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Madrid, Raúl L.

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## ***Ideas, Economic Pressures, and Pension Privatization***

*Raúl L. Madrid*

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### ABSTRACT

This article maintains that the recent wave of pension privatization has been spurred largely by rising pension expenditures and chronic capital shortages. Many policymakers in Latin America and around the world believed that privatizing their public pension systems would boost their domestic savings rate and resolve the systems' financial problems, thereby reducing their dependence on unstable foreign capital and freeing resources for other, more productive uses. There is no clear evidence that pension privatization will bring these economic benefits, however. To understand why policymakers held these beliefs, we must examine how ideas about pension privatization have formed. Two particularly important factors are the Chilean model and the World Bank's growing influence on pension policy. A probit analysis of the determinants of pension privatization provides support for these arguments.

A vast wave of pension privatization has swept much of the world in recent decades. Nowhere has this wave been more powerful than in Latin America. Since 1992, ten Latin American countries have privatized their pension systems, and a handful of other countries in the region have considered or are considering similar measures. The privatization schemes allow (or oblige) members of the existing public pension system to deposit some or all of their mandatory social security contributions in individual retirement accounts managed (principally) by private pension fund administrators, instead of paying these contributions to the state-run pension system.<sup>1</sup> To varying degrees, the privatization schemes thus transfer the responsibility for the provision of retirement pensions away from the state and toward the private sector.

It is not clear whether the new private pension systems will generate higher pensions on average than the old public systems. Nor is it clear whether the private pension systems will generate economic benefits. It is certain, however, that the privatization measures will increase the financial risks faced by workers and create substantial funding deficits for the state in the medium term.

Why, then, have so many countries opted to privatize their pension systems? One potential explanation would focus on the role of economic crisis, which much of the existing literature on economic reform has identified as the principal cause of market-oriented reform (Haggard

and Kaufman 1995; Tommasi and Sturzenegger 1998; Weyland 2002b; for a skeptical view, see Corrales 1997–98). Economic crises have indeed facilitated pension privatization in a number of ways. First, economic crisis undermined support for the existing state-led development model in many countries, which paved the way for market-oriented reforms, such as pension privatization. Second, economic crises weakened some groups that opposed pension privatization, such as organized labor, and strengthened some actors that supported it, such as the World Bank. Third, in many countries, economic crises helped create domestic capital shortages and wreaked havoc on the finances of public pension systems, both of which helped foster pension privatization.

Nevertheless, economic crisis is only one of the many factors that determine the degree of public support for market reform, the strength of organized interest groups, or the level of public pension spending or domestic savings in a given country. Moreover, it seems unlikely that a government would respond to an economic crisis by privatizing its pension system, because such a move could worsen the crisis by dramatically increasing the size of the government's fiscal deficit. We might, indeed, reasonably expect governments facing economic crises to be quite reluctant to privatize their pension systems, at least in the short run. Economic crises may discourage pension privatization by undermining confidence in the stock market and the ability of the private sector to manage the retirement funds effectively. These offsetting effects of economic crisis mean that any relationship between crisis and pension privatization is likely to be weak, distant, and indirect.

This article maintains that the recent wave of pension privatization has been spurred not by economic crisis in general, but by a more specific set of economic problems. Policymakers have sought to privatize their pension systems largely because of concerns about domestic capital shortages and the economic burden of public pension spending, which are only indirectly related to economic crisis. Many policymakers have believed that privatizing their public pension systems would boost their domestic savings rate and cut their long-term public pension expenditures, thereby reducing their dependence on unstable foreign capital and freeing up resources for other, more productive uses. To understand why many policymakers believed that pension privatization would yield these benefits, however, it is necessary to explore how ideas about pension privatization and its effects have taken hold.

This study argues that two factors have played a particularly important role in spreading beliefs about the economic efficacy of pension privatization: the emergence and diffusion of the Chilean model and the growing influence of the World Bank in the area of pension policy.<sup>2</sup> The findings of this article suggest that ideas need to be taken more seriously in studies of policy reform, but they also imply that the influence of

ideas may depend less on the intrinsic value of an idea than on the regional salience of an idea and the strength of its advocates.

The article develops this argument first with a review of the economic pressures that have placed pension reform on the policy agenda in many countries. There follows a discussion of how the Chilean model and the World Bank have shaped beliefs about how pension privatization might address these economic problems. The analysis presents a simple statistical test of the preceding arguments, and the conclusion discusses the implications of the findings for theories of ideas and policy reform.

## **ECONOMIC PRESSURES AND PENSION REFORM**

Public pension systems have become an increasing economic burden around the world. This is the case not only in the industrialized world, but also in Eastern Europe and some Latin American countries, such as Argentina, Brazil, Chile, Costa Rica, and Uruguay. Over the last several decades, public pension expenditures have skyrocketed, partly because of demographic trends, which have caused the population to age rapidly in many countries. The maturation of pension systems has also led pension expenditures to grow by making an increasing number of people eligible for pension benefits. Some countries, including a large number of Latin American countries, have inadvertently accelerated the maturation of their pension systems by imposing loose requirements for gaining pensions. Economic difficulties, such as rising unemployment and the growth of the informal sector, have also worsened the financial problems of public pension systems in many countries.

The growth in public pension expenditures has put pressure on countries to reform their systems, especially those countries in which public pension expenditures (as a percentage of GDP) are high (Kay 1999; World Bank 1994). Governments with large and growing public pension expenditures have feared that their public pension programs would hinder economic growth and absorb scarce resources that would be better devoted to other programs. Governments have become increasingly reluctant to pay for growing pension expenditures by boosting payroll taxes because they have feared that such measures would increase unemployment and reduce their ability to compete in the global economy.

Some policymakers have advocated pension privatization as a solution to these problems. As advocates of privatization point out, private pension systems, unlike most of the public systems, are fully funded. Therefore they are not undermined by the aging of the population to the same extent as are the public pay-as-you-go systems. Proponents of privatization also maintain that the private systems can generate better rates of return than the public systems, which means that they can make do

with lower payroll taxes. The assumption underlying this contention is that the long-term rate of return to capital, on which private fully funded schemes depend, will be higher than the annual percentage growth in total real wages, on which public pay-as-you-go systems depend. In addition, advocates of privatization maintain that it will improve the financial health of the pension system by reducing payment evasion. They point out that workers will have greater incentives to contribute to a system based on individual capitalization because pensions in such systems are tied more directly to contributions. Proponents of privatization also contend that private pension systems will not be so easily manipulated for political purposes, which will help ensure their financial health.

