Notes and Brief Reports

Social Security Abroad

Chile Changes Social Security*

After almost half a century of following the European pattern of social security, Chile is changing to mandatory private insurance coverage. The conversion from a public program to a basically private program is believed to be unique in social security history.

Chile has had one of the most developed social insurance systems of any of the Latin American countries, with programs for old-age, survivors, and disability insurance (OASDI), national health insurance, work injury, unemployment insurance, family allowances, and general coverage for wage and salaried workers. However, there were major problems: (1) The system was made up of over three dozen funds (including white collar, blue collar, and miners) with different benefit rates and financing patterns, (2) inequalities in benefit rates existed among the various funds, (3) management inefficiencies were common, (4) it was possible to evade contribution payments, and (5) program improvements (such as expanding coverage) were made without financing improvements. The result of these problems was that while benefits remained low, in part because of severe inflation, costs increased.

The November 1980 legislation, effective May 1, 1981, calls for phasing out the pay-as-you-go, employer/employee/Government financed OASDI program. The change initiates a system of enforced savings for old-age benefits—in effect a provident fund program—and private insurance for survivors and disability benefits. Each wage and salary worker has an individual account to which he or she contributes monthly for the purpose of retirement. These accounts go into funds to be invested and administered by newly created private pension fund management companies under Government supervision. Upon retirement, the worker can buy an insurance annuity or make periodic withdrawals from his account. The employer's contribution is eliminated for OASDI, health insurance, unemployment insurance, and family allowances. However, the employer is required to increase the worker's pay by 18 percent to make up for the increased contributions now paid by the worker.

During the transition period (beginning May 1981), those presently covered under social security have 5 years to choose between the new and the old systems, and those entering the labor force within the next 2 years will have 2 years to make the same choice. After 2 years the old social security system will be closed for new entries but will continue in operation for as long as there are participants. Under the new system, all workers will be able to change freely from one pension fund to another.

Through these changes, the national Government in Chile hopes to achieve the following goals: (1) To stimulate employment by eliminating the employer contribution and thereby lowering the cost of labor, (2) to encourage higher labor productivity by giving individual workers a more direct responsibility for how much they contribute to their retirement and how much income they will eventually receive, (3) to promote the growth of private investment, (4) to discourage widespread evasion of contributions by involving the worker more directly, and (5) to provide the worker with freedom to choose initially between the old and new systems and then between competing plans.

Background

As of December 1979, 68 percent of the Chilean population were covered under social security. Expenditures represented about 17 percent of the gross national product—about US$2 billion—almost half of which was spent on OASDI payments.

The old social security system is operated by more than three dozen funds, each with its own rules, eligibility requirements, and benefit levels. The two major funds are the Social Security Service (Servicio de Seguro Social—SSS) and Private Employees Fund (Caja de Empleados Particulares—EMPART). The SSS fund is essentially for blue-collar workers. After 30 years of contribution, a worker receives a maximum of 70 percent of his final pensionable salary (average unindexed earnings in the last 5 years). Pensions are computed in the following manner: 50 percent of final pensionable salary, plus an additional 1 percent for

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each year of contribution more than 10 years, up to a maximum of 30 years. The retirement age is 65 for men and 55 for women. A disability pension is equal to the employee's accrued retirement pension at the time of disability. A widow's pension is equal to half the retirement pension if death occurs after retirement, or half the disability pension if death occurs during employment. Until March 1981, the employee's contribution was 7 percent of salary, and the employer's was 16 percent of payroll.

The EMPART fund is basically for white-collar workers. The retired-worker pension equals 100 percent of final pensionable salary (average earnings in the last 5 years, the first 2 of which are adjusted to a consumer price index) after 35 years of contribution. The disability pension equals 70 percent of final pensionable salary plus 2 percent of pensionable salary for each year of contribution over 20 years, up to a maximum of 100 percent. A widow's benefit equals 50 percent of the old-age pension of the deceased where death occurs in retirement, and 50 percent of salary where death occurs during employment. Until March 1981, employees contributed 17 percent and employers 11 percent of pensionable salaries.

