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Social Security Individual Accounts and Employer-Sponsored Pensions

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Summary

The President's 2001 Commission to Strengthen Social Security recommended that Social Security be modified to include voluntary individual accounts. The commission acknowledged that establishing and maintaining a system of individual accounts (IAs) could impose new costs on employers, particularly small employers. The commission's final report urged that in designing and implementing a system of IAs, policymakers should attempt to minimize the cost to employers while maintaining the features of IAs that would make them attractive to workers.

Pension analysts generally agree that designing individual accounts would require trade-offs between individual choice and efficient management. A relatively "high-cost" approach would create a system of IAs in which contributions to the accounts are deposited quickly, participants have substantial control over their accounts and have many investment choices, but in which employers must take on substantial new administrative duties. A "low cost" option would deposit contributions several months after they have been deducted from employees' pay, give participants less control over their accounts and provide few investment choices, but would minimize the administrative tasks required of employers. The low-cost approach to implementing Social Security individual accounts would avoid imposing significant new expenses on small businesses, but the result would be a system that would have few of the investment features common to modern §401(k) plans.

The ability of an employer to absorb new administrative costs associated with Social Security individual accounts would depend in part on its size and whether it already sponsors a retirement plan for its employees. Large employers would be able to spread the fixed costs of administering the accounts over more workers, thereby reducing average costs. Employers that already offer their employees a retirement plan have an administrative infrastructure in place to perform any new tasks that might be required to maintain a system of individual accounts. Most employers in the United States are *small* employers with fewer than 20 employees, and most small employers *do not* sponsor a retirement plan for their workers.

Employers could seek to offset cost increases that arise from administering individual accounts by reducing or restructuring the benefits they currently offer to their employees. For example, employers who must absorb new costs to help administer IAs might reduce contributions to their §401(k) plans or otherwise reduce their existing pension benefits. Social Security IAs also could affect employees' contributions to §401(k) plans. With more of their future retirement income dependent on investment returns, some workers might invest their §401(k) contributions more conservatively. Alternatively, exposure to greater investment risk could encourage some employees to increase their contributions to §401(k) plans in an attempt to offset some of this risk. As they gain experience with the accounts, some workers might develop a "taste for saving" that would persuade them to save more through other savings vehicles such as Individual Retirement Accounts (IRAs).

This report will not be updated.

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Social Security Individual Accounts and Employer-sponsored Pensions

Introduction: The President's Commission

In December 2001, the President's Commission to Strengthen Social Security issued its final report. The report concluded that "Social Security will be strengthened if modernized to include a system of voluntary personal accounts."[1] The commission acknowledged that establishing and maintaining a system of individual accounts (IAs) could impose new costs on employers, particularly small employers. They urged that in designing and implementing a system of IAs, policymakers should attempt to minimize the cost to employers while maintaining the features of IAs that would make them attractive to workers. Because small employers would have more difficulty absorbing new costs than large employers, the commission cautioned that "personal account administration should not add any burden to small employers."[2] This CRS report describes employers in the United States in terms of their size, sponsorship of employee benefits, and other characteristics that might influence the extent to which implementing and administering IAs could add to employers' operating costs. It discusses the features of IAs that are most likely to affect their administrative costs and how the policies and procedures that might minimize those costs could also affect the extent to which participants would be able to exercise control over their individual accounts.

Over the past several years, a number of retirement policy analysts have considered the technical and administrative issues that would need to be addressed if individual accounts were to be added to the Social Security program. There has been general agreement among policy analysts that either of two approaches could be taken in designing and implementing a system of Social Security IAs. One approach would create a system of IAs in which contributions to the accounts are deposited quickly, participants have substantial control over their accounts and have many investment choices, but in which employers must take on substantial new administrative duties to assure that these goals are achieved. For employers, this would be a relatively "high cost" option. A "low cost" system would deposit contributions to the accounts several months after they have been deducted from employees' pay, give participants relatively little control over their accounts and provide few investment choices, but would minimize the administrative tasks required of employers.

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[1] President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, December 2001, p. 11.

[2] President's Commission, p. 47.

