Chileans Unravel Social-Security Tangle

The Americas

by Jose Pinera

SANTIAGO—If you are looking for a politically sensitive issue in any country—a sacred cow—you do not have to look further than the social-security quagmire. Social security is the least secure of any government system, and in many countries it is already bankrupt.

But there is a way to make social security just and efficient—and that method is succeeding now in Chile, and has been for five years.

On Nov. 4, 1980, Chile implemented a radical pension reform. For the previous 50 years the country's pension system had been like most others: Workers were taxed for their contributions to the system, the proceeds going into a general pool to be distributed to individual workers upon their retirement at age 65. That was the theory.

In practice, something else happened. First, as benefits were only loosely tied to contributions, the name of the game became pressure politics. By pressuring congress, each group of workers tried to minimize what it put in and maximize what it took out. For example, some groups were able to reduce their members' retirement age, thereby getting them their benefits sooner, at the expense of those who had to work longer. The result was a labyrinth of different and unfair pension provisions, with some powerful groups able to retire their members with nearly full benefits after as few as 25 years of work.

Second, the pension money was open to use, and mostly abuse, by government bureaucrats who were not accountable to the ultimate beneficiaries of the system. This led to such gross waste and mismanagement that it drained away the pension benefits of the majority, thereby weakening the country's social fabric.

Now, with the new pension system, each worker must set aside 10% of his monthly salary—deductible from income for tax purposes—in an individual pension account until legal retirement age (65 for men, 60 for women). In addition, the rules allow a worker to contribute voluntarily as much as 20% of his monthly wages to his pension account and still get a tax deduction. These pension savings are the property of the individuals, and each account holder gets a passbook to see how his account grows.

On retirement, an individual can keep his money in the institution he has always used, making limited, regular withdrawals, or he can use the accumulated capital in his account to buy an annuity from an insurance company (with provisions for beneficiaries).

The natural question at this stage is: What about the low-income worker? The answer: If any worker's pension savings are not enough at the legal retirement age to buy a specified minimum annuity, the government makes up the difference from general tax revenue. Thus, the neediest workers are helped by society in the most efficient way.

The next question is: Who manages the pension funds? The answer: private companies created for this purpose that compete with one another in the market. These companies manage pension funds whose returns accrue to workers' accounts, charging a commission for their management services. Accounts are fully portable: They can be transferred by workers from one company to another, depending upon the workers' objectives for return, risk and service. A regulatory body, similar to the Securities and Exchange Commission, was created to protect the funds from fraud or misuse.

For the first four years, pension funds were permitted to invest only in low-risk, domestic financial instruments such as mortgage bonds, government paper, private companies' debentures and bank certificates of deposit. Now that the system has matured, pension funds may invest up to 30% of their portfolios in widely owned Chilean blue-chip stocks and shares of state-owned enterprises, which the government has begun to privatize, mainly through the new pension system.

Workers already in the social-security system were offered the choice of staying with the original system or joining the new one. If a worker chose to move, he was given a "recognition bond," payable to his account on retirement, that approximated the value of his rights under the old system. The result: Out of a pool of two million eligible workers, 1.5 million joined the new system in the first year. Now, more than 90% of the work force has moved. New entrants to the work force must join the new system.

The bottom line is that when given the choice, workers will vote with their money overwhelmingly for the free market—even when it comes to such sacred cows as social security. And the free market has not let them down. During the first four years of the new system, the funds yielded an average 10% annual real rate of return. A total of 12 fund-management companies have been formed, two of them by workers.

For Chileans, their pension accounts now represent real and visible sources of security for retirement. But even more than this, the new pension system gives them a personal stake in the economy. And that, in turn, is a solid foundation for a more stable, free and prosperous society.

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