

Empowering Workers

The Radical Reform of Pensions in Chile

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A specter is haunting the world. It is the specter of bankrupt government-run pension systems.

The pay-as-you-go system that reigned supreme through most of the 20th century has a fundamental flaw: it destroys, at the individual level, the link between contributions and benefits—in other words, between effort and reward. Whenever that happens on a massive scale and for a long period of time, the final result is disaster.

Two factors external to the system aggravate the consequences of that flaw: the global demographic trend toward decreasing fertility rates and medical advances that are lengthening life. As a result, fewer workers have to support more and more retirees. Since increasing payroll taxes generates unemployment, sooner or later promised benefits have to be reduced, a telltale sign of a bankrupt system. Whether benefits are reduced through inflation, as in most developing countries, or through legislation, the result is the same: anguish about old age is created, paradoxically, by the inherent insecurity of an unfunded "*social security*" system.

In Chile, the Pension Reform of November 4, 1980 introduced a revolutionary innovation. The Reform gave every worker the choice of opting out fully from the government-run pension system and instead putting the former payroll tax (10% of wages) in a privately managed personal retirement account (PRA). Since 95 percent of the workers chose the PRA system, the end result was a "*privatization from below*" of Chile's social security system.

After 26 years, this comprehensive Reform has changed dramatically Chile's economy and society. Six million workers (95% of the labor force) have a PRA and, unless they are very poor, they will not depend at all on the government for their retirement.

The PRAs annual average rate of return for the past 26 years has been around 10%

above inflation. Retirement benefits in the PRA system already are 50 to 100 percent higher—depending on whether they are old-age, disability, or survivors' retirement benefits—than they were in the pay-as-you-go system. The resources accumulated in the workers PRAs and the life annuity reserves of the insurance companies amount to \$93 billion, or around 80% of Chile's GDP. By increasing savings and improving the functioning of both the capital and the labor markets, this Reform has been the single most important structural change that has contributed to the doubling of the growth rate of the economy once the reform matured (in the 1985-1997 period the historic annual growth rate of the economy went from 3% to 7.2%).

How It Works

Under Chile's new pension system, what determines a worker's retirement benefit is the amount of money he accumulates in his PRA during his working years. Neither the worker nor the employer pays a payroll tax. Nor does the worker collect a government-funded benefit (unless he is eligible for the minimum pension).

Instead, 10 percent of his wage coming from the previous payroll tax is deposited, tax free, by his employer each month in his own PRA.¹ The 10 percent rate was calculated on the assumption of a 4 percent average real return on a PRA during a whole working life, so that the typical worker would have sufficient money in his account to fund a retirement benefit equal to approximately 70 percent of his final salary. A worker may contribute up to an additional 10 percent of his wage each month also deductible from taxable income, as a form of voluntary savings. The return on the PRA is tax-free. Upon retirement, when funds are withdrawn, taxes are paid according to the income tax bracket at that moment.

A worker may choose any one of the private pension fund companies (called Administradoras de Fondos de Pensiones, or AFPs) to manage his PRA. A key provision is totally free entry to the AFP industry, for both domestic and foreign companies (foreign companies can own up to 100 percent of an AFP) in order to provide competition and thus benefit workers. Those companies can engage in no other activities and are subject to strict supervision by a government entity, the Superintendency of AFP, that was created to provide highly technical oversight to prevent theft or fraud.²

Each AFP operates five investment funds, with different bond/share proportions (the original scheme allowed only one fund for each AFP). Older workers have to own funds highly invested in fixed income securities, while young workers can have a much higher percentage of their funds in shares. Investment decisions are made by the AFP, but the worker can choose both the AFP and, within limits, the preferred fund. The law 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 progressively as the AFP companies gain experience and capital markets work better. There is no obligation whatsoever to invest in government bonds or any other specific private or government security. Legally, the AFP companies and the investment funds are separate entities. Thus, should an AFP go under, the assets of the funds - that is, the workers' investments - are not affected at all and only the AFP's shareholders lose their capital.

