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The History and Future of Social Security

William G. Shipman

About the Author: William G. Shipman is Chairman of CarriageOaks Partners LLC, a Massachusetts-based consulting firm specializing in retirement finance. An advocate of Social Security reform in the United States, Mr. Shipman has co-authored *Promises to Keep: Saving Social Security's Dream*. He is Co-Chairman of the Cato Project on Social Security Choice, and was on the National Advisory Board of "Americans Discuss Social Security," a non-profit organization funded by the Pew Charitable Trusts to generate informed debate on the issue. He also has testified before the House Ways and Means Sub-Committee on Social Security and served as a delegate to the White House Conference on Social Security. His research has been published by the *Financial Analysts Journal*, *The Journal of Investing*, The National Center for Policy Analysis, The Heritage Foundation and the Cato Institute, as well as numerous other publications, and was commended for one of its outstanding papers by *The Journal of Investing*. Mr. Shipman has discussed and debated public policy issues before the United Nations and both the Joint Economic Committee and House Budget Committee Task Force on Social Security of the United States Congress Prior to establishing CarriageOaks, Mr. Shipman spent more than 30 years in institutional financial research and consulting. He was a principal of State Street Global Advisors, a founding partner of H. C. Wainwright Co., Economics, and a general partner of H.C. Wainwright & Co. Mr. Shipman received his degree in psychology from Syracuse University.

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Eleven years ago I had the opportunity to testify to Congress concerning Social Security. I started my formal comments with the following:

As both a son and a father, I am interested that the elderly are well cared for, and that the young have the opportunity to build sufficient assets so that they, too, can retire in dignity. Social Security, as presently structured, ultimately will achieve neither objective. Although compassionate in its original intent, it is flawed in design.

The system's financial structure is fundamentally unsound. Legislation of 1977 and 1983 attempted to address this by raising taxes and cutting benefits; Social Security was to be on sound financial footing well in to the 21st century. And now, just a few years later, The 1994 Board of Trustees' report suggests that the system will run out of money seven years earlier than it projected just one year ago. Legislative initiatives to reduce benefits further and raise taxes are again on the drawing board. This did not work in 1977 or 1983; it will not work now. Social Security's financial integrity requires an entirely different approach. I offer this testimony in the spirit of the starting point for an alternative: a concept of privatization wherein Americans benefit from the engine of a free economy and free choice. With privatization properly structured, today's elderly will be protected, the young will retire with higher incomes, and our political leaders will have offered, once and for all, a lasting solution for which all voters will be thankful.

Since that testimony our nation has had a vigorous and open discussion. Many new ideas have been offered, ideas not developed prior to 1994. The climate of opinion has changed; more Americans are now aware of the issue, more Americans want the option to save and invest for their own future. We are getting closer to the point where the "rubber meets the road," when time is running out on the existing system.

Unfortunately, over the eleven years little has changed politically; we're still talking about raising taxes and reducing benefits. We have wasted precious time.

A Collision Course

Like other nations we face an unprecedented challenge of how to deal with a reality that

* This paper draws on two of the author's written testimonies to the United States Congress

mankind has never confronted before and one that most people are unaware of. How we and other governments respond will affect each American citizen, our families, businesses across the land, indeed our very way of life. The reality is not only unprecedented, it is unyielding.

Dr. Karl Otto Pohl, former president of the German central bank, the Bundesbank, stated it this way: "In a relatively short period, we must adapt our domestic institutions, international relationships, and even our individual life plans to a new, and powerful reality."

What he was speaking of, and what confronts each of us here, is the fact that there are two powerful forces on a collision course. The first is the aging of society, the reality that the elderly population is increasing more rapidly than the population as a whole. In America, but even more so in other countries, the elderly rely on Social Security to survive financially. Should Social Security falter, many elderly will be destitute.

The second force is that most Social Security systems, including ours, are, in fact, failing. They are financially unstable, and not sustainable as they are presently structured.

The challenge is to avoid the collision of these two forces. In my view, the risks are high that we will not. But should we prevail by structuring a lasting solution, the rewards will be as unprecedented as the challenge itself.

