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## Social Security Privatization in Chile: A Case for Caution

By [Steve Idemoto](#), September 29, 2000

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***In order to pay for the transition to a fully privatized system, Chile had to drastically cut public spending, raise taxes, lower benefits, sell government assets, and issue bonds.***

Proponents of Social Security privatization often trumpet the Chilean "success story." Right wing economists (and the finance industry-funded think tanks that sponsor them) spin fabulous yarns about the way the free market transformed Chile's pension system. In doing so, however, they leave out crucial parts of the plot. Privatization advocates paper over very serious problems with Chile's social security program.

While the full impact of privatization cannot be known until the system completely matures, a number of troubling issues have already arisen. For example:

- Transition costs have negatively impacted public spending.
- Pension fund management fees are exorbitant.
- Non-participation threatens the overall viability of the system.
- Individual accounts replace less of low-income workers and women's wages.
- Private accounts leave workers susceptible to market downturns.

Given the distinct social, political, and economic differences between Chile and the U.S., the relevance of Chile's privatization experience to U.S. policy-makers is debatable. While this concern is legitimate, we would be remiss if we failed to take note of the results of Chile's 19-year social experiment.

### A Need for Reform

By all accounts, Chile's public pension program was foundering in the 1970s. The system was extremely complex, consisting of over 100 different retirement regimes. Contribution rates, retirement ages, and benefits all varied by type of occupation. Inevitably, perhaps, this excessive complexity resulted in substantial administrative inefficiency.<sup>[1]</sup>

The retirement program's funding situation was similarly dire. The system was not generating adequate revenue to pay retirees despite payroll taxes as high as 25 percent.<sup>[2]</sup> Even with government general fund subsidies equivalent to 4 percent of Chile's GDP, a substantial majority of retirees were receiving benefits at a level below the official minimum pension.<sup>[3]</sup> Manual workers, for example, were supposed to receive benefits that would replace 70 percent of their wages, but by the 1970s the rate was closer to 20 percent.<sup>[4]</sup>

The program's numerous problems were exacerbated by widespread tax evasion. The pension system lost a significant amount of revenue to unscrupulous employers who skirted contribution requirements and to workers who joined the burgeoning underground economy. The fact that the Chilean government lacked the resources or the political will to adequately police the system no doubt contributed to the situation.<sup>[5]</sup>

## **Pinochet's Privatization Scheme**

In 1981, the Chilean government under military dictator Augusto Pinochet took the radical step of phasing out the country's troubled publicly funded social security program and mandating participation in a system of privately managed individual accounts. Under this program, workers must contribute 10 percent of their wages, up to a specified ceiling, to a government-approved investment fund. Workers are required to pay another 3 percent to cover term life and disability insurance. Participation is not mandatory for self-employed workers, but they may voluntarily set up accounts with the same basic features.

Individual account contributions are managed by private investment firms (called Administradora de Fondos de Pensiones, or AFPs). Once a worker signs on with an AFP, he or she must stay with the investment firm for at least four months before switching. Contributions, including voluntary contributions of up to an additional 10 percent, are tax deductible. Upon retirement, workers have two withdrawal options: they may purchase an annuity or withdraw money based on a government-determined schedule. At the time of withdrawal, pension benefits are taxable as income.<sup>[6]</sup>

## **The Consequences of Social Security Reform**

The Chilean experience with social security privatization gives much reason for pause. Major concerns include: the high cost of transition to a privatized system, exorbitant pension fund management fees, non-participation in the scheme, the effects on low/middle-income workers and women, and the vulnerability of workers to market risk. These concerns are examined more closely in the following sections.

### **High Cost of Transition**

Transition from a pay-as-you-go social security system to a privatized system entails substantial costs. Under a pay-as-you-go system, the contributions of today's workers fund the benefits of today's retirees. Under a newly privatized system, where workers' contributions are diverted into individual accounts, cash must be found to fund the benefits of retirees and workers nearing retirement (who paid into the old system but didn't have a chance to save up an adequate nest egg under the privatized system).

Chile funded its transition to a privatized system in five ways: drastically cutting public spending, raising taxes, reducing benefits, selling government assets, and issuing debt.

