Pension Reform Reversals – Can Robust Institutions Avert a Global Tragedy Of The Commons?

Student Book Project “Let’s get our freedom back”

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October 2014

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Abstract

Since the outbreak of the global financial meltdown many economies from Latin America and Europe have reversed their pension systems through the full or partial nationalization of the second pillar. The discretionary seizures of private capital have bestowed political elites with greater flexibility for public spending. However, the coercive initiative has brought along a twofold tradeoff. First, this sudden change of the rules of the game has propelled an exponential growth of the implicit and explicit long-term debt causing regime uncertainty and confirming the institutional weakness of the pension systems. Second, exchanging the accumulated pension funds for promises of future payments through the usage of creative accounting has opened a Pandora’s box insofar as it became a model for legal plunder at a global scale. Many countries have followed suit and many more are making the case for reversing their pension systems as well. In the present paper I look into the historical evidence of pension reform and into the ongoing reversals of the Club SEP countries. I then draw on the precepts of robust political economy in order to assess and delineate the institutional robustness of pensions and as such, avert this new tragedy of the commons from spreading globally. I find that Chile is the only country that passes the test of institutional robustness. I conclude that the Chilean success rests on the knowledge-generating properties of dispersed ownership and on the exit properties brought by low switching costs and dispersed administration. I argue against the World Bank’s multi-tier system and in favor of a one-pillar archetype à la Chile.

Keywords – pension reform reversals; second pillar; alleged commons; creative accounting; institutional robustness; behavioral symmetry; bounded rationality; limited benevolence; dispersed knowledge; dispersed ownership; dispersed administration; individual choice; transition costs; switching costs; competition.
1. Introduction

Demographic change is a common phenomenon of the first and second world as is the transition from industrial to post-industrial societies. Trusting the stock market has become somewhat uncertain and public welfare has led to only superficial security. We are in need of new embedding and new aftershocks, which may come about either organically or centrally planned. Unfortunately, since the outset of the Great Recession policymakers have taken the latter option by either using the monopoly power to expand the monetary supply and inject liquidity into their economies—thus tampering with the Wicksellian natural rate of interest—or by strategically and creatively stripping their citizens out of their accumulated retirement funds. Both forms of market intervention are equally detrimental to the individual. The first usually takes the form of a Cantillon effect\(^2\) thus transferring purchasing power away from those who hold old money to whoever gets the new money, but it also tampers with the signals of the price system, distorting the production structure of the economy as exposed by the Mises-Hayek Business Cycle Theory. The second form of intervention is very visible and it affects directly individual property and individual choice. However, this second area remains under-researched so we have a great divergence between the vast literature on monetary and financial theory and the still young literature on pension reform. Moreover, the main body of scholarly work on pensions has focused almost exclusively on the normative objectives of pensions, i.e. redistribution, consumption smoothing, insurance and poverty relief.\(^3\) Despite the overwhelming evidence of the growing number of Club SEP countries\(^4\) very little has been said about the real incentives and the unintended consequences triggered by adopting the World Bank’s multi-pillar approach. This paper will therefore focus on this new form of market intervention also known as “pension reform reversals” or “pension re-reforms.” These series of confiscations taking place around the world have one common denominator: they have included the redistribution of part of the pension savings toward the PAYGO (unfunded) first pillar, with some countries, e.g. Hungary, going even further with the full nationalization of all private pension assets. Simply put, the second tier has become a new and rich source for legal plunder. This is a new tragedy of the commons because the accumulated pension savings have been spent—in some cases to exhaustion—before they could be used for old age consumption.\(^5\) The study demonstrates why this confiscation is inevitable and how it can oftentimes become politically costless when the second pillar isn’t properly individualized. This is the main empirical limitation of the well-intended World Bank’s multi-pillar approach. The main objective of this paper is thus to contribute in a paradigmatic shift by reengineering the multi-pillar approach into a singular tier. The forthcoming objective is to avert nation States from mirroring the path-dependent response evidenced by Hungary,\(^6\) Poland\(^7\) and a growing number of Club SEP countries.

