The Reformed Mexican Social Security System: 15 years of experience …

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Mexico's Social Security ecosystem

IMSS: Covers workers of private enterprises
ISSSTE: Covers federal public employees
State government ISSSTEs: Covers state (provinces) and municipal public employees
ISSFAM: Covers armed forces employees
Pemex: Covers Pemex's workers
RJP IMSS: Covers IMSS employees

Size of the workforce	48,000,000
Contributing to Social Security	18,850,000
IMSS	14,600,000
ISSSTE	2,500,000
State government ISSSTEs	1,000,000
ISSFAM (Armed Forces)	250,000
Pemex	150,000
RJP IMSS employees	350,000
Non-Contributing	29,150,000

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Historical Background: The Social Security System until 1997

Contributions to the system since 1973 were 4.5% of salaries

Under normal economic conditions the system's benefits would have implied a replacement rate of 60%-80% of final salary for someone retiring at 65 after 35-40 years of contributions.

It has to be noted that under these "normal economic conditions" there is a huge gap (actuarial deficit) of 4:1 between present value of benefits and that of contributions.

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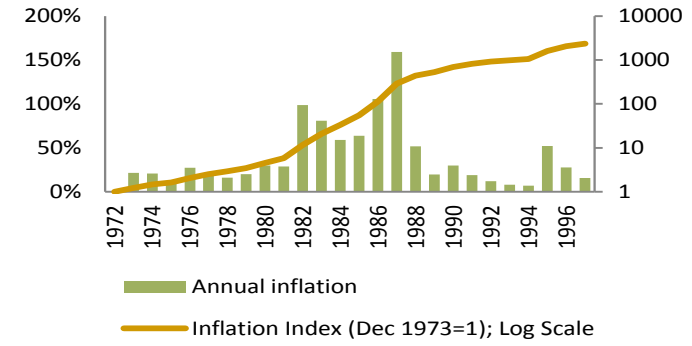
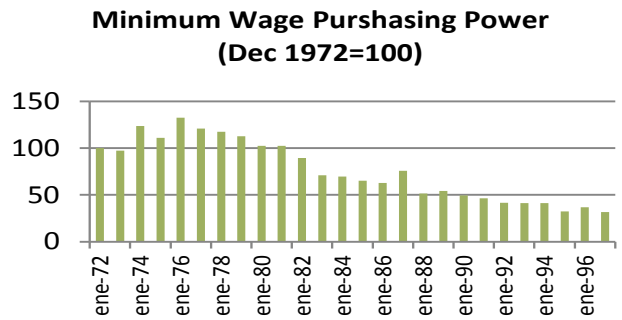
This would soon have been unsustainable, but economic conditions were far from "normal":

Inflation



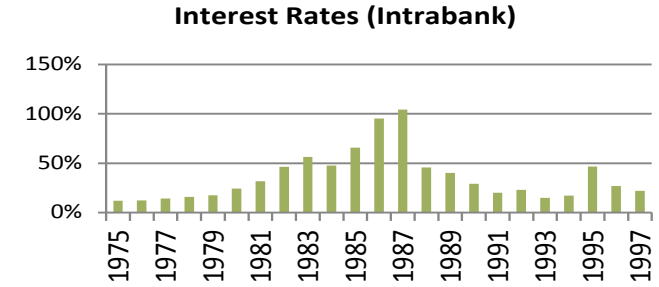
Average annual inflation (CAG) from 1972-1996: 36%

Minimum Wage purchasing parity



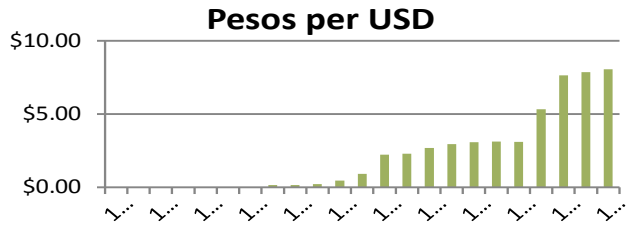
The minimum wage lost 70% of its purchasing power from 1972 to 1997

Interest Rates



Interest rates reached over 100% in 1987

Peso vs USD (1972=$0.0125)



The Peso was devaluated by almost 100% in 1976, several times during 1982, in 1985, 1986, 1987 and again in 1994.

