PENSION NOTES

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Incorporation of the self-employed to the pension system

- ***There are solid grounds for mandatory pension contributions by the self-employed with savings capacity.***
- ***However, in most of the countries of the region, with the exception of Uruguay, the existing legislation exempts the self-employed from this obligation.***

Executive Summary

The self-employed represent a significant percentage of the total number of Latin American workers. According to estimates of the International Labor Organization for 2016, they make up approximately 31% of the total number of workers, exceeding 40% in some countries. Thus, their inclusion in the pension systems is crucial for them to receive the same degree of protection in old age as dependent workers.

The evidence justifies mandatory contributions to the pension systems. By way of example, in Chile, where contribution is still voluntary, only 6.6% of the total number of self-employed workers paid contributions to the pension system in 2016. Meanwhile, in Uruguay, where contribution is mandatory, 26% of the self-employed paid contributions to the social security system in 2011.

Despite the efforts of different countries to incorporate the self-employed (Colombia, Chile and Peru), political pressure has made it difficult to legislate and implement mandatory contributions.

FIAP considers it crucial to incorporate this group of workers into the pension systems in the region.

Among the proposals put forward for effective incorporation into the pension system, is the implementation of simplified tax incentives and mechanisms. Education and awareness strategies could also be key to achieving greater participation of self-employed individuals in the pension systems (Bertanou and Vasquez, 2006).

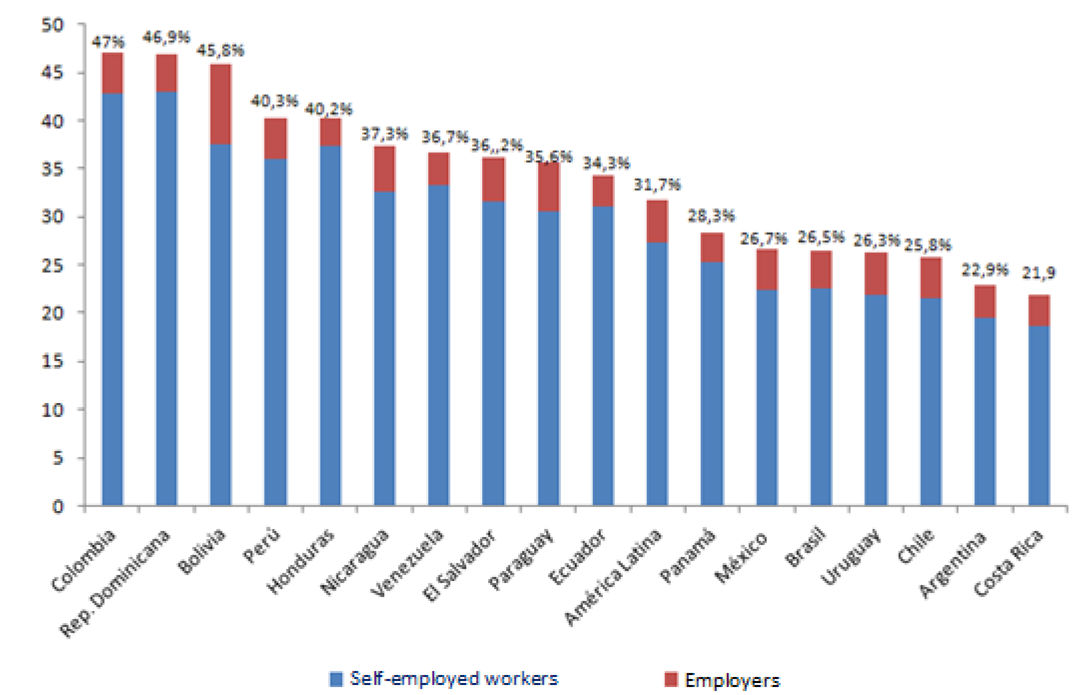
Background

The International Labor Organization (ILO, 1990) defines self-employed workers are all those who work on their own, or as employers (owners of companies that have not been incorporated as such, and in which they themselves work). Thus, this group of workers includes heterogeneous categories with substantial differences. There are differences regarding the formality/informality of the self-employed. According to the ILO (2002), the dependent and self-employed workers who elude compliance with tax and social security obligations, are considered informal.

