Politics, Economics, and Pension Reform in the Southern Cone

Paper prepared for the Social Security and Pension Reform Conference
March 2, 2001
Instituto Tecnológico Autónomo de México (ITAM)

Stephen J. Kay, Ph.D.
Latin America Research Group
Federal Reserve Bank of Atlanta
104 Marietta St., N.W.
Atlanta, GA 30303-2713
stephen.kay@atl.frb.org

The views expressed in this paper are those of the author and do not necessarily reflect the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

Abstract: Social security reform in Latin America has been a highly contested and politicized issue-area. Politicians seeking to reform regional pension systems have faced considerable political opposition. This paper reviews a series of political and economic variables which seek to explain how politics influence pension reform. Increasing openness to trade, the role of international financial institutions, and the pension systems' financial and administrative problems are variables which have created political incentives and shaped domestic political conflict over pension reform. This paper describes how these political factors have influenced social security reform outcomes in the Southern Cone.

Introduction

There is general agreement that the main purpose of social security is to maintain income levels when individuals can no longer work, and that compulsory social security is necessary to ensure income due to shortsightedness, inadequate savings mechanisms, or inability to save. The efficiency argument for compulsory social security is that uninsured losses would otherwise impose losses upon others (Barr 1987 p.191). However, there are numerous ways in which governments can organize social security, each with its own normative and distributional implications. For example, social security can be compulsory or optional, universal or selective, and can be funded by payroll or other forms of taxation.

Pensions represent claims on future output, and can be organized based on funded schemes, where pensions are based upon workers' accumulated financial assets, or pay-as-you-go schemes, where pensions are paid out of current tax revenues (see Table 1). As the table below demonstrates, social security can be financed through PAYG or capitalization, and can be managed either publicly or privately. While "private and funded," and "public and PAYG" are generally synonymous, there are important exceptions. Most of the world's social security systems are public PAYG, although Fiji and Malaysia have state-managed funded systems, and Sweden and Japan have a partially-funded component also managed by the state. Pension fund companies can be publicly owned, as is the case with Argentina's *Banco de la Nación* pension fund and Uruguay's largest capitalized pension fund *República*. A private PAYG system is not considered viable (see Musgrave and Musgrave 1980, p. 729).

Much of the controversy over social security reform has been over the merits of financing it through a pay-as-you-go (PAYG) or a funded system, and whether or not private management is superior. Barr argues that claims on future output is the key issue. Both PAYG and funding represent different financial mechanisms for organizing claims on future output, and from an economic perspective, the differences between them are a second-order question. In a funded system money is saved to purchase goods to be produced in the future by younger people, while in a PAYG system, the next generation promises to provide goods and services after retirement. He notes that macroeconomic shocks, demographic shocks, and political risks can affect both funding and PAYG systems, and that private funded systems face the additional risks of poor management and regulation, investment risk, and risks in the annuities markets. Barr suggests that effective government is the key variable necessary to ensure that a pension system is

effective, regardless of whether it is funded or PAYG (2000 p. 47).

Table 1: Social Security: Examples of PAYG vs. Funded, Private vs. Public

	Public	Private
PAYG	OECD Countries, Latin America Pre-1990s, Brazil	Unknown, considered unfeasible
Funded	Fiji, Malaysia, Japan; Partial for Sweden, Denmark	Chile, Bolivia, Mexico, El Salvador; Partial for Argentina, Uruguay, Colombia, Peru

There is considerable variation in the range of funded pension systems that have been implemented in Latin America (see Cruz-Saco 1998, Sinha 2000, Kay and Kritzer 2001). The table demonstrates the paths toward reform in the region in recent years. Mexico and El Salvador have followed Chile's lead in implementing a mandatory, funded system, while Argentina, Uruguay, Peru, and Colombia have privatized while maintaining basic PAYG benefits (see Sinha 2000). Brazil is the only country among the four South American social security "pioneers" (Mesa-Lago 1978) not to incorporate a system of individual retirement savings accounts into its public system (although it encourages optional supplementary private pension funds). Bolivia's new system in partially funded with the proceeds from privatizations of state-owned firms. These reforms are constantly subject to revision. For example, Argentina's President De la Rua recently decreed an end to the state-run PAYG system, and Colombia's current administration seeks to cut benefits in the public system.

The range of reform in the region is nuanced beyond a simple dichotomy of private vs public and in fact there is significant variation in the way in which programs are financed and administered (see Kay and Kritzer 2001). While studies have tended to refer to pension systems as private, public, or mixed, Brooks (2000) argues that the degree of private vs public funding is really a continuous variable and should be measured accordingly. Her privatization index is based upon the percentage of a worker's wage which is projected to come from private vs public pension systems. According to her classification, Colombia, Chile, El Salvador, and Peru are expected to be financed privately, followed in ranking by Bolivia, Mexico, Argentina, and Uruguay (in the latter case the public sector is still expected to fund over 50 percent of total pension benefits).

