Volume Title: Administrative Aspects of Investment-Based Social Security Reform

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Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-75485-5

Volume URL: http://www.nber.org/books/shov00-1

Publication Date: January 2000

Chapter Title: Introduction to "Administrative Aspects of Investment-Based Social Security Reform"

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Chapter URL: http://www.nber.org/chapters/c7466

Chapter pages in book: (p. 1 - 8)

Introduction

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This volume contains five research papers presented at a National Bureau of Economic Research (NBER) conference on the administrative costs of individual accounts as part of social security reform held on 4 December 1998 in Cambridge, Massachusetts. The conference also featured a panel of financial industry representatives commenting on the costs and feasibility of a mandatory individual account component of a reformed social security system. The remarks of the panelists are included in this volume. Also included are the remarks of the conference participants in the general discussion sessions.

There are many potential advantages of individual accounts as part of social security reform. First and foremost is that it is easier to generate and protect a real and significant accumulation of assets in individual accounts with accompanying property rights than in the central trust fund of social security. The additional personal and national saving facilitated by the individual accounts structure translates in the long run into a higher standard of living for workers. The additional saving potentially generated by a reformed social security system would earn a substantial real rate of return for the economy as a whole unlike the pay-as-you-go system, which merely transfers resources from workers to retirees. A second advantage of the individual accounts is that they provide a direct link between the contributions of workers and the benefits that they receive in retirement. This transforms what is now a distortionary tax and transfer system into a true pension system. Under many of the partial privatization plans, some of the current payroll tax would be converted into deferred compensation.

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This means that social security reform can amount to tax reduction and reform with the accompanying improvements in the efficiency of the economy. At the very least, the partial privatization plans avoid the major increases in the payroll tax that would be necessary to restore the solvency of the existing social security system.

Still, despite these and other advantages, the advocates of individual accounts must answer one major criticism. Critics of this approach argue that a system of approximately 140 million small individual accounts will be extremely expensive to run. The present social security system has relatively low administrative costs. Adding an expensive set of individual accounts could potentially wipe out all the alleged advantages of this type of reform. There are many types of expenses to consider. These include the costs of communicating with participants, the record-keeping costs borne by individual workers, their employers, the investment managers, and the government, and the investment-management fees of the money managers. Depending on how the system is set up, the various investment managers may spend vast amounts marketing their services. If the administrative costs are large relative to the earnings of the assets in the individual accounts, then the whole advantage of the approach will have been lost. The purpose of this conference and volume is to explore the costs of various ways of setting up individual accounts as part of a reformed social security system.

This volume is different from many NBER books that feature papers on an assortment of related topics. Four of the six chapters in this volume deal with precisely the same topic. The issue is how a system of individual social security accounts can be set up in a cost-effective way. Goldberg and Graetz, Schieber and Shoven, James et al., and Diamond all independently tackle this issue. Fortunately, there is more agreement than disagreement among their findings. All of them find that administrative costs are an important issue. They also all find that implementing a prudently designed system can dramatically reduce these costs. Several of the cost elements (particularly those related to record keeping) are essentially fixed charges per account. If costs are to be allocated in proportion to assets in the accounts, this implies that there will be a cross-subsidization from large accounts to small ones. The important element of fixed costs also means that costs as a percentage of assets should fall as the accounts become larger through time.

Goldberg and Graetz concentrate on two important sources of cost saving. First, they suggest that the existing program of wage reporting and payroll-tax collecting and crediting be used to collect and credit contributions to the new individual accounts. They assert that piggybacking on the existing payroll-deduction system would mean that there would be very little incremental cost in collecting the contributions. Second, they suggest that the government organize a simple "bare-bones" investment program with a limited number of funds managed by private companies. They estimate that the total administrative costs of this "no-frills" option could range between 0.3 and 0.5 percent of assets within three to four years of the start of the program. In addition to this basic service, Goldberg and Graetz suggest that privately sponsored funds with additional investment options and services could compete for the individual account assets. The presence of and competition from the cost-efficient bare-bones government-sponsored plan would discipline the private-sector offerings. Nonetheless, the private-sector plans would face some government regulation.