According to ILO data, the percentage of self-employed workers in Latin America has remained relatively stable between 2000 and 2016, representing a percentage of the employed population of 31%, on average. On analyzing the data by country (Graph 1), it can be seen that in countries like Colombia, the Dominican Republic, Bolivia and Peru, self-employed workers make up between 40% and 47% of the total workforce. The proportion of self-employed workers is less than 26% in Chile, Argentina and Costa Rica. It is important to note that in all countries, the self-employed mostly comprise people who work on their own.

Graph No. 1

Latin America: Proportion of the self-employed in overall employment (2016)



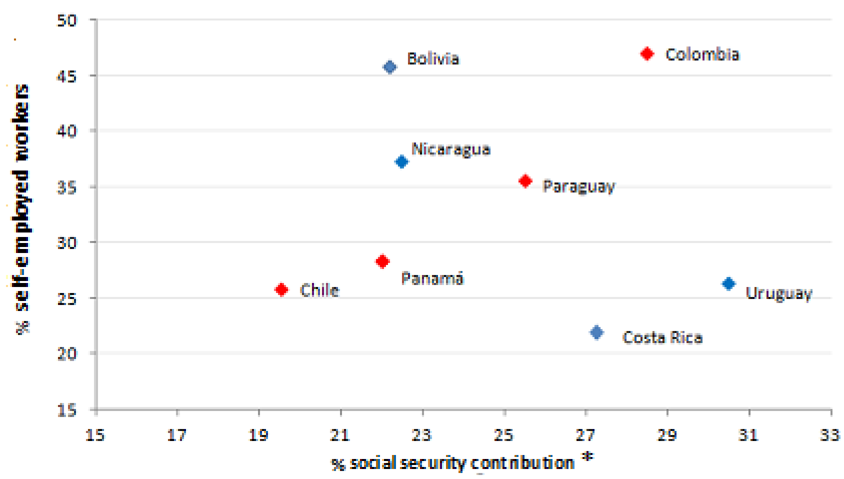
Source: In-house based on ILO data.

On comparing the relationship between the total percentage of social security contributions (pensions and health) with the percentage of self-employed workers (Graph No.2), we observe that there is a positive relationship between both variables for the majority of countries (highlighted in red on Graph No. 2). In other words, the higher the contribution to social security, the greater the number of self-employed workers. Nonetheless, in countries such as Costa Rica and Uruguay, it can be seen that despite the fact that social security contribution rates are high, there are lower percentages of self-employed workers. The other exception is in the poorest countries of the region (Nicaragua and Bolivia), where even though Social Security contributions are low, the percentage of self-employed workers is very high. The inverse relationship between the level of income of the country (measured by per capita GDP corrected for purchasing power parity) and the percentage of self-employed workers, is clearly visible in Graph No. 3.

It is therefore crucial for non-contributory social security benefits to be financed through general taxes, and not taxes on employment. Furthermore, these benefits (as well as those granted by other social programs) must be designed in such a way that they minimize disincentives to contribute to formal pension systems.

Graph No. 2

Latin America: Relationship between overall social security contribution and percentage of self-employed workers in the work force (2016)