\(^2\) 18th Century economist Richard Cantillon was the first to propose the idea that the first recipients of new money enjoy from higher living standards at the expense of later recipients. See, (Rothbard, 2006, p. 359)

\(^3\) See, (Barr, 2000)

\(^4\) The Club SEP considers the group of countries that have confiscated accumulated capital from the pensions’ Second Pillar. See, (Latorre Artus, China looks into individual retirement accounts amid the growing number of club SEP countries, 2014)

\(^5\) See, (Latorre Artus, Polish Pensions Setback – A New Tragedy of the Alleged Commons, 2014e) and (Busquets, 2012)


\(^7\) (J.P., 2011)
SEP countries. The final objective is to offer a guide to policy that strengthens the institutional robustness of pensions.

In the first part of this paper I describe why and how the World Bank’s endorsed formula for pension design has paved the way for the problem of political open access resource. I then explain how this has worked in conjunction with the ongoing sovereign debt crisis and the Great Recession to fast-track the tragedy of the pensions commons. Later, I draw upon the precepts of robust political economy in order to delineate the baseline arrangements for institutional robustness of pensions. Using these methodological lenses I examine what set of political economic arrangements have empirically limited human action when the incentives for depletion emerge and I evaluate to what extent the pension systems of Chile and the Club SEP countries have managed to channel opportunistic behavior into maximizing the normative objectives of pensions. Finally, I explore the findings and draw final recommendations.

2. The Unintended Consequences of The World Bank’s Multi-tier Formula

In Averting the Old Age Crisis: Policies to Protect the Old and Promote Growth, the World Bank set the new standard for pension design based on a multi-tier model. More than eighty countries have charted the World Bank’s recipe by reforming their unfunded pension systems and adding at least one funded pillar. The main problem with this multi-tier approach is that the second pillar has often functioned as a common pool resource subject to exhaustion, thus planting the initial seed of its own demise. Evidence demonstrates that the incentives triggered by the multi-pillar system have encouraged individuals within the political process—i.e. voters, politicians and bureaucrats—to overharvest the system. In addition, the original pension reforms have often individualized the second pillar rather poorly and have usually not come of age. This has had a direct effect on the electorate’s thorough understanding regarding their rightful property of the funds. These information asymmetries play against the institutional robustness of the system. As a result, looted citizens from the Club SEP countries have not reacted to these series of overhauls, proving its political feasibility, but more importantly: sending a strong signal for other countries to follow suit.

Garrett Hardin originally described the tragedy of the commons (hereafter: TotC) as the exhaustion of a finite resource caused by individuals rushing to take as much as possible before others come and take it first. Because of the perverse incentives triggered on individuals to overharvest the system, the TotC within pension systems manifests itself in three different forms. First, with the welfare State through the collective action incentive. Senior voters are historically more engaged in the democratic process and the policymaking is normally crafted based on the Overton Window. This dichotomy creates the incentive from both the elderly and from politicians to overharvest the welfare State. The second form of TotC stems from the last man standing rule, a legal arrangement under which multiemployer plans operate in certain nations. Here every firm is held responsible for the pension liabilities of all firms in the plan. Why is this a problem? This legally-born moral hazard allows businesses that go bankrupt to leave their liabilities behind to be absorbed by those firms still

8 See, (World Bank, 1994)
9 See, (Hardin, 1968)
10 Joseph Overton observed that politicians face a “window” of possibilities regarding politically acceptable policies. However, this “window” is largely defined not by what politicians truly prefer, but rather by what people support. See, (Russell, 2006)
left in the plan.\textsuperscript{11} This TotC portrays the perverse incentive for individual firms to contribute as little as possible in order to keep the plans running. In the United States, this common pool resource continues to grow dangerously underfunded.\textsuperscript{12}

The third form of TotC is perhaps the greatest tragedy of all and the reason is threefold. First, it depletes the accumulated savings originally promised and destined for old age consumption, triggering negative externalities, regime uncertainty and the unsustainable growth of the implicit and explicit sovereign debt. Second, because its depletion stems from political coercion there is no room for individual response, heightening a systemic risk, which individuals themselves cannot control or manage.\textsuperscript{13} And third, because pensioners no longer contribute into the system, they are not directly affected, unless the system goes bankrupt. Consequently, this scheme is hardly voted out of the market, contributing to the unsustainable increase of the debt burden, which is passed on to future generations and future administrations. Eventually, both groups are no longer willing to bear the increased costs on their shoulders. Future generations will vote with their feet by fleeing to freer regions or under-declaring income. Future administrations will simply change the rules—as they usually have in the past—leaving retirees earning cents on the Euro.

