The Boston Conversazioni

Toward A World of Worker-Capitalists

by José Piñera

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In mid 1999, *the Economist* sounded a clarion call when it stated:

"Radical reform of social security is the next great liberal reform, easily as significant a change as privatization of state owned enterprises--also dismissed in its time as Utopian. On pensions, Latin America has led the way. Let the world follow."

In fact, Chile's pioneering pension reform of November 1980--that ended its pay-as-you-go public pension system, in which current workers finance the pensions of current retirees, by approving the law that allowed workers to invest their full payroll contributions into private retirement savings accounts--is now serving as a model for what amounts to the beginning of a worldwide revolution in this area. Indeed, in the 1990s seven other Latin American countries--Peru, Argentina, Colombia, Uruguay, Mexico, Bolivia, and El Salvador--followed that path and today some 37 million Latin American workers own and accumulate real wealth in their retirement savings accounts. The late 1990s saw another landmark when Hungary, Poland and Kazakhstan introduced retirement savings accounts now enjoyed by 15 million workers in these former communist countries.

The pay-as-you-go public pension system was created by German Chancellor Otto von Bismarck at the end of the 19th century. Today, such pension systems are heading toward bankruptcy all over the world. That is because such schemes carry the seeds of their own destruction: by cutting the link between individual contributions and benefits--that is between effort and reward--pay-as-you-go systems open the door to political manipulation. The inevitable result has been the creation of “transfer states,” where the possibility of winning elections by buying votes with other people’s money--even with the money of other generations--have led to an “inflation of entitlements” and thus, to gigantic unfunded pension liabilities.

Global demographic megatrends, like longer life expectancy and reduced fertility rates, will accelerate the crisis of public pension systems. Over the next 35 years, the number of people over 60 years old in the world will triple, almost doubling their share to 16 percent of the total population by 2030. In the developed world, the elderly will make up 25 to 30 percent of the population in 30 years. It is interesting to note that the recent breakthrough of decoding the human genome, with its promise to cure ills such as cancer, may become a nightmare to pay-as-you-go administrators around the world. As former U.S. Secretary of Commerce, Pete Peterson, has observed, "the costs of global aging will be far beyond the means of even the world's wealthiest nations--unless retirement benefit systems are *radically* reformed. Failure to do so, to prepare early and boldly enough, will spark economic crises that will dwarf the recent meltdowns in Asia and Russia. . . . For this and other reasons, global aging will become not just the transcendent economic issue of the 21st century, but the transcendent political issue as well."[1]

[1] Peter G. Peterson, “Gray Dawn: The Global Aging Crisis,” *Foreign Affairs,* January/February 1999, p. 43.

Chile Leads the Way

Chile's pension reform replaces the state-run pay-as-you-go system with one of retirement savings accounts owned individually and managed by the private sector.[2] Workers already in the public system were given the choice to stay in that system or deposit their full 10 percent old-age monthly payroll tax in their own retirement accounts. Workers are free to select the manager of their choice and to contribute an additional 10 percent of their salary, tax-free, into their retirement savings accounts. Unlike pay-as-you-go systems, in which there is a compulsory legal retirement age, the Chilean system gives the worker the freedom to choose when he retires as long as he can buy with his own fund an annuity equal to at least 50 percent of his last wages (this threshold is to ensure that he will not become dependent on state money in the future, thus eliminating moral hazard).

Upon retirement, a worker can choose to make programmed withdrawals from his retirement account (based on his life expectancy and that of his dependents) or use the capital in his account to buy an annuity from a life insurance company, or opt for a combination of the two alternatives. In each case, the worker can withdraw from his account a lump sum above that necessary to obtain a pension benefit equal to 70 percent of his last wages. A worker choosing programmed withdrawals can leave the remaining funds in his retirement account as an inheritance to his family or beneficiaries.

The government's role in the new system is to provide oversight of the pension fund companies through a technical superintendency, to place (by law) prudent portfolio

[2] For a personal account of the battle to introduce pension reform in Chile, see José Piñera, *El Cascabel Al Gato* (Santiago: Editorial Zig Zag, 1991). There are other language versions: *Sin Miedo Al Futuro* (Madrid: Editorial Noesis, 1994), with an introduction by Pedro Schwartz; *Bez Obawy O Przyszlose* (Warsaw: Adam Smith Institute, 1996), with an introduction by Waclaw Wilczynski; *Auf dem Weg zum Mundig Burger* (Vienna: IMADEC, 1998), with an introduction by Kurt Leube; *Clopotelul Pisicii* (Bucharest: Editura Expert, 2000), with an introduction by Cazimi Ionescu; and a Korean version published in 1999 by the Korea Center for Free Enterprise in Seoul.

diversification rules on the pension funds, and to add general tax revenue funds to provide a legally defined minimum pension when needed by a poor retiree (with at least 20 years of contributions and older than 65 years).

