

# THE POLITICS AND ECONOMICS OF PENSION PRIVATIZATION IN LATIN AMERICA\*

Raúl Madrid  
*University of Texas at Austin*

*Abstract: This research note seeks to explain why a large number of Latin American countries have privatized their pension systems in recent years. It argues that the privatization schemes are a response to the severe capital shortages that have plagued their countries intermittently in recent years rather than to the financial problems facing some of the pension systems. The likelihood of pension privatization, I argue, is determined in large part by the vulnerability of countries to capital shortages as well as the influence wielded by international financial institutions, especially the World Bank. Whether such reforms are politically feasible, however, depends largely on the strength of organized labor and the president's degree of control over the legislature. A statistical examination of recent pension policy in Latin America provides support for most of these arguments.*

The last decade has witnessed a tremendous wave of market-oriented economic reforms throughout Latin America. Some of the most sweeping reforms have taken place in social security. Over the 1990s, seven Latin American countries privatized large portions of their public pension systems: Peru, Argentina, Colombia, Uruguay, Mexico, Bolivia, and El Salvador. Similar reforms have been placed on the policy agendas of numerous other countries in Latin America and elsewhere.<sup>1</sup> Modeled to varying degrees on the 1981 Chilean reform, the privatization schemes have cut back or eliminated the existing public systems and partially or fully replaced them with new

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1. In early 2000, Costa Rica and Nicaragua also passed legislation privatizing large parts of their pension systems. A few post-communist countries, namely Hungary, Poland, and Kazakhstan, have already implemented pension-privatization schemes; and some countries in the Organisation for Economic Cooperation and Development (OECD) have added a mandatory private pillar to their existing public pension systems.

privately managed systems.<sup>2</sup> Unlike the public systems, the new private systems operate on the basis of individual capitalization: the pensions that workers receive on retirement are determined by the amount of funds accumulated in their individual retirement accounts.<sup>3</sup>

Carmelo Mesa-Lago has identified three main variants of the reforms (1996a, 1996b). Countries such as Chile, Mexico, Bolivia, and El Salvador as well as Kazakhstan have opted for full privatization, phasing out the existing public pension system and requiring all future workers to join the new private pension system.<sup>4</sup> Other countries like Peru and Colombia have adopted what Mesa-Lago terms *parallel systems*. In these countries, the existing public pension system remains open, albeit typically with some changes, and competes with the new private system for members. The third category consists of countries that have opted for mixed systems, including Argentina, Uruguay, Hungary, and Poland. In such systems, workers typically make contributions to both a public and a private pension system and receive benefits from both systems. The reforms vary in other important ways. For example, in some countries, public-sector agencies such as state-owned banks or nonprofit institutions like cooperatives and labor unions are allowed to manage individual retirement accounts in competition with the administrators of private pension funds in the new systems.

What effect the reforms will have on workers in the new systems is the subject of great debate (Gillion and Bonilla 1992; Bustos 1993; World Bank 1994; Mesa-Lago and Bertranou 1998). It is clear nonetheless that workers will face more risk in the private systems because most pension guarantees have been eliminated. It is also likely that some groups, such as women, will fare poorly in the new system because they live longer or because they often have prolonged absences from the labor market while raising children (Arenas de Mesa and Montecinos 1999). Members of privileged public pension systems also stand to lose under the reforms because it is highly unlikely that the private systems can generate the generous benefits earned in the former systems.<sup>5</sup>

2. For a detailed comparison of privatization schemes in different countries, see Queisser (1998) and Mesa-Lago (1997a).

3. The public systems, in contrast, typically operate fully or partially on a pay-as-you-go basis in which the pension benefits of retirees are financed by the pension contributions of active workers. Workers who contribute for a certain amount of time are guaranteed a specified pension on retirement, usually equivalent to a certain portion of their salary.

4. Some of these reforms obliged current as well as future workers to join the new private system, while others gave current workers a choice. In most private systems, the state continues to guarantee a minimum pension to workers who meet certain requirements in terms of age and years of contributions.

5. Workers have also been hurt by measures tightening eligibility requirements for pensions, which accompanied the privatization schemes in most countries. These measures have been undertaken to cut expenditures in the public systems (a step that reduces the cost of the

Whether the average pension is higher or lower in the new private systems will depend largely on three factors: the returns earned on the individual retirement accounts; the fees charged by the pension fund administrators; and the amount of contributions that workers put into the private systems. To date, the returns generated by the private pension funds have been quite high. The private systems in Chile, Argentina, and Colombia have earned real returns of more than 11 percent annually since their inception, while the systems in Peru and Uruguay have earned returns of approximately 7 percent.<sup>6</sup> It is not clear, however, whether this level of returns will continue in the future. Moreover, the administrative costs charged by the pension-fund administrators have also been high, absorbing in most cases more than 20 percent of the workers' contributions (Queisser 1998; Mesa-Lago 1997a). These costs have reduced substantially the net returns on the contributions made by workers. A recent study estimated that if administrative costs and other factors are taken into account, the real average annual rate of return in Chile was only about 5 percent between 1982 and 1998 (Huber and Stephens 2000, 15).<sup>7</sup> But the biggest problem may be the high rates of evasion prevailing in many of the privatized systems. Fewer than 60 percent of the affiliates are contributing to the private systems in most of the countries (Mesa-Lago 1997a, 244; Queisser 1998, 41). If these levels of evasion continue, many workers will not have enough funds in their account to finance a minimum pension on retirement.

Not surprisingly, the recent privatization schemes have generated a great deal of resistance. Pensioners' associations and labor unions have typically led the charge against privatizing social security. But the recent reforms have also provoked vigorous opposition from members of powerful interest groups who could lose their jobs or their privileged pension schemes as a result of the privatization measures. Pension privatization has also been unpopular among Latin Americans as a whole. In a 1995 poll of ten countries by Latin Barometer, only 27 percent of the respondents stated that private enterprises should be in charge of pensions while 73 percent responded that such pensions should be the responsibility of the government (Basáñez 1997, 10). Where schemes to privatize social security have come before voters, as in Ecuador and New Zealand, they have been soundly defeated.

