

Milton Friedman's Ideas in Action: Privatizing Social Security in Chile as a Model for the United States

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Introduction:

Milton Friedman was one of the greatest champions of liberty. His ideas are timeless and his sophisticated rhetoric is a necessary tool and inspiration for society today.

Advocating for freedom in all aspects, one of Milton Friedman's most momentous ideas was reforming what he called, "The Biggest Ponzi Scheme on Earth" (Friedman 1999), also known as the Social Security system.

Friedman advocated privatizing the system, and his ideas inspired Chile to take action. With their program on the verge of collapse, Chile privatized their social security system and since then the reforms have proven to be successful in two aspects. First, they created a stable pension system that allowed investments to flourish. This in turn pushed their economy into a state of growth and productivity, altering their once low standards of living to a nation that is experiencing a momentum of increased standards of living (Piñera 2010). But the success does not end there. The second aspect of this achievement is the model it serves for other countries. Across the board, Chile's remarkable transformations have stunned the rest of the world and provided the hope and proof that Milton Friedman idea's once instilled in Chile.

Fortunately, this glimmer of social security hope is not dim where it needs it most, the United States. With trillions of dollars in unfunded liabilities, the U.S. Social Security system is viewed as one of the most unstable and unsuccessful programs and a

number of polls have reported the public's grave distrust and concern for the program (Page 2010). The only mechanism of fixing the system is implementing structural changes like privatizing the system as Chile did in the 1980s. The United States is now where Chile was thirty years ago. With the application of Friedman's ideas on the U.S. Social Security system, the United States would be yet another success story that is much needed in today's world.

The Ideas of Milton Friedman:

Milton Friedman's stories are truly the epitome of the saying, "ideas in action." Milton Friedman along with the Chicago Boys, a group of economists influenced by the University of Chicago's free market ideas, strictly changed the dynamic in Chile. For many years, students from the Catholic University in Chile had the opportunity to study the ideas of Milton Friedman and began understanding the importance of freedom and free markets. Through his writing and his talks in Chile, Milton Friedman inspired the nation to put the ideas of liberty in action.

One of these ideas was the importance of freedom in social security savings. Milton Friedman's ideas on social security were twofold: he argued both the immortality of program and the ineffectiveness of the program. In Capitalism and Freedom, Friedman explained that a mandatory retirement program infringes on the personal and individual rights of people and creates an ever-growing nanny state. Friedman says, "the citizen of the United States who is compelled by law to devote something like 10 per cent of his income to the purchase of a particular kind of retirement contract, administered by the government, is being deprived of a corresponding part of his personal freedom"

(Friedman 1962). The option and the amount of how much each person wants to save for his or her *own* retirement is the decision of that person, and forcing that person to do so is a serious deprivation of the very notion of having a personal freedom.

The idea of freedom in retirement savings inspired José Piñera, the pioneer of the privatization of social security in Chile, to make Milton Friedman's ideas happen. Piñera says, "As a young student in the 1960s in Santiago, I read Capitalism and Freedom by Milton Friedman. That book changed my life, and that book changed my country" (Piñera 2007). Furthermore, during the Chilean revolutions in 1975, Piñera and the Chicago Boys invited Milton Friedman to speak in Chile about the significance of the ideas that govern a free society. In the midst of chaos in Chile, Friedman instilled hope in the Chileans to take action and implement the free market ideas. Piñera said that Friedman had the "moral courage to go to Chile during a difficult situation in order to push economic and political freedom. He was there not supporting the government but supporting us, his disciples. He was an inspiration to us." (Piñera 2007).

A few years after his speech in 1981, Piñera was given the opportunity and courage to implement the ideas of Friedman by privatizing the social security reform. Piñera attributes the change of his country to the ideas of Milton Friedman. Specifically, he cites this text from Capitalism and Freedom as truly inspiring him to take action, "The "social security" program is one of those things on which the tyranny of the status quo is beginning to work its magic.... [I]t has come to be so much taken for granted that its desirability is hardly questioned any longer. Yet it involves a large-scale invasion into the personal lives of a large fraction of the nation" (Piñera 2006). Friedman's ideas emphasized the immortality and instability of the Social Security system—and these

ideas were applied by Chile to create, as Milton Friedman called it, the Miracle of Chile (Friedman 1999).

Chile as a Model for Privatizing Social Security:

At the height of their unraveling social security failure in the 1970s, Chile began looking left and right for ideas of reform and fortunately found them in Milton Friedman.

Recognizing the eminent flaws in a pay-as-you-go social security system, José Piñera reformed the system to better align with the incentives of individuals. Unlike a pay-as-you-go system, a private pension system does not systemically incentivize individuals to minimize putting into the system and maximize getting as much as possible out of the system by creating a true connection between contributions and benefits.

