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In Praise and Criticism of Mexico's Pension Reform

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Executive Summary

The privatization of Mexico's government-run pay-as-you-go social security system, which went into effect in July 1997, is the Ernesto Zedillo administration's most important structural reform. It is a measure that, if successful, will help bring much-needed social and economic stability. The Mexican peso crisis of 1994–95 underscored the fragility of Mexico's economy, its need for independent institutions, and its need for a large pool of long-term domestic savings. An increase in the rate of private savings in Mexico, which this reform will promote, would make the Mexican economy less dependent on short-term fluctuations of international capital flows and, thus, more stable. More important still, the privatization of social security will erect one of the basic pillars of a free society by turning Mexico into a country of property-owning workers.

The private system, however, has several structural flaws that should be corrected in the near future if it is to provide workers with the right incentives. Chief among those flaws is the requirement to invest a *minimum* of 65 percent of workers' savings in government instruments, a rule that is not consistent with the notion of pension privatization. Other flaws include prohibiting investment in equities or abroad; allowing the government agency that administered the old pay-as-you-go system to establish a pension fund company while retaining some regulatory functions; prohibiting public-sector workers from joining the new private system; and having the government subsidize every worker's retirement account, a measure that politicizes the private pension system and weakens the link between individual efforts and rewards.

President Zedillo should use his remaining time in office to strengthen the new pension system so that Mexican workers can enjoy financial security and other benefits in their old age.

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The cumulative effect of the system's conceptual flaws and administrative shortcomings was to put it in a precarious financial position.

Introduction

Latin American nations from Tierra del Fuego to the Rio Grande are fundamentally changing the role of the state in the provision of social services in a way that is more consistent with the principles of a free society.[1] In the area of old-age retirement income, that new role consists of the establishment of a regulatory framework and the provision of a minimum safety net for those in need of it, leaving to most individuals the responsibility and satisfaction of providing for their own retirement. Chile led the way in 1981, when the government there replaced its bankrupt pay-as-you-go social security system with a system of compulsory individual pension savings accounts managed by the private sector.[2] Since then, seven other Latin nations—Peru (1993), Argentina (1994), Colombia (1994), Uruguay (1996), Bolivia (1997), Mexico (1997), and El Salvador (1998)—have also privatized their pension systems along the lines of the successful Chilean model.[3]

In Mexico, the substitution of an investment-based private system of individual pension savings accounts for a government-run social security system is the latest in a series of structural reforms that have radically transformed the Mexican economy in the past decade.[4]

Mexico's Pay-As-You-Go Retirement System

Mexico's public pension system for private-sector workers was established in 1944 and has since been managed by the Instituto Mexicano de Seguridad Social (IMSS).[5] The IMSS also manages the national health care system and provides unemployment insurance and daycare services for private-sector workers. From its inception, the IMSS system has been plagued by numerous problems; some of those problems are general to all pay-as-you-go systems, and some are specific to Mexico.

Pay-as-you-go retirement programs have an intrinsic flaw that helps explain the crisis of Mexico's public pension system. That flaw is that old-age financial security depends on the political process, in which different groups compete against one another to determine which one benefits at the expense of the others. A public pension system is a compulsory government program that redistributes wealth among different groups and generations. Its universality is based on the faulty assumption that people are unable or unwilling to plan for their retirement during their working years and will thus be unable to provide for themselves in their old age. The substitution of political action for private action has severed the link between individual efforts and rewards, making this a self-fulfilling prophecy. In other words, individuals try to minimize their contributions to the system while they are active workers and to maximize their retirement benefits.[6]

In a pay-as-you-go system, the government taxes active workers to pay for the benefits of retired workers. Under such systems, retirement benefits are a function of the rate of growth in the tax base, which in turn depends on the rate of growth in the labor force and the rate of growth in real wages per worker (i.e., increases in labor productivity). But payroll taxes are a tax on the use of labor, not an investment. Thus, they have a negative effect on employment and distort the allocation of resources.[7]

In the case of Mexico, total payroll taxes were high—31.5 percent of total payroll at the time of the reform (see Table 1)—and contributed to underreporting of wages, tax evasion, and the growth of the informal sector, where labor productivity is considerably lower than in the formal sector. When workers move from the formal to the informal sector, the tax base usually grows smaller. As revenues failed to keep up with promised benefits, the government had to reduce those benefits (until 1989, benefits were not indexed, which resulted in their erosion through inflation), raise taxes, or both.

The conceptual flaw was aggravated in

Table 1
Total Payroll Taxes in Mexico as Percentage of Payroll

	Total	Employer	Employee	Government
IMSS system				
Old age, disabilty and life insurance	8.5	70	25	5
Health and maternity	12.5	70	25	5
Workers' compensation	2.5	100	0	0
Child care	1	100	0	0
SAR system[a]				
INFONAVIT[b]	5	100	0	0
Old-age retirement	2	100	0	0
Total	31.5	25.2	5.25	1.05

Source: IMSS.

[a]The Sistema de Ahorro para el Retiro (SAR), or Retirement Savings System, was established in 1992 as a fully funded savings program to complement the IMSS system.

[b]Instituto del Fondo Nacional de la Vivienda para los Trabajadores (INFONAVIT) is a government-run housing credit agency for private-sector workers.

