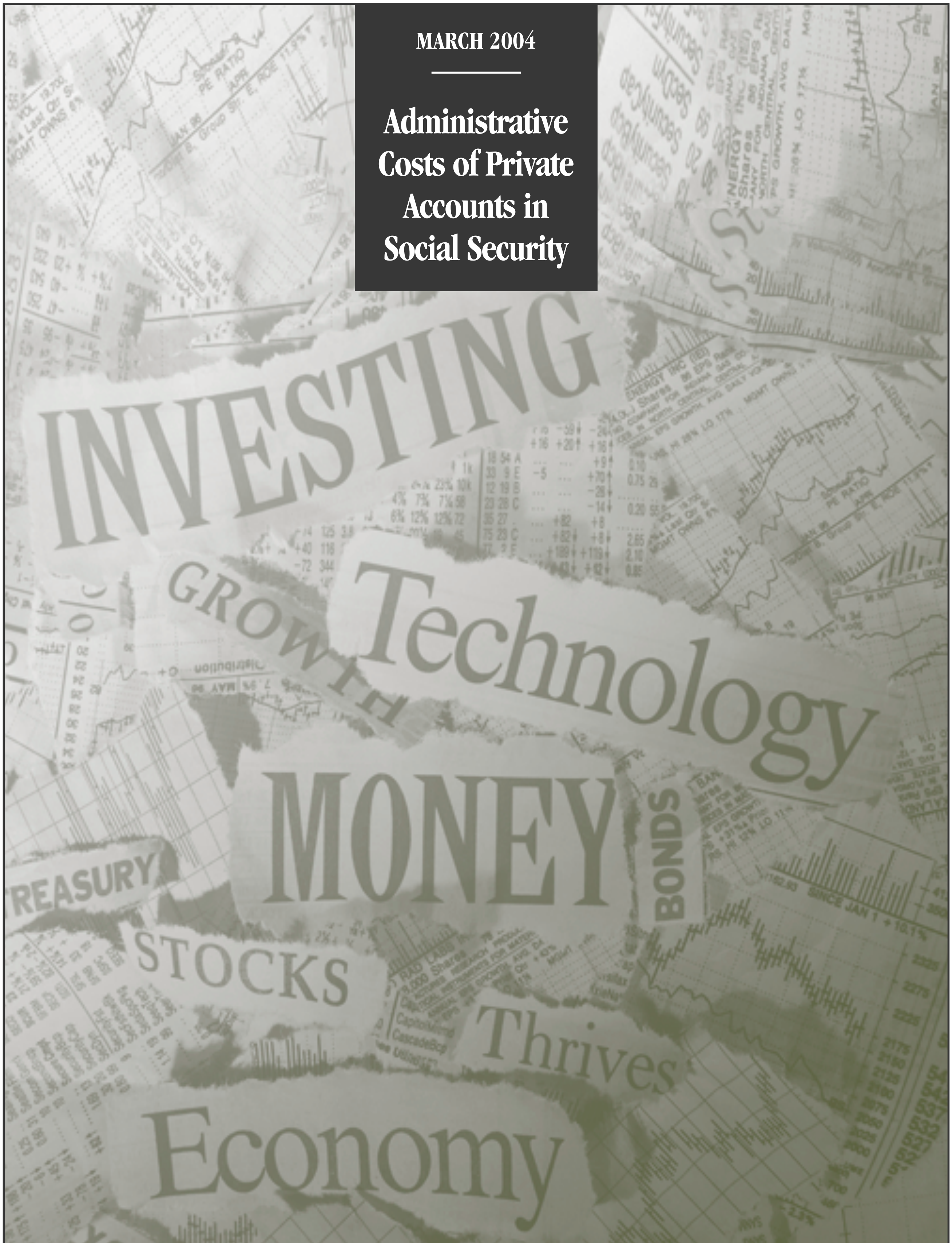
CONGRESS OF THE UNITED STATES
CONGRESSIONAL BUDGET OFFICE

A CBO STUDY

MARCH 2004

Administrative Costs of Private Accounts in Social Security



© Image Ideas

A CBO STUDY

Administrative Costs of Private Accounts in Social Security

March 2004

The Congress of the United States ■ Congressional Budget Office

Preface

A number of proposals for modifying Social Security call for the creation of a system of private retirement accounts. One important consideration, among many, in evaluating such proposals is the cost of administering the system. The operation of any system of accounts involves a number of administrative tasks whose costs will ultimately affect a retiree's account balance. To assess the range of possible administrative costs that a system of private accounts might generate, this Congressional Budget Office (CBO) study—prepared in response to a request from the Ranking Member of the House Ways and Means Committee and the Ranking Member of the Subcommittee on Social Security—examines the costs of four systems used to fund retirement in the United States: Social Security, the federal government's Thrift Savings Plan, retail mutual funds, and private defined-contribution pension plans.

Ben Page of CBO's Macroeconomic Analysis Division wrote this study under the direction of Douglas Hamilton and Robert Dennis. Paul Cullinan, Peter Diamond, Randall Mariger, Olivia Mitchell, David Moore, Noah Myerson, James Roosevelt, Ralph Smith, and Jan Walliser provided valuable comments.

Juyne Linger edited the study, and Christian Spoor proofread it. Maureen Costantino produced the cover and figure and prepared the study for publication, and Annette Kalicki prepared the electronic versions for CBO's Web site (www.cbo.gov).

Douglas Holtz-Eakin
Director

March 2004

CONTENTS

Tables

Figures

Boxes

CHAPTER

1

Summary and Introduction

Many proposals for reforming Social Security call for the creation of a system of private retirement accounts. Although proposals for private accounts differ in significant ways, they share a common feature: the assets in a worker's account at retirement would depend on the payments made into that account and the rate of return on the account's assets during the person's working life. Many types of accounts are possible, and their effects on retirement income would vary widely.[1]

A key consideration in evaluating proposals for establishing a system of private accounts is the cost of administering the system. The operation of any system of accounts involves basic administrative tasks such as collecting and processing contributions, managing assets, and paying benefits—all of which require recordkeeping. Each of those tasks carries costs, which will ultimately affect a retiree's account balance.

This study examines the administrative costs of four systems for funding retirement in the United States: Social Security, the federal government's Thrift Savings Plan, retail mutual funds, and private defined-contribution plans.[2] The study also reviews the administrative cost of annuities, which might be used by some or all participants in a system of private accounts to convert asset balances into regular payments.

The costs of administering the systems vary, in large part because of differences in the level of services and range of asset choices the systems provide. The current Social Security system, for example, restricts participants to one "asset"—promised benefits—and provides, on an annual basis, limited information about expected benefits. By contrast, most mutual funds offer a wide variety of services, including a broad range of asset choices and daily updates on account balances.

Another important factor that can affect administrative costs is the degree to which a system is centralized. For example, a centralized system such as the federal government's Thrift Savings Plan may generate few or no costs for marketing and sales. In a decentralized system that operates at the retail level, such as mutual funds, the cost of those tasks may be substantial. Decentralized systems, however, also allow for competition, which can lead to better services and more efficient operation over time.

1. For a review of the possible effects of private accounts, see Congressional Budget Office, *Social Security: A Primer* (September 2001).

