GrowthSTRATEGIES

LA JOLLA INSTITUTE
Steve PonTell

Dr. Roger Selbert, Editor & Publisher
E-mail: roger@rogerselbert.com

Trend Analysis That Builds Business Decisions

3200 S. Barrington Ave. #4 ▪ Los Angeles, CA 90066
Telephone: (310) 721-6322

IN THIS ISSUE: LESSONS FROM CHILE

I have been meaning to get to this subject for a while: how do we begin to replace the welfare/dependency state? We can look to places and examples where replacements are being successfully implemented. The Chilean Model offers evidence of how functions previously assumed to be the province of government – including education, pensions (social security), health care, transportation, energy policy, even welfare itself – can be privatized to great benefit, providing superior services more efficiently and less expensively. This reduces the intrusion of the leviathan state into all aspects of life and concomitantly, reduces the need for great government taxes, spending, borrowing, debt and deficits. The social and cultural effects can be even more profound: reducing dependency and reinforcing personal autonomy and responsibility, the foundations of true liberty (wake up, "liberals").

1 – A WORKING MODEL

Economist Richard Rahn in *The Washington Times*:

In 1881 Otto von Bismarck started the world's first modern pay-as-you-go social security system, which served as the model for the US Social Security system: basically a Ponzi scheme whereby young workers pay taxes to support the retirees. It only works over the long run where the population is growing and where most retirees do not live very long.

These conditions no longer exist in the high-income countries. As a result, many of the world's social security systems are headed toward bankruptcy.

Thirty years ago, a young Jose Pinera was Chile's labor minister. He saw the coming disaster. Inspired by an idea from the late Nobel Prize winning economist, Milton Friedman, he developed a solution that empowers workers and gives them real financial security. Pinera-type social security systems have now been adopted by more than 30 countries and cover several hundred million people.

Under the Pinera-type social security systems, workers are required to invest in highly diversified, qualified funds. Because they actually own their pension funds (unlike in the United States), workers can choose their age of retirement, whether it is age 50 or 80. The longer they work, the more money they will have. (The very poor and those unable to work are still covered by a government system.)

The Chilean privatized system began in 1981, exactly 100 years after Bismarck instituted his system in Germany. The results are remarkable. Chile's citizens have on average experienced a 10 percent per year, above inflation, compounded growth rate in their pension funds for the last 29 years. The result is most Chileans are no longer poor, but are, in fact, "small capitalists."

The Chilean government, increasingly freed from paying pensions out of tax funds (almost all Chileans have moved into the private accounts, though they could have stayed in the old government system), is now running a budget surplus of 10 percent of gross domestic product (GDP), which could pave the way for the abolition of the income tax.

The new Chilean system has provided so much investment capital that Chile moved from being a poor country to being a solid middle-income country with the highest per capita income in South America. Critics in the US and elsewhere claim investing pension funds in stocks and bonds is risky, but the real risk to the elderly is being trapped in government social security schemes headed toward insolvency.

Some critics of privatized social security claim that even though the returns are better under a privatized system, the "transition costs" are too great. In fact, there are no economic costs to the country of the transition, as Chile and other countries which have adopted the privatized system have shown.

We now know that both in theory and practice privatized social security works far better than pay-as-you-go government systems. Opponents can only keep their citizens from adopting Pinera-type systems by keeping them ignorant of the benefits, and making false statements about the privatized social security system's successes. Fortunately, the world still has a very vigorous Jose Pinera, who for three decades has made it his life's work to empower workers and make them small capitalists, freed from the government foot upon their necks. Mr. Pinera has already made life more secure and prosperous for millions, and with luck it will soon be billions of people.

2 – DESTITUTE NO MORE

From an article in *The Economist*, "A country that pioneered reform comes close to abolishing poverty"

Her neighborhood was once one of the biggest and poorest shanty towns in Santiago, Chile's capital. Over the past ten years, the roads have been paved and piped water installed. Most people now have fridges and telephones and some have cars. "Defeating material poverty is a mission well on the way to being fulfilled in Chile," says Benito Baranda of Hogar de Cristo, a charity. Its shelters now cater less for the destitute than for people with drug or psychiatric problems. Around 500,000 people still suffer extreme poverty, but that number is down by a third since 2003.

Poverty has fallen further, faster, in Chile than anywhere else in Latin America. Sustained economic growth and job creation since the mid-1980s are the main explanation, though it helps that poorer Chileans are having fewer children than in the past. In recent years public policies, such as Chile Solidario, have played a bigger role. In the 1990s poverty dropped by half a percentage point for each point of economic growth, but now it falls by one-and-a-half points, according to Clarisa Hardy, the planning minister.

Chile Solidario aims to help the poorest support themselves, by ensuring they take up various social benefits and keep their children healthy and at school, and by offering training and a grant to set up a small business. It is too soon to tell whether it will be a long-term success: the first of 250,000 very poor families enrolled in the scheme are only just graduating from it. Even so, Chile has a chance of all but abolishing poverty in the next few years.

