Empowering Workers: The Privatization Of Social Security in Chile

by
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A specter is haunting the world. It is the specter of bankrupt state-run pension systems. The pay-as-you-go pension system that has reigned supreme through most of this century has a fundamental flaw, one rooted in a false conception of how human beings behave: it destroys, at the individual level, the essential link between effort and reward—in other words, between personal responsibilities and personal rights. Whenever that happens on a massive scale and for a long period of time, the result is disaster.

Two exogenous factors aggravate the results of that flaw: (1) the global demographic trend toward decreasing fertility rates; and, (2) medical advances that are lengthening life. As a result, fewer and fewer workers are supporting more and more retirees. Since the raising of both the retirement age and payroll taxes has an upper limit, sooner or later the system has to reduce the promised benefits, a telltale sign of a bankrupt system.

Whether this reduction of benefits is done through inflation, as in most developing countries, or through legislation, the final result for the retired worker is the same: anguish in old age created, paradoxically, by the inherent insecurity of the "social security" system.

In 1980, the government of Chile decided to take the bull by the horns. A government-run pension system was replaced with a revolutionary innovation: a privately administered, national system of Pension Savings Accounts.

After 15 years of operation, the results speak for themselves. Pensions in the new private system already are 50 to 100 percent higher—depending on whether they are old-age, disability, or survivor pensions—than they were in the pay-as-you-go system. The resources admin-

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istered by the private pension funds amount to \$25 billion, or around 40 percent of GNP as of 1995. By improving the functioning of both the capital and the labor markets, pension privatization has been one of the key reforms that has

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pushed the growth rate of the economy upward from the historical 3 percent a year to 6.5 percent on average during the last 12 years. It is also a fact that the Chilean savings rate has increased to 27 percent of GNP and the unemployment rate has decreased to 5.0 percent since the reform was undertaken.

More important still, pensions have ceased to be a government issue, thus depoliticizing a huge sector of the economy and giving individuals more control over their own lives. The structural flaw has been eliminated and the future of pensions depends on individual behavior and market developments.

The success of the Chilean private pension system has led three other South American countries to follow suit. In recent years, Argentina (1994), Peru (1993), and Colombia (1994) undertook a similar reform. In the four South American countries, around 11 million workers have personal retirement accounts.

The Chilean experience can be instructive to countries around the world. Even the United States is beginning to seriously debate privatizing its 60-year-old pension scheme. It should be noted that the U.S. Social Security system is the largest single government program in the world, spending more than \$350 billion per year (more than the U.S. defense budget during the Cold War).

As an indication of the power of ideas, even officials from the People's Republic of China have come to Chile to study the private pension system. One of the results is this particularly interesting feud reported recently by *The Economist*:

> There is usually more acrimony than comedy in the long-running row between Britain and China over the future of Hong Kong. Yet a smile may have flickered across the face of Chris Patten, Hong Kong's governor, even as China scuppered his plans to introduce a (pay-as-you-go) pension scheme in the colony. Zhou Nan, Communist China's main representative in Hong Kong, harrumphed that Mr. Patten, a British conservative, was trying to bring 'costly Euro-socialist' ideas to Hong Kong [February 11, 1995].

It is possible that before entering the new millennium, several other countries, including all those in the Americas, will have privatized their pension systems. This would mean a massive redistribution of power from the state to individuals, thus enhancing personal freedom, promoting faster economic growth, and alleviating poverty, especially in old age.

The Chilean PSA System

Under Chile's Pension Savings Account (PSA) system, what determines a worker's pension level is the amount of money he accumulates during his working years. Neither the worker nor the employer pays a social security tax to the state. Nor does the worker collect a government-funded pension. Instead, during his working life, he automatically has 10 percent of his wages deposited by his employer each month in his own, individual PSA. This percentage applies only to the first $22,000 of annual income. Therefore, as wages go up with economic growth, the "mandatory savings" content of the pension system goes down.

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A worker may contribute an additional 10 percent of his wages each month, which is also deductible from taxable income, as a form of voluntary savings. Generally a worker will contribute more than 10 percent of his salary if he wants to retire early or obtain a higher pension.

