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February 2, 2009

Congressional Research Service

Report RL33398

*The Structure of Social Security Individual Account
Contributions and Investments: Choices and Implications*

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May 1, 2006

Abstract. This report focuses on policymakers' administrative and structural choices regarding the collection and investment of IA assets. The choices are many. It would need to be determined who would be eligible to participate in IAs, how individuals would enroll, how participants would make their contributions, and how much would be collected from them. Workers would need to be educated about enrollment in the new program, the investment choices they face, and the implications for their final benefits. It must also be established how records would be kept once contributions are collected, what services would be provided to account holders, and how assets would be invested. In each of these areas, this report briefly summarizes the options available within a system of IAs, the potential implications of particular policy choices and, when appropriate, current Social Security and pension policy.

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CRS Report for Congress

The Structure of Social Security Individual Account Contributions and Investments: Choices and Implications

May 1, 2006

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Prepared for Members and
Committees of Congress

The Structure of Social Security Individual Account Contributions and Investments: Choices and Implications

Summary

Policymakers have debated creating a system of individual accounts (IAs) as part of Social Security for many years. However, throughout this debate, very little attention has been paid to the practical issues of program design and implementation — issues that could have a significant impact on the cost of the program, the level of participation by workers, the fees levied on accounts, and, ultimately, the assets available at retirement.

This report describes policymakers' administrative and structural choices regarding the collection and investment of assets in a system of individual accounts. The choices are many. It would need to be determined who would be eligible to participate in IAs, how individuals would enroll, how participants would make their contributions, and how much would be collected from them. Workers would need to be educated about enrollment in the new program, the investment choices they face, and the implications for their final benefits. It must also be established how records would be kept, what services would be provided to account holders, and how errors would be corrected. Other choices surround how assets would be invested and whether there would be any restrictions on fees. In each of these areas, this report briefly summarizes the options available within a system of IAs, the potential implications of particular policy choices and, when appropriate, current Social Security and pension policy.

The consequences of inadequate system design have become clear in other countries that have adopted IAs. In Australia, a public campaign had to be designed to locate the owners of 3 million lost accounts. In Great Britain, unscrupulous financial advisers persuaded thousands of investors to leave state pension funds, to their disadvantage, in a widely reported "mis-selling" scandal. To provide insights, this report also gives examples of problems that other countries have faced when implementing IAs.

A system of IAs could involve millions of Americans, billions of dollars, and could have a broad impact on the American economy. If workers contributed 2% of their current taxable earnings, the accounts could grow to as much as 10% of GDP in 10 years and to 25% of GDP in 20 years. A contribution rate of 5% could accumulate more equities in IAs in 11 years than are currently held by all mutual funds combined. Thus, the stakes are high and there is a compelling need for thorough planning and administration.

This report will not be updated.

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The Structure of Social Security Individual Account Contributions and Investments: Choices and Implications

Much of the debate surrounding the creation of individual accounts (IAs) as part of Social Security has focused on the fiscal implications of funding accounts and the risks and rewards of investing in equities.¹ Rarely debated, however, are the structural and administrative choices surrounding the design of IAs. Arguably, these choices would have a more significant impact on the number of people who choose to participate in a system of IAs and the benefits that seniors receive during retirement than on the fiscal and budgetary issues that fill the newspapers.

This report focuses on policymakers' administrative and structural choices regarding the collection and investment of IA assets. The choices are many. It would need to be determined who would be eligible to participate in IAs, how individuals would enroll, how participants would make their contributions, and how much would be collected from them. Workers would need to be educated about enrollment in the new program, the investment choices they face, and the implications for their final benefits. It must also be established how records would be kept once contributions are collected, what services would be provided to account holders, and how assets would be invested. In each of these areas, this report briefly summarizes the options available within a system of IAs, the potential implications of particular policy choices and, when appropriate, current Social Security and pension policy.

Although there are clearly interactions between the collection and investment of assets and the payout of accounts (including early withdrawals), this report does not address the choices policymakers have regarding how IA benefits should be paid or how IAs might interact with current Social Security benefits.² The one exception is in describing how couples could share accounts. For completeness, a discussion of the option to share account withdrawals at retirement is included in this report.

Table 1 (below) lists the specific questions addressed in this report.

¹ This report was written by Debra B. Whitman, who is no longer on staff at CRS. Questions should be addressed to Kathleen Romig at (7-3742).

² For a thorough resource on this topic, see Virginia P. Reno, Michael J. Graetz, Kenneth S. Apfel, Joni Lavery, and Catherine Hill (eds.), (2005). *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy, Study Panel Final Report*, Washington, DC, National Academy of Social Insurance, January, at [http://www.nasi.org/usr_doc/Uncharted_Waters_Report.pdf]. (Hereafter cited as NASI, *Uncharted Waters*.)

Table 1. Individual Account Contribution and Investment Choices

Issues	Choices To Be Made
Eligibility	<ul style="list-style-type: none"> ● Would workers of all ages be eligible to participate? ● Would individuals who work in jobs that are not currently covered by Social Security be eligible to participate?
Participation and enrollment	<ul style="list-style-type: none"> ● Would participation in the program be voluntary or mandatory? ● If participation is voluntary, could contributors move in and out of the program over time? ● How would participants enroll in IAs?
Participation incentives	<ul style="list-style-type: none"> ● Would there be any tax incentives to encourage participation? ● Would the government provide other targeted incentives to participate? ● Would IAs affect a participant's eligibility for needs-based programs?
Contribution amounts	<ul style="list-style-type: none"> ● How much would participants contribute to their IAs? ● Would there be limits on total contributions? ● Could nonworkers contribute? ● Would couples share accounts?
Collection of contributions	<ul style="list-style-type: none"> ● How would participants' contributions be collected? ● If contributions are collected by the government, would they be collected as part of a worker's payroll tax or income tax? ● Would employers face new record-keeping requirements?
Education	<ul style="list-style-type: none"> ● What types of education would be provided? ● Who would provide workers with information about participating and investing in IAs? ● Who would provide participants with investment advice?
Administrative and record-keeping issues	<ul style="list-style-type: none"> ● Who would be responsible for the administrative and record-keeping tasks for IAs? ● What type of administrative and record-keeping services would be provided? ● Who would be responsible for finding and correcting errors?
Investment of account assets	<ul style="list-style-type: none"> ● Who would invest IA assets? ● Would accounts be insured? ● Would there be multiple investment choices? ● Would participants have access to "lifecycle" funds? ● What would the default investment portfolio be?
Fees	<ul style="list-style-type: none"> ● Would there be limits on the amount and structure of administrative fees? ● Would the government provide a subsidy to cover the start-up costs or administrative fees?

Source: The Congressional Research Service (CRS).

One recurring choice is whether the administrative functions should be managed by the government or private entities. For example, policymakers would need to establish who would be responsible for providing participants with information on how to enroll, who would be responsible for maintaining account records, and who would be responsible for investing account assets. In each of these choices, the government could assume these responsibilities, or these tasks could be contracted out to a single or diverse set of private entities. Although policymakers may have ideological preferences for one management system or another, this report will highlight the practical implications of each choice.

The administrative choices described in this report are relevant regardless of whether the IAs are designed to be in addition to Social Security, often referred to as add-on accounts, or to divert payroll tax from Social Security, often referred to as carve-out accounts. Depending on the type of account policymakers might choose, some choices would be more straightforward. For example, in a carve-out system of IAs, it would be straightforward to use the current payroll tax system to collect contributions.

Administrative and structural design is critical to a well-functioning system of IAs. The consequences of inadequate system design have become clear in other countries. In Australia, a public campaign had to be designed to locate the owners of 3 million lost accounts. In Great Britain, unscrupulous financial advisers persuaded thousands of investors to leave state pension funds, to their disadvantage, in a widely reported “mis-selling” scandal. These international experiences can provide valuable lessons for American policymakers. Thus, this report includes examples of the choices and difficulties other countries have faced while implementing their own systems of IAs.

If IA legislation were to move through Congress, the structural and administrative choices surrounding the collection and investment of account assets would need to be addressed. These issues would affect the cost of the program, the fees levied on accounts, and, ultimately, the assets available at retirement. There have been numerous proposals to include IAs as part of Social Security.³ To varying degrees, these legislative proposals have addressed the choices raised in this report. However, many questions remain unanswered. Although many of these decisions may seem mundane, no effective system can be designed without addressing them.

³ For details on these proposals, see CRS Report RL33544, *Social Security Reform: Current Issues and Legislation*, by Dawn Nuschler.

Eligibility

Would Workers of All Ages Be Eligible To Participate?

Under current law, employers are allowed to exclude some workers from employer-sponsored retirement plans based on their age or work status.⁴ Policymakers need to decide whether workers who are at the end or at the very beginning of their careers would be eligible to participate in IAs. Workers near retirement age may not have time to collect significant account balances. Very young workers may not have the financial sophistication to make decisions about whether to participate and how to invest their funds. Alternatively, legislators may wish to follow the model of Social Security, which receives contributions (i.e., payroll taxes) from all workers in jobs that are covered by Social Security.

Would Individuals Who Work in Jobs That Are Not Currently Covered by Social Security Be Eligible To Participate?

Currently 96% of all workers are covered by Social Security. However, approximately 28% of state and local government workers, as well as some federal employees (i.e., those covered under the Civil Service Retirement System), are exempt from paying taxes into Social Security.⁵ These workers are covered only by their public retirement pension program, unless they worked at some point during their careers in jobs that were covered by Social Security. Allowing workers who are not participating in Social Security to participate in IAs would provide consistent coverage of workers who move between covered and uncovered employment. However, this policy may require additional contributions for those workers who do not currently pay Social Security payroll taxes.⁶

⁴ The Employee Retirement Income Security Act (ERISA, P.L. 93-406) allows employers to exclude from their retirement plans workers who are younger than 21 years old, who work fewer than 1,000 hours per year, or who have worked for less than one year.

⁵ For a complete list of workers who do not participate in Social Security, see CRS Report 94-28, *Social Security and Medicare Taxes and Premiums: Fact Sheet*, by Dawn Nuschler.

⁶ Policymakers also may consider whether IA contributions for noncovered workers would count toward current offsets (i.e., the Windfall Elimination Provision and the Government Pension Offset) to their Social Security benefits. (For a description of these offsets, see CRS Report 98-35, *Social Security: The Windfall Elimination Provision (WEP)*, and CRS Report RL32453, *Social Security: The Government Pension Offset (GPO)*, both by Laura Haltzel.)

Participation and Enrollment

Would Participation in the Program Be Voluntary or Mandatory?

Once it has been determined which workers would be eligible to participate in IAs, it would have to be decided whether those workers would be required to participate or whether they could choose whether (or not) to join.⁷ A voluntary program would allow individuals to choose to participate based on their own calculations or impressions of the costs and benefits of an IA. The number of individuals who chose to participate in a voluntary program would likely depend on the extent of public education, the ease of enrollment, individuals' perceptions of risk, and whether or not there are any financial advantages to participating. On the other hand, a mandatory program, which would require all eligible individuals to participate, may help reduce administrative expenses by spreading fixed costs across a larger number of participants. However, a mandatory program would not allow Americans to make independent personal choices about whether it was in their financial interest to participate.

If Participation Is Voluntary, Could Contributors Move in and out of the Program over Time?

If individuals are allowed to move in and out of the program during their working years, they would accrue lower account balances because they would not consistently make contributions. In addition, allowing changes without penalties could encourage risky behavior by participants who invest their accounts in high-risk investments and opt out if their investments do poorly.⁸ Allowing a single decision point would also help to reduce administrative costs, reduce the ability of participants to try to time the market, and may help simplify benefit payments if there are interactions between the accounts and Social Security.

How Would Participants Enroll in IAs?

The mechanism by which workers enroll in IAs would have an important impact on participation. Choices for enrolling participants include registering through employers; registering through the income tax system; or applying directly through the mail, by phone, via the Internet, or at a Social Security branch office. Each

⁷ Another option is to initially have a system in which some individuals are required to participate, but participation is voluntary for another group, while some other individuals are prohibited from joining. This type of system existed in Poland when the country started a private account system in 1999. At that time, all citizens younger than 30 were required to participate, Poles age 30 to 50 could choose to join the system, and those older than 50 were prohibited from participating. (OECD, *Pensions at a Glance: Public Policies Across OECD Countries*, 2005, p. 153.)

⁸ American Academy of Actuaries Issue Brief, "Social Security Reform: Voluntary or Mandatory Individual Accounts?," September 2002, at [http://www.actuary.org/pdf/socialsecurity/accounts_sept02.pdf].

option has benefits and drawbacks. Enrollment through employers would capture the current working population but would require additional paperwork for employers and could lead to confusion on the part of individuals who hold multiple jobs simultaneously or who change jobs and are inconsistent in their enrollment elections. Employer-based enrollment must also include provisions for the 16 million Americans who are self-employed.⁹ Enrollment on income tax forms would reduce the burden on employers but would not address the 18 million households that do not file income tax forms.¹⁰ Enrollment through other mechanisms would require contacting and processing the enrollments of roughly 163 million current workers and continued outreach and enrollment of new entrants to the workforce.