What explains the recent trend toward pension privatization in Latin America? Why have numerous governments sought to enact reforms de-

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transition from a public to a private system) but also to ensure that pension entitlements in the private and public schemes are roughly comparable. Most of these measures would have eventually been necessary even if the privatization schemes had not been implemented.

6. Federación Internacional de Administradoras de Fondos de Pensiones (FIAP), 2000, website at <<http://www.fiap.cl>>.

7. CB Capitales, 1999, website at <<http://www.cb.cl>>.

spite such strong political opposition? And what accounts for the variance within the recent trend? Why have some countries fully privatized their pension systems, while other countries have partially privatized their systems or not enacted any sort of reform whatsoever?

This research note will proceed as follows. The first section will discuss why existing theories cannot properly account for the recent trend toward privatizing social security. I will then lay out my explanation for this trend. In the third section, the hypotheses will be tested statistically and the results discussed. The study will conclude by speculating on the implications of my arguments for existing theories of policy reform in developing countries.

#### THE CONVENTIONAL VIEW

One explanation for the recent wave of reforms, widespread in the media, has focused on the financial problems of the existing social security systems.<sup>8</sup> A recent article in *The Economist*, for example, stated, "In more or less every case, these reforms were a response to a looming or actual fiscal crisis. . . ."<sup>9</sup> Academic studies of the politics of pension reform have similarly suggested that the financial problems facing the social security systems prompted the privatization measures, although these studies have also argued that various other political and economic factors helped determine what kinds of reforms (if any) were implemented (Mesa-Lago 1997b; Kay 1998; Cruz-Saco and Mesa-Lago 1998). Mesa-Lago, for example, has argued, "The social security crisis has led to a process of reform which often has incorporated the private sector although in divergent degrees" (1997b, 497). Stephen Kay observed, "Private, individually capitalized investment accounts are currently being touted as the financial solution to social security crises in developing and industrial countries alike" (1999, 403).

Privatization can help resolve the financial problems of Latin American social security systems in two main ways. First, by shifting the social security system from a pay-as-you-go (or partly pay-as-you-go) basis to a fully funded basis, privatization reduces the vulnerability of the pension system to future demographic changes. Under the Chilean model, retirement pensions are funded by each individual's savings rather than by the contributions of active workers (or current state revenues), which means that the financial health of the system does not depend on the ratio of pensioners to active workers or the population as a whole. Second, privatization insulates the social security system from political interference, reduc-

8. James Brooke, "Quiet Revolution in Latin Pensions," *The New York Times*, 10 Sept. 1994, p. 37; and Norma Cohen and David Pilling, "Save Now, Spend Later," *Financial Times*, 9 Jan. 1995.

9. "Latin Lessons on Pensions," *The Economist*, 12 June 1999, p. 71.

ing the likelihood that political authorities will be able to divert pension revenues for their own purposes or grant financially unsustainable benefits to powerful interest groups—a common practice in most Latin American countries.<sup>10</sup> In the private systems, the pension contributions that each individual makes are channeled directly to his or her retirement account, which prevents politicians from spending pension revenues as they see fit.

Yet this explanation is problematic for a couple of reasons. First, despite their financial problems, most Latin American pension systems (including many of the pension systems that were privatized) were in better shape than their counterparts in the industrialized countries, which have not been privatized. Second, it seems unlikely that the growing financial problems of Latin American pension systems were central to the decisions made by Latin American leaders to privatize their pension systems because the schemes stood to worsen the financial difficulties of their pension systems in the medium term.<sup>11</sup> Schemes to privatize social security are costly because they allow (or oblige) members of the social security system to transfer some portion of their social security contributions to private pension fund accounts instead of paying them to the state. The state, however, continues to pay the pensions of existing retirees, and in most cases, the state also compensates members who transfer to the private system for the contributions that they had previously made to the public system. The state therefore loses a substantial portion of its social security revenue with no corresponding drop in expenditures in the short to medium term. Other kinds of reforms offered less costly ways to overcome the looming financial crises, such as raising the minimum age of retirement, increasing social security taxes, or eliminating the special benefits available to privileged groups.<sup>12</sup>

#### THE MACROECONOMIC ROOTS OF SOCIAL SECURITY PRIVATIZATION

The reforms, in my view, were driven largely by macroeconomic factors, particularly the serious shortages of capital that have plagued Latin American countries in the 1980s and 1990s. As a former undersecretary for

10. Insulating the pension system from political interference was apparently one of the main goals of the Chilean reform, according to its architect, former Labor Minister José Piñera (1991). I also interviewed him in Santiago on 15 Jan. 1997. A recent study by Godoy and Valdés (1994) suggests that Piñera's aims have been at least partly realized in that politicians have interfered more in recent years with the Chilean public pension system than with the private system.

11. One World Bank study (Schmidt-Hebbel 1995) estimated that the cumulative transition cost of the Chilean reform will total 126 percent of gross domestic product, while the cumulative cost of the Colombian reform was projected to reach 86.5 percent of GDP.

