PENSION NOTES

No. 26 – JUNE 2018

Proposals for reducing the gap between pension expectations and the pension amounts received in the Individually-funded System[1]

EXECUTIVE SUMMARY

The average pension amount in Chile is approximately US$ 283, whereas a pension considered to be reasonable for people aged 65 or more is US$ 624. Thus, there is a monthly pension gap of US$ 341. The aforementioned pension expectation is 94% of the average earnings of current workers and is also twice the income received during the previous working life. This is one of the main conclusions of the diagnosis of the study group *Better Pensions for Chile*, convened by the economist Salvador Valdes at Clapes UC.

Among the causes explaining the pension gap are low wages, the shortcomings of public pension policies, communication deficiencies, and the issues involved in people formulating their pension expectations.

Some of the shortcomings of public pension policies, are for example, that the Individually-funded system promises a "pension" to all, even though they contribute for a short period of time, and that promise could have given rise to optimistic expectations among workers in previous decades.

An example of communications deficiencies is the partial information provided by the media for decades, reporting on the good results in the financial management of the pension funds, without ever insistently and systematically stating that these returns will not suffice for providing adequate pensions to those with low contribution frequencies, or those who declare lower salaries than they in fact receive. This situation clearly gives rise to unrealistic pension expectations.

Pension expectation issues are related to two realities. First of all, few people under 60 understand that senior citizens have sources of income other than their pensions, making it unnecessary for pension alone to satisfy all household requirements. Secondly, few people realize that accessing pensions similar to expected amounts depends on having contributed a sufficient amount for a sufficient amount of time (without understating salary amounts).

The interdisciplinary group suggests that any improvements should prioritize relieving the most acute fears of pensioners and workers. To accomplish this, it recommends avoiding indiscriminate measures that extend aid to (almost) everyone, even to those who have “non-pension” resources, because they are regressive, too expensive and unsustainable over time.

[1] This Pensions Note contains information from the book "Pensions: From Discontent to Solutions" of the Latin-American Center for Economic and Social Policies of the Catholic University of Chile (Clapes UC), edited by Salvador Valdes Prieto, Doctor in Economics, MIT.

In order to clarify the official denomination of the benefits of the public pensions policy, clear up the misunderstanding regarding the contributory pensions available to people who have contributed for only a few years, and help people to formulate their pension expectations, the Group recommended adopting the three categories of benefits stipulated by the International Labour Organization (ILO):

(i) "Programmed Reimbursement of Insufficient Contributions" to individuals who have contributed for less than 10 years.
(ii) "Partial pensions" to individuals who have contributed for more than 10 years, but less than 30 years.
(iii) "Full Pensions" to individuals who have been contributors for 30 or more years.

Finally, the rest of the proposals include the creation of an insurance policy for addressing the contingency of severe dependence in extreme old age; a non-contributory subsidy of USD 77 per month for individuals who live in homes with senior citizens in this condition; and compensating Programmed Withdrawal pensioners whose pensions have dropped by more than 30%.

INTRODUCTION

This Pensions Note is based entirely on the book "Pensions: From Discontent to Solutions," published by the Latin-American Center for Economic and Social Policies of the Catholic University of Chile (Clapes UC) and edited by the economist Salvador Prieto Valdés. This study was conducted by a team of interdisciplinary professionals over a period of more than one year.

The book highlights the existence of a gap between pension expectations and pension amounts received. According to the study, the pension expectations of the pensioners consulted are almost double the income they receive during their working lives, which is clearly unrealistic. Experts in different fields (psychology, social communication, economics, etc.) discussed how to reduce this gap in the short term, proposing 25 measures. This Pensions Note summarizes the central core of these proposals.

DIAGNOSIS

Table 1 summarizes some of the study's findings regarding real and expected pensions.

Table 1
Summary of some findings regarding real and expected pensions in Chile

Estimated average pension received by current pensioners (A)	Pension considered reasonable for retirees of 65 or more (B)	Current wage declared by employed individuals in 2016 (C)	Pension gap (B) - (A)	Expected pension as % of current wage of employed individuals (B) / (C)
USD 283[2]	USD 624	USD 666	USD 341	94%

Source: FIAP based on the book "Pensions: From Discontent to Solutions."

Current level of pensions

The study's parting question concerns the pension amounts that current retirees are receiving. According to the INE's 2013 EPF survey, the average liquid old-age pension amount in the pension system is about CLP 164 thousand (approx. 273 USD) per month[3]. If we also consider the benefit of eliminating the 7% health contribution required of pensioners as of 2012, the average pension would be CLP 170 thousand (approx. USD 283).