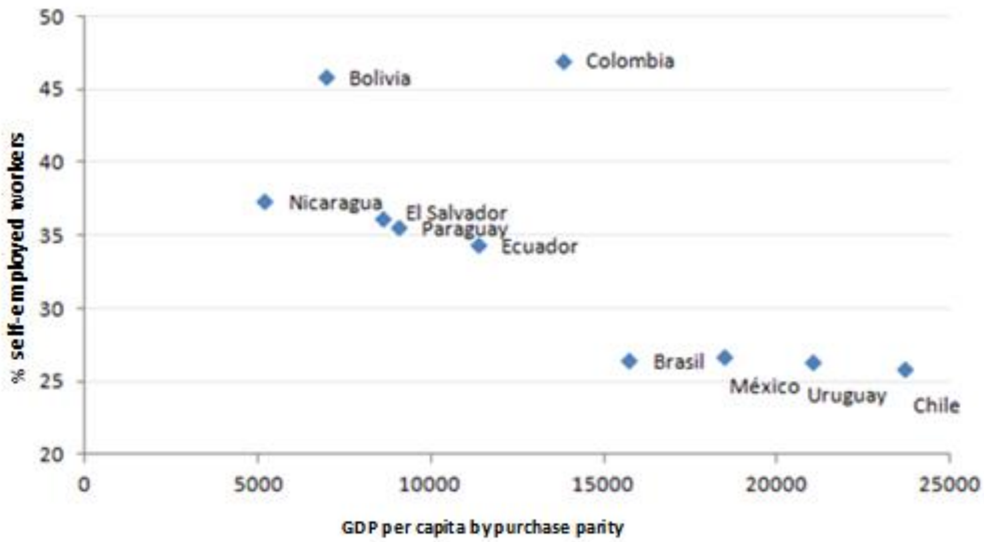


*The contribution rate includes contributions to pension systems (including the management commission and disability and survival insurance), plus contributions to the health system.

Source: In-house, based on the Social Security Administration and ILO databases.

Graph No. 3

Latin America: Relationship between per capita GDP by purchasing power parity and percentage of self-employed workers in the work force (2016)



Source: In-house based on IMF and ILO data.

Due to the importance of the self-employed workers category in overall employment in the region, and the fact that this situation does not appear to be transient, there is growing concern in the different countries regarding the mechanisms for providing social protection for this group of workers, who are often excluded from the Social Security contributory systems originally designed for employees in a dependent relationship.

Hence, FIAP believes it is worthwhile to examine the arguments for and against their mandatory inclusion in the pension system, and also present the legal situation currently in force in the FIAP member countries in the region.

Should it be mandatory for self-employed workers to contribute?

The obligation to contribute to pension systems worldwide is basically justified by what in the literature is known as "intertemporal myopia." In other words, individuals are unable to anticipate their needs in old age (passive stage) during their active working stage, and therefore do not voluntarily save, because they have a preference for present consumption. By making contribution mandatory, the pension systems seek to protect them from this lack of foresight, providing them with sufficient and stable income to avoid poverty in old age, as well as preventing or reducing the likelihood of them being a burden to the State in the passive stage.

However, mandatory insurance and saving for old age in some countries exclude certain groups, which, due to their occupational characteristics, make it difficult to enforce mandatory contribution. This is the case of the self-employed.

According to Bertanou and Vasquez (2006) it has been observed that contribution is mandatory for self-employed workers in developed countries with more mature pension systems, such as the United States, Canada.[1] and France[2]

It is also important to bear in mind that many workers switch between dependent and self-employed status throughout their working lives. In Chile, for example, it is estimated that individuals spend, on average, 40% of their working lives as dependent employees, 30% inactive, 17% self-employed, 8% as employees without a contract (informal) and 6% unemployed[3]. Given this variation in employment status, when the self-employed contribute, the coverage of the pension systems increases, especially contribution densities and pension amounts. Those who believe that it should not be mandatory for the self-employed to contribute, argue that given the absence of a salaried employment relationship, it is very difficult to supervise proper contribution. On the other hand, they argue that self-employed workers generally have low incomes, so that forcing them to contribute could aggravate their economic situation (Bertanou and Vasquez, 2006).

Current legislation governing mandatory contribution by the self-employed in Latin America

Uruguay is the only Latin American country with individually funded programs in which it is mandatory for self-employed workers to pay pension contributions that provide protection similar to that of salaried workers**.** In other countries, such as Bolivia, Chile, Costa Rica, El Salvador, Mexico and Peru, self-employed workers can contribute to the pension system on a voluntary basis. In general, voluntary membership is very low, so they are wholly or partly unprotected at retirement. This is evident in Chile and Peru, where the percentage of self-employed workers who made pension contributions were 6.6% (in 2016) and 5.85% (in 2015), respectively. In Costa Rica, there is also a voluntary pension contribution system through the Disability, Old Age and Death system (public).