Table 2: Social Security Reform Options

Reform Option	Country
Reform PAYG only (optional funded system)	Brazil, 1998
Privatize - PAYG as option or basic pillar	Colombia, 1994 Argentina, 1994 Peru, 1993 Uruguay, 1996
Privatize- eventually end PAYG	Bolivia, 1997 Chile, 1981 El Salvador, 1998 Mexico, 1997

Some scholars see social insurance as an inevitable consequence of economic development, however the level of industrialization and social policies are not as highly correlated as once predicted (see Skocpol 1992). In a similar vein, social security privatization in Latin America should not be seen strictly as being determined by structural adjustment or international economic pressures to lower wage costs, because privatization is only one of several possible policy responses (which would include some type of PAYG reform which would be less costly to finance in the short-run). In fact, moving to a system of individual accounts entails significant transition costs over the short and medium-term. If privatization is the policy of choice in the region and PAYG is out of fashion, it is also due to the greater political appeal of privatization. It would be far more difficult to generate political support for restructuring within a PAYG framework due to the more transparent political costs.

Reform as an Ongoing Project

It is important to note that social security reform in Latin America is itself an ongoing project. Rather than being a one-time event, the process of reform in the region is a multi-staged, politically-driven process. Reform has consisted of two basic components: reform of the state-run PAYG system, and the implementation of a new system based on private individual savings accounts. While PAYG reform includes transparent measures which require governments to impose costs on specific constituencies, the distributional impact of instituting individual accounts is less immediate, which allows political actors to postpone the political costs and claim credit for policy outcomes that will not occur until a future date - usually long after they have left office. It is far easier to impose measures where outcomes are postponed, rather than impose reforms which require immediate, and transparent reforms, which would be the case with a PAYG-only reform where benefits were cut and taxes raised.

The divergent political implications of these two aspects of policy reform are reflected in the sequence of pension reform measures in the region. The table below lists

a plausible sequence of fundamental steps that would be necessary in any pension reform (see Vittas 1995). Several key elements of the pension reform - such as reducing benefits for privileged beneficiaries, or raising the retirement age are more likely to be postponed due to political opposition (in this case the specific steps that were postponed in Argentina are italicized).

Table 3. Introducing Individual Accounts – Selected Reform Measures

I. Restructure Public PAYG System

1. *Raise retirement age*
2. *Eliminate preferential treatment for specific occupations*
3. Tighten disability and early retirement requirement
4. Factor in years of contributions and use longer averaging period for determining pensions (not wages from last three years)
5. *Lower targeted replacement rate to more realistic levels*
6. *Reduce inequality of pension levels*
7. Fight evasion
8. Improve administrative capacity

II. A. Establish a System of Individual Accounts

1. Establish role for public pillar (flat-rate, means-tested etc.?)
2. Create mandatory or voluntary accounts
3. Set contribution rates
4. Institute life and disability insurance
5. Establish rules (and markets) for annuities and withdrawal of funds

B. Establish a Regulatory Framework

1. Create or reorganize regulatory agencies (new or existing agency)
2. Establish competent supervision and regulation powers
3. Establish entry/exit requirements for pension funds
4. Solvency rules
5. Investment rules
6. Establish reporting and disclosure rules
7. Establish state guarantees (protection against insolvency)

C. Transition Plan and Actuarial Model to Estimate Costs

1. Compensation for vested pension rights (recognition bonds, other compensation)
2. Periodic review of regulations for insurance plans, pensions, training for staff
3. Train regulators, fund managers, actuaries, accountants, and auditors
4. Public relations campaign

Note: Reforms noted in italics were postponed in Argentina.

Source: Adapted from Vittas 1995.

This delay makes the adoption of new pension systems more politically viable, but adds significantly to the final costs of the reform. For example, the policy goals of reducing drastic inequality in benefits and restoring financial equilibrium are undermined by systems which preserve special programs for the military, civil servants, or other professional groups. Raising the retirement age for women from 60 to 65 was a policy goal for the Argentine government since the original reform was passed in 1993. The IMF conditioned its most recent financial assistance package upon making substantive changes in the pension system, including raising the retirement age for women and lowering benefits in the state-run PAYG system. Without assurance of legislative passage, President De la Rua issued a decree reforming the system in December 2000 but as of this writing, it is not clear whether or not these reforms will be reversed. The point here, is that the political process dictates a sequence where the new systems of individual accounts are introduced first, while more politically sensitive distributional aspects of PAYG reform – such as benefit cuts - are postponed, sometimes indefinitely. For this reason, social security reform in the region should be analyzed as a gradual and long-term process rather than a one-time event (see Kay 2000b).

1. A Changing International Context

As barriers to trade decline, the price of a given tradable good will tend to converge with the international price, putting pressure on domestic manufacturers to produce competitively-priced products. Frieden and Rogowski (1996 p.46) hypothesize that an exogenous easing of trade will provide incentives to those economic actors who are able to take advantage of increased trade to pursue policies that will advantage them, while disadvantaged actors will support policies that would protect them from harm. As this hypothesis would predict, the end of the Import-Substitution-Industrialization (ISI) era in the Southern Cone and the adoption of market-led export-oriented economic policies had a profound impact on domestic political actors that had traditionally benefited from ISI-era social security policies.

This hypothesis provides an important guide to understanding the sets of incentives that motivated supporters and opponents of pension privatization in Argentina, Brazil, and Uruguay. With the end of ISI-era protection, employers sought to reduce wages, which in Latin America included payroll tax rates that rivaled those in Europe. High labor costs were more affordable in the ISI-era, when they were merely passed on to consumers. However as barriers to trade were lifted and competition increased, employers sought to reduce the cost of labor, a goal which could be achieved in part through pension privatization. Governments seeking to implement structural reforms sought to cut public sector wages and employment. For example, business leaders in Argentina and Brazil complained about the so-called "Argentine cost" or “Brazilian Cost”, shorthand for the array of taxes and regulations on labor that were initiated during the eras of Juan Perón and Getulio Vargas. Organized labor and pensioners who had traditionally benefited the most from these ISI-era programs, were placed on the defensive. This pattern has been repeated throughout the Southern Cone.

