REFORMING PENSIONS IN CHILE*

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Nicholas Barr
London School of Economics,
United Kingdom

Peter Diamond**
London School of Economics,
United Kingdom
Massachusetts Institute of Technology,
United States of America

INTRODUCTION

In 1981, under military government, Chile moved away from a badly-designed set of diverse defined-benefit plans (Soto 2007), and put in place a mandatory fully-funded defined-contribution plan in the formal sector, with a guaranteed minimum for workers with at least 20 years of contributions.

Moving to such a plan was widely touted by the Chilean authorities, by some analysts, and by the World Bank (e.g. World Bank, 1994). And many countries started partially down this road, both in Latin America and Central and Eastern Europe (Box 1).

Box 1. Pension reform: The demonstration effect of Chile

The arrangements in Chile were highly influential in Latin America and elsewhere.

Beginning in the 1990s, Peru (1993), Argentina (1994), Colombia (1994), Uruguay (1996), Bolivia (1997), Mexico (1997), El Salvador (1998), Ecuador (2001), Costa Rica (2001), the Dominican Republic (2003–05), and Panama (2005–07) introduced structural reforms. These reforms had distinct aspects and characteristics, but they all shared a common objective: to make their social protection systems viable […], *or in other words to ensure that they are funded in the medium and long term*. (Rofman et al. 2015, p. 16).

In Central and Eastern Europe, funded individual accounts were introduced in Hungary (1998), Poland (1999), Latvia (2001), Bulgaria (2002), Estonia (2002), Lithuania (2004), Slovakia (2005) and Romania (2008). Funded individual accounts were also introduced in China (1998) and Hong Kong (2000).

The reality, however, did not turn out as well as projected, in Chile or elsewhere. With similar strategies, it should not be surprising that systems faced similar problems. Incomplete coverage remains a persistent problem, given the scale of informal activity in Latin America; the fiscal costs of transition were a problem in some countries; and administrative costs were and continue to be a problem. With hindsight, Chile made the approach look easier than it really was, with considerable retreat in some countries (see Box 2 on Central and Eastern Europe).

This paper argues that the experience of Chile demonstrates (a) limitations of individual accounts that were both predictable and predicted and (b) a mostly rational evolutionary approach to addressing those problems. In making changes, Chile has made use of Presidential Commissions, notably the Marcel Commission (Chile Presidential Advisory Council, 2006) and the Bravo Commission (Chile Presidential Advisory Commission on the Pension System, 2015a, 2015b). Commissions can have diverse roles. Sometimes they are set up with a narrow remit and an eye on early legislation, sometimes to increase understanding of the issues and perhaps also to provide public education, with an eye on eventual legislation. Most of the Marcel Commission's recommendations were included in a pension reform in 2008. With 58 specific proposals and three competing and controversial Global Proposals, the full impact of the Bravo Commission is likely to take longer.

Box 2. Retreat from individual accounts

A move towards funding has significant transition costs: if worker's contributions are diverted to individual accounts, they cannot be used to finance current pensions, hence past promises have to be met from elsewhere in the government budget. Countries in Central and Eastern Europe that introduced individual accounts in the years after the mid-1990s faced the problem acutely after the 2008 economic crisis and, as a result, many countries retreated.

Reform was of two sorts. Some countries, including Estonia, Latvia, Lithuania, Poland and Romania, retained individual accounts but changed the balance of contributions so that less went to individual accounts and more to finance Pay-As-You-Go (PAYG) benefits. In some countries those changes were intended to be temporary, in others permanent. Other countries, notably Hungary, abandoned individual accounts altogether and transferred both the flow of contributions and the stock of assets to the PAYG system. Argentina took the same path, again largely for fiscal reasons. For accounts of the retreat, see Bielawska et al. (2016) and Simonovits (2011).

Section 2 outlines the 1981 system and its problems. Section 3 discusses strategic reform in 2008, and Section 4 the background to and proposals of the Bravo Commission. Section 5 concludes.

