Administrative Costs for Social Security Private Accounts

This Fact Sheet compares the administrative costs that are charged to individuals in private account plans in the social security systems of Chile, Sweden, and the United Kingdom. It uses their experiences to make a rough estimate of what the administrative costs might be for a carve-out account system within the U.S. Social Security system. This Fact Sheet ranks the three countries in terms of the administrative costs borne by workers and discusses aspects of their systems that raise or lower the costs.

Administrative Costs

Administrative costs arise for a number of reasons. They arise due to the costs of collecting contributions, sending contributions to investment fund managers, keeping records of accounts, and sending reports to participants. They arise due to the costs of managing investments. They arise due to the costs of converting account balances to annuities and paying annuities.

Chile

Fees are high in the decentralized Chilean system of mandatory private accounts. The Chilean private accounts completely replace the social security system that existed before the private account system was started. In Chile, each month every employer must send a check to each of the pension fund companies in which its employees have invested—there currently are six companies, but not every employer would have employees investing in all six. The administrative costs of the pension fund companies in the Chilean system in 1998 averaged 1.4 percent of account balances (James, Smalhout, and Vittas 2001). Accumulated over the working life, 28 to 33 percent of the contributions of the average Chilean worker who retired in 2000 went to fees (Gill, Packard, and Yermo 2005). These statistics on fees, however, do not include the cost of annuitizing benefits or of other forms of benefit payout. The fee for annuitizing in Chile, where annuitization is voluntary and is done through private life insurance companies, averages 5.3 percent of the account balance at retirement (SAPF 2001).

Sweden

The Swedish system has some similarities in its administrative structure to the low-cost Thrift Savings Plan (TSP) for U.S. federal government workers, which has been advocated by some proponents as a model for administering a national private account system in the United States. Thus, the Swedish system may provide information relevant for predicting the level of fees in a national private account system based on the TSP, which has low fees in part because it receives contributions from only one employer, the federal government. The administration of the Swedish mandatory private accounts differs from most other private account systems. Sweden has reduced costs by creating a central government agency to administer the accounts. The clearinghouse collects the monthly payments from employers. Rather than making monthly deposits of contributions to private accounts, the clearinghouse invests the deposits in government bonds and makes a single annual deposit (including interest) approximately six months following the end of the calendar year. The clearinghouse handles the recordkeeping for the individual accounts.

The total administrative fee in Sweden averaged 0.95 percent of assets in 2000, the
first year of the system (Palmer 2001). Of the total fee, a 0.3 percent annual fee is paid to the government clearinghouse. The clearinghouse is intended to be self-financing over the long-run but initially has had to borrow from the government because of high start-up expenses. If workers’ choices were limited in Sweden to low-cost mutual funds, the total cost to workers would be approximately 0.55 percent of assets per year, excluding the cost of providing annuities.

The fees in Sweden are substantially higher than for the TSP for U.S. federal employees, which initially had fees of 0.3 percent of assets in 1988, but whose fees have declined over time. The TSP had fees of 0.07 percent of assets in 2002 for U.S. equity investments (Federal Retirement Thrift Investment Board 2003). The administrative costs of the TSP, however, are considerably understated because the administrative functions performed by the federal government agencies outside of the Thrift Savings Board are paid for out of the budgets of the agencies (Beedon 1999, Cavanaugh 2002). For example, each federal agency is responsible for distributing TSP materials and answering workers’ questions. Each agency serves as the worker’s primary contact with the TSP.

Applying the Swedish experience to the United States, the clearinghouse function, which costs roughly 0.3 percent of assets per year, and the investment management function, which costs roughly 0.07 percent of assets as currently charged for the TSP, would result in a total fee of 0.37 percent of assets per year for a mandatory system in the United States, not including the cost of annuitization.

