# Pension Reform as the Triumph of Form over Substance

LAURENCE J. KOTLIKOFF

A quarter century has passed since Chile privatized its pay-go pension system. The Chilean "reform" has inspired similar "reforms" in developing countries far removed from Chile, such as Kazakhstan and Poland. In South America the Chilean "reform" has been particularly influential. Since 1981 at least ten other countries around the world have "reformed" their pension systems along Chilean lines. The list includes major countries like Argentina, Mexico, Bolivia, Columbia, and Peru.

Question, though: do these so-called pension privatizations actually constitute real fiscal change or are they simply a triumph of form over substance, and a potentially expensive one at that? Unfortunately, I think the sad truth is that many of the "reforms" have been basically cosmetic and that others have used the cover of "reform" to actually worsen fundamental aspects of fiscal policy. To see how this can happen, consider pension reform in the country of Nachos.

## PENSION REFORM IN NACHOS

Nachos is a lovely country located south of the Bermuda triangle. Its president is a former insurance salesman named Chile Relleno. Chile Relleno has three close banker friends named Taco, Tortilla, and Salsa. The three bankers take Chile Relleno golfing one day. The bankers get Chile in a good mood by letting him win, and then, over a few beers, they convince him that privatizing the state's pension system is a great idea.

Chile Relleno announces the reform the next day. All workers will stop making contributions to the state pension system and instead contribute the same amounts to one of three pension funds established by, guess who?—Taco, Tortilla, and Salsa!

Chile's announcement is well received, particularly his statement that Nachos' workers will surely earn a great return on their contributions and be rich in old age. Chile Relleno also tells Nachos' workers not to worry about the fact that Taco, Tortilla, and Salsa are charging them 2 percent of their wages to manage their money. This is peanuts compared to the killing they'll make on the market.

*Laurence J. Kotlikoff is Professor of Economics at Boston University, a Research Associate of the National Bureau of Economic Research, and President of Economic Security Planning, Inc., which produces financial planning software. Kotlikoff has authored eleven books and hundreds of articles on saving, fiscal policy, macroeconomics, insurance, altruism, bequests, pensions, and personal finance. Kotlikoff and his co-authors pioneered computable general equilibrium dynamic life-cycle models, generational accounting, and consumption-smoothing software.*

Later that day Chile Relleno gets an angry call from Guacamole Enchilada—the head of the state pension system. "Chile," Guacamole screams, "You idiot. You eliminated the state pension contributions, and I have no money to pay benefits to the old people who are now attacking me with their bed pans."

"My Lord," Chile says. "You're right. Let me ask Taco, Tortilla, and Salsa. They'll know what to do."

The three bankers say, "No problema. We'll be happy to lend you the money from the pension funds we just created." So Chile instructs the Nachos Treasury to sell bonds to the three pension funds and give the proceeds to Guacamole to pay his elderly beneficiaries.

All is well until the next day when a young worker named Chimi Changas corners Chile Relleno and says, "Your reform stinks. We workers were directly sending Guacamole the money to pay pensions to the oldsters. Now it's taking a trip through the pension funds run by Taco, Tortilla, and Salsa, and these three crooks are charging us 2 percent of our wages for the privilege of doing what we were doing before—giving the government our money to give to the old timers. This is a scandal."

Chile says, "But Chimi, you're forgetting, the government bonds are paying a market return on your contributions. That wasn't the case before the reform."

"That's true," Chimi replies. "But Chile, who do you think is going to pay the taxes to cover the interest on those bonds? I will and so will my fellow workers. Once you factor in these taxes, I'm paying the same net amount now and getting the same net amount back when I retire—with two big differences. First, I have to pay 2 percent of my salary as a fee when the money goes into my account. And second, I have to pay an insurance company, which your three buddies have also set up, to get my money out in the form of an annuity. This entire transaction is a sham, a shell game, a deception, and a rip off."

"Gee, Chimi. You may have a point. But I can't believe Taco, Tortilla, and Salsa would have talked me into a sham, a shell game, a deception, and a rip off. Let me speak with them."