Another enrollment option is to assume that every worker wishes to participate but allow those who do not the option of dropping out. Workers would need to be notified in advance of their automatic enrollment and given adequate opportunity to opt out.¹¹ Recent research on §401(k) plans has shown the rate of participation increases substantially when workers are automatically enrolled.¹² However, even with the ability to opt out, automatic enrollment is likely to induce many individuals to participate, regardless of whether IAs would actually be financially advantageous.

Participation Incentives

Would There Be Any Tax Incentives To Encourage Participation?

The current tax code provides a variety of tax preferences for the deposits, earnings, and withdrawals of various retirement savings programs. Policymakers may wish to consider similar preferences for IAs. In general, the tax treatment of IAs would have an important impact on program cost, individual participation, account

⁹ Social Security Administration, Annual Statistical Supplement, 2005, available online at [<http://www.ssa.gov/policy/docs/statcomps/supplement/2005/4b.html#table4.b1>]. The Congressional Research Service (CRS) estimate is adjusted to include workers not covered by Social Security.

¹⁰ An estimated 18 million households, or 12% of all tax units, do not file an annual tax return, often because they do not owe taxes or are ineligible for any tax credits. Ninety-seven percent of nonfilers have income below \$10,000 per year. (*NASI, Uncharted Waters* p. 41.)

¹¹ The Internal Revenue Service (IRS) has issued several rulings in recent years to clarify that employers are permitted to enroll employees in §401(k) and §403(b) plans automatically through payroll deduction, provided that the employee is notified in advance and has the option to drop out of the plan. For more details, see CRS Report RS21954, *Automatic Enrollment in Section 401(k) Plans*, by Patrick Purcell.

¹² Studies indicate that automatic enrollment in §401(k)s boosts the participation rate from a national average of about 75% of eligible employees to between 85% to 95%. (See William Gale, J. Mark Iwry, and Peter R. Orzag, *The Automatic 401(k): A Simple Way to Strengthen Retirement Savings*, the Retirement Security Project No. 2005-1, at [http://www.brookings.edu/views/papers/20050228_401k.pdf].)

balances, and, ultimately, benefits. The importance of these incentives would vary across the population, depending on how they are designed.

One key choice would be whether the incentives are offered as tax credits or tax deductions. Tax credits reduce the amount of income tax an individual must pay.¹³ A tax credit is more valuable than a tax deduction of an equal amount because the credit results in a reduction in tax owed rather than a reduction in taxable income.¹⁴ Tax deductions, which lower taxable income, would provide larger incentives for high-income participants than for those with lower taxable income.¹⁵

What Tax Advantages Are Provided to Other Forms of Retirement Savings?

The current tax code contains a variety of tax preferences for the deposits, earnings, and withdrawals of retirement savings programs such as Social Security, IRAs, Roth IRAs, and employer-sponsored pensions.

- Employers and employees each contribute 6.2% of covered wages, up to a ceiling for Social Security (Old-Age Survivors Disability Insurance), although the tax treatment of contributions differs. Employees must pay income taxes on their own contributions but not on their employer's contributions. Self-employed workers pay the full 12.4% on 92.35% of net self-employment earnings, but they receive special income tax credits. Social Security benefits are not taxed for low-income beneficiaries, but high-income beneficiaries are taxed on 50% to 85% of their benefits (depending on their total income).
- Traditional IRAs and employer-based retirement plans (e.g., §401(k) plans) allow participants to deduct contributions from their income for tax purposes and defer taxes on all earnings until funds are withdrawn, at which point they are taxed as ordinary income.
- Roth IRAs and "Roth 401(k)s" allow taxpayers to make contributions from their after-tax earnings or savings, but all account accumulations and withdrawals are tax-exempt.
- Employers also receive tax incentives for private pensions. Employer contributions to pension plans are treated as tax deductible business expenses by the IRS.

¹³ Tax credits can be non-refundable or refundable. Non-refundable tax credits reduce the amount of tax owed, but would not provide any benefits for those low-income participants without a tax liability. In contrast, refundable tax credits either reduce the amount of tax owed or provide cash back to participants whose credit exceeds their tax liability. Such credits would have the largest impact on low-income participants, many of whom do not pay income tax.

¹⁴ For example, a \$300 deduction would reduce the taxes of a married couple in the 25% marginal tax bracket by \$75 and by \$30 if the couple were in the 10% bracket. A \$300 tax credit would reduce the taxes by \$300, regardless of the participant's tax bracket.

¹⁵ For example, a taxpaying married couple with \$6,000 in deductible contributions saves \$1,500 in tax if they are in the 25% marginal tax bracket, but only \$600 if they are in the 10% bracket.

Would the Government Provide Other Targeted Incentives to Participate?

To encourage participation in IAs, policymakers could provide financial incentives to all participants or to certain groups, such as low earners.¹⁶ Many employers, including the federal government, match their workers' contributions to defined contribution pension programs — such as §401(k) plans — up to a set threshold.¹⁷ Matching participants' contributions could provide a financial incentive to all individuals to participate, but would likely provide a larger transfer to high earners than low earners. Alternatively, policymakers could design a system of progressive matching that would provide larger transfers to low earners, mimicking the structure of the Social Security program, in which low earners receive a relatively higher replacement rate than high earners. Finally, a match could be provided only to participants who earn below a given threshold.

Would IAs Affect a Participant's Eligibility for Needs-Based Programs?

Some needs-based benefit programs, such as Supplemental Security Income (SSI), food stamps, Medicaid, State Children's Health Insurance Program (SCHIP), take into consideration both an individual's income and available resources to determine eligibility.¹⁸ Assets accumulated in defined contribution retirement plans, such as §401(k)s, IRAs, the federal Thrift Savings Program, are considered resources in some of these programs.¹⁹ These assets must generally be withdrawn (regardless

¹⁶ The characteristics of “low earners” would have to be carefully defined when targeting financial matches. Workers may have low earnings either because they have low wages or because they work for short periods of time. Workers with low wages may work multiple jobs, and their total earnings may not be low. Over an individual's lifetime, he or she could experience periods of both low earnings and high earnings. For example, a college student who works at summer jobs may fall below a set threshold but then rise above it when she graduates and take a full time job. It is also important to recognize that low earners may not have low incomes. Low earners may receive income from other sources, such as assets, or from other family members.

¹⁷ In the Thrift Savings Program (TSP), federal agencies contribute an amount equal to 1% of the base pay for each employee covered by the Federal Employees Retirement System (FERS) whether or not the employee chooses to contribute anything to the plan. In addition, employee contributions up to 5% of pay are matched by the federal government (dollar for dollar on the first 3% and \$.50 on the dollar for the next 2%).

¹⁸ A list of needs-based programs can be found in CRS Report RL32233, *Cash and Noncash Benefits for Persons with Limited Income: Eligibility Rules, Recipient and Expenditure Data, FY2002-FY2004*, by the Knowledge Services Group.

¹⁹ Resource limits vary by program and often by state. For example, food stamp rules count some defined contribution retirement savings plans, such as IRAs and Keoghs, as an asset but exclude others, such as §401(k) plans and Federal Employees Thrift Savings Plans. For a comprehensive discussion of how retirement accounts are treated in means tested programs see Zoë Neuberger, Robert Greenstein, and Eileen P. Sweeney, “Protecting Low-Income Families' Retirement Savings: How Retirement Accounts are Treated in Means-Tested

(continued...)

of tax penalties) and spent down to an amount below the program's resource limit before a low-income individual can qualify for the needs-based benefit, creating a disincentive for low-income workers to save for retirement in these plans. Amounts in defined benefit pension plans, however, are excluded from the resource tests in these programs. Withdrawals from defined contribution pension plans (whether taken while working or retired) and income from defined benefit pension plans are counted toward the income limits of needs-based programs.

Policymakers could decide whether assets in an IA would be considered when calculating an individual's eligibility for needs-based programs both before and after retirement age.

- **Before Retirement Age.** If IA assets are accessible before retirement age, many low-income participants may be forced to liquidate their IAs to qualify for needs-based programs, unless the accounts were explicitly excluded from resource calculations. On the other hand, if assets are considered inaccessible or if IA accumulations were excluded from resource calculations, eligibility for needs-tested benefits would not be affected. However, in some programs, this would create an inequity across retirement savings vehicles, with savings in IAs having preferential treatment to savings in defined contribution retirement plans.
- **After Retirement.** IAs could affect both income and resource eligibility. First, account withdrawals, including annuity payments, would likely be considered towards a program's income limits. Second, unless they are specifically excluded, post-retirement account assets would likely be considered toward a needs-based program's resource limits, forcing low-income retirees to exhaust their IAs to qualify for assistance. However, if such an exclusion were to be applied only to IAs, it could result in inequitable treatment of individuals with other types of retirement savings.

¹⁹ (...continued)

Programs and Steps to Remove Barriers to Retirement Savings," The Retirement Security Project, June 2005 at [<http://www.cbpp.org/6-21-05socsec.pdf>].

For a description of defined contribution and defined benefit pension plans, see CRS Report RL30122, *Pension Sponsorship and Participation: Summary of Recent Trends*, by Patrick Purcell.

Contribution Amounts

How Much Would Participants Contribute to Their IAs?

The amount that participants contribute to IAs would have an important effect on the cost and size of an IA system. Budgetary pressures could compel policymakers to consider limiting the amount participants may contribute to their IAs, regardless of whether funds come from current payroll taxes or from other sources. In a system of “carve-out” accounts (in which a share of payroll taxes is diverted from the Social Security Trust Funds), the higher the contribution limit, the larger the Social Security shortfall. Depending on the tax treatment of account contributions, there could also be significant budgetary implications of accounts funded outside the current payroll tax system.

In general, the amount that participants contribute to their IAs would directly affect the funds available at retirement. The Congressional Research Service (CRS) estimates that an average-wage worker who contributed 1% of his or her salary over a 40-year career would have an IA balance of \$34,429 at retirement, whereas a 5% contribution would yield \$178,924.²⁰

Would There Be Limits on Total Contributions?

Contribution limits can be established to limit the cost of the programs and, depending on the structure, the level of benefits for some individuals. Contribution limits could be set as a share of earnings, which would allow higher-earning participants to make relatively larger contributions and accrue higher account balances than low-earning participants. Alternatively, a ceiling could be set as a limit to the amount of earnings used to assess contributions. These ceilings are commonly found in other countries as a way to limit the amount that high-earning individuals contribute to their pension system.²¹ These contribution limits would primarily affect the relative contributions of higher-earning participants who would not be able to contribute the same share of earnings as low-earning participants. Finally, contribution limits could be a set dollar amount, as is done for §401(k) plans and IRAs.

Alternatively, policymakers could choose not to limit contributions; they could even try to encourage additional retirement savings by allowing IA participants to

²⁰ The Congressional Research Service (CRS) estimates are for illustrative purposes only and are expressed in real 2005 dollars. The estimates are based on an individual who earns the economy-wide average annual wage (projected using the intermediate assumptions of the 2004 Social Security Trustee’s Report), who makes contributions for 40 years (2010-2049), who earns a 3% real annual return on account assets (the projected rate of return to government bonds and the risk-adjusted rate of return used by the SSA Actuaries), and for whom no administrative fees are charged.

²¹ The average earnings ceiling on public pension contributions in 19 Organization for Economic Co-operation and Development (OECD) member countries is 183% of average economy-wide earnings. OECD, *Pensions at a Glance: Public Policies Across OECD Countries*, 2005, p. 33.

make contributions over and above any standard contribution rate. Once the administrative structure is established, participants may view making additional contributions to IAs as a low-cost way to increase their savings for retirement. This may be particularly true for individuals who do not have access to employer-sponsored retirement accounts. However, depending on the tax treatment and design of accounts, allowing unlimited contributions could weaken current employer-based retirement savings plans and may not increase net savings because individuals may simply substitute one form of retirement savings for another, especially if IAs receive tax preferences or other incentives.

What Are the Contribution Limits in Current Retirement Savings Programs?

Many current retirement savings programs, including Social Security, have limits on the amount that individuals contribute.

- In 2006, the maximum taxable earnings subject to the 5.3% tax an individual pays for the Old-Age Survivors portion of Social Security is \$94,200, so the maximum contribution is \$4,992.60 for an employee (or \$9,985.20 for both the employer and employee contribution).
- For an IRA (both traditional and Roth) in 2006, the maximum contribution is \$4,000 per year for those younger than 50 and \$5,000 for those 50 and older.
- In tax-deferred retirement savings such as the Thrift Savings Program and §401(k) plans, individual contributions are limited to \$15,000 in 2006. Participants age 50 or older can make additional “catch-up” deferrals of up to \$5,000. The combined employer and employee contribution is limited to \$44,000.

Could Nonworkers Contribute?

Another important policy choice would be whether to allow nonworkers to contribute to an IA, as is done in some other countries. In Italy, non-working people, including children, are allowed to participate in an IA. Allowing nonworkers to contribute would help ensure that account balances meet some standard of adequacy at retirement. Whether it is to provide family care-giving, to attend school, or due to job loss or disability, time out of the work force — especially at a young age — would significantly reduce a participant’s account accumulation. For example, when an average-earning female is out of the workforce and not contributing to an IA for five years, she would accumulate 16%-18% less than if she had not taken any time out.²² Generally, the younger a person is while out of the workforce, the smaller the account balance would be at retirement, as the participant would lose both contributions and compounded interest on those contributions. The ability to pay into accounts for non-working individuals, either by the individuals, their spouses, or other approved parties, such as parents, would help ensure that participants who

²² Employee Benefits Research Institute (EBRI) “The Impact of Workers’ Earnings Profiles on Individual Account Accumulations” *EBRI Notes*, vol. 21 no. 10, October 2000, at [http://www.ebri.org/pdf/notespdf/1000notes.pdf].

leave the workforce for an extended period of time would have adequate income during retirement. However, collecting contributions from nonworkers may be administratively burdensome, as nonworkers would not be able to use existing wage reporting systems.