Workers are free to change from one AFP company to another, and from one fund to another. There is then competition among the companies to provide a higher return on investment, better customer service, or a lower commission. Each worker is given a PRA passbook (to use if he wants to update his balance by visiting his AFP) and receives a statement by mail every three months informing him of 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 retirement benefit (with a provision for traditional survivors' pension 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 indulge in their true vocations or hobbies. The pay-as-you-go system does not permit the satisfaction of such preferences, except when powerful political constituencies exert collective pressure to have, for example, an early retirement age. It is a one-size-fits-all scheme that may exact a high price in human happiness.

The PRA system, on the other hand, allows 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 on which a worker can calculate the expected value of his future retirement benefit, based on the money in

his account, the life expectancy of his age group, and the year in which he wishes to retire. Alternatively, the worker can specify the retirement benefit he wishes to receive and determine how much extra money 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 or other relevant variables (for example, longer life expectancies).

All workers, whether employed by private companies or by the government, were given the opportunity to opt out of the pay-as-you-go system.³ Self-employed workers are not compelled to participate in the PRA system, as they were not in the government pay-as-you-go system, because of the practical difficulties in a country like Chile of enforcing any mandatory system for self-employed people. But the pension reform allows them to enter the PRA system if they wish, thus creating an incentive for informal workers to join the formal economy.

The government ensures a "*safety net*". A worker who has contributed for at least 20 years but whose benefit, upon reaching retirement age, is below what the law defines as a "*minimum pension*" is entitled to receive that benefit level from general government revenue sources once his PRA has been depleted. There is a second floor for those without 20 years of contributions, who are eligible for a welfare-type retirement benefit at a lower level.

A key feature of the reform was the change in the meaning of "*retirement*". The legal retirement age is 65 for men and 60 for women (those were the ages in the former pay-as-you-go system and were not discussed or changed during the reform process because they are not a structural characteristic of the PRA system). But in the PRA system, workers with sufficient savings in their accounts to buy a "*reasonable annuity*" (defined as 50 percent of the average salary of the previous 10 years, as long as it is higher than the "*minimum pension*") can cease working, begin withdrawing their money, and stop contributing to their accounts. Of course, workers can continue working after beginning to withdraw their money. A worker must reach the legal retirement age to be eligible for the government subsidy that guarantees the 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 retirement benefit purposes once you

have assured yourself a "*reasonable*" benefit as described above.

Upon retiring, a worker may choose from three payout options. In the first case, a retiree may use the capital in his PRA to purchase an annuity from any private life insurance company. The annuity must guarantee 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 (wife and orphans under the age of 21). Second, a retiree may leave his funds in the PRA and make programmed withdrawals, subject to limits based on the life expectancy of the retiree and his dependents; with this option, if he dies, the remaining funds in his account form a part of his estate and can be given to his heirs basically tax-free. 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 percent of his last wages. And third, he can choose any mix he wishes of the previous two.

The PRA 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 PRA system, the working population does not pay taxes to finance 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 - huge unfunded government social security liabilities - does not exist under the PRA system.

In contrast to company-based pension systems that generally impose costs on workers who leave the company before a given number of years and that sometimes result in the loss of the workers' retirement funds-thus depriving workers of both their jobs and their pension rights (such as in the infamous Enron case in the United States)-the PRA system is completely independent of the company employing the worker. Since the PRA is tied to the worker, not the company, the account is fully portable. Given that the pension funds must be invested in tradable securities, the PRA has a daily value and therefore is easy to transfer from one AFP to another. The problem of "*job lock*" is entirely avoided. By helping labor mobility, the PRA system increases labor market flexibility. And it neither subsidizes nor penalizes immigrants, who receive what they have contributed even if they return to their homelands. As PRA systems spread around the world, I envision portability between countries as well, which will help

people who are more internationally mobile (such as professionals or unassimilated immigrants).

A PRA system also can accommodate flexible labor styles. In fact, some people are deciding to work only a few hours a day or to interrupt their working lives-especially women and youngsters. In pay-as-you-go systems, those decisions create the problem of filling the gaps in contributions and, in some cases, may entail no right at all to a retirement benefit, despite years of contributing to the system. Not so in a PRA scheme where stop-and-go contributions do not impinge on the right to get back the totality of (plus the return on) one's contribution.

