Skin in the (Costa Rican Retirement) Game

By Kerry Pechter *Fri, Jan 20, 2017*

How do Costa Ricans pay for retirement? In San Jose, Alvaro Ramos Chaves (above), the pensions regulator, told RIJ how his nation's mandatory DB and DC plans work. His insights could inform our own debates.

To find out how Costa Rica's social security system works, I walked from my Airbnb condo in the San Pedro section of San Jose, up a congested avenue and past a mall to the Equus Tower, where I rode to the 11th floor and stepped through frosted glass doors into the offices of SUPEN, the country's pension authority.

After a few minutes' wait, during which I gazed out at the nearby Coronado mountain range, Alvaro Ramos Chaves arrived and shook my hand. In his early 30s, with an economics Ph.D. from U.C.-Berkeley, he has been head of SUPEN since succeeding Edgar Robles in mid-2015. As we sat down at a conference table, Ramos pointed to a small tube in his ear and said that if he didn't seem to understand my questions clearly, deafness, not poor English, would be the reason.

Clarity never became an issue. For ninety minutes or so, he described the basic architecture of the Costa Rican national pension system, the investment restrictions and other challenges that his office deals with, and the outlook for the country's economy, where jobs—the financial aquifer for the pension system—depend on tourism, the back-office operations of bigger countries, and agriculture.

Compare and contrast

Costa Rica's retirement system faces many of the same demographic and economic challenges that the U.S. system faces, but there are significant differences in the way the two programs work.

The national defined benefit system resembles Social Security. But its defined contribution system is mandatory, not voluntary, and the contributions are managed collectively, not individually. About 68% of workers participate; the goal is 80%. About 100,000 Costa Ricans who never contributed to any plan currently receive about $150 a month in retirement from the government. Teachers, firefighters, judges, and certain high-ranking academics and politicians have their own DB pensions.

About 14.41% comes out of payroll for retirement benefits. (The median income for Costa Rica's 4.8 million people is about $12,000.) That contribution rate will soon rise by a percentage point. About 9% (of which employers pay almost 5%) goes to pay for a defined benefit pension and 4.25% goes to the defined contribution pension. There's also a 5% tax for unemployment insurance.

Costa Ricans used to paid 7.5% of salary for a defined benefit that replaced 60% to 70% of earnings after at least 20 years of participation, Ramos said. But then came a big demographic shift. Women joined the workforce and the birth rate, formerly four per woman, dropped to 1.9. Meanwhile, life expectancies rose, and the country now has the world's highest longevity among men over age 80, Ramos said. But in 200o, Costa Rica added the mandatory DC plan to patch the actuarial gap.

Like North Americans, many Costa Ricans—"Ticos," an affectionate diminutive, is their adopted nickname–face the likelihood of spending 20 years or more in retirement. Costa Rica's national health system, financed by a 15% payroll tax, has helped push up longevity. Taken together, retirement taxes and health taxes add up to a hefty (and some say counterproductive) bite. But the highest marginal income tax rate for Costa Ricans is only 15%, and only those earning more than $1,500 a month (a mere 15% of the population) pay any income tax at all.

Bigger taxes loom on the horizon, however. Ramos cited a recent University of Costa Rica study showing that if the system retains its current retirement age and benefits, pensions could cost 35% of wages by 2060. There's also, by the way, a sales tax that operates like a value-added tax (VAT), with the difference that the tax is not applied consistently at every stage of production and distribution.

Where the nest eggs grow

Contributions to the basic DB system, or IVM, are invested in Costa Rican government bonds. There's an "implicit contingent fund," similar to the Social Security trust fund in the U.S. Like our trust fund, Costa Rica's has an expiration date. Remedial tweaks to the system, made in December 2015, have postponed that deadline by eight years, to 2038, Ramos said.

Contributions to the DC system go into funds that are managed by any of six state-licensed asset management firms, known as OPCs. Costa Rican firms run five and a Colombian firm runs the sixth. Most participants put their money into a single default fund. Only 3.7% of those over age 18 take advantage of their right to add voluntary contributions to other investment options. Other than GE Capital, which sold its business to the Colombian firm, no American company has ever managed a tranche of the Costa Rican DC money.