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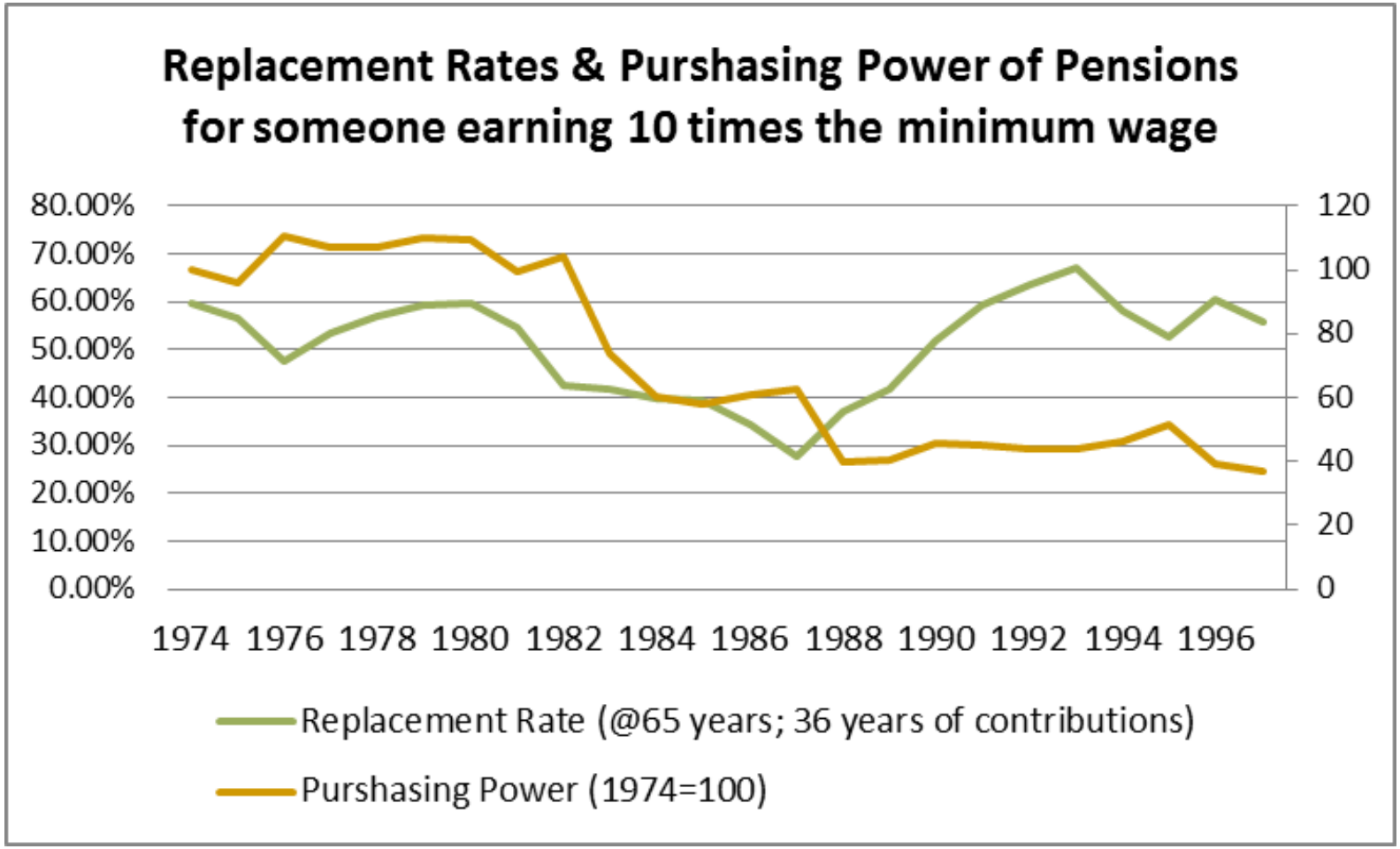

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1996: The Year of the Reform

In 1994/1995 Tequila Crisis: devaluation of the peso, high inflation (reaching 52% in 1995), a 6.2% fall in GDP and rising interest rates.