Taco, Tortilla, and Salsa meet with Chile at the country club and defend themselves by saying, "This is true, yes. But thanks to the reform we now have a competitive pension system and a vibrant annuity market. Chimi Changas and all the other workers have private accounts. We've developed our capital market. We now have new institutions trading in government bonds. When Chimi and his co-workers retire, they'll buy annuities. This will deepen our insurance markets. The invisible hand is working. So stop worrying."

Based on his extensive experience in the insurance industry, Chile Relleno knows when he's being taken. So he says to Taco, Tortilla, and Salsa, "Listen guys. You know and I know that what you just said is total BS. Your pension companies aren't competing to provide a beneficial product. They are simply funneling money from the workers to the government—something that was previously happening. The only difference is the money going from the workers to the government used to be called 'taxes.' Now we're calling it 'government borrowing.'

"And forcing people to buy annuities at the fees you're going to charge is yet more highway robbery. Sure, Chimi and others have private accounts. But they can't do anything with them, so what's the point? And having three companies buy government bonds is not much of a capital market.

"This situation looks bad and is bad. If Chimi Changas experiences nothing more than higher

costs associated with shipping his money to the elderly and receiving his own retirement income, all the other workers will as well. They aren't as dumb as you guys think. Isn't there something else you can do to get me off the hook?"

Taco, Tortilla, and Salsa huddle. "Yes, there is," they say. "We know that Chimi Changas and his co-workers own stock. So we're going to sell some of our government bond holdings to Chimi and his pals and use the proceeds to buy up some of the stock Chimi and his co-workers now hold. Our pension funds will end up with a mixed portfolio of stocks and bonds. Moreover, we'll be able, over time, to report a much higher average return on our pension funds than would otherwise have been true. This will make the workers feel good about the privatization. And the beauty of this is that no one—not even Chimi—will likely realize that this is still a sham, a shell game, a deception, a rip off."

Chile Relleno looks puzzled. "Gee, you lost me. Why is this still a sham, a shell game, a deception, and a rip off?"

"The answer," says Taco, "is that Chimi and his pals are currently the real/ultimate owners of both the bonds we hold and the stocks they hold. This transaction will just move some of their stock into our pension funds, meaning they'll still own this same stock, but indirectly. And the transaction will also move some of our bonds, which Chimi, et al., currently own indirectly, into their direct ownership. Think of it this way. Chimi has stocks in his left pocket and bonds in his right. We're just moving some of the bonds from his right pocket to his left and some of his stock from his left pocket to his right."

"Ok," says Chille, "I see your point. But you are not completely right. You're right that Chimi and some of his pals are rich and own stock. But most of his co-workers are poor and don't. So in swapping stocks for bonds with Chimi and those of his co-workers who own stock, the pension funds effectively make the workers who don't own stock part-shareholders in the stocks that the pension funds purchase. So this reform has a real effect after all."

"Well," says Tortilla, "I agree with you. But you're still not thinking hard enough. To ensure that nothing real actually changes and that this policy remains a sham, a shell game, a deception, and a rip off, all you need to do is to cut taxes on the rich, i.e, on Chimi and his pals, when stocks do well and raise them on the rich (Chimi and his pals) when they do poorly. If you do this right, you'll give Chimi and his stock-owning buddies *exactly* the same real income as they'd have absent the 'reform' both in situations in which stocks do well and in situations in which they do poorly. By the magical laws of the conservation of money, if nothing changes for the rich, nothing will change for the poor. Nothing will have changed except the language being used to label the government's transactions."

"Wow. You guys are good. This beats universal life insurance when it comes to a good scam," yells Chile. "And since I need Chimi and the other workers to reelect me, I'll forgo raising taxes to pay the interest on the debt you just floated. Instead, I'll just leave a bigger official debt to my successor, and he can hit up today's kids for the bill. So the policy won't be a sham, a shell game, a deception, and a rip off. It will be worse!"