2. For a review of systems of accounts in several foreign countries, see Congressional Budget Office, *Social Security Privatization: Experiences Abroad* (January 1999). Other reviews of the issues surrounding administrative costs include Olivia S. Mitchell, "Administrative Costs in Public and Private Retirement Systems," in Martin Feldstein, ed., *Privatizing Social Security* (Chicago: University of Chicago Press, 1998); Kelly A. Olsen and Dallas L. Salisbury, *Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs,* Issue Brief No. 203 (Washington, D.C.: Employee Benefit Research Institute, November 1998); General Accounting Office, *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design,* GAO/HEHS-99-131 (June 1999); John B. Shoven, ed., *Administrative Aspects of Investment-Based Social Security Reform* (Chicago and London: University of Chicago Press, 2000); and Lawrence E. Hart and others, *SSA's Estimates of Administrative Costs Under a Centralized System of Private Accounts* (Social Security Administration, January 2001).

Table 1-1.

Estimated Administrative Costs of Pension Systems and Their Effect on Assets at Retirement

Pension System	Annual Administrative Cost	Percentage Reduction in Assets at Retirement
Social Security	$11 per participant	2
Federal Thrift Savings Plan	$25 per participant	5
Mutual Funds (Average)	1.09 percent of assets	23
Private Defined-Contribution Funds, by Analyst		
Pension Dynamics Corporation (Large plan)	$24 per account plus 0.8 percent of assets	21
Pension Dynamics Corporation (Small plan)	$60 per account plus 1 percent of assets	30
IRS Form 5500 Tabulation	$49 per account	9
General Accounting Office	$103 per account	19

Source: Congressional Budget Office estimates based on data from the Social Security System, the federal government's Thrift Savings Plan, Pension Dynamics Corporation, the Internal Revenue Service, and the General Accounting Office.

Note: Calculations are for retirees contributing 2 percent of earnings to a retirement account for 40 years.

Evidence from the systems that the Congressional Budget Office (CBO) examined, combined with cost estimates that other researchers have calculated, suggests that administrative costs in a system of private retirement accounts would likewise vary according to the design of the system and the services that it provided—in particular, the degree of asset choice permitted and whether assets would be purchased centrally or by individuals at the retail level.

To provide a consistent basis to compare the costs of various systems, CBO estimated how those costs would affect balances in a benchmark private account that received contributions of 2 percent of earnings (similar to the percentage called for in many proposals). The systems that CBO reviewed have administrative costs that, if charged to account holders, would reduce account balances at retirement by as little as 2 percent or as much as 30 percent, depending largely on the level of service provided (see Table 1-1).

The size of the account is crucial in determining the percentage impact of administrative costs on account balances. Because large accounts are unlikely to cost much more to administer than small accounts, administrative costs would affect their balances proportionately less. For example, balances in accounts receiving 4 percent of taxable earnings would probably be affected by administrative costs only half as much, in percentage terms, as accounts receiving 2 percent of taxable earnings.

Evidence from existing systems, whose size and mix of participants differ from those of a nationwide system of private accounts, is of course only suggestive—not predictive—of the actual costs of administering a system of private retirement accounts. Forecasting the impact of those costs many years into the future, moreover, involves even greater uncertainty about their impact on a participant's retirement income. Retirement accounts would be held for several decades, and costs could vary in response to factors such as changes in technology and wage rates during that time.

CHAPTER

2

Administrative Tasks in a Pension System

The administration of any pension system involves a number of essential tasks. Identifying those tasks is crucial to any comparison of the costs of different systems. The requisite administrative tasks typically consist of the collection and processing of contributions; asset management; the calculation and payment of benefits; enforcement and oversight; and, in some cases, marketing and sales (see Figure 2-1). Because each system may assign a task to a different agency or individual, it is also important to determine who is responsible for performing each task. Some proposals would shift the administrative burdens to employers or spread them among different government agencies; a comparison of costs that focused on only one level of administration could therefore be misleading.

Furthermore, any comparison of systems has to acknowledge differences in the level and quality of services. Some systems may provide additional value for workers by keeping them informed about expected benefits, for example, or by giving them a range of investment choices. To the extent that workers desire and are willing to pay for those services, participants may be better off even though their retirement resources are likely to be reduced.

Collection and Processing

Any pension system must collect contributions in some form. In many systems, those contributions, as well as information that will ultimately determine benefits, must then be transmitted to institutions that either invest the contributions in some sort of assets (in a funded system such as a private pension) or pay them out directly as benefits (in a pay-as-you-go system such as Social Security). Theoretically, individuals could be required to make their contributions after they received each paycheck. In practice, however, most systems impose the task of collection on employers by requiring them to withhold the contribution from the paycheck. That arrangement has the advantage of reducing noncompliance.

The administrative burden of collecting and processing the contributions depends partly on the amount of information that must be gathered under a given system. In a simple system, the amount of each worker's contributions is the only information required. However, matters can be more complicated—and administrative costs higher—in a defined-contribution system with multiple investment funds. In that case, the collector must also convey the worker's choice of funds. More frequent collection and transmission will also tend to increase costs.

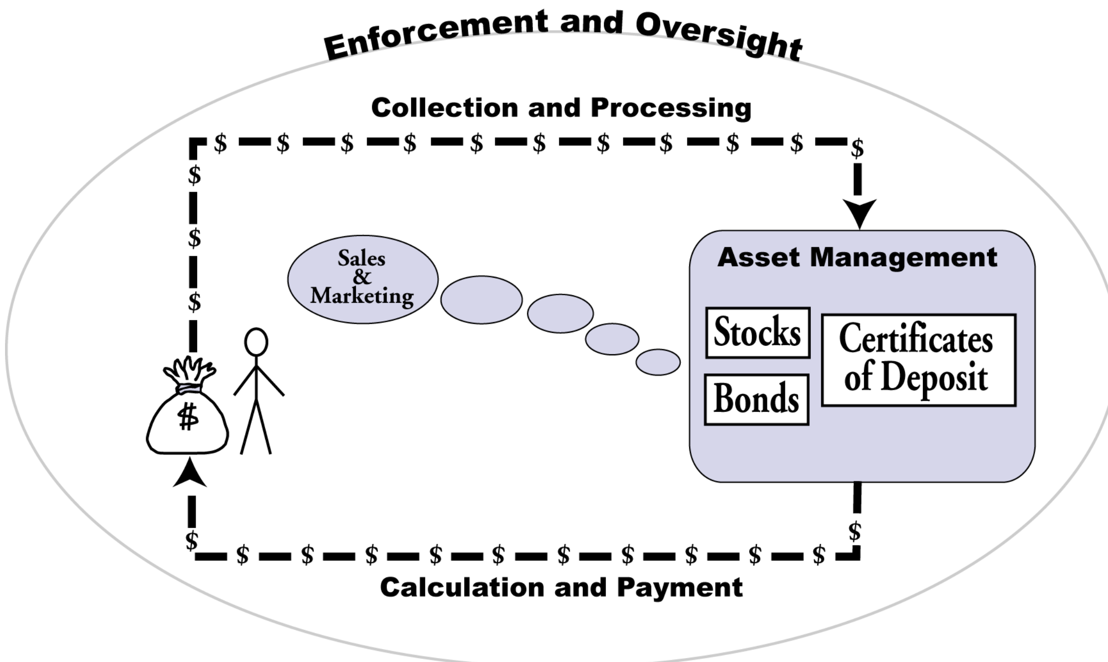
The time required to collect and transmit contributions and information may be more important in a defined-contribution system than in a defined-benefit system. In a defined-benefit system, errors in transmitted information can be corrected at any time up to (or even after) retirement simply by changing the recorded earnings history. In a defined-contribution system, however, delays in transmitting workers' choices of assets could lead to lost returns. If a system suffers from delays in transmission of information about asset choices, administrators may have to designate a default investment for contributions that have not been allocated.

