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The Thrift Savings Plan for Federal Employees

by
Laurel Beedon
AARP Public Policy Institute

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EXECUTIVE SUMMARY

Background

The Federal Employees' Retirement System (FERS), which became effective January 1, 1987 (P.L. 99-335) as a result of the 1983 Social Security amendments, required that federal workers hired after December 31, 1983, be covered by Social Security. FERS was designed to be comparable with the best private sector retirement systems that use the three-tiered approach to retirement income, i.e., Social Security as the first tier, an annuity or defined-benefit pension as the second, and an individual savings plan as the third. The Thrift Savings Plan (TSP) serves as the individual savings tier for FERS.

Reform proposals offered by the 1994-1996 Advisory Council on Social Security and by advocacy organizations, politicians, and scholars would have Social Security become a vehicle to provide individuals with the opportunity to save/invest on their own. The TSP portion of the FERS is being discussed by some as a model for such a vehicle.

Purpose

To determine whether the TSP is a viable model for use in investigating an individual investment tier for the Social Security system, this Issue Paper examines the TSP from a number of perspectives, including what Congress intended when it created the plan, how the plan's administrative design and investment options reflect that intent, and how employees have responded to the plan and what it offers.

The paper begins with a review of the basics. Next, an overview of the plan and its investment options is presented. The plan's administrative structure and accompanying costs are then described. Finally, using participant data gathered by the Federal Retirement Thrift Investment Board (FRTIB), participant demographics are examined and some questions for further research are posed.

Principal Findings

The TSP is readily available to federal employees. Yet, not all employees take full advantage of the opportunity. The majority of those who do invest either do not invest the maximum amount, or they do not invest their money aggressively enough to make substantial gains.

The differences between the Federal Employee Retirement System (FERS) and some of the reform proposals are important because the differences could significantly raise or lower the benefits an individual receives. The Federal Employee Retirement System (FERS) adds two distinct tiers (a defined benefit pension plan and the TSP) to the base of Social Security, while some of the reform proposals would replace part or all of the Social Security base. If, for example, an investment plan were intended to replace a portion of Social Security benefits and an individual's investment balances at retirement were lower than projected, there would be two negative consequences: the individual's savings component would provide a smaller portion of retirement income than planned and there would be a lower Social Security benefit to fill in the gap.

Social Security benefits were designed specifically to replace a larger portion of the contributions of lower-income workers than the contributions of higher-income workers. By taking away some or all of the guaranteed benefit base, an individual account plan could significantly alter the redistributive nature of Social Security.

The TSP loan program was liberalized in late 1996, and options for in-service withdrawal of individual TSP account balances became available in late 1997. While long-term trends cannot be determined because the options are so recent, the steady growth in number of in-service withdrawals in the first four months of their availability and the three-fold increase in the number of loans in 1997 over 1996 suggest that dissaving behavior could erode any individual account balances that are not annuitized. If individual accounts were not saved for retirement, could workers end up with nothing in their individual accounts and a severely reduced Social Security benefit?

All TSP employers are federal agencies and as such provide the TSP with administrative services such as reporting individual workers' contributions each pay period. It is at best uncertain how non-federal employers would respond to the annual reporting responsibilities of TSP-style individual accounts, much less to the responsibility of providing accurate, up-to-date transmittal and recording of employee transactions within the plan. How would employers deal with the additional costs? Would these costs affect the willingness of employers to offer other benefits such as health or disability? What would be the cost to individual account holders? Would the costs offset potential gains?

A transition would be necessary to protect those near and already in retirement. Because the TSP was able to piggy-back on other federal administrative structures, it does not provide much insight into what a transition involving millions of workers and millions of Social Security beneficiaries would entail.

Conclusion

Given the current emphasis on individual investments for retirement savings, the TSP provides some valuable information on how an individual, tax-favored, voluntary savings/investment account works when added to the retirement income spectrum that includes Social Security, pension benefits, and savings. If, however, the TSP is to be used as a model for reform of the Social Security program, a number of factors discussed in this paper must be taken into account.

- As it is designed, the TSP is one part of a three-part retirement system that comprises Social Security, a defined benefit pension, and the TSP. A plan that replaces all or part of Social Security with a TSP-style plan would alter the redistributive nature of Social Security.

- The data show that not all federal workers take advantage of the TSP savings opportunity. Further, the majority of those who do lean to low-risk rather than high-return investments. The data on workers who leave federal service and withdraw their TSP money strongly suggest that not all TSP dollars are saved until retirement. Further, the short-run data indicate that the number of in-service withdrawals has increased significantly since the rules were liberalized.

- The TSP is assisted in some necessary administrative services by the federal employing agencies. For example, every payday the agencies transmit each employee's investment allocations, interfund transfers, loans and loan payments etc. These employee data are usually transmitted on magnetic tape. Today, many private employers do not even report Social Security-required information in the most technologically efficient manner. This may have implications for private employers' ability to participate in a TSP-type savings vehicle that requires additional record keeping and reporting.

In general, the TSP has accomplished with great success what it was designed to accomplish. However, the TSP experience represents 2.3 million workers, whereas Social Security represents 129 million. Thus, using the TSP as a model for the individual investment of Social Security requires caution.

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The Thrift Savings Plan (TSP) for Federal Employees

"We believe the overall purpose of the thrift plan should be to provide 'the icing on the cake.' … The thrift plan should be used to encourage employees to save and thereby provide extras during retirement, not as a primary source of retirement income."
Donald N. Ledbetter, President of the National Association of Postal Supervisors. Testimony before the U.S. Senate Committee on Governmental Affairs, September 11, 1985.

"The TSP is more than just a federal retirement plan. It could well serve as a model for how the Social Security Administration could begin to offer privately invested, privately held retirement accounts."
U.S. Senate Republican Policy Committee. "Could Congress' Retirement Plan Serve as a Model to Reform Social Security?" March 10, 1998.

Introduction

The Federal Employees' Retirement System (FERS), which became effective January 1, 1987, (P.L. 99-335) as a result of the 1983 Social Security amendments, required that federal workers newly hired after December 31, 1983, be covered by Social Security. FERS was designed specifically to be comparable with the best private sector retirement systems that use the three-tiered approach to retirement income, i.e., Social Security as the first tier, an annuity or defined benefit pension as the second, and an individual savings plan as the third. The Thrift Savings Plan (TSP) serves as the individual savings tier for FERS. It provides FERS participants[1] the opportunity to supplement Social Security and the defined benefit plan.

Two of the options offered by the 1994-1996 Advisory Council on Social Security and recent proposals offered by advocacy organizations, politicians, and scholars suggest that Social Security should become a vehicle to provide individuals with the opportunity to save/invest on their own. The TSP is being suggested as a model for such a vehicle.

To determine whether it is a viable model, the TSP should be examined from a number of perspectives, including what Congress intended when it created the plan, how the plan's administrative design and investment options reflect that intent, and how employees have responded to the plan and what it offers. This Issue Paper begins with the basics. Sections I and II present an overview of the plan and its investment options, including discussion of what Congress had in mind. Section III describes the plan's administrative structure and accompanying costs. Section IV examine participant demographics, and Section V describes

[1] Federal employees who participate in the Civil Service Retirement System (CSRS) may also participate in the TSP, but the deferral and matching rules are different. This is the case because, for FERS employees, the TSP is considered an integral part of their retirement package. For CSRS employees, the TSP is considered a supplement to the CSRS annuity.

participant account options using data gathered by the Federal Retirement Thrift Investment Board (FRTIB). Finally, the paper offers some thoughts on the applicability of the TSP to the Social Security program.

I. TSP Overview

FERS-covered employees automatically have TSP accounts whether or not they contribute from their salary. All federal employing agencies are required, by law, to contribute to the FERS employee's account an amount equal to 1 percent of the individual's basic pay each pay period.[2] In addition, 10 percent of an employee's salary, up to an annual "elective deferral limit" estimated by the Internal Revenue Service ($10,000 in 1999) may be directed to the TSP; employee contributions are voluntary.[3] The employing agency matches contributions on the first 5 percent. The first 3 percent is on a dollar-for-dollar basis, and the next 2 percent is matched at 50 cents on the dollar.[4] (See Table 1.) All contributions and earnings are tax-deferred for federal and most state income tax purposes.

Table 1
Thrift Savings Plan Contributions
(FERS Employees Only)

Worker Contribution % of Wages	Agency Contribution: Automatic % of Wages	Agency Contribution: Matching % of Wages	Total Contribution % of Wages
0	1	0	1
1	1	1	3
2	1	2	5
3	1	3	7
4	1	3.5	8.5
5	1	4	10
6 - 10	1	4	11 - 15

Source: Federal Retirement Thrift Investment Board (FRTIB)

Participants may contribute to any or all of three investment funds, move their money among the funds, apply for loans from their accounts, and receive a distribution from their accounts at separation, or if they are in Federal service after they reach age 59½ , or if they experience a time of financial hardship.

