

# Pensions Observatory

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## Coverage in Pensions Systems: The experience of Chile and Colombia<sup>1</sup>

Reforms in the decade of 1990s to pensions systems in Latin America could be envisaged as a response to changes in the economy of those countries, having an impact on pensions liabilities and positive effects on economic growth, internal savings, capital markets and fiscal sustainability. After several years, the results may be assessed as positive, in terms of the fiscal system, economic growth, internal savings, and the development of capital markets (see Corbo and Schmidt-Hebbel 2003, Holzmann and Hinz 2005), but results have been uneven in terms of coverage, labour markets, and substitution rates, eliciting all new challenges.

According to the latest reports from the World Bank, pensions systems require additional reforms that will respond to needs of the population in terms of: i) the increasing entrance of women into workplace, ii) the emergence of new forms of employment in the global economy, iii) the deterioration of budget deficits, iv) the lack of coverage of pensions, and v) the increasing number of people in old age, among others.

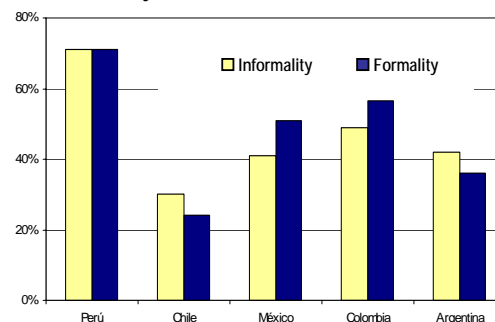
In general, the pensions systems of Latin America, except for Colombia, are characterised by the mandatory nature of the contributions of salary workers, with the contribution of self-employed workers being voluntary. Statistics indicate that the coverage of system members is about 50% of the economically active population in most countries in the region. Since in Latin America a significant proportion of workers are informal or self-employed, most of those people who are not covered by the pensions system are to be found in this group, and these people are more vulnerable, with low human capital and frequent periods of unemployment, moreover, they are mostly women and below the poverty line.

In this article we will analyse the current situation and the problems faced by informal and self-employed workers in the pension systems of Chile and Colombia, their main features, and how these impact on the decision whether or not to make pension payments, shedding light on possible reasons on why contributions are not being made. After this analysis, we will suggest public policy proposals designed to encourage this group to make pension contributions.

## Characterisation of workers who do not contribute to the pensions system

One of the main problems that has been detected in the performance of said pensions systems is the low level of coverage of the workers, mainly freelance and informal workers. The analysis of data and the research carried out by the Pensions Unit of BBVA indicated that the coverage of self-employed workers in

Informality and Self-Workers in Latin America



Source: UN-BBVA

<sup>1</sup> Chile: data from the Social Protection Survey of 2004. Colombia: data from the Survey of Households in Cities and Metropolitan Areas, carried out in the second quarter of 2006.

Chile is 66.4%<sup>2</sup>, but only 25% of this group make regular contributions. In Colombia, the coverage of self-employed workers is about 35%<sup>3</sup>, and for informal workers about 10%. As a result of the low coverage of the pensions systems, it can be inferred that this segment will obtain low or non-existent pensions on retirement, which will mostly not be enough to finance the overall cost burden of old age.

This is exacerbated if the following main characteristics of the segment of non-contributors are recalled, and which are similar for both Chile and for Colombia: i) concentration of employment in certain sectors, retail, services and industries, and in certain job descriptions, ii) low levels of income job related, which is exacerbated by the lingering periods of unemployment, iii) lower level of education, iv) higher level of informality, measured in terms of absence of formal labour relationship and social security (health and pensions), v) in the case of Chile, the density of contributions is lower than for salary workers. These results could be extrapolated to the entire population that is not covered by the Pension Systems of the region, as the countries share the same characteristics. This segment of the population, composed mainly of informal and self-employed workers, poses one of the main challenges to Latin American pension systems: to improve coverage and the levels of protection in the old age of said vulnerable population.

#### Mandatory contributions: do coverage and pensions improve?

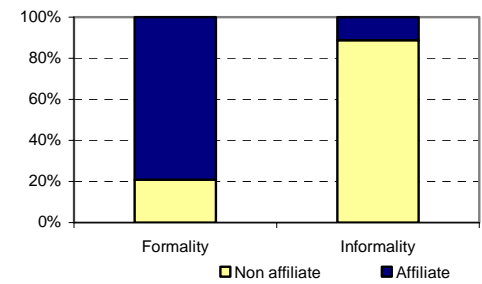
In Chile, the recent approval of the reform of the Pension System<sup>4</sup>, in as a way of solving the problems of coverage and the low pensions of self-employed workers includes certain remedies. Among others, a gradual introduction of a mandatory contribution to the pensions and health system, which until now was voluntary for self-employed workers. In addition, this group has been granted the same rights as salary workers.

For its part, in Colombia, contributions are mandatory for salaried workers and for self-employed workers, but the coverage of the system is lower than in Chile. One of the possible reasons for this in Colombia could be the low level of administrative inspection before 2005, despite the mandatory nature of contributions,. Since then, the country has implemented an integrated system of social security payments, which are made by electronic transfer using the Integrated Form for Payment of Contributions, known as PILA. This has improved the supervision of contributions, and is expected to reduce the level of non compliance.

