# How We Privatized Social Security in Chile

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Social Security is the single largest government program in the United States, spending $350 billion a year—more than the defense budget during the Cold War.

The bad news is that Social Security is approaching bankruptcy. It won't be able to pay all the benefits everybody has been promised. This is because any pay-as-you-go social security system has a structural flaw: it destroys the link between work and reward, personal responsibilities and personal rights. Whenever that happens for a large number of people over a long period of time, disaster is almost inevitable.

If nothing is done for another decade, the problems in the United States will be overwhelming. And it is not only experts who know this. A recent poll suggests twice as many young Americans believe in flying saucers than believe Social Security will make good on its promises.

The good news: there is an alternative that works. It was developed in Chile where a pay-as-you-go social security system had been started in 1925, more than a decade before it was enacted in the United States. Instead of paying a payroll tax, every Chilean worker sends his monthly contribution—between 10 percent and 20 percent of wages—to a tax-deferred pension savings account. This is the individual's private property. An individual can easily find out how much is in his or her pension savings account. Now the biggest asset of Chilean workers isn't their used car or their mortgaged home. Their biggest asset is the capital accumulated in their pension savings account. These contributions are invested in capital markets through private investment managers, yielding real positive rates of return. There are some interventions, including guidelines to exclude highly risky investments from pension savings accounts, but there aren't any compulsory investments, certainly not government securities. Chilean workers have become a nation of business owners—capitalists.

In Chile, if you aren't satisfied with the way your pension savings account funds are being managed, you can switch to another investment company, known in Chile as an AFP. When you change jobs, you take your pension savings account with you. It's as portable as your bank account.

Moreover, Chileans can now decide when they wish to retire. A worker figures how much he has accumulated thus far in his pension savings account and what additional percentage must be deducted from each paycheck so that when his chosen retirement date arrives, he will be able to buy an annuity yielding 50 percent of his last wages.

To those who express concern about the compulsory element of the Chilean privatization, I say this: we didn't introduce compulsion. It was already there. We reduced it, gave people far more choice than they had before. Moreover, since the very beginning, contributions have been based on the first $25,000 of income, while wages have soared, which means the compulsory element becomes less onerous each year.

### Taking Politics Out of the Pension System

The Chilean Constitution protects pension savings accounts from government expropriation, because we know that whenever politicians see a huge amount of money accumulated, they become greedy. Taking politics out of the pension system means that pressure groups can't lobby legislators to siphon a worker's money for somebody else. Pension savings accounts cannot be touched even during war. In that event, the government could issue war bonds, but they have no business taking private pension savings accounts. It's private property.

The Chilean investment-management industry is competitive—with free entry—as in the United States. We have 15 AFPs, two of them owned by U.S. firms. Competition is important because it spurs companies to improve investment returns and to minimize commissions.

What about poor people? I don't believe anybody should be barred from having a private pension account just because they're poor. That somebody might be poor at, say, age 25, doesn't mean they'll be poor at 40. With the Chilean system, everybody goes through life contributing at least 10 percent of their earnings. If by the time a man reaches 65, or a woman 60, an individual can't afford to buy an annuity yielding a minimum income, then the government supplements their accumulated capital to reach that level.

But we retained the vital link between work and reward. The more you put into your pension savings account, the more you will be able to take out. This is in dramatic contrast with Chile's government-run pension system. Workers paid up to 25 percent of their salaries into it, yet by 1980 it was broke. Like U.S. Social Security, the government-run Chilean system paid out often meager benefits which weren't related to individual effort and contributions, so there was a lot of discontent. And like U.S. Social Security, the government limited the ability of people to collect—with any pay-as-you-go government pension system, free choice about retirement age isn't allowed, because somebody else would be forced to finance your early retirement.

Moreover, politics had resulted in special privileges concerning when people could collect from their government-run pension. Factory workers couldn't collect until after age 65, white-collar workers, after 55. Bank employees could begin collecting after 25 years of work, members of Congress, after only 15 years!

Why give government such incredible power over your life? Working or not working has a lot to do with human happiness. There are some people who enjoy working well into their 80s. Others want to collect pension income and go fishing at 50.

How to handle the transition from a government-run system to a private pension saving system? In Chile, we had three rules, which entailed a degree of compulsion.

First, we continued paying the elderly who had become dependent on the government-run system. We didn't touch those benefits. Second, we offered every worker the freedom to stay in the government-run system at his own risk. Or the worker could leave the system completely and begin his or her own pension savings account. Third, we required new entrants to the labor force to join the pension savings account system, because we believed it was irresponsible to go on burdening our children and grandchildren with an unfunded debt.

Before we introduced a law for pension savings accounts, I spent six months explaining how they would work. Every week, I went on prime-time TV and spoke for three minutes. Sometimes I had a clock right beside me, because everybody knows that politicians promise to be brief, then go on and on. Viewers could see when three minutes were up.

