PART I

RECASTING THE DEBATE OVER PENSION PRIVATIZATION

Cambridge University Press
978-0-521-70149-5 - Social Protection and the Market in Latin America: The Transformation of Social Security Institutions
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Excerpt
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1

Welfare State Transformation

From Social Protection to the Market

> It is not possible to get the government out of the pension business.
>
> – Nicholas Barr (2002) "The Pensions Puzzle"

The "revolution" began quietly and without ceremony on the fourth of November 1980 in the unassuming South American capital of Santiago, Chile. On that day the military dictatorship led by General Augusto Pinochet published Decree Law 3500, abolishing the nation's state-run pension system and replacing it with a private system based on individual retirement accounts. Under the new "privatized" pension system, Chilean workers would no longer contribute to a national social insurance program for retirement, nor were pension benefits defined as a percentage of working income and guaranteed by the state. Instead, workers are required to contribute a fixed share of each paycheck to individual retirement accounts managed by private firms. At retirement, the average wage earner in Chile will lay claim to a pension based on his or her accumulated savings, and the return – be it positive or negative – to those invested funds.[1]

For the architect of this reform, José Piñera, Chile's pension privatization issued the opening salvo in a "world pension revolution."[2] Indeed, this upheaval has proved to be neither a merely local phenomenon nor inconsequential in its transformative ambitions and implications.[3] Not only did the fires of pension privatization ignite throughout Latin America in the 1990s, but the movement fanned across Europe as well, from Scandinavia to Central Asia. By 2006, pension privatizations of varying degrees had been implemented in twenty-six nations on five continents. Although reforms as drastic as Chile's

[1] For workers who have contributed for at least twenty years but have failed to save enough to finance a minimal retirement pension – approximately a quarter of the average wage – the Chilean government provides a means-tested guarantee to top-up the balance of qualified workers' accounts.

[2] Piñera 2001.

[3] See Piñera 1996; also see, Borzutzky 2002; Castiglioni 2001; Kurtz 1999.

have been exceptional even in Latin America, it is no less remarkable that workers in as dissimilar countries as Sweden and Kazakhstan would apportion *any* share of their state-mandated old age savings – much less all of it as in Kazakhstan – to competing private pension fund managers. In Latin America alone, by the end of 2006 more than 73 million people were enrolled in the region's private pension fund industry with more than US$136 billion in retirement assets under private management.

How did such radical transformations of old age pension systems come about? Why have some countries privatized, but not others? And why, among privatizing countries, did some adopt deeper institutional changes than others? These questions guide this book. The goal of the analysis is not only to understand shifts in retirement income programs, which are important, but also to use pension privatization as a window through which to explore the theoretical puzzle of institutional change. Specifically, I am concerned with institutional change of a specific type: where transformation entails a departure from the long-established and stable "path" of institutional development. In the case of old age pensions, such "path departure"[4] involves a shift from programs that pool risk, bind fates, and join disparate citizens in a common social project of insuring against poverty in old age, toward institutions through which individuals by themselves bear increasing responsibility for protection against the risk of old age poverty. The premise of this study is that the changing structure of risk protection inhering in old age pension privatization marks a sea change in the organizing logic of the welfare state, and thus of the very ends of state action in the social policy realm. This institutional change has been attended, moreover, by a fundamental shift in the paradigm governing pension institutions, from one based on the ideals and objectives of social protection to one based on the principles and instruments of the market. Thus it is a change that is as much political as it is economic in its implications. And the societal and distributional consequences cannot but be profound.

The transformations brought by pension privatization thus are meaningful in political, social and economic terms. For scholars of political economy and institutions, the number, location and diversity of private pension reforms present critical theoretical puzzles. Long considered the archetype of stable path-dependent institutions, pension systems are known to be subject to powerful stabilizing forces that make significant structural change ever more unlikely over time.[5] Understanding how a self-reinforcing institution such as this becomes subject to fundamental change through processes that are not solely exogenous has long eluded scholarship on the welfare state. Such an inquiry may lend critical insight into enduring theoretical puzzles about how institutions change, while addressing a recurrent dilemma of modern capitalism: how basic social contracts are revised and thus the dividing line moved between individual and collective responsibility for well-being.