The government set three rules for the transition to the new system. First, a guarantee to those already receiving pensions in the old system that their benefits would not be cut. Second, those who chose to move to the new system were given “recognition bonds” (marketable treasury bills) corresponding to the present values of the accrued rights in the public system (to be redeemed at retirement). Third, new entrants into the labor force had to join the new private system, closing the door of the state-run system.

To finance the cash-flow budget requirement of the transition, the Chilean government derived resources from a combination of the following: a budget surplus that was previously and deliberately generated for this purpose; the issuance of debt to spread the costs out over time (Chile financed about 40 percent of the transition in this way); reduction in government spending; privatization of state assets; a temporary transition payroll tax (when added to the private pension contributions, the amount was still lower than the old payroll taxes); and increased tax revenues that resulted from greater economic growth.

Today, 6 million workers, more than 94 percent of the labor force, participate in the private pension system, while 6 percent remain in the pay-as-you-go state system (when they retire, the public pension system will cease to exist). With pension contributions as a percentage of salary that are lower than under the pay-as-you-go system, pension benefits are much greater in the private system. The average retiree in the retirement savings account system receives about 78 percent of his mean annual income over the last 10 years of his working life. Real rates of return on retirement accounts have averaged 11.1 percent since their inception in 1981. (A real rate of 4 percent was used when explaining the reform to workers in 1981.) Assets under management have grown to $37 billion, or about 45 percent of GDP. The reform has not only created a huge pool of capital that can be used for domestic investment, but it has also increased the efficiency of capital by stimulating the creation of capital markets and the development of new financial instruments and a risk-rating industry.

It is important to note that pension privatization in Chile was introduced as part of a coherent set of free-market reforms in recognition that implementing such changes simultaneously was the best way to increase economic growth and get the most out of each reform. As a result, the growth rate of the Chilean economy went from an average of 3.7 percent per year in the period 1961-74 to 7.1 percent per year in the period 1990-97. According to economist Klaus Schmidt-Hebbel, of that extra growth of 3.4 percentage points per year, the pension reform would have contributed 0.9 percentage points per year, that is, more than a quarter of the total, and of the total increase of 12.2 percentage points in the rate of savings during those two periods, the pension reform contributed 3.8 percentage points, that is, 31 percent of the total increase.[3]

The impact of pension reform in Chile has gone beyond impressive economic indicators. Pension privatization led to a radical redistribution of power from the state to civil society and, by converting workers into individual owners of the country's capital has created a political and cultural atmosphere more consistent with free markets and a free society.

[3] Klaus Schmidt-Hebbel, "Does Pension Reform Really Spur Productivity, Saving and Growth?" Documentos de Trabajo del Banco Central (Chile), no. 33, April 1998, pp. 25, 29.

A Domino Effect in Latin America

A decade later, Latin American countries began to follow the same path. Already seven countries have implemented pension systems based on private retirement savings accounts. In all cases, the structure of the private pension system closely follows the Chilean scheme, and in all of them the private funds are overcoming the difficult initial years and beginning to make a relevant contribution to the establishment of a free-market economy. Of course, the characteristics of the transition process have differed across countries, taking into account the diverse economic, social and political starting points of the reforms.[4]

Mexico, Bolivia and El Salvador have adopted two crucial features of the Chilean reform: a) workers eligible for the private retirement savings account system do not contribute to the pay-as-you-go public pension system; and b) new entrants to the labor force join the private pension system. Together, the two conditions ensure that after the transition is finished, the public pension system is extinguished and there is only the private system for the vast majority of workers in the country (full privatization). Peru has adopted a), but not yet b). In Colombia, Argentina and Uruguay, workers are in both state pension and private pension systems (partial privatization).

Mexico -- despite a long tradition of state paternalism -- undertook in 1997 a major reform by completely eliminating the public pension system for private-sector workers and replacing it with a system of private retirement savings accounts managed by competing companies. All private sector workers who were previously participating in the pay-as-you-

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

go program had to begin contributing 11.5 percent of their wages to their retirement accounts, to which the government also contributes. Regrettably, public sector workers, including such large sectors as teachers, public health workers and the civil service, were forced to stay in the government pension system. The private system now has 16.1 million participants, the largest of any country in the region, and manages approximately $13 billion.