[2] The employing agency begins TSP contributions on behalf of the newly hired worker in the first pay period of the last calendar month of the open season in which the employee becomes eligible to participate in the TSP. There are two open seasons per year: May 15 through July 31 and November 15 through January 31.
[3] Eligible employees may sign up to contribute to the TSP during the two open seasons. FERS employees must wait until the second open season after they were hired to contribute. Elections, however, cannot be made effective before the last month of the open season.
[4] CSRS employees may contribute up to 5 percent of their basic pay, but there are no government contributions.

II. The TSP Fund Options

Congressional Intent

During the congressional deliberations, numerous ideas for investment options were considered and strong opinions were expressed about whether this new savings vehicle for federal employees would work. Some believed that individuals' investments should be restricted to government securities. Donald Ledbetter, President of the National Association of Postal Supervisors, testified in a hearing on the Senate's proposal, S.1527,[5] that "…we do not believe it would be wise for the thrift plan monies to be invested in the private sector. Taking money out of government and investing it in the private sector would add to the public debt. Also, if private investments do poorly, the loss is borne entirely by the employee" (Ledbetter, 1985).

Others advocated the opposite. Testifying at the same hearing, James Peirce, President of the National Federation of Federal Employees, voiced his opinion that individuals should be given full responsibility for their own investment choices: "…the thrift plan [S. 1527] fails to give employees adequate control over their thrift account. Although the thrift plan provides employees with vehicles by which to invest their funds,[6] it takes away their independence to make such decisions for themselves" (Peirce, 1985).

The House/Senate conference committee's ultimate rejection of workers' choosing their own investment vehicles from the broad market was discussed by the Executive Director of the FRTIB in testimony before the Senate Banking Committee (Mehle, 1997). He quoted the Conference Report on the Federal Employee Retirement System Act (FERSA): "However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who [sic] would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go bankrupt occasionally, and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer. Fifth, this 'retail' or 'voucher' approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size, so that employees acting individually would get less from their money." (U.S. House of Representatives, 1985.)

Three TSP Investment Options

TSP contributions may be invested in three statutorily specified funds: a federal government securities fund, a commercial bond fund, and a commercial large capitalization stock fund.

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[5] The bill S. 1527, dated July 30, 1985, was sponsored by Stevens (R-AK) and Roth (R-DE). It was designed to "…establish a new retirement and disability plan for Federal employees, postal employees, and Members of Congress, and for other purposes."

[6] The Thrift Savings Fund in S.1527 offered a Government Securities Investment Fund, a Fixed Income Securities Fund, and a Short-Term Fixed Income Fund.

1. Government Securities Investment (G) Fund—The G Fund consists exclusively of investments in short-term nonmarketable U.S. Treasury securities specially issued to the TSP. (These securities are similar to those issued to the Social Security trust funds and to other federal trust funds.) Currently, maturities range from one day to four days. There is no credit risk (risk of nonpayment of principal or interest) for the Treasury securities in the G Fund. They are guaranteed by the full faith and credit of the U.S. Government.

2. Common Stock Index Investment (C) Fund—The C Fund is invested primarily in the Barclays Equity Index Fund, a commingled[7] stock index fund that tracks the Standard & Poor's 500 (S&P 500) stock index as closely as possible. This strategy of matching the performance of the S&P 500 index is defined as "passive" management rather than "active" (which would base the selection of stocks on economic, financial, and market analyses). Passive management does not mean without risk: The values of these shares can move up or down sharply with changes in conditions affecting the economy, an industry, or an individual company. The performance of the Barclays Equity Index Fund is evaluated by comparing how closely its returns match the returns of the S&P 500 index.

3. Fixed Income Index Investment (F) Fund—The F Fund is a broadly diversified portfolio of high-quality (low credit risk) fixed-income securities with a broad range of issuers, industries, and maturities. The F Fund is invested primarily in the Barclays U.S. Debt Index Fund, a commingled bond index fund designed to track as closely as possible the Lehman Brothers Aggregate (LBA) index. The LBA represents U.S. Government, corporate, and mortgage-backed securities sectors of the fixed-income securities market.[8] Like the C Fund investment strategy, the F Fund strategy is passive, i.e., it attempts to replicate the LBA index. And, its performance is evaluated by its success in doing so.

Investment options may be added only by statute. At the request of the TSP Board, legislation was enacted in 1996 to authorize two new investment options: a small capitalization stock index fund that will track the Wilshire 4500 Index and an international stock index fund that will track the Morgan Stanley Europe, Australasia and Far East (EAFE) Index. Consistent with management policy for the C and F Funds, the new options will be passive index funds. They are scheduled to become available in May 2000.

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[7] The C Fund assets and the F Fund assets, respectively Barclays Equity Index and Barclays U.S. Debt Index, are commingled trust funds in which the assets of public and corporate tax-exempt employee benefit plans are combined and invested together. Separate accounting records are kept for each plan. As of December 1996, 260 employee benefit plans were invested in these two funds, that are open only to tax-exempt benefit plans like the TSP.

[8] Fixed-income securities represent obligations of issuers (the borrowers) to repay the amount borrowed (the principal) to holders of the securities at maturity. These securities, which include bonds, notes, and debentures, usually pay interest semiannually until maturity.

Rates of Return on the C, F, and G Funds

Since their inception, the three funds have earned different rates of return. The higher-risk, market-based C Fund has (except for 1990 and 1994) averaged a higher annual rate of return than the lower-risk bond index F Fund and the low-risk Treasury securities G Fund. Not unexpectedly, the market-based C and F Funds have shown more volatility than the Treasury-based G fund. (See Table 2.)

Table 2
TSP Annual Returns, 1988-1998

Year	C Fund %	F Fund %	G Fund %
1988	11.84	3.63	8.81
1989	31.03	13.89	8.81
1990	-3.15	8.00	8.90
1991	30.77	15.75	8.15
1992	7.70	7.20	7.23
1993	10.13	9.52	6.14
1994	1.33	-2.96	7.22
1995	37.41	18.31	7.03
1996	22.85	3.66	6.76
1997	33.17	9.60	6.77
12/97-11/98	23.52	9.47	5.83

Source: FRTIB

The compounded rates of return, since the inception of the funds through March 1998, equaled 18.5, 8.4, and 7.6 percent respectively for the C Fund, F Fund, and G Fund. In the 12 months beginning December 1, 1997 and ending November 31, 1998, the rates of return for the C Fund far exceeded those of the F and G Funds. (See Table 3.)

Table 3
Rates of Return[1]

TSP Fund	November 1998 %	12 Months (12/97 - 11/98) %
G Fund	**0.42**	**5.83**
C Fund	**6.04**	**23.52**
F Fund	**0.56**	**9.47**

Source: FRTIB

[1] The monthly rates of return represent the actual total rates of return used in the monthly allocation of earnings to participant accounts. Returns are updated after the monthly allocation of earnings, usually the 7th business day of the month.

Calculations and Updates on Rates of Return. TSP returns are calculated and individuals' accounts are valued monthly. The TSP is preparing to change to a system that values accounts daily, rather than once a month. It will be available when the new record-keeping system, currently under development, is in place in May 2000.

The monthly C, F, and G Fund returns represent the actual total rates of return used in the monthly allocation of earnings to participant accounts. The returns are shown after deduction of accrued TSP administrative expenses. The C and F Fund returns also reflect the deduction of trading costs and accrued investment management fees. (For more information, see Section IV, Administrative Costs of the TSP: Administrative Expenses.)

III. Administration of the TSP

The Federal Retirement Thrift Investment Board (FRTIB)

Designing an "appropriate" savings plan for federal employees required the Congress to grapple with the issue of fiduciary responsibility for such an entity. There clearly were concerns about political involvement by the Congress and the Administration in the plan management,[9] and ultimately legal and constitutional constraints were written into the legislation. The result was an independent government agency created to act as fiduciary for the TSP, called the Federal Retirement Thrift Investment Board.[10]

The agency is run by a five-member, part-time board of presidential appointees and a full-time executive director selected by those appointees. Each of these individuals is required to have "substantial experience, training and expertise in management of financial investments and pension benefit plans."[11] The Board members establish operating policies and provide oversight. The Executive Director carries out those policies. The Board and Executive Director have monthly meetings, that are open to the public, to review policies and practices.

The FRTIB and the Trust

Rather than imitating the administration of an executive branch agency, the Congress designed the TSP management structure using fiduciary standards applicable to private sector employee benefit plans. Thus, the board is exempt from the normal budget appropriation process and the legislative and budget clearance process of the Office of Management and Budget.

To assure no tampering or manipulation, Congress explicitly recognized that all funds held in trust by the plan belong to the participants and must be managed independently from political or social considerations.[12] The law states that the five members of the Board and the

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[9] The Conference Report on FERSA, House Report 99-606 of May 16, 1986, listed the concerns: "Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential appointees, could be susceptible to pressure from an Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes."

