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Report to the Chairman, Committee on
Ways and Means, House of
Representatives

June 1999

SOCIAL SECURITY REFORM

Implementation Issues for Individual Accounts



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United States
General Accounting Office
Washington, D.C. 20548

Health, Education, and
Human Services Division

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June 18, 1999

The Honorable Bill Archer
Chairman, Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

Social Security forms the foundation for our retirement income system. In 1998, it provided approximately \$265 billion in annual benefits to 31 million workers and their dependents. However, the Social Security program is facing significant future financial challenges as a result of profound demographic changes, including the aging of the baby boom generation and increased life expectancy. A wide variety of proposals to reform the program is currently being discussed—from more traditional approaches, such as reducing benefits and raising taxes, to more fundamental changes, such as creating a system of individual accounts. As policymakers decide whether and how to create a system of individual accounts, they must consider a range of difficult concerns. These concerns include broad macroeconomic issues, such as how to finance the accounts and how the accounts would affect the economy and program solvency, as well as program benefit issues, such as how to balance opportunities for improved individual investment returns with the need to maintain an adequate income for those who rely on Social Security the most. No less important is the need to consider how readily individual accounts could be implemented and administered.¹

Under a system of individual accounts, workers would manage their own accounts to varying degrees. This would expose workers to a greater degree of risk in return for both greater individual choice in retirement investments and, according to proponents, the possibility of a higher rate of return on contributions than available under current law.² Depending on the proposal, these accounts would replace all or part of the Social Security program, or they would supplement Social Security benefits. Moreover, some proposals would require that all workers participate, while others would allow workers to opt in or out. Yet not all individual account proposals clearly delineate how the accounts would be managed

¹In testimony earlier this year, we discussed how these three issues could be used as criteria for evaluating reform proposals. See Social Security: Criteria for Evaluating Social Security Reform Proposals (GAO/T-HEHS-99-94, Mar. 25, 1999).

²Others, however, believe that returns on contributions are not the only goal of Social Security and that individual accounts are not the only way to increase rates of return. We will address the complex rate of return issue in a forthcoming report.

and administered, and administrative feasibility is vital to the success of any individual account proposal. A system of individual accounts covering 148 million workers would constitute a fundamental change to Social Security and would be significantly larger than any existing retirement investment program. If practical issues such as administrative barriers and challenges are not adequately considered before reform decisions are made, implementation of any proposal could be delayed or even derailed. Therefore, as you requested, this report focuses on issues to consider regarding the design and implementation of an individual account system.

We performed our work from October 1998 to May 1999 in accordance with generally accepted government auditing standards. Appendix II contains a detailed discussion of our objectives, scope, and methodology.

Results

The Social Security system is one of our nation's most important and visible programs. While individual accounts offer the possibility of an improved rate of return on individual contributions, a flawed or failed system of individual accounts could have devastating effects on individuals' retirement security and on public confidence in government overall. In this context, we believe that three critical questions would need to be addressed in designing and implementing a system of individual accounts. All of the decisions made regarding these three critical questions would affect the design and structure of such a system, as well as who would bear any additional administrative responsibilities and costs.

Who would assume new administrative and record-keeping responsibilities? While proposals for individual accounts vary, certain key administrative functions would need to be performed under any system of individual accounts, just as under any other defined contribution pension plan.³ Worker contributions would need to be collected, and records on these individual contributions maintained; contributions would have to be invested, typically according to worker preferences; and benefits would need to be paid. Depending on system design, the employer, the worker, private sector service providers, and the government could all be affected to varying degrees. Section I addresses this question in detail.

How much choice would individuals have in selecting and controlling their investment options? The design of the investment structure, including how much discretion individuals would have in selecting who would invest the

³In defined contribution pension plans, contributions are allocated to individual accounts by a predetermined formula, and benefits depend on contribution levels and returns on investment of these contributions.

contributions as well as the possible range of investment choices, would need to be considered before implementation. These factors would affect the cost and administrative complexity of the system. Section 2 outlines the key issues and trade-offs associated with various options.

How much flexibility would workers have when they retire and begin to draw on their accounts? A number of options are available for providing payments to workers upon retirement. The variety and types of payments offered are important to a system's design. For example, if annuities were required, decisions would need to be made about who provided them and how they would be structured. A discussion of payment options and related issues is provided in section 3.

Table 1 summarizes the fundamental choices associated with each question and a number of options that could be considered.

Table 1: Key Design and Administration Issues

| Critical questions and decisions | Fundamental choices | Possible options to consider |
|---|---|---|
| Who would assume new administrative and record-keeping responsibilities? | Centralize or decentralize account administration and record keeping. | <ul style="list-style-type: none"> — Build on current Social Security tax and payroll reporting structure. — Build on employer-based 401(k) structure. — Build on individually controlled individual retirement account structure. |
| How much choice would individuals have in selecting and controlling their investment options? | Maximize individual choice or offer fewer choices. | <ul style="list-style-type: none"> — Offer a broad range of investment options. — Offer a small set of index funds. — Combine the two options by requiring a minimum account balance before a broader range of options is available. |
| How much flexibility would workers have when they retire and begin to draw on their accounts? | Maximize individual choice or ensure preservation of retirement benefits. | <ul style="list-style-type: none"> — Make annuities voluntary and permit lump sum and gradual account withdrawals. — Require lifetime annuities. — Combine the two options by requiring annuitization to ensure at least a minimum retirement income, with added flexibility for the remainder of the account. |

Essentially, these decisions amount to trade-offs between simplicity and standardization on the one hand and heightened individual choice and flexibility on the other. Simpler, more standardized systems could limit individual choice by offering only a few investment options and requiring that retirees annuitize their accounts. These simplified systems minimize the risk that individuals will not choose a diversified portfolio or will simply make a bad choice. Conversely, when a system offers more choice, either in investment options or in how accumulated savings are distributed upon retirement, individuals have more opportunity to tailor their financial situation to their own tastes and preferences. This increased choice is accompanied by increased risk for the individual. Decisions about system design would also affect the costs of administering the program. As systems become more complex, and more services are offered, administrative costs rise. Finally, any system of individual accounts would probably necessitate a change in current federal roles and responsibilities. Some proposals call for the government to assume a new administrative role, while others would require an increased government oversight role. Each proposed alternative offers new administrative and operational challenges.

When designing a system of individual accounts, the options that are available for each of the three critical decisions could be combined in a number of ways. For example, one proposal combines a centralized record-keeping system with a broad choice among preapproved investment options and mandatory annuitization. Another proposal would combine centralized account administration with few investment choices, and a portion of the account accumulation would be annuitized to provide an income comfortably above the poverty level. All of the various combinations would have associated trade-offs, costs, and other issues.

It is important to note that individual accounts are one of a number of provisions in Social Security reform packages being considered. Many of these broader initiatives contain a variety of provisions for addressing Social Security Trust Fund solvency. While individual accounts offer the potential for increased investment returns, they cannot by themselves restore Social Security's solvency without additional changes to the current system. Moreover, higher returns can be achieved through other approaches to reform—for example, from increasing the buildup of the Social Security Trust Fund and providing opportunities to diversify investments. Higher returns can also be achieved through such means as investing the Trust Fund in equities, as some have proposed.

Today, we are issuing another report that provides additional information on individual accounts as a component of Social Security reform. This report provides details on administrative costs, which could have a direct effect on the amount of savings accumulated in individual accounts over time.⁴

Agency Comments

We provided draft copies of this report to the Social Security Administration (SSA), the Internal Revenue Service (IRS), the Securities and Exchange Commission, the Department of Labor's Pension and Welfare Benefits Administration, the Department of the Treasury, and the Federal Retirement Thrift Investment Board, as well as other external reviewers who are experts in Social Security reform. In commenting on our report, the reviewers generally agreed with our characterization of the possible options and issues to consider under a system of individual accounts. They provided comments to us, either in oral or written form. These comments were primarily technical and clarifying in nature.

In addition to technical comments, SSA stated that we should devote a portion of the report to the challenges of ensuring compliance under an individual account system. While we do not discuss compliance in a separate section, we did expand our discussion of this issue throughout the report. SSA also stated that we should discuss in more detail the shifting roles of agencies under such a system. We expanded this discussion as well. SSA further suggested that we discuss the impact of individual accounts on capital markets; however, this issue will be discussed in detail in a forthcoming report.

We have incorporated these and other comments where appropriate. The written comments we received are included in appendixes III and IV.