12. Many of these other types of reforms were implemented in conjunction with the privatization schemes to reduce the transition costs and ensure that the private system could compete with the existing public system.

social security in Argentina told me, "The incentive behind the social security reform was not so much the issue of social security but rather the need to reconstruct savings and behind savings, investment."<sup>13</sup> Since the outbreak of the debt crisis in 1982, Latin American countries have suffered from devastating, if intermittent, cutoffs of foreign capital. These periodic cutoffs have led Latin American policy makers to stress increasing their domestic rates of savings rates, a policy priority that grew more important in the 1990s as domestic savings rates declined. Many policy makers believed that pension privatization would boost their countries' rates of savings and stimulate local capital markets. One of the architects of the Mexican plan, former Finance Minister Guillermo Ortiz, remarked, "The key for Mexico's future development is to induce a much higher savings rate. This is why we attach particular importance to the pension-fund initiative."<sup>14</sup> Former Bolivian President Gonzalo Sánchez de Losada argued that his pension privatization plan would "mean the development of domestic savings, capital formation, a stock and bond market almost overnight."<sup>15</sup>

Neoliberal economists and policy makers argue that pension privatization will increase national savings because the contributions that workers make to the privatized systems are saved, whereas in pay-as-you-go systems, the social security contributions of active workers are spent on the pensions of current retirees. For example, Martin Feldstein argued, "An unfunded pay-as-you-go system . . . reduces national saving by discouraging private saving without doing any public saving. In contrast, the substitution of a funded program for an unfunded program can eventually raise national saving by nearly the full amount of the mandatory saving" (Feldstein 1999, 30). Some economists have suggested that the creation of individual retirement accounts may also raise awareness of the need to save, leading workers to set aside funds in addition to their mandatory pension saving (World Bank 1994, 308-9; Corsetti and Schmidt-Hebbel 1995, 21). They also argue that privatized pension systems will reduce labor-market distortions and improve the depth, liquidity, and efficiency of local capital markets, thus boosting growth and productivity and thereby increasing savings as well (James 1997; CIEDESS 1995). Advocates of pension privatization point to the case of Chile, where the domestic savings rate soared in the wake of privatizing the pension system. It climbed from 20.5 percent in 1980 to 30 percent in 1989, giving Chile the highest savings rate in the region (World Bank 1995, 64-65).

13. Interview with Santiago de Estrada, former Subsecretaría de Seguridad Social, Buenos Aires, Nov. 1996.

14. Mary Beth Sheridan, "Mexico Completes Sweeping Overhaul of Social Security," *Los Angeles Times*, 26 Apr. 1996, p. D1.

15. Sally Bowen, "Andean Struggle for Reform," *Financial Times*, 1 May 1996, p. 12.

The connection between pension privatization and higher savings rates is far from clear, however.<sup>16</sup> As proponents of privatization acknowledge, privatizing the pension system is unlikely to generate any increase in savings if the costs of the transition are financed by borrowing rather than through taxation or fiscal cutbacks (Corsetti and Schmidt-Hebbel 1995; James 1997; Orszag and Stiglitz 1998). Where the transition is debt-financed, the increase in private savings generated by the pension privatization plan will be offset by a decrease in public savings. Skeptics also point out that the empirical evidence linking pension privatization to higher savings is tenuous (Mesa-Lago and Arenas de Mesa 1998; Barrientos 1998). It is difficult to isolate the impact of pension privatization on savings rates in part because such rates depend on numerous factors. Some studies have linked the Chilean reform to the increase in the country's savings rate (Haindl 1997; Morande 1996; Corsetti and Schmidt-Hebbel 1995). But other studies have found no relationship or even a negative relationship between the two variables (Holzmann 1996; Agosin, Crespi, and Letelier 1996; Mesa-Lago and Arenas de Mesa 1998). The latter group of studies have typically attributed the growth in the Chilean savings rate to increased corporate savings that were generated by the Chilean economic boom of the late 1980s.

It is evident nevertheless that policy makers have believed that privatizing their pension systems would increase their domestic savings rates, regardless of whether this belief was well founded. For example, the architects of pension privatization in Argentina and Mexico routinely noted in interviews that increasing the domestic savings rates was one of the goals of the reforms.<sup>17</sup> For this reason, I expect the probability of pension privatization to increase as a country's domestic savings rate declines. Moreover, the lower a country's rate of savings, the greater the degree of privatization it is likely to choose because according to the supporters of privatization, full-scale privatization will boost the domestic savings rates higher than partial privatization.

16. Some economists have also pointed out that it is full funding rather than privatization per se that promotes savings (Orszag and Stiglitz 1999). Publicly managed systems may be fully funded. Indeed, most Latin American pension systems started out as funded systems, and some continue to be partially funded systems.

17. Author's interviews with Gustavo Demarco, former advisor to the Secretaría de Seguridad Social, Buenos Aires, 25 Oct. 1996; Walter Schulthess, former Secretaría de Seguridad Social, Buenos Aires, Nov. 1996; Luis Cerda, former adviser to the Secretario de Hacienda y Crédito Público, Mexico City, 7 May 1997; Enrique Dávila, Coordinador, Subsecretaría de Egresos, Coordinación de Asesores, Secretaría de Hacienda y Crédito Público (SHCP), Mexico City, 13 June 1997; and Gabriel Martínez, Director, Dirección de Finanzas y Sistemas, Instituto Mexicano de Seguro Social (IMSS), Mexico City, 10 June 1997.

*The Role of International Financial Institutions*

Institutions such as the World Bank have also played an important role in promoting pension privatization in Latin America and elsewhere (Huber and Stephens 2000; Brooks 2000; Müller 1999; Lacey 1996; Mesa-Lago 1996b).<sup>18</sup> The World Bank has been involved in pension reform for several decades but stepped up its involvement dramatically in the last ten years.<sup>19</sup> More important, since the early 1990s, the bank has become a strong advocate of pension privatization<sup>20</sup> and has promoted this goal in part by providing technical assistance to countries carrying out pension reforms. The World Bank has conducted consulting missions on pension reform in almost every Latin American country in the last decade (Schwarz and Demirguc-Kunt 1999). The bank also has provided loans to Latin American countries to pay for designing and implementing the reforms as well as covering some of the transition costs of pension privatization. Major loans to cover transition costs have been made to Argentina, Mexico, and Uruguay.