The United States, the World Bank and the IMF came to the rescue with a $50 billion USD package

These loans included terms and conditions that Mexico would have to implement.

One of these conditions ("recommendations") was the reform of the Social Security system.

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As with any other Social Security system, the choices were limited and faced opposition from the affected parties:

Increase contributions: Corporations were opposed since they made most contributions.

Increase the retirement age: Public opinion, unions and politicians opposed this measure.

Reduced replacement rates: Opposed by the same parties as above.

Continue subsidizing the system: Unsustainable for public finances; opposed by creditors: IMF, World Bank, foreign banks.

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The reform was based in the following principles and objectives "agreed" upon with corporations, unions and workers:

"No to the privatization of Social Security"
"No to increasing contributions"
"Avoid the financial collapse of the IMSS"
"Increase affiliation to Social Security"
"Improve benefits"
"Promote employment and economic growth"
"Increase internal savings"
"Protect the disposable income of workers"
"Increase government contributions transparently"

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"Avoid subsidies within the IMSS (i.e. between retirement and health)"
"Make the system fairer and reinforce solidarity and its public nature"
"To solve the actuarial deficit of the system"
"Make it immune to economic crisis, especially to inflation and devaluations"
"Define properly the property of contributions by workers"
"To have dignified pensions"
"Define and respect vested benefits"
"Guarantee a minimum pension"
"Transition period for current affiliates"
"The creation of specialized entities to manage the contributions into individual accounts"
"Freedom of choice"

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The reformed system

The new social security system thus works as following:

Contributions (6.5% of salaries -same as before) go into individual accounts .

The government contributes an additional amount to each individual account (16% of salary for those earning the minimum wage; less than 2% of salaries for those earning up to 15 times the minimum wage); none for those who earn more.

If the accumulated amount is less than a pension worth the minimum wage, the government pays the balance to the insurance company, provided that the retiree has at least 60 years of age and 1250 weeks (24 years) of contributions.

People registered on the system prior to the reform (June 1997) may choose, at retirement, between applying the old system's defined benefit or using their accumulated amount the way they may under the new system (transition generation).

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For the most part, the administration in power at that time stressed two benefits: 1) people who could not meet the eligibility criteria for a pension (60 years of age and 9.5 years of contributions) would now receive something instead of nothing; and 2) the new system would be more transparent and IMSS would not be able to channel contributions to other, non-pension, benefits.

Under "normal economic conditions" : net replacement rate of 30%-35% of final salaries at 65 years of age and 35-40 years of contributions for an average earner. This replacement rate would be half of the one obtained under the old system and is the lowest replacement rate of all OECD countries.

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Replacement rates will evidently depend on average investment returns, but also on the choice made of the investing management firm (called AFORE by their initials in Spanish) and the investment returns just prior to retirement which in the case of a year like 2008-2009 can certainly make a big difference

Net investment returns (SB3)	
Invercap	12.42%
SURA	11.33%
Bancomer	10.96%
Banamex	10.82%
XXI	10.67%
PensionISSSTE	10.51%
Principal	10.50%
Metlife	10.25%
Profuturo GNP	10.01%
Azteca	9.59%
Afirme Bajío	8.62%
Coppel	8.00%
Inbursa	5.97%
Source: CONSAR	

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As Calderón-Colín et al (2008) show, workers do not have the knowledge necessary to make rational choices of investment managers.

Furthermore, given the option for the transition generation and the fact that the new system's benefit are around one half of the previous one, we might see people entering a job with one week of difference, following the same career path and retiring at the same time one with half a pension as the other.

