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19 September 1996

Dr Jose Pinera
Director
Center for International Pension Reform
SANTIAGO
Chile

Dear Joe

It is hard to exaggerate the influence you have had on the developing debate on the future of the pension system in the UK. Your fluent advocacy of radical change of which we had some indication when you appeared before the Select Committee in May this year, continues to provide a real challenge to those who seek to preserve in whole, or in part, some of the existing network of pension provision.

Our visit to Chile has challenged us to examine more critically our own system, while at the same time we have the opportunity to study the flaws and challenges still facing the Chilean system, notably the question of costs, coverage and diversification of investments. We will be debating the extent to which these problems are specific to Chile or inherent in any system of individually capitalised accounts underpinned by some kind of Government guarantee and subject therefore to strict regulation.

I expect that our paths will cross in the months and year ahead as the political debate worldwide becomes increasingly concerned with the issues which you have identified and addressed so uncompromisingly in Chile. My colleagues and I are grateful to you for inspiring and taking part in a visit which will have considerable significance for the future work of this Select Committee.

A handwritten signature in dark ink, appearing to read 'Frank Field'.

FRANK FIELD

MONDAY 20 MAY 1996

Members present:

Mr Frank Field, in the Chair

Mr Jeremy Corbyn
Mr Stephen Day
Mr David Faber
Mr Clifford Forsythe

Kate Hoey
Mr Robert G Hughes
Mr Bernard Jenkin
Mr David Shaw

Memorandum submitted by Dr José Piñera

"THE CHILEAN PRIVATE PENSION SYSTEM"

Article by Dr José Piñera

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 per cent higher—depending on whether they are old-age, disability, or survivor pensions—than they were in the pay-as-you-go system. The resources administered by the private pension funds amount to \$25 billion, or around 40 per cent 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 pushed the growth rate of the economy upward from the historical 3 per cent a year to 6.5 per cent on average during the last 12 years. It is also a fact that the Chilean savings rate has increased to 27 per cent of GNP and the unemployment rate has decreased to 5.0 per cent 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].

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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 per cent 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.

A worker may contribute an additional 10 per cent 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 per cent 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.

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.

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 countries, 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

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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 per cent of salary, which includes the commission to the AFP.

The mandatory minimum savings level of 10 per cent was calculated on the assumption of a 4 per cent 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 per cent 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 per cent 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 per cent 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.

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 per cent 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. 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—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

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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 as a 4 per cent 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 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 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 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 the 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 per cent.

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 stand-point, 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 system in 1980 has been estimated at around 80 per cent 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 macro-economic 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.

¹ See Piñera (1991) and (1995).

² See World Bank (1994).

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- (2) Since the contribution needed in a capitalization system to finance adequate pensions 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.
- (3) Using debt, the transition cost can be shared by future generations. In Chile roughly 40 per cent 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 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 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 Depositary 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 per cent per year (more than three times higher than the anticipated yield of 4 per cent). Of course, the annual yield has shown the oscillations that are intrinsic to the free market—ranging from minus 3 per cent to plus 30 per cent 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 per cent. According to a recent study by Sergio Baeza (1995), the average AFP retiree is receiving a pension equal to 78 per cent 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 per cent of salary threshold). If that money were included in calculating the value of the pension, the total value would come close to 84 per cent of working income. Recipients of disability pensions also receive, on average, 70 per cent 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.

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.¹

¹ See Baeza (1995) and World Bank (1994).

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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 per cent 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.

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. 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.

José Piñera is President of the International Center for Pension Reform and Co-Chairman of the Cato Project on Social Security Privatization. As Minister of Labor and Social Security from 1978 to 1980, he was responsible for the privatization of the Chilean pension system. This paper is based on a presentation made at the Mont Pelerin Society's regional conference in Cancun, Mexico, January 17, 1996. The author wishes to thank Edward H Crane for helpful comments.

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Examination of witness

DR JOSÉ PIÑERA, President, International Center for Pension Reform, Chile, was examined.

Chairman

240. Dr Piñera, welcome. Could I ask you to identify yourself for the sake of the record and then we will begin?

(Dr Piñera) I am José Piñera, former Minister of Labor and Social Security of Chile, and former Minister of Mines of Chile. I am today President and Chairman of The International Center for Pension Reform, a non-profit institution that promotes all over

the world the pension reform that Chile undertook almost 16 years ago.

241. Can I invite you to begin by making an open statement, and then we look forward very much to questioning you?

(Dr Piñera) I am very honoured to be here and I would like to thank you and every member of this Committee for this opportunity. As you know, 16 years ago Chile undertook a very radical reform of its pension system. We believe that a decent society is

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one that provides its workers with a decent pension system, one that allows people to retire with dignity, not to live in anxiety about whether in old age they will be able to live within a given level of income. Our state run pay-as-you-go system simply did not work in Chile. It was created with the best of intentions in 1925—very early this century—but it really was a system of social insecurity. Workers were not owners of their contributions. The system did not allow workers to save for their own future security, but rather their future was dependent on the decisions of the political process, and you do not know what those decisions will be 10, 20, 30, 40 years on, so it was not a system of social security. We decided to go to a fully-funded system where every worker has an individual savings account for his future. The system is managed by private companies that compete among themselves to give the workers the better service, and the better yield. The system has been very successful beyond all our dreams in terms of giving the workers a very high rate of return for their money. Already the pensions with the new system in Chile are 50 to 100 per cent higher than they were in the old system. The real return of the system has been 13 per cent a year above inflation during 15 years, even though we initially calculated a 4 per cent rate of return as being enough to provide workers with a good pension. The system has created a huge savings pool in the country; already the pension fund managers are managing the equivalent of 40 per cent of GNP, and we calculate when they reach their peak level in 2005 they will be managing the equivalent of 100 per cent of GNP. The traditional savings rate was less than 10 per cent of GNP and is now 27 per cent of GNP, close to Asian levels even though we still are of course a Latin American country. Several economists, among them Nobel Laureate Professor Gary Becker, have visited Chile and studied the system, and he said that the social security reform is the main reform that has allowed Chile to double its rate of economic growth from around 3.5 per cent, the historic rate, to 7 per cent a year during the last 12 years. So you can imagine how a rate of growth of that level is beneficial to the workers in terms of creating productive jobs, increasing wages, and in general providing people with a dignified way of living. In the last two years, three other South American countries have followed the Chilean model, and I have been very honoured to have been invited by the Presidents of those countries—President Menem of Argentina, President Fujimori of Peru and former President Gaviria of Colombia—to explain the system to them, to Congress and to public opinion. So now we are four members of the club of countries with a pension savings account system. Nowadays there is interest in several countries in the world. Six months ago I was appointed Co-Chairman of the CATO Institute Project for privatising the US social security system, which is the largest single government programme in the US spending 350 billion dollars a year, more than the defence budget of the US, and the system is in crisis and in the future, when the baby boom generation will begin to retire, the system will begin having an enormous deficit. So visionary people in America are trying to solve the problem now

and not wait for the last moment to make a structural reform of the US social security system. Now I am completely aware no system can be applied in other countries in exactly the same way, and specifically the transition provisions must be different in every country. So whenever I am invited to share our experience I am very happy to do so, and I am open now to any kind of questions by you, Sir, and your colleagues.

