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Social Security: The Chilean Example

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Summary

In 1981, Chile changed its state-run Social Security system in favor of mandatory individual private accounts. As Social Security programs in the United States and other countries increasingly experience long-range financing problems, interest has grown in the Chilean system, and some analysts have recommended it as a model for reforming the U.S. Social Security program. This report describes Chile's new Social Security system and presents arguments that support or oppose using a similar approach in this country. It will be updated periodically. (For a discussion of other proposals to privatize the U.S. system, see: CRS Report 96-504, *Ideas for Privatizing Social Security*, by David Koitz.)

Foremost among arguments for adopting the Chilean system are that by placing the responsibility and reward on the individual rather than the State, a privatized system would: reduce future demands on the government for financing the predicted high level of costs associated with the current system; provide ownership of retirement resources to a workforce that is increasingly skeptical that it will receive promised benefits; and enhance national saving and thus economic growth. The main arguments against adopting the Chilean system are that it would force a generation or two of workers to face a "double burden," (they would have to pay into their private accounts while also paying for the benefits of recipients under the old system), and that many workers could be worse off because they might make poor investment decisions and would lose the features of the current system that are designed to safeguard the more vulnerable in society.

Chile's Change to its Social Security System

In 1981, Chile began to phase out its "traditional" state-run, pay-as-you-go Social Security system financed by employees and their employers in favor of mandatory individual private accounts. The old system had several major problems. First, it was fragmented, with more than three dozen plans covering white and blue collar workers with different benefit structures. The self-employed, wage earners, and salaried workers paid different payroll tax rates (as did the employers of workers, usually at a rate higher than that applicable to employees). Second, it was widely seen to be inequitable, as the plans covering workers at the low end of the economic spectrum tended to provide the least generous benefits. Third, the multitude of systems and many methods of benefit computations led to high administrative inefficiencies and expenses. Fourth, many of the plans were underfinanced, forcing the government to make up the difference with general funds. These factors led to noncompliance and widespread contempt of the system.

To take its place, the law provided that, beginning in 1983, wage-earners and salaried employees entering the workforce were no longer covered by the old system. Instead, they were required to pay a proportion of their earnings to a private pension fund of their choice. Coverage for the self-employed was made voluntary. Workers under the old system were given the choice of joining the new system or remaining in the old one. However, if they stayed in the old system, they were made responsible for paying the full share of the payroll tax (i.e., there would be no employer contributions).

As part of the transition to the new system, and to help induce older workers to join it, employers were required to increase workers' wages and salaries by about 18% at the time the new system went into effect. The employer's burden in paying these higher wages and salaries was ameliorated by the elimination of the employer share of the payroll tax, and workers under the old system did not see any reduction in their pay when they picked up the employer's former share of the payroll tax (workers who switched to the new system usually received a substantial raise). Also, workers who switched were given "recognition bonds," to be redeemed at retirement, that represent the value of their rights accrued under the old system. About 10% of workers have remained in the old system.

To help finance the benefits of current recipients, Chile raised taxes on consumption, sold state-owned enterprises, and borrowed from the public. It also required that a portion of the contributions to the private pension plans had to be invested in government bonds (which effectively gave the government the use of the money). Investment requirements later were relaxed to permit purchase of stocks, corporate bonds, and some foreign securities.

Under the new system, the minimum contribution is 10% of earnings (up to a prescribed maximum) for old-age pensions, and the required contribution for disability and survivor benefits is about 3.3%, depending on the requirements of the individual pension fund. Contributions are tax-deferred. The amount of the pension is based on the value of the worker's contribution plus interest, but the government guarantees (i.e., it bears the cost) that no benefit will be lower than 85% of the current minimum wage. The Government also guarantees (and bears the cost of) a minimum rate of return. At retirement (age 65 for men, age 60 for women), the worker may elect to: (1) receive monthly payments from his or her account that are determined by the family members' life expectancy and the balance remaining in the account (and which are adjusted annually); (2) buy an annuity from a private insurance company; or (3) combine these two options. Earlier retirement is allowed if the funds are sufficient to provide adequate benefits, both in terms of monetary amounts and the rate of replacement of former earnings.

The funds are administered and invested by individual pension fund management companies under government guidelines. Investment may be in either the private (stocks, bonds, bank certificates of deposit, etc.) or the public (government securities) sector. As of March 1996, 60% of the funds were in private sector investments. The proportion of assets of each fund invested in stocks and bonds is limited: 37% for stocks; 50% for bonds (recently, in large part in reaction to the Asian financial crisis, investments in stocks were reduced to about 20% of assets). No more than 7% of a fund's assets can be invested in any one company, nor can a fund own more than 7% of a company's stock. Furthermore, the funds may purchase only those stocks that are on government-approved list. The law allows up to 12% of a fund's investments to be in foreign securities (as of September 1998, the average oversea investment was 3%).