The Early Years: Social Security's Roots

Social Security was enacted in 1935 during the Great Depression. During the first half of the 1930s real GDP fell by about 25 percent, unemployment jumped to 22 percent and the stock market virtually imploded and fell about 70 percent. Our nation was on her economic knees. President Roosevelt had to do something, something big, but large government programs were anathema to the frontier spirit of our young nation. In order to achieve his goals he needed unprecedented authority. To grasp that authority he went before the nation on March 4, 1933 in his first Inaugural Address and asked for authority "... as great as the power that would be given me if we were in fact invaded by a foreign

foe." He achieved his goal and ushered in Social Security, the flagship program of the New Deal.

Much like other Social Security programs that preceded ours, the first being Germany's in 1889, benefits paid to the elderly were financed by payroll taxes. In our case, during the Great Depression, people who had jobs were considered the wealthy. It wasn't like today wherein Americans have portfolios of stocks and bonds, real estate, defined benefit and contribution plans and the like; you were considered wealthy if you had a job. And needs were so urgent that the "payroll wealth" was taxed. A saving and investment structure would not have worked at that time because it takes time to compound investment returns to accumulate wealth, and time was short.

Today: A Fundamentally Flawed Program

Over the decades, however, this sort of urgent safety net has turned into the rough equivalent of a defined benefit plan. Yet its financial structure has not advanced. The Old-Age and Survivors Insurance part of Social Security, as its finances are presently structured, is inefficient, financially unsound and fundamentally flawed.

Because benefits are paid by taxing payroll, benefits can increase by no more than payroll increases, assuming that the tax rate on payroll is held constant. Over the last four decades or so, payroll has increased by about 1.5 percent per annum in real terms. That is roughly equivalent to saving and investing and receiving a rate of return of 1.5 percent. To put this into perspective, if one were to save \$1,000 each year for a 45-year working career and earn 1.5 percent, the saving would accumulate to about \$64,000. During the last 79 years a mixed portfolio of 90/10 percent large/small company stocks earned an inflation-adjusted average annual return of 9.7 percent. One thousand dollars invested annually for 45 years earning that return would accumulate to about \$650,000. And a conservative portfolio of 60/40 percent stocks and bonds, respectively, would accumulate to about \$288,000. These different values give a glimpse of the lost opportunity that our citizens incur by being required to finance their retirement through payroll taxes.

But it is worse. For any particular age group it matters how many workers pay taxes relative to the number of retirees who receive benefits. The change in this ratio is largely determined by the change in national wealth, or GDP per capita. As national wealth rises, life spans also rise. We observe this not only here but across all parts of the globe. When Social Security was enacted life expectancy at birth was 61 years of age; it is now about 78. In the post-war period global life expectancy has increased from 45 to 65 years of age, a greater increase in

the last 50 years or so than in the previous 5,000 years. This is all new. We didn't expect it. But now we think it will continue.

Also, as nations become more wealthy birth rates fall. In many countries they have fallen below the population replacement rate of 2.1. The combination of rising life expectancy and falling birth rates causes havoc with pay-as-you-go financed Social Security systems. In the United States there were 16 workers per beneficiary in 1950; today there are about 3.3. It is expected that there will be only two in just 35 years. Therein lies an interesting paradox: as countries become more wealthy their Social Security systems become more poor. The oddity is driven by the causal relationship between increasing wealth—and increasing life expectancy as well as decreasing birth rates—all wrapped around pay-as-you-go financing.

Birth rates have fallen to such low levels in Europe—France-1.9, Germany-1.4, Italy-1.3, Spain-1.3—that “there is now no longer a single country in Europe where people are having enough children to replace themselves when they die.”

The Global Political Response: Raise Taxes

The political responses to the changing demographics that squeeze Social Security's finances are frequently the same across the world. Governments and politicians tend to see the problem in the narrowest of lights: merely a solvency issue—too many benefits paid, too few taxes received. This near-sighted analysis is further compounded by the focus on just today's solvency and not tomorrow's.