Rising public pension spending was not the only economic factor to put pension privatization on the policy agenda of many nations, however. Concerns about capital shortages did so as well (Madrid 2002). In many countries, domestic savings rates have declined in recent decades, limiting the supply of local capital. As a result, many countries have become increasingly dependent on unstable foreign capital. The global rise in capital mobility has caused cross-border financing to mushroom as firms, countries, and individual investors have sought attractive opportunities to borrow, lend, and invest abroad. At the same time, the increasing mobility of international capital has made it easier for investors to pull money out of a country in the event of a crisis. In the last two decades, numerous countries have experienced massive capital outflows when investors have suddenly lost confidence in their economies.

Their rising vulnerability to capital outflows has led many countries to try to boost their domestic savings rates as a means to reduce their dependence on skittish foreign sources of capital. Many policymakers have viewed pension privatization as one of the most effective ways to boost their countries' savings rates. According to pension privatization advocates, mandatory private pension schemes would boost private savings by requiring people to save above the level that they would voluntarily save. Some economists have long argued that pay-as-you-go systems reduce national savings by discouraging private savings, because individual workers know that the government will provide them with a pension in their old age. Privatizing the pension system, they argue, would reverse this negative effect.

The authors of an important World Bank study of pension reform acknowledge that a mandatory private pension system would probably reduce voluntary savings to some degree, but they suggest that "this crowd-out effect may be only partial because people are shortsighted and would not have saved as much voluntarily for old age" (World Bank 1994, 209). Advocates of pension privatization also argue that it will promote savings by reducing "the probability that governments will have to borrow to cover escalating pension costs as populations age" (James

1997, 20). They maintain, furthermore, that pension privatization will reduce payroll taxes and other labor market distortions that impede growth and improve the efficiency of the local capital markets. Higher growth will boost savings, which, in turn, will promote further growth.

Those countries with low domestic savings rates have found pension privatization particularly attractive. In both Argentina and Mexico, the architects of the reforms proclaimed that raising their sagging domestic savings was one of the main goals of the reforms, and they carried out analyses that estimated the effects of the reforms on the savings rate (Schulthess 1996; Demarco 1996; Martínez 1997; Dávila 1997; see also Cottani and Demarco 1998; Cámara de Diputados 1995). In their expositions of the motives for their reforms, the Nicaraguan and Salvadoran governments justify the privatization plans on similar grounds, arguing that the privatization schemes will generate domestic savings and stimulate the local capital markets (INSS n.d.; Instituto Salvadoreño del Seguro Social 1997). Colombian President Alvaro Uribe Vélez, who was one of the key backers of the reform when he served in the Colombian Senate, has written, “the pension reform seduces me because of its macroeconomic effects—its impact on savings. Colombia is a country with a very low savings rate. I do not see a sufficiently valid reason to sacrifice the opportunity to improve [the savings rate] substantially” (Uribe Vélez 1993, 19).

A desire to raise the domestic savings rate and bolster the local capital markets also reportedly motivated the reforms in Hungary, Poland, and Kazakhstan (Nelson 2001; Müller 1999; Orenstein 1999). Indeed, the Hungarian government sought to finance the transition costs of its privatization plan through taxes and expenditure reduction rather than debt, specifically in order to boost the domestic savings rate (Palacios and Rocha 1998, 27).

## **IDEATIONAL INFLUENCES**

An explanation for pension reform choices that focuses solely on economic factors is insufficient, however. Economic factors alone cannot explain reform choices or even the decision to reform. As Adler has pointed out, the “environment does not ‘instruct’ policymakers, it challenges them” (1991, 53). How policymakers respond to those challenges depends partly on what sort of beliefs the policymakers and other actors hold.

Investigating the beliefs that frame the policymakers’ choices is particularly important in this case because of the controversy surrounding the economic effects of pension privatization. It is not clear that pension privatization is an effective solution to the problem of rising public pension spending. Indeed, social security privatization worsens rather than improves the financial situation of the public pension system in the

medium term. Pension privatization schemes are costly in the medium term 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, also compensates members who transfer to the private system for the contributions they 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 medium term.

It is not even certain that pension privatization will resolve the pension systems' financial problems in the long run. Political interference may wreak havoc on the finances of the private pension systems, just as with public pension systems, given that the government decides who may operate private pension funds and in what entities they can invest. Indeed, the struggling Argentine government recently forced the Argentine private pension funds to lend it billions of dollars at low interest rates, which has led to serious financial problems for the country's private pension system. Private fully funded pension systems, like public pay-as-you-go systems, may be affected by demographic transitions, because the return on their investments may decline once large cohorts of workers retire and begin to sell their assets.<sup>3</sup> Private systems are also vulnerable to inflation, bankruptcy, and fraud. Should a private pension system run into serious financial problems, the state would almost certainly be obliged to cover some of its debts, which could prove extremely costly.

The link between pension privatization and higher savings rates is even more controversial. Some strong theoretical arguments have been made as to why pension privatization might generate increased domestic savings. Nevertheless, 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 2001). Where the transition is debt-financed, the increase in private savings generated by the pension privatization plan will be offset by an increase in public dissaving. Skeptics also point out that the empirical evidence linking pension privatization to higher savings is tenuous. Indeed, in a noteworthy paper, the Nobel Prize-winning economist Joseph Stiglitz and a collaborator declared the idea that pension privatization boosts national savings to be "myth number 1" in the debate on social security (Orszag and Stiglitz 1997, 9–12).

Most of the studies of the macroeconomic effects of pension privatization have examined a single country, Chile, and have yielded contradictory results (Corsetti and Schmidt-Hebbel 1995; Haindl 1997; Holzmann 1997). The sizable literature on the macroeconomic effects of pay-as-you-go systems, meanwhile, has yet to find conclusive evidence

that these systems lower domestic savings (World Bank 1994; Thompson 1998). This ambiguity is partly a result of the thorny nature of the problem. It is difficult to isolate the impact of the pension system on savings rates, partly because savings rates depend on numerous factors.

