Individual Social Security Accounts: Administrative Issues

Executive Summary

Both major-party candidates in the 2000 presidential campaign advocated adding individual accounts (IAs) to the Social Security system. Former Vice President Al Gore advocated what he called “Social Security Plus,” an individual account paid for with contributions/taxes above and beyond the current Social Security program (an “add-on,” in the parlance of the debate). President George W. Bush advocated a voluntary individual account that would be funded by a portion of the taxes now paid for Social Security (termed a “carve-out”).

From a political perspective, it is significant that both parties had effectively agreed during the 2000 election cycle that: (1) Social Security alone does not provide adequate retirement income; (2) expansion of the existing Social Security program to provide a larger annuity is not on the table—that is, the issue is how to fund the current annuity, survivor, and disability programs, and not how to expand them; (3) supplementation of Social Security should be through a cash-based individual account; and, (4) investment in the private equity and bond markets would be a good way to enhance retirement income security and to build upon the base of Social Security. Now in 2001, after the election, it appears that (1) is still the case; (2) may be on the table in the form of an increased or new “minimum” benefit for the lowest-income recipients; (3) may be opposed by the Democratic congressional leadership in order to more clearly differentiate their position from President Bush’s on any form of new individual accounts; and (4) will likely continue to be advocated by both parties, with the distinction being between investment through individual accounts (as advocated by President Bush) as opposed to investment by the Social Security Trust Fund (as advocated by some Democrats).

From a public policy perspective, it is not surprising that most of the debate is centered on the current funding situation (whether the year 2016 or 2038 matters for the program and the Trust Fund); what the Trust Fund actually is; what the options are for reform; and whether the “carve-out” approach helps or hurts the program. It is also not surprising that advocates of both the “add-on” and the “carve-out” approaches appear to accept it as a given that, administratively, individual accounts can be done “easily and quickly” if the policy decision is made to adopt them.

But from a practical perspective, the debate so far has virtually ignored any specific considerations about how to administer such accounts. Any discussion of whether to create individual accounts must also address the basic but critical questions of how they would work: Who would run them? What would they cost? Logistically, in what form are they possible?

This EBRI Issue Brief/Special Report provides an update to the November 1998 EBRI Issue Brief, which presented an overview of the most salient administrative issues facing the current Social Security reform debate—issues that challenge policymakers to think carefully about how their proposals could be implemented, in order to achieve their policy goals.

Speeches, media articles, books, and television reports have frequently suggested that if the federal employee Thrift Savings Plan (TSP) can work, and if private employ-
ers can make 401(k) plans work, then individual accounts in (or in addition to) Social Security can be easily administered. As this EBRI Issue Brief/Special Report discusses, there is a way to design a system of individual accounts that could potentially be administered in a cost-effective and timely way—but for a variety of inescapable reasons, that system most likely would bear little or no resemblance to a modern 401(k) plan. If a typical Internet-based 401(k) with easy access to account information and investment options can be described as the “Porsche” of retirement savings plans, then the public should realize that a workable, cost-effective individual account within Social Security will most likely look like a “Model T”:

- The average 401(k) plan offers nine actively managed investment choices (“Porsche” plans offer virtually unlimited options through mutual fund “windows” and self-directed brokerage accounts); a startup universal IA system would offer a very limited number of index investment options—probably just one initially (the Federal Thrift Savings Plan offers only five).
- 401(k) plans typically offer daily access through the telephone, and “Porsche” plans offer round-the-clock Internet-based self-management with immediate access to account information, updated daily; something closer to an annual account statement would be likely for a startup universal IA system.
- 401(k) plans typically offer participants loans or hardship withdrawals from their accounts, with “Porsche” plans providing “do-it-yourself” loans over the Internet; a start-up universal IA system likely would find it impossible to offer either.
- Workers’ 401(k) contributions typically come out of every paycheck, with rapid crediting to investment accounts; a start-up IA system tied to Social Security would involve “bulk” contributions, with annual reporting of contributions to the Social Security Administration at the worker level, and crediting as much as 18 months later as the paper is processed. “Porsche” 401(k) plans do both contributions and allocations on a fully automated basis every pay period; a start-up IA system could not, since the majority of U.S. employers file with the government on paper.
- 401(k) plans allow participants to modify their contributions regularly, with “Porsche” plans allowing it round-the-clock over the Internet for next-pay-period implementation; a start-up IA system more likely would allow this once a year (per employer) when employees fill out their withholding form.
- “Porsche” 401(k) plans rely on employers and administrators being completely automated, with computer interface of all data; a start-up IA system would have to allow employers to continue using pen-and-paper reports—as most currently do—if high administrative costs are to be avoided (especially for small businesses).
- “Porsche” 401(k) plans offer proactive, personalized participant education and investment advice; a start-up IA system would likely offer only generic education materials.

