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.
Administrative Forethought

Examining policy administration is an integral part of basic public policy analysis, as history is replete with examples of inconsistencies between ideological intentions and administrative practices. Consideration of administrative feasibility, burdens, and costs prior to policy reform is especially imperative for today's Social Security reform debate, which involves various proposals to create individual accounts as part of the system. The debate centers largely over whether to add individual investment accounts to Social Security, patterned after savings vehicles currently found in the form of employment-based defined contribution retirement plans (such as 401(k) plans), rather than individual retirement accounts (IRAs), in order to have the employer act as the collection and transfer agent for contributions and initial participation choices.

Unlike today's defined benefit Social Security system, in which a formula specifies a final benefit, an
individual account (IA) plan would utilize a formula that specifies how funds are to be contributed to individual accounts. For IA participants, final benefits would depend on contributions plus or minus investment returns.

Although adding individual accounts to Social Security will primarily be a political decision, an objective examination of how to administer such accounts raises issues that cut across ideology. Adding individual accounts to Social Security would be a formidable administrative undertaking that should not be taken lightly. That is, determination of approach and feasibility should precede the political decision. Consider the following:

- **Social Security policy directly affects 96 percent of the U.S. work force and their employers every pay period** (U.S. Congress, 1998). Social Security is the largest single entitlement program in the United States.

- **More than twice as many workers are covered by Social Security as the number of individuals in the United States who own shares in mutual funds** (Investment Company Institute, 1998). Administering individual accounts for almost 148 million workers covered by Social Security would be possibly the largest undertaking in the history of the U.S. financial services industry (Lussier, 1998).

- **No unified system currently has the capacity to administer 148 million individual accounts.**
  
  —The number of workers covered by Social Security is at least four times higher than the total number of all U.S. defined contribution accounts, which are administered by hundreds of entities.
  
  —A system of IAs with full participation would include at least seven times the number of currently active 401(k) accounts.2
  
  —If all workers participated in individual accounts through Social Security, the program would cover almost 15 times the number of accounts currently managed by the nation’s largest private defined contribution plan administrator.

- **Social Security covers more than 49 times as many people as the largest public defined contribution plan, the Federal Thrift Savings Plan (TSP).**

- **The Ceridian Corporation reports that more than 50 percent of all employees in the United States are not paid through the use of a payroll service bureau, making it difficult to use the most cost-effective and administratively accurate systems to administer individual accounts (highly publicized state-of-the-art, Internet-based 401(k) enrollment and administration systems require an automated payroll system interface in order to deliver full automation and low cost).** Thus, while it is accurate to say that systems and technology exist that could make an IA system work “easily,” if universally applied, it is currently impossible to apply this technology universally because of the proportion of the labor force employed by small firms that have not yet adopted modern systems (such as automated payroll).

Because Social Security is such a large program, dissatisfaction (e.g., from over- or under-regulation) with administering an individual account system could reverberate through major economic markets and virtually every U.S. household. Hence, far from being unrelated to the social, political, and economic dissatisfaction with the current system that are precipitating interest in individual accounts,3, 4 administrative issues

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2 These figures do not include the number of defined contribution accounts whose assets have been transferred outside the employer plan (rolled over) to be held and managed by banks or annuity companies.

3 Despite substantial dissatisfaction among certain groups with projected low “returns” on Social Security contributions, general opinion surveys suggest that the public’s dissatisfaction with the current Social Security system is based on lack of confidence in the system’s ability to provide future benefits, rather than a lack of support for the system in general (Upston, 1998). Dissatisfaction with the administration of an IA system could undermine support and/or confidence in Social Security, depending on the extent to which over- or under-regulation inconvenienced or cost households, employers, or financial service providers.

4 For an overview of issues under the current Social Security system that are giving rise to interest in individual Social Security account reform, see Olsen and VanDerhei (1996) and Copeland (forthcoming).
are an indispensable part of assessing reform options. Administrative issues will determine whether such accounts could be cost effectively implemented and over what time period.

Providing Social Security IAs to all covered workers would impose uncertain administrative costs. For instance, uncertainty exists over the very definition of an “administrative” cost. For purposes of this report, administrative costs are operational expenses (e.g., time, staff, and other costs) that are incurred in order to provide financial benefits from individual accounts. Costs can be assessed to any party (i.e., government, employer, individual, or private firm) and include all expenses for individual accounts that are not a direct result of market losses or nonexcise taxes (e.g., income taxes). This means that investment fees, annuitization fees, management fees, and even paperwork burdens fall under the general rubric of administrative costs.

As will be emphasized later, program design is perhaps the largest and most uncertain determinant of administrative costs for an IA system; yet most reform proposals fail to discuss administrative details. Unfortunately, uncertainty extends beyond the current lack of detail regarding policy design, as cost confusion abounds even among today’s defined contribution plans. While many have cited the administrative costs of employment-based plans as a model for costs under an IA system, such comparisons are difficult for several reasons, including the fact that costs vary significantly across employment-based plans. The General Accounting Office (1996a) reports that administrative fees per defined contribution plan participant averaged $103 in 1993. Hustead’s data (1996) suggest that there is enormous variance in expenses across employers. A firm established as an Internet-based 401(k) administrator in 2000 has reported that its annual administrative cost per participant can be as low as $5 per year with no phone support, and $15 per year with an average of one phone call per individual, compared with traditional annual costs of $64 per participant. They estimate Internet-based investment cost at an added $16 per participant, compared with $48 per call for non-Internet-based approaches. These costs assume that the employer uses an automated payroll system and can provide a direct data feed to the administrative computer via the Internet. The traditional arrangement costs assume that some administrative steps must be taken with paper. Based upon examples used by the firm, expressed as a share of assets if charged as a flat percentage for all participants, such a fully automated system would cost 0.11 percent annually, compared with the traditional non-fully automated average of 0.39 percent.

Uncertainties Abound

The Ceridian Corporation (1999) reports that

5 Defined contribution plans provide a tax-favored vehicle through which savings can accumulate for retirement and/or other purposes. In the majority of defined contribution plans, account contributions are placed in individual accounts according to a predetermined formula. Individual benefits are equal to account contributions and investment returns thereon (Allen et al., 1997). 401(k) plans are a type of defined contribution plan in which employees defer a portion of their cash compensation into the savings account on a voluntary basis.

6 Average administrative fees (fees for accounting, contract administration, investment advice and management, legal services, valuations/appraisals, and trustee services) per participant for single employers sponsoring defined contribution plans only and who reported those fees to the Internal Revenue Service (IRS) on Form 5500 (U.S. General Accounting Office, October 1996a, p. 34).

7 It is a testament to the complicated nature of administrative costs for defined contribution plans that dollar-cost data from these two sources are not directly comparable. For example, Hustead found that annual costs per participant averaged $49 (excluding investment fees) for firms with 10,000 workers but $287 per plan participant for firms with 15 workers. These numbers are larger than they would otherwise be if they were computed instead from data provided by a firm that performed both administrative and investment services. The data that Hustead uses were from the Hay Group, exclusively an administrative services firm. Because the Hay Group does not also manage defined contribution investments, it cannot cross-subsidize its administrative expenses with investment expense. On the other hand, the GAO data are tabulated from Form 5500 reports. Many of the corporations reporting on the Form 5500 use firms that provide both administrative and investment services for defined contribution plans. Therefore, they use firms that can explicitly charge lower administrative expenses, because they receive investment fees that cross-subsidize administrative costs.

37 percent of all U.S. employees work for an organization that uses automated payroll service bureaus, suggesting that this level of administrative cost might be achievable for two-fifths of the labor force, but costs would approach the higher averages for the other three-fifths. It is unknown when, if ever, all U.S. employers will move to an automated payroll system that can tie to the Internet, but it is fair to say it will not happen quickly.

Administrative costs vary for many reasons, some of which are predictable, such as differences in plan design and employer size. However, they also vary for less understood reasons (see table 1). Service providers have hundreds of administrative fees, and each vendor charges differently (U.S. Department of Labor, 1998b). In fact, investment fees, which are the primary administrative costs for 401(k) plans, vary up to threefold across vendors and are seldom understood by either plan sponsors or participants (U.S. Department of Labor, 1998b). A second source of uncertainty that pertains to IA cost predictions is that actual plan operation costs for employment-based defined contribution plans are difficult to disentangle from expenses resulting from government compliance mandates. Finally, even if operational costs could be separated from compliance costs, defined contribution plan administrative data may not be useful for estimating administrative costs for IAs, as the employer and employee populations covered under the voluntary employment-based system differ significantly from those covered by Social Security.

The importance of administrative uncertainties in assessing the viability of IA policy objectives is becoming increasingly recognized. For instance, the House Ways and Means Subcommittee on Social Security held a public hearing in June 1998 on administrative implementation issues. In addition, reform plans are finally beginning to mention administrative operations. The plan recommended by the National Commission on Retirement Policy (NCRP) in May 1998 specifies that funds should be credited to personal accounts without imposing additional administrative burdens on employers. Other proposals, like those proposed in the past by Rep. John Porter (R-IL), Rep. Pete Sessions (R-TX), and Sen. Daniel Patrick Moynihan (D-NY), explicitly mandate employers’ role in administration.

The President’s Commission to Strengthen Social Security has taken testimony on administrative issues and costs, and plans to incorporate administrative details into its recommendations to the president. However, these recommendations have not yet been submitted to the president. The most recent legislation on including individual accounts in the Social Security system was introduced by Reps. Jim Kolbe (R-AZ) and Charles Stenholm (D-TX) (H.R. 2771 in the 107th Congress). They explicitly use the Thrift Saving Plan-Plus model for administering individual accounts to minimize employer burdens and administrative costs. Private firms selected by the Social Security investment board through a competitive bidding process would manage the accounts. The same investment funds as those available through TSP would be offered, so workers could assume various levels of risk.

Under this proposal, workers would have the option to choose a private investment institution to invest their individual account funds once their account balance reaches $7,500. Workers could choose—they would not be forced—to leave the TSP model plan and join the private alternative. Otherwise, the worker would remain in the TSP model funds. It should be noted that the administrative burden of individuals moving to the non-TSP model could be retained by the government, rather than being placed upon the employer, if contributions were still required to flow through government payroll

Table 1
Key Sources of Uncertainty for Assessing Feasibility and Costs for Social Security Individual Accounts

| ➢ Reform plans are vague about key administrative features. |
| ➢ Existing defined contribution plan administrative fees are not well understood. |
| ➢ How administrative data from existing defined contribution plans applies to individual Social Security accounts is uncertain, because their covered populations differ significantly. |

Source: Employee Benefit Research Institute.

10 Employers must perform tests and paper work, generally on an annual basis, demonstrating compliance with laws and regulations, most of which involve proving that the employer’s plan does not illegally discriminate in favor of highly compensated employees (Allen et al., 1997). For information about regulation possibilities under an IA system, refer to section on “How Would Accounts Be Regulated?”
11 See footnotes 34, 35, and 36 for more detail.
12 For further information on this proposal, see the summary on Rep. Kolbe’s Web site at www.house.gov/kolbe/KS_Billsummary.htm
tax payments.

The U.S. Securities and Exchange Commission (SEC), to ensure strict financial soundness and reporting requirements, would regulate financial institutions authorized to handle IAs. Financial institutions (including investment firms, credit unions, and insurance companies) would be required to offer broad-based, diversified investment funds with low administrative costs. The SEC's regulatory approval would be based on the fund's administrative fee structure, risk profile, and appropriateness as a retirement investment vehicle.

While the Kolbe-Stenholm legislation offers more administrative details than most previous legislation, there are still many issues that are not addressed. How would the TSP model be made to work, for example, when most private employers are submitting contribution information on paper once each year, as opposed to the automated payroll submissions now given to TSP by federal agencies each payday? Some of the most difficult specific administrative issues that will directly affect both employers and individuals, such as these, are not yet being addressed. And while they may not have to be addressed before an individual account system for Social Security is enacted into law, they must be faced and resolved before individual accounts can be implemented.

| Start-Up Costs & Time Frame |

Two important points of administrative uncertainty are the cost of establishing an IA system and the required time frame, both of which depend largely on the type of system designed. For example, start-up time for the TSP, a single-employer program with automated payroll computer data delivery and a relatively simple account system with limited participant services, took about three years from enactment of the law to plan implementation (see Appendix 2 in Olsen and Salisbury (1998) or www.tsp.gov for an overview of the TSP). In addition, the TSP's start-up costs were relatively low, totaling about $5 per participant during the first year of plan operation. These charges were not assessed to participants, because they were funded with an initial congressional appropriation of $5.25 million. Table 2 shows how start-up costs were allocated.