These controversies raise several key questions. Why have so many policymakers assumed that privatizing their pension systems would boost their savings rates and ease their fiscal burdens? Why have some policymakers reached this conclusion more readily than others? Where do ideas about the effects of pension privatization come from, and what determines whether they take hold?

### **Regional Salience**

The literature on ideas and policy reform suggests that two factors often play a key role in shaping how policy ideas are received: the regional salience of the idea and the influence of its advocates. As numerous studies have noted, policy innovations often diffuse in regional clusters (Walker 1969; Berry and Berry 1992; Mooney 2001). This occurs because policymakers are more likely to be aware of innovations that take place in their region, and they are more likely to view such innovations as relevant to their own situation.

Regional policy networks typically play a key role in facilitating regional diffusion because they bring policymakers in frequent contact with each other and create standards about what are appropriate policies (Mintrom and Vergari 1998; Teichman 2001). Other types of cultural, institutional, and economic ties, such as shared media, mutual trade and investment, and common values, may also facilitate regional diffusion by increasing the awareness and acceptability of policies that originate in neighboring areas. Weyland (2002a), moreover, suggests that psychological factors can help explain the geographic pattern of policy diffusion. Policymakers will tend to draw on information that is immediately available to them rather than gathering information from a variety of sources and areas.

### **Influence of the Advocates**

The power of the promoters of ideas, meanwhile, matters because the ideas of the powerful tend to carry more weight (Hall 1989; Sikkink 1991; Goldstein and Keohane 1993; Hira 1998). Actors that control substantial resources may not be able to compel policymakers to adopt certain reforms, but their influence tends to grant privileged access to their ideas and often makes them more persuasive. Policymakers who hear conflicting claims about the effectiveness of a particular policy will often give greater credence to the views of the more powerful actor. Indeed,

powerful actors often get their way because they have greater technical expertise in a given area, making it more difficult for opponents of their ideas to refute their claims.

The influence of the powerful, however, also stems from their ability to make available or take away the resources they control. DiMaggio and Powell (1983) and Babb (2001) argue that policy convergence frequently results from the pressures of resource dependence, because powerful actors, such as international financial institutions, will often provide significant material incentives for governments to adopt certain policies.

Evaluations of the costs and benefits of reforms are thus profoundly shaped not only by the regional salience of an idea, which tends to make certain policy ideas more prominent than others, but also by the distribution of power, which helps policymakers assign weight to different information and evaluate conflicting claims. The achievements of the Chilean model helped pension privatization gain a high degree of salience in Latin America beginning in the late 1980s. The World Bank, meanwhile, used its substantial influence to help persuade many policymakers that privatizing their pension systems would yield substantial benefits.

## **REGIONAL DIFFUSION OF THE CHILEAN MODEL**

During the military regime of General Augusto Pinochet (1973–90), the government of Chile carried out an unprecedented number of market-oriented reforms. After some initial difficulties, these reforms succeeded in generating impressive economic growth, prompting widespread interest in the Chilean economic model throughout Latin America.

Chile's pension privatization scheme attracted especially great attention because it represented a bold new policy approach. Although the possibility of pension privatization had long been discussed in academic circles, before the 1980s it was an untested idea with unclear implementation guidelines and unknown consequences. As a result, it was rarely considered as a serious policy option. The 1981 Chilean social security reform changed all that, providing a model that policymakers from other countries could use to craft similar reforms.

The Chilean reform persuaded many observers that pension privatization would bring numerous macroeconomic benefits. Policymakers and the media commonly attributed the rapid rise of the Chilean savings rate in the late 1980s and 1990s to the pension privatization scheme, although the evidence for this is mixed at best.<sup>4</sup> A 1994 *New York Times* article was typically effusive, arguing that "private pension funds have almost doubled [Chile's] savings rate in a decade" (Brooke 1994, 27). Gustavo Demarco, one of the main architects of pension privatization in Argentina, acknowledges,

the arguments based on the effects of private pensions on savings and the capital markets were probably outweighed by some of the sectors promoting the reform in Argentina and other Latin American countries. . . . In most cases the conclusions [about the economic benefits of pension privatization] were only supported by “common sense” arguments, or [by] diffusion material with simple correlations of variables from the Chilean experience. . . . (Demarco 2000, 4–5)

The Chilean reform also convinced many people that a private pension system would function more efficiently than a public system, which would reduce the amount of resources devoted to pensions. From the outset, the Chilean private pension system generated very high returns on the funds that workers deposited in their individual retirement accounts. Between 1982 and 2000, the pension funds generated returns averaging 10.9 percent annually above inflation (AIOS 2001, 24). As a result of these strong returns, pensions have so far been substantially higher in the Chilean private system than in the public system, in spite of the lower level of contributions (and the relatively high administrative costs) in the private system.

The Chilean pension privatization model has been especially influential in Latin America because of the cultural, economic, and institutional ties that bind the countries of that region to Chile. Policymakers, along with interest groups in Latin America, became acquainted with the Chilean reform before their counterparts outside of the region did, and the Chilean model continues to be much more salient in Latin America than elsewhere. Indeed, pension privatization has been widely discussed in almost every Latin American country.

Latin American policymakers not only have become more familiar with the Chilean model than their counterparts outside the region, but they have also been more inclined to view the Chilean experience as relevant to their own countries because of their countries’ numerous cultural and economic similarities to Chile. In addition, Chile has represented an especially compelling model for many Latin American policymakers because it is the only country in the region that has enjoyed strong and sustained economic growth since the mid-1980s. Policymakers from other regions, in contrast, have typically held up other countries as models; in their view, their own countries have little in common with the South American nation. In Hungary and Poland, for example, many participants in the reform debate have criticized social security privatization as a Latin American import, arguing that these countries should opt for the European model of reform (Palacios and Rocha 1998; Müller 1999). As one former World Bank pension expert put it, “It’s easier for Peru and Argentina to accept the reform of a relatively small and poor country like Chile . . . it has little relevance for Germany, France, the United States, and so on that a reform has been successful [in Chile]” (Schmidt-Hebbel 1997).