A worker chooses one of the private Pension Fund Administration companies ("Administradoras de Fondos de Pensiones," AFPs) to manage his PSA. These companies can engage in no other activities and are subject to government regulation intended to guarantee a diversified and low-risk portfolio and to prevent theft or fraud. A separate government entity, a highly technical "AFP Superintendency," provides oversight. Of course, there is free entry to the AFP industry.

Each AFP operates the equivalent of a mutual fund that invests in stocks and bonds. Investment decisions are made by the AFP. Government regulation sets only maximum percentage limits both for specific types of instruments and for the overall mix of the portfolio; and the spirit of the reform is that those regulations should be reduced constantly with the passage of time and as the AFP companies gain experience. There is no obligation whatsoever to invest in government or any other type of bonds. Legally, the AFP company and the mutual fund that it administers are two separate entities. Thus, should an AFP go under, the assets of the mutual fund—that is, the workers' investments—are not affected.

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Workers are free to change from one AFP company to another. For this reason there is competition among the companies to provide a higher return on investment, better customer service, or a lower commission. Each worker is given a PSA passbook and every three months receives a regular statement informing him how much money has been accumulated in his retirement account and how well his investment fund has performed. The account bears the worker's name, is his property, and will be used to pay his old age pension (with a provision for survivors' benefits).

As should be expected, individual preferences about old age differ as much as any other preferences. Some people want to work forever; others cannot wait to cease working and to indulge in their true vocations or hobbies, like writing or fishing. The old, pay-as-you-go system did not permit the satisfaction of such preferences, except through collective pressure to have, for example, an early retirement age for powerful political constituencies. It was a one-size-fits-all scheme that exacted a price in human happiness.

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The PSA system, on the other hand, allows for individual preferences to be translated into individual decisions that will produce the desired outcome. In the branch offices of many AFPs there are user-friendly computer terminals that permit the worker to calculate the expected value of his future pension, based on the money in his account, and the year in which he wishes to retire. Alternatively, the worker can specify the pension amount he hopes to receive and ask the computer how much he must deposit each month if he wants to retire at a given age. Once he gets the answer, he simply asks his employer to withdraw that new percentage from his salary. Of course, he can adjust that figure as time goes on, depending on the actual yield of his pension fund. The bottom line is that a worker can determine his desired pension and retirement age in the same way one can order a tailor-made suit.

As noted above, worker contributions are deductible for income tax purposes. The return on the PSA is tax free. Upon retirement, when funds are withdrawn, taxes are paid according to the income tax bracket at that moment.

The Chilean PSA system includes both private and public sector employees. The only ones excluded are members of the police and armed forces, whose pension systems, as in other coun-

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tries, are built into their pay and working conditions system. (In my opinion—but not theirs yet—they would also be better off with a PSA). All other employed workers must have a PSA. Self-employed workers may enter the system, if they wish, thus creating an incentive for informal workers to join the formal economy.

A worker who has contributed for at least 20 years but whose pension fund, upon reaching retirement age, is below the legally defined "minimum pension" receives that pension from the state once his PSA has been depleted. What should be stressed here is that no one is defined as "poor" a priori. Only a posteriori, after his working life has ended and his PSA has been depleted, does a poor pensioner receive a government subsidy. (Those without 20 years of contributions can apply for a welfare-type pension at a much lower level).

The PSA system also includes insurance against premature death and disability. Each AFP provides this service to its clients by taking out group life and disability coverage from private life insurance companies. This coverage is paid for by an additional worker contribution of around 2.9 percent of salary, which includes the commission to the AFP.

The mandatory minimum savings level of 10 percent was calculated on the assumption of a 4 percent average net yield during the whole working life, so that the typical worker would have sufficient money in his PSA to fund a pension equal to 70 percent of his final salary.

The so-called legal retirement age is 65 for men and 60 for women. Those retirement ages—the traditional ages in the pay-as-you-go system—were not discussed in the privatization reform because they are not a structural characteristic of the new system. But the meaning of "retirement" in the PSA system is different than in the traditional one. First, workers can continue working after retirement. If they do, they receive the pension their accumulated capital makes possible and they are not required to contribute any longer to a pension plan. Second, workers with sufficient savings in their accounts to fund a "reasonable pension" (50 percent of the average salary of the previous 10 years, as long as it is higher than the "minimum pension") may choose to take early retirement whenever they want.