Asset Management

In a funded system, additional costs arise from managing retirement assets. If the contributions are invested in a mutual fund, for example, some payment must go to the fund managers for researching and choosing investments and making trades. Management fees depend heavily on how actively the fund is managed and the type of assets in the fund. More actively managed funds tend to be more expensive because the investment manager devotes more

Figure 2-1.

Administrative Tasks in a Pension System



Source: Congressional Budget Office.

resources to making asset choices, and the fund's assets have higher turnover. By contrast, funds that seek to match the assets in a published index of stock values (such as the Dow Jones Industrial Average or the S&P 500) do not require research into particular investments and have lower turnover of assets. (Those funds may, however, miss investment opportunities.) Funds holding assets that require more extensive research, such as international funds, also tend to have higher costs. Note, though, that the cost of research tends to be largely fixed—additional participants or total assets are likely to have little impact on the costs of research.

In a defined-contribution system with a choice of assets, recordkeepers must also track contributions, returns, and balances for each type of asset, including transfers between asset types. All of that information must be recorded and processed—a task that becomes more costly as more asset types are allowed and more frequent contributions and transfers are permitted. A defined-contribution system with a choice of assets could involve multiple recordkeepers: if workers can simultaneously invest in funds from different providers, records for the same worker could be held by several providers.

Calculation and Payment of Benefits

Once workers become eligible to receive their pension, the accrued benefits must be calculated and benefit payments initiated. Because retired workers often rely heavily on their pension income, speedy calculation and timely payment of benefits are considered essential to a well-functioning pension system.

To calculate benefits, some entity must maintain records of the variables that affect benefit levels. The complexity of the task depends on the design of the system. For example, in a defined-contribution system, benefits are simply based on accumulated wealth. If good records on account balances have been maintained, no further calculation is necessary. In a defined-benefit system, the benefits are generally determined by a variety of factors, including the number of years of contributions and previous earnings. Benefits also may change over time because of altered circumstances. In the current Social Security system, for example, benefits may change as a result of events such as the death of a spouse or reentry into the workforce.

The speed and expense of calculating benefits also depends in part on the quality of recordkeeping. With timely, high-quality records, initial benefits can be determined quickly and without much additional cost. However, if records are poorly kept and information is lost, applying benefit formulas may require a costly cleanup of records. This process can also be time-consuming. Furthermore, the information required to calculate benefits may not be recorded immediately, causing further delays.

Additional costs may arise in a defined-contribution plan if the accumulated wealth is converted into an annuity—a stream of payments lasting for the life of the recipient.[1] To achieve the same protection against outliving resources that is offered by Social Security, workers in a defined-contribution system would have to purchase an inflation-indexed annuity with their retirement savings. However, purchase of an annuity can decrease retirement income in two ways. First, the firms offering the annuities generate their own administrative costs, including for marketing and sales. Second, if the system allows people to choose freely whether to purchase the annuities, their price will increase. In a phenomenon known as adverse selection, people who expect to have a long life span are more likely to purchase annuities than people without such expectations. As a result, annuities cost more than they would if all purchasers had average life expectancy. That increased cost prevents some people from purchasing annuities that they would otherwise want to buy if the annuities were priced on the basis of average life expectancy. Adverse selection does not occur, however, if all participants are required to annuitize their account balances.

Enforcement and Oversight

Some resources must also be spent on monitoring and enforcing a pension system to prevent improper activities, such as the misuse of contributions. Enforcement costs depend largely on the structure of the pension system. As indicated earlier, enforcement in a system in which the employer withholds contributions from paychecks is likely to be much less costly and intrusive than in a system in which the individual worker must make the contributions. To the extent that account contributions flowed through the existing system of employer withholding, there would be little or no additional cost for enforcement or oversight.

In addition, enforcement may be less costly with more centralized recordkeeping. In today's defined-benefit Social Security system, a single recordkeeping agency maintains earnings records. That makes it easier to compare those records with tax data or employers' accounts. (The Social Security Administration and the Internal Revenue Service share responsibility for enforcement in the current system.) A defined-contribution system with multiple investment choices could have many recordkeepers, making it more difficult to track the flow of payments.

In a funded system, government oversight is necessary to avoid pension fraud and underfunding regardless of whether the pension is a defined-benefit or a defined-contribution plan. In a fully funded defined-benefit system, the assets of the pension fund are projected to meet its liabilities from an actuarial perspective.[2] In a defined-contribution system, government oversight must ensure that records for each contributor are properly kept, that assets are actually invested on a worker's behalf, and that the investments conform to any government restrictions.

Additional costs may arise from establishing and enforcing other regulations governing the system. For example, in a decentralized system, financial firms providing investment services might be required to disclose their costs in a certain way and to refrain from fraudulent claims.

Marketing and Sales

If a pension system relies on a worker's choice of pension funds and annuity companies, additional costs arise because the companies must communicate and sell their products to customers. Those costs include advertising expenses as well as sales commissions. Though marketing and sales carry a cost, they can be a service to investors to the extent that they convey useful information.

1. For a discussion of market imperfections and the regulatory issues involved in the annuitization of retirement savings, see Congressional Budget Office, *Social Security Privatization and the Annuities Market* (February 1998).

2. In the United States, employer-sponsored defined-benefit plans are subject to the requirements of the 1974 Employee Retirement Income Security Act (ERISA). ERISA regulations regarding contributions help reduce the risk that plans will fall short of full funding. In addition, defined-benefit plans are insured by the Pension Benefit Guaranty Corporation, which was established to provide benefits for workers whose pension plan failed.

CHAPTER

3

Administrative Costs in Existing Systems

The United States has extensive experience administering different types of pension systems, including Social Security, employer-sponsored pension plans (including those of the federal government), and individual retirement accounts. The costs of those systems differ in part because they provide different levels of services and, to some degree, involve different sets of administrative tasks. For example, the Social Security system has relatively low administrative costs and does not incur transaction costs from investing in private assets, but it offers relatively few services compared with other systems.

In an effort to provide a sense of potential administrative costs of private accounts with various design characteristics, this chapter reviews the administrative costs of four different systems—Social Security, the Thrift Savings Plan (TSP) for federal government employees, mutual funds, and private defined-contribution plans. The costs are presented on a consistent basis to facilitate comparison (see Box 3-1 for an explanation of the Congressional Budget Office's methodology). Private accounts with characteristics similar to those of lower-cost systems are likely to have relatively lower costs, whereas accounts with characteristics similar to those of higher-cost systems are likely to have higher costs.

It is important to note that these examples provide evidence on costs at a specific point in time. The future path of costs is uncertain. Falling prices for computers and software might contribute to lower costs. At present, most administrative costs go to pay wages for people who perform tasks such as entering and checking data, rather than for electronic equipment. For example, almost three-fourths of the administrative costs of the Social Security Administration in 2003 (excluding payments to state agencies) went to pay salaries and benefits. However, technological changes that allow advances in administrative processes, such as submission of records via the Internet rather than on paper, could reduce costs substantially. Because the future path of costs is uncertain, this analysis focuses on current costs.[1]

Social Security

Social Security—the federal government's largest entitlement program—provides retirement, survivor, and disability benefits. It covers almost all workers in the United States.[2] In 2002, about 153 million workers (including the self-employed) were covered by Social Security. More than 46 million individuals received payments from the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds in the form of retirement income, spousal and family benefits, survivor benefits, and disability benefits.[3]

Social Security is a defined-benefit system, with benefits calculated using a formula based largely on previous qualified earnings. That implies that beneficiaries have no choice of different types of assets within the system; the

1. Historical evidence on the evolution of costs is mixed. For example, since 1990, administrative costs per participant in Social Security's Old Age and Survivors Insurance program have grown about 1.3 percent per year, less than the average rate of inflation. During the same period, costs per participant in the Thrift Savings Plan have grown by 6.4 percent per year. The TSP increased the level of services it provides during that time, however.