Diffusion of the Chilean Model

For both advocates and opponents of privatization, Chile's landmark 1981 reform served as the model of reference for reform. The association of privatization with the Chilean dictatorship was a sensitive political issue. However after Chile's return to democracy in 1990, the center-left *Concertación* maintained the country's free-market economic policies, a fact which diminished the association of Chilean policy with dictatorship. In advocating the view that privatization would bring an increase in domestic savings rates, the development of capital markets, and economic growth, there was little doubt that Chile was the model case, first for Latin America, and then for the rest of the world.[1] The Chilean model was so persuasive that it convinced policy-makers in Kazakhstan to adopt a Chilean-style system despite an underdeveloped financial sector, little regulatory experience, no existing annuities markets, and uncertainty regarding future benefit levels (Andrews 2000).

Scholars of the impact of international diffusion have documented the tendency for policies to travel internationally, but they have had a more difficult time explaining how this process functions (Collier and Messick 1975, Osui 1994). International financial institutions like the World Bank and the Inter-American Development Bank have taken an active role in encouraging privatization through financial and technical assistance (overshadowing the International Labor Organization's once-prominent role as advocates of PAYG), while Chilean technocrats have traveled the globe promoting privatization.[2]

Madrid (2000) found a correlation between proximity to Chile and the salience of privatization which could be explained by cultural, institutional, and economic ties. This is true because policy-makers are more likely to be aware of the choices of their neighbors, and may find these policies to be more relevant to their own situation than policies adopted by distant countries. One of the drafters of the Argentine reform acknowledged that the fact that neighboring Chile could put a system of individual capitalization into practice made it apparent that a similar system could be feasible in Argentina (Demarco 2000 p.14).

Brooks (2000) came to a similar conclusion as Madrid, finding that privatization is more likely among Latin American countries that perceive themselves to be similar to Chile. There was also increased awareness of privatization in the region due to vast policy networks. She suggests that regional diffusion not only raises the probability of success that policymakers attach to reform, but may increase the costs of not reforming as governments compete for foreign investment with neighbors that have already privatized.

International Financial Institutions

The World Bank's replacement of the International Labor Organization as the dominant international organization in the realm of social security policy marked a

[1] Chile's Jose Piñera, who as labor minister implemented Chile's privatization, has promoted similar reforms in countries such as China, Russia, and Switzerland.

[2] German technocrats of the 19th century who invented the world's first state-sponsored social security systems (which eventually evolved into PAYG) also traveled the world to diffuse their policy innovation.

radical shift among patterns of international organizational expertise. For most of the 20th century, the ILO's tripartite PAYG pension model dominated international discourse. Under this system, contributions from workers, employers, and the government fund pensions. This model is used in most industrialized countries, and developing countries generally sought to replicate it. However as private capitalized pension systems gained greater attention, the ILO model was increasingly criticized (see Kotlikoff 1994). The World Bank's 1994 endorsement of privatization (World Bank 1994) was remarkable for two reasons: it signaled the arrival of the World Bank as a dominant player in the international social security policy arena, and it symbolized pension privatization's transformation from a radical idea to a mainstream, global policy prescription. Since then, the World Bank has been a forceful advocate of pension privatization in both Latin America and Eastern Europe.

World Bank officials promoted privatization through studies, training, and workshops. Brooks (2000) hypothesized that World Bank activity, including not only technical assistance but reliance on country loans and credits would make countries more likely to undertake a structural pension reform. She found a correlation between level of World Bank financing and likelihood of privatization.

In sum, the preceding section describes how external economic and political factors shaped political choices for governments intent on pursuing social security reform. Increasing openness to trade, the diffusion of the Chilean model, and the advocacy of privatization by the international financial institutions provided domestic political leaders with incentives to pursue pension privatization.

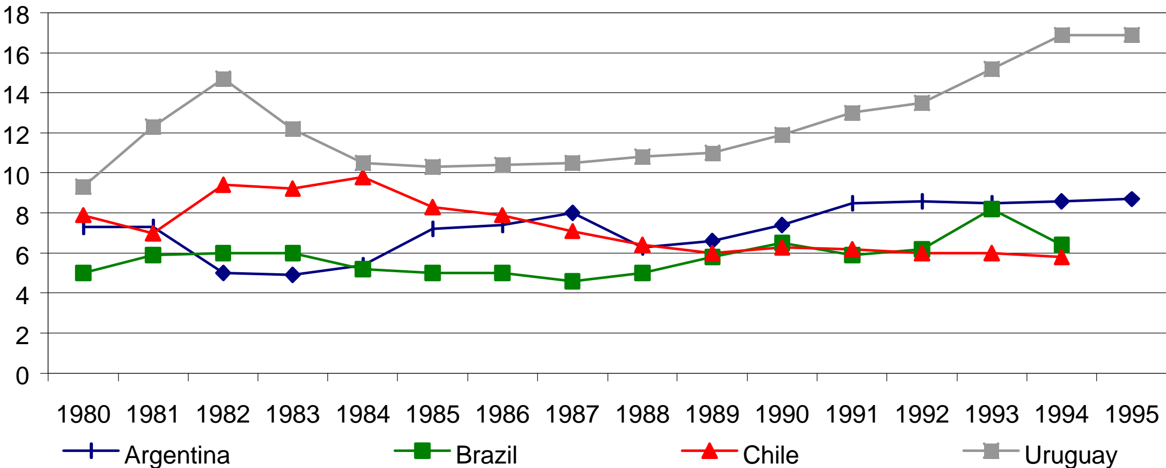
2. Financial and Administrative Challenges