3. The Sovereign Debt Crisis and The New Club SEP Countries

Because of its similarities with the subprime mortgage crisis—i.e. the European monetary union allowed a sudden decrease of the long-term interest rates among the Club Med countries allowing a rapid and unsustainable credit expansion with the well-known unexpected consequences—the European sovereign debt crisis has usually been linked to the 2008 Financial Crisis and the Great Recession. Its structural shortcomings are characterized by high government deficits and the exponential growth of debt. However, it is important to note that the global financial meltdown is only a collateral bystander, which of course made things all the worse, but are not the main cause of the sovereign debt crisis. In fact, the Eurozone debt crisis had already been propelled decades earlier by the European welfare leviathan. According to Piñera, the evidence from the entitlement State in Europe is overwhelming, irrefutable and it demonstrates how entrenched and entangled the entitlements are today with continuously soaring debt-to-GDP ratios. Because of the structural shortcomings of the three-pillar system explained in the previous chapter, today’s pension crisis has become a ticking time bomb, which might eventually sink the monetary union.\textsuperscript{14} These transformations among EU nation States have been associated with growing fiscal imbalances.\textsuperscript{15} According to Gokhale, the unfunded obligations within Europe evidence unsustainable levels of financial leverage with many member States at the verge of default.\textsuperscript{16} These restructurings have a direct impact on the ongoing pension crisis, making the case for urgent new embedding.

\textsuperscript{11} See, (Osorio, 2012)
\textsuperscript{12} See, (Osorio, 2012)
\textsuperscript{13} In a competitive system, if a private institution decides to use these funds to exhaustion, individuals can easily “vote” them out of the market. When politicians decide to deplete these funds by the power of coercion, there is little room for individual response.
\textsuperscript{14} See, (Piñera, Will The Pension Time Bomb Sink The Euro, 2004)
\textsuperscript{15} Fiscal imbalances (FI) are the unfunded liabilities measured as percentage of annual GDP, and can be understood as the amount of assets that governments must invest today in order to close future budget gaps.
\textsuperscript{16} The growing fiscal imbalances are quite alarming and a very revealing evidence of the pension crisis ahead. See, (Gokhale, 2009)
Unfortunately, the political elite is reacting by cashing in on the accumulated savings from the second pillar, leaving their citizens with the short end of the stick.

This new TotAC and the genesis of the Club SEP countries can be traced back to Argentine President Cristina Fernández and her administration. The infamous original bill was sent to the Argentine Congress back in 2008 allowing the government to seize USD 30 billion from pension funds, which, by the way, had been accumulating for over 14 years. Fernandez argued that she was rescuing the pension system from the global financial meltdown. However, evidence strongly suggests that the government needed to get its hands on these funds as it faced billions in due obligations. Sadly, nobody rebelled against these seizures. Of course the political class blamed the pension system and capitalism, but this is doubtfully sufficient ground to convince the citizenry to stay put. My hypothesis is that the looted citizens did not fully understand the contours of the reform and/or the consequences for old age security.

As a result, the revolt-free seizure in Argentina greased the wheels for other countries to join the momentum. Soon after, Bolivia (2010) and Hungary (2011) joined the raiders Club. According to Datz & Dansci, the governments of Viktor Orban in Hungary and of Cristina Kirchner in Argentina enjoyed from vast legislative support and no significant popular backlash. They argue that the incumbents systematically blamed the capitalization system for several market failures in e.g. coverage, poor performance, and high administrative costs, all of which made the looting smoother and politically costless to carry on. Be that as it may, I argue that there are deeper institutional weaknesses rooted within the multi-pillar system that allowed politicians to get away with the confiscation. I believe that because of its multi-tier structure, the system as such did not offer an easy individualization of the second pillar in many cases, with Poland being the prime example where the Supreme Court decided against individual property and in favor of a common pool resource.

