Chile’s Social Security Success

Think of the United States as a latter-day *Titanic*. Super-modern. Super-rich. And heading for an iceberg of colossal proportions. Unthinkable? So, too, was it unthinkable that the *Titanic* — at 46,329 tons, the largest, most luxurious, and arguably, most modern passenger ship afloat in 1912 — would ever go down. But go down she did, in 13,200 feet of frigid waters, 600 miles east of Newfoundland, with a loss of 1,500 lives. One looming danger that, by itself, could sink the American *Titanic* is called Social Security. Everybody knows it is in serious trouble, but virtually no one in public life has the political fortitude to do anything about it.

The U.S. Social Security system is the largest public spending program in the world, hauling in roughly $530 billion in 2006 and paying out $449 billion in that same year, with the difference added to the Social Security Trust Fund. However, the experts predict that by 2017, the Social Security system will be paying out more than it collects in taxes. At that time, the so-called Trust Fund will not even begin to cover the coming shortfall, since the government has already raided the Trust Fund for other programs and replaced the money that’s supposed to be there with IOUs. But even if the Trust Fund had not been raided, it would eventually run dry over time anyway, according to government projections. The reason: the retirement of the baby-boomer generation and the additional burden that will place on those still in the workforce.

Must the U.S. Social Security System go broke? No, not any more than the *Titanic* had to sink — the *Titanic* could have avoided the iceberg and tragedy altogether if the ship’s lookouts had merely been provided with binoculars. Take it from José Piñera.

On the Lookout for a Solution

Who is José Piñera? “If you were asked to name one person who has enabled more people to gain wealth and security than any other person on the globe, who would you name?” asked Richard Rahn, the brilliant economist who is chairman of the Institute for Global Economic Growth. The answer Rahn gave in a recent column he wrote while in Berlin is José Piñera. We’ll come back to him in a moment.

It is significant that Rahn was writing from Berlin because it was in Berlin that, in 1881, Otto von Bismarck — the man who created the modern Germany — invented the social security system now in place in much of the world, including the United States. As Rahn so wryly points out, it is “basically a Ponzi [pyramid] scheme whereby young workers pay taxes to support the retirees. It only works over the long run where the population is growing and where most retirees do not live very long.” Clever fellow that he was, Baron von Bismarck had observed that most Germans lived in those days only to age 45, so the pensions he promised at age 65 would be collected by only a relative handful of people. So, the pension funds, all round the developed world (and in much of the underdeveloped world) grew and grew. Except that, in modern times, people are living longer and longer. (In the United States and other industrialized nations, life expectancy at birth has been moving up steadily in recent years, to the mid-seventies for men and high-seventies for women).

As Piñera put it recently, “Bismarck knew why he was doing it. He said he aimed to make the population ‘docile’ so they would serve the state more easily. Well, the politicians aren’t as smart as Bismarck. They’ve promised greater and greater benefits, and even lowered the age when you can get them. So, the pension systems are going broke. They’re all going broke. You can count on it.”

Back to Piñera, because he holds the most promising key to save older Americans from being stiffed by their government. He can fix Social Security; he did it in Chile. Chileans, hundreds of thousands of them, were enrolled in one of the continent's first social security systems (inaugurated during the first government of Arturo Alessandri Palma, in 1925 — 10 years before it was established in the United States). In 1975 Piñera, who had earned a master's degree and then a doctorate in economics at Harvard (alongside his brother Sebastian), was a 29-year-old teacher at his alma mater, the Catholic University of Chile. Chile was then in upheaval following the 1973 ouster of the Marxist-Leninist government of Salvador Allende, with Gen. Augusto Pinochet now at the helm of government. The young economist realized that the pension system was not only hopelessly topsy-turvy and corrupt — but broke, bankrupt-broke. He set out to do something about it.

Who was this young upstart? He began his economics studies at the Catholic University of Chile in Santiago in the mid-1960s. The university had then hired Arnold C. Harberger of the University of Chicago to help in creating a modern school of economics. Harberger took full advantage of his years there to recruit a group of his brightest students to study at Chicago, then the most well-known U.S. citadel of free-market economics. While Harberger's protégés were at Chicago, Milton Friedman, later Nobel laureate, was the superstar. The protégés became known as The Chicago Boys.

