Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs

by Kelly A. Olsen and Dallas L. Salisbury, EBRI

Executive Summary

Whether to add individual accounts (IAs) to the Social Security system is a highly political issue. But almost lost in the debate so far have been any practical 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, are they even possible? This EBRI Issue Brief provides an overview of the most salient administrative issues facing the current Social Security reform debate—issues that challenge proponents to carefully think through how their proposals could be implemented so as to achieve their policy goals.

The options and difficulties 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 has largely ignored the pragmatic challenges of whether IAs would be too complex for participants to understand or too difficult for record keepers to administer.

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 to date 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 are tenuous 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 would be larger relative to benefits.

- **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 “privatization” 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 7–19 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 7–19 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.

- **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 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 employer-sponsored retirement arena, and how lessons from the employment-based system apply to Social Security reform.

- **Individual account benefits would be highly sensitive to administrative costs, according to results using the EBRI-SSASIM2 Policy Simulation model.** Workers born in 1976 and 2026 would receive 40 percent to 42 percent lower IA 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 produce meaningful retirement benefits.

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Kelly A. Olsen and Dallas L. Salisbury of EBRI wrote this Issue Brief with assistance from the Institute’s research and editorial staffs. Any views expressed in this article are those of the authors and should not be ascribed to the officers, trustees, members, or other sponsors of EBRI, EBRI-ERF, or their staffs. Neither EBRI nor EBRI-ERF lobbies or takes positions on specific policy proposals. EBRI invites comment on this research.
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Examining policy administration is an integral part of basic public policy analysis,¹ 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 "privatize" part of the system. The debate centers largely over whether to add individual investment accounts to Social Security, similar to savings vehicles currently found in the form of employment-based defined contribution retirement plans.

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 is a highly political issue, an objective examination of how to administer such accounts raises concerns that cut across ideology. In short, adding individual accounts to Social Security would be a formidable administrative undertaking that would have uncertain consequences. 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.

- **Over twice as many workers are covered by Social Security as the number of individuals in the U.S. 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 number of all defined contribution accounts in the U.S. combined, 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 largest private defined contribution plan administrator.
  - Moreover, Social Security covers more than 83 times as many people as the largest public defined contribution plan, the Federal Thrift Savings Plan (TSP).

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 dissatisfactions with the current system that are precipitating interest in individual accounts,³,⁴ administrative issues

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¹ Patton and Sawicki (1993), for example, categorize administrative analysis into two categories: technical feasibility and administrative operability.

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

³ Despite substantial dissatisfaction among certain groups with projected low money’s-worth returns on Social Security contributions, general opinion
Uncertainties Abound

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 paper, 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, policy design is an indispensable part of assessing reform options. Administrative issues will determine whether such accounts could actually be implemented, at what cost, and over what time period.

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.

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. Service providers have hundreds of administrative fees, and each vendor charges differently (DOL 1998; (k)la 1997). In fact, investment fees, which are the primary administrative costs for 401(k) plans ((k)la 1997), vary up to threefold across vendors ((k)la 1997) and are seldom understood by either plan sponsors or participants (Department of

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).

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 1996, 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 fee) 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 expenses. On the other hand, the data the GAO reports 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.

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Labor, 1998). 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.8 Finally, even if operational costs could be separated from compliance costs, defined contribution plan 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 meaningfully from those covered by Social Security (see table 1).

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 by Rep. John Porter (R-IL), Rep. Pete Sessions (R-TX), and Sen. Daniel Patrick Moynihan (D-NY), explicitly mandate employers’ role in administration.9 Unfortunately, reform proposals are still generally limited in their attention to administrative specifics.

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 Federal Thrift Savings Plan (TSP), a relatively simple account system with limited participant services, took about three years from the passage of the law to plan implementation. (See Appendix 2 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 $5,250,000.

Table 2 shows how start-up costs were allocated.

If one simply assumes that per participant expenses for IAs would equal those of the TSP plan, then the $5,250,000 start-up cost for TSP in 1987 would amount to $1.08 billion for IAs in 1998. This amount seems relatively modest when compared with the on-line budget surpluses projected by the Congressional Budget Office (chart 1).

Unfortunately, for reasons that will be discussed in this report, it is highly questionable whether a system of IAs would resemble the TSP in terms of cost or design. For one, start-up costs could be different because the work force and employers covered by Social Security are substantially different from those covered by the TSP.10 In addition, Social Security’s start-up environment would differ from that of the TSP. Development of extensive information systems for IA administration might be difficult if “Y2K” (Year 2000) computer programming problems presented delays, or if the aftermath of Y2K caused a shortfall in technology professionals.11

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8 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 “How Would Accounts Be Regulated?”

9 See footnotes 30, 31, and 32 for more detail.

10 For a discussion, see the section on “Which Workers Are Covered Affects Cost and Complexity.”

11 “Government Management, Information and Technology estimates that some of the largest U.S. agencies, including the Department of Transportation, State, Energy, and Health and Human Services, won’t fix the year 2000 problem until 2004” (Qualified Plan Alert, 1998).
Second, 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 would disproportionately affect those with the fewest years to accumulate account assets. Hence, as a whole, start-up costs are a very significant issue in terms of fairness, feasibility, and realistic time and service expectations for the beginning of an IA system.

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 start-up 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 feasibility and costs. To assess the implications of such uncertainty for individual account benefits, the EBRI-SSASIM2 Policy Simulation Model is used to calculate benefits over a range of administrative cost assumptions. Our 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 Boundaries of 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,
Life annuities provide a payment on a periodic basis for the life of the participant and possibly his or her spouse.

A defined benefit plan is a retirement plan in which benefits are calculated according to a formula or rule. Benefit 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).

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 using their account balances to purchase life annuities upon retirement incur further administrative expenses (table 3).

### 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 just as many 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 with 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 would 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.

### 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 involved, rather than of the generosity of Social Security benefits. For instance, whether the average defined benefit

### Table 3

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

Source: Employee Benefit Research Institute.

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12 Life annuities provide a payment on a periodic basis for the life of the participant and possibly his or her spouse.

13 A defined benefit plan is a retirement plan in which benefits are calculated according to a formula or rule. Benefit 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).

14 See section on “What Businesses Participate?” for a discussion of employer errors under the current system.

15 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 2.7 percent of benefits. The combined OASDI program operates with total administrative costs equal to 0.9 percent of benefits paid annually (Board of Trustees, 1998, Table IIC1, p. 38).
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>Calculating and Sending Required Contributions</td>
<td>Government refunds or tax credits.</td>
<td>Employer payroll deductions.</td>
<td>Individual contributions.</td>
</tr>
<tr>
<td></td>
<td>• How often?</td>
<td>• How often?</td>
<td>• How often?</td>
</tr>
<tr>
<td></td>
<td>• If &quot;earning sharing&quot; a between spouses, how does government keep records accurate?</td>
<td>• Cash, check, electronic?</td>
<td>• Cash, check?</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Float period?</td>
<td>• Float period?</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• If &quot;earning sharing&quot; a between spouses, how are records kept accurate?</td>
<td>• If &quot;earning sharing&quot; a between spouses, how are records kept accurate?</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.</td>
<td>Individuals report to government and/or private service provider reports to government.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• How often?</td>
<td>• How often?</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• In what form and to which agencies?</td>
<td>• 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.</td>
<td>Employer reports to individuals.</td>
<td>Private service provider reports to individuals.</td>
</tr>
<tr>
<td></td>
<td>• How often?</td>
<td>• How often?</td>
<td>• 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.</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.</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.</td>
</tr>
<tr>
<td></td>
<td>• How often permitted?</td>
<td>• How often permitted?</td>
<td>• How often permitted?</td>
</tr>
<tr>
<td></td>
<td>• Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
<td>• Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
<td>• Through what means? (telephone; 1040; W-2; on-line, etc.)</td>
</tr>
<tr>
<td>Sending Periodic Account Statements to Participants</td>
<td>Government.</td>
<td>Employer through DC plan.</td>
<td>Private-sector provider.</td>
</tr>
<tr>
<td></td>
<td>• How are nonactive individuals kept track of?</td>
<td>• How are nonactive individuals kept track of?</td>
<td>• 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 PBGC²-type insurance entity supported through contributions or payroll taxes.</td>
<td>Employer with government oversight; possibly employers or individuals would contribute to a PBGC²-type insurance entity.</td>
<td>Private-sector provider with government oversight; possibly private providers or individuals would contribute to a PBGC²-type insurance entity.</td>
</tr>
<tr>
<td>Providing Ongoing Investment Education</td>
<td>Government responsibility; differentiate ongoing education from initial start-up?</td>
<td>Employer responsibility; differentiate ongoing education from initial start-up?</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>
<tr>
<td></td>
<td>• How would government communicate investment prospectuses or other information on an elementary level?</td>
<td>• Would government educate employers about avoiding liability?</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• What kind of fiduciary liabilities would be created?</td>
<td>• How?</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• What kind of fiduciary liabilities would be created?</td>
<td></td>
</tr>
</tbody>
</table>

(continued)
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 1994–96 Social Security Advisory Council would 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. 16 Likewise, 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 record-keeping duties to the federal government. Having the government provide record-keeping services to a public policy sector. 18 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.