Perhaps most important, the World Bank has carried out a vast amount of research, held numerous seminars, and disseminated an array of publications detailing the problems with existing public pension systems and extolling the benefits of pension privatization. For example, the bank has played a key role in convincing policy makers that pension privatization would bring major macroeconomic benefits, including an increase in the domestic savings rates.<sup>21</sup> The focus on the macroeconomic benefits of pension privatization was evident in the World Bank publication *Averting the Old-Age Crisis* (1994), which carried the subtitle *Policies to Protect the Old and Promote Growth*. This publication set out a blueprint for reform that has had

18. I thank Evelyn Huber and several anonymous reviewers for urging me to test the international financial institutions variable statistically.

19. The World Bank has displaced the International Labour Organisation (which has opposed pension privatization) as the main international actor in pension reform. The two institutions have been at loggerheads for most of the 1990s, engaging in a highly public debate about the merits of pension privatization and offering conflicting advice to member countries (Beattie and McGillivray 1995; James 1996). Recently, however, the two groups have created a forum for exchanging views in an attempt to build a consensus on social security reform (Holzmann 1998; ISSA 1998).

20. Before the 1990s, the World Bank typically advocated parametric changes to existing public pension systems. The shift to a policy favoring pension privatization was pushed mostly by the macroeconomists and public-finance experts at the World Bank and was opposed by most of the traditional social security specialists. Interview with Dmitri Vittas, World Bank economist, Washington, D.C., 15 May 1998.

21. Not all bank staff members are convinced of the benefits of pension privatization, however, and even many supporters of pension privatization are skeptical that it will boost a country's rate of domestic savings. See Orszag and Stiglitz (1999); and Robert Holzmann, "The World Bank and Global Pension Reform: Realities, Not Myths," 1999. URL <<http://www.worldbank.org/pensions>>.



great influence in Latin America and elsewhere. According to the *World Bank Policy and Research Bulletin*, "partly as a result of this report, the Bank has witnessed an upsurge in pension reform efforts among client countries, and its support for such efforts has increased dramatically" (1996, 2). World Bank representatives similarly believe that they have played a significant role in convincing countries to privatize their pension systems. As one World Bank economist told me, "Some countries initially have said that they don't want to [privatize their pension systems], but we have sometimes been able to convince them to do so."<sup>22</sup>

Other international financial institutions have also promoted pension privatization. The Inter-American Development Bank (IDB) expanded its involvement in pension reform in the 1990s, undertaking research and providing technical assistance and loans to countries carrying out reforms (Mesa-Lago 1996b). Although the IDB has promoted pension privatization, one representative claimed that the institution is more flexible and less tied to a particular policy model than the World Bank.<sup>23</sup> In fact, the IDB has played a role in some countries (like Uruguay and Venezuela) after the World Bank pulled out because of disagreements about the nature of the reform plans.<sup>24</sup> The International Monetary Fund has been less involved in pension reform, although the fund has done some research and consulting in this area and pension privatization plans have been included in the lending agreements that the IMF has signed with some countries, such as Argentina. The IMF has expressed concern about the fiscal implications of pension privatization but recently changed the way in which the fund views reform-induced deficits in order to facilitate pension privatization (Holzmann 1998).

In view of these activities, I therefore expect that the greater the influence of international financial institutions in a particular country, the more likely a country is to privatize its pension system. The effect of influence by international financial institutions on the degree of privatization is less clear, however. The World Bank, for example, has formally supported a multi-pillar approach to pension reform (Holzmann 1998), but staff members at the bank are divided as to the appropriate size of the public pillar. Some staff members support full-scale privatization as in Chile, which would relegate the public pillar to providing a minimum pension, but others advocate retaining a sizable public pillar.<sup>25</sup>

22. Interview with Anita Schwarz, World Bank economist, Washington, D.C., 14 May 1998.

23. Interview with Gustavo Márquez, Inter-American Development Bank economist, Washington, D.C., 16 May 1998.

24. Interviews with Márquez; and Robert Palacios, World Bank economist, Washington, D.C., 15 May 1998.

25. Interviews with Gustavo Demarco; with Klaus Schmidt-Hebbel, former World Bank economist, Santiago, Chile, 10 Jan. 1997; and with Vittas.

*Control of the Legislature*

The prospects of pension privatization are also influenced by political variables. To enact schemes to privatize social security, presidents typically need to wield a good deal of control over their legislatures. Major social security reforms usually require congressional approval because many presidents do not have decree powers and those who do are often reluctant to use them to implement a sweeping institutional reform. A privatization scheme implemented by decree would have a shakier legal standing, which would discourage companies from making the substantial up-front investments needed to establish a private pension system.<sup>26</sup> Moreover, even if a head of state chose to enact a major social security reform by decree, he or she would still need support in the legislature to ensure that legislators did not veto it.

The president's control of the legislature is often determined by the percentage of seats that the executive's party holds in the legislature, which is in turn influenced by a number of factors like electoral rules (Lijphart 1994; Jones 1995). The relative size of the ruling party's congressional delegation is crucial when it comes to enacting highly controversial reforms like social security privatization because their unpopularity typically makes it difficult to obtain support from other parties. It can even be hard to obtain support from the president's own party, which makes privatization more likely where the ruling party holds a substantial majority rather than a narrow majority of seats.

