

## The Truth About Chile

By Estelle James

In 1981 Chile adopted a national system of personal retirement accounts that has become a focal point in the current controversy over Social Security in the United States.

The virtues of Chile's system have been trumpeted by those seeking to replicate it here. Unlike traditional social security payments, benefits in Chile are based on personal investment accounts owned by workers. Chileans don't worry about whether the government will run out of money as baby boomers retire, because benefits are financed by their own assets, which have been accumulating in their own accounts, not by taxes paid by current workers. The funds are privately managed and therefore insulated from political interference.

Less well known is this: To protect worker-investors from market risk, Chile's government has issued extensive regulations and guarantees—guarantees that are vital but which could still prove costly. While studies show that Chile's retirement system has contributed to the country's rapid rate of economic growth over the past 20 years, those who look to Chile's system as a model for the United States must remember that it is a work in progress. Chileans like their private accounts, but they have been busy improving the design ever since it started.

Before Chile launched a system of personal accounts, its pension system was out of control. Amid high rates of inflation and overly generous promises of benefits, the government was unable to keep the system afloat despite a payroll tax rate of 23 percent.

In 1981, Chilean workers were allowed to choose between a new system and the old. Practically everyone under the age of 50 (and some older people as well) switched. New entrants to the labor force were required to join the new system. The father of the new system, Jose Piñera, then minister of labor and now a leading advocate of U.S. private accounts, got on TV every week and warned workers that their benefits under the old system were unsustainable. It was an easy sell because the new employee contribution rate—12.6 percent—was much lower than the combined employer-employee payroll tax it replaced. That new rate, almost exactly the same as the U.S. payroll tax, included 10 percent for the accounts plus 2.6 percent for administrative costs and disability and survivors' insurance.

Has it been a good deal? Yes. The annual rate of return excluding fees (more on that shortly) during the first 22 years was an astonishing 10 percent above inflation—fortunate for the new system but far above the rate that any country can maintain in the long run. However, even lower returns can ensure comfortable retirements. If the rate of return falls to 4.9 percent above inflation (a figure the U.S. Social Security Administration uses as the expected return of a mixed portfolio of stocks and bonds) while wages grow at 2 percent above inflation, the average Chilean worker who contributes until he retires at 65 would get 60 percent of his final wage plus a survivor's pension for his spouse. (Under Social Security, the medium wage worker gets 42% of his lifetime wage, scheduled to fall to 36% by 2025).

Of course, it's not that simple. Higher returns entail higher risks. Financial market swings pose some dangers for retirees who rely on personal accounts. But Chile has reduced risk in several ways. Most important, it established a minimum pension guarantee, financed out of general tax revenues, for any worker who contributes to a personal account for 20 years. Every year the government has raised the pension minimum, roughly in line with wage growth. This keeps the pension floor around 25 percent of the average wage, almost double the poverty line, for retirees who earned little or use up the money in their accounts. (A lower means-tested pension exists for those who contribute for less than 20 years.) Only 4 percent of all beneficiaries collect the pension subsidy so far, but the numbers are bound to grow, and Chile hasn't figured out the ultimate costs, or how to pay for them.

The purpose of the guarantee is to keep the elderly from falling into poverty. Every country with personal accounts has adopted a pension floor for this reason. But a minimum pension seems to be missing from President Bush's proposal. In the United States, a minimum pension equal to 25 percent of the average wage would equal about \$750 a month. (Our current average Social Security benefit is \$1,000 monthly.)

One rationale for private retirement accounts is to give workers control over how they invest their savings. But regulations in Chile tightly limited the types of investments allowed in those accounts. Initially, almost all money was put into bank deposits and government bonds—little else was available in Chile's then undeveloped financial markets. Since then, regulations have loosened, permitting a wider variety of investments. Nonetheless, funds whose returns deviated by more than 2 percentage points from the industry average have been penalized. This has caused "herding," or copycat behavior, among fund managers, but has prevented workers from mistakenly betting on specific firms or sectors. In the United States, we can accomplish the same goal more efficiently by using index funds linked to diversified market benchmarks such as the Standard & Poor's 500-stock index.

