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Chile's New Pension Reforms

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In 2008 Chile initiated a major reform to its personal account social security system. The personal account system, established in 1981, replaced a traditional pay-as-you-go (PAYGO) system in which workers paid taxes that financed the benefits of those who had already retired — similar to Social Security in the United States.

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Executive Summary

In PAYGO systems, as the ratio of retirees to workers increases, successive generations must pay higher taxes to cover the benefits of the previous generation. Personal account systems, by contrast, require workers to save for their retirement, invest workers' savings productively, and fund workers' benefits through their own accumulated funds.

The Chilean personal account scheme worked well for individuals who contributed on a regular basis. But like most Latin American social security systems, it provided meager benefits for those who didn't earn wages, were self-employed or worked outside the formal labor market. These groups were not required to contribute to an account or the mandate to contribute was difficult to enforce. In general, a system that links benefits closely to contributions (whether public or private, funded or PAYGO) will leave such individuals with little or no pensions.

In 2008, a council appointed by Chile's newly-elected, center-left coalition government to review the pension system reaffirmed the basic principle of reliance on private individual accounts and extended the system to groups not previously required to participate. At the same time, the new reforms expanded and restructured public benefits for individuals with little or no private pension. These changes will protect noncontributors and low contributors from a sharp drop in income after they retire.

The danger under these new reforms is that fiscal costs may grow faster than expected. Furthermore, the phaseout of the generous public benefits for those with larger private pension accounts creates an implicit marginal tax penalty that may discourage some individuals from contributing to personal accounts.

How Personal Accounts Work. Since 1981, Chilean workers have been required to contribute 10 percent of their wages to a