

# **The Chilean system of contributory pensions as *locus* of rivalry and of a new social compact**

Ana Sojo



UNITED NATIONS

**ECLAC**



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DEUTSCHE ZUSAMMENARBEIT

**SOCIAL  
POLICY****The Chilean system of contributory pensions as *locus* of rivalry and of a new social compact**

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## Executive summary

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This study assesses the contributory pension system in Chile and offers some recommendations for reform, from the viewpoint of social rights that generate expectations of satisfaction. The primary objective of any pension system is to provide income security to the elderly, and contributory pensions must reflect the savings achieved throughout working life in order to guarantee that, for similar levels of effort, similar and proportionate protection will be obtained. Taking arguments from economic welfare theory and using empirical and quantitative evidence, we show that the low and decreasing long-term replacement rates of contributory pensions are related to the profit orientation of the contributory pension system and the accompanying rationale employed by private administrators and the related financial and business network.

The reforms proposed are justified on the grounds that under certain circumstances the State AFP (public pension fund administrator), because it is not governed by profit, can fulfil a crucial function in terms of a generalized increase in pension replacement rates, and can have direct and indirect systemic effects that will be of substantial benefit to the middle class, which is greatly disadvantaged under the current system. The study insists on the need to move toward a new, compulsory contributory system of individual accounts not geared to profits, and it offers some general guidelines to this effect. In addition, it illustrates the need for care policies that can enhance the sustainability of financing for social protection.



## Introduction

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A key test of decent society is the living standards of its older people, particularly the poorer among them. This includes their ability to participate in their community and thus their relative income and access to health care and other services. The financing of their consumption in old age depends on the accumulation of past resources, by themselves and by the State, and its reflection in overall current income flows. Any sensible set of policies must take into account both the effects on such accumulation and the uncertainties surrounding life expectations, abilities and disabilities. Thus policy analysis must examine issues of efficiency, distribution within and across generations and over individual lifetimes, as well as substantial uncertainties in individual circumstances. (Nicholas Stern, 2008)

As a first step, the study explains the focus of the principles of social protection and the rationale for public-private mixes in this area, which will support the analysis of the contributory pension system from a perspective of social rights that generate expectations of satisfaction. The primary objective of the pension system, which is to provide income security in old age, is contradicted in Chile by the profit orientation of the contributory pension system; throughout the study, we substantiate the importance of this linkage both with arguments from economic welfare theory and with empirical and quantitative materials, and we relate the low and decreasing replacement rate of contributory pensions with the profit motive and with the rationale followed by private administrators and the related financial and business network. In addition to the direct adverse effects on standards of living for older adults, the growing disrepute of the system and the negative disposition to which it gives rise encourage contributory evasion, and exert pressure on the contributory pillar, with consequent fiscal effects.

Within the current system of individual capitalization, and without changing the rules of free choice and competition, the study shows why the State AFP, under certain circumstances, because it is not governed by profit, can fulfil a crucial function in terms of a generalized improvement in the pension replacement rates, and can have direct and indirect systemic effects that will be of substantial benefit to the middle classes, which are disadvantaged by the current system. If the yield from the State AFP has an adequate demonstration effect —i.e. if it attracts contributors with various saving capacities thanks to the improvement in the replacement rates— it will encourage the transition toward a new, mandatory

contributory system of individual accounts not geared to profit, which should be the object of the reform, and with respect to which this paper offers some general guidelines. To this end, we propose an immediate transition towards a convergence of rules on the calculation of pensions, on ceilings, on correction indices, and on contribution rates, a convergence for which clear time limits must be set and observed. In this respect, the parametric adjustments that are currently proposed must be resolved in a manner consistent with the design of the new system of nonprofit individual accounts. In addition, we show the need to activate care policies that can support the sustainability of financing for social protection.

## I. The principles of social protection according to ECLAC, as a point of departure for the analysis to be undertaken

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As proposed by ECLAC, a protection system is more than an institutional structure. It is a political covenant to which society turns in order to lay the basis for building and regulating its life. This covenant, which is under constant construction, determines which rights must apply to the entire population, how they are to be guaranteed, and how they are to be made viable. Consequently, a certain degree of cohesion is needed to build consensuses that will take the form of institutions, norms, programmes and resources. As well, to move from a set of social policies to an integral system of social protection requires social cohesion. This needs to be promoted, and it means addressing conflicts between rights, resources, distribution patterns, and institutional designs. A social protection model based on rights and geared to cohesion requires decisions on four essential elements: determination of the levels and sources of contributory and non-contributory financing; the degree of solidarity in the financing; the development of social institutions for efficient management of the benefits policy, and identification of explicit rights of access to social benefits, which can be guaranteed and enforced (ECLAC, 2007)

In order to address the reductionist vision of social policy from a rights-based perspective, ECLAC has formulated principles on social protection (ECLAC, 2000, 2006, 2010, 2013). The principle of universality means guaranteeing that all members of society can enjoy certain protections or benefits in the form of rights, in the quantity and with the quality deemed necessary for full participation in society. Thus, the principle holds that all persons must have certainty that they will be guaranteed the maximum well-being permitted by a country's economic development at a given time. This does not, of course, mean that every benefit must be universalized, but rather that society should establish, through covenants, standards of quality and coverage that must be guaranteed to all its members.

Universality—in terms of making policies more effectively universal and addressing the multifaceted and heterogeneous nature of poverty and vulnerability within a framework of resource restrictions—does not conflict with the possibility of establishing criteria of selectivity, intended to preserve access to social services for the poorest population groups. In this respect, there must be virtuous and comprehensive interaction between universal and selective policies.

Universality is intimately linked with the principle of solidarity, of a redistributive nature, which holds that participation in the financing of social protection should be a function of individual economic capacity. Considering the asymmetries of economic conditions and of exposure to risks, particularly in the areas of health and employment, such redistribution must help to ensure universality and fairness in people's access to social benefits. This principle also assumes that, given its externalities, individual well-being is closely interrelated with social well-being: the scope and quality of services and social protection mechanisms has an influence not only on the lives of individuals but also on the development of societies.

For its part, the principle of efficiency in the use of public funds earmarked for social policy is also an intrinsic part of fairness, to the extent that it makes it possible to achieve the principles of universality and solidarity, without placing them in conflict. But it must not be understood exclusively in terms of its macro and microeconomic effects but rather, in the final analysis, as the capacity to maximize the social objectives that have been defined, using scarce resources.

As the labour market has not shown an adequate capacity in terms of creating high-quality jobs or of contributory coverage, it cannot be the only mechanism for protecting the majority of the population against the risks associated with income fluctuations, failing health and ageing, among others. For this reason, social protection must not be restricted to the mechanisms offered in the labour market: the great challenge is to rethink social protection within a framework of integral solidarity, in which contributory and non-contributory mechanisms are combined (ECLAC, 2006).

## II. The fairness and rationale of the public-private mixes on social protection

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It must be noted that, in the strict sense, fairness in social protection is not given or guaranteed by the legal character of the ownership of the responsible entities: in other words, by the public or private nature of the entities that comprise the architecture of health systems or pension systems.<sup>1</sup> This is determined by the existing rules of the game with respect to public-private mixes in the area of social protection, and the concomitant functions of the State; in other words by what principles and objectives those combinations are articulated and regulated. In conjunction with the characteristics and the development of the markets with which these systems interact, this determines a broad and heterogeneous range of situations (Sojo, 1999).

For example, the conservative proposal of the World Bank, known as “social risk management”, starting from the issue of risk and insurance, formulated an overall proposal for a reductionist social policy that articulated three fundamental positions, and that proposed a public-private mixes the delimitations and nature of which were functional to those positions: the social welfare responsibilities of the State are confined to combating poverty; risk insurance is designated as an individual and market responsibility; and solidarity in risk diversification is virtually ruled out (Sojo, 2003, page 134).

The application of the principles of universality, solidarity and efficiency in the design, financing, delivery and regulation of social protection poses some significant dilemmas, the solutions to which are not uniform, particularly when private agents are involved. Yet, regardless of the degree and type of private participation, the State retains non-delegable responsibilities to guarantee the rights of the citizens, to improve conditions of information and competition on regulated markets, to avoid problems

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<sup>1</sup> See for example the interesting analysis of the uncertainties regarding exercise of the medical profession in various European welfare states over time (Porter, 1999) or the discussion of how the objectives and principles of European welfare states have shifted with changes in the type of financing and management and with new instruments (Palier, 2010). Among other dimensions, the role of State entities, philanthropic organizations, regulations governing the practice of medicine as a liberal profession, the organization of labour markets in accordance with business-labour agreements, and profound demographic changes have undermined the welfare state in Western democracies.

of risk selection by providers and users, to see to the coverage and quality of systems, to ensure protection of users, and to arbitrate in the case of disputes (ECLAC, 2000, page 16).

Social protection can be constructed on the basis of various public-private mixes. The State can reserve to itself the role of single or main provider, which can be desirable, and as such represents a necessary benchmark with respect to private delivery, prevents the establishment of monopoly positions, avoids escalating costs and promotes greater symmetry in information to beneficiaries. But this can also be achieved in the context of various public-private mixes. In this context, as much to ensure the efficiency and effectiveness of services, private activity must be governed by regulations and procedures that will guarantee competition. With respect to the fairness objective, consistent with the principles of universality and solidarity, it is essential to guarantee the quality, relevance and inclusiveness of benefits, linked to the financial and regulatory mechanisms, with rules that will ensure suitable public-private mixes (ECLAC, 2007, page 137, and ECLAC, 2013).

As has been argued in the past (Sojo, 2003), compulsory insurance, conversely, by including and retaining people at low risk, makes it possible to operate by a logic different from that of private insurance and achieve stable risk differentiation. Social insurance may be run by private-sector insurers; its financing may come from compulsory premiums paid by workers and employers or by workers only, or from general taxation; but in either case its logic is substantially different from that of private insurance, as it breaks the identity between individual risks and premiums and establishes risk coverage on more general terms, so that it can include some who are not normally covered by individual insurance policies (Barr, 1993, pp. 123-128 and 308). Generally speaking, compulsory insurance operates with a long-term perspective: because guarantees are applied generally and not to subgroups categorized by risk, individuals are not reclassified if their risks increase (Arrow, 1963, p. 904). Stable risk differentiation, which has obvious effects on equity, also affects efficiency. Adverse selection phenomena reduce the latter and in extreme cases can result in the bankruptcy of insurers, the so-called "death spiral" (Cutler and Zeckhauser, 2000, pp. 606-625; Cutler, 2002, pp. 83-86).

