

Discussion of James-Smalhout-Vittas paper, Administrative Costs and the Organization of Individual Account Systems: A Comparative Perspective, prepared for the World Bank conference: New Ideas about Old Age Security

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This paper addresses a very important issue: if a country has mandatory individual retirement accounts, how should the accounts be organized? The paper has three aspects – data on investment account costs in several countries, a discussion of how to interpret the relevance of the data, and discussion of the benefits and costs of having government-organized, as opposed to privately-organized accounts (referred to as the distinction between institutional and retail markets). The paper adds considerably to analysis of this issue. Naturally, in my role as a discussant, in addition to reviewing the overall issue, I will concentrate on elements with which I disagree, rather than further expressing my appreciation for the data and many of the insights. I should state that I share their view that many countries would do better with government-organized rather than privately-organized accounts.²

The paper begins by separating out three aspects of individual accounts. To have accounts, one needs collection of contributions, record-keeping and communication (R&C), and investment of accumulations. Insofar as any of these functions are privately provided, there is also a need for government regulation. It is important to recognize that these functions can be separated - different providers can be used for the separate functions. Separation can exploit differences in comparative advantage in alternative ways of organizing the functions and can allow different procedures for selecting the providers of different functions.

Collection of contributions

¹ I am grateful to Tom Davidoff and Peter Orszag for useful comments.

² For more on the issues discussed here, see Diamond, 1999a and b.

Collection of contributions can be done most cheaply if there is an effective tax collection system on which to piggyback. Marginal costs are then considerably less than with a stand-alone system. Piggy-backing may entail using a system where the identification of contributors lags considerably behind the collection of revenues (as would be the case with annual reports from employers about individual employees, despite more frequent payment of aggregated contributions). This is the case in the Swedish reform (and would be the case in the US). Thus Swedish contributions will be invested in a central pool until they can be allocated. This raises the issue of whether the investment should be in safe government bonds or in a portfolio that matches aggregate investments. The latter approach would permit returns closer to what the workers would have chosen. Both approaches involve redistributions across workers if tax collectors can not date individual contributions within the year. The paper marks the difference between the government bond rate and the expected average return on funds as a cost to be included with the direct costs of collection. However, they make no risk adjustment in evaluating this return. Since it is safer than the average portfolio, some adjustment should be made, although not eliminating all of the expected return differential since some people would have chosen to hold no government bonds.

Some countries do not have reliable tax collection on which to piggyback. In this case the paper points out the advantages of centralized collection which can be done by a clearinghouse. Mandating use of a clearinghouse can remove a barrier to entry that arises in settings like Chile where each fund (AFP) collects contributions separately, giving an advantage to incumbents, particularly large ones. Such a clearinghouse could be collectively owned by the funds and required to be nonprofit to limit a potential source of government meddling while easing entry (Diamond and Valdes-Prieto, 1994).

Record-keeping and communication

Similarly R&C (record-keeping and communication - answering inquiries about the accounts and providing information on alternatives) can be done centrally. It can be done by the government or contracted out. If it is contracted out there is a need to ensure

adequate quality of services. This can be approached with two complementary tools. One is detailing the services to be provided ex ante and enforcing the contractual obligation, although the detailing will be incomplete. The second is using competitive rebidding from time to time, giving an incentive for adequate quality in order to be allowed to continue in the set of firms allowed to bid. A problem in Bolivia may come from the intention to add more firms, but not necessarily to expose current firms to the risk of being dropped from the market. Repeated bidding requires arrangements so that alternative firms are not at a great disadvantage. Alternatively, R&C can be combined with the investment function, as is natural with at least with some organizations of investment.

In considering R&C cost estimates, it is important to know what services are included in the cost estimates. For example, the paper mentions that some of the R & C costs of the Thrift Savings Plan for US federal employees (TSP) are borne by federal agencies, not the TSP. That cost allocation is part of the reason that I have estimated that a system trying to mimic the TSP for the entire US population would plausibly cost twice as much as TSP costs.

