Liberating Workers: The World Pension Revolution

by
José Piñera

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The world would be a better place if every worker were also an owner of capital. Workers would benefit from the appreciation of assets in the long term and feel more connected to the overall performance of the economy. The interests of the workers would be more in line with the interests of those who manage and control those assets, there would be less inequality of wealth, and workers would place a higher value on strong property rights and the rule of law. Above all, workers would find a new dimension of freedom and dignity in their lives.

The world would be a better place if every worker were also an owner of capital.

Karl Marx was right when he asserted that if workers could only sell their labor in the market, many of them would feel alienated from society. But he was terribly wrong in believing that collective ownership of property would give workers a sense of security and control over their lives. Liberating workers requires giving them access to individual ownership of capital in the context of a free market economy.

The worldwide pension crisis has created a great opportunity to empower workers without resorting to expropriations or violent revolutions. In most countries, workers are already compelled to contribute between 10 and 30 percent of their wages to pay-as-you-go retirement systems. The transformation of those unfunded systems into systems in which wealth is accumulated in individual accounts can bring about a new paradigm, a world of worker-capitalists.

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This was our guiding vision when we fully privatized the Chilean pension system 20 years ago. In a companion piece—"Empowering Workers: The Privatization of Social Security in Chile" (Cato's Letter no. 10, 1996)—I explained the essence of that reform. Chile's pension reform fully replaced the state-run pay-as-you-go system with one of retirement savings accounts that are owned individually and managed by the private sector.

It is important to note that pension privatization in Chile was introduced as part of a coherent set of radical free-market reforms, with the understanding that implementing such changes simultaneously was the best way to increase economic growth and get the most out of each reform. As a result, the growth rate of the Chilean economy doubled from its historical level to around 7 percent a year for more than a decade.[1] The average real rates of return on retirement accounts has averaged more than 10 percent since their inception in 1981, and pension assets under management have grown to be around 50 percent of GDP.

Liberating workers requires giving them access to individual ownership of capital in the context of a free market economy.

However, the impact of pension reform in Chile has gone beyond impressive economic indicators. Pension privatization led to a radical redistribution of power from the state to civil society and, by converting workers into individ-

[1] According to economist Klaus Schmidt-Hebbel, the rate of growth of the Chilean economy went from an average of 3.7 percent per year, in the period from 1961 through 1974, to 7.1 percent per year in the period from 1990 through 1997, and of that extra growth of 3.4 percentage points per year, the pension reform would have contributed .9 percentage points per year, that is, more than a quarter of the total. Of the total increase of 12.2 percentage points in the rate of savings during those two periods, the pension reform contributed 3.8 percentage points, that is, 31 percent of the total increase. See Klaus Schmidt-Hebbel, "Does Pension Reform Really Spur Productivity, Saving and Growth?" Documentos de Trabajo del Banco Central (Chile) no. 33, April 1998, pp. 25, 29.

ual owners of the country's capital, has created a political and cultural atmosphere more consistent with free markets and a free society.

The Chilean pension model is a comprehensive alternative to the social collectivism initiated by German chancellor Otto von Bismarck at the end of the 19th century, which was the model for the welfare states of the 20th century. By cutting the link between individual contributions and benefits—that is, between effort and reward—and by entrusting governments not only with the responsibility but also with the management of these complex programs, the Bismarckian pay-as-you-go pension system turned out to be the central pillar of the welfare state, in which the possibility of winning elections by buying votes with other people's money—even with the money of other generations—led to an inflation of social entitlements, and thus to gigantic unfunded, and hidden, state liabilities. In Chile the same rationale that applies to the private pension system has already been extended, although imperfectly, to the areas of health and unemployment, with individual insurance (health) or accounts (unemployment) managed by the private sector.

Pension privatization in Chile was introduced as part of a coherent set of radical free-market reforms.

In the 1990s seven other Latin American countries followed the path opened by Chile, and today some 40 million Latin American workers own financial wealth in their retirement savings accounts. The late 1990s saw another landmark when Hungary, Poland, and Kazakhstan joined the reforming club, and now around 15 million workers have individual retirement accounts in those former communist countries.

