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What lessons can we learn from systematic reform, in particular in countries that have funded systems?

Good Practices in Social Security: The Pension reform in Chile

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Good Practices in Social Security: The Pension reform in Chile

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Summary

The Pension Reform addresses various aspects of the functioning and organization of the Chilean pension system in a global manner, thus creating a modern and efficient social protection system which provides appropriate guarantees for the population.

It is considered to be the most important social change introduced by the Government of President Michelle Bachelet and has three main aspects:

- 1) Creation of a new Solidarity Pensions System (SPS), enabling the State to play its part in providing guaranteed social security for the poorest 60 per cent of the population;*
- 2) increase in pension coverage for vulnerable groups: young people, women and self-employed workers; And*
- 3) improvements in the funded individual account system (increased competition, reduction of costs, incentives for Voluntary Pension Saving (Ahorro Previsional Voluntario (APV)).*

The Pension Reform includes a wide range of measures that combined constitute a new global pension system rather than a collection of partial measures. This change allowed the transfer from a funded individual account system to one which includes funded individual account within a social protection system based on solidarity financed through taxation and with an important element of voluntary pension savings. In this way, the combination of contributory financed and non-contributory financed pensions ensures that the incentive value of individual contributions is maintained while at the same time the risks of poverty in old-age and disability are minimized.

CRITERIA 1:

What was the issue/problem/challenge addressed by your good practice?

The Pension Reform used a global approach to address various aspects of the operations and structure of the Chilean pension system, thus creating a modern and efficient social protection system which provides appropriate guarantees for the population.

From the late nineties onwards information and surveys on the functioning of the pension system began to emphasize the need for far-reaching change. It is in this context that the decision was taken to move towards a global system able to overcome the limitations of the existing scheme and to provide protection against poverty for the old and disabled. This raised challenges in terms of coverage, levels of contribution, organisation of the industry and responsibility, returns on investment, gender issues and demography, among others.

In order to respond to these challenges, the Reform includes a wide range of measures which can be summarised under three main headings. The first is the creation of the Solidarity Pensions System (*Sistema de Pensiones Solidarias (SPS)*) which provides pension coverage for those unable to generate sufficient savings to finance a decent pension, establishing universal rights in the form of social security for those who spend their working lives in Chile.

The SPS provides old-age and disability benefits integrated with the benefits provided by the funded individual account system. Once part of the scheme, any individual belonging to the poorest 60 per cent of the population and able to meet the age and residence requirements is eligible for SPS benefits: the basic solidarity pension (*Pensión Básica Solidaria (PBS)*) for those who have no pension rights; and the Solidarity Pension Benefit (*Aporte Previsional Solidario (APS)*) which supplements the pensions of those receiving less than the Maximum Pension with Solidarity Benefit (*Pensión Máxima con Aporte Solidario (PMAS)*). The State thus contributes through the Solidarity Pensions System to the public pension system via its role in the institution, the financing and administration of benefits.

A second central element in the reform is the increase in pension coverage for vulnerable groups: young people, women and self-employed workers. The Pension Subsidy for Young Workers (*Subsidio Previsional para los Trabajadores Jóvenes*) was set up to increase the coverage and savings of young workers. This subsidy provides employers with a state contribution for each low-income young worker they have under contract and a similar amount is paid into the worker's individual accounts.

The Reform constitutes a significant change for women in terms of the gender equity of the pension system. The creation of the SPS and measures such as the Child Benefit and the gender-based premium for disability and survivors' insurance, among others, help to improve pension coverage for women and to close the gap between their pensions compared with those of men.

New incentives, rights and obligations have been gradually introduced for self-employed workers in order to increase their coverage and the level of their pensions. Over a transition

period of three years, pension rights and obligations of self-employed workers are gradually becoming the same as of other workers.