In 1997, TSP managers contracted for upgrades in their record-keeping system to allow for more services, including daily valuation of accounts and transactions (loans, interfund transfers, withdrawals, etc.) being processed each business day. But the contractor for upgrading the computer system went significantly over budget and beyond deadline before ultimately being terminated from the project three years after its commencement. This experience provides a vivid example of what can happen in the implementation of an individual account system: It can be done, but it is time-consuming, difficult, and not a guaranteed success. One of the most difficult challenges is also one of the most basic: Once an individual account system is established, financial information must be obtained for that system. TSP works with just one fully automated employer, the federal government, but a Social Security individual account system would cover (and have to get information from) nearly 7 million employers—most of whom use paper payroll and are not automated.

If it is simply assumed that per-participant expenses for IAs would equal those of the TSP plan, then the $5.25 million start-up cost for TSP in 1987 would amount to more than $1 billion for IAs in 2002. This amount is modest relative to the size of the annual Social Security payroll (almost $4 trillion in 2000). It should be noted that this number reflects only the cost of central administration of IAs, and does not include the cost of employer compliance for information delivery and asset transfer to the administrator.

For reasons that are discussed later in this report, it is questionable whether a system of IAs could resemble the TSP in terms of cost or design. Start-up costs could
be substantially different because the work force and employers covered by Social Security are substantially different from those covered by the TSP. Processing of information delivered on paper, rather than magnetic tape, is much more expensive, for example.\textsuperscript{13} Also, start-up costs for Social Security accounts could have different effects on beneficiaries. Rather than being like the TSP’s start-up costs, and funded through an up-front congressional appropriation, start-up costs for IAs could be amortized over time. And, instead of being absorbed by the federal budget, they could be charged to participants. Amortization of IA start-up charges to participants could disproportionately affect those with the fewest years to accumulate account assets.

Initial Costs

Like start-up costs, the issue of how initial administrative costs would affect IA balances deserves considerable study. If initial administrative costs were very high, it would be important to design a policy that insulates small IA balances from erosion during the early years of system operation. But over time, administrative fees might be expected to fall: Flat administrative fees as a percentage of account balances would decline as account balances grow. In addition, both flat and percentage-based fees might fall below their initial levels as an IA system becomes more efficient. Efficiency could evolve as the system matures, by developing optimal administrative practices and achieving economies of scale.

Ongoing Costs

Though startup and initial costs raise important issues that need additional study, this Issue Brief focuses on providing an overview of long-range, ongoing administrative issues. First, key administrative questions and limitations are discussed, revealing a recurrent theme of uncertainty in predicting ongoing administrative costs. To assess the implications of such uncertainty for individual account benefits, the SSASIM policy simulation model is used to calculate the reduction in total benefits of moving from low to high administrative cost assumptions.\textsuperscript{14} These estimates are calculated by assuming that a high-cost plan would cost 2 percent of account assets per year, while a low-cost plan would cost one-tenth of a percent (0.1 percent) per year. While this is a very wide range, the myriad of uncertainties involved with administrative costs means that actual costs could prove higher or lower than these ratios. The EBRI data indicate that individual account benefits would be highly sensitive to administrative costs (see section on “Estimating the Uncertainty”).

Standard Ongoing Administrative Costs

Ongoing administrative costs usually associated with any kind of individual accounts include the following functions: enrolling new participants, calculating required contributions, sending contributions to accounts, providing investment education, overseeing participant investment selection and fund transfers, managing funds, and sending periodic account statements to participants. In addition, administration involves identifying mistakes, calculating losses incurred as a result of mistakes, and compensating participants for financial losses due to errors. Another layer of cost involves documenting activities as proof of compliance with applicable laws and regulations. Administrative costs surrounding benefit distribution involve processing benefit claims, such as for account access upon retirement, job termination, death, or divorce. Participants

\textsuperscript{13} For a discussion, see the section on “Which Workers Are Covered: Affects Cost and Complexity.”

\textsuperscript{14} SSASIM is based on 13 basic assumptions about the economy and beneficiary demographics. It can closely replicate the results from the model used by the Social Security’s Office of the Actuary to evaluate the soundness of the program. For more information on SSASIM, see Holmer (2001).
Table 3
Standard Administrative Costs Usually Associated With Defined Contribution Plans

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<td>1.</td>
<td>Enrolling new beneficiaries.</td>
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<tr>
<td>2.</td>
<td>Calculating required contributions.</td>
</tr>
<tr>
<td>3.</td>
<td>Sending contributions to accounts.</td>
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<tr>
<td>4.</td>
<td>Providing investment education.</td>
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<tr>
<td>5.</td>
<td>Overseeing participant investment selection &amp; fund transfers.</td>
</tr>
<tr>
<td>7.</td>
<td>Sending periodic account statements to participants.</td>
</tr>
<tr>
<td>8.</td>
<td>Identifying mistakes.</td>
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<tr>
<td>9.</td>
<td>Calculating losses incurred as a result of mistakes and compensating participants for financial losses due to those errors.</td>
</tr>
<tr>
<td>10.</td>
<td>Documenting compliance with laws and regulations.</td>
</tr>
<tr>
<td>11.</td>
<td>Processing benefit claims.</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute

Individual Accounts Mean Additional Ongoing Administrative Expense

Adding a system of IAs to the current Social Security program would require a largely separate administrative set-up, because most of the tasks listed above are not part of administering today’s payroll tax collection or wage crediting system. Therefore, adding IAs to Social Security would increase absolute administrative expenses.

As an option to circumvent additional costs, reducing benefit levels under the current defined benefit system is unlikely to be effective. The administrative cost of today’s program is primarily a function of the number of participants and employers involved, rather than of the generosity of Social Security benefits. For instance, whether the average defined benefit is $750 or $400 a month will not affect the administrative cost of sending the same number of benefit checks or of reconciling administrative errors committed by the same number of employers. Hence, even if IAs alone were to entail administrative costs proportionate to those of Social Security today (0.6 percent of annual benefits paid, or about $14 per covered worker), adding IAs to the program would increase total administrative expenses simply because IAs have their own set of administrative tasks.

Even tasks required for both the traditional (defined benefit) Social Security system and for new (defined contribution) IAs could increase costs. For example, benefits claims might need to be processed separately for each system. Other possibilities include separate benefit statements for each part of the Social Security system; contribution arrangement differences between traditional payroll taxes and IA contributions; and enrollment practice variation for the defined benefit versus IA systems, particularly if the IA is voluntary.

How Much Expense Depends Largely on Policy Design

The magnitude of the additional costs for administering two fairly distinct Social Security systems is highly dependent on how IAs are designed. Design details vary across reform plans, to the extent that they have been presented at all. Table 4 shows a matrix of possible responsibilities for major administrative tasks and some of the questions they raise. Hundreds of combinations of these responsibilities are possible for any actual IA system. The following section discusses some of the most critical administrative cost questions raised in this matrix and explores many possible answers and implications in the context of the current Social Security debate.

Who Holds and Provides Record Keeping for Accounts?—One mutual fund industry expert observes that “the most important determinant of administrative costs boils down to one question: who does the record keeping?” (Dickson, 1998). At one end of the spectrum, the “Individual Accounts Plan” proposed by two members of the 1994–1996 Social Security Advisory Council would

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15 Life annuities provide a payment on a periodic basis for the life of the participant and possibly his or her spouse.
16 A defined benefit plan is a retirement plan in which benefits are calculated according to a formula or rule. Benefits levels, as determined by the formula used, are guaranteed as a stated retirement income commencing at a specified age. Retirement benefits are usually expressed as a life annuity (Allen et al., 1997).
17 See section on “What Businesses Participate?” for a discussion of employer errors under the current system.
18 The Old-Age and Survivor Insurance program (OASI) has an annual administrative expense equal to 0.6 percent of benefits paid. The Disability Insurance program (DI) has a higher administrative expense rate of 2.9 percent of benefits. The combined OASDI program operates with total administrative costs equal to 0.9 percent of benefits paid annually (Board of Trustees, 2001, Tables VI.A2-A4, pp. 119–123).
**Table 4**

**Administrative Task Matrix Options: Responsibilities for Contributions, Crediting, Reporting, and Education Tasks Under Individual Social Security Accounts**

<table>
<thead>
<tr>
<th>Task</th>
<th>Government</th>
<th>Employers</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enrollment</td>
<td>Through Social Security number issuance.</td>
<td>Through employers upon beginning work.</td>
<td>By individual communication to government or employer.</td>
</tr>
<tr>
<td>Contributions Sent to</td>
<td>Private-sector providers, employer DC plan, or government-held accounts.</td>
<td>Government clearinghouse, employer DC plan, or private-sector providers.</td>
<td>Government clearinghouse or private-sector providers.</td>
</tr>
<tr>
<td>Holding Individual Accounts</td>
<td>Government-held accounts or private-sector institution.</td>
<td>Government-held accounts, employer’s DC plan, or other private-sector institution.</td>
<td>Government-held accounts or private-sector institution.</td>
</tr>
<tr>
<td>Managing Funds</td>
<td>Whether held by government or by private institutions, investment presumably would be in the private sector, through contract or individual choice.</td>
<td>Wherever held, investment presumably would be in the private sector through the employer’s DC plan, contract with government, or individual choice.</td>
<td>Wherever held, investment presumably would be in the private sector through contract with government or individual choice.</td>
</tr>
<tr>
<td>Reporting That Contributions Were Sent to the Government</td>
<td>If government surplus or tax refund, internal government reporting.</td>
<td>Employer reports to government. How often? In what form and to which agencies?</td>
<td>Individuals report to government and/or private service provider reports to government. How often? In what form and to which agencies?</td>
</tr>
<tr>
<td>Reporting Calculations and That Contributions Were Sent to Individuals</td>
<td>Government reports to individuals. How often?</td>
<td>Employer reports to individuals. How often?</td>
<td>Private service provider reports to individuals. How often?</td>
</tr>
<tr>
<td>Participant Investment Selection and Fund Transfers, If Permitted</td>
<td>Individuals report their choices directly or through employers to government-held accounts; copies possibly sent to government. How often permitted? Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
<td>Individuals report their choices directly or through employers to government-held accounts, employer’s DC plan, or other private-sector institution; copies possibly sent to government. How often permitted? Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
<td>Individuals report their choices directly or through employers to government-held accounts, employer’s DC plan, or other private-sector institution; copies possibly sent to government. How often permitted? Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
</tr>
<tr>
<td>Sending Periodic Account Statements to Participants</td>
<td>Government. How are nonactive individuals kept track of?</td>
<td>Employer through DC plan. How are nonactive individuals kept track of?</td>
<td>Private-sector provider. How are nonactive individuals kept track of?</td>
</tr>
<tr>
<td>Identifying Mistakes</td>
<td>Individuals and Government.</td>
<td>Individuals and employer with government oversight via verification of contributions.</td>
<td>Individuals and private-sector provider with government oversight verification of contributions.</td>
</tr>
<tr>
<td>Calculating Losses Incurred as a Result of Mistakes and Compensating Participants</td>
<td>Government assumes all responsibility; possibly through a PBGC-type insurance entity supported through contributions or payroll taxes.</td>
<td>Employer with government oversight; possibly employers or individuals would contribute to a PBGC-type insurance entity.</td>
<td>Private-sector provider with government oversight; possibly private providers or individuals would contribute to a PBGC-type insurance entity.</td>
</tr>
<tr>
<td>Providing Ongoing Investment Education</td>
<td>Government responsibility; differentiate ongoing education from initial start-up? How would government communicate investment prospectuses or other information on an elementary level? What kind of fiduciary liabilities would be created?</td>
<td>Employer responsibility; differentiate ongoing education from initial start-up? Would government educate employers about avoiding liability? How? What kind of fiduciary liabilities would be created?</td>
<td>To what extent would individuals be responsible for educating themselves, and private service providers be responsible for providing educational services and material?</td>
</tr>
</tbody>
</table>

(continued)
give the federal government sole responsibility for administering IAs, including the provision of mandatory annuities at retirement (Social Security Advisory Council, 1997). Similarly, legislation introduced by Rep. Thomas Petri (R-WI) in June 1998 would establish a central government clearinghouse to serve as IA record keeper. Likewise, the National Commission on Retirement Policy (NCRP), which has devoted more attention to administrative issues than possibly any reform group to date, recommended that “the burdens of record keeping for each individual [account] be assumed by a bureau within Social Security” (National Commission on Retirement Policy, 1998, p. 12). The NCRP plan also would assign this bureau responsibility for enforcing limits on size and timing of withdrawals from IAs.

