



International Awareness

PAPER: Toward a World of Worker-Capitalists
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The worldwide pension crisis has created a great opportunity to empower workers through public policy while at the same time advancing liberty.

I believe that 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 disparities 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.

This was my guiding vision 25 years ago when, as Minister of Labor and Social Security of Chile, I had the responsibility of designing and implementing a then radical pension reform (Law 3.500 of 1980). Chile's pension reform fully replaced the state-run paygo 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. The average real rates of return on retirement accounts has averaged more than 10 percent since their inception in May 1981, and pension assets under management have grown to be around 70 percent of GDP.

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 individual 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 paygo 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.

It should be added that in Chile the same rationale of the 1980 pension reform has been extended to the areas of health and unemployment, with individual insurance (health) or accounts (unemployment) managed by the private sector.

In the 1990s eight other Latin American countries followed, although partially, the path opened by Chile, and today some 60 million Latin American workers own financial wealth in their retirement savings accounts. The late 1990s saw another landmark when several former communist countries of Central and Eastern Europe joined the reforming club, and now around 25 million workers have individual retirement accounts in that area. 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, and in December 2004, Slovakia approved a Chilean-type partial pension reform that began to operate this year. It has been calculated that around a 100 million workers in the world have personal 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 paygo 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."

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 region's looming pension crisis is perhaps the most severe in the developed world. It is even possible that the pension time bomb may sink the euro in the long term.

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.

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.

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.

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).

France's paygo system is also in deep trouble. The generous public pension system will go into deficit after 2010. 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.”

“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 the United States, Social Security is the largest government program in the world and has an unfounded liability of 11.1 trillion dollars. 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.

It is encouraging that the President of the United States, George W. Bush, has made 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.”

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.

The writer was a Minister of Labor and Social Security of Chile and was the architect of Chile's successful private pension system.