[10] As designated in P.L. 99-335.

[11] 5 U.S.C. § 8472 (d) 1996.

[12] The original Senate version of the bill, S.1527, required that the Board's investment policies provide for prudent investments, low administrative costs, and "*…investments likely to receive broad acceptance by participants and the public….*" This last statement raised concerns about the potential for "social investing."

Executive Director, as statutory fiduciaries, are required to "…manage the TSP prudently and solely in the interest of participants and their beneficiaries. A breach of these responsibilities would make the fiduciaries civilly and criminally liable." This fiduciary responsibility is unique among government agencies.

Management of the Three Funds

The Federal Retirement Thrift Investment Board directly manages the G Fund. The assets of the G Fund are held in trust in the U.S. Treasury. They are invested in nonmarketable special-issue Treasury securities that earn interest equal, by law, to the average market rate of return on Treasury securities that are outstanding with four or more years to maturity.

The F Fund is invested in high quality, fixed income securities. Barclays Global Investors, a company owned by Barclays PLC, under contract with the FRTIB, holds the F Fund assets in trust and acts as the investment manager. The portfolio is designed to track the Lehmann Brothers Aggregate Index. The Board has no knowledge of the specific investments.

The C Fund is invested in a portfolio designed to track a common stock index that is a reasonably complete representation of the U.S. equity markets. The law leaves nothing to the imagination in its provisions about voting those securities. It explicitly states that the voting rights associated with the ownership of securities by the TSP may *not* be exercised by the board, other government agencies, the executive director, a federal employee, a member of Congress, a former federal employee, or a former member of Congress.[13] Under the contract awarded by the Board, the C Fund investment manager must vote all proxies in a manner that will result in maximum financial benefits to TSP participants.

The C Fund and F Fund outside managers are selected through a competitive bidding process. The FRTIB currently contracts with Barclays Global Investors to manage C and F Fund assets. The contracts were effective January 1, 1996 and expire on December 31, 1998, with options to extend the contracts for an additional two-year period.

Auditors and Advisors

The law requires that financial statements of the Thrift Savings Plan be audited annually by a private accounting firm. The audited financial statements are available on the TSP Web site.

Additionally, a 14-member Employee Thrift Advisory Council that includes representatives from the major unions and employee organizations meets with the Executive Director and advises on the investment policy and the administration of the TSP.

Senator Stevens, Chairman of the Subcommittee on Post Office, Civil Service and General Services of the U.S. Senate Governmental Affairs Committee, objected, stating that he did not think social investing should be the function of the TSP (U.S. Senate, Committee on Governmental Affairs, 1986). The quoted language was *not* incorporated into the final version of the bill.

[13] 5 USC § 8438 (f) 1996.

Record Keeping
The Board has an agreement with the U.S. Department of Agriculture's National Finance Center (NFC) under which the latter provides record-keeping services for the TSP. NFC maintains the accounts of TSP participants, and processes withdrawals, loans, and interfund transfers.

The TSP depends on the federal employing agencies and their personnel, payroll, and systems staff to handle its “non-investment” operations, such as the distribution of TSP forms and materials, employee education programs, and counseling on all aspects of the federal retirement system including the TSP.

Employing agencies are also responsible for transmitting in a timely manner to the TSP every payday the amount and investment allocation of each employee’s (and the government’s) contributions, as well as investment choices, interfund transfers, loans, loan repayments, withdrawals, and other essential information to ensure prompt and accurate investment and maintenance of employee accounts.[14]

It is of interest from an administrative efficiency point-of-view that the federal agencies generally report payroll deductions and other employee data to the TSP on magnetic tape. In contrast, over 80 percent of private employers are still reporting to the Social Security Administration *on paper* (Cavanaugh, 1998). The fact that many employers do not report Social Security-required information in the manner most technologically efficient for Social Security’s record keeping may have implications for their ability to participate in a TSP-type savings vehicle that could require additional record keeping and more reporting.

Administrative Expenses
Some observers assume, probably because federal workers are the plan participants, that taxpayers foot the bill for TSP administrative expenses. This is not the case. Administrative expenses are paid, not by the taxpayer, but by the Thrift Savings Plan fund itself, which belongs to the participants. Funds for administrative expenses come from two sources:

1. Forfeitures of any nonvested agency automatic contributions and earnings on those contributions. (Most FERS employees are vested in the automatic 1 percent agency contribution after three years.)[15]
2. Earnings on participant and agency contributions are used to pay the balance. Administrative expenses, net of forfeitures,[16] are deducted from the earnings of the funds in proportion to the size of each fund. Investment management fees of the C and F Funds are borne exclusively by the participants investing in those funds.

[14] Employing agency responsibility also includes the restoration of employee’s lost earnings resulting from deposits or other employer errors. Agencies must transfer data to allow the TSP to calculate the amount of lost earnings.
[15] FERS employees in congressional and some non-career positions are vested after two years.
[16] Forfeitures reduce the expense ratio by approximately .02 percent.

Expense Ratios. The effect of administrative expenses on the rates of return is measured by the expense ratio of each fund. The monthly expense ratio equals the total of monthly administrative expenses charged to each fund divided by the average fund balance during that month. An individual's share of the TSP net administrative expenses is based on the size of the individual's account balance. For example, if the expense ratio of the G Fund were .08 percent, the individual's earnings from that fund over the year would be reduced by $0.80 for every $1,000 in his/her G Fund account balance.

There has been a significant drop in the expense ratios for all three funds from 1988 through 1997, due mainly to the increase in account balances over time. (See Table 4.) For calendar year 1997, the *net* plan administrative expenses were .07 percent of fund balances.

Table 4
Expense Ratios for G, C and F Funds

Year	G Fund %	C Fund %	F Fund %
1988	.34	.29	.30
1989	.21	.20	.23
1990	.11	.13	.13
1991	.13	.15	.16
1992	.13	.14	.15
1993	.12	.13	.14
1994	.10	.11	.12
1995	.09	.10	.11
1996	.08	.09	.10
1997	.07	.07	.08

Source: FRTIB

IV. Participant Demographics and Analysis

Participation Rates

In 1997 the FRTIB prepared an analysis of 1996 TSP participant demographics. In some cases the 1996 data were compared to participant demographics reflecting earlier years. Those data used in the FRTIB analysis are the basis for the following discussion.[17]

The overall participation rate (including both FERS- and CSRS-covered workers)[18] at the start-up of the TSP in 1987 was a relatively low 44.1 percent. By 1996 that rate had grown to 82.9 percent. For FERS-covered employees, there has been steady growth in participation rates—from 44 percent in 1987 to 86.1 percent in late 1998.

[17] The FRTIB numbers are based on participant data enhanced with information from the Office of Personnel Management (OPM) database of Executive Branch and Postal Service employees.
[18] The data discussed in this paper are primarily about FERS-covered employees. If CSRS-covered employees are discussed, it will be noted specifically.

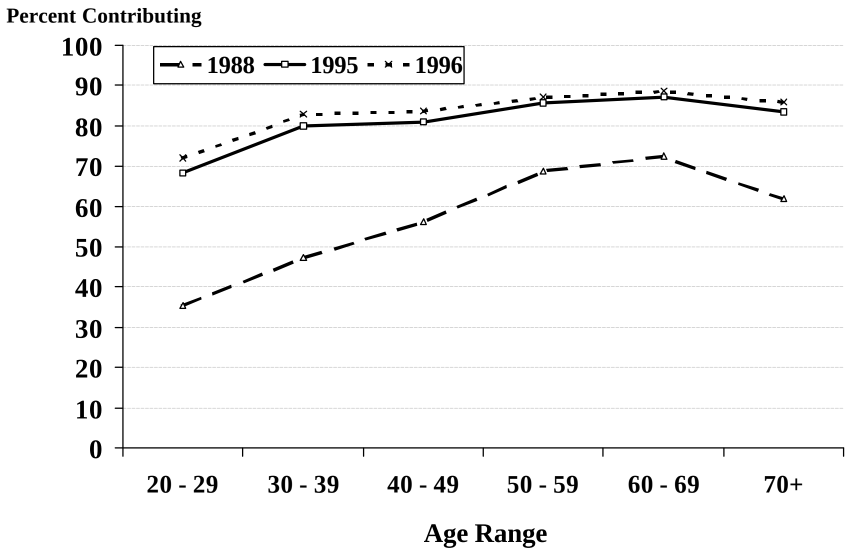
The FRTIB data show that since its inception, a greater proportion of new FERS participants has decided to participate in the TSP each year. In 1988 only 24.6 percent of new entrants chose to participate. By 1996, 54 percent chose to take advantage of the TSP. "New entrants" is not the only category of increased participation. The data also show that participation in the TSP increases with employee tenure. For example, of those employees who entered FERS in 1994, only 45.8 percent participated in the TSP in that year. By 1995, however, 66.3 percent of the 1994 entries were participating in the plan, and by 1996 the participation rate of the 1994 cohort had increased to 75.7 percent.