Mexico by additional defects in the design of that country's retirement program. Chief among those defects was the existence of different retirement systems for different types of workers. As stated above, the IMSS covers only private-sector dependent workers and those independent private-sector workers who decide to register with the IMSS. That has led to significant portability losses for workers moving in and out of the private sector. In addition, private-sector workers affiliated with the IMSS could also lose their accrued benefits even if they changed jobs within the private sector. Finally, under the IMSS program, some workers could obtain a retirement pension after participating in the system for only 10 years, whereas other workers (those choosing early retirement, for instance) might not receive a pension at all, even if they had been contributing to the system for a longer period of time.

Benefits under the IMSS program are based on the average base salary of the last 5 years of a worker's working life divided by the minimum wage at the time of the calculation. Workers also receive a fraction of their salary for every year they have contributed to the system in excess of the minimum requirement of 10 years. Finally, total benefits cannot exceed the worker's average salary in the last 5 years.

The system has been plagued by other problems, such as corruption, bureaucratic mismanagement, and inefficiency. The resources from the old-age retirement fund have been used for other purposes, especially to shore up the national health care system. Thus, the social security trust fund in Mexico, which was supposed to have reserves equivalent to 11 percent of GDP in 1995, had reserves equivalent to just 0.4 percent of GDP.[8]

The cumulative effect of the system's conceptual flaws and administrative shortcom-

Table 2
Demographic Trends in Mexico, 1950–2030

	Fertility Rate (number of children per woman)	Life Expectancy (in years)
1950	6.45	49.6
1995	2.84	70.8
2030[a]	2.10	77.0

Sources: Carlos Sales-Sarrapy, Francisco Solís-Soberón and Alejandro Villagómez-Amezcua, "Pension System Reform," in *Privatizing Social Security*, ed. M. Feldstein (Chicago: University of Chicago Press, 1998), p. 142; and Organization for Economic Cooperation and Development, *Ageing in OECD Countries* (Paris: OECD, 1996), p. 104.

[a]Expected.

ings was to put it in a precarious financial position. According to the Mexican government's own estimates, payroll taxes for the pension system *alone* would have had to increase from 8.5 percent to almost 24 percent of total payroll by the year 2020 to keep the system in actuarial balance.[9]

Demographic trends also made the reform necessary. Although Mexico is in a more favorable demographic position than most industrialized nations (even more favorable than Chile in the late 1970s), the support ratio in Mexico has been declining steadily for the past few decades. In 1950, the system had approximately 67 workers per retiree; by 1994, that ratio had declined to 8 workers per retiree.[10] That decline can be explained by an increase in life expectancy and a decrease in the fertility rate (see Table 2).

According to the IMSS, during the next 20 years the number of retirees is going to increase by an annual average of 5.6 percent, while the number of new entrants to the labor force will increase by an annual average of only 2.6 percent during the same period. The overall effect of those two trends is to increase the elderly dependency ratio (population aged 65 and over as a percentage of working-age population) from 6.4 in 1990 to 14.8 in 2030,[11] which in the absence of the reform would have put an unbearable burden on the working population.

In light of those problems, the government made a first attempt at structural reform in 1992 when it created the Retirement Savings System (Sistema de Ahorro para el Retiro, or SAR) as a complementary scheme to the existing pay-as-you-go system. The SAR program was a compulsory system funded with employer contributions of 2 percent of total payroll. Employers were also (and still are) required to make contributions of 5 percent of total payroll to INFONAVIT.[12] That system, however, was poorly designed.[13] Commercial banks collected the contributions but after four days had to send the money to the Bank of Mexico, which paid a 2 percent real rate of return on those contributions. Thus, in essence, the SAR accounts were "notional" (i.e., imaginary), and the government used the SAR system (which accumulated approximately $6.4 billion from 1992 to 1997)[14] and the banking system to borrow money from workers.

What was needed was not a system complementary to the failed government-run program but a private system that would replace the old one and offer proper work—and investment—incentives by giving workers clearly defined property rights over their contributions.

The Reform of 1995–96

In December of 1995, the Mexican Congress passed the Social Security Law that reformed the provision of all social services administered by the IMSS. In April 1996 President Ernesto Zedillo signed the Retirement Savings Systems Law (Ley de los sistemas de ahorro para el retiro), which established the legal and organizational framework under which the new system of individual pension savings accounts administered by the private sector would function. The new system began to operate on July 1, 1997.

Main Features of the New System

The new pension system in Mexico is a fully funded defined-contribution system, mandatory for all dependent private-sector workers and administered by specialized, single-purpose private companies. Since September 1997, workers deposit 11.5 percent of their wages every month in their own individual pension savings accounts.[15] Every month the government adds to each worker's account as a "social contribution" 5 percent of the minimum salary in Mexico City as of January 1997, which is equivalent to 2 percent of the average national salary.[16] Thus, for a worker earning the average salary, the total monthly contribution is equal to approximately 13.5 percent of total payroll (see Table 3).

Workers who want to retire early (i.e., before reaching the legal retirement age of 65) or with a higher pension may also open a voluntary savings subaccount to which they or their employers can make additional contributions. These contributions or a portion thereof may be withdrawn before retirement once every six months.[17] Contributions (up to a limit of 10 times the minimum wage) and the returns earned are deductible for tax purposes.