Compulsory insurance is typical of the so-called social, public or national insurance systems: the objective is essentially one of stable risk differentiation, which can be achieved in the framework of varied public and private combinations. In these terms, State welfare insurance can be seen as an insurance contract entered into voluntarily by risk-averse individuals (whereby citizens seek to protect themselves from some of life's uncertainties) behind the veil of ignorance, to use Rawl's term (in the sense that premiums are not adjusted to reflect individual risks) (Barr, 2001). Hence, coverage is generally established in more generic terms (Arrow, 1963, 2000).

By contrast, market insurance is driven by profit considerations, according to which the price of private insurance policies is adjusted to fit the specific risk profile of the person insured. This is the case with dualistic private-public combinations, according to which mandatory contributions and cross-subsidies from the public sector are used in accordance with the profit principle, to which the insurance is subordinated, abandoning the principles of social security in favour of a market approach to insurance. The dual logic of the Chilean health system is unique in the region and internationally, as the mandatory contribution, for which the worker is exclusively responsible, allows him to join the public health system through the National Health Fund (FONASA), the "pay-as-you-go" nature of which favours solidarity, or else private health insurance institutions (ISAPRES), which operate under a private insurance approach associated with individual risk, even though contributions are compulsory. The pensions system also has a dual design, reflecting the profit motive, according to which compulsory contributions to the individual funded pension system have translated into pensions with lower replacement rates, and into fat profits for pension administrators and the companies involved.

On this topic it is important to take the profit argument in perspective, by considering the profit "thresholds" or "break-even points".<sup>2</sup> The various agents involved (for example, physicians in the exercise of their profession) naturally seek to earn an adequate return from their labours, but the argument highlights the proportionality and reasonableness of their earnings, in systemic terms, in

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<sup>2</sup> The author is grateful to Olga Lucia Acosta for the idea of profit "thresholds".

relation to the resources available for effective social protection. Because they are organized to maximize private benefits, to the detriment of insurance functions, dualist public-private mixes violate the principles of social security. In the case of pensions, instead of fulfilling the essential objective of maximizing income protection after working life by offering the best possible replacement rates in a context of optimizing investment of the funds, resources are often channelled so as to obtain fat profits for the fund administrators and the related companies, due to the dual rationale of the system; if it were not for the profit motive, the earnings obtained on the funds would be devoted to maximizing the replacement rates of the pensions. Within this dual framework, there can be no progress toward universality, solidarity and efficiency, as defined at the outset. The dual term stresses the profit rationale notwithstanding the use of contributory or tax resources for social insurance, a phenomena different to the individual's out-of-pocket payments for a market insurance policy.

These, then, and not the caricature that is proffered by neoliberal ideology,<sup>3</sup> are the reasons that justify a thorough investigation of the rationale of public-private mixes in the area of social protection.

The history of social protection provides evidence of the importance of fund administration, its modalities and costs: the introduction of different modalities of social protection has been determined not only by strictly ideological considerations but also by feasibility, in terms of specific administrative or institutional requirements. In the United Kingdom, for example, at the beginning of the last century the proposal for uniform, non-contributory pension benefits was occasioned by constraints on organizing contributions, as education levels were inadequate for their administration. As noted by Baldwin (2003, pp. 100-101), "the battalions of clerks needed to run a Bismarckian earnings-related scheme could not be recruited, as they had in Germany, until the 1880 Education Act had shown an effect."

Objectively, at the present time there is no need for an army of administrative employees to organize contributory social protection schemes. In the concrete field of pensions, the consecutive increases in the productivity of administration of individual accounts —thanks, for example, to the growth of Internet connectivity for pension savers, or the connectivity with which investments are managed— and which represent a clear reduction in administration costs, should be transferred as a benefit to future replacement rates for contributors, among other mechanisms, by reducing administration fees.<sup>4</sup> In Chile, unfortunately, this has been done only to a very limited extent, unveiling the profit motive by which the system has operated.

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<sup>3</sup> "To believe that private enterprise was good for producing refrigerators and shoes, but not for producing social services, such as education, health, or pensions... no one could understand this inconsistency (José Piñera, 1991, page 22). "In Chile the lack of trust of private interests still persists today. Statism has not sown in vain. That resistance, for example, leads us to view success in the business world nearly always as a more or less fraudulent conspiracy against the interests of society, business success is almost never viewed as it is in a truly competitive market economy, as a reward that the community gives to those who are delivering to the market some good or service under better terms than the rest of the competition" (ibid., page 19).

<sup>4</sup> Even José Piñera believed that, simply because it involved private firms, technological progress would lower the costs of pension fund administration: "The key objective in handing over the administration to a private firm was to maximize the level of pensions that the individually funded system could provide. A determining element of that possibility is the cost of administering the system. Because this industry must work with enormous quantities of information (processing individual accounts), it was essential to incorporate the galloping technological progress that characterizes this field. It is obvious, and it has been proven in multiple cases, that private enterprise is infinitely better at this than is the State apparatus" (Piñera, 1991, page 22). This has not been the case, because the incorporation of technical progress has mainly helped the firms to reduce their costs, and has not translated into any cuts in fees and commissions. The new Chilean AFP named *Modelo* demonstrates the low costs that a quasi-virtual AFP can achieve, when it has very little in the way of physical offices, and it can adjust its fees to compete.



### **III. The legitimacy of social protection systems: determinants of a favourable or negative public attitude**

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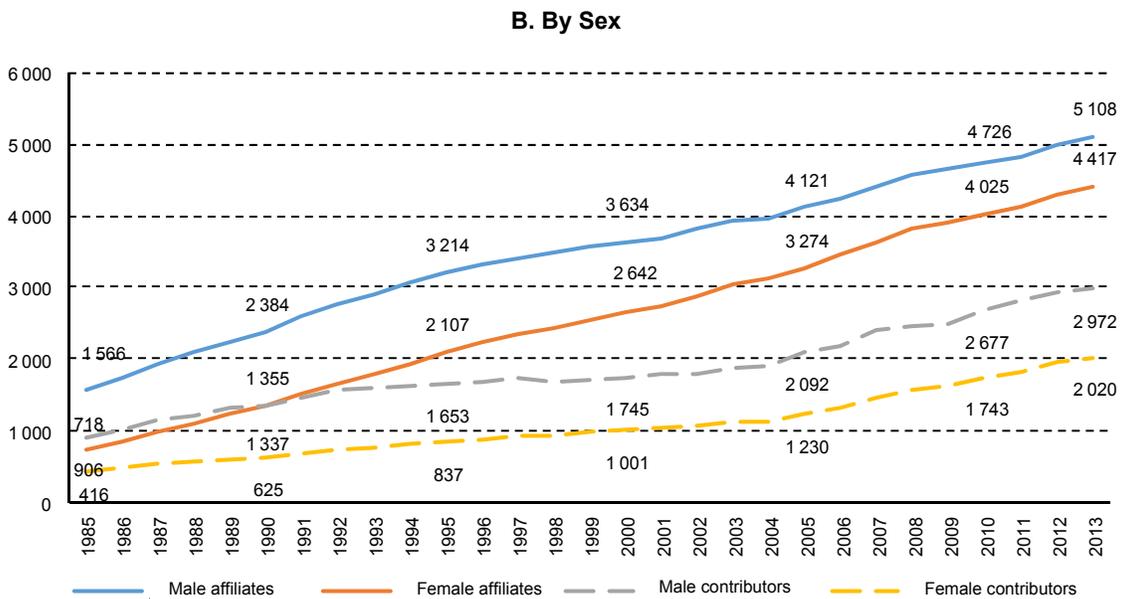
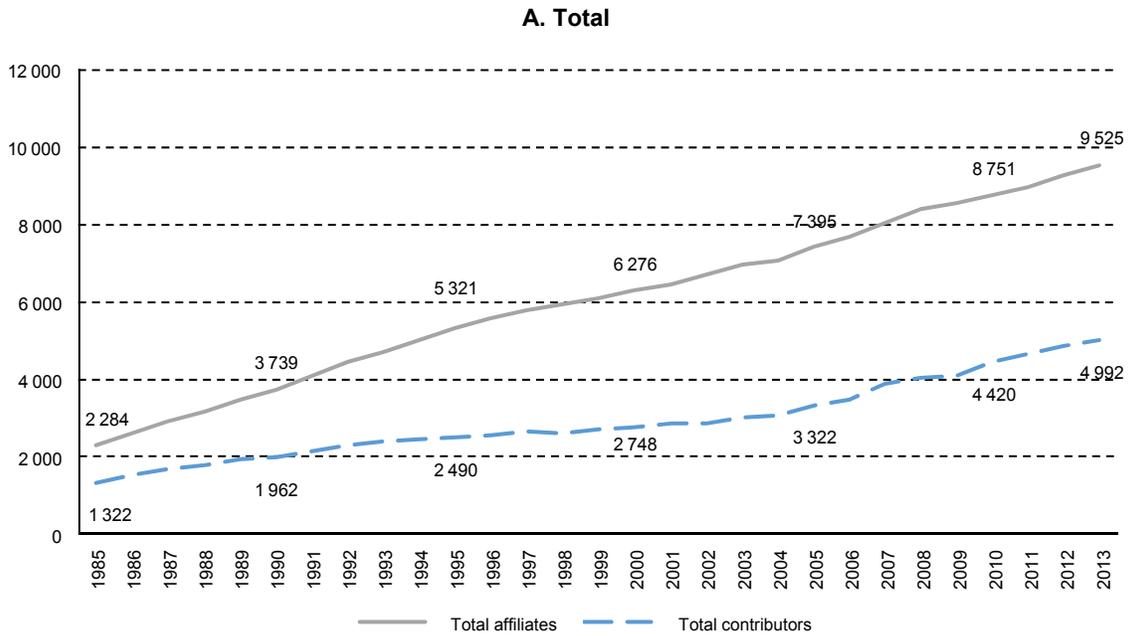
Legitimacy is essential for the political viability and the long-term sustainability of the social protection system, and it is important that the citizens should view it favourably. Social security failings or poor medical benefits have negative externalities in that they do not create sufficient incentives to strengthen and deepen labour markets (Sojo, 2003) or to induce people to pay their taxes and contributions. This creates a vicious circle, exacerbating the under-financing of the systems and calling their sustainability into question.