One pension analyst has described the design and implementation of individual accounts as requiring inevitable "trade-offs between free choice and efficient management,"[3] while another has observed that "the central issues in designing personal accounts involve tradeoffs between relatively standardized low-cost options with constrained individual choice and limited risk on the one hand and more flexible higher-cost options with enhanced opportunities for individual control and greater risk on the other."[4] One implication of the tradeoff between individual choice and administrative efficiency is that while it would be possible to design a system of individual accounts that would keep administrative costs low and avoid imposing significant new expenses on small businesses, "that system would likely bear little or no resemblance to a modern 401(k) plan."[5] For IA participants, "keeping the system as simple and inexpensive as possible would mean limiting the choices that make IAs attractive in the first place."[6]

Overview of Employer-sponsored Retirement Plans

Two characteristics of employers that would affect their ability to absorb administrative costs associated with Social Security individual accounts are their size and whether they already sponsor a retirement plan for their employees. Large employers can spread the fixed costs of administering accounts over more workers, thereby reducing average costs. Employers that offer their employees a retirement plan already have an administrative infrastructure in place to perform new tasks that might be required to maintain a system of individual accounts. For these reasons, it is important to note that (1) most employers in the United States are *small* employers with fewer than 20 employees; and, (2) most small employers *do not* sponsor a retirement plan for their workers and therefore do not have an existing administrative infrastructure to handle any new administrative tasks associated with individual accounts. Because of the limited resources they have available to deal with new administrative tasks, "small businesses may be particularly affected by reforms that add individual accounts to Social Security."[7] The Government Accountability Office (GAO) has observed, that "while large employers appear to be better able to handle the costs and administrative demands of an individual account system, smaller employers may face greater difficulties, such as reduced profitability, that could reduce their willingness to provide pensions."[8]

Although more than half of all workers in the United States are employed at firms with 100 or more employees, most employers in the U.S. are small firms. For example, of the 5.7 million private-sector firms in the United States in 2000, 3.4 million (60%) had fewer than five employees, and 5.0 million (88%) had fewer then 20 employees. (See **Table 1**.) Most small employers do not offer a retirement plan

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[3] Schreitmueller, p. 11.

[4] Burke and McCouch, p. 1328.

[5] EBRI, 2001, p. 4.

[6] EBRI, March 1999, p. 2.

[7] EBRI, April 1999, p. 3.

[8] GAO, 00-187, p. 30.

to their employees. According to the Census Bureau's *Current Population Survey* (CPS), of the 66.9 million people who worked at firms with fewer than 100 employees in 2003, just 19.7 million (29.5%) worked for an employer that offered a retirement plan to its employees. In other words, seven out of ten workers at small firms worked for employers who did not offer either a pension or §401(k)-type plan to their employees in 2003. Employers would not be able avoid incurring any new administrative costs associated with IAs by declining to participate in the system, because even if the accounts are *voluntary* for employees they would be *mandatory* for employers. All employers would have to accommodate the wishes of employees who wanted to establish Social Security individual accounts.

New administrative costs would not necessarily be limited to employers that do not now offer their employees a retirement plan. Some employees who work for employers that sponsor retirement plans are ineligible to participate in those plans. The Employee Retirement Income Security Act (ERISA, P.L. 93-406) allows employers to exclude from their retirement plans workers who are under 21 years old, who work fewer than 1,000 hours per year, or who have worked for the employer for less than one year. These exclusions reduce employers' administrative costs and thus encourage employers to sponsor plans.[9] Employers who already offer retirement plans to their employees could face higher administrative expenses if, as the President's Commission recommended, all workers who now participate in Social Security would be eligible to establish a Social Security individual account.

Table 1. Firms and Establishments by Employment Size in 2000

Number of employees	Employers (in thousands)	Percent
All firms	**5,653**	**100%**
Under 5 employees	3,397	60.1
5 to 9 employees	1,021	18.1
10 to 19 employees	617	10.9
20 to 99 employees	516	9.1
100 to 499 employees	84	1.5
500 or more employees	17	0.3
All establishments	**7,070**	**100%**
Under 5 employees	3,406	48.2
5 to 9 employees	1,035	14.6
10 to 19 employees	652	9.2
20 to 99 employees	674	9.5
100 to 499 employees	312	4.4
500 or more employees	990	14.0

Source: *U.S. Small Business Administration,* Office of Advocacy, March 2003.
Note: Excludes government employees, railroad employees, and self-employed workers. A *firm* is a business under a single management. It may include one or more *establishments*.

[9] The "Minimum Universal Pension System" (MUPS) proposed by the Carter Administration in 1980 would have allowed employers to restrict participation to workers between the ages of 25 and 65 with more 1,000 hours of service per year.

