From Chicago to Santiago:
Neoliberalism and Social Security Privatization in Chile

SILVIA BORZUTSKY*

Published in Governance: An International Journal of Policy, Administration and Institutions,Vol 18, N04, Oct 2005

Introduction

Politics and policies are part and parcel of the same process. This paper deals with the connections between politics and policies in Chile during the Pinochet regime and the social security reform enacted in 1981. The paper argues that the establishment of a fully funded, defined contribution system, was a reflection of, and an integral part of the market economic approach pursued by the regime. The paper contains a discussion of the principles that inspired the privatization of social security, a description of the system, and an analysis of the impact of the policies on both the state and the society.

This paper is also about the connections between governments and markets in the area of social security. Following Karl Polanyi, I argue that the establishment of a market economy requires the constant intervention of the state to establish and continuously improve the performance of the market. In Chile, just like in 19th century England, the establishment of a market society and economy required the enactment and enforcement on the part of the state of numerous policies that would guarantee the existence and success of the market (Polanyi 1944). Social security privatization illustrates clearly how much the market depends on the state and state policies in order to succeed.

The paper also highlights the importance of the transmission and application of economic ideas from the halls of the University of Chicago to the centers of power in Chile. The reform was inspired by the economic ideas of Milton Friedman and Frederick von Hayek and applied in Chile by their disciples. What is fascinating about this case is that the ideas of economic freedom espoused by Friedman and von Hayek were applied in Chile by a regime that had eliminated political freedoms and severely violated human rights. Was, then, the language of freedom just a rhetorical device used by the Chilean economists, or was it the reflection of a true commitment to these ideas? I argue that the rhetoric of freedom, modernity and neutrality of the market that accompanied the privatization of social security served to consolidate a repressive regime and facilitate the accumulation of capital in the hands of key private sector groups connected to the regime. The paper shows as well, that the promise of market economics that the faithful application of market ideas will increase the wealth of all has not materialized.

* Carnegie Mellon University

Finally, this study illustrate the nature of policy making within an authoritarian regime where politics has disappeared from the public space, but remains intensively competitive within the regime.

Social security privatization was part of a revolution going on in Chile in the late 1970s. This revolution transformed the functions and role of the state and the private sector. However, the impact of this reform is by no means limited to Chile since the Chilean model has been followed by countries in Latin America and in other parts of the world, and it has been recommended by international organizations such as the World Bank. Thus, it is my hope that the analysis presented here will contribute to understand the nature and effects of pension reform on states and societies throughout the world.

Background to the Reform

The origins of Chile's modern social security system can be traced back to laws enacted in 1924 that created separate social security programs for blue and white collar workers, the civil servants, the military and police. Over the years the four original funds grew both in size and complexity. By 1973 the separate systems covered about 70 percent of the population through more than 160 different funds regulated by more than 2000 laws. The end result was the creation of a social security system that was expensive, chaotic, stratified, and unequal. In the words of Jorge Prat, the chairman of a Commission geared to reform the system, "The present social security system is condemned to its disintegration because it is unfair, because it is oligarchic, because it is discriminatory and because it is ineffective and expensive, both for the working population and the national economy" (Prat 1965)

Attempts to rationalize the administration and create a more equitable system of benefits and financing during the Frei administration (1964-1970) failed due to opposition of the labor movement and other organizations representing white collar workers and civil servants. As President Frei argued, "In matters related to social security, all agree in considering unjust and inconvenient the present rules, but when the moment arrives for people to lose their privileges they rebel violently and bring all sorts of pressure to bear" (Frei 1965).

By the early 1970's, the Chilean social security system was in a deep crisis. The system was highly discriminatory regarding the conditions needed to get a benefit, the nature of the benefit, and the financing. Furthermore, pensions for the majority of the blue-collar workers were insufficient due to the combined effect of inflation and the system used to compute the value of pensions. The system was experiencing a severe financial crisis due in large part to the Congressional practice of establishing new benefits for particular groups or individuals and of creating exemptions to the existing laws through legislative riders. These riders imposed financial obligations on the system without allocating the required funding. Alternatively, these riders were used to give special concessions such as allowing the entrepreneurs to under-assess taxable wages for the purpose of paying the social security tax, or condoning debts to the system. Moreover, the state was permanently indebted to the different funds, which created a situation of financial instability and uncertainty (Borzutzky, 2002, Ch. 3).

Thus, the crisis and the need to reform the system in Chile was not simply the result of demographic changes, nor even the result of the expansion of benefits, as has been the case in other countries. The crisis of social security was a bi-product of Chile's unique democratic system; the expansion of political participation; the power of labor and entrepreneurs over the state and especially over members of Congress; and the unwillingness of politicians to carry out the political reforms that would make possible the establishment of a more efficient and equitable social security system. While the Frei administration tried to check those forces, the Allende administration (1970-1973) only fed them and ultimately planted the seeds of its own destruction. The destruction of Chile's political institutions and the destruction of Chile's social security were intimately linked processes (Borzutzky, 2002, Chs. 5 & 6).

The Pinochet Regime: The Establishment of a Market Society and the Intellectual Origins of the Reform

Allende's Chilean Road to Socialism ended violently on September 11, 1973 when General Pinochet took control of the government and unleashed a brutal campaign of repression against those who had supported the previous administration, as well as those who opposed the new order. But General Pinochet was not only determined to destroy Chile's political institutions, he was also determined to transform the economic structure of the country. Economic restructuring involved a total transformation of the role of the state, which in the past was inspired by Import Substitution Industrialization policies. The new strategy was based on the application of market economic ideas, known in Chile as neoliberal ideas, which called for a reduction of the state's social functions and a transfer of economic functions to the private sector through a set of policies known in Chile as modernizations.

