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Chile as Role Model?

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For many decades, Chile stumbled along with sub-par economic growth like much of the rest of Latin America.

It was relatively poor compared to its formerly prosperous next-door neighbor Argentina, but for the last three decades, Chile has outperformed the other South America countries and now has the highest per capita income in South America – averaging approximately $22,000 per year on a purchasing power parity (PPP) basis.

The World Bank lists Chile as a "developed economy," and it was the first Latin American country to become a member of the OECD. One of the major reasons given for Chile's success is that in 1981 it adopted the world's first privatized national pension system.

Because of the success of the Chilean pension program, similar systems have now been adopted by about 30 countries. Even though the Chilean program has had very high rates of return, enabling most to retire with a substantial income and nest egg, new socialist President Michelle Bachelet is proposing changes.

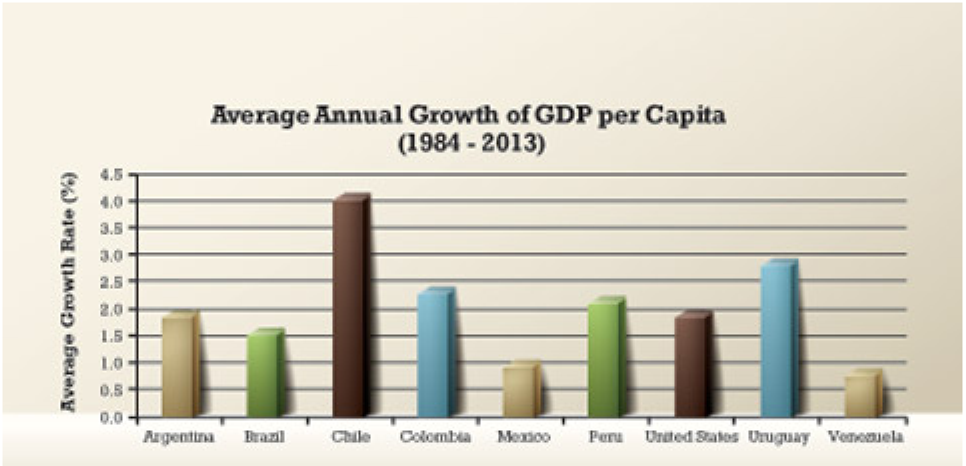
Chile is viewed as one of the 'aspirational countries' where real incomes and economic opportunity have soared. The average citizens of Chile, Hong Kong and Singapore now have real per capita incomes about three times higher than they did in 1983, and the citizens of South Korea have achieved an almost fivefold increase in real incomes over that same time.

The citizens of Hong Kong and Singapore now have higher per capita incomes than the average American. By the standards of the high-income countries, Americans have done relatively well over the last thirty years with average real per capita incomes about 71 percent higher than they were in 1983. By contrast, the average Frenchman has only seen a rise of about 42 percent in real income over that same thirty-year period.

Chile has done particularly well in comparison to its South Americans neighbors, with Brazilians having a mediocre 51 percent rise in real average income, and Venezuelans having only managed to obtain a miserable 16 percent rise over the last three decades.

As can be seen in the accompanying chart, Chile has been growing more rapidly than the major Latin American countries. The other should be doing better because it is easier for low-income countries to grow rapidly as they can import, copy, and otherwise emulate already developed technologies, systems and institutions that have proved to be successful elsewhere.

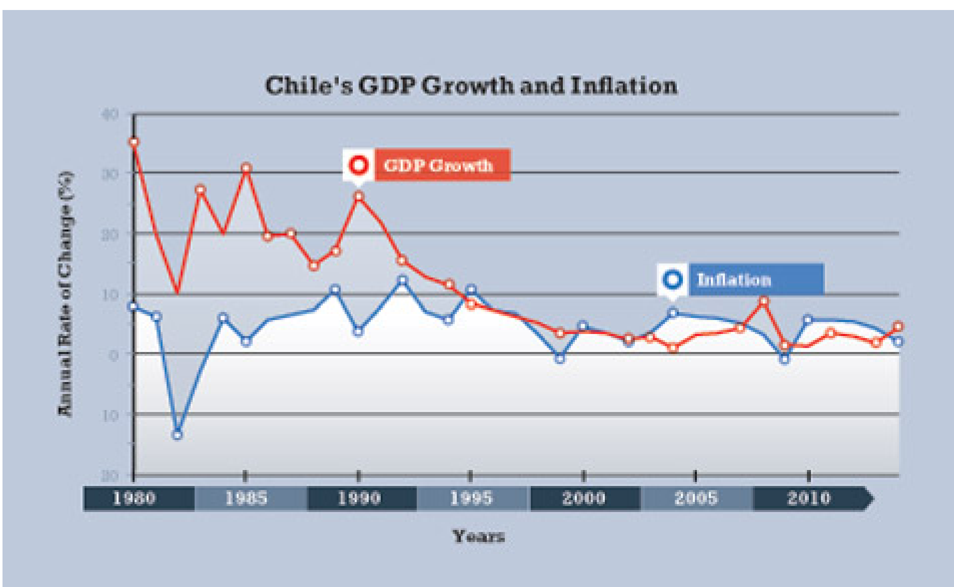
In recent years, Peru and Mexico have been growing much more rapidly after earlier periods of stagnation. Venezuela and Argentina now have negative growth caused by highly destructive policies by their respective governments. **See figure 1**



China has been the most successful country in catching up by taking technology from the developed countries and applying it productively. The typical Chinese has an average income more than 13 times higher than three decades ago. Even so, the Chinese are just now reaching the average income level that citizens of Hong Kong enjoyed in 1983.