Pension expectations or aspirations

The study then explores what a reasonable pension amount would be for individuals aged 65 or more, based on a survey[4], taking into account requirements in old age, that other household members can also contribute economically to financing expenditures, and that individuals may have resources other than their pension. The survey concludes that the reasonable liquid pension expectations of individuals aged 65 or more, is CLP 375 thousand[5] approx. USD 624) per month. Hence, the average difference between the median and expected pension is CLP 205,000 (approx. USD 341).

On the other hand, according to the Supplementary Income Survey (SIS) of the National Institute of Statistics (INE), the workers surveyed in 2016 declared that their current monthly wage was CLP 400 thousand (approx. USD 666).

Thus, pensioners consider a pension of 94% of the current wages of their children (USD 624 / USD 666) as reasonable. Furthermore, if we consider that the average wage was half of what it is today, 25 years ago, when the current pensioners were contributing, they consider a pension that is double the wages they received during their working lives as reasonable.

In the light of international evidence, the expected pension as a percentage of current wages is too high in Chile. As shown in Table 2, the average pension to current average wage ratio is much lower in countries that are more developed than Chile: 55% in Australia; 58% in Spain; and 39% in the U.S.

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[2] Based on the exchange rate observed on 24.04.2018. 1 USD = CLP 600.58. All other calculations use this exchange rate.
[3] Corrected to August 2017 for the variation in the CPI.
[4] Survey presented in Chapter 5 of the aforementioned Clapes UC book.
[5] This amount is the combined median of all the socio-economic sectors considered in the survey.

Table 2
Average pension to current average wage ratio in three rich countries

Country; Number of times its average wage exceeds the average wage in Chile	Average pension to current average wage ratio (net) (A)	The average monthly pension that country would pay a productive worker earning the average wage in Chile in 2016 (USD 666 per month) (B)	Funding; degree of sustainability in the next few decades. (C)
Australia; 3.04	55%	CLP 220 thousand (USD 366)	Individually-funded; sustainable because the contributory part is financed through the Individually-funded system
Spain; 2.10	58% in 2016 (the government already introduced a considerable drop to regain sustainability)	CLP 233 thousand (USD 388) in 2016 (the government already introduced a considerable drop to regain sustainability)	PAYGO; the 2013 reform applied a negative adjustment for 40 years
USA; 2.84	39% in 2016; 32% as of 2033	CLP 156 thousand (USD 260) in 2016 CLP 128 thousand (213 USD) as of 2033	PAYGO; Pensions drop 18% as of 2033

Source: Book: "Pensions: From Discontent to Solutions," p. 26.

The cost of covering the gap?

The additional cost of covering the monthly difference of USD 341 between pensions and expectations for two million seniors is approximately USD 8,184 million, equivalent to 2.7% of GDP in 2017, an enormous sum. This discrepancy is impossible to cover in a sustainable manner by means of a PAYGO or Individually-funded system, unless mandatory contributions are much higher and the standard of living of employed workers who do not migrate to jobs that are not covered is substantially reduced.

The above reveals the transience and unsustainability over time of promises made by some politicians and technicians to increase pensions through proposals to migrate to a PAYGO system, a conclusion reaffirmed by existing demographic trends.

The only way to sustainably finance this pension gap would be to levy a new tax of 11.5% on jobs that pay Social Security contributions, and in view of the demographic contraction, the rate of this new tax would have to be gradually increased to 31% by 2060 (like in Italy). Hence, in this scenario, increases in pension amounts would occur at the expense of sacrificing the young people under 35 of current and future generations. The alternative to the new tax would be to increase the VAT rate from 19% to 24.6%.

The fear of the employed population between 25 and 59 years of age

Another meaningful finding of the diagnosis is that employed individuals are aware of and terrified by the pension gap. As shown in Table 3, employed individuals between 25 and 59 years of age are clearly more fearful than current pensioners.

Table 3.
Pensions perception study indicators, by age group

Respondent Groups	Question	Negative score (percentage of 1 to 4 scores on a scale of 1 to 10)	Average score
65 and over	Current overall economic situation	38	4.9
	Own current pension	63	4.0
Employed individuals (25 - 59 years old)	Overall future financial situation	67	3.8
	Own future pension	72	3.4
	Current pension of "others"	91	2.4

Source: Book: "Pensions: From Discontent to Solutions," p. 28.