## DISTINGUISHING FORM AND SUBSTANCE

In relating this tale of pension "reform" in the country of Nachos, I don't necessarily mean to imply that the Chilean reform or any other reform modeled after it was or is a sham, a shell game, a deception, or a rip off. But I do mean to emphasize that the same fiscal policy can come

with many different labels. The only way we can judge what these reforms have really done is to consider whether they've been associated with changes in the four fundamental features of fiscal policy. These are the level of government consumption, the distribution of resources across generations, the distribution of resources within generations, and the structure of incentives to work, save, and make other economic decisions.

For its part, Chile seems in much better overall fiscal shape in this, the 25th anniversary of its pension reform, than it was in 1981. But how much the pension reform contributed to its fiscal health is hard to say and may never be fully resolved. Jose Pinera, the architect of the Chilean reform, gave me one example of how the reform impacted government consumption. Jose told me that he was able to keep the Chilean Navy from buying a used U.S. aircraft carrier by pointing out to the admirals that the pension reform had raised the government's (explicit) debt and limited the country's ability to borrow.

My sense is that in determining the size of the Recognition Bonds (bonds provided to Chilean workers to compensate them for foregoing future accrued state pension benefits) to be paid to existing workers, the Chilean reformers made sure to protect the interests of future tax payers by using conservative actuarial and economic assumptions. I also think that the Chilean reform improved work incentives and that it may have improved intragenerational equity.

But the fact that it's now 25 years after the reform and that no one has examined the reform in terms of these four fundamentals is telling. The only way we can possibly assess the true economic impact of a pension reform or, indeed, any reform is to measure these four fiscal fundamentals on an ongoing and systematic basis. I speak here of accurately measuring government consumption, doing very careful generational and intragenerational accounting, and documenting the structure of total effective marginal net tax rates.

Since none of the fiscal fundamentals is being properly and systematically measured for the U.S., let alone any other country in the world, it's very difficult for economists to pass informed judgments on particular pension reforms.

## PROBLEMS WITH THE CHILEAN PLAN

Having said this, it's clear that the Chilean-type privatizations suffer from some marked design flaws. These flaws, many of which have recently been discussed as part of a comprehensive pension review in Chile, include

- exorbitant pension management fees that can range from 1 to 2 percent of lifetime earnings
- the failure to exploit scale economies in contribution collection and record keeping
- the failure to exploit scale economies in investing
- the inability/failure of pension funds to diversify their domestic investments
- the inability/failure of pension funds to invest abroad
- the failure to enroll large fractions of informal-sector workers
- the failure to ask current generations to pay transition costs
- the failure to exploit scale economies with respect to annuitization
- the failure to address adverse selection with respect to annuitization

These problems are not that hard to solve. In fact, my Personal Security System proposal, which I have described in a prior *Economists' Voice* column, does just that. The fact that few,

if any, countries have implemented my plan or otherwise solved these problems I attribute to the overwhelming influence that bankers, insurance companies, brokers, investment companies, and other players in the financial sector have on government policy. Once the subject of personal accounts (a fully vested pension system) comes up, they each want a piece of the action.

---

Letters commenting on this piece or others may be submitted at http://www.bepress.com/cgi/submit.cgi?context=ev.

## REFERENCES AND FURTHER READING


**Green**, Jerry and Laurence J. Kotlikoff (2006) "On the General Relativity of Fiscal Language," working paper. Available at: http://people.bu.edu/kotlikof/General%20Relativity%206-10-061.pdf. (Giving a general proof of the invariance of fiscal policy to its labeling.)

**Kotlikoff**, Laurence J. (2006) "Averting America's Bankruptcy with a New New Deal," The Economists' Voice, 3(2): Art. 5. Available at: http://www.bepress.com/ev/vol3/iss2/art5.

**Sinha**, Tapen (2000) *Pension Reform in Latin America and Its Lessons for International Policymakers*. Boston, MA: Kluwer Academic Publishers. (Raising similar concerns to those raised in my parable.)


## ACKNOWLEDGMENTS


*I thank Michelle Favre for excellent research assistance. A prior version of this column was given as a speech to the Latin American Econometrica Society and the Latin American and Caribbean Economic Association, November 2, 2006.*