Other reform groups rejected the concept of delegating most record-keeping duties to the government. For example, the Committee for Economic Development (CED) recommended that “no new government bureaucracy” be created in reforming Social Security and warned of political implications for government-held accounts. Their report admonished: “Even if assets are credited to the accounts of individuals, it would be difficult to insulate them from government influence of budgetary juggling.” Similarly, members of the 1994–1996 Advisory Council supporting the “Personal Security Accounts Plan” (PSA) recommended managing IAs through private institutions. In addition to rejecting the idea of government as record keeper for IAs, the creators of these plans discarded the idea of government as sole provider of mandatory annuities. Several legislators, including Rep. Mark Sanford (R-SC), who sponsored the 1997 “Personal Retirement Accounts Plan,” also rejected it.

Still others have suggested a combination of public and private approaches. Healey (1998, p. 2) proposed delegating at least part of IA administration to a quasi-public agency. Quasi-public corporations are private corporations with a special franchise granted to them by Congress in return for an obligation to provide specified services to a public policy sector. Some quasi-public corporations, by design, function in areas where the private sector cannot operate profitably or is deemed to operate ineffectively. How a quasi-public organization assigned to administer Social Security IAs would be structured or function has not been explored.

This vast range of choices for IA record keeper(s) creates uncertainty about which system might be enacted into law. Yet another uncertainty is how each player would perform if assigned the role—or part of the role—of record keeper. Having the government provide administrative services for IAs could facilitate efficiency by centralizing the process and providing economies of scale, but would the government become bureaucratic and slow to assimilate new advances in cost-saving technologies? On the other hand, would competition among private vendors lower administrative service costs, or would competition only increase marketing costs and thereby add to administrative expenses? Moreover, how would regulations imposed by the government on any individual account system—private or public—add to administrative burdens? (Heller, 1998)

<table>
<thead>
<tr>
<th>Task</th>
<th>Government</th>
<th>Employers</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processing Distributions</td>
<td>Government processing. Would preretirement distribution be permitted (e.g., rollovers into other qualified plans)?</td>
<td>Employer processing. Would preretirement distribution be permitted (e.g., rollovers into other qualified plans)?</td>
<td>Private entity processing. Would preretirement distribution be permitted (e.g., rollovers into other qualified plans)?</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute.

a Earnings sharing under a defined contribution system, as defined here, is when the monies due for individual account contribution from each working member of a married couple is summed and deposited in equal shares between the husband’s and wife’s individual Social Security accounts at the same time. (Theoretically, the term “earnings sharing” could apply to any amount of cross-subsidization of individual accounts from one spouse to another, whether account contributions were equally divided or not.)

b Pension Benefit Guaranty Corporation.
How Are Account Contributions Made and Investments Credited to Individual Accounts? — Another issue clouding estimation of IA administrative costs is that most proposals are unclear on a number of points that, when eventually detailed, could create large disparities in administrative expenses between ostensibly similar reform proposals. One of the groups that address how contributions would be deposited into IAs, the NCRP, recommends “working within the current payroll tax structure” (analysis suggests that this would be the lowest-cost approach for both employers and the system). Others recommend increasing employer responsibilities, as has been done overseas (Harris, 1998; The Heritage Foundation, 1997); however, this would have the greatest cost impact on small employers and other employers who do not yet use automated payroll systems (see box, p. 21). Still others reject both approaches and prefer an individual approach based on an individual retirement account (IRA) contribution model (raising a totally different set of issues if there is a policy desire to somehow tie the IA to benefits paid by the current Social Security program). Each type of approach will be discussed in turn.

The Current Payroll Tax Structure

The overwhelming majority of U.S. employers send payroll taxes for all of their employees, along with federal income taxes, in regularly scheduled payments to Federal Reserve Banks or other authorized institutions (chart 1). Quarterly, via the Form 941, employers report to the Internal Revenue Service (IRS) the amounts they have sent on aggregate. Employers currently must reconcile only at the beginning of the year how much of the aggregate payroll and federal tax contributions from the previous year was paid on behalf of each employee (through the Form W-2) (see chart 2).

These infrequent (i.e., annual) reporting practices mean that it can take a year or more for some payroll taxes paid on behalf of an individual employee to be identifiable as belonging to that worker. (Because employer tax payments are reconciled once each year, this delay is not the same for all tax payments; a December payment, for instance, is generally identifiable within a month after payment, whereas a January payment waits about a year.) Moreover, it takes several months after payroll tax contributions are identified as being paid on behalf of individuals for the Social Security Administration (SSA) to post the attendant work credits to individual Social Security earnings records (see chart 2). The time lag is even longer for the approximately 14 million self-employed workers in the United States (U. S. Department of Commerce, 1997), for whom it can take up to 16–22 months before the aggregate taxes they have sent over the year can be separated into payroll taxes and federal income taxes.

However, if the individual accounts were voluntary, making use of the current payroll system would be the most cost-effective way to implement an IA system without adding administrative cost and burden to...
Chart 2

Administration of the Current Social Security System Wage Collection and Crediting Process

Year #1

Department of Treasury

➤

Employers submit W-2/W-3 forms by Mar. 2 (in 1998) reporting what portion of aggregate FICA contributions paid to Treasury in Year 1 were on behalf of each employee (see 3). ALSO: 4th Quarter Federal Tax Return sent to IRS for Year 1.

SSA receives tapes from IRS to post wages for self-employment earnings and earnings from domestic employment. Most self-employed persons send individual tax returns to IRS.


SSA begins preparing paper reports. SSA begins processing magnetic reports. SSA begins mailing notices about unverified Social Security numbers (SSNs) and names. SSA begins reconciling paper and magnetic reports. SSA begins mailing notices about unverified discrepancies in reconciling.

98 percent of magnetic reports are fully processed by July 30, and most U.S. workers are credited with earnings from Year 1.

SSA and the IRS verify reports, work with employers on correcting errors, and SSA posts correct data to earnings records.

Employers assist SSA and IRS in making any necessary corrections.

Year #2

SSA begins receiving employers' Quarterly Federal Tax Returns (reported deposits) with actual aggregate tax deposits made by employer over the year, generally on a semi-monthly or monthly basis. Funds are deposited and held in Federal Reserve Banks or other authorized institutions.

Quarterly Federal Tax Return sent to IRS for Year 1.

Quarterly Federal Tax Return sent to IRS for Year 1.

Quarterly Federal Tax Return sent to IRS for Year 1.

Department of Treasury

Year #1

➤

Quarterly Federal Tax Return is filed with IRS.

Quarterly Federal Tax Return is filed with IRS.

Quarterly Federal Tax Return is filed with IRS.

Department of Treasury

Chart 2

Department of Treasury receives aggregate federal income tax (including FICA) contributions from employers (on behalf of individual employees) over the year, generally on a semi-monthly or monthly basis. Funds are deposited and held in Federal Reserve Banks or other authorized institutions.

Employers send tax deposits to Department of Treasury with no breakdown of contributions on behalf of individual employees, generally on a semi-monthly or monthly basis over the entire year.

Quarterly Federal Tax Return is filed with IRS.

SSA begins receiving employers' Quarterly Federal Tax Returns (reported deposits) with actual aggregate tax deposits made by employer over the year, generally on a semi-monthly or monthly basis. Funds are deposited and held in Federal Reserve Banks or other authorized institutions.

Quarterly Federal Tax Return is filed with IRS.

Quarterly Federal Tax Return is filed with IRS.

Quarterly Federal Tax Return is filed with IRS.

Quarterly Federal Tax Return is filed with IRS.
Unfinished Processing and Reconciliation from Year #1

IRS continues working with employers to reconcile Quarterly Tax Returns with W-2 reports.

IRS notifies SSA of specific employers who have been nonresponsive to notices requiring reconciliation.

SSA continues to work with employers to reconcile Quarterly Tax Returns with W-2 reports.

SSA notifies IRS of any outstanding reconciliation errors.

Year #3

Unfinished Processing and Reconciliation from Year #1

IRS continues working with employers to reconcile Quarterly Tax Returns with W-2 reports.

SSA continues to work with employers to reconcile Quarterly Tax Returns with W-2 reports.

SSA notifies IRS of any outstanding reconciliation errors.

Year #4

Unfinished Processing and Reconciliation from Year #1

IRS closes reconciliation activities from Year #1 and assesses penalties.

SSA continues working with employers to reconcile Quarterly Tax Returns with W-2 reports.

Last date that tapes would be sent to IRS from SSA (Dec. Year #3 to January Year #4).

Source: Employee Benefit Research Institute
employers related to enrollment and contributions. In addition, it would allow the system to function with modification of the current Social Security administrative system, rather than requiring the creation of an entirely new system (like the TSP).

The trade-off for limiting administrative burden and system development costs by using the current tax collection and wage crediting system is that it would take at least seven to 22 months for every dollar contributed to individuals’ accounts during a calendar year to be sorted out in terms of individual ownership. That is, it would take that long for contributions to be sorted from the aggregate taxes that employers send to the government over the year and actually deposited into workers’ individual accounts. This lag—or “float period”—between contributions and credits (known as Type 1) does not affect benefits under the current system, because benefits are based on wage credits (a defined benefit) rather than cash contributions and/or investment returns thereon (a defined contribution). In the absence of special provisions, investment earnings would be lost on each dollar of payroll contribution for seven to 22 months if the current payroll tax collection system were used to administer IAs. Float losses for individuals could be minimized by investing contributions on a pooled basis during the float period, with investment earnings allocated at the same time as contributions are posted. Such an approach would likely include estimation rather than precision; however, since the Social Security payroll tax process only allows the government to know how much in payroll taxes was contributed in total for a worker in the prior year, not when in the year the payroll taxes from that individual were actually deposited.

There is a predictable objection to long float periods that are not accompanied by some method of pooled investment. Uncompensated floats could result in substantial losses in IA accumulations due to the nature of compound interest. For instance, assuming identical annual rates of return at 7 percent, a once-a-year deposit schedule of $1,200 would yield $254,166 after 40 years (481 months)—or $8,315 less than what a monthly deposit schedule of $100 per month would provide ($262,481).29 (See table 5.) Modern technology and modern investment systems could allow this problem to be avoided, at least partially. As a practical matter, however, individuals would not be able to switch investment options until such time as the contributions had actually been allocated to their account. Unlike a 401(k) plan, this would be on a rolling cycle of as much as 23 to 32 months after taxes were withheld from the worker’s paycheck (although in most cases it would mean a lag of nine to 21 months).

A second type of “float period” (Type 2) results from the many mistakes that are made by employers in the process of sending payroll taxes and reporting wages (largely due to the absence of automated payroll systems and hand processing of payroll and tax reports). Losses from these mistakes (including lost investment returns) could be only temporary, while the government works to recover contributions from the employer; or permanent, if contributions are never recovered (e.g., the employer goes bankrupt and no due payroll contributions can be collected).30

Quarterly W-2s—If approaches to minimizing or eliminating investment losses attributable to Type 1 or Type 2 float periods31 (such as pooled investments) are unacceptable, or some other acceptable approach is not found, then the current wage reporting and tax collection process could not be used for IA administration. A possible alternative might be to increase the reporting

29 This assumes that all float periods would actually represent a period of missed positive returns. If an individual intends to have all of these contributions invested in stocks, there could be float periods where individuals are better off by not yet having their money in these accounts. However, this would not be the case if individuals intend to invest only in money market funds.
30 See Appendix 1 in Olsen and Salisbury (1998) for further discussion of dealing with both Type 1 and Type 2 floats.
31 Again, see Olsen and Salisbury (1998) for further issues dealing with float periods.
requirements under the current system. For example, employers might be required to report W-2 information along with their quarterly wage and tax statements (Form 941), as was the case prior to 1978.32 This arrangement would lessen float time between when dollars are contributed and when those contributions are credited to individuals’ accounts. In most cases, interest on IAs could accumulate sooner if W-2s were issued on a quarterly basis rather than annually.