Would Couples Share Accounts?

In a simple IA system, assets would be collected from an individual and used to fund his or her own retirement. This contrasts with Social Security, which provides benefits to the worker as well as the worker's current and former spouses based on a worker's past earnings.²³ If policymakers choose to mimic this feature and allow married couples to share accounts or share in the benefits from those accounts, a system that transfers assets within couples would need to be established. However, there is at least one characteristic of Social Security that is impossible to mimic in IAs without additional federal contributions.²⁴ Any transfer of assets between husbands and wives would reduce the payout for the primary account holder. This contrasts with Social Security, in which a worker's benefits are not reduced if a current spouse, or even three ex-spouses, also receive benefits based on his or her earnings.

Transfers of assets between husbands and wives in a system of IAs could be done several ways: contributions could be split at the time of deposit, accounts could be split at the time of divorce, or individuals could be required to purchase joint and survivor annuities at retirement. Whichever policy is chosen to share assets, it would need to contain provisions for divorce, as there is a high probability that by the time a participant reaches retirement age, he or she would have been divorced at some point in his or her life.²⁵

Split Account Deposits. Accounts could be split at the time of deposit so that contributions and investment earnings accumulated during marriage are split evenly. Each spouse would retain any contributions and investment earnings accumulated while single or from previous marriages. There are some advantages and disadvantages to this approach. One advantage of contribution splitting is that,

²³ About 14 million individuals receive Social Security benefits based at least in part on a current or former spouses' work record. In Social Security, the current or former age-eligible wife or husband of a retired or disabled worker is eligible to receive retirement benefits of an amount equal to 50% of the worker's benefit, and an elderly widow or widower is eligible to receive an amount up to 100% of the worker's benefit (providing no early retirement reductions apply). These benefits are available to an unmarried, divorced spouse only if their marriage lasted at least 10 years.

²⁴ Other features of the current Social Security system that would be difficult to replicate include survivor and disability benefits for young workers who have small accounts, spousal benefits for spouses who retire before the worker gains access to his or her account, and the generally progressive structure of the benefit formula.

²⁵ In 2001, 41% of men and 39% of women age 50 to 59 had been divorced sometime in their lifetime. (Rose Kreider, "Number, Timing, and Duration of Marriages and Divorces: 2001" U.S. Census Bureau Household Economics Studies, February 2005, p. 6, at [http://www.census.gov/prod/2005pubs/p70-97.pdf].)

unlike with Social Security, women or men who divorce after fewer than 10 years of marriage would receive payments based on their former spouse's earnings. Participants may also prefer this option. Some one-earner couples may wish to divide contributions to allow a stay-at-home spouse to accumulate IA assets. Some two-earner couples may wish to split contributions between two accounts, as it would allow couples with different salaries to accrue similar account balances. Splitting contributions also may have disadvantages. Depending on how account fees are structured, two-earner couples may wish to consolidate their accounts into one account to reduce the impact of a flat-dollar fee, or to take advantage of lower fees with higher account balances (such as those currently offered by many banks). Splitting contributions would also add a significant administrative burden by requiring the collection of timely and accurate reports of each participant's marital status. Because marriage is a state-defined legal status, a new national reporting system would have to be created to track marriages, divorces, and possibly participants' joint preferences on contribution sharing.²⁶

Split Accounts at Divorce. Another way to transfer assets between couples would be to split contributions and interest earned during a marriage at the time of divorce. Policymakers could choose to model the rights of former spouses in IAs on Social Security law, on state family law, on laws used for other retirement plans, or to establish a new federal policy. Roughly 1 million women age 62 or over receive Social Security benefits based, either in part or in whole, on the work record of an ex-spouse.²⁷ To receive spousal benefits in Social Security, a divorcee's former marriage must have lasted at least 10 years. If IAs are legally considered property, then state family laws could be used to determine distributions between couples during marriage, divorce, and/or when an account holder dies. However, this would lead to inequities across states and confusion for couples who moved across state lines during their marriage.²⁸ In addition, many people who get divorced are unable to afford an attorney and may not fully pursue their rights to claim their spouse's IA assets. Alternatively, policymakers may wish to use rules currently governing

²⁶ No consistent national reporting system to track marriages and divorces currently exists. IRS records for taxpayers may not be an accurate record of marital status for that tax year, as there are certain circumstances in which legally married couples could file as unmarried (e.g., single or head of household). The Social Security Administration also does not collect information on a worker's marital history until the time at which he or she applies for benefits.

²⁷ *NASI, Uncharted Waters* p. 119.

²⁸ Distributions would be dependent on whether the couple resides in one of the nine community property states, which treat all property acquired during a marriage to be held jointly by the spouses, or in a common law state, where property belongs exclusively to the spouse who holds title. Movements between states could result in mixed property.

pensions or §401(k)s to define the rights of spouses.²⁹ Finally, policymakers may choose to explicitly establish uniform federal spousal rights for IAs.³⁰

Split Accounts at Retirement. Finally, couples could share account distributions at retirement, either directly or by purchasing joint and survivor life annuities. Account balances could be divided between married couples when either spouse retires. As with contribution splitting at the time of deposit, administrative issues surrounding the tracking of marriages over a lifetime would be an obstacle in ensuring that assets are properly credited to former spouses. Another way to share IAs at retirement would be to require the purchase of joint and survivor life annuities. A life annuity is an insurance product that promises payment for as long as the annuitant lives. Married participants could be required to purchase joint-life annuities for themselves and their current (or former) spouses. However, this would lower the payments a participant receives from his or her own IA. Joint-life annuities provide significantly lower payments than single annuities and are sensitive to the ages of both spouses. Also, it would be complicated to structure annuities for divorced and remarried participants or participants who divorce after they have purchased an annuity.

Collection of Contributions

How Would Participants' Contributions Be Collected?³¹

Policymakers could choose to designate whether contributions would be collected by the government, by employers, or whether individual participants would be responsible for sending in their contributions directly. All of these models exist currently for the various forms of retirement savings. Social Security contributions are withheld by employers and collected by government as a payroll tax. Contributions to employer-sponsored pensions are collected by employers and invested either directly by the company or forwarded to private fund managers. Finally, individuals who set aside funds for retirement in savings accounts or IRAs generally must take responsibility for opening their own accounts and making deposits.

²⁹ In an employer-provided defined benefit pension, the default payout to a married worker must be a joint and survivor annuity and spouses must consent to a lower payout and any loans. Accounts established under §401(k) provide few rights for spouses. Only if the §401(k) plan offers annuities *and* the worker chooses one is spousal consent required to choose a payment other than an joint and survivor annuity. Laws governing pensions and retirement savings accounts do not automatically provide divorcees with access to these accounts, requiring state courts to determine the distribution of funds as a part of divorce settlements.

³⁰ For a thorough list of options see *NASI, Uncharted Waters*, p. 127.

³¹ Rather than directly collecting IA contributions, policymakers could also choose to fund IAs with general revenue.

While each of these options is possible for a system of IAs, in general, the more decentralized the system of collection, the higher the administrative costs. A centralized system in which the government collects contributions from employers may also provide a more consistent record of deposits, which may be necessary if there are any interactions between IAs and Social Security benefits.

If Contributions Are Collected by the Government, Would They Be Collected as Part of a Worker's Payroll Tax or Income Tax?

One way to collect IA contributions would be through a payroll tax, which is how funds are collected for the current Social Security system. Under current law, covered employers and employees each contribute 6.2% of payroll for Old-Age Survivors and Disability Insurance (OASDI) and 1.45% for the Hospital Insurance (HI) part of Medicare. Self-employed individuals pay the full 15.3% but receive certain tax credits. High earners and their employers do not pay OASDI taxes on earnings greater than \$94,200, but there is no such limit for HI tax.³² If contributions are collected through the payroll tax system, policymakers would have to decide whether tax rates would be the same for participants and nonparticipants, whether the current cap on taxable earnings would apply, and whether the contribution would be withdrawn from the employer or employee share (or both). Tax treatment differs between the employers' and employees' contributions. Employees pay income tax on their share of the payroll tax, but not on the employers' share.

IA contributions could also be collected through the income tax system. Unlike with the payroll tax, the income tax form has the advantage of collecting information about a participant's total income from multiple jobs as well as non-wage income. Many tax filers also provide family information, such as their household income, marital status, and the existence of dependent children. A system of IAs that incorporates links among family members, provides participation incentives such as matching contributions based on earnings, or calculates rates of withdrawal based upon total retirement income may require this detailed information about participants. An additional mechanism for collecting contributions would also need to be implemented for workers who choose not to file income tax returns because their incomes are below the applicable filing thresholds. These workers could be required to file forms with an IRS service center or other centralized collection agency, although the additional filing burden would likely reduce participation among these workers.

³² See CRS Report RL32896, *Social Security: Raising or Eliminating the Taxable Earnings Base*, by Debra Whitman.

Would Employers Face New Record-Keeping Requirements?³³

Policymakers may choose to rely on the current payroll tax reporting system for employers or to develop new requirements for IAs. Relying on the current system could lead to long delays — estimated at 15 months on average — between the time when contributions would be deducted from participants' paychecks and when they would be credited to their IAs.³⁴ Under current law, employers are required to report individual tax contributions once per year. The current reporting system is also error-prone because the majority of small employers submit their reports on paper.³⁵ Long delays in reporting would cause participants to lose interest on their contributions.³⁶ To reduce delays, employers could be required to report and deposit IA contributions more frequently or to submit IA contributions electronically.³⁷ However, reporting contributions more frequently would impose additional costs on employers, particularly small employers or those without sophisticated salary-administration systems.³⁸

³³ For a more thorough discussion of these issues, see CRS Report RL32756, *Social Security Individual Accounts and Employer-Sponsored Pensions*, by Patrick J. Purcell.

³⁴ President's Commission to Strengthen Social Security, *Strengthening Social Security and Creating Personal Wealth for All Americans*, December 2001, p. 47.

³⁵ In 2003, 72% of all employers submitted reports to SSA on paper. (See CRS Report RL32756, *Social Security Individual Accounts and Employer-Sponsored Pensions*, by Patrick J. Purcell.)

³⁶ For example, assuming identical annual rates of return at 7%, a deposit of \$100 a month (\$1,200 per year) after 40 years would yield \$254,166 if funds were deposited annually, \$260,966 if deposited quarterly, and \$262,481 if deposited monthly. Smaller accounts would lose less interest. For a \$300 annual deposit, the difference between annual and monthly deposits over 40 years would only be \$2,080. (Kelly Olsen and Dallas Salisbury "Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs" in *Beyond Ideology: Are Individual Social Security Accounts Feasible?* Edited by Dallas Salisbury, Employee Benefits Research Institute, Washington, DC, 1999, p. 20) and (Fred T. Goldberg and Michael J. Graetz, "A Practical and Workable System of Personal Retirement Accounts, in *Administrative Aspects of Investment-Based Social Security Reform*, John B. Shoven ed., University of Chicago Press, Chicago, 2000, p. 19).

³⁷ Policymakers could choose to follow the depository requirements of §401(k) plans in which contributions must be credited to individuals' §401(k) accounts on the earliest date that they can reasonably be segregated from the employer's general assets, but in no event later than 15 days following the month in which a contribution was received by an employer. (As set in Department of Labor regulation 29 CFR § 2510.3-102, at [http://www.dol.gov/ebsa/regs/fedreg/proposed/97_7709.htm].)

³⁸ Prior to 1978, employers were required to report W-2 information along with their quarterly wage and tax statements. It has been estimated that the change from quarterly to annual reporting has saved small businesses close to \$1 billion per year. (Kelly Olsen and Dallas Salisbury "Individual Social Security Accounts: Administrative Issues" EBRI Issue Brief Number 236, Special Report 40, September 2001, p. 18, at [<http://www.ebri.org/pdf/briefspdf/0901ib.pdf>].)

Education

What Types of Education Would Be Provided?

Successful implementation of a system of IAs would benefit from an American public informed about its choices and the implications for its future retirement income. However, the type of financial education needed would vary significantly between those who choose to participate and those who do not, and between those who have a limited understanding of their financial options and sophisticated investors who regularly make decisions about their retirement savings and investments. Public education needs would also increase with the complexity of the program.

Information About Participation and Investment Options. All Americans would need basic information on who is eligible and how to participate in IAs. Individuals would need information on how to enroll and disenroll, how much they could contribute, how contributions would be collected, and whether they would receive any financial incentives for participating. Individuals would also need to be educated about the benefits and tradeoffs of participating in IAs so they could make informed choices about whether or not to join the system. In particular, participants would need to understand how participation in IAs could affect their Social Security benefits. Information may also need to be provided to all employers to describe any changes made to current withholding and reporting requirements for workers who participate in IAs.

