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How Well Has Chile's Retirement Program Aged?

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Viewed as one of the world's most innovative pension systems when it was created a quarter century ago, the Chilean retirement program is receiving new scrutiny as participants begin to reach retirement age, and President Bush promotes elements of the plan as a way to reform Social Security in the United States.

An upcoming Presidential election in Chile has prompted additional debate about whether the Chilean system provides enough coverage to prevent old-age poverty, according to Olivia Mitchell, director of Wharton's Pension Research Council, who recently led a panel entitled, "Exporting the Pension Revolution: Chile and Beyond," at the Wharton Global Alumni Forum in Santiago.

"Many comments are beginning to bubble up about how well the Chilean system is working and for whom it is working well," says Mitchell. "Some of these perspectives are being repeated in the U.S. press because Social Security reform is such a hot potato."

Chile enacted its national defined contribution pension system in 1981 after the prior government-run systems collapsed. The core element of the plan is that workers are required to set aside 10% of their earnings into private savings accounts. Eleven other Latin American countries have copied elements of the Chilean approach, in which bankrupt state-run pension plans are replaced by defined contribution-funded individual accounts. "This reform model has been exported all around the Americas and it's been held up by many as a fine example of a well-functioning national personal accounts system," says Mitchell. Overall, the Chilean system has provided savers a 10% real rate of return since its inception. "That has made the system very popular, but it's not clear whether this can persist in the future, or whether others can replicate it," she adds.

Six-Month Cushion

A World Bank report released in December 2004 entitled, *Keeping the Promise of Social Security in Latin America,* found that the reforms have reduced fiscal liabilities, helped develop the nations' financial sectors, and improved the equity of pension systems. "Most importantly," the report states, "the shift to individual accounts was a major structural improvement to the income-smoothing objective of pension systems for most current contributors.... But there have also been significant disappointments," the report continued, "chief among them the failure to extend access to social security to a broader segment of society."

To get a better sense of how the system is working, Mitchell and two researchers on the University of Pennsylvania Economics faculty, Jere Behrman and Petra Todd, are collaborating with the University of Chile's Centro de Microdatos to review survey data from pension plan participants and government records.

Mitchell says one concern about the system is the so-called density of contributions, which refers to the pattern of lifetime contributions into the system. If people don't pay in long enough, they may not accumulate enough money to generate an adequate pension benefit. In Chile, workers in the wage and salary "formal" sector are required to pay into the system. Self-employed workers in Chile, unlike those in the United States, are not required to pay into the system, although they may do so voluntarily.

Preliminary research indicates that the average Chilean worker has paid into the system about half the time, says Mitchell. "This suggests that he or she will likely have enough contributions by retirement to be eligible for some benefit." Also, initial work with new survey data shows that three-quarters of those not making contributions are women, and two-thirds of those women are not the heads of their household, says Mitchell. "The chances are that many are in households where the spouse is likely to be covered. If so, this would make policymakers worry less, since there's some degree of family protection."

The new data also suggest that formal sector workers paid into the system 19 of the last 24 months, according to Mitchell. Those where payments were not compulsory only worked during six of the past 24 months.

To get a sense of household assets that might be available for retirement, the Penn researchers asked whether respondents could support themselves for six months if they were confronted with some sort of household emergency, such as illness or a natural disaster. One-third of those working in the formal sector felt they had access to this amount of emergency funds. Of those not required to pay into the national pension system, only 20% could ride out a six-month emergency.

It might not be adequate, but it compares well to what U.S. workers have set aside, notes Mitchell. The researchers' next step is to look at household resources as well as sources of social and private insurance in the event of economic and health shocks. "We will look not only at the individual, but also the households," says Mitchell. "We hope to trace out the vulnerabilities of different types of households, whether they are in the pension system or not."

Survey results so far indicate a lack of financial literacy. "One of the things I found disappointing is how little people know about their pension system," she says. "We find that in the U.S. too. People tend to be oblivious."

For instance, Mitchell suggested that participants should report what their contribution rate is since the mandatory contribution is 10% of wages and has been for over two decades. But in the survey, a majority did not know their contribution rates, 80% did not know how the benefit would be computed, and over half did not know their pension balance amounts.

In addition, she says, 90% of those in the system did not know how commissions, fees and other charges are structured. "There is a huge task ahead, to educate people about both retirement needs and the system they are paying into."

The first wave of retirees with at least 20 years in the system is now beginning to receive benefits. Mitchell says one interesting trend that has surfaced is the high number of retirees who are converting their pension benefit into annuities. In the United States, there is little demand for private annuities, which pay the owner a guaranteed sum for life. "Because we do have Social Security in the U.S., which is an annuity, there is less demand for such a product. By contrast, in Chile, many people will have to rely on their own savings to cover longevity risk. In the latter case, there is a logic to annuitizing."

Multi-Fund Investment Choices

Mitchell notes that in 2003 the Chilean government made it easier for pensioners to buy annuities. Instead of having customers shop the market individually, the government built a web-based clearinghouse that allows consumers to go into the site anonymously and have insurance companies bid for their business. As a result, insurers' costs dropped sharply. "It seems to have been a sensible idea," says Mitchell. "The government saw it as a step forward in making it easier to move into the decumulation phase."

Financial markets, in general, have benefited from Chile's system. "One of the problems with developing countries is there are not well-developed financial markets. What a funded pension system can do is to help build the finance sector as well as the insurance sector," Mitchell points out.

Chile has just begun to offer multi-fund investment choices for savers, she adds. "I am most interested in seeing how people in this system have selected their portfolios. Do they end up trading a lot between funds or do they put their money in and leave it there? In the U.S. case, some people trade quite a bit in their 401(k) plans. That is expensive, and it probably costs them money."

Another issue to hash out, as Chile's new retirees begin to draw on their pension savings, is how much additional money the government will give them from assets held in the prior system, says Mitchell. In the next five to 10 years, retirees will want to cash in on that "promise money." The government "will have to come up with some funds which reflect the value of what they paid into the old system," says Mitchell. "It won't be an actuarial valuation, but it is a recognition of the old-program obligation."

Still another element of Chile's overall social safety program is its voucher system for health insurance. Workers can direct 7% of their wages either to public health insurance or private health insurance. Mitchell and the University of Pennsylvania team expect to study this system to gauge the possible response in the United States to credits or vouchers for private insurance for Medicare beneficiaries as an extension of the Medicare Plus Choice program, or for private insurance, as in the Bush Administration's proposal to reduce the number of low-income families without health insurance.

Mitchell says the researchers will also look into whether the Chilean system should push back the retirement age for women. Currently women are allowed to retire at 60, while men cannot receive benefits until they are 65. "There really is no good reason to have an earlier age for women. Women live longer, so if you let them retire at 60 and annuitize or get the lump sum, they will be living on very little over their future retirement period."

Mitchell also raised another concern about the earlier retirement age for women: It may lead employers to discriminate against women because they fear they will leave work sooner and any investment in training won't pay off as long as it would for a man.

The Chilean system requires 20 years of payment to receive a minimum pension benefit and the World Bank report indicates that participants may stop paying in after they hit the minimum. The minimum benefit provides approximately 25% of average national income of about $6,000 per year.

The Chilean government has instituted a welfare pension plan for the poorest elderly, which is means-tested to screen out beneficiaries with significant income or assets, Mitchell notes.

In the end, will it be enough? "People don't realize that it takes years and years for a pension system to bear fruit," says Mitchell. "There are still Chileans who earn low wages and are low skilled. Every country worries about the poverty of its population -- during their work lives and also in retirement."