Workers are free to choose one of the specialized pension fund management companies, known as Administradoras de Fondos para el Retiro (AFOREs), to administer their accounts. At the end of 1998 there were 14 AFOREs,[18] including one that belongs to the IMSS, managing 14 pension funds known as Sociedades de Inversión Especializadas en Fondos para el Retiro (SIEFOREs). The AFOREs must invest a *minimum* of 65 percent of the workers' savings in government instruments, cannot invest in equities, and are not allowed to invest abroad.[19] The AFOREs and the SIEFOREs they administer are two separate legal entities, a provision that provides both transparency and security: If an AFORE goes bankrupt, the workers' savings are pro-

Table 3
Contribution Rates in the New Pension System (percentage of total payroll)

	Old-Age Retirement	Life and Disability Insurance
IMSS	4.5	4
INFONAVIT	5	
SAR contribution	2	
Social contribution	2	
Total	**13.5**	**4**

Source: Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR).

tected. Furthermore, to minimize agency problems (e.g., situations in which the interests of the managers of the AFOREs conflict with those of the workers), the AFOREs are required to maintain a reserve fund and invest it in the SIEFOREs they manage.[20]

Mexican banks and other Mexican financial institutions are free to enter the industry. Foreign ownership of an AFORE is limited to companies from countries with a free-trade agreement with Mexico, such as the United States. Companies from other countries, however, are not allowed to become majority shareholders in an AFORE.

For the services they provide the AFOREs may charge commissions, which can be a percentage of taxable income, a percentage of assets managed, a percentage of real returns on assets invested, or a combination of the three. AFOREs may charge other minor commissions and fees as well. More important, they can offer discounts for permanence and for voluntary savings. This flexible commission structure will allow the AFOREs a greater degree of product differentiation than that of pension fund companies in countries with more rigid commission structures. Government regulations have set a market-share limit for each AFORE of 17 percent of the total market (to be increased to 20 percent in 2001) and also require that the AFOREs provide their customers with at least one statement of account per year.

What was needed was not a system complementary to the failed government-run program but a private system that would replace the old one.

Workers can switch AFOREs only once a year unless the AFORE they are enrolled with changes the commission structure or its investment strategy, in which case they can switch AFOREs as soon as the change takes effect. This restriction was implemented in an attempt to prevent frequent switches between AFOREs, which can raise administrative costs.

An independent and specialized government agency, Comisión Nacional del Sistema de Ahorro para el Retiro (CONSAR), regulates the industry. The main functions of CONSAR are:[21]

1. To approve or reject proposals for the creation of AFOREs, supervise their bylaws, and authorize their existence;
2. To supervise the AFOREs in legal, financial, and administrative matters once they are in existence;
3. To set general investment rules and supervise the investments made by the SIEFOREs;
4. To administer and operate the SAR national data bank;
5. To enforce present regulations and enact new ones, if necessary;
6. To levy fines on those participants in the system who violate regulations; and
7. To serve as an arbitrator should disputes arise between an AFORE and its customers.

For its part, the IMSS has the following functions:

1. It still pays out benefits to current retirees out of general government revenues;
2. It provides life and disability insurance, for which workers are required to pay 2.5 percent of their wages;[22]
3. It collects the contributions from employers and then sends them to each worker's AFORE;
4. It may audit the AFOREs;
5. It has its own AFORE; and
6. It will pay out pensions to some transition workers.

Upon retirement at 65, a worker has two options. One option is to use the money accumulated in his pension savings account to purchase a lifetime annuity from a private insurance company. The other option is to leave the money in his pension savings account and make programmed withdrawals based on his life expectancy and those of his dependents. If a worker choosing the latter option dies before the funds in his account are depleted, the remaining balance belongs to the beneficiaries of his estate, since workers now have property rights over their contributions. For workers who reach the age of 65 and have contributed to the system for at least 1,250 weeks (approximately 25 years), the government guarantees a minimum pension if the funds accumulated in their accounts are not sufficient to obtain at least that pension. (Under the old system, a worker qualified for the minimum pension after 10 years of contributions.)

Workers may choose early retirement if they have accumulated enough funds in their accounts to purchase an annuity that is at least 30 percent higher than the legally defined minimum pension.[23] However, workers who choose early retirement do not qualify for the government-guaranteed minimum pension, even if they have contributed to the system for 1,250 weeks. Even if the government discriminates against those who choose early retirement, it is important that workers have that option because, as José Piñera, the architect of the Chilean system, has stated, "Individual preferences about old age differ as much as any other preferences. Some people want to work forever; others cannot wait to cease working and to indulge in their true vocations or hobbies. . . . [A private system] allows for individual preferences to be translated into individual decisions that will produce the desired outcome."[24] The important thing is that they do not lose all accrued benefits if they choose to retire before 65, as they did under the old system.