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,” 17 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. 18 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?

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16 H.R. 4076.
18 Typically, these are public service entities such as water or power authorities or specialized insurance or financial corporations. Examples include the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae). Some of these organizations operate without subsidies and offer publicly traded securities while maintaining their special status and franchise under the law.

Table 4 (continued)

<table>
<thead>
<tr>
<th>Task</th>
<th>Government</th>
<th>Employers</th>
<th>Individuals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Processing Distributions</td>
<td></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.*

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*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.)

Pension Benefit Guaranty Corporation.
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 among private vendors 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)

How Are Account Contributions Made and Investments Credited to Individual Accounts?—Yet 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. Of the few groups that address how contributions would be deposited into IAs, the NCRP recommends "working within the current payroll tax structure." Others recommend increasing employer responsibilities, as has been done overseas (Harris, 1998; The Heritage Foundation, 1997). Still others reject both approaches and prefer an individual approach based on an individual retirement account (IRA) contribution model. IA contributions could also be deposited directly by the government through general revenues (e.g., tax surpluses). 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 lump-sum payments to Federal Reserve Banks or other authorized institutions (chart 2). Quarterly, via the Form 941, employers report to the 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 contribution from the previous year was paid on behalf of each employee (through the Form W-2). (See chart 3.)

These infrequent (i.e., annual) reporting practices mean that it can take a year or more for some payroll taxes paid on behalf an individual employee to be identifiable as such. (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 SSA to post the attendant work credits to individual Social Security earnings records. (See chart

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19 For a discussion, see McGough, 1998.

20 For example, individual account marketing expenses have been of concern in the Chilean Social Security system (Shah, 1997).

21 One reporter writes, "Some experts wonder if the financial services industry could profitably manage millions of individual accounts that would see less than $500 a year in contributions, yet probably carry major reporting requirements and substantial regulatory oversight" (Hansard, 1998). For more on regulatory concerns, see the section on "How Would Accounts Be Regulated?"

22 Both employee contributions and employer matching contributions are sent together in one lump sum periodically. Periodic payments for the overwhelming majority of employers are made on a semiweekly or monthly schedule, depending on the employer's employment and income tax withholdings for a 12-month look-back period. Actual deposit schedules are based on both determination of deposit schedule and the employer's payroll period (Internal Revenue Service, 1998).

23 Certain employer groups, such as farmers, send alternative forms, while the majority of employers send Form 941 Quarterly Tax Returns.

24 Only employers who withhold federal income tax from employee compensation and are subject to withholding and payment of Social Security and/or Medicare taxes are required to file Form 941 (O'Toole, 1998). For a list of the very few exceptions that apply, see O'Toole, 1998, pp. 8-21-8-22.
Chart 3
Administration of the Current Social Security System Wage Collection and Crediting Process

Year #1

Department of Treasury receives aggregate federal income tax (including FICA) contributions from employers (no breakdown of contributions 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.

Department of Treasury reconciles employer’s Quarterly Federal Tax Returns (reported deposits) with actual aggregate tax deposits made by employer over the year on an ongoing basis.

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.

Department of Treasury receives aggregate federal income tax (including FICA) contributions from employers (no breakdown of contributions 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.

Department of Treasury reconciles employer’s Quarterly Federal Tax Returns (reported deposits) with actual aggregate tax deposits made by employer over the year on an ongoing basis.

Year #2

SSA begins receiving and preparing W-2/W-3 reports.

SSA begins receiving quarterly tax return data from IRS and SSA.

SSA begins mailing notices about unverified Social Security numbers and names.

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

SSA begins mailing notices about unverified discrepancies in reconciling.

98.5 percent of both paper and magnetic reports from Year 1 are fully processed, with most U.S. workers credited with earnings from Year 1.

Missing reconciliation cases from Year 1 are identified and notices are mailed by SSA.

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-employed persons and earnings from domestic employment.

Most self-employed persons send individual tax returns to IRS.
Unfinished Processing and Reconciliation from Year #1

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

Year #3

IRS sends out follow-up notices followed by another notice before a penalty is assessed.

IRS notifies SSA of any outstanding reconciliation errors.

SSA notifies IRS of any outstanding reconciliation errors.

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

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

Source: Employee Benefit Research Institute
Table 5
Periodicity In Contributions and Interest Earnings Affects Benefits

<table>
<thead>
<tr>
<th>Time (End of Month)</th>
<th>Monthly Contribution Schedule</th>
<th>Quarterly Contribution Schedule</th>
<th>Annual Contribution Schedulea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Month 13</td>
<td>$1,346</td>
<td>$1,339</td>
<td>$1,207</td>
</tr>
<tr>
<td>Month 25</td>
<td>2,683</td>
<td>2,668</td>
<td>2,501</td>
</tr>
<tr>
<td>Month 37</td>
<td>4,116</td>
<td>4,093</td>
<td>3,889</td>
</tr>
<tr>
<td>Month 49</td>
<td>5,653</td>
<td>5,621</td>
<td>5,377</td>
</tr>
<tr>
<td>Month 481</td>
<td>262,481</td>
<td>260,966</td>
<td>254,166</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute tabulations.
aTotal annual deposits of $1,200; assumed rate of return of 7 percent.

3.) 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.25

The implication for an IA system that uses the current tax collection and wage crediting system is that it would take at least 7–22 months for every dollar contributed to the 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’ IAs. 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 7–22 months if the current payroll tax collection system was used to administer IAs.

There are two possible objections to such long float periods. First, 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). (See table 5.)

If this loss of $8,315 does not seem like a lot over a lifetime, consider that Congress mandated that starting in 1998, all except smaller employers must deposit their payroll and federal income taxes electronically rather than through federal tax deposit (FTD) coupons. Despite significant and ongoing political opposition,26 Congress passed this rule with the rationale that electronic deposits “will put the deposited amounts in Treasury’s account one day earlier than under the paper coupon deposit system,” and the amounts will therefore “earn more interest” (O’Toole, 1998, p. 8–11). If Congress overcame political opposition in order to obtain a day’s worth of additional investment time, it stands to reason that IA participants might reject the idea of sacrificing many months’ worth of investment time.

A second criticism of long float periods is that investment markets might be affected if floats resulted in the accumulation of large amounts of payroll revenue being saved up and sent to individual accounts every 12–18 months or so. Chart 4 shows projected annual account contributions from an IA system based on

25 Self-employed workers send W-2 type information on their individual tax returns in April, generally. Sometimes, an extension to October is granted.

26 The penalty for not filing electronically (10 percent of the tax liability) has been delayed at least twice because of opposition from employers.
2 percent of taxable payroll. In 1998 alone, IA contributions would have equaled almost $80 billion. By comparison, the average daily dollar volume traded on the NASDAQ stock exchange in 1996 (the latest year available) was just under $13 billion (NASDAQ, 1998). Methods of dealing with float periods of this type under the current payroll tax collection system are discussed in Appendix 1.

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. 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). A number of options are available to deal with such float periods, each with its own set of advantages and disadvantages, as detailed in Appendix 1.

Quarterly W-2s—If approaches to minimizing or eliminating Type 1 or Type 2 float periods (as detailed in Appendix 1) are unacceptable, then the current wage reporting and tax collection process cannot be used for IA administration. A possible alternative might be to increase the reporting 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 1978.27 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 employers alone an estimated $235 million annually (p. 813) (President’s Advisory Council on Management, 1972). Adjusted to 1997 dollars, that would amount to about $900 million a year.