In the Dominican Republic, the self-employed do not have the option of making social security contributions, even on a voluntary basis, despite the fact that law 87-01, which introduced the individually funded system, included mandatory enrollment of the self-employed in the Subsidized Contributory Regime. This regime should include self

[1] https://www.canada.ca/en/services/benefits/publicpensions/cpp/contributions.html

[2] https://www.canada.ca/en/services/benefits/publicpensions/cpp/contributions.html

[3] Estimates of the Office of the Undersecretary for Social Welfare (2013), based on the employment history of the 2002, 2004, 2006 and 2009 Social Protection Survey**.**

employed professionals, technicians and workers with average incomes at least equal to the national minimum wage. However, after 15 years of the pension reform, this regime is not yet operative, due to the failure to approve the respective regulations (see table No.1).

Table No.-1: Obligation of self-employed workers to contribute to the individually funded system

Country	Obligation to contribute to the individually funded program	Possibility of voluntary enrollment	Enrollment in an alternative pension program
Bolivia	No	Yes	No
Chile	No	Yes	No
Colombia	No	Yes	No
Costa Rica	No	Yes	Yes
El Salvador	No	Yes	No
Mexico	No	Yes	No
Peru	No	Yes	No
Dominican Republic	No	No	No
Uruguay	Yes	Yes	No

Source: FIAP Compared Regulations Compilation, Table 8.1

In Chile, the 2008 Pension Reform made it mandatory for self-employed workers who issue fee slips to contribute to the social security system. Nonetheless, implementation has been successively postponed. The government recently announced that its enforcement will be delayed again, and that it will be gradual over a period of 8 years, without giving details of the procedure.

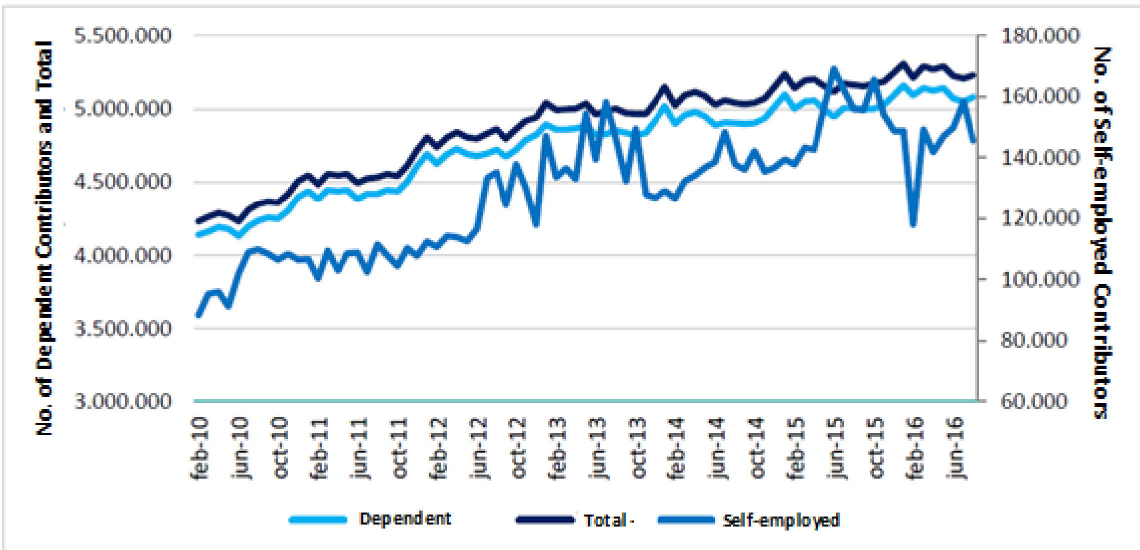
According to estimates by CIEDESS (2017), in August, 2016, 25% of Chilean workers were self-employed, with only 6.6% contributing to either the individually funded system, or the former PAYGO system.