In January 2001, Sweden, once a model welfare state, allowed its workers to put 2.5 percentage points worth of their 18.5 percentage payroll tax contribution into an individual account. The new program, known as the

Premium Pension System, passed the Swedish parliament with 85 percent approval.

A DOMINO EFFECT IN LATIN AMERICA

In the seven countries of the region that have implemented pension systems based on private retirement savings accounts, the structure of the private pension system closely follows the Chilean scheme, and in all cases the private funds are surviving the difficult initial years and beginning to make a relevant contribution to the establishment of a free-market economy. Of course, the characteristics of the transition process have differed across countries because of the diverse economic, social, and political starting points of the reforms.[2]

Mexico, Bolivia, and El Salvador have adopted two crucial features of the Chilean reform: (1) workers eligible for the private retirement savings account system do not contribute to the pay-as-you-go public pension system, and (2) new entrants to the labor force join the private pension system. Together, those features ensure that, after the transition is finished, the public pension system is extinguished, leaving only the private system for the vast majority of workers in the country (full privatization). Peru has adopted

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[2] For a review of these countries' pension reforms, see Luis Larrain, "Privatizing Social Security in Latin America," Policy Report no. 221, National Center for Policy Analysis, Dallas, January 1999. For reviews of reforms in individual countries, see Ian Vásquez, "Two Cheers for Mexico's Pension Reform," *Wall Street Journal*, June 27, 1997; L. Jacobo Rodríguez, "In Praise and Criticism of Mexico's Pension Reform," Cato Institute Policy Analysis no. 340, April 14, 1999; Herman von Gersdorff, "The Bolivian Pension Reform: Innovative Solutions to Common Problems," World Bank, Financial Sector Development Department, Washington, July 1997; and Juan Manuel Santos, "Testimonio: La Reforma de las 'Pensiones en Colombia,'" www.pensionreform.org.

(1) but not (2). In Colombia, Argentina, and Uruguay workers are in both state pension and private pension systems (partial privatization).

Mexico—despite a long tradition of state paternalism—undertook in 1997 a major reform by completely eliminating the public pension system for private-sector workers and replacing it with a system of private retirement savings accounts managed by competing companies. All private-sector workers who were previously participating in the pay-as-you-go program had to begin contributing 11.5 percent of their wages to their retirement accounts, to which the government also contributes. Regrettably, public-sector workers, including teachers, public health workers, and the civil service, were forced to stay in the government pension system. The private system now has 16 million participants, the most of any country in the region, and manages approximately $13 billion.

Today some 40 million Latin American workers own financial wealth in their retirement savings accounts.

Bolivia—one of the poorest countries in the hemisphere—closed its public pension system in 1997 and replaced it with a privately administered system of retirement savings accounts. Bolivians now have 10 percent of their salaries placed in retirement accounts for the provision of old-age benefits. The pension fund companies now manage $575 million, representing about 10 percent of GDP, and there are half a million participants.

El Salvador—until recently a country torn by civil war—approved its pension reform in 1998, even with the votes of some former guerrilla commandants turned members of Congress. The features of the system are very similar to those of the Chilean system, with workers contributing 10 percent of their salaries to private retirement accounts. Assets under management total $213 million, and close to one million workers are enrolled in the private system.

Peru—the first country to follow the Chilean pension reform—established a private pension system in 1993. Peru gives workers the choice of moving to a private system managed by companies of their selection and provides recognition bonds for those who do. Peruvian workers place 10 percent of their wages into the retirement accounts and pay nothing to the state. But the pay-as-you-go pension program has stayed in place for new entrants to the labor force, leaving open the door to an unfunded system that politicians may once again abuse. More than 2.5 million Peruvians have already moved into the new system, which has accumulated $2.5 billion.

