

# **Pension Reform in the English-Speaking Caribbean**

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## **Working Paper**

*This working paper is being published with the sole objective of contributing to the debate on a topic of importance to the region, and to elicit comments and suggestions from interested parties. This paper has not gone through the Department's peer review process or undergone consideration by the SDS Management Team. As such, it does not reflect the official position of the Inter-American Development Bank.*

This chapter reviews the main issues of pension reform and identifies principles for action in the Caribbean. It also analyzes the role of multilateral development banks—particularly the Caribbean Development Bank and the Inter-American Development Bank—in the reform process.

The next section reviews the literature on pension reform. After that the chapter identifies reform themes and issues that are attracting attention worldwide. It then analyzes the main aspects of the reform experience in Latin America, pointing out how expectations that capital market development would solve some of the problems of funding retirement have not been realized. The chapter goes on to describe pension systems in the Caribbean, then details principles for pension reform and illustrates the political factors that affect it. The conclusion considers the role that multilateral development banks can play in the region's pension reform efforts.

### **Brief Literature Review**

The adoption of market-oriented economic policies coupled with the forces of globalization has severely tested the ability of governments to meet the costs of welfare systems (see Reich 1991; Cox 1997; Greider 1997; Gray 1998). Globalization implies more competition and puts pressure on wages, reducing the basis for contribution in the public sector pillar of pension plans. Rodrik (1997), for example, argues that companies in developed countries can move their operations to other countries where labor costs are lower and unions are weaker, thus putting downward pressure on wages. On the other hand, some authors (Lora and Panizza 2002; Birdsall and de la Torre 2001) suggest that the globalization of financial markets does not preclude governments from pursuing progressive or redistributive programs, nor does it imply the demise of the welfare state (Garrett 1996, 1998; Rieger and Liebfried 1998; Hirst and Thompson 1999).

In Latin America, Chile has been the pioneer in pension reform, dismantling its pay-as-you-go public system in 1981 and replacing it with a defined contribution system managed by private pension fund administrators. The government chose to cover the transition cost from the old to the new system by issuing “recognition bonds.” This approach has been evaluated positively in the literature (Edwards 1998; Piñera 1992, 1999; Kritzer 1996).

While the Chilean model is generally held in high regard, some have pointed to shortcomings in the privatized system. High, regressive administrative costs reduce net returns for contributors (Diamond 1994; Graham 1998; Kay 1997) and distortions have arisen due to marketing costs and penalties for changing fund managers. There is no definitive answer in the literature whether Chilean-style pension reform has contributed to higher savings rates (Edwards 1998; Graham 1998; Kritzer 1996), but there is some consensus that it fostered innovation in the development of the capital market (Queisser 1999) and facilitated labor market flexibility (Graham 1998).

During the 1990s, following Chile's experience, many other Latin American countries fully or partially privatized their social security systems—including Peru in 1993, Argentina in 1994, Uruguay in 1995, Mexico and Bolivia in 1997, and El Salvador in 1998. (See, for example, Cruz-Saco and Mesa-Lago 1998; Mesa-Lago 1997; Peirce 1997; Queisser 1998, 1999; Williamson and Pampel 1998; and Stanton and Whiteford 1998 for descriptions of the main features of these reforms). Many scholars emphasize the shortcomings of the fully funded pension systems. These include high administrative and marketing costs, similar asset allocations (perhaps due to limitations imposed on investments), imperfect worker control over the use of funds relative to individual retirement accounts in the United States (Queisser 1998; Reisen 1997), and regressive results, as reflected in female and low-wage workers benefiting relatively less than highly paid public sector workers (Graham 1998; Quessier 1998; Ayala Oramas 1997; Isuani and San Martino 1998). Above all, pension reform that introduces a strong degree of privatization shifts from the state to individuals the burden of a prolonged depression of stock and financial markets.

### **Global Dimensions of Pension Reform**

Pension reform is high on the agenda of countries around the world, including Brazil, China, Colombia, Czech Republic, El Salvador, Estonia, France, Germany, Japan, Latvia, Lithuania, Slovakia, and the United States. Related articles appear in the press almost daily, addressing a variety of issues:

- In the United States the Social Security and Medicare programs will present future generations with crushing debt unless policymakers undertake serious reform.
- In Germany pensioners will see their disposable incomes fall due to drastic plans to slash 5 billion euros (\$5.9 billion) in state subsidies to the mandatory savings system.
- Changing demographics mean that euro zone countries—which continue to take inadequate, belated approaches to pension reform—will find the task getting harder as growing elderly populations use their voting power to block moves to reduce benefits or raise retirement ages. The battle over pensions will help shape Europe's future.