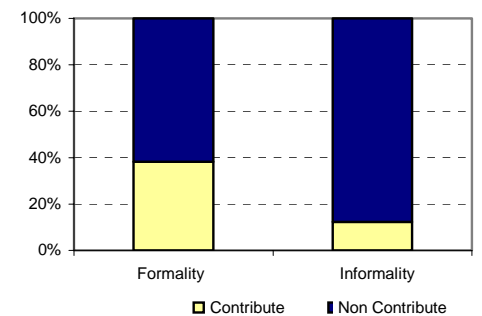
In Chile, one way of monitoring the contributions of freelance workers would be to use the internal taxes service (SII), which compiles the information of the income of workers. However, for self-employed workers, evidence suggests that only 37% declare their income to the SII and are hence subject to audit. In other words, there is a segment of this population which is not being inspected by the SII and hence which could continue to avoid making payments.

Given the experience of Colombia, and the data from Chile, we should wonder asked whether mandatory payments will be enough to ensure the coverage of self-employed workers. The information above suggests that it will only be effective for this segment if adequate inspection mechanisms are in place.

Colombia: Affiliates and non affiliates, by formality

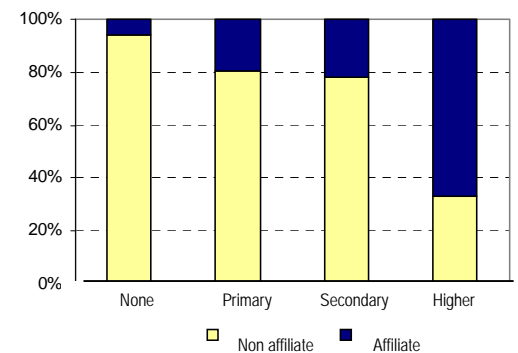


Chile: Contributing and non-contributing self-employed workers, by formality



Source: Based on the social protection survey, 2004.

Colombia. Members and non-members by level of education



Source: Based on the household survey, second quarter 2006

<sup>2</sup> Membership of the pensions system in Chile is about 100% of the economically active population, but only 70% of these make regular payments.

<sup>3</sup> The coverage of the pensions system is about 50% of the economically active population.

<sup>4</sup> The reform will begin to be implemented in July 2008.

In addition, it is interesting to note that there is a group of workers which, despite the lack of inspection and mandatory payments<sup>5</sup>, do make contributions to the pensions system. Here, we think it is appropriate to identify those variables that influence the contribution decision, which will allow public policies to be developed that will encourage this type of worker to make pension payments, conducive to a rise in coverage, without the need to enforce an audit scheme for compliance.

### Key factors in deciding to pay into a pensions system

The research of the Pensions Unit of BBVA for Chile and Colombia is based on identifying the main characteristics of workers who form part of the group with low coverage levels<sup>6</sup> and on what leads them to decide to contribute or not to the pensions system<sup>7</sup>. The main results of this research include:

- Higher income and a higher level of education generally increase the chance of a self-employed worker making pension payments. The data confirm this, as contributors in this segment have higher levels of income and education.
- Age has a positive impact on the probability of making payments, but it declines over time. Data indicate that the youngest and oldest population make the lowest proportion of payments.
- There is a preference for alternative savings, either in goods, services, or other instruments for investment. In Chile, the data indicate that the preferences for alternative investments depend on the income level of the person. Self-employed workers with higher incomes prefer to save in more liquid instruments (mutual funds and shares) rather than pay into the pension system. People with lower incomes prioritise house saving. The latter also holds true for Colombia. It should be recalled that a home is one of the most durable physical goods for people, especially people on lower incomes, and so this segment of the population puts a higher value on residential saving than on pensions.
- Health provision also has an impact on the probability of making pension payments. Data gathered indicate that those who pay into the health system also pay into the pensions system. In Chile, this result is true only for those who are contributing to the public system and for whom there is a degree of joint payment, as to receive these benefits they are required also to pay into the pensions system<sup>8</sup>. The opposite holds true for those who are members of the private health system, as these are not required to pay into the pensions system, which implies that there is a lower level of probability of their contributing to pensions.

Based on these results, we believe that it is possible to develop policies aimed at creating incentives which increase the appeal to this segment of the population of making pension contributions, for example: i) providing additional benefits to contributing workers, such as subsidies for housing, ii) subject the availability of health coverage to making mandatory pension payments, among others.

<sup>5</sup> Lack of tax inspection for the Colombian pension system, and voluntary contribution for freelance workers in the Chilean system.

<sup>6</sup> The characteristics identified are for freelance workers in Chile and for workers who avoid payments in Colombia.

<sup>7</sup> Econometric techniques have been used to identify the relevant characteristics. The estimated model is a Probit model. The binary outcome variable is whether to pay or not into the Pensions System, as a freelance worker. The variables are determined by a vector of characteristics of the household and of the person who is choosing to pay or not.

<sup>8</sup> Contributors to the Public Health System, with some level of joint payment must make at least six monthly payments per year.

Income from main occupation  
(US\$ for each year of survey)

	Contribute	Non contribute
Colombia	412	186
Chile	487	315

Source: Based on household survey, second quarter 2006, and social protection survey 2004.

Notes:

Chile: includes income from contributing and non-contributing freelance workers in US\$ 2004.

Colombia: includes income from contributing workers in US\$ 2006.

## Conclusions

Making contributions mandatory, and establishing a sufficient level of inspection, are important measures in terms of increasing coverage levels and final pensions for the most vulnerable population. However, as this sort of mechanism is not fully effective for all workers, the introduction of specific incentives for this segment of the population to save for pensions, such as those suggested in this article, should lead to an increase in pension contributions, as they would also generate complementary benefits.

It will be up to each country to analyse the preferences of these workers, and hence to design effective and sufficient incentives, perhaps related to the provision of services such as health, education, access to housing, loans, or others.

We believe that the sum of these measures will allow greater coverage of self-employed and informal workers, an increase in pension contributions, and as a result, higher pensions in the future.

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