Oversight by the government is provided by the Superintendent of Pension Fund Management Companies. If a company does not maintain a minimum return on investments (net of allowed administrative expenses), it has to make up the difference out of its required contingency reserve fund. If that fund becomes depleted, the government dissolves the company, makes up the difference, and distributes the individual accounts to other management companies. The most recent figures indicate that there are 13 Pension Fund Management Companies. Since 1981, several companies have merged or been liquidated.

Adopting the Chilean Approach for U.S. Social Security

Arguments For. Proponents advocate adopting the Chilean system for various reasons. As a matter of philosophy, they generally prefer using the private rather than the public sector to achieve protection against the costs of retirement, disability, and death. However, what gives special impetus to their cause is the generally recognized need to address problems facing the current U.S. Social Security system. Of these, foremost is the program's recurring long-range financial imbalance. Under current projections, the present system is unsustainable without major changes, and traditional remedies such as raising payroll taxes or finding new groups of workers to bring into the system are less likely to work and be far more unpopular than in the past. Proponents argue that by placing the responsibility and reward on the individual rather than the State, a privatized system would reduce future demands on the government for financing the predicted high level of costs associated with the current system. Eventually, it would relieve the government of bearing much of the burden of supporting an increasingly elderly population.

Associated with the concern about Social Security's long-term solvency is the skepticism of workers, especially younger workers, that they will receive promised benefits, or any benefits at all. A recent Gallup poll showed that Americans are more confident about the availability throughout their retirement years of pension and savings plan than Social Security. Proponents assert that a privatized Chilean-type system would allay this distrust by giving a sense of "ownership" of retirement resources to workers, who would have visible proof of their accumulating nest egg.

The current system also is criticized for creating an illusion that the government is saving to pay for future benefits by holding current excess Social Security revenues in "trust funds," which the critics maintain are just government IOUs. Currently, Social Security revenues go into, and its benefits are paid from, the U.S. Treasury. When the system's income exceeds its outgo, as it is projected to be for another two decades, the excess revenue is credited to the trust funds in the form of U.S. securities. These securities are a promise to raise revenue in the future when the securities are redeemed—the money itself is spent by the Treasury on other government services. Proponents of the Chilean system argue that placing retirement resources in the private sector would prevent the government from using them to pay for other activities, and that eliminating this arrangement would "unmask" the real costs of other government programs. They say that this could lead to increased spending cuts. Reduced government expenditures means less money need be borrowed from the public, thus freeing up more resources in the private sector for investment, leading in turn to more economic growth and international competitiveness. Thus, they contend that redirecting revenue from a state-run system, where the money is immediately spent, to a privately invested one, would promote real savings.

Critics also contend that the benefits paid from the new system would be more equitable than those under the current system. They aver that Social Security currently has a contradictory mix of insurance and social welfare goals, and in trying to accomplish both, does neither well. For example, it attempts to correlate benefits with presumed need, so it redistributes income to families and lower-paid workers at the expense of two-earner couples, and single and higher-paid workers. However, it also relates benefit to past earnings, and has no means test. The result is characterized as a mishmash where windfalls accrue to some, while others suffer a net loss. In contrast, the benefits paid from the new system would be strictly in proportion to the amount saved. This would provide workers with the opportunity to earn a higher rate of return than under Social Security.[1] They claim that younger workers especially would be attracted because forecasts predict worsening rates of return for them under the current system. It would induce them to focus on their resources in retirement and plan accordingly. They could track the performance of their funds and switch plans to maximize their rate of return. Thus, proponents say, workers would be more confident about the availability and fairness of their benefits.

Proponents point out that Chile's economy has enjoyed rapid growth since its Social Security system was changed. They say it is plausible that Chile's recent high economic growth rate could be duplicated by the United States if pension contributions were invested in private enterprises where innovation and inventiveness would be unleashed. They contend the new system would enhance worker productivity by providing more incentive for workers to think about the future and to work harder to achieve real wealth. Also, proponents argue that the decline in the cost of labor (because employers would no longer pay a share of the payroll tax) would lead to more jobs and lower costs of production.

Furthermore, they point out that once the new system became fully implemented, Federal involvement in providing retirement income would be greatly reduced. A vast Federal bureaucracy would not be needed to track employment histories, take and process claims using alternative benefit formulas, etc. Administration would be simpler because benefit computations would be straightforward and benefit categories would be fewer.

Arguments Against. Opponents of adopting the Chilean system also do so for various reasons. Many of them philosophically distrust a private sector approach to social issues because they believe it often hurts the poor or unlucky. However, often at the head of their arguments is a practical issue; how would the transition from the old to the new

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[1] From their inception, the Chilean pension funds have yielded an average real rate of return of 11.3%. The real rate of return was 13% from 1981 through 1994, but dropped to minus 2.5% in 1995 and averaged 1.8% over the past 3 years.

system be accomplished? They maintain that the transition to such a system in the United States would be much more difficult to implement than in Chile.