From a philosophical standpoint it is important to highlight the role that a group of Chilean economists trained at the University of Chicago had on the development and implementation of these policies. Few things were more foreign to Chilean society than the notions of individualism, competition and consumption that the ideology involves. The introduction of these ideas in Chile was the result of the influence that a group of economists -the Chicago Boys- had on the military regime.

The history of the Chicago Boys can be traced back to an agreement between the University of Chicago and the Catholic University of Chile signed in 1956 and financed by the United States Agency for International Development (U.S.A.I.D.). The agreement allowed students from the Catholic University to study in Chicago while professors from Chicago could teach in Chile. There were many interesting aspects to the agreement, including Cold War related assistance programs, and the need the expansion of market ideas in Latin America. This need was particularly pressing in the Chilean case given the strength of the political left, and the influence of Keynesian economics, import substitution industrialization policies and dependency ideas. These ideas entailed a flat rejection of market economics and the U.S.A.I.D. program was geared to eventually reverse this trend. The Catholic University, on the other hand, also gained from the agreement. While the university had an excellent reputation, its economists had not reached national prominence since their counterparts at the University of Chile controlled policy making. Thus, the agreement gave the Catholic University prestige and the possibility of having its students become the policy makers of the future (Valdés 1989).

The Chicago Boys were the product of this exchange. Sergio de Castro, one of the first students to go to Chicago, and the "dean" of the group soon became Ministry of Finance. Arnold Haberger, a professor of economics in Chicago, became the leader of the Chile project, married a Chilean, and guided the work of many of Pinochet's advisors once they achieved positions of power. The group remained marginal until 1972 when de Castro and others began to formulate an alternative economic plan to be used by the military after Allende's overthrown. The plan, which was financed by the CIA, was in the hands of the military by May of 1973 (Fontaine 1988).

While at the University of Chicago, the young Chilean economists were greatly influenced by the ideas of Fredrick von Hayek and Milton Friedman. Hayek's political ideas as developed in the *Road to Serfdom* emphasized the failure of centralized decision making and the importance of the individual. Following von Hayek, his Chilean disciples argued that the market is the only social arrangement capable of regulating human interaction without coercion, simultaneously guaranteeing freedom and rationally based behavior. The goal was to have the market replace the state as the central regulator of economic activity, guaranteeing efficiency and growth. For von Hayek any degree of state intervention and regulation was not only a limitation of freedom, but signals the beginning of a process of state encroachment upon the individual that will lead to a totalitarian system. As argued by Isserman and Kasin "For von Hayek…liberal planners differed only in degree from their Nazi or Stalinist counterparts. All sought to coerce individuals to behave in ways the planners deemed most useful to society as a whole. All were "'collectivists' who wanted to substitute a strong state for the spontaneous energies of citizens" (Isserman and Kasin, 207). Von Hayek's influence was not limited to teaching Chilean economists in Chicago. He traveled to Santiago frequently in the late 70's and early 80's attending seminars, giving lectures and advising his former students (Foxley 1981, 411-415, Brunner & García 1981, 487-494, von Hayek 1981).

What is paradoxical about the application of von Hayek's views in Chile is that they were implemented by an authoritarian regime organized around the presence of a patrimonial ruler, who anchored his power on repressive policies and a set of semi-religious attitudes about politics. General Pinochet led a sort of patrimonial system in which the authority of the ruler was uncontested and where the ruler assumed a mandate from Divine Providence. For instance, talking about the coup of September 11, General Pinochet said that, "Divine Providence, with her mysterious hand, gave the Armed Forces the order and fluidity to carry out the fast and prompt pacifying action…"(De Souza and Silva 1988, 18). Further evidence of the patrimonial nature of the regime is to be found in the military doctrine that inspired the regime (Borzutzky, 2002, 159-161). Revelations of corruption on the part of General Pinochet and his family disclosed by US Senate investigations of the failed Riggs Bank in mid 2004 and the discovery of savings accounts in a dozen other banks in early 2005 serve to confirm the patrimonial character of the regime and its corrupt nature (O'Hara and Day, 2004, AO1). The abusive nature of the regime has been analyzed extensively (Lira, 2005).

How can one reconcile these contradictions? As is well known, von Hayek's ideas were largely inspired by his distaste for the Nazi regime. In the case of Chile, application of the market philosophy was possible because of the existence of a repressive regime, which had centralized power and obliterated individual rights. It is interesting to note that this repressive regime was legally rooted in the 1980 Constitution, written by Pinochet advisors, which the regime named the "Constitution of Liberty" paraphrasing the title of von Hayek's 1960 book. Unfortunately, the only thing the constitution did not establish was liberty.

Do the answers to these contradictions lie in the fact that both General Pinochet and the market economists believed in a "salvational" role? Both the ideas of the Chicago school and the ideas of General Pinochet were presented as saving the economy and the society from chaos and collapse. Thus, while the economists were there to save the economy from the chaos and collapse produced by Allende's policies, General Pinochet was there to save the country from Marxism. Or, is it the case that those in charge of making economic policy were simply defending the class interests of those who had brought General Pinochet to power? The beneficial effects that the policies had for the new economic elite and the intimate connections between the economic elite and members of the administration sustain that view.