Participation Rates by Age. Since the inception of the TSP, participation rates for older workers have not only increased, but also have been consistently higher than those for younger workers. It is not surprising that workers approaching retirement participate in the TSP at a consistently high rate. At the beginning of the program in 1987, the participation rate for those age 50 and over was above 68 percent (except for those aged 70 and over in 1988). By 1996, that participation rate had grown to 90 percent. (See Figure 1.)

It is noteworthy that workers in their twenties, who are far from the retirement decision, have also increased their participation rates, from 35.5 percent in 1988, to 68.3 percent in 1995, and to 72 percent in 1996. (See Figure 1.)

Figure 1

TSP Participation Rates By Age



Source: FRTIB

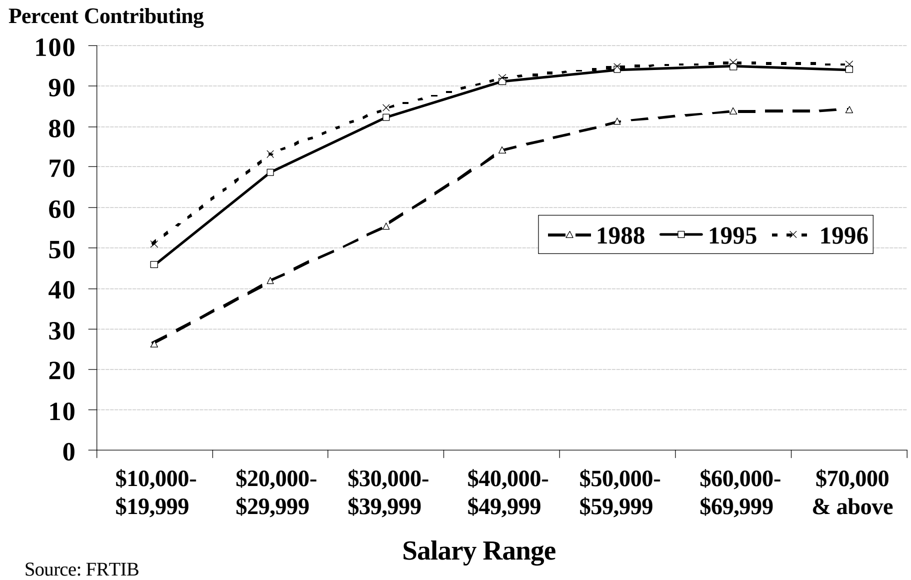
Participation Rates by Salary. The proportion of FERS-covered employees contributing to the TSP has increased steadily since 1987. However, the rate of those contributions varies based upon salary. It is to be expected that those who earn more can and do participate in savings programs at a higher rate. This is the case with the TSP. It is likewise to be expected that lower earners with less discretionary income will participate in savings plans at a lower rate, if at all. And, in fact, most of the FERS-covered employees who do not contribute to the TSP are lower-paid workers.

Since the beginning of the plan, lower-paid employees have been less likely to make voluntary contributions.[19] Nevertheless, this group has shown the greatest increase in participation rates over time of any group. For example, in 1988 only 41.9 percent of those earning between $20,000 and $29,000 were participating in the TSP. By 1996 their participation rate had increased to more than 73 percent—a 31.1 percentage point increase. (See Figure 2.)

For those in the higher income brackets, the increase in participation rates over time was less dramatic because they started out with higher participation rates. (See Figure 2.)

Figure 2

TSP Participation Rates By Salary



Source: FRTIB

Deferral Rates Over Time

Not only have participation rates increased since the first full year of operation, but the percentage of base pay FERS contributors deferred to the TSP also has increased steadily—from an average rate of 4.9 percent in 1988, to 6.2 percent in 1995, and to 6.4 percent in 1996.

The average deferral rate for CSRS participants, approximately 4.4 percent in 1996, is virtually unchanged from the 1988 rate. The maximum amount CSRS participants may

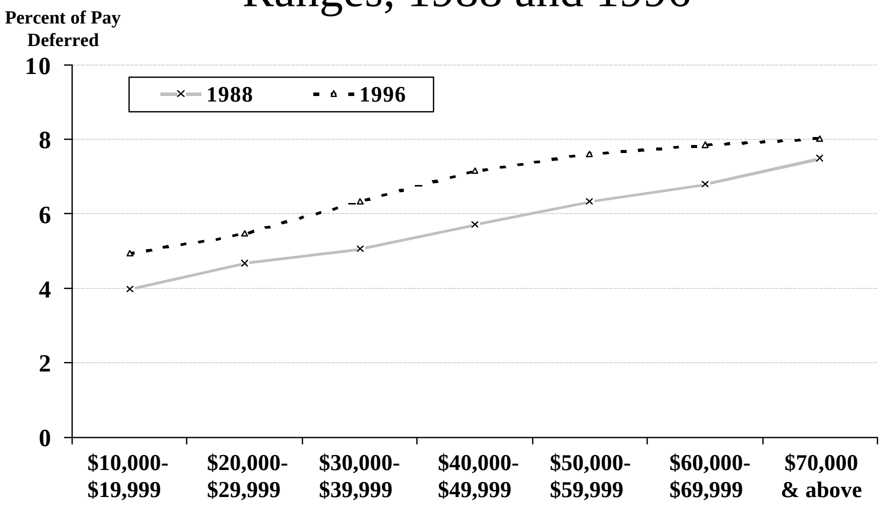
[19] This was not unexpected. The designers of the TSP were attempting to replicate the total CSRS replacement rates with the three-part FERS--Social Security as a base and pension and savings added on. It was assumed that the Social Security benefit "tilt" toward lower income workers would mean these workers would not have to defer as much to the TSP to achieve the desired replacement rates.

contribute is 5 percent. While this amount is tax-deferred, none of the TSP contribution is matched for CSRS participants.

Deferral Rates Over Time by Salary. Deferral rates are clearly related to salary level. It is not surprising that workers with higher salaries at the inception of the TSP contributed on average more than 6percent of their deferrable pay. (For workers who earned $60,000-$69,999 in 1988, the average percent of pay deferred was 6.8 percent.) Neither is it surprising that higher-earning workers increased their average deferral rate over time to 7.9 percent in 1996. It is notable, however, that an increase in deferral rates took place at all salary levels. Those with a salary between $30,000 and $39,999 increased their average deferral rates from 5 percent in 1988 to 6.3 percent in 1996. Even those in the $10,000-$19,999 salary group, who, on average, deferred 4 percent in 1988, increased that rate to 5 percent in 1996—the maximum deferral amount matched by the employer. (See Figure 3.)

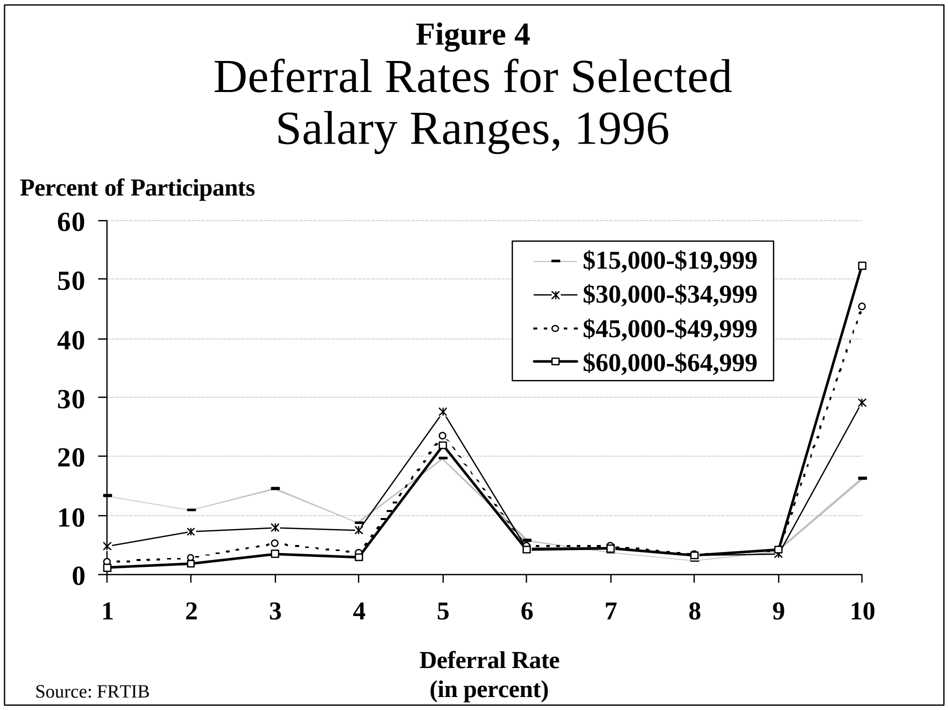
Figure 3

TSP Deferral Rates for Selected Salary Ranges, 1988 and 1996



Source: FRTIB

Deferral Rates by Salary. Deferral rates, like participation rates, increased as income increased. The 1996 FRTIB analysis identified the deferral rates for four salary brackets ranging from lower to higher: $15,000-$19,999; $30,000-$34,999; $45,000-$49,999; and $60,000-$64,999. The data showed that rates of deferral varied considerably, with those in the lowest salary bracket deferring significantly less. Sixty-eight percent of those in the $15,000-$19,000 group deferred 5 percent or less; and only one in six deferred the maximum percentage. (See Figure 4.)