2. A few categories of workers, including federal civilian workers under the old Civil Service Retirement System and some state and local employees, are not covered by Social Security.

3. Social Security Administration, *2003 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (March 17, 2003), p. 2, available at www.ssa.gov/OACT/TR/TR03.

Box 3-1.

CBO's Methodology for Comparing Administrative Costs

The costs of administering pension systems are measured in a variety of ways: per participant, per dollar of contributions, or per dollar of assets, among other methods. To provide a consistent basis for comparing the administrative costs of different pension systems, the Congressional Budget Office (CBO) estimates their impact as a percentage of the assets in a worker's account at retirement. Specifically, CBO calculates the effect of those costs on the account balance of a retiring worker who has earned average income and contributed 2 percent of his or her taxable earnings to the account (about the level of contributions called for in many proposals). The average taxable earnings of covered workers in 2001 were $27,350, so a 2 percent account would receive contributions averaging about $547 per year.[1]

The size of the account is crucial in determining the percentage impact of administrative costs on account balances. Because large accounts are unlikely to cost much more to administer than small accounts, administrative costs would affect their balances proportionately less. For example, balances in accounts receiving 4 percent of taxable earnings would probably be affected by administrative costs only half as much, in percentage terms, as accounts receiving 2 percent of taxable earnings.

In the case of Social Security, where no explicit administrative costs are charged to participants, CBO divides estimated total annual administrative costs by the number of participants to determine the cost per account. CBO then divides that cost by 2 percent of the average taxable payroll to establish the percentage effect on an account receiving 2 percent of earnings. Assuming that percentage remains constant over time, retirement assets will be affected by the same percentage.

Some other types of accounts, such as mutual funds, carry explicit charges, often calculated at least in part as a percentage of assets. In those cases, the effect on account balances is calculated by applying the percentage of assets charged annually to a simulated account.[2]

Most administrative costs are incurred on a per-account basis, but the cost to participants need not be distributed that way. If all accounts were charged the same flat fee, administrative costs would reduce the returns on small accounts by more than they would on large accounts. For that reason, policymakers may wish to restrict fees to a flat percentage of either contributions or accumulated assets. Of course, such a restriction would imply that small accounts would be charged less than the costs they generated, and large accounts charged more. In a system in which workers had wide latitude to choose among financial firms, that could lead firms to compete for the large accounts held by high-earners by offering better service or other inducements.

---

1. Social Security Administration, *Annual Statistical Supplement, 2002* (December 2002), Table 4.B1, p. 153. Taxable earnings do not include earnings above the cap on payroll taxes ($87,000 in 2003). The account of a worker with average (mean) earnings is used in this calculation because if total administrative costs are distributed in proportion to contributions, the percentage effect of costs on the balances in that account will be the same as the effect on all other accounts.

2. In simulating the growth of account balances, CBO makes the following assumptions: a constant portion of wages is contributed over a continuous working life of 40 years, real wages grow at 1 percent per year, and the assets in an account earn a real rate of return of 5 percent in each year. Under those assumptions, for example, an annual charge of 1 percent of assets reduces balances at retirement by about 20 percent. The calculation is not highly sensitive to the rate of return or wage growth, but it is sensitive to the length of working life and the continuity of work. A longer working life increases the impact of a given percentage-of-assets charge (because there are more years of charges when account balances are large). Interruptions in the working life also increase the impact of a given percentage-of-assets charge compared with the same number of years of work with no interruptions.

only "asset" that participants hold is the promise of future benefits. That restriction simplifies administration. Proper calculation of the initial benefit requires the worker's entire earnings history, aggregate wage growth over that period, and (in some cases) the earnings records of a current or former spouse. Given that information, it is relatively easy to compute the initial benefit. Benefits are adjusted for inflation each year thereafter.

Social Security benefits are financed mostly by taxes on current workers—that is, on a pay-as-you-go basis—rather than by assets and returns from past contributions. The level of contributions is fixed at a total of 12.4 percent for most people, with 6.2 percent coming from the employee and 6.2 percent from the employer (the self-employed pay the full amount). The absence of a choice of contribution level also simplifies administration.

In 2002, the OASI trust fund received income of $468.1 billion from payroll taxes (net of refunds) and the taxation of Social Security benefits, and $71.2 billion from interest on assets. In the same year, the trust fund made benefit payments of $388.1 billion and spent $2.1 billion on administration.[4]

The different administrative tasks of the Social Security system are performed by employers, the Internal Revenue Service (IRS), the Treasury's Financial Management Service (FMS), and the Social Security Administration (SSA).

Employers' Responsibilities. Employers bear the burden of the collection costs. They collect payroll taxes from employees and transfer them to the IRS together with other withheld income taxes. Most employers with $50,000 or less in total income and payroll tax payments during a four-quarter look-back period must deposit the taxes withheld from wages within a month after the wages are paid. Employers with more than $50,000 in tax payments during that period must deposit their taxes semiweekly. Any employer who accrues a total liability of $100,000 in one day must deposit all withheld taxes by the following day. The deposits can be made either at a Federal Reserve Bank branch or at a financial institution that is authorized by the IRS. The IRS determines the tax payments for the trust funds from the information provided by employers on Form 941. Moreover, tax payments on Social Security benefits are transferred to the trust funds according to the information on individual tax returns.

Employers are also responsible for transmitting substantial amounts of information to the SSA and the IRS. Employers must report the wages subject to Social Security taxes annually to the SSA. The SSA receives a copy of each W-2 form that is issued to employees for tax-filing purposes at the beginning of the year, detailing earnings and payroll taxes withheld during the previous calendar year. Moreover, employers must file form W-3, which summarizes aggregate tax withholdings, with the SSA. The IRS receives similar aggregate tax information from employers each quarter on Form 941.

The self-employed do not file their earnings reports directly with the SSA. Instead, they calculate and report their Social Security tax (also called a self-employment tax) on schedule SE of the income tax return. After processing the tax form, the IRS furnishes the information about taxable earnings of the self-employed to the SSA.

SSA's Responsibilities. The SSA's first administrative task is to keep accurate earnings data. For that purpose, the SSA must issue Social Security numbers (SSNs) to all workers. Workers can apply for those numbers at one of the field offices that the SSA maintains. After processing the personal data, the SSA issues a Social Security card and stores the worker's data.

The SSA processes, stores, and verifies earnings records. Each year, the information contained on all W-2 and W-3 forms is transferred to electronic records. The SSNs and names that are provided on the W-2 forms are checked against an SSA master file of all people with SSNs. When SSNs and names do not match the master file, the SSA contacts employers and employees. In some cases, the problem can be rectified, and the earnings records can be posted correctly. However, about 9 million of the approximately 250 million earnings records that the SSA processes each year cannot be reconciled with the master file.[5]

In addition, the earnings data that the SSA collects are compared to quarterly tax data from the IRS. When the figures do not match, the SSA and IRS share responsibil-

4. Social Security Administration, *2003 Annual Report of the Board of Trustees,* p. 4. This analysis concentrates on the OASI program because the DI system faces costs of determining disability, which would not be present in a system of private retirement accounts.