The fearful future outlook of the 25 to 59 years old cohort contrasts with their current standard of living, which has improved considerably compared to previous decades. This can be interpreted as the fear of losing the status that they achieved relatively recently, which they know is considerably better than what their parents had. This fear enables putting forward the following hypothesis: many respondents are only just beginning to process the fact that their future pension projections are clearly lower than what they had projected until recently. This change could have motivated many of them to demand more help from others, starting with a government that is not considered to be "one of us," but rather an unconnected third party. Others in turn seek responsible parties; some may assign responsibility to impersonal external causes (for example, a precarious economic situation that prevents or prevented them from saving for the future; or an ineffective or mean-spirited public policy); others assign the role of villains to a group of institutions.

Potential increase in pensions if the policies of other countries are adopted

The study concludes that the potential increase in pensions resulting from adopting the policies of other countries (such as Australia, Spain and the U.S.) and importing their labor markets, does not exceed CLP 55,000 per month (US$ 92), and that the public pensions policy in Chile can improve, but in amounts below those mentioned, because the labor market reality prevents any greater achievements. Table 2 illustrates this exercise.

How can the pensions gap in Chile be explained?

The study points out that the USD 341 pensions gap in Chile can be explained by factors such as:

1. **Low wage levels.** Table 2 shows the limitations on pension amounts imposed by Chilean wages and productivity levels. These would be modest even if contribution densities were to improve to the level of developed countries, and if all the labor market institutions, public pension and pensioner taxation and exemption policies were the same as in those countries. This conclusion indicates that in order to achieve the pensions of these countries, public policies, including pensions policies, must contribute to economic growth that sustainably increases wages.

2. **Shortcomings of the public pensions policy.** Some of the shortcomings of the

public pensions policy highlighted by the Clapes UC studies are the following:

(i) **Flaws in the internal pension policy.** Two examples of such flaws are:

- The Individually-funded system promises a "pension" to everyone, even though they contributed for a short period of time (less than 10 years, for example). The former PAYGO system, on the other hand, denies any tax benefit to members who fail to complete 10 years of contributions, and requires at least 20 years of contributions for accessing the minimum pension (US$ 241 per month in 2017, for individuals between 70 and 74 years of age). Hence, those who failed to meet the contribution density requirements in the PAYGO system could not access any pension whatsoever (pension = 0). Thus, one hypothesis is that this promise of the Individually-funded system created optimistic expectations among workers who did not meet the contribution density requirement. Switching from the former PAYGO system to an Individually-funded system would improve their pensions from USD 0 to USD 241. Chilean pension policies have done nothing to curb these expectations to date.

- Legal exemptions to mandatory contribution that benefit non-salaried workers, and the shortcomings of government oversight of mandatory contributions, help to explain why real pensions are less than what they could have been.

(ii) **Communication shortcomings**. These partially explain the extent of the pension expectations of members. An example of these shortcomings is the partial information provided by the media for decades, highlighting the positive results of the financial management of the pension funds, without ever insistently and systematically stating that these returns will not suffice for providing adequate pensions to those with low contribution frequencies, or those who declare lower salaries than they in fact receive. This situation clearly gives rise to unrealistic pension expectations.

3. **Issues in the formulation of pension expectations.** The belief that old-age pensions alone should finance 94% of the income of their children today, disregards at least two facts:

   a. The existence of other income they receive in retirement. Few people under 60 understand that senior citizens have sources of income other than their pensions, especially in the middle class. These alternative sources make it unnecessary for the pension alone to satisfy all household requirements.

   b. Access to better pensions requires having contributed a sufficient amount for a sufficient amount of time (without understating salary amounts). Very few people have considered what contributory pension members with an incomplete contribution history should receive, and the non-contributory support they should rightfully receive from the community. It is necessary to agree on criteria in this regard, since the existing large contribution gaps and the instability of the labor market will make these situations commonplace for many decades into the future. The conventions of the International Labour Organization (ILO) respond to this dilemma by recommending decreasing replacement rates related to the number of years of contributions (see Table 4); nonetheless, they recommend transferring members with less than 10 years of contributions to social assistance, which requires proof of poverty for providing subsidies.