Around the world, the basic problem facing pensions is that their financial sustainability is eroding because demographic dynamics are raising old age dependency ratios in systems designed on a pay-as-you-go, defined benefit basis. In many countries life expectancy has been rising and fertility rates declining, causing a gradual decrease in the share of the working age population—and raising the specter of what is commonly referred to as the *old age crisis*.

Countries are dealing with this issue differently, often taking several approaches. Policy responses include higher contributions (as in Colombia), lower subsidies (as in Germany), later retirement ages and increased years for contributors to qualify for

pensions (as in Brazil, France, and Italy), and the introduction of multipillar structures, combining publicly financed welfare benefits and privately funded schemes.

The switch from a public pay-as-you-go model to a funded scheme imposes a fiscal burden during the transition, when the flow of contributions falls short of promised pension payments. This burden could have dire macroeconomic consequences—witness Bolivia, where a troubling fiscal imbalance partly reflects the switch to a funded pension system. Almost inevitably, efforts to put pension systems on a financially sustainable path spark deep and sometimes angry political debate—as in France in the summer of 2003, where despite broad acceptance of the need for change, the public showed waning confidence in the government’s ability to implement pension reform.

### **Pension Reform in Latin America and the Caribbean**

For the past two decades Latin America has been in the vanguard of global pension reform. Since Chile reformed its pension scheme in 1981, nine other countries in the region have introduced elements of individual capitalization in their pension systems: Argentina, Bolivia, Colombia, Costa Rica, the Dominican Republic, El Salvador, Mexico, Peru, and Uruguay. These reforms have had three broad objectives.

First, they have aimed at consolidating social safety nets, reducing the threat of sharp income reductions during old age and so alleviating old age poverty. This goal has been especially important due to the shortcomings of the old systems, which had low coverage and were often captured by certain occupational groups that reaped the benefits of the systems at the expense of other professions.

Second, the reforms have pursued microeconomic goals—eliminating distortions that pay-as-you-go systems created in labor markets. The new systems clearly link contributions to benefits, increasing the efficiency of the work and leisure decisions made by workers. Previous systems often treated occupational groups differently, generating rent seeking and additional distortions in labor markets.

Third, the reforms have pursued macroeconomic goals such as increasing savings rates, tackling the implicit debt associated with previous pension systems, developing and widening financial and capital markets, and ultimately accelerating economic growth.

A crucial issue is related to the links between pension system reform and domestic capital markets. The first link is related to the accumulation phase. With the transition toward a fully funded, privately managed system, as assets are built up, pension reform is expected to have a direct impact on the widening and deepening of financial markets. An extensive body of development economics literature has emphasized the importance of the development of financial markets in stimulating economic growth.

Many Latin American countries have identified the transition to a mandatory, privately managed pension system as a means of capitalizing financial markets, and thus of improving overall economic performance. A powerful indicator of the link between

pension reform and financial market development is the volume of funds administered by the private sector under the framework of the new system. Table 13.1 shows the evolution over 1985–2002 of the value of pension assets in Latin American countries that have gone through reform and the value of the stocks traded on their stock exchanges.<sup>1</sup> Some of the data are rather impressive. In Chile, where reform has the longest history, the transformation of the pension system has likely been a key element in the development of financial and capital markets—and ultimately in the performance of the economy since the mid-1980s.

The expectation is that some of the benefits from reform in Chile could also be achieved in other countries in the region. But in most of the other countries the impact of pension reform on capital market development has been marginal at best. In fact, the value of stocks traded on stock exchanges in several Latin American countries indicates that capital market development has not materialized, despite the growth of pension assets. While pension assets have grown, the value of stocks has fallen in many cases. Table 13.2 looks at the growth of pension assets and of stocks traded in a few countries in other parts of the world—the Republic of Korea, Poland, Thailand, South Africa.

Correlations between the value of stocks traded and pension assets for the various countries show that the growth of pension assets is highly correlated with the growth of the stock market in the Republic of Korea (with a correlation coefficient of 0.785). For Latin American countries that have introduced pension reforms with fully funded individual accounts, Table 13.3 shows a high positive correlation in Chile (0.76), but low correlation in the cases of Mexico (0.33) and Brazil (0.19). The low or negative correlations between the two variables suggest that pension assets may have “detracted” from capital market development as most pension funds are invested in government securities. Although investments in government securities could help develop the bond market, which is a building block of the capital market, the fundamental issue remains of creating a diversified portfolio—including private bond and equity holdings, which in turn require a further step in capital market development. Although the time span for observing the impact of pension assets on capital markets is relatively short in this sample (about 10 years), in most Latin American countries capital markets remain weak.

