

# Social Security Privatization

March 9, 1999 SSP No. 15

## ***Administration Costs and the Relative Efficiency of Public and Private Social Security Systems***

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### **Executive Summary**

With a growing consensus developing in favor of transforming Social Security into a system of individually owned, privately invested accounts, critics of privatization have begun warning that individual accounts would be too complex and costly to administer. However, a careful examination of the administrative issues involved in individual accounts shows that, while administrative issues should be carefully considered in designing a privatized system, individual accounts are both administrable and affordable.

The cost of administering existing retirement savings programs indicates that administrative and money management expenses for a system of individual accounts could amount to anywhere from roughly 1.17 percent to 1.83 percent

of assets, or roughly \$35-\$55 per worker for the first year. After five years, as the size of the average account increases, the cost would be anywhere from roughly 30 to 65 basis points, or \$54-\$117 per year. For the great majority of businesses with outside payroll services, the collection function would entail little, if any, additional cost. For those businesses that do payroll without the aid of technology, there would be some modest additional reporting requirements.

This cost is slightly higher than that of the current government-run Social Security program. However, in exchange for slightly greater administrative costs, workers in a privatized system would receive a greater rate of return on their investment and better and more secure retirement benefits.

In short, administrative costs are not a barrier to privatizing Social Security.

**However, the relative efficiency gains in administering the current system are overwhelmed by the relative inefficiency of the government-run system in achieving its key objectives**

## **Introduction**

A consensus has been reached on several issues in the debate over the merits of the present government-run Social Security system versus personal retirement accounts (PRAs). First, it is widely recognized that the current government-run pay-as-you-go system is in serious trouble and cannot pay promised retirement benefits within the present tax structure. Second, it is widely acknowledged that the returns of the present system will be zero to negative for most of today's younger workers. As a result, trying to solve the Social Security problem by raising payroll taxes or postponing the retirement age, or both, ends up further reducing returns to today's workers and turns a bad deal into something much worse. Third, it is widely recognized that market-based returns to PRAs would produce returns that are three to five times higher than those promised by the government system. Returns on PRAs would be so high that, even when adjusted for risk, they would be far superior to the returns promised by the government-run system.<sup>1</sup>

A remaining issue of concern involves the cost of administering a system of PRAs versus the cost of the current system. By several measures, the cost of administering the current Social Security system seems to be fairly low. Some observers have suggested that the cost of administering a system of PRAs would be far higher. A study by the Employee Benefit Research Institute (EBRI) suggests that various administrative issues relating to PRAs may make the accounts too complex to understand or too difficult for record keepers to administer.<sup>2</sup> EBRI's study is correct in raising many important issues affecting the cost and complexity of PRAs. A careful examination of those issues, however, shows that PRAs can be administered efficiently and cost-effectively.

Some observers have suggested that in order to minimize cost, the government should continue to administer the program, but invest Social Security funds in stock or bond markets to achieve the superior returns of market-based investing. The idea of the government investing Social Security funds in private capital markets has serious drawbacks.<sup>3</sup> Perhaps the most serious is the shift in power and influence from individuals to government. The vast amount of funds involved would dramatically increase government's control and influence over the economy. That increase in power would come at

the expense of private individuals and would represent the most significant shift in power from private individuals to government since the creation of the income tax.

When one compares the costs of administering the current Social Security system with the cost of administering a system of PRAs in an effort to determine the comparative efficiency with which each system might work to achieve those objectives, it is apparent that the present government-run system may cost slightly less to administer than a system of PRAs. However, the relative efficiency gains in administering the current system are overwhelmed by the relative inefficiency of the government-run system in achieving its key objectives. To say that the government-run system is relatively efficient based on administrative costs is similar to saying that a Trabant (a cheap East German car that never worked) is less expensive than a Taurus or a Mercedes. While true, the comparison is hardly appropriate. Most people prefer to pay more for a car that works than to pay less for one that is unlikely to get them to their destination.

The administrative cost of a system of PRAs can vary significantly depending upon how the system is set up, the size of the accounts, and various rules and regulations associated with them. The more elaborate the requirements, the more expensive it will be to administer a private system. Since even small gains in efficiency in terms of administering the system compound over a lifetime, it is crucial to minimize administration costs wherever possible. If wise decisions are made with respect to the administration of the PRAs, administrative costs will be close to or only modestly higher than those associated with the present government system. At the same time, workers will receive the benefit of safe, secure retirement incomes that are substantially greater than those promised under the current system.