Before March 1981, in both SSS and EMPART there was a general revenue subsidy for OASDI. The worker paid 1 percent and the employer 2 percent for health insurance, while the employer alone financed work injury (1–4 percent, depending on risk), unemployment (2 percent), and family allowances (10 percent).

The multiplicity of funds with differing requirements for retirement and financing and benefit rates demonstrated the inequities in the system. Workers were not able to choose the fund they wanted because membership was determined according to occupation. As a result, many workers were dissatisfied because the more desirable funds were inaccessible. Administration of the funds as well as record-keeping and payment of benefits were inefficient.

The high contribution rates required for each employer discouraged employers from hiring additional workers. Some employers even hired workers informally in order to avoid paying the social security contributions. Since there was a minimum benefit, the widespread evasion of payments caused, in part, a rising Government subsidy, presently about 28 percent of the social security revenue. Inflation was also a major problem. A mounting social security deficit meant that general revenue subsidies were on the increase. It was feared that the general revenue supplement would need to be increased nearly tenfold in 20 years. Despite the differing benefit rates, 70 percent of the beneficiaries received the minimum benefit (85 percent of the minimum industrial wage). Under the old pension system, most workers faced a drastic reduction in their standard of living upon retirement.

Implementation of New Program

The November 1980 changes provide for modifying and eventually phasing out Chile's former OASDI system while establishing a private pension system funded by employee contributions, managed by the private sector, and regulated by the Government. The reforms also change financing for health insurance, unemployment insurance, and family allowances. The new plan is mandatory for wage and salary workers, but is voluntary for the self-employed. Programs for the military and national police are not affected by the legislation. The new program will operate through a network of management companies, each a kind of mutual fund that is newly established solely to administer a private pension.

Financing

The new OASDI and health insurance program are paid entirely by worker contributions of about 17 percent of earnings. Of this, 10 percent goes toward old-age pensions, 3 percent for survivor and disability insurance, and 4 percent for health insurance. By 1982, the 3 percent contribution for survivors and disability benefits will be replaced by differing rate schedules established by individual management companies. The rate schedule will depend upon: (1) The amount of accumulated funds in the worker's individual account, (2) the age of the potential beneficiaries and their relationship to the insured, (3) the age of the insured, and (4) the worker's income.

Employer contributions under both the old and new systems are eliminated except for a temporary 4 percent of payroll contribution for family allowances that will be phased out by 1984 and a 1–4 percent of payroll contribution for work injury insurance. The Government pays for family allowances and unemployment insurance programs.

The employer's contribution rate for white-collar workers is thus to be reduced from about 29 percent to a maximum 4 percent of payroll. On the other hand, the wage earner's share rises on the average from 7.25 percent to about 17 percent of earnings, and the salaried employees share decreases slightly from 17.67 percent to about 17 percent of earnings on the average. To make up for the shifts, employers will be required to increase wages by 18 percent for those who opt for the new system. This increase results in a net reduction of about 7.4 percent in the cost of labor for employers and an increase in the gross pay for workers who choose the new system. For those who remain in the old system, increases will vary from fund to fund. To what extent this will increase tax liability is not presently known. However, the Government has pledged that no one will have a reduction in take-home pay.

The ceiling on contributions is approximately

US$19,000 a year, compared with the average annual earnings of about US$3,300 in January 1979. Contributions to the new system are tax-exempt. The self-employed can choose the amount of income they want covered for purposes of social security, but it cannot be less than the minimum wage. The unemployed worker may continue to contribute voluntarily up to 1 year after termination of employment.

Employers deduct the contributions from the employee's wage or salary and deposit the deductions with the pension fund management company of the worker's choice in his or her individual account. Each management company has a relatively low capital requirement of US$500,000. Its income is derived from management fees charged to the individual accounts.