Countries engaging in pension reform had strong financial incentives to do so. Throughout the 1980s and 1990s, governments in the Southern Cone were devoting increasing percentages of GDP to social spending and pensions (see table 4 and figure 1 below). In all four countries, pensions are the largest target of social spending. In Argentina, Brazil, and Uruguay, spending on pensions has tended to expand at the same rate as overall social spending. By contrast in Chile, spending on pensions as a percentage of GDP fell along with overall social spending measured as a percentage of GDP. Increasing spending on pensions in Argentina, Brazil, and Uruguay was driven by a rise in benefit payments brought on by an aging population, relatively early retirement ages, and increases in legally-mandated benefit levels. Financing problems were exacerbated by inefficient public administration and tax evasion.

Table 4: Government Social Spending as a Percentage of GDP

	1980-81	1982-89	1990-91	1996-97
Argentina	16.7	15.3	17.7	17.9
Brazil	14.4	15.4	18.7	22.5
Chile	18.4	18.3	13	14.1
Uruguay	15.4	17.2	18.7	22.5

(Source: Cominetti and Ruiz 1998 p.27, CEPAL 1999)



Several studies cite concerns over financing social security as providing an important impetus for recent social security reforms (Kay 1999, Cruz-Saco and Mesa-Lago 1998). By the 1990s, pension systems in Argentina, Brazil, and Uruguay faced severe disequilibria. Expenditures increased faster than revenues due to universal extension of coverage, generous benefits for specific occupational groups, increasing longevity, evasion, and cost-of-living adjustments (Mesa-Lago 1994 p.84). Revenues were not increasing because coverage cannot be extended to new groups (except the poor), declining rates of contributors to beneficiaries, and widespread evasion of payroll taxes. When PAYG systems generated surpluses, investment often did not generate high or even positive returns. Investments often consisted of non-negotiable unindexed bonds (essentially forced loans), personal or mortgage loans (also unindexed), construction of administrative buildings or public housing (with inefficient revenue collection), and subsidies for state-provided services (Mesa-Lago 1991 p.28-29). Declining ratios of workers to pensioners, which contribute to financial disequilibria, resulted from both aging populations and massive evasion. For example, in pre-reform Uruguay, there were 2 contributing workers for every beneficiary (Saldain 1996 p.280), while in Argentina, the ratio was 1.66 to 1 in 1990 (Schulthess et al 1993 p.119).

High evasion is in part a consequence of high overall payroll taxes and large informal sectors. In percentage terms, payroll taxes in the region are among the highest in the world, a factor that increases incentives for employers and employees to evade taxes. Incentives for evasion were also built into the rules of the PAYG pension systems themselves, as all three countries based pension benefits on the final years in the work force. For example, prior to reform in Argentina, only the best three out of the last ten years were used for determining benefits, providing incentives for workers in the private sector to underreport their income until they were close to retirement. Employers had an incentive to collaborate since they would save on payroll taxes. This means that a higher-paid worker who only contributed at the end of a career could receive higher benefits than a lifelong contributor with lower earnings. In many cases, poor or nonexistent

records of individual contributions leave governments to rely on sworn declarations, which provide another avenue for fraudulent claims.[3]

Growing deficits within the state-run PAYG systems provided ample incentive for reform. While openness to international markets has spurred the adoption of market-oriented pension systems, financial pressures may have conflicting effects. Brooks (2000) found that where there is low capital mobility, low levels of domestic investment are associated with a greater likelihood to privatize, while heavily-indebted governments face greater constraints on privatization given the financial costs of reform. Brooks concludes that market constraints are not uniform but rather depend on each country's financial and political circumstances.

Brooks (2000) and Brooks and James (1999) also argue that implicit pension debt was an important factor in determining whether or not countries engaged in structural pension reform. There are of course significant transition costs in moving to a system of individual accounts as the government must overcome the shortfall in revenue that occurs when workers contribute to their own accounts instead of the public pension system. Brooks (2000) found that many governments choose a reduced level of privatization in order to reduce the financial costs of the implicit pension debt. This suggests that a country like Brazil, with a significantly large implicit pension debt, is unlikely to adopt compulsory individual accounts unless its implicit pension debt is reduced.

Pension Reform and Savings Rates

Madrid (2000) maintains that financial concerns were not a primary motive behind recent social security reforms. He argues that despite their financial problems, in many pension systems that were privatized expenditures as a percentage of GDP were lower than in several European systems which have not been privatized. Furthermore privatization stood to worsen finances in the medium term due to the massive transition costs of switching to a system of individual accounts. Madrid instead argues that capital shortages prompted governments to push for privatization in the hope of boosting national savings rates.