Regional policy networks have played a key role in diffusing the Chilean model throughout Latin America. Regionally based institutions, such as the Inter-American Development Bank, the Inter-American Conference on Social Security, and the United Nations Economic Commission for Latin America, have brought Latin American policymakers in contact with one another and have served as forums where the Chilean model is widely discussed. Numerous Chilean firms, research institutions, and government agencies, meanwhile, have actively sought to spread the Chilean model in the region. The Superintendency of Private Pension Funds in Chile, for example, has advised numerous Latin American countries on pension reform. PrimAmérica, a consulting firm founded by two former directors of a Chilean pension fund, has also been quite active in the region, carrying out consulting missions in El Salvador, Honduras, Bolivia, Ecuador, Mexico, Panama, Paraguay, and Guatemala, among other countries (Iglesias 1996).

Perhaps the most influential Latin American advocate of pension reform has been the architect of the Chilean reform, José Piñera. A former Chilean minister of labor, Piñera has traveled throughout Latin America, meeting with ministers and presidents in his effort to promote pension privatization (Piñera 1997). According to well-placed Peruvian officials, Piñera played a key role in persuading President Alberto Fujimori to privatize the Peruvian pension system (Boloña 1997; Roggero 1997). Indeed, Fujimori approved the project at the end of a three-hour meeting with Piñera (Roggero 1997, 41). Carlos Boloña, a former minister of economy in Peru, recalls,

At the time of the reform, the president of Peru was very concerned. He wasn't convinced that we should privatize the pension system. So we brought José [Piñera] to talk to him, to discuss what privatization had done for Chile. And, of course, José was able to convince him that privatization was in Peru's best interest. The reform might not have been signed into law without José's assistance. (Boloña 1997, 1)

Piñera also reportedly helped convince Colombian president-elect César Gaviria and his economic advisers of the merits of pension privatization during a 1990 visit to that country (Santos 1997; Nelson 1998, 3). According to Juan Manuel Santos, a former Colombian minister of trade,

The arguments and results presented by Piñera [at a presentation on pension reform] made a deep impression on those who knew about the problem and on Colombian public opinion. That day Piñera met with the president-elect and with his team of economic advisers. It was an intense meeting of five hours, after which Gaviria's economic team was convinced of the necessity of pushing the pension reform and of working on the basis of the Chilean scheme of private pensions. (Santos 1997, 42)

The influence of the Chilean model is particularly noticeable in the details of the pension reform legislation in Latin American countries, which tend to resemble closely the Chilean legislation. The original Colombian reform proposal, for example, was so close to the Chilean model that one World Bank adviser joked that they had taken the Chilean legislation and used a computer search-and-replace function to substitute the word *Colombia* for *Chile* (von Gersdorff 1998). Many Latin American policymakers freely acknowledge their debt to the Chilean reform, although they also highlight the adaptations that they have made to the Chilean model. Bolivian president Gonzalo Sánchez de Losada, for example, acknowledged that the Bolivian pension reform “is something that we have received and copied from Chile,” although he noted, “obviously, we have made changes, taking advantage of the Chilean experience” (*Presencia* 1996). The main architect of the reform in Argentina, Walter Schulthess, said, “We used a lot from Chile; we saw what functioned well. We made some changes—a different way of presenting the problem—but we used their experience a lot” (Schulthess 1996). One key Argentine policymaker went so far as to say that “if the Chilean case had not existed, it is probable that we still wouldn’t have the reform [in Argentina]” (Barassi 1996). The Chilean model has thus profoundly shaped the content of pension reform in Latin America, but it is only beginning to exercise the same sort of influence outside the region.

## THE ROLE OF THE WORLD BANK

The World Bank has also helped convince policymakers of the merits of pension privatization. In recent years, the World Bank has sought to recast itself as a “knowledge bank,” arguing that it may foster development more efficiently by serving as a conduit of ideas rather than by simply distributing resources (World Bank 1999).

In no policy area has the bank’s effort to influence thinking been more noticeable than in pension reform. Since 1990, the World Bank has carried out a vast amount of research; held numerous courses, workshops, and conferences; and disseminated a wide variety of publications detailing the problems with the existing public pension systems and extolling the benefits of pension privatization. Its landmark 1994 study of pension systems around the world, *Averting the Old Age Crisis*, has been especially influential. A subsequent publication asserts that “partly as a result of this report, the Bank has witnessed an upsurge in pension reform efforts among client countries, and its support to such efforts has increased dramatically” (World Bank 1996, 2). A later report states,

*Averting the Old Age Crisis* showed how a low-cost form of international assistance can stimulate reform of pension policy. In the wake of that report, donors have helped a wide range of coun-

tries—among them Argentina, China, Hungary, Mexico, Poland, and Uruguay—study the long-term fiscal and distributional consequences of their old age security systems. These countries were able to draw on the lessons of, for example, the successful Chilean pension reform. (World Bank 1999, 136)

The World Bank has played a particularly important role in persuading policymakers that pension privatization would bring major macroeconomic benefits, including an increase in the domestic savings rate. *Averting the Old Age Crisis*, for example, trumpeted the economic benefits of pension privatization—indeed, its subtitle is “Policies to Protect the Old and *Promote Growth*” (emphasis added). Estelle James, the lead author of *Averting the Old Age Crisis* and one of the principal architects of the new World Bank pension reform strategy, has written elsewhere that “the chief theoretical argument for the recommended multi-pillar system is that it will have a positive effect on efficiency and growth” (1997, 16).

The World Bank has also provided loans that have reduced some of the financial obstacles to pension privatization. Indeed, over the last 15 years, the World Bank has granted a total of \$3.4 billion in loans to 36 countries to finance pension reform, including loans to cover the transition costs of pension privatization in Argentina, Mexico, Uruguay, Hungary, and Kazakhstan (Holzmann 2000; Queisser 2000, 39). These financial incentives are nevertheless relatively minor, typically amounting to less than 1 percent of the total transition costs of the privatization schemes. On the whole, the influence of the World Bank has been more ideational than material in nature, although both types of influence have mattered. As a former secretary of social security in Brazil noted in a recent paper, the World Bank has promoted pension privatization through the diffusion of ideas and the construction of a proprivatization rhetoric, rather than by making financing conditional on pension privatization (Pinheiro 2004, 111).