THE 1981 SYSTEM[1]

The root of the post-1981 system is mandatory saving in a privately-managed defined-contribution account. Each worker was required to place 10% of covered earnings into an account, plus a contribution for disability insurance plus a commission to the firm that administers the individual account, collects contributions, manages the pension fund and purchases disability insurance. Initially, there was no employer contribution, but since 2008 employers have paid the contribution for disability. Legal retirement age was (and remains) 65 for men, 60 for women,[2] with later earnings not subject to the contribution mandate. Benefits can be taken as an inflation-indexed annuity from an insurance company. An alternative is phased withdrawals, with constraints on the rate of withdrawal to reduce the risk of outliving savings. Annuities and withdrawals were (and are) subject

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** Professor of Public Economics, London School of Economics and Political Science; Institute Professor Emeritus, Massachusetts Institute of Technology. Barr was a member of and Diamond an advisor to the Chile Presidential Advisory Commission on the Pension System (the Bravo Commission) in 2014–2015.

to mandatory coverage for survivors. The 1981 system included a minimum pension guarantee for people with at least 20 years of pension coverage.

To handle the individual accounts, Chile organized a highly-regulated market in which specialized fund management firms (*called administradoras de fondos de pensiones*, or AFPs) compete to manage funds. Firms were initially restricted to a single investment fund with tight rules on permitted assets; over time the number of funds a firm could offer was expanded to five, each with a different risk profile, and the range of permitted assets widened. Entry into the business was (and remains) open to any firm meeting sufficient capital and managerial criteria and having an exclusive activity as part of the pension system.

As commission charges were higher than anticipated, the regulations repeatedly experimented with changes to encourage more competition to try to lower charges.

A telling brief summary of the problems of the system came at a seminar in Santiago in 2004, referring to the *Seven deadly sins of Chile pensions*: low coverage, low pensions, high administrative costs, high fiscal cost, lack of gender equality, little competition, and political tests for Boards of Directors of AFPs.[3] In other words, reality was far from an idealized model of the capital market.

THE 2008 REFORMS[4]

Until 2008, with pensions based mainly on individual savings, the system did not provide adequate benefits for people with low lifetime earnings or incomplete contribution histories. This is to be expected with any system in which pension benefits are proportional to contributions. Thus Chile did not have a pension system, but only part of a system. Widespread informality made this problem important throughout Latin America (Rofman et al., 2015, pp. 1–2). To address that lacuna and some of the other problems identified above, President Michelle Bachelet established the Marcel Commission at the start of her first term.

Two elements of the resulting reforms stand out: the introduction of a non-contributory pension, and an auction mechanism designed to reduce administrative charges.

THE SOLIDARITY PENSION. The reforms introduced the Solidarity Pension System – a non-contributory pension benefit which is gradually withdrawn as contributory pension income rises and withdrawn completely for the top two quintiles of individuals, thus giving at least some benefit to the bottom 60% of pensioners. Benefits are financed in part from a Solidarity Fund which is subject to actuarial review every three years.

Since the benefit is non-contributory, in principle anyone is eligible, including formal- and informal-sector workers, urban and rural, employed, self-employed and outside the labor force. Thus the basic pension assists workers with low or sporadic incomes. By implication, it also recognizes caring responsibilities: someone who cares for young children or elderly dependents will make fewer contributions to their individual account; people with small accumulations are entitled to the full basic pension. Thus, as Figure 1 shows, the basic pension particularly benefits women.

THE AUCTION MECHANISM FOR ACCUMULATION. A system where firms compete for individual workers is inevitably expensive. The 2008 reforms introduced competitive tendering in which AFPs bid for all new entrants to the labour force over a two-year period, who have to stay with the winning bidder for at least 18 months. The AFP had to offer the same low commission to its existing members and to any new members. After 18 months, the AFP could increase its commission for all members, preserving uniformity.

THE AUCTION MECHANISM FOR BENEFITS. The market for annuities was very expensive. The 2008 reforms endorsed the Online Pension Consultation and Bidding System (SCOMP) introduced in 2004. In order to retire or switch options, consultation with this system is mandatory and includes insurance companies bidding for individual retirees. The web site provides members with information on the bids made by insurance companies and the estimated programmed withdrawals if switching AFPs.