When the military government came to power, that group would become the brain trust for the most profound economic revolution in the history of Latin America, sweeping aside historic commitment to socialist and populist economics in favor of free-market ideas. Piñera, though he had done his graduate work at pro-socialist Harvard, fit right in (unlike his now-prominent brother Sebastian, forever infected with the Harvard disease).

In May of 1977, Piñera gave a talk at his alma mater on one of his favorite topics: why shouldn't Chile one day be a rich country, a developed country? Part of the answer was businessmen. They were pro-business, but not at all congenial to that new-fangled idea, the free market, or, for that matter, any notion of a private role in such social programs as education, pensions, and the like. In the audience was an admiral named Roberto Kelly, who had emerged as something of a swami for overhaul of the economy and was the principal recruiter of The Chicago Boys for the new government.

Sinking the Old System

He liked what Piñera had to say, and invited him to do the selfsame presentation before President Pinochet. Piñera did, and Pinochet liked what he had to say, and remembered it a year and a half later, when the country was plunged in a two-pronged crisis. When he summoned Piñera to his office on Friday, December 26, 1978, Chile was within hours of being invaded by Argentina in a territorial dispute that had boiled out of control. Years later, the man who had been president of Argentina at that time, Lt. Gen. Jorge Rafael Videla, told me that his forces actually were "within minutes" of striking when Argentina agreed to accept arbitration by Pope John Paul II.

Pinochet had managed to keep news of the imminent invasion from reaching the public, so as to avoid uncontrollable panic, and so Piñera learned of the crisis only when he went into that meeting. At that point, Pinochet did not yet know it had been averted, but he did know about the other crisis: a threatened boycott of Chilean products in ports all around the Americas, a boycott promoted by the far-leftist International Longshoremen's and Stevedores' Union and powered by the AFL-CIO. Under AFL-CIO prodding, the Interamerican Regional Labor Organization (ORIT), meeting in Lima, had voted to boycott, beginning on January 8, 1979. In large measure, the boycott was fall-out from the unrelenting, Moscow-masterminded propaganda barrage aimed at the anti-socialist Chilean regime from its very first day. But, in part, it also took advantage of the chaotic — and largely anti-union — character of

Chile's labor code.

Piñera, in that 45-minute meeting, was appointed minister of labor and ordered to defuse the boycott. He set about doing that — but he also set about, from day one, making a reality of his crusade against the dilapidated pension system. But first, to defuse the boycott time bomb. The day after his appointment with Pinochet, Piñera met with the new finance minister, Chicago Boy Sergio de Castro. Together, the two hammered out a five-point program to create a genuinely free trade-union movement. No sooner finished, they sought an emergency meeting with Pinochet. At the meeting, Pinochet — though skeptical of opening the door to what he saw as a return of the labor union tactics of yesteryear: strikes called to batter and pressure the government — initialed the memorandum.

Next, Piñera enlisted the help of J. Peter Grace, a personal friend of George Meany, the head of the AFL-CIO. Grace agreed to meet with Piñera shortly after his fortuitous arrival in Chile. The fact that both were Ivy Leaguers (Grace, Yale; Piñera, Harvard), and the fact that Piñera had worked as a trainee at the offices of Grace and Company during the time his father was Chilean Ambassador to the United Nations, and the fact that an uncle was a distinguished Roman Catholic Bishop in Chile (Grace was active in a number of Roman Catholic organizations) all helped. There is such a thing as the right man, at the right place, at the right time. Grace's right-hand man, Tony Navarro, said Grace took quickly to Piñera. He listened with interest — and more than a little amazement — to the five-point labor code Piñera and Sergio de Castro had crafted, and was particularly impressed that Piñera said the code would become law no later than June 30 of that year. Within a few days, Meany had agreed to delay the boycott a week, to January 15, and a few days after that, to June 30. The war was far from over, but the battle had been won.

On July 1, 1979, Piñera went on television to announce that the labor reform — pioneering in Latin America, creating unprecedented levels of freedom in labor legislation — was now a fact.

And so it was with this dynamic young man, who at age 30 had already, against staggering odds, created a revolutionary labor code as a cornerstone of a political system of genuine liberty that he and his colleagues of the military government were bent on creating and bequeathing to Chile. Now it was the turn of another formidable hurdle, bringing order out of the chaos of the country's collapsing pension "system."

As in the United States, he wasn't the first to notice the problem. Jorge Prat, arguably the outstanding political analyst in Chile at the middle of the 20th century, referred to the "system" as "this great swindle." And former socialist-adhering Chilean President Eduardo Frei Montalva (1964-1970) in 1968 called it "a monstrosity." But the politicians did nothing to fix it. There, as in the United States, politicians preferred to spend tomorrow's money to buy today's votes.