The essence of insurance is risk diversification through a partial transfer of individual risk to the insurer, in return for which the customer is willing to pay a “loading fee”, as it is known in insurance jargon. This is the portion of the insurance policy premium that covers the insurer's operating costs (administration, advertising), the costs associated with payout of unpredictable risks (beyond the payment of risks that are relatively predictable), the insurer's investments, and the insurer's profit (van de Ven, 2013, pages 52 and 53). The desired level of health insurance coverage depends on the trade-off between the welfare gain due to risk reduction and access to otherwise unaffordable care and the welfare reduction due to moral hazard and premium costs. In this respect, high premium costs or loading fees can reduce the willingness to insure (van de Ven, 2013). The theory of insurance predicts that risk-averse individuals will seek health insurance, even when they are suffering, provided the policy is not excessively costly because of administrative expenses and profits, with due allowance for moral hazard (Zweifel, 2013, p. 565).

Extrapolating this reasoning to the field of pensions, we may say that when the cost of covering administrative expenses and profits is seen by potential contributors as excessive, this will provide a disincentive to contribute. Although contributions may be compulsory, they can be evaded or postponed, as with the fee-for-service contracts in Chile. When the legitimacy of social protection systems is compromised, this increases the propensity to default (depending on the form of financing) on the payment of contributions or taxes. The perception that the eventual pensions will be low is no incentive to compliance.

In Chile's contributory pension system there is a serious discrepancy between affiliation and payment of contributions, and thus a wide “contribution gap”, under circumstances where the density of contributions is crucial both for future replacement rates and for the potential fiscal commitments needed to sustain the solidarity pillar. Moreover, this gap has been widening over time.

**FIGURE 1**  
**CHILE: NUMBER OF AFFILIATES AND CONTRIBUTORS TO THE CONTRIBUTORY PENSION SYSTEM, 1985-2013**  
*(Thousands of persons, total and by sex)*



Source: prepared by the author on the basis of data provided by the Office of the Superintendent of Pensions. Contributors are deemed to be those who have paid their contributions in December of each year for remuneration accrued in the previous month; affiliates are persons in the workforce, and contributing pensioners are excluded.

Non-payment of contributions, which we may call “contributory evasion”, is a crucial aspect to be taken into account in the design and functioning of pensions systems, as it has an impact on the future level of pensions, on the financial sustainability of the system, and on its political legitimacy. Contribution gaps may be due to the vagaries of employment, to the “free rider” phenomenon, and to the myopic behaviour of young people in putting off their contributions (Manchester, 1999), or to any of a number of strategies for deliberately evading contributions on the part of employees or employers. In the social protection area, contributory non-compliance can result in exclusion from the system, or the under-payment of benefits. In the case of pensions organized in individual accounts, among other elements, the amount of the pension is associated with the density of contributions. From this perspective, contributory evasion affects the financial sustainability of social protection and has negative fiscal externalities, as it may require greater economic efforts by the State —or higher than optimal taxation rates— in order to implement supplementary and non-contributory schemes, which make it possible to pay basic health and pension benefits to people excluded from the contributory regime, or may produce shortfalls that must be offset from tax revenues under "solidarity" schemes. Thus, contributory evasion and insecure employment in informal labour markets can increase fiscal pressures on governments to pay for non-contributory schemes financed by taxes (Gómez Sabaíni, Cetrángolo and Morán, 2014).

Pensions should reflect the savings effort made throughout the insured person's life. The equivalency rule must guarantee that, for similar levels of effort, similar or proportionate protection will be obtained (ECLAC, 2000, page 78). In the contributory system, the equivalence is between the person's contributions history and the replacement rate. Given the characteristics of the system, which has no insurance mechanisms, equivalence in the Chilean case applies strictly at the individual level, with no mechanisms of solidarity or risk differentiation, for example in the face of financial risks.

The economic theory of insurance has shown clearly that it is difficult and complicated to opt for an optimum package of insurance and consumption smoothing, as this requires a sophisticated and detailed analysis of data and decisions. Hence, a public programme can optimize decisions (Diamond, 1977, page 157) and, moreover, regulation is vital for protecting individuals in areas that are highly complex, and to guarantee clear and transparent rules, for example, with respect to financial management of the funds, and their financial risk exposure. Yet beyond the information asymmetries inherent to the complexity of the pension product (Arrow, 1963 and 2000) and with respect to the process and the determinants underlying the levels of pensions that will be obtained upon retirement, individuals will find themselves in receipt of pensions at a determined replacement rate, and these may not be commensurate with the personal savings effort made and the expectations based on those savings, or with the promises that were made by the promoters of the system. This generates negative or positive perceptions of the pension system and the rationale for the benefits it provides, in terms of the link between savings and benefits, its proportionality, and also the question of whether the private profits generated by the system are not disproportionate in terms of the effective welfare of retirees. In other words, there is a positive or negative perception of welfare gains, beyond the information asymmetries.



## **IV. The contributory pensions system in Chile is increasingly criticized as lacking democratic legitimacy and as failing to meet its primary objective**

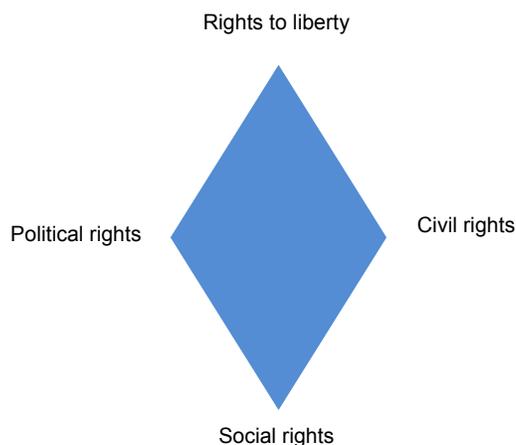
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The primary objective of the pension system is to provide income security in old age. This in turn involves four elements: consumption smoothing, insurance (or risk sharing), poverty relief, and redistribution. As these objectives cannot usually be fully achieved at the same time, policy must seek optimization, rather than minimization or maximization, across this range of objectives (Barr and Diamond, 2008, page 21).

In Chile, the solidarity pillar represents poverty relief, it is redistributive, and it contributes to risk-sharing, through old-age incomes that cushion the decline after working life. Tax revenues play a key role in the system. Yet the mandatory contributory private pension system betrays some severe shortcomings in terms of smoothing consumption and it lacks a redistributive element which, for example, would soften the negative impact of economic cycles and financial volatility. Moreover, the actuarial calculation of pensions discriminates against women.

It is useful to examine the system from a rights perspective. Taking the terminology of the Italian jurist Ferrajoli, the four-dimensional model of democracy revolves around four dimensions of rights: political, civil and social rights, and the right to freedom. While insufficient in itself, the political dimension is indispensable, for in its absence we cannot speak of democracy in any sense of that term, and the other three dimensions presuppose the enjoyment of political rights. Fundamental democratic rights include, on one hand, those that embody negative expectations, i.e. they impose limits or prohibitions on their violation; the rights to liberty, both civil and political. On the other hand, there are rights that generate positive expectations, namely those that impose duties and performance obligations, and which when violated generate gaps: this is the case with social rights. Political and civil rights are the foundation of formal democratic legitimacy. Social rights and the right to freedom are the foundation of substantive legitimacy, in both the negative and positive sense of democracy, as they prescribe what is prohibited and what is mandatory (Ferrajoli, 2008, pages 80-82, figure 1).

**DIAGRAM 1**  
**FOUR-DIMENSIONAL MODEL OF DEMOCRACY (FERRAJOLI)**



Fuente: Ferrajoli (2008).

In these terms, the contributory pensions system of Chile has a spurious and antidemocratic political origin.

Just two days after the military coup, the governing junta were aware of the willingness of a core of economic professionals and students to collaborate with it.<sup>5</sup> A small group of economists joined the government in senior positions, with a comprehensive agenda of reforms intended to transform the State and the economy in line with a neoliberal ideology. The strategy by which this group was created and functioned, virtually free of limitations on its scope of action, made it easier for the regime to formulate and implement reforms on the margin of internal and (to some extent) external political negotiation between the military factions and the interest groups affected by the changes. In this process, the factions for or against reforms within the government sought the support of the few groups that could exert any degree of influence or, at least, demonstrate their support for one position or another, within the drastic limits imposed by the regime. Consequently, that core also forged links with groups that shared its ideology, or that could benefit from economic liberalization and deregulation in order to counter resistance to change, for example on the part of physicians and the Medical Association, in the case of the health reform. At the outset they constituted a closed team that shared the same ideology and political agenda, and different roles were assigned in light of each member's comparative advantage, such as the formulation of long-term policies, the design of short-term operating policies and legislation, political haggling, and even the recruitment of public officials. Subsequently, in order to strengthen and enhance the political feasibility of their agenda, they implemented strategies for action within the State. First, they constructed vertical networks or close and lasting links with high-ranking members of the government, to achieve political support for their proposals in the face of persistent resistance from the majority of factions in the armed forces and allied interest groups. Later, horizontal networks were established, with persons holding key positions with veto power, in times or places where their reform agenda could be at risk: these included the President's Advisory Committee, the Legislative Committees, and senior positions in ministries such as Planning and Finance. Finally, once their members were solidly entrenched in senior positions, they undertook a strategy of "colonization", i.e. a systematic and coordinated scheme for the recruitment and integration of professionals who shared the same ideology and mission to bring about radical change, and who would ensure follow-up to the reforms (Gonzales-Rossetti and Bossert, 2000, pp. 22-23).

<sup>5</sup> That disposition was transmitted to the junta by its member the Commander-In-Chief of the Navy, Admiral José Toribio Marino Castro, as confirmed by *Acta Secreta* of the Junta No. 2 of 13 September 1973.

Among the champions of privatizing social security were José Piñera and Hernan Büchi. In his capacity as Economic Undersecretary, Büchi chaired the team of economists and lawyers that prepared the pension reform, consisting of representatives of the ministries of labour, economy, the national planning office (ODEPLAN) and the Budget Office. The pension reform was led by José Piñera, Minister of Labour, and at the same time Büchi developed the idea of a private health insurance system. As Piñera put it some years later, the success of such comprehensive reform was possible thanks to the cohesion and unanimity that could be achieved only by a team that was not riven by factions and particular political interests. The governing junta created four legislative committees, which served as a political filter for proposals put forward by the team of economic advisers. Each committee was headed by a member of the military junta representing one branch of the armed forces. The social sector committee was headed by the Air Force: it covered the fields of education, justice, labour, pensions and health, and was comprised of lawyers, jurists, generals and colonels of the Air Force, members of right-wing parties, physicians, and business people. The committees reviewed and held heated discussions of the "legislative" proposals submitted to the junta by the ministries, and they could make changes in them. The interaction of the reform proponents with the respective "legislative" committee was a fundamental strategy for convincing the politicians of the military government as to the appropriateness or speed of the reforms, and to overcome opposition—for example—, in the ranks of the police forces or the military, which was in the end overcome by exempting the armed and police forces from the pension reform (Piñera, 1991, pp. 36-40; González-Rossetti, Chuaqui and Espinosa, 2000, pp. 15-16).