But from this myopic perspective the options are clear; raise taxes, cut benefits. Of the two, governments tend toward raising taxes first. This makes sense for at least a couple of reasons. There are more workers to tax than there are retirees from whom to cut benefits. Therefore, if the choice were only one or the other, raising taxes inflicts a lesser per capita burden. The second reason is that workers are younger than retirees, therefore, they have more time to adjust to a tax increase than retirees have to adjust to a benefit cut.

The short-sighted strategy of raising taxes has been employed world-wide. In the United States, for example, in 1950 when there were 16 workers per beneficiary, the maximum Social Security tax any American worker paid was \$90 a year. At that time the tax rate was 3 percent on only \$3,000 of wage income. As the glacial force of demographics slowly and unrelentingly squeezed the system, the \$90 tax rose and squeezed the worker. Now, the tax, just for the

retirement portion of Social Security, is 10.6 percent of \$90,000, or \$9,540. After adjusting for inflation over the last 55 years, that tax has increased almost 2,000 percent. In all likelihood, the reason that we stood for this is that the tax rose slowly; the increase was never really noticeable in any one year, but over time it has become more of a burden than the income tax for about three quarters of American workers.

Our friends in Europe, however, would consider us lucky. The payroll tax in France is about 50 percent and in Germany, Italy and Spain it ranges roughly between 38 and 42 percent. It is true that these countries' systems provide more services than ours, but this is not a plus, for Europeans are dependent on more of their needs from government programs that are not sustainable.

As many European nations have raised their payroll taxes to prohibitive levels they have choked individual economic freedom and incentive. Economic growth is stagnant, and unemployment rates hover around 10 percent, even 12 percent in Germany. Civil unrest is now more common in Germany and France as governments tell their people that benefits are no longer affordable and will have to be cut, while at the same time they extol the virtues of the welfare state. We are traveling the same path.

Then, Cut Benefits

At some point, the strategy of raising taxes approaches a political wall. People sense that maybe, just maybe, they could achieve more with their hard-earned wages than they get from Social Security. Politicians sense this and move to the lesser desirable option of cutting benefits. Such blunt language, however, is not commonly uttered. Code is employed: progressive price indexing, longevity indexing, adding a third bend point, reducing bend point factors, increasing the NRA, decreasing the PIA, and it goes on and on. It's all code for cutting benefits.

Fundamental Reform: Retarded by the Claim of Insurance

Eventually, after cutting benefits hits its political wall, the thinking shifts to fundamental reform, saving and investing in wealth-producing assets for all workers. This idea of market-based financing for retirement income is not new, in fact it is old and well established in the private sector, but it is viewed with some disdain from advocates of the status quo. They object to the notion that Social Security should be an investment structure and defend their objection by claiming that it is insurance. This claim had some merit decades ago, but not now. In fact, Social Security's finances are in trouble largely because they are inappropriately based on the insurance model.

Insurance works well when many people are subject to an event that has little chance of happening to any single individual. A good example is homeowners' fire insurance. Many people buy fire insurance to protect their homes and yet few homes burn. Because the number of homes insured is many times the number of homes that burn, the annual insurance premium is very low relative to the replacement cost of one's house. Insurance companies are simply the medium through which individual uncertainty of loss is transferred to, and financed by, the group.

The insurance model does not work well when the group is subject to an event that the entire group experiences. For example, if it were certain that everybody's house would burn down, say, when the owner reached age 65, then insurance companies would have to charge annual premiums the future value of which would be the cost of rebuilding all the houses. This premium would be a large multiple of the premium charged for the uncertain case. Central to the insurance model is that the ratio of the annual premium to the dollar value of what it protects is negatively correlated to the uncertainty of individual loss.

Social Security is frequently heralded as insurance, more precisely social insurance. The 'social' part of the term merely means that the government plays the role of the insurance company. Other than that, it remains the insurance model. When Social Security was enacted in 1935, life expectancy was 61 but benefits weren't payable until age 65. Now benefits are payable at age 62 and life expectancy is 78. The element of uncertainty has flipped upside down. Because of this, the retirement component of Social Security isn't insurance; once born, reaching age 62 and needing retirement income is almost certain. As a result, there is very little risk, or uncertainty, to transfer to the group, resulting in the fact that annual premiums must be enough to accumulate to a sum, including interest, that will finance retirement income.

