



Options for Administering Individual Accounts in Social Security

Lawrence H. Thompson

INTRODUCTION

INDIVIDUAL ACCOUNTS HAVE BECOME A popular feature in Social Security reform proposals during the past several years. However, the precise meaning of “individual accounts” is unclear, as approaches vary greatly in their financing, management, and structure. The diversity of approaches reflects variation in the objectives people have for individual accounts and the assumptions they make about how a given approach will work. This brief draws, in part, on the experience of other countries in exploring the choices facing designers of individual accounts in the United States.

OBJECTIVES OF INDIVIDUAL ACCOUNTS

The most common reason cited in support of individual Social Security accounts in the United States is the belief that they will increase the rate of return individuals receive on their contributions. If investing in private financial markets can produce higher future pensions, less painful tax or benefit adjustments will be needed to deal with the projected financial shortfall. Other commonly cited reasons for individual accounts are (1) to

give people greater freedom (and responsibility) to determine their own well-being and (2) to provide an additional avenue for retirement saving to supplement traditional Social Security benefits.

Proposal design is also influenced by the desire to avoid creating new problems, specifically: (1) imposing new burdens on employers by increasing either the size or frequency of employer-provided reports; (2) undercutting current benefit protections, particularly the guarantee of inflation-adjusted, unisex-priced annuities; (3) creating new government liabilities through implicit or explicit guarantees of investment returns or institutional solvency; and (4) opening the door to government interference that might reduce rates of return or lead to excessive government control over the economy.

Balancing the Objectives

Proposals differ in large part because some objectives conflict with others. Two such conflicts are of particular importance: the implications of a centralized administration and the implications of allowing workers to make relatively unconstrained investment choices. Administration by private managers is seen as a way to reduce the risk of government interference in investment decisions. Where it has been implemented, however, decentralized administration has also produced high administrative costs, notably for commissions to those who sell the pension plans. Similarly, giving workers significant control over how their savings are invested and the pace at which they are drawn down in retirement can create conflicts with the objectives of avoiding increased employer burdens, avoiding increased government contingent liabilities, and preserving current benefit protections.

Administrative costs for the Social Security retirement program in the United States run about 0.7 percent of contributions, not counting costs borne by employers. Countries that have switched to decentralized management of both account records and investment portfolios find that the administrative charges for

these tasks alone can easily run 30 times as high.¹ Moreover, converting account balances into annuities at retirement involves additional charges equalling from 5 to 20 percent of the balance in the account.²

Centralization can reduce administration charges, even in a system of individual investment accounts. The Thrift Savings Plan for federal government workers, for example, runs at a fraction of the cost of foreign systems. One concern with public management, however, is that it will produce lower investment returns. Experience abroad and with state and local pension plans in the United States lends some credence to this concern. Several studies find investment returns in public, centralized systems running from 1.5 to 2.0 percent per year below those in comparable private systems.³

If administrative costs are ignored and investments earn the full market rate of return, a 5 percent annual contribution could provide a benefit in retirement equal to 20 percent of previous earnings.⁴ An individual account plan that was managed as cheaply as the Thrift Savings Plan and paid its benefits as supplements to the regular monthly Social Security benefit could provide a 19 percent replacement rate, only slightly lower than the theoretical maximum. However, the benefit might fall to just 12 percent of previous earnings if government administration depressed investment returns by 1.95 percent per year, as some suggest has been the case in Malaysia.

Protecting against artificially depressed investment returns with decentralized management leads to higher administrative charges. If everyone were required to purchase an annuity, administrative charges at the historic Chilean level (19 percent of contributions) would reduce retirement benefits by a quarter, producing a replacement rate of around 15 percent. The combination of investment management charges at the level experienced in the United Kingdom and the costs of decentralized annuity purchase experienced in the United States will cause benefits to fall to just 12 percent of prior earnings.

The challenge in designing individual accounts is to try to avoid both high administrative costs and government interference in investment decisions. Either could cause retirement benefits under an individual account approach to fall by as much as 40 percent from their theoretical level. In either case, contributions that would have generated benefits worth 20 percent of previous earnings under ideal circumstances could actually end up producing benefits of some 12 percent of previous earnings.

INDIVIDUAL ACCOUNT MODELS

Approaches that have been proposed for the United States or adopted elsewhere illustrate the various ways in which centralization and worker choice issues might be addressed. Most individual accounts follow one of four basic models, of which only two are currently operating on a national scale.

1. Latin American Model

The oldest and best known of the individual account models was developed in Chile and subsequently adopted (with many modifications) in several other Latin American countries as well as Hungary, Poland, and Kazakhstan. In Chile, a worker selects one of a dozen pension fund administrators to handle his or her account. Contributions are remitted each month directly from the employer to the administrator. Employers must track the pension fund choices of their employees and process individual contribution information each month. Workers may change administrators up to twice a year. The decentralized structure insulates investment management from government interference, but in addition to its high administrative costs, it imposes greater burdens on employers than does the current U.S. system.