[4] Hering 2003.
[5] Myles and Pierson 2001; Pierson 2000a.

RECASTING THE QUESTION OF PENSION REFORM

An ineluctable feature of social insurance pension systems is that they must be periodically revised.[6] Indeed, the inexorable shifts of demographic and economic tides dictate that this is so. The question of pension reform thus is not *whether* existing institutions will change but rather *how* such change will be effected. When faced with the challenge of demographic and economic shifts, governments thus have a choice: either make incremental revisions within the extant paradigm of social insurance or undertake more fundamental reform in the instruments and ends of the institution, such as through privatization. Both options can realign pension system revenue and liabilities so as to accommodate demographic and economic change.[7] Whereas parametric revisions to the existing program typically entail an increase in contributions or cuts to old age benefits, privatization involves the shift from a defined-benefit (DB) formula to a defined-contribution (DC) regime, where each worker saves for his or her own retirement in a (typically) privately managed and fully funded pension account. In DC systems, only the rate of contribution to individual pension accounts is fixed by law; the value of old age pensions is determined by the accumulation of funds during working life, and the return on invested funds. Uncertainties over retirement income thus are transferred from the state to individuals.

Why do governments privatize? Pension privatization has been touted as a policy that is good for the state, the economy, and the individual. Advocates of this reform point to the close link between individual contributions and benefits as a way to transfer the rising costs and risks of pension provision from states to individuals, and thus to correct financial imbalances and reduce state pension liabilities in the long term.[8] These were among the arguments advanced by the World Bank in the 1990s as it endorsed privatization as a way not only to cope with demographic change but also to achieve desirable macroeconomic ends.[9] Individual retirement accounts thus came to be viewed not simply as a social policy concern but also as a tool to enhance labor market flexibility, deepen capital markets, raise domestic savings, and spur macroeconomic growth. For their part, workers were enticed with ownership and control of retirement funds, and the opportunity to achieve higher rates of return on pension contributions. Although each of these claims is fiercely contested, vocal advocates of privatization and market-oriented reform have

6 Most social insurance pension systems are organized as defined benefit (DB) schemes, wherein a worker's retirement pension is set typically as a percentage of working income. By their design, DB pensions must be adjusted periodically in response to changes in the program's liabilities and revenue from payroll contributions and taxation. Whereas gains in longevity raise state liabilities, slowing growth and declining fertility curtail program revenue, necessitating periodic adjustment of these parameters to restore actuarial balance.

7 Diamond 1999.

8 Feldstein 1995; James 1996; Palacios and Whitehouse 1998.

9 World Bank 1994.

emerged in nearly every corner of the globe, inserting privatization into the center of political debate. The possibility of pension privatization reaching the political agenda thus extends as far as the market itself. As such, the fundamental political question of pension privatization is not why governments seek to privatize but rather why and how, given the dramatic implications and fierce contestation to which such reforms are subject, some privatization efforts prevail?

WHAT PRIVATIZATION IS AND IS NOT

While the shift to private management of old age pension funds in such disparate and unlikely countries as Sweden, Kazakhstan, and Bolivia is striking, it is not the "privateness" per se that makes this reform a fundamental institutional departure. For social protection and private provision are not antinomies. Indeed, social protection was at its very origin a private sector issue. The notion that social protection can or should be provided by non-state actors thus dates to the very earliest pension systems, which were organized by guilds and fraternal orders. But these primordial forms of social insurance – based in mutual aid and friendly societies – obeyed a markedly different logic than contemporary privatized pension systems do: They represented a *collective* means of countervailing insecurity, of pooling risk, and of tying fates. They rested upon the principles of mutuality and shared burden rather than on individualization or the logic of the market.[10] The privateness of social protection thus has been a defining feature of this category of institutions for most of its history.

Social protection only came under the purview of the state following the industrial revolution, when large-scale urban migration tore workers away from the safety nets of family and social relations in the countryside, making risks such as old age poverty into a *social* problem, rather than an individual one.[11] The state's assumption of substantial responsibilities in pension provision did not significantly alter the instruments or principles of risk-pooling, however; it merely applied these to an ever-larger community.[12] Nor did the state usurp altogether the function of risk-pooling from the private realm. Rather, the public and private forms of social protection long existed as compliments.[13] Privateness – the reliance on nonstate actors to administer old age income – thus is *not* the feature of this institutional change that necessarily transforms its essential logic, nor is it what makes pension privatization so revolutionary.