Of the participants in the $30,000-$34,999 bracket, 29 percent deferred the maximum 10 percent, 28 percent deferred 5 percent, and only one-fifth deferred 3 percent or less. Only one in ten of those in the $45,000-$49,999 group deferred 3 percent or less, while one quarter of the group contributed 5 percent, and 45 percent contributed the maximum amount of 10 percent. Those in the highest income group identified had the highest deferral rates—over one-half deferred at the maximum rate of 10 percent. (See Figure 4.)

Deferral Rates by Age[20]. There are two distinct peaks in deferral rates for all three age groups—5 percent and 10 percent. The first peak strongly suggests that TSP participants, younger and older, understand the significance of the employer match that ends when an employee has contributed 5 percent. And it could be assumed from the second peak at 10 percent that a portion of workers--a portion that increases with age--understands and is able to take advantage of the full 10 percent of tax-deferred savings. (See Figure 5.)

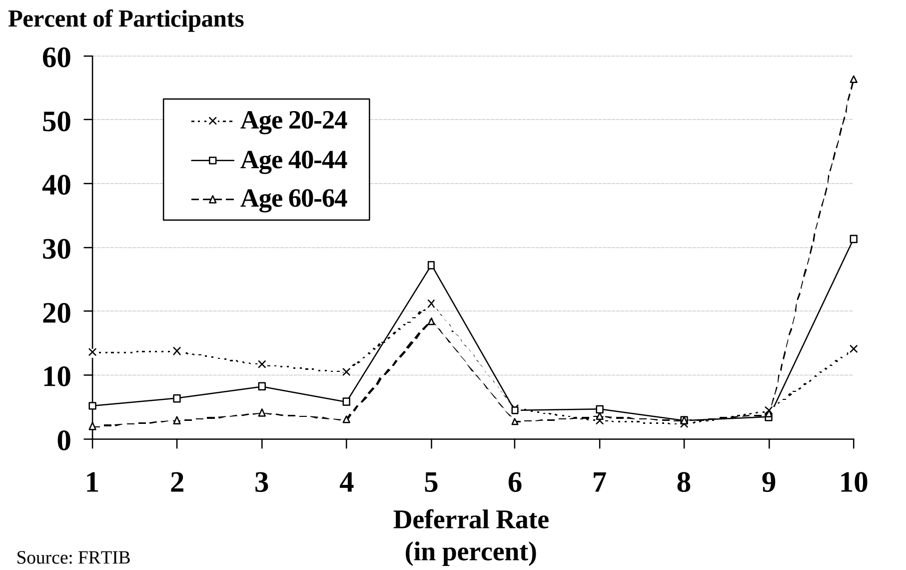
There are, however, significant differences among the age groups in the deferral rate that each peak represents. Predictably, the age group with the highest percentage of workers contributing at the maximum deferral rate is the group nearest to retirement. Of those age 60-64 in 1996, 56.4 percent were deferring the full 10 percent. In fact, more workers in this age range deferred at 10 percent than at any other rate. In contrast, only 14.2 percent of the 20-24 age group deferred 10 percent. A larger portion of 20-24 year olds—21.2 percent—deferred 5 percent. Almost three out of four in this younger group—70.9 percent—deferred 5 percent or less.

[20] The FRTIB selected certain age groups to examine more closely. The three age groups discussed here were those chosen by the FRTIB for this category.

Just over 31 percent of the 40-44 year olds deferred at the 10 percent maximum. Almost the same proportion (just over 27 percent) deferred at the 5 percent match level. Still, more than 50 percent of the middle age group deferred 5 percent or less. (See Figure 5.)

Figure 5

Deferral Rates for Selected Age Ranges, 1996



Source: FRTIB

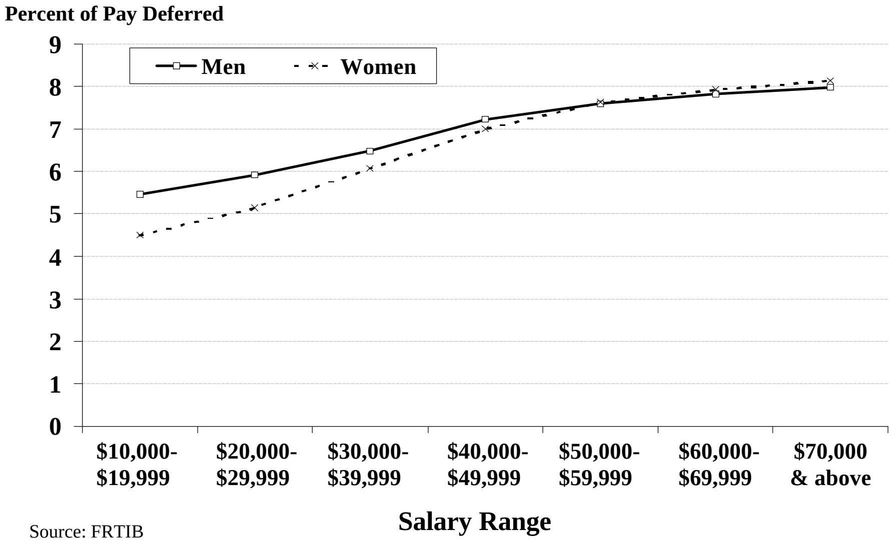
Deferral Rates by Gender. There is only a small difference between the overall *participation rates* for men and for women—84 percent and 82 percent respectively. There are differences in *deferral rates*, however, between men and women below $50,000 in wages and below 50 years of age. Men under age 50 defer, on average, more than 6 percent of their pay to the TSP. Younger women defer less than younger men, but as women age, deferral rates grow steadily. After age 50, both men and women defer more than 7 percent.

Likewise, women with wages below $50,000 deferred less than men in the same wage bracket. But both men and women in the over $50,000 wage bracket deferred at least 7.6 percent of pay. (See Figure 6.)

These data on TSP savings behavior contrast in part with the findings reported in a 1998 study of 401(k) plans that showed women were somewhat more likely to participate in 401(k) plans than men (Clark, 1998). In 1995, 79.9 percent of women, compared to 77.7 percent of men, made contributions to the plans covered in the study. The same study also showed that women deferred a larger portion of their pay than their male colleagues. The exception was among younger and less-well-paid workers. This finding shows 401(k) savings behavior consistent with the behavior of the TSP participants with like characteristics; i.e., among young workers and workers with earnings of less than $15,000, men were more likely to have participated in their plans than women.

Figure 6

Deferral Rates by Salary and Gender, 1996



Source: FRTIB

Allocation of Investments

Since legislation enacted in 1990 removed the restrictions on investment allocation, participants in the TSP have had control over the full amount of their account balance. Prior to 1991, the law restricted the amounts that could be invested in the C and F Funds. CSRS-covered employees were required to invest in the G Fund. In 1987, FERS-covered employees were required to allocate 100 percent of their TSP savings to the G Fund. This requirement to invest only in the G Fund decreased by 20 percent each year through 1990 and was eliminated altogether in 1991. Starting in 1991, participants in the TSP could also reallocate their past contributions among the three funds.

Allocation of Investments by Participants. An aversion to risk is seen in a snapshot of 1996 allocation choices made by TSP investors. The overall average year-end allocation by contributing participants in 1996 was 56 percent to the virtually no-risk U.S. Treasury securities fund (G Fund), 38 percent in the common stock index fund (C Fund), and 6 percent in the bond index fund (F Fund).

The one-year snapshot can be misleading, however. The average allocation to Treasury securities remained larger than the average allocation to common stocks in 1996, but the difference between the C and F Fund allocations was not as great as it was in 1995. Average allocation to the C Fund increased from 30 percent in 1995 to 38 percent in 1996, while the average allocation to the G Fund dropped from 63 to 56 percent. In 1996, TSP participants had shifted some of their allocation from the G Fund to the C Fund (possibly in response to the gains of the market). This shift from government securities to stocks was present in all age and salary groups.