Those individuals who choose to participate in a system of IAs would need to understand the types of investment options that would be available to them and the structure of any administrative fees that may exist. Unless this information is standardized and clearly presented, the average worker may find it too complicated or time-consuming to compare fees and performance across multiple investment vehicles. Even then, if the number of choices becomes too high, participants may feel overwhelmed. In 2004, new entrants to the Swedish personal account system faced 664 investment fund choices. Fewer than 10% of these new participants made an active investment choice, while the other 90% ended up in the default fund.³⁹

Financial Education. IA participants would need at least a basic level of financial literacy to make informed investment choices. Although it has been estimated that nearly one-half of all American households own a mutual fund,⁴⁰ a universal system of IAs would add millions of new investors who may not have any

³⁹ One explanation is that many of the new entrants were very young workers. (Weaver, R. Kent, "Social Security Smorgasbord? Lessons from Sweden's Individual Pension Accounts," Brookings Policy Brief #140, June 2005 at [<http://www.brookings.edu/comm/policybriefs/pb140.pdf>].)

⁴⁰ Investment Company Institute, "U.S. Household Ownership of Mutual Funds in 2005," *Fundamentals*, vol. 14 no. 5, October 2005, at [<http://www.ici.org/shareholders/us/fm-v14n5.pdf>].

previous experience with financial institutions.⁴¹ Participants would benefit from understanding historical investment returns, the behavior of various asset classes, the financial mathematics of compounding, the principle of portfolio diversification, the relationship between risk and return, the implication of fees, and the impact of inflation.⁴² To plan for an adequate retirement income, participants would need to have a realistic estimate of their final account balances based on their earnings and rates of contribution. They would also need to understand that the number of years remaining until retirement should be a factor in determining the appropriate level of risk in their portfolio. In addition, participants should be educated about annuities, scheduled withdrawals, and other ways account balances can be used to provide income after they retire. Investment education may boost participation in IAs. In §401(k) plans, investor education has been shown to improve both participation and the savings rate.⁴³

Financial Advice. Many participants may wish to have more personalized advice on how to invest their accounts. Although financial *education* can be generic and provided to all participants, financial *advice* would be targeted to an individual participant or group of participants to help them make the proper choice among investment options. Ideally, financial advisers would provide assistance with a participant's IA asset allocation while considering that individual's (and his or her spouse's) current and expected future financial status, including private pension coverage, the type and amount of investments in other savings accounts, preferences toward risk, and expected retirement date and life span. This type of detailed assistance can be expensive, because the advisers would need a high level of training and consultations may take several hours. As participants age or face major life events, such as a disability or the death of a spouse, they may need to reassess their financial plan and require additional advice.

⁴¹ Roughly 10% to 20% of the population does not have a checking account or a savings account with a bank or credit union. (NASI, *Uncharted Waters*, p. 10.)

⁴² The impact of inflation is a crucial but misunderstood concept for retirement planning. Inflation has averaged 3% per year over the last 75 years, implying that expenses have doubled every 25 years. If this trend continues, a 40-year-old would need twice his or her current income just to maintain the same standard of living in retirement at age 65 and four times his or her current income to maintain that standard at age 90. One survey found that nearly two-thirds of American adults and students did not know that money loses its value in times of inflation. Elizabeth Bell and Robert I. Lerman "Can Financial Literacy Enhance Asset Building," Urban Institute Opportunity and Ownership Project, No. 6, September 2005 at [http://www.urban.org/UploadedPDF/311224_financial_literacy.pdf].

⁴³ Steven Nyce, "The Importance of Financial Communication for Participation Rates and Contribution Levels in §401(k) Plans," *Benefits Quarterly*, vol. 21, Issue 2, April 2005.

Who Would Provide Workers with Information About Participating and Investing in IAs?

Traditionally, the federal government has been responsible for providing the public with basic information regarding changes to a public program.⁴⁴ One advantage of the government providing the public with information about IAs would be that it would increase consistency and allow a single point of contact. The educational outreach could rely on existing public outreach, such as the annual Social Security Statement⁴⁵ or one of the several existing federal programs aimed at increasing financial literacy.

The cost of a federally managed public education campaign would depend on the complexity of the IA program and the types of media used for outreach.⁴⁶ These costs could be charged to participants as part of their administrative fees or passed on to taxpayers through general revenue financing.

⁴⁴ For example, in 1965, a massive outreach effort was conducted to get older individuals to sign up for the newly enacted Medicare program. The effort consisted of mailings, a media campaign, and targeted door-to-door outreach targeting individuals age 65 and older that cost \$7.2 million (roughly \$44 million in today's dollars). More recently, the Centers for Medicare and Medicaid Services spent \$253 million and the Social Security Administration spent \$347 million in FY2005 for education and outreach for the temporary Medicare-approved discount card and the new Medicare Part D prescription drug program. Even with the extensive public education campaign, the Inspector General found that 37% of beneficiaries needed additional help with the process of signing up after they decided to enroll in the discount card program.

Sources: CRS Report RL32828, *Beneficiary Information and Decision Supports for the Medicare-Endorsed Prescription Drug Discount Card*, by Diane Justice; CRS conversation with CMS budget analyst on Jan. 6, 2005; and Department of Health and Human Services, Office of the Inspector General, "Temporary Medicare-Approved Drug Card: Beneficiaries' Awareness and Use of Information Resources," October 2005, at [<http://oig.hhs.gov/oei/reports/oei-05-04-00200.pdf>].

⁴⁵ The Social Security Statement is an easy-to-read statement of past earnings and expected future benefits which is mailed annually to workers and former workers age 25 and older. [<http://www.ssa.gov/mystatement/>].

⁴⁶ A 2001 study by the Social Security Administration estimated that start-up costs for a public information campaign for a centrally administered system of IAs would be \$60-\$225 million and that ongoing costs would be \$5 million per year. (Lawrence E. Hart, Mark Kearney, Carol Musil, and Kelly Olsen "SSA's Estimates of Administrative Costs Under a Centralized Program of Individual Accounts" January 2001, p. 29, at [<http://www.ssa.gov/policy/docs/research/rr2000-01rev.pdf>], hereafter cited as Hart et al., "SSA's Estimates of Administrative Costs.")

Existing Federal Programs Aimed at Improving Financial Literacy.

There are a number of existing federal programs aimed at improving financial literacy. The “Savings Are Vital to Everyone’s Retirement (SAVER) Act of 1997” (P.L. 105-92) directed the Secretary of Labor to provide education and outreach to promote retirement savings. The act also required that National Summits on Retirement Savings be convened in 1998, 2001, and 2005 (held in March 2006). Past summits have produced reports to highlight major findings and recommendations.

Established in 2002 and located within the Department of the Treasury, the Office of Financial Education promotes access to financial education tools that encourage personal financial management, planning, and saving. The office also has responsibility for coordinating the Financial Literacy and Education Commission, which was established as part of the Fair and Accurate Credit Transactions (FACT) Act of 2003 (P.L. 108-159). Charged with improving the financial literacy and education of people throughout the United States, the commission is chaired by the Secretary of Treasury and composed of representatives from 20 federal departments, agencies, and commissions. The commission has established a website (<http://www.mymoney.gov>) and a toll-free telephone number (1-888-mymoney) to coordinate the presentation of educational materials from across the spectrum of federal agencies that deal with financial issues and markets.

Congress recently required the Office of Personnel Management (OPM) to develop a retirement financial literacy and educational strategy for federal employees as part of the Thrift Savings Plan Open Elections Act of 2004 (P.L. 108-469). OPM is required to educate federal employees on the need for retirement savings and investment and on how to calculate the retirement investment needed to meet their retirement goals. They must also provide information and counseling on the benefits the federal government provides and on how to plan for retirement.

Other federal programs are also directed at improving American’s financial education. The Excellence in Economics Education (EEE) program was established as part of the No Child Left Behind Act (P.L. 107-110) to promote economic and financial literacy of all students in kindergarten through grade 12. The Federal Deposit Insurance Corporation (FDIC) has created the Money Smart program as a model for banks and other organizations interested in sponsoring financial education workshops, and the Federal Reserve has hosted a variety of personal financial education programs. The U.S. Department of Housing and Urban Development (HUD) provides free counseling to address homelessness, buying or renting a home, and mortgage delinquency.

Sources: Dept. of Labor, Saver Summit: [<http://www.saversummit.dol.gov/1997saveract.html>]. Department of the Treasury, Office of Financial Education: [<http://www.treas.gov/offices/domestic-finance/financial-institution/fin-education/>]; Office of Personnel Management, Retirement Financial Literacy and Education Strategy: [http://www.opm.gov/benefits/literacy_education.asp]; Department of Education, Excellence in Economics Education Program: [<http://www.ed.gov/programs/econeducation/index.html>]; Federal Deposit Insurance Corporation, Money Smart Program: [<http://www.fdic.gov/consumers/consumer/moneysmart/overview.html>]; U.S. Department of Housing and Urban Development (HUD); and Housing Counseling [http://www.hud.gov/offices/hsg/sfh/hcc/hcc_home.cfm].

There are also a wide range of financial education programs currently available to the public, including programs through nonprofits, schools, employers, financial institutions, and community-based organizations.⁴⁷ Policymakers could rely on these current systems to provide information about the IAs or develop new systems and resources specifically targeted to informing the public about participating and investing in the program.

Alternatively, private investment managers or sales agents could be given the responsibility of educating the public about the IA program and the available investment options. Private investment managers could include financial education in their individual marketing materials or, to avoid conflicts of interest, be required to contribute to independent financial literacy campaigns. Alternatively, sales agents who represent one or multiple investment managers could be given the responsibility to provide the public with investment education. The costs of education, like the costs of advertising, could be incorporated into the management fees charged to participants. Government oversight would likely be necessary to ensure that education materials meet basic standards for accuracy and protect the public interest.⁴⁸

Some countries that have implemented IAs have used a mixed public and private campaign to promote financial literacy and provide information on participation and investment options. For example, in Sweden, information about all private investment fund managers and investment options is consolidated by the government into a single catalog, which is mailed annually to participants. A major media campaign by both the government and private investment funds helped provide Swedes with information about their new IA system and facilitate a high level of active participation. Unfortunately, attempts to limit costs have led to a substantial decline over time in the resources dedicated to Swedish investor education.⁴⁹ This may be why a recent survey found that 52% of Swedes felt they have far from sufficient knowledge needed to handle their pensions.⁵⁰

To be most effective, information materials would have to be delivered in a variety of formats. Due to the diversity of the population, there is no one-size-fits-all

⁴⁷ Burhouse, Susan, Donna Gambrell, and Angelisa Harris, "Delivery Systems for Financial Education in Theory and Practice," FYI, Federal Deposit Insurance Corporation, Sept. 22, 2004, at [<http://www.fdic.gov/bank/analytical/fyi/2004/092204fyi.html>].

⁴⁸ The Centers for Medicare and Medicaid Services (CMS) issued extensive guidelines for private firms in their marketing of the Medicare Part D prescription drug benefit. [<http://www.cms.hhs.gov/pdps/PrtDPlnMrktngGdlns.asp>].

⁴⁹ Statement of Julia Lynn Coronado, Testimony Before the Subcommittee on Social Security of the House Committee on Ways and Means, June 2005, "Sweden's Public Pension Reform: Lessons for the United States, at [<http://waysandmeans.house.gov/hearings.asp?formmode=view&id=2800>].

⁵⁰ Swedish Premium Pensions Committee, 2005 Report to Minister Sven-Erik Osterberg, "Difficult Waters? Premium Pension Savings on Course," at [<http://www.sweden.gov.se/content/1/c6/05/22/65/077d40e8.pdf>].

approach to delivering financial information.⁵¹ Although the Internet has been shown to be the most popular source for personal financial information, many individuals do not have regular Internet access. Those individuals likely to be most in need of financial education — females, minorities, older individuals, and less educated individuals — report that they prefer learning in a communal environment, such as a seminar.⁵² In addition, targeted educational strategies would need to be developed for individuals with limited education or low levels of literacy, with limited language ability or proficiency, or with special needs.

⁵¹ To inform the public about the prescription drug discount card, CMS relied on a variety of education and outreach efforts, including media advertising, direct mail, Medicare’s website and toll-free help line, one-on-one counseling, and partnerships with community organizations. (Government Accountability Office Report 06-139R “Medicare: CMS’s Beneficiary Education and Outreach Effort for the Medicare Prescription Drug Discount Card and Transitional Assistance Program,” Memorandum to Henry Waxman, at [<http://www.gao.gov/new.items/d06139r.pdf>].)

⁵² Jeanne M. Hogarth and Marianne A. Hilgert, “Financial Knowledge, Experience and Learning Preferences: Preliminary Results from a New Survey on Financial Literacy,” *Consumer Interest Annual* 48 (2002), p. 6, at [<http://www.consumerinterests.org/files/public/FinancialLiteracy-02.pdf>].

Individuals with Special Needs.

Using survey data, CRS estimates that in 2001, more than 1% of the non-institutionalized population age 18-64 (2 million individuals) and 8% of those age 65 and older (more than 2.5 million individuals) had difficulty keeping track of money or bills due to a physical or mental health condition. Financial education programs could be designed to specifically target these individuals to help them make wise decisions in a system of IAs.