## **Objectives of Social Security**

Traditionally, the government-run Social Security system has had two main objectives: first, to provide earnings replacement for retirees and, second, to provide welfare support for the elderly indigent.<sup>4</sup> Although they are seldom mentioned, there are other important objectives. The returns to the system in the form of benefits should be as great as possible in relation to the contributions to the program. That means

that any supplemental retirement program should be run in the most efficient manner possible. Efficiency means not just running the program at the lowest possible administrative cost but also assuring that the net returns to the worker are as large and secure as possible for any given level of contributions.

## **Administrative Functions of a Social Security System**

Any retirement system has four important administrative functions: collection, transmission, record keeping, and money management. First, there must be a system to collect the retirement funds from the worker. Next, the funds must be transmitted to an administrator. The administrator is responsible for keeping records of each worker's contribution to the retirement program and the benefits that each worker will eventually receive. Finally, the money has to be invested and managed between the time it is received and the time it is disbursed.

The present government-run Social Security system may be considered highly efficient in the management of some administrative functions. It collects retirement funds through the Internal Revenue System (IRS). Each employer calculates the total obligation for retirement funds for each of its workers and deposits the amount in a special IRS account at the employer's bank. No worker ever gets to see his or her retirement funds. In fact, the worker's payroll statement identifies only half of the amount that is collected. The other half comes in the form of a tax on the employer (effectively a tax on employing the worker) that is equal to the tax on the worker. Few workers realize that the full amount of funds they are contributing to the government-run retirement system is twice what appears on their pay stubs.

Once deposited with the IRS, retirement funds go into the general account funds of the U.S. Treasury, where they are indistinguishable from all other government revenues. The Treasury makes the appropriate accounting entries to the Social Security retirement account to allow for the total amount collected. When retirement benefits are paid, the account is debited. Whenever more money comes into the Social Security retirement account than goes out, the Treasury spends that money on other government programs. It recognizes the surplus in the Social Security account by issuing IOUs

to the Social Security Administration (SSA). By law, those IOUs take the form of a special class of Treasury securities, which are credited to the SSA and are the only type of investment the Social Security Trust Fund is permitted to hold.

Throughout the year, each employer continues to calculate the wages and Social Security contributions for each employee. However, employers send only the *total* contributions for all their workers to the IRS. When the year is over, each employer notifies the SSA of the wages and salaries of its individual employees and the amount of retirement contributions for each employee. Hence, the SSA enters the information on the contributions of each worker once a year.

The SSA is also responsible for calculating benefits. The benefits formula is based on a number of factors, including earnings history, marital status, age, and anticipated wages and salaries for the coming calendar year.<sup>5</sup> To receive benefits, a worker must apply to the SSA prior to his or her expected retirement date. The worker is also responsible for estimating expected wages and salary for the upcoming year. Even though workers may be "retired" and receiving Social Security retirement benefits, any wages and salaries they receive continue to be subject to the same retirement contribution rates as the earnings of other workers.

## **Costs of Administering the Current Social Security System**

In several important ways, the present Social Security Administration does a highly efficient job in administering the retirement program. Overall administration costs are currently close to \$10 per worker. Those costs amount to 0.42 percent of contributions and 0.57 percent of benefits paid. As a percentage of assets, the administration costs are 0.39 percent. However, since the government system has only minimal assets, that figure is not comparable to the cost figures for private plans.<sup>6</sup>

In assessing the cost of the current system, it is important to note that the costs of administering retirement systems tend to be relatively high when the system is first put into place. Those costs fall over time as the fixed costs are spread over larger participant pools.<sup>7</sup> For example, in the early days of the program, SSA costs were roughly ten times their current levels.<sup>8</sup>

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**A system of PRAs may be organized in a variety of ways to accomplish those administrative functions. The cost will depend on how the system is organized.**

There are other reasons why the costs of administering the government-run system are so low: The collection function piggybacks off the IRS collection system, and, since there is no investment or money management function, there are few expenses in that category. The bulk of the administrative expense (93 percent) involves administering the benefit function. By all objective measures of timeliness and accuracy, the SSA does an excellent job in that area.<sup>9</sup>

The only area where the SSA administrative system does not perform particularly well is in terms of the timeliness of tracking earnings and contributions. For the 1991 calendar year, only 70 percent of earnings contributions were tracked within six months of the end of the year. But, since workers have no legal rights to their contributions, that is not a significant shortcoming.<sup>10</sup>

Overall, the SSA does a highly efficient job in administering the various functions of the current retirement program.