Goldberg and Graetz suggest that a symmetrical two-part program could be designed for the distribution phase of the individual account program. Social security could offer to annuitize the individual account accumulation at the time of retirement by simply supplementing the regular defined-benefit pension annuity. Private insurance companies could compete with this government program by selling inflation-indexed life annuities directly to retirees. Once again, competition between the two programs would discipline the terms of the private-sector plans. Still, there would be government regulation to assure the financial soundness of the private market products.

Schieber and Shoven analyze very similar cost-efficient ways of organizing individual accounts. They survey the experience with privatized and partially privatized social security programs in other countries (Chile, Australia, the United Kingdom, and Sweden). They note that Australia has a relatively new program, begun in 1973 and still in its start-up phase. Nonetheless, the average administrative costs for the private accounts was 0.835 percent of assets in 1997. As one would expect, the average cost is going down fairly rapidly as the average account size is growing. This again reflects the fact that administrative costs have a large fixed-cost element to them. In general, U.S. financial markets are far more efficient and competitive than Australian markets. Therefore, we should be able to administer a program of individual accounts for less than the Australians do.

Schieber and Shoven also examine the administrative cost experience of U.S. 401(k) accounts. In 1997, the average total administrative cost for 401(k) plans was 0.77 percent of assets. There are reasons why social security individual accounts should be less expensive to administer (e.g., the disallowance of loans and early withdrawals), and there are other reasons that would tend to make them more expensive (lower average earnings of participants). Schieber and Shoven report that some large mutual fund companies currently manage IRA accounts (with minimum balances as low as $500) for total administrative fees ranging from 0.19 to 0.77 percent of assets.

In evaluating cost-efficient structures for social security individual accounts, Schieber and Shoven offer ideas that are similar to those of Goldberg and Graetz. They argue that cost efficiency suggests that there be only one central record keeper, which they call PSA (personal security account) Central. This central record keeper could be operated by social security itself, or it could be run by a private firm operating under contract with the federal government. Like Goldberg and Graetz, Schieber and Shoven suggest that a government-sponsored bare-bones program be offered in addition to a wide variety of individual private offerings. Again like Goldberg and Graetz, Schieber and Shoven propose piggybacking on the existing payroll-tax deduction system. In their plan, private investment managers chosen through a request-for-proposals (RFP) procedure would run the basic program. The higher-service, higher-cost program offered directly by private asset managers could accept direct deposits (like the existing 401[k] plans), keeping the central record keeper informed of all transactions. Interestingly, both Goldberg and Graetz and Schieber and Shoven (and discussant Olivia Mitchell) argue that a case can be made for the use of general federal government revenues in building the administrative infrastructure during the start-up phase of an individual accounts program.

The paper by James et al. investigates the cost effectiveness of three alternative ways of constructing a funded portion of social security. The three ways are (1) individual accounts invested in the retail market with relatively open choice (as with 401[k] accounts), (2) individual accounts invested in the institutional market with constrained choice among investment companies, and (3) a centralized fund without individual accounts or differentiated investments across individuals. The authors estimate the cost of each approach. In particular, they ask whether the cost differentials are large enough to outweigh other important considerations.

James et al. gather data regarding the costs of mutual funds and institutional funds in the United States and evaluate those data econometrically. Their findings based on this empirical evidence are that the retail market (alternative 1) approach allows individual investors to benefit from scale economies in asset management, but at the cost of high marketing expenses, which are needed to attract and aggregate small sums of money into large pools. In contrast, a centralized fund (alternative 3) can be much cheaper because it achieves scale economies without marketing costs but gives workers no choice and hence is subject to political manipulation and misallocation of capital. The system of constrained choice described by James et al. is much cheaper than the retail market and only slightly more expensive than a single centralized fund. It obtains scale economies in asset management and record keeping while incurring low marketing costs and allowing significant worker choice. It is much more effectively insulated from political interference than a single centralized fund. The authors estimate that a system of constrained choices and institutional investments can be offered at an annual cost of 0.14–0.18 percent of assets. The large administrative cost saving over a retail market approach can be close to a pure efficiency gain as long as choice is not constrained "too much."

