago.
[iii] http://www.safp.cl/portal/informes/581/articles-10562_recurso_1.pdf
[iv] In the case of the Social Security Service (SSS), it required women to make contributions for a minimum of 10 years and men, 20 year; while CANAEMPU (former Public Employees Fund) and EMPART (former Private

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Employees Fund), required 10 years minimum, both for men and women; in addition to having the quality of active contributor when demanding the retirement pension.

[v] http://www.safp.cl/inf_afiliados/cotobl.html

[vi] http://www.ips.gob.cl/pensiones-y-tramites-96642/134-tasas-ex-cajas-regimen-antiguo

[vii] Superintendence of Pensions, based on administrative data of AFP pensioners between January 2012 and May 2013. The Superintendence made the following filters:

a) Pensioners with affiliation date equal or after 2008 were excluded from the sample, with the purpose of clearing the effect of those who were affiliated only to obtain the Allowance per Child, and have contributed to the system for a very short time.
b) The sample considers only those pensioners who were affiliated to the AFP system with 35 years old or less.
c) Pensioners whose last contribution was made for an income lower than 0.5 minimum wages were not considered, so as to avoid biasing the measurement of replacement rates, which are distorted when last wages are too low.

[viii] Estimation based on administrative data of the Superintendence of Pensions in relation to pensioners between January 2012 and May 2013.

[ix] OECD (2013), Pensions at a Glance 2013: OECD and G20 Indicators, OECD Publishing.