Another cautionary note is that costs differ across different covered populations. The set of people in a voluntary market, or in a portion of a voluntary market, or the set of people employed by firms providing pensions is not typical of the general public. So one needs to ask whether it will cost more or less to service the general public than to service the population from which a cost observation is drawn. That, too, is part of the increase in my extrapolation of TSP costs to the general US population, where the general population has less education, more language difficulties, and less access to the internet.

Also relevant when considering total costs is how much people pay for financial advice and whether this would vary with type of organization. In the US, some people pay 1 percent of assets under management each year for asset allocation across readily available mutual funds (called wrap accounts).

Multiple accounts per worker

The paper does not recognize the issue of some workers possibly holding multiple accounts with multiple providers, thereby adding to the fixed costs per worker by having more accounts. In Chile, workers are restricted to a single fund. In the TSP workers can hold some of each of the funds offered, but there is a single record-keeper and single supplier of information. In Australia and the UK, the tendency of some workers to have multiple accounts as they move across employers is a genuine issue. Centralized record-keeping is one way of avoiding such increased costs.

Investment

The distinction between government- and privately-organized accounts is in terms of two aspects. Does the market select the set of available alternatives (under regulation) or is it done directly by the government. Are prices set by suppliers in a (regulated) market or by bidding by alternative firms for a limited number of places. There are many differences between approaches that are drawn out in the paper (and in Diamond 1999a and b).

Sweden

The paper puts Sweden in the category of the institutional market. It seems to me that Sweden is using the retail market with price controls. This is a separate category and needs to be thought about separately. In particular, one needs to consider the nature of the political outcome for the determination of controlled prices. The paper treats the current restrictions set by the government for the pricing of acceptable funds as if it were a long-run equilibrium. The system is so new (participants are scheduled to start making choices in September, 2000) that it is premature to take the initial pricing as a perfect guide to how such a system would work in the long run (in contrast with a competitive bidding system). In essence, the Swedish approach is to give workers access to the entire retail market in Sweden, but subject to price controls. The history of price controls has

shown many problems, including the possibility of regulatory capture, where the government ends up being concerned about profits as well as consumers and so sometimes supports prices that are not significantly lower than they would be without price controls. I think it is way too early to have any call on how well the Swedish approach will work, and I am skeptical,

Thinking about market equilibrium

In thinking about the implications of alternative ways of organizing individual accounts, it is helpful to think explicitly about the nature of equilibrium. I will discuss individual accounts where individuals choose providers from a wide set of regulated firms, where the regulation is focused on safety and soundness, and, possibly, the structure of pricing, but not the level of pricing. Like the paper, I do not consider a mandate on employers, as in Australia.

A market with a wide choice of mutual funds does not behave like an idealized competitive market. Individuals are somewhat responsive to differences in price and quality, but that responsiveness is limited in both size and speed. So, the pressure on pricing from consumer responses is present but limited. We would expect to find equilibrium with prices above marginal costs, with advertising to attract profitable customers, and with a wide range of prices for similar or identical products.

Indeed these properties hold for all consumer markets. Search theory has been developed to recognize the reality that limited price and quality responsiveness of consumers produces equilibrium with these three properties. We can ask about the properties of this market relative to other consumer markets in thinking about how important these factors are. And we can consider how different types of regulation might change a market with these properties.

Several elements stand out. A mandated market aiming at everyone will include a large number of inexperienced investors – the concept of a risk-return tradeoff is not simple,

nor is the role of portfolio diversification in holding down risk, nor the fact that attempts to time movements between classes of assets can significantly increase risk. In the US, experience with worker education in 401(k) plans shows that substantial and expensive worker education is needed to have a noticeable effect on workers' investment choices (Bayer, P., Bernheim, B.D., Scholz, J. 1996). And the average worker covered by a 401(k) plan is probably well above the US average in education and financial experience.

A mandated market aiming at everyone will include a large number of low-earners, many of whom will have intermittent covered employment and all of whom will have small accounts. At a minimum, this raises the issue of the distributional implications of alternative ways of allocating the costs of running the accounts.