Thus the 65-60 threshold is not a rigid fixture of the system. Rather, a worker must continue making a 10 percent contribution to his PSA until he reaches that age, unless he has chosen early retirement—that is, to retire his money, as a monthly pension, which is not the same as retirement from the workforce. In addition, however, a worker must reach those threshold ages to be eligible for the government subsidy that guarantees a minimum pension.

But in no way is there an obligation to cease working, at any age, nor is there an obligation to continue working or saving for pension purposes once you have assured yourself a "reasonable pension" as described above.

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Upon retiring, a worker may choose from two general payout options. In one case, a retiree may use the capital in his PSA to purchase an annuity from any private life insurance company. The annuity guarantees a constant monthly income for life, indexed to inflation (there are indexed bonds available in the Chilean capital market so that companies can invest accordingly), plus survivors' benefits for the worker's dependents. Alternatively, a retiree may leave his funds in the PSA and make programmed withdrawals, subject to limits based on the life expectancy of the retiree and his dependents. In the latter case, if he dies, the remaining funds in his account form a part of his estate. In both cases, he can withdraw as a lump-sum the capital in excess of that needed to obtain an annuity or programmed withdrawal equal to 70 percent of his last wages.

The PSA system solves the typical problem of pay-as-you-go systems with respect to labor demographics: in an aging population the number of workers per retiree decreases. Under the PSA system, the working population does not pay for the retired population. Thus, in contrast with the pay-as-you-go system, the potential for intergenerational conflict and eventual bankruptcy is avoided. The problem that many countries face—unfunded pension liabilities—does not exist under the PSA system.

In contrast to company-based private pension systems that generally impose costs on workers who leave before a given number of years and that sometimes result in bankruptcy of the workers' pension funds—thus depriving workers of both their jobs and their pension rights—the PSA system is completely independent of the company employing the worker. Since the PSA is tied to the worker, not the company, the account is fully portable. Given that the pension funds must be invested in tradeable securities, the PSA has a daily value and therefore is easy to transfer from one AFP to another.

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The problem of "job lock" is entirely avoided. By not impinging on labor mobility, both inside a country and internationally, the PSA system helps create labor market flexibility and neither subsidizes nor penalizes immigrants.

A PSA system is also much more efficient in promoting a flexible labor market. In fact, people are increasingly deciding to work only a few hours a day or to interrupt their working lives—

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especially women and young people. In pay-as-you-go systems, those flexible working styles create the problem of filling the gaps in contributions. Not so in a PSA scheme where stop-and-go contributions are no problem whatsoever.

The Transition

One challenge is to define the permanent PSA system. Another, in countries that already have a pay-as-you-go system, is to manage the transition to a PSA system. The transition has to take into account the particular characteristics of each country, of course, especially constraints posed by the budget situation.

In Chile we set three basic rules for the transition:

1. The government guaranteed those already receiving a pension that their pensions would be unaffected by the reform. This rule was important because the social security authority would obviously cease to receive the contributions from the workers who moved to the new system. Therefore the authority would be unable to continue paying pensioners with its own resources. Moreover, it would be unfair to the elderly to change their benefits or expectations at this point in their lives.

2. Every worker already contributing to the pay-as-you-go system was given the choice of staying in that system or moving

to the new PSA system. Those who left the old system were given a "recognition bond" that was deposited in their new PSAs. (The bond was indexed and carried a 4 percent real interest rate). The government pays the bond only when the worker reaches the legal retirement age. The bonds are traded in secondary markets, so as to allow them to be used for early retirement. This bond reflected the rights the worker had already acquired in the pay-as-you-go system. Thus, a worker who had made pension contributions for years did not have to start at zero when he entered the new system.

3. All new entrants to the labor force were required to enter the PSA system. The door was closed to the pay-as-you-go system because it was unsustainable. This requirement assured the complete end of the old system once the last worker who remained in it reaches retirement age (from then on, and during a limited period of time, the government has only to pay pensions to retirees of the old system). This rule is important because the most effective way to reduce the size of the government in our lives is to end programs completely, not simply scale them back so that a new government might revive them at a later date.

After several months of national debate on the proposed reforms, and a communication and

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education effort to explain the reform to the people,[1] the pension reform law was approved on November 4, 1980.

To give equal access to creating AFPs to all those who might be interested, the law established a six-month period during which no AFP

[1]See Piñera (1991) and (1995).

could begin operations (not even advertising). Thus, the AFP industry is unique in that it had a clear day of conception (November 4, 1980) and a clear date of birth (May 1, 1981).