Hence, small businesses could be facing a cost increase of roughly $900 million a year under an IA system that required quarterly rather than annual W-2 reports. 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 is that float periods would still exist with quarterly reports, albeit they would be 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

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27 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 who had to file several times each year, versus once.

28 Employers with 499 or fewer employees.
protection from Type 2 float periods (i.e., those caused by reporting errors), but for all the 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 is proposed in the Individual Social Security Retirement Accounts Act of 1997 (H.R. 2929), the Savings Account for Every American Act of 1998 (H.R. 3683), and in the Social Security Solvency Act of 1998 (S. 1792).

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, 1998, 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, where employers would send monthly contributions may likely make a difference in terms of float time. If the employers were required to...

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29 H.R. 2929, 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 employee’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.”

30 H.R. 3683, 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.”

31 S. 1792, 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.”

32 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, 1996).

33 There are no widely accepted estimates of the number of employers that offer defined contribution savings plan to their employees. However, since about 37 percent of workers who are offered a defined contribution plan do participate in the plan at any given time, it stands to reason that a majority of employers do not offer a defined contribution plan.

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

35 See section on “Which Businesses Participate?” for a discussion of how small employer technology limitations affect the current wage collection and crediting process.
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, if employees were free to choose providers, this approach likely would be the most expensive of all contribution and record-keeping schemes and most burdensome for 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 who do not offer defined contribution plans. In addition, some type of government audit of employer records likely would be required in order to ensure employer compliance.

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.

The primary objections to this approach are enforcement concerns. Former IRS Commissioner Fred Goldberg states that relying on individuals to make IA contributions directly “wouldn’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).

General Revenue Funding—Some plans propose funding accounts through government tax credits or refunds, say, through federal budget surpluses (for example, H.R. 3456 and S. 2369). It remains unclear what would happen to account contributions after any surplus runs out, or if a budget surplus large enough to fund 148 million IAs never materializes. Nevertheless, IA account contributions could come from general revenues whether or not there is a surplus. The government could agree to pay workers' accounts a flat amount or an earnings-based contribution on a periodic basis.

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36 Given the recent hearings 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.

37 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.


39 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.


Such a general revenue-funded system likely would require more data on a more frequent basis than currently is collected by the government in order to determine contributions. For example, would only workers receive contributions, as opposed to all U.S. nonretired residents? How would “nonretired” be defined? Or would the system cover only workers above a certain earnings threshold? Would the government’s contribution amount be flat or based on earnings? If based on earnings, would it be weekly, monthly, or annual earnings? Anything more specific than annual earnings would require record keeping of a worker’s earnings at a specific time—information that is not gathered under the current system.

The contribution amount theoretically could be calculated based on annual information (e.g., annual earnings from two years ago to ensure most records had time to be reconciled), but paid in portions on a more frequent basis (e.g., monthly). This would eliminate concerns about depositing IA funds into the financial markets all at once. Another advantage is that, since all IA contributions would be paid using general revenues, presumably there would be little need to create a separate contingency reserve for correcting errors discovered many years later. If the IAs permitted investment choice, account holders would need to tell the government where to send contributions. Workers could possibly communicate directly with the fund provider to change investment options. Presumably, automatic options would be selected for workers who fail to choose investment options.

Putting simply, general revenue funding would circumvent many practical constraints faced by other contribution schemes. However, a criticism of this approach is that it would involve government spending from general revenues, raising precisely the same political concerns about tax pressures and political risk that prompted proposals for IAs to replace part of the current Social Security system in the first place.

Earnings Sharing—Earnings sharing under a defined contribution system, as defined here, is when the monies due for individual account contributions from each working member of a married couple are summed and deposited in equal shares between the husband’s and wife’s IAs at the same time. (Theoretically, the term “earnings sharing” would apply to any amount of cross-subsidization of individual accounts from one spouse to another, whether account contributions were equally divided or not.) Earnings sharing is offered as a means of simplifying Social Security IA claims at divorce, and of ensuring egalitarian policy outcomes for couples. An example of a proposal that calls for earnings sharing between spouses is that from Laurence Kotlikoff of Boston University (Ekaterina and Spiegler, 1998).

Unfortunately, earnings sharing could multiply IA administrative complexity and costs. First, the government would be brought in to mediate any claims of errors in earnings sharing practices, whether IAs are administered through the current wage and tax collection process, a quarterly process, the 401(k) approach, or the IRA approach. Especially in divorce cases, IA records and record keepers presumably would be subject to court subpoena.

More notably, individual information that is currently not recorded would need to be collected. Although Social Security today pays benefits to spouses and divorced spouses, SSA must only obtain proof of marriage at the time benefits are claimed. But under an individual account system with earnings sharing, the overseeing government agency and the entity directing contributions to IAs would need to have consistently accurate and up-to-date records throughout the life of a

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42 Such policies are generally directed at women, who tend to earn less and live longer than men, and spend less time in the work force.
corrected version 12/02/98

marriage in order to correctly direct contributions to both spouses’ accounts.

Since more than two million marriages occur each year, along with more than one million divorces and annulments (U.S. Department of Commerce, 1998, p. 105), administrative record keeping for earnings sharing under IAs would be substantial. Depending on the degree of sophistication of the contribution and interest crediting system for IAs, keeping track of marriages and divorces in order to ensure that contributions were credited properly to each spouse’s account could literally require tracking all participants’ marital status on a month-by-month basis. This would require a technological infrastructure that does not currently exist within the federal government.

Without adequate record keeping on the front end, more mistakes would need to be dealt with retrospectively. Retrospective crediting for missed contributions would presumably be easiest for spouses with existing accounts and investment selections. In those cases involving spouses for whom mandatory IAs were never opened, some type of approach would be needed to credit lost investment earnings.

How Many Investment Choices and Services?—

Valuation Periods—One large 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 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 recently 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.

Preretirement Access—Most major Social Security reform proposals prohibit loans and other preretirement access to IA balances (Olsen 1996 and 1998; Appendix 2 of ERIC, 1998). However, even if loans were initially prohibited, loan provisions might be added to IAs over time as a result of political pressure (Heclo, 1998). And the administrative costs for loan provisions could be significant. 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 over 220,854 loan disbursements equaling

43 Heclo (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).
$1.5 billion for its 2.3 million participants (Federal Retirement Thrift Investment Board, Monthly Activity Reports, April 1998).

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 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 will 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 ([k]la, 1997). One mutual fund industry executive who did not want to be identified in this report estimated that a Social Security IA system would require financial service firms to hire over 100,000 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 5), TSP still serves as an example of an individual account system with limited services:

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

Although these limited-service features reduce costs, they have trade-offs. For example, TSP participants are constrained by monthly interfund transfer rules in their abilities to time investments.44 (Refer to Appendix 2 for details.)

As a result of service and investment restrictions, the TSP provides fewer transfers per participant

44 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. For a discussion, see Causey (1998).
than most private plans. The TSP administers 300,000 interfund transfers for approximately 2.3 million participants per year. Plus, the TSP receives about one-sixth the volume of phone calls (under 11,000 calls daily) reported by one major financial services firm (Federal Retirement Thrift Investment Board, Monthly Activity Reports, April 1998). 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 minimal additional cost, Internet use is not as common or prevalent nationwide as many Washington policymakers may believe. One survey found that fewer than 20 percent of Americans under age 45 had accessed the Internet over a 30-day period in 1997 (table no. 889, U.S. Department of Commerce 1997, p. 566). In addition, one large financial services provider reports that just 12 percent of its customers take advantage of its on-line account inquiry and interfund transfer options (Fidelity, 1998). Though Internet use is growing, additional services and investment choice will continue to mean significant increases in administrative expenses for the foreseeable future. Moreover, anecdotal evidence suggests that expanded access to inexpensive and easy means of making account inquiries and interfund transfers does not lower overall service costs, since more customers take advantage of the services as a result.

### 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 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, some argue that restrictions actually 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 lower than would otherwise be the case. Participation restrictions (especially age) generally limit record keeping to longer-term workers (table 6). 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.

Employees not meeting tenure, hourly work, and/or age requirements tend to have lower earnings than those who meet these criteria. For example, about 75 percent of workers with annual incomes in excess of $30,000 participate in an employment-based plan,
compared with one-quarter of those with incomes under $20,000 a year (Employee Benefit Research Institute, 1997). 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).