The Transition

Any transition from a pay-as-you-go system to a private pension system must take into account the fiscal resources of the government and the special circumstances of each country. In general, however, a successful transition should satisfactorily answer the following questions. First, how are those already retired going to be affected by the reform? In Mexico, the only effect on the approximately 1.6 million workers already retired will be positive: Their benefits will be guaranteed. According to government estimates, 90 percent of current retirees in Mexico receive a pension equivalent to the minimum wage. This low level of benefits is largely due to the high inflation rate of the last 15 years, which has lowered the minimum wage in real terms (the minimum pension is equal to the minimum salary).[25]

Second, do transition workers (i.e., those already in the labor force by December 31, 1996) have the choice of remaining in the old system or moving to the new? All transition workers have until 2001 to choose an AFORE and transfer to the new system. According to CONSAR, 13.8 million workers, or about 93.3 percent of workers affiliated with the IMSS, had already selected an AFORE by the end of 1998.[26] The contributions of those who have not yet transferred are deposited in a special account at the Bank of Mexico (Cuenta Concentradora) until they choose an AFORE, or until 2001, at which point the government will assign an AFORE for them.[27]

Upon retirement, transition workers have a "life-switch" option; that is, they may choose the system (old or new) that will give them the highest level of benefits. If they choose the old, they surrender to the government all the funds accumulated in their individual pension savings accounts and their pension benefits are calculated according to the benefit formula of the old system. The Mexican government will pay out pension benefits until the day that the last Mexican worker who contributed to the old system before January 1997 dies.

Third, is the government going to acknowledge the contributions transition workers have already made to the old system? In the case of Mexico, the answer is no. While other countries that have privatized their state-run pension systems gave workers recognition bonds for the taxes they had paid into the old system, Mexico decided to offer transition workers the "life-switch" option.

Fourth, what are the costs of the transition and how does the government intend to pay for those costs? The costs of the transition and how the Mexican government intends to pay for them are not clear at this point. In 1994, the implicit debt of the pension system in Mexico was estimated at 141 percent of gross domestic product. Estimates indicate a total fiscal cost of 1 percent of GDP for the next 20 years.[28] However, the social contribution, the government part of the mandatory contribution, the "life-switch" option for transition workers, and the existence of a minimum pension guarantee make it difficult to estimate with accuracy the fiscal costs of the transition. The total fiscal cost depends on the growth of

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real wages, on the inflation rate as measured by the consumer price index, on the growth of the labor force, and, most important, on the performance of the new system.

Key Criticisms

The most important flaw of the new Mexican pension system concerns the rules on investment, which should be liberalized to allow the AFOREs to invest in bonds and equities—at home and, especially, abroad. As stated above, at present, the AFOREs must invest a *minimum* of 65 percent of workers' savings in government instruments and are not allowed to invest abroad. The requirement to invest in government instruments, which allows the government to finance its expenditures without explicitly raising taxes, may lead workers to rightly view their contributions as another tax. Those rules are also putting workers' retirement savings at risk by forcing the AFOREs to place "all the eggs in one basket," and may give workers who believe that the government basket is unbreakable a false sense of security. Most important, the requirement to invest in government instruments is not consistent with the notion of pension privatization, where individuals acting in the private sector are responsible for their own retirement.

As the rules on investment stand today, workers do not really have an incentive to put any funds in the voluntary savings subaccount,[29] because they might be better off by saving any additional funds for retirement outside the AFORE system. That way they diversify their investments and spread their risks. As soon as investment rules are liberalized, they will have an incentive to put additional funds into the system, as a form of voluntary savings, since the AFOREs may offer discounts on the commissions for voluntary contributions.

Second, most functions of the IMSS should be eliminated. As it stands today, that government institution wears too many hats: It has an AFORE, functions as a clearinghouse, collects data and contributions, provides life and disability insurance,[30] enforces regulations, pays out pensions to workers already in retirement, will pay out benefits to some transition workers, and is still responsible for providing the minimum pension to all private-sector workers who qualify for it.

The centralized collection system was implemented on the assumption that collection of contributions and control of accounts constitute a natural monopoly, which, given economies of scale, would reduce administrative costs.[31] Whatever validity that assumption may have in economic theory, the argument fails to take into account the considerable political risk of conferring such broad powers on an institution like the IMSS, which might be tempted (or forced) to keep some of those contributions to finance other government programs.[32] As University of California–Los Angeles economist Sebastian Edwards says, "It's like getting the fox to guard the hens. The IMSS won't give up its pension contributions easily."[33] There are obvious conflicts of interest that will have to be resolved in the near future to prevent the IMSS from engaging in unfair competition—especially if its own AFORE fails to attract customers, as it has so far.[34]

Third, the "life-switch" option given to all transition workers in lieu of recognition bonds poses a moral hazard, especially because the AFOREs are (appropriately) not required to guarantee a minimum return. Transition workers have an incentive to make riskier investments, because (with only a 10-year requirement for contributions) they are certain to get the guaranteed minimum pension under the old system if those investments are not profitable. It may also increase the size of the informal sector, because workers under the old system qualified for the minimum pension after only 10 years, whereas in the new system they have to contribute for 25 years.

Fourth, the social contribution by the government should be eliminated. Although it is small and meant as somewhat of a substitution for the recognition bonds that other countries gave workers who moved to the new system, it is flat and universal: All workers who participate in the new system receive the same amount regardless of whether or how much they paid into the old one. As a result, it establishes no link between taxes paid and benefits accrued under the old system.

In addition, the existence of a social contribution paid out of general government revenues might lead to pressure from different interest groups, including the AFOREs, to increase it in the future. After all, private companies in Mexico have often demanded (and obtained) public funds for themselves in the name of social welfare. The AFOREs will not behave differently.[35] A better solution would have been to issue recognition bonds to all transition workers to acknowledge all or part of the taxes they had paid into the old system.

