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Administering Private Social Security Accounts

As an alternative to the current pay-as-you-go Social Security system, many reform plans would allow individuals to invest a portion of their payroll tax dollars in private investment accounts. Critics claim the costs of administering such accounts would be as high as 20 percent. Is this criticism valid?

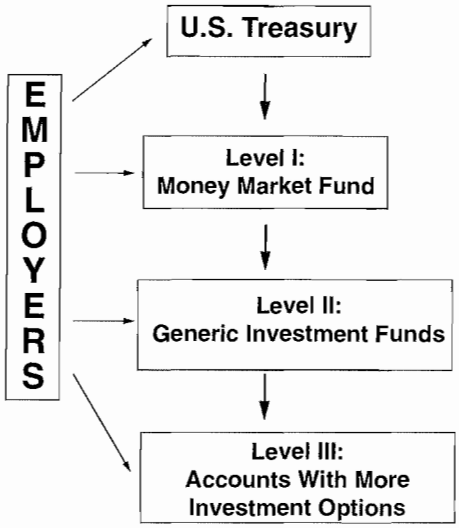
Before we can assess administrative costs, we first have to specify how employees' earnings would get into private investment accounts and how the accounts would be managed. In what follows, we estimate the administrative costs of an employer default option, which has the least amount of employer involvement. Employers could elect to be more involved, as they are with 401(k) plans. But presumably such additional involvement would take place only if the benefits to employees exceeded the cost.

Using a methodology developed by State Street Global Advisors, we estimate that the administrative costs of the default option for the first five years are less than 40 basis points (4/10ths of 1 percent) per year under a system in which employees invest 3 percent of taxable wages.

The Default Option. Under this option, employers would have no more record keeping or administrative burden than they currently have — other than indicating what portion of their payroll tax is to go into private accounts as taxes are paid and reporting whether or not each employee has chosen the private investment option on the employee's W-2 form. The remaining administrative burden would be shifted entirely to the government. As Figure I shows, the management of employee account balances would progress through three levels.

FIGURE I

Private Social Security Accounts: Options for Small Business



Note: Under the default option, the employer sends the entire payroll deduction (15.3%) to the U.S. Government and 3% of funds are automatically deposited in a private, generic money market fund. Once the accounting establishes individual ownership, the funds are automatically deposited in generic investment accounts. As account balances grow, individuals will have more investment choices.

Level One Investment: A Pooled Money Market Account. One of the problems of the current system is that although payroll taxes are collected and paid by employers throughout the year, the federal government will not actually know how much money was paid on behalf of any particular worker in 1998 until about September 1999!

The idea behind Level One Investment is that workers should start earning interest from day one. Accordingly, funds destined for private accounts will be placed in generic money market funds. The portfolios will be managed by professional asset managers chosen through an open, competitive bidding process. Interest earnings will be imputed, on the assumption that everyone's contribution entered and remained in the pool for the average length of time. Individual workers will know from their payroll stubs and W-2 forms how much money they have in the pool at all times. They will be able to check earnings daily in newspapers and continuously online.

Level Two Investment: Balanced Funds. Once the Social Security Administration has completed its reconciliation, the private money market funds will be able to assign ownership shares to individual workers. Once this is done, individual account balances will automatically be invested in funds that earn a higher yield. These Level Two investments will be balanced funds: diversified portfolios of stocks, bonds and cash. Although workers can choose among several balanced funds, there will be default portfolios. For example, one for younger workers might be weighted more toward stocks, whereas one for those closer to retirement might be weighted more toward

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bonds. In addition, the money market fund could continue to be available to those even closer to retirement. Providing stable although low returns, this will help reduce uncertainty at a critical point in one's retirement planning.

Participants at this stage would receive a statement annually showing the balance in their account. In addition, the funds would be valued daily and prices would be published in newspapers and online. Workers could multiply their units in a fund by the daily price to monitor their account balance. Accounts holders could shift from one balanced fund to another annually during the early years of the system.

Level Three Investment: More Options. Levels One and Two are designed to keep administrative costs low for workers whose payroll tax investment is small. Thirty million Americans have taxable annual incomes of less than $5,000. For them, 3 percent of payroll is less than $150 a year. However, at some point the accumulation will become large enough to attract funds willing to bid for the individual worker's account. In the same way, today most mutual funds have some required minimum investment (typically $1,000). This is Level Three.

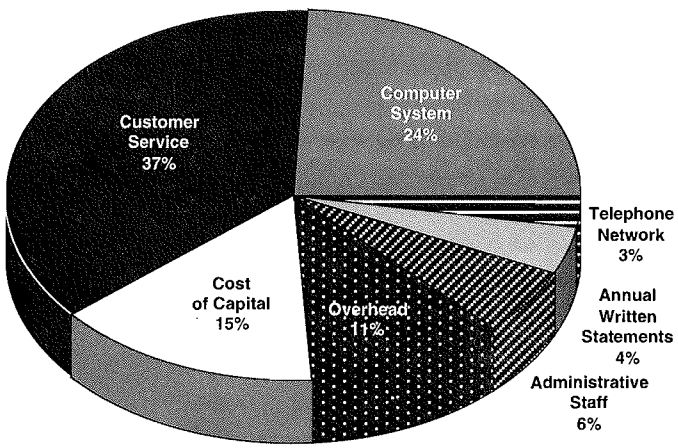
Investors seeking more investment choices will have the option of transferring assets to a qualified account with a financial services company. Level Three investment managers will act as the fiduciary for their product offerings and be subject to government oversight, including a requirement that all funds be invested conservatively in diversified portfolios.

Other Employer Options. Employers need not choose the default option. Instead, they could incur costs on behalf of their employees to ensure that employee funds are accounted for and given access to higher yields more quickly. As Figure I shows, employers could send employee funds directly to Level One money market funds, bypassing the Social Security Administration's accounting delays. Employers could also send employee funds directly to individualized Level Two accounts. And if the employer is willing to bear the cost of administering low-dollar amounts, employees might also have direct access to Level Three options — just as they do today with 401(k) accounts.

Administrative Costs. As Figure II shows, the principal costs of administration arise from customer service — answering inquiries from account holders through automated systems and live personnel. In estimating total administrative costs for the Employer Default Option, we assume that: (1) the Social Security Administration, at its cost, will provide timely accurate data on each worker; (2) the government will bear the expense of communicating the program to employees; and (3) costs will be assessed as a percent of assets, as is common in the mutual fund industry.

FIGURE II

Cost of Administering Private Accounts



Source: State Street Global Advisors.

As assets increase, cost as a percent of assets would fall. Assuming a 3 percent contribution from payroll, costs would range from 0.18 percent to 0.34 percent of assets over the first five years, depending on assumptions made.

Conclusion. The cost of administering private Social Security Accounts under this plan will be competitive with existing investment products. For example:

- The Federal Thrift Plan, often cited as an example of an efficient retirement plan, had an expense ratio of 0.65 percent in its second year.
- A balanced mutual fund that is currently available has a total cost of about 0.4 percent of assets.

Because of its size, this program will have significant clout and perhaps the ability to demand the lowest prices in the history of financial services.

This Brief Analysis was prepared by NCPA President John C. Goodman.