Nor is the real story of privatization found in the ostensible retreat of the state from the pension business.[14] Far from being consigned to redundancy,

[10] Ball 2000, p. 12; Gilbert 1983, p. 6.
[11] Frieden 2006.
[12] Baldwin 1990; Rubinow 1913.
[13] Gilbert 1983, p. 8; Hacker 2002.
[14] This claim contrasts, for instance, with Madrid's premise in *Retiring the State* (2003).

privatization demands that the state remain intimately involved in the creation and sustenance of the private pension market, for which it becomes the ultimate guarantor. In this sense, there is no respite for the state following privatization, as government regulations necessarily extend into almost every aspect of the private pension business. The state must establish and enforce fiduciary standards, guard against excessive risk-taking, provide citizens with information, and ensure the transparency of pension market transactions. State institutions often participate in these markets as well, providing collection and record-keeping services, and in some cases even establish pension funds that compete alongside private firms to manage individual retirement accounts.[15] Thus while the quotation from Barr at the opening of this chapter may seem paradoxical for a study of the politics of pension privatization, the inextricability of the state from the pension business may quite possibly be the closest thing to an iron truth of pension reform. Pension privatization thus is not about the *retreat* of the state from social protection; it is about the state's transformation.

Instead, the critical upheaval occurring through pension privatization is the transformation in the structure of risk protection: from a system that pools risk to one that individualizes it through self-insurance. Along with this shift is a change in the institution's broader organizing principles, from that of social protection to the ideals of the market. The concepts and underlying logics of social protection and the market could not be more different.[16] Under systems of social protection, risks are pooled, and coverage is offered irrespective of actuarial status. Risk-pooling, at its base, is thus a form of redistribution. As Baldwin has observed, it is a system of reapportioning mischance from those who are less risk-prone and advantaged by markets to those who are less fortunate and unable to bear alone the array of risks inhering in market-based society.[17] Whereas social protections *redistribute* the cost and risk of protecting against poverty, market-based systems *individualize* them, returning the cost and risk of income loss to the shoulders of each worker, who must bear these, increasingly, alone. The operating rule of the market is thus much simpler than that of social protection: You get out according to what you put in; each quid is returned with a quo.[18] Market-governed forms of income protection thus link the value of an individual's lifetime contributions tightly to his or her old age income. Risk protection in markets is apportioned by purchasing power, such that your security in old age is determined by the amount of coverage you buy for yourself with lifetime savings, regardless of differences in the ability to save.

Social protection and the market also represent starkly opposing ways of organizing human relations. Whereas market systems take the individual as their basic unit, social protection embraces an organic view of society, seeing

15 Kay 1999.
16 Polanyi 1957.
17 Baldwin 1990.
18 Lindblom 2001, p. 111.

its members as part of a connected whole. In markets, relationships are, at least in principle, based on unfettered, voluntary exchange; by contrast, state authority and normative order connect people in social protection schemes. Markets organize risk and preclude any guarantee of outcome; they secure for all participants, regardless of heritage or status, the chance to compete in the arena of exchange. To some takers of risk, the market lavishes rewards of great profit, but to others it issues massive loss. Social protection, by contrast, treats individuals differently in the service of shared ends. Through risk-pooling, social protection strives to countervail the vicissitudes of the market system, allaying these forces with measures to dissipate risk and share reward.

Like the organizational yin and yang of capitalist society, the principles of social protection and the market express at once a fundamental opposition, but also reciprocal dependence. Social protection offers the hope of rest from the toil and insecurity of wage dependence, limiting to some degree the precariousness of income and consumption in market economies. Where markets apportion risk protection, disparities in income and chance are largely reproduced and extend into old age. Despite such diametric opposition, social protection *needs* the market. Not only does it derive its existence from the centrifugal market forces, but the affluence generated by economic exchange provides vital sustenance for social protection – making significant forms of redistribution possible in the first place.[19] Social insurance, in turn, enhances the functioning of markets by broadening the range of tolerable economic activities in which an individual may engage, from innovating to acquiring new skill.[20] Thus while representing fundamentally conflicting logics and institutional forms, social protection and the market would become essentially lifeless without each other.