Large and Small Firms Employ Different Kinds of Workers. The administrative costs of individual accounts relative to the account balances would depend in part on the characteristics of the employees who participate in the system of IAs. Relative to account balances, administrative costs will tend to be lower for employees who remain with an employer for longer periods of time, who work full-time, and who have higher annual earnings. These characteristics are more common among employees of large firms than those of small firms. The data displayed in **Table 2** show that workers whose employers currently offer retirement plans differ in several respects from workers whose employers do not offer such plans. In general, workers whose employers do not offer retirement plans are younger (and therefore change jobs more frequently), work fewer hours, earn lower wages, and work for smaller firms than workers whose employers offer retirement plans. For many such workers, annual contributions to an IA would be small and administrative expenses would be large relative to their account balances. Among the 152 million workers in the United States in 2003:

- 23.6 million were under 25 years of age and 15.8 million (67%) of those under age 25 worked for employers who did not offer a retirement plan;

- 28.9 million had earnings of less than $10,000 and 21.3 million (74%) of those with earnings under $10,000 worked for employers who did not offer a retirement plan;

- 10.3 million typically worked fewer than 20 hours per week and 7.5 million (73%) of those who worked fewer than 20 hours per week worked for employers who did not offer a retirement plan;

- 47.4 million were employed at firms with fewer than 25 employees and 37.3 million (79%) of those who worked at firms with fewer than 25 employees worked for employers who did not offer a retirement plan.

Table 2. Employee Characteristics by Employer Retirement Plan Sponsorship, 2003

(number of workers, in thousands)

Age	All workers	Employer sponsors a retirement plan		Employer does not sponsor a plan	
		Workers	*Percent*	Workers	*Percent*
15 to 19	7,852	1,784	*2.2%*	6,068	*8.6%*
20 to 24	15,754	5,977	*7.3*	9,777	*13.8*
25 to 34	32,807	17,583	*21.6*	15,224	*21.6*
35 to 44	36,604	21,367	*26.3*	15,237	*21.6*
45 to 54	34,058	21,236	*26.1*	12,822	*18.2*
55 to 64	18,843	11,147	*13.7*	7,696	*10.9*
65 and up	6,082	2,276	*2.8*	3,806	*5.4*
Total	152,000	81,370	*100%*	70,630	*100%*
Earnings in 2003					
Under $5,000	16,846	3,858	*4.7%*	12,988	*18.4%*
$5,000 - $9,999	12,101	3,775	*4.6*	8,326	*11.8*
$10,000- $19,999	26,923	9,970	*12.3*	16,953	*24.0*
$20,000- $29,999	26,054	13,989	*17.2*	12,065	*17.1*
$30,000- $39,999	21,255	13,874	*17.1*	7,381	*10.5*
$40,000- $49,999	15,172	10,768	*13.2*	4,404	*6.2*
$50,000 and up	33,650	25,136	*30.9*	8,514	*12.1*
Total	152,000	81,370	*100%*	70,630	*100%*
Hours usually worked per week					
Fewer than 10 hours	3,297	794	*1.0%*	2,503	*3.5%*
10 to 19 hours	6,969	2,016	*2.5*	4,953	*7.0*
20 to 29 hours	13,049	4,467	*5.5*	8,582	*12.2*
30 hours or more	128,684	74,092	*91.0*	54,592	*77.3*
Total	152,000	81,370	*100%*	70,630	*100%*
Firm size (# of workers)					
Fewer than 10	32,130	5,366	*6.6%*	26,764	*37.9%*
10 to 24	15,298	4,783	*5.9*	10,515	*14.9*
25 to 99	19,473	9,578	*11.8*	9,895	*14.0*
100 to 499	19,753	12,643	*15.5*	7,110	*10.1*
500 to 999	8,008	5,527	*6.8*	2,481	*3.5*
1,000 or more	57,338	43,473	*53.4*	13,865	*19.6*
Total	152,000	81,370	*100%*	70,630	*100%*

Source: CRS analysis of the March 2004 *Current Population Survey*.

Administrative Tasks and Individual Accounts

Social Security IAs could increase employers' operating costs both directly and indirectly.[10] Employers' costs would be affected directly to the extent that they would be required to help administer the accounts. Some administrative tasks may be performed by the Social Security Administration (SSA) or another governmental agency, and some may be performed by private sector financial institutions (such as mutual fund providers), but responsibility for other administrative tasks could fall to employers. Whether these costs would be borne fully by the account owners, or would be shared among the account owners, employers, financial service providers, and the government would depend on the specific features of the IAs and the manner in which the accounts are set up, administered, and regulated.

For employers, administrative tasks associated with individual accounts could include:

- informing each employee of the option to participate in a voluntary IA;
- enrolling interested employees in the system;
- establishing and maintaining a record for each account;
- sending individual account contributions to the central administrator or other entity;
- correcting errors in the amounts contributed or the fund in which contributions were invested; and
- tracking employees' marital status so that account balances can be divided in the event of divorce.[11]

Centralized vs. Decentralized Administration. Costs to employers of administering IAs would depend in part on whether the administrative and record-keeping functions would be centralized or decentralized. A centralized system could build on the existing tax collection and record-keeping systems of the SSA and the IRS. A centralized system that allowed employers to continue using their current procedures for reconciling tax payments would be more likely to maintain the current level of employer costs and administrative responsibilities, but it would result in significant delays in crediting contributions to participants' accounts because many small employers continue to file wage reports on paper once a year. A decentralized system would require employers to reconcile tax collections and individual contributions more frequently, to transmit contributions to a greater number of public and private entities, and might require all employers to submit both contributions and financial reports electronically. A decentralized system would provide a higher level of service to participants, but would increase costs for many employers. Higher costs for IAs might inadvertently cause some employers to reduce or eliminate the retirement benefits they offer to their employees.