The World Bank has been particularly influential in those countries where it has carried out pension reform missions. Such missions have enabled World Bank representatives to maintain extended contacts with host country social security policymakers, which have provided them greater policy influence. The pension reform missions have also provided access to the demographic and financial data necessary to carry out sophisticated analyses of the problems facing the countries' public pension systems, as well as analyses of the economic consequences of privatization. The technical and financial assistance provided by the World Bank has strengthened domestic advocates of pension privatization in their struggles with opponents of privatization.

The World Bank's pension reform missions in Latin America have been numerous over the last 15 years. During the late 1980s and early

1990s, the World Bank conducted pension reform missions in Argentina and Mexico, both of which gave impetus to the pension privatization efforts in those countries. The pension reform missions financed preliminary studies of the problems facing the countries' public pension systems, which ultimately led to the formulation of pension privatization proposals. World Bank officials in both countries also used their formal and informal contacts with policymakers to encourage them to privatize their pension systems, and the bank provided some financing to ease the implementation costs of the reforms.

In El Salvador and Bolivia, the World Bank's pension reform mission brought in Chilean pension experts to study the countries' pension systems. These experts encouraged the countries to privatize their pension systems and formulated privatization proposals that were eventually implemented, albeit with some changes. The pension reform mission in Costa Rica similarly enabled the bank to lobby hard for pension privatization in that country. A 1995 World Bank report on Costa Rica argued that privatization would reduce evasion, produce higher returns, and "generate savings for the economy," whereas limited reform "simply delays problems rather than solving them once and for all" (Demirgüç-Kunt and Schwarz 1995, 29).

The World Bank has also carried out a large number of pension reform missions in the postcommunist world, promoting pension privatization in that region. It established a pension reform mission in Hungary in the early 1990s, for example, and in 1995 published a study that described the main problems of the existing Hungarian pension system and proposed partial privatization. That same year, the World Bank began to fund a working group of the Hungarian Ministry of Finance that was developing a privatization proposal. The World Bank's financial and technical assistance helped strengthen the Ministry of Finance in negotiations with other governmental and societal actors. Subsequently, the bank became heavily involved in funding and participating directly in an interministerial working group on pension reform that worked out differences within the government with regard to the reform. The World Bank also brought in international pension experts from various countries to serve as consultants on the reform, and it helped finance the transition costs of the reform after the privatization plan was implemented.

In both Poland and Croatia, a World Bank official (on leave) headed the government's pension reform team, which provided the bank with considerable policymaking influence (Müller 2002). In Poland, the bank assisted in the creation and funding of the Plenipotentiary for Social Security Reform, which planned and implemented the pension privatization scheme in that country. In Croatia, the bank sponsored a 1995 conference that brought in foreign pension experts and led the incom-

ing prime minister to endorse partial pension privatization (Müller 2002, 85). The World Bank also provided technical assistance to the Croatian government and helped finance the transition costs of the reform.

In Kazakhstan, the World Bank did not become involved until the reform was well under way (Andrews 1998; Orenstein 1999). Nevertheless, the reform's principal architect, Grigori Marchenko, read World Bank publications on pension reform and attended World Bank conferences on the topic, both of which, he acknowledges, influenced his thinking about pension reform (Orenstein 1999, 24).

The World Bank has thus helped shape policymaking on pension reform around the world. In some instances, the bank has had to overcome countries' initial reluctance to privatize. As one bank pension expert said, "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" (Schwarz 1998). In other instances, governments have been divided over what type of pension reform to carry out; the World Bank's recommendations, along with its technical and financial resources, have helped tip the balance in favor of pension privatization.

## **EXECUTIVE CONTROL OF THE LEGISLATURE**

Pension privatization proposals have typically met staunch opposition from a variety of sources, including pensioners' associations, labor unions, and opposition political parties. Because pension privatization measures usually require congressional approval, the legislature has often been the setting for major battles over the reform proposals.<sup>5</sup>

Legislators have come under intense pressure from opponents of pension privatization to vote against the reform proposals, making it difficult for the executive to obtain votes for such legislation. Even legislators who are ideologically sympathetic to privatization have often been loath to assume the political costs of voting for the unpopular reforms. To gain approval for pension privatization bills, executives have therefore typically needed to wield a good deal of control over their legislatures.

The degree of control that the executive has over the legislature depends largely on the percentage of seats the ruling party holds. The executive typically has much more influence over the votes of members of its own party than those of other parties, particularly when it comes to unpopular measures like social security reform. The degree of internal unity or discipline of the ruling party varies considerably from country to country, however. Where the ruling party has been relatively unified and has held a majority or near-majority of the seats in the legislature, the executive has typically been able to enact pension privatization legislation.

The ruling party, for example, used its majority or near-majority and strong party discipline to push through pension privatization plans in Mexico, Argentina, Bolivia, El Salvador, Nicaragua, Hungary, and Croatia despite resistance from the main opposition parties. Presidents have had a much more difficult time gaining legislative approval for pension reforms in instances where the ruling party has held a small minority of seats in the legislature or where the ruling party has been split. Repeated efforts to enact major pension reforms in Brazil and Ecuador, for example, were undermined by the president's low degree of control of the legislature. A lack of internal party unity, meanwhile, hindered efforts to privatize the pension system in Colombia, Paraguay, and Venezuela, although the Colombian government eventually managed to enact a watered-down version of its original pension privatization bill. The executive's degree of control of the legislature has thus shaped the political feasibility of pension privatization.