The obvious drawback to this approach is the additional cost to employers. Data from the 1972 Senate Select Committee on Small Business lend some insight as to the magnitude of these costs. The chairman of the President’s Advisory Council on Management Improvement testified before the committee that eliminating the quarterly wage report in favor of a single annual wage report (Form W-2) would result in “substantial net savings within the Internal Revenue Service and the Social Security Administration” (p. 802) and save small employers33 alone an estimated $235 million annually (p. 813) (President’s Advisory Council on Management Improvement, 1972). Adjusted to 2001 dollars, that would amount to close to $1 billion a year.

Hence, all small businesses combined could be faced with a cost increase of close to $1 billion a year if an IA system that required quarterly rather than annual W-2 reports is enacted. The administrative expenses for more frequent reports would also impose additional costs on larger employers and the government agencies that process W-2 information. Presumably, employers’ additional administrative expenses would be passed onto employees through slower growth in cash compensation, or through fewer benefits (ERISA Industry Committee, 1998, p. 66). Such expenses could also possibly hamper business expansion or establishment, or increase consumer prices.

A second drawback to using the current wage and tax reporting structure with no change except reporting acceleration is that float periods would still exist with quarterly reports—albeit shorter than with annual reports. Workers might be more amenable to losing this shorter period of investment time, obviating the need to handle Type 1 floats. As shown in table 5, the 40-year (481 months) difference in account balances between a quarterly and a monthly deposit schedule is $1,515 on contributions equal to $1,200 per year (at an assumed identical annual rate of return of 7 percent).

A third possible criticism of quarterly W-2 reporting is that workers would continue to expect protection from Type 2 float periods (i.e., those caused by reporting errors), but for the entire additional burden put on employers little might be achieved in terms of error prevention. While quarterly reconciliation might be somewhat easier and less error-prone than annual reconciliation, expert administrators claim it would still be much more difficult to reconcile errors on a quarterly rather than a monthly basis.

The 401(k) Approach—A seemingly simple alternative to annual or quarterly wage reporting would be to administer IAs in a manner similar to the way 401(k) plans are operated today. This method has been proposed in various bills, such as the Individual Social Security Retirement Accounts Act of 1997 (H.R. 2929),34 the Savings Account for Every American Act of 1998 (H.R. 3683),35 and in the Social Security Solvency Act of

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32 Prior to 1978, W-2 information was filed on Form 941A of the quarterly 941 reports. Congress acted in order to reduce the inherent administrative burden on employers that had to file several times each year, versus once per year.

33 Employers with 499 or fewer employees.

34 H.R. 2929, introduced in the 105th Congress and sponsored by Rep. John Porter (R-IL), states that “under such plan, 5 percent of the employee’s wages is deducted by the employer and paid to the employer’s individual Social Security retirement account within 10 business days after the date of payment of such wages . . . The employer receives no compensation for the cost of administering such plan.”

35 H.R. 3683, introduced in the 105th Congress and sponsored by Rep. Pete Sessions (R-TX), states that the employer “makes timely payment of the amount so deducted [from payroll] as a contribution to the designated S.A.F.E. account, and . . . the employer receives no compensation for the cost of administering such program.”
With 401(k) plans, employers are required to deposit account contributions soon after contributions are made. However, this requirement would dramatically increase administrative expenses for the millions of employers that do not offer defined contribution plans and therefore do not have the administrative infrastructure already in place to assist in the administration of IAs. In 1996 comments to the Pension and Welfare Benefits Administration (PWBA) regarding a proposal to require the deposit of 401(k) plan funds on the same schedule as tax deposits are made, employers made a very clear distinction between the time and cost involved in paying aggregate taxes and the cost involved in crediting funds to individual 401(k) accounts (U.S. Department of Labor, 1998b, p. 5):

Tax deposits are made without providing any data regarding the allocation of the deposit amounts to individual employees until the end of the year. By contrast, commenters stated that each time participant contributions are transmitted to the [401(k)] plan, eligibility must be confirmed, contributions must be allocated to the participants’ individual accounts, and the individual accounts must be reconciled to the aggregate amount.

Commenters also indicated that those additional tasks would likely be most burdensome for smaller employers that lack timesaving technology.

If IA contributions were administered like 401(k) plans nevertheless, precisely where employers would send monthly contributions is likely to make a difference in terms of float time. If the employers were required to send monthly contributions through a government clearinghouse, some Type 1 float time might remain while deductions from workers’ earnings were processed through employer payrolls, through the central clearinghouse, and into individual accounts. Alternatively, Type 1 float periods would be completely eliminated if employers were required to send monthly contributions on behalf of specific employees directly to investment providers, rather than to a single government clearinghouse. However, for the large proportion of workers whose employers still hand them a paper paycheck, the requirement that the employer process contributions would be a new burden—especially so if employees were free to choose providers. These approaches likely would be the most expensive of all contribution and record-keeping schemes and the most burdensome for small employers.

Costs might also rise, although not likely to the same degree, if employees and employers could opt out of the Social Security system and instead deposit payroll contributions to employment-based defined contribution plans. However, alternative arrangements would need to be made for the majority of employers that do not offer defined contribution plans. In addition, some type of

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36 S. 1792, introduced in the 105th Congress and sponsored by Sens. Daniel Patrick Moynihan (D-NY) and Robert Kerrey (D-NE), states that, “the employer is required to pay the amount so contributed with respect to the specified voluntary investment account of the electing employee within the same time period as other taxes ... with respect to the wages of such employee ... under which the employer receives no compensation for the cost of administering such plan.”

37 Contributions must generally be credited to individual 401(k) accounts within 15 business days of the beginning of the month following the month in which the contribution was made (U.S. Department of Labor, 1996b).

38 The majority of workers are employed by a minority of the approximately 6.5 million U.S. employers (unpublished information, SSA, 1998). According to the U.S. Department of Labor, there are a total of about 700,000 employment-based retirement plans, and many employers have more than one plan.

39 While a tax break could be provided for smaller employers for additional administrative requirements, these theoretically would not as a total administrative burdens. If financed through general revenues, these costs would be directly transferred to taxpayers (although not necessarily directly to all participants).

40 See section on “Which Businesses Participate?” for a discussion of how small-employer technology limitations affect the current wage collection and crediting process.

41 Given past testimonials on Internal Revenue Service performance, an interesting political debate might develop over whether a government clearinghouse should be operated by the IRS, which would then be responsible for enforcing contribution levels and disseminating amounts to investment providers.
government audit of employer records likely would be required in order to ensure employer compliance. Finally, since most 401(k) plans currently follow the federal minimum participation standards, which exclude young and part-time workers, creating the option of individual accounts for all workers would substantially increase the cost of Social Security individual account plans. It should also be noted that a voluntary system would be more difficult to administer (and per-participant costs would be more expensive) than a mandatory universal system, because employers would have to determine the interest of each employee regarding participation.

**The IRA Approach**—Another option for crediting account contributions is modeled on individual retirement accounts (IRAs). Presumably, Type 1 float periods would be eliminated under the IRA approach, as IA contributions would be made on a regular basis directly by individuals to the institution holding their IA. To check for errors (i.e., Type 2 float losses), both the institution and/or the worker could submit proof that the correct amount was contributed at the proper time(s). Presumably, both individuals and their providers would hold records of investment history in case lost contributions needed to be credited or excess contributions needed to be deducted later. It is possible that individuals or service providers would be required to convey copies of this information to the government. A Social Security reform in which individual accounts were optional would most easily fit with this approach, since only those who decided they wanted an individual account would be required to open the SSA-IRA to accept contributions.

The primary objections to this approach are enforcement concerns. Former IRS Commissioner Fred Goldberg states that relying on individuals to make IA contributions directly “won’t work.” Still other commentators suspect that such an approach would be far more expensive than other administrative options. Additional expense would result because of the economies of scale and bargaining power that centralized plans have relative to individual plans for negotiating investment and management fees (Cavanaugh, 1998; Schultz, 1998).

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42 One idea is to provide taxpayers with a year-end tax credit, which they would have to invest in their Social Security accounts. Since the government would keep the money until this time, a float period would exist between the time when workers paid payroll taxes and when funds became available for investment.

43 Goldberg, 1999.

44 Another means of getting contributions from employees to individual accounts is to create a work force that acts as intermediaries, as is the case in Chile. There, individual workers interact with collection agents directly to transmit funds.
Small-Employer Attitudes on Administering Individual Accounts

In November 1998, the Employee Benefit Research Institute (EBRI) commissioned Mathew Greenwald & Associates, Inc., to conduct a survey of 500 small businesses on their attitudes about possible administrative scenarios. The survey studied small-business decision makers because they are more likely to be affected by this type of reform due to their slower adoption of time-saving technology (computer automation).

**General Knowledge and Impressions**—Three-quarters of small-employer decision makers have heard about proposals to reform Social Security by allowing individuals to divert a portion of their payroll taxes into individual accounts. Nearly 60 percent of respondents say they favor this type of reform (chart 3). However, the majority of small-employer decision makers interviewed are not closely following the debate on Social Security reform in Congress. When first asked about their feelings about being mandated to help administer such a system, 40 percent reacted positively and 48 reacted negatively (chart 4).

**Preference of Administrative Scenarios**—One of the three possible administrative approaches included in the survey did not receive a majority of the support of these decision makers (table 6). Small-employer decision makers are almost equally likely to favor reporting investment choices annually on W-2 reports (46 percent) or sending a portion of taxes directly to the financial services providers of the workers’ choice each month (48 percent). Adding those respondents who say they are neutral but lean toward favoring each of these methods yields slightly more support for an annual approach than for a monthly 401(k)-type of approach (59 percent and 53 percent, respectively).

There is less opposition to an annual approach than to the other methods tested. Only 2 in 10 oppose or lean toward opposing an annual approach, compared with 35 percent who oppose or lean toward opposing a 401(k)-type of approach, and 45 percent who oppose or lean toward opposing a quarterly approach. Almost one-quarter of respondents would not favor any of the three specific approaches tested even if these were the only ways a Social Security individual accounts system could pass Congress. In addition, 6 in 10 of these respondents say there is no type of employer-administered system that they would support (chart 5).

**Willingness to Pay to Help Administer**—Despite the fact that the three approaches tested clearly have different payroll-processing cost implications, responses suggest that the small-business community as a whole is not willing to spend more for one approach than for another. For each approach, 2 in 10 respondents are willing to pay nothing, 15 percent are willing to spend up to $500 annually, 1 in 10 is willing to pay between $500 and $999, and one-quarter are willing to pay $1,000 or more per year (chart 6). In other words, one-quarter of those who say they favor each approach are willing to spend little or nothing in order to help administer a Social Security individual accounts system, while an equal portion express a willingness to pay $1,000 or more annually.

Two in 10 small-business decision makers say that considering employers’ possible role in administering Social Security individual accounts has changed the way they feel about this type of reform. While 3 in 10 of these respondents—32 percent of total respondents—say they are now more likely to favor this type of reform, 6 in 10—or 61 percent of total respondents—are now less likely to favor it (chart 7).