Fifth, the existence of the housing subaccount poses several problems. INFONAVIT is an overstaffed and inefficient government agency. Returns on contributions to the housing subaccount depend on the operating surplus of INFONAVIT, which has been negative in recent years. In essence, the average worker in Mexico is putting 43.5 percent of his contribution (5/11.5) into an investment with an almost guaranteed *negative* rate of return. The solution is either to eliminate the contribution to the housing subaccount or to convert it into a contribution for retirement.

Sixth, public-sector workers should be given the choice of joining the new private system. Otherwise, portability losses—an Achilles' heel of the old system—will remain. Today, only public-sector employees from the central bank can participate in the new private system. That restriction could be especially problematic for workers who switch between the private and the public sector. If the government believes in the reform, it should allow those who work for it to join the new system immediately.

Seventh, the rules on market share—17 percent of the total market, 20 percent in 2001 (article 26 of the reform law)—should be eliminated. If there are economies of scale, those rules could lead to increased inefficiencies and, consequently, to higher costs that will be borne by the workers. More important, the existence of those rules could deny some workers the freedom to choose the AFORE of their choice, in contradiction of article 74 of the reform law, which states that workers are free to choose the AFORE of their liking to manage their retirement savings.

Eighth, allowing banks to operate AFOREs might present potential conflicts of interest. In principle, so long as banks (and other private financial institutions) compete under the same rules as other market participants, they should be allowed to participate in the AFORE system. It is likely that in a market environment banks would have to develop effective separations between the banking department and the AFORE to attract and protect workers' investments. Furthermore, the AFOREs may invest in instruments of a higher quality to allay any fears that the public might have about the safety of their investments. The problem in Mexico is that the banks are government-supported institutions that were bailed out after the peso crisis of 1994–95 at a cost to the Mexican taxpayer of $65 billion. It is important that CONSAR make it clear at an early stage that no bailouts of the AFOREs at taxpayers' expense will be provided, and that workers' retirement savings will not be used to bail out other private enterprises.[36]

Ninth, breaking down the contribution into employer and employee contributions maintains the illusion that both contribute to the system. In reality, the worker is likely to bear the full burden of the payroll tax because the aggregate supply of labor is highly inelastic. Furthermore, employers deduct from workers' marginal productivity all labor costs, including payroll taxes. Breaking down the contribution also allows for the political manipulation of those rates. If the employee were officially to contribute the whole amount, the system would be simpler and more transparent.

Tenth, at first view, the Mexican reform seems to have contradictory objectives, which may lead CONSAR to impose regulations that are contrary to the interests of the workers. On the one hand, article 43 of the reform law states that one of the aims of the reforms is to increase the rate of national savings to adequate levels given Mexico's state of economic development, which might explain why the

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SIEFOREs cannot invest abroad. That same article, however, states that the reform is a vehicle to provide workers with an adequate retirement pension. Of course, that may be difficult if the AFOREs are not given enough flexibility in their investment decisions to provide an optimal mix of risk and return through the diversification of workers' investments. To minimize risk, they should be allowed to invest some of workers' savings abroad, which may be seen as contradicting the goal of increasing national savings.[37] The solution to the apparent contradiction is in the hands of the government, which should continue with its reform program so that Mexico attracts more direct investment, both foreign and domestic. After all, there are many reasons why Mexicans do not save as much as they could, or why they decide to put their savings in the United States. As Mexican economist Luis Pazos says, "In Mexico, the fiascos of the INFONAVIT, the excesses of the IMSS, along with the inflation and devaluations of the last 25 years, have generated a logical culture of non-saving among the majority of Mexican workers."[38]

Finally, the lack of an educational campaign on the part of the government partly explains the confusion that surrounded the implementation of the new system. The Mexican authorities have explained the reform only in terms of the macroeconomic effects that it will have: how it will increase the savings rate, how it will make Mexico less dependent on foreign capital, how it will improve the functioning of the capital and labor markets, and how it will lead to increases in economic growth. The reality is that those macroeconomic effects fail to capture the imagination of the average worker, who is generally more concerned with how the reform is going to affect his pocketbook. To the extent that workers realize that a private pension system can benefit them, they will become more supportive of the reform and more attached to the free market. For Mexicans, the notion of pension privatization is a revolutionary one. It makes workers more responsible for their own money and for their own financial security in old age, and more independent of the government.

Mexico and Chile: A Brief Comparison

Chile was the first country in the world to replace its government-run social security system with a system of individual accounts managed by the private sector. Although the countries following Chile's example have had the benefit of learning from the Chilean experience,[39] none of them has yet been able to create a system superior to Chile's. Nevertheless, the Mexican system represents an improvement on the Chilean system in the following respects:

- The Mexican system does not have a guaranteed rate of return. In Chile, each year each Administradora de Fondos de Pensiones must guarantee that the real return of the AFP is not lower than the lesser of (1) the average real return of all AFPs in the last 12 months minus 2 percentage points and (2) 50 percent of the average real return of all AFPs in the last 12 months.[40] This "return band" was instituted to prevent investment product differentiation at the beginning of the system.[41] Its existence beyond the initial period has meant that all the pension fund management companies in Chile have similar portfolios.
- The AFOREs will eventually be allowed to manage more than one SIEFORE.[42] Furthermore, since workers will be allowed to invest in more than one SIEFORE (within the same AFORE), they will be able to diversify their investments to obtain higher returns at a lower risk. For instance, they could invest all their mandatory savings in a low-risk portfolio and their voluntary savings in a riskier portfolio. Or they could invest in higher-risk portfolios in their early working years and then transfer their savings to more conservative portfolios as they

approach retirement. Allowing the AFOREs to manage more than one fund will contribute to lower administrative costs, if rotation of workers among the AFOREs is lower (as it is likely to be).[43]