## A QUANTITATIVE ANALYSIS

To test these arguments, a probit analysis was conducted on the determinants of pension privatization worldwide.<sup>6</sup> The dependent variable was coded as 1 if a country enacted legislation privatizing its pension system between the years 1990 and 2000, and 0 if it did not enact any sort of privatization legislation during that period. The sample was limited to middle- and upper-income countries with populations above one million, partly because of the difficulty of finding reliable data for low-income countries and nations with tiny populations.<sup>7</sup> Many low-income countries, moreover, lack the financial infrastructure necessary to privatize their pension systems or have no pension systems at all. The sample comprised a total of 82 countries, including 17 that privatized their pension systems to some degree.<sup>8</sup>

The independent variables were measured in the following manner. Public pension expenditures as a percent of gross domestic product were used to measure the economic burden of public pension spending. These data represent various years in the 1990s or, in a few cases, estimates based on regional averages.<sup>9</sup> The average domestic savings rate between 1990 and 1998 was used to measure the sufficiency of local capital sources.<sup>10</sup> To minimize problems of endogeneity, only the years before a nation privatized its pension system were used for those countries that enacted pension privatization schemes during this period. The extent of World Bank influence over local pension policy was measured by whether a country had hosted a World Bank pension reform mission.<sup>11</sup> An additional, dummy variable was created for Latin American countries, to accommodate the argument that these countries were particularly likely to privatize their pension systems because of

regional diffusion of the Chilean model. The executive's degree of control of the legislature was gauged by the average share of seats held by the ruling party in the lower chamber during the 1990s.<sup>12</sup> Unfortunately, cross-national data on party discipline were not available.

The results of the statistical analysis provide broad support for the arguments made in this article. The first column of table 1, labeled Model 1, displays the results of the initial probit analysis. The model correctly predicts 91.5 percent of the cases, including 13 of the 17 cases of privatization and 62 of the 65 cases of nonprivatization.

As the table makes evident, the variables in the initial analysis all had the expected signs, and most of them were statistically significant at the 0.05 level or better. The coefficient of public pension expenditures had a positive sign, as expected, and was statistically significant at the 0.01 level. This indicates that the likelihood that a nation will privatize its pension system does indeed increase as its public pension spending rises. The substantive effect of this variable is powerful. The probability that a nation will privatize its pension system is less than 2 percent if all variables are held at their means. However, a one-standard-deviation increase in public pension expenditures from 5.1 percent of GDP to 9.5 percent of GDP (holding all other variables at their means) boosts the probability that a nation will privatize its pension system from less than 2 percent to 39 percent.

The variable that measures the ruling party's share of seats in the legislature was also positive and statistically significant at the 0.05 level. This suggests that, as expected, the probability of pension privatization rises as the ruling party's control of the legislature increases. The substantive effect of this variable is somewhat weaker than the public pension spending variable. If the ruling party's share of legislative seats is increased by one standard deviation from its mean (from 49 percent to 71 percent) and all other variables are held at their means, the probability that a nation will privatize its pension system rises from 2 to 12 percent.

The regional dummy variable for Latin America was also positive and statistically significant at the 0.01 level, indicating that, other things being equal, Latin American nations are more likely to privatize their pension systems. This study has argued that the Latin American bias toward pension privatization is largely a result of regional diffusion of the Chilean model, but other factors that are unaccounted for in this analysis might also lead Latin American nations to want to privatize their pension systems. The Latin America dummy variable had a strong substantive effect on the likelihood of pension privatization. If we increase this variable by one standard deviation from its mean and hold all other variables at their means, the probability that a nation will privatize its pension system rises from less than 2 to 21 percent. Other things being equal, Latin American nations have a 69 percent probability of privatizing their systems.

Table 1. Determinants of Pension Privatization Around the World

	Model 1 (binary probit)	Model 2 (binary probit)	Model 3 (binary probit)	Model 4 (binary probit)	Model 5 (ordered probit)
Constant	-7.749** (-3.154) <sup>a</sup>	-7.550** (-2.972)	-3.015* (-2.416)	-7.715** (-3.038)	-3.403** (-2.999)
Public pension spending (as percent of GDP)	0.423** (3.030)	0.481** (3.109)	0.243** (3.248)	0.482** (3.159)	0.162** (2.822)
Gross domestic savings (as percent of GDP)	-0.036 (-1.448)	-0.102* (-2.241)	-0.079* (-2.271)	-0.101* (-2.184)	-0.072** (-2.591)
Ruling party's share of seats in legislature	0.045* (2.453)	0.053** (2.622)	0.030* (2.152)	0.055** (2.661)	-0.295* (2.370)
Latin America	3.359** (3.213)	3.600** (3.254)	2.600** (3.580)	3.774** (3.237)	1.847** (3.387)
World Bank pension reform mission	2.621** (2.932)	3.006** (2.973)		2.700* (2.432)	1.631** (2.997)
World Bank loans/GDP			2.241 (0.408)		
Economic recession				0.383 (0.549)	
Number of observations	82	81	81	81	81
Percent correctly predicted	91.5	96.3	83.9	95.0	82.7
Log likelihood (at convergence)	-18.061	-15.453	-24.516	-15.303	-29.734
Log likelihood (initial)	-56.838	-56.145	-56.145	-56.145	-69.366

\* &lt; .05; \*\* &lt; .01 (two-tailed t-tests)

<sup>a</sup>t-statistics in parentheses

The World Bank pension reform mission variable also had a positive sign, and its coefficient was statistically significant at the 0.01 level, which indicates that countries that host World Bank missions are more likely to privatize their pension systems. Its substantive effect was also

relatively large. *Ceteris paribus*, nations that host World Bank pension reform missions have an approximately 20 percent likelihood of privatizing their pension systems, as opposed to a minimal likelihood for those countries that do not host pension reform missions.

The relationship between World Bank pension reform missions and pension privatization is at least partly endogenous—that is, some governments request World Bank missions because they intend to privatize their pension systems. Interviews with World Bank staff members and Latin American policymakers, however, suggest that the causal relationship also runs in the other direction—the World Bank pension reform missions are at times able to persuade reluctant policymakers to privatize their systems. For example, neither the Argentine government, the Costa Rican government, nor the Mexican government was fully committed to privatizing its pension system when it invited the World Bank to establish pension reform missions in the country. In all three cases, the World Bank missions put pension privatization at the forefront of the policy agenda and helped pave the way for subsequent administrations to carry out the privatization schemes.

The one variable that did not perform as well as expected was the domestic savings rate variable. The coefficient of this variable had a negative sign, as predicted, but it was not statistically significant at conventional levels. The lack of statistical significance of this variable, however, is because of a single outlier, Albania—and there are strong theoretical reasons for excluding Albania from the analysis. Albania suffered from a great deal of political and economic instability during the 1990s, which made it difficult to privatize the nation's pension system. This may explain why the country did not do so even though it presumably had substantial economic incentives, given its extraordinarily low domestic savings rate (–16.3 percent) during that period.