Under these circumstances, the current contributory pension system in Chile lacks original legitimacy, as it was established when political and civil rights had been suspended, and it was hatched behind closed doors in an extreme top-down manner.<sup>6</sup>

In addition to its initial democratic illegitimacy, we must add that the entitlement to social rights has been gaining ground around the world and also in Chile, as a normative and political framework for public policies, one that calls for the strengthening of institutions and the expansion of resources for satisfying those rights. In this respect, it is important to stress that social rights set binding standards for society, and define situations that are inadmissible for members of society (Abramovich and Courtis, 2002; Courtis, 2007; CEPAL, 2007).

From the perspective of social rights, a primary objective of the pension system must be to ensure a decent income after working life, and this should be seen as a substantive democratic norm which, if not respected, can affect the substance of decisions and their legitimacy. The other objectives or externalities that a system might have must not interfere with achievement of the supreme and primordial objective of pension systems, which in the case of contributory pensions must mean proportionate and adequate replacement rates.

It is in this light that we must analyze the architecture of the contributory pension system in Chile. Its original illegitimacy is compounded by a further lack of legitimacy: as the system has matured it has given clear evidence of having failed to satisfy this social right. In the terms set out above, the primary objective of

<sup>6</sup> In this analytical context it is interesting to see how José Piñera, in his recapitulation of the reform, recounts the manner in which it was approved. When the process was bogged down by resistance from the armed forces, he threatened to resign as minister, and Pinochet asked him to be patient. Within a week the reform team was becoming demoralized and finally, by exempting the armed forces from the pension reform, it was possible to secure prompt approval of the project by the governing junta. "President, you have given me your support in the boycott and the labour plan. You have done more for Chile than any president. I respect and admire you, *but I cannot continue as minister if you now abandon me and if you do not approve the pension reform*. I understand very well, President, that you are under pressure from senior Army officials. I understand that you are between a rock and a hard place, but it seems to me that you should decide what is good for Chile. If you cannot do this, I will understand and I will still support you, but from outside government, in order to continue fighting without restrictions to achieve my ideals for Chile. He looked me squarely in the eyes, he held his gaze, and then he told me: don't act in haste, Minister. *Of course I did not, even though as the days passed my anxiety increased. The team was starting to become demoralized*. In contrast to the defeat that we suffered three months earlier, this one would be final. The last time we did not play all our cards and the debate was influenced by an external factor, the constitutional plebiscite. Now, on the other hand, it would be an irreversible setback because the problem is the government's lack of will to move forward. Now we would be losing not a battle but the war. *One week later the President called me to his office. The meeting lasted exactly 1 minute. How are you, José? I am convening the Junta to finalize analysis of the project. That was all*. There was no reference to the crisis of the previous week. Nor did I want to ask anything. What happened meanwhile with the positions that seemed irreducible? I never knew exactly and I preferred not to bring up the subject again." (Piñera, 1991, pages 38-40, emphasis mine).

the pension system, which is to provide income security in old age, is not being fully met in Chile because the level of pensions is low. The breach of the civic right to enjoy an adequate smoothing of consumption in old age, and which could even consider some dimensions of insurance in terms of individual exposure to economic cycles, must cast doubt on the current profit-driven orientation of the contributory system, in which replacement rates are low and at the same time the direct profits of the administrators and insurers are high, as are the indirect profits of those who benefit from a concentrated investment of pension funds, placed at low interest rates. In this respect, in addition to its spuriously origins, the contributory pension system, which over time has revealed its scope and limitations, does not fulfil the supreme objective of providing pensioners with a decent income after working life, precisely because of the rationale underlying its architecture, a matter that we shall examine below from various aspects.

Empirical evidence allows us to assess achievement of the objectives with which its promoters justified privatization of the contributory pension system. “The key objective in handing over the administration to a private firm was to maximize the level of pensions that the individual capitalization system could provide” (Piñera, 1991, page 22). The level of pensions that has been achieved by the system is clearly inadequate, because it is hobbled by its own architecture. Returns on the capital paid into the individual accounts are inadequate and provide low replacement rates, a feature that is systemic and endemic, since it is inextricably linked with the administrators' maximization of their profit, the transaction costs of externalizing financial management of the AFP funds to other firms as a result of the 2008 reform, and the benefits that flow to the finance companies, the banks, the brokers etc. through which the pension funds are invested, and which pay very low interest rates on those investments (Rivera, 2009, 2014a and 2014c).

## V. The contributory pension system administered by the AFP is losing its political legitimacy

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Some aspects of the pension reform undertaken during the first government of President Bachelet were actively promoted by the administrators and the various groups with an interest in the system. Among the proposals we may note those put forward by the president of the AFP Association, Guillermo Arthur, who called for boosting coverage and generating incentives for voluntary savings by the poor, and also those promoted by Solange Berstein, for liberalizing the caps on the investment of pension funds abroad. The creation of the solidarity pillar, for its part, despite its undeniably redistributive bias, was of interest to the administrators from a more general point of view: it freed them from answering criticisms that the individual capitalization system offered no solution for half of the population; it did not mean any costs to them, as they were borne exclusively by the State; and moreover, the resources saved by those who would receive the complementary public subsidy would remain under AFP administration, generating the corresponding commissions (Rivera Urrutia, 2014, p. 91; 2010).

Exercise of the veto power of the misnamed “industry”<sup>7</sup> over aspects of the reform that were seen as adverse extended into the government itself. This became clear, for example, when a challenge to the creation of a State AFP, an idea that had been floated, well before there was any discussion of pension reform, by various left-leaning political figures and social security experts as an alternative for fostering competition and reducing the costs of administering the contributory system. Although it was not shared by all parliamentarians of the governing party, the proposal gained enough adherents to launch a debate on the possibility of having the Executive consider it, something that strained relations between the Finance and Labour portfolios, which maintained their existing positions, especially on the part of their ministers. Andrés Velasco, Minister of Finance, was always opposed to a State AFP, and he was prepared only to have administration of the fund placed with the banking system, which would allow participation by a public institution such as the Banco Estado. But even this modest proposal sparked a debate within the financial system, the AFP industry, the banks and the insurance companies, which subsequently spilled over into parliamentary debate, by which time it was beyond discussion, revealing

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<sup>7</sup> The term “industry” in reference to the firms that gravitate around the contributory pension system, even though they are pre-eminently service and finance firms, was coined by its ideologist, José Piñera. See Piñera 1991.

the weight of the interrelations between economic players with interests in that industry and political players with decision-making powers (Maldonado and Palma, 2013, pages 35 and 59).

Given its authoritarian origins, and the fact that it was not based on any democratic social covenant, this system has been subjected to strong structural tensions. It is appropriate to consider some political conditions that could subsequently have modified the tenacious veto power of the diversified "pensions industry". While the current veto power of that industry must not be underestimated, the changes in the political situation must also be taken into account, above all the involvement of the student movement and its decisive influence on public debate, in terms of having openly questioned the profit motive in social and education policies, the effects of which go beyond social protection, and which legitimize the search for alternative policies.

Claudia Serrano identifies this shift, suggesting that the way is now open for reforms that will appeal to a more demanding citizenry, and for changing the prevailing wisdom as to what is feasible in social policy through negotiation and persuasion, as the influence of market criteria and the subsidiary State has weakened, and questions have been raised about a reformist zeal that had become ossified and compromised: "The citizenry made us see in 2011 something that can be traced in part to the outcomes of 20 years ago. Clearly, they have told us "this has reached its limit". But this limit did not have to do with problems of access or even of quality and services, which was the second issue that was put on the table... the basic values of the system and the basic accords of society as to what were important issues for the citizens. What was put forward was the concept of citizenship and rights of those who are part of the same civic community, not questions of coverage or access in the technical sense of the policy, but in the sense of being a full member of the community. For example, what rights do I have as a middle-class Chilean? In this debate many responses emphasized achievements: mass access to university, expanded enrolment or access to higher education for the first generation in many families; but the street protests made it clear that families were still indebted, there was a very high dropout rate and, what is worse, for those who overcame these obstacles, the training and the diploma obtained left them uncompetitive because their education was clearly deficient. For these reasons, the citizen protests displaced the implicit hegemony as to what was acceptable, desirable and responsible in the area of public education. Eight years ago, it would have been unthinkable to claim that we were doing away with the profit motive in education, because it seemed to be part of the implicit accord associated with a certain model for the management of public goods and services. Today, it is unthinkable among broad sectors of the centre and the left to say that we should tolerate profit-making from public funds" (Serrano, 2014, pages 108-109).

In Chile we find a variety of social policy institutions (education, health and pensions) that have produced disadvantages for broad social sectors—in education, essentially because of the costs it represents for families, as well as problems of quality and social segregation, and in health, because of its dual financing: the ISAPRES, although they are funded through compulsory contributions, tend to "skim" the market through insurance policies with tariffs 10 that have sparked an alignment of dissatisfaction, a wide-ranging social malaise, that is creating conditions for change.

Because of institutional complementarities (Hall, 2009), the challenging of other privatization moves in social policy (education) and social protection (health) governed by the profit motive are creating potential conditions for reforms in various spheres to be mutually reinforcing. Under these circumstances, we may say that the very frontiers of policy and policy formation have been challenged (Blythe, 2012) through strong discursive interactions (Schmidt, 2011). By reinterpreting "what players associate with an institution—rejection of profit—they have generated changes in the way players act (Streeck and Thelen, 2005), which are reinforced by the layering of institutions (Hall, 2009, page 217) in this case, of profit-oriented institutions, which provide a framework for many courses of action; and it is the layering of institutions that creates mobilization (Streeck and Thelen, 2005, page 23). In a context of widespread unrest, failure to keep promises regarding the coverage and quality of pensions, the erosion of the "equity" in individual contribution accounts when these do not translate into adequate pensions, show decreasing returns vis-à-vis expectations (Streeck and Thelen, 2005).