The actual link between pension reform and savings rates is unclear, and the subject of much controversy. While Chile's savings rate soared after privatization there is much disagreement about the extent to which pension reform is responsible for this increase. Some scholars argue that there is a direct link (see Haindl Rondanelli 1997), others (Uthoff 1997) argue that Chile's pension reform did not boost the savings rate (on the controversy see Kay 2000). The issue of savings rates received renewed attention in the wake of the 1994-95 Mexican peso crisis, when many analysts associated Mexico's low and declining savings rates with greater vulnerability to economic crisis. The East Asian countries and Chile, which had relatively higher savings rates, were at the time spared from the turbulence that countries with lower savings rates experienced. With hindsight, we now know that high savings rates did not spare the East Asian countries from Asia's economic crisis that began in 1997. Nevertheless, this contrast has led many

[3] Advocates of private pension funds argue that they provide a greater incentive for individuals to contribute to social security, however evasion continues to be a persistent problem. In Chile, the proportion of those belonging to private schemes who contributed regularly declined from 76% in 1983, to 70% in 1987, and to 54% in 1998 (Mesa-Lago 1994 p.118, Salomon Smith Barney 1998).

to suggest that policies to promote savings rates are an important step toward achieving economic stability.

While economists disagree about the relationship between pensions and savings, Madrid argues that regardless of the actual link, world leaders *believed* that domestic savings would increase, which would lead to less reliance on foreign capital. This suggests that government leaders associated the adoption of a Chilean-style pension system as being an essential step toward emulating Chile's economic success. For example, Bolivia's ex-president argued that "the secret of the growth and the 'boom' (in Chile) was the individual capitalization pension funds" while former Mexican Finance Minister Ortiz stated that "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." (cited in Madrid 2000).[4] Madrid found that the lower a given country's domestic savings rate, the more likely it would be for that country to pursue privatization (2000, 1999).

This section has described how financial constraints presented incentives for political leaders to pursue social security reform. By the 1990s the region's social security systems were incurring greater deficits and consuming ever-greater percentages of GDP. It was apparent that some type of reform was necessary. Meanwhile, it was widely believed that pension reform would improve savings rates, which would in turn reduce reliance on volatile foreign capital. However the extent to which governments could turn to individual private accounts was constrained by a country's implicit pension debt.

3. Domestic Politics and Pension Reform

Economic openness and financial incentives do not themselves explain the role of politics in social security reform. The course of social security reform is ultimately determined in the domestic political arena. This section describes how domestic politics shapes reform.

Policy Legacies and Interest Groups

Reform options are constrained by previous policies. In the case of privatization, a country with a mature PAYG system would confront higher transition costs than a country with a smaller-scale program. The impact of these transition costs was made clear by Brooks and James (1999) in their discussion of implicit pension debt. Brooks (2000) found that structural reform was more likely where occupational pension programs were already strong since the political, legal, and technical framework for a large private pensions market would facilitate the adoption of private pensions.

On the political side, existing programs clearly have an impact on the path of reform. The "policy feedback" approach (Skocpol 1992, Pierson 1994) posits that

---

[4]The pension reform in general was expected to have widespread economic benefits – President Zedillo argued that "The increase in the availability of resources in the financial markets will result in the decrease in interest rates for business loans, the development of new debt instruments, and the growth of the capital markets" (cited in Madrid 2000).

previous policies shape future ones in part through the creation of new constituencies. Social security programs created a new interest group – social security beneficiaries – and once these interest groups are created, they can be staunch defenders of their political programs. Pierson argues in his study of the United States and Great Britain that the constituencies of individual programs played a far more important role than labor unions in fighting proposed cutbacks (Pierson 1994).

In the Southern Cone, interest group opposition was led by groups of beneficiaries, their labor union representatives, and professional associations seeking to preserve benefits that were threatened by the prospect of social security reform. The relative "strengths" of these groups depended not only upon their finances or membership, but also their degree of monopoly on representation (whether or not they competed with other groups for the same membership), and the extent to which they formed coalitions with other interest groups. However interest group "strength" alone was not sufficient for achieving policy aims. Kay (1999) argued that the degree to which each country's set of political institutions permitted these actors to operate as "veto players" determined whether interest groups were ultimately able to influence policy outcomes.

One indicator of interest group strength is union density. Since unions were central opponents of privatization, union density can serve as an indicator of their relative political strength. In the 1980s, Union membership as a percentage of the economically active population averaged 36.1% in Argentina, 29% in Brazil, and 20.9% in Uruguay. These figures would indicate that we should expect more intense opposition to privatization from unions in Argentina than in Brazil and Uruguay. However while the main Argentine labor confederation supported privatization, unions in Brazil were successful in blocking it, and Uruguayan unions managed to postpone privatization until Uruguay's unprecedented coalition government passed the 1995 reforms (see Kay 1998). In a region-wide study Madrid (2000) found that countries with high unionization rates are less likely to privatize pensions than a country with low unionization rates. In Argentina and Mexico, which have high unionization rates and privatized, labor confederations supported privatization after obtaining major concessions from the government.

The degree to which interest groups had a monopoly on representation and formed alliances with other pressure groups and parties is another way to measure interest group strength. Presumably, a labor movement divided along party or ideological lines will wield less political clout than a unified organization. Furthermore, groups that form coalitions with other interest group actors may have more of an impact on policy than groups which fail to form alliances. While Brazilian and Uruguayan opponents of reform were relatively well-organized and unified, and formed coalitions opposing privatization, Argentine opponents were fragmented along party, union, and ideological lines. Meanwhile, pro-privatization organizations in Argentina representing finance, industry, and commerce mobilized far earlier in the reform process, and lobbied more actively than their Brazilian and Uruguayan counterparts (Kay 1998). In recent years, interest groups representing financial interests have become active in lobbying for privatization in Brazil (Pinheiro 2000).