As model 2 of the table shows, if we exclude Albania from the analysis, the domestic savings rate variable achieves statistical significance at the 0.05 level. (Excluding Albania has only a minimal effect on the other variables.) Even excluding the Albanian case, the substantive effect of the domestic savings rate is modest. If we decrease the domestic savings rate by one standard deviation from its mean (from 21.4 percent to 12.4 percent) while holding all other variables at their means, the likelihood that a nation will privatize its pension system rises from less than 1 percent to 6 percent.

To test alternative explanations of pension privatization, the statistical model was reestimated with a number of additional variables. The first of these was a variable that measured the value of World Bank loans (as a percentage of GDP) to each country between 1990 and 1998, so as to test whether the World Bank's influence was based on the financial inducements it could offer instead of the bank's ability to persuade pol-

icymakers of the merits of pension privatization.<sup>13</sup> The assumption was that if the World Bank had influence principally because of the financing it provided, the likelihood that a country would privatize its pension system would rise as the amount of World Bank loans increased. As model 3 indicates, a statistical analysis provides little support for this alternative hypothesis.<sup>14</sup> Although the World Bank loan variable had the expected sign, it did not approach statistical significance. Moreover, the explanatory power of the model declined significantly when this variable, instead of the World Bank pension mission variable, was included in the analysis. This finding provides support for the hypothesis that World Bank influence is more ideational than material in nature.

Second, a statistical test was conducted to see whether economic crisis, either in the 1980s or the 1990s, had a significant effect on the likelihood of pension privatization. Economic crisis was initially measured by whether a country had experienced hyperinflation (measured as an annual inflation rate of more than 100 percent) or a serious economic recession (measured as a downturn of more than 5 percent of GDP in a single year) at any point between 1980 and 1998.<sup>15</sup> Additional tests examined whether pension privatization was correlated with the average inflation rate or the average growth in GDP between 1990 and 1998. All these variables had the expected sign, but none of them proved to be statistically significant at conventional levels. (Model 4 of the table presents the economic crisis dummy variable.) These findings suggest that economic crisis has, at best, a weak relationship with the likelihood of pension privatization. Nevertheless, economic crisis may affect the probability of pension privatization indirectly through its effect on some of the other variables.

## **DETERMINING THE SCOPE OF PRIVATIZATION**

The preceding analyses suggest that the aforementioned variables affect the likelihood of pension privatization, but do they also increase the scope of privatization? To examine this question, the dependent variable was reformulated, assigning a score of 2 to countries that fully privatized their pension systems between 1990 and 2000, 1 to countries that partially privatized their pension systems, and 0 to countries that did not enact any type of pension privatization scheme during this period. Model 5 of the table presents the results of an ordered probit analysis with the reformulated dependent variable.

All the variables remain statistically significant, but only the Latin America and domestic savings rate variables achieve higher levels of statistical significance in the ordered probit model. (The coefficients from the binomial probit and the ordered probit models are not strictly comparable, however.) More important, only the Latin America variable sig-

nificantly increased the likelihood of full-scale pension privatization in the ordered probit model, and even then the impact was modest. According to a simulation based on the ordered probit results, Latin American countries are 10 percent more likely to privatize fully their pension systems than non-Latin American countries (holding all other variables at their means), presumably because the influence of the Chilean full privatization model is greater in the region.

The other variables included in the analysis do not appear to increase the scope of pension privatization. It can be argued that one of these variables, the level of public pension spending, will actually tend to reduce the scope of pension privatization, largely because the medium-term costs of pension privatization are quite high for countries with high public pension expenditures. The transition costs are particularly large for such countries because they tend to have a greater number of retirees whose pensions must continue to come from the state after the pension system is privatized. They also tend to have more elderly workers who may need to be compensated for their past contributions to the public pension system. Countries with high levels of public pension expenditures are therefore much more likely to opt for partial privatization.<sup>16</sup> By only partially privatizing the pension system, the government may continue to collect a portion of the contributions that were traditionally paid to the public system. (Under full privatization, the state typically forgoes these revenues entirely.) The payroll taxes that the state collects can be used to finance partially the pensions of current retirees, which makes the fiscal burden of such reforms more manageable.<sup>17</sup>

Whereas the transition costs of pension privatization are quite large for countries with high current public pension expenditures, they are considerably smaller for countries with low public pension expenditures. Countries with low pension expenditures thus enjoy what Pei (1995) has termed an "advantage of backwardness": sweeping reform is easier in these countries because their pension systems are still relatively undeveloped. These countries are therefore much more likely to opt for full privatization if they choose to privatize their pension systems at all.

Another variable that has constrained the scope of pension privatization is the degree of democracy (Mesa-Lago 1997; Mesa-Lago and Müller 2002). Authoritarian regimes are no more likely to choose to privatize their pension systems than democratic regimes. Indeed, if a variable measuring the level of democracy is included in the probit model, it does not achieve statistical significance. Authoritarian regimes nevertheless are more likely to carry out full-scale pension privatization when they do choose to privatize their pension systems.

In a democracy, by contrast, privatizing the pension system typically requires the consent of numerous political actors, from legislators to particular powerful interest groups. Sweeping pension privatization

Table 2. Determinants of Degree of Pension Privatization

	Degree of Democracy <sup>a</sup>	Public Pension Spending (as percent of GDP)
Partial Privatizers		
Argentina	2.5	6.2
Bulgaria	2.5	7.3
Colombia	3.0	1.1
Costa Rica	1.5	3.8
Croatia	4.0	11.6
Estonia	1.5	7.0
Hungary	1.5	9.7
Latvia	1.5	10.2
Macedonia	3.0	8.7
Poland	1.5	14.4
Sweden	1.0	11.4
United Kingdom	1.5	8.3
Uruguay	2.0	15.0
Average	2.1	8.2
Broad Privatizers		
Bolivia	3.0	2.5
Chile	6.0	5.6
Dominican Republic	2.5	0.4
El Salvador	3.0	1.3
Kazakhstan	5.5	5.0
Mexico	4.0	0.4
Nicaragua	3.0	4.3
Peru	5.5	1.2
Average	4.1	2.4

<sup>a</sup>Scale based on the Freedom House index of civil and political rights, ranging from 1 (most free or democratic) to 7 (least free or democratic).