The Transition

In countries that already have a pay-as-you-go system, one crucial challenge is to design and implement the transition to a PRA system. In Chile we set three basic policy rules:

1. The government guaranteed those already receiving a social security check that their benefits would not be touched by the reform. It would be unfair to the elderly to break the promises made. I stated this basic rule in this way: "*Nobody will take away your grandmother's check*".
2. Every worker was given the choice of staying in the pay-as-you-go system or moving to the new PRA system. Those who opted out of the former system were given a "*recognition bond*" that was deposited in their new PRAs. That bond was indexed to inflation and carried a 4 percent real interest rate. It was basically a zero-coupon Treasury bill maturing when the worker reaches the legal retirement age. The bonds can be traded in secondary markets, so as to allow the worker to use them to build the capital necessary for early retirement. The bond was calculated to reflect the contributions the worker had already paid in the pay-as-you-go system. The exact formula was in the law and was extensively and simply explained to the people. Thus, a worker who had paid social security contributions for years did not have to start at zero when he entered the PRA system.
3. All new entrants to the labor force were required to enter the PRA system. This requirement ensured the complete end of the pay-as-you-go system once the last worker who remained in it reaches retirement age. From then on, the government

has to pay benefits to retirees of the old system only for a limited period of time.

To give all those who might be interested in doing so an equal opportunity to create AFPs, 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). Note that in this way we transformed May Day into a day celebrating the empowerment of workers through social security choice.

Together with the creation of the new system, all wages were redefined so as to include in the gross wage 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 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 then 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 percent.

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 standpoint, all the contributions are ultimately paid by the worker, because employers take into account all labor costs - whether termed salary or social security contributions - in making their hiring and pay decisions. So, by renaming the employer's contribution and by including it in the gross wage, our reform made it clear - without reducing workers' take-home pay - that all contributions are paid ultimately by the worker. Of course, at the end of the day, wage levels will be determined by the interplay of market forces.

The financing of the transition is a complex technical issue that we addressed successfully without raising taxes and that each country must resolve according to its own circumstances. The key insight in this regard is that, contrary to the widely held belief, there is no "*economic*" transition cost, because there is no cost to GNP due to this reform (on the contrary). A completely different, and relevant, issue is how to confront the "*cash-flow*" transition cost to the government that emerges not from this

reform but from the fact that there is an enormous unfunded liability created by the pay-as-you-go-system.

The implicit pay-as-you-go debt of the Chilean system in 1980 has been estimated by a World Bank study at around 80 percent of GDP. As that study states, "*Chile shows that a country with a reasonably competitive banking system, a well-functioning debt market, and a fair degree of macroeconomic stability can finance large transition deficits without large interest rate repercussions*".⁴

We used five "*sources*" to finance the fiscal costs of changing to a PRA system:

1. Using debt, the transition cost was shared by future generations. In Chile, roughly 40 percent of the cost has been financed by 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 beneficiaries of the old system are no longer with us (a source of sadness for their families and friends but, undoubtedly, a source of relief for future treasury ministers).
2. Since the savings rate needed in a defined-contribution system, like the PRA, to finance adequate retirement benefit levels was lower than the existing payroll taxes, a fraction of the difference between them was used as a temporary "*transition tax*" (which was gradually reduced to zero, lowering the cost of hiring labor and leading to more employment).
3. In a government's balance sheet there are liabilities-such as social security and health obligations-but also government-owned enterprises, land, and other types of assets. Since we were also at that time privatizing government-owned assets, especially companies, that was one way to finance the transition that had several additional benefits, such as increasing efficiency, empowering workers with ownership, and depoliticizing the economy.
4. The need to finance the transition was a powerful incentive to reduce wasteful government spending. Prior to the reform, the government deliberately created a budget surplus, and for many years afterwards the treasury minister could legitimately use the need to "*finance the transition*" as a powerful argument to contain the permanent pressure from all sources to increase government

expenditures.

5. The increased economic growth fueled by the PRA system substantially increased tax revenues, especially those from the value-added tax, and this has allowed Chile to even run budget surpluses in these last years.

The Results

Since the system began to operate on May 1, 1981, the average real return on investment has been 10 percent per year (during 26 years). Of course, the annual yield has shown the oscillations that are intrinsic to the free market-ranging from minus 3 percent to plus 30 percent in real terms-but the important yield is the average one over the working life of a person (say 40-45 years) or the full working plus retired life (say 55-60 years) if a person chooses the programmed withdrawal option.