I argue that in Chile, regardless of the commitment to von Hayek's ideas, there was a strong complementarity between the ideological, political and economic models. There was also complementarity between the political needs of the regime and the interests of those who were part of the regime. In fact, the market ideology served the political regime by enabling the government to hide domination behind the notion of "técnicos" or technocrats. It provided the government the justification needed to dwarf the social functions of the state and to transfer those functions to the private sector establishing, what in Chile was called the *subsidiary state* (Declaración de Principios del Gobierno de Chile, 1980 Constitution). In turn, the creation of a perfect market required the atomization of society, particularly the disarticulation of powerful interest groups that could oppose both the market and the regime. Simultaneously, the disarticulation of interest groups was essential to the creation of the authoritarian- patrimonial regime. What followed were dual processes of political and economic disarticulation. Political disarticulation took place through the suspension of political activities and the ensuing repression. Economic disarticulation took place through the passage of the so-called "modernizations", a set of laws inspired by the market ideology that reformed the labor laws, the education, social security and health system, the land tenure system, and the role and functions of local governments.

Equally important was the complementarity that existed between the private and the public sector. Between 1978 and 1983, the glorious years of the Chicago Boys, the most important policy makers rotated between the government and the private sector and were associated with the largest economic groups created as a result of the process of privatization of state owned enterprises. For instance, former Ministers Jorge Cauas, Fernando Léniz, Pablo Barahona, José Piňera y Alfonso Márquez de la Plata, served as executives of the largest economic group at the time: the Cruzat–Larraín conglomerate (Dahse 1979). This group's fortune was intimately linked to the privatization of state owned enterprises in the mid and late 70s; in 1981 the group became the owner of Provida, the largest pension fund management corporation (Dahse 1979, 27).

The analysis of the social security reform illustrates the large degree of complementarity that existed between the political regime and the economic policies and it will highlight the effects that the policies had on specific sectors of the society, including interest groups, lower income groups, the AFPs and women.

Social Security Privatization: The Establishment of a Fully Funded, Defined Contribution System (FFDC)

The early development of social security systems was inspired by a set of collectivist principles which involved a number of state obligations toward the society. In most of the industrialized nations, these principles were translated into the welfare state ideology which informed the development of social policies throughout Western Europe. Accordingly, social security programs were seen as a right of citizenship to be granted on a universal basis. However, an anti-collectivist movement began to appear as early as the 1940's with von Hayek, and it became fully developed in the 1990's (Dixon, forthcoming). The anti-collectivist ideology argues that the welfare state undermines individual freedom, that individuals require the space to identify appropriate personal ambitions, and that voluntary action enables individuals to meet important spiritual needs. Those who support this view argue that "public retirement income provision undermines freedom by imposing uniformity, which prevents people from exercising freedom of choice, and so denies the right to exercise personal responsibility, by expressing a preference for alternative modes of income support."(Dixon). The discourse on freedom is coupled with a discourse on economic efficiency which argues that the market is an efficient, impersonal distributor of resources. Finally, there is an argument made about the impact on human nature according to which state involvement in the provision of retirement benefits undermines individual capacities for self-reliance and personal responsibility (Dixon).

Those who oppose state involvement in the provision of retirement benefits argue in favor of a system in which pensions are linked to the saving effort made by individuals and where these voluntary savings accounts are administered by private entities. Accordingly, the state should have a residual role creating a means-tested system in which fiscal resources are used to provide a welfare pension to those in need (Dixon). The establishment of a FFDC system was inspired by this approach.

General Pinochet's Minister of Labor and Social Security, José Piňera was assigned the task of "modernizing" Chile's social security system. Following von Hayek, Piňera argues that the reform was needed because the previous system denied the individual the freedom to choose and the option of deciding where and how much to save. In his words, "Freedom was a blasphemy. Nobody had the right to choose where to save. Nobody could establish, not even in his dreams, a pension fund managing institution. Competition was systematically prohibited … When we decided to use freedom as the bases for the new pension system our pension system was turned upside down. Our system was going to be based on freedom of choice, not on the oppression of the past" (Piňera 1991, 70).

The Pinochet regime became concerned with the question of social security reform soon after it came to power. However, given the divisions within the regime between corporatists and neoliberals regarding the scope and principles of the reform, not much was done until 1979. The reforms proposed by the corporatists—led by former Air Force General Gustavo Leigh and Minister of Labor, General Diaz—called for a rationalization of the administration and the elimination of the costliest features of the system, including the so called *perseguidoras* and the pensions based on years of service. While the *perseguidoras* guaranteed the retiree a pension equal to the salary currently received by the individual actually performing the function, the pensions based on years of service established that the people could retire, not after having reached a certain age, but after being in the job for a number of years. This feature allowed people to earn two, three or more pensions during a life time imposing a huge burden on the system. Both the *perseguidoras* and the pensions based on years of service were costly privileges received by powerful interest groups.

The first legislative action of the Pinochet regime reflected these views. D.L. 2448, enacted in 1979, eliminated both the *perseguidoras* and the pensions based on years of service. The new legislation also equalized benefits, established a general minimum retirement age, and established a universal system of pension readjustment tied to the consumer price index. Long sought by democratic regimes in the past, particularly the Frei administration, these reforms solved the most important problems of the system by reducing costs, eliminating its most expensive vices, reducing inequalities and generating funds to provide sufficient pensions. In brief, the legislation provided the resources needed to solve the financial problems without privatizing the system (Superintendencia de Seguridad Social 1979).

Once the Chicago Boys took control of the economic apparatus—with Sergio de Castro in the Ministry of Finance and Jose Piňera in the Ministry of Labor—D.L. 2448 appeared to be irrelevant. In a document known as El Ladrillo, or the brick, Sergio de Castro argued that a parametric reform of the pension system, such as the DL 2448, would not work and that the new system "should include elements of competition in management and contractual savings mechanisms" (Acuňa and Valenzuela, 2001).