The second link between pension reform and financial markets is during the decumulation phase, which is the payout period when resources are being withdrawn from the system. Under fully funded systems, and in general for privately managed pension funds, variations in financial returns have a direct impact on the pensions paid to retirees. Until a few years ago mature economies such as the United States and Western European countries seemed to be much more concerned about the decumulation phase link between financial markets and pension systems. This was mainly due to demographic factors. With a younger population, Latin American and Caribbean

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<sup>1</sup> Four countries (Bolivia, Chile, El Salvador, and Mexico) have privatized their public pension schemes; six others (Argentina, Colombia, Costa Rica, Dominican Republic, Peru, and Uruguay) have partially privatized them. With respect to the typology of pension systems, one could be more specific and identify four categories: full privatization; parallel public PAYGO and private individual accounts; mixed systems; and PAYGO. Some authors (for example, Mesa-Lago 2003) suggest three categories of pension systems: substitutive, parallel, and mixed.

countries were less affected by the old age crisis, and thus were more focused on raising savings and building up financial markets.

However, in the context of the financial volatility that has affected Latin America in recent years, the decumulation phase link between financial markets and pension systems has become a major concern. In fact, one of the main objections to the new systems introduced in the region has been that they transfer investment risk to individual workers, who are then exposed to the vagaries of financial markets. This has led many to argue that the new personally funded systems are unable to provide satisfactory pension benefits to all retiring workers, thus failing to constitute an appropriate social safety net.

Table 13.4 tells two different stories. One is for average returns of stock markets in some Latin American countries, that is, low or negative returns (with the exception of Mexico) with significant annual volatility that ranges between 20 and 41 percent. The other is for returns of stock markets in the four countries of reference outside the region (the Republic of Korea, Poland, South Africa, and Thailand), which show positive and at times high returns (for example, Korea has an annual return of over 15 percent) and a level of volatility comparable to that of Latin American countries.

Despite the overall long-term positive aspects, certain obstacles need to be addressed to make reforms sustainable. In addition to the capital market issue discussed above, one of the most significant challenges has to do with the transition costs of pension reform. That is, moving from a public pay-as-you-go to a privately capitalized system implies that for a significant period the reform will drain fiscal resources, which are represented by the difference between pensions paid and the revenues lost when contributors (future pensioners) opt for private plans. Governments should thus be careful in planning this transition and making the fiscal adjustments needed to face the potential increasing deficits. Without appropriate planning and provisioning, transition costs could add to public debt sustainability problems, weakening the financial feasibility of such reforms. At present, after more than a decade of the reform of the pension systems, another challenge confronts policymakers. In fact, while the total amount of resources of the Latin American countries that opted for a total or partial private pension scheme is impressive (around US\$120 billion<sup>2</sup>), between 50 and 80 percent is directed to government financing.

In that context, there are other issues of consequence in the Latin America and Caribbean environment to take into consideration, such as the need to ensure fiscal discipline and to increase the competitiveness of the region's economies, as well as the need to establish a sound regulatory environment to ensure the sustainability of reform. These considerations call for adopting an approach to reform centered on the beneficiaries.

Despite the difficulties associated with political resistance and technical problems (especially those related to the fiscal burden associated with transition costs and the shift of resources invested by pension funds), governments in the region continue to be committed to such reforms. However, after 15 years of basic consensus on pension

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<sup>2</sup> Argentina, Bolivia, Colombia, Costa Rica, Chile, Dominican Republic, El Salvador, Mexico, Peru, and Uruguay.

reform in Latin America, in recent years the debate has been reopened. There is disappointment with the results of reform in various countries. In particular, there is a preoccupation with the fiscal costs, the costs faced by beneficiaries due to financial volatility and depressed financial markets, and the financing needs of the real sector, particularly infrastructure.

### **Pension Reform in the English-Speaking Caribbean**

The debate on pension reform in the English-speaking Caribbean countries is still in its early stages. National insurance systems were established only 30–40 years ago. Public sector employees have traditionally been covered by noncontributory pension schemes, and old age pension payments are straight transfers from government budgets. Leaving aside any judgment about the level and quality of benefits, financial sustainability has not been a pressing problem.

English-speaking Caribbean countries do not yet face the old age crisis that is becoming typical of, for example, Japan and many European countries. The pressure to reform pension systems has been relatively low, and political incentives weak. But there are strong arguments to give high priority to this issue now:

- The demographic window of opportunity is the best time to implement reform—the old age dependency ratio is still low, so there is more flexibility to use payroll taxes without eroding the competitiveness of the economy or driving activity into the informal sector.
- Reform in a mature society is likely to encounter much stronger opposition than in a society with a younger population.
- Systems in the English-speaking Caribbean display some serious inadequacies, such as low and unequal coverage, that cannot be easily remedied.
- The build-up of long-term savings will facilitate capital market development, but given the constraint of size, judicious diversification of asset holdings into global markets will be required.