Bolivia -- one of the poorest countries in the hemisphere -- closed its public pension system also in 1997 and replaced it with a privately administered system of retirement savings accounts. Bolivians now have 10 percent of their salaries placed in retirement accounts for the provision of old age benefits. The pension fund companies now manage $575 million, representing about 10 percent of GDP, and have 540,000 participants.

El Salvador -- until recently a country torn by civil war -- approved its pension reform in 1998, even with the votes of some former guerilla comandantes turned members of Congress. The features of the system are very similar to that of Chile, with workers contributing 10 percent of their salaries into private retirement accounts. Assets under management are $213 million and 736,000 people are enrolled in the private system.

Peru -- the first country to follow the Chilean pension reform -- established a private pension system in 1993. Peru gives workers a choice to move to a private system managed by companies of their selection and provides recognition bonds for those who do. Peruvian workers place 10 percent of their wages into the retirement accounts and pay nothing to the state. But the pay-as-you-go pension program has stayed in place for new entrants to the labor force, leaving the door open on an unfunded system that politicians may once again

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Colombia," at www.pensionreform.org; Carlos Boloña, *Dueño de tu Jubilación?* (Lima: Instituto de Economía de Libre Mercado, 1995).

abuse. More than 2.3 million Peruvians have already moved into the new system, which has accumulated $2.5 billion.

Colombia -- even under threat from Marxist guerrillas allied to drug cartels -- introduced pension reform in 1994. It too allowed workers to opt for investing 10 percent of their wages into retirement savings accounts. In a unique and most troublesome feature, however, workers can switch back and forth between the public and private systems, giving rise to a permanent struggle between a state-run agency and the private system, and perpetuating the pay-as-you-go system. Even so, the private system has attracted 3.6 million participants and has accumulated $3 billion in pension funds.

Argentina -- under a Peronist government that engineered a break with the populism of the disastrous Peron era -- set up a private retirement system in 1994. Argentine workers are given the choice to place 11 percent of the salaries into their retirement accounts. However, the pay-as-you-go system was kept in place and provides all workers, including those in the public and private systems, a so-called "basic pension." Thus, the law establishes that all workers provide 16 percent of their salaries to the public pension program. Those workers opting to stay in the public program face a total of 27 percent of payroll taxes for pensions, and receive benefits on top of the basic pension. By allowing the public pension scheme to continue, the Argentine government continues to add to its unfunded pension liability. Assets under management in the private pension system have grown to $18 billion and the number of participants to 8.1 million people.

Uruguay -- the Latin American country most influenced by the European social model -- introduced a very limited reform in 1996, similar to the Argentine reform in that it keeps the pay-as-you-go system in place for all workers and allows for a portion of wages to be diverted into retirement savings accounts. As of this year, the pension fund companies are managing about $651 million in assets for 544,000 participants in a country of 3 million people.

It can be said that with eight countries already having private retirement systems, Latin America has become the world leader in structural pension reform. If Mexico and El Salvador are successful, pension reform will spread rapidly to the rest of Central America. In fact, Nicaragua approved a reform introducing retirement savings accounts a few months ago that will go into effect in May 2001.

The biggest laggard in the continent is Brazil. Even though some companies offer their workers private pensions, the largest country by size and population in Latin America suffers under the weight of an unfair and unaffordable pay-as-you-go public pension system whose deficit amounted to 4.6 percent of GDP in 1998. Special privileges have made the system more unsustainable. For example, many workers, especially public sector employees, retire at middle age and receive generous benefits. Half of the pay-as-you-go public pension program payments went to 2.7 million retirees from the government sector, while the other half went to 17.7 million retirees from the private sector. So far, the government has kept the social and economic problem from exploding by tinkering with the system, an approach that is reaching its limits.