We are sending copies of this report to the Honorable Charles B. Rangel, Ranking Minority Member, House Ways and Means Committee; other interested congressional committees; the Honorable Kenneth S. Apfel, Commissioner of Social Security; the Honorable Alexis M. Herman, Secretary of Labor; the Honorable Robert E. Rubin, Secretary of the Treasury; the Honorable Arthur Levitt, Chairman of the Securities and Exchange Commission; and the Honorable Roger W. Mehle, Executive

⁴Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design (GAO/HEHS-99-131, June 18, 1999).

Director of the Federal Retirement Thrift Investment Board. We will also make copies available to others on request.

If you have any questions concerning this report, please contact me on (202) 512-7215. Other GAO contacts and key contributors to this report are listed in appendix V.

Sincerely yours,



Cynthia M. Fagnoni
Director, Education, Workforce,
and Income Security Issues

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Abbreviations

| | |
|-------|--|
| ERISA | Employee Retirement Income Security Act of 1974 |
| FERSA | Federal Employees' Retirement System Act of 1986 |
| FICA | Federal Insurance Contributions Act |
| IRA | individual retirement account |
| IRS | Internal Revenue Service |
| PWBA | Pension and Welfare Benefits Administration |
| SSA | Social Security Administration |
| TSP | Thrift Savings Plan |

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Who Would Assume New Administrative and Record-Keeping Responsibilities?

A new system of individual accounts would entail additional administrative and record-keeping activities. Decisions about where and how the information for each individual's contributions would be recorded and managed, as well as how the money itself would be invested, would determine the administrative structure of a system of individual accounts. There are several options for how such a system could be structured, and each option offers advantages and challenges that must be considered. Moreover, decisions about structure would affect the related federal role and responsibilities. Depending on the system structure, the government could be taking on a new role or expanding its current role. Finally, designing a new system of individual accounts would take time.

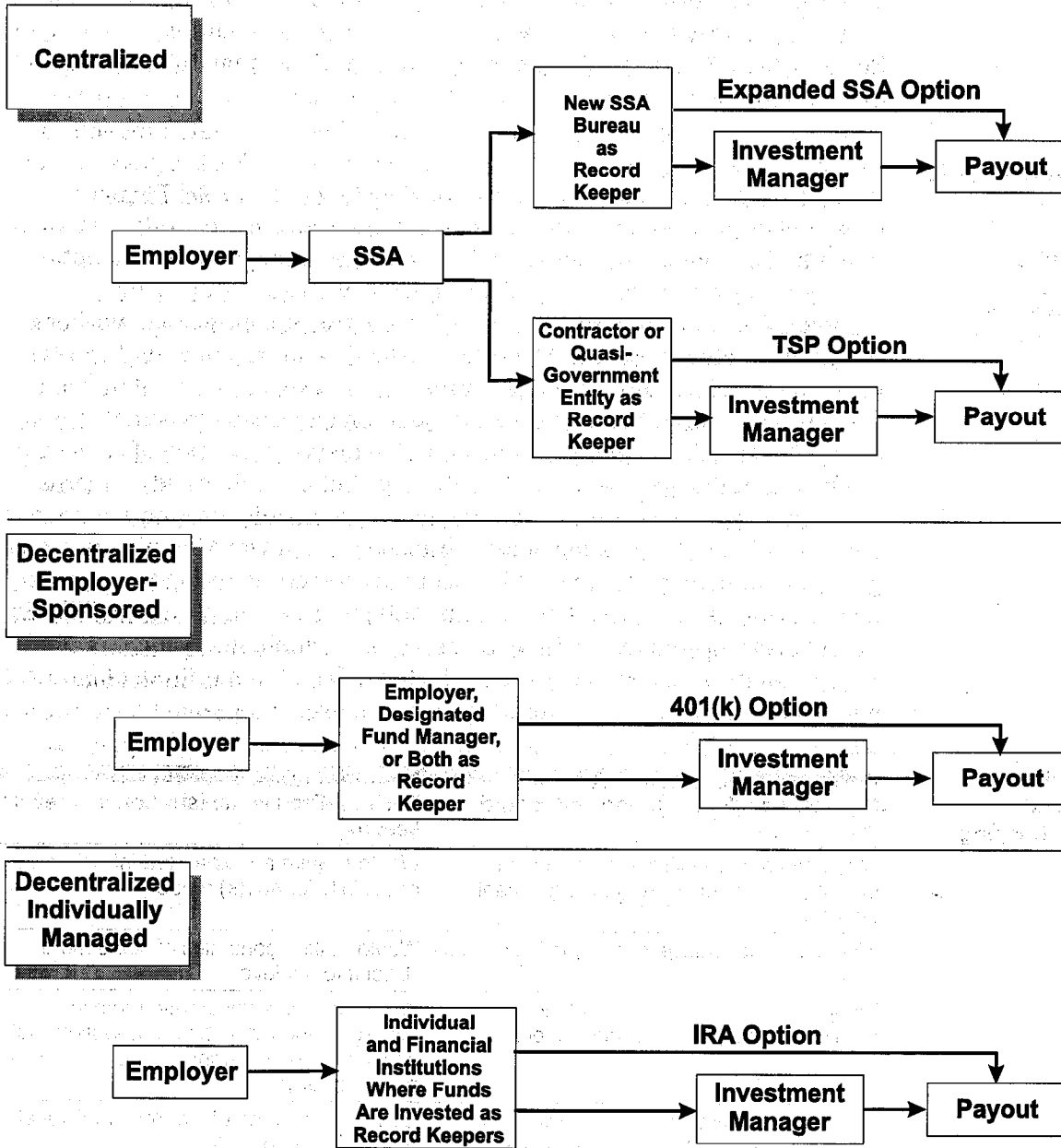
Options for Account Administration and Record Keeping

The basic options for account administration and record keeping span a continuum ranging from a centralized record-keeping system operated by the government to a completely decentralized system managed by individuals or various entities in the private sector (see figure 1.1). Under a centralized structure, which would build on the current payroll reporting and tax collection system, a federal agency, such as SSA, would assume record-keeping responsibilities. Alternatively, a new centralized government clearinghouse could assume responsibility for centralized record keeping, similar to the structure for the federal Thrift Savings Plan (TSP). A decentralized structure could build on the system that has grown up around employer-sponsored 401(k) plans or individually managed individual retirement accounts (IRA).⁵ Under 401(k) plans, individual records are maintained by either the employer or a separate entity hired to manage the plan, or both. Under an IRA, the record-keeping responsibility rests with the individual investor and the financial institution where the funds are invested.

⁵A 401(k) pension plan is an employer-sponsored defined contribution plan that allows participants to contribute, before taxes, a portion of their salary to a qualified retirement account. An IRA is a personal, tax-deferred retirement account.

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 and Record-Keeping Responsibilities?

Figure 1.1: Options for Account Administration and Record Keeping



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and Record-Keeping Responsibilities?**

Some proposals to create individual accounts include provisions for a tax credit to finance all or part of a worker's individual account. Under these proposals, contributions would be transferred from the Treasury to an individual's account.⁶ Moreover, some proposals call for replacing all or part of the current Social Security program or supplementing Social Security benefits. Regardless, accounts could still be maintained centrally or could be decentralized.

**Issues and Trade-offs
to Consider When
Choosing Among
Options**

While each of the options depicted above is based on an existing program or model, none of the models could accommodate a nationwide system of individual accounts without significant change. Depending on the option selected, these changes could place additional costs, burdens, or responsibilities on government agencies, employers, individual workers, or private sector providers. Therefore, selecting an option would involve carefully weighing the associated trade-offs. For example, a centralized system is an option because it would build on an already existing centralized record-keeping system, could achieve economies of scale, and would maintain employers' responsibilities. Yet, it could raise concerns about increased government involvement, responsibilities, and contingent liabilities. In contrast, using a decentralized system would minimize direct government involvement yet still affect government workloads. However, economies of scale could be more difficult to achieve and responsibilities of and costs to employers, individuals, or both would likely increase. Table 1.1 summarizes issues to consider when weighing the merits of centralized and decentralized account administration and record keeping.

**Table 1.1: Trade-offs Between
Centralized and Decentralized
Administration and Record Keeping**

| Centralized administration and record keeping | Decentralized administration and record keeping |
|--|---|
| Would build upon existing government system, but would still require significant changes | Would require an expanded infrastructure, especially for 401(k) model |
| Would take advantage of economies of scale | Would make economies of scale more difficult to achieve |
| Would increase government role in managing individual account system | Would minimize government role in managing individual account system, but an increased oversight role would need to be considered |
| Would likely maintain employer role or minimize additional employer responsibilities | Could increase employer role, individual responsibility, or both |

⁶The funds from the Treasury could originate either from the unified budget surplus or from general revenues.