The third area of Reform is the improvement of the funded individual account system in order to increase competition and returns, to reduce the costs and reinforce Voluntary Pension Savings (APV). Significant measures include the broadening of alternative investments and the creation of the Investment Scheme, tendering for Accounts Administration, abolition of the Fixed Commission, new regulations for sub-contracting work; the separation of the disability and survivors' insurance from the administration of the Pension Funds (*Administradores de fondo de pensions (AFP)*), the improvement of the corporative administration of the AFPs, the creation of the function of Pension Assessor and the introduction of rules concerning conflicts of interest and restricted sales, among others.

The introduction of new incentives and formulae for voluntary pension savings – such as the APV for the middle class and the Voluntary Group Pension Fund (*Ahorro Previsional Voluntario Colectivo (APVC)*) which includes employers' contributions – has thus led to reinforcement of the system of voluntary savings to provide access not only for the higher income brackets but also to provide opportunities for voluntary savings for the medium and low income brackets.

In short, the Pension Reform includes a wide range of measures that together constitute a new articulated and integrated global pension system.

CRITERIA 2:

What were the main objectives and the expected outcomes?

The SPS was created in order to guarantee a minimum income in old-age and in the event of disability and to provide a subsidy to the lowest pensions. The aim of the SPS is to establish rights and guaranteed coverage in order to minimize the risk of poverty in old-age or in the event of disability. Similarly, it seeks to increase pension coverage for vulnerable population groups – young people, women and self-employed workers – and thus improve the level of benefits provided by the system. The improvements in the funded individual account system are designed to raise the replacement rates of contributory pensions and to increase Voluntary Pension Savings (APV).

Expected results include effects which will be monitored over time. For example, the creation of the SPS is hoped to lead gradually to a substantial extension of coverage which will take full effect in 2011. According to the projections, the SPS will provide coverage for an estimated 1,200,000 beneficiaries in December 2012, which means that it will double its coverage by the end of the transition period.

The level of benefits will increase as a result of the combined effects of the SPS and the improvements in the funded individual account system. An increase in the annual rate of return of 0.05 per cent due to improvements mentioned above would lead to an increase of 10 per cent of the pension at the end of a beneficiary's working life.

CRITERIA 3:**What is the innovative approach/strategy followed to achieve the objectives?**

The design of the combined SPS/Funded individual account system is innovative in that it guarantees that beneficiaries will receive a minimum income equal to the PBS and that higher pension contributions will always provide an higher final pension; there are no requirements in terms of years of contribution to prevent those with low contribution density receiving benefits and protection is provided for those in low income brackets as well as those in middle income brackets.

Another innovative approach was the intensive use of information technologies as a main factor in institutional restructuring. A vital factor was the need to remedy the lack of consolidated data concerning the pension sector which was a major problem in the design, implementation, evaluation and follow-up of the Reform and its benefits. This led to the implementation of a Pension Data Information System (*Sistema de Información de Datos Previsionales (SIDP)*) to ensure high standards of service as soon as the SPS began its operations. Based on the SIDP, quality control systems were developed to provide on-line monitoring of each request and improve the management of resources in order to provide an efficient service.

In this context, the approach applied in the Reform follows along the same lines as the modernization of the State administration, in which information and communication technology (ICT) plays a vital role.

The creation of the Pension Education Fund (*Fondo para la Educación Previsional*) designed to remedy a lack of information on the pension system among its members, is another innovative measure.

CRITERIA 4:**Have the resources and inputs been used in an optimal way to implement the practice?**

The scope of this reform and its fiscal impact have created major challenges in the area of fiscal discipline and the transparent and efficient administration of government funds. In this context, a vital step prior to the Reform was the introduction in 2006 of legislation concerning fiscal obligations which established the Pensions Reserve Fund (*Fondo de Reserva de Pensiones*), an instrument designed to provide additional funds for the SPS and to guarantee its financial sustainability. Alongside this, a budgeting system has been designed to keep track of both temporary and long-term fiscal obligations related to the pension system, which combined with the institutional restructuring measures and the use of ICTs has led to an efficient administration and optimization of resources.

