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Prospects for Social Security Reform

Edited by Olivia S. Mitchell, Robert J. Myers, and
Howard Young

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Frontispiece: Special Treasury securities, stored in a federal government filing cabinet in West Virginia, represent \$700 billion in Social Security Trust Fund assets. Photo: Jeff Baughan.

Chapter 17

Investment and Administrative Constraints on Individual Social Security Accounts

Robert C. Pozen and John M. Kimpel

Several practical issues would become important if Congress decided to allow a modest portion of the OASDI contribution (currently 12.4 percent of annual compensation up to \$68,400 for 1998) to be directed toward an individual social security account. Such an individual account would provide a variable part of a participant's social security benefit in addition to a guaranteed social security floor. For example, Congress could decide to enact legislation similar to the Kerry-Simpson bill¹ with its 2 percent contribution to "Personal Investment Plans," which would supply a supplemental social security benefit in addition to certain guaranteed social security payments. Alternatively, Congress could adopt the proposal by two members of the last Advisory Council on Social Security for a 1.6 percent Individual Account, or the proposal by five members of the Council for a 5 percent Personal Security Account to be invested by individual participants. As noted in Chapter 1, these proposals share the common strategy of converting the social security structure from one that is entirely defined benefit to one that is partially defined contribution.

One practical issue that deserves attention is the range of investment constraints that might be placed on individual social security accounts such as those discussed in this volume. Another is the administrative alternatives for implementing such an individual account system. We discuss both below.

Investment Constraints

Several approaches to investment alternatives might be adopted in an individual account system. Since defined contribution plans shift the risk and rewards of investment experience from the plan sponsor to the plan participant, investments that can be held in an individual account should seek to

maximize individual choice. However, this goal may be moderated by a desire to maintain an appropriate balance between risk and return for investments that constitute part of the social security system.

One possible investment model is that of the Individual Retirement Account (IRA). IRAs currently allow an individual to choose among many different investments. These include individual stocks and bonds, bank accounts, mutual funds, and various types of physical commodities. It is, however, unclear whether Congress is prepared to allow a similar breadth of investment choice in an individual social security account. Since this account is intended to provide part of a participant's social security benefit, albeit a modest and variable portion of such a benefit, Congress may be reluctant to allow participants to take a significant degree of risk in this portfolio.

For example, Congress might prohibit participants from investing social security contributions in any individual stock, bond, or commodity. Instead, Congress might limit participant choices to diversified securities pools, where the aggregate risk is reduced by investments in multiple issuers. Such diversified pools could be in the form of common trust funds maintained by banks, separate accounts run by insurance companies, or mutual funds managed by investment advisers. The Congressional view is also likely to be influenced particularly by the level of guaranteed social security payments under the reformed plan relative to the poverty line.

Another investment model is presented by the Federal Thrift Savings Plan. That plan offers currently only three investment options, all of which are diversified pools. One pool is a Government Securities Fund, which purchases securities directly from the United States Treasury. The other two pools, a Stock Index Fund (based on the S&P500) and a United States Debt Index Fund (based on the Lehman Brothers Aggregate bond index), are run by a private firm. This firm is selected through competitive bidding by an independent body, the Federal Retirement Thrift Investment Board, appointed by the President.

While the Thrift Savings Plan provides diversification at a low expense rate, the range of investment choices is quite narrow. In fact, over 60 percent of the assets of the Thrift Savings Plan are currently invested in the Government Securities Fund. In practice, some participants might want returns with reasonable risk from a diversified pool of smaller stocks or international securities, rather than a S&P index fund. Other participants may want the opportunity to choose among investment managers, instead of being required to use the one selected by the Federal Retirement Thrift Investment Board. Among the 200 largest defined benefit plans, only 30 percent of the assets are invested in bonds.² Among Fidelity 401(k) and other participant-directed defined contribution plans, fixed income and money market investments constitute less than 30 percent of assets.³

An intermediate model between the IRA and Thrift Savings Plan models

would allow participants to direct some amount, say 2 or 5 percent of their OASDI contributions, to any qualified provider offering an appropriate array of diversified pools. A "qualified provider" could be defined as an investment manager qualified under Section 3(38) of the Employee Retirement Income Security Act (ERISA), which would limit qualification to insured banks, insurance companies, and SEC registered investment advisers. There could be additional qualifications, such as bonding and reporting, designed to assure the integrity and solvency of providers.