From Communism to Property Rights

The late 1990s saw another landmark when Hungary, Poland and Kazakhstan, as part of the transition from a collectivist system to a market one, reformed their pay-as-you-go pension schemes and allowed workers to use payroll taxes to build their own retirement savings accounts.[5]

In 1998 Hungary became the first of the former communist countries in Europe to allow a portion of workers' salaries to be invested in retirement savings accounts. Its pay-as-you-go public system, for example, was already experiencing deficits in the 1990s while imposing 30 percent payroll taxes. With an already large elderly population, the country would have had to raise payroll taxes to an unfeasible 55 percent while each pensioner would be supported by one worker by 2035. Current workers were given the choice to stay in the public system or move to the new one. New entrants into the labor force are required to enter into the new system. However, all workers still contribute to the public pension system. For those in the private system, 24 percent of their wages go to the pay-as-you-go system, while only 6 percent go to their own retirement savings accounts. The main shortcomings of Hungary's system are similar to those of Argentina and Uruguay: high payroll taxes are used to maintain the public system, thereby discouraging job creation, and the vulnerability of political manipulation inherent to a state-run pay-as-you-go system is maintained. Hungary's private pension scheme has so far generated $1 billion in assets under management and has 2 million participants.

Kazakhstan -- an oil-rich former Soviet republic -- opted in 1998 for a reform of its pension system by allowing workers to place 10 percent of their wages into retirement accounts managed by competing pension fund companies, while continuing to contribute 15 percent of wages to the state run pay-as-you-go system. However, there is a dangerous

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[5] See Michal Rutkowski, "Restoring Hope, Rewarding Work: Pension Reforms in Post-Communist Economies," in Lucjan Orlowski, ed., *Transition and Growth in Post-Communist Countries: The Ten-Year Experience* (Northampton, Mass. Edward Elgar Publishing, forthcoming in 2000); and Dr. Krzysztof Ostaszewski, "Testimony: Poland's Pension Reform," at www.pensionreform.org.

requirement that a minimum of 40 percent of the funds has to be invested in government securities, and in fact 85 percent of the funds are now in government bonds, reflecting the infancy of its domestic capital market and the turmoil in the area after the Russian default of 1998. As in Argentina and Mexico, there is a state-run pension fund company that competes unfairly with the private sector. But while in 1999, that company managed around 70 percent of the assets in the system, that share has gone down to 42 percent and its privatization is contemplated when its share of the market is further reduced to 25 percent. There are 3.2 million workers enrolled in the private pension system, and pension assets have grown to $700 million (4.2% of GDP).

Poland -- the most successful of the former communist countries -- introduced a pension reform in 1999. Workers between the ages of 30 and 50 at the time of the reform were given the choice to stay fully in the state run old age pension system -- in which they have to pay a 19.52 percent payroll tax -- or divert 7.3 percent of their salary into their own retirement accounts and pay a 12.2 percent payroll tax to build "virtual" individual accounts in the state run system. Younger workers must join the private pension system, while older workers must stay in the pay-as-you-go one. So far, 10 million workers have enrolled in the retirement savings account system (60% of those that could choose a retirement account, that is, people between the ages of 30 and 50) and the funds have accumulated $1.5 billion.

As in Latin America, the example of the pioneers is already generating followers in the region. Several countries, including Russia,[6] are planning to introduce Chilean-style pension reform in the near future, Croatia, Macedonia and Romania being among the most advanced.

The Coming Crisis in Western Europe

In stark contrast to some of its eastern neighbors and Latin America, the political elites in western continental Europe have so far been unwilling to engage in structural pension reform. For Europeans, that political paralysis will be disastrous if it continues, since the region's looming pension crisis is perhaps the most severe in the developed world.

According to the OECD[7], European countries' unfunded liabilities arising from pay-as-you-go public pension programs are enormous -- more than 200 percent of GDP in France and Italy and more than 150 percent of GDP in Germany, for example. By 2025, nearly one third of Europe's population will qualify for public pensions. In 30 years, in Germany and Italy, each retiree will be supported by one worker. Combined with those countries' generous benefits and weak or non-existent private savings for old age, drastic tax hikes or benefit cuts would be necessary just to keep the public pension schemes going. Italians who already face 33 percent payroll taxes for pensions could see those taxes increase to 48 percent, for example. For a region that faces chronically high unemployment rates, such a move would only make job creation more difficult.

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

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[6] See José Piñera, "A Chilean Model for Russia," *Foreign Affairs*, September-October 2000.
[7] Van der Noord, Paul, and Richard Herd, "Pension Liabilities in the Seven Major Economies," OECD Working Paper, 1993, cited in World Bank, *Averting the Old Age Crisis* (New York: Oxford University Press, 1994), p. 139.