Piňera's assignments included the reform of the social security system and the institutionalization of a new system of labor relations, or Plan Laboral, which created a depoliticized labor movement and eliminated basic labor rights. The social security reform was to be founded in three basic principles: *subsidiarity* of the state in the administration of the funds, reduction of the principle of social solidarity, and the elimination of the portion of the social security tax paid by the employer. Although the proponents of the new policy claimed to believe and respect liberty and freedom of choice and to oppose centralized decision making because of its tyrannical nature, the reform was drafted in total secrecy by a commission headed by Martin Cóstabal, Director of the National Budget Office and announced to the public by Minister Piňera without any consultation with relevant interest groups.

The reform entailed the elimination of the common fund (CF) system and established a compulsory, FFDC system also known in Chile as an individual capitalization fund. In Piňera's view the collectivist ideology upon which the old system was based had to be replaced. He argued that the CF system had not only failed to achieve social solidarity, its principal goal, but in fact it had encouraged inequalities and inefficiencies. The new system "establishes a clear relationship between the personal effort and the reward" and "gives the individual the freedom of choosing and deciding" (Piňera 1980, 2). Decree 3500 which established the new social security system, also eliminated the employer's portion of the social security tax and established that pension accounts would be administered by new entities known as *Administradoras de Fondos de Pensiones* (AFPs), or Pension Fund Management Corporations. The AFPs also provide retirement pensions. The creation of the AFPs was geared to reduce the role of the state in the provision of pensions; enhance the role of the private sector; increase the savings rate; contribute to the development of a capital market; and contribute to Chile's economic growth. The elimination of the employer's portion of the social security tax was designed to reduce the cost of labor and reduce unemployment (Piňera 1980, 2).

It is important to note that those who were employed at the time of the reform could choose between staying in the CF system and joining the new one. However, those who became employed for the first time after December of 1980 had to enroll in the FFDC system. In fact, there was a massive transference to the FFDC system because of the reduction in contributions, because the old system was discredited, and because of the effects of a massive propaganda campaign. The propaganda campaign launched both by the government and the AFPs stressed modernity and in the words of one advertisement, the person who did not change to the new system was a *quedado,* someone who was not smart enough to understand that the new approach was better and more modern. It is also ironic that the only groups that were allowed to maintain the existing CF system were the military and the police.

In brief, the much heralded Chilean reform entailed the establishment of a compulsory, FFDC system premised on a rejection of collectivist principles and based on notions of individualism and competition. Was this the only way to solve the problems of Chile's social security system? There is no doubt that the CF system had to be rationalized, stream-lined and made more equitable. There is no doubt either that the privileged pensions had to be eliminated and that better pensions for all citizens were needed. The D.L. 2448 accomplished most of these goals by eliminating privileged, expensive pensions, equalizing benefits and establishing a common structure of pension readjustments. These reforms, in turn, would allow for a sizeable reduction in the contributions and an improvement in the pensions of the blue collar workers (Arellano 1981, 11). However, D.L. 2448 was not in line with the neoliberal ideology and it was always seen as a temporary concession to those within the regime that were not interested in the neoliberal approach and who were satisfied with parametric reforms, much like those proposed during the Frei administration.

By mid 1979, those within the regime who opposed neoliberal ideas lost their power and influence and their views about social security fell out of favor as well (Borzutzky, 180-181). As the conduction of the nation's economic policies came under the control of the neoliberal economists, social security reform and the other modernizations were based on the market ideology and were geared to fit the needs of the new economy. These reforms enhanced the role of the private sector and reduced the administrative functions of the state. In the case of social security, the reform replaced social solidarity by individualism, drastically reduced employers' involvement, and transformed the role of the state.

The Rhetoric and the Reality: The Fully Funded, Defined Contribution System 1980-2004

a) Characteristics of the System

The 1980 legislation reformed both the financial and the administrative structures by eliminating the employer's portion of the social security tax (in the CF system could be as high as 52 percent of the taxable wages) and transferring administration to the AFPs. The FF system was to be financed with a 10 percent tax paid by the insured. The insured has to make additional contributions of 2.5 percent and 3.7 percent to finance disability and survivors pensions, and at least 7 percent to become eligible for health and maternity benefits. Currently, the total compulsory contribution paid by the insured amounts to 19.5 percent to 20.7 percent of the wages in the private sector and 27 percent in the public sector.

The individual social security accounts, which are at the core of the system, are administered by the AFPs', lucrative, private corporations whose only function is to administer the accounts and provide pensions. There are currently 6 AFPs which, at least in theory, compete by offering the best return and the lowest commissions. However, from the very beginning, there has been a little competition and a large degree of concentration on the two largest AFPs. Sixty-nine percent of the insured are enrolled in the three largest AFPs. The large degree of concentration is explained by the economies of scale that exist in the industry (Acuňa and Iglesias, 2001, 32).

Entrance into the AFP market is free, but the corporation is required to hold a reserve fund equivalent to 1 percent of the funds they manage. There are no state owned AFPs and banks cannot own AFPs, but there are no restrictions against foreign owned AFPs. The AFPs fund and the individual accounts have to be maintained in separate funds and the investment of the funds is carefully regulated by the law and supervised by the government through the Superintendencia of Administradoras de Fondos de Pensiones (SAFP). The funds can be invested in government bonds and other government instruments, instruments generated by the financial sector such as fixed term deposits, shares and bonds generated by financial institutions and by private enterprises, and investments abroad. By the end of 2003, 27.7 percent of the funds was invested in public debt securities and other public instruments; 28.17 percent was invested in the financial sector; 22.62 percent in shares and investment funds; and 21.83 percent was invested abroad (SAFP, 176, 2003).