In his paper on the administrative costs of individual social security accounts, Diamond differentiates between government-organized accounts and privately organized ones. By *government-organized accounts,* Diamond means an individual accounts system in which the government arranges for both the record keeping and the investment management for the funds in the account. These actual functions might be conducted by the government itself or contracted out to private firms. An example of this approach is the current Thrift Savings Plan (TSP) offered to federal government employees. Under Diamond's privately organized accounts, individuals directly select private firms to handle both record keeping and investment management. An example of this sort of arrangement is the IRA structure in the United States.

Diamond discusses several alternative ways of measuring and imposing the administrative costs of individual accounts. Chile imposes administrative costs as a front-load fee. That is, a fraction of each contribution is set aside for administrative costs. All costs are imposed on contributions—the return on assets in the account is not reduced by these costs. This amounts to a prepayment of all administrative costs over the life of the assets in the fund. Of course, the more common alternative is to allocate administrative costs to assets in the accounts.

Diamond describes a low-cost government-sponsored program. In estimating the costs of the program, he uses the costs of the TSP program as a starting point. His best estimate is that the administrative costs for such accounts would be $40.00–$50.00 per year. This translates to an average of 0.40–0.50 percent of assets per year over a forty-year career for 2 percent accounts. Given the economies of scale, the costs for accounts with higher contribution rates would be correspondingly lower. Five percent accounts would cost 0.16–0.20 percent of assets per year.

Diamond estimates that the costs of privately organized accounts would be much higher than those of government-organized ones—at least twice as high. He bases this on the experience in Chile and the average costs of U.S. mutual funds. Further, he expresses skepticism about the feasibility of capping administrative costs at any particular level (such as the 1 percent of assets suggested by Schieber and Shoven). Diamond argues that measuring administrative costs on such diverse things as certificates of deposit, equity mutual funds, guaranteed-investment contracts, and the like would be somewhere between very difficult and impossible. In Diamond's opinion, government-organized accounts dominate privately organized ones. His discussant, Martin Feldstein, disagrees with his cost estimates for privately organized accounts (he thinks that they are too high for a number of reasons) and disagrees with Diamond about the relative desirability of government-organized individual accounts.

The first four papers all illustrate that there is a continuum between full privatization and a purely public social security program. None of the papers evaluates a completely unregulated, fully private system for cost and, presumably, other reasons. All of them suggest that there is a role for the government in structuring individual accounts programs in a cost-effective manner. On the other hand, the types of institutions described in these papers still give individuals considerable choice and control over how their individual account assets are invested. It is my opinion that the papers correctly balance the advantages of a privatized or partially privatized social security program with the cost efficiency of centralized record keeping and regulation.

The fifth paper in this volume is on a distinctly different topic. Poterba and Warshawsky present evidence relevant to the administrative costs of the payout phase of individual accounts. They examine new data regarding the costs of purchasing private annuity contracts in order to spread a given stock of assets over an uncertain future lifetime. Their paper reports three types of evidence and describes the operation of individual annuity arrangements within two large group retirement-saving plans. First, it presents current information on life-annuity contracts that are currently available in the individual single-premium immediate-annuity marketplace. For a sixty-five-year-old male annuity buyer, the expected present discounted value of the payouts offered by the average policy that was available in June 1998 was approximately 85 percent of the purchase price of such a policy. This assumes that the individual faces the mortality risks of the average individual in the population. However, the expected present value of payouts is much higher, 97 percent of the purchase price, and the "cost of annuitization" dramatically lower if the buyer faces the mortality rates of the typical annuitant. People who buy annuities have significantly lower mortality risks than average individuals. This adverse-selection problem would disappear if annuitization of individual accounts were mandatory.