Political Institutions

The degree to which interest group actors could effectively veto policy depended upon political institutions. Recent studies have sought to explain how the incentives that political institutions create motivate state actors in the process of policy formation (Ames 1987, Geddes 1994). For example, the importance of patronage in Brazil's open-list electoral system, where legislators must rely upon individual rather than party support, helps to explain the legislature's repeated rejection of efficiency and equity-enhancing social security reforms which threatened important middle-class constituents such as civil servants.

Whether or not interest groups may shape policy as veto players depends upon political institutions. A veto player is an individual or collective actor whose agreement is required for a change in policy (Tsebelis 1995). Tsebelis suggests that there are institutional veto players built into the structure of government (for example the "checks and balances" of the US constitution), as well as partisan veto players who are members of a governing coalition.

Different political institutions give interest groups with similar resources varying opportunities to act as veto players. Immergut (1992) found that physicians were well-organized in France, Switzerland, and Sweden, but the Swiss federal system, with its referendum, gave Swiss doctors greater opportunities to veto national health insurance than in unitary Sweden, where Social Democrats held a parliamentary majority. Swiss doctors were better able to achieve policy aims because the checks and balances of the Swiss Federal system and the referendum provided them with an opportunity to veto policies that harmed their interests. Without the opportunity to fight reform at the local level, and without access to the referendum, Swedish doctors did not have the opportunity to veto national health insurance. In short, this approach forces us to recognize how political institutions shape (but do not determine) political conflict by providing interest groups with varying opportunities to veto policy.

Kay (1999) used this approach in a comparative study of pension reform in Argentina, Brazil, and Uruguay, arguing that the range of policy outcomes depended upon the degree to which political institutions provided political actors with the opportunity to veto policy. Electoral laws which tended to promote or inhibit party discipline, the referendum, interest group influence within the social security bureaucracy, and the powers of the executive compared to the legislature provided varying degrees of access to the policy-making process for interest groups and their political representatives. Where political institutions afforded interest groups greater opportunities to veto policy, reforms were limited, while political institutions which prevented interest groups from acting as veto players provided governments with greater opportunities to implement fundamental reforms (Kay 1999, 1998).[5]

[5] Castiglioni (2000) also incorporates the role of veto players in a comparative historical study of welfare reform in Chile and Uruguay. She argues that the contrasting patterns of policy change in these two countries can be explained by the presence or absence of broad cross class alliances for welfare support, the ideological positions of policy makers, and the concentration of government authority, which in turn creates opportunities for veto players.

Uruguay, Argentina, and Brazil

In Uruguay, retirees, labor unions, and the left political coalition *Frente Amplio* formed a coalition that successfully contested government reform plans from the return to democracy in 1984 through the election of President Sanguinetti to a second term in 1994. Pensioners were organized into one national federation, and allied with the country's unified trade confederation, the *PIT-CNT*. The turning point came when the incoming *Colorado* administration made pension reform its top priority in 1994. The two traditional political parties – which for years had enjoyed a duopoly on power - was now threatened by the growing popularity of the left *Frente Amplio* coalition, which had come close to winning the 1994 election. This provided the two parties with sufficient incentive to overcome decades of rivalry in order to form a coalition government. The coalition agreement was predicated upon the passage of four major reforms, beginning with pensions, and in 1995 approved a reform that maintained a universal public benefit while adding private individual accounts.

The opposition's most effective weapon had been the popular plebiscite. It had backed two initiatives defending the public system, and defeated a government-sponsored initiative. The fact that pensioners and the labor confederation had seats on the board of the pension system's governing board gave them a voice in day to day operations as well as policy decisions. These representatives led a successful campaign to defeat a planned modernization drive that would have facilitated the creation of individual accounts, a move which opponents viewed as a precursor to privatization. Government reform efforts were complicated by the fact that Uruguay's two traditional political parties were generally undisciplined, as electoral sub-lists regularly broke off and formed new lists. Sub-lists courting votes were loathe to offend pensioners. Consequently presidents traditionally had problems commanding a legislative majority, resulting in "policy gridlock" (González 1993). All of this changed with the coalition government formed in 1994, when the new government embarked on a series of structural reforms, starting with pension reform. In 1999, opposition groups fell just short of collecting enough signatures to place a plebiscite on the ballot that would have derogated the reform. The popular plebiscite remains a potent weapon for opponents of reform.

In Argentina, interest group ambitions for vetoing policy were hindered by the increasing authority of the executive branch (what Carlos Nino (1996) labeled "hyper-presidentialism"). The packing of the Supreme Court and the unrestrained use of the emergency presidential decree had a profound impact on policy reform in Argentina. The traditionally powerful labor movement demanded and received concessions prior to legislative approval of privatization, but these concessions were later eliminated through a presidential decree "of necessity and urgency". Since the president regularly bypassed the legislature via this decree, the congress lost its power to act as an institutional veto player. The net result was that despite the unpopularity of the new private system, interest group opponents lacked the institutional means to veto policy. The most recent pension reforms of President De la Rua which would eliminate the universal public benefit were also issued via the decree of necessity and urgency once it became apparent that legislative passage was uncertain.