### **Administration Costs in a PRA System**

Given the relatively low costs associated with many of the administrative functions of the present Social Security system, there is a natural assumption that a system of individual PRAs would be less efficient and cost much more than the present government-run system. However, the extent to which this may be true depends on the parameters of the private system. Consumers who choose to pay more for a Mercedes than for a Ford Taurus do so because they find greater value in the higher-priced alternative. Those who choose to pay for a Taurus instead of buying a Trabant realize that it is often necessary to pay a price to get where you want to go. Even so, it is true that "every dollar which is unnecessarily or uneconomically expended on administration is a dollar which could otherwise go to the plan participants."<sup>11</sup> Over a lifetime, the compound interest impact of even a relatively small boost in administrative costs leaves retirees worse off than they might have been. So, it is important to assess the likely costs associated with administering a system of PRAs.

### **General Parameters of a PRA System**

While there are infinite combinations of parameters that might apply to PRAs, the following can be considered reasonably accepted principles in providing for secure earnings for retirees and welfare support for the elderly indigent:

1. All current workers should have a choice as to whether to stay with the current system or switch to a private account. Those who decide to switch should be given some compensation in their private accounts (such as a discounted government bond) to reflect some portion of their past contribution to the Social Security system.

2. No one should be worse off under a system of PRAs than under the current system.

3. There should be some minimum level of benefits comparable to that of the present system. Those reaching retirement age who have worked for a total of 40 quarters and do not have the minimal level of benefits should receive supplemental government payments sufficient to allow for a minimal level of monthly benefits.

4. The system should be regulated by a self-regulatory organization (SRO) that is responsible for certifying administrators and money managers, regulating the types of investments permitted in accounts, and determining other details necessary to provide maximum security for PRAs while minimizing administrative costs.

5. All new workers entering the labor force must be part of the new system.

6. Married couples should have joint ownership of their accounts.<sup>12</sup>

### **Factors Affecting Administrative Costs**

Like the government-run system, a system of PRAs must deal with the basic administrative functions of collection, transmission, record keeping, and money management. A system of PRAs may be organized in a variety of ways to accomplish those administrative functions. The cost will depend on how the system is organized.

While there are many directions that a private system could take, the most efficient system would use the existing infrastructure to accomplish the administrative functions.<sup>13</sup> At the pres-

ent time, there is an entire industry that is responsible for most of the various administrative functions associated with collection, transmission, record keeping, and money management of individual retirement accounts.

## Collection and Transmission

In large firms (usually those with more than 50 employees), the payroll function is generally automated and performed by outside vendors that specialize in the field. As a result, there would be few, if any, costs associated with changing the individual's payroll deduction from a category that currently gets deposited in the IRS collection system to one where the money is sent directly to the plan administrator.

For small employers that handle their own payrolls, the collection problem becomes only slightly more involved. Instead of sending one check for employee retirement contributions to the IRS each month, the employer could choose to send the check to any certified PRA administrator. (The employer would still have to send a check to the IRS for the Medicaid and Medicare portion of Social Security.) Along with the check, the employer would have to send a form showing the wages and retirement contributions for each worker. Since each employer already calculates that information in order to determine the total Social Security contribution, only a relatively minor additional burden would be placed on small employers. First, they would have to choose a certified administrator. Second, they would have to send the administrator the name and Social Security number of each worker along with information about the worker's wages and contributions for the period.

To prevent discrimination against small businesses, each certified administrator could be required to provide its services to all businesses. To keep costs at a reasonable level, administrators might be required to charge the same basis point cost for all individual accounts. In that case, the relatively low cost of administering large business accounts would subsidize the accounts of smaller businesses. An alternative to the idea of cross-subsidies would be a "default pool" for businesses that are too small to attract an administrator. The system regulator could decide to bid out the function of administering small business accounts so that the costs to that group would be fully transparent.

To summarize, the above-described system

for collecting funds for PRAs and transmitting them to an account administrator involves only a negligible additional burden for small businesses. Under this proposal, the owner of a small business would simply choose an account administrator and send the total contributions to the administrator instead of to the IRS. Along with the check (or electronic deposit), the business owner would have to send a list of individual workers and each worker's Social Security number, wages, and contributions. Every employer already has to perform those calculations. The only additional burden on owners of small businesses would be sending the information to the account administrator. Surveys of small businesses indicate that most do not believe it would pose a significant burden.<sup>14</sup>

However, a significantly greater burden would be placed on the administrator. The administrator is responsible for all record-keeping functions and for ensuring that the funds are sent to the appropriate money manager. Those functions do entail additional expense.