Retirement benefits under the PRA system (with a mandatory savings rate of only 10 percent) have been significantly higher than under the old, state-administered system, which required a much higher payroll tax. According to one study, the average AFP retiree was receiving, after 15 years of operation of the system, a retirement benefit equal to 78 percent of his mean annual income over the previous 10 years of his working life. Upon retirement, workers may withdraw in a lump sum their "*excess savings*" (above the 70 percent of salary threshold). If that money were included in calculating the value of the retirement benefit, the total value would come close to 84 percent of working income. Recipients of disability retirement benefits also receive, on average, 70 percent of their working income.⁵

The pension funds have already accumulated an investment fund equivalent of 80 percent of GNP, and some experts forecast that that percentage will rise to 100 percent of GNP when the system reaches full maturity. This long-term investment capital not only has helped fund economic growth but has spurred the development of efficient financial markets and institutions. The decision to create the PRA 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 PRAs, to capture a large share of the wealth created by the privatization process.

One of the key results of the new system has been, then, to increase the productivity of capital and thus the rate of economic growth in the Chilean economy. 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 independent directors of the companies in which they own shares, thus shattering complacency at board meetings.)

The new social security system has made a significant contribution to the reduction of poverty by increasing the size and certainty of old-age, survivors', and disability benefits; by the indirect but very powerful effect of promoting economic growth and employment; and by eliminating the unfairness of the old system. According to conventional wisdom, pay-as-you-go schemes redistribute income from the rich to the poor. However, when certain income-specific characteristics of workers and the modus operandi of the political system are taken into account, those systems generally redistribute income to the most powerful groups of workers, who are obviously not the most vulnerable or poor.

Pension issues in Chile have ceased to concentrate the energy and focus of the government, thus depoliticizing a huge sector of the economy and giving individuals more control over their own lives.⁶

It is not surprising that the PRA system has survived intact four center-left governments in the last 16 years, since it really has become the "*untouchable*" pillar of the Chilean economy. Not only has it been left untouched in its structural design, but technical adjustments have improved it, for example, by allowing more competition in the management of voluntary retirement savings and enlarging the choices of funds from one to five.

When the PRA system was inaugurated in May 1981, one-fourth of the eligible workforce signed up in the first month of operation alone, and today 95 percent of covered Chilean workers are in the PRA system. When given a choice, Chilean workers have voted with their money overwhelmingly for a free-market-based

retirement system.

For Chileans, their PRAs now represent real and visible property rights—indeed they are the primary sources of security for retirement, and 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 PRA. The new pension system has given Chileans a personal stake in the economy. A typical Chilean worker is not indifferent to the behavior of the stock market or interest rates. He knows that a bad economic policy can harm his retirement benefits. When workers feel that they themselves own a part of their country's assets, not through party bosses or a Politburo, they are much more attached to the free market and a free society.

The overwhelming majority of Chilean workers who chose to move into the new system freely decided to abandon the government system even though some of the national trade union leaders and most of the political class advised against it. I have always believed that common workers care deeply about and pay a lot of attention to matters close to their lives, such as social security, education, and health, and make their decisions for the well-being of their families, not according to political allegiances or collectivist ideologies.

The ultimate lesson of the Chilean experience 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.

Epilogue

Why first in Chile? What was the political context? How did you manage to do it? Those are invariably the first questions I am asked whenever I explain the Chilean social security reform in my travels around the world. So let me answer them briefly here.

It all began in 1956 when the Faculty of Economic Sciences of the Catholic University of Chile signed a three-year agreement of cooperation with the Department of Economics of the University of Chicago. The agreement was renewed twice, for a total of nine years. The extraordinary transfer of ideas that took place created the best economics faculty in Latin America. In the 1960s hundreds of students such as myself

were learning rigorous economics and discovering public policy ideas based on individual freedom and private enterprise.

Soon there was a critical mass of free-market economists, with a common diagnosis of the country's economic problems and similar views on the needed solutions. Since ideas have consequences, this group began to influence the public debate and began to be referred to as the "*Chicago Boys*". When I got my economics degree in Chile in 1970, I decided that after four years of intensive and rewarding study in a faculty that, from an intellectual point of view, was a "*wholly owned subsidiary*" of the University of Chicago, it would be enriching to go to another university for my postgraduate studies. So, breaking tradition, I went to Harvard University for my M.A. and Ph.D. in economics. Years later, when I was already a minister, some newspapers began calling me not a "*Chicago Boy*" but a "*Harvard Man*". I am really proud of being both.