### **Principles for Reform**

Based on the experiences of the past two decades and numerous studies, several principles can help ensure the sustainability of pension reforms:

- Strong political leadership and the active involvement of all major stakeholders in the development of a new model. This requires courage and vision.
- A solid regulatory framework and effective supervision to underpin the integrity of the system. This requires professional knowledge and integrity.
- Full appreciation of transition costs and adoption of appropriate fiscal policy to guard against an uncontrollable increase in public debt.

- A strict, enforced commitment that the resources of a funded scheme not be heavily invested in government paper—the fiscal trap will be set and waiting. This requires transparency and education.
- Unambiguous recognition of the need to factor in the cost of a robust social safety net to protect against old age poverty. This requires political skill.

Ultimately, successful reform requires the public sector to create appropriate incentives. The interests of the various parties in pension reform—workers, unions, and public sector employees—have been studied in various circumstances, and despite geographic and country differences are present everywhere and are part of the process of achieving better, more equitable pensions. There are important methodological and political considerations of how public policy should tackle this challenge. The debate should not be limited to policymakers and so-called experts but extended to beneficiaries who after all are the ones most affected by policy decisions. Target beneficiaries should be given the opportunity to understand the issues at stake and to be fully involved in the design of policies.

### **The Role of Multilateral Development Banks**

The Inter-American Development Bank has been actively involved in the construction of Latin American pension systems through the provision of technical assistance and sector loans. The Bank, given its origins and traditions, focuses on the region's social development while supporting the creation of an efficient economic environment. Thus, the Bank has struggled to deal with the two sides of the equation: equity and efficiency. During 1990–2003 the amount of Bank resources devoted to the pension sector surpassed \$3 billion.

Various factors explain the Bank's involvement in the region's pension systems. Pension systems are a crucial element of the social safety nets that the region needs to fight poverty, which is a Bank priority. Pension reforms are also consistent with the other priorities that guide the Bank's activities in Latin America, such as modernization of the state. In addition, by helping the development of capital markets, pension reform could make economies more competitive—another Bank priority.

Much of the Bank's current support for pensions involves developing solid, effective regulation and supervision systems. In Nicaragua a \$30 million project is supporting the establishment of a financially sustainable defined contribution pension system. The project's components include establishing a legal framework for the new system as well as institutional arrangements for supervision and service provision. In the Dominican Republic, where pension reform began recently, a \$5 million technical cooperation loan is supporting the creation of a pension superintendency and an adequate normative framework. Another Bank pension reform activity is a technical cooperation loan in Bolivia aimed at developing adequate regulation for the sector.

The Bank is also conducting research projects to evaluate pension reforms in a number of Latin American countries and to develop a reform model for small emerging economies,

such as those in the English-speaking Caribbean. These efforts complement several previous initiatives, such as research conducted in 1998 with the Economic Commission for Latin America and the Caribbean to assess the fiscal costs of pension reforms in the region.

Pension reform cannot be categorized in a specific sector because it involves fiscal policy, social welfare, capital and financial markets, and in many cases civil and military service reform, among other facets. It is a typical public policy issue, involving a variety of stakeholders and with a fundamental role for policies and politics. In that context the Inter-American Development Bank has been involved in the full range of pension reform activities and debates, from setting agendas to devising policy alternatives and providing technical assistance and advice. The Bank's sustained research efforts aim to devise policy alternatives and reforms that improve the performance of current systems in line with the principles delineated above—and that have broad political acceptance and support in the region.

Together with the Caribbean Development Bank, the Inter-American Development Bank is ready to work with Latin American and Caribbean countries committed to pension reform. The essential first step, however, is country ownership: broad consensus across the nation, and a government ready to take the lead in making changes in a timely manner—before the demographic window shuts.