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[10] Under current law, both the employer and employee contribute an amount equal to 6.2% of pay to the Social Security trust fund for benefits under Old Age, Survivors, and Disability Insurance (OASDI), more commonly known as Social Security.

[11] EBRI, 2001, p. 9.

Promptness and Accuracy of Record-Keeping. The current Social Security program is a *defined benefit* plan in which a worker's retirement benefit is based on a record of his or her past earnings. Although all workers who are covered under Social Security (about 96% of the workforce) pay social security taxes, "an individual's benefit bears no direct relationship to his or her total contributions."[12] An individual's Social Security benefit is based *solely* on the benefit formula written into law by Congress, regardless of the amount of Social Security taxes previously paid by each covered worker. In this system, small errors in employers' reports of employee earnings or delays in recording those earnings on each worker's Social Security record rarely affect the amount of the worker's retirement benefit. In fact, under the current system, "even in instances in which an employer fails to report earnings, workers who can provide evidence of those earnings have them credited to their record."[13] In contrast, in a *defined contribution* plan — such as Social Security IAs — the worker's benefit consists of the balance in the account at the time the worker retires. The account balance is the sum of all past contributions, interest, dividends, and capital gains minus any pre-retirement withdrawals and investment losses. Defined contribution plans require "accurate and timely record keeping"[14] so that contributions can be invested promptly and begin to earn interest, dividends, and capital gains.

Remitting Income and Payroll Taxes. Employers are responsible for sending both Social Security payroll taxes and federal income taxes withheld from employees' pay to the federal government. The majority of employers today send payroll taxes and federal income taxes in lump-sum payments to Federal Reserve Banks or other authorized institutions. At least once each calendar quarter employers must submit a report (IRS Form 941) that summarizes their total tax deposits. This report indicates only the *aggregate* amount of taxes withheld from workers' pay. It does not indicate the amount of taxes paid by each worker, nor even how much of the total represents payroll tax and how much is income tax. Reconciliation of gross tax payments with individuals' earnings is done just once each year on the Form W-2. Small employers are permitted to file reports on paper, and most still do so. In 2003, although **60%** of workers' W-2 forms were submitted to the Social Security Administration electronically or on magnetic tape or cartridge, **72%** of employer reports to SSA (Form W-3) were submitted on paper, mostly by small employers. According to SSA, "the reason for this is the vast amount of small and medium-sized businesses (under 250 employees) that send SSA paper wage reports."[15]

Frequency of Remitting Taxes and Contributions. The frequency with which contributions must be transmitted to the IA central administrator or other entity would directly affect the cost of administering IAs. The 2001 report of the President's Commission on Strengthening Social Security stated that "personal account owners are entitled to have their contributions credited to their personal

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[12] Schreitmueller, p. 12.

[13] SSA, 2001, p. 5.

[14] American Academy of Actuaries, 2003, p. 2.

[15] Personal communication with SSA Office of Legislation & Congressional Affairs, January 5, 2005.

accounts in a timely and accurate fashion, but without imposing additional compliance costs on employers."[16] The Commission recognized that imposing new requirements on employers could also impose new costs, stating that "to prevent compliance costs from increasing, employers must be allowed to continue to submit contributions through the existing payroll tax system, which requires some centralization."[17]

The two goals of depositing contributions quickly while imposing no new costs on employers could be difficult to reconcile in practice. Using the existing payroll tax system is widely regarded as the lowest-cost option for transmitting contributions to IAs, but it would do so only with a considerable delay between the time the money would be withheld from the worker's pay and the date on which it would be deposited to the investment account of his or her choice.[18] The Social Security Administration has estimated that in a low-cost system of IAs, "contributions would be credited to specific individuals' IAs within seven to 22 months after being deducted from workers' earnings."[19] The President's Commission acknowledged that "using the current payroll contribution system, it would take about 15 months on average before payroll contributions are credited to personal accounts."[20] Because it would be costly for small employers to transmit contributions more quickly, the Commission recommended that IA funds should be invested in interest-bearing government bonds during the period between the date that the contributions are deducted from employees' pay and the time at which they are allocated to each individual's account.