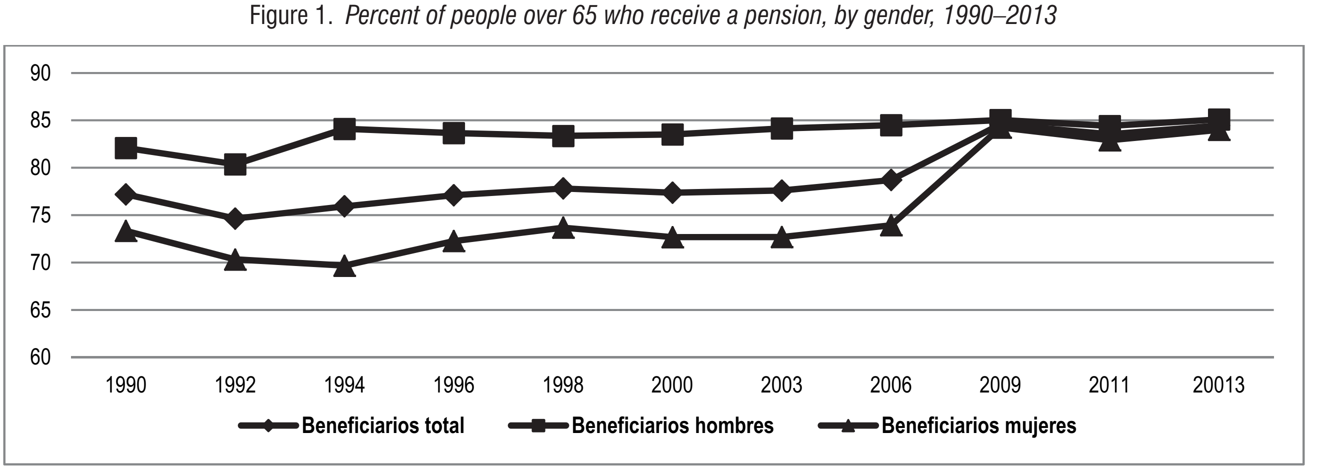
Thus the 2008 strategy is based on two core elements:

- A partially funded element – the Solidarity Pension System – provides poverty relief for people with little or no other retirement income, and offers some insurance against poor labor market outcomes by topping up benefits for those with low covered earnings histories.
- A saving element – the AFP system – mainly provides consumption smoothing for those with complete or near-complete contribution records, plus some smoothing for those with incomplete coverage.

THE BRAVO COMMISSION 2015

The 2008 strategy was sound because it addressed the three core objectives of poverty relief, old-age income insurance, and consumption smoothing. However, it left unfinished business, in recognition of which at the start of her second term President Michelle Bachelet established the Bravo Commission to diagnose the problems and propose solutions. Thus the remit had both short-run and long-run elements. The Commission comprised 16 national and 8 international members.

Figure 1. *Percent of people over 65 who receive a pension, by gender, 1990–2013*



Source: Chile Presidential Advisory Commission (2015b, Spanish version, p. 85).

The Commission's assessment of the pension system

The Commission's assessment identified a range of problems (unless otherwise stated, all quotes are from the Executive Summary (2015a, English version)).

INADEQUATE PENSIONS. At the time of reform in 1981 people were led to expect a 70% replacement rate. Yet, *[i]n contrast with OECD member countries, whose average net replacement rates are 66% for men and 65% for women with histories of regular contributions, Chile is below that average by 18 percentage points for men and 28 percentage points for women* (p. 14). Widespread discontent about low pensions raised the central question of how to raise replacement rates. Since the solidarity pension improved poverty relief for the elderly, a particular concern was replacement rates above the poverty line.

LOW COVERAGE. Many people do not contribute all the time, nor pay the full amount owed to their account; and many self-employed workers do not participate.

CONTINUED HIGH CHARGES. Administrative charges continued to be a concern, despite improvements from the auction mechanism, because many people do not move to AFPs with lower charges.

GENDER INEQUALITY. Women in Chile face a quadruple disadvantage: (a) on average their annual earnings are lower than those of men; (b) on average they have fewer years of contributions; (c) retirement age for women is lower than for men; and (d) single-sex life tables are permitted. As a result, replacement rates are systematically lower for women than for men. Though (a) and (b) are outside pensions policy, (c) and (d) are not.

HOSTILITY TOWARDS THE AFP SYSTEM. *A high percentage of the population believe that only a complete change in the AFP system would help improve pensions (72%) and believe that most of the responsibility for low pensions lies with the AFPs (66%)* (p. 17), though with lack of clarity whether the discontent is with the system itself (including its origin under a dictatorship) or the fact that pensions fall short of people's expectations.

LOW FINANCIAL LITERACY. In this respect Chile is like other countries. Lack of financial literacy helps to explain at least in part why the AFP system is blamed for low pensions when for many people the underlying cause is an incomplete contributions record. It also helps to explain why people do not move to AFPs with lower charges.