The Chilean model is tightly regulated to reduce the risk that workers will end up with inadequate pensions or that the government will be forced to assume additional costs to provide adequate incomes to the aged. This tight regulation sharply limits the amount of worker choice in the system. Each pension fund must guarantee that its returns are not significantly lower than those of its competitors, which encourages all firms to hold similar portfolios and all but eliminates any opportunity for workers to decide how their money should be invested. Also, account withdrawals are constrained at retirement: Workers must either purchase a price-indexed annuity from an insurance company or leave their account balance with their pension administrator and make periodic withdrawals. Because annuities are optional, annuity prices are gender specific, meaning that a given account balance produces a higher monthly benefit for men.

Several proposals for individual accounts in the United States follow the Latin American model, requiring employers to prepare monthly reports on each employee's contributions and to transfer employee contributions to fund managers. However, the U.S. proposals place far fewer restrictions than are found in Latin America on who can manage retirement

portfolios, how the portfolios can be invested, and how account balances can be withdrawn. Proposals for the United States that follow this general approach include the Personal Security Account option outlined in the *Report of the 1994–1996 Advisory Council on Social Security* (Bok et al. 1997) and a plan introduced last year by Representative John Porter (D-IL) (1997). A proposal from Martin Feldstein and Andrew Samwick (1998) differs from the others mainly in that individuals would deal directly with the fund manager of their choice. The Porter and Feldstein-Samwick plans also include generous government-financed guarantees of the minimum pension that these accounts will produce.

All three of these plans would provide workers with a great deal of choice, but all also imply increased employer record-keeping and reporting burdens. None attempts to address the problems that have driven up operating costs in Latin America, particularly the use of commissioned sales agents. The minimum benefit guarantees in the Porter and Feldstein-Samwick plans are more generous than those found in individual account programs elsewhere in the world, while the limitations imposed on workers and investment managers are significantly less. Taken together, these aspects of the plans would create substantial contingent liabilities for the U.S. Treasury.

2. United Kingdom Model

The United Kingdom created a different model, in which all workers are covered by a basic social security plan, and higher earners are also covered by either (1) an employer-sponsored plan, (2) a state-sponsored supplemental plan, or (at the worker's option) (3) a personal pension. Those who select the personal pension option can open an account at any of a number of financial institutions. Employers deposit pension contributions each month but report on individual earnings only once a year. Initially, all funds flow to the government. After the earnings reports are processed, the government sends a specified fraction of the social security contribution that the individual has already paid to the provider of each worker's personal pension.

Holders of personal pensions are required to purchase annuities with at least 75 percent of their account balance. Retirees decide for themselves whether to include a survivor benefit, and annuity prices are gender specific.

As with the Latin American model, the U.K. approach involves decentralized fund management and high administrative costs. The U.K. system is much less regulated, however, and workers have more investment options.⁵ On the other

hand, providers are freer to structure their commissions in a way that locks workers into the firm they originally selected.

Annual reporting of individual contribution information holds down employer burdens but introduces certain limits on employee choice and creates fairly long lags between the collection of pension contributions and their investment in the fund of the worker's choice. Of necessity, all choices about where to participate, designations of the institution with which to do business, and calculations of the size of the rebate must be made on a full calendar-year basis; midyear changes are not allowed. Also, almost two years can elapse between the time pension contributions are withheld from the worker's pay and the time they are actually invested according to the worker's selection.

3. Swedish Model

Sweden is implementing a different approach to individual accounts, which it hopes will produce worker choice almost as great as that in the United Kingdom with lower administrative costs and more consumer protection. However, achieving this mix requires giving the government a larger administrative role than is found in either the Latin American or U.K. models.

In the new Swedish system, a 2.5 percent contribution collected on behalf of each worker will be deposited in a government-managed, interest-bearing account. Once a year, Swedish workers will be allowed to move the previous year's balance to one or more approved, privately managed mutual fund(s). The transaction will be handled by another government agency, which will purchase blocks of shares in the designated mutual fund and maintain the individual account records. The operators of the mutual funds will not know the identities of the individual share owners. Participation in the system is open to any mutual fund company operating in Sweden that agrees to certain conditions, including not charging exit fees and issuing regular financial information according to a prescribed, standardized format.

This model avoids additional employer burden by piggybacking on the current annual reporting for social security and income tax purposes. It seeks to hold down administrative charges by creating a government institution to serve as the information intermediary between workers and mutual fund operators, thereby eliminating the commission agents that play such a prominent role in other countries. All account balances must be converted to annuities at retirement, which will allow unisex pricing of annuities and should minimize overhead charges. The Swedish approach shares the

disadvantage of long time lags between the collection of contributions and their investment in the fund selected by the worker, although it is contemplated that funds can be transferred from one participating mutual fund to another at any time after the original investment.

It is too early to know how successful this model will be in keeping administrative costs down.

4. Federal Thrift Savings Plan Model

The model that has been invoked most frequently in individual account proposals in the United States is the federal Thrift Savings Plan model.⁶ Under this model, management responsibilities are even more centralized than under the Swedish model, with the goal of producing even lower administrative costs. In addition, investment options are restricted to a small set of index-linked funds in the hope of insulating investment decisions from political interference.