Centralized Administration and Record-Keeping Structure

The current centralized Social Security record-keeping system was not designed to maintain records on individual accounts that are owned and managed by individual workers. SSA records annual earnings and calculates benefits on the basis of these earnings; the agency does not maintain individual contribution records nor does it base benefits on the payroll taxes paid into the system.⁷ As a result, aspects of the existing system would probably have to change to accommodate the introduction of individual accounts, or workers would have to accept certain limitations built into the system. For example, the system is not designed to record contributions, earnings, or losses to individual account records in a timely manner. This delay does not affect Social Security benefits, but it could affect benefits based on an individual's earnings on investments in the equities market.

Under the current centralized system, SSA and the IRS work together to record each worker's earnings and collect taxes owed. Currently, both employers and employees pay Federal Insurance Contributions Act (FICA) taxes, which are used primarily for Social Security. Employers withhold FICA taxes from employees' pay and then regularly deposit both employers' and employees' shares of the taxes to a designated Federal Reserve bank or other authorized depository. Employers submit reports summarizing these deposits to the IRS at least quarterly. These reports indicate the aggregate amount of taxes withheld from workers' paychecks; they do not link the taxes paid to a particular individual. Once a year, usually at the beginning of a calendar year, employers submit an IRS W-2 form to SSA for each worker, showing the individual's earnings for the previous year. SSA then begins the process of checking this information and posting it to the earnings files it maintains for individual workers. Only when these W-2s were posted to earnings records would SSA know how much would be available for investment on behalf of an individual. Appendix I contains a detailed time line for the responsibilities of the employer, IRS, and SSA under the current system.

Relying on the current record-keeping system would present several challenges under an individual account system. Several important decisions would need to be made if a centralized structure was chosen.

How Much Additional Information on Individual Workers Would Be Needed?

While SSA maintains information on workers' earnings and work histories, more information would need to be obtained and maintained for an individual account system. For example, SSA does not keep personal

⁷To determine a worker's monthly benefit, SSA applies a formula to reported lifetime earnings. This approach, therefore, holds the worker harmless when the employer does not remit the accurate Social Security tax payment to the IRS.

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information such as addresses on an ongoing basis, and IRS keeps only addresses that are submitted annually on individual tax returns. If individual accounts were to be considered the personal property of the individual, current information on such things as addresses would become important, especially when assets must be allocated or distributed in response to life events such as death or divorce.

**What New Administrative
Functions Would Need to Be
Included, and Who Would Be
Responsible for Them?**

The current reporting and tax collection system does not include other administrative activities that would need to occur under an individual account system, such as creating systems to collect and record individual investment choices, transmitting contributions to investment managers, recording account value changes, sending periodic account statements,⁸ and providing payout entities with necessary account information. While the investment manager could perform some of these activities, under a centralized system, government agencies would likely assume many of these responsibilities.⁹

**Would the Current Reporting
Error Threshold Change?**

Each year SSA receives a large number of incorrect W-2 forms from employers. Under a system of individual accounts, these errors could result in lost investment returns. For example, of the 235 million W-2s received for tax year 1996, about 19 million, or 1 in 12, had errors.¹⁰ Following internal corrections, SSA was able to resolve inconsistencies for about 15 million of the W-2s, leaving about 4 million uncorrectable without contacting the employers. SSA does not contact all of the employers whose reports include these errors, however, because contacting employers can be time-consuming and expensive for both SSA and the employer. Therefore, SSA sets a tolerance threshold for errors and does not pursue errors with dollar amounts that fall below the threshold. According to SSA, if these tolerances were eliminated, its workload would at least double. Under a system of individual accounts, in which the account is considered to be personal property, it would be necessary to determine if such a threshold for error could be tolerated and whether the worker would be held harmless for employer error.

⁸Beginning in fiscal year 2000, SSA will be required by law to send Personal Earnings and Benefit Estimate Statements to almost every U.S. worker. However, if these statements were to be used for individual accounts as well, they would need substantial revision.

⁹See National Academy of Social Insurance, "Report of the Panel on Privatization of Social Security" (Washington, D.C.: National Academy of Social Insurance, Nov. 1998), which contains a detailed discussion of administrative activities under individual accounts.

¹⁰These errors or inconsistencies include mismatches between individual names and Social Security numbers, errors in FICA calculations, and inconsistencies between aggregate reports submitted to the IRS and the W-2 reports.

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Would Changes in the Current Regulation and Oversight Structure Be Needed?

Under a centralized system, the federal role would be mostly administrative in nature. However, if a centralized clearinghouse was established, the oversight role would increase (especially if individuals were allowed to opt in or out of the system). Striking a balance between the need for additional personal information and the need to maintain individuals' privacy and limit access to this information would be an important oversight consideration. In addition, the government would need to ensure that workers' contributions were made promptly and accurately, as well as prevent fraud and abuse in the system.

Would Posting Delays Be Tolerated?

If the current system of employers' reporting individual earnings on an annual basis continued, it would result in a considerable lag—as much as 7 to 22 months—between the time taxes were deducted from an individual's earnings and the time funds were credited to the individual's name. Depending on the performance of an individual's selected investments, these lags could result in lost account accumulations. However, changing to a system that recorded earnings more frequently would place additional reporting burdens on employers and the government as well as increase administrative costs.

The delays in posting contributions or earnings information to individual accounts are viewed by some as a significant barrier to a centralized system. However, there are several options for mitigating the effects of a time lag, each of which poses new record-keeping challenges. The record keeper, working together with the designated investment manager, could do one of the following:

- Pool the aggregate funds into a safe investment vehicle, such as a money market account, until they are allocated to individual accounts. The earnings could then be credited to individual accounts along with actual contributions at a later date, and all workers would earn the same return during the lag period.
- Permit workers to select personal investment options annually; group these individual selections by investment option; and invest incoming, pooled funds accordingly.
- Project future contributions (perhaps on the basis of prior earnings history) and credit the accounts according to individual investment choices until actual cash contributions are deposited into accounts.¹¹

¹¹These options were developed by the Employee Benefit Research Institute and are discussed in more detail in Kelly A. Olsen and Dallas L. Salisbury, Individual Social Security Accounts: Issues in Assessing Administrative Feasibility and Costs, special report of the Employee Benefit Research Institute (Washington, D.C.: Nov. 1998).

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Under a centralized system of individual accounts, it is likely that the agencies involved would require additional time and resources to address the above issues. However, at the same time, building on the current system and keeping records centrally could achieve economies of scale and minimize additional burdens and costs for employers and individuals.

Decentralized
Administration and
Record-Keeping Structure

Alternatively, individual account record keeping and administration could be based on a model similar to either the current 401(k) or IRA system. While minimizing government involvement in the administration of the system, either approach would probably be accompanied by additional responsibilities and costs for employers, workers, or both. Moreover, for both of these options, the appropriate government oversight role would have to be considered.

Under a 401(k) defined contribution pension plan, individual employers sponsor a retirement plan for their employees. Employees are able to contribute pretax dollars to a qualified tax-deferred retirement plan. Under such plans, employee contributions can be invested in several options and, depending on the plan, employees may control how the assets are allocated among the various choices; the employer, a designated fund manager, or both, maintain records. Although the number of 401(k) plans has risen dramatically, employers are not required to provide such a retirement plan. If this model was chosen, several important questions would need to be addressed.

What Changes Would Be
Required to Ensure That All
Workers Could Be Covered
Under Such a System?

Not all employers offer employee retirement plans—about 50 percent of full-time private sector workers are covered by any type of employer-provided retirement plan; about 25 million people participate in a 401(k) plan. Under a 401(k) model, employers, especially those that currently do not provide any retirement plan, would bear the additional cost and responsibility of creating an infrastructure to quickly deposit contributions and provide employees with links to and choices among funds. However, recent employer surveys and our interviews with employers' groups showed that most employers oppose any additional paperwork burden or costs.

What Would Be the Potential
Outcomes of Building on the
Current System?

401(k) plans differ in both the services they offer and the diversity of available investment options. These differences would raise questions of fairness if the system became the foundation for a universal system of

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individual accounts. In addition, requiring uniformity across the different plans would need to be considered.

**What Would Be the Possible
Effect of Placing Additional
Requirements on Employers?**

If employers were asked to bear additional costs and responsibilities, they might decide to change or reduce the benefit packages they currently offer, thus possibly undermining the overall goal of pension plans and individual accounts: improved retirement security. In addition, it is not clear how current contributions to 401(k) plans would be handled. For example, policymakers would need to decide whether or not individual account contributions would be separate and distinct from 401(k) contributions. If these contributions were not considered separately, then individual accounts could replace 401(k) savings.