By 1968, the system was only 43 years old, but already had 2,000 laws and thousands of regulations; in just three years, 1966-1968, 1,300 new regulations were added.

Most, of course, were aimed at rewarding special interest groups — or individuals. In 1966, the pension programs, in all of their grotesque "glory," cost 600 million escudos (the monetary unit in those days). By the time Piñera appeared on the scene in 1978, the cost had ballooned to 1.3 billion escudos, or 18 percent of gross national product.

In Chile, there was no fixed age for retirement. Nor was there any correlation between how much one contributed and the amount of the pension — as, loosely, there is in the United States (for citizens, anyway).

Moreover, fraud flourished in the running of these funds. Shortly after Piñera took office, the leadership of the private employees pension fund paid him a courtesy call. During the meeting, one took him aside and, in a whisper, told him the fund had 20 luxury cabins in Reñaca — then the spiffiest of the beach resorts near Santiago. One was awaiting him and his family — fully furnished, fully equipped. That fund had 300,000 contributors — but only 20 cabins. Obviously, not for the unwashed.

Around that time, he learned about the perks of working for horse race tracks. Chile had eight tracks. Each had two pension funds — one for the jockeys, trainers, grooms, and stable boys, and a second for track employees. All could retire after 10 years of service, so there were any number of 30-year-old pensioners around the tracks. Furthermore, the jockeys and handlers were not hired by the owners of the horses, but by the pension funds. Inevitably, Chile came to have more handlers than anywhere else in the world.

Plotting a New Course

The first major reform was already in place as he arrived: setting ages as pre-conditions to retirement, 65 for men, 60 for women. But from the start, it was clear that the system was beyond salvaging; it had to be replaced with something new. However "replacement" had to await the plebiscite that would decide the fate of the Pinochet government, as well as a new constitution for the country. That plebiscite, on September 11, 1980 — the seventh anniversary of the arrival of the military government — finished with 65.71 percent in favor of the government remaining in power for another eight years. With that outcome, Pinochet became a constitutional president, and the military junta was thereafter headed by Admiral Jose Toribio Merino Castro — the man who actually detonated the September revolution in 1973 (and a man who served in combat with the U.S. Navy in World War II, as a gunnery officer aboard the light cruiser *Raleigh*, including against repeated kamikaze attacks off Okinawa).

Forever the man of action, Piñera asked for an appointment with Pinochet for the day after the plebiscite. During the meeting, the president agreed to send the reform legislation to the legislature. On November 4, 1980, it was approved, to go into effect on May 4, 1981. When Pinochet told Piñera of its approval, Piñera pushed for more. "What? You've got your bill," Pinochet said. "I think," Piñera replied, "that we should move up the effective date to May 1, because here and in much of the world, that date has belonged to the hard left, and I think we should now rescue it as the date when the workers of this country earned the right to dignity in their old age. One must not underestimate the value of symbols, President." Pinochet quickly agreed. (Coincidentally, on that very day, Ronald Reagan was elected President of the United States, defeating Jimmy Carter. Carter had been hostile to the military government throughout his administration. Of the advent of the Reagan administration, Piñera wrote, "At last, in Chile, we were going to feel less alone." The first years of Reagan were the only ones of frank cordiality with the United States.)

Back to pensions. Between that November 4 meeting and the May 1 launch of the pension program, Piñera delivered a series of TV talks for which he used his mother's egg-timer so as to limit each to three minutes. In those talks, he explained that the old system was, in fact, broke, but that the good news was that he was offering something better. As it turned out, it was far better.

Those workers who chose could enroll in the new system. The same 10 percent would be deducted from their salary, but instead of being paid into a general fund "pot," it would go into a private investment account that each worker would own, outright. The accounts would be administered by private companies — so as to keep government out of it. And each worker could choose when he wanted to retire, whether at age 50 or 80. Obviously, the longer he stays in — and pays in — the bigger his nest egg will be. If he dies, the proceeds of the account go to his survivors. Along the way, the worker is free to change from one fund to another, and if he gets queasy about the stock market, from stocks to bonds.

The Chilean system was the first in the world that made individual workers owners of their own pensions. No one had to sign on to this revolutionary program. Those who opted for the old plan were free to remain in it.

