SHCP
SECRETARÍA DE HACIENDA
Y CRÉDITO PÚBLICO

ESTADOS UNIDOS MEXICANOS

CONSAR
Comisión Nacional del Sistema de Ahorro para el Retiro

Designing Pension systems: Lessons from Mexico

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CONTEXT

- Mexico created a DB pension system for private sector workers in the early 1940´s and later for public sector workers in 1960´s.
- At the time, demography was benign and the macroeconomic environment was stable.
- That started to change in 1976 with the first of several consecutive financial crisis: 1976, 1982, 1987 and finally, the Tequila crisis of 1994. Many determinants of those crisis but one in common to all of them: a structural problem of a low savings rate.
- 1995:
  - ✓ The DB system was without reserves
  - ✓ Mexico in the midst of a huge financial crisis
  - ✓ Mexico decided to reform its pension system: from DB to DC

MEXICO'S OVERVIEW TODAY

120 million Mexicans

60 million Mexicans are economically active

8.7% of Mexicans are over 65 years old

6 out of 10 workers do not contribute to social security

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21 years later, Mexico's pension system is composed of 4 non-integrated pillars

1. Non-contributory social program	• Created in 2007**, a non-contributory benefit** equivalent to $30 USD per month for individuals 65 years and older.
2. Public Defined Benefit System	• **A (generous) DB ecosystem –now closed-** that covers private and public sector workers who were active before the different federal systems were reformed
3. Privately funded mandatory DC System	• Created in 1997, **a DC scheme based in individual accounts** that covers formal workers, private and public
4. Voluntary pillar	• **Voluntary savings schemes** include voluntary contributions to individual accounts and other occupational pension plans.

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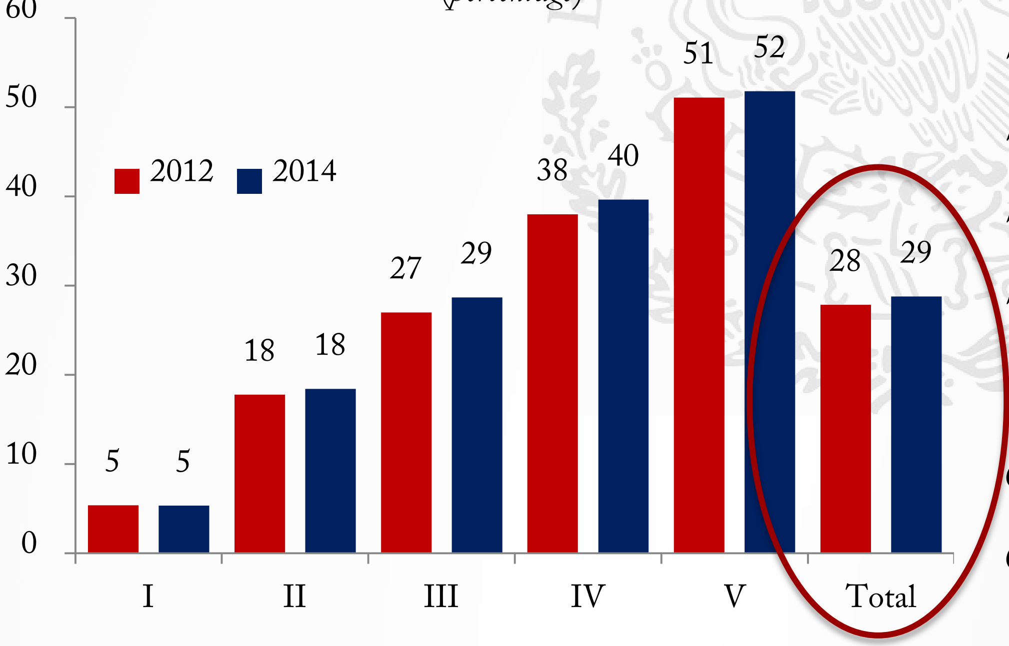
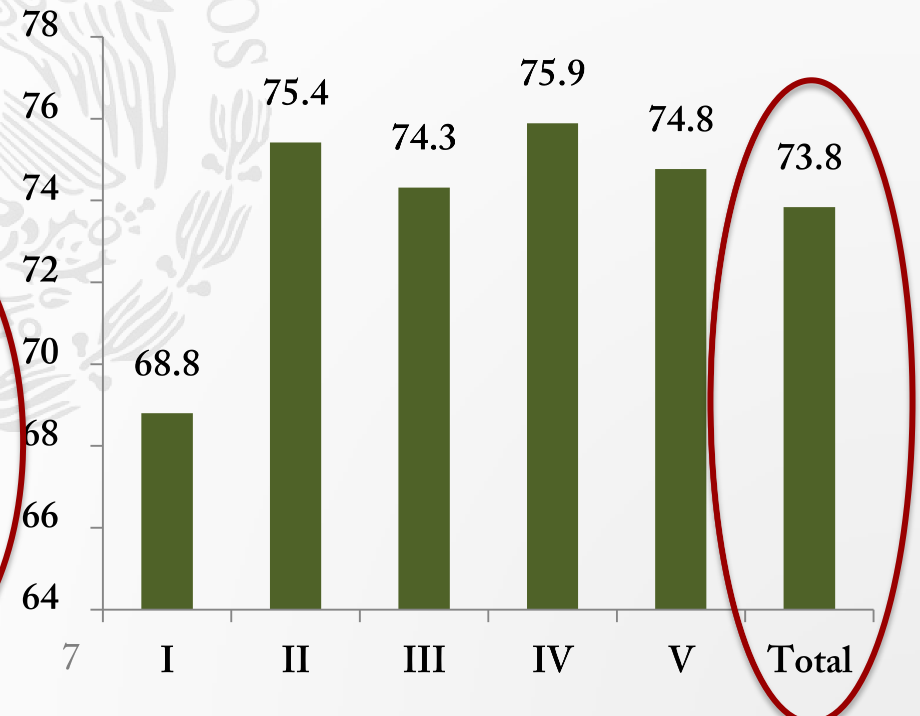
LESSON 1: IN AN ENVIRONMENT OF HIGH INFORMALITY, A SOCIAL PILLAR IS CRITICAL

