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BOOK REVIEW

Los sistemas de pensiones en América Latina: institucionalidad, gastopúblico y sostenibilidad financiera en tiempos del COVID-19 [Pension systems in Latin America: institutional framework, public spending and financial sustainability in times of COVID-19]

By Alberto Arenas de Mesa. CEPAL, Santiago, Chile, 65 pages, 2020.

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Alberto Arenas de Mesa's new volume on pension is timely. He was a key participant in the pension reform of Chile in 2006. [Full disclosure: He co-wrote a chapter on 25 years of reform of the Chilean pension system in a book I co-edited with Stephen J. Kay.]

It is not quite a book. A document of 50 pages with 16 tables does not qualify as a book – in my book. Nevertheless, it is an important document for the Latin American pension systems. He notes the demographic transition of the region. What remained unsaid was how fast the population is aging. For example, the proportion of the population above age 60 in France was 5% in 1750. Mexico reached the same milestone in 1985. However, by 1985 the proportion of the French population older than 60 rose to 15%. It took France 235 years to get to that point. Mexico will reach this number by 2026, in only 36 years. This pattern is typical across almost all Latin American countries. It implies that the institutional changes to cater to the needs of the retirees have to be speed up many fold. Unfortunately that has not happened. As a result, the coverage of pension schemes has remained low in almost all countries in the region.

Arenas de Mesa divides the pension system into two: civil and military. Then he uses a subclassification of contributive versus not-contributive systems and further into public versus private management. He notes that only a segment of the civil pension system is private and the rest are publicly managed. Unfortunately, here the classification is somewhat deceptive. For when he uses the phrase 'contributive', it does not necessarily mean 'fully funded'. Therefore, a contributive military pension scheme does not mean the contribution by the personnel fully funds those schemes.

Then, he makes two critical observations. Both are extremely important. I quote Arenas de Mesa in full:

'The vast majority of Latin American countries have a contributory pension scheme that covers the military sector and the police. In general, due to national security reasons, statistics of coverage and benefits are not public with a few exceptions. They are managed directly by the armed forces themselves'. [Original in Spanish, my translation]

He is right. It was even more secretive than that. For example, the total number of people in the armed forces in Mexico was considered a state secret just two decades ago, let alone total money spent on them.

'Public spending on military pension systems is less than spending on private systems of civilian pension schemes, especially due to the lower coverage of military schemes, although the level of benefits, on average, are much higher than that exhibited by the systems civil pension. If public statistics are scarce for the expenses of the systems civil pensions, in the case of the pension schemes of the armed forces, these are of even more difficult access. This document includes information on the public expenses of the system military pensions of seven countries in the region'. [Original in Spanish, my translation]

Once again, his point is well taken. It also clarifies why he only picks seven of them. For most of the others, it is next to impossible to access the data. Civil pension schemes, especially at the state and municipal levels, have very little details on the current beneficiaries or future beneficiaries. In the case of Mexico, for example, a number of state governments authorized pension to a number of 'advisors' who did not have the required number of years of service to get the state pension. The authorizations are perfectly legal – even though they are questionable. In 2010, I was examining the profile of pension beneficiaries in several states in Mexico. It turned out that the state governments had eliminated all the records prior to 2005. It was a deliberate policy.

About funding military pensions, de Mesa is not clear on one critical issue: it is impossible to make military pensions self-sustaining. Consider a new recruit starting at a non-commissioned rank at the age of 18. He (or she) would most likely serve between 5 and 10 years and leave. All countries in the world have an 'up or out' policy. You either get promoted or you are discharged. Therefore, less than 10% have more than 20 years in the armed forces. As a result, an 18 year old will still be under 40 after leaving the armed forces and will still have a quarter of a century of working life. Given that the armed forces recruit the fittest in a cohort, their life expectancies will be higher than the average individual in that country. Thus, the standard model of a sustainable self-funded pension scheme that an affiliate pays for 40 years and then gets benefits for 15 more breaks down.

Sustainability is the main thrust of this book. Hence, the impact of COVID-19 is an important point. In particular, government mandated, privately funded pension schemes adopted by many in Latin America critically depend on the performance of these funds. Ultimately, all funds depend directly or indirectly in the global stock and bond markets. The year 2022 showed us how sobering that experience has been at the global level. Let us consider an extreme example. A person with his entire fund invested in the stock market in 2022 wants to retire at the end of June 2022. If a person has a fully diversified fund, at a minimum, she will see a 20% decline in the value of the portfolio. Even if that person invested fully in bonds at the beginning of 2022 to avoid stock market volatility, she would have still lost 13% of the value of her portfolio. What was considered once in a lifetime event in the financial markets, now has become a once in a decade event. As a result, Arenas de Mesa's book has become even more important for future policymakers.

The final section of the book concentrates on the sustainability issue across a group of countries in Latin America. Depending on the available and comparable data, the author goes on to discuss at least a dozen countries in the region. In Argentina, the proportion of the GDP spent on pension has already reached over 10.7% in 2017. The aging of the population is one reason for such a rise. The proportion of the population over 65 has gone from 5% in 1960 to 11% in 2018. Another subtler reason has been the generosity of successive governments to hold up the real value of the pension of the elderly for both the private and the public sector workers. In many other countries in the region it has not been so. For example, in Mexico, 90% of the pension of the beneficiaries of the private sector under the IMSS scheme receives a pension equivalent to the minimum wage – the floor value. The real value of the average pension under the IMSS has fallen by over 70% between 1985 and 2000. On the other hand, the average pension of the federal government workers has held up in real terms. Thus, the sustainability of the Mexican system over the next decades is less precarious than that of Argentina. In the case of Chile, sustainability is slated to be a smaller problem. The reason is that in Chile, the pay as you go system had been abandoned far earlier than other countries in the region.

In most countries in Latin America, the burden of non-contributory pension systems is projected to be relatively small – less than 1% of the GDP.

It is an excellent book in many dimensions. It brings out issues that have not been fully exposed to scrutiny before (such as the military pension). However, I found one persistent issue with the way the overall data with the averages are presented. In every table, the average across countries is taken to be a simple average. That means a table containing the data of Mexico and Panama get the same weight even though Mexico has a population 30 times larger than Panama. This gives us a warped view of what is going on in the region as a whole. A population weighted average would have made more sense.