CRITERIA 5:

What impact/results have been achieved so far?

One of the most significant results to date has been the successful establishment of the SPS as from July 2008. The PBS automatically replaced the Welfare Pensions (*Pensiones Asistenciales (PASIS)*) for those over 18 years of age and began to receive requests for new benefits. The PBS will provide higher pensions for former PASIS beneficiaries with increases of up to 56 per cent. Just over a year after their introduction, over 700,000 people have been able to rapidly access SPS benefits and this system currently provides coverage for the poorest 50 per cent of the population.

The first child allowances were paid in July 2009. To date, more than 20,000 applications for this benefit have been registered. The Pension Subsidy for Young Workers came into effect in October 2008.

Implementation of the new institutional structure has been fully completed: this includes the Pension Superintendency, the Social Pension Institute and the Occupational Security Institute, based on existing institutions; it also includes new institutions such as the Technical Investment Council (*Consejo Técnico de Inversiones*), the Pension Advisory Council (*Consejo Consultivo Previsional*) and the Users Committee (*Comisión de Usuarios*).

Finally, a wide range of measures were successfully introduced to improve the funded individual account system. A system of tender for disability and survivor's insurance with employers responsible for contributions and the creation of new mechanisms and incentives for Voluntary Pension Savings are among the most outstanding of them.

CRITERIA 6:

What lessons have been learned from the introduction of this good practice?

The Pension Reform is considered to be the most important social change introduced by President Michelle Bachelet's Government. The first proposals for the reform of the pension system appeared in March 2006 within a week of taking office starting with the creation of the Presidential Advisory Council for Pension Reform. Draft legislation was sent to the National Congress in December 2006 and the Act was promulgated in March 2008.

The SPS and the extended coverage it brought with it lent considerable social value to the Reform and ensured a highly positive opinion of it. This change allowed the transfer from a funded individual account system to one which includes funded individual account within a social protection system based on solidarity financed through taxation and with an important element of voluntary pension savings. In this way, the combination of contributory financed and non-contributory financed pensions ensures that the incentive value of individual contributions is maintained while at the same time the risks of poverty in old-age and

disability are minimized. Thus, this new system puts an end to the exclusion of various groups which under the previous scheme did not qualify for pension shelter.

Another basic conclusion concerns financial sustainability. The Reform includes a series of measures to guarantee the sustainability of its financing and the efficient administration of its resources. These measures began to be developed even before the Reform itself with the creation of the Pensions Reserve Fund in 2006. Finally, fiscal discipline has allowed creating a financially sustainable Reform.

In addition, the use of IT is considered to be a central element in ensuring efficient administration and high quality management of the benefits.

Finally, there is the process itself which was used to design and implement the Chilean Pension Reform and which is worth underlining. Behind the development of the Pension Reform lay extensive political and social consensus which gave it legitimacy and guaranteed its stability. The composition of the Presidential Advisory Council for Pension Reform, made up of a cross-section of experts is part of the innovative approach to the development of public policy; it organised public consultation of citizen involving more than 70 social organizations, employers' organizations, actors in the finance industry, research institutes, international organizations and experts. The proposals of the Advisory Council were then analysed by a Ministerial Committee which was responsible for proposing a programme for Pension Reform to the President of the Republic and for drawing up draft legislation on the subject. This extensive reform was translated into legislation after only 15 months of legal debate, a reflection of the general consensus which existed concerning the basic principle of this initiative.

CRITERIA 7:

To what extent would your good practice be appropriate for replication by other social security institutions?

The universality and importance of this reform are such that the various different aspects of the functioning of the pension system which were addressed provide numerous interesting examples appropriate for replication. The capacity to emulate these practices will depend, however, on the special particularities and characteristics of each system, since this reform was specially designed for the funded individual account system which previously existed in Chile.