242. Thank you very much. Can I ask a general question about how you see the doubling of the rate of economic growth? Do you think that was because of the new investment being transferred into savings? Is that an approach which every country can follow, or were there specific circumstances in your own country which allowed the historic growth rate to be doubled in this dramatic fashion?

(Dr Piñera) I believe a system like the Chilean one has a definite impact on the rate of growth of a country because of several reasons and I will mention four main ones. The first one is that by eliminating the payroll tax—which is the idea that social benefits must be financed by imposing a tax on the hiring of labour—you create a much more competitive, flexible and well-functioning labour market. As has been proved in economic theory, a well-functioning labour market first of all creates productive jobs, and that has an impact on the rate of growth of the economy. Second, the reform in Chile has meant investing in capital markets and they have also been enormously improved by this reform; we have a much more transparent stock exchange market, we have created a risk assessment industry and so on, and this has increased the productivity of capital in the economy. So this reform increases the working of the labour and the capital markets, two markets which are crucial to economic growth. Third, a system like this creates in people a sense of responsibility for their future; really this is a national savings plan for workers and their children. That creates a culture of self-reliance, of responsibility, of self-discipline, and that has enormous side effects. In Chile, as you may know, there is a compulsory rate of savings of 10 per cent of wages but you can save up to 20 per cent of your wages if you want a better pension or if you want to retire earlier or simply to have more money in your account. An increasing number of Chilean workers have chosen to save more than the compulsory rate. All that has increased the savings rate of the country and therefore also promoted economic growth. Finally, we have taken the discussion about social security away from the political process. Now the system works in a well-designed, clear, simple way and has allowed political leaders to dedicate their energies to other areas of public policy that need political attention, and therefore in my view that has improved the process of decision-making in general in the country. Government authorities, are not having to discuss every day whether they will raise the benefits of the social security system, or what will be the deficit, or the payroll tax, or the tax deductions. That was all settled 16 years ago, and they can now dedicate their efforts to improving the health system and issues like education, and that has a lot to do with investing

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DR JOSÉ PIÑERA

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[Chairman Cont]

in human capital, in people, who are a crucial element of growth. So I believe this has had a definite impact on the rate of growth in the country. Can this happen in other mature economies? My answer is yes. I will quote here from Harvard Professor Martin Feldstein, who was President of the Council of Economic Advisers to the US President, so one of the top economists in the US. Only five months ago he gave a lecture to the American Economic Association, called *The Missing Piece in Policy Analysis: Social Security Reform*, and he says: "The combination of the improved labour market incentives and the higher real return of savings of privatised social security in the US has a net present value gain of more than 15 trillion dollars, an amount equivalent to 3 per cent of each future year's GDP forever." The most impressive statement I have heard about this. This is a professor who says that privatising the US social security system will have a net present value gain of more than 15 trillion dollars. The GDP of America is 7 trillion dollars. Now if I may follow, and in a way I may pre-empt some questions, Professor Feldstone says, "It is possible to design a transition to a funded programme which leaves each generation better off than it would be with the existing programme. This can be done by using additional debt to smooth the cost of the transition over more than one generation." He ends a Wall Street Journal article (March 8, 1996) saying, "There is no more important long-term issue facing the American economy than social security reform, and there is no better time to start the transition than now."

243. Leaving the trillions aside for the moment, can I move on to the aspect of compulsion and the response in Chile? Those of us who advocate compulsion here are told that the workers will not stand for it, it is another tax. Am I right that what you are suggesting is far from viewing it as another tax, large numbers wish to pay far in excess of what the compulsory level is?

(Dr Piñera) That depends on the starting point. If you begin from a situation in which there is no compulsion whatsoever, of course if you ask someone to contribute to a mandatory savings system for him it is a compulsion. But, remember, what we have done is replace the payroll tax, that in Chile was at some point even higher than 20 per cent of the wages, with this saving contribution of 10 per cent. So we have reduced the compulsion element in the Chilean economy but we have kept a 10 per cent compulsory contribution rate, so we have achieved in a way both goals. So the workers could see in Chile their payroll tax went down effectively, but the contribution did not go down to zero in which case they would not have a social security system. I am in favour at least for some time to have a social security system, that is I do not believe our societies are prepared to have people in old age in poverty, and to tell them, "Well, you did not save." We see our societies as compassionate societies and would not accept a situation like that. So I believe in the recent argument for some compulsion in savings, as long as first that is lower than existed before, secondly, as long as workers really understand that it is their money, it is protected by law, that is it

cannot be taken by politicians to use in whatever way they like or for whatever their pet projects are—like in Singapore, for example, where the Government manages the funds—and as long as the workers are empowered to manage their funds and have an enormous amount of choice. That could be, for example, choosing the company which provides the pension, choosing the way they get a pension at the end of their life—in Chile you can choose among several options—or choosing the level of contribution from a 10 per cent minimum up. That would be my view on the issue, Sir.

Mr Shaw

244. Can I very briefly try and summarise and perhaps you could agree or disagree with this point? The magic ingredient you have got, as I understand it, to try and get it encapsulated into a small paraphrase, if you like, is that you have established a direct relationship between the business performance in Chile, the business and economic performance, and the amount a person receives in pension. Not only have you established that relationship, but actually you have got people to understand it. Is that a fair summary of it?

(Dr Piñera) That is a very good summary, Sir. We have established a relationship, that is a fact, because the pension of the person—not only the pension, even the age at which he can retire—depends enormously on his contributions and on how that contribution grows during his working life. That has a lot to do with how the economy works. So we have created a direct link between the workers' interests and the performance of the economy. One of the problems of western societies is that sometimes the workers see the benefits that owners or shareholders get as different from what is their interest. In Chile we have taken it together, not by creating a corporatist society, not by asking unions to have board members in the banks or the companies, we do not like that kind of approach which was used in some countries some years ago, we like better the workers to be linked to the benefits of the economy. So, for example, when share prices go up, in Chile the workers understand they benefit directly, so they do not consider share prices going up as something that is good for the shareholders but bad for the workers. We have created an economy of shareholders. The workers are the shareholders. You do not have to invent another type of economy, you simply transform every worker into a shareholder. So ours is a shareholder economy, Sir, but a workers' shareholder economy.

Chairman: Take it from there, David!

Mr Shaw

245. To establish that relationship you must have been in the situation where many people were not educated to the level of understanding that is required. Did you have a programme of educating people? How did the Government go about delivering that programme?