On the other hand, the old, vanishing, pay-as-you-go public system provides higher replacement rates and its demonstration effect calls into question the reformed system, i.e. revives a hindrance that

was destined to submerge and disappear (Streeck and Thelen, 2005). We must also consider that the negative outcome from this maturing process of the system affects highly diverse social sectors, including the middle and upper-income classes that have multiple party loyalties, according to surveys (Castiglioni, 2007). To paraphrase the economist Albert Hirschman (1977), these sectors have a voice, and the magnitude of frustrated expectations creates attitudes in favour of “exit” reforms, i.e. reforms that will provide alternatives for improving pensions.

Naturally, among other challenges with respect to achieving political accords, this will require continuing efforts on the part of the reformers, in terms of forging a clear communicative discourse (Schmidt, 2013) that will appeal to the middle classes and will explain succinctly the rationale for the measures in terms of seeking to improve replacement rates, and that will explain why the improvement in replacement rates is frustrated by the profit maximization motive that governs the public-private mixes of the present system.



## VI. Some stylized facts on pensions in Chile, from a joint vision of contributory and non-contributory subsystems

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The *Social Panorama of Latin America 2013* (ECLAC) sheds some light on certain features of the pension system.<sup>8</sup> According to current levels of wage-earner affiliation in pension systems in Latin America, Chile is among those countries with the greatest pension coverage. On average in 16 countries of the region, coverage was more extensive among female than male wage earners at both points in time (2002 and 2011), and they have gained more, proportionately speaking, where access has expanded for both indicators. But in Chile this trend is not to be found, and female wage earners have lower levels of affiliation to pension systems than do men, even if there has been an increase in affiliation by non-wage-earning women. With respect to the socioeconomic distribution of affiliation to pension systems, there has been a significant improvement for the lower-income sectors in Chile, and affiliation is now somewhat less regressive (ECLAC, 2013).

Chile is among the group of countries with high pension coverage in Latin America, but it has the lowest average level of pensions in that group. Those pensions, moreover, have declined in recent years: measured in 2005 dollars, pensions fell between the years 2000 and 2011, both for the richest quintile and for the second, third and fourth quintiles, a systematic trend not observed in any other country of the region<sup>9</sup> (ECLAC, 2013).

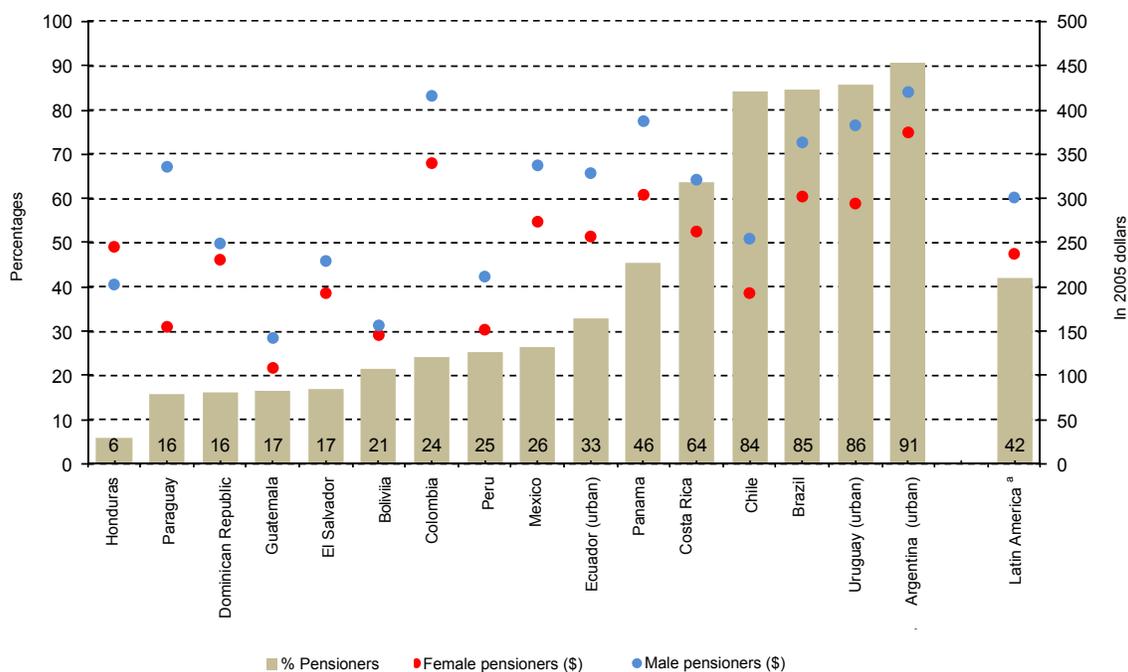
With respect to job category, in all Latin American countries except Chile a public employee has a greater probability of contributing in comparison to wage earners with private firms: this probably reflects the quantity of fee-for-service contracts. Being a self-employed worker has an especially negative impact in Chile (ECLAC, 2013).

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<sup>8</sup> The analysis in this section is based on ECLAC (2013), Chapter IV, where the respective tables and analyses can be consulted. Due to the disaggregation of household surveys, it was not possible in the analysis of certain aspects to distinguish between contributory and non-contributory regimes.

<sup>9</sup> These figures combine pensions under the contributory and solidarity pillars, which we were unable to separate.

**FIGURE 2**  
**LATIN AMERICA (16 COUNTRIES): PERSONS 65 YEARS AND OVER RECEIVING PENSIONS AND**  
**AVERAGE MONTHLY PENSION**  
*(Percentages and 2005 dollars)*



Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Social Panorama of Latin America*, 2013 (LC/G.2580), Santiago, Chile, 2013, table IV.8.

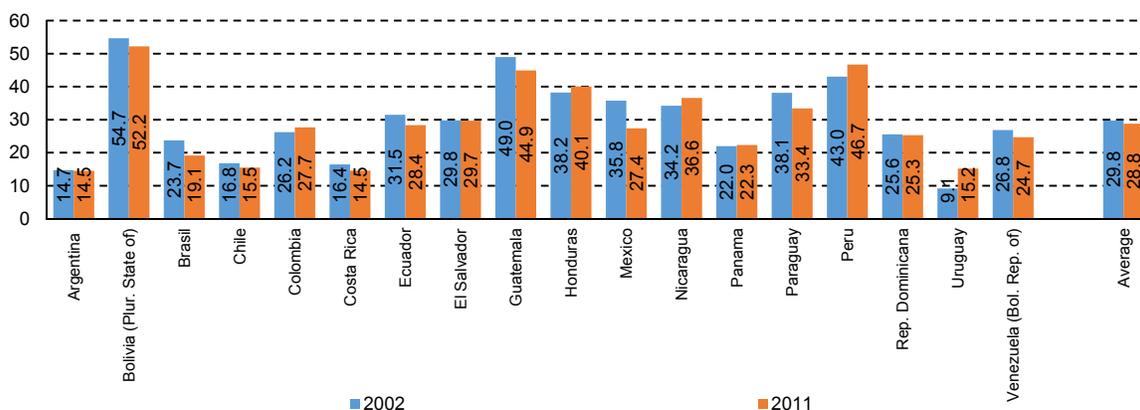
<sup>a</sup> Simple average for 14 countries. Excludes countries on which no data are available for the two points in time taken as reference.

For purposes of this report, we have also examined the profile of the population aged 65. Considering its occupation, 16.5% of this population was in the labour market in 2011, representing a slight reduction from 2000<sup>10</sup> (figure 3).

As can be seen from figure 4, among this contingent of persons 79.5% and 76.7% of males and females, respectively, are receiving pensions, a feature that differs from other countries, such as Costa Rica, where the employed workers of that age are the ones with no pensions. This raises questions as to whether these Chilean pensioners are obliged to work because their pensions are inadequate, or for other reasons (such as self-fulfillment), and in what proportion.

<sup>10</sup> This magnitude does not seem consistent with the OECD report on pensions, which for Chile estimates a very advanced age at which people actually retire. See OECD (2013), table 3.8.

**FIGURE 3**  
**LATIN AMERICA (18 COUNTRIES): WORKING PERSONS 65 YEARS AND OVER,**  
**AROUND 2002 AND 2011**  
*(Percentages)*



Source: prepared by the author on the basis of special tabulations of household surveys conducted in the respective countries.  
 Note: In the case of Argentina, it refers only to urban regions.

**FIGURE 4**  
**LATIN AMERICA (17 COUNTRIES): AFFILIATION TO THE PENSION SYSTEM FOR WORKING**  
**PERSONS 65 YEARS AND OVER, BY SEX, 2011**  
*(Percentages)*