The Commission's Report includes 58 specific recommendations concerned mainly with the structure of benefits, and three Global Proposals, each with different strategies for organising and financing them. Each specific proposal was supported by at least a simple majority of the 24 Commissioners; none of the Global Proposals reached that target.

Specific proposals

The proposals are wide-ranging: some are detailed (e.g. increasing the solidarity pension by 20%), others indicate a direction of change (e.g. increasing earliest pension age), others are more in the form of aspirations (e.g. establishing higher-quality jobs for older workers). Some could lead to legislation soon, some only in the medium term, some never. We therefore do not discuss the proposals in detail; instead, we draw out directions of travel for which there is support, illustrating the general theme that Chile has pursued a mostly sensible evolutionary approach to its pension design, though the reforms that introduced the Solidarity Pensions System could usefully have come earlier.

EXPANDING THE SOLIDARITY PENSION SYSTEM. There is near-universal support for the Solidarity Pension System. The main proposals are twofold: increasing the non-contributory benefit for people with little or no AFP pension by 20%; and tapering the benefit so that at least the bottom 80% of pensioners receive some benefit, compared with 60% at present.

INCREASING CONTRIBUTIONS. Proposals include:

- Introducing a new 4% employer contribution,[5] some of which would go into the Solidarity Fund which helps to finance the non-contributory pension.
- Expanding the contributions base by (a) expanding the definition of covered earnings and (b) raising the contribution ceiling on covered earnings and indexing it to wages.

INCREASING COMPETITION WITHIN THE AFP SYSTEM. One approach is to extend the 2008 auction mechanism to a wider group than new entrants, using a mechanism to be defined.

In addition, the Report endorses parallel legislation that introduces a state-run AFP that might lower charges and might partly sidestep the unpopularity of private AFPs. On the last point, interestingly, despite the hostility to the AFP system, *79% of survey respondents agree with the creation of a State AFP and 69% would transfer their funds to it if it existed* (p. 17).

CHANGING PENSION AGE. These proposals include:

- Over time raising women's pension age to 65, the same as for men, and subsequently periodically reviewing earliest pension age.
- Extending the period of compulsory contribution to the age of actual retirement.
- Paying higher solidarity pensions to people who delay the start of benefit.

IMPROVING GENDER EQUITY. In addition to equalising pension age, the proposals include:

- Requiring the use of unisex life tables.
- Allowing judges to divide pension funds equally at divorce.
- Establishing shared pension funds. In this arrangement, originally set out in Barr (2001, p. 150), 50% of the husband's annual pension contribution goes into his wife's pension accumulation and vice versa, and analogously for other recognised partnerships. An implication is that the costs of forgone pension accumulation while caring for young children is shared between parents.
- Recognising caregiving in the pension system.

CHANGING ARRANGEMENTS FOR DECUMULATION. The proposals include:

- Making it compulsory to annuitise, though further work is needed about whether the mandate should apply to all pension wealth or give people some choice.[6]
- Including a person's education level or average income in the pricing of annuities. Poorer people on average have shorter life expectancies than richer people, and the difference can be considerable.
- Restructuring SCOMP to accommodate a group bidding process for annuities

REMOVING EXCEPTIONS. The 1981 system applied to civilian pensions; the military continued to have its own PAYG defined-benefit arrangements. The Bravo Commission's remit was to consider civilian pensions. Proposal 58 moves beyond that remit by addressing military pensions (tackling what up till now has been a taboo subject): […] *the Armed Forces, Carabineros, and similar bodies should, in general, receive the same treatment regarding affiliation and contributions as other workers'.*[7]

IN SUM. The 58 specific proposals taken together would have the effect of increasing replacement rates for men by about 13.5% and for women by about 29% (Executive Summary, p. 27).

The global proposals

The Report sets out three Global Proposals, A (build on the 2008 reform), B (introduce structural reform by diverting some of the flow of contributions to the AFP system into a new element), and C (abolish the AFP system). As noted, the choice among the three Global Proposals was controversial: 12 Commissioners voted for Proposal A, 11 for Proposal B and 1 for Proposal C.

GLOBAL PROPOSAL A. The proposal recommends building on the 2008 reform by expanding the non-contributory system and improving the AFP element.