Mexico´s non-contributory scheme has increased pension coverage from 30% (contributory pillar) to 74%. Nevertheless, the level of benefit is too low (1/3 of a minimum level of subsistence). Mexico´s level of poverty among elders is 30%

Population aged 65 or more with a contributory pension by income quintile
(percentage)

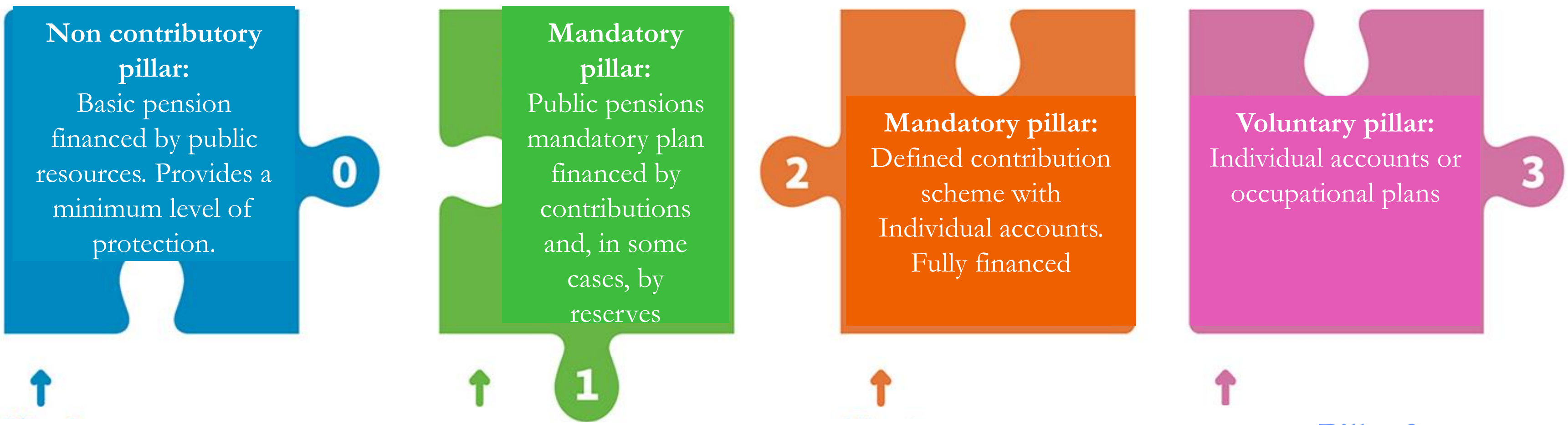


Total pension coverage
(percentage of 65 + year old population)



Lesson 2: Pillars should be integrated to improve incentives to contribute

In Mexico pillars are not integrated which generate inefficiencies and low incentives to save in the contributory system