**Would Changes in the Current
Regulation and Oversight
Structure Be Needed?**

Under this decentralized system, government oversight and regulatory responsibilities would likely increase; the more complex a system of individual accounts, the more challenging and costly oversight and compliance activities could be. Currently, the Department of Labor's Pension and Welfare Benefits Administration (PWBA) has responsibility for overseeing and regulating the 401(k) system. The Department of the Treasury and IRS have responsibility for drafting and enforcing rules regarding 401(k) plans' qualified tax status. With the Pension Benefit Guaranty Corporation and IRS, PWBA also enforces compliance with the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, these agencies are expected to protect employee benefit plans and their participants and beneficiaries should employers go out of business, fail to remit payments, and so on. ERISA requires, among other things, that participants receive annual reports, that assets be held in trust, and that there be a fiduciary responsible for acting solely in the interests of the plans' participants and beneficiaries. The role of ERISA—or some other entity or mechanism to safeguard individual account accumulations—would need to be carefully considered.

An IRA is a specific retirement account purchased by an individual worker, usually through a bank or another financial institution, that can be invested in almost any kind of investment vehicle. Under current law, IRAs are subject to a contribution limit. Several questions would need to be considered if individual accounts were managed under a decentralized structure, similar to today's IRA system.

**How Would the Individual
Worker Be Affected?**

Individual workers would be responsible for selecting an investment manager or managers to invest their contributions. Workers would be expected to keep track of investments, understand the system as a whole,

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pursue error corrections, and generally ensure that contributions were made according to applicable rules and that tax obligations were properly met. Workers might benefit, however, because this approach could minimize lag time between depositing contributions and beginning to earn returns on those contributions.

**Would Changes Be Needed in
How the Market Was
Regulated?**

IRAs that are not provided through employee benefit plans are exempt from ERISA; yet various entities have oversight responsibility for the range of vehicles available under IRAs. For example, the IRS sets the rules for IRA tax qualification, and the Securities and Exchange Commission has broad responsibility over the securities markets. In 1992, about 9.6 million individuals contributed to an IRA.¹² Overseeing the large number of accounts, ensuring compliance, and preventing fraud would be significant issues to consider under this model.

**A System of Individual
Accounts Would Face
Record-Keeping
Challenges**

Regardless of the type of administration and record-keeping structure selected, additional challenges would need to be addressed under an individual account system. These challenges primarily center on the nature of the ever-changing American workforce and its employers and can complicate keeping accurate and timely records on earnings or account contributions. Table 1.2 details these challenges.

Table 1.2: Characteristics of U.S. Businesses and Workforce Pose Challenges for a System of Individual Accounts

| Characteristic | Challenge |
|-------------------------|---|
| Employer turnover | About 650,000 employers go out of business or start new businesses each year (about a 10-percent turnover rate). This turnover could create particular challenges in ensuring that contributions were made and credited to individual accounts. Once an employer went out of business, making corrections to individual accounts would be difficult, if not impossible. |
| Employer record keeping | About 4 million employers have 10 or fewer employees. These small businesses tend to have particular record-keeping problems, and their records are often error-prone. According to SSA, about 85 percent of the nation's 6.5 million employers still submit forms on paper, requiring additional administrative steps to check and record the data. |

(continued)

¹²This number includes individuals who contributed to an IRA through their employer.

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Characteristic

Challenge

Workers with more than one employer

Many workers in the United States have more than one job at any given time or work for more than one employer during the year. Specifically, about 58 million workers (about 40 percent of the total workforce) have annual earnings reported to SSA from more than one employer. This could pose special problems for administering and monitoring compliance with individual account requirements unless a mechanism was created to consolidate the records, especially at retirement.

Unique reporting structure used by self-employed

In 1998, the United States had approximately 12 to 15 million self-employed individuals. The self-employed have their own wage reporting system—they do not file W-2s directly with SSA but rather provide information to only the IRS through their annual tax filings. The IRS then forwards this information to SSA at a later date. Further complicating their record-keeping status, about one-half of the self-employed also work for employers that send W-2s to SSA. Because of similar problems, some of the countries whose pension systems we reviewed for this work either do not include the self-employed in their pension systems or offer coverage as an option rather than a requirement. Ensuring the compliance of the self-employed under a system of individual accounts would need to be considered.

**Start-Up Issues:
System Design and
Development Would
Take Time**

Estimates of how long an individual account system's design and development would take would depend upon how quickly the proposal moved through the legislative process and how complex the proposed system was. Some reform proponents have cited the federal TSP as an example of quick implementation. Ten months after passage of the Federal Employees' Retirement System Act of 1986 (FERSA), the federal TSP began investing participants' contributions in the government securities fund, and the TSP began investing contributions in the stock and bond index funds 8 months later. Moreover, the TSP plans to add two additional funds in May 2000. While this example illustrates how a system can begin with one simple investment fund and add more over time, the challenges of establishing the TSP differ in certain ways from those of setting up a

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national system of individual accounts. The federal workforce, as well as the federal government as a single employer, differs substantially from the workforce that would be covered under a nationwide system. For example, the federal workforce experiences less job turnover, tends to be older, and has higher average earnings than the general workforce. In addition, federal agencies experience greater stability and have greater access to automation for payroll and record-keeping functions than the employer population at large. These characteristics helped expedite the implementation of the TSP, since an infrastructure for implementing the system already existed and could be built upon. Issues to consider before selecting a system would include

- computer system design, development, and testing needs;
- year 2000 systems design issues;
- the contract procurement process (requests for proposals, the bidding process, and contractor selection);
- regulation development and promulgation;
- hiring and training new staff;
- the possible need to set up individual accounts for those who do not have earnings; and
- the need for employer and public education.

Regardless of the type of individual account management system selected, the length of time needed to develop the system would need to be considered—especially since no system exists that has demonstrated the capacity to handle a national system of individual accounts without significant changes.

Creating a centralized system that would build on the existing computer capacity of federal agencies such as SSA and the IRS could pose special challenges in the near term. Officials from various federal agencies told us their computer systems staff have been working to ensure that their systems are ready for the year 2000, and as a result, other needed systems changes have been deferred until that challenge has been met. Moreover, systems staff may need to continue working on year 2000 issues even after 2000 arrives, thus affecting their ability to take on any additional requirements.

If the new system design involved any contracting out for services, then lead time would need to be considered for such things as issuing requests for proposals, qualifying bidders, and carrying out other activities required by law and regulation. These requirements would need to be incorporated

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into any implementation time frame. Moreover, regardless of the account management system chosen, the time needed for regulation development and promulgation would need to be considered. For example, the ERISA construct is a well-developed body of law on employee benefits; however, the ERISA framework has been developed over a number of years. In fact, some regulations alone have taken years to be promulgated.

Hiring and training qualified staff would also take time. Depending on the structure of the new design, staff might be expected to be able to answer any number of technical questions about system design, requirements for employers and individuals, and investment and payout options. Even if these services could be contracted out, lead time would also need to be considered if this option was chosen. In addition, measures to prevent employee fraud and to protect account holders' personal information would need to be considered.

Moreover, some proposals call for establishing accounts for individuals who do not have any earnings. One such approach might be to allow a spouse without earnings to set up an account that was based on the other spouse's earnings. Accommodating such accounts would be important in considering system design.

Finally, educating employers and the public on the essentials of the new system would be important to its administration and implementation. It would take time to develop and implement an education campaign for both employers and workers to ensure that the public understood the new system and how it would affect their retirement income security. Many proposals do not specify what entity would be responsible for public education or what would be involved, but, as an example, SSA officials told us that it currently takes about 1 year and costs about \$1 million to develop a specific public service announcement campaign.