An appropriate range of investments could be based on the model reflected in the regulations issued under Section 404(c) of ERISA. These regulations require a provider to offer at least three diversified pools as "core" options, each of which has materially different risk and return features. One of these core options must be a money market fund, a managed income account consisting of GICs and other stable value investments, or a FDIC-insured bank account. In addition, providers who seek the benefit of Section 404(c) must distribute to participants written material on each core option, as well as other options available under the plan, designed to educate participants about the range of investment choices. Among other things, such disclosure is intended to educate participants about the investment objectives of each option and the risk and return characteristics of each such alternative.⁴

Under such an intermediate model, each qualified provider would have to offer three core options, with risk and return characteristics similar to those provided under the Thrift Savings Plan. But participants could also choose among other diversified pool options that focused on subasset classes, such as international stocks or small cap growth stocks. Providers offering such alternatives would be required to meet disclosure requirements comparable to those required by ERISA.

Administrative Constraints

The administration of an individual account system should maximize individual control and minimize costs, but these objectives are difficult to achieve because of the small size of many of these accounts. For example, if only 2 percent of the OASDI contribution were invested in an individual social security account, this would amount to only \$600 invested per year for the average social security participant. Moreover, social security payments are made by most employers on a weekly basis, which would mean investments of \$12 per week on average. If as much as 5 percent of pay were invested in an individual social security account, as suggested by members of the Advisory Council on Social Security proposing a Personal Security Account, it would amount to a \$1500 annual contribution amount or only \$30 per week.

The situation becomes even worse if we move beyond averages. Two-

thirds (67 percent) of all workers covered by social security earned less than \$25,000.⁵ As a consequence, one could expect two-thirds of those covered by individual social security accounts to contribute less than \$300 per year (or less than \$6 per week) if the contribution rate were 2 percent, and less than \$1,250 (of less than \$25 per week) if the contribution rate were 5 percent. In other words, one of social security's greatest virtues—its universality—is also one of its problems. Administering social security in its current defined benefit form, without individual accounting or investment management requirements, is expensive: 0.42 percent when expressed as a percentage of contributions, and 0.57 percent when expressed as a percentage of benefits paid (Mitchell 1998). This compares to the 0.09 percent cost of administering the considerably smaller Thrift Savings Plan (137 million vs. 2.3 million workers), even though the Thrift Savings Plan cost includes individual accounting and investment management expenses (Mitchell 1998).

The universality of social security creates another administrative burden: by covering all workers, social security must interface with all employers. Of the approximately 6.5 million employers in the United States, 4 million have fewer than 10 employees; almost 5.5 million have fewer than 250 employees. Currently more than 5.4 million employers file their wage reports with social security by paper and not electronically (NASI 1998). Contrast this to the Federal Thrift Savings Plan, where the employer is the Federal Government (this covers many different agencies, but virtually all of them submit wage data electronically).

In the private plan arena, the average employer Fidelity deals with has over 1,000 employees. Virtually all of them submit most contribution and other data electronically (to do otherwise would require us to convert paper data manually to electronic format for input to our recordkeeping system). The high cost of manual data inputting is a barrier to providing a low-cost defined contribution plan to small employers.