Pillar 0

- Non-contributory pension for 65+ years old
- Welfare programs at the state level

Pillar 1

- Public universities
- Local governments
- PEMEX
- Development Banks

Pillar 2

- Private and public workers
- IMSS and CFE employees

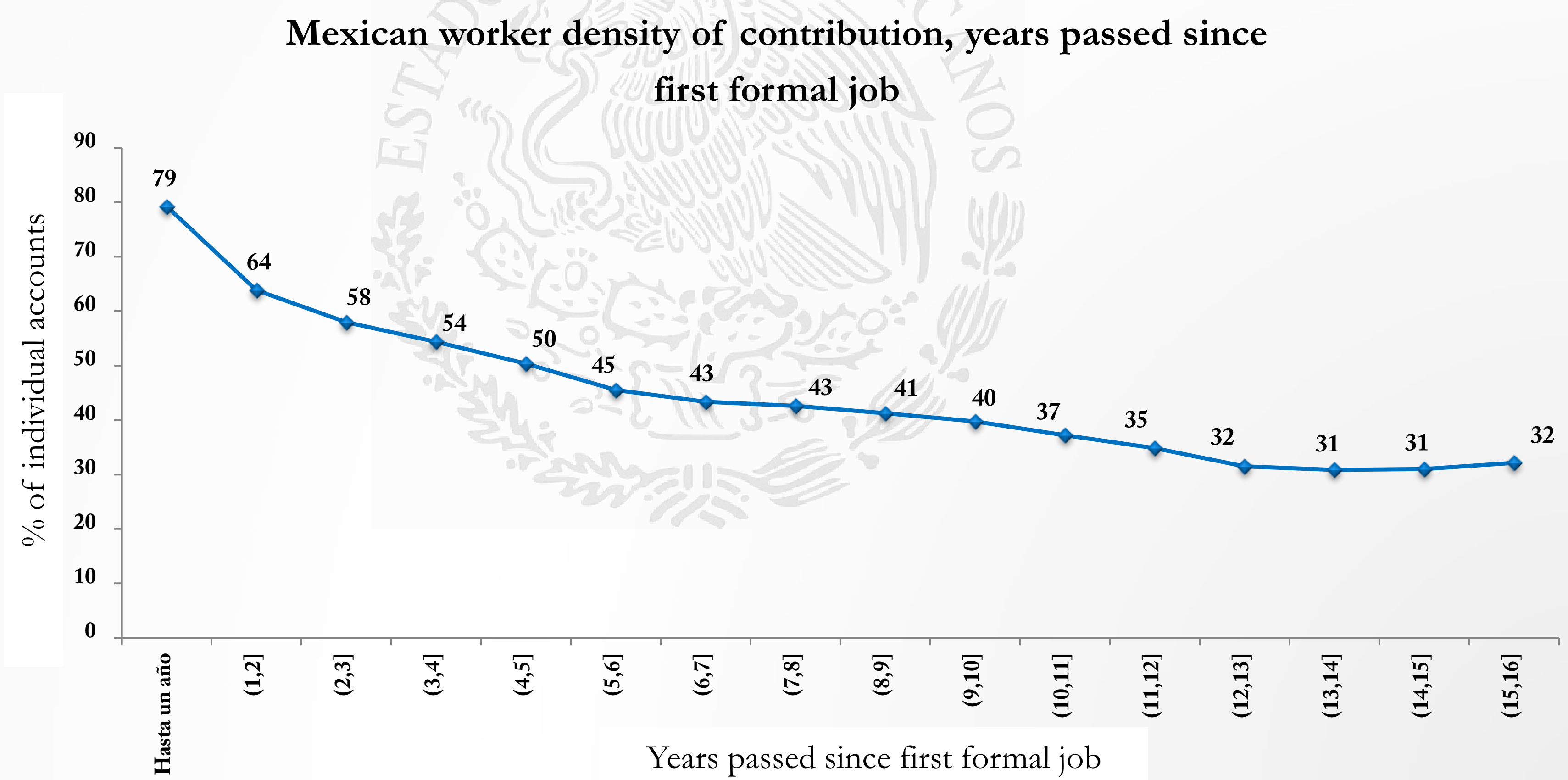
Pillar 3

- Voluntary savings in individual accounts
- Occupational plans

National Pension System

Lesson 3: A DC system with high levels of informality will likely be a problem

Informality levels in Mexico result in low densities of contribution and few people will be able to comply with requisites to obtain a pension