Interestingly, even the “universal” pension system proposed by the Carter Administration would have had participation restrictions. The plan drawn by President's Commission on Pension Policy in 1980 allowed employers to restrict participation to workers between the ages of 25–65 with over 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 total work force (Salisbury, 1980).

In summary, participation restrictions that effectively lower administrative costs relative to assets are used in virtually all defined contribution plans. These restrictions generally limit participation to workers with more job tenure, higher ages, greater incomes, 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 stating that these accounts would take many years before recovering just their start-up costs.
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\(^{51}\) 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. EBRI tabulations of the March 1997 Current Population Survey reveal that a significant proportion of workers in their peak earning years comprise those earning below $10,000 – $15,000 a year (chart 6). 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 covered by Social Security IAs would likely be more mobile than those covered by the employment-based retirement system. SSA received over 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,\(^{52}\) suggests that the population covered by employment-based retirement plans has lower job turnover.

In summary, the 47 percent of workers covered by a retirement plan in 1993\(^ {53}\) are different, on average, from the 96 percent of the work force that Social Security IAs would cover. Social Security includes more young, mobile, low-earning, part time, and seasonal workers—all the populations that have been traditionally excluded from employment-based plans. Hence, all else equal, employment-based plans are able to achieve lower administrative expenses than Social Security IAs would be able to achieve simply by virtue of the populations covered. As a result, the applicability of direct comparisons between IAs and employment-based retirement plans is tenuous at best.

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.\(^ {54}\) 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 7). On a proportionate basis, Social Security covered 1.8 times as many part-time workers as the TSP, almost twice as many

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51 Defined as wages equal to or less than $5.70 per hour.
53 Specifically, the civilian labor force ages 16 and over. 1993 is the latest year for which figures are available. See Yakoboski (1994), p. 22.
workers under age 21, and more than 10 times as many workers with annual earnings of $15,000 or less.

**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.\(^5\) 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 7.)

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 small employers and government agencies alike. As a result, an IA system that relies on small employers to help administer it will

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**Table 7**

**Comparison of the General U.S. Work Force\(^a\) With Federal Workers\(^b,c\)**

<table>
<thead>
<tr>
<th></th>
<th>General Work Force</th>
<th>Federal Workers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Part-Time Workers</td>
<td>20.8%</td>
<td>7.4%(^d)</td>
</tr>
<tr>
<td>Mean Age</td>
<td>38.7</td>
<td>44.8</td>
</tr>
<tr>
<td>Workers Under Age 21</td>
<td>10.3%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Average Annual Earnings</td>
<td>$26,489</td>
<td>$43,187</td>
</tr>
<tr>
<td>Percentage with 4-Year Degrees or More</td>
<td>28.5%</td>
<td>39%</td>
</tr>
<tr>
<td>Average Length of Service</td>
<td>4.2 years</td>
<td>15.9 years</td>
</tr>
<tr>
<td>Workers With Aggregate Earnings of $15,000 or Less</td>
<td>41.5%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>


\(^5\) 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 1988, 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.

\(^d\) Note: Data do not include employees on leave without pay.

\(^5\) Data from the Federal Retirement Thrift Investment Board (1998) indicate that 8 percent of TSP participants were part-time or intermittent workers (p. 2).

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\(^5\) It is extraordinarily difficult to directly compare costs per participant or the administrative cost-to-asset ratios across plans, though anecdotal evidence and repeated testimony from pension experts underscores that the TSP does indeed provide lower administrative costs than other defined contribution plans. For evidence of the difficulty of direct, dollar-for-dollar cross-comparisons, see the sections, “Uncertainties Abound” and “How Much Education and By Whom?”

\(^5\) 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).
be slower and more error-prone than if small employers were excluded, all else being equal.

Accurate Administration—Firm size is correlated with employer stability.\textsuperscript{56} 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 (Dennis, 1997).\textsuperscript{57} 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 IRS, and 5 percent (or 10 million reports) provide information failing to match anyone's Social Security record. Chart 8 shows that errors are primarily concentrated in industries with large turnover rates and seasonal employment (i.e., agriculture, bars and restaurants, and services)—

\begin{center}
\begin{tabular}{l|c|c|c}
 & Agriculture & Services & Bars and Restaurants \\
\hline
\% of All Employer Reporting Errors, & 16.8 & 16.3 & 13.2 \\
by Industry, 1998 & & &  \\
\end{tabular}
\end{center}

\textit{Source: Social Security Today, Vol. 3, No. 4 (July/August 1998).}

the very industries that have the lowest rates of employment-based retirement plan sponsorship (Employee Benefit Research Institute, 1997).

While the 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, the total number still containing errors is larger than 4 million, since it does not include incorrect reports caught in the IRS editing process.\textsuperscript{58} SSA or the IRS send discrepancy notices to erring employers,\textsuperscript{59} 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.\textsuperscript{60} For

\begin{itemize}
\item 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 states that business start-up and turnover rates are generally underestimated with conventional measures (Dennis, 1997).
\item EBRI staff did not locate IRS estimates as to how many reports continue to contain errors after IRS editing routines are applied.
\item 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.
\item 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.
\end{itemize}
example, every year, some employers mistakenly report only to IRS or SSA rather than (correctly) to both agencies. Or, employers may incorrectly calculate nontaxable compensation as taxable or vice versa.61

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 (chart 3). 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.62 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.

Benefits under the Social Security system today are exclusively based on credits from past work history, leaving more room for error than a cash-based system (like an IA system) that must account for every dollar. SSA has tolerance thresholds that effectively reduce the number of errors that must be investigated. Employer records are not investigated if there is a discrepancy of one wage credit ($700) or less in 1998 (Myers, 1998) between the IRS Form 941 reports and the Social Security W-2 report totals. SSA alone sends out 500,000 initial notices to employers each year who fail this reconciliation check. The number would be almost twice as high if SSA did not permit the one-credit error threshold (unpublished data, SSA, 1998). Partially as a result of the error tolerance, about 98.5 percent of all Form W-2 reports are fully processed and attendant wage credits are posted to individual earnings records by September after the year they were earned.

Whether an IA system would be able to match this speed in crediting IAs with contributions would depend largely on whether workers and policymakers are willing to accept annual errors of up to $700 per employer—a seemingly small sum that, in the long run, could amount to millions of dollars in lost IA retirement income. Under the current Social Security system, allowing up to a one-credit error generally does not affect benefits because most workers have more than four work credits (the maximum) for any given year, since they earn more than $2,800 annually ($700 x 4). Those who do not exceed four work credits a year may also not be affected by an employer’s error, as it may not apply to their wages at all, or their portion of the error may be less than one credit’s worth of earnings for them. But such an error threshold would almost always affect benefits in an IA system.

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

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60 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.

61 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).

62 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).
wages to SSA file their reports on paper, and not electronically\(^63\) (chart 9). 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.\(^64\) However, because very large firms employ about half of all workers, most wage reports are reported electronically (chart 10), 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 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.\(^65\)

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

\(^63\) Electronic reporting can be done through diskette, wire-to-wire reporting, bulletin board, or magnetic tape.

\(^64\) 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).

\(^65\) 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.
part of an IA system (see “How Would Accounts Be Regulated?” below). Inevitably, mandating that employers assist in the administration of IAs would increase their burdens and costs, whether or not regulations are increased. Such a change could have major economic and political implications, as 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 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 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).66

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 though 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.67

Allowing rollovers and dealing with property claims could exponentially increase the amount of paperwork involving IAs. For example, Aaron (1998) argues that trading 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 (1998) claims that for employment-based retirement plans today, “complex sets of regulations . . . require spousal notification of rights and approval of optional elections [and] determination and payment of benefits under a Qualified Domestic Relations Order (QDRO).”68, 69 In other words, IA record keepers could 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

66 See section on “How Much Education and By Whom?” regarding variation in annuity pricing among identical products.

67 See Pension and Benefits Reporter (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.

68 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).

69 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 overblown 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.
The 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 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.70 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.

Another maintenance issue for small account balances is that if administrative costs were charged as 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

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70 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 onus is usually on individual responsibility because the individual participates on a voluntary basis.
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 individual retirement accounts (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 workforce covered by Social Security, annual account contributions 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 larger account holders would be courted by investments firms, 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 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 as soon as real or perceived problems or abuses are discovered in the IA system. Arthur Levitt, chairman of the Securities and Exchange Commission, recently 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). The clear implication is that regulation of individual accounts is inevitable, and that these new regulations would affect participants, employers, and the government.

