Eduardo Engel: This paper provides a masterful primer on the economics of pensions.[1] Barr and Diamond also cover the shortcomings of arguments for privatizing pensions in Latin America, as well as problems that were not envisioned at the time of reform. I organized a lecture on pensions in the undergraduate course I teach at Yale on economic policy in Latin America based on this paper, and it worked very well. In these comments, I provide additional evidence illustrating the paper's main points and discuss issues on which I differ. Among the latter, I argue that political economy considerations may temper some of the paper's policy recommendations.

[1] Promise [end]

A pension system based on individual accounts as part of a fully funded defined-contribution system was introduced in Chile in 1981. Argentina, Bolivia, Colombia, Costa Rica, Dominican Republic, El Salvador, Mexico, Peru, and Uruguay introduced similar systems in the decades that followed, sometimes as one of many options and in other cases as the main or only option available for new entrants to the labor force.[2]

Four main arguments for the Chilean pension reform were given in the early 1980s. First, providing well-defined ownership rights reduces the risk of opportunistic behavior aimed at obtaining a larger share of accumulated funds and current taxes destined to finance pensions. Both advocates and detractors of the Chilean reform provided ample evidence that the old system was plagued by blatantly unfair and corrupt practices.[3] Second, competition among pension providers would lead to better service and higher returns on savings, translating into higher pensions. A third argument, closely related to the first one, was that the new system would foster sounder public finances by reducing the burden on the government budget imposed by the partially unfunded systems in place at the time. José Piñera, Labor Minister at the time of the Chilean reform, went so far as to claim that the fiscal cost of the reform would be zero.[4] Finally, many arguments were presented linking a system based on individual accounts to the development and deepening of financial markets.

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1. I thank Eduardo Bitrán, Ronald Fischer, Eduardo Lora, and Claudio Raddatz for comments and suggestions.
2. Arenas and Mesa-Lago (2006).
3. Arellano (1985); Piñera (1991).
4. "20 respuestas acerca de la previsión dio ministro Piñera," *El Mercurio*, 15 November 1980, p. A1.

[1] **Experience [end]**

As is so often the case with economic reforms, the benefits are oversold and a number of problems are not anticipated. The transition from a system with defined benefits to one with defined contributions based on individual accounts evidently has a cost for public finances. Taxes must finance pensions for those belonging to the old system for a period lasting many decades, with no recourse to social security contributions from workers entering the new system. Only a comparison of steady states that ignores the transition costs involves no fiscal cost.[5]

The analysis by Barr and Diamond also tempers the enthusiasm for pension systems based on individual accounts as a means to develop financial markets. I do not have space to address the debate on whether pension reform fosters the development and deepening of financial markets.[6] The potential is there, especially for countries that privatized publicly held utilities concomitantly with reforming pensions, since the long-term financing needs of privatized utilities match the pension fund managers' demand for long-term assets. Nonetheless, the challenges faced when addressing this question empirically based on aggregate evidence are large, since other reforms coincided with pension reform in many countries, making identification close to impossible.[7]

A more promising route to study the impact of pension reform on financial markets is to use microeconomic data to test specific channels for potentially beneficial effects. Raddatz and Schmukler provide an interesting example along these lines.[8] They look at investment strategies by Chilean pension fund managers and find that they mainly hold bank deposits, government paper, and short-term assets; that they tend to hold similar portfolios and follow momentum trading strategies; and that they do not actively trade the assets they hold. All of this suggests that even if pension funds helped create markets for long-term instruments, as they most likely did, they did not contribute to making these markets particularly liquid. Raddatz and Schmukler

5. The present discounted value of government outlays will also be higher with reform than without reform, since the transition from the partly unfunded defined-benefits system to the fully funded defined-contribution system with individual accounts is the converse of the well-known result according to which introducing social security constitutes a Pareto improvement (Samuelson, 1958).

6. See Raddatz and Schmukler (2005) for a good summary of the main issues and references.

7. For example, Morandé (1998) argues that Chile's high growth period beginning in 1985 is explained by increased savings that resulted from pension reform.