## Record Keeping and Money Management

Under a system of PRAs, it would be the administrator's responsibility to make sure that the appropriate funds were credited to each worker's account and to send out statements to each worker reflecting reported wages and contributions. (To keep administrative expenses low, employees should be responsible for verifying the accuracy of their quarterly wage and contribution statements.) Discrepancies would be handled through procedures similar to those followed when an employee receives an incorrect paycheck. If a dispute could not be reconciled between employer and employee, the employee could file a complaint with either the Labor Department or the organization regulating PRAs.

The administrator would also be responsible for transferring funds to an appropriate money manager to ensure that the funds in each account were prudently invested. For most employees, there would be no delay at all between the employer's sending contributions to the administrator and the administrator's redirecting the funds to an appropriate money manager.

In addition, administrators would have to keep track of potential benefit levels, potential options for annuities, and notifying the govern-

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ment when retirement account balances were no longer sufficient to provide for minimal monthly retirement benefits. It is in those areas that costs would be incurred. However, a vast industry performing functions similar to these already exists. Over the past two decades, the development and growth of individual retirement accounts (IRAs), 401(k)s, 403(b)s, and countless other individual retirement programs has led to a substantial infrastructure to handle the types of administrative functions that would be associated with PRAs. As that infrastructure developed over the past two decades, it went through a normal process in which expenses were relatively high in the early part of programs but, as the number of accounts increased and the assets under management grew, administrative expenses declined.

Among the industries that have developed the existing infrastructure to perform such administrative functions are mutual funds, pension plans, insurance companies, banks, brokerage firms, and data and systems administrators. Discussions with representatives of those groups suggest that administrative expenses could be reduced substantially if the government reduced the reports and regulations associated with retirement funds.

### **Costs of Administering Existing Retirement Programs**

Using existing retirement programs to gauge the cost of administration produces a wide range of estimates. At the low end of administrative expenses is the Federal Retirement Thrift Investment Fund, a fairly large civil service retirement plan with more than two million participants and \$36 billion in assets. Its 1996 annual report indicates that administrative expense ratios total nine basis points or \$16 per participant.<sup>15</sup> Next on the list is the College Retirement Equity Fund (CREF), the nation's largest defined-contribution pension plan, covering workers in higher education and research institutions. According to Mitchell, "The system is quite responsive to individual participating employers, permitting cross-employer differences in contribution levels, rules regarding lump sum versus annuity payouts, and asset-allocation choices; these differences may drive up expenses."<sup>16</sup> Even so, administrative record-keeping expenses for 1994 averaged 24 basis

points, or less than one-quarter of 1 percent of assets.

The costs associated with administering private pension plans vary significantly. For single-employer defined-contribution plans, the costs (excluding money management) came to 11 basis points of assets under management, or less than \$22 per participant per year. For multi-employer defined-contribution plans, administrative costs amounted to 57 basis points, or \$68 per participant. Mitchell's analysis of these costs suggests that the administrative costs for single-employer plans may be understated because the sponsoring companies absorb some of the expenses. On the other side, the administrative costs for the multi-employer plans are probably overstated because such plans have a relatively smaller asset pool and are faced with substantial legal expenses.<sup>17</sup>

Based on existing pension plans, it appears reasonable to assume that the costs of administering a well-run system of PRAs might be anywhere from a low of roughly 15 basis points to a high of roughly 50 basis points. It is important to understand that those costs would vary significantly depending on such factors as the size of the retirement accounts, the regulations and reporting requirements placed on the administrators, and their legal liability for handling the accounts. As a percentage of assets, administrative costs would be larger in the early years, when the size of an average account is smaller, and would drop significantly as the size of the accounts grew. Thus, starting the system with workers placing a full 10 percent of their wages in PRAs would substantially reduce administrative costs as a percentage of assets.

If every worker participated in the program and a full 10 percent of wages and salaries went into PRAs, those accounts would amount to close to \$400 billion in the first year. With 130 million workers, the average account size would be close to \$3,000. Discussions with industry representatives suggest that there would be a minimum cost of \$30-\$50 to handle any account. If administrative costs (not including money management costs) amounted to \$30-\$50 per account, the average cost would be 1.0-1.7 percent of assets the first year. If money management costs were included it would add an additional cost of about \$5 per account. Within five years, the average account would be close to \$18,000. At that point, the same \$30-\$50 per account administrative costs would

average anywhere from 17 to 28 basis points. This is close to the 15–50 basis point range discussed above. Over time, as the average account size increased, administrative costs would become an insignificant percentage of total assets. (See Table 1.)