The issues and options in administering IAs raise concerns that cut across ideology. The object of this report is neither to dissuade the advocates nor support the critics of individual accounts. Rather, it is to bring practical considerations to a political debate that must ultimately deal with the pragmatic challenges of designing IAs that would not be too complex for participants to understand, too burdensome for small employers to administratively support, too difficult for a record keeper to administer, or too expensive for low- and moderate-income participants to afford.

The major findings in this analysis include:

- Adding individual accounts to Social Security could be the largest undertaking in the history of the U.S. financial market, and no system currently exists that has the capacity to administer such a system. The number of workers currently covered by Social Security—the largest single entitlement program in the nation—is at least four times...
higher than the combined number of all tax-favored employment-based retirement accounts in the United States, which are administered by hundreds of entities.

- **Direct comparisons between employment-based retirement savings plans and Social Security reform options are difficult at best.** Social Security covers workers and businesses that are disproportionately excluded from employment-based plans. Because of these differences, a system of individual Social Security accounts would be more difficult to administer than employment-based plans, and total administrative expenses could be larger relative to benefits due to most employers not using automatic payroll systems, large numbers not using direct deposit, the vast millions of short-service and young workers who are not included in either public or private employer savings plans, and the high relative cost of even one phone conversation with the holder of an account (commonly estimated to be an average of $10 per phone conversation).

- **Credit-based systems such as the current Social Security program are less difficult to administer than cash-based systems, which must account for every dollar.** Inherent in the individual account debate is generally the presumption that IA benefits would be based on cash contributions and investment returns. The current credit-based system tolerates small errors in wage reporting, because they rarely affect benefits. But every dollar counts in a cash-based IA system. To ensure that benefits are properly provided, an IA system would require more regulation, oversight, and error reconciliation than the current Social Security program.

- **Social Security individual accounts cannot be administered like 401(k) plans without adding significant employer burdens—especially on small businesses.** Under the current wage reporting and tax collection process, it would take at least seven to 19 months for every dollar contributed to an individual’s account to be sorted out from aggregate payments and credited to his or her IA. This seven to 19-month “float period” could result in substantial benefit losses over time. Options for preventing such losses involve difficult trade-offs, such as increased government responsibility, increased complexity, greater employer burdens, and/or investment restrictions for beneficiaries. Elimination of this “float period” by requiring faster action by small employers would lead to significant new administrative burdens and costs.

- **If legally considered personal property, the IAs of married participants could pose significant administrative challenges.** Social Security today must obtain proof of marriage only at the time spousal benefits are claimed. But some IA proposals would require contributions to be split between spouses’ individual accounts, requiring records on participants’ marital status to be continuously updated to ensure that contributions are correctly directed. Also, dealing with claims on individual account contributions in divorce cases could place IA record keepers in the middle of spousal property disputes.

- **The current body of knowledge is too uncertain, and in general the proposals to date are too vague, to make an objective estimate of how much an IA system would cost to administer or whether it would succeed in accomplishing its policy goals.** Uncertainty exists over how IA proposals would address key policy areas affecting administrative cost and complexity, how administrative costs operate in the current employment-based retirement arena, and how lessons from the employment-based system apply to Social Security reform. For instance, in July 2001 the Federal Retirement Thrift Investment Board terminated and sued a contractor for failure to design a workable administrative system after nearly three years of effort. Given the relatively small size of the Federal Thrift Savings Plan (fewer than 3 million participants) compared with the total U.S. work force (more than 148 million), a great deal could be learned by policymakers from...
Individual account benefits would be highly sensitive to administrative costs, according to results using the SSASIM policy simulation model. Workers born in 1976 and 2026 would receive between 14 percent and 23 percent lower total benefits under high administrative cost assumptions than under low-cost assumptions, indicating that additional research on administrative costs is essential to assessing how—or whether—IAs could achieve the lower-cost assumptions. Proposals to use a flat percentage administrative charge could approach the lower-cost assumptions if the system had a simple (and therefore “inexpensive”) design.

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