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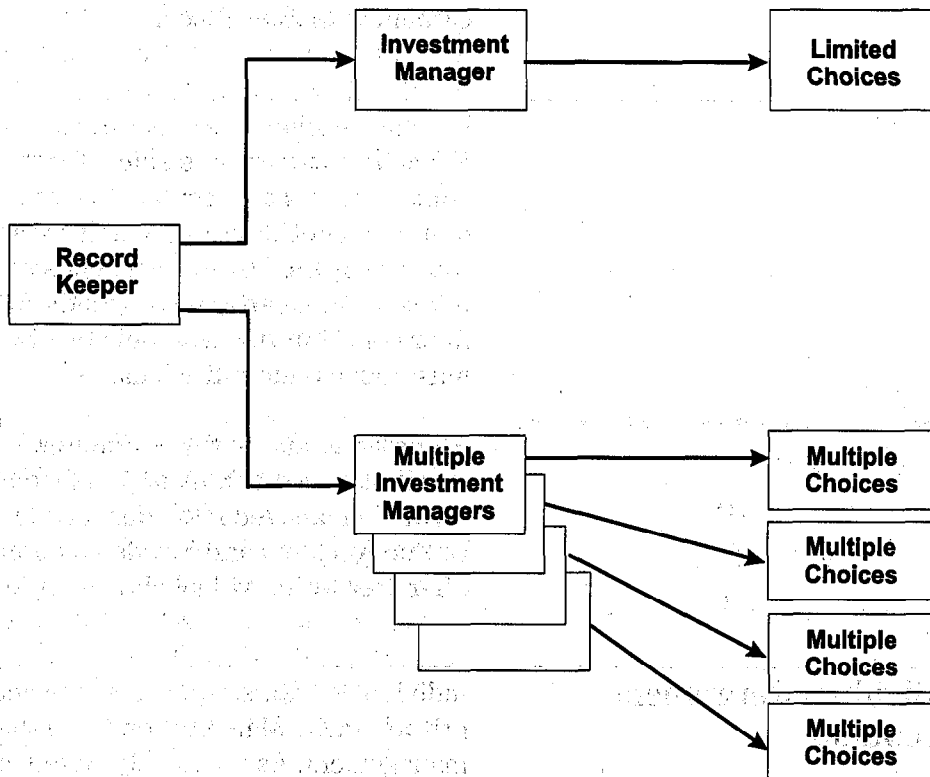
A system of individual accounts would provide workers with opportunities to assert greater control over their retirement savings and possibly receive a greater rate of return than is available under current law. When designing a system, critical decisions would need to be made about how much choice or discretion individuals would have in selecting funds, who would invest their funds, and what the range of their investment choices would be. These decisions, in part, would determine the cost and complexity of the system and the degree of public education needed. Moreover, offering the level of customer service found in the private sector, such as frequent deposits and accessibility of account information, would add costs and administrative complexity to a system.

Options for Management Structure and Investment Choice

Alternatives for designing the investment structure of a system of individual accounts range from offering the individual a limited number of preselected funds, such as those offered by the federal TSP, to offering a broad array of private market choices, such as those available through IRAs. As with record keeping, options for managing these investment choices could vary from a centralized, government-managed system to a decentralized, privately managed system. Figure 2.1 shows the basic options that represent both ends of the spectrum; however, numerous variations fall in between.

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Figure 2.1: Options for Management Structure and Investment Choice



Examples of some of the existing investment management options and the choices they offer are discussed below. The federal TSP and the system of individual accounts developed in Chile illustrate different approaches to limiting choice.

Thrift Savings Plan

The TSP currently offers three investment fund choices to contributors. The first, a government securities fund, is managed by the independent Federal Retirement Thrift Investment Board. The other two funds, a fixed income (or bond) fund and a common stock fund, are managed under competitively awarded contracts, currently with Barclays Global Investors. Barclays has no responsibility for record keeping or reporting requirements at the individual TSP participant level. Instead the Thrift Investment Board, through an agreement with the Department of Agriculture's National Finance Center, maintains individual records.

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Individuals may invest their contributions in any of the funds in any combination they choose.

Chile

In Chile, workers may select from over 12 qualified private pension funds. Each fund was created solely for the country's retirement program. Fund administrators are responsible for maintaining records, as well as investing contributions, which are sent directly to the private fund from the employers. The government sets minimum and maximum rates of return for the participating funds. Under this system, workers must invest their contributions with only one fund; if they decide to change funds they must move their entire balance.

At the other end of the continuum, offering greater investment choices, IRAs illustrate the flexibility individuals can experience when investing in privately managed individual accounts. The systems developed in the United Kingdom and Sweden demonstrate still other approaches that also offer greater individual choice for investments.

Individual Retirement
Accounts

Individuals with IRAs can manage accounts themselves or select their own private financial institution to do the record keeping and investment management. As previously stated, IRA contributions can be invested in almost any kind of investment vehicle. In general, the individual IRA owner is responsible for complying with the rules applicable to IRAs.

United Kingdom

The United Kingdom system consists of a state-provided, flat-rate benefit based on work history and an earnings-related benefit. For the earnings-related benefit portion, individuals have a choice of participating in the state earnings-related benefit program, participating in their employer's pension plan (if available), or voluntarily opting out and choosing their own individual account through any private financial provider. As in the United States, employers withhold each individual's contributions and remit them to the government. After a reconciliation process, the government sends the contributions to the individual's financial provider for investment. This provider, like an IRA, maintains the records and manages the investment. In 1996, the United Kingdom's Personal Investment Authority regulated about 4,000 firms providing individual accounts.

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Sweden

Sweden has planned a system of individual accounts, but it is not yet in full operation. This system will include a basic state pension and an individual account benefit. Employers and individuals will contribute a total of 18.5 percent of an individual's earnings to the social security system; 2.5 percent of this contribution will be collectively invested on behalf of the individual in government bonds.¹³ When systems are in place, individuals will be able to direct their 2.5 percent contributions into a registered fund of their choice. To register, a fund must be licensed to operate in Sweden and agree to certain reporting and fee requirements. In addition, all records will be maintained by the government pension agency, and, at retirement, the government agency provides the individual's annuity.

Issues and Trade-offs
to Consider When
Choosing Among
Options

There are trade-offs associated with the range of investment choices offered, as illustrated in table 2.1. When individuals have more investment choices, they have more opportunity to tailor their financial situation to their own tastes and preferences and assert greater control over their personal property. However, with a greater variety of choices comes the possibility that individuals will not choose a diversified portfolio or will simply make a bad selection, thus lessening their retirement income from the individual account.¹⁴ As the range and variety of investment choices grow, so does the risk that an individual's retirement income will not be adequate. This results in increased risk to the government that individuals with inadequate income will turn to the government for support from other programs. In addition, a wider range of investment choices also leads to higher administrative costs, which, if not offset by significantly higher returns, could undermine the retirement income for individuals. Limiting investment choice would help to minimize risk and administrative costs, but doing so could also limit the possible return on investments. Moreover, limiting choices raises concerns about the role of government in selecting the investment vehicles and the possibility of political influence over these selections. Essentially, the challenge becomes finding the right balance between individual choice and the related risks and costs to the individual and the government.

¹³Currently, the individual's contribution is 6.95 percent and the employer's contribution is 6.4 percent of earnings, and 2.5 percent of the total is invested in government bonds. As of 2000, the total contribution will amount to 18.5 percent: 9.25 from both employer and employee.

¹⁴Under some proposals for individual accounts, retirees would continue to receive Social Security benefits at some level, as well as the accumulated balance in their individual accounts.

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Table 2.1: Trade-offs Between Limited Investment Choice and Greater Choice

| Limited, but diversified, investment choice | Greater investment choice |
|---|--|
| Minimizes individual risk, but may also limit returns | Increases individual risk because of possibility of less diversification, but also provides opportunity to maximize returns for some |
| Minimizes government risk | Increases government risk |
| Minimizes administrative costs | Increases administrative costs |
| Increases concern over political influence | Decreases concern over political influence |

Limited, but Diversified, Investment Choice

Several proposals suggest offering individual accounts with a limited set of investment options to minimize risk and administrative cost, while providing some degree of choice and the possibility of earning higher rates of return than are available under today's Social Security program. If participants were given limited investment choice, a number of issues would need to be resolved.

Would There Be Ways to Mitigate the Concern Over Political Influence of Investment Choices?

The federal TSP structure minimizes this risk by having a third party passively manage index funds.¹⁵ In addition, the law creating the TSP mandated an independent, five-person oversight board with specific fiduciary responsibilities to the plan participants. The Thrift Investment Board must manage the funds solely for the benefit of the participants; if they fail to do so they can be civilly and criminally liable. In Chile, the use of private fund administrators helped to insulate investment policies from political influence, and the ability of individuals to change pension funds gave private administrators incentives to protect investors' interests.

What If Individuals Did Not Make an Investment Choice?

As part of program design, it would be necessary to decide what should happen to the contributions of those individuals who did not choose among the investments offered. Some have proposed placing these contributions in the lowest risk accounts. Another option would be to place these contributions in a few balanced funds, or life cycle accounts, that had portfolios with the same components but were weighted differently depending on the age of the worker—with less risk as workers neared retirement.

How Much Public Education Would Be Necessary Under a System With Limited Choice?