Although partial-privatization plans are not prohibitively expensive, if less than 10 percent of wages and salaries were to go into PRAs, it could cause additional administrative problems. For example, at 2 percent of wages and salaries, low-wage workers would end up with very small amounts in their PRAs. Under a 2 percent plan, the main benefits of privatization would go mostly to higher-income individuals, since 2 percent of a higher income is proportionately greater. Because the administrative cost burden increases as a percentage of assets for smaller accounts, the cost of administering the accounts would take a significantly greater portion of the returns during the early years—another reason for privatizing all, or at least most, of a worker’s contribution instead of a mere 2 percent of income. If a program of PRAs will significantly benefit all workers, it is sensible to adopt it completely so that workers enjoy the full benefits rather than only a small portion of those benefits.

## Money Management Expenses for PRAs

Research into the expenses associated with managing the money for PRAs points to management fees of anywhere from 15 basis points for passively managed indexed portfolios to close to 200 basis points for actively managed international portfolios.<sup>18</sup> That suggests that money management fees might be reduced substantially for workers who invest in passively managed index funds. In some markets, passively managed portfolios have provided returns that are competitive with those of actively managed portfolios. If the investment options provided to workers included passively managed products, workers would have an option that offers high returns with low administrative costs.

## Total Expenses for Administration and Money Management of PRAs

Representatives of money management firms have stated that costs can easily be prorated on the basis of overall assets, which means that they could be included in the basis points associated with the fee for money management. If

**Table 1**  
**Expenses Associated with Personal Retirement Accounts**  
(Estimates based on existing experience)

	<u>Low</u>	<u>High</u>
Expenses as a percentage of assets under management:		
Administration expenses without money mgmt.	0.15%	0.50%
Money management expense	0.15%	0.15%
Total	0.30%	0.65%
	<u>Dollars per account*</u>	<u>Percent of Assets</u>
First-year expense without money mgmt.	\$30–\$50	1.00%–1.67%
First-year expense with money mgmt.	\$35–\$55	1.17%–1.83%
Fifth-year expense with money mgmt.	\$54–\$117	0.30%–0.65%

\* Dollar estimates are based on an average account size of \$3,000 for the first year and \$18,000 for the fifth year.

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that approach were used, larger accounts would tend to subsidize the cost of administering smaller accounts. Thus, new, smaller accounts would not see their entire first year's return wiped out by a fixed administration fee. Industry officials also point out that the current experience with IRA accounts suggests that PRAs would be relatively inexpensive to administer and manage. They point out that the huge potential size of each personal account and current experience with the stability of IRAs (where transfers are relatively infrequent) suggest that competition for the accounts is likely to be intense. As a result, many believe that their firms would be willing to lose money on the accounts in the initial years in return for the opportunity to earn large profits as the accounts grew.

Based on existing plans and on discussions with industry representatives, it is likely that the range of administrative and money management expenses for PRAs could reasonably be expected to fall between 30 and 65 basis points of the assets under management. In the first year, if the PRAs were to total 10 percent of wages and salaries, total administrative and money management expenses would be likely to range between 1.17 percent and 1.83 percent of assets, or roughly \$35–\$55 per worker. As the size of the average PRA grows over time and as technology improves, total administrative costs could be expected to decline. For example, after five years the average cost would be expected to be 30–65 basis points or \$54–\$117 per account. Eventually the size of the accounts would dwarf the cost of administration. Even so, it is likely that PRAs will cost at least \$25–\$45 more during the first year than the cost of the existing Social Security system. As the size of each worker's account increases, the dollar expense would rise, but this expense as a share of total assets would decline dramatically.

The range of expenses predicted by industry representatives is at the lower end of the 30–250 basis point range suggested by Mitchell's survey of current retirement plans. However, at the high end of the range are relatively high expenses associated with actively managed accounts and accounts that are relatively small in size. The lower end of the range is justified by two factors. First, the relatively large size of a system of PRAs that consisted of 10 percent of wages and salaries would create significant economies of scale. Second, if workers chose passively managed accounts, it would tilt the survey results

closer to the range suggested by industry representatives.

Although costs would normally be expected to be larger in the early years when account sizes are smaller, many believe that the potential for higher profits as the accounts grow is so apparent that administrators and money managers would compete intensely for accounts. Competition could be expected to lower costs considerably in the early years.