United Kingdom

While the systems in Chile and Sweden are mandatory, the system in the U.K. is voluntary and therefore more complex, leading to higher administrative costs. In the U.K., workers can voluntarily withdraw from part of social security and instead have part of their contributions diverted into private carve-out accounts. The government collects all contributions and distributes them to the pension fund providers chosen by the participants. The record keeping for the accounts is decentralized, being maintained by each pension fund provider. In 1998, the fees charged workers by pension fund providers averaged 3.2 percent of assets per year for individuals in plans for 10 years and 1.7 percent per year for those in plans for 25 years, with the rate declining for longer periods due to the front loading of fees (Blake and Board 2000).

Part of the costs of private accounts is the administrative cost of converting accounts to annuities. The fees for annuitization measured as a percent of assets would be lower the higher the account balance because of fixed costs involved in annuitization. A study in the U.K. has estimated that the costs for an annuity of the U.S. equivalent of roughly $15,000 to $20,000 would be 0.29 percent of assets per year (Murthi, Orszag, and Orszag 2000). That estimate is for an annuity that is fixed in nominal terms. If the annuity were price indexed, the cost would be higher.

One study has found that these fees, including the cost of annuitizing private account balances, have reduced benefits at retirement by 40 to 45 percent of the value of private accounts in the U.K. (Murthi, Orszag, and Orszag 2001). The fees charged individuals in the U.K. understate total costs.
because the government does not charge a fee for its role as a clearinghouse.

Cost Implications for the United States

Although reducing the size of government is a goal of some proponents of private accounts, administrative costs tend to be lower when the government establishes a bureaucracy that serves as a clearinghouse for contributions and as a record keeper for the accounts.

The U.S. Social Security Administration has estimated that it would need an additional 7,700 to 33,600 employees if it were to administer a system of carve-out private accounts, compared to the 19,600 employees it currently has to administer the Social Security Old-Age and Survivors Insurance (OASI) program. A system that provided services similar to those which employees receive from 401(k) plans would require an additional 33,600 employees. With the smaller number of additional employees, the contributions of workers would not be credited for a period from 7 months to 22 months after being deducted from their pay (Hart et al. 2001).

Based on the experience of the Swedish system, it would appear that a mandatory system with a government clearinghouse, and a long lag time in the crediting of contributions could be provided at an administrative cost of 0.37 percent of assets per year or perhaps less, not including the cost of providing annuities. The experience of the United Kingdom suggests that a voluntary carve-out system, because of its added complexity, may cost substantially more to administer, depending on exactly how it was structured. If workers are not allowed to reverse their decision and to return fully to Social Security, that would reduce costs. However, that arrangement may prove to be politically unpopular during some time periods, so that it is difficult to rule out that feature.

An estimate of administrative cost depends on the details of a proposal, with important factors being the size of the accounts and the frequency of crediting of contributions. The costs of administering such a system would include the cost of maintaining a government clearinghouse for collecting contributions and for recordkeeping, the cost of mutual funds for investment management, the cost of providing annuities, and the extra cost of a voluntary carve-out as compared to a mandatory account. Taking these factors into account, it would appear that such a system might cost 0.6 to 0.7 percent of assets per year after an initial period of higher costs while the system was being set up and account balances were growing. The amount by which these costs would reduce benefits at retirement would depend on how long a person worked and the time path of his or her earnings, but a rough approximation would be about 12 percent, assuming a full career of work.

Conclusions

High administrative costs have been an issue with private accounts. To reduce such costs, Sweden and the United Kingdom use a government agency that collects all contributions on a monthly basis but makes a single annual contribution to private accounts. Sweden also maintains centralized recordkeeping for accounts, while the recordkeeping in the U.K. is decentralized.

Although a government clearinghouse requires substantial government involvement, it reduces administrative costs and thus appears to be better than other administrative approaches, especially in a system that offers workers many choices. A
government clearinghouse for collecting contributions also reduces the costs to employers, which are not included in the statistics on administrative costs.

Compared to the mandatory systems, fees have been particularly high in the voluntary carve-out accounts in the United Kingdom because of the complexity of a voluntary system.

References