The evolution of the number of contributors to the pension system, by type of worker for the 2010-2016 period, is shown in Table No.4. One can observe a positive trend in the total number of contributors, mainly explained by the increase in dependent contributors. However, a significant increase in self-employed contributors can be observed as of mid-2012, which could be explained in part by the gradual obligation that would apply to this group of workers.

The evolution of pension coverage of the self-employed, understood as the ratio between self-employed workers who contribute to the pension system and the total number of self-employed workers, rose from 5.1% in 2010, to 6.6% in August of 2016, according to estimates by CIEDESS (2017).

Graph No. 4

Chile: Evolution of the number of contributors in the pension system by type of worker (2010-2016)



Source: CIEDESS (2017) based on Superintendency of Pensions data.

In Colombia, Law 1753 of June 2015 expressly states that self-employed workers with a monthly income equal to or higher than one minimum wage, must pay Social Security contributions based on a minimum of 40% of their total monthly income. However, this obligation has not been enforced to date. Furthermore, according to Acuña et al, (2015), about 55% of the working population earns less than the minimum wage, thus excluding them from the obligation to contribute to the pension system.

In Peru, the 2012 reform made it mandatory for certain categories of self-employed workers to contribute. This was repealed in September 2014, only one month after it was enforced. In fact, the mandatory contributions paid in by self-employed workers were returned to those who requested it. According to Acuña et al,1(2015) the design of the incorporation of the self-employed in Peru was deficient, since it did not use the time available before enforcement to advantage for adequately informing these workers, in order to facilitate the process of incorporation, which could have avoided their rejection of the measure.

This measure clearly has a negative impact on old age protection for this group of Peruvian workers, who represented 39% of the economically active population by 2015, according to the Peruvian Institute of Economics. Only 15% of these workers are enrolled in a pension system, and only 39% of those 15% effectively contributed in 2015 (i.e., only 5.85% of the self-employed contributed to their pensions in 2015).

The case of Uruguay

Uruguay is an interesting case for analysis, since it is the only country in the region with an individually funded system in which it is mandatory for self-employed workers to contribute to the pension system. Furthermore, according to information from the National Institute of Statistics[4], 22.9% of the labor force was self-employed in 2016.

The self-employed are covered in two ways: through the general regime for non-dependent workers, managed by the Social Protection Bank (BPS), and the Simplified Regime, which comprises a group of entrepreneurs and micro-entrepreneurs.

The general regime covers all workers in one-man companies. The base income on which the contribution amount is calculated, depends on whether the self-employed worker is enrolled in the Mixed Regime or the former PAYGO system.

The Simplified Regime was created by Law 17.296 in 2001. It is a tax on small-scale business activities, whereby eligible companies pay a sole tax substituting all national taxes (excluding import duties) and contributions to the social security system. These workers are entitled to access Social Security benefits, including the pension system.

Due to the failure of the original proposal to include workers from the informal sector, some modifications were introduced in 2007, aimed at making the conditions set out in the regulations more flexible, for the purpose of achieving greater inclusion of self-employed workers.

The modifications include: The elimination of restrictions regarding the place where the activity is performed (only those working in public spaces were included previously, and now those working in small shops are also included); the extension of the type of activities considered (formerly covered only companies with marketing activities, now also includes small producers of artisan type manuals); the extension of the type of activities considered (previously only companies with commercial activities were included, and now small manual artisan-type producers are also included); the extension of the types of companies (de facto companies are now included,

[4] http://www.ine.gub.uy/documents/10181/30865/ECH+Marzo+2017/d1486924-b54d-4a7b-9d3c-d2776fa9b7ca

and not only one-man or family companies); the increase in sales conditions (credit sales are now allowed); an increase in the maximum invoicing limit; in the case of some activities, the possibility of selling not only to end consumers, but also to companies and the State; and changes with respect to the number of dependent employees (allows the hiring of up to one dependent employee, and in certain activities up to three dependents may the requested on admissible grounds).