**A. Men**

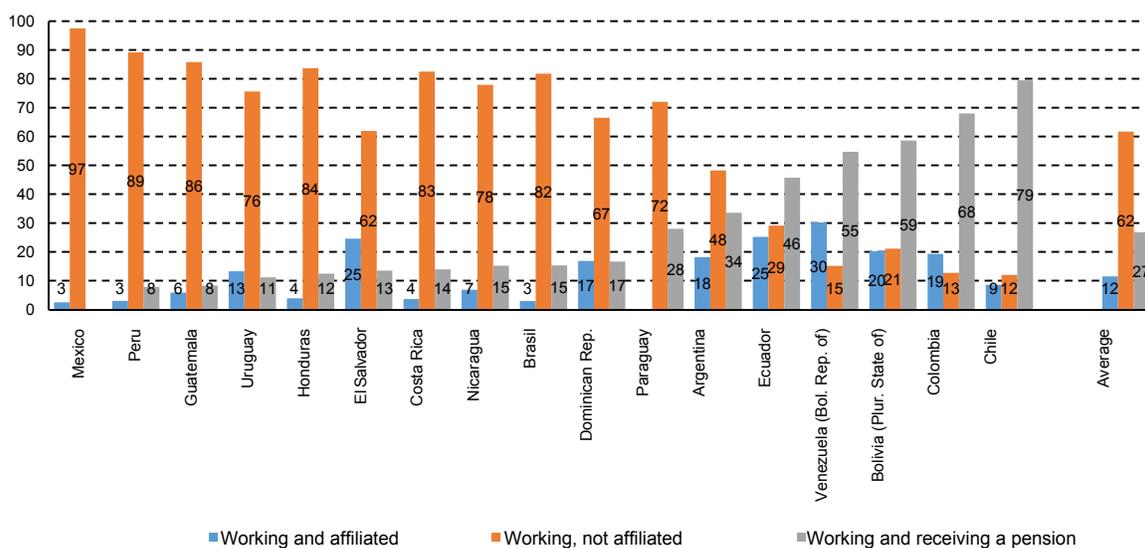
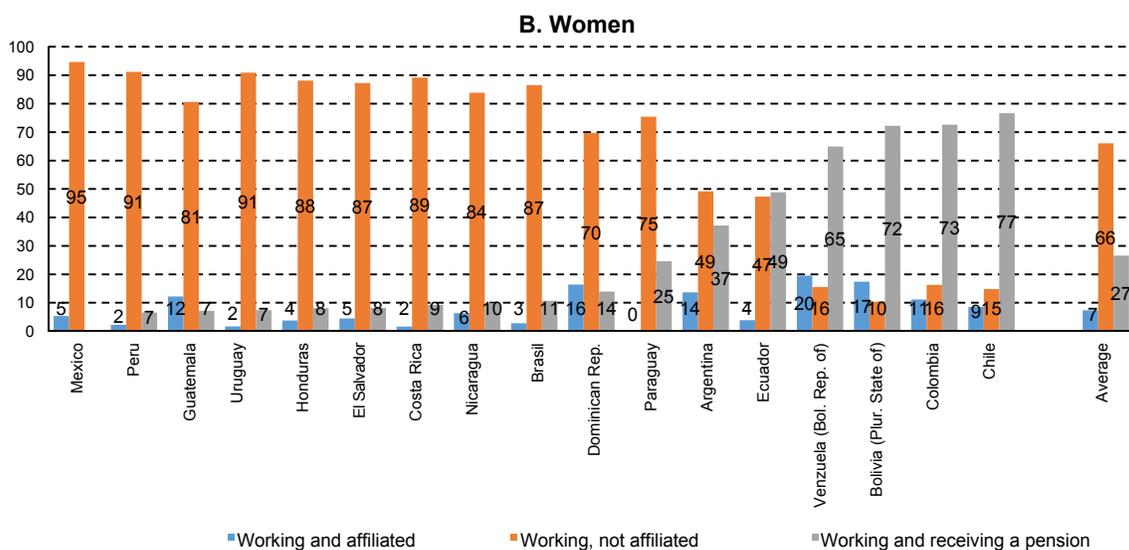


Figure 4 (concluded)



Source: prepared by the author on the basis of special tabulations of household surveys conducted in the respective countries.  
 Note: In the case of Argentina, it refers only to urban regions.

## VII. The great debate: low replacement rates for individually capitalized pensions, their determinants, and some of their collateral effects

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Replacement rates reveal the adequacy of pensions in comparison with the incomes on which contributions were based during working life. The low returns that are evidenced by the replacement rates are the crux of doubts about the contributory system in Chile.

The concept of the replacement rate refers to the ratio between the level of the pension and the level of incomes on which contributions were based over the individual's working life. ECLAC conducted a study on the determinants of the replacement rates in individually capitalized pension systems in order to analyze the profile of the rates that the pension systems offer to the population as a whole<sup>11</sup> (and not on the effective individual replacement rates obtained by persons who are or will be receiving pensions) (Durán and Pena, 2011).

Some of the variables that condition defined-benefit pension systems also apply to individual capitalization systems: these include longevity, demographic dynamics and ageing. Yet, given the characteristics of the individual capitalization systems, the demographic burden or risk is assumed by its affiliates and, in particular, by women. The simulation made it possible to show the importance of the determining factors and the magnitude of their impact, and to simulate scenarios of interest for the design of policies in different Latin American countries. It demonstrated that the replacement rate in

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<sup>11</sup> The analysis in that study, in this sense, does not deal with the effective individual replacement rates obtained by persons who are or will be receiving benefits, for those rates, which depend on individual characteristics and careers of the persons selected, would not be representative of the pensions provided by the system as a whole to the target population established in a social security law. The study took as the unit of analysis the individual, through a theoretical long-term prospective measurement that captures average horizontal data, combines the main individual characteristics of the group covered, and evaluates the substitution of incomes. To this end a mathematical actuarial model was constructed to capture a set of characteristics of the environment in which the systems operate: regulation of benefits, contribution densities, career and wage patterns by branch of activity and occupational category, profitability of investments, administration fees, insurance commissions, etc. (Durán and Pena, 2011, p. 9).

these systems is a variable dependent on multiple factors – economic, sociodemographic, programmatic and institutional – relating to the design, financial organization and administrative regime of the systems, for example the rate of return, the rate of the administration fee, and the cost of purchasing an annuity. This multiple determination means that the factors interact to generate very different results in each country, by economic sector, by age, sex and income level, and by categories of workers or employment careers (Durán and Pena, 2011).

The level of benefits was found to be highly sensitive to small changes in the system's returns, and they have a greater impact on women. Administration commissions have a heavy effect on the replacement rates, in this case with a greater impact on men. This is important, given that the level of commissions is far in excess of many of those charged on financial markets. The results of the analysis by sector of economic activity show a great dependency on the level of formalization and of labour regulation. The institutional and administrative arrangements of the social security system are key determinants of the replacement rate: while they are to a large extent exogenously determined by the characteristics of the labour market, which affect the degree of labour formalization and the density of contributions, it is also clear that the legal framework for combating contributory evasion as well as the administrative capacity of the inspection, affiliation and collection systems have a sharp impact on those densities, and thus on the level of contributions (Durán and Pena, 2011). Table 1 below summarizes some of the conclusions from the replacement rate simulations conducted in this study, in the case of Chile.

**TABLE 1**  
**CHILE: SIMULATION OF REPLACEMENT RATES IN THE INDIVIDUALLY CAPITALIZED PENSION SYSTEM, UNDER DIFFERENT SCENARIOS**

	Contribution in percentages	Final salary in percentages		Average salary over last 20 years in percentages		Average salary over full career in percentages	
		Women	Men	Women	Men	Women	Men
Existing salary	10	48.6	46.3	40.1	39.5	41.5	45.3
Return at 3.5%	10	58	54	48	46	50	53
Return at 4%	10	69	63	57	54	59	62
Assuming zero commissions	10	51	57	42	49	44	56

Source: F. Durán and H. Pena, "Determinantes de las tasas de reemplazo de pensiones de capitalización individual: Escenarios latinoamericanos comparados", Seminario y Conferencias series, No. 64 (LC/L.3329-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2011.

Moreover, the study revealed Chile to be the Latin American country where the payment of fees for the administration of individual accounts represented the greatest number of contribution years: 7.4 years for men and 6.3 years for women. In turn, measured as the ratio between the years that represent commissions paid and the years that represent actual savings, this amounted to 19% for men and 20% for women. Another way of analyzing the cost of commissions is in comparison with the total amount contributed at the time of retirement: in these terms, they represent 19 and 19.7% per year of contributions for men and women respectively (Durán and Pena, 2011). The zero commission assumption in table 1, which obviously is not empirically feasible under any scenario as there will always be administrative costs, is added to highlight the heavy impact of commissions.

A recent addition to the public debate in Chile has been the figures produced by the OECD, which should show "high" replacement rates in the order of 45.5% (see for example Schmidt-Hebbel, 2014). It must be noted, however, that this figure results from a partial reading of the OECD report, and it is drawn from a table that treats the solidarity pillar jointly with the contributory system. In table 4.4 of that report, which distinguishes between public regimes (corresponding to the solidarity pillar), and private mandatory and voluntary systems, the situation with the contributory regime looks quite different when only the private mandatory system is considered: for no income bracket does the replacement rate reach 38% (see OECD, 2013, tables 4.1 and 4.4, pages 135 and 137, which were used to construct tables 2 and 3 of this study).

Moreover, it must be noted that this calculation of replacement rates by the OECD is a simulation, conducted for purposes of inter-country comparison, with assumptions that differ greatly from empirical observations of contributory gaps and the volatility of employment: it represents a calculation of rates "for a full career", i.e. without contributory gaps, and for long working careers – from age 20 to 65 for men and from age 20 to 60 for women (OECD, 2013, page 132).

**TABLE 2**  
**CHILE: GROSS PENSION REPLACEMENT RATES BY EARNINGS**  
(Individual incomes, multiple of mean, by sex)

Median earner		0.5		1.0		1.5	
Men	Women	Men	Women	Men	Women	Men	Women
45.5	36.6	57.3	48.3	41.9	33	37.3	27.9

Source: Organization for Economic Cooperation 4.1

Simulation of rates calculated under the assumption of no contributory gaps and for working lives from age 20 to 65 for men and 20 to 60 for women.

**TABLE 3**  
**CHILE: GROSS PENSION REPLACEMENT RATES FROM PUBLIC, MANDATORY PRIVATE AND VOLUNTARY PRIVATE PENSION SCHEMES**  
(Percentage of individual earnings, men)

Public			Mandatory private			Voluntary DC			Total mandatory			Total with voluntary		
0.5	1.0	1.5	0.5	1.0	1.5	0.5	1.0	1.5	0.5	1.0	1.5	0.5	1.0	1.5
20.4	4.8	0.0	36.9	37.2	37.3	-	-	-	57.3	41.9	37.3	-	-	-

Source: Organization for Economic Cooperation and Development (OECD), *Pensions at a Glance 2013. OECD and G20 indicators*, Paris, OECD Publishing, 2013, table 4.4. Simulation of rates calculated under the assumption of no contributory gaps and for working lives from age 20 to 65 for men and 20 to 60 for women.

Note: DC = defined contribution

There are several ways to approximate the measurement of replacement rates. As Barr puts it, "one measure of adequacy is the replacement rate, i.e. the ratio of pension benefits to monthly earnings (after taxes and transfers) during work. The replacement rate can be defined in two ways: ... (i) as the average person's pension benefit as a per cent of the average wage, the replacement rate is a measure of the living standards of the elderly relative to those of the working population, i.e. measures the extent to which pensions provide poverty relief..." (Barr, 2013, p. 53). Now, if we apply this empirical measure of pension adequacy to the private mandatory system in Chile, we find the following: the average wage in May 2013 in Santiago, according to the University of Chile's employment survey, was 539,800 pesos; in that same month, the average old-age pension was 169,000 pesos. In gross terms then, without adjusting for local conditions, this produces a replacement rate of 31.3%.

In many cases, it is not only the retirees who are affected by low replacement rates. In the presence of intergenerational solidarity, deficient pensions have adverse intergenerational effects, in terms of family incomes. Moreover, these effects can be cumulative in nature, if those who top up their elderly parents' pensions must also look forward to low pensions.