A mandated market aiming at everyone will include a large number of workers with little incentive to monitor closely – for some because of the small amounts in their accounts; for some because of their limited attention to retirement issues, which is a central reason for the existence of the mandate to save for retirement; for others because of the presence of income guarantees once they retire. Moreover, this is a setting where procrastination in reconsidering portfolio providers may be particularly rampant (O'Donoghue and Rabin, 1999) – there is little apparent gain from changing providers this month rather than next month, even if one had the ability to tell good providers from bad ones. Inattentive mandated participants affect the profitability of different pricing and marketing strategies.

And it is a market where it is hard to tell a good product from some bad products, given the great stochastic variability in returns and the inherent difficulty people have in understanding stochastic settings. This is further complicated when the pricing structure is complex, as has been the case, for example, in the UK market for opt-out pensions.

So the market will respond to the profit opportunities coming from different levels of earnings and accumulated portfolios, different degrees of attention to choices, and different degrees of understanding of the available options in the market. In a small

market, the equilibrium will focus on the most profitable opportunities overall, ignoring smaller groups. What is most profitable will depend, inter alia, on regulation of price structures. In a large market, there will be firms trying to fill niches that are large enough, given the presence of some increasing returns to scale. Understanding equilibrium is not easy.

In this setting, there are likely to be pluses and minuses to different regulations. Regulations might, as in Chile, require uniform pricing, as opposed to allowing workers to form groups and bargain for reduced rates. The latter might lower costs for some workers while raising it for others. I suspect that the total costs of the system are not theoretically comparable in general, but that theory has not been worked out as far as I know.

Regulations might, unlike Chile, require uniformity in percentage terms, to enhance cross subsidization of low earners.

Regulations might, as in Chile, restrict prices to front-loads. Allowing charges on asset balances creates an incentive for firms to raise prices for workers who are not currently contributing. If these workers are less sensitive to prices than workers who are contributing, the lack of attention from these workers could result in higher overall charges than without fees on account balances. Moreover some workers could do very badly if some firms choose to exploit this opportunity at the expense of the firm's long-run viability. Equilibrium analysis needs to be done with explicit attention to the type of market this is, not implicitly based on an idealized competitive market model.

In settings with deviations from idealized competitive markets, pricing depends on perceived elasticities of all consumers who might demand a product. Restrictions on allowable products, either directly (e. g., only bond or stock or balanced index funds) or indirectly (e. g., through the incentives from guarantees), are likely to affect the price sensitivity of consumers. Less variety in products is likely to put more attention on pricing. Of course, not all index funds using the same index are the same, but it is easier

to appreciate the differences. Insofar as customers for some investment strategy, such as indexing, have different price sensitivity than the population average, then pricing for this type of strategy will reflect this. Thus, regression coefficients for having an index fund may not be a good estimate of how things would be different if the entire population were restricted to index funds. The paper recognizes a further difficulty in that existing firms with a number of different types of funds may engage in cross-subsidization, making prices not fully reflective of costs.

Regulations, as in Chile, can effectively limit choice. I suspect that the similarity in portfolios decreases marketing costs. We need to develop the industrial organization of such mandated markets to have a better feel for such questions.³

Limiting worker choice

Government-organized accounts get some of their cost advantage from bidding by alternative providers for a limited number of places on the menu of alternatives for workers. Competition comes primarily at the bidding stage and through the anticipation of rebidding. One plus of this approach is that it pretty much eliminates the profit-oriented advertising to workers. This has a negative in that workers might get too little information, as has been the case with Social Security in the US, where annual statements should have been instituted long ago. There is also the issue of how the selection process for providers will work. This puts the issues of potential corruption, collusion and rent-seeking in the center. The scope for good pricing is likely to be affected by whether this is the only institutional pricing in the country or whether there are other (private and public) uses of this approach to serve as a benchmark. Different countries will have

³ The paper uses the methodology of paying attention to averages of what happens in actual markets, rather than citing some firm with low costs as somehow representative of what would happen in an actual market, as happens too often. There is one slip, however, where the cost of an S&P 500 index fund is cited as available at 21 basis points, rather than citing the average cost of 32 basis points shown in Table 7.

different degrees of success in substituting a centralized pricing process for a decentralized one.