(Dr Piñera) I believe enormously, Sir, that to govern is also to educate and to communicate your

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[Continued]

[Mr Shaw Cont]

views. I do not believe that a technocrat can devise a magic system and impose it upon the will of the people. So we undertook a huge education and communication effort in which all the members of our team, who were also very good economists or lawyers or whatever, had the obligation to go to the people and explain their views. Personally, I went, for example, to the public through a TV programme six months before the law was actually approved and I went every week for three minutes in the news programme—not more than three minutes because I do not believe people like to see ministers for more than three minutes (they zapp away, there is soccer playing and music) but three minutes you can give them! I went every week, three minutes, with a very simple thing. I believe in simplicity. I believe that the only way you can explain something is not when you mix a defined contribution with a defined benefit with a basic system and tax breaks, nobody understands that system, a worker cannot understand such a complication. It must be very, very simple. That is why we invented the idea of the pension passbook. I always carry it around. Every Chilean worker has a passbook like this¹ with where his monthly contribution goes, where the yield goes, and at any moment in time he can go to the company managing the fund with his passbook and he knows exactly how much money he owns. He can even ask a friendly computer what will be the level of his pension if he goes on saving like he has done in the past. It is a very simple and transparent system. In that communication programme I showed the passbook every time I went there. The Chilean system is called by many the passbook system, not the fully capitalised, fully funded, defined contribution, workers do not understand that language. They understand a passbook and the fact that they own the money in the passbook. You are right, sir, that in my view to have a system like this—successful—you need to have a huge education and communication process.

Kate Hoey

246. Presumably, Dr Piñera, it was made much easier for you because this was introduced at a time of military dictatorship. I just wonder given that, because presumably there were not the kinds of party political divisions or opportunities to having that, how would you see a country like ours where very often changes like this become very much a party political issue that without us having a military dictatorship we could actually begin to move towards what many of us see might well be a very good idea?

(Dr Piñera) The question is very interesting. First of all, it was what we call the military government that prevented Chile from becoming a second Cuba. We are very proud of that. It was a transitory government, of course, as George Washington's government was transitory in his revolution, and as you know it has created the most stable democracy in South America with the most successful economy. By that standard it has been an incredibly successful government. Now, whether it is easier to explain this to generals than to MPs? You are saying that it is easier to generals. May

I say that it is a debatable question. Why an MP should not understand this and why a general should understand this better? Let us simply think aloud: generals are people who deal with state owned companies, the army is a fully state owned company; they generally deal with central planning, war is a centrally planned operation, except in some areas of Bosnia sometimes, but generally it is a centrally planned operation. It was not easy to explain this to hundreds of people. There were all kinds of committees full of lawyers, economists, and so on. May I say that even though I know this is a very debatable question, it was basically an educational problem, that is you had to explain it to a lot of people in government and my world experience in the last 15 years has been that is exactly the same, the questions were very similar to the ones I am receiving here, very similar to the ones I have received all over Latin America where I have explained this system. Finally, as you know, it has been able to do this system in three countries with a democratic government—Argentina, Peru and Colombia—where I have met personally with presidents, congressmen and the cabinet. Ultimately it is the power of an idea that makes the difference, not the type of government you have. I am in favour of a democratic government completely and that is why we were so happy preventing Chile from becoming a communist dictatorship for 50 years, as it was in Eastern Europe for 50 years. This system has been, I believe, a very important element in contributing towards a stable economy and the base of a free society and that led ultimately in Chile to a democratic transition that has been exemplary all over the world. Finally, I would say to you that this can be done because of the power of an idea and it has been proven that way in three other Latin American countries in the last three years and probably this year it will be implemented in Mexico, Bolivia and El Salvador. I hope by the end of the century all Latin American countries will have a system like this and some day maybe some developed countries will have a system like this. Empirically we have proven that you do not need any kind of specific government but rather an idea well thought out and well explained to the people.

Mr Corbyn

247. Would you confirm, Minister, that you were a minister from 1979-1981 in the regime run by Pinochet and during that period there were massive human rights abuses, imprisonment of trade unionists and summary executions of many opposition leaders?

(Dr Piñera) No.

248. You were not a minister then?

(Dr Piñera) No, I do not confirm your statement.

249. So what happened then?

(Dr Piñera) Okay, I will explain what happened. I am very glad to do that.

Mr Corbyn: The question I wanted to ask was—

¹ Submitted to the Committee. Not printed.

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[Continued]

[Mr Corbyn Cont]

Chairman: We would like to hear your response and then we will actually get back to pensions.

Mr Corbyn

250. The point I wanted to raise was that since you were appointed by Pinochet as a minister and you introduced, or were part of the team that introduced, this system to destroy the welfare state that was there from the Popular Unity Government and you exempted the military from this, could you explain why the military are exempt from this?

(Dr Piñera) That is a second question. Do you want my first response also?

Chairman

251. I think we would prefer the second one.

(Dr Piñera) You would prefer the second one. Do you want to take a vote? Well as Minister of Labour and Social Security I was in charge of the social security system of all Chilean workers except the military who are in most countries, and specifically in Chile, under the Ministry of Defence and their pensions system is part of their pay system. So my responsibility had absolutely nothing to do with the pensions system of the military. So the reform idea applied to 100 per cent of the workers that were under the responsibility of the Minister of Labour and Social Security. Now, just for the record, at that time I expressed my opinion that even though it was not my responsibility it was much better even for the military to enter the system. The answer was that they had these special pay conditions that were not better than the rest, but were different because theirs is a different profession and they decided not to follow the leadership of the Ministry of Labour and Social Security. During the last 15 years I have contemplated how their pension system has worsened a lot. In the magazine that I direct and founded, last month I published an article saying that their system is in a big crisis and that they should have entered our system 15 years ago and they have made a mistake that will harm them because it is much better to have a fully funded system like the one all Chilean workers have than to have theirs. In a way they inflicted on themselves a discrimination that will hurt them in the long term rather than benefit them.

Chairman

252. Are they in a non-funded scheme now?

(Dr Piñera) They are in an unfunded scheme that has been accumulating enormous deficits. In my magazine called *Economía and Sociedad*, Economy and Society, I stated that their deficit this year is US \$866 million. They depend on the minister of finance to give them every year \$866 million. They have a system that makes them dependent precisely on the political debate about the budget instead of having a system where they can save for their own future. Sixteen years ago, and I am on record on that in Chile, and even today, I was and I am the leading proponent of the military system to go also into the fully funded individual savings accounts. I am also very sorry that

the government that we have now in Chile has not been willing to go along with my proposition.

253. Are there moves to cut the deficit in the defence pension funds?

(Dr Piñera) I am not aware of important reforms in that direction, sir. I believe that the best reform would be to give the military personnel the same option we gave all Chilean workers 15 years ago, that is to remain where they are or to move to a fully funded system. As you know, more than 90 per cent of Chilean workers chose the fully funded system in a free decision.