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Were expectations met?

"No to the privatization of Social Security": The new system is managed and funds invested by mostly private companies. The system has in all but name been privatized.

"No to increasing contributions": They were increased for higher earners, since now the salary taken into account for contributions is capped at 25 times minimum wage instead of 10 times.

"Avoid the Financial Collapse of the IMSS": The IMSS is technically broke.

"Increase affiliation to Social Security": Contributors to IMSS in 2006 were ca. 28% of total working force; in 2011 they are 31%.

"Improve benefits": Replacement rates were halved under normal economic conditions.

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Were expectations met?

"Promote employment and economic growth": Economic growth in Mexico averaged 2.9% in real terms from 1996 to 2010. This rate was well below the 5.7% rate observed for emerging economies during the same period.

"Increase internal savings": Before the reform, contributions were invested in federal government bonds. After 15 years of various changes in the investment rules, still around 70% is invested in federal, state and municipal government or other bonds placed by public entities (CFE, Pemex, Infonavit, etc.).

"Increase government contributions transparently": The government still has to pay the transition costs of the system and still subsidizes IMSS activities.

"Avoid subsidies within the IMSS (i.e. between retirement and health)": This is doesn't take place any longer since pension contributions are now directed to individual accounts.

"Make the system fairer and reinforce solidarity and its public nature": Individual accounts are by definition non-solidary and the new system naturally allows for different replacement rates for similar workers.

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Were expectations met?

"To solve the actuarial deficit of the system": The system has a large transition cost to pay (and no assets).

"Make it immune to economic crisis, especially to inflation and devaluations": Many workers saw their savings reduced by more than 10% in 2008 due to the global financial crisis.

"Define properly the property of contributions by workers": Few understand the system; few pay attention to its individual statement; few have any idea of how much will they receive

"To have dignifying pensions": Mexico has the lowest replacement rate of all OECD countries.

"Define and respect vested benefits": In the past system you could lose all your contributions if you didn't meet certain requirements. Now, they are portable within social security systems (IMSS/ISSSTE) and may be withdrawn even if one stopped working before reaching retirement.

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Were expectations met?

"Guarantee a minimum pension": The same as the old system: the minimum wage (currently $1,870 MXP per month –ca. $150 USD).

"Transition period for current affiliates": Indeed, every worker enrolled before June 1997 may choose, at retirement, between the old and the new system.

"The creation of specialized entities to manage the contributions into individual accounts": AFORES have been very profitable. In 2011 the AFORES had a ROE of 27% and receive commissions worth US$ 1.5 billion per year.

"Freedom of choice": Workers may indeed choose the AFORE that manages and invests their contributions … at their own risk.

The new system has certainly helped to reduce the federal government's fiscal deficit, which was the real priority of the reform.