In my four years in Cambridge (Massachusetts), not only did I deepen my knowledge of economics and other social sciences, but I immersed myself in the exhilarating climate of freedom of American society. In search of the ultimate causes of the success of America, I became a passionate admirer of the Founding Fathers and their two great legacies to all the world: the Declaration of Independence and the Constitution of the United States. I also found great inspiration in the works of thinkers on liberty such as John Locke, Adam Smith, Frederic Bastiat, Friedrich Hayek, Karl Popper, Ludwig von Mises, and Milton Friedman (in whose 1962 book, *Capitalism and Freedom*, I first read about the idea of privatizing social security). During those years, I became convinced that only fundamental economic and political reforms based on individual freedom could deliver my country from poverty and all forms of oppression.

In the meantime, the communist takeover of Cuba in 1959 and its government's efforts to create, in the words of Che Guevara, "*multiple Vietnams*" in Latin America, led ultimately to the breakdown of democracy in Chile. Soon after, the new military government decided to invite some of the "*Chicago Boys*" to help reconstruct a destroyed economy and the real revolution began in Chile: a radical, comprehensive, and sustained move toward free markets. This "*Chilean Revolution*" doubled Chile's historic rate of economic growth (to an average of 7 percent a year from 1984 to

1998), drastically reduced the proportion of people living in poverty, and unleashed the forces that brought liberal democracy and the rule of law.

At the end of 1974, I faced a very difficult choice: remain in Boston enjoying the academic life I loved so much or go back to help found a new country from the ashes of the old one. When I went back, I knew the road ahead was full of dangers and risks. Almost immediately, I became very active in promoting the ideas of economic, social, and political liberty in public debate. Two years later, in 1977, I gave a speech in which I described a possible future for the country should we choose to make a dash for economic freedom. The next day, I was invited by the president, whom I had never met before, to repeat the speech to him and the full cabinet, and in December 1978, I became Chile's secretary of labor and social security with two big goals: creating a new social security system and reforming the rigid and anti-employment labor law of my country.⁷

My ideas for pension reform were then part of an overall vision of a free market and a free society in Chile. At the ministry, I assembled an excellent team to help me design not only the new system but also a transition strategy. For decades in Chile, those striving for social security reform had failed, because their plans were biased and flawed. I decided that we should "*take the bull by the horns*". My motto was that we needed a "*radical reform with a conservative execution*". I remember often reiterating to my team that there was nothing as satisfying in life as to do something others deem impossible. We were bound together by our faith in the power of ideas and by the conviction that we could make a difference for millions of Chilean workers.

During my two years in the ministry, I divided my seven-day workweek equally between excruciating work with my team, perfecting every detail of the reform project, and educating people on the values and logic of those ideas. I had countless meetings with workers across the country, and I began a weekly, three-minute explanation of the reform on one of the prime-time TV news programs. Those TV appearances, promoting the reform in the most simple and truthful terms, were crucial to building the popularity of pension reform among the nation's workers.

Let me share two revealing anecdotes regarding the temptations a reformer faces and must avoid. At some moment, it seemed very likely that the pension reform would

finally be approved, as the idea was gaining support everywhere. But some special interest groups thought they could hash out some last-minute compromises. One day, I was petitioned to attend, by myself, a closed-door meeting with the top union leaders of the country. After a round of cordial greetings, their spokesman explained that, although they were ideologically opposed to the reform, they knew that it was likely to be passed. *"We have come to suggest to you that our support could be helpful in the future. After all, you are a young man of 30, maybe with a promising political career in front of you. . . . So, we are willing to immediately give you our public support, as long as you are reasonable and modify a single detail in your project: instead of giving workers the right to choose the manager of their individual accounts, it should be the exclusive decision of the directors of the unions to which workers belong."* He continued: *"The workers, Mr. Minister, do not know how to make a decision of that nature. If we can come to an agreement about this, we will be very pleased to be of use to you in the future."*