FROM SOCIAL PROTECTION TO THE MARKET: DEFINING STRUCTURAL CHANGE

The significance of the shift from social protection to the market in old age pension systems rests upon a view that risk protection, and specifically risk-pooling, is a central goal of the welfare state.[21] Of course, the objectives and instruments of social provision are diverse and have varied markedly over time, from the development of human capital through education and health care, the assurance of social peace and response to claims for justice and equality through cash transfers.[22] For Esping-Andersen, however, many other welfare state goals, such as equalization, in fact derive from "what is and always was

[19] Carroll 1987.
[20] Economic theory thus provides firm grounds to justify mandatory social protections. See Creedy and Disney 1985, pp. 16–18; Feldstein 1998.
[21] Baldwin 1990; Esping-Andersen 1999; Mares 2003; Taylor-Gooby et al. 2004.
[22] Moon 1988, pp. 44–5; Offe 1984, p. 195; Wilensky 1975, p. 15.

the foremost objective behind social policy, namely insuring the population against social risks."[23] Indeed, various forms of social insurance respond to one of the most pressing and ineluctable features of modern industrial – and postindustrial – society, namely, the aspiration for security against the risk that one's standard of living may be eroded by income loss due to sickness, accident, old age, or death of the family breadwinner. Of course, welfare states manage risk differently in every national circumstance and across different social policy areas according to the nature and incidence of the risk. They all, however, rest upon some objective of reapportioning social risks broadly across society. For Esping-Andersen, therefore, differences across welfare regimes reside not in *whether* there is pooling but rather in the *way* that risks are pooled.[24]

The view that risk-pooling is a central element of the welfare state provides the theoretical premise of this study: that the changing structure of risk-pooling that occurs in pension privatization constitutes a shift in the *ends*, and thus in the nature of the welfare state itself.[25] Some risk-pooling is inherent, of course, in any pension system that is sponsored by the state. Thus the shift from social protection to the market should be understood in terms of degree of structural shift along a continuum between the dominance of risk-pooling instruments and those of market governance.

RETRENCHMENT VERSUS RESTRUCTURING

The preceding claim that privatization is not so much a retreat of the state as it is its transformation suggests that as an empirical strategy, the commonplace search for evidence of state contraction through declines in social spending may fail to capture the pivotal structural transformations at issue in pension privatization. Other data are needed. For it is entirely possible that welfare state spending may remain constant or even increase while the underlying risk-pooling functions are eviscerated by privatization. The result would be the arrival at misleading conclusions of program stasis when fundamental change has occurred. Examining the overall size of the welfare state thus may fail to capture the essential structural transformation in risk protection: as Schwartz put it, "It is not the welfare state that has been killed but rather social protection."[26]

Most critically, the view of pension privatization as a withering of the state fails to capture the *creative* dimension of this project, which revolves around the establishment of new forms of market relations and property rights. Pension privatization is more than simply a process of taking away benefit

[23] Esping-Andersen 1999, p. 32. Other precepts such as equal social citizenship also may be subsumed within the concept of risk-pooling. See Baldwin 1990; Marshall 1964.
[24] Esping-Andersen 1999, p. 33.
[25] Green-Pedersen 2002; Hinrichs and Kangas 2003.
[26] Schwartz 2001.

guarantees and risk-pooling; it is an extension of state authority and of concepts of private ownership. Viewing pension privatization as an extreme form of retrenchment, or strictly as a *loss* of property rights, thus will invariably fail to capture the broader story and political possibilities embedded in the *transformation* from one form of socially constructed rights to another. Whereas the loss of benefit rights – to the extent that they are observable – is always unpopular, acknowledging the additional fact that privatization creates *new* areas of market operation permits a broader range of theoretical insights. For instance, the view of privatization as a multidimensional project thus allows scrutiny of the opportunities for politicians to seek, and sometimes even to win, political credit for expanding distributive benefits such as greater private investment options, choice and (putative) control of retirement income through privatization.[27] When politicians do this effectively, they can obscure the extent of losses that are simultaneously imposed by the curtailment of risk-pooling structures through privatization.