The objective of a pension fund is to protect post-working-life incomes. What, then, is the *raison d'être* for a system of individual accounts coordinated by pension administrators? Beyond information asymmetries, and recognizing that those administrators have been delegated decisions that require a certain technical capability in the area of finance, the rationale must surely be that they can invest the funds so as to achieve adequate earnings on these savings, which will redound primarily to the benefit of the pension fund. Yet the track record of earnings on the funds reveals disturbing trends, in various respects.

Table 4 highlights the following aspects. First, earnings have been highly volatile over time, and more so in the most recent period: if we compare the last 12 months, taking two consecutive months (May and June 2014), we see that all the funds, except D and E, have been subject to great volatility. Returns over a longer period, covering 12 years or more, appear reasonably in line with what we might expect in terms of their impact on replacement rates. But this is not the case with more recent yield, over the last 36 months, which was representative of the new, stiffer international regulatory conditions and the performance of the economy following the 2008 crisis: for that period, returns declined sharply, and were far below the 5% deemed reasonable for a decent pension.

Again taking the period of 36 months as the point of reference, there is another disquieting element that deserves attention: on the long term, the more conservative investment is the one that produces the highest returns. This is serious, because it demonstrates the decline in the return on investments in financial instruments, the use of which would presumably justify the onerous system of managing individual accounts through the AFPs, and it sheds light on the desirability of having the individual accounts managed in accordance with a more conservative but also less onerous logic, in the context of a system administered with other parameters: non-profit, and with substantially lower transaction costs in the administration of funds.

**TABLE 4**  
**CHILE: RETURNS ON PENSION FUNDS, MAY AND JUNE 2014**

Pension funds	May 2014	Last 12 months June 2013- May 2014	Annual average for last 36 months	
			June 2011- May 2014	September 2002- May 2014
Type A – Most risky	0.49	5.94	1.57	6.90
Type B – Risky	0.34	4.95	1.48	5.77
Type C – Intermediate	0.28	5.52	2.62	5.25
Type D – Conservative	0.24	6.02	3.60	4.82
Type E – Most conservative	0.21	5.83	4.49	4.10

Pension funds	June 2014	Last 12 months July 2013-June 2014	Annual average for last 36 months	
			July 2011-June 2014	September 2002- May 2014
Type A – Most risky	1.18	11.70	2.43	6.95
Type B – Risky	0.90	9.07	2.22	5.81
Type C – Intermediate	0.93	8.38	3.25	5.30
Type D – Conservative	0.82	7.49	4.10	4.86
Type E – Most conservative	0.74	5.96	5.09	4.14

Source: Office of the Superintendent of Pensions of Chile.

To understand the effective rate of return that the pension funds are achieving would require, for example, calculating a weighted average. By way of proxy, we have consulted information on the annuities that insurance companies are prepared to pay, and we find a clear decline in those rates since 1990, suggesting that the insurance market has been “reading” the outlook for returns on the funds (table 5). What is alarming, in this respect, is the steep drop in the interest rates that pension insurance companies are paying out of the accumulated funds (Rivera Urrutia, 2014a and 2014b).

**TABLE 5**  
**IMPLICIT AVERAGE ANNUAL INTEREST RATES ON THE ANNUITIES CONTRACTED IN THE MARKET (BY VIRTUE OF DL NO. 3500 OF 1980), WEIGHTED BY THE AMOUNT OF THE SINGLE PREMIUM FOR EACH POLICY<sup>a</sup>**

Year	Old age pension	Early retirement pension	Total disability	Partial disability	Survivor benefit	Mean
1990	5.65	5.3	5.72	0	5.48	5.48
1995	4.97	4.82	4.93	5.03	4.76	4.83
2000	5.58	5.34	5.38	5.26	5.18	5.37
2005	3.3	3.3	3.26	3.18	3.07	3.28
2010	3.42	3.39	3.34	3.23	3.35	3.39
2013	3.12	3.13	3.04	2.87	3.04	3.1

Source: Office of the Superintendent of Securities of Chile (SVS).

<sup>a</sup> For 2013, the information in the SVS database runs only to August.

Replacement rates are affected by a number of aspects. These include the great gaps in contributions; the fact that financial risks are transferred solely to affiliates and not to the administrators, who have no incentives to maximize replacement rates and are not penalized by their earnings when they decline; the expiry of the “golden age” of investments in Chilean government bonds, which underpinned the system's initial profitability; the sharp decline in returns on financial instruments in the wake of the international financial crisis and the concomitant regulations of financial markets; the high exposure to financial risks in the context of the liberalization introduced in 2008; inadequate protection against financial risks (e.g. in the cases of Polar and Cascadas) and the fact, moreover, that the 2008 reform, by liberalizing investments, increased the exposure to risk; the low returns at which the AFPs invest resources in Chile, where the investment portfolio is concentrated in a few business groups and large banks; and last but not least, the high commissions that the AFPs charge for administering the pension funds, from which they earn very high profits (Rivera Urrutia, 2010, 2014a and 2014b).

Under these circumstances, the high profits of the AFPs and related companies are the “flip side” of the contributory pension system’s meagre replacement rates: because the system is geared to profit, the two aspects are intimately linked and must be analyzed jointly.

The current profitability of Chilean banks is around 18%, which is high by international standards. This offers a compelling point of reference with respect to the annual profitability levels of the AFPs: we find high rates of profitability both for the administrators that cover many affiliates, such as *Provida*, and for those with few affiliates, such as *Modelo*, which because of its characteristics has very low operating costs (table 6).

Moreover, the system does not reward efficiency: the AFPs receive a fixed and predictable commission, regardless of the pension benefits they earn for contributors through their intermediation; they are affected only to the extent of the 1% of the resources that they must invest in the instruments of the pension fund they manage. This disconnection between pension benefits and profits reduces net social benefits, and does nothing to stimulate competition; for example, it makes it less important to cut costs and boost efficiency.

**TABLE 6**  
**PROFITS OF THE PENSION FUND ADMINISTRATORS AT 31 DECEMBER 2012 AND 2013**

Administrators	Fiscal year profits	
	31 December 2013	31 December 2012
Capital	11.92	10.53
Cuprum	68.80	43.81
Habitat	33.82	34.73
Modelo	95.15	211.30
Planvital	13.91	22.59
Provida	43.62	33.32
Sistema	31.38	26.50

Source: Office of the Superintendent of Pensions of Chile.

<sup>a</sup> Profit (loss) on initial net equity of the administrator

In addition, we must consider that the Chilean pension system has been and, if its rationale is not reformed, can be expected to remain very costly in fiscal terms. It was costly from its creation, for the shift brought with it high transition costs: as an incentive to transfer, all contributions were recognized, adjusted for inflation and with an interest rate, without any ceilings (Mesa Lago, 2000). And, in a system that has already matured, because a major contingent of contributors has important contribution gaps and suffers low replacement rates there is a greater number of pensioners who qualify for minimum pensions or who receive the solidarity supplement, which poses the “crowding out” effect that is problematic for other social policy objectives. In this respect, eliminating profit as the rationale for the pension system would allow more efficient and equitable use to be made of pension savings, and would reduce pressures to channel

funds to the solidarity pillar, at a time when new risks are emerging, such as the care needs of persons at both points in life.

The ageing of the population and the new risks associated with the obsolescence of human capital, the volatility of employment, and growing care needs, make it urgent to envision welfare in terms of the lifecycle and, within it, the period after working life.

Another important aspect to consider is the behaviour of affiliation. Given information asymmetries and the lack of incentives to competition, it can hardly be the administrators' reputation for excellence, in terms of their achievements with respect to replacement rates or the amount of commissions, that determines the behaviour of contributors; on the contrary, it is important to consider the impact of various kinds of advertising for capturing contributors, which smacks of "moral hazard".

## **VIII. Given the failure to fulfil the promises of pension coverage and quality, the State AFP could represent a strategy of gradual change through layering and transition**

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Opponents of the current bill to create a State AFP have put forward various arguments. As summarized by Schmidt-Hebbel, that argumentation holds that a State AFP would not improve pensions, because *"the only way to offer better rates of return and better services than those provided through private competition is through State subsidies... this would displace private competition and ultimately lead to a large State pension fund reserve, as in Argentina.... Nor would it resolve the problem of contributory gaps and low replacement rates.... Consequently, it would not improve the pension system (Schmidt-Hebbel, 2014, emphasis added).*

Such arguments can be refuted from various angles. Thus, along with the increase in coverage mentioned in the preamble to the bill, the State AFP could play a crucial role in improving pension replacement rates across the board. To understand the systemic effects that this reform could produce, we have used the concept of gradual institutional change developed by Kathleen Thelen, Wolfgang Streeck and James Mahoney.

Far from being a mere substitute, the State AFP could improve pensions through its direct and indirect systemic effects, and could thus be of substantial benefit to the middle classes, who are disadvantaged by the present system, where the poorest sectors are covered by the solidarity pillar.

This would be a gradually change by layering (Mahoney and Thelen, 2009, pp. 14-18; Streeck and Thelen, 2005, pp. 19-23) in that the basic rules would not be abandoned —individual accounts would remain in effect for pension savings and they would be managed by private entities and a public institution, under conditions of free choice and competition— but it would have the virtue of creating a dynamic that would alter the path, through a mechanism of differential growth at the margin (*ibid.*, page 23). This would be achieved through a new rule, involving creation of a State AFP that is not governed by the profit principle, in contrast to the maximization of private earnings for which the AFPs and related companies strive, but instead seeks to maximize the pension replacement rate in order to reward

proportionately the savings effort that people have put into their individual accounts. To the extent that the AFP has the principle and objective of maximizing the pension replacement rate, this implies a redistribution of resources toward pensions; to this end, the commissions charged by the new entity must cover the costs associated with efficient administration of the funds without extracting a profit (loading fee), and the State AFP would also have to eliminate the withdrawal fee (which represents 1.25% of savings) and, without incurring high financial risks, expand the investment portfolio to boost the return on the funds it administers.

In contrast to the claim of Schmidt-Hebbel, this in no way involves subsidizing the State AFP. The extent to which it "crowds out" (Streeck and Thelen, 2005, pp. 20 and 24) the traditional profit-oriented AFPs will depend on its effective performance under competition, and the demonstration effect it may exert. If it is successful in its mission, it can lead the transition toward a new system of individual accounts which as a whole will operate under the principle of maximizing old-age income security.

It is essential, then, that the State AFP should be efficient in its management of resources in order to reduce administrative costs, that the gains resulting from technological progress should translate into improved pensions, that the remuneration of its senior officials and directors should be consistent with a non-profit approach, and that it should be subject to strict regulations and oversight against fraud and abuse.