Spain's pay-as-you-go public pension system is the most expensive program in the federal budget and gives its workers a minimal rate of return. Yet despite the fact that an economically feasible transition to a private system has already been identified and that the government is committed to economic liberalization in other areas, political inertia has prevailed.[8]

In Italy -- the country with the lowest fertility rate in the world – annual public pension outlays stand at around 14.5 percent of GDP. There is, moreover, blatant corruption in the system. In 1997, a Treasury Ministry study discovered that the government had been paying disability pensions to 30,000 dead people. Spot checks of 15,000 recipients of disability pensions found that 5,000 of them had faked their handicaps (they included a young woman who was collecting a pension for blindness while working as a chauffer). It is no wonder that professor Steve Hanke has asserted that "Italy's pension system is the most generous and corrupt in Europe."[9]

France's pay-as-you-go system is also in deep trouble. According to Prime Minister Lionel Jospin, the generous public pension system will go into deficit after 2010. Attempts by previous governments to tinker with the system have been crushed by political opposition and the current government assures that it will neither raise the retirement age nor the payroll taxes to address the shortfall. The almost total lack of a parallel private pension system will makes matters worse for future retirees.

As UK economist Tim Congdon observed in 1997, "Europe's growth prospect is worse now than at any time since the start of the industrial revolution. If Europe's

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[8] See José Piñera, “Una Propuesta de Reforma del Sistema de Pensiones en España,” (Madrid: Círculo de Empresarios, 1996).
[9] Steve Hanke, “Is Chile on the Italian Menu? A Secret Recipe for Economic Survival,” *The International Economy*, July-August, 1992.

governments cannot solve the problem of unfunded pensions, they will not be able to control their larger fiscal difficulties or to prevent rises in taxation which will wreck their economies."[10]

A Breakthrough in the United States?

Several developed countries have substantial private pension systems, especially the United States, Japan, the United Kingdom, the Netherlands, Switzerland, and Canada. According to Intersec Research, Americans now own three-fifths of the $13 trillion world retirement assets -- that is, $7.8 trillion -- versus Japan's $1.5 trillion and the UK's $1.1 trillion. But they coexist with important and flawed public pension systems.

Only two rich nations -- the United Kingdom and Australia -- have so far undertaken a structural reform of their public pension system. In 1986, Great Britain gave its workers the choice to opt out of the second tier of its public pension system and with 4.6 percent of their wage purchase either defined-contribution or defined benefit plans in the private sector. Two thirds of the workers have opted out and contributed to the private funds. Currently, all workers contribute a percentage of their wages to the first, pay-as-you-go tier, and receive the Basic State Pension from the government upon retirement; the UK public pension system still has an unfunded liability of around 40 percent of its GNP. Australia's previous system was a state-run operation funded by income taxes. In 1992, employers were required to establish superannuation accounts for all workers (9 percent of wages will be deposited by 2002) and they will form the primary source of retirement income for most workers. In February 1998, the UK Conservative government proposed the "Basic Pension Plus" plan,

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

which would have allowed workers to open a retirement savings account with their first-tier contributions, but close elections prevented a real debate on that proposal from occurring. As the *Financial Times* noted at the time, the "scheme, which bears some resemblance to Chile's restructuring of pensions in 1981…would be the biggest change to Britain's welfare state since its foundation in 1945."

In August 1995, the Cato Institute created its Project for Social Security Privatization to make the case for allowing American workers' Social Security taxes to be invested private retirement savings accounts. In 1996, during the Republican primaries, candidate Steve Forbes made this proposal an important element in his presidential program. Since then important members of Congress from both parties have expressed support for private retirement accounts. In mid-1998, in a testimony before the Senate Budget Committee, Federal Reserve Chairman Alan Greenspan summarized the state of the debate when he said that "the general broad principles, which are somewhat similar to the Chilean-type system, strike me as the way in which convergence of opinion is starting to move and a valuable first step in moving toward a solution."

In May 2000, Republican presidential candidate George W. Bush took a courageous stand when he stated that "Social Security reform should include personal retirement accounts for young people. . . . The idea works very simply. A young worker can take some portion of his or her payroll tax and put it in a fund that invests in stocks and bonds. We will establish basic standards of safety and soundness, so that investments are only in steady, reliable funds. . . . And money in this account could only be used for retirement, or passed along as an inheritance. Right now, the real return people get from what they put into Social Security is a dismal two percent a year. Over the long term, sound investments yield about a six percent return. Investing that four percent difference, over a lifetime, can show dramatic results." During the campaign, several polls indicated a majority support for this idea, and it was a main issue in the election.

