Council on Hemispheric Affairs

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A.F.P: Another Failed Promise

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Introduction

In July, the Chilean public discovered that the wife of a former Job Minister of the first Bachelet period was receiving a monthly pension of $7,800 USD, following her retirement from the prison police department. [i] As the average Chilean only receives a monthly pension of about $300 USD, this scandal was followed by an immediate wave of protests, and served as the boiling point for many Chilean citizens, whom have grown increasingly dissatisfied with the perceived corruption in the country's political system.

On August 21, purportedly 500,000 Chilean citizens marched in Santiago in opposition to Chile's private pension system, a remnant of the neoliberal economic policies of Augusto Pinochet's 27-year dictatorship. The protests were organized by the group, "*No Más A.F.P.*", referring to the government's Pension Administration Fund (*Administradoras de Fondos de Pensiones – A.F.P.s*). [ii] The grassroots group claims their march in Santiago was the largest public demonstration since Chile's return to civilian rule in 1990. Accompanied by demonstrations in 50 of Chile's 345 municipalities, their protest demanded for immediate reform to the antiquated pension system, which fails to cover nearly 50 percent of the working population and leaves thousands of retirees destitute and poverty stricken. [iii] Due to excessive administrative costs, low contribution rates, huge benefits for the managers of the A.F.Ps, and the absence of competition between the private fund administrators, the Chilean pension system has devolved from an economic trailblazer to an economic disaster over the last decade.

Background

Following the 1973 Chilean coup d'état, in which Augusto Pinochet, backed by the United States, overthrew the democratically elected socialist president, Salvador Allende, Chile gained the title of the "world's free market laboratory". [iv] After consolidating power, Pinochet enforced widespread, free market reforms across much of the Chilean economy. In a stark contrast to the protectionist policies of former President Allende, Pinochet relied on a neoliberal economic study, called "*El Ladrillo*", which had been prepared by a group of economists, known as the "Chicago Boys". [v] Trained at the University of Chicago under economist Milton Friedman, the "Chicago Boys" were a product of the US State Department's Chile Project, which was a part of President Truman's Point Four Program. Organized in 1950, the Point Four Program offered technical assistance to developing countries, and served as the first US program for international economic development. [vi] Designed to influence Chilean economic thinking, the Chile Project provided the "Chicago Boys" the opportunity to obtain high-level positions in the Chilean government, where they were responsible for deregulating and privatizing state enterprises, as well as curbing hyperinflation. However, while these policies did expand Chilean capital markets and fuel the country's economic growth for 30 years, it can also be said that they contributed to the extremely high levels of economic inequality and unemployment across the country in the 1980s.

In November, 1980, Augusto Pinochet's Secretary of Labor and Pensions, Jose Piñera, instituted the Social Security Reforms, which replaced the *Cajas de Prevision*, the former state funded pay-as-you-go (PAYGO) pension system, with a fully privatized system based on personal retirement funds. In Piñera's system, Chilean citizens are required to contribute 10 percent of their monthly earnings to one of five investment funds, managed by six private administrators or A.F.Ps. [vii] Viewed as an "experiment in real time", Piñera's brainchild enabled Chile to become the first country to fully privatize social security. [viii] As a result, it attracted the attention of many foreign governments and earned him praise from international organizations, such as The World Bank and International Money Fund. Due to the recommendations from various international organizations and neoliberal economists, as well as its subsequent success, the Chilean Model was replicated in more than 30 countries, ranging from Latin America, Southeast Asia, and Eastern Europe.

Today, this controversial pension system manages over 10 million affiliated citizens and over $171 billion USD in assets, an amount equivalent to 71 percent of Chile's GDP. [ix] To put this in perspective, without the profits from the invested savings, Chile's annual GDP from 1981 to 2001 would be 0.5 percentage points lower than in reality. [x] Over these two decades, the influx of capital from private pensions enabled Chile to develop into one of Latin America's richest countries. If the pension system has been this profitable, then why do millions of Chileans support its total overhaul?

Problem

As Chile's private pension system only succeeded in generating impressive amounts of capital for select conservative business groups, it fell short of Jose Piñera's aspirations. Originally, he envisioned that the pensions would improve as a result of the competition between twenty different A.F.Ps, and ultimately pay out 70 percent of retirees' former salaries. [xi] In reality, there are only six A.F.Ps, and the lack of competition between these private administrators has allowed fixed administrative costs and commissions to become unreasonably high. Due to the barriers to entry of the Chilean pension system, almost 50 percent of the population is not covered, and around 45 percent of the uncovered citizens are not financially capable of paying the A.F.Ps minimum requirements. [xii]

When faced with criticism regarding their unusually high fees, the A.F.Ps assert their innocence, as evidenced by Mr. Rodrigo Pérez, the president of the Association of Pension Administrators and former Minister of President Piñera, who stated, "The A.F.Ps have never lost money, stolen money, or gone bankrupt. Does that mean that pensions are good? No they are not. The system needs important changes. But the A.F.Ps administers the funds of those who save, and they've done that very well." [xiii] Although the fund managers deny wrongdoing, they still reluctantly admit the system is ineffective and that immediate change is required. Even if a worker is able to buy into the system, investment returns have averaged a respectable 8 percent, however after commissions are removed, the net returns equal a modest 3 percent, meaning that the commissions are worth almost double the retirees' returns. [xiv]