Public education about the choices available and the risks associated with each would be needed under any system. However, the need to educate the public about the consequences of using different investment strategies

¹⁵Index funds are a common form of passive investment management in which securities are held in proportion to their representation in certain stock or bond market indexes.

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would be less under a system with limited choice than under a system with a broader range of choice. When the number of choices is limited, the degree of risk is more defined, and the program is less complex.

What Would the Federal Role Be in a Limited Choice Structure?

Because both choice and risk would be limited, the need for government regulation and oversight of investment activities would be less complex under a TSP model than under a system offering wider choice; under the TSP model, individuals' accounts are pooled and invested collectively. The government's role would depend on whether the government invested in funds on behalf of participants, as Sweden plans to do, or individuals invested directly in the funds. The government's role would likely center around authorizing an independent infrastructure and monitoring the overall operations. However, the mechanisms used to minimize risk can have unintended consequences that should be considered. In Chile, because the government sets maximum and minimum rates of return for all participating funds and places restrictions on the composition of the fund portfolio, fund managers tend to hold portfolios of assets that are similar to the ones held by their competitors. Each fund, thus, earns a return that is close to the national average. While helping to lessen individual risk, this requirement has limited the variety of choice and earnings potential of the privately managed funds.

What Protections Would Investors Have If Funds Failed?

It would be necessary to determine the role of government if any of the available funds failed. While this would be an issue for scenarios with either limited or greater investment choices, it would have significance because of the role played by the government in selecting the available options.

Greater Investment Choice

Some reform proposals would give individuals more discretion in selecting their investments. This greater discretion could be provided under a management structure similar to that of IRAs or the United Kingdom's plan, or under a centralized system such as Sweden's. If greater investment choice was offered, certain decisions would need to be made.

What Options Would Be Available to Minimize High-Pressure Sales Tactics, Especially for Inexperienced Investors?

Experiences in Chile demonstrate that extensive competition among investment funds can lead to frequent and costly switching among funds. To minimize this, Chile has reduced the number of times participants may switch among funds from four to two times a year. In contrast, Sweden designed its program to protect its investors from high-pressure sales tactics. In Sweden, individual contributions will be amalgamated, and the government pension agency will execute buy orders in its name. As a

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result, the identities of the individual account holders will be known only to the pension agency, not to the investment providers.

How Much Public Education
Would Be Necessary?

Currently, the information that is required to be disclosed to investors is not uniform across different investment products. Under a system of individual accounts, this information would need to be presented in a more clear and simple format for the general public to understand. Moreover, the public would need a greater level of education to learn about the wider variety of investment options, understand and use the information disclosed to them, and fully appreciate the consequences of investment choices.¹⁶ The United Kingdom experienced substantial difficulties when it moved to individual accounts, in part, by providing too little public education and relying on its already existing regulatory system, which proved to be inadequate. In what has become known as the "mis-selling" controversy, high-pressure sales tactics were used to persuade individuals, especially older workers, to switch to unsuitable individual accounts that could not meet their retirement needs.

What Should Be Done With
Contributions When the
Individual Fails to Choose an
Investment?

Just as in the limited choice option, it would be necessary to decide what should happen with the contributions of those individuals who neglected to choose among the investments offered. This decision could be more complicated if many investment options were offered.

What Would the Federal Role
Be in a System With Greater
Investment Choice?

The government's regulatory and oversight role would be designed to protect investors from fraudulent and inappropriate sales practices. A lack of such oversight was a factor in the mis-selling controversy in the United Kingdom. In the United States, regulations and oversight mechanisms exist for the current IRA and 401(k) structures, as well as the securities market. It would be necessary to consider what special provisions should be included in a nationwide system of individual accounts. For example, requirements to disclose information to investors vary across different products or investment types, and more simplified information could be needed to ensure that inexperienced investors received information that was helpful to them.

Should the Government
Provide Guaranteed Minimum
Benefits?

More investment choice increases the possibility that individuals will not choose diversified portfolios or will simply make bad selections, and thus their retirement income may not be adequate. Some governments have explicitly accepted this risk by guaranteeing a minimum benefit. In Chile, the government sets a minimum rate of return that investment fund

¹⁶More information on this topic can be found in a forthcoming GAO report that discusses capital markets and educational issues related to individual accounts.

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companies must provide. In addition, Chilean workers are guaranteed that they will receive at least a minimum monthly pension if they participate for at least 20 years in the system. Some U.S. proposals would ensure that workers receive at least the benefits promised under the current Social Security system. This raises the possibility that some people might take greater risk with their investments if they knew that the government would provide a guarantee, thus creating a contingent liability for the government.

System Design and
Administrative Costs

Decisions about the design of a system of individual accounts, including the flexibility offered in making investment decisions, have a direct effect on administrative cost.¹⁷ In general, the more services offered to the investor and the more investment options provided, the higher the administrative costs. Much of these costs would probably be borne by individual account holders, which would directly affect their accumulations and, eventually, their benefits. Moreover, under almost any scenario, government agencies would require additional resources, either for new record-keeping and administrative duties or new oversight and monitoring responsibilities. Decisions would have to be made concerning who would bear the different costs associated with the accounts.

There are, however, options that could help limit administrative costs while still offering a degree of choice in investment vehicles. Offering choices among investment funds that are passively managed or based on a broad market index could keep costs down. Indexing does not require research on individual companies or securities, and securities held in index funds are not bought and sold frequently.¹⁸ Both activities—market research and frequent trading—can increase investment costs. In the TSP, where costs per participant are kept low relative to other defined contribution plans, both the bond and equity funds are invested in index funds, and records are kept centrally.

System design can also be used to keep administrative costs down, when offering a greater range of investment choices. In the United Kingdom, one study found administrative costs to be as high as 36 percent of an

¹⁷See GAO/HEHS-99-131, June 18, 1999.

¹⁸Index funds that require a specific ratio between stocks and bonds would require daily buying and selling to maintain the ratio.

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account's value.¹⁹ The study attributed these high costs, in part, to the fact that these accounts are voluntary, decentralized, and do not take advantage of economies of scale. In contrast, in Sweden, a centralized mandatory system can take advantage of economies of scale. Sweden's system is in the early stages of implementation, and it is too early to know how well it will work.

Preretirement Access to Individual Account Funds

Whether to allow individuals access to their account funds prior to retirement would be both a policy and a cost consideration. Ensuring that retirement income is available for the life of the retiree is a fundamental goal of Social Security. However, with accounts viewed as the property of the contributor, there could be pressure for access to the funds before retirement age, including access to these accounts through divorce, disability, or loans. While some may argue that individuals should be allowed the freedom to optimize their lifetime income through borrowing from their accounts before retirement, the added complexity and potential diminution of retirement income and possible increased risk to the government should be given serious consideration. Most major proposals prohibit loans and other preretirement access to individual account balances.

A number of issues would need to be addressed if loans were allowed under an individual account system. These issues include the following: for what purposes would loans be allowed; who would approve and service the loans; how would loan denials, if any, be appealed; who would enforce loan repayment; and what would happen if an individual defaulted on a loan? Under a 401(k) plan, employers may allow individuals early access before age 59 in certain circumstances (including death, disability, hardship situations, and separation from service), but individuals may be subject to a 10-percent additional income tax for early withdrawal.

Administrative costs would be affected by the treatment of each of these issues, and these costs could be significant.

Customer Service Considerations

There would also be a range of customer service options that could be considered in any system of individual accounts. When more services and more flexibility are offered, the costs and administrative complexity of

¹⁹This percentage includes costs attributed to fund accumulation (that is, management and administrative costs) and costs of switching from one financial provider to another or stopping contributions altogether; it does not include annuitization costs. If annuitization costs were included, the study estimated that total charges could be as high as 43 percent. See Mamta Murthi, J. Michael Orszag, and Peter R. Orszag, "The Charge Ratio on Individual Accounts: Lessons from the U.K. Experience," Birkbeck College Working Paper 99-2 (London: University of London, Mar. 1999).

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managing the investments increase. Moreover, if individuals consider the individual accounts as their personal property, they may expect more options and better service than they would from a government program. Many of the services that could be considered in the design of an individual account system are discussed below.

How Frequently Should Statements Be Issued?

Statements provide individuals with information on the actual value of their account, and the frequency of such statements under current systems varies. Statements estimating future Social Security benefits will be provided to all U.S. workers once a year beginning in fiscal year 2000. Sweden will also require annual statements, while the TSP currently provides statements twice a year. Statements for private investments, such as brokerage accounts, however, are often provided on a quarterly or monthly basis.

How Often Should Deposits Be Credited to an Individual Account?