Social Security, the U.S. state pension system (at $400 billion a year, the largest government program in the world), has prevented the common worker from owning his retirement savings and has politicized decisions that should rightfully be made by individuals instead of politicians. Even though 40 percent of Americans have some sort of private retirement system (IRAs, 401K, etc.), another 60 percent do not. Yet they are still mandated to put one eighth (12.4 percent) of their covered earnings in a system that does not give them either ownership, market returns, or security.

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

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

2.*The Rate of Return Argument.* Pay-as-you-go systems are, by their very nature, a good deal for their earliest recipients, but with time, what is essentially a financial pyramid scheme begins to expropriate younger workers. Today the implicit rate of return for current workers is less than 2 percent, and those born today will probably see negative returns. Mechanisms to postpone the public pension system's insolvency, like increasing payroll taxes or the retirement age, reduce the already minimal rates of return. In contrast, in the period from 1802 to 1997 in the United States, the annual real rate of return for stocks has been 7 percent and 3.5 percent for long-term government bonds. From 1802 to 1995, the average real rate of return for corporate bonds was 4.97 percent.[11] So, a private retirement system can provide a higher rate of return, even if all the funds are invested in zero risk government bonds.

3. *The Fairness Argument.* Since the poor tend to start work earlier in their lives and have shorter life expectancy than the better off, the pay-as-you-go old age retirement system is actually regressive for certain categories of workers. One RAND Corporation study found, for example, that because of the lower life expectancy and marriage rates of blacks, Social Security actually ends up transferring about $10,000 from blacks to whites over a lifetime.[12] Under a system of retirement savings accounts, poor workers would be accumulating savings in their accounts and therefore would be allowed to benefit from the rewards that markets are giving to wealth ownership, preventing the recent increase in the so-called "wealth gap" -- an unsurprising result given that most workers are forced to place all their savings in a program giving them less than a two percent rate of return.

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

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

[12] Constantijn W.A. Panis and Lee Lillard, “Socioeconomic Differentials in the Return to Social Security,” RAND Corporation Working Paper Series no. 96-05, February 1996.

rights' would deprive it of the flexibility and boldness in adjustment to ever-changing conditions which it demands."

5. *The Macroeconomic Argument.* The public pension system negatively impacts labor markets and savings because funds are immediately spent, rather than invested, and the payroll contributions amount to a tax on hiring labor. Harvard professor Martin Feldstein estimates that privatization of Social Security could add $10 to $20 trillion in net present value to the U.S. economy.[13] Contrary to conventional wisdom, the transition to a privatized system does not entail new costs to the government or to the economy. It would indeed make an unfunded liability explicit and force policymakers to find a way to pay for the promises made, while generating the mentioned gain to the economy. The projected budget surpluses for the next 10 years have created an historic opportunity to finance the cash-flow challenge of the transition.

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

[13] Martin Feldstein, "Privatizing Social Security: The $10 Trillion Opportunity," Cato Social Security Privatization paper no. 7, January 31, 1997.

toward big government itself is going to change. This dynamic has in fact already occurred in Chile."[14]

Finally, it is interesting to note that there are several reasons why an retirement savings account system in the United States will work even better than in Chile: a) there is already an investor class comprising close to half of the population; b) the capital markets are by far the best in the world, providing multiple efficient mechanisms to optimize the management of risk; c) the information technology revolution has substantially lowered the cost of managing millions of accounts, allowing possibly substantial economies of scale.

Conclusion

Pension privatization is a megatrend in Latin America and the former communist countries of Europe. In the United States, a breakthrough may be at hand. The privatization of the U.S. Social Security system would not only transform every American worker into an owner of capital --creating a massive new investor class-- but would put further pressure on the rest of the world, and especially continental Europe and Japan, to reform their own bankrupt pay-as-you-go public systems. The benefits to workers and economies around the world would be enormous.

Chilean-style pension reform replaces a flawed and collectivist pay-as-you-go state retirement system and gives individuals the right to save and invest their own money so that they can live with freedom and retire with dignity. In the process, the reform not only

[14] Edward H. Crane, "The Case for Privatizing America's Social Security System," S.O.S. Retraite-Sante Conference, Paris, December 1997, www.pensionreform.com. For a complete case for privatizing U.S. Social Security, see Peter Ferrara and Mike Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998).

resolves looming fiscal and social crises, but it creates a world far different than the one Bismarck engendered; it creates a world of worker-capitalists.