72 For example, Shah (1997) argues for changing Chile's administrative charges to a percent basis. Also see Goldberg (1998), pp. 4 and 6.
Many Ways to Regulate—Ross (1998) lists many ways that the government could regulate individual accounts (table 8). Among them are registration of participants; establishing and protecting beneficiary and participant rights; setting and enforcing standards for reporting and disclosure (see next section); balancing investment choice versus risk by setting investment guidelines (e.g., asset class limitations as a percentage of a portfolio and other investment restrictions) and ensuring that the guidelines are adhered to; regulating withdrawals; and taxing IA withdrawals (for example, penalizing early withdrawals from accounts). Examples of all these restrictions are evident today both in the United States (e.g., the penalty taxation for unsanctioned early withdrawals from IRAs or 401(k)s) and abroad (e.g., the limitations in Chile’s privatized system that restrict equity investments to 37 percent of an account balance).

Other potential areas of regulation include limiting the number of times investment companies can buy and sell (i.e., actively manage) investment funds and subjecting IA fund managers to the same regulations that cover the fund managers of tax-qualified defined contribution plans (Schieber, 1998). Additional regulations could also be added to the annuity market as a result of an IA system.

Predicting the Extent of Regulation—On one hand, today’s downsized government environment suggests that IA regulation would be constrained because of government personnel limitations. The SSA employed 83,000 persons in the mid-1980s but has 62,000 today, a drop of 25 percent (U.S. Department of Commerce, 1997, p. 134).

On the other hand, the trend towards increased regulation of employment-based plans, especially since the passage of the Employee Retirement Income Security Act of 1974 (ERISA) portends a large role for government regulation of IAs. Given the amount of regulation that currently exists for voluntary retirement accounts, some speculate all the more regulation would be built around a mandatory individual Social Security system. The reasoning is that if the government forces people to save through these accounts, it has a liability (implicit or explicit) for ensuring that these accounts are operated in the participants’ interests. The Joint Committee on Taxation calls the rules surrounding employer-provided retirement benefits “among the most complex set of rules applicable to any area of the tax law” (Joint Committee on Taxation, 1998, p. 4).

Regulatory Risks—Regulatory risks include both a lack of adequate regulation and too much regulation, and each type of regulatory risk places “conjectural liabilities” on government. Heller (1998) suggests that lack of government regulation may impose a “conjectural liability,” inasmuch as the government would feel obligated to provide retirement benefits in the event of a market downturn or, presumably, in the event of real or perceived account mismanagement. In other words, the government could be called upon to pay up if individual Social Security accounts don’t work out as planned. But if policymakers sought to minimize this liability, they might overregulate, as some argue has been the case in Peru and Chile (Shah, 1998; Heller, 1997). In some years, regulatory expenses in those nations contributed to such high set-up and marketing expenses that investment returns were offset and participants received a negative rate of return (Shah, 1998).

However, the government may also open itself to a conjectural liability by regulating, Heller suggests. By involving itself in the supervision of private account activity, the government creates for itself some liability if “these funds fail to yield satisfactory returns, let alone if there is fraud or bankruptcy,” (Heller, p. 9). In other words, would the government be called upon because it had played a part in an IA system that had an undesir-

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### Table 8

**Many Possible Areas of Individual Social Security Account Regulation**

1. Registering participants.
2. Establishing and protecting beneficiary and participant rights.
3. Setting standards for reporting and disclosure.
4. Ensuring standards are met.
5. Setting investment guidelines.
6. Making sure the guidelines are adhered to.
7. Regulating withdrawals.
8. Taxing accounts.


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73 The number of times funds are bought and sold, or “churned,” in active fund management affects administrative costs. Other transaction costs are discussed in Middleton (1998).
able policy outcome (whether overregulation was to blame or not)?

Who Would Pay the Price of Regulation?—While there is currently no way to realistically estimate what a new regulatory structure for IAs would cost, an obvious concern is whether regulatory costs would be transferred to account holders. If the government were to set up an elaborate infrastructure for self-regulation, costs presumably would be covered through tax revenues. If the private sector administered the accounts, evidence from the Chilean system suggests that expenses incurred by administrators would be passed onto account holders through higher commissions (Shah, 1997, p. 6). If commission limits imposed on administrators disallowed full offset of regulatory compliance expenses, then cost could be passed to consumers through other fees; the government could subsidize administrators; or administrators could find IA management no longer in their financial interests and stop providing services. In summary, the nature, expense, and ramifications of IA regulation present many unknowns.

How Much Education and By Whom?—Efficient markets depend on educated consumers. Yet 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 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; Katzeff, 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 (Gebhardt, 1998) suggests a lack of 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 DOL recently 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 (Kac, 1997; 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 costs are important to employers because high fees lessen the effectiveness of

74 Statement of Arthur Levitt, chairman of the Securities and Exchange Commission, as reported in Burns, 1998.
75 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.
76 See Tam (1998) for a brief description of these fees.
77 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).
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:78

... 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 was 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 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 asset-undefined reform designs, their contribution to total administrative costs is unknown.

Estimating the Boundaries of Uncertainty

Key Modeling Assumptions—In the analysis with the EBRI-SSASIM279 model presented below, administrative costs are explicitly subtracted from Social Security benefits. While this could be the case in practice, administrative costs could also be imposed on workers through less direct channels. For example, if general revenues funded a portion of administrative costs, then workers would still pay some of the costs through higher income tax rates. If employers were asked to absorb administrative costs, then costs could be passed onto workers or through slower growth in compensation. The calculations below do not take into account such possible second-order effects, but are instead based on the assumption that administrative costs directly reduce benefits obtained through the Social Security program. This was the only way to make administrative costs explicit.

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 of an interplay between administrative costs and benefits (Patterson, 1998). The possibility of administrative costs increasing benefits was not modeled, because administrative detail sufficient to assess any positive effect is lacking under all reform proposals to date.

Moreover, even if administrative details were spelled out, estimation of administrative costs' positive effects on benefits would be highly speculative. For example, if these costs paid for investment education, how effective would this education be in getting participants to invest more wisely and earn higher returns on their IA contributions? If costs paid for oversight and regulation, how much would these provisions protect beneficiaries from losing assets due to employer or investment services fraud or mismanagement? Indeed,

78 The 1998 DOL report, Study of 401(k) Plan Fees and Expenses, was part of a multi-pronged campaign launched in November 1997.
79 For background on the model, see Olsen et al. (1998).
80 The macroeconomic feedback effects and productivity feedback links are turned off in the model for purposes of this comparison.

81 Plans such as the Individual Accounts (IA) plan, offered by the 1994–96 Social Security Advisory Council (SSAC); H.R. 4256 (sponsored by Reps. Jim Kolbe (R-AZ), Charles Stenholm (D-TX) et al., 1998); and S. 2313 (sponsored by Sens. Judd Gregg (R-NH), John Breaux (D-LA), et al., 1998) propose individual account contributions equal to 2 percent of taxable payroll. The CED plan recommends a 3 percent individual account contribution (2 percent from workers, 1 percent from employers), and the plan proposed by Rep. Nick Smith (R-MI) recommends 2.5 percent contributions. Some plans recommend larger contributions, such as the SSAC’s Personal Savings Account plan (5 percent) and the Porter plan (10 percent). See Olsen (1998) for a summary of plan parameters.
Individual account benefits seem highly sensitive to administrative costs.

working lives largely explains their lower IA balances, relative to workers born in 1976 and 2026. This is also the reason why the difference between real (inflation-adjusted) annual benefits under the high and low administrative cost assumptions for these birth cohorts is lower than those for workers born in 1976 and after. While IA benefits for workers born in 1946 are simulated to be 22–24 percent lower on average under high administrative cost assumptions, their 1960 counterparts could experience 32 percent lower benefits. In comparison, workers born in 1976 and 2026 would receive 40 percent to 42 percent lower benefits under high administrative cost assumptions than under low-cost assumptions.

As the 40–42 percent difference for workers born in 1976 and 2026 indicates, workers contributing to IAs over the major portion of their working lives would (not surprisingly) be hit hardest by high administrative costs. For the steady-earning male born in 1976, the high versus low administrative costs translate into annual annuity benefits of $4,970 versus $2,982—a $1,988 difference annually. For his 2026 counterpart, administrative cost differences could result in a $7,872 or $4,673 annual benefit—a $3,199 difference. Hence, IA benefits seem highly sensitive to administrative costs.