As can be seen in Table No. 2, the changes were successful, since a significant increase in the number of companies and the number of contributing workers is evident after 2007, an almost tenfold increase between 2006 and 2013.

In addition to these two systems, university professionals who exercise their profession independently, can make contributions to the University Professionals Retirement and Pension Fund, or the Notary Public Social Security Fund (in the case of notaries public), both regulated by the Central Bank of Uruguay.

Table No. 2

Number of companies with payrolls taxed under the simplified regime (to December of each year)

Year	Enrolled companies	People contributing
2006	2,566	2,925
2007	6,217	6,753
2008	10,259	11,320
2009	13,061	14,347
2010	15,625	17,356
2011	19,108	21,132
2012	21,127	23,319
2013	22,968	25,319

Source: Social Protection Bank, Uruguay.

According to estimates by Amarante and Perazzo (2013), 26% of the self-employed in Uruguay were covered by one of the systems mentioned above, in 2011. Although the coverage of self-employed workers is still not as high as that observed for dependent workers, it is remarkable that it is more than four times the coverage observed in countries where contribution by self-employed workers is voluntary.

How to incorporate the self-employed into the pension system?

It is clear that incorporating them into the pension system is a complex undertaking, and sometimes with significant political costs, due to the refusal of self-employed workers themselves to be forced to contribute to the pension system. As a starting point, contribution should only be mandatory for those self-employed workers with the ability to contribute. Forcing very low-income self-employed workers to contribute would certainly be counterproductive. It would be more reasonable for low income self-employed workers to be covered by non-contributory programs financed with general tax resources.

According to Bertanou and Vasquez (2006), the self-employed can be Incorporated through the implementation of tax incentives and simplified mechanisms. Tax simplification can be an effective tool for capturing a greater number of self-employed workers, using the simplified regime operating in Uruguay as an example. The implementation of tax incentives could also favor the incorporation of self-employed workers. In countries with tax incentives for encouraging savings, many self-employed workers with savings capacity do not take advantage of them due to lack of information regarding their existence and the functioning of social security instruments. Hence, education and awareness strategies could be the key to a greater incorporation of self-employed workers.

Since a large number of self-employed workers pay their income taxes, it makes sense to link the contribution to the pension system with their tax returns. This requires proper coordination between the tax collection agency and the pension fund managers. Canada and the United States used the annual tax return as an instrument for social security contributions by self-employed workers. This collection mechanism was the one designed in Chile in the 2008 Pension Reform.

One of the aspects that has been mentioned as a disincentive to contribution, is the existence of other social programs whose benefits are dependent on income levels; thus, those who declare income and contribute, are handicapped in obtaining such benefits; added to the above is the granting of non-contributory pension benefits, that decrease or are lost when the self-employed contribute to the system. Hence, it is crucial for the benefits of the different social programs to be designed to minimize disincentives to contribution in formal pension systems.

Moreover, Martinez and Puentes (2011), propose that in the Chilean case, mandatory contribution should be extended over time to all self-employed workers, and not just to those issuing fee slips. They especially suggest using the General Treasury of the Republic to collect contributions from other self-employed workers who pay income tax. They propose taking advantage of instances of formalization to contribute. For example, in activities requiring municipal permits, the permits could be subject to the payment of social security contributions, or else higher scores could be assigned to companies bidding on projects, that can demonstrate a certain number of contributions to the pension system.

Finally, it has been proposed to provide certain flexibility for accessing the savings accumulated in the individual accounts of the self-employed (allowing the withdrawal of a certain predefined percentage) in order to improve the incentives for enrollment and contribution (Bertanou and Vasquez, 2006). This, however, would undermine the fundamental purpose of the pension system, which is to finance the old age of savers. It would also set a precedent that could be extended to dependent workers, which does not seem to be an alternative in the right direction.

Sources

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