In addition to participant account size and employer size, the administrative cost of individual social security accounts will be driven by the number of annual transactions. The Social Security Administration's current transactions are generally limited to the annual reconciliation of wage data (the actual collection of weekly or less frequent payroll tax contributions is handled by the Internal Revenue Service), and the payment of monthly benefits to retirees. Contrast this to the typical private sector defined contribution plan, where multiple investment options, daily transaction capabilities, and 24 hour telephone service are the norm. Last year, for example, Fidelity's recordkeeping operation performed over 90 transactions per participant, or over 450 million monetary transactions for 5 million participants. These included periodic contribution allocations among investments, daily exchanges among investment options, and distributions. In addition, Fidelity's recordkeeping operation handled over 140,000 telephone calls daily. These are the costs of giving participants maximum control over the invest-

ment of their accounts. The Federal Thrift Savings Plan, by contrast, curtails monetary transactions (and thereby expenses) by limiting participant control (for example, by limiting investment options and by limiting the number of exchanges to once a month rather than daily).

What administrative system would provide the best compromise between maximizing participant control over individual social security accounts and retaining reasonable administrative costs? One possible administrative system would be for the U.S. Treasury to continue to collect social security tax payments from employers, and subsequently to send the individual account portion to the provider selected by the participant. This system could operate through an additional page in the annual income tax filing, on which a participant would compute his applicable OASDI tax, designate his preferred qualified provider, and direct the Treasury to deposit his monies in a specific investment alternative offered by that provider.

While a governmental model would have the advantage of piggybacking on existing procedures for collecting social security payments and making Internal Revenue Service filings, it would have several disadvantages. First, there would be a substantial delay between the collection of the social security payments and the transmission of funds to the individual account provider. For example, 1998 social security payments could not be transmitted to the investment provider until the social security Administration had reconciled the individual's wage data and the Internal Revenue Service had received the individual's tax return. This would probably not occur until the end of 1999 or even the beginning of 2000. Second, this system would impose a new computer burden on the Internal Revenue Service, an agency already hard pressed to cope with its current computer demands. Procedures would have to be established to rectify any mistakes in individual social security accounts, perhaps requiring participants to deal with both the Social Security Administration and the Internal Revenue Service. Third, requiring all allocations to be made by the Internal Revenue Service might subject the individual account process to a broad range of government constraints unrelated to the system itself (for instance, an elaborate set of government contractor rules).

A different administrative model would piggyback an individual account system on the existing 401(k) plans offered by many employers to their employees. Under this model, the 401(k) plan's recordkeeper would allocate the employee's 2 percent or 5 percent contribution to a sub-account under the employer's 401(k) plan, to be periodically invested under the plan in the appropriate investment pool at the appropriate provider. Employers would have the same fiduciary responsibilities with respect to those sub-accounts that they now have to the plan as a whole.

The latter model has the advantage of utilizing an existing processing system in the private sector that has proved to be relatively efficient, but it

too has several serious drawbacks. First, while 401(k) plans are virtually universal at large firms, they are almost nonexistent at small firms (although the new SIMPLE plan created by Congress in 1996 is beginning to make a dent). At present, however, only about 20 percent of employees working for small businesses with fewer than 100 employees participate in any type of pension plan. A national system for administering individual accounts would therefore need another procedure to address employees of small businesses as well as the self-employed. Second, participants in a 401(k) plan at a large firm may desire to invest their social security contributions with financial institutions other than the provider involved in their 401(k) program. If a business must allocate contributions to several different providers, administrative costs would increase significantly. Third, it is unclear who would absorb the incremental cost of piggybacking individual account allocations on 401(k) systems. Even some large employers may not want to take on the task of implementing an individual social security account system. A result of these drawbacks, this model may best serve as an optional administrative arrangement for those employers willing to undertake it.