The head of state is most likely to receive support for initiatives from members of his or her own party for several reasons. First of all, the executive branch's policy positions are more likely to resemble the positions of legislators from the leader's own party. Even when this is not the case, the logic of political competition often leads legislators from the leader's party to back his or her initiatives. The political future of members of the ruling party are tied to the fortunes of their national leader, and they therefore have incentives to support him or her in the congress. Most important, presidents typically have various tools at their disposal for marshalling the support of members of their own party. As leaders of their parties, presidents usually have at least some control over various party resources, and they may be used to reward or punish legislators according to how they vote. For example, presidents may help decide the position of candidates

26. Concern about the legal standing of the private pension system reportedly discouraged the Argentine government from privatizing its pension system by decree. As one legislator told me, "The investors in the AFJPs [Administradoras de Fondos de Jubilaciones y Pensiones] told us that they were not disposed to run the risk of having a pension reform by decree. . . . No investor was inclined to invest in something that didn't have juridical security." Interview with Eduardo Santín, former federal deputy from the Radical Party, Buenos Aires, Nov. 1996.

on the party's electoral lists, and they often have some control over who receives party financing as well. Thus they frequently have a great deal of influence over the electoral possibilities of legislators running for reelection or seeking new posts.

The head of state's degree of control of the legislature will also depend on the level of party discipline. This level will depend in turn partly on the degree of control that party leaders have over the ballot (Mainwaring and Shugart 1997; Carey and Shugart 1995) and the nature of the ties between the president and the other leaders of his or her party.

Consequently, I expect the probability of pension privatization to increase as the ruling party's share of the seats in the legislature goes up and as internal party discipline increases. One would also expect the degree of pension privatization to go up with increases in the head of state's control of the legislature because more control of the legislature will prevent opponents of privatization from watering down such plans.

### *Interest-Group Opposition*

To enact major social security reforms, leaders must also overcome the opposition of powerful interest groups. Interest groups may pressure the president to modify or withdraw reform proposals, or they may lobby legislators to block or alter proposed reforms. Interest groups have different political resources at their disposal. Some interest groups can apply pressure by carrying out strikes or demonstrations. Others may control large numbers of votes or financial resources, which they can use to influence electoral outcomes. The ability of interest groups to block or alter policy proposals depends on their control of political resources but also on their willingness to use them to achieve policy objectives. Interest groups typically fight battles at varying levels of intensity, depending on what is at stake.

Associations of retired persons are likely to represent one source of opposition to pension privatization. Pensioners' associations will typically oppose social security privatization on the grounds that it undermines the finances of the public pension systems on which they depend. In Latin America, however, these organizations are too poor and weak to pose much of an obstacle to pension reform. The budget of the main Mexican pensioners' organization was approximately fifty thousand dollars in 1997<sup>27</sup> while the principal Argentine pensioners' association had liquid assets valued at about five thousand dollars and fixed assets worth less than seventy thousand in June 1995 (*Jubilados* 1996, 6). In contrast, the American Association of Retired Persons (AARP) in the United States had a budget exceeding 340 million

27. Interview with Blanca Alonso Tejeda, president of the Movimiento Unificador Nacional de Jubilados y Pensionados (MUNJP), Mexico City, 6 June 1997.

dollars in 1994.<sup>28</sup> Scarcity of resources prevents the pensioners' organizations from hiring lobbyists, making campaign contributions, or carrying out advertising campaigns against policies that they oppose. Nor are the pensioners' organizations able to mobilize substantial numbers of retirees for marches and demonstrations.<sup>29</sup>

I would expect the main interest-group opposition to social security reform to come from the labor movement. Labor unions typically oppose pension privatization because it entails shifting risk from the state to workers. Under the Chilean model, for example, workers rather than the state will lose out if the investment returns on their individual retirement accounts are low.<sup>30</sup> In addition, many of the pension-privatization schemes include tightening eligibility requirements for pensions and eliminating certain kinds of benefits, which unions usually oppose. Labor leaders are also likely to be skeptical that pension privatization (or other neoliberal policies for that matter) will bring the social and economic benefits that advocates of the Chilean model have claimed (Ensignia and Díaz 1997).

Where the labor movement is strong, I would expect it to become a major obstacle to social security privatization. Some Latin American labor unions, unlike the pensioners' associations, control substantial economic resources from union dues, state subsidies, or their control of enterprises. Labor unions can wield these resources to mount major political campaigns against policy initiatives like pension reform. Powerful labor movements can also try to block reform by immobilizing a country's economy through strikes and demonstrations. Finally, strong labor unions can credibly threaten to punish politicians who vote for social security privatization by mounting campaigns against them in the next election. As a result, pension privatization seems considerably more likely to take place where the labor movement is weak or divided and cannot mount a major campaign against reform. I would also expect that the degree of privatization will increase as the strength of the labor movement declines because weak labor movements will be unable to force the government to scale back privatization plans.

#### DATA ANALYSIS

To test the preceding arguments, I compiled a data set on the universe of cases: all governments of middle-income Latin American countries

28. Milt Freudenheim, "AARP Will License Its Name to Managed Health Care Plans," *The New York Times*, 29 Apr. 1996, p. 1.

29. The opposition of pensioners' associations to the reforms generated a great deal of media coverage, however, which may have helped turn public opinion against the reforms.

30. The degree to which risk is shifted under privatization should not be exaggerated. The state assumes some market risk under the Chilean model because it typically guarantees a minimum pension. In the formerly public systems, however, workers were exposed to political risk in that the state frequently reneged on its pension promises.

that began during the 1990s.<sup>31</sup> Governments that started in the 1980s or are ongoing were included in the data set only if they lasted for more than a year in the 1990s. The period of analysis was limited to the 1990s because many of the posited relationships were expected to hold true only during the last decade. The World Bank, for example, has promoted pension privatization only since the beginning of the 1990s, and widespread discussion of the supposed economic benefits of pension privatization began in the late 1980s, in the wake of the dramatic expansion of Chile's rate of savings. The analysis was limited to middle-income countries on the grounds that low-income developing countries typically lack the financial infrastructure necessary to privatize their pension systems.<sup>32</sup>

For purposes of this analysis, a government is defined as a particular configuration of the executive and legislative branches. Under this definition, a change of government occurs whenever a new president or legislature takes office, even if only a portion of the legislature is renewed.<sup>33</sup> As would be expected, changes of government occurred more frequently in some countries than in others during this period because some countries elected their legislatures or presidents more often than others and also because some countries removed their presidents from office ahead of schedule.