By statute, these firms can invest up to 40% of Costa Rica's roughly $10 billion in assets (of a total of $14 billion in total national pension assets) outside of the country. But currently they invest only about 10% abroad. "There's a lot of room to grow," Ramos told me. "The system is still immature. Another $4 billion could leave the country," he said. Recently, under guidance from the World Bank, Costa Rica switched from a rules-based to a risk-based supervision system, which should give the OPCs more flexibility in their choice of investments.

OPCs earn a maximum of 50 basis points for their services. The fee fell recently from 70 basis points, and will go lower in the future, Ramos said. Personally, he doubts that neither a rigidly fixed fee nor the lowest possible fee will optimize investment outcomes. "You won't have a sophisticated system if you charge too little," he said. "In the Netherlands," known for pension sophistication, "the fee is 66 basis points."

Costa Rican men can take monthly retirement benefits at age 62 and women at age 60, from both the DB and DC plans. "We do allow lump sum distributions from the DC plan, but the rules have not been well thought-out," Ramos told *RIJ*. "If your DC benefit is less than 10% of your DB benefit, you can take the DC benefit as a lump sum."

Because the DC plan is relatively new, "very few people have a DC benefit right now that's bigger than 10%," he said, because the plan is relatively new. "We expect the lump sum to become more common," he added.

In addition to the lump sum provision, participants can receive interest alone from their savings and set aside the principal for a bequest. They can also draw down a combination of interest and "some capital" each year, or they can buy an individual annuity. "What annoys people here is that there is no partial lump sum option. But I don't like a partial option. As it stands today, if you retire and have never used your unemployment fund, then you have that as a lump sum," he said.

Sleep-deprivation triggers

What keeps Ramos awake at night? In his view, the spread between equity returns and bond returns, driven partly by the vast monopolistic profits of tech companies like Amazon, Facebook, and Apple. Their stock prices will keep going up, he said, they'll have huge cash flows and they'll never have to issue borrow money from pension bonds. "There will be no bonds from companies like Apple. So it will be harder and harder for pensions to find investments. That's a big concern for me."

Advances in automation, such as the use of intelligent chatbots to replace call center operators, also worries him. "In the past 40 years, we've gone from an agricultural economy to a service economy. We're the 'back office' of the world. 'So far so good.' But what happens to us [and El Salvador or the Philippines] if the back office is automated?"

Globalization, of course, giveth and taketh away. For years, an Intel chip assembly plant and design facility employed thousands of Costa Ricans and accounted for an enormous 5% of national GDP. In 2014, however, Intel relocated its chip assembly operation to Asia, and Costa Rica lost 1,500 high-paying jobs.

Fewer jobs means less tax revenue which means rough times for pension systems. "This is a worldwide phenomenon," Ramos noted. Climate change also worries him. It made its presence felt in the fall of 2016, when Costa Rica's Caribbean-facing coast experienced its first hurricane damage in 200 years. Hurricanes can discourage investment and are expensive to clean up after.

Changes in rainfall could also hurt the country's agriculture sector. Costa Rica has long grown coffee in the cool central highlands and bananas in the warmer lowlands. Warmer ocean temperatures could hurt its commercial fishing industry—a major employer—and perhaps degrade sport fishing for sailfish and tarpon off the Pacific coast. "This climate change is real," Ramos said.

Because of the inter-generational conflict that national pensions often entail—the current generation pays for the previous generation's benefits—pension policy is not just an economic or financial problem but also a political and personal problem. Ramos told me that he feels this tension first hand.

"My generation paid for the previous generation, and the next generation will pay even more. My baby daughter will begin contributing to our pension system in 2040. How much are we going to ask her and her peers to pay?" To prevent pension taxes from ballooning to 35%, his agency will have to come up with some innovations.

"I like the Swedish system," he said. "They have a notional account system for defined benefit plans, where benefits are connected to future productivity. Right now, in Costa Rica, the two are disconnected.

“The traditional DB plan guarantees you a certain level of purchasing power in the future, even if productivity in the future isn’t high enough to support the benefits. In Sweden, if the country is poorer when you retire, you get a lower benefit. The retirees have skin in the game.”

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