5. Social Security Administration, *Performance and Accountability Report for Fiscal Year 2003* (November 2003), p. 23.

ity for contacting employers and obtaining consistent information.[6] Together, the two agencies contact almost a million employers each year.

The SSA posts earnings records with some delay after the end of the tax year. Not including the self-employed, in fiscal year 1999, 84 percent of earnings records were posted within the six months of the close of the tax year, and 95 percent were posted within nine months. Because the SSA must retrieve the Social Security earnings of the self-employed from income tax returns, only 93 percent of earnings of the self-employed are posted within nine months.[7] The use of electronic filing may increase over time, particularly if opportunities for Internet filing increase. However, many small employers are likely to continue to file on paper in the foreseeable future.

The SSA's second major task is to determine an applicant's eligibility for benefits, calculate the amount of benefits to be paid, and initiate payments. People may be eligible for benefits for several reasons. Those who worked in covered jobs for at least 10 years can apply for retirement benefits as early as age 62. People with sufficiently low earnings histories may qualify for spousal benefits based on their spouse's primary insurance amount if their current or former spouse is an eligible retiree. Survivors of insured workers are also eligible to receive payments. Moreover, people who are unable to continue working because of severe impairments may receive disability benefits. Determining eligibility, therefore, can require checking the insurance status and age of an applicant, his or her marital status, the relationship to a deceased insured worker, and the gravity of a disability.

After eligibility has been established, the SSA calculates benefits and initiates the payments. The SSA supervises those payments, but the Treasury issues the Social Security checks through its Financial Management Service. The SSA also must maintain current addresses for beneficiaries and assist participants with questions. Because tasks such as processing claims, determining eligibility, maintaining rolls of beneficiaries, and answering phone calls tend to be labor-intensive, those beneficiary services account for the bulk of the administrative costs in the Social Security system.

The IRS enforces Social Security payroll tax payments and the SSA monitors continuing eligibility for benefits. If an employer fails to withhold payroll taxes or does not pay the tax bills, or if a self-employed individual does not pay self-employment taxes, the IRS is responsible for collecting those taxes.[8] The SSA also recalculates benefit levels. For example, additional earnings after retirement may affect benefits.

Unlike products that are purchased at the retail level—mutual funds, for example—Social Security does not incur marketing or sales costs but still faces a substantial burden of serving workers and beneficiaries. Although the SSA does not need to sell its product to workers and beneficiaries, it assists workers and beneficiaries with their questions through its field offices and toll-free numbers. In 2002, the SSA's toll-free service responded to 51 million calls.[9] Each year, SSA sends statements summarizing lifetime earnings and projected benefits to covered workers over age 25 who file income tax returns. Restricting calculation of those statements to once a year reduces costs relative to products such as mutual funds, which generally update balances daily.

The SSA faces only small costs for asset management because of the simplicity of its investments and the relatively low level of assets held. Because the trust funds are restricted to invest in special government securities, asset management consists mostly of recording the number of securities owned by the trust funds, their maturity, and the interest earned. In addition, because the system is largely operated on a pay-as-you-go basis, the assets of about $1.4 trillion held by the trust funds at the end of fiscal year 2002 are small compared with future benefit obligations under current law.

6. The SSA is responsible for contacting employers when tax returns received by the IRS show higher total wages than do earnings reports received by SSA; the IRS has responsibility when tax returns show lower wages.

7. Social Security Administration, *Performance and Accountability Report for Fiscal Year 1999* (November 1999), p. 81.

8. Among self-employed workers, the self-employment tax is subject to substantial evasion because some individuals reclassify their income on their tax returns. See Joyce Manchester, "Compliance in Social Security Systems Around the World," in Olivia S. Mitchell, Robert J. Myers, and Howard Young, eds., *Prospects for Social Security Reform* (Philadelphia: University of Pennsylvania Press, 1999), pp. 295-312. The gains to people who evade payroll taxes by failing to declare earnings are partially offset because they ultimately receive lower benefits.

9. Social Security Administration, *Performance and Accountability Report for Fiscal Year 2002* (November 2002), p. 27.

Governmental Administrative Costs. Data on administrative costs in Social Security are available, but they can be difficult to interpret. The SSA can explicitly calculate its total administrative costs. However, although the SSA attempts to divide those costs between OASI and DI, the retirement and disability portions of Social Security, many costs contribute to more than one portion, making the allocation difficult.

Similarly, although the Treasury charges the trust funds for services performed by the IRS and the FMS (net of some services the SSA provides to the Treasury), it is difficult to separate the cost of the different administrative services of the SSA, IRS, and FMS. For example, the IRS incurs administrative costs in processing both income tax and payroll tax payments that often arrive simultaneously. There is no clear way, even in theory, to separate the costs of processing the two types of taxes. In addition, the reported costs may be understated if the agencies do not pay the full economic cost of their activities—for example, if they do not properly account for the cost of using government-owned buildings.

The reported governmental administrative costs of the OASI system in 2002 were less than $11 per participant (that is, workers plus beneficiaries) in the system.[10] One must be cautious in interpreting the implications of that cost for a system of private retirement accounts for several reasons. On the one hand, a system of accounts based on SSA procedures would not necessarily need to duplicate the entire administrative structure of the SSA, but it could instead take advantage of the existing structure. On the other hand, the SSA does not perform some roles that might be required in a system of accounts, such as investing in a mix of assets or crediting returns to individual workers. Nevertheless, the $11 charge represents about 2 percent of the average contribution under a system of private accounts with contributions of 2 percent of payroll ($547 in 2001); assuming that percentage remained constant over time, the costs would reduce assets in an account at retirement by an identical 2 percent.[11]

The administrative costs discussed above do not include the burden on the private sector. Costs to firms and individuals in the form of time and increased paperwork are probably substantial. However, it is difficult to assess the administrative burden for employers in dollar values because those costs depend on the individual circumstances of each employer (for example, their use of electronic reporting and the size of their workforce). Furthermore, it is difficult to separate the cost to employers of processing payroll tax contributions from other costs, such as remitting income taxes withheld from employees. For those reasons, this analysis makes no attempt to estimate the administrative burden on the private sector. Evidence about the operation of labor markets indicates that workers are likely to bear most of that burden in the long run.

The Thrift Savings Plan

The TSP is a defined-contribution plan available to workers in the federal government. Like Social Security, the TSP is a large-scale, centrally organized system. It offers some choice in assets and contribution levels, however, and in that respect is similar to private account plans. Services are intentionally limited to hold down administrative costs. No toll-free number is maintained for inquiries, for example. Unlike actively managed funds, TSP limits investment choice to a few funds that track financial market indices.

As of December 31, 2002, 3 million employees participated in the TSP, and the amount in all TSP accounts totaled more than $102 billion.[12] Workers under the Federal Employees Retirement System may contribute up to 14 percent of their wages (subject to a cap of $13,000 in 2004) to the TSP. The employing agency contributes 1 percent of wages and matches all employee contributions up to 3 percent of wages, and half of contributions be-

10. That calculation is based on administrative costs of $2.1 billion, divided by 153 million workers plus 46 million beneficiaries in the OASDI system (Social Security Administration, *2003 Annual Report of the Board of Trustees,* pp. 2, 4) minus 6.9 million beneficiaries under DI (Social Security Administration, *Annual Statistical Supplement, 2002,* Table 5.A1, p. 170). Costs including administration of the Disability Insurance program are substantially higher because of the more complicated tasks related to verifying disability claims; however, private accounts are unlikely to require such costly tasks.