Mr Hughes

254. One of the criticisms that is made by the unions is about the cost of administering the system, 25 per cent as I understand it of the contributions. I just wonder how that compares actually with an unfunded system that is invisible to the state where you probably have absolutely no idea how much of it is swallowed up in administration. What is your view about that?

(Dr Piñera) May I correct you, sir. We do not have an institution called "the unions" in Chile.

Mr Corbyn

255. You destroyed those.

(Dr Piñera) No.

256. You banned them.

(Dr Piñera) We have unions, sir, but each union may think different from other unions. When more than 90 per cent of the workers chose the new system, it would be a conceptual contradiction to say that "the unions" criticise the system, because the workers of the unions are in the system. So if I can rephrase it to say very few trade union leaders are worried about the administrative costs and compare them to the state run system. My answer would be that they are comparing apples with pears. You cannot compare a fully funded system, in which the companies must have to update the accounts of each worker and must hire investment managers to manage the money, with the administrative costs of a uniform state run pension system. It is true that the administrative costs are higher in the new system, but the yield is 13 per cent. So, after you take the administrative costs from the yield, still the workers are immensely better than in the state run system. In a way, to put it this way, the cost of producing a Mercedes Benz is higher than the cost of producing a Russian car, but one is much, much better than the other one. Really we are comparing things which are completely impossible to compare. This is not to say that every effort should not be made to reduce administrative costs. Of course, that has a lot to do with the regulation of the system. I do believe that the regulations can be a little simpler after 15 years, so that can allow for lower administrative costs. But the important point, Sir, is the yield. The yield after cost has been more than 12 per cent a year during the 15 years, above inflation. That is an extraordinarily good deal for Chilean workers.

257. Can you tell us a little more about what happens to people in a sense who fall out of the

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[Mr Corbyn Cont]

system, people who are unemployed for a long period? Does the Government put any money in to cover their contributions or what happens to them?

(Dr Piñera) That is a very important question, Sir. I forgot to mention at the beginning our way of providing for people who have had a difficult life because they have been unemployed or very low paid. We do not define anyone as poor when he enters the labour force. I believe that everyone at 20 years old has a life in front of them full of opportunities in a free society and a free market economy. So everyone enters the pension saving system, we do not want to foster a culture of dependency, of poverty. If you say to someone at 20: "You are poor", that person will believe he is poor forever and will always stay in the welfare role. So everyone is in the system but when they reach retirement age—a man at 65—at that moment you can have after a full life someone who is poor, who has not been able to accumulate enough money in his account. In that case the Government guarantees a minimum pension for every worker that has contributed a minimum number of years to the pension savings account system. At that moment you see whether his accumulated capital is enough to buy him an annuity equal to the minimum pension defined by society. If it is not, the Government foots the difference. So every Chilean worker is assured then a minimum level of benefit and above that minimum level of benefit your pension depends on your savings during your working life.

Chairman

258. When you were talking about costs in answer to Robert's earlier question, have not some restrictions been placed on the enthusiasm of workers moving their funds around between different schemes? Has that switching of funds not added unnecessarily to the costs?

(Dr Piñera) Well, freedom has a cost. To exercise your own freedom generally has a cost, but we believe in allowing people freedom of choice so workers can move from one fund to another. Now it is under consideration by the Government, a little change in the law that instead of allowing them to move every 90 days if they want, they will be able to move every year. Now I believe that is reasonable. But I am very much in favour of the freedom of choice and I believe that in free societies that has a cost. It is easier to produce one model of car rather than many and so on. I believe that people derive enormous satisfaction from being free to choose. Now whether you are free to choose every three months or a year is debatable and therefore that is a matter for legislation. The idea that people can choose the company that provides their pension to me is crucial of the Chilean model and has been crucial in incentivising competition among private companies. That competition leads not only to higher yields but also to something that is very important to workers, that is better service. Workers are treated like clients, workers are treated as human beings not as with a monopoly, either a private or state owned monopoly, that treats workers badly.

Mr Hughes

259. To come back on something you said earlier which was about the three per cent that you reckoned this scheme was adding to the growth in the GDP of the country.

(Dr Piñera) Not only this scheme, Sir. What I said was that the scheme has been one of the main reforms, according to Professor Gary Becker the main reform, that has been instrumental in doubling the rate of growth. I must state very clearly that Chile really did a free market economic revolution, we opened the economy to global competition, we freed the market, we did several reforms and all of them jointly have doubled the rate of growth of the Chilean economy.

260. I share very much that view but one of the reasons why the funds have done so well is that they have invested a lot of their money in the privatised industries that themselves have done very well and therefore the money has come back to them. In a sense there is not very much left to privatise in Chile unlike this country where there is masses left to be privatised. We are on an auspicious day, as you may know, Dr Piñera, because today we privatised Railtrack. As you know there may be different views on this Committee. Where will the engine of growth for these pension schemes come in the future or is it simply the deregulated markets that you have or are they liable to produce rather lower returns?

(Dr Piñera) Of course, Sir, the fact that after creating the private pension system we began to privatise in a very transparent way our state owned companies and that they were bought in part by the pension funds and also by their own workers, as you know, has produced very good results to the pension funds. That was done deliberately, that is we chose to follow what we call a virtuous sequence in Chile. First we created the pension funds and later on we privatised the companies, because that way we knew that when we were going to privatise the companies, the pension funds, the workers' money, would be one of the big buyers and not only domestic or foreign entrepreneurs. So we did it deliberately because we wanted to create a nation of worker shareholders as I mentioned before. As you say very well, whenever you privatise a state owned company generally the productivity of the company goes up enormously, that is the world experience and of course was the case in Chile. Therefore, the nice thing in the Chilean reform was that by privatising after creating the pension fund we allowed the workers to capture most of the increasing productivity of the privatised state owned companies. So we reached several good consequences as a result of that scheme. Now what will happen in the future? First of all, may I say that still we have some companies to privatise in Chile. Regrettably we were not able to privatise the state owned copper companies nationalised by our former Marxist government. That was in the Constitution of the country and that Constitution could not be changed in that respect. The Government still owns the biggest copper company in the country called Codelco. So we have in the future the challenge to privatise Codelco, and hopefully for the pension funds to be able to transform themselves into shareholders. We still have

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[Mr Hughes Cont]

to go and privatise companies but anyway probably we are not going to repeat these incredibly high returns. When we set up the system we calculated that the workers would have a good pension if the pension funds were able to give them four per cent real rate of return—four per cent—that was the way we calculated the ten per cent contribution. The fact that the funds have given 13 per cent has just added to the workers' accounts and the workers' benefits, but even if from tomorrow the funds were only going to give four, five or six per cent still the workers would be much better off than with a government run pension system. What will be the future in terms of the yield, I do not know, I never predict the future of yields.

