Advertising and Competition in Privatized Social Security: The Case of Mexico

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The issue. With a solvency crisis looming, social security privatization is a top political and economic issue. Often seen as a third-rail of American politics, aging populations will force the country to make tough decisions about our pay-as-you-go system. A handful of countries have already opted for partially- or fully-privatized social security systems. What can we learn from their experiences? Can a privatized social security system deliver higher retirement wealth by allowing individuals greater control over their investment decisions? Does the free market deliver price competition and efficiency?

In markets with complex choices and consumers from diverse backgrounds, can privatization work?

Mexico launched a fully-privatized defined contribution plan in 1997, with 17 participating fund managers who could compete to manage investors' privatized social security accounts. Given the tight regulations on investment vehicles, fund managers each offered one, essentially homogenous investment product. Investors could choose which firm they wanted to manage and invest – for a fee – their personal social security account.

Surprisingly, after one year of competition for accounts, fees remained high with an average load of 23% and annual fee of 0.63%. That's right – at these fees a 100-peso deposit earning a 5% annual real return would only be worth 95.4 pesos after five years. *How could competition among many firms result in fees at this level?*

Investigation. In "Advertising and Competition in Privatized Social Security: The Case of Mexico" Hastings, Hortacsu and Syverson use administrative data in partnership with the Mexican Social Security Administration to answer this question. They investigate how investors chose fund managers and how competition did or did not work in the newly privatized market. The authors find that investors simply weren't sensitive to management fees. This was especially true in lower-income segments of the population. They show that sales forces were in part to blame for poor choices: firms used advertising to turn inexperienced investors' attention away from fees and towards brand name. The persuasive impact of sales forces and advertising was strongest in lower-income segments of the population, where investors have less education, less financial experience, and lower financial literacy rates.

Competition did occur – but it was competition on advertising, not on price – shifting a significant fraction of GDP from savings for retirement to fund manager profits and advertising expenditures. Five years after the launch of the privatized system, fund manager annual return on expenditure averaged 39%.

Policy Problem. In markets with complex choices and consumers from diverse backgrounds, can privatization work? If firms choose persuasive advertising instead of consumers, will privatization lead to efficiency or inefficiency? These are important questions in policy discussions from Medicare to school choice to savings for retirement. The authors use their results to glean insights into how regulators might improve performance in privatized social-safety-net markets like this one.

Possible remedies: Supply side. Introducing a government or government-regulated competitor is often suggested as a policy solution for increasing competition. If private competition is limited, a government player could enter, sell at cost, and enforce price competition in the market. The authors simulate this intervention, and find that introducing a government player can have unintended consequences, leading to higher prices rather than lower ones. The intuition is simple: If there are many unsophisticated consumers in the market who can be convinced to value brand over price, savvy consumers will buy from the cheap government option and private firms can raise prices on the remaining price inelastic customer base. Think Walmart and the mom-and-pop. When Walmart comes to town, the mom-and-pop can try to match their price, or they can raise prices knowing that only price inelastic customers will still visit their store. Walmart helps the mom-and-pop price discriminate.

A government competitor may be both ineffective *and* regressive.

Demand side. Consumer confusion and price insensitivity have been linked to financial literacy and have prompted calls for financial education. Does increasing price sensitivity, say by educating investors, result in a more price-competitive market? In short, yes. The authors simulate what fees would have been if the most price-insensitive segment of the market simply paid average attention to fees. This intervention did the trick. By shrinking the price-insensitive segment of the population, the policy lowers prices. Total management costs could have fallen by over 37%.

The authors also explore what would happen if sales forces were unable to persuade investors to focus on non-fee attributes, for example through disclosure and information regulation. They find that fees would have been 67% lower.

Combined policies. There's no need to choose policy over the other. They can provide even greater benefit when implemented together. Once consumers pay more attention to prices, the government player becomes effective, stealing substantial business from private firms unless they lower price. What was the simulated impact of both demand- and supply-side policies? A whopping 74% reduction in management costs. That's a big savings given that contributions are 6.5% of private-sector labor earnings.

Take away points

- Social security privatization in which the government is truly hands off does not create a competitive market, and generates a loss of wealth, particularly for the poorest investors.
- Adding a government player to the market is not sufficient to lower costs to investors. Quite the contrary, this intervention on its own can raise fees and overall costs.
- Demand-side interventions, such as disclosure regulation or financial literacy and information campaigns can complement the government intervention, leading to substantially higher price competition and lower fees.

Implications and Recommendations. The results indicate that to create a price competitive environment, it may be necessary to do more than simply set up a market with a sizeable number of firms. If firms can find other ways to compete than on price, they will, and it is apparent that circumstances in the Mexican market allowed firms to channel competitive efforts into brand-oriented advertising that served to make workers even less price sensitive. However, private markets can work with smart policy design. While the research findings suggest that merely creating a low-cost public option will not necessarily foster price competition, they show convincingly that demand-side efforts that raise workers' sensitivity to the costs they pay for management of their accounts can be fruitful interventions.

the fine print

technical information

Data

Administrative data on accounts and local sales force exposure in collaboration with the Mexican Social Security Administration.

Methods

Estimation of flexible demand model which allows advertising exposure to influence Brand and Price preferences ; simulation of proposed policy using Nash-Bertrand iterative best response functions.