### *Dependent Variable*

To measure the chosen dependent variable, I constructed an index of pension privatization, reproduced in table 1. The index was derived by calculating the percentage of all state-mandated pension contributions (from both employees and employers) that members of the private system contribute to the private system, multiplied by the percentage of total members who choose or are obliged to join the private system. The index provides a way to rank mixed, parallel, and private systems on a single continuum. It assesses to what extent workers contribute to the private system but also whether membership in the private system is voluntary or obligatory and what kinds of incentives (if any) are provided for workers to join the private system.<sup>34</sup> This index can also determine whether certain groups are

31. Fifteen countries are included in this data set: Argentina, Bolivia, Brazil, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Mexico, Panama, Paraguay, Peru, Uruguay, and Venezuela.

32. If low-income Latin American countries are included in the sample, the World Bank loans variable ceases to be statistically significant, but the variables measuring a country's domestic savings rate and the executive's degree of control of the legislature remain significant at the 0.05 level.

33. By my definition, a change of government does not occur when an individual legislator switches parties or is replaced.

34. Brooks and James (1999) have also proposed an index of pension reform, but it fails to take into account whether membership in the private system is optional or mandatory and

left out of the privatization scheme (such as soldiers or state employees) and whether workers can opt to join pension funds that are managed by state agencies but compete in the private system. Because of data limitations, however, I was unable to take the last two factors into consideration in assigning scores to each reform. The scores provided in table 1 are therefore based on membership and contributions in the main pension system and are derived largely from data provided by Mesa-Lago (1997a).

A government was assigned the score indicated on the pension privatization index if it enacted legislation partially or fully privatizing its pension system or 0 if it did not. I excluded from the analysis governments that took office after their pension systems had been privatized on the grounds that these governments were unlikely to enact additional pension privatization schemes. This criterion left seven cases of governments that partially or fully privatized their pension systems in the period under study and thirty-eight cases of nonprivatization.<sup>35</sup>

### *Independent Variables*

Various indicators were used to measure the independent variables. A country's domestic savings rate was used to measure the adequacy of a government's sources of domestic capital. The data on domestic savings rates were taken from the World Bank (2000) and consist of the domestic savings rate during the first year of each government's term. Three indicators were employed to measure the degree of influence of the international financial institutions: disbursed multilateral public debt outstanding (as a percentage of gross domestic product); outstanding loans (as a percentage of GDP) from the International Bank for Reconstruction and Development and the International Development Agency, the two main lending branches of the World Bank; and use of International Monetary Fund credits (as a percentage of GDP). These data were obtained from the World Bank (2000) and the Inter-American Development Bank<sup>36</sup> and represent the figures corresponding to the first year of each government's term.

Measurement of the political variables was also relatively straight-

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what kinds of incentives, if any, are provided for individuals to join the private system. As a result, their index yields inaccurate scores: reforms creating parallel systems, as in Colombia and Peru, are given the same scores as reforms creating fully private systems, as in El Salvador and Chile. Brooks and James's index is also problematic in that it is based on a calculation of what percentage of a worker's future pension benefit will come from the private system, which makes it highly dependent on the economic assumptions used.

35. Chile was excluded from the analysis because the country privatized its pension system prior to the period under study, but I have included the Chilean reform in this table for comparison. Inclusion of Chile in the sample weakens the significance of the domestic savings rate and World Bank loans variables, although they remain significant at the 0.05 level.

36. Inter-American Development Bank, 2000. URL: <<http://www.iadb.org/int/sta>>.

# POLITICS AND ECONOMICS OF PENSION PRIVATIZATION

TABLE 1 *Index of Degree of Pension Privatization In Latin America*

Country	Contributions to Private Pillar as a Percentage of Total Contributions <sup>a</sup> (1)	Members of Private System as a Percentage of Total Members (2)	Score on Privatization Index (1) x (2) (3)
Argentina	.41	.67	.27
Bolivia	1.00	1.00	1.00
Chile	1.00	.95	.95
Colombia	1.00	.38	.38
El Salvador	1.00	.91	.90
Mexico	1.00	1.00	1.00
Peru	1.00	.58	.58
Uruguay	.38 <sup>b</sup>	.39	.15

Sources: Mesa-Lago (1997) and personal communication; and Queisser (1998).

<sup>a</sup> For those individuals belonging to the private system

<sup>b</sup> This figure assumes that the members of the private pension system earn the equivalent of 10,000 pesos (May 1995 value) on average. Due to rounding, the score in the privatization index may not be exactly equal to (1) x (2).

forward. The strength of the labor movement was measured by the number of union members divided by the total nonagricultural workforce.<sup>37</sup> Data on unionization rates were taken from the International Labour Organisation (1997) and represent years ranging from 1991 to 1995. These data were interpolated where possible to assign a figure for the first year of each government's term. I used the ruling party's share of seats in the lower chamber of the legislature as a proxy for the president's degree of control over the legislature. Data on this variable were taken from Dieter Nohlen (1993) and various volumes of the *Europa World Yearbook*; they represent the ruling party's share of seats at the time of the election. Because data on party discipline are unavailable for most Latin American countries, I used the prevailing electoral laws as a proxy for the level of party discipline. Following John Carey and Matthew Shugart (1995), I expected countries where the electoral laws grant party leaders considerable control over the ballot to have greater degrees of party discipline than countries in which the electoral laws provide incentives for legislators to cultivate a personal vote. Based on the data on electoral and party laws provided by Scott Mainwaring and Shugart (1997, 424), governments were assigned values ranging from 0, where party leaders had little control over the ballot, to 2, where party leaders had a great deal of control over the ballot.

37. Unfortunately, I had no comprehensive data on other measures of labor strength, such as the level of fragmentation of the labor movement and the degree of union autonomy from state controls. Nevertheless, the unionization rate is probably the most commonly used measure of labor strength (McGuire 1998; Wallerstein 1989).