8. Raddatz and Schmukler (2005).

conclude that the observed investment patterns are not consistent "with the initial expectations that pension funds would be a dynamic force stimulating the overall development of capital markets, especially that of secondary trading markets."[9]

[1] Competition [end]

The advantages expected from competition did not materialize. As noted by Barr and Diamond, the economics of information and behavioral economics both help explain why. For example, 95 percent of account holders of Chile's private pension providers do not know the administrative charges they pay, despite the fact that they receive quarterly statements containing these charges and that this is the main determinant of differences in returns across pension funds.[10] It is therefore not surprising that competition among providers has been weak, leading to average annual returns on capital for these companies that are many times those obtained by assets facing similar risk profiles elsewhere in the economy. For example, the average annual return of pension administrators in 1998–2003 was 53 percent, which is four times larger than normal returns.[11] Despite such high returns, no new firm entered the industry between 1998 and 2010, when the system was reformed to introduce more competition (see below).

Interestingly, well-designed competition *for* the field can be a good surrogate when competition *in* the field does not work properly.[12] Private pension markets provide an excellent illustration of this powerful idea. In February 2009, the Chilean government auctioned the individual accounts of all workers entering the labor market over a two-year period, with the accounts being awarded to the pension provider bidding the lowest fees. If an incumbent won the auction with a bid lower than the fees it charged existing customers, it had to pass on the reduction in charges to all customers. Workers assigned to the winner are free to move to another provider if they so desire.

The winner of the auction offered a commission 16 percent below the lowest commission in the market. Furthermore, the winner was new to the industry, the first entrant in more than a decade. Having a Demsetz auction lowers entry costs significantly, since new firms can count on

9. Raddatz and Schmukler (2005, p. 7).
10. Berstein and Ruiz (2004).
11. Valdés-Prieto and Marinovic (2005).
12. Chadwick (1859); Demsetz (1968).

a sufficiently large number of clients (approximately 7 percent of the market in the Chilean case) to operate at an efficient scale without having to invest in marketing. Despite the fact that incumbent pension providers lobbied strongly against the auction and succeeded in watering down the extent to which it reduced entry costs, the outcome is promising and may lead to significant fee reductions in years to come.

[1]Administrative Costs [end]

Arellano was one of the first to point out the high administrative costs of the Chilean pension system.[13] In general, the administrative costs of private investment funds in Latin America are high. As of December 2002, fees as a percentage of total contributions were are follows: Argentina, 36.2 percent; Chile, 15.0 percent; Colombia, 14.0 percent; El Salvador, 12.5 percent; Peru, 22.1 percent; and Uruguay, 13.5 percent.[14] Bolivia is the one exception, with administrative fees of only 4.8 percent of total contributions. Why are administrative costs so much lower in Bolivia? Bolivia learned from the Chilean experience and used a Demsetz auction to reduce administrative costs by two-thirds. Instead of allowing free entry, Bolivia opted for two pension providers selected via competitive bidding based on the lowest average monthly administrative charges.[15]

[1] Pensions and the Political Economy of Deficits [end]

Unsustainable public deficits played a major role in most of the economic crises that took place in Latin America in the second half of the twentieth century. Governments routinely monetized their deficits, which time and again resulted in major recessions and economic and political crises. Things have improved in the last two decades, and inflation has been considerably lower thanks to various institutional reforms, including the creation of autonomous central banks.

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13. Arellano (1985). See also Diamond and Valdés-Prieto (1994).

14. Barr and Diamond (2008, table 9.2, p. 166).

15. Barr and Diamond mention the very low administrative costs of the U.S. Thrift Savings Plan, which are 0.6 percent of average account balances. A comparison with the costs of pension administrators in Latin America is not straightforward, however, since commissions are generally a percentage of contributions instead of balances, and any comparison requires making allowances for differences in both labor costs and average balances across countries.

Nonetheless, improving fiscal institutions continues to be a high priority in the region. For example, the second-most promising policy proposal for Latin America, according to the Consulta de San José, is improving fiscal rules: "Consolidating the budget process through procedural rules that would set structural deficit targets, limit deficits, spending, and debt levels, and increase budget transparency would help avoid insolvency and excess spending in good times. At a low cost, this could potentially increase nations' growth rate substantially."[16] Underlying the Consulta de San José's proposal is the fact that the temporal profile of government expenditure is far from optimal in most countries in Latin America, with highly procyclical fiscal policy.[17] This is further compounded in some cases by a level of expenditure that continues to be too high. For example, Brazil's chronic high interest rates have been diagnosed as the main factor holding the country back. Underlying these high rates are overly generous pensions and high public debt.[18]

Understanding the political economy of pensions and its impact on the level and dynamics of government debt remains an important research question for Latin America. Policymakers across a broad political spectrum agreed, by the late 1960s, that the pay-as-you-go pension systems in place in Latin America at the time were an important cause for chronic government deficits and inflation. Insufficient government savings combined with a ratchet effect on debt led to higher and higher deficits. A pension system based on individual accounts was a promising idea to break this vicious cycle. The argument was that clearly defined property rights would create a majority of voters opposed to government expropriations of resources set aside to finance future pensions.