Mr Jenkin

261. Firstly, I am absolutely convinced of the advantages of moving to a funded system and a personalised system for pensions and using that system as a platform for underwriting welfare, privatising welfare, but there are three areas that I would like to explore which are relevant to the United Kingdom's present position. They relate to the problems of transition, the impact on work incentives, particularly for low paid people and people currently excluded from the labour market, and perhaps the limitations there are for the amount that an economy can save because whereas a small economy might be able to save very large amounts of GDP and export capital that becomes more and more problematic for a larger economy. To start with, I wonder if you could say something about how the process of transition was managed in Chile and how you think that experience might be relevant to a country like the United Kingdom or the United States of America where the state welfare is much more embedded, there is a much more adverse age ratio, many more people retired compared to the number of people in work, historically a much slower growth rate and probably would still be a much slower growth rate than a developing country like Chile, and all the problems of an inherited system which has become much more embedded than was the situation in Chile in the early 1980s. How should we manage the transition and how should we fund it?

(Dr Piñera) Let me tell you first how we managed our transition. We basically put in three rules for the transition. The first one was that we guaranteed the benefits of the people already receiving pensions. I believe that is a very important decision, it is a fair decision. We said that the reform cannot damage those who are already receiving a pension or who are already retired, those people are at the end of their lives, they cannot simply compensate for whatever change in their conditions. So the government guarantees the pensions for the elderly and that guarantee stands today. The second important definition, a crucial one, was that since we believe in free choice we allowed every Chilean worker to decide whether to stay in the old system. We knew it was bankrupt but you should allow people even to go bankrupt in a free society. We allowed people to stay in the old system if they chose to, or move to the new one on a voluntary basis. Let me tell you that more than nine out of ten Chilean workers have moved to the new system. This has been

a social referendum won by over 90 per cent of the poll.

262. Can I just press you on that.

(Dr Piñera) Yes, press me.

263. If any government said: "Your pension is finished unless you change into the new system", I should imagine the new system would be very popular.

(Dr Piñera) No, we did not say that.

264. You said it was bankrupt.

(Dr Piñera) No. I said that as an economist. I know that the present value of that system, that is the future benefits compared to the future payroll tax receipts, is not sound financially. That is what I mean by bankrupt, bankrupt in an economic sense. According to current law the system is bankrupt. Of course, you can raise the tax rate or you can increase the retirement age, but according to the current position on what you have been promised and on what you are contributing the system simply does not hold.

265. Forgive me, but there was no party on offer at the time suggesting that they would stand against you in an election to say that they would raise taxes rather than change the system.

(Dr Piñera) No, but there were a lot of economists, political leaders of the old system, who were not at that moment engaging in political elections but we all knew that we were going to a democratic system. The merit of the Chilean case was precisely, as I mentioned before, even though some of your Members do not like it, that we prevented the communist dictatorship to come upon us. We created the basis of a democratic and free country. That was continuously being explained to the people. As a matter of fact when we were doing this a Constitution had been approved only two months before on 11 September 1980. Chile approved the Constitution by popular vote saying that eight years later, a Congress would come into operation, there would be free elections, there would be no exceptional provisions. So when we approved this pension reform on 4 November 1980, we had a Constitution that clearly set a path towards the restoration of a civil government. There was enormous debate. May I say for the record that I published a book called *El Cascabel al Gato. La Batalla de la Reforma Previsional*, translated "The Bell to the Cat. The battle for the pension reform". And it was a battle. It was very difficult to make this change because there were a lot of people opposing it and because there was debate. Really there were other people who were saying at that time: "Stay in the government system, it will give you better pensions. The private system will go bankrupt or some companies will go bankrupt, do not trust the private sector". The difficult position was precisely that of the one who was proposing the new system.

266. That was the second principle?

(Dr Piñera) Yes. The third principle was that all new entrants to the labour force go into the new system. That is, we closed the door of what we thought was an untenable system. I do not believe it is responsible to keep the door open to an 18 year old young man going into the labour force if we know that

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[Mr Jenkin Cont]

the system will not be able to provide the benefits that were in the laws with the payroll taxes that were in the laws.

Chairman

267. Can I take you up on that because in this country half of our payroll taxes go to pay existing pensioners their state pension. But if, in fact, you then say: "We abolish the payroll tax. We require a ten per cent contribution from you for your own funds", where does the money come from to pay for the existing commitments of those who have already built up those entitlements and who are drawing them?

(Dr Piñera) Mr Shaw said that it was a magic reform, sir!

268. I want to understand the magic.

(Dr Piñera) That was a joke. Let me explain where the money came from.

269. You knew it was a joke, I knew it was a joke, do you want to convince Mr Shaw it was a joke?

(Dr Piñera) Those are the rules of transition. Once we had these rules of course we had to take care of the financing of the transition. That was a very complex challenge. The good news is that Chile last year had a fiscal surplus of 3.5 per cent of GNP, a fiscal surplus after 15 years of the transition. We are paying the pensions of the elderly and we are having a fiscal surplus.

270. But was that an act of faith that you thought you would get the economic growth to expand the base on which you levied other taxes so that government revenue would rise, possibly with even falling taxing rates? Was there an element of real risk and of belief here?

(Dr Piñera) No, to be frank, Sir, it was not an act of faith. I have a lot of faith in God but not in economists' predictions. So we did not accept dynamic scoring, as it is called in the US. Let me explain this to you. We used four basic provisions, the first—and the very important one, the one that Professor Feldstein mentioned here—is that you can always transfer part of the cost of the transition to a future generation by issuing Government debt to ease the transition.

271. Right. Pay as you go scheme.

(Dr Piñera) Because as you know the money does not disappear, the money that does not go into the state run pension system goes to the private funds, so the money is there. So what we decided with the Minister of Finance was that the Government would issue Government bonds at a market rate of interest and capture around 40 per cent of the money that the Government was losing. We disposed immediately of 40 per cent of the problem.

272. You disposed of it for today.

(Dr Piñera) We did a 50 year simulation of how this debt would be paid. Precisely because the new workers were going into the new system we knew that some day the elderly population would pass away and therefore the Government would not have to pay them. So if you do this in a 50 year period you can clearly

simulate the moment when the Government begins to have a surplus in welfare expenditure and at that moment you begin to pay the debt. You will have forever that surplus unless the Government lowers taxes. So if you do it with zero coupon bonds and other financial techniques, you can do it perfectly well because there will be not a Government obligation to pay pensions after the last person who is still in the old system dies. So that is why I call this "bridge debt", it is a different debt from the one your book now shows. Ultimately, Sir, it is a recognition of an unfunded liability that you have anyway.