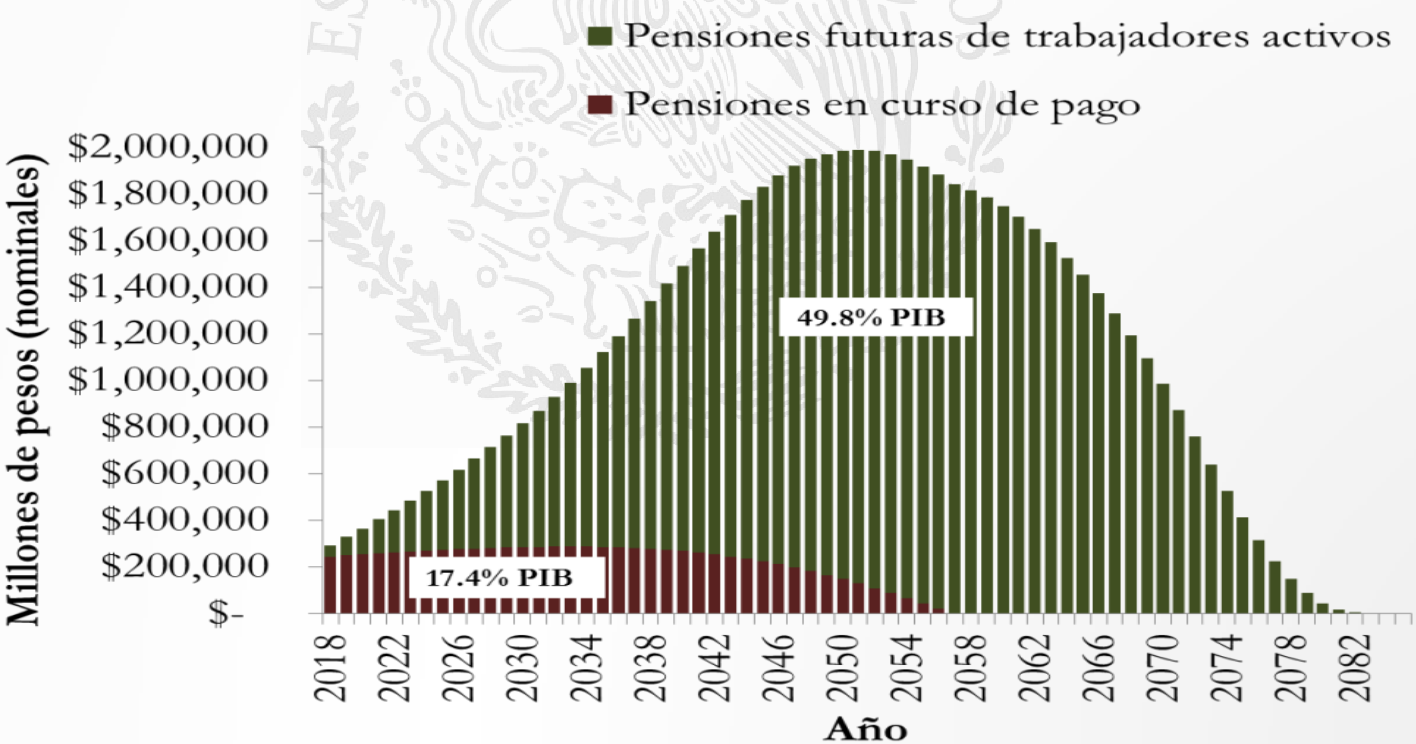


Lesson 4: Transition costs are likely to be higher than what was originally anticipated

Mexico will continue to pay DB pensions until 2080 although the scheme was closed in 1997

