ECONOPOWER. HOW A NEW GENERATION OF ECONOMISTS IS TRANSFORMING THE WORLD

By Mark Skousen (John Wiley & Sons, 2008)

Chapter 5. How Chile Created a Worker-Capitalist Revolution

In the 1950s, under the guidance of Theodore Schultz and Arnold C. Harberger, the University of Chicago began a scholarship program for students from the Catholic University. of Chile. Dozens of Chilean economists sat at the feet of Milton Friedman, George Stigler, and other giants of the Chicago school to learn about the advantages of markets and democratic capitalism. Known as the "Chicago boys," they returned to Chile to implement a pro-market approach to Latin American issues.

Out of small things come great rewards. This small program has led to a worldwide worker-capitalist revolution that would astonish Karl Marx. Because of the incredible success of tiny Chile's privatized retirement program, today over 30 countries have followed Chile's lead and converted their own style of social pension systems into genuine pro-growth personal retirement accounts. Major developed nations, including the United States, are now debating whether to adopt the Chilean pension model.

The primary architect of this worldwide revolution, José Piñera, was a student at Catholic University of Chile in the late l960s. After graduating in 1970, Piñera did graduate work at Harvard University, where he received his M.A. and Ph.D. in economics. Piñera returned to Chile in 1975 as a professor at the Catholic University of Chile, and found himself in the midst of a political crisis. Chile had suffered a major economic disaster in the early l970s under the first democratically elected Marxist, Salvador Allende. Allende's socialist policies of nationalization, high wages, and price controls created shortages, black markets, and runaway inflation. After a series of public protests, the military, led by General Augusto Pinochet, staged a coup d'état in September 1973. Allende committed suicide. When the global inflationary recession exacerbated the problems in Chile, General Pinochet called in Piñera and the Chicago Boys to reorganize the economy. They urged drastic cuts in government spending, denationalization, tax reform, expanded trade, and

strict control of the money supply. Pinochet was favorably impressed by Piñera's economic reform plans that would, he promised, dramatically increase Chile's growth rate.

Piñera was appointed Minister of Labor and Social Security (1978-1980), and then Minister of Mining (1980-1981), in the Pinochet cabinet. He carried out four major reforms in Chile: the world's first privatized retirement system, a private health insurance program, the reestablishment of democratic trade unions, and a constitutional law establishing property rights in the mining industry. He also was a leading advocate for the new 1980 Constitution that established a bill of rights and a gradual transition path to a return to democracy.

Piñera is most famous for his radical reform of social security in Chile, a program that has been imitated around the world. Today Piñera is the president of the International Center for Pension Reform, and speaks and consults full-time around the world on this subject. He has personally met with most of the world's leaders to convince them to change their public pension programs.

How Does Chile's P rivate Pension System Work?

As Chile's labor secretary; Piñera recognized that the traditional pay-as-you-go retirement system was bankrupt. The Chicago Boys decided to go in a different direction, to link individual benefits to individual contributions (the accountability principle). Under the new scheme, funds invested by workers would go into individual accounts owned by the workers. Employees were required to contribute 10 percent of their wages, but could invest up to 20 percent voluntarily. As in other countries, contributions are tax deductible, and returns earned in the private accounts are untaxed until withdrawal at retirement. When workers reach retirement age, determined by the worker, as there is no set age for retirement in Chile, workers can transfer the value of their account into an annuity through an approved insurance company that pays them a fixed amount of income for the rest of their lives, Thus, the retiree who lives a long life does not have to worry about running out of money, but he has the advantage of directing his investments during his saving years.

Employees can manage their own retirement accounts by choosing among 20 mutual funds, which are managed by private investment companies known as AFPs (from the Spanish for pension fund administrators). They can choose among stocks, bonds, government debt, and most recently foreign stocks. They are free to change from one

AFP to another. AFPs are highly regulated, and none have gone bankrupt. Workers are required to be well diversified and cannot have too heavy a position in one fund. "Our plan was to be radical (even revolutionary) in approach but conservative and prudent in execution" Piñera states. "We trust the private sector, but we are not naive. We knew that there were companies that might invest in derivatives and lose a lot of money. We didn't want the pension funds investing workers' money in derivatives in Singapore?'[1]