The SAFP's main functions are to supervise the system, authorize the constitution of new AFPs; supervise the structure of the commissions and the agreements between AFPs and the insurance companies, regulate the investments and dissolve the AFPs in case of violations of the law. The SAFP also produces very valuable information.

The FFDC system provides old age, disability and survivor's pensions. The value of the old age pension is determined by the amount of money accumulated in the savings account, which in turn depends on the wages, the years of contributions, and the interest generated by the accounts, minus the commissions charged to administer the account. Retirement age was maintained at 60 years for women and at 65 for men. Anticipated pensions are allowed when the money saved allows the retiree to get a pension greater than 50 percent of the average wage. Disability and survivor's pensions are granted in cases of non-work-related injuries or death. They are covered by a separate fund and are calculated as an average of the wages received in the last ten years of work.

Upon reaching retirement age the retiree has three options: to obtain a pension directly from an AFP; to buy an annuity from an insurance company; or to choose a combination of the two. If the retiree chooses to obtain the pension directly from an AFP, the value of the fund has to be large enough to provide for a pension that is at least 120 percent the value of the minimum state pension.

The law also established a system of minimum pensions for those affiliated with the system to be applied in cases of depletion of the fund, or if the rent produced by the fund was smaller than the minimum pension. In order to qualify for this pension the insured must have at least twenty years of contributions. The AFPs charge commissions for the administration of the fund. They are discussed below.

b) The Economic Impact of the Fully Funded, Defined Contribution System

The impact of the privatization of social security will be analyzed along several lines, including coverage, the value of pensions, administrative costs, and the AFPs profits. The consequences for the fiscal budget will be analyzed as well.

Coverage. Coverage has fallen dramatically since the inception of the privatized system. While the CFS covered over 70 percent of the work force, by 2003 only 52.5 percent of the work force was covered by the FF system and 2.7 percent remained in the CF system(SAFP, 2003, 2). The self-employed, who in the past were largely outside the system, remain without coverage (only 4 percent are insured). The reduction in coverage is a direct consequence of the reform and not a necessary step to acquire financial solvency. In fact, the reduction of coverage has coexisted with a large budget deficit produced by the privatization of the system. The deficit is analyzed below.

Pensions. The value of pensions, or replacement ratio, in the FFDC system is determined by the value of the fund accumulated in the retirement account, which in turn depends on the value of wages and the interest generated by the account, minus the commissions charged for administering the fund. If the retiree was working before 1980, the money accumulated in the CF system is transferred to the account at the time of retirement through the *Bono de Reconocimiento*, or Recognition Bond.

The performance of both the wages and the investment fund has oscillated during the past 20 years. During the 1980s the real value of wages decreased. By 1985 wages were 13 percent below the 1970 level. On the other hand, the real yield of the pension fund investments averaged 13.8 percent per year. In the 1990s the situation was different. Between 1990 and 1998 the real value of wages increased by 35 percent, but the average investment yield decreased to 10.3 percent. The yield has been quite unstable, oscillating from 28.6 percent in 1991 to -11.6 percent in 1998. The average yield between 1980 and 2003 has been 10.3 percent and between January 2000 and December of 2003 was 6.1 percent (SAFP, various issues). If the charges for administration are subtracted the net average yield is reduced to about 8 percent. There has been an intense discussion about the real nature of the yield; many argue that the SAFP has consistently overvalued the yield by not including the effects of the commissions on the estimates (Qué Pasa 1999). The future investment yield is estimated to be about 5 percent.

Privatization was largely explained as a result of the failure of the CF system to provide sufficient pensions. Data regarding the value of pensions is contradictory. A study done by the Association of AFPs, an institution that represent the corporate interest of the AFPs, argues that the replacement ratio in the fully funded system is on average 71 percent of the last wages, which is very much in compliance with international standards (Asociación de AFPs, 2001a). The government estimates that the average value of a monthly retirement pension provided by the FF system is about US $177 ($106,581) while the average value of the pensions provided by the CF system is about $125 ($95,000) or 89 percent of the value of the pension provided by the FF system. However, a recent report indicates that public sector pensioners are better off than their counterparts in the private sector (New York Times, Jan. 27). In the case of disability pensions the FF system pays US$231 ($143,966) while the CF system pays $US 386 ($231,720) or about 50 percent more than the FF system (SAFP, 2001, 1-2).

It is important to disaggregate the data and to look at the effect of the FF system on women. The privatized system has turned out to be very damaging for women retirees since it reinforces the inequities found in the market place. The situation for women is worse than for male retirees because they earn less than men, live longer, and save less due to childbearing and child-rearing responsibilities. The data indicates that on average, a woman's salary is 31.1 percent lower than that of a man performing the same job (El Mercurio, 2001, B2). When the other factors enter into the equation, i.e. less years of contribution and longer life expectancy, the result is that female pensions on average are between 52 and 76 percent lower than men's pensions (Arenas and Montecinos).

