

Design features of an IA System: What Can We Learn from Other Countries?

By
Estelle James

Reasons for pre-funding

- Pre-funding makes system more sustainable, less sensitive to demographic change
- Earns investment return, requires lower payroll tax to maintain benefits (after transition stage)
- Avoids passing large debt to our children
- Pre-funding can help to increase national saving, therefore productivity and growth

Problems with public management of funds

- Currently, treasury gets exclusive access to trust funds, iou's don't count as publicly-held debt so government may borrow more (nontransparent)—this becomes taxpayer problem tomorrow
- If trust fund is invested in stock market leads to:
 - conflict of interest between govt as regulator & investor
 - political lobbying for inclusion, exclusion
- In other countries public funds get lower rate of return, political manipulation, misallocated capital
- Piecemeal reforms are necessary but inevitably involve build-up of funds—how can we invest them productively, avoid their use to finance larger government debt? IA's are one way out.

Private investment also entails problems

- High administrative costs, financial market risk, accumulation may be used up too quickly, some workers may fall below poverty, transition cost problem
- I will outline how other countries solved these problems in their IA systems
- Devil is in the details, in answers to key design issues.

Big range of contributions and public/private benefits

- Chile—12.5% of wages to accounts+fees. Almost 100% of benefits from IA's, except for safety net—minimum pension guarantee (MPG)
- Sweden—2.5% tax to accounts + 16% to PAYG + MPG financed by general revenues. IA's 14% of total payroll tax but 30% of projected benefits
- Australia, Switzerland, Netherlands—9-14% of wage to accounts. Private benefit 50% of total
- Eastern and Central Europe—much variation
- Mixture of PAYG & funding diversifies risks

If private, who chooses investment managers?

- Workers—Latin America, Eastern & Central Europe (retail market--choice, but may lead to high costs)
- Employers—Switzerland, Netherlands, Denmark, Australia, Hong Kong
 - Long tradition of employer-sponsored plans, government recently made them mandatory
 - Initially DB, but shift toward defined contribution (DC)
 - If DC worker bears risk and will demand choice of investment manager & strategy
- Thrift Saving Plan in US, Bolivia, Kosovo—
 - competitive bidding process for fund managers—
 - workers get lower cost with limited choice, possible political manipulation

How to keep administrative costs low

- Important to keep costs low: If expenses are 1% of assets annually, pension falls 20%
- Chile—administrative costs high at start-up but 1.2% of assets now; projected to be .7% over lifetime of full career worker (< US mutual funds)
- Costs higher in new plans in rest of Latin America, E. and Central Europe
- Costs only .1% of assets in TSP, .3-.5% in large employer plans in Holland, Australia, Switzerland
- Why these differences? How can we keep costs low?

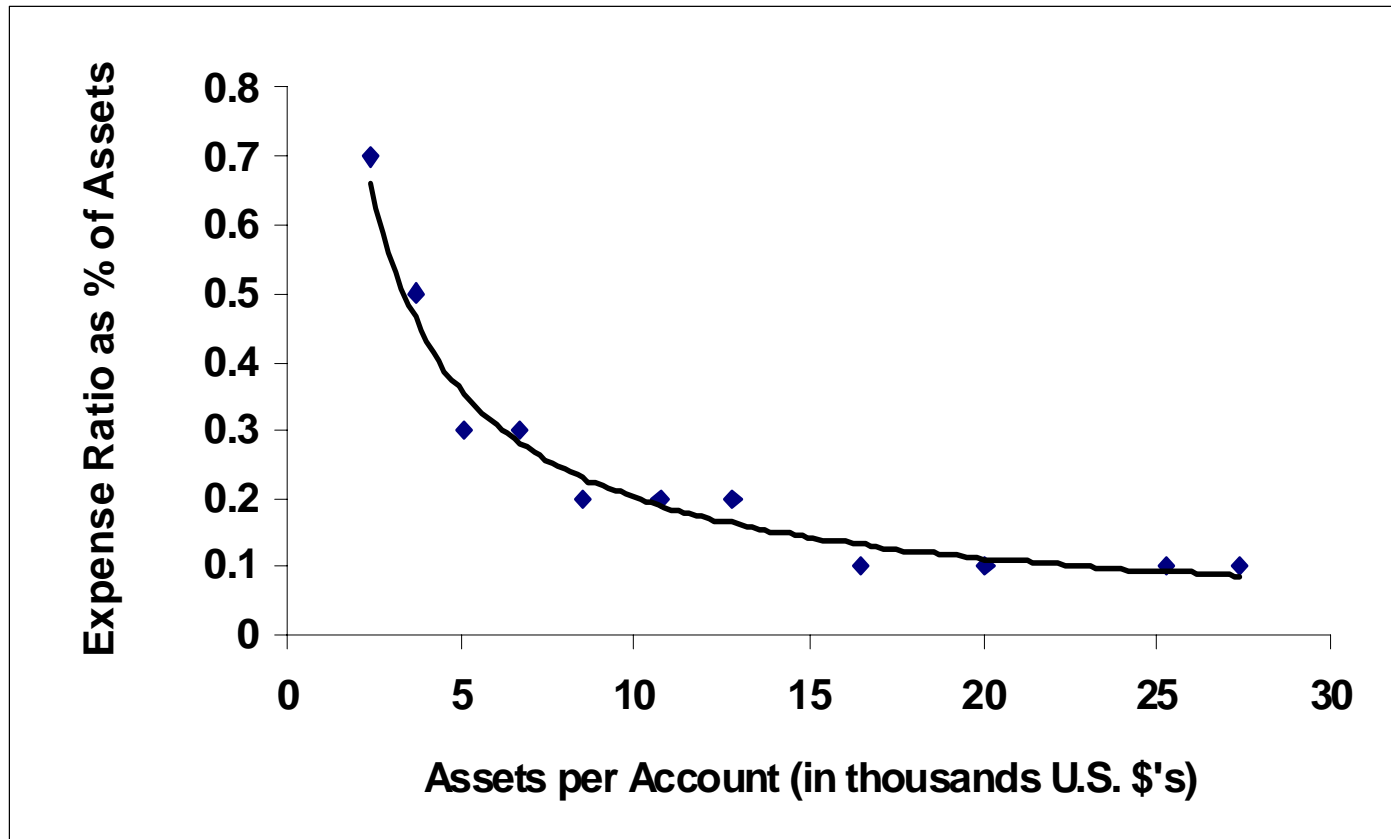
For low investment & marketing costs use institutional market