How did the Chicago Boys come up with the idea of a competitive privately run pension system? Surprisingly, it was not Milton Friedman's idea. In his 1962 book, *Capitalism and Freedom,* he argued against Social Security on economic and ethical grounds, but did not offer an alternative[2]. According to Chicago professor Arnold Harberger, the idea of privatization originated from the teacher's annuity plans, known as TIAA-CREF, or Teachers Insurance and Annuities Association/ College Retirement Equities Funds, at the University of Chicago, where the faculty was offered a choice of stock and bond funds. Chilean graduates and professors saw how well the teachers' annuities worked, and Piñera adopted the idea.[3]

There was a transition period to the new system. The Chilean government offered a .minimum guarantee on every retired worker's pension. Workers already in the workforce who had contributed to the state system for many years were given the option of staying in the system. Those who moved to the new system received a recognition bond, which acknowledged their contributions to the old system. When those workers retired, the government cashed their bonds.

The privatized social security plan opened on May 1, 1981, which was Labor Day in Chile and most of the world. It was supposed to open May 4, but Piñera made a last-minute change to May 1. "When my colleagues asked why" he said, "I explained that May 1 had always been celebrated all over the world as a day of class confrontation, when workers fight employers as if their interests were completely divergent. But in a free-market economy, their interests are convergent. I told my colleagues, 'Let's begin this system on May 1, so that in the future, Labor Day can be celebrated as a day when workers freed themselves from the state and moved to a privately managed capitalization system.'"[4]

The Benefits of Following the Chilean Model

Chile was the first country in the world to privatize Social Security. The results have been astounding. Today 93 percent of the labor force is enrolled. in 20 separate private pension funds. Annual real returns on pension investments averaged over 10 percent since 1981 (compare that to the average 1 percent in the U.S. Social Security system). Just as importantly, Chile's private pension plan deepened the nation's capital market and stimulated economic growth. Its domestic savings rate has climbed to 26 percent of gross domestic product, and the economic growth rate averaged over 5 percent annually from 1984 on. Today the total funds in Chile's private pension system exceed $120 billion, 80 percent of Chile's GDP.

In short, Chile provides a role model for successful privatization of the US. Social Security system. According to Piñera, converting the pay-as-you-go system into a genuine savings program would dramatically increase capital formation and economic growth in the United States even though it would admittedly involve serious transition problems much greater than those experienced in tiny Chile. Some economists still oppose privatizing Social Security, but most are willing to experiment with a small percentage of the FICA tax to see what happens. For example, President George W Bush proposed that two percentage points be assigned to personal investment accounts, but so far the bill has not been adopted.

A wide variety of media have endorsed the Chilean model, including *Time* magazine and *BusinessWeek*. According to *BusinessWeek* (cover story, "Economic Growth: A Proposal," July 6, 1996) converting Social Security into a fully funded pension plan, complete with individual savings accounts, could boost national savings and increase. U.S. plant and equipment by 25 percent by 2020, and would dramatically increase the economic growth rate. The massive flow of funds into the equity markets would substantially reduce the cost of capital and encourage investment. The late MIT professor Rudi Dornbusch, no friend of supply-side economics, endorsed privatizing Social Security and education as two key sources of growth. According to Dornbusch, the resulting capital formation would support rising real wages and therefore offer a long-term answer to the eroding standard of living.[5]

José Piñera thinks that the biggest boost to Social Security reform will come if China adopts private accounts. "Then the United States will have to act; otherwise, they will be left behind in rather dramatic fashion."

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[1] José Piñera, "The Success of Chile's Privatized Social Security," *Cato Policy Report,* http://www.cato.org/pubs/policy_report/pr-ja-jp.html

[2] Milton Friedman, *Capitalism and Freedom* (University of Chicago Press, 1962), 182—89. Friedman later endorsed the Chilean model and favored privatization of Social Security in the United States.

[3] Private interview with Arnold C. Harberger at the Mont Pelerin Society meetings in Salt Lake City, August 18,2004. TIAA-CREF isn't the only pension system in the United States that offers individualized pension accounts. The federal government's Thrift Savings Plan (TSA) offers federal employees a variety of fund choices in their personal retirement accounts.

[4] José Piñera, "The Success of Chile's Privatized Social Security," *Cato Policy Report,* http://www.cato.org/pubs/policy_report/pr-ja-jp.html.

[5] Rudi Dornbusch, "Dole Blew a Chance to Be Bold," *BusinessWeek,* September 2, 1996.