Colombia—even under threat from Marxist guerrillas allied with drug cartels—introduced pension reform in 1994. It too allowed workers to opt for investing 10 percent of their wages in retirement savings accounts. A unique and most troublesome feature, however, allows workers to switch back and forth between the public and the private systems, giving rise to a permanent struggle between a state-run agency and the private system and perpetuating the pay-as-you-go system. Even so, the private system has attracted almost four million participants and has accumulated $3 billion in pension funds.

Hungary, Poland, and Kazakhstan joined the reforming club, and now around 15 million workers have individual retirement accounts in those former communist countries.

Argentina—under a government that engineered a partial break with the populism of the disastrous Perón era—set up a private retirement system in 1994. Argentine workers are given the choice of placing 11 percent of the salaries in their retirement accounts. However, the pay-as-you-go system was kept in place, providing all workers, including those in the public and private systems, a so-called “basic pension.” The law establishes that all workers put 16 percent of their salaries in the public pension program. Those workers opting to stay in the public program face a total of 27 percent of payroll taxes for pensions and receive benefits on top of the basic pension. By allowing the public pension scheme to continue, the Argentine government continues to add to its unfunded pension liability. Assets under management in the private pension system have grown to $20 billion and the number of participants to 8 million people.

Uruguay—the Latin American country most influenced by the European social model—introduced a very limited reform in 1996, similar to the Argentine reform in that it keeps the pay-as-you-go system in place for all workers but allows for a portion of wages to be diverted into retirement savings accounts. As of this year, the pension fund companies are managing about $651 million in assets for half a million participants.

Many of these reforms have important flaws that have to be eliminated before their full potential can be realized.

It must be emphasized that many of these reforms have important flaws that have to be eliminated before their full potential can be realized. But the basic structure of individual retirement accounts is firmly in place, and new constituencies of workers, entrepreneurs (including substantial foreign financial companies), and technical experts have emerged that will defend it in the future. So, with this new "G-8" of countries with private retirement systems, Latin America has become the world leader in structural pension reform. If Mexico and El Salvador are successful, pension reform will spread rapidly to the rest of Central America. The biggest laggard on the continent is Brazil. Even though some companies offer their workers private pensions, the largest country by size and population in Latin America suffers under the weight of an unfair and unaffordable pay-as-you-go public pension system, the deficit of which amounted to

4.6 percent of GDP in 1998. So far, the government has kept the social and economic problem from exploding by tinkering with the system, an approach that is reaching its limits.

FROM COMMUNISM TO PROPERTY RIGHTS

In the late 1990s, Hungary, Poland, and Kazakhstan, as part of the transition from a collectivist system to a market one, reformed their pay-as-you-go pension schemes and allowed workers to use payroll taxes to build their own retirement savings accounts.[3]

In 1998 Hungary became the first of the former communist countries in Europe to allow a portion of workers' salaries to be invested in retirement savings accounts. Its pay-as-you-go public system was already experiencing deficits in the 1990s, while imposing 30 percent payroll taxes. With an already large elderly population, the country would have had to raise payroll taxes to an unfeasible 55 percent, and each pensioner would have been supported by one worker by 2035. Current workers were given the choice of staying in the public system or moving to the new one. New entrants into the labor force are required to enter into the new system. However, all workers still contribute to the public pension system. Twenty-four percent of the wages of those in the private system go to the pay-as-you-go system, and only 6 percent go to their own retirement savings accounts. The main shortcomings of Hungary's system are similar to those of Argentina and Uruguay: high payroll taxes are used to maintain the public system,

"The costs of global aging will be far beyond the means of even the world's wealthiest nations—unless retirement benefit systems are *radically* reformed."

[3] See Krzysztof Ostaszewski, "Testimony: Poland's Pension Reform," www.pensionreform.org.

thereby discouraging job creation, and the system remains vulnerable to political manipulation. Hungary's private pension scheme has so far generated $1 billion in assets under management and has 2 million participants.