- The AFOREs have a flexible fees-and-commissions structure similar to the one Chile had until 1987, when the rules on commissions were changed. One of the major criticisms of the Chilean system is that administrative costs are high. "Compared to what?" one might ask. But that criticism is misplaced, since costs as a percentage of total funds managed have decreased over time to about 1 percent of total assets managed, which is similar to costs of mutual funds in the United States.[44] If administrative costs are too high, that is the result of government regulations on the commissions the AFPs can charge and on the investments those companies can make. The existence of a "return band" prevents investment product differentiation among the different AFPs. As a result, the way an individual AFP tries to differentiate itself from the competition is by offering better service to its customers. One way to provide better service would be to offer a discount on the commission fee to workers who fit a certain profile—for example, workers who have maintained their accounts for an extended period of time or who contribute a certain amount of money to their accounts. Government regulations, however, do not allow that. The AFPs are required to charge a commission based on the worker's taxable income and expressed as a percentage of that income.[45] The administrative costs of managing the account of a wealthier worker are proportionally no higher than the costs of managing the account of a poorer worker, but the wealthier worker is charged a higher commission by the AFP.[46] The AFPs thus have an incentive to capture the accounts of wealthier workers and attempt to do so by offering them better customer service.[47] AFPs will continue to spend money until the marginal cost of trying to capture new accounts is equal to the marginal revenue derived from those accounts. In addition, AFPs generally do not charge exit or entry fees, even though the law allows them to do so, which means that consumers do not pay a penalty by changing from AFP to AFP.
- Workers who have been unemployed for at least 45 days may withdraw from their accounts the lesser of 10 percent of the cumulative balance in the account or the equivalent of 75 times their daily taxable base salary if they have contributed to the account for at least 250 weeks and have made no withdrawals in the previous 5 years. Workers with 150 weeks of contributions may withdraw from their account the equivalent of their monthly salary if they are getting married. Although it would probably be best that the savings be used for retirement purposes only, workers should be the ones deciding what to do with their money. Giving them the option of making early withdrawals—an option Chilean workers do not have—expands their freedom of choice and thus should be considered an improvement on the Chilean system.[48]

Initial Results

It has been just over a year and a half since Mexico's new system was implemented, so it is difficult to assess the system's success. At least in terms of enrollment, the reform has been a huge success. Even though workers have until 2001 to sign up with an AFORE, more than 93 percent of eligible workers, or about 13.8 million workers, have already done so. The contribution rate (i.e., the number of workers who contributed to their accounts divided by the total number of workers who have a pension savings account) at the end of 1998 was 82.3 percent, or 11.3 million workers. In terms of numbers of workers, Mexico's system is already the largest government-mandated pri-

If administrative costs are too high, that is the result of government regulations on the commissions the AFPs can charge and on the investments those companies can make.

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In terms of assets under management, the SIEFOREs had accumulated 54.5 billion pesos, or about $5.5 billion, by the end of 1998.[49] Salomon Smith Barney estimates that the SIEFOREs will have about $25.6 billion by 2000 and $138.9 billion by 2015,[50] which would make Mexico's the largest government-mandated private pension system in the world, in terms of both affiliates and assets under management.

As for the returns, it is not surprising that the SIEFOREs have had moderate success so far, providing a net real return of 4.8 percent since the system was implemented. Investing about 95 percent of workers' assets in government bonds is obviously a risky and not very profitable strategy that will soon have to change.

Conclusion

The privatization of Mexico's public pension system did not occur in a vacuum. Its success (or lack thereof) will depend on other reforms adopted by the Mexican government. It is certain that pension privatization can empower the common worker by turning him into a shareholder. But if property rights are not secure in Mexico, will workers really be empowered by this reform? If the risk of expropriation—either direct or indirect—through inflation remains, do workers really have property rights over their contributions? The answer is, probably not. For that reason, the Mexican government still needs to continue with its market-oriented reforms. In particular, property rights need to be strengthened through a reform of the judiciary, and inflation needs to be brought under control if the government is serious about protecting the retirement savings of 13.8 million present workers and of future generations of Mexican workers.

But assuming that the reform process continues (and indeed that workers with a direct stake in the functioning of the economy will demand those reforms from the government), what should we expect from this reform? A virtuous cycle. First, the reform is likely to lead to the establishment of a culture of savings. As Mexican economist Agustín Carstens has stated, "With the reform a large portion of the population will for the first time have access to savings services in the formal financial system, which should translate into more efficient intermediation of saving in the economy as a whole."[51] Higher savings will translate into a domestic pool of capital that will be a new source of financing for all kinds of business enterprises. That will lead to more efficient capital markets and more jobs. All those effects will translate into faster economic growth, which in turn will give workers in the informal sector an incentive to join the formal economy.[52] More important, as has been the case in Chile, workers will become more attached to a free society and the free market.