However, some of these individuals, particularly those with cognitive impairments or cognitive disabilities, may never be able to make independent and informed choices about whether to participate and invest in an IA. Unless an individual, institution, or organization is specifically designated to make investment decisions on their behalf, individuals with special needs would likely follow the defaults of the system. They would participate only if the system is set as opt-out, would contribute at the default rate and into the default investment fund, and follow the default payout option.

Nearly 2 million adult OASDI beneficiaries currently have a designated individual, institution, or organization that is allowed to make financial decisions on their behalf. Under current law, if a Social Security beneficiary cannot independently manage or direct the management of his or her money, a “representative payee” is given the task of receiving the Social Security benefits and paying for the beneficiary’s current needs. Representative payees receive no compensation and are personally liable for reimbursement of misused funds.

Under current law, if the OASDI beneficiary’s benefits are greater than his or her current needs, representative payees are responsible for conserving or investing the excess funds. Investments by representative payees of conserved funds are limited by state law. Most states have adopted the Uniform Prudent Investor Act (UPIA) within their laws or have state laws that parallel those of the UPIA. The UPIA provides investment rules for trustees and fiduciaries, including representative payees, that protect the OASDI beneficiary’s assets while providing the prospect of a better income. In most states, no specific type of investments is required or restricted. Policymakers would have to determine whether individuals who have cognitive disabilities or impairments or who require representative payees would be eligible to participate in a system of IAs and, if so, how participation and investment decisions would be made on their behalf.

A comprehensive system of IAs would require policies that accommodate individuals with special needs, including those with cognitive impairments or disabilities. These individuals may continue to have some paid employment or may develop impairments later in life after they have made contributions to an IA. These issues will have to be examined in relation to current federal and state laws and existing federal programs including the Social Security Disability Insurance program.

Source: CRS analysis of the 2001 Panel of the Survey of Income and Program Participation. State laws for investments of representative payees’ conserved funds: [<http://policy.ssa.gov/poms.nsf/lnx/0200603040>].

Who Would Provide Participants with Investment Advice?

Currently a wide variety of financial specialists — stockbrokers, financial planners, registered investment advisers, life insurance salespeople — provide investment advice. These professionals face differing educational and certification requirements, as well as different federal and state regulations.⁵³

As described above, individualized investment advice can be costly. The structure of advisory fees may affect both the type of investment advice offered and the population who receives it.⁵⁴ If advisers are compensated for their services by the participants with a flat fee, the fees may consume a large share of contributions of low earners. Alternatively, if advisers fees are paid as a proportion of account assets, there would be financial incentives to provide detailed advice only to individuals with high earnings or account assets. Under current law, advisers are generally restricted from charging “performance fees” — compensation tied to capital gains or asset appreciation.⁵⁵ Policymakers would need to determine whether IA investment advisers would face any additional fee restrictions or reporting requirements.⁵⁶

The provision of investment advice may also carry responsibility. Policymakers would need to determine whether IA investment advisers would face personal liability for providing advice that is against the interests of their clients. Under current law, registered investment advisers are considered fiduciaries and are required to act in their clients’ best interests. To protect workers against potential

⁵³ People or firms that get paid to give advice about investing in securities generally must register with either the Securities and Exchange Commission (SEC) or the state securities agency where they have their principal place of business. The SEC regulates larger investment advisers, whereas the states regulate investment advisers with less than \$25 million in assets under management who do not advise a mutual fund. Stockbrokers who provide advice that is “solely incidental to” their business as brokers are not required to register as advisers. Currently, there are approximately 8,100 SEC-registered investment advisers and approximately 15,000 investment advisers registered in one or more states. (Investment Advisers Registration Depository at [<http://www.iard.com/regulatory.asp>].)

⁵⁴ To provide at least a limited level of advice at a reasonable cost, the UK has implemented a two-tiered system. “Full advice” is provided by professionals with financial planning qualifications. Salespeople providing “basic advice,” which is heavily prescribed and limited to a specific range of products, are not required to hold formal qualifications. (Financial Services Authority, “A Basic Advice Scheme for the Sale of Stakeholder Products,” June 2004, at [http://www.fsa.gov.uk/pubs/cp/cp04_11.pdf].)

⁵⁵ These restrictions are designed to limit the incentives for investment advisers to take undue risks while managing their clients’ assets. However, investment advisers are allowed to charge performance fees to registered mutual funds, persons with assets exceeding \$1 million, or sophisticated investor pools.

⁵⁶ In the UK, financial advisers were recently required to standardize the information about their services into two documents. The first provides the consumer with information about the type of advice and the range of products offered. The second document tells the consumer about the amount and existence of commissions of fees and provides information on how these fees compare to market averages. (Financial Services Authority, “New rules from the FSA on financial advice: Bringing more choice for consumers,” August 2005, at [http://www.fsa.gov.uk/consumer/10_WHATS_NEW/FIRMS/new_advice_rules.html].)

conflicts of interest, firms that offer §401(k) investment funds to a company's workers are banned (under the Employee Retirement Income Security Act) from providing direct financial advice to those workers.⁵⁷ Many American employers also currently shy away from providing direct investment advice for their employees who participate in private pensions because they could be perceived as acting as a fiduciary and potentially incur personal liabilities.⁵⁸ Under a system of IAs, the potential liability for providing poor investment advice could be huge. In the UK system of IAs, the widely reported “mis-selling” scandal led to billions of dollar payments by investment advisers to nearly 2 million Britains who were sold personal pensions when they would have been financially better off at retirement in their employers' pension scheme.⁵⁹

Administrative and Record-Keeping Issues

Who Would Be Responsible for the Administrative and Record-Keeping Tasks for IAs?

Maintaining account records, responding to participant questions, and tracking account balances and transactions are just a few of the administrative tasks that would be required under a system of IAs. Policymakers could choose to designate these responsibilities to the government, private entities, or employers.

One option would be to administer accounts through a highly centralized government administrative structure. If there were linkages between IAs and current Social Security benefits, this function could be included within or in tandem with the Social Security Administration. Having the government provide administrative services for IAs could facilitate efficiencies by relying on existing systems for collecting data, centralizing processing, and providing economies of scale. However, it could require a significant new bureaucracy.

⁵⁷ Jennifer Levitz, “Congress Is Split on 401(k) Advisers — Lawmakers May Loosen Restrictions but Worry Over Conflicts of Interest,” *Wall Street Journal*, Jan. 31, 2006, p. D2.

⁵⁸ A fiduciary who breaches any of the responsibilities imposed by the Employee Retirement Income Security Act (ERISA) is, under § 409, personally liable to make good to the plan any losses resulting from each such breach. (See CRS Report RL31248, *Enron: Selected Securities, Accounting, and Pension Laws Possibly Implicated in its Collapse*, by Michael V. Seitzinger, Marie B. Morris, and Mark Jickling.)

⁵⁹ UK investment advisers paid billions of pounds in fines and compensation for allegedly providing poor advice to more than 1.7 million investors to leave state pension funds and participate in personal accounts. As of 2002, the mis-selling scandal was reported to have cost insurers and financial advisers at least £11.8 billion (\$20.5 billion in 2004 dollars) in compensation payments to investors and nearly £10 million (\$17.5 million) in fines. (Financial Services Authority press release, “11.8 Billion Compensation for Pensions and FSAVC Reviews,” June 27, 2002, at [<http://www.fsa.gov.uk/Pages/Library/Communication/PR/2002/070.shtml>], and BBC News, “Pension Scandals Cost £11.8 Billion,” June 27, 2002, at [<http://news.bbc.co.uk/1/hi/business/2070271.stm>]).

Record keeping could also be centralized under a single, private entity. This centralized clearinghouse could assume record-keeping responsibilities similar to how the federal government's Thrift Savings Plan (TSP) uses the National Finance Center to process records for all federal employees.⁶⁰ The advantage of either a public or private centralized system is that personal information about participants could be kept confidential even if funds are eventually transferred to private fund managers. It would also reduce the burden on employers and participants, who would only have to deal with a single entity.

The private sector could also manage IAs through a decentralized structure run similar to the current system of IRAs. Participants would deal directly with financial institutions to make contributions, investment allocations, and possibly to withdraw their benefits. Although competition among providers could help lower administrative costs, generally the more decentralized the system, the higher the costs due to economies of scale.

The final administrative option would be to give employers the responsibility of setting up pension funds for each of their employees, a model that is currently used in most employer-sponsored pensions. Similarly in Australia, some 8,000 organizations manage pension funds. Some of these are associated with large Australian companies; others are set up by financial institutions and allow small employers to band together; finally, some funds are industry-wide organizations generally jointly organized by union and employer representatives.⁶¹ Administrative costs would be likely be higher under this option, as costs would be incurred each time a worker changes jobs and a new account must be established.

What Type of Administrative and Record-Keeping Services Would Be Provided?

Regardless of the choice of who provides the administrative function, there are a host of options regarding the types of services that could be provided. On one extreme, participants could receive an annual statement of account balance by mail, receive customer service only by telephone during regular work hours, and have the ability to change asset allocations only once per year. At the other end of the spectrum, a high-service system could provide IA participants with personalized participant education, round-the-clock Internet and telephone-based self-management, immediate access to account information updated daily, and the

⁶⁰ The National Finance Center (NFC) of the Department of Agriculture is the record-keeper for the Thrift Savings Program for federal departments and agencies. The NFC performs detailed record keeping of participant account balances and responds to telephone and written inquiries from participants. The NFC's fees to the TSP for these services for FY2005 were approximately \$30 million. (Deloitte Independent Auditors Report of the Thrift Savings Fund, dated Mar. 4, 2005, at [<http://www.tsp.gov/forms/financial-stmt.pdf>].)

⁶¹ Lawrence H. Thompson "Administering Individual Accounts in Social Security: The Role of Values and Objectives in Shaping Options," Occasional Paper Number 1, The Retirement Project, The Urban Institute, Washington, 1999, p. 10-11, at [http://www.urban.org/UploadedPDF/retire_1.pdf], hereafter cited as Thompson, "Administering Individual Accounts in Social Security."

unlimited ability to change allocations. Participants could also receive personalized “wake-up calls” — notices that the value of their portfolio fell below a comparative benchmark — to supplement their regular statements and warn of investment performance below a comparative index. In general, providing participants with additional services and account access would raise the administrative costs and therefore decrease IA account balances over time.⁶²

Who Would Be Responsible for Finding and Correcting Errors?

IAs would require a system of checks and balances to find and ultimately correct errors. Errors can be the mistake of the participant, the employer, the record keeper, the investment fund manager, or the government. In some cases, accounts may be lost due to changes in name or address, the death of the worker, or participant errors. In the United States, the Social Security Administration is unable to process approximately 1% of all contributions due to mismatches between workers’ names and Social Security numbers.⁶³ Similar mismatches within a system of IAs could mean that billions of dollars would not be credited to participants’ accounts. In Australia, the government is trying to locate the owners of 3 million lost personal accounts, representing up to one in three workers and worth \$5.7 billion (in U.S. dollars).⁶⁴ Errors may also be caused by an employer and may result from negligence, business closure, or even fraud.⁶⁵ Errors that are thought to involve fraud could result in costly litigation. Sixteen years after Chile adopted a system of IAs, some 150,000 cases involving alleged problems with employers remitting pension contributions were pending in Chilean courts.⁶⁶

⁶² One study by the SSA estimates that the ongoing costs of a centrally administered high-service IA program similar to the one described above, but without the “wake-up calls,” would be \$1.3 billion and require 12,470 additional full-time employees, whereas a system with basic services would cost \$440 million and require an additional 4,965 full-time employees (Hart et al., “SSA’s Estimates of Administrative Costs” p. 24).

⁶³ SSA places wage items that fail to match name and Social Security number records into its Earnings Suspense File (ESF). As of October 2004, the ESF had accumulated about \$463 billion in wages and 246 million wage items for Tax Years 1937 through 2002. (Social Security Administration, Office of the Inspector General, “Social Security Number Misuse in the Service, Restaurant, and Agricultural Industries,” April 2005, Audit Report#: A-08-05-25023, at [<http://www.ssa.gov/oig/ADOBEPDF/A-08-05-25023.pdf>]).

⁶⁴ One reason for the lost accounts is that employers choose the financial intermediary for their employees. Thus, when a worker changes jobs, they may lose track of previous accounts. See [<http://www.unclaimedsuper.com.au>].

⁶⁵ Approximately 10% of U.S. employers reporting wages to SSA go out of business each year. (Kelly Olsen and Dallas Salisbury “Individual Social Security Accounts: Administrative Issues,” EBRI Issue Brief Number 236, Special Report 40, September 2001, p. 31, at [<http://www.ebri.org/pdf/briefspdf/0901ib.pdf>]).

⁶⁶ Thompson, “Administering Individual Accounts in Social Security,” p. 27.

In 1999, Chile had roughly 6 million participants in its pension system. (Carmelo Mesa-Lago, “Structural Reform of Social Security Pensions in Latin America: Models, Characteristics, Results and Conclusions,” *International Social Security Review*, vol. 54, no.