Kazakhstan—an oil-rich former Soviet republic—opted in 1998 to reform its pension system by allowing workers to place 10 percent of their wages into retirement accounts managed by competing pension fund companies, while continuing to contribute 15 percent of wages to the state-run pay-as-you-go system. However, there is a dangerous requirement that a minimum of 40 percent of the funds be invested in government securities, and, in fact, 85 percent of the funds are now in government bonds, reflecting the infancy of the country's domestic capital market and the turmoil in the region following the Russian default of 1998. As in Argentina and Mexico, there is a state-run pension fund company that competes unfairly with the private sector. Although in 1999 that company managed around 70 percent of the assets in the system, the share has now gone down to 42 percent, and the system may be privatized when its share of the market is further reduced to 25 percent. There are 3.2 million workers enrolled in the private pension system, and pension assets have grown to $700 million (4.2 percent of GDP).

The political elites in western continental Europe have so far been unwilling to engage in structural pension reform.

Poland—the most successful of the former communist countries—introduced a pension reform in 1999. Workers between the ages of 30 and 50 at the time of the reform were given the choice of staying fully in the state-run old-age pension system—in which they have to pay a 19.52 percent payroll tax—or diverting 7.3 percent of their salary into their own retirement accounts and paying a 12.2 percent payroll tax to build "virtual" individual accounts in the state-run system. Younger workers must join the private pension system, while older workers must stay in the pay-as-you-go one. So far, 11.5 million workers (70 percent of those who could choose a retirement account, that is, people between the ages of 30 and 50) have enrolled in the retirement savings account system, and the funds have accumulated $1.5 billion.

As in Latin America, the example set by the pioneers is already generating followers in the region. Several countries, including Russia, are planning to introduce Chilean-style pension reform in the near future.[4] In another continent, China, the world's most populous nation and still nominally a communist country, has been studying ways to solve its pension crisis by adopting a system of individual retirement accounts.

THE COMING CRISIS IN WESTERN EUROPE

Global demographic megatrends, such as longer life expectancy and reduced fertility rates, will accelerate the crisis of pay-as-you-go pension systems, especially in mature developed economies such as those of Europe, the United States, and Japan. As former U.S. secretary of commerce Pete Peterson has observed: "The costs of global aging will be far beyond the means of even the world's wealthiest nations—unless retirement benefit systems are *radically* reformed. Failure to do so, to prepare early and boldly enough, will spark economic crises that will dwarf the recent meltdowns in Asia and Russia.... For this and other reasons, global aging will become not just the transcendent economic issue of the 21st century, but the transcendent political issue as well."[5]

In stark contrast to some of their neighbors to the east and in Latin America, the political elites in western continental Europe have so far been unwilling to engage in structural pension reform. For Europeans, that political paralysis will be disastrous if it continues, since the

[4] See José Piñera, "A Chilean Model for Russia," *Foreign Affairs*, September–October 2000.

[5] Peter G. Peterson, "Gray Dawn: The Global Aging Crisis," *Foreign Affairs*, January–February 1999, p. 43.

region's looming pension crisis is perhaps the most severe in the developed world.

According to the Organization for Economic Cooperation and Development, the unfunded liabilities in Europe are enormous—more than 200 percent of GDP in France and Italy and more than 150 percent of GDP in Germany, for example.[6] By 2025 nearly one-third of Europe's population will qualify for public pensions. In 30 years, in Germany and Italy each retiree will be supported by one worker. Given those countries' generous benefits and weak or nonexistent private savings for old age, drastic tax hikes or benefit cuts will be necessary just to keep the public pension schemes going. Italians, who already face 33 percent payroll taxes for pensions, could see those taxes increase to 48 percent, for example. In a region that faces chronically high unemployment rates, such a move would only make job creation more difficult.

A pay-as-you-go public pension system is a collectivist scheme that deprives individuals of freedom in organizing their lives and planning for their futures.

Yet even though continental European countries are spending up to 15 percent of GDP on public pension outlays—a figure that may rise to more than 18 percent within 40 years for some countries—they have so far implemented only expediency measures. Germany, for instance, has recently proposed raising payroll taxes and using state funds to encourage workers to put additional money into private accounts. Needless to say, such a move would hardly solve the coming crisis in a country whose pension system costs 11.5 percent of GDP—more than twice the U.S. figure.