273. I agree with that. That was 40 per cent of it.

(Dr Piñera) Okay, 40 per cent. Now the other 60 per cent was disposed in several ways. First, as I mentioned before when you asked me about the compulsion element, you may remember that I mentioned we reduced the compulsion element from the 20 per cent payroll tax to 13 per cent, because there is 10 per cent for old age pensions and a three per cent premium for disability and survival insurance. So we reduced it from 20 to 13 per cent. So there were seven points of the payroll tax that we did not eliminate immediately. We phased it out during several years. We said we would keep it not as a payroll tax, but we relabelled it as a transition tax on payrolls and we said this money would go to finance precisely the pensions of the elderly. Since we knew that that commitment would be decreasing, we put into the law that the tax had to be eliminated gradually because I did not believe that necessarily future politicians would be willing to eliminate the tax. So we put into the law a phase out of that tax, so that today that tax is zero. But during the first years of the transition, those receipts were very helpful. Thirdly, we used the proceeds of privatising the state owned companies. So if it is true what Mr Robert Hughes said that you have state owned companies here to be privatised, well there, Sir, you have an important source of financing because it is completely reasonable from an economic point of view that if you are financing a liability in the balance sheet of the state you can use the assets of the state to do that. You should not privatise to finance current expenditure, of course.

Mr Corbyn: Or to win elections.

Chairman

274. That is a message addressed to this side.

(Dr Piñera) I know nothing about your politics. This gentleman may be a Tory and the other one may be an anarchist.

Mr Corbyn

275. How would you describe yourself?

(Dr Piñera) A libertarian.

Chairman

276. Back to the question.

(Dr Piñera) Let me finish. So we privatised state owned companies and that way we financed part of the liability. Finally, the last resort was to reduce some

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[Continued]

[Chairman Cont]

wasteful Government spending. We made an effort to reduce Government spending in the areas where we knew it was possible to be done. Basically by these four mechanisms—bridge debt, using part of the payroll tax to finance the transition, selling state owned assets, and finally reducing the spending—we were able to present from day zero a mechanism to finance the transition. Then, after the reform came, as you said very well, the fact that the reform helped to double the rate of growth of the economy and began to produce enormous tax revenues that we did not contemplate to finance the transition, that is why now we are having a fiscal surplus. Our calculation was to end up with a zero fiscal deficit, but the situation has been much better than we ever thought and we have had in the last few years a fiscal surplus and last year I am sure was 3.5 per cent of GNP. I remember it because you have the Maastricht conditions for monetary union where you cannot have a higher than three per cent deficit. We have a counter Maastricht provision, a three per cent surplus.

Chairman: Your figures are very similar to our public sector borrowing requirements.

Mr Jenkin

277. To summarise, what you are saying is 40 per cent of the future liability was funded by Government borrowing of one sort or another and 60 per cent, it was planned to fund the 60 per cent with the transition tax.

(Dr Piñera) No, with all the other things, with the other three mechanisms: transition tax, reducing spending, selling state owned companies.

278. You planned for privatisation proceeds——

(Dr Piñera) Yes.

279. —and you planned for faster economic growth?

(Dr Piñera) No, no, faster economic growth is the only element that we did not plan for. As I mentioned, the three other elements were using the payroll tax, selling state owned companies and reducing spending.

280. Moving on from the transition, which I think you have solved, the question of what happens to poorer people in the system now and what is the effect on work incentives of people who have to pay a savings levy. Just as we have a problem of a poverty trap when people come into the labour market that they have to start paying taxes and they lose social security benefit, surely the same problem occurs with the compulsory savings that the minute you start working and have to pay compulsory savings that creates a disincentive to work. Does that apply to you?

(Dr Piñera) I mentioned before that we started from a system in which the payroll tax to finance pensions was around 20 per cent. So the poorest worker in Chile was paying at least 20 per cent to finance pensions, not to mention health for which there were other percentage points. So we took that down from 20 per cent to 13 per cent, ten for the passbook and the other three per cent as a premium for disability and survivor insurance. So really we have increased by this mechanism the net home pay of the Chilean

worker. As you say very well, that is money that a poor worker values enormously. That seven per cent of extra money, is the money that can mean for a poor worker to cross the level of surviving. This system—and this is the point I want to make to you—costs less than a state pay as you go system. That is the key to understand. Why does it cost less, because the money is invested in capital markets that under the worst circumstances gives a yield of let us say four per cent. That is much higher than the return a pay as you go pension system can give. So this system is less expensive than the other one, so it requires less let us call it tax or mandatory savings than the other one and in that sense it allows for workers to control a larger part of their salaries.

281. Do you think there are limits to what can be saved in an economy? Your savings ratio is a staggering 27 per cent. Is that the limit?

(Dr Piñera) The Asians save even more. I understand that some Asian countries save even more.

282. In a free society?

(Dr Piñera) Hong Kong—— What is Hong Kong?

283. It is a free society.

(Dr Piñera) But without elections! Until recently I am told. I am told by the Chinese that until recently they were very mad at you because you are giving them democracy only now. I do not know what is the saving rate that a mature economy can hold. The savings rate is not crucial to my argument. Let me be very clear, even if the savings rate of Chile had not increased, a very unlikely event because you are creating all this incentive to save, a system like the one I am describing I believe is immensely superior to a state run pay-as-you-go system. Of all the other elements that I have mentioned, eliminating distortions in the labour market, allowing people to control their lives in so many ways. Something we have not mentioned here, which was something that worried me a lot 16 years ago, is the fact that a state run pay-as-you-go system has to be uniform, it has to be the same for all, but people are not uniform. I believe strongly that people have very different personal preferences about old age. Some people want to work forever. I generally use the example of the Chinese leader, Deng Xiaoping, who is 95 and still working even though he probably has a pension but he likes to be there and we hope he is there.

Chairman

284. So do the Chinese! There is a lot of money being spent on that.

(Dr Piñera) But some people want to go and fish at 50. A state run system puts a uniform rate because that is the only way a state can work. A uniform age put by the government is an incredible intrusion in our private lives and exacts a price on human happiness; you have to get out of the labour force. In our system that is not so. We have a legal retirement age as a reference for those who need the minimum pension. If you want the government to help you, you must work until a given age. If you want to retire earlier you can

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Dr JOSÉ PIÑERA

[Continued

[Chairman Cont]

do it with your own savings. I understand, Mr Field, you are taking your Committee down to Chile in September.