- Most Latin American and Eastern European countries use retail market—many asset managers sell directly to individuals. High marketing cost.
- Bolivia, Kosovo, TSP, large employer plans, use institutional (wholesale) market—
 - Aggregate small accounts to capture scale economies, increase bargaining power, reduce marketing costs.
 - Choose small number of asset managers through competitive bidding
 - Danger: limited entry increases danger of political manipulation, regulatory capture by companies

Other cost-cutting measures

- Use passive investing (indexing to benchmark like S&P500 or global index)—investment costs negligible
- Collect contributions through tax system
- Centralize record-keeping and communications costs (R&C) for scale economies
 - R&C biggest single cost item
 - Fixed cost per account once service level is chosen
 - As average account size rises, costs as % of assets falls
- Amortize high start-up costs over time
- If cost per account is about \$20, admin. costs < .3% of assets once average account size > \$7000

Thrift Saving Plan—expense ratio falls as average account size grows



How countries reduce risk via portfolio restrictions

- Require diversification by limiting concentration
 - But not enough international diversification
- Limit investment in risky assets
 - Which are risky assets?
- Life cycle funds?
 - Chile limits % in stocks after age 55 (less return, less volatility, less subject to date of retirement risk)
- Too much choice, worker mistakes in UK
- Carefully structured choice (like TSP) is best
 - Make risk-return trade-off clear
 - Gradual conversion to bonds as retirement approaches

Safety net for low earners

- Every country with IA has minimum pension or flat benefit that sets floor (15-40% average wage)
 - MPG in most Latin America, Eastern Europe
 - Moral hazard re work, investment, annuitization,
 - Flat benefit in Western Europe
 - Expensive, less distortionary
 - Means-tested benefit in Australia, UK
 - Transactions costs, saving disincentive
 - Flat public payment to IA per day worked in Mexico
- We should consider pension floor tied to months of work to insure against labor and financial market risk

Many guarantees

- Relative rate of return guarantee common in Latin America--herding, index to benchmarks better
- Absolute rate of return guarantees:
 - 0 real rate in Kazakhstan
 - 4% nominal interest rate & annuity conversion rate in Switzerland--doesn't adapt as market rate changes
- 75% annuity guarantee by government in Chile
- MPG in Chile--will likely cost more than expected
- Private market guarantees possible--but must be carefully regulated (costly, hard to evaluate)
- Public guarantees--pose moral hazard problems and contingent liability that should be costed out

How to handle payouts

- *Will workers spend down money too soon? Annuities guarantee life-long income. Can private sector handle this? Will workers buy annuities?*
- Chile has had IA system since 1982
 - many workers have retired, government requires annuities or gradual withdrawals--2/3 have annuitized
 - lump sum only if pension > 70% own wage, 150% MPG
 - pensions must be price-indexed, joint for married men--inflation insurance, protection for widows
 - risk differentiation permitted
 - high money's worth ratio
 - pensioners who work don't have to contribute to their account—encourages work
- Private sector can handle payout stage
 - but only if government sets careful rules of the game

How to protect women

- Women work less, earn less, live longer, and if married their husband are older, so they become widows with low incomes. Very old women are pockets of poverty in many countries.
- Women are the biggest gainers in lifetime income from the pension reform in Latin America. Why?
 - MPG or flat benefit helps low earners
 - Survivors benefits purchased through group insurance contract during working stage
 - At retirement, husbands required to purchase joint pension--financed by husbands (in US by taxpayers)
 - Widows keep own pension plus widow's pension (in US widows must choose between the two; many women who work & contribute get no added benefit)

How to handle the transition

- Chile, Latin America, Central & Eastern Europe—used carve-out from existing payroll tax that was high ($>25\%$) at start. Transition financing gap
 - Most downsized current benefits that were too generous
 - Chile accumulated fiscal surplus before reform but still has large financing deficit (also deficit in old system)
 - Debt finance played large role but we don't know how much because money is fungible
- Australia, Netherlands, Switzerland, Denmark, Hong Kong—add-on, no transition cost problem
- US--trust fund surplus, low contribution rate, so carve-out or add-on are both possible; mixture might be best
 - transition costs for carve-out, not for add-on
 - to increase national saving we shouldn't use pure debt finance (personal saving offset by public dissaving)

Conclusion

- Mixture of PAYG DB and funded IA would make system sustainable, protect workers, improve econ
- The devil is in the details. Possible design:
 - Competitive bidding, index funds, diversification, gradual move out of stocks
 - Minimum pension tied to years of work
 - Annuities up to reasonable threshold
 - Possible add-on with progressive match by carve-out
 - Strategy for covering transition financing gap
 - Trade-off between ownership, choice and political insulation vs. costs and risk
- Ultimately we will have to make value judgment between reducing benefits vs. increasing revenues --but we will get more for our extra money if we put it into funded accounts