In Brazil, pension reform required a constitutional amendment which had to be approved by a 3/5 majority in the Chamber of Deputies. Brazilian presidents generally

have a difficult time achieving majorities for controversial legislation given weak party discipline – even the president's own allies are unreliable supporters when asked to vote for controversial legislation that could hurt their political supporters. To make a majority even more difficult to attain, opposition legislators unbundled the legislation by calling for well-publicized item-by-item votes (the *DVS*) on the most controversial details of the reform. Weak party discipline, which the president attempted to overcome through extensive patronage, made pension reform prohibitively expensive during most of President Cardoso's first term (1994-1998). Unlike President Menem in Argentina, Cardoso could not easily legislate by executive decree. Until late 1998, he introduced piecemeal measures, such as introducing voluntary pension savings plans and placing ceilings on pension benefits. The financial emergency that began in late 1998 compelled President Cardoso's normally undisciplined legislative allies to vote for a series of reforms in 1999 and 2000 that lowered benefits and raised taxes for the most privileged beneficiaries. The government's plan is to move toward greater reliance on funded pension programs in a piecemeal fashion, rather than institute a drastic break with past policy as occurred in Argentina, Chile, and Uruguay.

Other scholars have looked at political parties and the role of the legislature. Madrid measured the degree to which the president had control over legislative seats, a factor which is in part determined by electoral rules and party discipline. He found that ruling party dominance was a significant factor in privatization in Argentina, Mexico, El Salvador, Colombia, and Peru. In Bolivia and Uruguay, governments passed the reforms with coalition partners. Brooks (2000) measures the number of parties in the legislature as a proxy for the likelihood that a government will encounter opposition and found that a higher degree of fragmentation is associated with a smaller degree of change in institutional design. In essence, this argument suggests that the more parties there are, the more veto players there are, and the less likely it is that structural reform will take place. These studies all point to the central role that political institutions play in the formation of policy.

Conclusions:

This paper describes how political factors shape social security reform. Since pension reform is a highly contentious issue, political actors have encountered tremendous obstacles in instituting reforms. The research presented here discusses how political incentives drive the policy-making process. As discussed above, since we are still in the midst of an ongoing process of social security reform, conclusions must be qualified accordingly.

As once-closed economies opened and faced greater international competition, governments were faced with the challenge of lowering labor costs, and cutting spending on social security became a top priority. International Financial Institutions like the World Bank and the Inter-American Development Bank were forthcoming with technical assistance and financing for countries which were incorporating individual savings accounts. The fact that social security programs were consuming greater percentages of GDP and representing an ever-greater financial burden presented an additional incentive for governments to implement reforms.

Encouraged by IFIs, privatization was the model of choice, yet policy outcomes were mediated by domestic politics. The promise of improved competitiveness, the availability of IFI support, and the signal that privatization sends to international investors made privatization appealing to political leaders. When faced with this set of incentives, politicians preferred promising future improved benefits – which would or would not be realized long after they had left office - to the more transparent and politically-charged task of cutting current benefits and raising taxes which would constitute the core of a PAYG-only reform.

In short, with growing financial costs of the old PAYG systems, pressure to lower wage costs, technical and financial support from the IFIs, and the example of the Chilean reform, governing politicians had every incentive to pursue privatization. Yet the extent to which they would be successful in such endeavors depended upon domestic political factors. Governments faced an array of interest group opponents, whose opportunities to act as veto players in the policy making process were contingent upon the structure of political institutions.

References:

Ames, Barry. 1987. Political Survival: Politicians and Public Policy in Latin America. Berkeley: U.C. Press.

Andrews, Emily S. 2000."Kazakhstan: An Ambitious Pension Reform." Paper Prepared for the World Bank Pension Primer on Country Experiences in Europe and Central Asia. Washington: World Bank.

Barr, Nicholas. 1987. The Economics of the Welfare State. Stanford: Stanford University Press.

________. 2000. "Reforming Pensions: Myths, Truths, and Policy Choices." IMF Working Paper WP/00/139.

Brooks, Sarah M. 2000. "Social Protection and Economic Integration: The Politics of Pension Reform in an Era of Capital Mobility." Unpublished Manuscript, Duke University.

_______ and Estelle James. 1999. "The Political Economy of Pension Reform." Paper presented at the World Bank Conference on New Ideas about Old Age Security, Sept. 14-15.

Castiglioni, Rossana. 2000. "Welfare State Reform in Chile and Uruguay: Cross-class Coalitions, Elite Ideology, and Veto Players." Paper presented at the Latin American Studies Association, Miami, FL, March 16-19, 2000.

CEPAL. 1999. Panorama Social de America Latina 1998. Santiago: CEPAL.

Collier, David, and Richard Messick. 1975. "Prerequisites versus Diffusion: Testing Alternative Explanations of Social Security Adoption," in American Political Science Review. Vol. 69, No.4 (December): 1299-1315.

Cominetti, Rosella, and Gonzalo Ruiz. 1998. Evolución del Gasto Público Social en América Latina: 1980-1995. Santiago: CEPAL.

Cruz-Saco Oyague, Maria Amparo, and Carmelo Mesa-Lago. 1998. Do Options Exist? The Reform of Pension and Health Care Systems in Latin America. Pittsburgh: University of Pittsburgh Press.

Demarco, Gustavo. 2000. "The Argentine Pension System Reform and the International Experience." Paper presented at the Woodrow Wilson Center Conference on "Learning from Foreign Models in Latin American Policy Reform." September, 2000.