Commissions and AFPs Assets and Profits. The FF system also reinforces the income inequities found in the workplace and, in turn, those inequities are reinforced by the commission's structure. The cost of the commissions charged by the AFPs to administer the private accounts can be estimated either as a percentage of the taxable wages or as a percentage of the monthly deposit. Since the inception of the system, the commissions, on average, have amounted to 2.14 percent of the taxable wages. Measured as a percentage of the monthly contribution, the commissions cost oscillates between 21.71 and 34.98 percent (SAFP, 2001, 28-30 & 2002). Competition did not produce a reduction of the commissions, but it augmented marketing expenditures, which in turn increased administrative costs. By 1997 marketing expenditures amounted to 37 percent of the total operating costs of the AFPs, or 60 percent of the commission charged to the insured (Mesa-Lago, a&b). The government decided to stop some of the worst practices in 1998 by restricting the movement from one AFP to another one. This reform, which in fact limited free market principles, had the salutary effect of reducing administrative costs by half (SAFP, Principales Estadísticas, 8).

Carmelo Mesa-Lago and others have analyzed the regressive nature of the commissions. The data indicates that for the low-income insured earning about $160 per month the administrative costs are between 25.6 and 37.9 percent of the monthly contribution. For an insured with an income of about $1,300 per month the cost is reduced to between 24.1 and 30.2 percent of the contribution (SAFP 1998, 28&32). Thus, administrative costs are both high and regressive and both factors impinge on the amount of the pension and the well-being of the retiree. This estimates have recently been confirmed by the World Bank which argues that about a quarter to a third of all contributions go to pay commissions (Gill, Packard and Yermo 2004).

The high administrative costs and profits of the AFPs have been at the center of a protracted discussion in Chile. The AFPs charges are 67 percent higher than the fees charged by banks to manage savings accounts and if compared with other fully funded systems, Chile exhibits the third most expensive system (Mesa-Lago, 2001; Acuňa and Iglesias, 21). As a result, the AFPs are generating huge profits. By 2001 the AFPs had already accumulated over US $35 billion, or 55 percent of the country's GDP (SAFP, 2001). The SAFP estimates that the annual return on assets is about 50 percent, while others estimates suggest that the returns have been even higher (New York Times). Government officials declared in January of 2005 "that commissions are high and need to come down," however the nature of the industry is such that according to the same official "the dynamic of the market is one of consolidation and concentration" (New York Times).

The effects of the high costs of the commissions are not limited to the retiree. They also have a sizeable effect on the fiscal budget since the state provides minimum pensions when the accumulated funds are not sufficient to provide a pension equal to the minimum pension. Thus, high commissions reduce the amount saved, force state involvement in the provision of pensions, and increase the deficit generated by the system.

Transition Costs and the Fiscal Deficit

Although the establishment of a FF system promised a reduction of the state involvement in the provision of pensions, what really happened was the withdrawal of the state from the administration of the funds, but not from the financial aspects of the system. Any attempt to establish a FF system will generate transition costs which result from the transference of the social security contributions to the private sector, while the state continues spending money in the system. In Chile, transition costs result from the state's obligation to pay minimum and welfare pensions and the Recognition Bond. It is also important to remember that the state continues paying the pensions of the military and the police, as well as those who opted for staying in the CF system. Until the end of

2004 the state had paid about $2 billion in pensions for the military and the police (New York Times).

In the short term, the deficit resulted from the massive move to the FF system in the first year (about 75 percent of the insured moved to the privatized system) and the lack of preparedness of the government to deal with this move (Interviews 1981). Furthermore, in order to facilitate accumulation of capital in the hands of the AFPs the law exempted them from paying pensions during the first five years. In the long run, the deficit results from paying minimum and welfare pensions and the Recognition Bond, an obligation which will decrease over the next 20 years. Fiscal obligations regarding minimum pensions are expected to grow in the future from 6.5 percent of the insured at the end of the 1990s to over 50 percent, given the high unemployment rates and the high administrative costs. The deficit produced by the pension system has grown from 3.8 percent of GDP in 1981 to 6.1 percent in 2000. The deficit is expected to begin a slow decline in the early years of the new millennium and to become stable by the year 2040 at about 3.3 percent of GDP (Arenas de Mesa 1999). The deficit has been financed through increases in the public debt and new taxes (Mesa-Lago 1994, 22&23).

Despite initial suggestions that the FF system was going to be self sustainable, Chile has spent more than $66 billion on benefits since 1981 (New York Times). It is quite remarkable that the cost of the pension system for the state was twice as high in 1999 as it was in 1980. This data alone reveals once more that the CF system had to be eliminated not because it produced a huge burden on the state's finances as argued by the neoliberal economists, but because of ideological reasons which called for a massive transfer of economic power to the private sector.

Conclusions

Chile's pension system has not only become a model for other Latin American countries, but it has also been fully or partially adopted by transitional democracies in Eastern Europe and the former Soviet Republics, and it is often heralded as a model to be followed by the United States in order to deal with what some see as an impending crisis of its social security system. In this context then, the analysis of the ideas that inspired the FFDC system, the political environment in which these ideas were applied, and their consequences are relevant not only for the Chilean case, but also for many others across the globe. The analysis made above highlights a number of issues that are critical not only for those interested in pension reform and Chilean politics, but also for those with a wider interest in the functioning of governments and markets.

First, the analysis illustrates the nature of politics in an authoritarian regime where public discussion, political rights, and political institutions have been eliminated. What one sees is that politics were not eliminated, but just transferred from the public sphere to the intra-governmental spheres. It was within the regime, and specifically within the *Junta,* that the discussions about the extent of the reform took place. It was within the regime that those who called for a parametric reform had to contend with those who called for a total overhaul of the system. Those who supported the parametric approach succeeded in the approval of D.L. 2448, which eliminated the privileged pensions, established a uniform system of benefits, as well as a uniform retirement age and system of pension readjustment. Ultimately, the parametric reform was linked to the power of a group of people within the regime who were associated with corporatist political ideas. Their demise from the halls of government left the field open to the neoliberal economists and their policies.