*Statistical Results*

The model was estimated using ordinary least squares, and the results are presented in table 2. Most of the variables had the expected signs and were statistically significant at the 0.05 level. The domestic savings rate variable was negative and statistically significant at the 0.01 level, indicating (as predicted) that governments are more likely to enact sweeping pension privatization measures where they face shortages of domestic capital. The substantive effects of this variable are large. *Ceteris paribus*, a one-standard deviation decrease (6.5 percent) in the domestic savings rate leads to a 9.8 percent increase in the degree of pension privatization. As expected, most of the Latin American countries that have privatized their pension systems in recent years were suffering from serious shortages of domestic capital at the time of the reforms. Mexico, for example, privatized its pension system in the wake of the massive capital flight that occurred in late 1994.

As explained, I tried to gauge the influence of the international financial institutions on pension policy through three variables. Because the variables are highly correlated (especially the total multilateral debt and the World Bank loans variables), I estimated the model with each of them separately, although only the results of the model including the World Bank loans variable are included here. All three variables had the expected signs, but only the total multilateral debt and the World Bank loans variables were statistically significant. The World Bank loans variable had a higher level of statistical significance than the total multilateral debt variable. This finding suggests that the World Bank, rather than the other international financial institutions, plays the key role in promoting pension privatization. Other things being equal, a one-standard deviation increase (2.2 percent) in World Bank loans as a percentage of GDP results in an 8.4 percent increase in the degree of pension privatization. I tried logging the World Bank loans variable to test whether high amounts of World Bank loans promoted partial pension privatization rather than full privatization (that is, whether the impact of increased World Bank influence on the scope of pension privatization diminished at higher levels). The coefficient of the logged variable, however, registered a slightly lower level of statistical significance than the unlogged variable, which suggests that increased World Bank influence tends to augment the scope as well as the likelihood of pension privatization.

The variable corresponding to the executive's share of seats in the legislature was also positive and statistically significant. This variable too had a strong substantive impact, suggesting that the president's control of the legislature plays an important role in facilitating pension privatization. Holding other variables constant, a one-standard-deviation (22 percent) increase in the ruling party's share of seats in the legislature leads to an 8.6 percent rise in the degree of pension privatization. As expected, most of the governments that have privatized their pension systems—the Carlos Menem



POLITICS AND ECONOMICS OF PENSION PRIVATIZATION

TABLE 2 *The Determinants of Pension Privatization in Latin America*

	<i>Model 1</i>	<i>Model 2</i>	<i>Model 3</i>	<i>Model 4</i>
Constant	0.110 (.692)	0.133 (.795)	0.121 (.728)	0.119 (.690)
Gross domestic savings (as a percentage of GDP)	-0.0150** (-2.712)	-0.01513** (-2.701)	-0.01496** (-2.665)	-0.01525** (-2.617)
World Bank loans (as a percentage of GDP)	3.806* (2.418)*	3.834 (2.410)	3.746* (2.327)	3.797* (2.379)
Ruling party's share of seats in the legislature	0.00392** (2.540)	0.00389** (2.493)	0.00388** (2.467)	0.00390** (2.485)
Index of party discipline	0.04546 (-.910)	-0.05317 (-1.006)	-0.04986 (-0.936)	-0.04915 (-.864)
Unionization rate	0.00391 (1.164)	0.04266 (1.230)	0.00450 (1.104)	0.00408 (1.133)
Public pension spending (as a percentage of GDP)		-0.00684 (-.488)		
Implicit pension debt (as a percentage of GDP)			-0.00016 (-.261)	
Public pension surplus (as a percentage of GDP)				0.00708 (.141)
Adjusted r-squared	.255	.240	.237	.236

NOTE: N equals 45 for all four models; t-statistics in parentheses.

\*p < .05. \*\*p < .01 (one-tailed t-tests).

administration in Argentina, the administrations of Ernesto Zedillo in Mexico, Armando Calderón Sol in El Salvador, César Gaviria in Colombia, and Alberto Fujimori in Peru—held a majority or near majority of seats in the legislature at the time of the reforms. In each case, the ruling party's dominance of the legislature was crucial to the passage of the pension-privatization measures because legislators from the opposition parties by and large voted against the reform bills.<sup>38</sup> Although the ruling parties in Bolivia and Uruguay did not hold a majority of seats in the legislature when they enacted their

38. The Fujimori administration represents a partial exception in that it privatized the Peruvian pension system by decree. Nevertheless, Fujimori's control of the legislature was crucial to approval of the reform because it prevented the political opposition from passing legislation to annul the decree.

pension-privatization measures, they managed to approve the reform bills with the support of other members of the ruling coalition.<sup>39</sup>

The variable that measures party discipline was not statistically significant, and it had the opposite sign from what I predicted. The failure of this variable to perform as expected may mean that high levels of party discipline make it difficult for the ruling party to obtain votes from other parties. Or it may stem from the fact that this variable does not actually measure party discipline but rather the incentives to cultivate a personal vote. In some Latin American countries, divisions within the ruling party in recent years have emerged from conflicts between the president and party leaders or struggles between various party leaders for the control of the party rather than from efforts by individual legislators to cultivate a personal vote. In the Paraguayan administration of Juan Carlos Wasmosy and the Venezuelan administration of Carlos Andrés Pérez, these struggles reduced the president's level of support in the legislature on a variety of issues, including pension reform. Conversely, in some countries where legislators have had major incentives to cultivate a personal vote, presidents have used side payments to obtain an acceptable level of party discipline. In Colombia, for example, the Gaviria administration managed to gain approval for its pension privatization bill by striking various bargains with legislators.