11. The assumption that costs will remain a constant percentage of contributions amounts to an assumption that costs will rise at the same rate as average taxable earnings. A reasonable alternative would be to assume that costs will rise only with inflation rather than with earnings. However, using that assumption does not substantially affect the results—the estimated effect on balances at retirement still rounds to 2 percent.

12. Ernst & Young, *Financial Statements of the Thrift Savings Fund—2002 and 2001* (McLean, Va: Ernst & Young, March 2003), available at www.tsp.gov/forms/financial-stmt.pdf.

tween 3 percent and 5 percent of wages. (Employees under the older Civil Service Retirement System receive no matching contributions.)

Workers can allocate their contributions among five investment funds: an equity fund that seeks to match the S&P 500 stock index (the C fund); an equity fund that seeks to match the Wilshire 4500 index of small-capitalization corporations (the S fund); an equity fund that seeks to match the EAFE index of 21 stock markets in foreign countries (the I fund); a bond fund that seeks to match the returns of a broad index of government and private fixed-income securities (the F fund); and a fund composed of nonmarketable government securities that pay the average market rate of return on marketable U.S. Treasury securities with four or more years to maturity (the G fund).

TSP contributions and the returns on TSP assets are not taxable; however, withdrawals from TSP accounts are taxed as regular income. Funds can be withdrawn as a lump sum or in a series of monthly payments; alternatively, they can be used to purchase an annuity.

The task of collecting and processing contributions is split between the agency employing a worker and the Federal Retirement Thrift Investment Board (FRTIB), which oversees the plan. The Department of Agriculture's National Finance Center (NFC), under contract with the FRTIB, keeps the records of all TSP accounts. The personnel department in the employing agency reports the employer's and employee's contributions to the NFC. The NFC records the contributions and their returns. In addition, the FRTIB provides annual updates on the status of TSP accounts and information about investment strategy. The equity and bond index funds are managed by a financial firm. The management fee and the other administrative costs not borne by the employing agencies are paid out of the earnings on accounts and account balances that are forfeited to the TSP when employees leave federal service before they are vested.[13]

In addition to their role in collection and processing, the employing agencies have primary responsibility for employee education. The TSP Web site advises employees, "While you are employed, your agency is your primary TSP contact."[14] All the costs incurred by the employing agency are paid by that agency. Much like employers' costs of administering Social Security, those costs are difficult, if not impossible, to measure and are not included in published measures of the TSP's administrative costs.

Reported administrative and investment costs of the TSP totaled about $75 million in 2002 (excluding costs to the employing agencies). That translates to about $25 per participant.[15] Most of those costs represent payments to the NFC for recordkeeping.[16] The administrative costs of the TSP are held in check by several factors: investment choices are restricted; the system is quite large, and investments are bundled and made centrally; and all covered workers operate under the same payroll system, which simplifies recordkeeping. In addition, all records provided by the employing agencies are in electronic form. An annual cost of $25 would reduce the assets in an account receiving 2 percent of earnings by about 5 percent at retirement. However, the administrative costs of a universal system that offered the same services as the TSP could be higher because a different set of employers and employees would be covered. For example, many employers provide Social Security with paper earnings records, which are more costly to process than electronic records.

Mutual Funds

Mutual funds are collections of assets, chosen and managed by professionals. Individuals can purchase shares in mutual funds directly or through employer-sponsored retirement plans. The value of the shares rises and falls with the value of the assets in the mutual fund, minus administrative fees. Assets invested in mutual funds totaled over $6.4 trillion in 2002.[17]

In addition to enabling individuals to invest easily in a diversified portfolio of assets, mutual funds tend to offer a wide range of services. According to the Investment

13. Only the "agency automatic contribution" of 1 percent of pay, which is made by the employing agency, and the earnings on that contribution are ever forfeited. Employees are vested after two or three years, depending on the employing agency.

14. See www.tsp.gov/features/chapter01.html#sub3.

15. Ernst & Young, *Financial Statements of the Thrift Savings Fund—2002 and 2001.*

16. Ibid. The NFC is a government agency. Therefore, as is the case with Social Security's payments to the Treasury Department, it is not clear how closely the TSP's payments to the NFC correspond to true costs.

17. Investment Company Institute, *2003 Mutual Fund Fact Book* (Washington, D.C.: ICI, May 2003), p. 7.

Company Institute, an industry group, those services include "toll-free telephone service, 24-hour telephone access to account information and transaction processing, consolidated account statements, shareholder cost basis (tax) information, exchanges between funds, automatic investments, checkwriting privileges on money market and some bond funds, automatic reinvestment of fund dividends, and automatic withdrawals. Mutual funds also provide extensive investor education and other shareholder communications, including newsletters, brochures, retirement and other planning guides, and websites."[18]

Those services, together with marketing costs associated with sales at the retail level, tend to have higher administrative costs than those of lower-service systems such as Social Security. The administrative costs of mutual funds may therefore provide a guide to possible costs in a decentralized system of private accounts with an extensive choice of assets and a high level of services, perhaps modeled after individual retirement accounts (IRAs).[19] In that type of system, individuals make contributions, and financial management firms record and manage the accounts.

Analyzing mutual fund fees is complicated by the fact that they come in two varieties: shareholder fees and operating expenses. Shareholder fees, or loads, are primarily one-time fees paid when shares are purchased, sold, or shifted from one fund to another. Those fees generally finance commissions for investment advisers or salesmen. Shareholder fees may not exceed 8.5 percent by law, but few funds charge the maximum, and no-load funds levy no shareholder fee at all. Operating expenses are used to pay for the costs of running a fund and are generally charged as a percentage of the balance in an account.

Averages of the fees in each category are not available, but analysts at the Investment Company Institute have converted all fees to a single annual percentage-of-assets charge for purposes of comparison. According to those calculations, the dollar-weighted average annual fee on retail equity mutual funds was 1.28 percent of account balances in 2001; the average fee on bond mutual funds was 0.90 percent; and the average fee on money market mutual funds was 0.36 percent.[20] (The dollar-weighted measure accounts for the fact that less-expensive funds constitute a larger percentage of total investments.)

Asset allocation in IRAs, 401(k) plans, and similar retirement accounts suggests how assets in private retirement accounts might be divided among the different types of mutual funds. In 2002, retirement assets invested through mutual funds included $1,334 billion in equity mutual funds, $288 billion in bond funds, and $283 billion in money market funds.[21] Weighting the average fees on each type of mutual fund by those amounts yields an estimated average fee of 1.09 percent of assets per year. Because balances grow over time and the fee is charged against the total balance each year, a percentage-of-assets charge can have a surprisingly large effect on assets at retirement. Under moderate assumptions, a 1.09 percent annual fee would reduce assets at retirement by roughly 23 percent for an account held over an entire working life. A General Accounting Office survey of expense ratios found lower fees—0.70 percent of account balances for equity funds and 0.54 percent for bond funds—than the Investment Company Institute calculated (1.28 and 0.90, respectively), but GAO's estimates explicitly exclude shareholder fees.[22]

Overall industry averages mask significant differences in the average fees for various types of funds. Fees tend to be higher for funds that require more research. For example, the Investment Company Institute calculates that the average asset-weighted operating expense (not including shareholder fees) was 1 percent for international funds

18. Ibid., p. 14.

19. Such a system would include additional costs for monitoring, enforcement, and education, among other things.

20. John D. Rea, Brian K. Reid, and Travis Lee, *Total Shareholder Cost of Mutual Funds: An Update* (Washington, D.C.: Investment Company Institute, September 2002). In that study, the loads were translated into annual charges based on the average holding period for mutual funds. If private accounts were held longer than the average mutual fund, the annual cost would be somewhat lower. The holding period would be likely to depend partly on regulation—if workers were allowed to switch assets between funds at will, the holding period would probably be similar to the current average. If switching was not allowed, the holding period would be significantly longer. In that case, however, charges would probably increase in the long run to make up for the revenue lost because of reduced turnover.