**How Many Investment Choices and Services?**

**Valuation Periods**—One determinant of administrative costs under an IA system would be whether participants’ account valuation is performed on a daily or periodic basis. Valuation is the process by which investment gains or losses are reflected in account balances. If valuation is daily, then participants’ accounts reflect daily changes in market performance. Because valuation is rather involved, daily valuation is more expensive than periodic valuation. Pooled assets in each investment fund must be reconciled with market performance. Then, each individual investor’s share of that aggregate pool must be identified and communicated to the entity holding the investor’s individual account. Such reconciliation, identification, and comparison must be performed for each investment fund that an individual holds in his or

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45 See Olsen and Salisbury (1999) for further discussion of this survey.
46 Businesses with five to 100 full-time employees.
Table 6
Possible Approaches to Administering Individual Social Security Accounts That Were Tested

<table>
<thead>
<tr>
<th>Administrative Scenario</th>
<th>Scenario Description Given to Small-Business Decision Makers</th>
<th>Percentage Favoring</th>
</tr>
</thead>
<tbody>
<tr>
<td>First (Annual)</td>
<td>Employers report workers’ total Social Security account taxes and investment choices once a year on their W-2 reports.</td>
<td>46%</td>
</tr>
<tr>
<td>Second (Quarterly)</td>
<td>To cut down investment time lag that would occur under the first scenario, employers file W-2 reports containing workers’ Social Security account taxes and investment choices quarterly rather than annually.</td>
<td>35%</td>
</tr>
<tr>
<td>Third (Monthly)</td>
<td>The quickest way that workers’ individual Social Security accounts could be credited with their taxes is if part of Social Security worked something like a 401(k) plan. This would require employers to send part of Social Security taxes directly to the financial service provider of each worker’s choice on a monthly basis.</td>
<td>48%</td>
</tr>
</tbody>
</table>


Chart 5
Suppose the Only Way an Individual Social Security Accounts System Could Pass Congress Was if Employers Were Required to Help Administer it. Is There Any Type of System That You, as an Employer, Would Favor?


Chart 6
Amount Small Employers Are Willing to Spend on Administration

her portfolio. To catch any errors in the valuation process, credited values in each shareholder's account are summed in order to compare them to the aggregate value of the investment pool. Any differences indicate errors that must be reconciled.

While periodic valuation saves on administrative costs, participant account balances are current only after immediate valuation, and participants must wait until the next valuation period to see how market performance has changed their account balances, to withdraw account balances at their current value, and/or for the effect of asset allocation transfers to materialize. With daily valuation, balances are always current when participants make account inquiries. For this reason, daily valuation is used by 64 percent of 401(k) plans (IOMA, 1998). Without daily valuation for a system of IAs, political concerns may arise, as suggested by the following statement made in IOMA's 401(k) management report (1998): "In these times of market volatility . . . forcing employees to stay in a fund they want to get out of is courting a lawsuit" (p. 15). On the other hand, the extent to which daily valuation would increase expenses is largely undetermined.47

Preretirement Access—Most major Social Security reform proposals prohibit loans and other preretirement access to IA balances (Olsen, 1996 and 1998; Appendix 2 of ERISA Industry Committee, 1998). However, even if loans were initially prohibited, loan provisions might be added to IAs over time as a result of political pressure (Hedo, 1998).48 And there would be administrative costs for loan provisions. For instance, average administrative costs per participant in the federal government's Thrift Savings Plan grew from $16.64 in 1995 to $20.27 in 1997 (an increase of 21.8 percent), a year after universal purpose loans were first allowed. In 1997 alone, the TSP administered more than 220,854 loan disbursements equaling $1.5 billion for its 2.3 million participants (Federal Retirement Thrift Investment Board, 1998b).

If loans were allowed in an individual account Social Security System, a host of questions arise that would affect administrative expense: Are loans allowed for any purpose, or only hardship? Who would serve as gatekeeper? If hardship restrictions or other limits were placed on loans, could participants appeal denials of loan applications? If so, additional administrative burdens would be introduced, as methods for processing appeals would be required. Which government agency would enforce loan repayment for participants who borrow against their IA balances (Reno, 1998)? And what happens if participants default on repayments?

Other Services and Options—Unlike prohibitions on preretirement access to IA balances, other design features that would affect administrative costs are left uncertain in the NCRP plan and wholly unaddressed in many other proposals. These are service features such as the frequency of permitted fund transfers between investment options and/or other approved savings plans (i.e., rollovers); access to plan and investment information; and the number of investment options offered. Not surprisingly, analysis of industry data for 401(k) plans indicates that greater services result in greater administrative costs (U.S. Department of Labor, 1998b). One mutual fund industry executive who did not want to be

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47 One of the goals of upgrading TSP was moving to daily valuation. When the upgrade is finished, this could provide evidence on the cost of moving and maintaining daily valuation.

48 Hedo (1998) says, "The very advantage claimed for the new system—namely, the political attraction of selling forced savings with the idea that it's your money—will make it more difficult in the long run to sustain such nest eggs for retirement" (p. 5).
new workers in order to provide services similar to those provided for most 401(k) participants.

In contrast, systems with less choice can be less expensive to operate. Although administrative costs for the TSP have risen over time as participant services have been expanded (chart 8), TSP still serves as an example of an individual account system with limited services:

- TSP participants were limited to three investment options.49
- Two of the three investment options were limited to index funds, and the third is a government securities fund.50
- Participants are limited to semi-annual account statements.
- Participants are limited to one monthly interfund transfer.

Although these limited-service features reduce costs, they have trade-offs. For example, TSP participants' ability to time investments is constrained by monthly interfund transfer rules.51 (See Appendix 2 in Olsen and Salisbury (1998) for more details on TSP, or www.tsp.gov)

As a result of service and investment restrictions, the TSP provides fewer transfers per participant than most private plans. The TSP administers 300,000 interfund transfers for approximately 2.3 million participants per year.52 Plus, the TSP receives about one-sixth the volume of phone calls (fewer than 11,000 calls daily) 1998b). In contrast to the 100,000 new worker estimate for a private-sector-operated IA system with 401(k)-type services and investment options, a federal TSP expert estimates the government would need 10,000 additional employees to respond to participant inquiries for an IA system with TSP-like services and investment options (Cavanaugh, 1998).

While the increasing use of the Internet is allowing expanded investment choice and services at low additional cost,53 Internet use is not universal. Though Internet use has been growing rapidly, additional services and investment choice will continue to mean significant increases in administrative expenses for the foreseeable future. As previously noted, the absence of automation by large numbers of small employers, and the absence of automated payroll service bureaus for more than one-half of all workers, limits the ability of any reform to make full use of Internet technology advances.

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49 TSP added two additional index funds in May 2001, which are not reflected in the costs cited above.
50 The two additional funds added in May 2001 were also index funds.
51 Interfund transfers made by the 15th of the month are credited on the last business day of that month, at the closing price of the investment fund for the last business day of the month. If transfers are made after the 15th of the month (with some exceptions for weekends or holidays), the transfer is not processed until the last business day of the following month. See TSP’s Web site at www.tsp.gov for more details.
52 Figures are from the end of April 1997 through April 1998.
Which Workers Are Covered Affects Cost and Complexity

**Employment-Based Individual Accounts**—Hustead (1996) found that average per-participant administrative costs for private defined contribution plans are correlated with firm size. If such a correlation existed for all plans, then a mandatory system of IAs for Social Security would have very low per-participant costs, as Social Security covers nearly 148 million workers. However, the types of economies of scale that appear to contribute to Hustead's results are likely to apply only within the limited universe of workers who are covered by employment-based retirement plans. An important distinguishing feature of the employment-based retirement system is its voluntary nature, resulting in coverage bias. For instance, employment-based retirement plans generally exclude workers who do not meet age, tenure, and hourly work requirements. Such restrictions are prevalent among private-sector, federal, state, and local retirement plans.

Though the unfortunate outcome of participation restrictions is less pension coverage among certain types of workers, the restrictions may increase overall employment-based pension coverage by making plan sponsorship administratively manageable and cost-effective for employers; otherwise, employers might not offer plans in a voluntary system. Excluding certain types of workers from defined contribution plan eligibility keeps administrative costs relative to plan assets (as well as the cost of employer matching contributions) lower than would otherwise be the case. This is because of the high turnover of these workers and the very small account balances that would normally accompany low-income and/or part-time workers. Participation restrictions (especially age) generally limit record keeping to longer-term workers (table 7). The more mobile the work force covered by a plan, the more frequently employers have to set up accounts, provide education upon enrollment, and make benefit distributions upon job termination, and the less time employees have to accumulate account balances.

**Table 7**

<table>
<thead>
<tr>
<th>Age in 1995 and Gender</th>
<th>Total</th>
<th>18 - 22 Years</th>
<th>23 - 27 Years</th>
<th>28 - 32 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>8.6</td>
<td>4.4</td>
<td>3.3</td>
<td>2.6</td>
</tr>
<tr>
<td>Men</td>
<td>8.9</td>
<td>4.5</td>
<td>3.4</td>
<td>2.8</td>
</tr>
<tr>
<td>Women</td>
<td>8.3</td>
<td>4.3</td>
<td>3.1</td>
<td>2.4</td>
</tr>
</tbody>
</table>


Employees not meeting tenure, hourly work, and/or age requirements tend to have lower earnings than those who meet these criteria. For example, just over 75 percent of workers with annual incomes in excess of $30,000 participate in an employment-based retirement plan, compared with approximately one-fifth of those with incomes under $20,000 a year (Copeland, 2000b). Lower incomes translate into fewer contributions to a defined contribution plan relative to the costs of plan administration.

Restrictions imposed by most mutual funds serve as an example of the direct relationship between the size of account balances and administrative costs. About 90 percent of U.S. mutual funds have minimum investment requirements that effectively suppress the average administrative cost-to-asset ratio (Investment Company Institute, 1998). Nonetheless, minimum investment contributions sometimes take many years before generating enough income for the financial service provider to recoup its start-up costs on the account (Dickson, 1998). As one investment firm president explains, his company's minimum investment requirement of $250 requires at least $50 monthly deposits thereafter. Even then, he reports, “It takes close to 10 years before the accounts become profitable” to his company (Hansard, 1998).

54 Ibid., page 25. The largest majority is the 39 percent requiring a minimum investment of between $500 and $1,000. Twenty-four percent require $500 or less to start investing. Lower minimums do not necessarily mean that administrative costs are not significant.

55 Consider someone earning $30,000 under an IA system in which 2 percent of taxable payroll is contributed to IAs annually. “A low-cost mutual fund provider may only charge an average of 0.3% annually, resulting in first-year revenue of just $1.80, which would not even cover the cost of sending account statements. These accounts would take many years before recovering just their start-up costs.”

56 See also Koitz, Kollmann and Nuschler (2001) on this issue.
Interestingly, even the “universal” pension system proposed by the Carter administration would have had participation restrictions. The plan drawn by the President’s Commission on Pension Policy in 1980 would have allowed employers to restrict participation to workers between the ages of 25–65 with more than 1,000 hours of service. At the time this Minimum Universal Pension System (MUPS) was under consideration, workers meeting these criteria comprised just 54 percent of the nation’s total work force (Salisbury, 1980).

In summary, the federal minimum participation standards that allow exclusion of workers under 21 years of age, those who work less than 1,000 hours per year, and other restrictions, effectively lower administrative costs relative to assets, and are used in virtually all defined contribution plans. These restrictions generally limit participation to workers with more job tenure, older ages, and full-time job status. Administering today’s defined contribution plans is less expensive and less complex than would otherwise be the case in the absence of eligibility restrictions.

Social Security Coverage Differs From Employer Coverage—In contrast to the voluntary, employment-based system, or even MUPS, Social Security coverage is almost universal, and no one has proposed placing participation restrictions on IAs. Unlike a mutual fund or defined contribution plan that can restrict participation to some extent, political constraints would likely result in an IA system that covers either all eligible workers (through a mandatory IA system) or all who wanted to participate (in a voluntary IA system).

As a result, the population covered by IAs would differ substantially from that covered by employment-based retirement plans. For example, IA participants would have lower earnings: In 1996, 46 percent of workers covered by Social Security had annual incomes of $15,000 or less, while only 16 percent of employment-based defined contribution plan participants had incomes under $15,000 in 1993 (the last year for which data are available). Moreover, persons earning less than $15,000 annually accounted for just 8.3 percent of workers with a salary reduction plan (i.e., a 401(k)-type of plan).

Some dismiss the significance of the proportion of Social Security participants with low earnings by arguing that covering low earners is not administratively costly in the long term, as those workers are younger workers and adults in transition who become higher-wage earners later in life. To an extent, they have a point; fewer than 6 percent of full-time, full-period jobholders experience more than 12 months of low wages in a 24-month period (Ryscavage, 1996). However, this 6 percent still amounts to millions of full-time workers who work for prolonged periods at low wages and it does not count the millions of part-time workers who would have very small account balances if contributions were based on earnings. Moreover, younger workers are not the only ones who earn small amounts.