In Chile, as in most countries (but not the United States), May 1 is Labor Day. The choice of that date was not a coincidence. Symbols are important, and that date of birth allows workers to

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celebrate May 1 not as a day of class struggle but as the day when they were freed to choose their own pension system and thus freed from “the chains” of the state-run social security system.

Together with the creation of the new AFP system, all gross wages were redefined to include most of the employer’s contribution to the old pension system. (The rest of the employer’s contribution was turned into a transitory tax on the use of labor to help the financing of the transition; once that tax was completely phased out, as established in the pension reform law, the cost to the employer of hiring workers decreased). The worker’s contribution was deducted from the increased gross wage. Because the total contribution was lower in the new system than in the old, net salaries for those who moved to the new system increased by around 5 percent.

In that way, we ended the illusion that both the employer and the worker contribute to social security, a device that allows political manipulation of those rates. From an economic standpoint, workers bear nearly the full burden of the payroll tax because the aggregate supply of labor is highly inelastic. Also, all the contributions are ultimately paid from the worker’s marginal productivity, and employers must take into account all labor costs—whether termed salary or social security contributions—in making their hiring and pay decisions. By renaming the employer’s contribution, the system makes it evident that all contributions are made by the worker. In this scenario, of course, the final wage level is determined by the interplay of market forces.

The financing of the transition is a complex technical issue and each country must address this problem according to its own circumstances. The implicit pay-as-you-go debt of the Chilean

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system in 1980 has been estimated at around 80 percent of GDP.[2] (The value of that debt had been reduced by a reform of the old system in 1978, especially by the rationalization of indexing, the elimination of special regimes, and the raising of the retirement age).

A recent World Bank study (1994: 268) stated that "Chile shows that a country with a reasonably competitive banking system, a well-functioning debt market, and a fair degree of macroeconomic stability can finance large transition deficits without large interest rate repercussions."

Chile used five methods to finance the short-run fiscal costs of changing to a PSA system:

> 1. In the state's balance sheet (in which each government should show its assets and liabilities), state pension obligations were offset to some extent by the value of state-owned enterprises and other types of assets. Therefore privatization was not only one way to finance the transition but had several additional benefits such as increasing efficiency, spreading ownership, and depoliticizing the economy.
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> 2. Since the contribution needed in a capitalization system to finance adequate pension levels is generally lower than the current payroll taxes, a fraction of the difference between them can be used as a temporary transition tax without reducing net wages or increasing the cost of labor to the employer.

[2]See World Bank (1994).

3. Using debt, the transition cost can be shared by future generations. In Chile roughly 40 percent of the cost has been financed issuing government bonds at market rates of interest. These bonds have been bought mainly by the AFPs as part of their investment portfolios and that "bridge debt" should be completely redeemed when the pensioners of the old system are no longer with us.

4. The need to finance the transition was a powerful incentive to reduce wasteful government spending. For years, the budget director has been able to use this argument to kill unjustified new spending or to reduce wasteful government programs.

5. The increased economic growth that the PSA system promoted substantially increased tax revenues, especially those from the value-added tax. Only 15 years after the pension reform, Chile is running fiscal budget surpluses.

The Results

The PSAs have already accumulated an investment fund of $25 billion, an unusually large pool of internally generated capital for a developing country of 14 million people and a GDP of $60 billion.

This long-term investment capital has not only helped fund economic growth but has spurred the development of efficient financial

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markets and institutions. The decision to create the PSA system first, and then privatize the large state-owned companies second, resulted in a "virtuous sequence." It gave workers the possibility of benefiting handsomely from the enormous increase in productivity of the privatized companies by allowing workers, through higher

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stock prices that increased the yield of their PSAs, to capture a large share of the wealth created by the privatization process.

There are around 15 AFP companies and they are a diverse group. Some belong to insurance or banking conglomerates. Others are worker-owned or tied to labor unions or specific industry or trade associations. Some include the participation of international financial companies, such as AIG, Aetna, and Banco de Santander. Several of the larger AFP companies are themselves publicly traded on the Chilean stock exchange, and one of them recently issued American Depository Receipts on Wall Street (helped by the recent "A–" credit rating of Chilean sovereign bonds).