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In the current Social Security system, workers are largely sheltered from any negative consequence of an administrative or contribution error. To protect workers from errors made by their employers, SSA posts earnings credits to participants' records even if their employers have failed to send the attendant taxes, as long as the worker supplies proof of earnings (such as a copy of the worker's W-2 tax form).⁶⁷ Resolving errors in a system of IAs would likely be costly both for the entity charged with correcting them and for the participants who may lose contributions or interest on any funds in dispute.⁶⁸ Policymakers could decide whether these costs would be borne by workers or the government, or whether a separate insurance system should be established.

Investment of Account Assets

Who Would Invest IA Assets?

Policymakers would need to determine who would have the responsibility for investing account contributions and accumulations. This responsibility could be given to a government entity, a centralized investment board, or to private fund managers. The implications of each choice are described below.

Government Management. One option would be to have all IA assets invested by a single government entity. This would likely lead to lower administrative costs due to economies of scale and reduced transaction costs. The government could determine the asset allocation of the collectively invested funds, or individual IA participants could choose an asset portfolio and the government would invest funds to meet aggregate totals.

A common concern raised with regard to a government-managed fund is that it may be susceptible to political interference — such as choosing or limiting specific investments based on political criteria or trying to influence the private market

⁶⁶ (...continued)

4, September 2001, pp. 67-92(26), at [<http://www.ingentaconnect.com/content/bpl/issr/2001/00000054/00000004/art00105>].)

⁶⁷ The SSA does not investigate errors of less than one earning credit (\$920 in 2005). It has been estimated that if no errors were allowed, up to 15% of all employers would need to be contacted annually to correct errors (Hart et al., "SSA's Estimates of Administrative Costs," p. 27).

⁶⁸ According to the Government Accountability Office (GAO), in 1998, nearly 2 million businesses owed \$49 billion in unpaid payroll taxes. GAO concluded that most unpaid payroll taxes are not fully collectable and that there is often no recovery potential because many of the businesses are insolvent, defunct, or otherwise unable to pay. GAO Report GAO/AIMD/GGD-99-211, "Unpaid Payroll Taxes; Billions in Delinquent Taxes and Penalty Assessments Are Owed," August 1999, at [<http://www.gao.gov/archive/1999/a299211.pdf>].

The Federal Retirement Thrift Investment Board requires federal agencies to repay both principal and interest earnings to employees' Thrift Savings Plan accounts that were lost as a result of an agency's error (5 §U.S.C. 8432a).

through the use of proxy voting rights. Political interference or controls on investments can decrease returns. In the United States, one study found that pension funds directly managed by state and local governments experienced average returns of 1.5% less per year than comparable private pension plans.⁶⁹ In Sweden, public pension funds are estimated to have earned 3.2% less per year from 1960 to 1975 because of interference by the Central Bank.⁷⁰ To reduce fears that government-controlled investment would lead to political interference in private business, some countries with publicly managed IAs have imposed concentration limits, delegated voting rights to independent fund managers, or put caps on the voting power of the fund.⁷¹

Centralized Investment Board. One way to protect funds from political interference but retain economies of scale would be to use a centralized investment board to manage IA assets. The investment board could be designed to insulate investment decisions from political motives by restricting investments to index funds or other benchmarks, creating strict conditions on the voting rights associated with the ownership of securities, isolating the board's budget from the appropriations process, and creating other barriers to maintain independence.

Two examples of a centralized investment board within the federal government currently exist: the Thrift Savings Program (TSP) and the National Railroad Retirement Investment Trust (NRRIT). Since 1986, federal employees have had the choice of contributing a share of their salary into the TSP retirement savings program. These contributions, along with a government match, are centrally invested in funds managed by the Federal Retirement Thrift Investment Board. Since 2002, the federal government has been acquiring corporate stocks, bonds, and other assets to provide revenue for a federal entitlement program, Railroad Retirement. An independent entity, the NRRIT board, manages and invests the assets of the Railroad Retirement program with the assistance of independent advisers and investment managers.

As in the case of government-managed investments, investments in a centralized investment board can be centrally managed or participant-directed. For example, the NRRIT board collectively invests the total assets of the trust and uses active investment management strategies to increase portfolio returns. In contrast, individual TSP participants direct the investment of their contributions in a limited

⁶⁹ E. P. Davis, *Pension Funds, Retirement-Income Security and Capital Markets, an International Perspective*, Oxford University Press, 1995.

Other studies have shown that socially and politically targeted investments at the state and local level have been rare and the impact on investment returns have been insignificant. (Alicia H. Munnell and Annika Sunden, "Investment Practices of State and Local Pension Funds: Implications for Social Security Reform," in *Pensions in the Public Sector*, Olivia S. Mitchell and Edwin C. Hustead, eds., Pension Research Council & University of Pennsylvania Press, 2001.)

⁷⁰ Thompson, "Administering Individual Accounts in Social Security," p. 6.

⁷¹ Robert Holzmann, Richard Hinz, and World Bank staff, *Old-Age Income Support in the 21st Century: An International Perspective on Pension Systems and Reform*, World Bank, Washington, DC, 2005.

set of index funds. While it is possible to structure a centralized program to allow participants choice between funds, this approach does not provide participants with a choice between providers.

Centralized Investment Management: The National Railroad Retirement Investment Trust and the Federal Retirement Thrift Investment Board.

The Railroad Retirement Board (RRB) is an independent agency in the executive branch of the federal government. The RRB's primary function is to administer comprehensive retirement-survivor and unemployment-sickness benefit programs for the nation's railroad workers and their families. Railroad retirement benefits are a federal entitlement and are protected by statute.

Revenues in excess of railroad retirement-survivor benefits and administrative expenses are invested to provide additional trust fund income. Historically, the RRB was required to invest excess assets in interest-bearing U.S. government or U.S. government-guaranteed securities. In 2001, as part of the Railroad Retirement and Survivors' Improvement Act (P.L. 107-90), Congress created a new entity, the National Railroad Retirement Investment Trust (NRRIT), which is allowed to invest in non-Treasury securities such as publicly traded stocks in private companies. As of September 30, 2005, the market value of NRRIT-managed assets was \$27.7 billion.

The NRRIT was designed to insulate investment decisions from political interference. The NRRIT is not considered a government agency and is separate from the RRB. Congress directed that the NRRIT be managed by an independent board of trustees, jointly chosen by railroad employers and employees. The members of the board are not considered officers or employees of the U.S. government and are not subject to congressional confirmation. Trustees and fund managers are required to vote proxies solely in the interest of the RRB. To ensure accountability, the board of trustees is subject to reporting and fiduciary standards similar to the ERISA standards. All individual trustees must be bonded to protect the NRRIT against fraud and have the option of being insured.

The Federal Retirement Thrift Investment Board is an independent agency of the executive branch that sets policies for investment of the Thrift Savings Program (TSP) assets and administers the TSP. The board consists of five part-time board members appointed by the President and an executive director selected by the rest of the board. The executive director and members of the board are fiduciaries of the fund and are required to act prudently and solely in the interest of TSP participants and beneficiaries.

To protect the TSP from political interference, the board is exempt from the normal budget and appropriations process and the legislative and budget clearance process of the Office of Management and Budget. In addition, voting rights associated with the ownership of securities in the TSP may not be exercised by the board, other government agencies, the executive director, federal employees, Members of Congress, former federal employees, or former Members of Congress. Further, the board does not select specific investments; rather, it selects appropriate indices for investment funds and contracts with Barclays Global Investors to manage fund assets. Finally, proxy voting rights are exercised by the fund manager, Barclays, who is required to vote all shares to provide the maximum financial benefits to TSP participants. As of December 31, 2005, TSP managed assets totaling \$173 billion.

Sources: National Railroad Retirement Investment Trust [<http://www.rrb.gov/mep/nrrit.asp>]; Federal Retirement Thrift Investment Board [<http://www.frtib.gov>].

Private Fund Managers. A more decentralized option would be to allow participants to contract with private fund managers to manage their account assets. This structure is currently used for retirement savings accounts such as §401(k) plans, where many employers contract with private money managers to invest the retirement savings of their employees, or IRAs, where individuals contract with private fund managers to invest their personal retirement savings.

Policymakers could establish the conditions under which fund managers were allowed to participate. Policymakers could consider whether private fund managers should follow any licensing and registration requirements.⁷² Current securities law and regulations would need to be reviewed to ensure they are adequate to protect the range of investors participating in IAs and the size of the account assets. Policymakers could also determine which fund manager could invest the assets of accounts in which the participant does not actively choose a fund manager. This default may randomly assign participants with fund managers — similar to the way elderly Medicaid recipients were randomly assigned to a Medicare Part D prescription drug provider — or a single fund manager could be chosen as the default provider. Finally, policymakers could determine whether there would be a limit on the number of fund managers that are allowed to participate, either nationally or by state, and what criteria would be used to choose among eligible fund managers.⁷³ Too stringent limits could result in a very small number of firms with few incentives to compete by offering lower prices or better services. Alternatively, if the number of investment managers is unrestricted, participants may be faced with the responsibility of choosing from hundreds or even thousands of fund managers who each offer a range of investment options. A choice of this magnitude would likely reduce the probability that an individual would participate in the system and, for those who do participate, would likely lead many to invest their accounts in the default fund manager (if one is designated).

Countries that have private fund managers also typically have private sales agents that represent one or more fund managers. These agents generally receive a commission for enrolling participants into a particular fund and may provide information about fund options and some form of financial education and advice to potential participants. Many countries have found it necessary to regulate both the qualifications of sales agents and the types of information they provide to potential participants.⁷⁴ Other countries with sales agents have regulated the ability of

⁷² For a discussion of these issues, see Fred T. Goldberg and Michael J. Graetz, “A Practical and Workable System of Personal Retirement Accounts,” in *Administrative Aspects of Investment-Based Social Security Reform*, John B. Shoven, ed., University of Chicago Press, Chicago, 2000, p. 19.

⁷³ Participants in individual accounts in Sweden must currently choose from more than 700 mutual funds. A recent government report that evaluated the pension system recommends lowering the number of choices to between 100 and 200 by requiring a fund to achieve a set share of the market or be eliminated. (Swedish Premium Pensions Committee, 2005 Report to Minister Sven-Erik Osterberg, “Difficult Waters? Premium Pension Savings on Course,” at [<http://www.sweden.gov.se/content/1/c6/05/22/65/077d40e8.pdf>].)

⁷⁴ In Poland 450,000 agents — representing roughly 1% of the total population — were
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individuals to move between funds to reduce the incentives for sales agents to generate commissions by switching participants between funds.⁷⁵

Mixed Administration. A mixed administrative structure is also possible. Participants could be required to invest their assets in a centrally managed fund until they obtain a threshold balance in their account, at which point they could move their funds to a private fund manager. This type of system could take advantage of economies of scale to reduce administrative costs for small accounts. However, this design would set up a two-tiered system in which participants with larger account balances — primarily those with high incomes or older participants who have accumulated balances over a longer period of time — would have more choices than those with smaller account balances.

Implications. When choosing the responsible party for investing IA assets, it is important to be cognizant of how large these funds could become as a share of the economy. If workers contributed 2% of their current taxable earnings, CRS estimates that the accounts could grow to as much as 10% of the country's total economic output (GDP) in 10 years and to 25% of GDP in 20 years.⁷⁶ A 5% contribution rate could amass assets of as much as 25% of GDP in 10 years and could surpass 62% of GDP in 20 years. In three years, a 5% contribution could accumulate more assets in IAs than the total current holdings of the largest mutual fund

⁷⁴ (...continued)

registered to sell pension funds in 1999. The large number was likely due to the limited number of requirements for becoming an agent (no criminal record, being of legal age, and paying a \$25 registration fee) and may have led to questionable practices to lure workers to particular funds. (Barbara E. Kritzer, "Social Security Reform in Central and Eastern Europe: Variations on a Latin American Theme," *Social Security Bulletin*, vol. 64, no. 4, June 2003, at [<http://www.ssa.gov/policy/docs/ssb/v64n4/v64n4p16.pdf>].)

⁷⁵ In Chile, there was more than 1 sales agent per 200 customers and roughly half of the participants switched providers in 1995. This high turnover was associated with large administrative costs, and the Chilean authorities responded by imposing restrictions on switching between funds. (Solange Berstein and Alejandro Micco, "Turnover and Regulation in the Chilean Pension Fund Industry," Central Bank of Chile Working Paper No. 180, September 2002, at [<http://www.bcentral.cl/esp/estpub/estudios/dtbc/pdf/dtbc180.pdf>].)

⁷⁶ CRS estimates are for illustrative purposes only and assume that IA contributions are taken as a share of the Social Security wage base (as projected by the SSA Actuaries), began in 2005, were invested solely in equities which grew at a constant real annual rate of 6.5% (the equity rate used by SSA Actuaries when projecting solvency proposals), no administrative fees were charged, and no withdrawals were taken. Actual account accumulations may be smaller (if withdrawals were taken, administrative charges were paid, or investment returns were less than 6.5%) or larger (if investment returns were more than 6.5% or workers who are not currently covered by Social Security were allowed to participate).

manager.⁷⁷ And in just 11 years, IA assets could surpass the combined total currently invested by mutual funds in the U.S. equity market.

The decision regarding who should be responsible for investing IA assets has broad implications for the cost of the program, the administrative system, and possibly the diversity of choice of investment options. In justifying the decision to use a centralized investment structure for the Thrift Savings Plan, Congress stated:

As an alternative the committee considered permitting any qualified institution to offer employees specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who 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 for their money.⁷⁸

Would Accounts Be Insured?