Under these conditions, social insurance cannot provide such income at a lower cost than saving and investing for retirement. Unfortunately, however, it can and does provide it at a higher cost because it is financed through the payroll tax and is subject to unyielding demographic forces. In a perverse way Social Security's finances and its adherence to the insurance model are caught in a kind of time warp; in the age of the iPod Social Security is a 78 RPM, wind-up phonograph. Unless protected by the power of the state, it can neither compete nor survive.

The State Monopoly Faces Competition

Being protected by the power of the state really means that for 10.6 percent of their wage income American workers are not free to choose among alternatives for their retirement. Bad as that is, the 10.6 percent doesn't buy much relative

to reasonable and available alternatives. This is why Social Security is mandatory; few would participate if they had the freedom not to. Competition, as always, is a threat to the status quo. For workers, however, competition is their hope.

Competition would allow all workers to invest part of their payroll tax in capital markets around the world, in professionally managed portfolios that are highly diversified across asset classes, national borders and time. Such an opportunity would allow one to accumulate enough wealth to replace the pay-as-you-go benefit entirely.

For an average wage worker retiring this year at age 65, Social Security's scheduled benefits are projected to replace about 42 percent of his last year's wage. But for workers retiring in the future full benefits won't be paid until age 67. For those future retirees, should they choose to retire at age 65, benefits will replace only 36 percent of their last wage. The worker's cost for these scheduled benefits, which are in excess of what is affordable based on present law, is the 10.6 percent payroll tax.

The Market-Based Alternative

The market-based alternative is significantly more attractive. Over the last 79 years a conservative portfolio of 60/40 percent stocks and bonds, respectively, earned a real return of just a little over 7 percent. Investing just half of the retirement payroll tax, 5.3 percent, each year for 45 years would provide a retirement benefit equal to 97 percent of one's last year's wage. This assumes that there is no interruption in saving each year, that the market return is as stated and falls by 2 percent during the distribution phase, and that life expectancy upon retirement is 20 years. Each of these assumptions can be changed. Work may be interrupted. Markets may do worse or better. Life expectancy may be more or less than 20 years once retired.

To take a conservative path, if the market return were only 5.5 percent and if life expectancy were 30 years at the onset of retirement—about 10 years more than assumed by Social Security—then under these conditions the replacement rate would be 39 percent, higher than Social Security's scheduled benefits at age 65 and significantly higher than payable benefits.

Americans Understand the Tradeoffs

Our citizens sense these tradeoffs, risks, uncertainties, and the fundamental differences in providing retirement income from a tax system versus a saving and investment system. This is why, but only part of why, they want the option, the freedom to choose.

If they could acquire this freedom they also would have personal property rights over their accumulated wealth. They have no such rights to Social Security benefits. They also could bequeath some or all of their retirement assets. They cannot under Social Security. They would benefit from the direct relationship between effort, their saving, and reward, their accumulated wealth. They would have the dignity that comes with being personally responsible for their future. They would no longer be tethered to the government. They would no longer be subject to politicians' preferences over when they can retire, how much they can get, how their spouses are treated, how much they're going to pay, and all of the rules and regulations that have evolved to the point of being incomprehensible. They would be free.

But that freedom would come with some structure for many people want the option to save for retirement, but are not knowledgeable of markets. The structure is designed to allow them the benefits of markets without causing each and everyone to be an expert. Here is how it may work.

The Objective: An Individual Account, Market-Based Social Security Option

The objective is to develop an investment and administrative plan that:

1. Creates individual accounts with assets owned by the account holder;
2. Ensures reasonable costs for all participants, low- as well as high-income workers;
3. Minimizes employers' administrative burden;
4. Provides the opportunity for workers of all incomes to invest in capital markets;
5. Ensures that inexperienced investors will not suffer poor returns relative to experienced investors;
6. Provides investment choice;
7. Offers a solution for workers who make no investment choice;
8. Automatically adapts to changing technology and services offered by the financial services industry.

