IN BRIEF: AN UPDATE ON CHILE’S EXPERIENCE WITH PARTIAL PRIVATIZATION AND INDIVIDUAL ACCOUNTS

Introduction

In 1981, Chile became the first nation in the world to shift from a pay-as-you-go defined benefit (PAYG-DB) social insurance model to a funded defined contribution (FDC) model. In part because it was the first nation to make this shift and in part because its FDC scheme has been in place so much longer than those in other nations, the Chilean model has become arguably the most influential model of partial privatization in the world.

In An Update on Chile’s Experience with Partial Privatization and Individual Accounts, John B. Williamson examines how Chile’s system of individual accounts seems to be working more than 20 years after reform. The report also discusses what other countries might learn from Chile’s experience.

Findings

An Update on Chile’s Experience with Partial Privatization and Individual Accounts offers some good news and some bad news. The good news is that the new FDC scheme does seem to be working quite well for affluent workers, particularly for men who hold steady full-time jobs that pay well. It also has had a number of positive benefits for the Chilean economy, especially with respect to the development of the banking, insurance, and asset management industries. These changes have helped with the expansion and institutionalization of capital markets. There are now far better regulatory procedures in place than previously and many more finance experts available to administer these institutions. The reforms have increased the amount of investment capital available and have contributed to the economic growth of the country.

In the Chilean economy, many workers are employed part time, seasonally, or on short-term contracts, and many work in the informal sector. The bad news is that these workers have generally not done well. Many workers, particularly women and others with low wages, are unable to accumulate enough funds to provide a pension greater than the level of the guaranteed minimum pension.

Additionally, many of these workers are unable to accumulate the 240 months of contributions needed to become eligible for the government-subsidized guaranteed minimum pension. What happens to them? When they retire, they spend down the assets in their individual accounts over a period of several months or a few years, and then, with luck, they get a very modest means-tested pension called the assistance pension. Since there is a cap on the number of assistance pensions, many end up dependent on their families for support.

Currently, slightly more than 41 percent of those over age 65 are receiving a pension of some sort—this includes 55 percent of those in the highest income quintile, but only 15 percent of those in the lowest income quintile. Women seem to be particularly disadvantaged, as only 30 percent of women who have contributed to the pension system qualify for a pension above the guaranteed minimum pension. The average pension for retired women is about 60 percent of that for retired men.
Conclusion

Replacement rates for workers in Chile are likely to continue to be a problem so long as such a large portion of Chilean workers reaches retirement age with less than the 240 months of contribution to the system needed to qualify for the government guaranteed minimum pension. This issue is particularly problematic for women and low-wage workers.

The pension burden on the government has gradually been declining, and this trend is likely to continue. While this burden averaged 6.1 percent of GDP between 1981 and 1989, it declined to 4.8 percent between 1990 and 1998 and is projected to decline further to 4.3 percent of GDP between 1999 and 2037. Some costs, such as the cost of the “recognition” bonds (compensation for prior contributions to the old PAYG-DB scheme) and pensions to those who have retired under the old PAYG-DB scheme, will be going down. However, there are some expenses that will be going up, including the cost of the assistance pensions and the cost of subsidizing guaranteed minimum pensions.

Due to a number of factors, including the impact of global economic pressures and related hiring practices, there is reason to believe that substantially less than half of those who have contributed to the pension system are going to end up with more than the guaranteed minimum pension, while close to 40 percent are not going to be eligible for more than a short-term pension as they spend down the modest accumulations in their individual accounts. The Chilean reforms have had benefits for the economy, but these benefits have come at the cost of a substantial increase in inequality and a reduction in economic security for some of the most vulnerable.