The estimates above are based on extensive discussions with industry representatives as well as research into the cost of existing investment funds. But there are some factors—involving additional administrative requirements that may apply to the new accounts—that have the potential to raise the cost of the system substantially. In general, the more reporting and regulatory burdens that are placed on administrators, the greater will be the costs of administering the personal accounts. The following are examples of requirements that are likely to lead to a substantial increase in administrative costs:

1. Limiting the size of accounts by moving to partial rather than total privatization,
2. Requiring administrators to be responsible for educating individuals about prudent investment choices,
3. Subjecting administrators to extensive new reporting requirements,
4. Requiring administrators to produce monthly statements,
5. Permitting individuals to borrow from their accounts,
6. Allowing a wide range of actively managed accounts,
7. Permitting frequent changes in investment choices, and
8. Placing the burden for employer compliance on administrators.

In many instances, the dynamics of the industry with respect to administration are changing dramatically with changes in technology. For example, some industry officials suggest that limiting the choice of accounts to passively managed index accounts, limiting the frequency at which individuals could move their accounts, and limiting the number of investment choices would substantially reduce administrative expenses. Others suggest that computer systems are becoming so efficient that such additional expenses may soon become insignificant.

Rather than specifying a list of extensive requirements, administrative costs could be low-



ered, and the potential for higher administrative expenses reduced, by means of a system that limits regulations and requirements to the minimum amount necessary to assure the safety and security of PRAs.<sup>19</sup> To ensure that the system offers appropriate protections for individuals, it would be wise to establish an independent self-regulatory board to certify investment managers and provide guidelines for prudent investments. The board could direct administrators to prorate administrative fees as suggested above. It could also initially suggest limiting investments to a narrow range of passive index funds and requiring that stocks make up no more than a certain percentage of an individual's portfolio as that individual approaches retirement. Or the regulatory authority could decide that once an individual's account exceeds an amount needed for adequate retirement income, the individual should be allowed greater discretion with respect to investing any amount above that level. Over time, as economic conditions and perceptions of risk change, the degree of control over the accounts exercised by this board could also change.

### **Can Government Invest More Efficiently than Individuals?**

Some have suggested that it would be far easier and more efficient to maintain the existing system for the collection, transmission, and record-keeping functions and to permit the government to invest in stocks. They have suggested that by allowing government to invest in stocks, we could enjoy the best of all worlds. Not only could we assure that administrative costs are no more than \$10 a year per worker, but they believe that the increased returns from market-based investing could be used to help solve the problems associated with the current system. This line of reasoning has several flaws, all of them related to the essential question of the nature of retirement funds and who owns them.

Under the present system, the government owns these retirement funds. Individuals have no legal claim to them. Congress has the right to eliminate benefits at any time. In fact, it does just that every time it postpones the retirement age. Most proposals for retaining the current government-run system include recommendations for further raising the retirement age. Since the government owns these funds, it is perfectly

legal for Congress to decide not to pay full benefits to anyone at any time.

In addition, so long as the retirement funds belong to the government, they are available to be used for whatever purpose Congress decides. That is one of the root causes of the system's financial troubles. Political pressures to increase benefit levels and to use surplus funds for other government programs have simply been too strong to overcome, a point that was made again last year during the budget process. Both the Administration and Congress have accepted the principle of not raiding the Social Security retirement funds. And yet that fund is running a surplus of just over \$80 billion. Since the government counts the money as its own, it spent the surplus on other things and sent the Social Security Administration IOUs for \$80 billion. Without access to those funds the government would not have recorded a \$70 billion surplus but a \$10 billion deficit.

In spite of pleas by both the Administration and Congress that the entire surplus in Social Security retirement funds be used to help save the program, both parties recently chose to add to the federal budget funds for farmers, for peacekeeping operations, for anti-terrorism, and even for a bailout for Brazil. In effect, politicians concluded that all of those items were more important than Social Security.

There is a fundamental difference between the government's *trying* to save for retirement expenditures and individuals' *actually* saving. So long as government retains the property rights to the retirement funds, those funds belong to the government and can be used for any purpose that is deemed by legislators to be worthy at that moment. When each individual has property rights to the retirement funds, that temptation does not exist.

Another important reason why government cannot invest the Social Security Trust Fund is that the funds do not exist. The trust fund includes special Treasury securities, which are merely government IOUs. Some have argued that the interest rate on those securities provides the fund with an attractive return. However, since the government has no savings, whatever interest rate it pays simply represents a higher tax burden on the public. The interest rate the government pays to the trust fund (or, alternatively, that the government pays itself) has no economic significance. Every increase in the rate on the Treasury securities adds the same

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amount to taxpayer liabilities that it adds to the trust fund. It represents a classic case of taking money from one pocket and putting it into another.

