The Bull by the Horns: The battle for Chile's Social Security Reform

By José Piñera

In 1925, Chile became the first nation in the Western Hemisphere to follow the example of Bismarck's Prussia in creating a pay-as-you-go (paygo) social security system. Ten years later the U.S. Social Security Act was approved, based on the same concept. Paygo systems operate in contravention of the laws of human nature and human action. By destroying the link between contributions and benefits, between effort and reward, between rights and responsibilities, the paygo system carries the seeds of its own destruction

After a couple of decades of apparent success, a host of unintended but predictable consequences of the paygo system began to manifest themselves in my country. In addition to the well-known demographic problems that plague paygo systems, Chile's system also fell prey to the abuses of special interest legislation. The greatest abuses came from laws that allowed politically connected employee groups to obtain a premature retirement, often with full benefits.

In December 1978 when I was appointed Secretary of Labor and Social Security, I was a Professor at the Catholic University of Chile, having returned from the United States with a Ph.D. in economics from Harvard University only three years before. Since my days as a graduate student, which I mostly spent reading the works of Adam Smith, Thomas Jefferson, F.A. Hayek, Ludwig Mises, Milton Friedman, and other such heroes of liberty, I had the conviction that only fundamental economic reforms based on individual freedom would deliver my country from poverty and underdevelopment, and would create the conditions for a return to democratic rule.

So when I was offered a cabinet post, notwithstanding the very difficult historical circumstances , I could not morally refuse to serve my country and strive for a better world.

My ideas for social security reform were part of an overall vision of a free market and a free society in Chile. To make a clean break with the old social security system, we would have to begin by being honest: we would promise nothing that could not be delivered. In practice, the new system would be based on a defined individual contribution, rather than a defined benefit. After all, life itself is not a "defined-benefit" proposition, but rather an endeavor where your contributions to it mainly define its outcome.

On my speech to the country on May 1st, 1979 (Labor Day in

Chile), I announced that the new system would be constructed on three pillars, each cemented in the strong mortar of individual liberty: individual accounts, administration of the pension funds by private enterprise, and a safety net. Liberty and freedom of choice were the keystone of the whole plan.

Individual retirements accounts, where workers deposit what was formerly their payroll tax, constitutes the key innovation of this revolutionary reform. This is ultimately a paradigm shift regarding social security. It transformed a pay-as-you-go, unfunded, defined-benefit, national retirement system, into an individually capitalized, fully funded, defined-contribution one. By giving workers the choice of investing their former payroll tax in the market through these accounts (ensuring by minimal and market-friendly government regulation that the managememnts companies do it in a prudent portfolio of bonds and stocks), the whole working population can accumulate wealth, become shareholders-capitalists, control their own resources with all the dignity that that entails, have property rights over that money, exercise the freedom to tailor their retirement plans to their individual needs, and finally benefit from what Albert Einstein allegedly called the most powerful force in the universe: compound interest.

In a sense, our biggest challenge was philosophical: we had to dig the country out from under the weight of collectivist ideas, ideas that had been assimilated, admittedly, under the guise of good causes. In Chile, there had long been a widespread distrust of private enterprise. Further, there was the tenacious belief that social security could and should be an effective vehicle for the redistribution of wealth in society. In practice, of course, paygo social security was an undeniably regressive system, one which locked the poorest workers into the bottom tier of the pyramid scheme, while increasing privileges for the more politically powerful, wealthier workers higher up. The truly damned were the poorest laborers, who would work and contribute the longest, because they enter the labor force in their teens, and receive the least, because they have much shorter life expectancies.

Under the new system, individual actions like working and saving more would be good for the greater society, improving the use of existing human capital and the savings rate. And the right incentives inherent to the system would have wealth-creating, supply-side consequences like improving the productivity both of capital and labor.
Moreover, the system would foster a new ethos of personal responsibility and civil morality. An individual would begin to ask himself: Why make others do what is my responsibility? Why should I become a burden to the State or to future generations? Rather than fomenting a culture of dependency, why not improve my situation in life through work and savings, which will in turn help society?