Chile's mechanism allowed individuals to opt-out of the government-run social security program and investment in a personal retirement program. This program emphasized individual choice and allowed the citizens to benefit from the interest compounded in their private retirement accounts. But the success of the story really spoke for itself. Within a year of enactment in 1981, ninety-three percent of Chileans voluntarily decided to choose the new private pension system (Piñera 1997). Their actions demonstrated their trust, willingness, and preference for the securing their money in the market over securing their money with the government. The Chilean workers understood the risks of politics and given the choice to opt-out of such a risky and unstable program, they did just that.

The effects of this new program were dramatic. In addition to completely eliminating the payroll tax, Chile's growth in savings has increased from ten percent of

Gross National Product (GNP) to over twenty-seven percent of GNP (Piñera 2010). This leap has been incredible in that it dramatically helped to power the Chilean economy. With over fifteen completely private mutual funds companies operating, Chilean pensions have increased anywhere from fifty to one-hundred percent more with the introduction of the private pension plan. With their retirement funds in private accounts, Chileans have been able to average a real return of about ten percent per year and their savings have allowed investments to thrive in Chile (Piñera 2010).

An essential aspect of this success is the overall effect it has on the Chilean economy. In fifteen years, the private pensions collected \$25 billion worth of investments (Piñera 1999). With increased investments, Chile has seen mass improvements in capital mobilization and labor productivity, pushing its overall economy to extraordinary levels of growth. With virtually dormant capital markets for all of its existence, Chile was finally able to finance a long-term domestic capital market, responsible for their economic achievements. Historically, Chile has maintained merely a three percent growth rate annually, but with the introduction of new reforms, Chile has now been experiencing over seven percent growth annually (Piñera 2010). Moreover, since the social security reforms, Chile's unemployment rate has decreased to as low as five percent (Piñera 1997). Observing the success in the retirement savings in Chile, more than twenty other countries have implemented similar pension reforms; specifically modeling the Pension Fund Administrators in Chile (Büchi Buc 2006). In the 1970s Chile had the worst economy in all of Latin America. Today, Chile has the best and fastest growing economy in all of Latin America and continues to serve as a model of hope for the region.

Reforming the American Social Security System:

Social Security is a nightmare today with over \$15.3 trillion dollars in unfunded liabilities (Biggs 2010). The deprivation of the funds is just around the corner and making any surface remedies will only further prolong and exacerbate the epic downfall of the system. The United States needs to look at Chile as model and make the structural reforms necessary to save individuals from further burden and to prevent the destruction of the U.S. economy. As the largest government program in the world, the U.S. Social Security system spends more than \$350 billion *per year*, which is actually more than the defense budget during the dangers of the Cold War (Tanner 2010).

The U.S. Social Security system will begin running a deficit in less than seven years, and all of the funds will be exhausted by 2040 (Tanner 2010). That is, the entire system will unravel and the individuals who pay for social security today will never see their benefits at retirement. In short, the system is a complete fraud and has misled individuals to think that it actually operates as a trust fund (Attarian 2000). To continue the system even after the funds have all been exhausted, the government will need to depend solely on payroll tax, which means, more tax increases for Americans to pay into a failing system. To fund the program, the U.S. will be required to implement the largest tax increase in all of history—1.3 trillion dollars in the first ten years (Tanner 2010). But even with extravagant tax increases, there will still be an automatic twenty-six percent cut into benefits for every individual (Tanner 2010).

Privatizing pensions and allowing people to opt-out of social security is the only answer. Not only is the system completely and utterly financially unstable, but it creates

a perception that government is holding the social security funds. In fact, though, the excess funds are used to pay for other government spending and programs. This scheme could be abolished by switching to the Chilean system and thus also beginning to show the true cost of government spending.

Furthermore, just as Chile's economy experienced rapid growth after the privatization of their social security system, the United States could experience a similar effect. Allowing for private saving and retirement funds would encourage the workers to benefit from the real rate of return and at the same time expand the capital markets. Savings are the sole driver of investments and growth and the United States will have the same opportunity as Chile did to experience real growth from increased investments and innovations.

This also complements the notion of ownership of the benefits that is missing from social security. Even though Americans are forced to pay into the social security system, they are not guaranteed anything back from the system. On the other hand, a private social security system would allow individuals to maintain ownership over their funds. Just as the reformed system helped cause a decrease in unemployment in Chile, the United States could experience a similar effect. With both the high rates of return and the claim to ownership as well as decreased costs of employing the person when payroll taxes will be eliminated, workers will be encouraged to work and employers will be encouraged to hire.

Conclusion:

The poignant ideas of Milton Friedman have transformed a once failing nation to one of the fastest growing and rapidly expanding economies in Latin America. Inspired by the ideas of Friedman, the privatization of the Chilean Social Security system has led to incredible outcomes in terms of both providing a reliable pension plan as well as providing a mechanism of rapid growth for the Chilean economy. With the currently failing system, the United States should embrace the ideas of Milton Friedman and look to Chile as a model for privatizing and thus creating a real retirement fund for Americans.

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