Since there are no real assets in the Social Security Trust Fund, the government has to resort to some combination of borrowing from the private sector, raising taxes, or cutting spending in order to raise the money necessary to buy stocks. Of course, the government may have to resort to some of those options in making the transition to a system of PRAs, but such options would be far more palatable if individuals were to receive a direct benefit in the form of an increase in their personal assets.

The most compelling argument against government investment of retirement money involves the extent to which it would increase government power at the expense of individuals. It is frightening to contemplate how government might abuse the power to invest nearly \$400 billion per year, picking and choosing corporate winners and losers, interfering with corporate governance, and dispensing corporate welfare and political favors. Allowing the government to invest directly in private capital markets would amount to the largest shift in power from private individuals to government since the creation of the income tax.

### **Efficiently Fulfilling the Objectives of Social Security**

The objectives of Social Security involve providing earnings replacement for retirees and providing welfare benefits for the elderly indigent. It is generally accepted that those objectives should be achieved as efficiently as possible so workers can achieve the maximum retirement benefits for their contributions. The current Social Security system is a low-cost system in terms of collecting, transferring, and paying benefits. The monthly benefit for low-income workers is close to \$600, for the average-income worker the benefit is close to \$900, and the maximum benefit is close to \$1,300. In terms of costs, the current system delivers these benefits at an administrative cost of roughly \$10 per year per worker. There are several reasons for the low costs associated with the government-run system. Because the money belongs to the government instead of the individual, the IRS system serves as the collection agent. More importantly, there is no money

management function and no administrative cost of running personal accounts.<sup>20</sup> In return for that “efficiency,” the returns promised to many of today’s workers are either zero or negative.

Extrapolating from existing costs, one should reasonably expect that administrative and money management expenses for a system of PRAs would amount to anywhere from roughly 1.17 to 1.83 percent of assets or roughly \$35–\$55 per worker for the first year. After five years, as the size of the average account increases, the cost would be anywhere from roughly 30 to 65 basis points or approximately \$54–\$117 per year. For the great majority of businesses with outside payroll services, the collection function would entail little, if any, additional cost. For those businesses that do payroll without the aid of electronic technology, there would be some modest additional reporting requirements.

In the early stages of the process it may be necessary to require certified administrators and money managers to accept all applicants and charge similar fees based on a percentage of the assets under management. Such a requirement may be necessary to ensure that administrators and money managers will be available for small businesses with low-wage workers and high turnover. Because the amount of money administered and managed by the system would be so large, the cross-subsidizing of less attractive accounts is likely to be a relatively small price to pay for equal treatment.

Extensive research shows that the returns to PRAs are likely to be substantial. Historical analysis shows that had workers contributed to individual accounts in the past, retirees would have received three to five times the monthly income currently promised by the existing Social Security system. This means that for the same amount of money paid in, the minimum monthly benefit for a low-income worker would be \$1,800–\$3,000 instead of \$600. For the typical worker, the monthly benefit would be \$2,700–\$4,500. For those with the maximum benefit, the monthly benefit would be \$3,900–\$6,500 rather than \$1,300.

Looking to the future, one could expect workers with PRAs to retire with a substantial nest egg. At the low end of the scale, a worker who spent his or her entire working life making the minimum wage (and working without interruption) would retire with more than \$450,000 in terms of today’s buying power,<sup>21</sup> and with an

annuity paying well over \$4,000 a month. Obviously, workers who earn more than the minimum wage would do even better.

Whereas administration costs under the current Social Security retirement system amount to close to \$10 a year, the costs associated with PRAs would vary depending upon the nature of the system that is established and the rules and regulations imposed on the system. Most current retirement programs suggest that a system of PRAs is likely to cost from \$30 to \$50 dollars more a year per worker at the start of the program. Costs are then likely to increase in dollar terms, but decline significantly as a percentage of assets as the size of the average account grows. In return for the possibility of a modest increase in expenses, the system would provide substantial, secure retirement income far in excess of that provided by the current system.

Returning to the analogy used earlier, a system of PRAs will enable the lowest-paid worker to purchase a Mercedes for the cost of a Trabant.

## Notes

This paper reflects the deliberations of the Cato Project on Social Security Privatization's Infrastructure Working Group. While the individuals listed below have contributed significantly to the paper, not everyone agrees with every view expressed in it. In the end, the views are those of the author, who does not intend to speak for any other member of the Working Group.