I said I'm the Secretary of Labor and Social Security, and I don't know how much money I have in the Social Security system. Do you know how much money you have?

Next week, I came back and said, Would you like to have your money in a passbook like this? I held one up to the TV camera. I said, You can keep it at home and look it up. Next week, I will tell you how it will work.

Next week, I asked, Are you worried about safety? I talked about how your pension contributions would go into a diversified mutual fund of your choosing, whose assets would be kept apart from the assets of the investment manager. The bankruptcy of an investment manager, if that occurred, wouldn't touch your pension savings account.

And so on, explaining one aspect of the proposed pension savings accounts at a time.

Initially, I encountered skepticism. Many were against the proposed new system. It meant radical change and seemed risky. Nobody else in the world had done anything like this. Why not be the first? I suggested. Someone has to be first.

At the end of each three-minute TV segment, I had always emphasized that if you don't like the proposed new system, you don't have to join it. People became intrigued with this government official who spoke pasionately about an idea but offered the freedom to turn it down. People began to say there must be something very good about the idea.

After a while, people everywhere were talking about the proposed pension savings account. They began asking when a new law would come.

While popular support was growing for it, there were formidable interest groups against it. Labor union bosses declared that pensions must not be based on individual choice. They were opposed to having pension contributions managed by private investment managers. The bosses demanded power to control where pension contributions went. I was offered perks, such as the free use of a beautiful beach resort. The bosses made clear they would do everything they could to make my life difficult if I didn't yield to their demands.

The new law was approved on November 4, 1980—the day, as it turned out, when Ronald Reagan was elected president of the United States.

The law was to take effect six months later, May 4, 1981. But it occurred to me, though, that since May 1 is Labor Day in Chile, as well as most other countries, there would be enormous symbolic significance if pension savings accounts began on Labor Day. Traditionally, this had been celebrated as a day of class struggle, with parades displaying the red flags of those who hated private employers.

I took the liberty of changing the starting date of the new law to May 1. Afterward, Labor Day was celebrated as the day Chileans were able to free themselves from big government and take control of their pension contributions.

### An Enormous Response

Despite critics who warned people not to trust the private sector, the response was enormous. During the first month, 25 percent of Chilean workers—about 500,000—opted out of the government-run system. By the end of the first year, 70 percent of Chilean workers chose to open tax-deferred pension savings accounts. By the end of the second year, 90 percent had.

Individuals opting for private pension savings accounts received a recognition bond (zero coupon, indexed to inflation with 4 percent interest), which recorded their contribution to the government-run system. Upon retirement, this bond was cashed and added to their assets available to purchase an annuity.

As I mentioned earlier, after the new law took effect, people who started working for the first time made payroll contributions to their own pension savings accounts, not the government-run system. There hasn't been anybody entering the government-run system.

Yes, moving away from a pay-as-you-go system was a challenge. There was a transition gap: the amount of money we ceased to collect from workers who opted out of the system, yet had to pay current and future retirees. The transition gap was around 3 percent of our gross national product. We paid a substantial portion by reducing wasteful government spending and by using debt financing. As a consequence, we went to private pension accounts without increasing taxes, inflation, or interest rates. During the last six years, we have had government budget surpluses equal to 1 percent or 2 percent of GNP.

Going to pension savings accounts helped boost the economy, because it has raised the saving rate—now about 27 percent of GNP—and people's contributions became available for private capital markets. Since pension savings accounts got started, they have generated capital equivalent to 40 percent of Chilean GNP. During the past dozen years, annual growth has been about 7 percent, double our historic growth rate. Faster economic growth made it easier to handle the transition gap.

The real rate of return on private pension accounts has been about 12 percent. Pensions are already 50 percent to 100 percent higher than with the government-run system.

Chile has eliminated the payroll tax, which, by making it more expensive for employers to create jobs, put a damper on employment.

Chilean unemployment is around 5 percent—and without the disguised unemployment of government make-work jobs. By contrast, in the Western European welfare states, unemployment is generally between 10 percent and 25 percent.

To be sure, Chile embraced many other free-market reforms which helped accelerate economic growth. We went to free trade, cut income taxes, privatized state-owned companies, and so on, but according to many observers, the most important reform has been the pension reform.

I believe that the way to cut the size of government is not only to reduce government programs but to abolish them. I long for the day, fast approaching, when the last person in Chile's government-run system retires and 100 percent of workers are making contributions into their own pension savings accounts.

Just imagine how this idea could energize the U.S. economy. More people would see their own efforts, not the government's, as offering the key to their future. Trillions of dollars would become available to help finance economic growth. Payroll taxes would be cut and ultimately eliminated, contributing to higher employment, higher wages, or both. Individuals would gain freedom to control their pension savings. They would almost certainly have more retirement income and greater peace of mind. It would be hard to think of a single economic reform that would do more good for everyone. []