Chile began its march to success after the overthrow of the Marxist Salvador Allende in 1973 by General Augusto Pinochet. Allende had nationalized many companies, including the copper industry. Inflation reached 140 percent. Allende's protectionist policies caused a lack of foreign exchange and a falling GDP. Pinochet had little understanding of economics when he seized power, and after flaying about, he hired a group of free-market economists, collectively known as the "Chicago Boys" because many of them had done their graduate work at the University of Chicago.

The Chicago Boys began to free up the economy by removing many of the tax, regulatory, trade and other impediments to growth imposed by the socialists. According to the Annual Index of Economic Freedom, Chile had, in 1970, the least free economy among those being rated. By the early 1980s Chile moved into the top half of the ranking, and by 2008 it was ranked as the fifth freest economy in the world. Its ranking has modestly slipped in the last several years, and in 2012, the latest year available, it was ranked as number 10. **See figure 2**



A unique and key component of Chile's reform was the creation of the world's first national privatized pension (social security) system in 1981. It was the brain child of a brilliant young economist, Jose Piñera, who was serving as Minister of Labor and Pensions at the time. Piñera recognized the fatal flaw in the pay-as-you-go system Chile had at the time; there was little link between what individuals put in the pension program and what they took out. Unfortunately, the U.S. and many other countries still run their social security systems on pay-as-you-go basis.

As Piñera put it: "So we decided to go in the other direction, to link benefits to contributions. The money that a worker pays into the system goes into an account that is owned by the worker." Piñera is considered a "Chicago Boy" even though he earned his Ph.D. in economics from Harvard.

Workers are required to contribute ten percent of their salary into one of several approved private investment funds. Workers can track the performance of their own accounts much in the same way Americans track the performance of their IRA accounts. They are also allowed to contribute more, up to 20 percent of their salaries, so they can choose to retire early or take a bigger payout when they retire.

When a worker retires, he or she can purchase an annuity or take some money out in a lump sum. Last year, Dictuc, a consulting firm affiliated with the Catholic University of Chile, released a study of 28,000 households that showed in the first 32 years of the privatized pension program workers earned an exceptional 8.7 percent compound rate of return above inflation. This is more than triple the rate of return that U.S. workers receive from their social security contributions. The average Chilean now retires with a far higher pension than Americans receive from the government-operated social security system.

In reflecting upon the success of his program, Dr. Piñera said: "The Chilean worker is an owner, a capitalist. There is no more powerful way to stabilize a free-market economy and to get the support of the workers than to link them directly to the benefits of the market system." The workers savings are invested largely in Chilean companies. This additional investment has fueled the high growth of the Chilean economy which has created more jobs at higher wages while at the same time causing the stock market to rise rapidly, enhancing the value of the pension accounts.

Chilean President Bachelet, like any good socialist, is unhappy with a total private pension system, despite its spectacular success – a success so obvious that approximately thirty countries, including Sweden, have adopted variations of the Chilean pension model. Bachelet is now advocating an additional public pension system to bring "more competition" to the private investment firms that handle the pensions. Is there any evidence that state-managed pension systems operate more efficiently and are more fiscally responsible than private-operated ones?

In addition to serving as a role model for other countries as to how to design and operate a national retirement program, Chile has done several other things that are worth emulating. Chile has restrained the growth of government, keeping it to about 23 percent of GDP. According to a number of studies, once government exceeds 25 percent of GDP, economic growth, job creation and the rate of improvement in the general welfare begin to decline. Hong Kong and Singapore, which have been more successful, have even smaller government sectors.

Recent Chilean governments have been very fiscally responsible, at least up to this new government, and enjoyed a very low debt-to-GDP ratio. Chile has an average tariff rate of 4 percent and has had essentially a free trade agreement with the U.S. for the last decade. Chile welcomes foreign investment, has strong protections for private property and has a competent and independent judiciary.

Chileans managed a peaceful transition from the Pinochet dictatorship. Free markets increase the pressure for civil liberties and, ultimately, democracy. As people get richer, they demand more say in how they are governed – witness Taiwan, South Korea, etc. The "Chicago Boys" understood that prosperity would bring democracy.

Since the full restoration of democracy in 1990, Chile has been politically and economically stable and peaceful with governments swinging back and forth from moderate right to moderate left. President Bachelet has increased corporate tax rates, is trying to give the state a greater role in education by reducing private competition and is trying to give the state a bigger role in the pension system.

All of these changes are likely to hurt economic growth, but there is little indication that she is out to destroy the private sector as is being done in Argentina and Venezuela.

The bet is that Chile will remain a prosperous and high-growth country over the long run.

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