- Cutting public spending. The Chilean government has cut social expenditures, including health and education spending, to help pay the pensions of retired and retiring workers.<sup>[7]</sup>
- Raising taxes. Chile introduced a value-added tax in 1975 in order to raise revenue for the anticipated transition.<sup>[8]</sup>
- Reducing lifetime benefits. In order to cut costs, the Chilean government raised the retirement age for beneficiaries. Prior to reform, retirement ages varied—ranging from 44 to 65. In order to cut costs, the Pinochet regime standardized retirement at 65 for men and 60 for women. The dictatorship also eliminated special pensions based on years of service.<sup>[9]</sup>
- Selling government assets. Transition to a privatized system was partially subsidized through the sale of state-owned enterprises to the private sector.
- Issuing debt. Government bonds finance approximately 40 percent of the annual costs of transition. These bonds are sold to AFPs and will be gradually redeemed by the government using general revenue.<sup>[10]</sup>

Analysts project that costs from the transition to a privatized system will be completely paid by 2050, at which point there should no longer be any beneficiaries in the old system.<sup>[11]</sup>

### **Exorbitant Management Fees**

At first glance, returns on individual account investments in Chile appear quite respectable. After factoring in management fees—which currently range from 16 to 20 percent of annual contributions—the situation can look much different.

Over certain periods, management expenses dragged rates of return to nearly negligible levels. For example, although the average rate of return on individual accounts from 1982 to 1986 was 15.9%, the real return after commissions was just 0.3%. Returns between 1991 and 1995 averaged 12.9%, but management fees lowered the return to 2.1%.<sup>[12]</sup> For a new worker enrolling in 1996, the 3.5% gross yield actually amounted to a -6.8% return after taking management fees into account.<sup>[13]</sup> These adjusted returns, moreover, do not include the cost of annuitizing retirement accounts, which in Chile entails a fee equivalent to 8 to 9 percent of total retirement assets.<sup>[14]</sup>

A substantial proportion of these fees are used to pay sales staffs and to cover marketing expenses. AFPs compete fiercely for new enrollees, offering inducements such as toaster ovens and promising workers higher returns if they switch plans. Between 1990 and 1997, the AFP sales force in Chile grew from 3,500 to 20,000. The upshot of this intense marketing is that 50 percent of all enrollees switch investment funds each year.<sup>[15]</sup>

### **Pension Non-Participation**

In Chile, only 50 percent of the workforce regularly contributes to the social security system.<sup>[16]</sup> Of workers who do participate, many underreport their income in order to lower their tax liabilities. A study by Chilean economist Jaime Ruiz-Tagle, for example, found that workers contributing to AFPs earned an average of \$1000 in February 1995, but declared only \$460 for tax purposes.<sup>[17]</sup> If, as could be expected, these non-contributing and underreporting workers retire with inadequate savings, the fiscal and social implications for future governments will be substantial.

### **Effects on Low-Income Workers and Women**

While actual returns on investments are the same for all contributors to a particular fund, a number of flat fees and expenses siphon off a greater proportion of the contributions of low- and middle-income, than higher-income, workers. Moreover, individual accounts do not allow for redistribution of income the way pay-as-you-go systems do. This leaves many low- and moderately-paid workers worse off under a privatized system than they would have been under a public system.

Chilean women—who are paid less, work more intermittently (often taking time off to give birth and raise children), and live longer than men—will inevitably receive lower benefits than men. While public systems tend to compensate for women's social and economic situations, private programs do not. Chilean women, then, are at particular risk under the privatized system.

## Vulnerability to Market Risk

From the mid-1980s to the early 1990s, returns on AFP accounts were impressive (as noted above, returns after fees were less so). Recently, however, returns have been poor. In 1994, more than half of AFPs incurred losses. Between 1995 and 1998 returns were -2.5%, 3.5%, 4.7%, and -1.1% respectively.<sup>[18]</sup> Taking management costs into account, workers actually lost a substantial amount of money over this period. In fact, when financial markets slid again in 1998, Chilean officials asked workers to defer retirement until the situation improved.<sup>[19]</sup>