This new phenomenon has rapidly spread around Europe spilling over the retirement funds of Poland, Lithuania, Latvia, Romania, Bulgaria, and it will probably and very soon reach the accumulated assets and sovereign funds of Ireland and France. This growing trend of reversals also demonstrates a strong path-dependent response, which highlights a clear tension between economic rationality—i.e. long term goals—and political rationality—i.e. short term objectives. In the case of Hungary, for example, the government admittedly coerced its citizen to refinance its short-term debt. Dismantling the second pillar was done in order to meet the fiscal requirements set by the provisional loans from the EU and the IMF. This seizure allowed Hungarian officials to liquidate over 10 percent of their debt.

The case of Poland was more gradual, yet not less coercive. On February of 2014, Polish officials carried out a law passed by parliament in 2013 allowing them to seize about EUR 37 billion from the pensions’ second pillar. Before the seizure took place, the latest official data showed that Poles were reaching the 55 percent debt-to-GDP legal limit:

17 See, (Arza, 2012)  
18 See, (Datz & Dansci, 2013)  
19 See, (Latorre Artus, Polish Pensions Setback – A New Tragedy of the Alleged Commons, 2014e)  
20 (Dziennik, 2011) (Deon, 2011)  
21 Refinancing public debt was admittedly the main objective for taking over the private funds from the pensions second pillar. See, (Racz, 2011)
Again here, the move seems directly related to balancing the budget in the short-term. This clever arrangement based on creative accounting—i.e. swapping accumulated assets and exchanging them for promises of payment to the future—reduced Polish sovereign debt by roughly 8 percent of GDP. The problem is that this short-term debt reduction was done not by efficient administration, but rather by drawing on private capital, which clearly doesn’t fix the problem. It lowers the temperature, but it does not kill the bug. According to Balcerowicz, this short-term debt reduction has put Polish finances under a tremendous and unsustainable debt burden into the future.

Meanwhile, these political elites face absolutely no revolt. This evidence suggests that a multi-tier system plays against not only the effective individualization of the second pillar, but more importantly: against the efficient spread of knowledge among the taxpayers regarding their true property rights upon these funds. To put it simpler: I argue that, on average, there is a lack of understanding regarding the real tradeoff between capital funding—thus real trust funds—and promises of future payments—i.e. unfunded liabilities that can easily be erased at the moment of retirement. This evidence strongly suggests that people believe that in, e.g. thirty years from today, future administrations will honor the promises made by elites in the past and thus, will receive the promises that are being manufactured today. It is my contention that a pension system that mixes capital funding with other pillars of redistribution and/or common pool resources does not allow the average Joe to fully grasp the contours and consequences of this tradeoff. I believe that this is the main reason why we have witnessed so many revolt-free seizures.

Policymakers around the world understand now that the alleged commons from the second pillar bestows them with a rich source of sound money to pay off external obligations. As long as people stay put, the number of Club SEP countries will continue to rise, making this new tragedy of the alleged pension commons a global phenomenon. In order to effectively address this problem we need to figure out what kind of institutional arrangements could minimize the negative effects of bounded rationality and information asymmetries among policymakers and taxpayers, among looters and looted, and as such, limit the scope of what policymakers can confiscate. The answer will be uncovered by looking into Chile’s pension revolution based on a single-pillar of individual capitalization and by drawing upon the precepts of robust political economy.