Frieden, Jeffry, and Ronald Rogowski. 1996. "The Impact of the International Economy on National Policies: An Analytical Overview," in Keohane, Robert O., and Helen V. Milner, eds., Internationalization and Domestic Politics. New York: Cambridge.

Geddes, Barbara. 1994. Politician's Dilemma: Building State Capacity in Latin America. Berkeley: University of California Press.

González, Luis Eduardo. 1993. Estructuras Políticas y Democracia en Uruguay. Montevideo: Fundación de Cultura Universitaria.

Haindl Rondinelli, Erik. 1997. "Chilean Pension Fund Reform and its Impact on Savings," in Robert Grosse, ed., Generating Savings for Latin American Development. Miami: North-South Center Press.

Immergut, Ellen M. 1992. "The Rules of the Game: The Logic of Health Policy Making in France, Switzerland, and Sweden," in Sven Steinmo ed., Structuring Politics: Historical Institutionalism in Comparative Analysis. Cambridge: Cambridge University Press.

Kay, Stephen J. 2000."Privatizing Pensions: Prospects for the Latin American Reforms," in Journal of Interamerican Studies and World Affairs. Vol. 42, No. 1, Spring 2000, pp. 133-142.

_________. 2000b. "The Politics of Postponement: Political Incentives and the Sequencing of Social Security Reform in Argentina and Uruguay," presented at the International Social Security Association's International Research Conference on Social Security, Helsinki Finland, September 25, 2000.

__________. 1999. "Unexpected Privatizations: Politics and Social Security Reform in the Southern Cone," in Comparative Politics. Vol. 31, No. 4, July, 1999, pp. 403-422.

__________. 1998. Politics and Social Security Reform in the Southern Cone and Brazil. Ph.D. Dissertation, Political Science Department, University of California at Los Angeles.

__________ and Barbara E. Kritzer. 2001. "Recent Social Security Reforms in Latin America and the Challenges of Privatization," in Economic Review Q1 Vol.86, No. 1.

Kotlikoff, Lawrence J. 1994. "A Critical Review of Social Insurance Analysis by Multilateral Lending Institutions," in Analisis Economico. Vol.9, No.1, Junio de 1994.

Madrid, Raul. 2000. "The New Logic of Social Security Reform: Politics and Pension Privatization in Latin America." Paper presented at the Latin American Studies Association, Miami, FL, March 16-19, 2000.

Madrid, Raul. 1999. The New Logic of Social Security Reform: Politics and Pension Privatization in Latin America. Ph.D. Dissertation, Political Science Department, Stanford University.

Mesa-Lago, Carmelo. 1994. Changing Social Security in Latin America. Boulder CO: Lynne Reiner.

_________. 1991. "Social Security and Prospects for Equity in Latin America." World Bank Discussion Papers, 140. Washington D.C.: World Bank.

_________. 1978. Social Security in Latin America: Pressure Groups, Stratification, and Inequality. Pittsburgh: University of Pittsburgh Press.

Musgrave, Richard A., and Peggy B. Musgrave. 1980. Public Finance in Theory and Practice. New York: McGraw-Hill.

Nino, Carlos Santiago. 1996. "Hyperpresidentialism and Constitutional Reform in Argentina," in Arend Lijphart and Carlos Waisman, eds., Institutional Design in New Democracies: Eastern Europe and Latin America. Boulder, CO: Westview.

Osui, Chikako. 1994. "Welfare State Development in a World System Context: Event History Analysis of First Social Insurance Legislation Among 60 Countries, 1880-1960" in Janoski, Thomas and Alexander M. Hicks, eds., The Comparative Political Economy of the Welfare State. New York: Cambridge.

Paul Pierson. 1994. Dismantling the Welfare State? Reagan, Thatcher, and the Politics of Retrenchment. New York: Cambridge University Press.

Pinheiro, Vinícius C. "A Política Da Reforma Da Previdência No Brasil." Paper presented at the Woodrow Wilson Center Conference on "Learning from Foreign Models in Latin American Policy Reform." September, 2000.

Saldain, Rodolfo. 1996. Reforma Jubilatoria: El Nuevo Modelo Previsional. Montevideo: Fundación de Cultura Universitaria.

Salomon Smith Barney. 1998. "Private Pension Funds in Latin America, 1998 Update." Latin America Equity Research, Industry Report, December.

Schulthess, Walter and Gustavo Demarco. 1993. Argentina: Evolución del Sistema Nacional de Previsión Social y propuesta de reforma. Santiago: CEPAL

Sinha, Tapen. Pension Reform in Latin America and Its Lessons for International Policymakers (Huebner International Series on Risk, Insurance, and Economic Security, #23). Boston: Kluwer Academic Publishers.

Skocpol, Theda. 1992. Protecting Soldiers and Mothers: The Political Origins of Social Policy in the United States. Cambridge: Belknap

Tsebelis, George. 1995. "Decision Making in Political Systems: Comparison of Presidentialism, Parliamentarism, Multicameralism, and Multipartism," British Journal of Political Science. Vol.25, Part 3, July 1995.

Uthoff, Andras. 1997. "Reformas de los Sistemas de Pensiones y Ahorro: Ilustraciones a Partir de la Experiencia Chilena," in Ahorro Nacional: La Clave Para Un Desarollo Sostenible En America Latina. Madrid: Instituto de Relaciones Europeo-Latinoamericanas (IRELA).

World Bank. 1994. Averting The Old Age Crisis: Policies to Protect The Old And Promote Growth. New York: Oxford University Press.