Economic outlook

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25 years on, Chile has a pensions message for Britain

'One of the attractive features of the Chilean system is the ease with which workers can check the progress of their savings and contributions'

Bill Jamieson

"A SPECTRE is haunting the world. It is the spectre of bankrupt, government-run social security systems." Thus spoke Jose Pinera, Harvard economist and Chile's radical former social security minister, who has championed the biggest, the boldest and arguably the most successful pension privatisation of modern times.

It was the young Pinera who inaugurated the reform of Chile's bankrupt state pension scheme a quarter of a century ago. It remains a central pillar of the rescue and transformation of Chile's economy. As with so much associated with that country under the regime of Augusto Pinochet, who died this week, it is seen as a tainted reform, relevant only to the specific problems of Chile at that time and of no relevance to the rest of the world.

In fact, more than 25 years on, countries from Mexico to Sweden have adopted the system, or elements of it. Some 6m Chilean workers, more than 90% of the regularly employed labour force, now have their own Personal Retirement Account nest eggs.

The value of these accounts has been growing at an average annual rate of 10.3% in real after-inflation terms; and the savings in aggregate now total more than $50bn (£25.5bn, €37.5bn) with pay-outs commonly reaching between 50% and 70% of final salary.

Here in Britain, where Pinera has been championed by former Social Security minister Frank Field, Chile's pension reform has compelling relevance for its transparency and simplicity, features that continue to serve to highlight Britain's own feeble and unsuccessful efforts at encouraging people to save for retirement.

This week saw the publication of yet another pension White Paper wrestling with a familiar and seemingly intractable problem: millions of workers in the private sector, many of them educated and in responsible positions, are not saving anything like enough for their retirement – if they are saving at all.

But they are obliged to fork out tax to help pay the pensions of those in the public sector, where many can look forward to retiring at an earlier age than their private sector counterparts and at a substantially higher level of their final salary.

I have followed the Chilean pension reform since meeting Jose Pinera in Santiago more than a decade ago to examine the pension system at first hand. He was then, and has remained since, through the International Centre for Pension Reform a tireless and infectious enthusiast for pension privatisation.

While the system he ushered in has imperfections and flaws – for instance, it does not cover the self employed as well as it could and has been open to accusations of high administrative charges – it is acknowledged even by its critics to be far superior to the teetering state social security system it replaced.

It is often said to be of little relevance to Britain. But its central principle is more applicable than ever.

The pay-as-you-go system that characterises Britain and other Western state pension models has, in Pinera's view, a fundamental flaw: "It is one rooted in a false conception of how human beings behave. It destroys, at the individual level, the link between contributions and benefits. In other words, between effort and reward. Wherever that happens on a massive scale and for a long period of time, the final result is disaster."

How does the Chilean scheme work? All workers in full-time regular employment are required to put 10% of their pre-tax pay into a pension plan. Employees can choose between six competing pension fund providers, each of whom offers a range of funds covering equities, property and fixed interest investments.

One of the attractive features of the Chilean system is the ease with which workers can check the progress of their savings. This is done through their own individual passbooks updated at three-monthly intervals to show their latest contributions, the total amount paid in so far and the accumulated value of their personal fund.

Workers can switch between the various funds should they wish to pursue a more adventurous or cautious investment policy. For a country previously dependent on a state system that nobody trusted, the scheme provides reassurance of personal entitlement and encourages personal involvement. Many make additional voluntary contributions.

Retirement benefits are already 50% to 100% higher – depending on whether they include old age, disability or survivors' retirement benefits – than they were under the former system.

The benefits to the wider economy have been huge. The $50bn of combined savings approximates to around 65% of Chile's gross domestic product (GDP). This enabled government spending in Chile to fall from 34.3% of GDP in 1984 to 21.9% by 1990; of that 12.4 point decline social security and welfare changes accounted for half.

By increasing savings and improving the functioning of the capital and labour markets, this reform has been the single most important structural change that has contributed to the more than doubling of the annual growth rate of the economy from an historic 3% to 7.2%.

How ironic that an emerging market economy from which we thought we had nothing to learn can show us, a quarter of a century on, that personal responsibility, not state dependency, is the better guarantor of a comfortable retirement.