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22 (Ministry of Finance - Republic of Poland, 2013)
23 See, (Latorre Artus, 2014e)
24 See, (Deon, 2011) (Dziennik, 2011)
25 As opposed to printing new money, or issuing new long-term securities, or increasing the tax rate.
4. Chile’s Pension Revolution: Forced Savings Through Taxation

In the midst of the 1970s and beginning of the 1980s Chile led a radical transformation from a command economy to a free market economy. The genesis can be traced back to a freedom revolution that started in the streets and continued in parliament by officially declaring unconstitutional the socialist government of Salvador Allende. The struggle to free themselves from this populist regime ended with a military Coup d’état that radically replaced a centrally planned economy for one based on a bottom-up approach and individual choice. Since these liberal reforms took place in the midst of the Cold War, Chile enjoyed from the complicity of the United States and as a result became a perfect laboratory to test the new economic ideas promoted by prominent economists of the Chicago school led by Milton Friedman. In the following years, Chile underwent a series of radical transformations with the pension revolution as the mother of all reforms. It replaced the old and bankrupt Pay-As-You-Go system for a fully funded one, which is still the most complete and most radical reform up to date. It is based on a system of Individual Savings Accounts (hereafter: ISA), where its citizens are “forced” to save for old age, i.e. each citizen is assigned by the constitution his/her own and private account. This properly individualized single-tier system does not give any room for a common pool resource. The system of ISA is a system of forced savings because they are collected through taxation, however, the government outsources the control of these funds to several Pension Fund Administrators (hereafter: PFA). These PFAs are regulated but they are relatively free and compete with each other over the tax-money of the citizens.

The robustness of the system is found in its exit properties. Since PFAs operate within free markets and face competition, if a PFA wishes to collect these pension taxes, they must offer good rates of return; otherwise individuals will vote them out of the market. The ISAs grow along the course of forty or more years of taxation. The key element is that at retirement citizens need not look at the government or beg them for goodies or promises made forty or more years earlier, probably by political elites who are long gone. Instead of waiting for political promises to be fulfilled, Chilean citizens draw from their own nest eggs which have been paid for by their own taxes.

Since its inception in 1981, the pension system has grown exponentially. The following figure represents the saving trends of the AFPs, as of June 2011, i.e. 30 years from the original reform. It reveals that the pension funds have spurred the country’s savings rate by 26% with a total accumulation of 69.6% of total GDP.

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26 See, (Piñera, Una Casa Dividida - How Allende Destroyed Democracy in Chile, 2003)
27 See, (Fontaine, 1993) (Meller B., 2007)
29 See, (Arenas De Mesa & Mesa-Lago, 2006)
Chile’s pension revolution is the oldest and most radical pension reform in history, which triggered the “Golden Years of Growth.” With thirty-five year of age, the reform has matured and is reaching the new steady state. Corbo and Schmidt-Hebbel have tested this model empirically and they conclude that the success of a pension reform based on ISA depends, by and large, on financial liberalization and on disciplined monetary policy. The evidence found by Corbo and Schmidt-Hebbel goes beyond the robustness of the pension system because it also offers positive spillovers on domains outside the pension system, e.g. by raising formal employment and by greasing the wheels for financial development and economic growth to take off. More specifically, the study of Corbo and Schmidt-Hebbel revealed a strong and positive correlation between capital funding and financial maturity (by improving the allocation of resources in the economy and expanding its Total Factor Productivity frontier) and also on GDP growth. In addition, they suggest that if the reform is escorted by labor reforms that lower other roots of pure taxes on labor, a pension system based on ISAs may also contribute to raising formal and total employment. The most important corollary from Corbo and Schmidt-Hebbel’s study is that these effects are magnified when the original reform is done à la Chile, i.e. the more radical the reform, the more radical the replacement of the PAYGO system by a fully funded one and the more the transitional deficit is financed by fiscal readjustment, the greater the effects on the accumulation and efficient use of the factors of production.

These complementary reforms can also be used and aimed at strengthening the institutional robustness of younger pension systems elsewhere and as such, avert the TotAC from spreading further.