IA participants would be exposed to the risk that their accounts could lose value due to the failure of the institution that holds their deposits or due to market volatility.⁷⁹ To maintain investor confidence and protect participants' assets, policymakers may wish to consider a system to insure participants against these risks. However, providing protection may have the unintended effect of encouraging risky investment behavior by participants who may seek out risky private fund managers or high-return, high-risk investments because they have nothing to lose.

Currently, investors receive some protection from the risk that they will lose their deposits if the institution in which they have entrusted their savings fails. Investors who make deposits in financial institutions, such as banks, credit unions, or with securities firms, are insured — up to a set limit — if those institutions close due to bankruptcy or other financial difficulty and customer assets are missing.⁸⁰

⁷⁷ In 2005, the mutual fund industry had \$3.9 trillion in assets invested in domestic equities. The largest fund group was Vanguard, with \$788 billion in assets (of all types). (Financial Research Corporation, "November 2005 Estimated Mutual Fund Net Flows," Dec. 27, 2005, at [http://www.frcnet.com].)

⁷⁸ Conference Report 99-606 to accompany H.R. 2672, Federal Employees Retirement System Act of 1986.

⁷⁹ Other risks, such as inflation, could also affect account values.

⁸⁰ Banks and thrift institution deposits are insured up to \$100,000 against institutional collapse by the Federal Deposit Insurance Corporation. The National Credit Union Share Insurance Fund insures customers' credit union "shares" up to \$100,000. Investors in stocks, bonds, and mutual funds held at securities firms are insured up to \$500,000 (of which \$100,000

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Assets in defined benefit pension plans — and not defined contribution plans, such as §401(k)s — are insured if their plan terminates without enough assets to pay benefits owed to each participant.⁸¹ The cost of these guarantees in times of financial trouble has been significant.⁸² Policymakers would need to determine whether IA deposits would receive protection from these existing institutions, whether a new system of protection would be established, or whether participants would bear the full risk.

Although investors in many cases are currently protected against loss due to the collapse of the institution that holds their deposits, there are no similar protections against losses due to market volatility.⁸³ Individual investors bear the sole burden if the value of their portfolios plummet.⁸⁴ Concern over the impact of market volatility on retirement income has caused countries such as Japan, Argentina, Chile, and Poland to adopt “guarantees” for their defined contribution pension accumulations.⁸⁵ Guarantees fall into two basic categories, *minimum rate of return* guarantees and *minimum benefit* guarantees, and can be designed to protect against loss, promise a

⁸⁰ (...continued)

may be cash) against institutional collapse by the Securities Investor Protection Corporation. Depending on the size of the accounts, these limits may be too low to offer IA participants adequate levels of protection. For more details, see CRS Report RS21987, *When Financial Businesses Fail: Protection for Account Holders*, by William D. Jackson.

⁸¹ This insurance is provided through the Pension Benefit Guarantee Corporation. The maximum pension guarantee is \$47,659 a year for plans that terminate in 2006. For more information, see CRS Report 95-118, *Pension Benefit Guaranty Corporation: A Fact Sheet*, by Paul J. Graney.

⁸² For example, in the 1980s, the total cost to taxpayers of the savings and loan crisis was \$132 billion. The current liabilities to the Pension Benefit Guarantee Corporation are estimated to be \$87 billion over the next 10 years. (U.S. General Accounting Office, GAO-AIMD-96-123 Financial Audit: Resolution Trust Corporations 1995 and 1994 Financial Statements (1996), p. 15, at [<http://www.gao.gov/archive/1996/ai96123.pdf>], and Congressional Budget Office, “The Risk Exposure of the Pension Benefit Guaranty Corporation,” September 2005, at [<http://www.cbo.gov/ftpdocs/66xx/doc6646/09-15-PBGC.pdf>].)

⁸³ Federal employees have access to an investment vehicle that provides a guarantee of principal (a *minimum rate of return* guarantee of at least 0%). The Thrift Savings Program G Fund is invested in short-term U.S. Treasury securities specially issued to the TSP. Payment of principal and interest is guaranteed by the U.S. government. Thus, there is no “credit risk” for assets in the G Fund. However, the guarantee does not protect participants from inflation risk.

⁸⁴ IA participants could lose money in their accounts due to poor investment performance. In the first year of the Swedish system, the 10 worst performing funds lost, on average, 77% of their value. While it was unlikely that Swedish participants put their entire contributions into these funds, there were no legal constraints on doing so. (Weaver, R. Kent, “Social Security Smorgasbord? Lessons from Sweden’s Individual Pension Accounts,” Brookings Policy Brief #140, June 2005, at [<http://www.brookings.edu/comm/policybriefs/pb140.pdf>].)

⁸⁵ John A. Turner and David M. Rajnes, “Relative Rate of Return Guarantees for Social Security Defined Contribution Plans: What Do They Accomplish?” The Pensions Institute of Birkbeck College, University of London, Discussion Paper PI-0202, March 2002.

minimum rate of return, or ensure plan participants that the benefits they receive upon retirement would be at a minimum level irrespective of the accounts' actual performance.⁸⁶ These guarantees are expensive and are highly sensitive to the type of guarantee offered, the structure of the participants' portfolio, and the number of years the portfolio would be invested.⁸⁷ The Congressional Budget Office (CBO) recently estimated the cost of guaranteeing that IA participants would receive at least the current level of scheduled Social Security benefits.⁸⁸ CBO estimates that there is a 1 in 10 chance that such a guarantee could cost as much as \$1.9 trillion over 75 years, whereas a guarantee of at least 80% of scheduled benefits could cost \$400 billion.

Key issues in designing any insurance system would be how the protection is funded and what liability the government would assume.⁸⁹ Guarantees could be provided by the private market, and IA participants could bear the costs directly through higher fees, allowing investors who have a low tolerance for risk to pay directly for their enhanced security. Insurance costs would generally rise with the size of the portfolio, so that fees would be more expensive for high earners or older participants with larger accounts. Alternatively, the government could assume responsibility for any liabilities. This would force non-participants to help subsidize the premiums of account participants. However, depending on the size of the accounts and the types of risks that are insured, the federal government may be the only entity with enough resources to provide financial backing.

Regardless of the funding source, if IAs were to be insured, they would have to face strong regulations on the types of portfolios offered and the institutions that invest them. The cost of insuring unregulated accounts is likely prohibitive. Some countries have found that strict regulations have helped their systems' viability. However, other countries have found that there may be unintended consequences to specific regulations designed to protect investors from risk. For example, in Chile, regulations that attempted to reduce risk have resulted in reducing meaningful investment choice for participants.⁹⁰ In Poland, investment funds are required to

⁸⁶ Marie-Eve Lachance and Olivia S. Mitchell, "Understanding Individual Account Guarantees," pp. 159-186, in *The Pension Challenge: Risk Transfers and Retirement Income Security*, Oxford University Press, December 2003.

⁸⁷ For a portfolio invested half in equities and half in bonds over a 40-year career, the cost of providing a *rate of return* guarantee of at least the 10-year Treasury bond return or a *minimum benefit* guarantee of at least the current Social Security scheduled benefit would be 16% of total contributions or 0.65% of assets annually. (Ibid.)

⁸⁸ Congressional Budget Office, "Evaluating Benefit Guarantees in Social Security," Background Paper, March 2006, at [http://www.cbo.gov/ftpdocs/70xx/doc7058/03-07-SS_Guarantees.pdf].

⁸⁹ For more details on the current system of deposit insurance, see CRS Report RL31552, *Deposit Insurance: The Government's Role and Its Implications for Funding*, by Gillian Garcia, William D. Jackson, and Barbara Miles.

⁹⁰ Chile measures a fund manager's performance against the returns of other funds. This has caused most funds to hold very similar portfolios. (Statement of Barbara Bovbjerg, Government Accountability Office "Social Security Reform: Preliminary Lessons from (continued...)

meet performance targets or else to make up the shortfall. Because the performance targets are calculated quarterly, investment managers focus on short-term goals rather than a long-term investment strategy.⁹¹

Would There Be Multiple Investment Choices?

As mentioned above, collectively managed assets could also be collectively invested, leaving participants with no choice in how to invest their contributions. Alternatively, participants could be offered a choice in the way their accounts are invested. In deciding how many investments to offer, policymakers face a tradeoff between offering a variety of investment choices, reducing risk, and keeping administrative costs low.⁹²

One option would be to follow the same rules governing private defined contribution retirement plans and require that participants be given at least enough choice so as to allow them to diversify their portfolio.⁹³ Alternatively, investment choices could be limited to a set choice of stock index funds and bond funds similar to the Federal employees' Thrift Savings Program (TSP). If policymakers wish to limit the number of funds, the investment criteria may have to be carefully defined to achieve an adequate level of choice for asset diversification while insulating the selection process from political interference.⁹⁴

⁹⁰ (...continued)

Other Countries' Experiences," Testimony Before the Subcommittee on Social Security, Committee on Ways and Means, House of Representatives, June 16, 2005, at [<http://www.gao.gov/new.items/d05810t.pdf>].)

⁹¹ Dariusz Stanko, "Polish Pension Funds, Does the System Work? Cost, Efficiency and Performance Measurement Issues," The Pensions Institute, Working Paper, January 2003, at [<http://www.pensions-institute.org/workingpapers/wp0302.pdf>].

⁹² Regardless of the absolute number of funds IA participants are offered, a determination would be needed if funds could be actively managed or must follow a set investment index. In general, actively managed funds have higher administrative costs than index funds. Policymakers could also establish diversification requirements for the funds. Specifically, they could decide if funds would be required to reflect the performance of a large number of companies, or invested across all major commercial sectors, or be concentrated in a single firm or industry.

⁹³ For example, section §404(c) of ERISA relieves the sponsor of an individual-account plan, such as a §401(k) plan, of responsibility for investment losses if the plan allows the participant to exercise control over the assets in his or her account and provides the participants with a broad range of investment choices. Federal regulations require these plans to offer participants at least three investment alternatives, not including the employer's own securities, that have materially different risk and return characteristics. One study found that the median number of investment options in §401(k) plans was eight and approximately 12% of §401(k) offer four or fewer investment choices, and approximately 11% offer 13 or more alternatives. (Edwin J. Elton, Martin J. Gruber, and Christopher R. Blake, "The Adequacy of Investment Choices Offered by 401K Plans," *Journal of Public Economics*, March 2004, at [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=567122].)

⁹⁴ Many countries have used political criteria for determining investment options. For (continued...)

What Are the Investment Choices in the Thrift Savings Program?

Thrift Savings Program (TSP) participants can choose to allocate all or part of their accounts to any of five funds.

- There are two fixed income funds. The “G Fund” consists of short-term, nonmarketable U.S. Treasury Securities. The “F Fund” is invested in the Lehman Brothers Aggregate bond index.
- There are three stock funds. The “C Fund” is a large-company domestic stock fund that tracks the Standard and Poor’s 500 stock index. The medium and small company “S Fund” tracks the Wilshire 4500 stock index. The International Stock Index Investment “I Fund” tracks the returns of the Morgan Stanley Capital International EAFE (Europe, Australasia, Far East) stock index.

In August 2005, the TSP also began to offer five lifecycle “L Funds.” Each fund provides a different mix of the fixed income and stock investments and is geared toward employees with a particular retirement date.

Source: For more recent information on the TSP, see CRS Report RL30387, *Federal Employees’ Retirement System: The Role of the Thrift Savings Plan*, by Patrick J. Purcell.

At the other extreme, IA investment choices could be unlimited and include any type of financial asset. However, this would likely raise administrative expenses and could subject participants to extremely high-risk assets. In addition, when presented by an unlimited and possibly confusing array of investment options, participants may find that they lack the expertise or the interest to choose a well-diversified portfolio.⁹⁵

A related issue is whether to allow IA fund options in which investments are chosen based on social, ethical, or environmental criteria. U.S. 401(k) plans are increasingly adding socially responsible investment funds to their portfolio options.⁹⁶ Some countries have developed policies on “responsible investing” that set standards for the types of investments used in their publicly managed pension funds.⁹⁷

⁹⁴ (...continued)

example, some countries have tried to promote domestic capital market growth by limiting the share of account assets that can be invested internationally.

⁹⁵ Having too many investment choices may also reduce the number of people who choose to participate in IAs. Recent research has shown that the likelihood of an individual to participate in a §401(k) diminishes by about 2% for every 10 additional options. (Iyengar, Sheena S., Jiang, W., & Huberman, G., “How Much Choice is Too Much: Determinants of Individual Contributions in 401K Retirement Plans,” in Mitchell, O. S. & Utkus, S., eds., *Pension Design and Structure: New Lessons from Behavioral Finance*, Oxford: Oxford University Press, 2004, pp. 83-97.)

⁹⁶ William Baue, “Socially Responsible Investment Through 401k Plans Comes of Age,” Oct. 10, 2003, at [<http://www.socialfunds.com/news/article.cgi/article1239.html>].

⁹⁷ Canada has a policy of responsibly investing their centrally-managed pension assets that includes a “commitment to engage with companies to encourage improved performance and (continued...)”

Policymakers could decide if criteria other than an investment's projected risk and return could be used to select IA investment options.

Would Participants Have Access to “Lifecycle” Funds?