Under the proposals that follow this model, employers would continue to report earnings information only once a year, and contributions collected over the course of the year would be placed in a temporary holding account until the information needed to process them further had been gathered. From 18 to 24 months after the beginning of one year, the contributions collected that year would be shifted to the investment fund chosen by the worker. The worker would be able to select from among three to six index-linked funds. The government would keep all records and would select the fund indexes, but investments would be managed by private sector firms.

Administrative costs for the Thrift Savings Plan currently run less than 0.1 percent of assets each year. Costs are held down by limiting investment options to index funds, which can be managed more cheaply than the average bond or equity portfolio. Also, workers are allowed to shift money from one fund to another only once each month and only after having given 15 days' advance notice, which further reduces operating costs.

This model probably cannot be extended to the whole population at the same unit cost as the Thrift Savings Plan for federal government workers, but it is not clear how much higher the costs would be. The current costs of the federal thrift plan do not include the costs of educating workers and processing their choices (functions handled by the agency employing the worker) or the costs of providing annuities, which are handled separately by an insurance company under contract to the plan. Finally, the Thrift Savings Plan has the advantage of operating with the highly centralized and automated payroll systems of the nation's largest single employer. It is not likely that the interaction with several million much smaller employers could be accomplished quite so efficiently.

CONCLUSION

Designing a system of mandatory individual Social Security accounts involves balancing conflicting objectives. A decentralized approach like that followed in the United Kingdom can offer workers a wide range of investment choices and create an effective barrier to political interference in fund management, but it is likely to mean higher administrative costs. The Latin American model is almost as expensive and offers workers fewer investment choices, but it also minimizes the risk of low benefits as a result of poor investment choices by workers. Administrative costs can be lowered with more centralized management of the process, most notably through the Thrift Savings Plan model. These lower costs are possible, however, in part because fewer investor services and investment options are offered, and they include a somewhat greater risk of political interference in investment management decisions.

No model is superior on all criteria. If individual accounts are to be incorporated into the U.S. Social Security system, a consensus will have to be developed about the proper balance among these various objectives.

About the Author

Lawrence H. Thompson is a senior fellow at the Urban Institute. He has served as principal deputy commissioner and chief operating officer of the Social Security Administration, assistant comptroller general of the United States, and chief economist of the U.S. General Accounting Office. He is president-elect of the National Academy of Social Insurance.

The Retirement Project

The Retirement Project is a multiyear research effort that will address how current and proposed retirement policies, demographic trends, and private-sector practices affect the well-being of older individuals, the economy, and government budgets. The project is made possible by a generous grant from the Andrew W. Mellon Foundation.

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URBAN INSTITUTE

2100 M Street, N.W.
Washington, D.C. 20037

Telephone: 202-833-7200
Fax: 202-429-0687

e-mail: paffairs@ui.urban.org
Web site: <http://www.urban.org>

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T H E R E T I R E M E N T P R O J E C T

ENDNOTES

¹The Government Actuary (1996) estimates that investment management costs for individual accounts in the United Kingdom averaged 8 percent of contributions, plus 0.9 percent of assets under management, plus £30 (approximately \$50) a year. In Chile, these costs run about 19 percent of contributions (Shah 1998). *Business Week* (1998) reports that administrative charges (excluding any sales charge) among U.S. equity mutual funds averaged 1.21 percent of assets in 1997, which is roughly comparable to the Chilean figure.

²On average, it will cost a 65-year-old male an additional 20 percent of the value in his account to buy an annuity on the private market. About half of this is the charge that insurance companies must levy to adjust for adverse selection, which would not be necessary if all retirees were forced to purchase annuities. The cost is a little lower for women and for joint and survivor annuities but a little higher if the alternative is to invest at the corporate bond rate (Mitchell et al. 1997).

³See Asher (1998) and Valdés-Prieto (1998) for an analysis of plans in Singapore and Malaysia and Davis (1995) for a comparison of public and private sector returns in the United States.

⁴These calculations use the wage, price, and investment return assumptions employed by the 1997 U.S. Advisory Council on Social Security (average wages in the economy grow at 4.4 percent per year; prices rise at 3.5 percent per year; bonds earn a 2.3 percent real rate of return; and stocks earn a 7 percent real rate of return). The illustrative worker experiences personal wage growth at 1 percent per year above the national average, works for 35 years, holds 50 percent of the account in stocks and 50 percent in bonds, and receives an 18-year, price-indexed annuity at retirement. The examples ignore the impact of taxes.

⁵Indeed, Stecklow and Calian (1998) report that lax regulation was a major cause of recent scandals involving inappropriate sales of personal pensions.

⁶Proposals following this model include the Individual Accounts Plan from the 1997 U.S. Advisory Council on Social Security (Gramlich and Twinney 1997), the CSIS proposal (Center for Strategic and International Studies 1998), and the proposals of Senator Daniel Patrick Moynihan (D-NY) and Senator William Roth (R-DE).