Policy Implications

Despite their importance, administrative details about how individual Social Security accounts would operate have been largely unaddressed by a majority of individual account proponents. Even when they are addressed, sources of uncertainty abound, as little is understood about the systemic administrative costs under existing defined contribution accounts that are sponsored by employers. As EBRI-SSASIM2 model analysis has shown, administrative cost variations can create differences of thousands of dollars in annual benefits, even under an individual Social Security account system based on just a 2 percent annual salary contribution.

If Social Security reformers expect IAs 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. 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? And how many and what types of services would be accessible to account participants? 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 individual account operation, then administrative feasibility and costs should be researched 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.

Specifically, richer data about the population covered by Social Security and a better understanding of administrative fees for today’s defined contribution plans are needed. In addition, highly detailed input from

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82 An additional factor is that average returns over 1,000 scenarios for individual account balances are higher across later cohorts. For the 1946 cohort, individual account returns equal 6.71 percent (nominal). For the 1960 cohort, returns average 6.85 percent. Returns average 6.86 percent for the 1976 cohort and 7.00 percent for those born in 2026.

83 The differences in dollar benefits are attributable to real wage growth between the generations, as Social Security initial benefit calculations take into account real wage growth.
professional record keepers and technology professionals—preferably those without preexisting political agendas—in both the government and private sectors, and with multiple levels of expertise, must be obtained. Until this type of research is gathered, broad claims about the overall administrative feasibility or unfeasibility, efficiency or inefficiency of individual Social Security accounts will continue to largely reflect opinion and political desires, rather than substantive fact.

Dealing With Float Periods of 18 Months or More

To summarize the previous discussion, “working within the current payroll tax structure” produces two distinct types of float periods, each with implications for participants’ economic well-being (table 10).

Table 10  
Summary of Float Periods under the Current Tax Collection and Wage Crediting Process

<table>
<thead>
<tr>
<th>Type of Float</th>
<th>Occurrence</th>
<th>Implications</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type 1</td>
<td>Delays between correct contributions and correct account crediting.</td>
<td>Lost investment earnings.</td>
</tr>
<tr>
<td>Type 2</td>
<td>Delays because of errors between contributions and crediting.</td>
<td>Lost investment earnings and/or lost credit for account contributions.</td>
</tr>
</tbody>
</table>

Source: Employee Benefit Research Institute.

Type 1 Float Periods: Option #1—To address Type 1 float periods, the government could credit workers’ IAs with contributions and investment earnings theoretically until actual cash contributions are deposited. This could be done on a retrospective basis. One way could be for the government to invest all aggregate payroll contributions received over the year in a uniform investment pool. At the end of the year, workers’ IAs could be credited with their cash contributions as well as a uniform rate of return from the pooled funds. After being credited to IAs, the investments would presumably be available to workers to allocate among personally selected investments.

This approach to eliminating interest losses during Type 1 Floats is open to criticism for the following reasons. Foremost, this approach would require the government to choose an investment for the pool of incoming annual tax deposits. If the government could invest in anything other than government-issued securities, this approach would invite concerns about social investing and political manipulation of investment decisions. Similar concerns have been raised surrounding government investment of the Social Security trust funds and are sometimes given as a rationale for favoring individual accounts over such central government investment in the first place. However, it might be considered less objectionable for the government to invest relatively small amounts (i.e., annual payroll contributions) as opposed to the large amounts accumulated in the Social Security trust funds.

As chart 4 suggests, even if the government were limited to investing incoming aggregate IA contributions over the year in U.S. government securities, large sums of money would accrue and then be credited to individuals’ investment accounts. The first question that arises is where the federal revenue would come from to liquidate the $80 billion in government bonds needed (at a minimum) for cash depositing into IAs. A second question is how such regular, mass liquidation would affect the government securities market. Finally, if individuals were able to then direct these funds among different investments, how would mass periodic injections of IA funds into other markets (particularly the equities markets) affect pricing levels and market activity? Chart 11 shows that injections of 45 percent of annual IA contributions equal to 2 percent of taxable payroll into the equities market would likely represent a large sum,
possibly amounting to a 5 percent share of total annual U.S. equity market growth. 84

Another possible criticism of this approach is that it would subject the government to political and financial liabilities if participants perceived that the investment pool performed poorly over a particular year, especially if they thought their contributions would have performed better under an alternative investment selection. For example, if the government initially invested exclusively in U.S. Treasury bonds, would individuals pressure it to diversify into higher yielding investments? After all, some are already calling for equity investment of the OASDI trust funds, which are owned collectively and whose investment performance is less directly related to Social Security benefits than initial IA contributions would be. Would workers’ perception that their money was being initially invested in a manner inconsistent with their desires lead to pressure for the government to invest in private securities?

**Type 1 Float Period: Option #2**—An alternative approach to handling Type 1 floats exists if workers find it politically unacceptable for their initial IA contributions to earn a uniform investment return. Rather than assigning all contributions and accounts a fixed rate of return for the first 7–19 months or so, the government could permit workers to select personal investment options once a year for their incoming contributions. The Social Security Administration, or a quasi-public agency, or another entity, could be assigned to compute aggregate investments and invest incoming pooled funds accordingly. To avoid concerns about social investment, investments could be allocated among the same fund managers that were selected for IA asset allocation. 85 Ideally, at the end of the year, the assigned entity would have predicted aggregate investments well enough to retrospectively credit workers with their individual payroll contributions plus any earnings or losses resulting from personal investment selections. This approach would eliminate at least part of the interest loss resulting from the float period between contributions and deposits to IAs. In addition, it would ensure more gradual and smaller infusions of IA contributions into market investments, obviating to at least some degree adverse pricing and other undesirable market reactions surrounding the expected large IA deposits.

However, this approach could also be criticized for several reasons. First, the government or quasi-public agency in charge of allocating incoming contributions among investment providers would somehow need to know workers’ investment decisions one year in advance. Individuals (or their employers) would at least be given, if not mandated, the option to report individual investment selections on annual payroll contributions for IAs. Perhaps a default option would be used for individual workers who fail to communicate this information. But at this point, individuals who want a say in their IA investments would be given an administrative task that does not exist under the current wage reporting and tax collection system. Furthermore, unless workers were only allowed a

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84 The effect of periodic mass injections of IA funds into private markets (e.g., on pricing levels) was a concern raised by the Center for Strategic and International Studies (CSIS) task force on individual account administration on Sept. 25, 1998.

85 Members of the CSIS task force on individual account administration, at a meeting on Sept. 25, 1998, are credited with the idea of averting social and political investing concerns beyond those already implied by government selection of IA investment options by using the same investment managers to invest aggregate incoming funds as would be chosen to manage IA funds in a system of limited investment choices.
certain grace period during which to detect contribution and investment errors made on a given year’s IA contributions, historical records would need to be maintained on these investment selections over workers’ lifetimes. Such records would be necessary to resolve mistakes discovered years later, using the return rates from workers’ investments at the time the incorrect IA deposits were made or correct deposits were not made.

Another objection to this approach to handling Type 1 floats concerns fairness among individual workers. Under such a system, individuals would be subsidizing one another, since annual returns on asset allocations are a function of market performance when contributions are received over the year. For example, a seasonal employee whose contributions are made by his or her employer at the end of the year during a low point in the market would receive a higher rate of return than the contributions actually earned, if the returns on other workers’ contributions during the earlier part of the year were higher. This would happen because, under the current wage crediting and tax collection system, the government only knows the individual’s annual contributions, not when the contributions entered the market.

Perhaps the most significant objection to this approach, however, is that some workers might demand greater investment choice for their initial annual contributions. The idea of requiring workers to make annual investment decisions in January for contributions made the following December might not play well with investors who believe, for example, that they would have avoided a drastic November market downturn in the absence of such restrictions. If individuals demanded the ability to select investments more frequently, the government would need to keep track of when their contributions were made as well as their investment choices over the course of the year. Such heavier record-keeping demands would inevitably increase administrative costs. In addition, new administrative burdens would be introduced, because this information would have to be communicated to the IA record keeper, precluding the ability to work within the existing payroll tax structure.