After decades of paternalism, the Mexican authorities finally replaced a bankrupt pension system with one largely based on individual choice, which will allow workers the great satisfaction of providing for their own retirement. That is the main reason to be optimistic about the future of Mexico and its new pension system. If a second wave of reforms is implemented, the system will allow Mexican workers to enjoy something that, until now, has been an elusive hope for the majority of them: more freedom and economic security in their old age.

Notes

1. In a free society, individuals should be free to decide how to allocate their resources between present and future consumption and social security should exist as a voluntary savings program. As politically unrealistic as it may seem today, that should remain the ultimate goal for those Latin American countries that have implemented a fully funded, investment-based system of individual retirement accounts. Carlos Boloña, former finance minister of Peru, put it best when he referred to the privatization of social security in Peru:

> Despite such success, we still face another challenge—the final challenge. The final challenge is to allow individuals

to move from a forced savings system into a voluntary savings system . . . as individuals, we can manage our destiny, our future, our pensions, in a much better way than the government can—either directly or indirectly. If we wish to live in a free society—where people are free to live their lives as they wish—that must be our ultimate goal ("Solving the Global Pension Crisis." *Cato Policy Report*, March–April 1998, pp. 7–10).

See also Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962), pp. 182–89; and Roger Pilon, "Beyond Efficiency: A Comment." *Cato Journal*, Vol. 3, No. 2 (Fall 1983): 603–8.

2. For an overview of the Chilean reform, see, for instance, José Piñera, "Empowering Workers: The Privatization of Social Security in Chile." *Cato's Letters* No. 10 (Washington, D.C.: Cato Institute, 1996); and Sebastian Edwards, "The Chilean Pension Reform: A Pioneering Program." In Feldstein (1998), pp. 33–62.

3. For general overviews of these reforms and the similarities and differences among the new systems, see, for instance, Monika Queisser, "The Second-Generation Pension Reforms in Latin America." *Ageing Working Papers* 5.4 (Paris: Organization for Economic Cooperation and Development, 1998); and Salomon Smith Barney, *Private Pension Funds in Latin America. 1997 Update* (December 1997).

4. For an overview of the Mexican reform program, see Luis Rubio, "Stability and Stabilization in Mexico: A Historical Perspective." In J.A. Dorn and R. Salinas-León, eds., *Money and Markets in the Americas* (Vancouver, B.C.: The Fraser Institute, 1996), pp. 79–99.

Comprehensive studies of the Mexican pension reform include Instituto Tecnológico Autónomo de México, "La reforma a la seguridad social en México. Suplemento." *Gaceta de Economía*, no. 4 (Spring 1997); Luis Pazos, *Mi dinero y las afores, ¿cuál elijo?* (Mexico City: Editorial Diana, 1997); Gloria Grandolini and Luis Cerda, "The 1997 Mexican Pension Reform: Genesis and Design." Mimeo (1998); and Carlos Sales-Sarrapy, Francisco Solís-Soberón, and Alejandro Villagómez-Amezcua, "Pension System Reform: The Mexican Case." In M. Feldstein, ed., *Privatizing Social Security* (Chicago: University of Chicago Press, 1998), pp. 135–72.

5. Public-sector workers, members of the military and police forces, and workers in state-owned institutions such as Pemex, the state oil monopoly, have their own pension and health care systems. Since those systems, which are also funded on a pay-as-you-go basis, were not part of the 1995–96 reform, they are not discussed in this study.

6. See Piñera, p. 1.

7. By artificially increasing the price of labor, payroll taxes lead to the substitution of capital for labor.

8. See Sales-Sarrapy et al., p. 144.

9. See Francisco Solís-Soberón, "The Mexican Experience." Summary of remarks delivered at the Cato Institute's Conference on Solving the Global Pension Crisis, London, England, December 8, 1997, p. 2.

10. See Sales-Sarrapy et al.

11. See Organization for Economic Cooperation and Development, *Ageing in OECD Countries* (Paris: OECD, 1996), p. 102.

12. Workers may use the funds in that INFONAVIT account to buy subsidized housing. If, upon retirement, the funds accumulated in the housing subaccount have not been used, they are transferred to the retirement account and used for retirement purposes. For a criticism of this arrangement, see below.

13. The system was so poorly organized that there were, on average, three accounts per worker. That has complicated the integration of the SAR system into the new private system. Part of the integration process has been the assignment of individual identification numbers called Clave Unica de Registro de Población (CURP) to private-sector workers. According to CONSAR, the government agency that regulates the new private system, only 5.1 million workers had received a CURP as of July 24, 1998.

14. This amount, provided to the author by CONSAR, includes both the SAR and INFONAVIT contributions (2.6 and 3.8 billion dollars, respectively). The exchange rate used is 8.87 pesos per dollar, the one quoted in *Wall Street Journal*, July 24, 1998, p. C18.

15. The cap on contributions applies to salaries up to 25 times the minimum wage.

16. The social contribution will be indexed to the consumer price index to maintain its purchasing power.

17. Article 79 of the reform law, which can be found at http://www.consar.gob.mx./pages/Normatividad/LeySAR/leysar.html.

18. The system began with 17 AFOREs. However, there were three mergers in the last months of 1998, thus bringing the total number of companies to 14.