The proposal strengthens solidarity benefits, by (1) significantly increasing the solidarity pension and (2) making the benefit universal. It finances the increase (3) through increased taxes and (4) a new 2% employer contribution to the Solidarity Fund. It introduces major reforms to the savings element by introducing (5) a new 2% employer contribution to AFP accounts and (6) a new government AFP with strict rules of governance, and (7) takes further action to reduce charges. It improves gender equality by (8) sharing partners' pension contributions on a year-by-year basis, (9) over time, equalizing retirement ages between men and women and (10) mandating the use of unisex life tables (p. 19).

The main motivation was to fulfil the Presidential remit by increasing benefits in the short run without creating problems – either structural or financial – for the future.

PROPOSAL B. The proposal diverts contributions on the first 350,000 pesos of earnings (about half of total contributions) that currently go to AFPs into a new partially-funded element, *organized through citizen social security accounts (which may take the form of notional accounts)*.[8] And it redesigns the solidarity pillar, providing a basic pension, of the same size, to 80% of pensioners and adding a tax-financed match to the social security accounts for people with low pensions. Financing the match is *a three to four percent increase in the contributions from employers, and with complimentary support from state contributions* (p. 19).

The main motivations were to address the widespread hostility towards the AFP system by reducing its scale, and to increase (and help finance) pensions immediately.

GLOBAL PROPOSAL C. The proposal absorbs both the stock of assets of the AFP system and the flow of contributions into a new defined-benefit system, in part out of an ideological objection to funded pensions generally, and to the AFP system in particular.

Global Proposal C seeks to respond to the views expressed during the public participation process by transforming the system into one that is purely pay-as-you-go (p. 18).

The full amount of contributions will be used as income to pay contributory pensions, with no State subsidies […]. *On average, retirement benefits would be increased by 75–100%. Contribution rates will not be raised until 2035* (p. 19).

ASSESSMENT. We regard Proposal A as the best way forward and Proposals B and C as mistaken.

We support Proposal A because in broad terms the current system works well and is a good vehicle for improvements.

- It provides an adequate replacement rate for workers with fairly complete contributions records. The use of fully-funded individual accounts does not necessarily require competing private providers; the government could transition to a lower cost, differently organized system, such as the default in the Swedish Premium Pension or the Thrift Savings Plan for US federal government employees.
- It provides a good base for expanding the solidarity pillar, with a range of flexible options for increasing pensions at different parts of the income distribution. Thus the Presidential remit for higher pensions can be achieved with an expansion of the non-contributory system, within whatever fiscal envelope the government decides to provide.

We regard Proposal B as mistaken. Major strategic reform is difficult, and should not be undertaken without (a) a very good reason and (b) a reform strategy in which policy and implementation are both clearly worked out. Proposal B unambiguously fails the latter test.

The description of the Proposal is not clear, making it hard to judge the distributional details. It appears that the design of the non-contributory element, in particular the positive match for those in covered work, by focussing on the formal sector, is too narrow a target for using additional revenues. The expansion of the basic pension without any offsets also appears too focused on higher earners.

The lack of specificity makes the proposal vulnerable to political pressures to raise the $350,000 ceiling; and government might not be strongly motivated to resist such pressures since moving further towards PAYG can create a short-term fiscal windfall, with the risk that Proposal B will move closer and closer to Proposal C.

Proposal B contains no discussion of the transition, i.e. of how benefits and finances will evolve as the new system is phased in. The presentation in the Report is almost entirely in terms of what the system will look like when mature.

Finally, though saving and investment could be maintained, as with A, the intent appears to be to use what would otherwise be future AFP accumulations as an additional source of revenue. Transferring benefits from future retirees to current ones, with a negative impact on aggregate savings, does not seem justified.

For equivalent increases in pensions, this proposal allows for the possibility of relying less on fiscal adjustments through taxes and /or public debt. This is an essential factor in the current context, where there is little-to-no room for establishing new tax reforms and where the delicate fiscal situation requires that public borrowing be handled with extreme prudence (Chile Presidential Advisory Commission on the Pension System 2015b, emphasis added).[9]

A decline in saving is a particular concern given declining fertility (hence fewer workers) and rising life expectancy (hence more pensioners). Consumption by pensioners during longer retirements must rely on growing output. But a declining workforce will exert downward pressure on output unless offset by other factors. An appropriate response to fewer workers is to make each worker more productive through investment in human and physical capital. Policies that reduce saving, by exerting downward pressures on investment, are thus strategically the wrong way to go.

