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Social Security Reform:
Keeping Administrative Costs Low

by Estelle James, Ph.D.

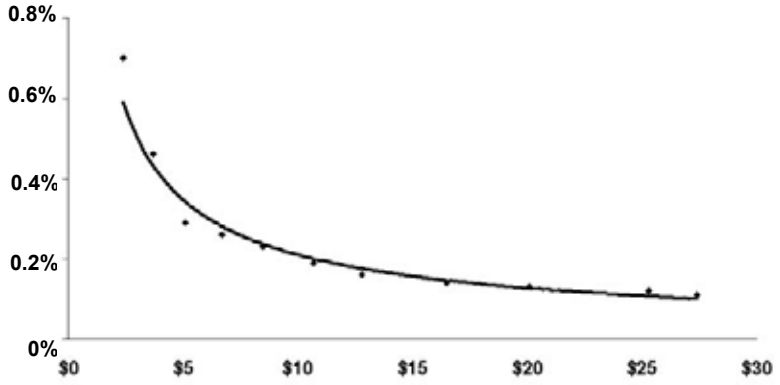
Public pension programs — including the U.S. Social Security system — tax workers to pay current retirees' benefits. But in the United States, as in other developed nations, falling birthrates and rising life expectancies leave fewer workers to support each retiree. Without reform these factors will eventually require large tax increases, large benefit cuts or both to keep the programs alive.

To avoid these painful choices, more than 30 countries have reformed their public pension systems to partially or fully fund future retirement benefits through worker saving programs. The accumulated savings in worker-owned accounts will reduce future tax burdens. Financing future retirement benefits in this way can also increase national saving, thereby increasing productivity and economic growth.

But if personal accounts are not properly designed, poor investment decisions and high administrative costs can dissipate much of the potential gain from saving for retirement. For example, if annual administrative expenses consume just 1 percent of assets, the final pension is reduced by 20 percent!

As Americans consider Social Security reforms that include personal accounts, we can learn from the experience of other countries and from relevant U.S. experience about how to keep administrative costs low and protect inexperienced investors.

U.S. Thrift Saving Plan Costs as a Percent of Assets, 1988-98



Source: Estelle James, G. Ferrier, J. Smalhout and D. Vittas, "Mutual Funds and Institutional Investments: What is the Most Efficient Way to Set Up Individual Accounts in A Social Security System?" in John Shoven, ed., *Administrative Costs and Social Security Privatization* (University of Chicago Press, 2000).

Examples of Success. Administrative costs for accounts, as a percentage of assets, appear high in the beginning because the accounts are small. But the percentage falls over time. [See the figure.] In Chile, for example, first year operating costs claimed more than 12 percent of assets. However, costs have now declined to about 1 percent of assets — lower than the average mutual fund in the United States — and will continue to decrease for workers who spend their entire lives in the reformed Chilean system.

There is ample evidence from around the world that administrative charges can be kept low:

- Administrative fees in Chile will be only 0.7 percent of assets over the lifetime of the average worker who contributes for his full working life.
- Costs are even less than 0.7 percent of assets for large employer-sponsored pension plans in Australia, Denmark and Switzerland.
- Costs are only 0.1 percent of assets in the Thrift Saving Plan (TSP) for federal civil servants in the United States. [See the figure.]

How to Reduce the Cost of Accounts. Based on the experience of existing systems, the United States can keep administrative costs low for a personal account system by incorporating the following design features:

Use the institutional rather than the retail market. Costs are relatively high when asset management firms market their services to individual workers, which is the case in most Latin American and Eastern European countries. In these competitive retail markets, to attract worker-investors fund managers incur high marketing

expenses — often more than half of their total administrative cost — which they pass on in the form of higher fees.

In contrast, costs are much lower for industry-based or employer-sponsored plans that use wholesale or institutional markets. This is the case in Australia, Switzerland, the Netherlands and the United States. For instance, the federal Thrift Saving Plan lets individuals choose from a limited number of investment options, aggregates the many small accounts of workers choosing the same portfolio and selects asset managers through competitive bidding. This allows plan administrators to bargain with potential managers for lower fees and reduces asset managers' marketing costs. Workers have some choice of investment strategy — for example, how much to put into stocks versus bonds — and the system avoids political control and manipulation of the funds.

Use passive investing. The federal Thrift Saving Plan does not allow workers to invest in individual stocks or sectors of the economy. Rather, the asset manager creates stock and bond portfolios that replicate broad diversified benchmark indices — like the S&P 500. Over time, these investments rise in value with the overall market — which has earned a rate of return of at least 6.4 percent over any 35-year period in the last seven decades. This is called passive investing. Most large company pension funds also use passive investing extensively. Active fund management, which picks individual stocks, can earn higher returns, but it also carries the risk of lower returns than the market average.

Most studies have shown that index funds, on average, realize higher net returns than actively managed funds. Unlike actively invested funds, index funds do not require fund management companies to spend money to research individual corporations or forecast the direction of the economy. Thus, the fund manager's cost — and ultimately the investors' costs — are lower. Furthermore, index funds do not carry the risk of making the wrong choices. As a result, costs for passive investments can fall to less than 0.01 percent of assets. The new Individual Account system in Kosovo, for example, keeps costs low by investing in a globally diversified index fund chosen on the basis of competitive bidding.

Spread start-up costs over time. Start-up costs are high for any new individual account system because staff must be hired, information technology systems developed and equipment purchased before any money is invested. For example, Poland's costs for its individual account system were 21 percent of contributions in 2000 — the second year of operation — but by 2002, these costs had fallen to only 8 percent of contributions, and they continue to fall. These start-up costs should be covered by a loan that is amortized over a long time period. Otherwise, workers who only participate in the new system for a few years, at the beginning, will pay a high price.

Collect contributions through the tax system and centralize record-keeping and communications. Piggybacking on the tax system keeps the marginal cost of receiving and accounting for contributions close to zero. Centralized record-keeping also exploits economies of scale. For instance, even though it is relatively new, the Swedish individual account system is relatively low-cost, in part because of centralized collection and record-keeping.

Use asset-based fees. The dollar costs of record-keeping and communicating with account-holders tends to be the same whether the account has $200 or $20,000. Therefore costs are high relative to assets in small accounts. Asset-based fees rather than flat fees per account should be used and everyone should be kept in the same record-keeping system. Otherwise, low earners with small accounts will receive a lower net rate of return on investments, further reducing the growth of their savings. This does not lower total costs but implies a policy decision to cross-subsidize small accounts.

Conclusion. By following the design features outlined here, it is reasonable to estimate that a personal account system in the United States will have administrative costs of about 0.3 percent of assets in 8 to 10 years. And these costs are likely to fall even more after the system has existed for more than a decade — reducing costs for workers with small accounts to a level much lower than they could achieve as individual investors.

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