19. See Salomon Smith Barney, p. 155, for a description of these limits.

20. The special reserve capital must be equal to the greater of 1 percent of total assets under management or the minimum capital required for the formation of an AFORE, which is equivalent to $3 million.

21. These functions are specified in Article 5 of the reform law.

22. The IMSS also receives a contribution of 1.5 percent of total wages to cover health expenses for retirees. Disability and survivors' pensions are covered by the IMSS and therefore are not discussed in this paper. For a criticism of this arrangement, see Solís-Soberón, p. 6.

23. See Sales-Sarrapy et al., p. 147.

24. See Piñera, p. 5.

25. In 1995 the minimum pension was increased to 100 percent of the minimum salary. Before 1989 it was equivalent to just 35 percent of the minimum salary (Grandolini and Cerda, p. 7). See also Salomon Smith Barney, p. 173.

26. Data taken from CONSAR, http://www.consar.gob.mx.

27. Private-sector workers who entered the labor force after January 1, 1997, must go to the new private system upon registration with the IMSS.

28. See Queisser, p. 92.

29. Total voluntary contributions amounted to 11.26 million pesos in 1998, or about $1.14 million.

30. For a criticism of this arrangement and how it will lead to higher costs borne by workers, see Sales-Sarrapy et al., p. 155.

31. Ibid., n. 30.

32. After all, if the IMSS had not used the retirement-system funds for other purposes, the public system would not have been in the precarious fiscal balance that it was.

33. Quoted in Daniel Dombey, "Private Pension Funds Out to Lure Mexicans," *Financial Times*, February 4, 1997, p. 7.

34. At the end of 1998, the government AFORE, AFORE XXI, was ranked ninth in terms of affiliates, with 3.1 percent of the total market, or about 424,000 workers.

35. See Ian Vásquez, "Two Cheers for Mexico's Pension Reform." *Wall Street Journal*, June 27, 1997, p. A18.

36. Given the traditionally cozy relationship between big business and the government in Mexico, that is a serious concern for many Mexicans.

37. Pension reform should be undertaken with the sole goal of giving workers property rights over their contributions so that they may have adequate savings to provide for their own retirement. If, as added benefits, the functioning of the labor markets improves, the rate of national savings increases, capital markets are developed or improved, the economy grows faster, and taxes are lowered, those are welcome positive externalities. But in no way should pension reform be undertaken as a way to achieve those results directly; there are other measures that can achieve those goals.

38. See Pazos, p. 106.

39. The Chilean reform has been by any measure an astounding success. The annual real return since the system was implemented in 1981 until the end of 1998 has been 11 percent on average. The economy has been growing at an average rate of 7 percent during the last 13 years, and the savings rate has soared to around 25 percent of GDP. More important, workers now have property rights over their contributions and are much more attached to the free market. For the cultural and political effects of the reform in Chile, see Piñera.

40. If an AFP falls short of the minimum return, it must make up the difference using its own capital.

41. This was done to reduce the variance in the return rates of the different AFPs, which would have had very negative political implications, and because capital markets in Chile were very underdeveloped at the time of the reform (1980–81).

42. Article 47 of the reform law states that the AFOREs will be obligated to operate at least one SIEFORE invested in instruments that maintain the purchasing power of the workers' savings.

43. Chilean authorities are now contemplating the possibility of allowing the AFPs to manage a second fund.

44. See Congressional Budget Office, *Social Security Privatization: Experiences Abroad* (January 1999), http://www.cbo .gov/showdoc.cfm?index=1065&sequence=0&from=7.

45. The AFPs also charge a flat monthly fee, but that fee is very small, currently ranging from zero to a little over $2.

46. This restriction, introduced after the initial reform, provides in effect a cross subsidy to lower-income workers and to workers who do not contribute to their accounts regularly (since by law those workers cannot be charged a commission by the AFPs on the months they do not contribute to their accounts).

47. Critics of privatization often point to the giving of toasters and other consumer goods as incentives to switch from one AFP to another as proof of the excesses of the Chilean system. Retail banks in the United States engage in similar practices on college campuses without any negative effects to the banking system or consumers.

48. Since the goal of the reform is to increase retirement pensions, some economists may think that allowing workers to make early withdrawals could lead to economic losses due to inefficiency. However, the more important concern is one of moral hazard, because the Mexican government guarantees the pension benefits of all Mexican workers irrespective of the behavior of the AFOREs.

49. Data taken from CONSAR, http://www.consar.gob.mx.

50. See Salomon Smith Barney, p. 153.

51. See Agustín Carstens, "The Reform of Social Security in Mexico." In S.A. Sass and R.K. Triest, eds., *Social Security Reform. Conference Proceedings* (Boston: Federal Reserve of Boston, 1997), pp. 153–56.

52. In general, the aggregate supply of labor is highly inelastic. However, the supply of labor in the *formal* sector in Mexico and in other developing nations with a large degree of informality is highly elastic. As a result, the decrease in payroll taxes will be accompanied by a more than proportional increase in the labor supply. There is evidence that that may have begun to happen already. According to CONSAR, the number of workers registered with the IMSS went from 9.4 million to 14.8 million from November 1996 to June 1998, an increase of 57 percent. Most likely, the vast majority of the workers who registered with the IMSS in that period were not new entrants to the labor force.

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