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ADMINISTRATIVE FEES NO BARRIER TO PERSONAL RETIREMENT ACCOUNTS

Questions have been raised about the technical feasibility of substituting privately administered personal retirement accounts for some or all of Social Security's retirement benefits system. Particular concerns have been expressed about the administrative and fund management costs attached to private retirement accounts. Such concerns are easy to remedy. They do not justify retaining centralized administration of personal retirement accounts or investment of contributions by the Social Security Administration, as some have suggested.

> ***[C]oncerns have been expressed about the administrative and fund management costs attached to private retirement accounts. Such concerns are easy to remedy.***

Some Social Security reform proposals would let workers set aside (or "carve out") 2, 3, 5, or 10 percentage points of their payroll tax in mandatory personal retirement accounts in exchange for reductions in future Social Security retirement benefits. The less generous of these percentage carve-outs would lead to very small contributions that might not be economical for private sector financial institutions to handle. Consequently, suggestions have been made that the collection of contributions and the record-keeping should be left, centralized, in the hands of the Treasury and the Social Security Administration (SSA), and that only the investment of the funds should be privatized. (Having Social Security invest the funds directly is too great a threat to the free market to consider that option.)

> ***They do not justify retaining either centralized administration of personal retirement accounts or investment of contributions by the Social Security Administration...***

In the first few years of any retirement account, the accumulated contributions and the investment income are small. During that time, a fixed dollar administrative and management fee (perhaps \$50 a year) might absorb a substantial portion of the earnings. This is particularly true if the worker is a low-wage earner, and if the contributions are restricted by law to a limited percent of income. The same fee would offset a smaller percentage of the investment earnings of a higher-paid worker.[1] For all participants, the fees would gradually become insignificant as the accounts grow larger over time.

A flat administrative fee makes economic sense because it costs as much to process a \$10 deposit as a \$1000 deposit, or to mail an account statement for a small account as a large account. Instead of flat fees, however, many financial institutions employ a sliding fee schedule that shifts some of the administrative costs from small accounts to large ones (or from early years of an account to later years). Mutual funds go further, and charge a flat percent of assets with no cap. This enables them to keep the rate very low, a few tenths of a percent in the cheapest funds. Institutions undercharge small account holders to build up a business relationship that they hope will last for many years, by which time the accounts will be larger and more profitable to manage.

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A mandatory personal retirement saving program would generate huge pools of saving. The size of the program would enable financial firms to handle accounts with basic services for perhaps 25 to 50 basis points (1/4 to 1/2 percent of assets). The fees would cover administrative costs and management (trading) costs. Such accounts would be invested in broad stock index funds with little buying and selling of assets to keep trading costs to a minimum.

> ***Concerns over the effect of these small fees on account holders can easily be dealt with... [J]ust allow a larger percent set-aside...***

Fees of this magnitude would still leave savers with much higher rates of return than they can get from Social Security. Most of today's young workers will get between **minus** 1.3% and plus 2.7% returns on their Social Security contributions after inflation.[2] History suggests that, over a lifetime, they could get 7% after inflation from a stock index mutual fund, 2% to 3% after inflation from a bond fund, and about 5% after inflation from a mixed portfolio. Even subtracting 25 to 50 basis points in fees, returns on private accounts could dwarf those available from Social Security.

> ***Claims that the SSA could manage accounts more cheaply than the private sector are misleading... If SSA had to manage individual accounts, ... its costs would approximate the private sector's.***

Concerns over the effect of these small fees on account holders can easily be dealt with. If a $50 annual fee is deemed to be a hardship for workers, simply make the payroll tax reduction equal to, say, 2% of payroll plus $50, instead of just 2% of payroll. If percent fees are used, just allow a larger percent set-aside, such as 2.25% instead of 2%. If all workers receive the extra tax cut, the added cost to the program would be about $6 to $10 billion a year, which is small compared to the $80 billion federal budget cost of a 2% payroll tax set-aside. If the added $50 or percentage tax cut were only given for the first 5 years of each account, the cost would drop to about $1 billion yearly in the sixth year, with only new labor force entrants covered thereafter.

Businesses are also nervous about the extra cost of sending retirement contributions to several different fund managers selected by their workers, instead of one payroll tax check to the Treasury. To cover their concern, cut the employer's half of the payroll tax by, say, $25 per year per worker, or some other appropriate amount.

Claims that the SSA could manage accounts more cheaply than the private sector are misleading. Social Security currently has low administrative costs, but that is because the program does almost nothing until a worker retires. Benefits are based on a worker's earnings history. Consequently, SSA does not need to track workers' contributions. Most revenues are paid out at once, not invested. Revenues that aren't paid out are "invested" by the Treasury Department in special Treasury securities, at no charge to SSA (but at taxpayer expense). If SSA had to manage individual accounts, keep track of each person's contributions and investment selections, pay commissions, track each individual's account balance over time, and issue statements, its costs would approximate the private sector's. There would be no free lunch.

It is easy to deal with the costs of private administration and management of individual retirement accounts. For best results, such accounts should be handled by the private sector, not by the government.

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Endnotes

1. Some Social Security reform proposals would allow workers to set aside only 2% of payroll in personal accounts. A worker earning $25,000 a year would set aside only $500 the first year, and might earn only $25 in interest at 5%. A $50 annual fee would be twice the earnings. By year 5, the account would exceed $2,500, earnings would exceed $125, and the fee would be under half the earnings. By year 10, the fee would be less than 20% of the earnings, and would fall further in relative terms thereafter. A $50,000 a year worker might set aside $1,000 the first year and earn interest of $50, just covering the fee. By year 10, his account would exceed $10,000, the income would exceed $500, and the fee would be less than 10% of the income. It would decline in relative terms over time. With higher percent carve-outs, fees would be much less significant.

2. "Social Security's Rate of Return", William W. Beach and Gareth G. Davis, A Report of the Heritage Center for Data Analysis #98-01, Heritage Foundation, Washington, DC, 1/15/98.

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.