285. We are indeed.

(Dr Piñera) It would be wonderful if you could go to some of these companies and see what I have explained to you, that they have these friendly computers so that workers can sit in front of them and he or she, because there are also a lot of women in the system, can put the number of their account in and immediately the computer tells them how much money they have, where it is invested, what has been the yield, all the information they want is on-line immediately. The value of the fund that day, because the value of each worker's passbook account is calculated daily at the close of the stock exchange yesterday, is available. You may want to know your passbook money today. There is a programme called early retirement and you push the button, the computer asks you at what age you want to retire. You discuss that fully with your wife, and there are of course some interesting discussions there! Then let us suppose that the worker puts 55, the computer makes an immediate simulation of what capital will be required to get a pension at 55 equal to 50 per cent of your last wages. Then it gives you an answer in terms of instead of saving ten per cent monthly maybe you must save 12.5 per cent. You can play there for an hour tailoring your old age the way you want it, not the way a government committee has decided that you want it but the way you really want it. Finally, you simply go to your employer and tell him: "Instead of withholding ten per cent of my wage, please withhold 12.5". If he asks why, you say: "Because I want to retire at 55". Imagine the amount of freedom this gives.

286. So the employer collects?

(Dr Piñera) Yes.

287. Does it then go into a central fund to go out to the companies or does the employer send it directly to the companies?

(Dr Piñera) No central funds. We dislike anything that has to do with centralising. At the time—16 years ago—we discussed that idea of having it all in a central fund, but some government official will be above the central fund because there is always someone above and we decided that the companies should send the money directly to the pension funds. It does not go through a central clearing house.

288. It is quite interesting that in this country we have got what is called the State Earnings Related Pension Scheme and discussions that I have had with private companies about bringing lower paid in, they are very anxious that the SERPS scheme should continue to collect the money and send it on to them, they want to keep their costs down and they want taxpayers to carry the cost of running the collection scheme.

(Dr Piñera) That is a legitimate demand that you should not accept, of course!

Mr Forsythe

289. Could I ask you a couple of questions about the scheme itself rather than the idea of the scheme. I understand that those who save get four statements during the year, is that right?

(Dr Piñera) Yes. The pension fund companies have to send to the worker's home a quarterly statement stating whether the money that was taken from his wage by his employer has been accredited to his account and the yield of the account.

290. We had this debate in our Pensions Bill here, whether we should have one annual report sent to each person, and that was turned down. We need not get into that. Is it very expensive to send out four statements per year?

(Dr Piñera) No. A stamp in Chile costs only 25 cents of a US dollar, the rest is almost nil. The decreasing computer costs of producing information, thanks to those geniuses at Silicon Valley and say from Birmingham, I do not know where they are in the UK—

Chairman

291. We wish it was.

(Dr Piñera) Thanks to all those people the computer cost is nil. The real price is the price of the stamp, 25 cents of the dollar. Maybe you should add something more but I do not believe it is expensive. Secondly, as I said before, I believe that information is a valuable commodity. I believe that people feel better when they are informed. They feel better when they know what has been taken from their wages is in the passbook rather than not being sure. People who survive on not large amounts of money take care of their money. Therefore, I believe all that we can do in terms of information, as long as we do not place, of course, what could be called excessive requirements, a daily statement, should be done. I am willing to discuss whether the quarterly is too much and maybe it should be once every six months but really in Chile there has not been much debate on this. That is part of the administrative costs, but I believe that is a cost that cannot be dismissed because people value knowing how much money they have and the fact that everything is in order and so on. The good thing about the Chilean system is that it is so simple that reading this statement you know everything about your pension life. As I mentioned before, the government gave every worker a recognition bond for past contributions and the government will pay it only when the worker reaches retirement age. The amount of the recognition bond is updated because it has an interest rate of four per cent real. So really you have two lines, one is your accumulated savings in the new system and another line is the recognition bond, how it grows, and you can see that it is growing in real terms so you feel very well in that sense, and then you have a column that adds all of these and tells you your total net worth for pension purposes. Maybe someone should write a thesis on, for example, how the fact that workers know how much money they have has contributed to the stability of Chilean politics in the last years. As you know we had this transition, that we

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[Continued]

[Chairman Cont]

were talking of before, and no politician has been against this system once the system was successful. A lot of them were against me 15 years ago, but once the system was successful all want to be fathers of the system.

292. You mentioned your passbook and everyone has a passbook and you are rightly proud of your passbook, what happens if you lose it?

(Dr Piñera) The passbook's cost value is nothing. If you lose this passbook it is replaced. As a matter of fact maybe I can leave this passbook for the Committee here.

Chairman

293. It is yours, is it?

(Dr Piñera) No, it is a sample. I will leave this passbook with the Committee in order to show that the passbook was present at this session. The passbook's cost is one dollar, so you go to the company and they replace your passbook immediately. No, that is not a problem at all.

Mr Forsythe

294. What about the identification of the person?

(Dr Piñera) Remember, Sir, that the passbook is just for information, the passbook does not allow you any benefit as such. Of course, when you do reach retirement age at that moment it is crucial that the money in the passbook is not given to the wrong person, but at that moment they would ask you much more questions in order to begin providing you with the payments, specifically your identification number and a lot of other things. Really the passbook is a psychological device. It is a device that allows people to feel that they own what they have here but really it is not like a share that can be traded in the Stock Exchange as such. You cannot withdraw money by presenting this passbook at all. Really the worker, even when he reaches retirement age, he does not take out the capital, he simply chooses the life insurance company that will provide him with the annuity but the money goes from the pension fund company directly to the life insurance company. The life insurance company begins to pay you an annuity.

295. I understand at the end, before you get your retirement pension, it is taxed, is that right?

(Dr Piñera) Of course, the contribution—

296. Could I ask you a bit more: is it taxed as one lump sum?

(Dr Piñera) No, your contributions are tax free and when you retire your annuity—not the capital amount, your annuity—is taxed at the progressive income tax rate that your annuity falls. Basically if your annuity is lower than the income you have had in your working life, you are taxed at that moment at a lower tax rate, but you are exempted when you put the money into the passbook.

297. You say the AFPs will give sometimes 70 per cent of salary, what is the minimum pension then which is guaranteed by the Government?

(Dr Piñera) Let me just answer the first part. There is a study that came out two months ago by an economist called Sergio Baeza, who happens to be the president of one of these AFPs. He made a study and according to him the AFPs are giving workers pensions equivalent to 84 per cent of last wages. The article of Sergio Baeza has just been published by the Centro de Estudios Públicos, Centre for Public Studies. Now the minimum pension in Chile is today around 110 or 120 dollars a month, but as you know, Sir, the absolute level is without relevance here because that has to do with the income per capita of the country. So since we are still a developing country, of course, the pension is in accordance with that. And it is basically a value political decision. The level of the minimum pension is not a structural part of the Chilean pension model. Any Government can increase or decrease the minimum pension, as long as they provide the tax to finance that minimum pension, because it is paid out of general tax revenue. But the exact level of the minimum pension is not something that I would call a structural feature of the system. It is a definition of society of what should be the minimum benefit assured to everyone and has a lot to do with the income per capita of the country.

298. Can I ask you one last question: there are over 100 AFPs, is that right?

(Dr Piñera) Excuse me?

299. There are over 100?

(Dr Piñera) No, no, there are around 18 AFPs.

300. 18, right.