Piñera and his associates had estimated that perhaps as few as 25 percent of those eligible would join the new scheme, and anything over 51 percent would be a great success. Actually, 95 percent of eligible Chileans signed up for it. Those that did are thankful that they did. In these 29 years, those pension funds have averaged a compounded growth rate of 10 percent per year, above inflation and free of taxes. (Taxes are payable only when a person withdraws his funds.) The people in Chile's public plan are earning far less.

Furthermore, since the government no longer had to pay out more than a pittance to the five percent who remained in the system, the federal treasury was spared a calamity. If the old system had remained in place, estimates then were that by the year 2000, the deficit would have reached four billion dollars — an impossible amount for the Chilean economy to finance.

There was one other major boon to the economy: the monies flooding into the 20 companies administering the pension funds — AFPs, for the Spanish Pension Fund Administrators — pushed Chile's domestic savings rate up to 26 percent of gross national product, a key factor in the strong growth of Chile's economy under the military government and beyond. (Chile's gross domestic product was number one in Latin America for four years of the 10-year period 1990-2000, and never dropped below fifth place. During the past five years, with a Socialist government in power, Chile has been among the Latin economies with the lowest growth rates.) Still, the strong underpinning for the economy is there: the AFPs now have $120 billion in liquid assets, 80 percent of the country's current GDP.

Each of the AFPs offers their clients a choice of five types of funds, ranging from low-risk, low-yield (averaging between 3.03 and 4.31 percent in the five years since that system was installed) to high-risk, high-yield (16.01 to 17.88 percent). There are strict income limits on who can invest in those high-risk funds, but those who can invest often do invest: of the 472,000 account-holders who switched from one fund to another in 2005-2006, 49 percent of them moved into the high-risk fund. The AFPs charge average commissions of 0.7 percent, which is below the fee charged by most mutual funds in the United States.

Chile has been governed for the past 18 years by Socialist governments and their Christian Democrat lap dogs. Inevitably, they snipe at a program that gives private citizens such freedom. Socialists, after all, aspire to control people's lives to a maximum. Indeed, President Michelle Bachelet has proposed a partial return to the old government-run program as part of her overall welfare-state ideas.

All on Board?

In many respects, the funds resemble the Individual Retirement Accounts of the United States, except that in the United States those monies do not accrue to the economy. Were the United States to convert Social Security to fully funded pension plans, complete with individual savings accounts, increased national savings could boost U.S. business entities and equipment by 25 percent by 2020, dramatically increasing the economic growth rate. As a study by Mark Skousen has shown, "The massive flow of funds into the equity markets would substantially reduce the cost of capital and encourage investment."

That, in turn, would support rising real wages and offer a long-term solution to the sliding standard of living.

The Chilean model has been copied to varying degrees by 31 countries, providing coverage to close to one billion persons around the world, ranging from Mexico, Argentina, Bolivia, Colombia, and Peru to Denmark, Sweden (the original cradle of The Welfare State), Poland, Nigeria, Macedonia, Australia, and India. Russia is still on the fence but may adopt it, as are Italy and one or two others. The other 31 countries are doing well with it, but Socialists still bash this system because of the potential volatility of the stock market. They're correct that there is volatility, but in countries that haven't adopted the system — the United States, for instance — Social Security recipients actually face yearly losses of buying power when inflation is figured in. Piñera helps countries that wish to move to privatized Social Security and donates all of his services pro bono — he is a true humanitarian. In the United States, he has since 1995 served as co-chairman of the CATO Institute's Project on Social Security Privatization.

Both Bill Clinton and George W. Bush have had positive reactions to his message. Back in 1998, prior to his impeachment, President Clinton invited Piñera to be one of five panelists in his "Summit on Social Security." But whatever Clinton's enthusiasm for Social Security reform, it died with the Lewinsky affair. And Bush, while governor, told Piñera he thought of this as the most important challenge to the American economy in the 21st century. But when President Bush met with fierce — and well-organized — public and congressional resistance to Social Security reform, he used his political capital elsewhere.

Social Security is, and always has been, a sacred cow. But, sacred cows are scarcely any match for a fighter like José Piñera. And he just happens to believe that the private pension fight can be won — even in the United States — under a plan he has drawn up that pays for those who remain in the system even as the system is dismantled.

James R. Whelan lives and works in Chile, where he has served as visiting professor at the University of Chile and authored numerous books and articles, including a landmark history of Chile.