I must confess to having been surprised, not only by the brazen nature of the offer, but also by the Olympian contempt they showed for the freedom and dignity of the workers. In formulating a response, I opted for humor. *"Unfortunately, I cannot accept the offer that you have come to tender, because I am concerned with saving your souls."* *"How is that, by God?"* shouted several of them at the same time. *"It's just as you heard it, gentlemen. As we all know, union leadership in our country has always been highly politicized, but it is not corrupt. If the manager selection becomes a union leader decision-as opposed to one made by each worker-you directors would be inundated by so many pressures that it would not be easy to maintain your integrity. The pension managers, who would love to manage the retirement savings of large groups, will find it much cheaper to corrupt union officials than to compete for the accounts in the free market by offering better returns or lower commissions. I will not accept that, because it will lend itself to temptations which none of you would want to face."* Nobody raised his voice after that. The meeting was quietly adjourned, though much less cordially than it had begun.

The next visit was that of the chairmen of the most powerful banks in Chile. They told me they fully supported the concept of private individual retirement accounts, but that they wanted the system to be managed only by the banks. One of them even made an

impassioned argument against allowing "*foreign*" financial institutions to manage the workers' retirement savings. As I had the trade union leaders', I pondered their arguments but rejected their position completely. Competition was crucial to providing good service. And it was out of the question for me to restrict workers' choices to grant Chilean financial businessmen a monopoly on managing the system. I knew I was creating adversaries, but there is nothing more dangerous than diluting the coherence of a reform in order to please those with vested interests. It is not only moral and intellectual dishonesty, but also very bad policy.

Those two meetings reminded me of Thomas Jefferson's words, which had been engraved on my mind and soul since I first read them: "*Whenever a man casts a longing eye on public office, a rot begins in his conduct.*" The key phrase here is "*a longing eye*", by which Jefferson distinguished between the necessary role of public men and the illegitimate desire to hold office for reasons of private gain. In fact, a Republic needs patriots willing to sacrifice themselves in public service working hard, honestly and truthfully in the quest for the common good. But a Republic is corrupted when individuals use a public office to serve their own appetite for power, money or glory, or to favor relatives, friends or political colleagues. America's Founding Father saw the need for real leaders - leaders who are willing in other words to place the common good above everything else - in order for a republic to survive and prosper. And in this statement, he also illuminated clearly the difference between this type of leadership and the mere quest for power that is the curse of most of today's politics.

On November 4, 1980, the reform was finally approved. The law gave the pension fund companies six months to start up, which would have set May 4 as the date. An idea suddenly hit me: to move the inauguration date up to May 1, the international Labor Day. It is a date that historically has had a special meaning for workers but that regrettably had been turned into an occasion for protest fueled by the rhetoric of class warfare. For Chile in the future, I foresaw that day as one of celebration of a reform that gave freedom and dignity to our nation's workers.

With this minor adjustment approved, I rushed to my office to share the good news with the rest of the team. In the midst of all the cheering, a voice broke through the noise: "*We did it! We took the bull by the horns! Viva Chile!*"

I arrived home very late that evening. I was extremely happy but completely exhausted. To relax, I turned on the TV news. They were announcing the breaking news that Ronald Reagan had just been elected president of the United States. As I slept that night, my dreams were filled with hope for Chile and hope for the world.

APPENDIX

(Presentation by economist José Luis Daza of José Piñera, keynote speaker at the Annual Dinner of the North-American Chamber of Commerce, Drake Hotel, New York, February 19, 2004)

José Piñera, a freedom fighter

It is not the first time that I introduce José; on previous occasions it has usually meant an enormous effort followed by great pleasure. In order to get this man to speak in forums I had organized, I had to pursue him all over the world. Fortunately, this time the Chamber exerted the effort in getting him to speak to us tonight, and I am keeping the pleasure.

As always, I have an enormous sense of excitement at the prospect of listening to José, for, every single time I have been with him, heard him or read him I have learnt something new. As I said a year ago, when the Chamber graciously invited me to be the keynote speaker, José has profoundly influenced my thinking.

When we are young, I believe most of us dream of having an opportunity to leave a positive mark on the world, we all dream of having a chance to make the world a better place. Some people achieve it through ideas, others through actions in the policy arena, and others through the influence they exert in their daily human interaction.