Members of the working group include: Stephin Allis, KPMG Peat Marwick; Mary Barneby, Delaware Investments; Daniel Carper, Lord, Abbett & Company; Wade Dokken, American Skandia Marketing; Andrew Donohoe, Oppenheimer Funds; Kelly Haughton, Frank Russell Company; Mark Hollen, Great West Life Assurance Company; Henry Hsiang, American International Companies; Thomas McDonnell, DST Systems Inc.; Gerald O'Driscoll, Citicorp; Brian Pietsch, American Express Financial Advisors; José Piñera, International Center for Pension Reform; Brian Reardon, National Federation of Independent Business; and William Shipman, State Street Global Advisors.

<sup>1</sup> See Peter Ferrara and Michael Tanner, *A New Deal for Social Security* (Washington: Cato Institute, 1998) and

Robert Genetski, *A Nation of Millionaires* (Lanham, Md.: Madison Books, 1997).

<sup>2</sup> Kelly Olsen and Dallas Salisbury, "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs," Employee Benefit Research Institute Special Report no. 34, November 1988.

<sup>3</sup> See, for example, Michael Tanner, "The Perils of Government Investing," Cato Institute Briefing Paper no. 43, December 1, 1998; and Krzysztof Ostaszewski, "Privatizing the Social Security Trust Fund? Don't Let the Government Invest," Cato Institute Social Security Paper no. 6, January 14, 1997.

<sup>4</sup> Olivia Mitchell, "Administrative Costs in Public and Private Retirement Systems," in *Privatizing Social Security*, ed. Martin Feldstein (Chicago: University of Chicago Press, 1998), p. 404.

<sup>5</sup> Benefits are *not* based on contributions, or on the compounded contributions invested in specific retirement accounts as in a PRA. Therefore, the Social Security Administration does not perform all the tasks of a PRA administrator.

<sup>6</sup> Mitchell, p. 422.

<sup>7</sup> *Ibid.*, p. 414.

<sup>8</sup> Robert Myers, "Can the Government Operate Programs Efficiently and Inexpensively?" *Contingencies* (March/April 1992): 15-17.

<sup>9</sup> Mitchell, p. 415.

<sup>10</sup> The U.S. Supreme Court held in the case of *Fleming v. Nestor* that workers have no right to Social Security benefits based on having paid Social Security taxes and that there is no direct link between Social Security taxes and benefits. *Fleming v. Nestor*, 36 U.S. (1960).

<sup>11</sup> Elsie Hoextra, *Administrative Expenses of Welfare and Pension Plans*, U.S. Department of Labor, Labor Management Services Administration, Washington, 1970, p. 134.

<sup>12</sup> Earnings sharing might be a better method of achieving this objective, but it would be more administratively complex. See Ekaterina Shirley and Peter Spiegler, "The Benefits of Social Security Privatization for Women," Cato Institute Social Security Paper no. 12, July 20, 1998.

<sup>13</sup> It should be noted that there are a number of possible administrative benefits of combining existing 401(k) and other defined-contribution administrative functions with private administration of Social Security. Currently, over 40 million working people participate in one defined-contribution plan or another. As noted elsewhere, for many of those plans, there are electronic links between the payroll systems and the record-keeping systems. Many workers participate in more than one plan. For example, a company might have both a 401(k) plan and a profit-sharing plan. Given the electronic links, the marginal administrative costs of keeping track of an additional account for the worker are low. For companies that have defined-contribution plans already in place, the marginal cost of adding a private Social Security account for each worker could be quite low. A combined (defined-contribution and Social

**The most compelling argument against government investment of retirement money involves the extent to which it would increase government power at the expense of individuals.**



Security) statement and record keeping would be viewed as a major positive by the workers. Since the number of workers already participating in defined-contribution plans is so substantial, the possibility of this administrative synergy would be significant.

<sup>14</sup> See, for example, William Dennis Jr., "Small Business Assesses Social Security: Results of a Survey," National Federation of Independent Business, September 10, 1998.

<sup>15</sup> Mitchell, p. 439.

<sup>16</sup> Ibid., p. 440.

<sup>17</sup> Ibid., pp. 432–34.

<sup>18</sup> Ibid., p. 420.

<sup>19</sup> The author does not necessarily endorse any of the regulatory requirements discussed. These are merely theoretical options available to lawmakers to address specific objections to individual accounts.

<sup>20</sup> If the Social Security Administration were to try to invest money on behalf of individuals with different asset allocation choices, and keep track of specific performance of each account, its costs would be higher than those for the current system. It is misleading, therefore, to compare the cost of private accounts directly to current SSA costs. Rather, the comparison should be to the higher costs that SSA would incur if it were to try to do the same job as the private fund managers.

<sup>21</sup> Genetski, p. 41 (updated for current minimum wage).