The unionization variable also had the opposite sign from what was expected, although it was not significant. This result was surprising given that in a number of instances, strong labor unions have been able to water down pension-privatization schemes or get their members excluded.<sup>40</sup> In Argentina the main labor confederation insisted that the pension-privatization scheme be made optional, which reduced the degree of privatization in that country. The labor strength variable may have performed poorly in part because the rate of unionization is an inadequate measure of labor strength. The failure of this variable to perform as expected may also result from omission of a variable that measures ties between the ruling party and labor. Two countries with high unionization rates (Argentina and Mexico) managed to privatize their pension systems in part because close ties between the ruling party and labor ties mitigated the unions' opposition to the re-

39. The Bolivian and Uruguayan cases suggest that the percentage of seats held by the ruling coalition may be more important than the percentage of seats held by the ruling party. But large, unwieldy coalitions can be difficult to hold together, as indicated by the case of the Fernando Henrique Cardoso administration in Brazil. I was unable to test this hypothesis because of lack of access to data on the composition of ruling coalitions for the all the countries in my data set.

40. Strong labor unions have also lobbied successfully for other changes in the pension-privatization schemes, such as compensation for past contributions to the public pension system and the establishment of (or permission to establish) state-owned or union-owned pension funds that compete with privately owned pensions funds in the new system.

forms. Unfortunately, the lack of regionwide data on this variable prevented its inclusion in my analysis

To test the alternative hypothesis that the privatization schemes were prompted by the financial difficulties of the existing public pension systems, I reestimated the model, incorporating a series of variables that measured the financial burden of the existing systems. These variables consisted of the level of public-pension expenditures (as a percentage of GDP), culled from several sources: the World Bank (1994) and Robert Palacios and Monserrat Pallarès-Miralles (2000, 2); the implicit pension debt, also from Palacios and Pallarès-Miralles (2000), which represents the existing obligations of the public pension system to current pensioners and workers; and public-pension deficits as a percentage of GDP, taken from ILO (1995). As columns 2, 3, and 4 of table 2 show, none of these variables proved to be statistically significant. My analysis thus provides little support for the conventional view that Latin American countries have privatized their pension systems in response to financial problems.

Although growing financial difficulties may not have led the countries to privatize their pension systems, the financial problems of the public pension systems have constrained the reform choices of Latin American governments (Madrid 1997, 1998). Countries with high pension expenditures find it extremely difficult to privatize their pension systems fully because the transition costs of pension privatization are large for such countries. As noted, a government that fully privatizes its pension system ceases to receive the social security contributions from all active workers but must continue to pay the pensions of all current retirees—a heavy financial burden. Countries with high pension expenditures therefore typically opt to privatize their pension systems partially, if at all. The two Latin American countries with the highest public pension expenditures, Argentina and Uruguay, both opted to privatize partially, as did Eastern European countries with high public pension expenditures, like Hungary and Poland. By partially privatizing their systems, they have been able to continue to collect a portion of the contributions traditionally paid into the public pension system, which helps them finance the pensions of existing retirees. Latin American countries with high public pension expenditures have also sought to reduce the costs of privatization by declining to compensate workers for past contributions to the public pension system. Argentina, for example, provided compensatory pensions only under pressure from the labor movement, while Uruguay succeeded in providing no compensation at all.

## CONCLUSION

In the last decade, numerous studies have explored the causes of the recent wave of market-oriented reforms in the developing world (Nelson 1990; Haggard and Kaufman 1995; Bates and Krueger 1993; Smith, Acuña, and Gamarra 1994; Williamson 1993). Although these studies have generated important insights, they have suffered from a couple of significant methodological shortcomings. First, most of the literature has consisted of individual or comparative case studies, which have focused on explaining particular cases rather than developing a theory of the determinants of policy reform. Moreover, studies that have developed precise and general hypotheses have typically not tested the hypotheses through statistical analysis.<sup>41</sup> Second, the existing literature has tended to treat reform as a single policy rather than a package of many different and often contradictory policies.<sup>42</sup> The underlying assumption has been that the causes of different types of reforms are the same (for example, the factors that lead a country to reduce its trade barriers are the same as those that cause a country to reduce its fiscal deficit or privatize its pension system). This assumption is highly suspect because different types of reforms are governed by different institutional rules and vary sharply in their distributions of costs and benefits. It also seems unlikely that the same factors determine the probability of all different types of reforms, given that countries have often adopted sweeping reforms in some areas but not in others.

In this research note, I have sought to avoid the shortcomings of previous works in two ways. First, I have used statistical methods to test my theoretical arguments. Second, I have focused on one narrow but important area of reform. My aim has been to unravel the determinants of pension policy rather than market-oriented reform as a whole. Nevertheless, my findings may have relevance to understanding the determinants of some other types of reforms. The same macroeconomic factors that explain why so many Latin American countries have moved to privatize their pension systems may also explain why they have moved much more slowly to enact major reforms in social sectors such as health, education, and housing. Many policy makers have believed that privatizing pensions, along with reducing fiscal deficits and eliminating barriers to foreign trade and investments, would create major short- to medium-term macroeconomic benefits. But they have been less optimistic about the medium-term macroeconomic benefits of health, education, and housing reforms. This pessimism about the medium-term macroeconomic benefits has made policy makers reluctant to assume the fiscal and political costs of reforming other social sectors. Additional variables identified here may also play an impor-

41. For an exception, see Remmer (1998).

42. For exceptions, see Naím (1995) and Nelson (1995).

tant role in determining what countries adopt other social-sector reforms. The World Bank, for example, has actively promoted health, education, and housing reforms as well as pension privatization, and thus the degree of its influence may also prove an important determinant of the fate of reforms in these areas. The president's degree of control of the legislature, meanwhile, may also be crucial to enacting housing, education, and health reforms. Like pension privatization, these reforms are unlikely to be enacted by consensus and cannot typically be enacted by decree. A rigorous test of these hypotheses, however, will have to await further research.

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