

Selected examples of pension reforms in other countries

Latin American pension schemes are generally considered to have transitioned successfully. The main problem with these schemes initially was that the systems' running costs had been high (though in Chile's case not big enough to alter the fact that returns to investors had been high). Competition among the specially instituted funds (AFPs) had failed to curb their operating costs, which amounted to a steep 3% of wages in some countries: instead of competing on price, the firms had spent heavily on advertising and sales agents. This was partly because funds were obliged to let investors switch managers almost as they pleased - which had led to "transfer wars". In Chile, 50% of contributors used to change funds every year; new rules have now cut this by half. Mexico too has put limits on transfers. However, Chile's pension reforms have cut down on the government's deficit funding of pension liabilities.

Whatever the path of reform, it is now amply clear that there has to be a transition from the current unfunded pension to (at least partially) funded mechanisms. There have to be curbs on increasing and indexing Defined Benefits of unfunded systems. Individual retirement accounts based on increasing Defined Contributions are the way forward. A combination of the various methods is being increasingly adopted all over the world. The problem is not confined to developing countries - rich nations, with comprehensive social security structures, face similar problems.

The Chilean pension reform: a pioneering programme

In 1981, the military government introduced sweeping reforms in the retirement system. The reform replaced a basically insolvent PAYG system with a capitalisation system, based on individual retirement accounts managed by private companies known as AFPs. Workers employed in the formal sector (including government employees) are required to pay 10% of their wages to the AFP of their choice and can transfer funds freely among them, upto four times a year. The system also has survivor benefits (family pensions) and a disability programme funded through an additional insurance premium of 3% of wages. There is a modern regulatory framework, the Superintendency of Pensions, that regulates investment portfolios, ensures free determination of fees and commissions, and free entry into the industry.

From a fiscal point of view, the reform process gave rise to major forms of public expenditures. One was the servicing and payment of the "Recognition Bonds". The other was the payment of retirees in the old system. As can be seen from Table 3 below, the bulk of the costs are related to the payment of pensions to old retirees. These costs are financed directly out of general government revenues.

Again, as evident from the Table below, the deficit costs were quite large. There was a sharp jump in the direct deficit of the government in 1982, immediately after the switch to the new pension system from 1.47% of the GDP to 4.08%. This was due to the abrupt mismatch between the inflow and outflows from the pension system. Chilean workers who opted out of the government-run Social Security system were no longer required to pay anything into the old system; they were allowed to keep all their money and invest in the private system instead. On the other hand, the burden of honouring the past commitments of pension payments was borne directly by the government exchequer (this swelled the direct deficit). Recognition Bonds were

issued by the government to transfer past contributions of transferees to provide the base for the new retirement fund.

It turns out that the required payments into the private system were substantially less than the taxes required for the old system, a change that effectively provided a large tax cut for those who opted for the new system. The reduction was justified because with the substantial investment returns of the private system, much more in benefits could still be paid even with the lower payments during working years.