3 – THE AWESOME POWER OF IDEAS

James Flanigan in the *Los Angeles Times* ("Chile's Reforms Launched a New Era"):

In the early 1970s, Chile was one of the first economies in the developing world to test such concepts as deregulation of industries, privatization of state companies, freeing of prices from government control, and opening of the home market to imports. In 1981, Chile privatized its social-security system. Many of those ideas ultimately spread throughout Latin America and to the rest of the world. They are behind the reformation of Eastern Europe and the states of the former Soviet Union today, which demonstrates, once again, the awesome power of ideas.

4 – THE PRIVATIZATION OF SOCIAL SERVICES

From Eldis.org:

The privatization of social services in Chile began in 1981. This reform of social services created a system where there is competition between private providers, although the State kept a regulatory and supervisory role. This paper examines the privatization of Chilean social services and its impact on the performance of social service markets, focusing on three main social services:

- the pension fund system
- the health insurance market
- the education system

After providing a detailed description and an evaluation for each sector, the paper underscores a number of benefits realized through the privatization of social services. The main benefits include:

- an increase in the security and predictability of pensions
- an improvement in the public system health due to the introduction of the private health insurance system as an alternative to the public one
- an improvement in the coverage of higher education as well as in the quality of the traditional State financed institutions due to the increased competition

However, the paper also highlights a number of problems that appeared as a result of the privatization process:

- the lack of information and/or knowledge needed by households to make rational decisions
- the focus of the providers' competitive efforts on marketing rather than the variables that are relevant from the point of view of the consumer
- a decrease in social equity and an increase in segregation
- a limitation of the benefits expected from competition due to excessive regulations

The paper concludes that broadly speaking, privatization has had a positive impact on the provision of social services. This improvement in the performance of social service markets can be attributed to changes in regulation (fewer restrictions and more information), the consolidation of the industries, and better decisions of consumers.

5 – ABOUT CHILE'S MIRACLE

Investor's Business Daily Editorial (03/21/2011)

President Obama had nothing but praise for Chile's democracy and economic miracle, declaring it a model "for the region and world." So why is he obstructing the same reforms in the US that gave Chile its success?

Arriving in Santiago on the second leg of his Latin American tour, the president told *El Mercurio* he picked Chile as one of his three stops because: "The Chilean experience, and more particularly its successful democratic transition and sustained economic growth, is a model for the region and the world. ... It is also a powerful example of how the opportunities of today can and must be seized."

He's right on that. But if he isn't just uttering vague platitudes, why doesn't he make it a model for US economic growth, too?

Chile's reforms not only enabled it to emerge from military regime in 1990, but to become the success story much of the world seeks to imitate.

In 30 years, Chile has gone from being a Third World country to a developed one, raising per capita income to $17,000, achieving 6% to 7% GDP growth most years, and attracting billions in foreign investment.

It didn't happen in a vacuum.

The country was the first nation to try free-market reforms as articulated by the great economist Milton Friedman, whose ideas were still new in 1974.

When Gen. Augusto Pinochet was asked by Chile's legislature to take over in September 1973, he turned the job of cleaning up a ravaged economy over to a group of University of Chicago-trained economists.

Known as "Chicago Boys," they found a nation that was a mess after the short Marxist dictatorship of Salvador Allende and four decades of bad policy, including state-owned industries, heavy protectionism and massive bureaucracy. Special interests – unions and corporate monopolies – controlled major parts of the economy. Property rights were battered.

The Chicago Boys rescued their country with three critical economic reforms: fiscal control, privatization of social security and free trade. It not only worked, it quietly freed the nation from even the military regime and created the vibrant democracy Chile is now.

First, Finance Minister Sergio De Castro made the central bank independent. He ended subsidies and cut government spending. He slashed bureaucrats from 700,000 to 550,000. It was a painful austerity in the absence of a big private sector.

In the first four years of the new government, Chile's economy surged 32%.

Next, economist Jose Pinera, Chile's Labor and Social Security Minister, privatized social security. The plan helped the government balance its books and let workers choose between personal retirement accounts or the bankrupt state-run pension system. Workers could keep their own money, invest it, decide when to retire, and, best of all, owned their pensions as property they could leave to heirs. Some 97% of Chileans switched.

Pinera's privatized accounts not only outperformed the state system by a factor of 10, but the savings they created provided capital to rebuild the country.

The last step came as Chile slashed tariffs and opened itself to the world. It signed more free-trade pacts than any nation, 58 at last count, which gave it access to 2 billion customers, an outsize market to swim in for a relatively small nation.

That enabled the country to specialize in what it did best – seafood, fruit, wine and its traditional mining exports. Its citizens got rich.

All three pillars upon which Chile's stunning transformation rests can be duplicated in any country, which is why so many imitate these reforms.

But oddly enough, not the US. Under Obama's leadership, the US continues to put its head in the sand on runaway federal spending, dismisses privatizing Social Security without discussion and ices free trade.

One thing that should come of the trip to Latin America is for Obama to take his own advice on Chile and look closer at its economic lessons.

And if he doesn't, the rest of us should.