My analysis thus emphasizes two politically relevant dimensions of pension privatization: The first is *retrenchment*, involving cutbacks in state benefit guarantees and risk-pooling, and the second is *distributive*, encompassing the creative elements of privatization and the possibilities for individual gain. The existence of the second, creative, dimension sets the politics of pension privatization apart from that of retrenchment alone. For the creative elements of this reform are typically advanced under the mantle of expanding ownership, control, choice, and freedom and of increasing rates of return to old age pension contributions. These concepts are more than merely political slogans; they constitute real possibilities for reward and distributive advantage for those who can benefit from "going it alone" rather than from sharing broadly the risk of mischance and poverty in a market economy.

Although privatization upends the usual set of winners and losers in social protection, distributional advantage under privatized pension systems is often not apparent ex ante. Most citizens are unfamiliar with the stochastic properties of private capital markets or the relationship of interest rates and bond prices, the principles of annuitization, or their ideal position on the risk and reward frontier. Such uncertainty opens vast possibilities for strategic political actors to reconstitute political alliances in ways that cross-cut traditional income and power resource lines. The manipulation of perceptions of distributive advantage thus opens up vast new possibilities for reform-seeking governments to win – although not necessarily to sustain – public support for pension privatization. Whether political conflicts are organized around the distributive or loss-imposing dimension of pension privatization is therefore likely to have a critical bearing on the nature and outcome of contests over this reform. Which aspect will dominate political debate is not given ex ante; rather, it is an outcome of political conflict.

[27] Bonoli 2000; Esping-Andersen 1990; Kitschelt 2001; Pierson 1994, 2001; Schwartz 2001; Starr 1989, pp. 28–9.

THE ARGUMENT

This study seeks to explain the transformation of social protection institutions by analyzing three analytically distinct but interrelated arenas through which any reform must progress. The first examines the effect of economic integration on pension reform in the technocratic decision-making process. For it is in this realm that macroeconomic objectives and constraints are most directly weighed in the institutional design. Research on social welfare reform has widely viewed globalization as a source of inexorable downward pressures on state social insurance programs, especially in the developing world. I challenge this view by arguing that it is *not* the most economically open, capital-scarce countries that are more likely to privatize old age pensions. Nor should globalization be viewed as a source of strictly downward pressure on social protection. Rather, I argue that globalization has generated both incentives *and* constraints for governments seeking to restructure old age pension systems. Globalization's effect, in this sense, is to place reform-seeking governments in a double bind, with the consequence of impeding or constraining movements toward more market-oriented pension designs in the most capital-scarce nations. This is because even though global financial integration has heightened the attraction to privatization as a means to achieve long-term macroeconomic goals, it has also raised the risk of punishment – via capital flight – for governments that overstep their financial means in the short term, even if they do so in the service of long-term market-oriented reform. Government policy makers in open, capital-importing nations thus may respond to these short-term market risks by advocating that their governments curtail, if not forego altogether, the decision to privatize.

My second argument examines the process through which government leaders seek public consent to structural pension reform; that is, how they "sell" reform to society. Pension reform has long been viewed as a politically lethal endeavor for career-minded politicians. Indeed, the willingness of program beneficiaries to punish politicians for imposing losses has long been seen as providing an essential political feedback to social welfare programs that prevents radical shifts from the existing institutional path.[28] As pension systems grow in generosity and coverage, this view suggests, the prospects for radical change become ever more remote. But increasing evidence of public acquiescence, if not support, for pension privatization in democratic settings demands a reconsideration of this conventional wisdom. The approach to explaining fundamental institutional change in research on path dependence has generally been to examine how exogenous factors such as war, depression, or crisis overwhelm one set of self-reinforcing institutional feedbacks and reconstitute a wholly new path of development.

My argument takes a different approach, which is to look *within* the forces of institutional stability to understand how and when these may permit, or

[28] See, e.g., Pierson 2001.