## Lessons for the U.S.

The United States and Chile are very different in many ways. Politically, the U.S. has a strong, functioning democracy that has been in place for over 200 years. Chile, on the other hand, only emerged from military rule 10 years ago. Chile's economy, likewise, is much less developed than that of the U.S. The U.S. has a per capita GDP nearly 3 times that of Chile (\$31,500 vs. \$12,500 in 1998).<sup>[20]</sup>

More importantly, America's Social Security system is in a very different position than was Chile's in 1981. Chile's social security administration was highly inefficient. The U.S. system, in contrast, is run extremely proficiently. All administrative duties are performed at a cost of 0.9 percent of net contributions, or less than a penny per dollar contributed.<sup>[21]</sup> Moreover, Chile's public program was having serious funding problems. Even with substantial general fund injections and payroll tax rates more than double those in the U.S., the system was not able to pay promised benefits. In the U.S., even according to the pessimistic projections of the U.S. Social Security Trustees, the system will be completely self-sufficient and fully funded until 2037.<sup>[22]</sup> If economic growth in the U.S. continues at the same average rate it has been for the past 50 years, then our system will be fully funded indefinitely. With some minor changes to the program (i.e. lifting the cap on taxable wages), Social Security in the U.S. would be fully funded past 2075, even under the pessimistic growth scenario of the Social Security Trustees. Despite these differences, however, there are a number of lessons that we can take away from Chile's experience with privatization.

First, transition to a privatized system would be extremely expensive. In order to pay for the transition to a fully privatized system, Chile had to drastically cut public spending, raise taxes, lower benefits, sell government assets, and issue bonds. In the U.S., researchers estimate that even a plan to privatize 2% of the 12.4% Social Security payroll tax would cost \$74 billion per year, or 4% of the annual federal budget.<sup>[23]</sup> This is a substantial loss of funding and would necessitate substantial general fund transfers, spending cuts, tax increases, benefit reductions, or some combination of these options.

Second, exorbitant management fees in Chile wipe out a significant portion of workers' returns. Experience with individual accounts in Britain suggests that administrative fees in the U.S. would average 2.5 percent of assets per year. Over an average career and retirement, fees charged at this level would reduce the total value of a worker's account by 25 percent. Add in alteration costs (incurred when a worker switches pension providers or temporarily stops making contributions) and annuitization expenses and approximately 43 percent of the average worker's account will be spent on fees before the first retirement check is cut.<sup>[24]</sup>

Third, privatized pension accounts put Chilean women and low-income retirees at risk. The U.S. Social Security system has a progressive benefit structure that replaces a larger proportion of low-earners' wages. Moreover, the system provides a guaranteed, inflation-adjusted benefit for life.

These features help low-income workers generally, but particularly help women (who tend to live longer than men). Under a privatized system, these beneficial features would be lost.

Lastly, private accounts leave workers at the mercy of the market. In Chile, a market downturn in 1998 drained many retirement accounts leaving officials in the awkward position of urging workers to defer retirement indefinitely. Privatization advocates in the U.S. note that the 70-year average real rate of return on the stock market has been 7 percent. While this is true, it ignores the fact that the stock market is very volatile. According to John Mueller, former economic counsel to the U.S. House of Representatives' Republican Caucus, the 20-year average real return on the stock market fell to zero three times since 1900—from 1901 to 1921, from 1928 to 1948, and from 1962 to 1982.<sup>[25]</sup> Factor in administrative costs and actual returns dipped significantly below zero during these periods. Under these circumstances, workers would have been hard-pressed to save for a decent retirement.

## Conclusion

Advocates of Social Security privatization continually crow about Chile's high returns under individual accounts. In concentrating on returns, however, they miss crucial parts of the story. They ignore the fact that Chile has cut social spending, raised taxes, and cut benefits in order to pay transition costs—transition costs that the government will continue to pay until 2050. They ignore exorbitant management fees that have, over a number of periods, cut these much-vaunted returns to nearly zero. Advocates also fail to mention that these individual accounts have increased economic inequality and left workers vulnerable to market downturns. Moreover, privatized systems must either require retirees to convert a substantial portion of their account into an annuity – which means that the account can't be passed on to heirs other than the spouse – or accept a high percentage of the very elderly outliving their account and falling into dire poverty. Once these factors are taken into account, the case for privatization becomes much shakier.

## Endnotes

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