A final criticism of the second approach to handling Type 1 floats is that it would presumably consign to the government and/or other IA record keeper any liability or surplus arising from unsuccessful attempts to predict aggregate investment choices and to invest in a way that matches the predicted requirements exactly. Errors might be small proportionate to contributions but large in absolute dollars. The government, or quasi-public agency, or other entity that allocates the incoming aggregate funds to investment managers would have either too much or too little money at the end of the year. If there were too few funds with which to credit IAs, some party would face a financial liability. On the other hand, if there were too much money at the end of a year and the surplus were placed into general revenues, an IA contingency fund, or individual accounts, an incentive could exist to regularly invest more aggressively than projected needs would suggest is necessary.

Type I Float Periods: Option #3—A final approach to handling Type 1 floats would be for the government to project payroll contributions from one year into the next year. Based on these projections, workers could be credited with account contributions to invest as they choose before the actual contributions reach their accounts. Workers whose actual payroll contributions were higher or lower than the projections would receive end-of-the-year adjustments to their account balances. A criticism of the third approach to handling Type 1 floats—advance crediting based on income projections—is that some people would receive too much in initial IA credits. This would happen to workers whose annual incomes were lower than projected by the government, but who may be angry nonetheless at seeing the government take away these revenues. For others, initial credits would be too low, i.e., their actual income would be higher than projected.

Conversely, adding amounts to the accounts and crediting them retrospectively to the workers’ investment choices would be administratively challenging. The
IA record keeper would have to ascertain when and by what amounts the projections deviated from reality and what investments the workers had made during those periods. Presumably, this third approach to handling float periods would be less administratively challenging if accounts were credited with a uniform investment return. However, the objections raised earlier in reference to the first option for handling Type 1 float periods would also apply to this approach.

**Type 2 Float Periods**—To the extent feasible, the government could use the above three general methods of crediting workers’ accounts retrospectively during the Type 1 float. However, these or other approaches would be fully effective only if Type 2 floats were precluded for workers experiencing administrative errors. Recall that the Type 2 float period would exist when employers and/or the government make mistakes (e.g., the employer’s W-2 and 941 reports do not have equal sums\(^86\) and workers’ accounts are not credited on the proper schedule.

To hold workers harmless while the government investigates the employer, the government might choose to give workers their cash and investment earnings as soon as the earnings can be proven, even if IA contributions are not yet collected from the employer. While the government pursues the employer (if it is still in business), the worker could be credited retrospectively with interest from general revenues or the special contingency reserve. Alternatively, a government insurance entity like that currently existing for private defined benefit plans (i.e., the Pension Benefit Guaranty Corporation) could be created and funded through payroll taxes, employer contributions, individual account contributions, or other means.

Criticisms of this approach include the following. First, this approach to Type 2 floats would depend on workers’ ability to prove payroll deductions made on specific amounts of wages, which might be difficult if the employer is noncompliant or erroneous in issuing the W-2 wage reports. In the current system, it sometimes takes decades for workers to discover missing wage credits and to prove that they have accrued.

Second, presumably, workers participating in an IA system who discover employer errors years after they are made would require back contributions and would want to be made whole for lost investment time. This would necessitate a more complicated error reconciliation process than exists under current Social Security policy. To perform retrospective crediting for errors discovered under a system of individual investment choice, the government would need a record of workers’ investments at the time IA contributions should have been made. A record-keeping agent would need to be assigned this responsibility. Presumably, it could not be workers, who would have an incentive to falsify investment information records to indicate high-yielding investment choices. Alternatively, workers could be given a grace period for discovering errors and required to accept any errors discovered after the grace period expired.

A third criticism of approaches that would annually match employee IA contributions with accounts is that annual reconciliation is much more difficult than more frequent checks. One defined contribution plan administrator stated that rectifying errors on a monthly basis, as opposed to daily, is one of the most time-consuming and costly parts of administration. Reconciliation of reports and contributions on an annual basis would be an even more formidable challenge.

A final criticism of this approach is that having the government or an insurance agent make workers whole for employer errors would likely result in increased employer regulation and penalties. In a cash system of IAs—as opposed to the current earnings credit system—inaccurate contribution amounts and timing would result in increased liability for making participants whole for employer errors. In today’s system, employers are generally subject to deposit penalties only.

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\(^86\) Under some circumstances, amounts on the W-2, W-3, and Form 941 may not add up for valid reasons (Internal Revenue Service, p. 23).
if they have acted out of “willful neglect” (Internal Revenue Service, 1998, p. 20). Due deposits can be collected at a later date without the need to make participants whole for lost investment income. It is not known whether, in a cash-based system, the government would continue to be lenient in imposing penalties on employers that are acting in good faith. (See section titled “How Would Accounts Be Regulated?”)

Overview of the Federal Thrift Savings Plan

History—The Federal Thrift Savings Plan (TSP) is a key component of the three-part Federal Employees’ Retirement System (FERS) that became effective on January 1, 1987, and covers those employees who first entered a covered position on or after January 1, 1984. The TSP is a tax-deferred defined contribution retirement savings and investment plan that contains features typically found in private-sector 401(k) plans. Even though the FERS Act of 1986 established the TSP, employees in both the Civil Service Retirement System (CSRS) and the FERS may participate. The TSP is considered a supplement to CSRS retirement benefits, and the contribution rules are different than those for FERS participants.

According to a Congressional Research Service (CRS) report, Congress included the TSP as a part of FERS for three reasons: (a) to increase retirement income replacement rates under FERS, especially for higher paid employees for whom Social Security replacement rates are low; (b) to provide a portable benefit and thereby reduce retirement income penalties associated with changing jobs; and (c) to replicate benefits available to private-sector workers (Merck, 1996). As of March 31, 1998, thrift savings fund accounts were maintained for more than 2.3 million participants. The participation rate among FERS employees has risen from 28.9 percent in 1987 to 85 percent in 1998 (Federal Retirement Thrift Investment Board, 1998a).

Work Force—Federal workers tend to be more educated than the general work force. For example, 28.5 percent of the general U.S. work force had a bachelor’s degree or higher in 1996 (U.S. Department of Commerce, 1998, p. 399), as compared with 39 percent of the federal work force (U.S. Office of Personnel Management, 1997). Federal workers also tend to be older, have less job turnover, and higher average earnings (table 7).

Eligibility—Open seasons occur twice a year: May 15 to July 31 and November 15 to January 31. CSRS participants can begin making contributions to the TSP during any open season. FERS participants newly hired in any month from January to June become eligible to participate in the TSP the first full pay period starting the next January. They begin to receive the automatic 1 percent employer contribution, and, if they elect to contribute, the employer matching contribution. FERS participants newly hired July through December become eligible to participate the first full pay period starting the next July. They begin to receive the automatic 1 percent employer contribution and, if they elect to contribute, the employer matching contributions.

Employer and Employee Contributions—TSP participants may contribute either a percentage of basic pay each pay period or a fixed dollar amount. All contributions must be made through payroll deductions; lump-sum contributions are not permitted. Employee contributions to the TSP reduce the individual’s taxable current income for federal (and usually state and local) income tax purposes. FERS employees may contribute up to 10 percent of basic pay on a pretax basis; CSRS employees may contribute up to 5 percent of basic pay on a pretax basis. All participants are also subject to the annual deferral limit set by IRC sec. 402(g)—the same
The limit as for sec. 401(k) deferrals. The limit is subject to an annual inflation adjustment and was set at $9,500 in 1996. Employees may change their contribution rates only during the open seasons.

The government (acting in the role of employer) automatically contributes 1 percent of basic pay for all eligible FERS participants, regardless of whether the employees make personal contributions. For FERS participants who choose to make their own contributions, the government matches the first 3 percent of employee contributions at 100 percent and the next 2 percent of employee contributions at 50 percent. As noted, CSRS participants may make tax-deferred contributions to the plan, but there are no automatic or matching employer contributions for CSRS participants.

**Investment Options**—There are three TSP investment funds: the Government Securities Investment Fund (G Fund), the Common Stock Index Investment Fund (C Fund), and the Fixed Income Index Investment Fund (F Fund). Individuals who choose to invest in the C and/ or F Funds are required to sign a statement saying that they understand and accept the risk of investing in these funds. If a FERS participant does not submit an investment election form, the automatic 1 percent employer contribution is invested in the G Fund.

The G Fund consists of investments in short-term nonmarketable U.S. Treasury securities specially issued to the TSP. By law, all investments in the G Fund earn interest at a rate equal to the average of market rates of return on U.S. Treasury marketable securities that are outstanding with four or more years to maturity. The Federal Retirement Thrift Investment Board manages the G Fund.