Financial advisers nearly universally recommend investors follow a strategy of holding a mixed portfolio of stocks and bonds and rebalancing the portfolio's allocations over time as asset prices change, and also reallocating between assets as an individual ages, to reduce the level of risk as the person nears retirement. However, in practice, few investors rebalance their portfolios. Therefore, in addition to funds of pure stocks and bonds, policymakers could decide to require that participants are offered funds that combine stocks and bonds in ways to reduce risk while allowing participants exposure to higher returns.⁹⁸

To address this behavior, a financial product that automatically reallocates investment funds is becoming a more popular offering in private pensions. These so-called “lifecycle funds” are balanced portfolios with varying risk and reward characteristics. There are two types of lifecycle funds: targeted-maturity and static-allocation. In the first, targeted-maturity funds, the proportion of stock in a portfolio falls over time to provide a level of risk appropriate to the participant's age. A targeted-maturity lifecycle fund, however, can expose younger investors to more risk than they might prefer or expose older investors to less risk and lower returns than they need to adequately provide retirement income. An alternative investment structure is the static-allocation lifecycle fund, which is consistently rebalanced to maintain a fixed ratio of stocks and bonds over a career based on the participant's preference for risk. However, unless participants reallocate their investments as they age, static-allocation lifecycle funds may expose participants to more risk than is appropriate.

Lifecycle funds have become increasingly popular among defined contribution pension plan sponsors and participants.⁹⁹ Five months after they began, more than 220,000 (out of 3.5 million) TSP participants had already shifted their investments or contributions into the new lifecycle “L” funds as of December 31, 2005. These funds offer participants, even those with little or no investment knowledge, the ability

⁹⁷ (...continued)

disclosure of environmental, social and governance (ESG) factors.” Available online at [<http://www.cppib.ca/info/faqs/index.html#SIP>].

⁹⁸ Although a portfolio with a mix of stocks and bonds would reduce the variation in potential account outcomes, it would also lower the long-run return. The size of annual pensions for a worker who invested half of his or her contributions in stocks and the other half in bonds would typically be about one-third lower than for a worker who invested solely in equities. (Gary Burtless, “How Would Financial Risk Affect Retirement Income Under Individual Accounts?” October 2000, Center for Retirement Research an Issue in Brief #5, at [http://www.bc.edu/centers/crr/ib_5.shtml].)

⁹⁹ Assets in lifecycle funds totaled \$103 billion in 2004, up from \$69 billion in 2003 and \$44 billion in 2002. (Investment Company Institute, 2005, “Mutual Funds and the U.S. Retirement Market in 2004,” *Fundamentals*, vol. 14, no. 4, Washington DC, Investment Company Institute, at [<http://www.ici.org>].)

to broadly diversify their accounts and follow an appropriate asset allocation strategy. In designing a system of IAs, policymakers could determine whether these types of funds would be available to IA participants.

What Would the Default Investment Portfolio Be?

It would have to be determined how to invest the assets of workers who fail to make an active choice of where to allocate their IA contributions. The default option could allocate all nonresponsive participants' assets into a particular fund, such as a bond index fund, or allocate them across the range of funds to ensure diversification.

In choosing default funds, retirement fund managers often pick investments that provide the lowest risk and therefore also provide the lowest expected rate of return. For example, in the Thrift Savings Program, all contributions are invested in the government securities "G Fund" until the participant designates an alternative contribution allocation. Studies of investment behavior show that there is a great deal of inertia in investment and allocation choices.¹⁰⁰ Thus, the choice of a default may be a key decision, because many workers may remain in the default fund until they retire.

Fees

Would There Be Limits on the Amount and Structure of Administrative Fees?

The amount and structure of management fees would have a significant impact on participants' flexibility and on their final account balances. Although a 1% fee may sound modest, compounded each year it would reduce the ending account balance by 22% over a 40-year period.¹⁰¹ Experience in other countries has shown the impact of high fees. In Chile, fees consumed 33% of the individual account contributions of a worker earning the minimum wage and 28% of the contributions of an average worker who retired in 2000 and participated in the plan since its inception in the 1980s.¹⁰²

While the level of fees would have a large effect on account balances, the structure of fees, whether they are proportional or flat-dollar, would also play an

¹⁰⁰ John Beshears, James J. Choi, David Laibson, and Bridgette C. Madrian, "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States," National Bureau of Economic Research Working Paper 12009, January 2006, at [<http://www.nber.org/papers/W12009>].

¹⁰¹ Calculation by CRS assuming a \$1,000 annual deposit and a constant annual return of 7%.

¹⁰² Indermit S. Gill, Truman Packard and Juan Yermo, *Keeping the Promise of Social Security in Latin America*, The World Bank, 2005, p. 148. Text uses revised estimates.

important role.¹⁰³ Proportional fees are assessed as a set share of account assets, deposits, or a percentage of the fund's annual yield. These fees can be charged on contributions at the time of deposit, periodically on assets during the life of the account (such as quarterly or annually), or at the time of withdrawal. Under a system of proportional fees, private fund managers would have financial incentives to discriminate against small account holders because providers would receive more revenue from high-income participants or individuals with large accounts. As the costs of account management are generally unrelated to the size of an individual's account, fund managers may prefer to charge flat-dollar fees. With a flat-dollar fee structure, all accounts are charged the same amount, and private fund managers would not have the same financial incentives to treat small and large investors differently. However, these fees act like a regressive tax that consumes a larger share of small accounts than larger accounts.

Add-on fees or loads such as those charged to mutual fund investors could also have an important impact on participants' flexibility and choice. For example, back-end load fees, which provide a commission at the time of sale, could be set to discourage participants from switching between private fund managers. Although UK workers are allowed to move between account managers annually, it was reported in 1999 that many managers set penalties for moving that reduced the average pension by 27%.¹⁰⁴ Private fund managers could also impose transaction fees, which could discourage participants from switching investments or rebalancing their portfolios, or encourage fund managers to actively manage or "churn" accounts to increase revenue.

¹⁰³ Account holders could also be charged a mix of flat and proportional fees.

¹⁰⁴ Kelly Olsen and Dallas Salisbury "Individual Social Security Accounts: Administrative Issues," EBRI Issue Brief Number 236, Special Report 40, September 2001, p. 153, at [<http://www.ebri.org/pdf/briefspdf/0901ib.pdf>].

How High Are the Administrative Fees Estimated To Be in IAs?

The administrative costs of a system of IAs would depend on many of the choices raised in this report. Specifically, administrative costs would vary depending on the size and structure of the accounts, on whether the accounts are administered centrally or through a decentralized system of private fund managers, on the level of services and education provided to account holders, and on the degree of choice participants have among investment options. The amount individual participants would pay would also depend on the amount of government subsidy (if any) and the structure of the fees.

Recognizing these uncertainties and that costs would be higher in the early years of plan implementation, several government agencies have attempted to quantify the administrative costs of a system of IAs. There is a large range of estimates. In a 2001 report by the Social Security Administration, analysts estimated that a centralized program of IAs would require startup costs from \$1.2 billion to \$2.3 billion and ongoing costs of between 0.95% and 4% of IA assets, which would decline over time. In their analysis of a specific IA proposal, CBO estimated that the total administrative costs would be roughly \$27 billion over the first 10 years, an amount that includes \$1.5 billion in start-up costs and ongoing annual charges of between \$7 and \$17 per account, depending on the investment options. A Government Accountability Office study estimated that fees could range between 0.1% and 3.0% of assets per year, depending on the structure of the system.

To put these estimates in context, the Federal Thrift Savings Plan currently charges administrative fees of less than 0.1% of account assets, or roughly \$25 per year per participant. However, this charge does not include the costs to federal agencies of collecting contributions and educating their workers about participation and investment options. In the private market, one study of fees estimated that the dollar-weighted average annual fee in 2003 on retail equity mutual funds was 1.25% of account balances, whereas the fees charged on bond mutual funds were 0.88% and on money market funds 0.33%.

Sources: CBO “Analysis of H.R. 3304, Growing Real Ownership for Workers Act of 2005,” Letter to the Honorable Max Baucus, September 2005 at [<http://www.cbo.gov/ftpdocs/66xx/doc6645/09-13-BaucusLetter.pdf>]. CBO “Administrative Costs of Private Accounts in Social Security,” March 2004 at [<http://www.cbo.gov/ftpdocs/52xx/doc5277/Report.pdf>]. GAO “Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design” GAO/HEHS- 99-131 June, 1999, at [<http://www.gao.gov/archive/1999/he99131.pdf>]. Investment Company Institute, “Total Shareholder Cost of Mutual Funds, 2003” *Fundamentals*, vol. 13, no. 5, 2004, at [<http://www.ici.org/stats/res/fm-v13n5.pdf>]. Lawrence E. Hart, Mark Kearney, Carol Musil, and Kelly Olsen “SSA’s Estimates of Administrative Costs Under a Centralized Program of Individual Accounts,” January 2001, at [<http://www.ssa.gov/policy/docs/research/rr2000-01rev.pdf>].

Small accounts present a unique set of issues. Roughly 30 million workers (roughly 18% of the total workforce) in this country earn less than \$5,000 per year.¹⁰⁵ Under an IA plan with a contribution rate of 2%, each of these workers would annually contribute less than \$100. If fees are structured as a share of contributions or account assets, private fund managers may find that it is not cost effective to manage such small accounts. Alternatively, if fees are set at a flat rate for all participants, the fees could consume a large share of small account assets.

In setting up a system of IAs, policymakers may choose to set restrictions on the level or structure of administrative fees. Currently, private pension funds do not have explicit restrictions on fees other than broad “prudence” or “reasonableness” standards. However, many countries with IAs have set limits on the structure of charges, and some have established ceilings for asset-based charges.¹⁰⁶ While many countries have been successful at reducing costs, they have largely done so by restricting individual choice and competition among pension fund administrators.¹⁰⁷ Limiting fees would likely reduce marketing, education, and the range of choice and services provided to account holders (unless these activities are subsidized by the federal government).¹⁰⁸ Whether or not limits are set on the level or structure of fees, consistent reporting and disclosure standards should be established to allow participants to easily compare and understand fees and their impact on account balances.

<http://wikileaks.org/wiki/CRS-RL33398>

¹⁰⁵ Preliminary data for 2003; number represents wage and salary and self employed workers covered by Social Security. (Social Security Administration, Annual Statistical Supplement, 2005, at [<http://www.ssa.gov/policy/docs/statcomps/supplement/2005/4b.html#table4.b1>]).

¹⁰⁶ Robert Holzman and Richard Hinz, *Old-Age Income Support in the Twenty-First Century: An International Perspective on Pension Systems and Reform*, The World Bank, 2005, p. 121.

¹⁰⁷ Indermit S. Gill, Truman Packard and Juan Yermo, *Keeping the Promise of Social Security in Latin America*, The World Bank, 2005, p. 233.

¹⁰⁸ In practice, it would be difficult to set an appropriate limit on fees. A limit that is too high would be ineffectual, whereas one too low might prevent fund managers from covering their costs. In other countries, ceilings have become a “de facto minimum as well as a legal maximum” so that virtually all funds charge the maximum rate. (Edward Whitehouse “Administrative Charges for Funded Pensions: Comparison and Assessment of 13 Countries,” in *Insurance and Private Pension Compendium for Emerging Economies*, Book 2 Part 1:6b, Organization for Economic Co-operation and Development, 2001, at [<http://www.oecd.org/dataoecd/8/20/1816104.pdf>].)

Would the Government Provide a Subsidy To Cover the Startup Costs or Administrative Fees?

Policymakers may choose to finance startup costs or administrative costs through general revenue, either for all accounts during the start of the system or for some IA participants such as those with small accounts or low earnings.¹⁰⁹ This would effectively increase the rate of return on assets in those accounts. However, it would reduce incentives for investors to seek low-cost providers. This policy may also raise concerns about equity, because nonparticipants would be forced to pay some of the costs of IAs.

Conclusion

A system of individual accounts within Social Security could involve millions of Americans, billions of dollars, and could have a broad impact on the American economy. Thus, if IAs were to be adopted, the stakes are high to design a well-functioning system to administer the collection and investment of account assets.

Each choice also involves a cost. Although competition may help to drive down costs, in general, the more decentralized the system, the higher the administrative costs. Costs would also be higher for options that provide participants with more services — such as account management options, multiple investment choices, and personalized financial advice. Even small costs can have a significant impact on the retirement income of participants. Over a 40 year period, a 1% administrative fee can reduce final account balances by 22%.

Program design is important. Some countries have faced major problems with retirement accounts due to inadequate planning and insufficient regulation. Most recently, we have seen in this country the importance of adequate planning in the difficulties some beneficiaries have reported during the implementation of the new Medicare Part D prescription drug benefit. One lesson to be learned from these experiences is that major policy changes require insight and foresight.

More research is needed on the implications of IA program design. Although this report highlights the broad implications of basic IA collection and investment options, more thorough analysis is needed, especially in regard to the interaction among options. Seemingly unimportant details may have large impacts, and policymakers should be made aware of the implications when considering IA proposals.

¹⁰⁹ Another way to subsidize the account fees would be to adjust the “offset” or reduction in Social Security benefits by the administrative costs that are charged to the individuals’ accounts. In effect, the administrative costs are then paid by the Social Security Trust Funds.