Table 4
The ILO's contributory pension recommendations per number of years of contributions

Years of contributions	Denomination of the benefit according to ILO conventions	Adequate basic replacement rate in accordance with ILO conventions	Contributory pension according to ILO standards, prior to complementation with a subsidy, if the average income declared while contributing was:	
			CLP 500 thousand per month	CLP 250 thousand per month
45	Full pension	60%	CLP 300 thousand	CLP 150 thousand
30	Full pension	45%	CLP 225 thousand	CLP 112,500
20	Partial pension	30%	CLP 150 thousand	CLP 75 thousand
15	Partial pension	22.5%	CLP 112,500	CLP 56,250
11	Partial pension	16.5%	CLP 82,500	CLP 41,250
Less than 10	Not a "pension"	Social Assistance	CLP 0	CLP 0

Source: Book: “Pensions: From Discontent to Solutions,” p. *30.*

SOLUTION STRATEGIES AND PROPOSALS

The central points of the proposals of the Book "Pensions: from Dissatisfaction to Solutions" are highlighted below.

The book’s message is optimistic, since even though the Chilean pension situation is complicated, there are many areas in which progress is possible and desirable. First of all, improving pensions should prioritize relieving the most acute fears of the employed population. This entails denying assistance to (almost) all, based on their expectations, because a gap of the size detected (USD 8,184 billion per year) can never be closed. Second, imaginative measures must be adopted to demonstrate that the reconstruction of public pension policies has begun. Among the most important measures proposed by the Better Pensions Group are:

I. **<u>Protection for severely dependent senior citizens.</u>** This protection is absolutely essential, since the "severely dependent" condition[6] occurs increasingly with age (affecting 37% of people over 80, i.e., some 512 thousand people by 2050), and at the same time, the impossibility of adequately covering the high costs

[6] A person is considered to be severely dependent when subject to at least one of the following three conditions: (1) The individual is prostrate and confined to bed; (2) The individual suffers from any degree of dementia; (3) The individual is unable to perform any basic activity of daily life (for example: getting dressed, bathing, eating alone, etc.), or to carry out two practical activities of daily life (for example: preparing a hot meal, managing their own money, organizing their medications and taking them).

involved in the care of a severely dependent senior citizen contributes to breeding discontent with current pensions and increases fear among people under 59 years of age. The proposals include the following, among others:

(i) **Encourage the creation of an insurance policy to address the severe dependence contingency in extreme old age.** This insurance would initially finance the most urgent and basic needs, extending coverage over time. Taking out the insurance would be voluntary, and it would be financed by means of a co-payment by those who wish to be insured in the future.

(ii) **Reformulate existing home care programs for severely dependent individuals,** aimed at providing the central core for a public-private partnership for the care of severely dependent senior citizens, and overseeing the provision of monetary assistance.

(iii) **Create a non-contributory subsidy of 11.5% of the average wage (CLP 46 thousand in 2016, approx. USD 77 per month), for individuals living in households with severely dependent senior citizens** (caregivers), in order to help households to cover the expenses arising from this situation. The cost of this subsidy amounts to a surcharge on the mandatory contribution of 0.31 percentage points today, and due to demographic contraction, the cost will double by 2050, increasing to 0.62 points on the mandatory contribution.

(iv) **In order to facilitate the incorporation into the labor market of caregivers of severely dependent individuals in the household, it has been proposed to extend day care center coverage to severely dependent individuals who are not prostrate** (as in the case of individuals suffering from Alzheimer's disease, for example). This relieves the family care burden and opens the door to labor market participation for those who are available to do so and have not done so due to their caregiver responsibilities.

(v) **Promotion of teleworking, for the benefit of caregivers and the senior citizens they take care of.**

II. **Protection for extreme old age individuals in Programmed Withdrawal (PW).** This pension mode has a serious defect among the middle-class: it reduces the pension paid to surviving members, accumulating a 50% drop by the time they are 80-82 years old, for the absurd purpose of paying more substantial inheritances to third parties (individuals other than spouses) when the member dies before the age of 80. The study puts forward several proposals for addressing this situation, even covering those who have already retired, benefiting 410,000 people. These proposals are as follows:

(i) **In order to increase the PW pensions paid in extreme old age, it is proposed to establish a new mandate, which would require those who choose or are assigned to the new "Protected PW," to divide the funds they have in their individual accounts and allocate a portion of their pension savings to a longevity insurance,** which would start paying life annuity pensions when the individual reaches extreme old age (82-85), and in which the extreme old age pension amount is not less than 80% of the initial pension the individual could have obtained by purchasing a fixed life annuity (LA) from an insurance company. The rest of the savings would be returned to the member, either as a temporary income that ends at the beginning of extreme old age, the amount of which would be calculated with the existing PW formula, or as an inheritance, should the individual die before reaching advanced old age.