The funds' investments, determined by the Central Bank of Chile, must be in low-risk domestic instruments. These include: (1) Government bonds, (2) time deposits and securities of financial institutions, (3) bonds guaranteed by financial institutions, (4) letters of credit sent by financial institutions, (5) debentures of public and private companies, and (6) shares in other pension funds. By restricting the investments to domestic instruments, retirement income is tied to the performance of the Chilean economy. Each fund is required to publish information on its financial situation, including capital investments and profitability. It must also maintain the privacy of the individual's account and, upon request, provide up-to-date information to the worker on the status of his or her account.

The way in which two types of liabilities under the old system are to be handled is as yet not entirely clear. First, the number of contributors will be decreased, but it is not clear if benefit levels will be affected. Before the change, the total employer/employee payroll contribution for blue-collar workers was 23 percent. As of March 1981, it is approximately 19 percent and is to be paid by the worker alone. For the white-collar worker, the former total averaged about 28 percent, but it also drops to about 19 percent (as shown in table 1). Moreover, the number of contributors to the old system is expected to decrease significantly, while benefits for the current beneficiary population must continue to be funded on a pay-as-you-go basis. Presumably, the Government will make up the deficit through general revenues, although this is not specified by law.

A second funding deficiency can occur when a worker who has switched from the old to the new system retires soon after the reorganization. The amount of his accrued entitlement is transferred from the old social security system to the appointed management company in the form of a bond. Since there is a guaranteed minimum benefit and because many workers will come into the new system with very low earnings records, additional funding will be needed. (Aside from the guaranteed minimum benefits in a pay-as-you-go system, the Government does not have the money to fund this bond.) However, partially to offset this burden, the Government has stated that those who choose the new system cannot retire within 5 years of joining.

Table 1.—Changes in employee and employer OASDI contribution rates[1] under the old and new systems, by effective date and type of worker

Effective date and type of worker	Percent paid by—	
	Employee (earnings)	Employer (payroll)
	Old system	
Before March 1981:		
Blue collar	7	16
White collar	17	11
After March 1981:		
Blue collar	19	0
White collar	19	0
	New system	
As of May 1981:		
Blue collar	13	0
White collar	13	0

[1] Rates represent approximate percentage of employee's earnings and employer's payroll.

Benefits

Retirement benefits drawn from the worker's individual account will consist of the worker's contributions plus accrued interest from the pension fund management company's investments. Under the new program, the retirement age is 60 for women and 65 for men with a minimum of 20 years of contributions. Workers may retire before the required age limit if their pension equals 70 percent of the average of the last 10 years of wages. This can be accomplished by making additional payments (up to 10 percent of income) to their account, along with the mandatory 10 percent of salary, for retirement. At retirement, the workers may either buy an annuity from a private insurance company with minimum protection for survivors or maintain the account with the management company from which the worker may make withdrawals that are regulated to guarantee retirement income for the rest of the worker's expected life. In the second case, upon the worker's death, the capital from the account is transferred to the worker's estate. However, if the worker exhausts the funds from his account before he dies, he receives a minimum pension from the Government for the duration of his life.

The benefits for survivors will be distributed as follows: 60 percent of the insured's benefit for a dependent surviving wife with no children and 50 percent if there are children, plus an additional 15 percent for each single child under age 18 (age 24 if in school and no age limit if disabled). Those workers who are at least two-thirds disabled will be eligible for 50–70 percent of the full disability benefit depending upon the rate schedule established by their chosen management company. Two years of contribution in the last 4 years qualifies a worker for the minimum invalidity benefit, except in the case of an accident. In that case, 6 months of contributions and current insurance status are necessary. As the new system is phased in, workers temporarily remain covered for disability and survivors benefits under the old system.

Transition

The Government has emphasized that one of the major features of the new pension system is the amount of choice given to the individual. Participation is still obligatory, but workers may choose their own management company and change companies if dissatisfied with its investment performance. They may contribute additional money to their account in order to retire early or to have a larger pension upon retirement. They may choose between an annuity or periodic withdrawals as means for pension payment. Workers can also select the system they want: current workers (and new entrants into the labor force up to the end of 1982) can choose to remain with the old, modified pension system. Members of the old system have 5 years from the date of implementation of the system on May 1, 1981, to convert to the new system.