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31 See, (Perry, 2011) (Diario Estrategia, 2011)
33 See, (Corbo & Schmidt-Hebbel, 2003, p. 300)
34 See, (Arizala, Cavallo, & Galindo, 2009)
35 See, (Corbo & Schmidt-Hebbel, 2003)
36 (Corbo & Schmidt-Hebbel, 2003)
5. Robust Political Economy and The Robustness of the Chilean Model

The precepts of robust political economy stress the Hayekian knowledge problem of bounded rationality and highlight the often-overlooked idea of limited benevolence. In a world of imperfect information the theory suggests that decisions must be made within institutions that facilitate learning over time. In a world of self-interested individuals, it advocates the idea that decisions should take place within institutions that can endure the strains brought by human errors. Under these lenses we can relax the often-biased assumptions regarding individuals’ information as well as the behavioral asymmetries represented by the classic dialectic between self-interested individuals in the private sector and the allegedly altruistic motivations of individuals in the public domain. By behavioral symmetry, robust political economy draws on public choice theory in order to depict a more realistic view of politics, i.e. individuals are self interested and responsive to incentives regardless of the domain where they operate, public or private. In other words, individuals do not magically turn intro altruists human beings once in public office, and then back to self-interested after 6pm when they go home.

Boettke and Leeson make it very succinct: “Robust political economy requires that both the assumptions of agent benevolence and omniscience be relaxed so that both incentive issues and knowledge problems can be adequately addressed.” Once we relax these assumptions, we can then evaluate the capacity of a pension system to channel the incentives they provide and opportunistic behavior in ways that maximizes social welfare.

Two of the proponents of robust political economy, Leeson and Subrick, write: “In the context of political economic systems, “robustness” refers to a political economic arrangement’s ability to produce social welfare-enhancing outcomes in the face of deviations from ideal assumptions about individuals’ motivations and information.” In the context of pension systems, this paper has offered substantial evidence from the Club SEP countries, which corroborates these deviations from ideal motivations—e.g. self-interested politicians depleting the second pillar—and information—e.g. information asymmetries between electorates and bureaucrat officials. The growing evidence from the Club SEP countries suggest that the World Bank’s endorsed multi-pillar system cannot be a robust institution as such, because it has not been able to channel the incentive problem or the knowledge problem in ways that could maximize the normative objectives of pensions. However, we have also seen evidence from Chile’s single-tier system and the exponential growth of its constitutionally protected pension funds. Regarding the precepts of robust political economy, Mark Pennington explains: “If people are acting opportunistically, the capacity to exit from relationships with these actors provides a disciplinary check on potentially self-interested behavior.” The one-pillar system of ISA has empirically provided this disciplinary check.

The institutional robustness of Chile’s pension system rests on the knowledge-generating properties from the dispersed ownership of personal accounts (ISA), thus minimizing the information asymmetries that would occur otherwise. The institutional robustness also rests on the exit properties provided by low switching costs as well as the competitive dynamics of dispersed administration through PFAs.

See, (Boettke & Leeson, Spring 2004)
See, (Leeson & Subrick, 2006)
See, (Pennington, 2011) (Pennington, Robust Political Economy: Classical Liberalism and the Future of Public Policy, 2011)
While the Chilean pension system still evidences relatively high administration costs, the switching costs for individuals who wish to move their assets to another Pension Fund Administrator are near zero.
Though there are clear elements for a competitive market, the number of PFAs stretches to six in total, which could generate rent-seeking activities, cartels and regulatory capture under certain circumstances. Here is where the Chilean system still evidences Pareto sub optimality. Increasing the range of choice to other
Dispersed ownership: the government does not collect the taxes from social security, but they go directly to each taxpayer’s unique personal account protected by the constitution. Exit Properties: a system of competing PFAs and switching costs close to zero provide disciplinary checks so taxpayers can assess which PFA exhibits higher performance and which one is not. Since individuals can easily change PFAs every month, the system also provides a disciplinary check on possible predatory behavior. Since knowledge is dispersed and competition enhanced, the system minimizes the likelihood of introduction of information asymmetries by competing PFAs, which lowers other risks associated with information monopoly, adverse selection, collective action practices and other rent seeking activities that would otherwise occur among PFAs.

Probably the most important element of robustness is offered by the system of ISAs and by the maturity of the system. Both, individual ownership and because the reform has come of age, has encouraged individuals for a span of 30 or more years to learn about their true ownership on these accumulated assets. Moreover, the current Socialist administration of Michelle Bachelet has been trying to dismantle de Chilean pension system and after two periods in power they still have not been able to do so. Recent evidence from Chile demonstrates that the exit properties of a competitive system of ISAs allowing the average taxpayer to increase his/her specific knowledge regarding his/her true ownership of the funds have minimized the probability of revolt-free seizures.