The high administrative costs are not the only reasons why over a million Chileans protested across the country on August 21. Other inherent flaws attributed to the Chilean Pension System include the lack of regulation on administrative costs, lack of competition among fund administrators, required contributions from the self – employed, popular participation, and the fact that the contribution rate of 10 percent is drastically too low. Together, these deficiencies have marred the 30-year-old system's acclaimed track record. David Blake, a pensions expert at the Cass Business School in London, shared a similar sentiment when he stated, "Initially the Chilean model appeared to be very successful, but the sting in the tail appears to be that charges extracted by the industry have resulted in pensions being much lower than otherwise would be the case." [xv] Despite the prolonged economic growth, the Chilean pension system allowed these underlying issues to fester, and now it seems Chile is facing the "sting in the tail". [xvi]

Furthermore, instead of the 70 percent return on former income that was promised by the creators of the A.F.Ps, the average pension is around 34 percent of a retirees' former average salary. [xvii] By gender, men receive only 48 percent and women receive only 24 percent of their former incomes. [xviii] As a result, Luis Messina, the national coordinator of *No Más A.F.P.*, claims that 90 percent of Chilean retirees receive a monthly pension of approximately 202,945 Chilean pesos or $300 USD, which is far less than the established Chilean minimum wage of 250,000 Chilean pesos or $371 USD. [xix] Therefore, 45 percent of Chilean retirees live below the poverty line, exposing the ineffectiveness of Chile's private pension system. Organizers of *No Más A.F.P.* have also pointed out that Chile's contribution rate of 10 percent is half the average rate (20 percent) of the other countries in the Organization for Economic Cooperation and Development (OECD), of which Chile is a member. [xx] In turn, the lack of funds is the primary reason for the high rate of poverty in the elderly. Overall, the confluence of these flaws has resulted in massive recent protests across Chile. However, these calls for pension reform are reoccurring, as the Chilean population never fully embraced the pension system, which similarly to the Constitution of 1981, was controversially imposed on them by the Pinochet Regime.

Solution

Back in 2008, the Michelle Bachelet administration implemented a multitude of reforms to the pension system in order to address the two main problems: the coverage of the population and the amount of the administrative costs. As 60 percent of Chile's population is unable to finance worthwhile pensions due to low incomes, these reforms were designed to increase coverage by making participation less expensive. [xxi] In order to increase the rate of participation, President Michelle Bachelet's leading economic advisor, Andrés Velasco, introduced a solidarity pension system (SPS), funded by a value – added tax, which includes a minimum pension of $140 USD for those retirees that were unable to save during their careers. [xxii] Since the institution of the federally funded safety net, the average pension has risen from an average of 34 percent of a retiree's former salary to 45 percent. [xxiii] The increase in average pension returns over the past eight years is an impressive feat; however, it is still a long way from the 70 percent that Jose Piñera promised. According to the Bachelet government, this scheme will help pay out more than half of the Chilean government's pension bill by 2030. [xxiii] From the perspective of the Chileans, the Bachelet reforms of 2008 were a step in the right direction, but not the solution that they demanded.

After the recent wave of demonstrations in August, President Michelle Bachelet has held discussions on a new set of pension reforms. Her latest plan includes requiring companies to contribute 5 percent to the minimum pension, the introduction of a state-run A.F.P. to increase competition, and political measures to keep fund managers' commissions under control. [xxiv] The discussion to extend the age of retirement was included in the reform debates, however, despite approval from numerous economic experts, the working class overwhelmingly voiced their disapproval of the measure. Despite President Bachelet's plan for improvement, many Chileans still demand for more pension reform from the Bachelet administration.

To many international observers, it appears that instead of scrapping the outdated pension system of the Pinochet regime, President Bachelet is remodeling it. This appears to be the correct decision as well. As put by Mr. David Bravo, the former president of the Chilean Pension Advisory Committee, "After going from a totally public system to the other extreme in 1981, now we are moving towards a middle ground that combines individual savings, state spending and contributions from employers. Another option is tearing down the A.F.P. system, but it's too costly. We don't have the privilege of starting from zero anymore." [xxv] Mr. Bravo's words show that despite the demands for a complete overhaul of the pension system, it is impossible and erroneous to do so because of the potential losses in national and per capita GDP. These potential losses were foreshadowed following the 2008 pension reforms, which resulted in Chile losing $1.5 billion USD or 0.5 percent of its GDP over the next year. [xxvi] If these small reforms had such a large impact on the national economy, then abandoning the A.F.P. system would amount to an economic catastrophe.

Conclusion

Once hailed as an "example to follow" by former President George W. Bush, the Chilean social security system was, at one point, one of the most important pension systems in the world, as it became the "poster child" of neoliberal economic development and the individualistic model of society policy. [xxvii] The huge recent protests show that despite the A.F.P. system's vital role in facilitating Chile's maturity into an economic power in Latin America, the system is now in shambles and in desperate need of reform. The efforts of President Bachelet to improve the pension system in 2008 provided assistance to those in dire need, but the next set of reforms must offer more holistic change to the system if future administrations wish to provide a steady and sufficient source of income to tomorrow's retirees. If her reforms prove to be successful, they could provide a model for other countries facing similar pensions shortfalls, and if they are a failure, they will illustrate what mistakes other countries should avoid.

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