These objectives are considered important because they have been central in the debate on Social Security reform. They are also integral to the most popular defined contribution system in the United States, the 401(k) plan.¹ Indeed, the 401(k) plan structure is often referenced as a potential model for an individual retirement account plan for Social Security. It should be noted that even though

¹ Profit Sharing/401(k) Council of America. "Helping Americans to Help Themselves: The Role of Profit-Sharing/401(k) Plans in the Retirement-Income Security Framework." <http://www.pasca.org/role.html>.

the 401(k) plan may be a useful model, it is unlikely that it would be applied precisely.

The Model: The 401(K) Plan

Since the late 1970s, defined contribution systems have increased in popularity among American companies and workers. And just since 1985 those that have sponsored as well as those that have participated in 401(k) plans have increased several fold.

Under 401(k) programs, a plan sponsor, usually a company or union, oversees administration of a savings and investment program for its employees. Under such plans:

1. Employees opting to participate in the program designate the amount they wish deducted from their pay;
2. Employees select investment options prescribed by the plan sponsor;
3. The plan sponsor deducts the specified funds from the employee's pay and in many cases invests the funds as of that day in the designated investment vehicles;
4. Deductions are made on a pre-tax basis;
5. Investment earnings grow on a tax-deferred basis;
6. Benefits are subject to tax when taken out;
7. In many plans, the employer provides some level of matching contribution to the employee's account;
8. Account holders normally can call an 800 number voice response unit or individual account representative and change their portfolio holdings and receive that day's closing price for each asset traded.

In the early years of 401(k) plans investment options were often limited to a stable value fund, a diversified fund and company stock. In recent years, however, there has been a significant increase in investment choice. Many plans now include a large number of investment options as well as self-directed brokerage accounts. These accounts provide access to a large universe of institutional and mutual funds as well as individual securities. With all of the choice available, individuals can now create portfolios that are appropriate for their age, their risk tolerance, and their wealth objectives.

The Challenge: The Government's Record-Keeping and Accounting System

The major challenge in creating a 401(k) model of individual accounts linked to Social Security is the timely posting of individuals' savings contributions. This is

not possible given the present Social Security record-keeping system.² Although the Treasury Department has built a comprehensive system for the collection of FICA taxes from employers, there is no detailed record of individual taxes paid at the time they are collected and sent to Treasury. This information is not communicated to the government until the following year.

Companies remit FICA taxes in lump sums throughout the calendar year, but do not forward to the government at the same time the names of the individual employees who paid those taxes or the amount each paid. That information isn't provided to the government until the next calendar year when the employer sends W-2 forms to both the government and the employee. Treasury knows throughout the year, for instance, that a company has paid a sum of FICA taxes for its employees, but the Social Security Administration will not update its records until late June of the next year, and possibly a few months later, with the names of the individual workers who paid those taxes and how much each worker paid. The government never knows when during the year the individual paid the taxes. This recordkeeping process, although workable in Social Security's defined benefit structure, is unworkable in a daily environment defined contribution structure. But it is all that currently exists for identifying individual payroll taxes.

The Solution: A Three-Level Approach

A solution is to structure investment options, not all of which require timely and detailed contribution data. This approach involves three investment levels.

At the first level, workers' savings are deducted from payroll and invested in a collective money market fund. Workers own the assets of the fund although the accounting at the individual level is not completed until the following year. This reconciliation is accomplished with the filing of the W-2 form. When the individual's assets are accounted for, units in the money market fund, which include earned interest, are then posted to each worker's account. The fund is dollar priced which means each unit is valued at one dollar.

The units are then invested in one of three balanced funds selected by the worker. Individuals who do not or choose not to make a selection have their assets invested in a default option.

² See, for example, Kelly A. Olsen and Dallas L. Salisbury, "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs." EBRI Special Report and Issue Brief #203.