Well, José has impacted the world, through every one of these avenues. But today I would like to highlight what is perhaps his greatest contribution of all; something that is not sufficiently mentioned: his contribution to democracy, to freedom.

I am sure you are all aware of his role as “*the father*” of Chile’s spectacularly successful pension fund system; of his role as the author of the mining code which led to Chile’s quadrupling of copper output since the early 1980s (by the way, almost all

of this increase carried out by the private sector). Of his role in reforming the labor market.

I am also sure you are aware of his role as advisor to governments all over the world, from the USA to Russia, from China to Mexico, etc, etc.

Unfortunately, his advice was not always followed. I remember an episode in September of 2001; just three months before Argentina’s massive default. Finance Minister Domingo Cavallo was addressing a group of about two hundred investors in Bariloche. All of a sudden he noticed that Jose was in the audience. He stopped reading, he looked up and said *“I see José Piñera in the audience; José, if we had only followed your advice we wouldn’t be in the mess we are in now”*. He looked down and continued reading; we all know the ending of that story.

However, tonight I would like to recognize José’s efforts in one front which is not mentioned sufficiently. His role in helping establish a solid, stable democracy in Chile.

Last year I said that I believed that, from its foundations, Latin America evolved in a perverse universe, in a perverse political and economic equilibrium where poorly designed institutions and bad economic policies led to bad economic outcomes, which in turn created the conditions for populist demagogues, which in turn led to poor economic results, and on and on and on.

I also mentioned that Chile was the only country in the region had been able to break away from this perverse equilibrium, to a new virtuous, political and economic equilibrium. The negative shocks that have hit Chile’s economy and political system over the last few years have prompted a benign, positive response by the key players, and its democracy has been strengthened. There is no doubt that individuals deserve great credit for these actions, but there is also no doubt that all incentives were in the right direction.

I honestly believe that the seeds for these responses were planted in the late 1970s and 1980s by a group of idealistic individuals who implemented revolutionary reforms that led to the creation of the institutions essential for democracy.

Their ultimate motive was the promotion of individual freedom, in all its spheres. José was a vocal defender of freedom of the press and of human rights at all times. José was one of those individuals who played a critical role creating the institutions that have been the basis for the best functioning democracy in Chile’s history.

So José, while everyone admires you for your role in the economy, I thank you for your role in helping make Chile, if not the only one, one of the few functioning, stable democracies in Latin America.

Notes to the Main Text:

1. This mandatory percentage applies only to the first \$15,000 of annual income. Therefore, as wages go up with economic growth, the “*mandatory savings*” content of the system decreases as a percentage of the worker’s total wage. It should be noted that this cap, which is expressed in the law in indexed pesos, has not been touched in 26 years by four different governments.
2. For complete statistical information on the 26 years of the system, visit the website of the Superintendency of AFP, www.safp.cl
3. Members of the armed forces and the national police were not given the choice to opt out. Since then, the deficit of their pay-as-you-go system has increased to unsustainable levels. The original pension reform project included them, but that provision was vetoed by the Defense Ministry on the grounds that it was its legal prerogative to introduce such changes.
4. World Bank, *Averting the Old Age Crisis* (New York: Oxford University Press, 1994), p. 268.
5. Sergio Baeza, *Quince Anos Después: Una Mirada al Sistema Privado de Pensiones* (Santiago: Centro de Estudios Públicos, 1995).
6. For more information, see L. Jacobo Rodríguez, “*Chile’s Private Pension System at 18: Its Current State and Future Challenges*”, Cato Institute – Social Security Choice, Paper no. 17, July 30, 1999.
7. The labor reform was approved in 1979, and the full story is in my book, *La Revolución Laboral en Chile* (Santiago: Zig Zag, 1990). I told the story about the social security reform in a companion book, *El Cascabel al Gato* (Santiago: Zig Zag, 1991). The anecdotes of the meetings with the trade union leaders and the top bankers were published in that book.

José Piñera is president of the International Center for Pension Reform (www.pensionreform.org). As Chile’s minister of labour and social security from

1978 to 1980, and of mining in 1981, he was responsible for three key structural reforms: the privatization of the pension system, the labour law, and the restoration of private property rights in mining. He holds an M.A. and a Ph.D. in economics from Harvard University (U.S.A.).

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José Piñera

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