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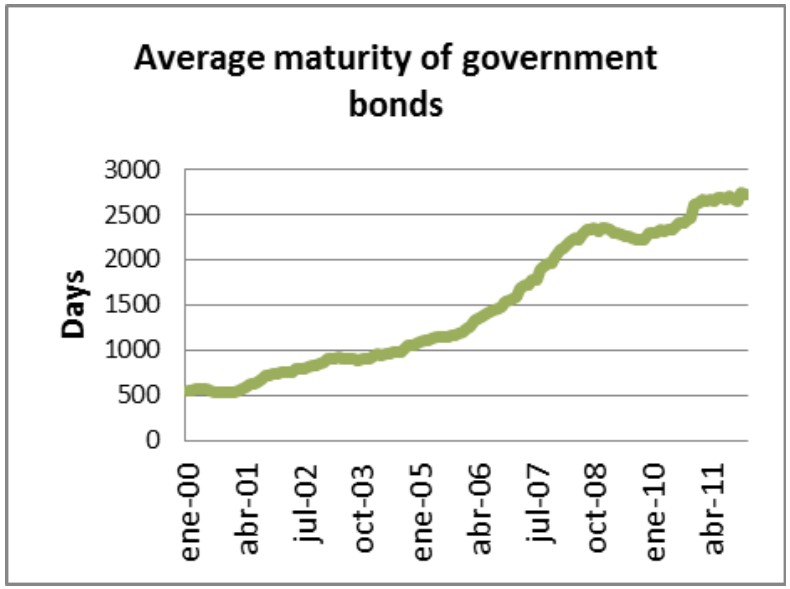
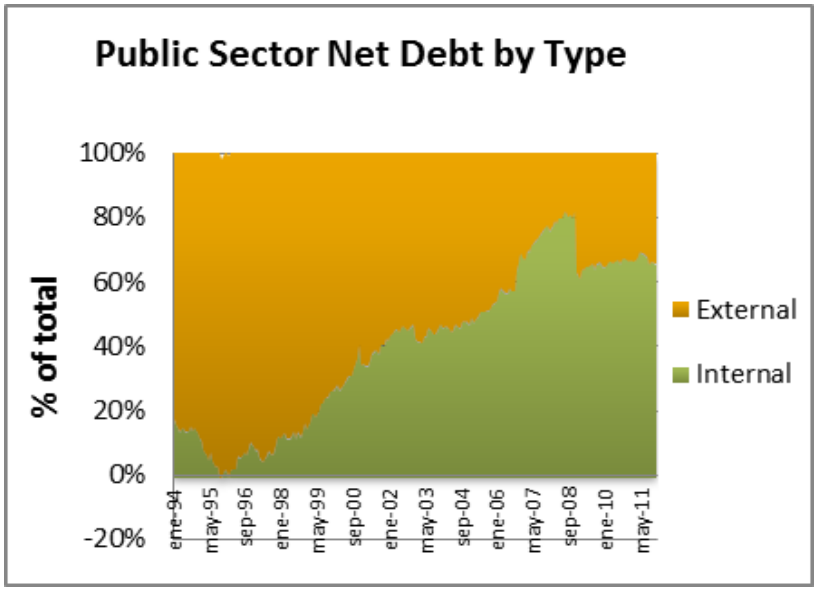
One externality produced by the system –and not stated specifically in the principles of the reform- has been the deepening of domestic financial markets and a lower reliance of the government in foreign debt.





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Conclusions and paths for improvement

A structural reform of a social security system does not magically avert old age crises nor necessarily promotes growth. And it does not avoid the hard choices of increasing contributions (or subsidies), increasing retirement age or reducing benefits.

Changing from an unfunded system to one invested mainly in government bonds does not change the fact that benefits will be paid in the future by the government (most likely, through taxation or even worse, through inflation). However, excluding the transition costs, it is now clear which is the government's debt with the system and it's transparently accounted for.

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Conclusions and paths for improvement

People are not aware of expected replacement rates and the transitory regime will not make it clear until it's too late.

Privatization of the system has not avoided governments (e.g.: Argentina, Hungary) from nationalizing its assets in case of "emergencies". A big pot of money is always a big temptation for any politician.

The most pressing problem in Mexico's Social Security is not a new vs old, collective vs individual, funded vs unfunded system, but a lack of coverage for most workers, followed by insufficient contributions for those in the new system.

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Some ideas that have been aired to enhance the system are:

Increase contributions to at least 10% of salaries (a 5% contribution is already been made for housing through Infonavit, the federal government's housing agency, to a separate individual account).

Create a Universal Pension for people reaching old age, regardless of employment conditions. Schemes of this type already exist in the Federal District and for certain other groups.

Independent workers (doctor, lawyers, "free lancers") and the self-employed should be forced into contributing for their retirement.

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Some ideas that have been aired to enhance the system are:

Rules should be eased to promote more private investments (debt and equity).

Pool investment returns so that everyone receives the same return.

Clearly inform workers of expected replacement rates.

Incentivize the creation of private corporate pension plans.

Ask (mandate) companies to send employees an annual letter with a projection of their expected pension at retirement from Social Security and from their company (if any).