BZW Barclays Global Investors, N.A. (Barclays) manages the C Fund and the F Fund through competitive bid. The C Fund is invested primarily in the Barclays Equity Index Fund, a stock index fund that tracks the Standard & Poor’s 500 (S&P 500) stock index. The F Fund is a bond index fund invested primarily in the Barclays’ U.S. Debt Index Fund, which tracks the Lehman Brothers Aggregate (LBA) bond index.

**Vesting**—All TSP participants (both CSRS and FERS employees) are immediately vested in their own contributions and investment earnings on those contributions. FERS enrollees are also immediately vested in the government matching contributions, plus associated investment earnings. Most FERS participants vest in the automatic 1 percent employer contribution and its earnings after three years of federal civilian service. However, members of Congress, congressional staff, and certain political appointees to the Executive Branch vest in the automatic 1 percent employer contribution after two years of such service. If an employee leaves federal service before vesting, the automatic 1 percent employer contribution and its earnings are forfeited. In the case of death, vesting is immediate.

**Plan Loans**—Those eligible for the TSP Loan Program include current employees with a TSP account that has at least $1,000 in employee contributions and investment earnings. TSP loans were once available only for purchase of a primary residence, educational expenses, medical expenses, and financial hardship. Due to participant demand, loans are now available for any purpose. The interest rate charged is the G Fund rate in effect at the time the loan application is received. Repayment is made through payroll deductions. To obtain a TSP loan, FERS employees must obtain spousal consent, and the spouses of CSRS employees must be notified of the loan application by the TSP.

**Death Benefits**—A participant may designate beneficiaries (including a surviving spouse, children, parents, or other named beneficiary) to receive the TSP account balance if the participant dies with a TSP account. Payments to spouses of deceased participants are subject to 20 percent mandatory federal income tax withholding. The withholding tax cannot be waived, although spouses of deceased participants can avoid the withholding by having the TSP transfer all or a portion of the payment...
to an IRA (but not to another eligible retirement plan). Payments to beneficiaries other than a spouse are subject to 10 percent withholding, which may be waived. Payments to nonspouse beneficiaries cannot be transferred to an individual retirement account (IRA) or other plan.

Withdrawal of a TSP Account Balance—Employees who separate from federal service are permitted to withdraw their TSP accounts. An individual must be separated from federal service for 31 or more full calendar days before the TSP account can be paid out. Withdrawal options include: (1) a TSP life annuity, (2) rollover into another qualified retirement plan, (3) a single payment and/or (4) a series of monthly payments that begin immediately or at some future date. Participants also have the option of leaving their accounts with the TSP on separation and making a withdrawal decision later. Amounts paid to participants from TSP accounts are considered taxable income for federal income tax purposes in the year in which payment is made. Payments not subject to these rules include TSP annuity purchases and direct transfers by the TSP to IRAs or other eligible retirement plans, since such payments are not made directly to the individual.

The first withdrawal option, known as the TSP annuity, is a monthly benefit that is paid for life. A participant can request a single life annuity (with level or increasing payments), a joint life annuity with his or her spouse, or a joint life annuity with someone other than a spouse. As with the single life annuity, a participant with a joint life annuity can choose to have level or increasing payments. For participants with TSP account balances of at least $3,500, an annuity can be purchased from the TSP’s annuity provider. If an account balance is less than $3,500, the participant can request an annuity with a specific future date. (The account must be at least $3,500 before the annuity can be purchased.) Annuity payments are taxed as ordinary income in the years in which they are received.

The second option is for an individual to transfer all or a portion of a TSP account to an IRA or other eligible retirement plan (in some cases, a series of monthly payments can be transferred). If this option is chosen, the participant continues to defer taxes on the amounts transferred, and savings continue to accrue tax-deferred earnings until the money is withdrawn.

The third withdrawal option is the single payment option, which is simply a withdrawal of the entire TSP account balance in a single payment. Participants with vested account balances of $3,500 or less are subject to automatic cash-out procedures. Under the automatic cash-out procedure, the account balance is automatically paid directly to the participant unless the participant makes another withdrawal election. An automatic cash out is subject to the same taxes as other cash payments from the TSP. If the amount withdrawn in a single payment is paid directly to the participant (and is not transferred to an IRA or other eligible retirement plan), the payment is subject to mandatory 20 percent withholding. In addition to the ordinary income tax an individual must pay on money received directly from the TSP account, the IRS imposes a 10 percent penalty tax on amounts received from the TSP if the individual separates or retires before the year he or she reaches age 55 and receives the money before age 59½. In this case, the individual is subject to the penalty tax on all amounts received before age 59½.

The fourth withdrawal option is a series of monthly payments. Participants may choose the number of monthly payments they want to receive. Another option available to participants is to choose a specific dollar amount for each monthly payment. A final alternative is for participants to have monthly payments computed by the TSP based on an Internal Revenue Service (IRS) life expectancy table. As with the single payment option, an individual who chooses the monthly payments option (unless the payments are based on life expectancy) is subject to a 10 percent penalty tax on all amounts received before age 59½ if he or she separates or retires before the year he or she reaches age 55.

Individuals who reach age 70½ and are receiving a
series of monthly payments from their TSP accounts are subject to IRS minimum distribution requirements.

An alternative to withdrawal for participants with an account balance greater than $3,500 is to leave the entire TSP account balance in the TSP (up to age 70½). Accounts continue to accrue investment earnings tax-deferred, and individuals can continue to change investment allocations among the three TSP funds by making interfund transfers.

**Limits on Participant Choice and Services**—The TSP has some limits on participant choice and services relative to private 401(k) plans. For example, only during open seasons may employees begin or terminate contributions, alter contribution amounts, and/or change the way future contributions are invested. Plus, for FERS employees, the investment allocations chosen necessarily apply to both personal contributions and to agency automatic and matching contributions. In private plans, participants can often allocate their own contributions differently from employer contributions.

Also in private plans, participants can generally begin or cease contributions at any time after they are eligible for plan participation. Although TSP participants may stop contributing at any time, if they cease contributions during an open season, they must wait to resume making contributions until the next TSP open season. If a participant stops outside an open season, he or she must wait until the second open season to resume making contributions.

Twice a year, in late May and November, employees receive participant statements showing employee and employer contributions and gains or losses due to investment experience. In many private-sector plans, account statements are sent on a more regular basis.

Although interfund transfers of previously contributed amounts are permitted in any month, participants must generally wait until the next month before their investment choices are executed. Interfund transfers made by the 15th of the month are executed 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 put through until the last business day of the next month. (For a discussion of this topic, see Causey, 1998.)

**Administration**—The Federal Retirement Thrift Investment Board, an independent federal agency, manages the TSP. The board consists of five members who are nominated by the president and must be confirmed by the Senate. The board members serve part-time and appoint a full-time executive director of the agency. In total, the agency had 110 employees as of September 30, 1996 (U.S. Department of Commerce 1998, p. 348). The agency is able to maintain a small administrative staff in large part because of the limited choice of investments available to participants, the type of work force covered, and the fact that federal agencies perform administrative tasks for the TSP, such as participant education, that are not counted as administrative expenses.

Such factors have allowed the TSP to charge very modest administrative costs per participant. In 1997, TSP administrative expenses per participant were approximately $20 a year (see chart 5). Although relatively low compared with private 401(k) plans, the cost per participant has grown by 133 percent since the program’s inception, largely because of the addition of participant services over time.

Information based on Employee Benefit Research Institute, Fundamentals of Employee Benefit Programs, fifth edition.

Benjamin, J. “401(k) Plan May be Costing You, If It's More Than Three Years Old.” Warfield’s Business Record (April 14, 1995).


Diamond, Peter. Testimony before the Subcommittee on Social Security of the House Committee on Ways and Means, June 18, 1998.


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President's Advisory Council on Management Improvement. Testimony before the Senate Select Committee on Small Business, 1972.


Corrections were made to this Issue Brief after the original printing had occurred. Those changes are:

p. 10 footnote 17 was deleted and all subsequent footnote numbers were changed to reflect this deletion.

p. 20 first bullet—“four investment options.” was changed to “three investment options.”

p. 20 second bullet—the following was added, “Two of the three investment options are limited to index funds, and the third is a government securities fund.”

p. 20 third bullet—“biannual” was changed to “semiannual.”
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