Spain's pay-as-you-go public pension system, the most expensive program in its federal

[6] Paul Van der Noord and Richard Herd, "Pension Liabilities in the Seven Major Economies," OECD Working Paper, 1993, cited in the book by the World Bank, *Averting the Old Age Crisis* (New York: Oxford University Press, 1994), p. 139.

budget, gives workers a minimal rate of return. Yet despite the facts that an economically feasible transition to a private system has already been identified and that the government is committed to economic liberalization in other areas, political inertia has prevailed.[7]

In Italy—the country with the lowest fertility rate in the world—annual public pension outlays stand at around 14.5 percent of GDP. There is, moreover, blatant corruption in the system. In 1997 a Finance Ministry study discovered that the government had been paying disability pensions to 30,000 dead people. Spot checks of 15,000 recipients of disability pensions found that 5,000 of them had faked their handicaps (including a young woman who was collecting a pension for blindness while working as a chauffeur).

There is the possibility of a breakthrough in the United States, where the government-run pension system, at $400 billion, is the largest government program in the world.

France's pay-as-you-go system is also in deep trouble. The generous public pension system will go into deficit after 2010. Attempts by different governments to tinker with the system have been crushed by across the board opposition. The almost total lack of a parallel private pension system will make matters worse for future retirees.

As UK economist Tim Congdon observed in 1997, "Europe's growth prospect is worse now than at any time since the start of the industrial revolution. If Europe's governments cannot solve the problem of unfunded pensions, they will not be able to control their larger fiscal difficulties or to prevent rises in taxation which will wreck their economies."[8]

[7] See José Piñera, "Una Propuesta de Reforma del Sistema de Pensiones en España," (Madrid: Círculo de Empresarios, 1996).

[8] Tim Congdon, "Europe's Pensions Time Bomb," *The Times*, March 1, 1997.

"THE PROMISE OF AMERICA"

Several developed countries have substantial private pension systems, especially the United States, Japan, the United Kingdom, the Netherlands, Switzerland, and Canada. But those private systems coexist with important and flawed public pension systems.

Only two rich nations—the United Kingdom and Australia—have so far undertaken structural reform of their public pension systems. In 1986 the United Kingdom gave its workers the choice of opting out of the second tier of its public pension system and, with 4.6 percent of their wages, purchasing either defined-contribution or defined-benefit plans in the private sector. Two-thirds of British workers have opted out and contributed to the private funds. Currently, all workers contribute a percentage of their wages to the first, pay-as-you-go, tier and on retirement receive the basic state pension from the government. The United Kingdom's public pension system still has an unfunded liability of around 40 percent of GNP. Australia's previous system was a state-run operation funded by income taxes. In 1992 employers were required to establish superannuation accounts for all workers (9 percent of wages will be deposited by 2002), which will form the primary source of retirement income for most workers. But workers freedoms are unnecessarily curtailed by several restrictions, the main one being the obligation to contribute to the pension fund of their own sector.

There is the possibility of a breakthrough in the United States, where the government-run pension system, at $400 billion, is the largest government program in the world. Whatever its advantages to the first generation that has received its benefits, the way it was structured has prevented common workers from owning their retirement savings and has politicized decisions that should rightfully be made by individuals instead of politicians. Even though 40 percent of Americans have some sort of private retirement fund (IRA, 401[k], etc.), another 60 percent do not. Yet all workers are still required to put one-eighth (12.4 percent) of their covered earnings in a system that does not give them ownership, market returns, or security.

There are six key arguments for privatizing Social Security in the United States:

1. The Moral Argument. A pay-as-you-go public pension system is a collectivist scheme that deprives individuals of freedom in organizing their lives and planning for their futures. A mandatory private retirement account system keeps compulsion to a minimum (the mandatory savings), thus maximizing the freedom to choose within a national retirement scheme.