The account holder has the option--after a startup of about three years, a period required to successfully build up assets to achieve economies of scale--to transfer some or all of his balance to an appropriate retail retirement account.

Level One Investment: A Pooled Money Market Account

This pooled account would be a conservative fund similar to a large institutional money market fund. The funds would be held in this pool earning interest for all participants. Given that the timing of an individual's contribution is not known, all participants are assumed to invest on June 30th. Because of this assumption high-income workers effectively subsidize low-income workers because high-income workers contribute a disproportionate amount of their income during the early part of the year.

Each worker would know during the year how much is invested because it is the same as the year-to-date reduction in the FICA tax that goes to savings, often referred to as the carve-out. The carve-out may be itemized as a separate line item on the pay stub. Interest would always accrue, so the account balance would be in excess of the contribution. All workers, regardless of income, would receive an identical rate of return. Funds would remain in the money market account until the reconciliation of how much each worker contributed, about August of the following year.

Level Two Investment: Balanced Funds

When the individual account balance is determined it is converted to units in one of three balanced funds that the worker chooses. Balanced funds are diversified portfolios that are generally invested in stocks, bonds and cash. The combined assets underlying very successful private employer-sponsored defined benefit plans are essentially balanced funds. One of the Level Two balanced funds may have an allocation that closely approximates these plans. This allows all workers, if they wish, to maintain an asset allocation similar to that provided to the employees of many sophisticated corporations in the world. There would be another fund on each side of this fund: one for younger workers that would be weighted more toward equities, while the other would be weighted more toward bonds for those closer to retirement.

Although workers could choose their balanced fund, some may not. In this case, they would default to the middle fund. In other words, a worker—perhaps low income and financially unsophisticated—would be invested in a well diversified balanced portfolio suited for retirement savings. The portfolios would be managed by professional asset managers chosen through an open and

competitive bidding process. Index fund investment management fees most likely would be less than two basis points (bps): two one-hundredths of one percentage point. The balanced funds would be valued daily and prices would be published in the popular press. Workers only need multiply their units by the daily price to monitor their account balance.

Level Three Investment: Rollover Option

After a period of perhaps three years, a period required to successfully build up the assets in the Level Two account system to realize economies of scale, investors seeking more investment choice would have the option of rolling their investment funds out of the Level Two asset allocation funds and into any qualified retirement investment account.

Those choosing Level Three would transfer assets to a qualified account with a financial services company meeting reasonable and specified standards.³ While investors would have a wider range of choice within Level Three, there still would be reasonable

investment guidelines. In Level Three investment managers would act as the fiduciary for their product offerings and be subject to Department of Labor oversight. This is consistent with many employer-sponsored plans, both defined contribution and defined benefit.⁴

Level Three might well suit those workers who have a high degree of confidence in a particular money manager, a particular firm or a particular style of investing. It will also serve investors seeking a type of investment unavailable in the Level Two asset allocation funds. An investor, for example, may wish a greater concentration of equity investments than is available in the asset allocation funds. Should a worker find a particular Level Three provider or product unsatisfactory, the worker could transfer to another provider or move back to Level Two. This assures competition across Level Three as well as competition between Levels Two and Three. Competition will ensure the lowest cost and best service for the entire system.

Record-keeping and Administration

The administration of an individual account system will require the development of a large-scale, customized record-keeping system with the capability to

³ This process should be fully automated and driven by a third party, such as the National Securities Clearing Corp. At the individual account holder's instructions the Level Three provider should be able to initiate the transfer and cause the money to be moved from Level Two to Level Three without having to provide any paperwork.

⁴ Department of Labor Pension and Welfare Benefits Administration. "Study of 401(k) Plan Fees and Expenses." April 13, 1998.

produce a highly efficient service solution. The efficiency of the service application will be dependent upon the design and execution of the system. There is no existing application that meets all the requirements.

The requirements to support a national individual account system will be complex, large-scale and capital intensive. As noted above, this is a challenge of unprecedented scope.