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For a description of workers who are exempt from Social Security participation, see Myers (1993), pp. 33–47.


Defined as wages equal to or less than $5.70 per hour.
EBRI tabulations of the March 2000 Current Population Survey reveal that a significant proportion of workers in their peak earning years comprise those earning below $10,000 and below $15,000 a year (chart 9). Similarly, using W-2 data recorded by the SSA, Kunkel (1996) found that three-quarters of women ages 35–64 in 1993 reported annual wages of under $18,000. In addition, at least 25 percent of males ages 34–45 in 1993 had earnings of approximately $15,000 or less.

In addition to having lower earnings, the population offered Social Security IAs would likely be more mobile than those covered by the employment-based retirement system. SSA received more than 220 million W-2 reports for just 132 million workers in 1993, suggesting that Social Security covers many workers holding multiple jobs or changing jobs over the course of a year. The fact that 81 percent of workers covered by an employer-sponsored plan have been at their jobs for at least a year, and 48 percent have been there five years or more, suggests that the population covered by employment-based retirement plans has lower job turnover than the working population as a whole.

**Case Example: The Thrift Savings Plan**—The TSP, the largest single operating defined contribution plan with individual investment choice in the United States today, features a very low administrative cost-to-asset ratio and low administrative expenses per participant, relative to other defined contribution plans. It is doubtful that such low administrative expenses per participant could have been obtained if TSP covered the same percentage of part-time, seasonal, multiple-employer, or low-wage earners, as does Social Security (table 8). On a proportionate basis, Social Security covered 1.8 times as many part-time workers as the TSP, almost twice as many workers under age 21, and more than 10 times as many workers with annual earnings of $15,000 or less.

One solution that has been offered to the small account issue is charging fees based on the total assets placed in individual accounts. This would cause the larger accounts to subsidize the smaller accounts, as is common in mutual funds and the investment business in general.

Since many proposals suggest that many private companies administer these accounts (and not a centralized government agency), subsidization in this manner becomes more difficult, since the distribution of account

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**Table 8**

<table>
<thead>
<tr>
<th>Comparison of the General U.S. Work Force&lt;sup&gt;a&lt;/sup&gt; With Federal Workers&lt;sup&gt;b,c&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Work Force</td>
</tr>
<tr>
<td>Part-Time Workers</td>
</tr>
<tr>
<td>Mean Age</td>
</tr>
<tr>
<td>Workers Under Age 21</td>
</tr>
<tr>
<td>Average Annual Earnings</td>
</tr>
<tr>
<td>Percentage with 4-Year Degrees or More</td>
</tr>
<tr>
<td>Average Length of Service</td>
</tr>
<tr>
<td>Workers With Aggregate Earnings of $15,000 or Less</td>
</tr>
</tbody>
</table>


<sup>a</sup>In 1997, 96.0 percent of paid civilian employees were covered by Social Security (OASDI) (U.S. Congress, 1998.)

<sup>b</sup>Most federal civilian employees participate in either the Federal Employees Retirement System (FERS) or the Civil Service Retirement System (CSRS). In 1996, 49 percent of federal civilian workers participated in the FERS, and 44 percent participated in CSRS. In 1998, 82.9 percent of FERS-covered workers made voluntary salary deferrals to the Thrift Savings Plan (TSP) (Federal Retirement Thrift Investment Board, 1997). The same year, 60 percent of CSRS participants made voluntary salary deferrals. Hence, roughly 68 percent of federal workers participate in the TSP.

<sup>c</sup>Note: Data do not include employees on leave without pay.

<sup>d</sup>Data from the Federal Retirement Thrift Investment Board (1998a) indicate that 8 percent of TSP participants were part-time or intermittent workers (p. 2).
sizes across the companies would need to be the same. If this distribution is not equal across companies, either account owners would be charged different amounts depending upon the company that administers their account, or the administering companies with a disproportionate share of small accounts would be left footing the bill of the uncovered expenses, most likely leading them to leave the business. Furthermore, providing an extra subsidy to those companies with a disproportionate share of small accounts would be problematic, because it would be difficult to determine whether their inability to cover administrative costs is the result of having too many accounts or of inefficient administration. If such provisions or protections were not put in place, potentially it would greatly reduce the number of companies willing to administer these accounts. This underlines why the simplest and lowest-cost system would involve one administrative organization and one or a small number of pooled investment options—the model adopted by Congress in setting up TSP in the 1980s.

**Which Businesses Participate?**

If employers will be expected to assist in administering IAs, which businesses participate is a policy decision that will affect administrative costs. Just as workers covered by employment-based defined contribution plans are different from the general population (see above), the businesses sponsoring these savings plans also tend to have distinguishing characteristics that lower administrative expenses. Larger firms are far more likely than small and medium-size firms to offer any kind of voluntary retirement plan, including defined contribution plans (Employee Benefit Research Institute, 1997). By comparison, like Social Security today, universal participation in IAs would affect virtually all employers, including very small ones. For example, 14 million self-employed individuals report wages to SSA; 37 percent of the 6.5 million employers reporting wages to SSA (excluding the self-employed) have three or fewer workers; and 23 percent (1.5 million employers) have only one employee (unpublished data, Social Security Administration, 1998). (See chart 10.) Voluntary IAs would not change this, as the choice to participate would be with the individual, not the employer.

Implications for the cost of an IA system are twofold. First, smaller firms tend to make more administrative mistakes, and second, smaller firms have technological limitations that make processing their wage and tax data more time-consuming, burdensome, and potentially expensive—for both small employers and government agencies alike: They file with the government on paper.

**Accurate Administration**—Firm size is correlated with employer stability. Unlike employers sponsoring defined contribution plans, approximately 10 percent of employers reporting wages to SSA go out of business each year (unpublished data, SSA, 1998). About 3.9 million businesses were estimated to have started up in 1996, while about 1.6 million terminated for various reasons.

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63 Almost every kind of employment is required to include participation in the Social Security program (Myers, 1993). Some state and local employers who opted out of the program have been allowed to stay out, although many reform proposals would change this (Olsen, 1996).

reasons (Dennis, 1997). The SSA reports that employer stability is correlated with accurate, timely administrative record keeping in terms of the quality of wage data sent by employers to the SSA (unpublished data, Social Security Administration, 1998).

Unfortunately, because Social Security covers many small and unstable employers with limited technology, administrative mistakes are routine occurrences in the current wage reporting and tax collection system. For instance, 8 percent of the 223 million reports submitted to Social Security each year are initially inconsistent with employer reports submitted to the Internal Revenue Service (IRS), and 5 percent (or 10 million reports) provide information failing to match anyone’s Social Security record. Chart 11 shows that errors are primarily concentrated in industries with large turnover rates and seasonal employment (i.e., agriculture, bars and restaurants, and services)—the very industries that have the lowest rates of employment-based retirement plan sponsorship (Employee Benefit Research Institute, 1997).

SSA is able to reduce the number of reports containing Social Security-related errors to 4 million a year through a variety of internal routines and initiatives. Discrepancy notices are sent by SSA or the IRS to erring employers,66 but SSA data show that only about 40 percent of employers respond to SSA notices and just 20 percent of notices result in a corrected wage report.

Some of these mistakes are due to employers going out of business and not submitting required forms, employers believing workers are contractual workers rather than salaried employees, and a myriad of common human errors such as typographical mistakes.67 For example, every year, some employers report (mistakenly) only to IRS or SSA rather than (correctly) to both agencies. Or, employers may incorrectly calculate nontaxable compensation as taxable or vice versa.68

Considerable government efforts are spent to ensure that employer payroll tax contributions over the year match the sum of their quarterly reports (Form 941); that Form 941 reports match the W-3 Transmittal of Wage and Tax Statement totals; and that W-3 statements match the W-2 Wage and Tax Reports. Of the millions of mistakes made annually, most are resolved within a year after the employer is notified of an error (which can be up to 23 months after the wages in question were earned). However, some errors can remain unresolved for decades, and some are never resolved (see

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65 Most numbers used to assess business turnover focus on businesses that terminate at a loss, but business experts generally believe that such terminations are the minority. The Wells Fargo NFIB 1998 report cited in Dennis (1997) states that business start-up and turnover rates are generally underestimated with conventional measures.

66 IRS sends copies of its quarterly wage report (Form 941) records to SSA, and SSA exchanges data with the IRS. SSA and IRS use these data to check whether the information the employer reported sending (to a Federal Reserve Bank or other authorized institution) regarding aggregate FICA taxes matches what the employer reports for individual employees on the W-2. If the IRS and W-2 data agree, no further action is needed. If they do not agree (i.e., the case is “discrepant”), one of the agencies investigates the problem. If the total on the IRS’ quarterly tax returns is smaller than that reported on the SSA’s W-2 form, the IRS investigates. If SSA’s W-2 forms have the lower total, SSA investigates—but only if the report is off by more than one work credit.

While the reality of the interaction between agencies and employers is actually more complex, one can theoretically think of SSA as investigating employers that report more on their 941 Forms than on their W-2s to ensure that the Social Security trust funds and workers’ earnings records are credited their due. The IRS can be thought of as investigating employers that report more on their W-2s than on their 941 Forms to ensure that the U.S. Department of Treasury has received the contributions it needs from employers to credit the Social Security trust funds with the amount they are due.

67 See “Social Security: Software Specifications and Edits for Annual Wage Reporting—Tax Year 1997” (Baltimore, MD: Social Security Administration, 1997: pp. 3–4) for a list of nine common employer errors that result in a mismatch between data submitted on different required forms. This publication is available online at www.ssa.gov

68 There are a number of rules surrounding who is an employee that the employer must pay payroll taxes for and what forms of compensation are taxable versus nontaxable (Internal Revenue Service, 1998; O’Toole, 1998).
chart 2). While penalties exist for employers who make mistakes, they typically are imposed only if the employer acts out of "willful negligence" (Internal Revenue Service, 1998).

To protect workers from errors made by their employers, SSA posts earnings credits to participants' records even if their employer has failed to send the attendant taxes, so long as proof of individual earnings is supplied. For example, workers can (and sometimes do) receive wage credits posted to their records today for work done in the 1960s or even earlier. Unless workers are "held harmless" in this way under an IA system, workers could lose significant cash contributions and interest earnings because of employer error or noncompliance. Being "held harmless," however, requires someone else (such as the government) to contribute money to replace these lost funds.

Benefits under the Social Security system today are exclusively based on credits from past work history, leaving more room for error than would occur in a cash-based system (like an IA system, workers could lose significant cash contributions and interest earnings because of employer error or noncompliance. Being "held harmless," however, requires someone else (such as the government) to contribute money to replace these lost funds.

Benefits under the Social Security system today are exclusively based on credits from past work history, leaving more room for error than would occur in a cash-based system (like an IA system, workers could lose significant cash contributions and interest earnings because of employer error or noncompliance. Being "held harmless," however, requires someone else (such as the government) to contribute money to replace these lost funds.

Administrative Time Frame and Effort—Small employers tend to lack technological tools (computers) that allow government agencies such as the SSA and IRS to process their data electronically (without first converting it from paper). About 85 percent of employers reporting wages to SSA file their reports on paper, and not electronically (chart 12). Not surprisingly, 90 percent of paper filers were small firms with fewer than 25 employees (unpublished SSA data, 1998). In addition, the only employers that are permitted to pay payroll and income taxes using federal tax deposit coupons—which require hand-written information using a soft-lead pencil—are smaller employers. However, because very large firms employ about half of all workers, most wage reports are reported electronically (chart 13), and most federal tax deposits were made electronically.

The differences in time and effort between processing electronic and paper reports are illustrated in the way Social Security is administered today. Paper Form

69 Sometimes, if employers acted in good faith and had strong reason to believe contributions and reports were prepared properly, they may be exempted from their own mistakes under special circumstances (Internal Revenue Service, 1998).