(Dr Piñera) There is free entry to the industry. Of course there could be 100 if British investors choose to go there, because one of the few countries that has not got investors there is the UK, I do not know why. We have American companies like Citicorp that just bought into one AFP a month ago, we have the American International Group, we have Aetna Life Insurance, we have a Spanish bank, Banco de Santander, at some moment we had a French insurance company, I cannot remember the exact name, but we have not had a British company yet.

301. Would it be possible for one or two or three of those AFPs to capture the market, the whole system, if they were very successful perhaps and advertised and brought in a lot of other accounts, could they perhaps corner the market on AFPs?

(Dr Piñera) Theoretically yes, practically no. We know there are these diseconomies of scale that have not allowed in any industry in the world to have only one company providing everything. I know of no industry in the world where one company or even two provides 100 per cent. Some people thought IBM would go in that direction, but Bill Gates thought otherwise and other people thought otherwise, and you know what happened in the computer industry. No, I believe there are strong diseconomies of scale. After some size, the management of huge institutions gets sometimes as bureaucratic as the Government, therefore costs begin to go up and therefore they cannot grow any more. That has been the experience in the Chilean AFP but it is the experience generally,

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[Continued]

[Mr Forsythe Cont]

Sir, among every kind of industry. God is wise. He created diseconomies of scale, so that nobody could corner the market. That is both in business and political affairs!

Chairman: Your minder has arrived to take you to your next appointment but a brief question from Bernard.

Mr Jenkin

302. When we visited Singapore last year we saw that other social benefits were taken out of the savings system such as health insurance and disability and others. To what extent is that already happening out of the Chilean pension system and do you envisage that happening more as the system develops?

(Dr Piñera) No, Sir. I believe that the compulsory element of the system should be kept to a minimum. I believe, as Mr Field mentioned, that regrettably you must have some monthly savings in order to assure people that they will save for old age, but I do not believe in a society in which Government takes upon itself to make mandatory everything. In that regard I am worried about the Singapore system because, as I understand, they have a 40 per cent mandatory saving of your wage and it is 40 per cent that has to go to this Central Provident Fund. The Government manages the Central Provident Fund and gives people a rate of return of 2.5 per cent. So it is a very bad deal for the workers to have 40 per cent of your wage go into a fund that is managed by one Government and it gives you 2.5 per cent. So I do not understand why some people like such a system.

303. Peter Mandelson for example.

(Dr Piñera) I know nothing about British politics. All my comments here are about pension systems. I

want to make that clear today. I am against a government taking 40 per cent out of your wage, and more so if it is only managed by the government. I am against that not only on purely economic grounds but also on civil liberties' grounds.

304. What about the other benefits, disability for example?

(Dr Piñera) Disability I have mentioned. We have disability, yes. Old age pensions and disability pensions, yes. But, for example, housing, I do not believe in a mandatory programme for housing. It is not that I do not like houses, I feel the pain of people who do not have houses, as Mr Clinton says, but I do not believe in a mandatory system for houses because then someone will say: "Why not a mandatory system to have cars? Why not a mandatory system to be able to go to a restaurant?" and at the end of the day the government will be taking everything out of your wage and you will go to a collectivist society. I accept the mandatory element in the Chilean system because I do not believe that people will save enough for retirement given the education level of our world, to put it that way. May be in 15 years' time if I am invited again to this Committee I will be against compulsion if the level of responsibility in the world goes up in the next 15 years.

Chairman

305. On that optimistic note, could we thank you very much for your evidence, it has been very helpful. You said you were going to give us that passbook, you have put it away.

(Dr Piñera) Here you have it. A gift to a good politician!

Chairman: Thank you very much.



HOUSE OF COMMONS SOCIAL SECURITY COMMITTEE

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27 March 1996

Sr. José Piñera
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Dear Mr Piñera,

Mr Frank Field MP, the Chairman of the House of Commons Select Committee on Social Security, and his colleagues have asked me to invite you to give evidence at a specially convened meeting of the Select Committee on Monday 20 May at 4.15 pm, in Committee Room 21 in the House of Commons, to finish by about 6pm.

The Select Committee is at the early stages of an inquiry into the possibility of a compulsory funded old age insurance scheme. The Committee have had discussions in London with MPs from Chile and Mr Jamieson, The Economics Editor of the Sunday Telegraph, who visited Chile recently. The Committee hopes very much to have the opportunity of having a discussion in public with you as part of their current inquiry. Subject to parliamentary business, the Committee is planning a short visit to Chile in September this year. It would be invaluable to have the benefit of discussing with you in May the outline of the issues which could be followed up in more detail in September.

I understand that the London part of your programme in May is being organised in conjunction with the Adam Smith Institute and the National Association of Pension Funds. I hope that you will be able to accept the invitation to take part in the Select Committee's programme.

Yours sincerely,

Liam Laurence Smyth

Liam Laurence Smyth
Clerk of the Committee

[20May96 UK: UK MPS LIKE WHAT THEY HEAR FROM PENSIONS PIONEER.]

LONDON, May 20 (Reuter) - The architect of Chile's privatised pension system won new converts on Monday as members of parliament responded enthusiastically to proposals that would turn Britain's social security system on its head.

Former Chilean labour minister Jose Pinera outlined the advantages of emulating Chile's free-market pension reforms.

Pinera explained that the introduction in 1980 of a privately run "passbook" system whereby workers save for their own future -- instead of paying taxes to the state to provide their pension -- had not only made pensioners much better off but had helped transform Chile's economy.

Pinera was giving evidence to parliament's Social Security Committee, which is examining the Chilean model as part of an inquiry into how Britain could reform its pension system to ensure it does not go bankrupt as the population ages.

Free-market Conservative MPs glowed as Pinera, now president of Chile's International Centre for Pension Reform, said the system of individual Pension Savings Accounts had bred a culture of self-reliance while generating handsome investment returns.

Pensions were already as much as 100 percent higher than under the old pay-as-you-go system, Pinera said.

On the day the government was under fire for privatising Britain's railways at what critics called a fire-sale price to an army of small investors, he said another big advantage of the Chilean system was that it gave workers a personal stake in rising stock markets.

"We like workers to be linked to the benefits of the economy," Pinera said. "Ours is a shareholding economy, but a workers' shareholding economy."

The reforms were introduced when Chile had a military government and MPs, although impressed by the results, wondered sceptically whether such a scheme -- based on compulsory savings -- could ever be adopted in a fractious democracy like Britain.

Pinera, after quipping that it was debatable whether the idea was easier to sell to generals than to MPs, said Argentina, Peru and Colombia were already following the Chilean model.

"Ultimately, it's the power of the idea that makes the difference," he said.

MPs on the Social Security committee will get a chance to see for themselves whether the reforms have worked as well as Pinera says when they visit Chile in September.

— Alan Wheatley, London newsroom 44-171-542 7767

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