21. Investment Company Institute, *2003 Mutual Fund Fact Book,* p. 56. An additional $209 billion was held in hybrid funds containing both bonds and equities, but estimates of shareholder costs for those funds are not available.

22. General Accounting Office, *Mutual Funds: Information on Trends in Fees and Their Related Disclosure,* GAO-03-551T (March 12, 2003), p. 7.

but only half that amount for growth and income funds.[23]

Private Defined-Contribution Plans

Defined-contribution pension plans are employer-sponsored retirement accounts. They tend to offer services similar to those provided by mutual funds; indeed, most plans include at least some mutual funds among a limited menu of asset choices. Their administrative costs can be higher or lower than those of mutual funds. Some defined-contribution plans have an extra layer of recordkeeping and collection costs on top of normal fees for retail mutual funds. However, larger plans may be able to negotiate discounted fees or bypass mutual funds by contracting directly for investment services.

One method of surveying administrative costs in defined-contribution plans is to solicit bids for hypothetical plans from firms that administer employer-sponsored pension plans. A survey by Pension Dynamics Corporation for *Money* magazine found that average fees for a large plan with 4,000 participants and $20 million in assets consisted of an administrative charge of $24 per participant and an investment fee of 0.8 percent of assets.[24] Those fees would reduce account balances by about 21 percent in a 2 percent-of-earnings system. Fees for a smaller plan, with 100 participants and $2 million in assets, were considerably higher on average: an administrative charge of about $60 per participant, and an investment fee of 1 percent of assets. Those fees would reduce account balances at retirement by about 30 percent.

One criticism of the survey method is that pension providers are unlikely to reveal their best price at an early stage of negotiations. Employers who actually hire pension providers may get discounts. Also, it is unclear what assumptions the providers make about the likely length of the contract and the future path of assets in pricing their plans.

Government data on pension plan costs avoid that problem, but they have other flaws. Some data on defined-contribution plan costs are included on Form 5500 and Form 5500 C/R, documents that all employers with pension plans must file with the IRS. The data from Form 5500 have significant shortcomings, however. First, the costs do not include financial management fees deducted from workers' accounts, which are often the largest category of fees. Second, firms may not always accurately separate the cost of pension administration from that of other administrative tasks; Form 5500 only details expenses explicitly charged to the plan, not those paid by the employer. For example, if a firm already has a personnel department with full-time employees, equipment, and office space, what portion of those costs should be ascribed to administering the pension plan? Third, published data on Form 5500 combine plans with very different features, making it difficult to interpret the implications of average costs for private plans with specific features. Finally, Form 5500 does not include the costs to the government agencies providing oversight and enforcement.

Tabulations of data from Form 5500 for 1998 show that defined-contribution plans reported spending an average of $49 per participant on administrative costs covered by the form.[25] That cost would reduce the balances in a 2 percent-of-payroll plan at retirement by about 9 percent. However, the average of $49 includes many plans that report no expenses—a finding that raises questions about the reliability of the data. The General Accounting Office used the same data source but excluded plans reporting zero costs. It found an average reported administrative cost of $103 per participant in 1993.[26] That cost would reduce the balances in a 2 percent-of-payroll account by about 19 percent. The actual impact would be greater, however, because the accounts would also be subject to investment fees, which are not included in the Form 5500 reports. Nonetheless, the evidence suggests that the results of the private surveys discussed earlier are unlikely to overestimate average costs.

Annuities

Investors in mutual funds and many private defined-contribution plans have a pool of assets at retirement. If they finance retirement expenses by withdrawing money

23. Investment Company Institute, *The Cost of Buying and Owning Mutual Funds* (Washington, D.C.: ICI, February 2004), p. 21.

24. Penelope Wang, "Protect Yourself Against the Great Retirement Rip-Off," *Money* (April 1997), pp. 96-101.

25. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin: Abstract of 1998 Form 5500 Annual Reports* (Winter 2001-2002).

26. General Accounting Office, *Private Pensions: Most Employers That Offer Pensions Use Defined-Contribution Plans,* GAO/GGD-97-1 (October 1996).

from that pool, they run the risk of running out of money before they die. For that reason, retirees may wish to convert some or all of their assets into a life annuity, a stream of payments that is guaranteed for the lifetime of the recipient (and, in the case of a joint life annuity, the recipient's spouse). Some proposals for retirement accounts would make conversion to annuities a requirement.

Annuities cost more than the value of the stream of payments they provide because financial firms must cover administrative costs, including marketing and sales. In addition, if the system allows people to choose whether to purchase them, the price of annuities will increase as a result of adverse selection: because longer-lived people are more likely to purchase annuities, the annuities cost more than they would if all purchasers had average life expectancy. That increased cost prevents some people from purchasing annuities even though they would choose to buy them if the price of the annuities was based on average life expectancy.

The impact of those factors is substantial. For a 65-year-old with average life expectancy, private annuities currently pay out about 15 percent to 20 percent less than they would if there were no administrative costs or adverse selection.[27] A person with average life expectancy who wishes to annuitize the balance in a mutual fund, for example, faces an additional burden of 15 percent to 20 percent on top of the costs paid to maintain the account up to that point. Of that amount, between 7 percentage points and 9 percentage points represent administrative costs, with the remainder resulting from adverse selection (which would not occur if annuitization was mandatory).[28]

The impact on payouts could be lower still if the annuities were purchased on a group basis through a central clearinghouse. For example, annuities purchased by 65-year-olds through the Thrift Savings Plan cost about 4 percent to 6 percent less than those purchased by men on the open market and 12 percent to 13 percent less than those purchased by women.[29] (Unlike most privately marketed annuities, the TSP annuities are offered at one price to both men and women. Because women live longer than men on average, annuities cost more for women when different prices are charged to men and women).

TSP annuities are voluntary, however, and therefore still subject to adverse selection. If the purchase of the annuities was mandatory, costs would be even lower. The evidence from the TSP suggests that if they were purchased through large groups, mandatory annuities could cost at least 4 percent to 6 percent less than they would if purchased individually. Consequently, although administrative costs might reduce the payout of individually purchased mandatory annuities by 7 percent to 9 percent of assets, group purchase could lower that reduction to 1 percent to 5 percent of assets.

27. See James M. Poterba and Mark J. Warshawsky, "The Costs of Annuitizing Retirement Payouts from Individual Accounts," in John B. Shoven, ed., *Administrative Aspects of Investment-Based Social Security Reform* (Chicago and London: University of Chicago Press, 2000); Olivia Mitchell and others, "New Evidence on the Money's Worth of Life Annuities," *American Economic Review,* vol. 89, no. 5 (December 1999), pp. 1299-1318; and Congressional Budget Office, *Social Security Privatization and the Annuities Market* (February 1998).