While making deposits more frequently could increase earnings potential, it could also increase administrative costs and require additional reporting and reconciling because of the likely increase in reporting errors. Shifting to more frequent deposits might not be costly for employers with electronic record keeping, but doing so could represent a significant cost for small businesses. Conversely, making deposits to accounts less frequently would raise the issue of how funds collected but not deposited would be treated and who would benefit from any earnings.

Should Valuations Be Performed on a Daily or Periodic Basis?

Valuation is the process by which investment gains or losses are reflected in account balances. If valuation is performed daily, then participants' accounts reflect daily changes in market performance. Because valuation is rather involved, daily valuation is more expensive than periodic valuation and raises the possibility that some participants might switch among funds more frequently. This in turn could lead to their having inadequate retirement income.

How Often Should Individuals Be Allowed to Transfer Funds Between Investment Options, and Who Should Bear the Cost?

The frequency of interfund transfers can affect the value of an individual's account, depending on who incurs the cost of the transfer. The TSP currently allows individuals to move their assets once a month, and there is no direct charge to the individual. At the end of each calendar year, individuals in the United Kingdom may transfer to a new provider. However, they are charged exit fees, and other provisions often make such changes financially unrewarding. Under Sweden's plan, individuals will be able to transfer their funds at any time and incur a cost of about \$10 per transfer.

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What Channels of Direct Communication Should Be Established for Individuals to Obtain Account Information?

A number of options, such as toll-free numbers, regional offices, the Internet, and form inquiries, are available for interaction on account information. For example, participants in the TSP can conduct transactions, such as changing their account allocations, through either a computer-assisted phone service or the Internet.

As a general rule, more flexibility equals higher costs. However, higher costs could be associated with more customer service and, potentially, with higher investment returns; yet higher investment returns are not consistently correlated with higher administrative costs. Many actively managed investment options have not been able to generate higher returns than broad market indexes.

Start-Up Issues: Developing an Investment Structure Would Take Time

As with the start-up of any new system, considerations such as the following would need to be addressed prior to implementation:

- establishing a link between the record keeper and investment manager for fund deposits;
- phasing system changes gradually; and
- addressing the challenges of small accounts.

If the investment management function was contracted out from a centralized record-keeping entity, a mechanism would be needed to link the information on deposits with actual contributions and the individual's investment selection before crediting deposits to the individual's account. For instance, for an individual account system under the current structure, SSA would maintain an individual's record, IRS would receive contribution information from employers, and individual contributions would be sent to a Federal Reserve bank or other authorized repository. After reconciliation between SSA and IRS was completed, this information and the individual's contribution would need to be linked to the individual's investment choice and forwarded to the designated investment manager.

Phasing the new system in gradually and limiting choices would have advantages. For example, the TSP started with one fund, then added two more funds, and, in May 2000, will add another two: a Small Capitalization Stock Index Fund and an International Stock Index Fund. This gradual phase-in allowed the TSP and federal agencies sufficient time to establish a record-keeping system, inform the participants of their investment options, and observe the investment patterns before expanding the choices offered. Sweden plans to collect and accumulate contributions

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before crediting them to individual accounts; the phasing allows more time for investor education about the new system and more substantial accumulation of account balances before investment.

Small accounts would pose challenges during both system start-up and full-scale implementation. Average taxable earnings for U.S. workers in 1997 were \$22,383, so an annual contribution of 2 percent of earnings would equal an average contribution of about \$448 per year. The level of administrative costs can have a significant effect on account accumulation: the higher the percentage charged, the greater the effect. Moreover, if individuals were charged a flat fee per account for administrative costs, accumulations in small accounts would be affected to a greater extent than if an annual percentage rate were charged.²⁰ However, there are ways to mitigate the problems associated with small accounts. Suggestions from various pension experts include (1) designing an administrative fee structure that permits large accounts to cross-subsidize small accounts; (2) establishing a separate, privately managed defined benefit plan for low earners; and (3) pooling the contributions of small accounts and investing them until they reach a designated size and then moving the contributions and earnings into individual accounts.²¹ Another alternative would permit workers initially to select among a small set of passively managed funds. Then, after several years, when account assets had built up sufficiently, workers seeking more investment choice would be given the option of rolling their investment funds into any qualified retirement account.

²⁰For more information on the effects of administrative costs, see GAO/HEHS-99-131, June 18, 1999.

²¹State Street Corporation, among others, has raised this third option as a possible means to address small accounts.

How Much Flexibility Would Be Granted in Paying Retirement Benefits?

A third critical decision would involve how much flexibility in the choice of payout options to afford workers when they retire and begin to draw on their accounts. Several options are available for the payout of benefits upon retirement, and each option has issues and trade-offs associated with it. In essence, the desire to give retirees flexibility in drawing on their accumulated savings must be balanced with the goal of ensuring reliable income over a retiree's life span. While some may argue that the method for payout would not need to be addressed for some time, it is important to note that there are many issues related to payout that could affect the overall goals of the program. These issues would need to be explored and clarified before implementation.

Options for Payment of Retirement Benefits

There are three basic ways to pay retirement benefits under a system of individual accounts: annuitization, timed withdrawals, and lump sum payments. Under a system of annuities, the retiree contracts with the annuity provider, generally an insurance company, to provide income for an agreed-upon length of time. Individuals provide a mutually agreed upon dollar amount, called a premium, to the provider in return for their monthly benefit.²² The contract specifies the premium paid to the company, the monthly amount paid to the retiree, and the interest rate that will be calculated on the premium over the life of the annuity. Premiums can be paid either as a lump sum or as a series of annual payments. For example, \$100,000 today (the average premium in today's annuity market) yields a monthly benefit of approximately \$700 to \$800 per month for a 65-year-old male for the rest of his life.

Other options for the payout of accounts include timed withdrawals (also referred to as self-annuitization) and lump sum payments. In a timed withdrawal, retirees specify a withdrawal schedule with the investment manager or record keeper. Each month, they receive their predetermined amount, while the balance of the individual account remains invested. Under a lump sum payment option, individuals may liquidate their accounts through a single payment at retirement and choose to spend or save their money according to their needs or desires.

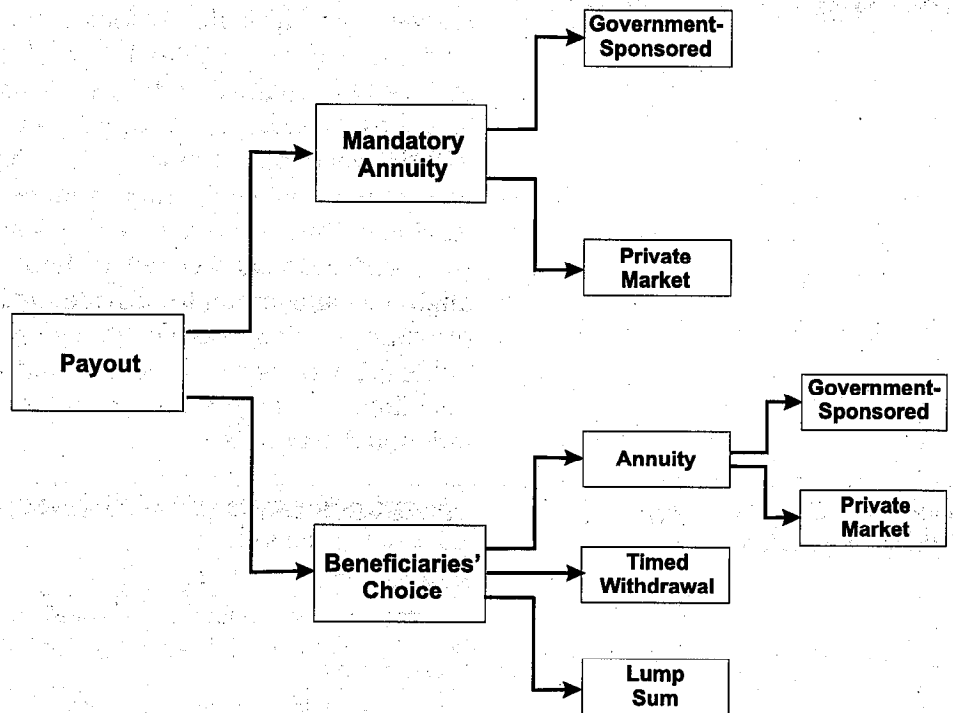
A fundamental decision in paying retirement benefits to participants in individual accounts would be whether to require participants to annuitize the funds in their accounts. Figure 3.1 illustrates the options that would be available under a system in which individuals were required to annuitize

²²In a forthcoming report, we will provide a more detailed discussion of the factors that affect the costs associated with purchasing an annuity and how this cost could factor into a system of individual accounts.