First, they argue that society would face a “double burden” if young workers were to contribute to private accounts while commitments to current recipients and older workers were kept in place. Initially, the Social Security system (and the Federal Treasury) would lose the contributions of new workers and the younger workers who would volunteer to join the new systems. As each year went by, the number of these workers would increase. However, because few older workers would be likely to leave the Social Security system, the number of Social Security recipients would be virtually unaffected for many years. Absent other measures, keeping Social Security’s commitments would require the government to raise taxes, cut spending on other programs, or borrow more from private financial markets. Put another way, a generation or two would have to pay twice, bearing both the cost of prefunding the new system and the costs of benefits under the old system. (The Social Security Administration estimates if all workers currently under age 40 were to stop paying into Social Security, the system would need an infusion of $7 trillion in order to pay promised benefits to those remaining in the system). They also point out that part of the 1981 reform was the imposition of a value-added tax. In 1995, this tax amounted to 8.3% of Chile’s Gross Domestic Product (more than the entire cost of the U.S. Social Security system expressed as a percentage of GDP in any year of the 75-year projection period).

Opponents also point out that Chile’s situation in 1981, when its plan was enacted, was far different from ours. Chile’s old system lacked social justice because different groups received widely disparate treatment. Its benefits were often heavily eroded by the double-digit inflation Chile suffered in the 1960s and 1970s (it was triple-digit in 1973-76). The multitude of systems, inadequate non-automated recordkeeping, and many methods of benefit computations caused poor (but expensive) administration, and great public dissatisfaction and derision. Many systems were financed from fixed-income assets that, because of Chile’s high inflation over the years, were practically worthless. This forced the government to intervene with general fund payments that were becoming so large, and projected to increase to unsustainable levels, that drastic reform was necessary. Moreover, Chile’s radical approach was part of a wholesale reform of the domestic economy under a military dictatorship designed to roll back Socialism and ease foreign exchange controls. Opponents point out the Social Security system in the United States, while it does have long-range financing problems, is operating relatively smoothly and enjoys broad public acceptance. Whereas the public in Chile overwhelmingly believed that the old system should be replaced, most Americans still support Social Security.

Opponents also express concern that self-interest would drive up costs during the transition. Because it would advantage them most, those switching to the new system most likely would be higher-paid workers. Conversely, participation of workers remaining in Social Security would likely be concentrated among those who expected to receive protection of greater value than their contributions. Critics believe a process of “adverse selection” would drive the per capita costs of Social Security upward.

Aside from the transition problems, opponents take issue with other virtues attributed to the Chilean system. They dispute that adopting the Chilean system necessarily would lead to increased national savings. They say that although the contributions into the private pension funds would increase private savings, if the government compensated for the lost revenue by increased borrowing from the public, the net effect on saving would be nil. They point out that the Chilean government continues to bear heavy obligations (past service credits, the minimum guarantees for benefits and rate of return) under the new "privatized" system, and therefore it is in fact "underfunded." Also, although employers might perceive that labor costs were lower because they no longer would pay the employer share into Social Security, they might face additional costs if part of the burden of financing the old system were placed on them.

Opponents also argue that there would be controversy if, as under Chile's system, the government were to set policy for how and in which instruments the funds were to be invested. There probably would be broad public interest in the use of these funds. Political pressure could be brought to bear to use these investments to shore up ailing industries or support social causes. That pressure also could be evident in cases where funds held stock in companies that pollute, make products objectionable to certain constituencies, or invest in countries with repugnant or unpopular policies. Critics also point out that maximizing the return of the pension funds in Chile sometimes can be inimical to the country's other interests, citing that recently pension fund managers have been criticized for harming Chile's economy by speculating against its currency.

Opponents also object to weakening the social welfare features of the current system. For example, the current benefit formula is progressive, replacing a higher percentage of earnings for lower-paid workers than for higher-paid workers. Also, dependent benefits are available at no additional cost to the worker. Opponents argue that, although the minimum guarantee would retain some progressivity in the system, adopting the Chilean approach would make most workers' benefits strictly a function of the amount of their earnings and the rate of return achieved by their plan's investments. Also, even if private investment produced an overall higher rate of return, the value of the portfolio could vary widely as the values of stocks and bonds rise and fall. Thus, they argue that it is possible that a substantial number of recipients under the new system could be worse off than under the current system.

Opponents also point out that the administrative costs of the Chilean system have been higher than those of the U.S. Social Security program. Since the beginning of the new system, they have averaged about 15% of contributions, in contrast to 1% for the U.S. Social Security system. Also, competition among the pension companies has led them to offer inducements to workers to switch companies (25% of enrolles do so each year), which has led to high commission costs. It has been said that these commission costs have reduced the nominal real rate of return on workers' contributions by as much as 58%.