Private administration. The old system manifested all of the worst

aspects of a monopolistic bureaucracy. It was opaque and difficult to understand for anyone who was not a lawyer or an expert. Service was anything but "user-friendly." The administrators did not see pensioners as customers. Instead, they were viewed-and treated-as annoying statistical problems, or even as liabilities (which, in an accounting sense, they were). Under the new system, however, the pension fund managers would be competitive, profit-oriented enterprises, eager to win new clients and keep the old ones happy. Although the system would be private, the government would still have a key role to play in setting prudent investment ceilings, prosecuting fraud, and regulating competitive business practices.

Safety net. Although the main engine of the reform would be the productivity and industry of the individual, the government would guarantee a basic minimum pension, allowing each worker to live out his old age with dignity. If an individual had not accumulated enough capital during his or her working life-as long as they had worked a minimum of 20 years-the government, using general revenues, would fill up the account to the point where the retiree could purchase a minimum annuity. (Independently of the social security system, there was already a welfare pension created for elderly people in conditions of extreme poverty, unrelated to the years worked.)

At the Ministry of Labor and Social Security, I was able to assemble an excellent team of young people to design the new system, remembering at every turn that "the devil is in the details." All of us knew how difficult our task was. For decades in Chile, social security reform was deemed a nearly impossible task, one of "taking a bull by the horns". Still, we were bound together by our faith in the power of ideas and the benefits of freedom. This faith was crucial: there is a time to study and to listen carefully to the opinions and concerns of various critics, but the moment arrives when one has to make difficult decisions and step boldly into the future.

By the time my team finished a first draft of the social security reform plan, it was already 1980. A new decade was already upon us. I announced the reform in countless meetings all over the country, fostering a real conversation on the issues involved, with the common man and not only with the élites.

Immediately, the antireform forces geared up to defend the status quo, and we were attacked on several fronts. The attackers fell into different groups: Vested interests, who would lose their privileges under the new system; leftist ideologues, the intellectual hand-maidens of big government; bureaucrats in the social security administration, who did not want to earn a living in the private sector; national union leaders, who exercised illegitimate political and economic power through the paygo system; and, most career politicians, fearful of economic liberalization and generally opposed to reductions in the size and power of the State. It was as if the anti-reform forces had

adopted the slogan jokingly coined by chilean anti-poet Nicanor Parra: "If Left and Right unite, we'll never lose the fight!"

On August 11, 1980, the government announced that it would hold a constitutional referendum. The new document would include a Bill of Rights and a clear transition to civilian rule. The main objective of the Constitution of 1980 was to restore representative democracy as a mechanism, under a regime of limited government, to ensure a free society in Chile.

I must admit that I feared the misuse of the results of the referendum. Many people-both inside the government and out--saw it basically as a referendum on the market liberal reforms of the past seven years. Even though those reforms were slowly becoming successful, as it is widely recognized today, those vested interests harmed by them were trying to use this referendum to derail the reform process before the benefits of the new policies were evident to all citizens. So, if the Constitution were rejected, market liberal economists would be held as scapegoats for the defeat. That would mean, without a doubt, the end of social security reform. The referendum was held on September 11, 1980. When the votes came in, the new Constitution had been approved by a majority of 65.71 percent.

After the referendum, the antireform forces resumed their efforts to defeat our plan. I resumed the weekly three-minute explanations of the reform, begun earlier that year, on one of the primetime TV news programs. Those TV appearances were crucial to building the popularity of the pension reform among the nation’s workers.

The "silver bullet" was the provision that gave every worker the right to choose whether to stay in the paygo system or opt freely to invest his payroll taxes in individual retirement accounts.

Soon it was October, only weeks away from the final meeting of the legislative body that had to approve or reject the reform. It seemed very likely that the pension reform would pass, since the idea was gaining supporters everywhere. Some special interest groups thought they could hash out some last-minute compromises.

