

Rebuttal

Critics of private choice claim that the costs of private plans exceeds the cost of a government managed plan. I believe this conclusion is wrong for, not one but several reasons.

First is the neglect of differences in services and benefits. Private plans send the beneficiary a quarterly report on their wealth and future benefits. The government will send a printout of payments or a schedule of benefits only if you request it. Private plans allow beneficiaries to change the mix of their investments. The government offers no choices.

Second, perhaps the largest source of cost differences arise from adverse selection. If the government permitted more choice, it would face this cost as well. It is a mistake and highly misleading to compare a mandatory government plan with no choice to plans that allow beneficiaries to change the way their pensions are invested.

Third, Professor Diamond's calculations have a one-time, one percent cost for the present social security system and about 20% lifetime cost for private plans. The comparison does not allow for the difference in services. Social security makes no investment decisions, so it incurs no portfolio management costs. All costs of collecting funds are paid by the IRS from general revenues. These costs are not avoided. They simply don't appear in the expense statement of the current social security fund. And Professor Diamond assumes that private plans earn only a 4% real return instead of the 7% long-term average real return on common stock.

A large privately managed fund, TIAA-CREF, manages pension assets for employees at universities and research institutions. Recently, it began to manage mutual funds available to a wide variety of investors. A recent report shows the

rates of return earned by different funds and gives a more satisfactory basis for comparing costs of public and private plans.

Insert Table 1 here

Table 1 helps to clarify some of the issues in this debate. First, Professor Diamond's paper claims that the government's cost advantage arises from the large size of the public fund. Columns 1 and 2 show that this claim is false. Cost per dollar of assets is about the same for funds ranging in size from \$130 million to \$97 billion. Small differences are explained principally by type of fund and not by size.

Second, notice the comparative costs in the table. I used the cost of the CREF stock fund (0.31%) in Table 1 as the base of the calculation. To convert from cost per dollar of assets to cost per dollar of benefits paid, I used the ratio of the number of beneficiaries to the number of insured by the fund, about 20%. This puts the cost per dollar of benefits paid at about 1-1/2%. For the government fund, the cost is about 1%, but this excludes costs of collecting receipts or investing assets, both of which are included in the private fund costs.

I do not want to overstate the accuracy of my estimate. No doubt a more precise estimate could be had. It should be clear, however, that Professor Diamond's estimate that private funds are 20 times more costly should not be taken seriously. My calculation suggests instead that when costs are counted the same way, and all costs are included, the government fund may be more expensive.

Professor Diamond obliquely recognizes the private sector's possible cost advantage (p. 14) when he recommends caps for administrative cost. I prefer to rely on market competition.

We must not fall into the mistake for paying attention only to costs and ignoring differences in benefits. Table 1 repeats the widely accepted estimate of long-term social security returns, about 1.5% a year -- equal to the expected growth

of real wages. This estimate will be an overestimate unless economy-wide productivity growth rises faster in the future than in the past 25 years. I will, however, use this estimate.

Compare this return to the long-term return on common stocks or corporate bonds -- 7% and 2% respectively -- based on a sixty-year average.

The conclusion I draw is that government has grossly mismanaged the pension system, used it to produce a politically popular transfer to the old, failed to face up to its future liabilities, and produced low returns. This is gross mismanagement. Any private firm that totally failed to anticipate the future would--and should--be out of business. The government should be out of the pension business because of gross mismanagement and poor returns.

Third, I turn now, briefly, to political issues. Since time is limited, I will concentrate on two issues. One is conflict of interest, the other is rate of return.

Government is the main regulator to achieve politically selected social goals. There is a conflict of interest between government the regulator, clearly in a position to effect rates of return and even to ban products, and government as an investor. It is hard to see how government can effectively keep separate public pressures to regulate and inspect from impacting on its ability to earn a competitive market rate of return.

One need not belabor these points. We need only look at what happens. Professor Roberta Romano examined the returns to 50 state pension plans for the years 1985-89. She wrote:

"[P]ublic pension funds are subject to political pressures to tailor their investments to local needs, such as increasing state employment, and to engage in other socially desirable investing.... Their return is typically not commensurate

with the risk." [These funds avoided investment in companies that reorganized if the reorganization meant a loss of jobs within the state.¹]

A separate study of 200 state and local pension plans for 1968 to 1986 found that public pension plans earned rates of return substantially below those of other pooled funds and often below leading market indexes.² Lower average returns have also been the experience of so-called social investment funds that avoid similar kinds of investment.

People should, and do, have the opportunity to invest in funds that try to meet their social goals. The private market provides that opportunity. It should not be imposed on anyone.

Old age pensions are too important to people to be left to the government. Proponents of government-run programs overstate the costs of private programs, understate the costs of government programs, and assume without offering any evidence that individuals would have the same benefits from private and government programs. It has not been true, and there is no reason to believe it will be true in the future. [Comparisons of public privately managed plans err most when they assume, usually implicitly, that both will be managed with the same concern for market value.] Let's not give up the right of those who want to rely on market competition to maximize their expected retirement income.

¹ Quoted in Weaver, *op. cit.*, pp. 7-8.

² Quoted in Weaver, *op. cit.*, pp. 8-9.