Yet a third administrative model would be to utilize the procedures developed for annual IRA contributions. Under this scenario, a participant would instruct his or her employer to withhold only 10.4 percent or 7.4 percent (rather than 12.4 percent) of his or her paycheck for OASDI payroll tax. Then, each participant would periodically (perhaps annually) deposit 2 or 5 percent of his wages in an individual account at a qualified provider selected by the participant. He would then submit to the IRS a receipt for such contribution along with his income tax form. While this IRA model would minimize bureaucratic constraints and maximize individual control, the Treasury is likely to express concerns about possible social security fraud. The Treasury would have difficulty ferreting out those individuals who falsified receipts, underpaid their social security tax, or simply forgot to make a deposit.

A variant of the IRA model could be developed to address Treasury's concerns. Under this variant, Treasury would continue to collect all social security payments, but a participant could obtain a tax credit if he chose to make contributions to a qualified provider selected by the participant. Accordingly, participants could make an individual account contribution to providers of their choice and reduce their tax payments on their income tax filings. Alternatively, participants could reduce their withholding taxes or estimated taxes to reflect their anticipated tax credit. This variant gives participants maximum control over their individual social security accounts, though it does require participants to adjust their tax payments in order to avoid advancing the government the amount of their contributions. In addition, the tax credit should be refundable for participants who are not currently paying income tax. This variant, however, shifts much of the admin-

istrative complexities imposed on the employer under the 401(k) model to the individual. While it may be a workable solution for many individuals, it may be simply too complicated for others.

Under another variant of this alternative, participants could avoid adjusting their withholding and writing a check by instead presenting a copy of their W-2 form to the qualified provider of their choice and requesting that their tax credit be sent directly by the Internal Revenue Service to such provider. By establishing such a system (which perhaps could be built on the existing electronic refund system), participants would be sure to have the funds available to make the contribution. While such an alternative eliminates the need for writing a check, it might share some of the problems described above with regard to the governmental model (such as the potential delay between the collection of the social security payments and the transmission of the contribution to the qualified provider).

Conclusion

This discussion suggests that a system of individual social security accounts can be designed with a reasonable range of investment choices. Arguments can be made for very broad or very narrow investment choices, but the most powerful case is from an array of diversified investment pools including one stable value fund. Such an array of options has worked for private pension plans under ERISA by providing a reasonable balance between risk and return.

The administrative issues posed by a system of individual social security accounts is more difficult to resolve. The 401(k) model would be attractive to some large employers, but most small employers will not want to participate in such a program. The Treasury could both collect social security taxes and allocate contributions under a governmental model, but this would be a bureaucratic and slow system with relatively little individual control. By contrast, an IRA model maximizes individual control and minimizes bureaucracy, but may be vulnerable as a tax collection system. The best middle ground, in our view, is an IRA-type model under which the Treasury would continue to collect social security taxes and participants would be allowed a tax credit upon making their own individual account contributions. But this model might shift too much of the administrative burden to participants to be universally accepted. Perhaps the best result would be a program encompassing multiple solutions. It is not hard to envision a scenario where some employees held individual social security accounts in their employer's 401(k) plans, while others held them in an IRA.

In any event, the administrative issues presented by individual social security accounts are significant. The factors most affecting administrative costs are account size, employer size, and number of transactions. Further

analysis of the effect of these factors on the various individual account proposals needs to be done before any of them are implemented.

Notes

1. S. 825, 104th Congress. Similar bills have been introduced by others.
2. Overall assets for the 200 largest DB plans were divided as follows: stocks, 60 percent; bonds, 30.5 percent; and other, 9.4 percent (Barr 1998).
3. Fidelity is the nation's largest defined contribution plan recordkeeper, with over 6,000 plans covering more than five million participants. As of 12/31/97, investment allocations (excluding company stock) were as follows: equities, 75 percent; fixed income and GIC, 17 percent; and money market, 8 percent.
4. See Labor Regulations 2550.404c-1(b)(2)(B)(1)(ii). More extensive information must be disclosed on request, including a description of the annual operating expenses which reduce the rate of return on the diversified pool.
5. Office of the Actuary, SSA, as cited in NASI (1998).

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