In terms of building political coalitions favourable to the reform, it is essential to stress this virtue, which may not be immediately understood even by sectors that would clearly benefit from the reform, such as the middle classes. Once again, we highlight the importance of "communicative" discourse (Schmidt, 2002) for this purpose.

## **IX. Toward a not-for-profit contributory system of individual accounts**

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If the performance of the State AFP can have an adequate demonstration effect, i.e. if by improving replacement rates it can attract contributors with varying savings capacities, it will assist in the transition toward a compulsory contributory system of individual accounts that is not geared to profit. Given the structure of individual accounts in the current system, from the viewpoint of achieving proportionality between benefits and savings effort, or allowing the savings to be available as an inheritance, it would be very interesting for Chile to examine the Swedish pension model as a way of moving beyond the profit-based system.

To maximize the likelihood of a decent income in old age and relative smoothing of consumption throughout the lifecycle, the benefits must be adequate. The objective of individual savings accounts within the contributory pension system must be to preserve proportionality between people's savings effort (i.e. their contributions) and the replacement rate of their pensions.

But the system must also contain certain insurance functions and certain redistributive thresholds within the same cohorts. For example, it must eliminate gender discrimination in the actuarial calculations of pensions that is based on women's' greater life expectancy. There must also be certain intergenerational redistributive thresholds that will cushion exposure to economic cycles and financial shocks.

A reform in relation to this last aspect is now under consideration for the Swedish pension system. It involves the design of redistributive aspects that will meet the objective of insurance, with elements of intergenerational fairness, so that the weight of lesser or greater risk will not fall, in an univocal way, solely on the cohorts according to the differing economic situations to which they are exposed (Barr, 2013). It is uncertainty, as singled out by Arrow in the literature on insurance (Arrow, 1963 and 2000), in this case with respect to economic cycles, which provides an objective basis for this design, and which provides a political argument for acceptance by taxpayers.

Because of the vicissitudes of working life in a globalized world, with constant technological change and economic and political shocks, it is important that the system of individual accounts should be, as now, open to labour mobility, because it is positively associated with portability.

Another element of risk diversification, as is currently the case in Sweden, is the voluntary postponement, total or partial, of retirement, but with concomitant gains in the replacement rate (Barr, 2013).

Pension products are very complex. Information asymmetries (Arrow, 1963 and 2000) limit well-informed decisions on the part of contributors and constrain competition, and this must be considered in the design. Information asymmetries and the complexity of decisions expose contributors to moral hazard, against which there must be regulations. But there are also behavioural problems of indecision, inertia and immobilization, which affect mobility and restrict effective competition (Barr and Diamond, 2008, pages 174-175; Barr, 2013, pages 73-80). Under these circumstances, the system's design should not encourage excessive freedom of choice, as this will not be exercised effectively and involves high transaction costs without offering greater benefits (Barr and Diamond, 2008, page 175). Hence, an appropriate "default" option may be to have a public administrator that operates with low administrative costs (Barr, 2013) and, of course, without the profit motive.

Any parametric adjustments proposed today must be consistent with the design of a new, non-profit system, i.e. they must move towards a convergence of rules in the calculation of pensions, in the ceilings, in the correction indices and in the contribution rates, and that convergence must be subject to clear time limits.

## **X. In the face of demographic shifts and the inadequacy of parametric changes: interactions with care provisions as a framework for social protection policies**

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As we have argued in the past, public policies relating to care-giving imply new balances in the interrelationship between State, market, community and families, and they may have very diverse objectives that can reinforce each other over the course of time.<sup>12</sup> Among the virtual objectives we may note: giving a boost to the development of childhood skills and capacities through early education initiatives that are critical for cognitive development and that can reduce social inequalities; ensuring the well-being of vulnerable and dependent older persons and persons with disabilities through a range of interventions that provide care and encourage activity and independence and work against social isolation; offering real options for care-giving relatives; narrowing the opportunity gaps between women and men; expanding employment opportunities for women and thus generating positive externalities for the creation of employment and productive capacity; reducing poverty and the vulnerability of families at risk of falling into poverty, by increasing the ability of lower-income women to find employment of higher quality; helping to rejuvenate the population through the free exercise of people's maternity and paternity rights, by removing the obstacles that inhibit reconciliation of family and working life; and promoting sustainable financing for social protection. Depending on their priority and their practical impact, there may be tensions or conflicts among the potential objectives (Sojo, 2011, page 9).

We also stress the importance of viewing the care issue from the perspective of the financing of social protection.<sup>13</sup> The degree of ageing in the population as well as the labour supply are key considerations for the sustained financing of pensions. In this framework there are two crucial aspects related to care: the lower participation of women in the workforce, or discontinuities in their employment, and the impact of low fertility rates (Barr and Diamond, 2008, pages 130-132). These have

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<sup>12</sup> The distinction and the specification of these different but interrelated objectives were favoured by the technical assistance provided to the Chinchilla Miranda administration on the care network in Costa Rica.

<sup>13</sup> Here we reproduce the text of Sojo (2011), pages 30-32. On the definition of care and the policies needed, see also ECLAC (2012).

an adverse impact on the financing of social protection and on women's pension income. In the case of individually capitalized pensions, the gender gaps are exacerbated (Durán and Peña, 2011).

The relatively greater success that the Nordic countries have had in addressing the new social risks arising from the inability to combine caregiving with paid work can be attributed to the fact that those policies were introduced at a time when the degree of ageing and commitments in the pensions area were inducing lower pressures and competition in pension financing than in other European countries that had more mature welfare states, designed around the “male breadwinner” model (Bonolli, 2005).

With the process of ageing in the region, the financing of social protection systems will fall increasingly upon the younger cohorts, whose ranks will be smaller, and the output of the economic system will be crucial for the capacity to finance social protection (Barr and Diamond, 2008, pp. 104, 130, 132, 143-144, 149-150).

For this, it is essential to raise the productivity of these cohorts by investing in their human capital from early childhood, to increase female participation so as to broaden the financing base for social protection, and to boost productivity in the use of resources in the economic system and in social policies – for example, in the case of health, to reduce costs. But it is also important to promote longer-term processes of rejuvenating the population, which over the medium term will give rise to new balances in the financing of social protection, in its sustainability and in its possibilities of expansion. In this respect, expanding the social provision of care services can help to counter the effects of ageing on the sustainability of social protection financing.

We reiterate that care policies are beneficial not only to individuals and families but to society as a whole, and in many areas. They could have favourable impacts on fertility and on dependency ratios, which will be positive for striking proper balances with respect to the working population as well as job creation, productive capacity, and the sustainability of social protection financing.

The development of care networks should be accompanied by labour market policies that encourage reconciliation of working and family life. This framework, which is not addressed in this article, promotes economic development and performance and business productivity, and enhances the quality of work and the functioning of the labour market.

The so-called national transfer accounts are being used to analyze the possible implications of future demographic changes for the public finances and for the solvency of social protection systems in the region,<sup>14</sup> where there is growing concern over government programmes that serve specific age groups, with respect in particular to pensions, healthcare and the living conditions of the elderly (Uthoff, 2010, page 61). But then there is the question of how to model that methodology so as to include care needs in the terms analyzed here: this is a multifaceted conceptual and practical challenge given that care cannot be visualized in the national accounts (Duran, 2012), social protection systems have not substantially addressed the related risks, and education and similar systems have ignored early childhood care, and have addressed preschool care only partially.

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<sup>14</sup> The methodology uses the national accounts to construct age profiles for per capita consumption and incomes from work, it employs population volumes by simple age to estimate the flows that must be transferred from surplus to deficit age groups, it identifies the role of government transfers in intergenerational equity, and it supplements flows through requirements for family and private financial transfers as needed to achieve equilibrium.

## **XI. Corollary: the need for action against a pension system with distorted objectives**

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To propose a non-profit-oriented contributory system of individual accounts is not to take a “statist” stance and, from the four-dimensional perspective of democracy (Ferrajoli), it is far from the spirit of the “philanthropic ogre” against which Octavio Paz warned so eloquently many years ago. Nor does it reflect any hostility to the business world or the market.

In the end, this is a system financed first and foremost by its contributors, and it must not be distorted in ways that will generate undue fiscal liabilities. The idea is that the pensions system should provide reasonable benefits proportionate to the savings effort that people make during their working lives, and it should not have an adverse fiscal impact. In a context of rising life expectancy and the promotion of higher fertility through care policies, pension improvements must be consistent with improvements in economic productivity, with the increase in contribution densities as a result of better working careers, and the reduction of contributory evasion. The idea is to achieve the best financial return and to reduce exposure to risk. Older persons must enjoy economic independence, they must not be a burden on those who would have to supplement their inadequate incomes, and the burden on working people must be eliminated or reduced. What is needed in Chile is a non-profit contributory system of individual accounts, so that the essence of the system's effort will be to maximize pensions for the benefit of all taxpayers, from the most humble to those with the highest incomes.

This means eliminating the profit orientation of the existing public-private mixes, recognizing that the profits of the AFPs and related companies are the obverse of the contributory pension system, and that the other side of the coin is lower replacement rates. Because the system is geared to profit, these two aspects are intimately linked, and poor returns on equity in the individual accounts are of a systemic and endemic nature. Consequently, beyond its spurious origin, the contributory pension system, which has matured to reveal its scope and its restrictions, is by its very design incapable of fulfilling the supreme objective of providing pensioners with decent incomes after their working life.

The maturing of the system and the adverse effects that low pensions have for Chileans in all income groups are creating conditions favourable to change, which will include the parametric adjustments deemed appropriate. Understanding the concept of "de-institutionalization" as institutional change, the following thoughts on institutional change are highly germane.

*"The lower the overall confidence in compliance [with the norm], the lower the probability that actors attach to the likelihood that others will cooperate and, consequently, the lower the value of their own compliance. In the end, the costs of upholding the norm will have to be borne entirely by those who profit from it ñ which means, in effect, the end of the norm. ... the likelihood of de-institutionalization is higher, the stronger the beliefs of unjust outcomes and the weaker the cooperation norms."* (Avdagic, Rhodes and Visser, 2005, p. 31).

Consequently, in due course, and before the current problems become worse, we need to strike a political accord that will make pension maximization the supreme norm of a non-profit contributory system of individual accounts. The parametric reforms, while indispensable, make no sense by themselves, but must be analyzed in the context of reforming the system's architecture – for example, eliminating the gender discrimination that flows from the use of sex-adjusted life expectancy tables.

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