Even though the average *allocation* by individuals, to the G Fund was larger, as of June 1997 the aggregate *balance* for the C Fund was higher than the aggregate *balance* for the G fund. This is due in part to the increase in the market value of stocks.[21] (See Table 5 and Appendix C.) Additionally, the 38 percent allocation figure is an *average*. It does not show that those with annual incomes above $40,000 allocate a larger percentage of their income to the C Fund than do those in the lower salary groups. For example, in the $10,000-$19,000 salary group the average allocation was 29.3 percent to the C Fund and 64.7 percent to the G Fund, whereas for those in the $50,000-$59,000 group, an average of 46.9 percent was allocated to the C Fund and 46.3 percent to the G Fund.

Table 5
CHANGE IN INVESTMENT BALANCES (in 000s)
January 1997 - December 1997

Description	G Fund	C Fund	F Fund	Total
Investment Balance Beginning of Year	$ 23,989,920	$ 18,778,176	$ 2,585,205	$ 45,353,301
ADDITIONS:				
Contributions				
Participants	1,805,842	2,683,767	331,435	4,821,044
Employer	943,492	1,125,239	154,527	2,223,258
Interfund transfers	(1,401,851)	1,570,367	(168,516)	-
Earnings	1,629,547	437,858	189,585	2,256,990
Net change in market value	-	6,325,926	68,335	6,394,261
Participant loan repayments	279,589	229,821	27,038	536,448
Forfeitures	10,276	-	-	10,276
	3,266,895	12,372,978	602,404	1,624,277
DEDUCTIONS:				
Benefits paid to participants	859,432	484,967	69,198	1,413,597
Participant loan disbursements	730,562	655,059	82,602	1,468,223
Administrative expenses paid	36,023	24,528	3,432	63,983
	1,626,017	1,164,554	155,232	2,945,803
NET INCREASES	1,640,878	11,208,424	447,172	13,296,474
Subtotal	25,630,798	29,986,600	3,032,377	58,649,775
Special Treasury Securities (net)	61,528	(52,407)	(9,121)	-
Accrual-to-cash adjustments (net)	11,366	11,924	12,624	35,914
Investment Balance End of Year	$ 25,703,692	$ 29,946,117	$ 3,035,880	$ 58,685,689

Source: FRTIB

Allocation based upon risk aversion was demonstrated by a portion of TSP participants in August and September of 1998. As reported by James Glassman in the Washington Post on November 5, 1998, "…participants in the TSP … shifted $106 million of their retirement money out of stocks and into bonds [in August]. In September, they moved another $427 million. After all, the TSP participants had watched while the DOW plummeted from 9339 on July 17 to 7633 on October 1—a decline of 18 percent. The [money] that was transferred out of C [Fund] in August and September represents less than 2 percent of assets in that fund. …But the exit from stocks is troubling since $1 billion was transferred from G and F [Funds] into C between February and July" (Glassman, 1998).[22]

Investment Allocations by Age and Salary. Allocation of funds is also influenced by the individual investor's age and salary. While market gains have provided a strong incentive for participants to allocate their investment dollars to the C Fund, the data show that, consistent with life cycle principles, as age increases, there is higher allocation to the less risky G Fund. In contrast, as salary increases, there is higher allocation to the more risky, but potentially more profitable, C Fund. These findings are consistent with the findings of a 1990 TSP participant survey (Hinz, 1990),[23] that showed higher earners were significantly more likely to invest in the C Fund than were lower earners. (See Table 6.)

Table 6
Participant Investment Average Allocations (includes both CSRS and FERS)

Investment Choice	**1995**	**1996**	**1996**		**1996**	
	Overall Average Allocation %	Overall Average Allocation %	Youngest (age 20-29) %	Oldest (age 70-plus) %	Lowest Salary ($10K-$19K) %	Highest Salary ($70K+) %
G Fund	63	56	49	69	65	43
C Fund	30	38	44	26	29	50
F Fund	7	6	7	4	6	7

Source: FRTIB

Investment Allocations by Gender. Gender also is influential in investment choice. Women, according to the FRTIB data, are more risk-averse than men. In all age groups and in all but the highest salary group, men make lower average allocations to the G Fund and higher average allocations to the C Fund than women. These data support the findings from the earlier study of TSP participants (Hinz, 1990). The researchers found that only 28 percent of women, in contrast to 45 percent of men, allocated their TSP funds to the more risky C Fund.

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[21] The net change in the market value of the C Fund in 1997 was $6,325,926,000. The change in 1996 was $2,788,603,000.

[22] The average account balance asset allocations at the end of July 1998 for the G, C, and F Funds were 31 percent, 63 percent, and 6 percent respectively. In August, those allocations were 35 percent, 59 percent, and 6 percent, and in September they were 34 percent, 59 percent, and 7 percent.

[23] This study was based on a survey in which self-selected respondents reported their behavior and interests.

High-salary women are an exception to the rule. Both men and women in the $70,000-plus salary bracket allocated an average of 43.5 percent to the G Fund in 1996. Allocations to the C and F Funds for this same group of high-salary men and women were also similar. (See Table 7.)

Table 7
1996 Investment Allocation for Men and Women by Selected Salary Range

Salary	G Fund		C Fund		F Fund	
	Men %	Women %	Men %	Women %	Men %	Women %
$10,000 - $19,000	60.7	67.4	32.6	26.9	6.7	5.7
$30,000 - $39,000	59.4	64.0	34.9	30.3	5.7	5.7
$50,000 - $59,000	44.7	49.9	48.8	43.4	6.5	7.2
$70,000 and over	43.5	43.5	50.1	49.0	6.5	7.5

Source: FRTIB

V. Participant Accounts: Actions and Options

TSP Contribution Change or Reallocation

Contributions to the TSP are made on a pay-period basis, usually through payroll deductions. A TSP account owner can allocate a portion of future contributions to any or all of the three TSP funds. An election to change or reallocate the investment of future TSP contributions can be made during the two TSP open seasons held each year (November-January and May-July). The last month of each open season (January or July) is called the election period. An Election Form can be submitted to the employing agency at any time during an open season, but the election will not become effective before the first full pay period of the election period.

TSP Interfund Transfer

There is no prohibition against an employee moving some or all of an existing account balance among the G, C, and F Funds—including the 1-percent agency contribution and earnings. However, interfund transfer requests are processed monthly after accounts are valued. That means if an individual’s paperwork request is received by the 15th, the transfer is effective as of the end of the month. This lag can be problematic for those who want to “control” their money on a daily basis. It is not possible, for example, in anticipation of a market drop or a market increase, for an individual to move money quickly from the bond fund to the stock fund. (Daily transfer capability will be available in the new record-keeping system that will be operating the year 2000.)

Early Withdrawals for In-Service Employees

From the outset of the TSP, an individual’s access to his or her own TSP savings for other spending prior to retirement was minimal and continues to be an issue for discussion. Until November 1997, access rules prevented a worker while in federal service from making a withdrawal from the TSP, and borrowing was permitted in only very limited circumstances.

Those who argued that the money in a TSP account belonged to the employee and should be accessible when and how the account owner desired did not agree with the stringent access rules written into the law. Beginning in May of 1995, the Congress held hearings to review the status of the TSP, examine potential improvements to the system, and recommend legislation. Ultimately, the Thrift Savings Plan Act of 1996 was passed.[24] Included in this legislation were two new early withdrawal options.

The Senate Committee on Governmental Affairs, in its report on the changes to the original TSP, provided background on the thinking behind the new withdrawal options: "…we also looked at how we might improve the liquidity and flexibility of the program, to improve participation in the program and to encourage employees to save. We looked at ways to allow employees to gain access to their savings without jeopardizing the primary purpose of providing retirement income security. We also looked at how we might modify the withdrawal options under the program so that upon retirement a participant could tailor a plan to meet their [sic] retirement needs…" (U.S. Senate Committee on Governmental Affairs, 1996).

The two in-service withdrawal options that were made available through the Thrift Savings Plan Act of 1996 (TSPA) are:

- Individuals who are 59 ½ or older may make a one-time withdrawal from their accounts. Those who make this type of withdrawal can continue to invest in the plan. (After age 59 ½ the IRS early withdrawal penalty does not apply because an individual is considered to be "retirement age.")

- Individuals who can demonstrate "financial hardship" may also make an in-service withdrawal. However, it must come only from the worker's contributions and earnings (not from the employer contribution and earnings). Once this type of withdrawal has been made, no contributions (or employer match) can be made for six months. The withdrawal, unlike a TSP loan, cannot be repaid and it is taxable as well as subject to the early withdrawal penalty.

While the following data do not provide much insight into long-term trends because they became available so recently, the data are nonetheless revealing. The numbers of early withdrawals in 1997 (for November and December) were 875 for age-based withdrawals and 743 for hardship. For the combined months of January and February, 1998, the number of age-based withdrawals increased to 1,058, and hardship withdrawals went up to 1,441.