The second part of the Poterba-Warshawsky paper considers individual annuity policies that are available to participants in the federal government's Thrift Savings Plan. Because these annuities are purchased through a large group retirement-saving program, some of the administrative costs are lower than those in the national individual annuity market. Correspondingly, the expected present value of payouts is higher than that in the individual annuity marketplace. Finally, the paper describes the individual annuity products offered by TIAA-CREF, the retirement system for college and university employees. TIAA offers participating annuities, which have among the highest payouts in the individual annuity market. The ability to offer these payout levels owes mainly to superior investment returns and low expenses.

The bottom-line interpretation of the Poterba and Warshawsky paper in terms of including individual accounts in social security reform is that private annuity markets function more efficiently than had been previously thought. If the adverse-selection problem can be mitigated (by, e.g., requiring everyone to buy annuities), the market promises to be quite efficient. Poterba and Warshawsky do not convince David Cutler, their discussant, that private annuity markets are highly efficient.

Perhaps the most important conclusion from the panel of investment-industry representatives presented in chapter 6 is that all of them believe that a program of cost-efficient individual accounts can be designed and operated. That is not to say that administrative costs can be ignored. Far from it—all the panelists think that the details on how the plan is designed can affect costs dramatically. Still, statements from executives or former executives from Fidelity Investments, the Vanguard Group, State Street Bank, Barclays Global Investors, and Aetna Retirement Services that an individual account system can be made to work in a cost-efficient manner are extremely encouraging for advocates of partially privatizing social security.

There are some themes that come out of the panelist remarks and out of the research papers. First, central record keeping rather than record keeping by each plan sponsor or money manager offers considerable cost efficiencies. Second, the program of individual accounts should piggyback on existing structures where possible. In particular, the collection of contributions and the crediting of accounts should take advantage of the existing payroll-tax program and/or existing private-sector defined-contribution pension plans. Of course, some proposals for individual accounts do not depend on contributions per se but rather are funded from the federal government budget surplus. Third, there are important advantages to having a strong low-cost default option for small accounts or for participants who are willing to sacrifice some level of choice and service for low cost. The low-cost nature of the default option is feasible but may require periodic valuation (monthly or quarterly) rather than daily valuation, limited asset choices, restricted withdrawals (no early withdrawals or loans), and infrequent deposits (e.g., once per year). Fourth, costs could be reduced if employees or employers were involved in the record keeping, but not both.

After attending the conference and assembling these papers, my own conclusion is that there is a general consensus on both the feasibility of cost-efficient individual accounts and the design features necessary to achieve low administrative expenses. That is not to say that there still is not a lot of work to be done before we choose how to reform social security. One issue that is briefly discussed in this volume that needs more examination (and is getting it in an NBER volume edited by John Campbell and Martin Feldstein, tentatively entitled *Risk Aspects of Investment-Based Social Security Reform*) is the risks borne by individual participants in the alternative social security reform proposals. The issue is how to preserve the social safety net in a program with individual choice with respect to asset allocation and risk taking. A second issue (briefly discussed by Robert Pozen in this volume) is the effect that individual account investments could potentially have on asset prices. Would this effect be particularly severe if most of the money were placed in passively managed index funds? This is an important topic for future research. My own prior is that even the largest of the partial privatization plans being discussed (those with 5 percent of covered payroll being invested) could be absorbed by U.S. and global financial markets with only a slight effect on prices. Nonetheless, additional attention to this issue is warranted. While this volume cannot possibly address all the issues surrounding individual accounts, it does make a significant contribution toward social security reform—it offers clear guidance on how to organize a cost-efficient program of personal accounts.