28. Mitchell and others, "New Evidence on the Money's Worth of Life Annuities," Table 3.

29. Poterba and Warshawsky, "The Costs of Annuitizing Retirement Payouts from Individual Accounts," Tables 5.1 and 5.4, pp. 177, 188.

CHAPTER

4

The Administrative Costs of a Personal Account System: Identifying the Trade-Offs

The evidence on administrative costs presented in this study can be used to illustrate some of the basic trade-offs in designing a system of personal accounts. The way a personal account system accomplished each administrative task—collection and processing of contributions, asset management, calculation and payment of benefits, and enforcement and oversight—could have a significant impact on administrative costs. However, each task might involve trade-offs; lower costs often mean reduced services.

Collection and Processing

The additional costs of collecting contributions could be reduced to the extent that the system of personal accounts adopted the procedures currently used by agencies such as the Social Security Administration and the Internal Revenue Service, and to the extent that choice of investments was limited.

If the system used the same collection procedures now used for payroll taxes, there would be no additional costs for that task (assuming the private accounts were financed by payroll taxes at their current level; there could be some adjustment costs for employers and the SSA if the payroll tax rate changed). If a different administrative structure performed the collection task, additional costs—at least as high as those in the current system—would probably be generated. Most proposals would maintain the current system for some portion of contributions, so the administrative costs of the new system would come on top of those of the old system. If the new system changed collection procedures to credit contributions to accounts more quickly, the costs would be higher because faster processing would require some combination of more employees, improved hardware, and more sophisticated software.

In a defined-contribution system with asset choice, information on asset allocation would also have to be collected and processed. If the choice of assets was restricted, little additional information would be required, and the costs of collecting and processing it would be reduced. In the extreme, if the system permitted investing in only one asset, no additional information would be necessary. By contrast, if the system allowed unlimited choice of assets, much more information would be required, generating higher costs.

Minimizing the cost of collection would limit services, of course. If the existing collection procedures were used, the system could credit contributions to specific workers only after a delay, meaning that workers would not be able to allocate contributions to their chosen investments immediately and might lose some returns in the meantime. In addition, workers might desire a broad choice of assets to tailor their portfolio to their own preferences.

Asset Management

Asset management costs would most likely be lower if the system was more centralized, for two main reasons. First, a centralized system can bundle together contributions to different accounts and invest them all at once. That reduces the costs of processing and transferring money. Second, larger purchasers have a great deal of buying power, so they may be able to reduce the profit margins of investment firms. For both reasons, a system in which investments were made through large groups, such as employers, would be likely to face lower asset-management costs than a system in which investments were made directly by individual workers. A system in which all investments were made through one central clearinghouse would be likely to have still lower costs.

A defined-contribution system must also maintain records on account balances. Tracking those balances requires the recording of contributions, allocation among asset types, returns on various assets, and loans and repayments (if allowed). The more choice that is permitted, and the more often contributions and balances can be shifted among assets, the more costly those tasks will be.

The cost of maintaining accounts could be reduced by limiting the transmission of account information to investors. For example, the system could provide infrequent statements or not offer a toll-free number for inquiries. Limiting the choice of assets and transfers between assets would also be likely to reduce the cost of providing account information because less-active accounts would probably generate less demand for information.

A related cost is that of investor education. Many people have little or no experience making investments. For that reason, it might be desirable to give workers information to help them make wise investment decisions. However, an investor-education program would increase costs.

In the absence of publicly provided information, workers would have to purchase investment advice or do their own research. Investment advice, such as that provided by a full-service broker or financial advisor, can be costly. Self-education could also require substantial time and effort, and might lead to more mistakes. Clearly, education would be more important if a greater range of investment choices was permitted.

Calculation and Payment of Benefits

In a system of personal accounts, the costs of calculating benefits would probably be low if high-quality records were kept. In a defined-contribution system, for example, if reliable records on account balances have been maintained, little or no additional calculation is required. Similarly, in a defined-benefit system such as Social Security, it is simple to calculate benefits given well-maintained earnings records. However, if records are poorly kept, applying benefit formulas can involve a costly process of data reconstruction. Of course, high-quality recordkeeping also carries costs.

The cost of paying benefits would be lower if the benefit level was more stable and fewer types of distribution were allowed. The level of service offered in response to inquiries would also influence costs. In addition, if account balances were to be converted to an annuity upon retirement, costs would be lower if annuitization was mandatory and if a central institution converted the funds into an annuity or pooled the funds and purchased annuities from a private provider rather than allowing individuals to make the purchase themselves.

The cost of distributing benefits to beneficiaries would most likely to be low as well. For example, in 1994, the Social Security Administration calculated that it cost about $2 per year to pay retirement benefits to each beneficiary. However, costs for processing changes are higher; each change of address costs the SSA about $7.[1] (That cost may fall as more payments are made electronically.) Similarly, costs would be higher if life events such as divorce or additional earnings after retirement altered the benefit level, requiring additional processing.

Costs would also be lower to the extent that services to beneficiaries are limited. For example, people might want advice about potential benefit levels or they might inquire about missed payments. Such information could be provided through face-to-face meetings at field offices, a toll-free telephone number, mailings, or a Web site or simply not be offered, in roughly descending order of expense.

Payment costs would also be lower if benefits were distributed only once, as a lump sum. To the extent that individuals had a choice of payout options—lump sum, annuity, or phased withdrawal, for example—costs could increase because administration would be more complicated. If benefits were disbursed in a lump sum, however, individuals might still face additional costs in managing the money.

Lump-sum distribution could also mean that some retirees might exhaust their assets before death.[2] Retirees could avoid that risk by converting their assets into an annuity. Buying annuities on an individual basis is expen-

1. Social Security Administration, *SSA Selected Workload Unit Costs* (1994).

2. Asset exhaustion could impose not only personal but also governmental costs. Those who ran out of assets could be eligible for income-supplement programs such as Food Stamps and Supplemental Security Income, as well as medical care through Medicaid, depending on their income level.

sive, though, in part for the same reasons that asset management is more expensive when accounts are purchased on an individual basis. The charges to accounts would most likely be somewhat lower if the annuities were purchased through a central clearinghouse or provided directly. In addition, if only some retirees purchased annuities, adverse selection would further raise the cost.

Adverse selection could be eliminated if the government made annuitization mandatory and put everyone in the same pool. In addition, mandatory annuitization could reduce expenditures on federal income-security programs such as Supplemental Security Income by ensuring that retirees did not spend their assets too quickly. With mandatory annuitization, all payments could be made along with traditional Social Security benefits; only one recalculation of benefits would be required. The conversion to an annuity could be done through contracts with private providers, or within the Social Security system, with taxpayers implicitly taking on the risk of unexpected changes in mortality and interest rates.

The combination of mandatory annuitization and purchase through a central clearinghouse would be the lowest-cost method of providing all retirees with an annuity, but that low cost would come at a price: some retirees would probably prefer to receive their benefits as a lump sum—either because they do not expect to live as long as the average person or because they would like to pass on some of their assets to their children. Furthermore, some workers would be forced to annuitize during temporary market downturns, which could significantly reduce their retirement resources.

Enforcement and Oversight

Enforcement and oversight costs would be lower to the extent that contributions were made through employers rather than individually. Monitoring contributions by individuals would be extremely difficult, and audits would not be cost-effective. By contrast, corporate employers are audited by outside accounting firms, with the results made public.