Both the frequency and method of reporting information would be important factors in determining the administrative costs associated with individual accounts.[21] The delay between withholding Social Security taxes and posting earnings to workers' social security records occurs in part because the reporting system in place today is designed to keep the demands on employers' time and resources to a minimum. Faster processing of contributions would require accelerating the frequency of the wage-reporting process, and in that case, "employers'

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[16] President's Commission, p. 44.

[17] President's Commission, p. 45.

[18] EBRI has said that "making use of the current payroll system would be the most cost-effective way to implement an IA system without adding administrative costs and burdens to employers related to enrollment and contributions." (EBRI, 2001, p. 17.) The GAO has noted that "building on the current system and keeping records centrally could achieve economies of scale and minimize additional burdens and costs for employers and individuals." (GAO, 99-122, p.18.) Likewise, the American Academy of Actuaries has stated that IA proposals could "reduce administrative costs by taking advantage of the current infrastructure for tax collection." (American Academy of Actuaries, 1998, p.3.)

[19] SSA, 2001, p. 6, SSA also estimates that "if SSA had additional resources, processing the majority of reported W-2 earnings to earnings records could theoretically be performed within two to 13 months of the date payroll taxes were withheld from a given paycheck." (SSA, 2001, p. 18, footnote.)

[20] President's Commission, p. 47.

[21] SSA, 2001, p. 17.

responsibilities for sending and reporting payroll contributions would grow in number and frequency."[22] Employers might, for example, be required to report W-2 information along with the quarterly wage and tax statements they submit to the IRS on Form 941. This was the case prior to 1978, when Congress ended the requirement for quarterly reporting of W-2 information to SSA. Inevitably, however, "employers would incur additional administrative costs from having to report more frequently."[23] According to SSA, "the burden of more frequent periods of reporting would fall disproportionately on the self-employed, small employers (over 80% of the employer universe), and employers who prepare records manually."[24] The process of crediting earnings to employee records (or allocating contributions into individual accounts) also could be accelerated by requiring all employers to submit wage reports electronically. The use of electronic filing has increased substantially in recent years; however, the Congressional Budget Office (CBO) expects that "many small employers are likely to continue to file on paper in the foreseeable future."[25]

Employer costs of submitting taxes and reporting earnings could increase under a system of IAs even if the frequency of reporting were not increased, because under a *defined contribution* retirement system such as individual accounts, employer reports would need to be held to a high standard of accuracy.[26] Currently, if the difference between wages reported and the payroll taxes submitted is less than one Social Security wage credit ($920 in 2005), SSA takes no further action because errors of less than one wage credit rarely affect an individual's retirement benefit.[27] Discrepancies much smaller than this amount probably would not be tolerated by participants in a system of Social Security IAs. Consequently, the number of errors that SSA and employers need to resolve would increase substantially.

Although maintaining the current system of submitting taxes and earnings reports would minimize costs to employers, a time lag of seven to 22 months would elapse between the date when IA contributions would be deducted from pay and when these contributions would be allocated to individual workers' accounts. This lag, referred to as a "float period" could reduce workers' future benefits by "reducing the amount of time that contributions have to accrue investment earnings based on workers' individual fund choice(s)."[28] Long delays in crediting deposits to individual accounts are not permitted in §401(k) plans sponsored by employers in the private sector. Federal law requires employers to deposit account contributions into

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[22] SSA, 2001, p. 6.

[23] SSA, 2001, p. 19.

[24] SSA, 2001, p. 19.

[25] CBO, 2004, p. 10. According to the Social Security Administration, "although requiring all employers to submit electronically may appear to be an optimistic assumption, it is consistent with actions currently under way at the Internal Revenue Service to increase the frequency of electronic reporting." (SSA, 2001, p. 20, fn.)

[26] SSA, 2001, p. 22.

[27] If the taxes submitted are less than the amount owed, the IRS may take action to collect the amount due, even if the discrepancy is less than the equivalent of one wage credit.

[28] SSA, 2001, p.18.

employee accounts within 15 days of the beginning of the month after the contribution is made. However, if this were required of Social Security individual accounts, it "would dramatically increase administrative expenses for the millions of employers that do not offer defined contribution plans, and therefore do not have the administrative infrastructure already in place to assist in the administration of IAs."[29]

Investment losses during the "float period" could be reduced by "investing contributions on a pooled basis with investment earnings allocated at the same time as contributions are posted."[30] The President's Commission proposed "that the aggregate pool of contributions be invested in government bonds until information on contributions by individuals is reconciled with aggregate employer payments."[31]

Reconciling Errors. In order to protect workers from errors made by their employers in reporting earnings or submitting payroll taxes, the Social Security Administration posts earnings credits to participants' records even if the employer has failed to send the attendant taxes, provided that the individual can provide proof of earnings. Unless workers are "held harmless" in this way under an IA system, some of them could lose substantial contributions and investment earnings because of employers' errors or noncompliance. However, being held harmless in a cash-based system like IAs "requires someone else (such as the government) to contribute money to replace these lost funds."[32] In the event of an employer's bankruptcy, lost contributions may never be recovered. In those cases, the government may be the only possible source of funds to make the workers' accounts whole.