Nonetheless, the application itself is relatively straightforward. Development time can be minimized to allow focus on sizing and scaling the network and building the necessary interfaces to the Social Security Administration (SSA). Unlike mutual fund or 401(k) record-keeping systems, there will not be many unique product features or functions, thus significantly reducing complexity and cost. It is reasonable to assume a system could be developed in 12-18 months to support these requirements.

The greatest challenge in building a record-keeping system to support the requirements of an individual account system is not the complexity of the application, but the need to support the high volume of participant inquiries, transactions, transfers and report generation. To keep costs low, it is critical that most participants utilize voice and Internet technology to obtain information and transact business. The greater the percentage of calls that requires a customer service agent the higher the administrative cost.

The volume of calls will be driven by the frequency of transactions and statements, as well as average account size and market volatility. Assuming 140 million accounts and

the plan described, participant call volumes are projected to range from 175 million to 350 million annually. In addition, the system will issue 140 million statements, process fund transfers and distributions. This approach assumes the funds are priced daily and accounts updated nightly.

Whether the record keeping is done by a government entity such as the Social Security Administration or out-sourced to the private sector, this task will require the formation of a large service organization to support these requirements. The service firm would need call centers in multiple locations around the country and would need to hire between three and seven thousand employees. For the purpose of this analysis, it is assumed that the Social Security individual account system will incur volumes between 0.5 and 1.0 calls per participant per annum.

Another important factor in projecting costs is determining what percentage of the participant's call volume will be processed by voice response and Internet technology versus requiring the services of a call center representative. The cost

to handle calls using the technology is a fraction of the cost to process through a representative. Therefore, to achieve an efficient solution it is critical that high levels of automation are achieved. The analysis assumes 85 percent of the call volume will be handled through voice and Internet technology, comparable to the levels currently achieved in many large defined contribution plans. Estimated first year expenditures will range from \$473 to \$922 million.

Cost Model

Based on the plan design defined above, a cost model has been developed to project the administration costs under a range of assumptions. The unit cost factors are based on experience in the 401(k) business and have been adjusted in some cases to account for the scale of the individual account option. The requirements of a national system of individual accounts are unique and, therefore, extrapolations from 401(k) experience pose some risks. Unlike the 401(k) structure we assume that in a timely fashion the Social Security Administration will provide the individual account recordkeeper an accurate, automated transmission of earnings' histories that will be used to calculate annual contribution data. These and any other expenses associated with reconciling W2 records are to be borne by Social Security and are not included in this cost model. It is also assumed that Social Security, at its cost, will maintain accurate and up to date employee address files, as will be necessary anyway with the annual mailing of Social Security statements starting in 2000. We envision that one's investment account statement would be included in this mailing.

Another cost not included in this model is the expense associated with communicating this program to employees. The assumption is that the government would bear these expenses. Therefore, they expressly are not included in the asset based fees reported below. There is precedent for this in that the government pays directly some of the communication expense of the Federal Thrift Plan.

Cost Summary

Based on the design criteria outlined and our unit cost assumptions, it is projected that the first year's administrative expenses to support an individual account system will range from \$473 to \$922 million. Assuming 140 million accounts this translates to a cost per account range of \$3.38 to \$6.58 in the first year. Although costs would be expected to increase annually driven primarily by employee compensation and benefits, assets would increase more rapidly. Costs as a percent of assets, therefore, would fall. We project that steady-state asset based costs would range from 19 to 35 basis points.

These costs are competitive with other investment products. For example, the Federal Thrift Plan, which is often used as an example of an efficient retirement plan, had an expense ratio of 65 bps in its second year. Another benchmark is a portfolio of individual mutual funds representing different asset classes and weighted to approximate a Level Two balanced fund. Such a portfolio is presently available for a total cost of about 40 basis points.

Final Comments:

Although many approaches to the administrative challenges inherent in an individual account system linked to Social Security may be expensive, not all need to be. Under reasonable assumptions, a well thought out plan that meets our nation's retirement needs is affordable.

Although our nation has wasted time in the reform of Social Security, during this period we have learned much in how to administer a more modern system and why reform is so important. There is now little excuse to wait further.