As the paper shows, much of the cost advantage comes from restricting worker choice in terms of portfolio and in terms of fund manager. Indeed, the latter would be completely eliminated if there were a single provider of each type of fund (as with the TSP in the US). Proposals for possible government-organized individual accounts in the US have suggested that the funds might be too large for a single provider, calling for spreading them among several providers. Nevertheless, these proposals have often suggested that individual workers still get no choice among providers, merely accepting the average for the funds in each category. This works most simply with index funds. I doubt that workers have enough ability to choose among providers to offset the disadvantage of another basis for advertising. Moreover, with providers, as opposed to portfolios, different workers have very similar objectives – there is not a tradeoff similar to that between risk and return over which workers might differ significantly.

The paper seems to suggest that there would be significant additional competitive pressure from having choice of provider as well as choice of type of fund. I am skeptical for two reasons. One is that such choice may make less effective the competitive pressure from possible future removal from the set of allowable firms – removal would be harder to do politically when workers have explicitly chosen a particular provider. Second is that similar pressure can be maintained by following the strategy adopted by the TSP (and apparently being followed in Sweden) of requiring commingling of social security funds with voluntary market funds. Thus competition in the voluntary market serves as protection for workers in the compulsory market. Multiple providers may be useful for yardstick purposes as well as spreading around investment control which might otherwise be too concentrated. But this does not require worker choice among provider.

In recognizing the implications of more choice, the paper cites the advantage from more choice for workers who are good at selecting a risk-return point. I think the paper does not give adequate weight to the difficulty of making such choices and so the prevalence

of poorer choices as a consequence of more choice. The evidence on worker choice shows considerable problems with more choice (e. g., the recent paper by Madrian and Shea, 2000) showing many workers holding their retirement funds in money market accounts). The paper seems to think that the quality of managers is fairly readily revealed over time, ignoring entry and exit issues as well as the difficulty in inferences given the high volatility in returns and turnover in individual managers. Indeed there is not much persistence in the market in terms of returns, apart from very poor firms which disappear and a very few successful investors over the long haul.

I think the advantages to workers of a wide choice are somewhere between small and distinctly negative as we increase the number of choices. The description of worker choice above is part of this evaluation. The ability of people to invest their nonmandated savings is a second reason for the limited importance of wider choice for mandated savings. The greater difficulty in regulating portfolio quality with wider choice is a third reason. And the widening of choice must be balanced against higher costs.

Costs, prices, and profits

The paper recognizes that the costs to workers depend on the prices charged by the providers of services. As a proxy for these, the paper focuses on the costs of service providers. The justification for this approach is the assertion that pure profits would be eliminated in the long-run. The paper does recognize that slow responses of workers to differences among firms may require a long time for profits to disappear. The paper does not recognize that the increasing returns to scale found in the empirical work is suggestive that there will be profits in the long run, despite a potential for entry. This is what one would expect from an inherently oligopolistic industry with significant returns to scale (as well as the incumbent advantage as workers are slow to respond to new firms). I do not see why profits should disappear in the long-run. Nevertheless, looking at costs is instructive and likely to be a reasonably good guide to prices.

Cost estimates

The paper has many interesting numbers, which appear to have been very carefully assembled. There are two with which I have questions. The paper uses 26 and 12 basis points as the unweighted and weighted average brokerage costs on U. S. mutual funds. It reports that the number was calculated from a subset of funds that reported these data for 1997. I can't help but wonder if the available sample is producing a biased estimate. It is common in the industry to cite considerably higher numbers as an average for managed funds and passive funds are still a small share of the market. For example, Bogle (1999) suggests a much higher number. The paper refers to the Dahlquist et al (1999) estimate of costs in Swedish mutual funds as comparable to the US calculations presented. However, I believe that Dahlquist et al do not include an annualization of front loads and exit fees and is not fully comparable – costs in Sweden are higher than in the US.

Conclusion

With privately-organized accounts, I suspect there are not methods to hold down costs for the long run to a level significantly below that observed in Chile. Government-organized accounts, with limited alternatives and bidding for the opportunities, can hold down costs below this level; but successful implementation puts significant demands on the abilities of government, abilities which may or may not be present.

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