What I argue here, then, is that a parametric reform could have solved the major problems of the system which resulted not only from the expansion of coverage, but which was linked mostly to the *massification* of benefits and exemptions contained in the CF system (Mesa-Lago 1978, Borzutzky, 2002). The fact that the budget deficit produced by the CF system, which covered over 70 percent of the work force, was certainly a lot smaller than the deficit produced by the FFDC system, which only covers about 50 percent of the population, clearly illustrates the point that the reform was not premised on fiscal reasons, but on ideological reasons.

The establishment of the FF system reflects the power that a cadre of Chicago trained economists had on the regime and the support they received from General Pinochet. Social security reform was an essential component of the revolution that was taking place in Chile. This revolution emphasized the ideas of transformation of state functions, the creation of a *subsidiary* state, the expansion of freedom and the enhancement of the role of the private sector. Where does the language of freedom and rights fit in this discussion? How is this language of freedom compatible with a reform that was drafted secretly and only announced to the public after it was ready? Is not this kind of centralization of decision making that von Hayek considers to be detrimental for the individual? What was the value of economic freedom when the most basic personal freedoms had been eliminated and severely abused? And who benefited from this freedom?

It is my view that the market economy certainly enhanced the freedom of those who could buy the newly privatized properties, establish AFPs, send their children to the recently created private universities, and enjoy the benefits of a globalized market in the luxurious malls that appeared in the upper income neighborhoods of Santiago. At the same time, by 1989 when the first presidential elections took place, 50 percent of the population lived in poverty and 25 percent of them lived in extreme poverty. In fact, I would argue that this was the same 50 percent that was repressed, abused, often unemployed, and when employed their wages were substantially lower than in the past given the reforms in the labor laws and the destruction of unions and parties.

Thus, the expansion of freedom and wealth for all as a result of the faithful application of the teachings of Friedman and von Hayek certainly did not come true. Economic and political freedoms, in fact, were a privilege enjoyed by a small elite often linked to a small number of economic groups, which in turn were linked to the neoliberal economists through family and business connections. It should come as no surprise, then, that at the inception of the system over 60 percent of the pension accounts were managed by the two largest economic groups (Cruzat who owned Provida and Vial who owned Santa María) and that, in turn, these groups had close connections with the government, as Ministers Piňera and others served on the board of directors of those institutions after leaving public office (Dahse 1979, 27).

It is also important to point out that the market oriented economists created a compulsory system, just as compulsory as the one that existed in the past. Patricio Mardones, Under-Secretary of Labor at the time the reform was enacted, argued that the reform was designed to allow the individual freedom of choice. In an interview he said that "people should be free to decide how to save for old age," but mindful of the needs of the patrimonial-authoritarian state he also stated that "one can't trust that everyone will know that they have to save for retirement" (Interview) and for that reason the freedom to choose will operate only after the state has made some basic decisions for the individual.

What we see happening in Chile is not a withdrawal of the state, but a transformation of the role of the state. The state transferred to the private sector the administration of the funds, eliminated the portion of the social security tax paid by the employers, and supervises the system. The principle of social solidarity that had been at the core of the idea of social insurance throughout the world was eliminated and replaced by an individualistic approach which reinforced the economic disparities created by the market. But the market needs that the retirees remain active consumers and consequently the state is responsible for supplementing the individual accounts with a system of minimum pensions.

The actions of the state had two simultaneous effects: they empowered those with capital and facilitated the destruction of key interest groups organized around the social security funds. In the past these groups had had a critical role not only in the formulation of social security policies, but also in Chilean politics. The reform certainly contributed to the ongoing process of social atomization, which served well the needs of the authoritarian regime and enhanced the power of the ruler.

Have any of the promises made by the neoliberal economists materialized? Coverage has decreased, unemployment has remained high, administrative costs are high, the budget deficit generated by the social security system is twice as large as it was in 1980 and there have been no positive effects on national savings (Holzman 1997). As shown above, what has also happened is that the savings in the hands of the private sector have increased dramatically and the earnings of the AFPs are very high. On the other hand, the major accomplishments of the FF system have been the development of a capital market and an increase in the value of retirement pensions of those with a stable high paying job. For those who do not have a high paying job the situation is getting worse. There is now an Association of People with Pension Damage with 157,000 members who feel that if they had stayed in the CF System their pensions will be twice as large as what they are getting from the FF System (New York Times).

The democratic regimes that have governed Chile since 1989 have chosen to maintain the neoliberal economic model. In the area of social security, there have been reforms geared to enhance the role of the market and regulate some aspects of the system, such as administrative costs. New modalities, such as voluntary savings accounts, modeled after the KEOG plans in the US, and new forms of unemployment insurance have also been introduced. These reforms have reinforced the role of the market while the role of the state has not changed.

Karl Polanyi argued that the establishment of a market system requires the transformation by the state of existing economic and societal structures. The task of the "Chicago Boys" was to transform those structures. They accomplished their goals through the *"modernization"* of the social security, health, labor, educational and land tenure systems, as well as through trade liberalization policies, deregulation and privatizations. The legacy of the Chicago Boys has so far been quite permanent and their impact on Chilean society quite dramatic.