Errors in wage reporting to SSA are not uncommon, and some cannot be resolved. The Congressional Budget Office reports that "about 9 million of the approximately 250 million earnings records that the SSA processes each year cannot be reconciled with the master file."[33] SSA notes that in a system of IAs, "unresolved discrepancies could lead to appeals that would mean additional expenses for SSA and employers."[34] The high rate of turnover among small businesses also would present a challenge to administering a system of individual accounts for Social Security. About 650,000 employers — more than 10% of the total — start up or go out of business each year, possibly creating difficulties in ensuring that contributions are collected and applied to individual accounts. After an employer goes out of business, recovering lost or misplaced funds would be difficult.[35]

Distributing Funds from Accounts. Employers might have to consider changes to their pension plans to coordinate them with the rules for taking

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[29] EBRI, 2001, p. 19.

[30] EBRI, 2001, p.17.

[31] President's Commission, p. 47.

[32] EBRI, 2001, p. 30.

[33] CBO, 2004, p. 9.

[34] SSA, 2001, p. 21.

[35] GAO-99-122., p. 20

distributions from Social Security individual accounts. In 2005, full Social Security benefits are available at age 65 and six months. Reduced benefits are available at age 62, and this will continue to be the case after the full retirement age reaches 67 in 2022. Workers with §401(k) accounts may start to take distributions without penalty at age 59½. Section 72(t) of the Internal Revenue Code allows penalty-free distributions from individual retirement accounts (IRAs) and §401(k) plans before age 59½ in certain instances, such as to purchase a primary residence or to meet qualifying educational expenses, or if taken in a series of payments based on life expectancy. The President's Commission recommended that no such pre-retirement distributions should be permitted from IAs.[36] To minimize confusion among participants and to ease administrative burdens on employers, Congress would need to consider how the rules for taking distributions from Social Security individual accounts would interact with those that now apply to Social Security and to distributions from §401(k) plans and IRAs.

Educating the Public. Participants in a system of individual accounts would need to be educated about the rules for participating in the plan, the available means of taking money out of their account at retirement, and such essential financial concepts as investment diversification, market risk, and the effects of compound interest on account balances over long periods of time. Investor education would be particularly important for people who are unfamiliar with making investment choices, especially low-income workers, those with less formal education, and those for whom English is a second language.[37] It is likely that primary responsibility for this ongoing educational effort would fall to the federal government because "employers would be very unlikely to accept the burden of educating employees about the Social Security decision."[38]

Other Issues

Social Security IAs and Pension Integration. When designing their pension plans, employers sometimes take into account the Social Security taxes they pay and/or the benefits that Social Security provides. Pension plans that "explicitly incorporate Social Security benefits or contributions into their plan design" are called *integrated* plans.[39] Adding individual accounts to Social Security could cause some employers to change the type of pension integration they use or the type of retirement plan they offer. In defined benefit plans, integration is usually related to the *benefit paid* to participants, while in defined contribution plans it most often relates to the *contributions made* by employers.[40] In an integrated *defined benefit* plan, the amount of the worker's monthly pension is reduced or *offset* by a percentage of his or her Social Security benefit. In an integrated *defined contribution* plan, the amount

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[36] "Pre-retirement access to funds in personal accounts should not be allowed." (President's Commission, p. 55.)

[37] GAO, 99-115, p. 56.

[38] American Academy of Actuaries, 2002, p. 3.

[39] GAO, 00-187, p. 4.

[40] GAO, 00-187, p. 15.

contributed by the employer is higher for the portion of the employee's salary that is *in excess* of a specific amount, called the integration level. The most common integration level is the maximum amount of annual income that is subject to Social Security taxes ($90,000 in 2005). Federal law limits the extent to which an employee's defined benefit pension can be reduced under the "offset" method and the permissible disparity in contributions between lower- and higher-income employees under the "excess" method of integration.

Adding individual accounts to Social Security could induce some defined benefit plan sponsors that integrate through the *offset* method to abandon pension integration because this method requires that they estimate the participant's Social Security benefit to calculate the appropriate pension offset. With IAs, estimating the benefit to determine the appropriate offset would be difficult. Some employers might abandon defined benefit plans integrated through the offset method in favor of defined contribution plans integrated through the excess method. In an integrated defined contribution plan, the employer needs only to satisfy IRS regulations on the permitted disparity between contributions for workers whose earnings are less than the integration level (typically the annual Social Security taxable maximum) and those whose earnings are above the integration level.