**Table 13.1 Pension Fund Assets under Management and Stock Market Value Traded in Latin America, 1985–2002**  
(Millions of U.S. dollars)

Country	1985	1987	1989	1991	1993	1995	1997	1999	2000	2001	2002
Argentina Assets	...	...	...	...	...	2,497	8,827	16,787	20,381	20,786	11,409
Value traded	631	251	1,916	4,824	10,339	4,594	50,956	7,781	5,956	4,180	1,353
Bolivia Assets	...	...	...	...	...	...	98	535	842	936	1,144
Value traded	...	...	...	...	...	1	1	3	...	1	28
Brazil Assets	...	...	...	...	...	62,693	83,444	71,230	74,755	67,958	56,053
Value traded	21,484	9,608	16,762	13,373	57,409	79,186	202,450	87,276	101,282	65,090	48,203
Chile Assets	1,553	2,708	4,470	10,064	15,942	25,143	30,525	34,501	35,886	35,460	35,515
Value traded	57	503	866	1,900	2,797	11,072	7,425	6,874	6,083	4,220	3,120
Colombia Assets	...	...	...	...	...	265	1,367	2,887	3,584	4,955	5,482
Value traded	30	80	74	203	732	1,254	1,851	704	397	355	273
Costa Rica Assets	...	...	...	...	...	...	...	160	...	21	136
Value traded	...	1	4	9	11	16	...	216	...	...	...
El Salvador Assets	...	...	...	...	...	...	...	213	482	768	1,088
Value traded	...	...	...	...	...	...	15	48	26	23	24
Mexico Assets	...	...	...	...	...	...	615	11,509	17,012	27,146	31,748
Value traded	2,360	15,554	6,232	31,723	62,454	34,377	52,392	36,042	45,340	40,043	27,726
Peru Assets	...	...	...	...	29	583	1,510	2,406	2,752	3,622	4,527
Value traded	38	301	90	130	1,672	3,935	4,015	2,289	1,521	849	1,133
Uruguay Assets	...	...	...	...	...	...	191	591	811	1,045	893
Value traded	0.4	4	1	...	14	5	3	2	...	1	0

Source: Federación Internacional Administradoras de Fondos de Pensiones, Fiap <http://fiap.cl> and Standard & Poor's Emerging Stock Markets Fact Book

**Table 13.2 Pension Fund Assets under Management and Stock Market Value Traded in Comparator Countries, 1985–2002**  
(Millions of U.S. dollars)

Country	1985	1987	1989	1991	1993	1995	1997	1999	2000	2001	2002
Korea, Rep. Assets	...	...	...	...	...	15,000	25,000	40,000	50,000	62,500	77,300
Value traded	4,162	24,919	121,264	85,464	211,710	185,197	172,018	825,827	1,067,669	703,960	873,692
Poland Assets	...	...	...	...	...	...	...	...	2,481	4,454	6,674
Value traded	...	...	...	...	2,170	2,770	7,951	11,149	14,631	7,432	5,842
South Africa Assets	...	...	...	...	...	...	32,913	34,319	33,289	24,012	...
Value traded	2,836	9,568	7,095	8,051	13,049	17,048	44,722	72,917	77,494	69,676	78,831
Thailand Assets	...	...	...	...	...	...	...	3,123	3,117	3,587	4,426
Value traded	568	4,633	13,452	30,089	86,934	57,000	24,206	41,604	23,258	35,705	47,612

Source: Federación Internacional Administradoras de Fondos de Pensiones, Fiap <http://fiap.cl> and Standard & Poor's Emerging Stock Markets Fact Book

**Table 13.3 Correlations between Pension Fund Assets under Management and Stock Market Value Traded in Latin American and Comparator Countries, 1995–2001**

Country	Correlation
<i>Latin America</i>	
Argentina	-0.51320
Bolivia	-0.50689
Brazil	0.19557
Chile <sup>a</sup>	0.75870
Colombia	-0.88599
El Salvador <sup>b</sup>	-0.74105
Mexico	0.33430
Peru	-0.93024
Uruguay	-0.92835
<i>Comparator country</i>	
Korea, Rep.	0.78553
Poland	-0.92600
South Africa	-0.09683
Thailand <sup>b</sup>	0.21648

a. Data are for 1981–2001.

b. Data are for 1998–2001.

Note: Pension assets are lagged one period.

Source: Authors' calculations based on data from Federación Internacional Administradoras de Fondos de Pensiones, Fiap <http://fiap.cl> and Standard & Poor's Emerging Stock Markets Fact Book.

**Table 13.4 Average Stock Market Returns and Volatility in Latin American and Comparator Countries, 1995–2002**

Country	Average return (annual percentage change)	Volatility (standard deviation)
<i>Latin America</i>		
Argentina	-4.29	31.08
Brazil	2.89	39.11
Chile	-2.28	20.16
Colombia	-4.60	29.70
Mexico	8.34	41.19
Peru	5.35	24.69
<i>Comparator country</i>		
Korea, Rep.	15.40	73.64
Poland	5.13	31.28
South Africa	5.03	34.22
Thailand	-15.04	43.31

*Source:* Authors' calculations based on <http://fiap.cl> and Standard & Poor's Emerging Stock Markets Fact Book

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