The empirics from the Chilean model seem to confirm that the most robust pension system built up-to-date is one where not only ownership, but also where knowledge is dispersed. On the one hand, individuals need not know the extent to which their funds are being traded in national or international markets, provided that they enjoy from low switching costs, i.e. true exit opportunities. On the other, each PFA is free to engage in their own investment strategies, unlike public sovereign funds, where the State has the control of the funds in their entirety. Not only competition but also dispersed knowledge among PFAs has played in favor of the positive growth and impressive performance of the pension funds.

This goes in line with Hayek’s contention regarding the use of knowledge in society, where the planning is done, to a large extent, by the taxpayer who can choose where their funds go, every single month, to the click of a mouse and at a cost near zero. The rest of the planning is done by each PFA, using information and financial models that they alone deem best within their particular organizations. The main economic problem that Hayek sought to comprehend was “[H]ow to secure the best use of resources known to any of the members of society, for ends whose relative importance only these individuals know. Or, to put it briefly, [the problem] of the utilization of knowledge which is not given to anyone in its totality.” Of course, Hayek was aiming at the aggregate, specially regarding the production, distribution and allocation of all resources in an economy. However, in the domain of pension reform, having a system of dispersed ownership and dispersed knowledge has also proven the most robust pension system so far. This is true if we see the constant and fruitless attempts from today’s political class in Chile to dismantle the system. But this is especially true if we agree with Hayek that the main problem is dictated by society’s necessity of rapid adaptation to changes in time and place. As

institutions, thus avoiding the concentration of the administration of the funds, will be one of the recommendations for improvement in the system's robustness.

42 (Latorre Artus, The World’s Most Successful Pension Reform Based on Individual Choice has Been Called for Reversal, 2014f)
43 (Hayek, 1945, p. H3)
Hayek greatly articulated it: “[I]t would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them.”

Finally, in assessing the robustness of a system, be that of pensions or any other domain, one needs to assess how well do they respond and adapt to change. Economic problems, as Hayek put it, arise from change. And the evidence from Chile and from the growing number of Club SEP countries is that the pension system that has best adapted to exogenous and endogenous stressors—e.g. political change within the country or global financial shocks thus altering the profitability of the accumulated funds—has been the single-pillar system of both dispersed ownership and dispersed knowledge.

6. Conclusions, Policy Choices and Recommendations

The present study has been, by and large, a rather positive analysis insofar as it included the interaction of self-interested individuals within the political process in the domain of pension reform and pension reform reversals. First, it demonstrated with historical evidence the institutional weakness of the World Bank’s multi-tier approach. The main weakness was found on the intrinsic nature of the second pillar, which oftentimes allows policymakers to consider it a commons and thus, overharvest the system. We could then evaluate the capacity of the one-tier system to channel the incentives they provide and opportunistic behavior in ways that maximizes social welfare.

First, regarding the opportunistic behavior and self-interests from one or all PFAs combined, the exit properties that Chilean citizens enjoy from unfair relationships have offered welfare-enhancing outcomes with regards to the growth and preservation of their pension funds. Secondly, regarding the incentives provided by the one-tier system: PFAs face competition among them, which drives them to offer good rate of returns and low administration costs. The first has been enhanced, but the administration costs have not yet been minimized to people’s expectations. The suggestion here is to lower barriers to new entrants. This will take care of lowering the administration costs. The exit properties of the single-pillar model channels the incentives for depletion away from the PFAs, making the system much more robust than the World Bank’s multi-tier formula.