Reductions in traditional Social Security benefits could increase pension costs for employers that sponsor integrated *defined benefit* pension plans because reducing Social Security benefits would result in a smaller pension offset, and thus a bigger pension payment. In response, employers "could redesign their plans to eliminate that feature, absorb the costs, or take other actions."[41] Because the integration rules for *defined contribution* plans are tied solely to *employer contributions* to Social Security, they would not be affected by changes in promised benefits under the traditional Social Security program. If, however, Social Security payroll taxes were increased or if the cap on taxable earnings were raised, employers who integrate their defined contribution plans through the *excess* method "might adjust upward the integration level of plans, thus reducing the number of covered workers eligible for higher contributions or accruals."[42]

Employers' Fiduciary Responsibilities. In a §401(k) plan, the employer transmits contributions directly to the financial institution that manages the account or to an administrator that forwards deposits to a number of such financial institutions. In handling employees' account contributions and performing other activities, employers take on a *fiduciary* responsibility with respect to their employees' retirement accounts.[43] In establishing a system of Social Security IAs, it would be important for Congress to define the fiduciary responsibilities that

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[41] GAO, 00-187, p. 19.

[42] GAO, 00-187, p. 20.

[43] A fiduciary is a person or institution in a position of trust, confidence, or responsibility with respect to the property of another. Federal law requires that anyone acting as a fiduciary in a retirement plan must act solely in the best interest of the plan participants.

employers would have for managing their workers' IA contributions.[44] The Employee Retirement Income Security Act requires, among other things, that in managing their employees' retirement funds, employers have a fiduciary responsibility to act solely in the best interests of the plans' participants and beneficiaries. In establishing employer responsibilities for IA's, "the role of ERISA — or some other entity or mechanism to safeguard individual account accumulations — would need to be carefully considered."[45] Legislation also might consider a need to define the extent to which employers that offer investment advice or education for IA participants would be taking on fiduciary responsibilities.

Possible Employer Responses to Increased Costs. Employers could seek to offset any increases in costs that arise from administering individual accounts by reducing or restructuring the benefits they currently offer to their employees. For example, the American Academy of Actuaries has expressed concern that employers who must absorb new costs to help administer IAs "might reduce contributions to their pension and §401(k) plans."[46] Employee contributions to employer-sponsored plans could be affected too, because if employers were to cut back on §401(k) contributions in response to new costs from administering IAs, employee contributions to §401(k) plans might decline. Similarly, the GAO has noted that "employers might seek to offset any higher costs arising from individual accounts by reducing or restructuring their existing pension plans."[47] The ERISA Industry Committee (ERIC) has suggested that if administrative costs of IAs are significant, they "could cause a shrinkage of pension sponsorship."[48]

Possible Employee Responses to Individual Accounts. Workers may find that Social Security individual accounts do not offer the same range of investment choices or the amount of individual control over contributions that a typical §401(k) plan offers. In a §401(k) plan, for example, contributions must be deposited into employee accounts soon after the contribution is made. If, to prevent Social Security IAs from imposing new costs on small employers the current method of collecting Social Security payroll taxes is used to process IA contributions, there would be a "float period" of roughly seven to 22 months between the time payroll taxes are withheld from an employee's pay and the date when those taxes are credited to his or her IA investment account. During that period, the funds would probably be held in U.S. Treasury bonds, as is the case with the Social Security trust fund today. As another measure to prevent IAs from imposing new costs on employers, the President's Commission recommended that participants should be permitted to re-direct their contributions among investment funds and re-allocate account balances

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[44] "The private sector faces many unresolved issues with individual accounts — such as the fiduciary responsibility that employers would likely face for managing their workers' contributions." EBRI, March 1999, p. 3.

[45] GAO, 99-122, p. 19.

[46] American Academy of Actuaries, 1998, p. 4.

[47] GAO, 00-187, p. 31.

[48] EBRI, March 1999, p. 4.

among funds just once a year.[49] Participants in §401(k) plans typically have the opportunity to re-direct new contributions and re-allocate account balances at least monthly.