70 Electronic reporting can be done through diskette, wire-to-wire reporting, bulletin board, or magnetic tape.

71 Smaller employers are those depositing less than $50,000 in payroll taxes per year. In addition to smaller employers, new employers may pay with coupons. Since these are the only exceptions to the electronic deposit rule, "the vast majority of payroll taxes [are] paid electronically" (O'Toole, 1998, pp. 8–10).
W-2 reports must be reviewed for completeness and scanned into computer format by SSA. Those that cannot be scanned are manually reviewed and keyed into the system in groups, or batches. Batches are then sent to the National Computer Center for processing. Any outstanding errors or reports that cannot be read are saved until the reconciliation process at the start of each calendar year.

On the other hand, electronic reports are sent immediately for reading, and the approximately 10 percent that cannot be initially read are sent back to employers for correction (unpublished data, Social Security Administration, 1998). In addition, if more than half the records have errors, the file is sent back to the employer for correction. Hence, electronic reporting involves less time to check for errors, less intensive SSA staff time to correct errors, and more employer responsibility for providing accurate information prior to the reconciliation process. As a result, the “processing year” for electronic reports is considered to be two months shorter (January through August) than for paper reports (January through October). Technological limitations are also cited as a reason why firm size is related to pension coverage. For example, the federal government’s Thrift Savings Plan is administered electronically, as are defined contribution plans among other large employers. One TSP expert states that “most private employers could not meet TSP reporting standards” because of its intensive use of computer technology (Cavanaugh, 1998). All else being equal, administering IAs through employers covered by Social Security is likely to be more expensive than administering today’s defined contribution plans.72

Implications—The limitations of employers participating in the existing Social Security system have implications for policy decisions as to whether employers should assist in IA administration. They also have implications for using defined contribution plan administrative costs to predict the costs of an IA system that depends on employers to help administer it. Because of the lost investments and compounding time that can occur in an IA system, timely and accurate contributions are extremely important—so much so that additional regulations and enforcement activities may be levied on employers if they are called upon to administer all or part of an IA system (see “How Would Accounts Be Regulated?” below). Inevitably, mandating that employers assist in the administration of IAs would increase employer burdens and costs relative to the present system, especially for small employers. Such a change could have major economic and political implications, as small employers are a cornerstone of the U.S. economy and have considerable political influence.

How and When Are Benefits Paid?

Benefits can be paid from an employment-based retirement plan in a number of ways. Employers can provide annuities or timed withdrawals for retired beneficiaries. In addition, participants can use lump-sum distributions from an employment-based retirement plan to purchase a private annuity or to open a bank account that permits timed withdrawals (the amount of which are usually

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72 It is unknown whether the administrative compliance costs experienced by employers sponsoring defined contribution plans are more or less than the additional costs that would result in covering all employers in an IA system.
based on life expectancy and account balance). Alternatively, benefits can be paid in lump sums to retirees, or in preretirement lump sums as a result of property division upon divorce. (See Appendix 2 in Olsen and Salisbury (1998) for a description of how the TSP distributes account assets.) Costs vary across and within these benefit distribution methods (e.g., annuities with more features may cost more, or variation in fees may exist for identical annuity products).73 Similarly, IA balances could be distributed in any number of ways, with variation in cost. For example, some would argue that the cost of a government-provided annuity would differ from one purchased through the private markets. In addition, record keeping and distribution costs would be affected by such issues as whether IAs would be divisible assets upon divorce, whether they could be rolled over into other qualified retirement plans, whether they would be considered inheritable wealth, and whether spousal consent would be required.74

Allowing rollovers and dealing with property claims could exponentially increase the amount of paperwork involving IAs. For example, Aaron (1998) argues that tracing spouses after divorce would be difficult under an IA system unless spousal information like that required from newly hired federal employees was somehow obtained for all workers (this is spousal information that private employers do not routinely collect). Moreover, Hustead (1996) claims that for employment-based retirement plans today, “complex sets of regulations... require spousal notification of rights and approval of optional elections [and] determination of benefits under a Qualified Domestic Relations Order (QDRO).”75, 76 The result is that IA record keeper(s) would find themselves in the middle of millions of spousal disputes and divorce claims.

Another large factor in IA benefit distribution costs would be how very small account balances are handled before a participant reaches retirement age. Today, employers sponsoring retirement plans are allowed to “cash-out” retirement account balances of $5,000 or less upon employee termination. This means employers can refuse to hold accounts less than $5,000 whenever a worker leaves, resulting in lower administrative cost-to-benefit ratios in employment-based plans than would otherwise be the case if employers had to hold small accounts indefinitely.

Presumably, the growth of IAs into larger nest eggs for continuous workers with lower incomes is desirable public policy and one of the goals for adding individual Social Security accounts. A more ambiguous policy question is whether Social Security, employers, or the financial services firm that holds accounts should be required to maintain very small account balances for workers who have dropped out of the work force for substantial periods of time. For example, would accounts equal to $115 (roughly what a minimum-wage earner would contribute over two summers, at a 2 percent contribution rate) be held inactive for four or eight years while students obtain a full-time education? Would women or men with small balances who leave the work force permanently or for long periods of time have their accounts maintained until retirement age?

If small Social Security IA balances for persons who leave the labor force were not able to be cashed out, then the SSA, employers, or financial services firms that issue

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73 See section on “How Much Education and By Whom?” regarding variation in annuity pricing among identical products. Furthermore, see Brown (2000) and VanDerhe and Copeland (2001) for issues relating to the purchasing of annuities and asset payout rates likely to ensure one not outliving one's assets.

74 See Bureau of National Affairs (1998) for a discussion of spousal consent falsification on TSP loans for an idea of compliance issues that might arise under an individual Social Security account system requiring spousal consent for distributions.

75 A QDRO is a judgement, decree, or order that creates or recognizes the right of an alternative payee (such as a former spouse, child, etc.) to receive all or a portion of a participant's retirement plan benefits (Profit Sharing/401(k) Council of America, 1998).

76 The QDRO process is so complicated today because each QDRO must comply with the individual retirement plan to which it is going to apply. If everyone participated in one type of plan, such as Social Security individual accounts, it would be relatively simple to have a standard QDRO procedure. While the importance of QDRO complexity to an IA system is therefore overlooked by some critics of IAs, the fact that the IA record keeper could find itself in the middle of millions of spousal disputes and divorce claims is no small administrative matter.
account statements and educational materials would need to constantly keep track of those persons. Social Security does not currently keep up-to-date address information on every working-age person, or even on persons currently paying into the system. Individuals could be required to keep their own records up-to-date at the risk of losing account statements if they failed to do so.

However, a political argument might be made successfully that, in a mandatory IA system, those keeping records on participants’ money would be obligated to keep the owners periodically abreast of asset losses and gains. If so, keeping track of persons who have temporarily or permanently left the labor force would be a new and significant challenge, as illustrated by the recent controversy in Congress over how the U.S. Census Bureau should count the number of U.S. citizens. Constantly updating individual addresses and account statements for all Social Security recipients in the United States would be extremely difficult, if not impossible.

The 1990 Census count reportedly missed approximately 2–4 million persons who were disproportionately Hispanic, black, and/or children (Maxwell, 1997; Greenhouse, 1998). The Census, however, is conducted every 10 years. Keeping track of persons on a year-to-year basis (or month-to-month) would be a far greater challenge; the Census Bureau estimates that 42.1 million Americans (or 16 percent of the population) moved between March of 1996 and 1997. Of that total, most movers (65.9 percent) stayed in the same county, 18.9 percent moved between counties within the same state, and 15.2 percent changed states (U.S. Department of Commerce, 1998).

Indeed, mobility is considered the major reason why individuals were missed by the U.S. Census count (Brownrigg and Martin, 1989). Error factors identified in the Census apply equally to the challenges of keeping accurate records on IA participants’ addresses:

- Mobility.
- Language and illiteracy barriers.
- Concealment to protect resources (e.g., illicit income), combined with disbelief in Census confidentiality.
- Irregular housing and household arrangements.
- Resistance, passive or active, as a strategy for dealing with outsiders, especially government.

Another maintenance issue for small account balances is that if administrative costs were charged as a percentage of account balances, these accounts would be in effect subsidized by other account holders. To some extent, cross-subsidization of small account holders already occurs in today’s employment-based defined contribution system. However, such subsidies would be larger in an IA system because the spread between smallest accounts and largest accounts likely would be greater. How much the subsidy would cost and whether very small accounts should be maintained for former workers are unanswered questions that would affect administrative costs under an IA system.

How Would Administrative Cost Be Charged, and Who Would Pay?

Institutions providing IRAs often charge a flat-rate annual administrative fee (Lussier, 1998) on small account balances in order to compensate for the fact that small accounts pay lower investment management fees. If flat fees were applied to all Social Security IAs, these fees would disproportionately affect those with smaller account balances, which would raise issues of fairness if such fees were charged to participants (Aaron, 1998). For example, for 46 percent of the work force covered by Social Security, annual account contributions were smaller than the average administrative fee.

77 The Social Security program needs to keep track of participants’ addresses only when they are beneficiaries, not over their entire lives. Presumably, individuals receiving regular Social Security checks have a greater incentive to keep the administration abreast of their current information. However likely or unlikely, one can at least imagine participants who are lax in keeping their records up to date complain bitterly later that had they known about a change in account balance (e.g., because of market losses), they would have been able to prevent additional loss. To some extent this argument applies to employment-based defined contribution plans, but the responsibility usually belongs to the individual because he or she participates on a voluntary basis.

of 3 percent of taxable payroll would amount to $450 or less. For a worker earning just $15,000 a year and contributing 3 percent ($450) to an IA, a $22 flat annual fee would constitute almost 5 percent of the year's contributions. This same $22 flat rate would represent 2.4 percent of contributions for a $30,000-a-year wage earner, and just 1.5 percent of contributions for a $50,000-a-year wage earner. Hence, flat fees would have a regressive impact on lower-income Social Security participants.

The regressive effects of flat-rate fees on small accounts have led to a suggestion that smaller contributions be pooled until they are large enough to be transferred into an IA (Schieber, 1998). Another idea is to charge administrative costs as a set percentage of annual account assets. This percentage approach, especially in a system using private administrators, raises the possibility that investment firms would court larger account holders because they would be more profitable to service. This practice could result in two separate types of IA providers—a basic one for smaller account holders, and a privileged one that provides more services and better fund managers (and possibly higher returns as a result) for larger account holders who are able to pay for these advantages.

However, neither flat nor percentage-based costs would necessarily be charged directly to participants' accounts. Theoretically, the government could pick up all or a portion of the administrative charges for individual accounts. Alternatively, the government could cross-subsidize small account holders by levying larger administrative charges on bigger accounts. Or, as is common among commercial defined contribution administrators, administrative and investment fees could be "bundled," so that investment fees cross-subsidize the expense of plan administration. Anecdotally, at least, defined contribution plan administration is not very profitable in and of itself—which is why most large-scale defined contribution plan administrators also offer investment services.

How Would Accounts Be Regulated?

Whether IAs are administered in the private or public sector, the government would likely become actively involved in their regulation, whether or not real or perceived problems or abuses are discovered in the IA system. This is certainly the case for existing 401(k) plans, regardless of whether they offer basic or "high-end" services. Arthur Levitt, the former chairman of the Securities and Exchange Commission, underscored this possibility: "Regulators would need to spend more money and effort fighting a potential increase in fraud. A big influx of new, relatively unsophisticated investors can create more opportunities for fraud, as happened in the long-running bull market that turned downward this summer" (Gordon, 1998). By another account, Levitt stated that IAs "hold considerable implications for oversight of the markets" and "would require regulators to step up efforts at investor protection" (Stevenson, 1998). A TSP model with one central administrator and a small number of pooled investment managers would provide the least need for regulation. Proposals that allow individuals to select private investment firms would expand the scope of regulation, as is specified in the Kolbe-Stenholm proposal described above. Among the complex issues that would need to be addressed are how to regulate individual accounts, the regulatory risks of being either too lax or too strict, and determining who pays for the regulatory costs.

How Much Education and By Whom?