Withdrawal Options at Separation

Concerns about a worker's spending TSP savings upon withdrawal were voiced by the Comptroller General in 1985 when he testified before the U.S. Senate Committee on Governmental Affairs about one of the early savings vehicle proposals. "The bill (S. 1527) also differs from private sector thrift plans by prohibiting employees from withdrawing their

[24] P.L.104-208

funds upon separation before retirement except for transfer to an individual account [IRA]. We believe that this provision is sound in that it emphasizes the purpose of the plan which is to provide retirement benefits" (Bowsher, 1985).

As the law stands today, at separation from Federal service, a worker has several options for withdrawal of a TSP account: a life annuity, single payment, monthly payments, transfer, cashout or loan.[25]

Life Annuity. Three basic annuities can be purchased through the TSP:

- Single Life—paid only to the worker during the worker's lifetime.

- Joint Life with Spouse—paid to both spouses, then to the survivor during his/her lifetime. (Any joint life annuities may be designated to pay either 100 percent or 50 percent of the couple's benefit to the survivor.)[26]

- Joint Life with Someone Other Than Spouse—paid to both individuals, then to designated survivor for his/her lifetime. (The designated survivor must have an insurable interest in the plan participant.)

These annuities are purchased from a commercial annuity vendor. Currently they are provided through a master annuity contract between the TSP Board and Metropolitan Life Insurance Company, the provider competitively chosen by the Board.

Single Payment, Monthly Payments. If the individual chooses not to have the TSP purchase and administer an annuity, the individual can withdraw the account in either a single payment or a series of monthly payments. If a series of payments is chosen, the separated individual can receive payments for a fixed number of months or in a fixed dollar amount until the account is depleted, or s/he can have the TSP compute monthly payments based on an IRS life expectancy table. With this option, the individual continues to exercise control over the investment allocation of the account. If an individual chooses to receive a series of monthly payments, s/he can decide at any time to have the balance paid out in a single payment.

Another option is that the participant may instruct the TSP to transfer all or part of a single payment, or in some cases, the monthly payments, to an IRA or other eligible retirement

[25] The employee must be separated for 31 or more full calendar days to be eligible to withdraw his/her account. Payment(s) can begin immediately upon separation or at a later date. There may be tax penalties for an individual who separates or retires before the year in which she or he turns 55 and withdraws funds before age 59½.
[26] Spousal rights requirements apply to withdrawal choice for a married participant. The spouse of a married FERS participant has the right to a joint and survivor annuity with 50-percent survivor benefit, level payments, and no cash refund feature, unless that spouse waives the right to that annuity.

plan.[27] There is, however, no requirement that TSP accounts be rolled over to other retirement or savings vehicles.

Transfers, Single Payments, and Cashouts. In 1997, there were 86,316 withdrawals from the TSP by those separating from government employment. These withdrawals represented well over $1.3 billion. Of the withdrawal options available, three were prevalent: transfers (rollovers), single payments, and cashouts. Of the withdrawals, just under one-third (25,645) were trustee-to-trustee transfers into other qualified plans. The $723 million in transfers represented more than half of the 1997 withdrawn dollars. The number of transfers has remained relatively stable, but the dollar amount has grown impressively. In the first three months of 1998, the transfer amount totaled $242 million, more than one-third the amount of all transfers in 1997.

There were also 29,759 single payments, representing $403 million, made to workers who had left service in 1997. Unlike transfers that move dollars from retirement account to retirement account, single payments are dispensed to the individual. As a result, it is not known how large a portion, if any, is rolled over by individuals into retirement savings vehicles and/or what portion is spent.

If a worker's account is less than $3,500, unless the worker has directed the plan to do otherwise, a single payment termed a "cashout"[28] is made.[29] The number of cashouts has dropped from a peak of 35,915 in 1995 ($36.6 million) to 19,256 ($23 million) in 1997. Data are not available on whether these workers invest or spend their cashouts.

Loans from Individual TSP Accounts to In-Service Employees

While it has been deliberately made difficult to withdraw funds from a TSP account, a loan program gives currently employed workers access to the money they have contributed to their accounts.[30] Workers cannot borrow agency contributions (including the attributable earnings) from their accounts. The minimum loan amount is $1,000; under the Internal Revenue Service (IRS) rules, the maximum that can be borrowed is $50,000. (Other IRS limits also apply to loans.)

Two types of loans are available:

1. A general-purpose loan with a repayment period of 1 to 4 years; and
2. A residential loan (for the purchase of a primary residence) with a repayment period of 1 to 15 years. No more than two loans can be outstanding at any one time. Only one can be residential.

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[27] An eligible retirement plan is one of the following: a tax-qualified employee benefit plan, an individual retirement account, an individual retirement annuity, or an annuity plan described in section 403(a) of the Internal Revenue Code.

[28] An automatic cashout is subject to the same taxes as other cash payments from the TSP.

[29] Spousal rights requirements do not apply to automatic cashouts or other withdrawals when the account balance at disbursement is $3,500 or less.

[30] FERS employees are required, by law, to have spousal consent for a TSP loan. For CSRS employees, it is only required that the spouses of be notified before approval.

Loans are repaid through payroll allotments. The loan interest rate is the same as the G Fund interest rate at the time the loan application is received. The interest paid on the loan goes back into the individual's TSP account along with repayments of the loan principal.

Prior to 1997, TSP loans could be approved only for four purposes: purchase of a primary residence, education expenses, medical expenses, or financial hardship. TSP Executive Director Mehle, testifying in hearings about expanding the loan provisions of the plan, observed that "While the limited TSP 'purpose' loans have provided a degree of liquidity for employees, they place substantial administrative costs and bureaucratic burdens on loan applicants and on the Plan itself, because of the inescapable requirement under current law that participants thoroughly document their loan purposes. Further, the current 'purposes' do not include all of those that some (perhaps many) consider worthwhile." (Mehle, July, 1996.)

In an attempt to allay fears that the money individuals took as loans from their accounts without explicit "purpose" would not be replaced, the TSP Executive Director reminded the Members of the U.S. House Subcommittee on Civil Service that: "Loan repayment is simple and certain through payroll allotment. As a loan is repaid, the account is replenished to serve its primary role as a source of income during retirement." Mehle did not discuss the potential lost interest with the committee members, however.

An individual is required to repay the loan with interest. However, the interest is paid at the G Fund rate. If the money is loaned from a high-interest-earning account, a substantial amount of earnings (and compounding thereon) could be lost. By law, before a loan is issued, the Executive Director must provide to the applicant written information concerning the cost of the loan.

While there are no data to show what borrowers would have done without the general-purpose loan (i.e., shopped for a loan elsewhere at a higher interest rate, borrowed less at a lower interest rate, or gone without), the available data provide some interesting information. In 1997, 204,344 general purpose loans at an average amount of just over $6,300 were disbursed. While there were fewer residential loans (only 16,510), the average residential loan amount of just over $12,000 was significantly higher. The *number* of loans disbursed in 1997 was close to three times the number disbursed in 1996 (79,670). And, the *dollar amount* loaned in 1997 was more than three times that loaned in 1996—$1,506,455 and $497,603 respectively.

Conclusion

With more than 2.3 million accounts[31] and $68 billion in account balances, the TSP is the largest defined contribution plan in the nation. As one part of the Federal Employee Retirement System that also includes Social Security and a defined benefit pension, it provides federal employees the opportunity to invest a portion of their income, on their own, toward the goal of retirement income security. In this way the TSP is a great success. If, as is being discussed by some policy makers, the TSP is to be used as the model for reform of the

[31] There are 1.162 million FERS contributors, 205,000 FERS non-contributors, 658,000 CSRS active employees, and 300,000 inactive employees as of April 1998.

nation's premier social insurance program, a number of factors discussed in this paper must be examined under a different light.

Individual Patterns of Investment. The data show that not all federal employees take advantage of the TSP retirement savings opportunity. The majority of those who invest in the TSP neither invest the maximum amount nor invest their money aggressively enough to make substantial gains. Investment allocation data show that, even when the market is doing extremely well, individuals such as lower-income workers and workers in their thirties who could benefit from the potentially higher returns on equity investments put more than half of their investments in the lower risk/lower return government bond fund.

Three-Tiered Structure of the FERS. There is a major structural difference between FERS and Social Security. The FERS comprises three distinct components: It uses Social Security as a base and adds to it both a defined benefit pension and the TSP. Thus, if the TSP portion of an individual's three-part retirement package is not as large as expected, the other parts of the plan are still there. If, however, an individual investment plan were to replace a portion of Social Security and an individual's final account balances were much lower than expected (due to a downturn in the market, for example), there would be two negative consequences: the savings component would be smaller, and there would be less of a Social Security benefit to fill in the gap.

Replacement Rates. A corollary policy concern is that Social Security benefits were designed specifically to replace a greater portion of the contributions of lower-income workers than of higher-income workers. Depending on how the plan were designed, a TSP-style account could significantly alter the redistributive intent of Social Security by taking away a portion of the guaranteed benefit base.