One critique may arise regarding the transition costs that a radical reform based on individual capitalization would generate, i.e. social security taxes would go to individual’s own accounts and as such, governments would not be able to collect this tax money to pay for today’s pension benefits. However, this study understands these transition costs as the only feasible alternative to avert the tragedy of the commons and to stop the unsustainable growth of unsound promises. In other words, the transition costs of moving toward a single-tier model are dissected as the necessary investment to avoid the forthcoming collapse of the system. Moreover, balancing the budget today by wiping out people’s savings will not solve governments’ inefficiencies. A radical reform based on individual capitalization—while increasing the costs of transition in the short-term—will finally set governments out of the pension business in the long run. That will effectively solve the growing problem of public inefficiencies regarding pensions.

44 (Hayek, 1945, p. H17)
By drawing upon individual capitalization, the main lesson of the study is that an effective solution against the ageing population and the sovereign-debt crisis can only come about from a drastic change in the policy recommendations proposed by the World Bank and the political and intellectual elite. In order to effectively avert the future collapse of the welfare State the establishment must adopt a complete paradigmatic shift from the deep-rooted State Control pretense of knowledge toward a new global mindset based on the outsourcing of the welfare State through economic policies that disperse ownership and disperse knowledge among the entire population.

It is envisaged that the main contribution that this paper has made to debates and discussions in the domain of pension reform has been in the form of a paradigmatic change in the way we understand social security. This means providing a more realistic account through the lenses of robust political economy in order to highlight the unexpected effects of a purely normative pursuit of social security as most pension literature does today unfortunately. This should extend the scholarly understanding of pension reform in the sense that balancing the budget cannot come about from nationalizing private savings. Neither can it be sustained by forcing individual behavior as most literature suggests, i.e. through the extension of retirement age and/or the increasing of pension contributions.

I argue that these alternatives being offered by most pension scholars could work in the short to medium run only, however my contention is that human behavior cannot be forced endlessly. As explained in chapter two, one of the unintended consequences of forcing behavior is that eventually people will not be willing to pay an increasing burden upon their shoulders—even when it might work in theory through productivity gains which are transferred to wages and to taxes on wages. By drawing upon the precepts of robust political economy we can easily and rapidly forecast that people will not accept this soaring burden and will eventually vote with their feet by under-declaring income or fleeing to freer regions.

But more importantly, and as a general rule, any system based on short-lived governments that promise goodies today and bill our children tomorrow gives absolutely no assurance that the same guarantees will hold in the future. The latest developments evidenced by the Club SEP countries reaffirms the institutional weakness of such systems which deliberately endorses financial shortcomings into the future and where the logic of collective action is naturally enhanced. Under the current western social democratic model and its current sovereign debt crisis, the systemic unsustainability of the multi-pillar pension systems and their forthcoming collapse are inevitable.

The growing number of Club SEP countries is a real threat stemming from our political elite. Policymakers figured out how the alleged commons from the pensions’ second pillar can offer a rich source of sound money and fiscal space. As long as individuals stay put the number of Club SEP countries will continue to grow. In order to effectively address this problem, this paper has sketched the set of institutional arrangements that could minimize the negative effects of bounded rationality and information asymmetries and as such, limit the scope of what policymakers can confiscate. The answer has been offered by drawing upon the precepts of robust political economy and by looking into the empirical evidence from Chile’s pension revolution based on a single-tier of individual capitalization. According to Piñera, western economies with at least one tier of PAYGO destroy the essential link between effort and reward, i.e. between contributions and benefits. Add this to an aging population and they became passengers in a titanic headed toward the pension iceberg.45

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45 See, (Piñera, Will The Pension Time Bomb Sink The Euro, 2004, p. 48)
However, I believe that the battle has not been lost yet. All we need is that policymakers change the course of the titanic, and they will engage but only when it is politically profitable to do so, the way that Joseph Overton once envisioned. From an Overtonian viewpoint, avoiding the tragedy of the pensions commons, as well as the political profitability of changing to a single-tier system, requires from the understanding of the citizenry that the only sound system of welfare is one where their own taxes will save for old age consumption, i.e. a system where they do not depend on political promises and on younger generations to pay the tab.

46 As explained in chapter two, Joseph Overton observed that politicians face a “window” of possibilities regarding politically acceptable policies. However, this “window” is largely defined not by what politicians truly prefer, but rather by what people support. See, (Russell, 2006)
Works Cited