Public spending in DB pensions

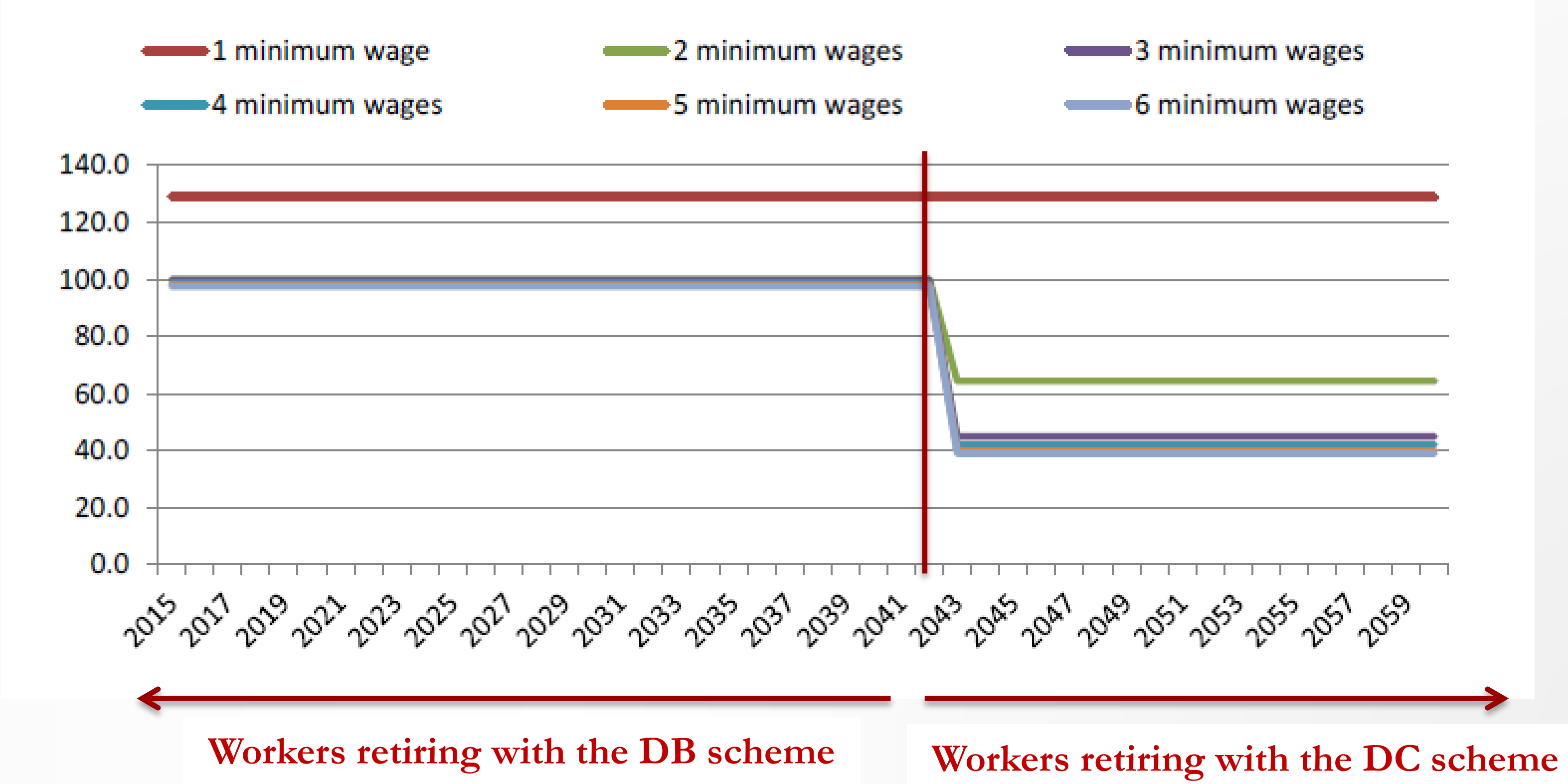
(yearly pesos)



LESSON 5: INTERGENERATIONAL EQUITY WILL EVENTUALLY BECOME A PROBLEM

Replacement rates of DB workers will be on average 80%. Replacement rates for DC workers will be close to 40%.

Replacement rates for workers retiring with the previous DB scheme and the current DC scheme



Lesson 6: If you start with a low level of contributions, it will likely be hard to increase them

Mexico has a very low level of contributions: 6.5%. Highly sensible political issue to increase them

Lesson 7: Incentives are key

- Incentives to start saving young
- Incentives to contribute
- Incentives to save an additional part of your income
- Incentives to choose correct pension provider
- Incentives to have a low cost system
- Incentives to improve long term returns
- Incentives to retire late

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Concluding remarks

- The OECD recommends diversifying sources to finance retirement and argues that both public and private components have to complement each other.
- Mexico's experience points out the importance of:
  - ✓ Half-hearted reforms will likely cost you a lot more than you assume
  - ✓ Establishing a contribution rate that allows reaching adequate replacement rates
  - ✓ Giving the right incentives and establishing automatic enrollment schemes
  - ✓ Providing incentives to contribute to workers, not only formal
  - ✓ Integrating pillars
  - ✓ Taking into account intergenerational equity when reforming a pension system

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