Efficient markets depend on educated consumers. Yet surveys suggest that more than half of all Americans do not know the difference between a stock and a bond, and only 16 percent say they have a clear idea of what an

79 For example, Shah (1997) argues for changing Chile's administrative charges to a percentage basis. Also see Goldberg (1998), pp. 4 and 6.
80 For a discussion of regulatory issues raised by the non-TSP model, see Olsen and Salisbury (1998)
individual retirement account is. To make a market-oriented individual account system work most efficiently, consumer education would be critical. Such a public education effort, which would involve describing sometimes-complicated financial terms and concepts, would be a massive challenge, at best. This is especially true for the 21 percent of the adult population with only rudimentary reading and writing skills (at or below the fifth-grade level, according to the National Center on Education Statistics, 1993) and who have little if any exposure to retirement accounts, annuities, or investing.

In addition, education appears to be necessary for persons already possessing retirement accounts, as research shows that a significant number of defined contribution account participants in employment-based plans do not understand the basics of investing (Bernheim, 1994; Katzef, 1998; Yakoboski and Schiffenbauer; 1997; Employee Benefit Research Institute, 1998). The fact that many who would benefit from purchasing an annuity at retirement do not do so (Gebhardtsbauer, 1998) suggests a lack understanding of annuities as well. Moreover, many who do purchase annuities are unlikely to fully understand the many types of fees that can be imposed, and how these fees affect annuity payouts. Perhaps partially as a result of a lack of comprehensible information from providers, research suggests premiums among identical annuity products vary significantly (U.S. Congressional Budget Office, 1998, p. 14).

The importance of (and lack of) education does not stop at the participant level. Two studies suggest that even many employers do not have a firm understanding of the total administrative expenses paid for their own 401(k) plans (KPMG, 1998; U.S. Department of Labor, 1998b). This lack of knowledge is worrisome, given that the Department of Labor (DOL) conducted a study that found that 401(k) plan fees varied by as much as 300 percent within one investment type (White, 1998) and can comprise up to 3–5 percent of 401(k) balances per year (Kalbrener, 1998). In most arrangements, fees are passed on to participants but are sometimes shared by the employer. Although sometimes not directly incurred by the employer, such fees are important to employers because high fees lessen the effectiveness of plan sponsorship to business goals.

One reason that individuals and employers do not have a good understanding of expenses may be that some are not willing to devote time to learning how administrative expenses affect investment returns. However, DOL (1998b) found that even those persons trying to learn face a formidable challenge:

. . . Not all investment products disclose the fees and expenses charged to a 401(k) plan. . . [A] Dalbar study in 1992 shows that 78% of plan sponsors did not know how much their costs were, largely because there are about 80 different ways in which vendors charge fees . . .

Assuming that better fee disclosure would be required (see regulation section above) if almost all of the U.S. work force were placed into mandatory Social Security accounts, widespread education would still be necessary. Explanations would be required of investment basics and annuity options, in addition to encouraging participants to monitor their fees. These activities could be handled several ways, and the level of education required would depend on the type of reform. The more freedom participants have to make their own decisions about individual Social Security accounts (e.g., choosing

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81 Statement of Arthur Levitt, the former chairman of the Securities and Exchange Commission, as reported in Burns, 1998.
82 For a discussion of the challenge of explaining the basics of benefits under the current Social Security program, see U.S. General Accounting Office, 1996b.
83 See Tam (1998) for a brief description of these fees.
84 A useful way to classify expenses and fees for the 401(k) plans is: set-up and conversion fees, recurring administrative costs, communications expenses, investment management fees, distribution fees, and mortality and expense risk fees (U.S. Department of Labor, 1998b).
85 The 1998 DOL report, Study of 401(k) Plan Fees and Expenses, was part of a multi-pronged campaign launched in November 1997.
among fund options, purchasing an annuity, making interfund transfers), the more education would be required. In any event, education can be provided on an ongoing basis (e.g., as is the case with the TSP), or at the beginning of an IA system through a massive public outreach campaign (e.g., as was done in Australia). Because educational activities are so contingent on as-yet undefined reform designs, their contribution to total administrative costs is unknown.

Estimating the Uncertainty

Estimates of Administrative Costs

As discussed previously, the costs of administering IAs will depend upon their design. The U.S. General Accounting Office (GAO) (1999b) examined several studies of various potential administrative mechanisms. The estimates from these studies for a centralized system ranged from 0.11 percent of assets to 0.79 percent. The range for a decentralized employer-sponsored system was 0.28 percent of assets to 3.0 percent, while for a decentralized individually managed system, costs varied from 0.32 percent to 1.5 percent. However, some of these studies are not necessarily applicable to a Social Security IA system, as they are estimates of employer-sponsored 401(k) plans that would not necessarily have the same cost structure as the IA system, for reasons previously outlined. Furthermore, some of the studies do not fill in all of the details that would be necessary to administer a system. And, they do not include the costs absorbed by the employer in making contributions to the administrator, or of collecting choices from employees. Yet, they do provide a range of estimates for determining the nonemployer costs of going forward with an IA system.

The State Street Corporation (1999) provided a detailed study of a possible centralized system of administering an IA system. A three-level approach was developed, where the first level contained the payroll tax dollars to be earmarked for individual accounts being collectively invested in money market accounts until reconciliation of the W-2 forms is completed; this addresses the Type 1 float issue. After reconciliation is completed, the IA funds are transferred to the second level, where the worker can select between three balanced funds and a money market fund. The third level would then be started approximately three years after commencement of the IA system, presumably after the balances have achieved a certain level. Thus, this system would use the existing payroll tax collection structure and a TSP-like model to start, and then build upon it after balances have reached a threshold for greater choice by bringing in more investment options with private investment companies.

State Street also estimates the costs of this type of system. First, certain limitations are assumed: one fund transfer per year; no loans; distributions only in the event of death or retirement; a single annual contribution to Level Two; a single annual account statement; and one fund per participant. Under the State Street analysis, the main costs would come from participant inquiries, transactions, transfers, and report generation, and fees would be charged as a percentage of total assets, not as a flat fee per account. By the fifth year of this individual account system, the annual administrative costs are estimated to range from 0.19 percent of assets to 0.34 percent, depending upon the level of inquiries to the record keepers. These estimates do not include communication/education of the system to workers, enrollment costs, or any costs that the Social Security Administration would bear to provide the necessary information to the administering body.

The Social Security Administration (Hart et al., 2001) also provided a detailed estimate of the costs of SSA administering a centralized program of individual accounts. Again, these estimates are only the costs that...
would be borne by SSA—not individuals, employers, or other government agencies. This model offers two types of a centrally managed, wage-based, national, mandatory program of individual accounts—basic and higher service.

The basic program would have customer service at a level comparable with that provided today, with limited investment options and payout processed at the same time as other Social Security benefits, resulting in a combined check; there would be additional costs for enrollment and customer service. The higher-service program would increase employer responsibility by increasing their reporting requirements. Much higher levels of customer service and public education would be available, and more options for investments and payouts would be allowed.

Under these two approaches, the administrative costs borne only by SSA would have a relatively broad range. For the basic option, the costs are estimated to be 0.95 percent of assets in the first year of operation, and for the higher-service option, costs were estimated to be 4.0 percent of assets. These costs are predicted to decrease (as a percentage of assets) as the program matures.

**Key Modeling Assumptions by EBRI**

In the analysis with the SSASIM model presented below, administrative costs are explicitly subtracted from Social Security benefits. The analysis below also assumes that administrative costs cut directly into fixed benefits. But in reality, a positive correlation sometimes exists between returns and administrative costs; that is, investment strategies yielding higher returns sometimes have higher administrative fees (U.S. Department of Labor, 1998b; Vantagepoint Funds, 1998). Unfortunately, sometimes higher returns are offset enough by higher fees that the net yield is the same as for lower-return strategies (Dickson, 1998). In other cases, however, there is more interplay between administrative costs and benefits (Patterson, 1998).

**Percentage Reduction in Benefits**

SSASIM simulations are used to determine the impact on total benefits when moving from low administrative cost assumptions to high ones. From the studies above, the administrative cost assumptions used by EBRI were determined to be 10 basis points (0.1 percent of assets) at the low end to 200 basis points (2 percent of assets) on the high end. As described above, the administrative costs are directly linked to the level of services and choices provided in the IA system. Another assumption in these simulations is that all IA balances are annuitized at retirement. Consequently, the loading factor or cost of annuitizing must be estimated. The annuity loading factors were determined from experts in the area to range from a low of 5 percent to a high of 15 percent. The reform proposal used to illustrate the effects of administrative costs is the legislation introduced in 1998 as S. 2313 and H.R. 4256 in the 105th Congress by Sens. J ohn Breaux (D-LA) and J udd Gregg (R-NH) and Reps. J im Kolbe (R-AZ) and Charles Stenholm (D-TX).

The level of administrative costs has a significant impact on the total benefits that retirees would receive. However, the impact of administrative costs across birth cohorts and earning levels is different. Those individuals in the older cohorts would have a lower reduction in total benefits due to administrative costs, since the benefit coming from the IA would be a smaller portion of their total benefit due to fewer working years under the IA system. Furthermore, male low-wage earners would have their total benefits reduced by up to 14 percent, male

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87 For background on the model, see Olsen et al. (1998) and Holmer (2001).

88 For more detail about this proposal and a comparison of benefits with generic reform proposals, see Copeland, VanDerhei, and Salisbury (1999).

89 See Copeland (2001) and Copeland (2000a) for the effects of administrative costs on actuarial balance in an Archer/Shaw-type proposal where benefits would be guaranteed at currently promised levels.
average-wage earners by up to 19 percent, and male high-wage earners by up to 23 percent, when administrative costs go from low to high (chart 14).90, 91

Policy Implications

Despite their importance, administrative details about how individual Social Security accounts would operate have been largely ignored by a majority of individual account proponents, although this has changed somewhat since the publication of the first EBRI Issue Brief on this topic in November 1998. Yet, sources of uncertainty abound even when administrative issues have been addressed, since little is understood about the systemic administrative costs under existing defined contribution accounts that are sponsored by employers. As SSASIM analysis has shown, administrative cost variations could lower total benefits by approximately 20 percent, even under an individual Social Security account system based on just a 2 percent annual salary contribution.

If those who would reform Social Security expect individual accounts to fulfill policy objectives, they need to decide on a variety of administrative details that could profoundly affect administrative costs, and to which individual account benefits appear to be highly sensitive. Just a few of the many questions needing answers:

- How frequently would employers be required to report contributions on behalf of specific employees?
- Would employers be required to send contributions to one entity or many?
- How many and what types of services would be accessible to account participants?
- Who pays—and how much—to operate individual accounts?

Far from being “mere technicalities” that are better left to agency personnel, administrative details will affect the feasibility, character, and desirability—ultimately, the success or failure—of any system of individual Social Security accounts that Congress may enact.

Once proponents develop their preferences in terms of how individual accounts would operate, then the administrative feasibility and costs should be estimated in detail. As explained above, the populations covered by Social Security are sufficiently different from those covered by the employment-based retirement system to warrant independent examination of Social Security individual account administrative feasibility and expenses. In other words, administrative costs and options for individual Social Security accounts will require separate analysis that cannot be obtained simply by looking at the experiences of employment-based retirement plans.

Individual accounts have the potential to work, but administrative details cannot be ignored if that potential is to be realized. The set-up and operation of these accounts are faced with hurdles that must be dealt with before any system can begin to be implemented in a timely manner and in a way that is affordable for individuals, employers, and plan providers. The amount of operational and administrative detail that is specifi-

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90 This is a reduction in total benefits, traditional benefit plus IA benefit. The reduction in the IA benefit would be significantly more.

91 Low earners are defined as earning 45 percent of the average gender/age wage, and high earners are defined as earning 160 percent of the average gender/age wage. This correlates with the Social Security Administration’s definition of low and high earners in the annual Trustees Report.
cally addressed could very well determine the ultimate success or failure of individual accounts.

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 is more likely to look like a “Model T.” This is not an argument for or against any particular program design; rather, it reflects the administrative realities of a work force dominated by paper-based small employers and adding a defined contribution element to a defined benefit Social Security system:

• 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 start-up 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 startup 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.

To extend the automotive analogy, better to promise and deliver a perfect Model T than to promise and fail to deliver a Porsche. Technology may ultimately permit delivery of a Porsche, but only when every employer and worker in the nation has adopted that technology.

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