References

Acuňa, Rodrigo, and Augusto Iglesias. 2001. "Chile's Pension Reform after Twenty Years." World Bank, 32. Available on the Internet at WdsWorldbank.org/servlet/WDSContentServer/WDSP/IB/2002/5//0000 949

Arellano, Jose Pablo. 1981. "Elementos para el Analísis de la Reforma Previsional Chilena." Colección Estudios Cieplan, No. 6 (December): 11.

Arenas de Mesa, Alberto, and Verónica Montecinos. "The Privatization of Social Security and Women's Welfare: Gender Effects of the Chilean Reform." *Latin American Research Review* 34, No. 3 (Fall).

Arenas de Mesa, Alberto. 1999. "Efectos Fiscals del Sistema de Pensiones en Chile: Proyección del Deficit Fiscal 1999-2037." Presented at Seminario Sobre Responsabilidades Fiscales del Sistema de Pensiones.

Asociación de AFPs. 2001. "Cálculo de las Pensiones que Entregan las AFPs Muestra Eficiencia del Sistema." *Serie de Estudios*, 17 Septiembre.

Borzutzky, Silvia. 2002. *Vital Connections: Politics, Social Security and Inequality in Chile.* Notre Dame: Notre Dame University Press.

Brunner, J.J., and E. Garcia. 1981. "Chile: Un Nuevo Paisaje Cultural." *Mensaje* No. 302 (Septiembre): 487-494.

Dahse, Fernando. 1979. *El Mapa de la Extrema Riqueza: Los Grupos Económicos y el Proceso de Concentración de Capitales.* Santiago: Editorial Aconcagua.

Declaración de Principios del Gobierno de Chile. 1973.

Dixon, John, Mark Hyde, and Glen Drover. 2005. *The Privatization of Mandatory Income Protection: International Perspectives.* London: Edwin Mellen Press, forthcoming.

De Souza, María Dolores, and Germán Silva. 1988. *Auge y Ocaso de Augusto Pinochet: Psicohistoria de un Liderazgo.* Santiago: Ediciones del Ornitorrinco.

Fontaine, Arturo. 1988. *Los Economistas y el Presidente Pinochet.* Santiago: Editorial Zig-Zag.

Frei, Eduardo. 1965. "Primer Mensaje Presidencial." 21 May.

Friedman, Milton, 1962, *Capitalism and Freedom.* Chicago: University of Chicago Press.

Foxley, Alejandro. 1981. "Perspectivas Economicas." Mensaje, No 310, Agosto, 411-415

Gill, Indemit S., Truman G. Packard, and Juan Yermo. 2004. *Keeping the Promise of Old Age: Income Security in Latin America.* World Bank.

Holzman, Robert. 1997. *On Economic Benefits and Fiscal Requirements of Moving from Unfunded to Funded Pensions.* Santiago: United Nations Economic Commission for Latin America and the Caribbean.

Informe Serman. 2001. *El Mercurio*, 8 Junio, B2.

Isserman, Maurice, and Michael Kazan. 2000. *America Divided: The Civil War of the 1960s.* New York: Oxford University Press.

Lira, Elizabeth. "Human Rights in Chile 1990-2004: The Long Road to Truth, Justice and Reparations." In *Traversing the Past: The Chilean Road to Democracy and the Market, 1990-2004,* Silvia Borzutzky and Lois Hecht Oppenheim. Under review, University of Florida Press.

Mesa-Lago, Carmelo. 1978. *Social Security in Latin America: Pressure Groups, Stratification and Inequality.* Pittsburg: University of Pittsburg Press.

__________. 1998a. "Pension Reform around the World: Comparative Features and Performance of Structural Pension Reforms in Latin America." *Brooklyn Law Review*, No. 64 (Fall): 782.

__________. 1998b. "La Reforma Structural de Pensiones en América Latina: Tipología, Comprobación de Presupuestos y Enseňanzas." In *Pensiones en América Latina: Dos décadas de Reformas,* ed. Alejandro Bonilla and Alfredo Conte-Grand. Ginebra: Organización Internacional del Trabajo, 120.

New York Times. 2005. "Chile Learning of Risks and Costs in Taking the Private Path on Pensions." January 27.

O'Hara, Terence, and Kathleen Day. 2004. "Rig Bank Hides Pinochet Assets, Report Says." *Washington Post*, 15 July, A1.

Piňera, José. 1991. *El Cascabel al Gato: La batalla por la Reforma Provisional.* Santiago: Editorial Zig-Zag.

Polanyi, Karl. 1944. *The Great Transformation: The Political and Economic Origins of our Times.* Boston: Beacon Press.

Prat, Jorge. 1965. Informe *sobre la Reforma de la Seguridad Social Chilena*. Santiago: Editorial Jurídica de Chile.

Que Pasa. 1999. P. 62.

Samuels, W.J. 1989. "Further Limits to the Chicago Doctrine." Quoted in *La Escuela de Chicago: Operación Chile,* Juan Gabirel Valdés. Buenos Aires: Editorial Zeta, 102.

Superintendencia de Fondos de Pensiones (SAFP). Various issues (1988, 1998, 2001, 2003). *Boletín Estadístico*.

__________. 2001. "Cuadro Comparativo de Pensiones Pagadas en el Sistema Provisional Respecto a Pensiones Pagadas por las Antiguas Cajas." September 30.

__________. 2002. Unpublished data at Safp.cl/inf-estadistica.index.html.

Superintendencia de Seguridad Social. "Significado e importancia del DL 2448." Mimeo.

Valdés, Juan Gabriel. 1989. *La Escuela de Chicago: Operación Chile.* Buenos Aires: Editorial Zeta.

Von Hayek, Frederick. 1944. *The Road to Serfdom.* London: Routledge and Kegan Paul.