Argentina's nationalization of private pension funds in late 2008 provides an interesting test for this argument.[19] Since only a minority of workers were affiliated with the private system in Argentina, the median voter is likely to have been in the public system. This may explain why

16. Lomborg (2009, p. xxvii),The Consulta de San José is an expert panel of nine distinguished economists (namely, Orazio Attanasio, Jere Behrman, Nancy Birdsall, John H. Coatsworth, Ricardo Hausmann, Finn E. Kydland, Nora Lustig, José Antonio Ocampo, and Andrés Velasco) who met in San José, Costa Rica in October 2007 to assess more than forty solutions to the biggest challenges facing Latin America and the Caribbean. See Lomborg (2009) for details.

17. Gavin and Perotti (1997); Ilzetzki and Végh (2008).

18. Hausmann (2008). See also "Lula's Legacy," *The Economist*, 30 September 2010.

19. Additional examples include the recent nationalization of assets held by private pension funds in Bolivia and Hungary. The law enacted by Bolivia in December of 2010 also lowers the country's retirement age to 58, which goes against the trend to have people work longer due to rising life expectancies. This change raises doubts about the health of the country's medium-term public finances.

there were limited protests when the government of Christina Fernández decided to use private pension assets to finance current spending in the face of the international financial crisis of 2008 (and upcoming elections).

Looking forward, some interesting lessons emerge for countries that want to maintain a system based on individual accounts, aimed at making it harder for the government to expropriate the private pension funds. First, expropriation should be less likely when the reformed pension system is mandatory, at least for new entrants into the labor force. Second, to keep most funds out of reach of the government, fund assets should be held abroad. This stipulation does not preclude the pension system from helping fund domestic firms, as they may be allowed, for example, to buy American Depositary Receipts (ADR) of local stock traded in the United States.[20]

Barr and Diamond's argument in favor of notional defined-contribution (NDC) systems is somewhat weakened once political economy considerations are incorporated. It is true that an NDC system combines individual accounts with low administrative costs, while avoiding a substantial share of the risks associated with short-term capital market fluctuations, which are a concern under the Chilean system. However, the political risks associated with having a notional interest rate that is set on an annual basis can be considerable. This rate may end up being negative if the government decides to use the accumulated funds to finance current expenditures, or it may rise far above the optimal level should the incumbent government believe this benefits its reelection prospects.

My criticism of Barr and Diamond for not incorporating political economy considerations is unfair, since their paper is about the economics of pensions, not the related political economy. Their choice is further justified by the fact that the tools needed to compare the political economy of alternative pension systems are less developed than those necessary to compare their economic implications. Nonetheless, it may be too strong to state the choice among systems "should be economic, not primarily political." All of this highlights the need for more research on the political economy of pension systems.

[1] Concluding Remarks [end]

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20. Lora (2004) proposes an alternative design, with an important role for international financial institutions, aimed at achieving the same objective.

The proponents of any major economic reform will tend to oversell it to the public. Barr and Diamond remind us that pension reform in Latin America was no exception, when they conclude that "the litany of funded schemes that have failed completely or that have not lived up to the promises that were made for them attests to… the dangers of basing policy on… excessively optimistic predictions." Their analysis of pension systems based on economic fundamentals helps avoid the narrow discussion that often characterizes debates of these issues in Latin America. Thus, for example, the obvious fact that individual accounts do not include a poverty relief component is well summarized when they state that "unless accompanied by a robust system of poverty relief, individual accounts do not constitute a pension system, but only part of a pension system." Their description of the Chilean pension reform of 2008, which incorporated a significant poverty relief component while maintaining a central role for individual accounts, also contains important lessons for countries throughout the region.[21]

[1] References [end]

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21. See also the chapter they dedicate to this reform in Barr and Diamond (2008).

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