(ii) **In order to protect pensioners who receive a PW pension and reduce the inherent low pension risks, it has been proposed to exclude fixed LA from insurance companies and government agencies from the options permitted for fulfilling the mandate in (i)** On the one hand, fixed LA from insurance companies entails the risk of dropping should there be few mortality data, and also when there is a shortage of equity capital during the phase in which the new generation starts its retirement. On the other hand, the LAs of government agencies also entail the risk of dropping, since the Ministry of Finance would probably not assume the financial risk due to a lack of data on advanced old age mortality and would demand lowering pensions. Furthermore, the Ministry of Finance would limit share capital during the decumulation phase in the event of a fiscal restriction that would compel it to do so, or in the event that the agency is approaching insolvency after being captured by political parties, a group of officials or public employee trade unions.

(iii) **Repeal the existing PW adjustment factor.** Two reasons are given: (a) this factor provides an extreme old age pension base of only 30% of the initial pension, without resolving the drop in the the PW pension; (b) it has had an undesirable systemic effect, since the reduction of the initial PW pension skews the pension mode choice in favor of the insurance companies (LAs), increasing the risks inherent in the system.

(iv) **Create a new lifetime supplement for those who had already retired with PW at the time of the reform, for the purpose of improving their pensions.** This supplement would be financed with a special contribution. It would not be more than 0.1% of wages in the first year of implementation and would gradually diminish in future in accordance with the expenditure projection associated with the purpose of this supplement. It has been proposed that people should meet the following requirements to access this supplement:

(a) Have a normal PW old age pension, or have initiated early retirement in this pension mode at at least 55 years of age for women, and 60 years of age for men;
(b) Have suffered a decrease in the final pension of more than 30% of the initial value of the pension (in UF).
(c) Meet the Solidarirty Pillar requirements regarding residence in Chile.
(d) Allocate 100% of the beneficiary's accumulated savings to purchasing a mutual life insurance that begins payments immediately.

(v) **<u>Create a new mandate for pensioners with a PW pension at the time of the reform who do not meet all the requirements for accessing the proposed subsidy (iv)</u>:** divide the funds they have in their individual account to allocate a portion of their pension savings to a longevity insurance, which starts paying life annuities when the person reaches advanced old age (82-85). The amount of the mutual longevity insurance pension must be the percentage of the final initial pension calculated by using a formula determined by the Superintendency of Pensions, resulting in values between 70 and 80%.

III. **<u>Incorporate measures into the public pensions policies aimed at helping individuals to formulate and reformulate their pension expectations.</u>** One of these measures is to make the official denomination of the benefits of the public pension policy explicit, in order to clarify the misunderstanding regarding the contributory pension for individuals who have contributed for only a couple of years. In order to inform citizens about the requirements for obtaining a true pension, it has been proposed to follow the example of other OECD countries and differentiate between pensions with all their desirable attributes and a reimbursement of contributions. It is therefore recommended to adopt the three categories stipulated by the International Labor Organization (ILO):

(a) "Programmed Reimbursement of Insufficient Contributions," to those with less than 10 years of contributions.

(b) "Partial pension" to those with more than 10 years of contributions, but less than 30.

(c) "Full Pension" to members who complete 30 or more years of contributions.

In this regard, it is essential to create an institutional framework that provides, communicates and distributes in a regular and credible way, and in a manner easily understandable for mass audiences, opinions regarding the possible magnitude of pensions to members and leading journalists. The contents that should be generated are:

(a) The good news that there are resources in old age other than one's pension, that provide significant amounts to the middle class. This news should present a comprehensive view of old age. Any recommendation should start by constructing a projection of the "other resources" that each individual has in old age, to then calculate by subtraction how much will have to be completed by the pension, and finally, calculate how much has to be contributed prior to retirement. Pension simulations that start by asking for some kind of pension goal are defective, because they lead one to forget "non-pension" resources and suggest a replacement rate of 100% of income in active working life.

(b) Quarterly or monthly delivery to mass public opinion, of three data or projections for typical members, classified by age, sex and income:

(i) The average wage amounts in each classification.

(ii) The average monthly contribution amount and the number of months of contributions to date, counted as of the first contribution of such typical members.

(iii) Projection of benefits (pension, reimbursement) for each age cohort and contributed amounts, in accordance with the recommendation of the ILO conventions for such members.

References

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