2. The Rate of Return Argument. Pay-as-you-go systems are, by their very nature, a good deal for the earliest recipients, but with time, what is essentially a financial pyramid scheme begins to expropriate younger workers. Today the implicit rate of return for current workers is less than 2 percent, and those born today will probably see negative returns. Mechanisms to postpone the public pension system's insolvency, such as increasing payroll taxes or the retirement age, reduce the already minimal rates of return. In contrast, in the period from 1802 to 1997 in the United States, the annual real rate of return has been 7 percent for stocks and 3.5 percent for long-term government bonds. From 1802 to 1995, the average real rate of return for corporate bonds was 4.97 percent.[9] So a private retirement system can provide a higher rate of return, even if all the funds are invested in zero-risk government bonds.

3. The Fairness Argument. Since the poor tend to start work earlier in their lives and have a shorter life expectancy than do the better off, the pay-as-you-go old-age retirement system is actually regressive for certain categories of workers.[10] Under a system of retirement savings accounts, poor workers would be accumulating savings in their accounts and therefore would be

[9] Jeremy Siegel, *Stocks for the Long Run* (New York: McGraw Hill, 1998); and "Stocks, Bonds, Bills and Inflation," *1997 Yearbook* (Chicago: Ibbottson Associates), pp. 266–75.

[10] See Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998).

allowed to benefit from the rewards that markets are giving to wealth ownership, mitigating the recent increase in the so-called wealth gap-an unsurprising result given that most workers are forced to place all their savings in a program that gives them less than a 2 percent rate of return.

4. The Property Rights Argument. A system of private accounts gives retirees clearly defined property rights in their benefits. The elderly can make programmed withdrawals from their accounts, leaving money to their heirs if they die before they fulfill their life expectancy, or use the savings to buy indexed annuities from an insurance company. By contrast, the Social Security system provides no such rights to the money workers are forced to pay for their retirement, as ruled in 1960 by the Supreme Court in *Nestor v. Flemming*.

5. The Macroeconomic Argument. The public pension system negatively impacts labor markets and savings because funds are immediately spent, rather than invested, and the payroll contributions amount to a tax on hiring labor. Harvard economist Martin Feldstein estimates that privatization of Social Security could add $10 trillion to $20 trillion in net present value to the U.S. economy.[11] Contrary to conventional wisdom, the transition to a privatized system does not entail new costs to the government or to the economy. It would indeed make an unfunded liability explicit and force policymakers to find a way to pay for the promises made, while generating the mentioned gain to the economy.

“There is no human dream stronger than the dream of having something you can call your own.”

[11] Martin Feldstein, “Privatizing Social Security: The $10 Trillion Opportunity,” Cato Institute Social Security Privatization Paper no. 7, January 31, 1997.

6. The Social Harmony Argument. The privatization of Social Security would end the division between capitalists and workers by turning the United States into a country of worker-capitalists, with consequent changes in the country's political dynamics. It may well represent a massive blow against the political manipulations of the "transfer state." As Cato Institute president Edward H. Crane has observed: "Social Security privatization means changing the political dynamics of America in a very fundamental sense. For when members of labor unions, the average blue collar worker, blacks, and other traditional constituencies of the Democratic party start investing in stocks and bonds on their own, rather than counting on government as a security blanket, their attitude toward the free enterprise system, toward corporate profits, and indeed, toward big government itself is going to change. This dynamic has in fact already occurred in Chile."[12]

It is very encouraging that the President of the United States, George W. Bush, is making a principled case for pension reform: "My plan reforms Social Security so that every worker can be a saver and an owner. There is no human dream stronger than the dream of having something you can call your own. It is the promise of America. It is the promise of independence and dignity."[13]

If the United States institutes this reform, it would not only transform every American worker into an owner of capital, it would also encourage the rest of the world, especially continental Europe and Japan, to reform their systems. The benefits to workers and economies would be enormous. It would be a giant step toward liberating workers around the world.

[12] Edward H. Crane, "The Case for Privatizing America's Social Security System," S.O.S. Retraite-Sante Conference, Paris, December 1997, www.pensionreform.com.

[13] George W. Bush, Speech given at Western Michigan University, Kalamazoo, March 27, 2001.

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