Note: Scores correspond to the year the pension system was privatized or the nearest year for which data are available.

Source: Palacios and Pallarès-Miralles 2000; Gastil 1985–2000.

plans are therefore likely to get watered down in democratic regimes, which is exactly what occurred in Argentina, Colombia, and Costa Rica, among other countries. In authoritarian regimes, interest groups often have little ability to affect public policy, and authoritarian legislatures are typically “rubber stamp” institutions, if they exist at all. As a result, authoritarian or semiauthoritarian regimes that have sought to implement full-scale pension privatization measures have typically been able to do so with relatively little difficulty. Such was the case in Chile, Kazakhstan, and, to a lesser extent, Peru and Mexico.

Table 2 presents some evidence in support of the aforementioned hypotheses. As the table indicates, the countries that opted for sweeping privatization measures had an average score of 4.1 on the Freedom House index of civil and political rights while the countries that only partially privatized their systems had an average score of 2.1, which suggests that broad privatization measures may be more likely to take place under regimes that restrict civil and political liberties (Gastil various years).

The difference between the two groups of countries is even more glaring with regard to public pension expenditures. Public pension expenditures represent, on average, only 2.4 percent of the gross domestic product of those countries that fully privatized their pension systems, but they average 8.2 percent of gross domestic product in those countries that have opted for partial privatization. This suggests that sweeping privatization measures may also be more likely to take place in countries with relatively low public pension expenditures.

## CONCLUSIONS

This article has argued that a specific set of economic concerns, rather than economic crisis in general, has contributed to the wave of pension spending in Latin America and around the world. The specific concerns include limited access to capital and the growing economic burden of public pension expenditures. Many countries have opted to privatize their pension systems in the belief that such measures would boost their sagging domestic savings rates and solve the long-term financial problems of their public pension systems. There is no clear-cut evidence, however, that pension privatization will resolve either of these economic problems. Why, then, did so many policymakers believe that pension privatization would yield major economic benefits?

This study maintains that the Chilean model and the World Bank have been particularly influential in forming beliefs about the economic efficacy of pension privatization. The sharp rise in Chile's domestic savings rate in the late 1980s and the strong financial performance of the country's private pension system helped persuade many policymakers that pension privatization would boost their domestic savings rates and resolve the long-term financial problems of their pension systems. The Chilean model was particularly influential in Latin America because Latin American policymakers were more familiar with the Chilean model and more likely to think it relevant to their own countries. The World Bank, meanwhile, constantly championed the economic benefits of pension privatization and used its considerable financial and technical resources to help persuade policymakers to privatize their systems. The World Bank has been particularly influential in those countries where it has had pension

reform missions because the missions have granted the bank extensive access to key policymakers and technical data.

The article thus shows that ideas play a crucial role in policy choice. For any given economic problem, a variety of possible policy solutions typically exist. Ideas not only determine the range of possible policy solutions but also suggest, correctly or incorrectly, the costs and benefits associated with each type of policy solution. Ideas thus suggest to policymakers what they ought to do to maximize their interests in an uncertain world. The challenge for theorists of ideas is to show how and where ideas matter. This article has suggested that the local salience of an idea and the power of its promoters often play a crucial role in determining whether an idea takes hold. Where policy ideas have high visibility and influential advocates, they are likely to be enacted, regardless of the merits of the ideas themselves.

## NOTES

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1. Pension privatization is defined here as the partial or complete replacement of a publicly managed pension system with a privately managed system. By definition, this excludes add-on schemes that create new private pension schemes without reducing the scope of the existing public pension systems.

2. For an expanded version of this argument, see Madrid 2003.

3. This risk is reduced to the extent that the pension funds invest abroad. Most of the countries that have privatized their pension systems, however, have placed low limits on the funds that can be invested in other countries.

4. The Chilean model did not become the object of envy until the end of the 1980s, largely because the dramatic increase in Chile's savings rate did not occur until the late 1980s. By this time, the Chilean private pension system had also been achieving high returns for a long time.

5. To date, no democratic government has privatized its pension system by decree. Even democratic leaders who enjoy decree powers have preferred to seek legislative approval for the reform measures, so as to give the private pension systems a solid legal foundation.

6. Unfortunately, the absence of annual data for many of the variables under study precluded a cross-sectional time series analysis.

7. This includes all countries that the World Bank publication *World Development Indicators* lists as having a gross domestic product per capita of more than two thousand dollars in 1995. See World Bank 2000.

8. The countries that enacted privatization schemes during this period were Argentina, Bolivia, Bulgaria, Colombia, Costa Rica, Croatia, El Salvador, Hungary, Kazakhstan, Latvia, Macedonia, Mexico, Nicaragua, Peru, Poland, Sweden, and Uruguay. Including in the sample the countries that privatized their pension systems during the 1980s does not significantly change the results. Nor do the findings change significantly by including the countries that added private pension schemes to their existing public pension schemes.

9. The public pension spending data come from Palacios and Pallarès-Miralles 2000 and World Bank 1994.

10. The domestic savings rate data were culled from World Bank 2000.

11. Data on World Bank pension reform missions come from Schwarz and Demirgüç-Kunt 1999.

12. These data come from the *Europa World Year Book* 1985–2000..

13. Data on World Bank loans come from World Bank 2000.

14. Using data from World Bank 2000, two alternative measures of World Bank influence were tried: debt service payments as a proportion of total exports in 1995, and external debt as a proportion of gross domestic product in 1995. Neither of these variables achieved statistical significance. Debt service payments/GDP had a coefficient of .039 and a standard error of .033, and external debt/GDP had a coefficient of -.037 and a standard error of 1.222. Inclusion of these variables did not qualitatively change the overall results.

15. These data come from World Bank 2000. Data were not available before 1990 for a number of countries in the sample.

16. Countries with high pension expenditures may also try to reduce the costs of privatization by declining to compensate workers for the past contributions to the public pension system or renegeing on other pension commitments.

17. In mixed systems, the social security contributions that the state collects will also eventually be used to pay a basic pension to future retirees, but in the near term these payments will be minor, which makes the transition from a public system to a mixed system considerably easier.

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