How the opportunity to participate in Social Security IAs might affect employees' participation in or contributions to employer-sponsored retirement plans would depend on their perceptions of the potential for the accounts to increase their retirement income, their expectations about the future benefits they will receive from the traditional Social Security program, and their attitudes toward risk. Even if there is no increase in the payroll tax, IAs could affect employees' contributions to §401(k) plans. If employees believe that a reduced Social Security benefit plus the IA balance would provide adequate retirement income, some workers "may offset their individual account saving by saving less elsewhere or borrowing more."[50] With more of their future retirement income dependent on investment returns, some workers might invest their §401(k) contributions more conservatively, seeking to reduce the increased investment risk that would result from replacing part of Social Security with IAs. Alternatively, greater exposure to investment risk could encourage some employees to increase their contributions to §401(k) plans in an attempt to offset some of this risk. Some workers who currently contribute little or nothing to §401(k) plans might increase their contributions as they gain knowledge and experience as investors. Given the opportunity to invest in financial markets, some workers might develop a "taste for saving" that would persuade them to save more for retirement through vehicles such as Individual Retirement Accounts (IRAs).

The possibility that some employees might see the introduction of IAs as an opportunity to cut back on other retirement saving would need to be carefully addressed in worker education efforts. For example, employees' responses to IAs also could affect employers if some workers perceive the IA as a *substitute* for their employer-sponsored retirement savings plan rather than a *complement* to it. If some workers reduce their contributions to their employer's §401(k) plan, the employer might find it more difficult to meet the "nondiscrimination" requirement of the tax code, which prohibits contributions by highly-compensated employees in employer-sponsored retirement plans from exceeding the contributions of lower-paid employees by more than specific ratios. In some cases, this possibility might persuade employers to adopt "safe harbor" 401(k) plans in which the employer makes contributions for all eligible employees. Other employers might seek to satisfy the nondiscrimination requirements by adopting automatic enrollment in their plans.

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[49] President's Commission, p. 48.

[50] GAO, 00-187, p. 32.

The Thrift Savings Plan: A Model for Individual Accounts?

Both the President's Commission on Strengthening Social Security and President Bush himself have referred to the *Thrift Savings Plan* (TSP) for federal employees as a possible model for the structure of individual accounts under Social Security.[51] The TSP currently has more than 3 million participants and has assets of more than $150 billion, making it the largest defined contribution plan in the United States. The TSP offers participants five investment funds: one that invests in U.S. Treasury bonds, one that invests in private-sector bonds, and three that invest mainly in common stocks. The private-sector bond fund and the common stock funds are passively managed "index funds" that track the performance of broad market indices. Index funds have substantially lower administrative costs than actively managed mutual funds. In its most recent annual report, the TSP reported administrative costs of just six basis points, or six-hundredths of 1%. In other words, the administrative expenses of the TSP are about 60 cents for each $1,000 invested. This is far lower than the average administrative costs of §401(k) plans in the private sector, where total administrative costs under 50 basis points are rare.

The Congressional Budget Office (CBO) recently observed that "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."[52] As the data displayed in **Table 1** showed, most employers in the United States are small firms with fewer than 20 employees. The majority of small employers still submit wage reports to SSA on paper. Most do not have automated payroll systems that could communicate wage data quickly and efficiently to a central record keeping agency. The employees of small firms also differ markedly from the federal workforce. As the GAO, reported in 1999, "the federal workforce, as well as the federal government as a single employer, differs substantially from the workforce that would be covered under a nationwide system [of IAs]. For example, the federal workforce experiences less job turnover, tends to be older, and has higher average earnings than the general workforce."[53]

The low administrative costs of the TSP have been achieved in part because other federal agencies provide substantial administrative support for their employees who participate in the TSP. The administrative costs for the TSP do not include the services that federal agencies provide for TSP participants.[54] The agencies where federal employees work are responsible for educating employees about the TSP, enrolling them in the plan, and transmitting payroll information to the central TSP record keeper. As a former executive director of the TSP has said, "the TSP relies heavily on government agencies to provide these services through their human

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[51] "Bush Lauds TSP as Outline of Future Social Security," Stephen Barr, *The Washington Post*, December 19, 2004.

[52] CBO, 2004, p. 12.

[53] GAO, 99-122, p. 22.

[54] GAO, 99-131, p. 17.

resources departments free of charge."[55] The TSP itself advises federal employees that "while you are employed, your agency is your primary TSP contact."[56]

In summary, a number of analysts have concluded that adapting the TSP model to the private sector would be difficult because the nearly 6 million employers in the United States and their 150 million employees differ in important ways from the federal government and its workforce. One analyst has pointed out that "the TSP functions well because it is essentially a single-employer plan with ready access to centralized record keeping and services."[57] Another has asked how the TSP model could be made to work in the private sector when most private employers submit contribution information on paper once each year, "as opposed to the automated payroll submissions now given to the TSP by federal agencies each payday."[58] While the TSP is an efficient provider of retirement savings accounts to the federal workforce, it is a model that would be difficult to duplicate among the numerous and diverse employers in the private-sector.

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[55] Cavanaugh, p. 10.

[56] CBO, 2004, p 12.

[57] Burke and McCouch, p. 1334.

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