One day early in the month, I was petitioned to attend a closed-door meeting with nearly 30 labor union directors. After a long round of cordial greetings, we got down to business. The spokesman explained that although they were ideologically opposed to the reform, they knew that it was likely to be passed. I offered to explain again the reform to them in full detail, so as to dispel their doubts and concerns. I even said that perfect reforms were not possible in this world, so there was also room for improvement without compromising the principles and the coherence of the plan, which was essential to its success. "Don’t try to do that," said the spokesman. "We have not come here for more explanations, nor for technical improvements. We have

come to suggest to you that our support would be very helpful to you in the future. After all, you are a young man of 30 with--maybe--a promising political career in front of you …. We are willing to give you our public support, Mr. Secretary, as long as you are willing to be reasonable and modify a single detail in the forthcoming reform."

I was astonished at such an indecent proposal. At that moment, I was reminded of Jefferson's extraordinary dictum, which had dug into my mind and soul from an early age: "Whenever a man casts a longing eye on public office, a rot begins in his conduct."

But out of curiosity I asked what that "detail" was. "Very simple," he answered. "Instead of giving workers the right to choose the manager of their individual accounts, it should be the exclusive decision of the directors of the unions to which workers belong." He continued: "The workers, Mr. Secretary, will not know how to make a decision of that nature. Most of them are probably not even interested in the matter. On the other hand, we are in a much better position to judge which institutions will be most beneficial to the workers. If we can come to an agreement about this, we will be very pleased to be of use to you in the future."

I must confess to having been surprised, not only by the brazen nature of the offer, but also by the Olympian contempt they showed toward the freedom and dignity of the workers. In formulating a response, I tried to soften my outrage. In the end, I opted for humor. "Friends," I said, "I would very much like to be able to count on the support of directors like you. But, unfortunately, I cannot accept the offer that you have come to tender. And I can't accept it … because I am concerned with saving your souls." "How is that, by God?" shouted several of them at the same time. "It's just as you heard it, gentlemen. As we all know, union leadership is politicized, but I have never believed that it might be corrupt. And I hope you will pardon me … but I will not open the door to dishonesty and corruption. I don't have the slightest doubt that if manager selection becomes a union leader decision-as opposed to one made by each worker-you directors would be inundated by so many pressures that it would not be easy to maintain your integrity. The pension managers, who would love to manage the retirement savings of large groups, will find it much cheaper to corrupt union officials than to compete for the accounts in the free market by offering better returns or lower commissions. I will not accept that, because it will lend itself to temptations which none of you would want to face." Nobody raised his voice after that. The meeting was quietly adjourned.

The next visit was that of the chairmen of all the powerful banks in Chile. They supported the concept of private individual retirement accounts, but they wanted the system to be managed only by the banks, and one of them even made an impassioned argument against allowing "foreign" financial institutions to manage the workers' retirement savings. As with the trade union

directors, I pondered their arguments but rejected their position completely. Competition was crucial to providing good service. And it was out of the question for me to restrict workers' choices to grant Chilean financial businessmen a monopoly in managing the system.

On November 4, 1980, the reform was finally approved. The last matter to be decided was the day of inauguration of the new retirement system. The plan gave the pension fund companies six months to start up, which would have set May 4 as the date. As I read the law just approved in that historic meeting, an idea suddenly hit me: To move the inauguration date up to May 1, the international Labor Day. It is a date that historically has had a special meaning for workers, and that regrettably in some countries is an occasion for protest fueled by the rhetoric of class warfare. But in Chile, in the future, I foresaw that day as being one of celebration of a reform that gave freedom and dignity to our nation's workers.

With this final modification approved, I rushed to my office to share the good news with the rest of the team. In the midst of all the cheering, a voice broke through the noise: "We did it! We took the bull by the horns! Viva Chile!"

I arrived home very late that evening. I was extremely happy but completely exhausted. To relax, I turned on the TV news. They were announcing the breaking news that Ronald Reagan had just been elected President of the United States.

(Excerpts of the book by José Piñera entitled "El Cascabel al Gato: La Batalla por la Reforma Previsional", 1991, only in spanish)