How do people get their money out of the accounts? Two-thirds of Chile's retirees buy annuities, which protect them from the risks of bad investments or of outliving their savings. Otherwise, retirees can take gradual withdrawals according to a formula set by regulators. Lump sum withdrawals are prohibited until the worker has enough to ensure that he or she will remain far above the pension floor throughout their retirement years. (By contrast, the Bush administration would allow people at the poverty line to cash out.)

In Chile, annuities must be price-indexed to protect workers from inflation. The government guarantees a large part of the annuity just in case the insurance companies become insolvent.

Lots of rules, and lots of guarantees. All these guarantees will cost money in the long run. The risks (of low returns or insurance company failure) are there and someone has to bear them. Chile decided that the taxpayer is the risk-bearer of last resort.

So what are the downsides to Chile's scheme? What should we do differently here?

First, workers in Chile had practically no investment choice for 20 years. Each asset manager could offer only one portfolio and portfolios were all similar. A young worker might have wanted to make riskier investments than an older worker, but that wasn't an option. Chile recently modified its rules to enable each asset manager to offer five portfolios, with different degrees of risk. But now some low earners game the system and choose the riskiest investments, hoping for big gains while knowing that the government will give them the minimum pension if the risk does not pay off.

If we create personal accounts in the United States, we should also make portfolio choices simple, limited and diversified—including international securities—to protect inexperienced investors from themselves.

Second, Chile's system initially had very high administrative costs, in part because fund managers had to invest in new information technologies and marketing tools. As assets grew, costs fell dramatically and are now about 1 percent of assets, lower than in the average U.S. mutual fund. Over a lifetime, costs in Chile are projected to reduce a worker's final pension by 15 percent. In the United States, we can do better. We can enjoy economies of scale and the bargaining power obtained from aggregating many small accounts into enormous sums. For example, we could auction off the rights to run the funds to a limited number of asset managers, which would push down their fees. We could require the use of index funds and collect contributions through the existing tax collection system. The experience of the retirement plan for federal civil servants suggests that these techniques would cut our costs to about one-third of those in Chile.

Third, Chile allows workers to stop contributing and start withdrawing once they meet a certain threshold. Most workers qualify before age 60, some even before 50—and they have taken their annuities as soon as they can. Eventually many retirees will qualify for subsidies when the government's minimum guarantee overtakes their annuities. (Taking the pension does not mean you must stop working. In fact, Chile encourages pensioners to continue working by exempting them from the payroll tax. This is good for their incomes and the economy.)

Fourth, Chile's minimum pension is good, but could be even better. On the "plus" side: It keeps low-income pensioners from falling way below the average standard of living. On the negative side: It offers no extra safety net for more than 20 years of work. Some low earners avoid contributing beyond 20 years because their additional contributions would simply replace subsidies they would get otherwise. In the United States, we could avoid creating such perverse incentives.

Should we do a Chilean type of reform? If we did, we would face huge transition costs—paying current Social Security benefits to people 55 and over while diverting the current payroll taxes that would ordinarily go to those beneficiaries. Over time, this would cost trillions of dollars. Chile planned for this transition by building up a large fiscal surplus before changing its system. This fiscal discipline increased Chile's national saving and productivity, and therefore the size of the gross domestic product pie. In contrast, the United States is starting with a large fiscal deficit. If the government borrowed money to interest rates might rise, and the opportunity to increase national saving and GDP would be missed. It would be a shell game, at best. There are, however, good ways to cover transition costs, such as raising the payroll tax ceiling, postponing income or estate tax cuts for the wealthiest Americans or financing the new accounts, in part, with new contributions.

The president often says that personal accounts are important to building an "ownership society" and reducing government's obligations to our nation's retirees. But one of the lessons of Chile is that when the welfare of a nation's retirees are at stake, the government's obligations remain crucial and lasting, and ownership comes with a lot of strings attached.

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