Advocates for plans that return a portion of FICA taxes to individuals to invest on their own often make the assertion that these accounts would provide a higher rate of return to beneficiaries than current Social Security benefits. Still, could lower-income earners, for example, be expected to respond differently from the way they do with the TSP? That is, would they be willing to take the investment risks necessary to replace the portion of the benefit they would not receive through monthly Social Security benefits?

Options for Withdrawal. Options for in-service withdrawals became available in late 1997, and the TSP loan program was liberalized in late 1996. The TSP data from the first two months of 1998 show that, with liberalization, the number of in-service withdrawals has increased significantly, as has loan activity. The data also show that when workers separate from federal service, more participants make single-payment withdrawals than make trustee-to-trustee transfers. This strongly suggests that not all the TSP dollars are saved until retirement. It is not illogical to assume that this dissaving behavior would apply to individual Social Security accounts as well. Assuming workers' propensity to make in-service or single-payment withdrawals, if TSP-like investment accounts were added to Social Security for the purpose of strengthening individuals' retirement income security, should individual workers be given access to their money at any time before retirement? Would this defeat the purpose of individual retirement accounts?

Costs and Structure of Administration. The TSP has the advantage of assistance from all employing federal agencies in providing certain administrative services such as reporting individual workers' contributions each pay period. If a TSP-like component were to be made a part of Social Security, would the Social Security Administration be expected to function as the TSP Board does? What would be the cost to the agency, or any administering body, in additional person-hours and computer time? Who would provide information and explanations to plan participants?

TSP employers are all federal agencies operating under the umbrella of the federal government. Private sector employers are generally operating individually. It is at best uncertain how non-federal government employers would respond to the annual record-keeping and reporting responsibilities of TSP-style accounts, much less to the responsibility of providing accurate up-to-date transmittal and recording of employee transactions within the plan. How would employers deal with the additional costs? Would these costs affect the provision by employers of other benefits such as health, disability, or defined benefit pensions. In any case, what would be the cost to individual account holders? Would the cost offset potential gain?

Costs and Structure of Transition. A change that would have an effect on nearly every American worker's future retirement income could not be put in place overnight. A transition would be necessary. Time and dollars would be required to protect those near and already in retirement. The transition period would have to be designed to avoid "notches." Participants would have to be informed. The TSP, designed primarily for newly hired federal employees, had the luxury of starting small. It was also able to piggy-back on federal administrative structures already in place. As such, the TSP is probably not the most accurate indicator of what would be involved in a Social Security transition.

Finally. The TSP can provide valuable insights into how individual, tax-favored, voluntary savings/investment accounts might be added to the retirement income spectrum that includes Social Security, pension benefits, and savings.[32] However, it is important to proceed thoughtfully. As Frances X. Cavanaugh, first Executive Director of the TSP, noted, "…the [TSP] program is small compared to any plan that would have to include over 140 million Social Security-covered workers" (Cavanaugh, 1998).

[32] It is worth a reminder that adding a savings track does nothing to solve the financing problem facing the Social Security system.

Appendix A
Taxation of TSP Benefits and Withdrawals

All the money from a TSP account is taxable as ordinary income for Federal tax purposes in the year (or years) that it is received. (Contributions to the TSP are made before Federal income tax. Interest earnings are not counted for tax purposes until withdrawal.)

The way an account is withdrawn determines when the income tax must be paid. If all or part of the TSP is transferred directly to an IRA or other eligible retirement plan, Federal income taxes are not due until the individual receives payment from the IRA or plan. There is, therefore, no withholding at the time of the transfer.

There is a mandatory 20-percent federal income tax withholding on certain payments that are received directly. If an individual receives the money directly, even if it will be rolled over to an IRA or other plan within 60 days of receipt of the funds, the TSP must withhold 20 percent for Federal income tax.

In addition to the income tax an individual would pay on money withdrawn directly from a TSP account, there is a 10-percent penalty tax on money received from the TSP if the individual separates or retires before the year in which she or he reaches age 55 and the money is withdrawn early either in a single payment or a series of monthly payments. In this case, the individual is subject to the penalty tax on all amounts received before age 59½, including in-service withdrawals.

The penalty tax does not apply to either a series of monthly payments based on life expectancy or to annuity payments, payments made because of death, or payments made to participants who retire on disability.

Those who separate or retire during or after the year in which they reach age 55 will not be subject to the penalty tax on their withdrawal.

Appendix B
Inheritance of TSP Accounts

An advantage of the TSP, often cited by those who support individual accounts as a replacement for part of Social Security, is that money in the individual's name is inheritable.

TSP Account Beneficiaries

- If the employee dies before separation from Federal service, the beneficiaries are entitled to the entire account balance, whether or not the vesting requirement has been met.
- If the employee dies before the TSP account is completely withdrawn, the balance in the account will be distributed according to the Designation of Beneficiary (Form TSP-3). The beneficiaries will receive the money in a final single payment.
- However, if the employee dies after the TSP Service Office receives a completed annuity request, benefits will be provided in accordance with the annuity selection.
- If the employee did neither of the above (file Form TSP-3 or request an annuity), the account will be distributed according to the order of precedence required by law: to the widow/er; if none, the child or children equally, and descendants of deceased children by representation; if none, the parents equally or the surviving parent; if none, the appointed executor or administrator of the estate; if none, to next of kin who is entitled to the estate.

Taxation of TSP Beneficiaries

- Payments made to spouses of deceased participants are subject to 20-percent mandatory Federal income tax withholding, which cannot be waived. However, spouses of deceased participants can avoid the mandatory withholding and defer paying taxes on all or part of their payments by having the TSP transfer that amount to an IRA (but not to another retirement plan).
- Payments to beneficiaries other than a spouse are subject to 10-percent withholding; this withholding may be waived. Payments to nonspouse beneficiaries cannot be transferred to an IRA or other plan.

Appendix C
TSP Balance Sheet

THIRFT SAVINGS FUND
Statements of Net Assets Available for Plan Benefits as of December 31,

(Dollars in Thousands)

Assets	**1997**	**1996**
Investments, at market value		
U.S. Government Securities		
Investment Fund	**$ 25,703,692**	$ 23,989,920
Barclays Equity Index Fund	**29,946,117**	18,778,176
Barclays U.S. Debt Index Fund	**3,035,880**	2,585,205
Total investments	**58,685,689**	45,353,301
Receivables		
Participant's contributions	**191,085**	171,407
Employer's contributions	**87,676**	79,785
Participant loans	**2,036,236**	1,003,426
Total receivables	**2,314,997**	1,254,618
Fixed assets		
Furniture, equipment, and leasehold improvements, net of accumulated depreciation and amortization of $2,128 in 1997, and $1,714 in 1996	**1,228**	1,501
Data processing software, net of accumulated amortization of $6,010 in 1997, and $5,956 in 1996	**1,009**	50
Total fixed assets	**2,237**	1,551
Other assets	**546**	441
Total assets	**61,003,469**	46,609,911
Liabilities		
Accrued payroll and benefits	**806**	761
Accounts payable	**22,041**	34,762
Due to Barclays for securities purchased	**271,156**	211,512
Deferred rent	**1,014**	1,110
Deferred credits	**251**	301
Total liabilities	**295,268**	248,446
Funds restricted for the purchase of fiduciary insurance	**4,624**	4,426
Net Assets available for plan benefits	**$ 60,703,577**	$ 46,357,039

THRIFT SAVINGS FUND
Statements of Changes in Net Assets Available for Plan Benefits for the Years Ended December 31,

(Dollars in Thousands)

Additions to net assets	**1997**	**1996**
Investment income		
Net change in market value		
Barclays Equity Index Fund	**$ 6,325,926**	$ 2,788,603
Barclays U.S. Debt Index Fund	**68,335**	(73,992)
Earnings		
Government Securities		
Investment Fund	**1,629,547**	1,503,371
Barclays Equity Index Fund	**437,858**	329,013
Barclays U.S. Debt Index Fund	**189,585**	168,213
Less investment expenses	**(2,280)**	(1,550)
Net investment income	**8,648,971**	4,713,658
Contributions		
Participants	**4,821,044**	4,386,941
Employer	**2,223,258**	2,046,204
Total contributions	**7,044,302**	6,433,145
Forfeitures	**10,276**	6,736
Interest income on participant loans	**100,924**	56,113
Total additions	**15,804,473**	11,209,652
Deductions from net assets		
Benefits paid to participants	**1,367,868**	1,042,473
Administrative expenses	**44,140**	39,453
Participant loans declared taxable distributions	**45,729**	25,197
Total deductions	**1,457,737**	1,107,123
Net increases	**14,346,736**	10,102,529
Less funds restricted for the purchase of fiduciary insurance	**(198)**	(186)
	14,346,538	10,102,343
Net assets available for plan benefits		
Beginning of period	**46,357,039**	36,254,696
End of period	**$ 60,703,577**	$ 46,357,039

Source: FRTIB

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