One of the key results of the new system has been to increase the productivity of capital and thus the rate of economic growth in the Chilean economy. The PSA system has made the capital market more efficient and influenced its growth over the last 15 years. The vast resources administered by the AFPs have encouraged the creation of new kinds of financial instruments while enhancing others already in existence but not fully developed. Another of Chile's pension reform contributions to the sound operation and transparency of the capital market has been the creation of a domestic risk-rating industry and the improvement of corporate governance. (The AFPs appoint outside directors in the companies in which they own shares, thus shattering complacency at board meetings).

Since the system began to operate on May 1, 1981, the average real return on investment has been 13 percent per year (more than three times higher than the anticipated yield of 4 percent). Of course, the annual yield has shown the oscillations that are intrinsic to the free market—ranging from minus 3 percent to plus 30 percent in real terms—but the important yield is the average one over the long term.

Pensions under the new system have been significantly higher than under the old, state-administered system, which required a total payroll tax of around 25 percent. According to a recent study by Sergio Baeza (1995), the average AFP retiree is receiving a pension equal to 78 percent of his mean annual income over the previous 10 years of his working life. As mentioned, upon retirement workers may withdraw in a lump sum their "excess savings" (above the 70 percent of salary threshold). If that money were included in calculating the value of the pension, the total value would come close to 84 percent of working income. Recipients of disability pensions also receive, on average, 70 percent of their working income.

The new pension system, therefore, has made a significant contribution to the reduction of poverty by increasing the size and certainty of old-age, survivors, and disability pensions, and by the indirect but very powerful effect of promoting economic growth and employment.

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The new system also has eliminated the unfairness of the old system. According to conventional wisdom, pay-as-you-go pension schemes redistribute income from the rich to the poor. However, recent studies have shown that once certain income-specific characteristics of workers and of the operation of the political system are taken into account, public schemes generally redistribute income to the rich—and especially to the most powerful groups of workers.[3]

[3]See Baeza (1995) and World Bank (1994).

Conclusion

It is not surprising that the PSA system in Chile has proven so popular and has helped promote social and economic stability. Workers appreciate the fairness of the system and they have obtained through their pension accounts a direct and visible stake in the economy. Since the private pension funds own a sizable fraction of the stocks of the biggest companies of Chile, workers are actually investors in the country's fortunes.

When the PSA was inaugurated in Chile in 1981, workers were given the choice of entering the new system or remaining in the old one. Half a million Chilean workers (one fourth of the eligible workforce) chose the new system by joining in the first month of operation alone—far more than the 50,000 that had been expected. Today, more than 90 percent of Chilean workers who had been under the old system are in the new system. By 1995, 5 million Chileans had PSA accounts, although not all belonged to active, full-time workers, and therefore not all contribute in any given month.

The bottom line is that when given a choice, workers vote with their money overwhelmingly for the free market—even when it comes to such "sacred cows" as social security.

As the state pension system disappears, politicians will no longer decide whether pension checks need to be increased and in what amount or for which groups. Thus, pensions are no longer a key source of political conflict and election-time demagoguery, as they once were. A person's retirement income will depend on his own work and on the success of the economy, not on the government or on the pressures brought by special interest groups.

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For Chileans, Pension Savings Accounts now represent real and visible property rights—they are the primary sources of security for retirement. After 15 years of operation of the new system, in fact, the typical Chilean worker's main asset is not his used car or even his small house (probably still mortgaged), but the capital in his PSA.

Finally, the private pension system has had a very important political and cultural consequence. The overwhelming majority of Chilean workers who chose to move into the new system moved into it faster than Germans going from East to West after the fall of the Berlin Wall.

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Those workers freely decided to abandon the state system even though some of the national trade-union leaders and the old political class advised against it. Workers care deeply about matters close to their lives, such as pensions, education, and health, and make their decisions thinking about their families and not according to political fashions.

Indeed, the new pension system gives Chileans a personal stake in the economy. A typical Chilean worker is not indifferent to the behavior of the stock market or interest rates. Intuitively he knows that a bad minister of finance can reduce the value of his pension rights. When workers feel that they own a part of the country, not through party bosses or a Politburo, they are much more attached to the free market and a free society.

This is a brief story of a dream that has come true. The ultimate lesson is that the only revolutions that are successful are those that trust the individual and the wonders that individuals can do when they are free.

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