For such reasons, three Commissioners (Attanasio, Meghir and Mitchell 2015) wrote: *Our objection to Proposal B, which in the short run would provide a level of pensions very similar to that of Proposal A, was about how the increased solidarity pensions would be financed. Proposal B would divert money from workers' individual accounts and give the cash to current pensioners, rather than building up funding for their own retirement.* […] *[B]y diverting savings, this plan would undercut investment and future productivity growth*.

Proposal C received only one vote (quotes from the Executive Summary, p. 20). *As a result, the Commission does not* *support global proposal C* […]. *The Commissioners' main reasons for opposing this proposal included:*

• *Proposal C transfers all the deposits and savings*, […] *into the PAYG system, without compensating the workers for taking their individual accounts*.

• *It is unsustainable: The proposal requires an abrupt and large increase in* […] *contributions and taxes [once]* […] *the reserves are depleted*.

• It puts saving and investment at risk to a greater extent than B: *Moving to a fully PAYG system reduces saving and investment* […].

For over 25 years, we have criticised the World Bank's over-promotion of individual accounts managed by AFPs, so that our support for Proposal A is not ideological. We support the Proposal because of its flexibility over the distribution of benefits and its virtue in preserving investment levels, taking account of two sets of facts: (a) the system has been in place for 35 years and has lowered costs, has improved benefit options and has mostly met the transition costs, (b) fertility is declining. This does not imply that we view adoptions of individual funded accounts elsewhere as necessarily worthwhile – the ability to implement the approach well and/or the ability to finance it suitably are not present in many countries. For such reasons we opposed individual funded accounts in our 2005 and 2010 reports for the Chinese government (Barr and Diamond 2010b). That we take a different position under different circumstances is not inconsistent – if circumstances differ, so does the appropriate policy.

WHAT NEXT?

One of the strengths of the Bravo Commission's Report is its assessment of the existing system. Also important is its summary of public attitudes. The latter exposes deep divisions along at least three dimensions: views about the legitimacy of a system introduced under a military dictatorship, views about funded individual accounts from competing providers, and discontent with the level of pensions. These are fundamental issues, which need to be fully debated and discussed. Identifying and exposing those divisions was immensely useful.

The divisions, both within the Commission and in wider society, hampered the ability of the Commission to make strong, fully (or largely) worked-out recommendations. Thus the specific proposals show a direction of travel, but more work is needed on many of the details; and there is no agreement about the need, or lack of need, for basic structural change.

The Commission presented its Report to President Bachelet in September 2015. Given the need for further work, the President established a Committee of Ministers, including the Ministers of Labour (Chair), Finance. Social Development, Economy and Women, to consider how to take things forward. The expectation is that the Committee will make recommendations in 2016 about implementing some of the specific proposals but may leave decisions about the Global Proposals till 2017.

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[1] For fuller discussion, see Barr and Diamond (2010a, Ch. 10).

[2] Earlier retirement is possible for someone with a large enough accumulation.

[3] For broader criticism of choice and competition in the context of individual funded accounts, see Barr and Diamond (2009).

[4] For fuller discussion, see Barr and Diamond (2010a, Ch. 10).

[5] As noted, the 1981 system included worker contributions but no employer contributions.

[6] Reasons for retaining some liquidity include the need to meet unexpected costs, e.g. health care or long-term care and/or bequest motives. Thus the optimal extent of annuitisation is generally less than 100%.

[7] Executive Summary (2015a, English version, p. 26). Unless otherwise stated, all quotes below are from the Executive Summary.

[8] On notional accounts, see Barr and Diamond (2010a, pp. 33–34).

[9] Translated from the Spanish version of the full Report of the Bravo Commission, p. 192.

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SUMMARY

This paper argues that experience in Chile demonstrates (a) problems with fully-funded defined-contribution individual accounts that were both predictable and predicted, and (b) a mostly rational evolutionary approach to addressing those problems. Section 2 briefly outlines the 1981 system and its problems. Section 3 discusses strategic reform in 2008 which addressed some of those problems. Section 4 – the main focus of the paper – discusses the unfinished business left by the 2008 reforms and sets out the main proposals of the 2015 Bravo Commission, including its 58 specific proposals, which commanded majority support from the Commissioners, and its three very different Global Proposals, about organising and financing the system, which are highly controversial.

Keywords: Chile, pension system, strategic reform, organising and financing the system