When workers retire under the new system they must have at least 12 months of contributions within the last 5 years. The Government will then issue social security bonds representing the value of their accrued rights under the old system, adjusted to a consumer price index. The bonds are nontransferrable and redeemable upon retirement. Once under the new system, if a worker decides to change funds, the bond is considered part of his individual account.

The new organizational structure, created to govern the old system, consists of an Advisory Council,[1] the Institute of Social Security Normalization, and the Social Security Financing Fund. The Advisory Council supervises the activities of the other two organizations, while the Institute proposes policies and methods for carrying out social security laws and agreements to the Council and oversees the Social Security Financing Fund. The Social Security Financing Fund is responsible for the transfer of assets and credits of the social security institutions, investments of the various funds, the financing of bonds given to those workers who convert to the new system, and the disbursements of pensions for those who remain under the old system.

[1] The Advisory Council is made up of the Minister of Labor and Social Security, the Minister of Housing, and the Director of the Office of National Planning.

Government Role

Under the new system, the Government's role is to regulate the pension fund management companies and to continue to guarantee minimum benefits. The Government has set up a new agency, the Superintendency of Pension Fund Management Companies, to regulate the operation of the companies and guarantee investments. The Superintendency may fine the individual funds for minor infractions and will establish norms for the insurance contracts purchased for survivor and disability insurance for individual workers.

As previously mentioned, the Central Bank of Chile will determine the type of investments the companies can make. The companies must maintain a minimum return on investments, which is the smaller of 2 percentage points less than the average return on all funds or one-half the average return. If the management company does not earn the minimum, it must pay the difference from its contingency reserve fund within 6 months or the Superintendency will make up the difference, dissolve the company, and distribute the individual accounts to other management companies.

The Government also guarantees a minimum old-age benefit to all participants reaching retirement age after at least 20 years of contribution, regardless of whether their account is sufficient to cover it. In addition, the Government continues a means-tested program for the needy elderly who do not have sufficient social security contributions.

Conclusion

The November 1980 social security changes are among the most far-reaching economic changes the present Government of Chile has undertaken. Under this new system, the Government has a number of economic goals: To encourage better management of the pension program by promoting competition among the private management companies, to stimulate the establishment and growth of private investment funds and to discourage evasion of social security contribution by making the individual responsible for his or her own retirement income, to raise labor productivity by tying an individual's retirement income to his own contributions and to the performance of the Chilean economy, to encourage employment by lowering the employer's cost of labor, to reduce a growing social security deficit, and to grant the worker greater freedom and responsibility in planning for retirement.

Most Chileans agreed that the old social security system required significant changes. However, some feel that the old system could have been revised instead of replaced. It is important to note that these reforms were proclaimed by executive decree and not by a plebiscite. Labor unions were not consulted. Critics of the plan complain that the program discriminates against workers since they would not have the necessary US$500,000 capital, nor the management expertise, to form and successfully operate a pension fund. Critics feel that this will allow a small number of conglomerates to dominate the field and discourage a more equitable distribution of income and wealth.

The establishment of a provident fund represents the abandonment of the social insurance principle and a step backward in social security terms. A provident fund is little more than a savings account where each individual is responsible for his or her own welfare. A social insurance program, on the other hand, calls for the pooling of resources for the common good.

The success of the changes is dependent, in part, upon the performance of the economy and the curbing of inflation. The 1973 inflation rate of 1,000 percent has declined steadily to a current 35 percent. If the economy thrives and the pension fund management companies invest in instruments that yield good returns—ones that at least keep up with inflation—then the workers will gain.

The current Chilean market, which has limited opportunities for investment, will have to accommodate the growth of the private funds established as a result of the November 1980 reform. An improvement in employment will depend upon the labor force's ability to meet the demand for the new jobs that may be created. Other requirements for the smooth operation of the new program are efficient management and a reliable source of funds to back the minimum income guarantees.

It is too early to assess how successful these extensive reforms are likely to be. Their success will be judged in part by the number of people that join the new system during the next 5 years.

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