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their funds as well as the options available if more flexibility was granted regarding the payout of funds.

Figure 3.1: Options for Payment of Retirement Benefits



There are at least two ways that annuities could be provided: the government could sponsor the annuities centrally or individuals could purchase their annuities from the private market. If the government sponsored annuities, the government could provide them, contract with a private provider, or create a new quasi-governmental agency to provide the annuities.²³

²³For example, the Pension Benefit Guaranty Corporation currently pays annuity benefits to participants in defined benefit pension plans that are terminated with insufficient assets to pay guaranteed benefits.

Issues and Trade-offs to Consider When Choosing Among Options

Choosing between options such as making annuities mandatory and allowing beneficiaries to select their own course would require carefully examining the significant trade-offs associated with each option. For example, requiring individuals to annuitize individual accounts would be one way to ensure that benefits were available for the entire life of the retiree, regardless of how long that might be. Yet annuitization would allow individuals less flexibility, especially those with shorter life expectancies. Timed withdrawals and lump sum payments also present issues to consider. For example, a worker who selected a timed withdrawal could live longer than expected and run out of money, or a worker who selected a lump sum could spend it quickly or invest it badly, leaving nothing for retirement. These possibilities increase the risk that some retirees would be left without adequate income and the government might be called upon to provide further income support; however, providing choice would enable individuals to pass on accumulated wealth. Table 3.1 depicts the trade-offs that would need to be considered before deciding how the payout system would be structured under a system of individual accounts.

Table 3.1: Trade-offs for Paying Retirement Benefits

| Mandatory annuitization | Choice for beneficiaries |
|--|--|
| Reduces range of individual choice | Maximizes individual choice |
| Ensures reliability of income over a lifetime, but may disadvantage those with shorter life expectancies | Increases risk of elderly population with inadequate retirement income |
| Minimizes risk to government of need to provide further income support | Increases risk to government of need to provide further income support |
| Provides option to choose to ensure family benefits if annuitant dies | Provides opportunity to pass on accumulated wealth |
| Can be less costly to administer | Can be more costly to administer |

Deciding on payout options for a system of individual accounts would not be limited, however, to choosing between requiring annuities or permitting maximum choice. Partial annuitization is one way of coping with the trade-offs. Payout options could be combined to ensure minimum benefits while offering greater flexibility to the individual. In Chile, for example, individuals are required to purchase an annuity that represents 70 percent of the average worker's salary, but they can withdraw the funds that exceed this level.

Mandatory Annuitization

Some of the proposals for individual accounts require annuitizing account accumulations to ensure dependable retirement benefits. The

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administrative functions would be performed by an annuity provider, which would both prepare the annuity contract and pay the benefits according to its terms. Once a provider was chosen, the investment manager would be released from its responsibilities. For example, under the TSP, MetLife is the current annuity provider; when participants leave federal employment and choose to annuitize their TSP accounts, they then deal only with MetLife. MetLife offers five different types of annuities, each with a variety of features from which to choose. It is up to individuals to select the annuity they want to purchase, and the TSP transfers the funds to cover the premium. Any individual account system would require that a mechanism for communication be established among the record keeper, the investment manager, and the annuity provider to share personal information and account balances to initiate the payments. This mechanism would take time to develop and should therefore be thought through prior to implementing individual accounts. In creating the TSP, the establishment of a payout system at the same time as the entire system was recognized and included in the initial FERSA legislation.

Payout Structure Affects
Administrative Costs

Concerns over administrative costs raise important issues regarding system design. The administrative cost of purchasing an individual annuity in the current market is relatively high, averaging a one-time charge of about 5 percent of the premium.²⁴ This cost is for maintaining records, making payments, and providing services to the annuitant as well as some profit margin for the annuity provider. These costs can significantly reduce the amount accumulated in a savings account and therefore reduce lifetime benefit amounts. Government-sponsored and centrally managed annuities are one way to lower administrative costs, in part by taking advantage of economies of scale. In addition, the current Social Security system has demonstrated that it has the capability of managing a large volume of benefit payments.

In addition to these administrative costs, current retirees who purchase annuities in the private market pay additional costs because of the characteristics of the other individuals who buy annuities. This situation is known as "adverse selection." In the current private market, consumers who expect to live a long time are much more likely to purchase annuities than others are. As a result, annuity providers charge higher prices than they would if every retiree purchased an annuity. The cost of insuring

²⁴James M. Poterba and Mark J. Warshawsky, "The Costs of Annuitizing Retirement Payouts from Individual Accounts" (Cambridge, Mass.: National Bureau of Economic Research, Jan. 1999).

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against adverse selection could be as high as 12 percent of the premium.²⁵ Making annuities mandatory would help equalize the pool of applicants by including individuals with lower life expectancies, thus somewhat mitigating the need for these additional costs. Moreover, managing the annuities centrally could provide additional opportunity for reduced costs. Pooling individual annuitants would provide more certainty that those with longer life expectancies would be balanced out by those with shorter life expectancies. However, making annuities mandatory or managing them centrally limits individual choice and increases the role of government in the payout process.

Other Implementation
Issues

In addition to the broad issues of payout structure and administrative costs, there are a number of implementation issues that arise in relation to a discussion on mandatory annuities that should be addressed before making a decision on a method for paying retirement benefits.

Would a Unisex Mortality Table
Be Used?

As a result of a Supreme Court decision, pension plans that provide group annuities must use a unisex mortality table that pools together the risk factors for men and women, thereby ensuring that both sexes receive the same monthly benefit, although they have different mortality rates. In contrast, individual annuities are not required to use the unisex table. Under the current system, SSA pays the same benefit to women and men who have the same earnings record. If a unisex mortality table was required, there would be the possibility that insurance companies would market only to men.

What Would Happen If a Person
Retired When the Market Was
Down?

This could affect the overall account accumulation and, therefore, the value of the annuity that a retiree would be able to purchase. Unlike a lump sum, under an annuity an individual would no longer control the money and would not be able to move it in and out of the financial market. Additionally, the interest rates at the time of retirement affect the annuity payments. If, for example, the interest rates were low at retirement, then the monthly payments would be lower than at higher interest rates and would stay constant regardless of any change in interest rates. In the United Kingdom, an annuity purchase may be delayed until an individual reaches age 75.

What If a Retiree Wanted
Access to His or Her Funds?

Once individuals contract with an annuity company, their only access to the funds is through the monthly payment; individuals needing extra money are not able to draw from their premium. Under a lump sum,

²⁵Poterba and Warshawsky, "The Costs of Annuitizing Retirement Payouts from Individual Accounts."

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however, the money would be accessible. This becomes an issue when people begin to consider their individual accounts to be personal property. It would be important to make sure individuals understood that agreeing to an annuity would deny them access to their accumulated account balance but would ensure them a lifetime of retirement benefits. An important consideration is that any early retirement provisions would affect the annuity payout.

Would Annuity Payments Be Indexed to Inflation?

Currently, Social Security beneficiaries get a cost of living adjustment to their benefits. Most private annuities do not offer this option. Insurance companies have said that if payments were indexed to inflation they would charge more.

Who Would Be Responsible for Small Accounts?

Insurers have told us that early on under a new system, account balances would be small and that the government should hold and annuitize accounts because it would not be economical for insurers to do so. Monthly payment amounts are linked to the premium, which may be all or some portion of an individual account, and a premium of \$10,000 might provide a monthly payment of only \$60 to \$80. Some argue that it would be especially important for these small accounts to be given every opportunity to face minimal administrative costs.

How Would the Federal Role Change Under a System of Mandatory Annuities?

If annuities were offered through the private market, there would need to be coordination between SSA and the investment manager. A system would need to be created whereby the money in individual accounts for annuity payments to retirees would be sent to the annuity provider for benefit payments. If the payout structure was decentralized, additional oversight and regulation would be needed to prevent fraud in the system and to ensure that individuals received the money that was due to them. Similarly, a decision would need to be made about whether the government would guarantee annuities to the full amount. Currently, by law, each state is responsible for regulating the insurance industry, but if annuities became part of a national system of individual accounts, the role of the federal government would need to be revisited.

Timed Withdrawals and Lump Sum Payments

If annuities were not required, retirees could be permitted to assess their individual needs and make decisions based on their personal situations. Several questions would need to be answered before implementing timed withdrawals or lump sums as payout options for individual accounts.

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Would Individuals Be Able to Choose These Options If They Retired Early?

Under the current Social Security system, retirees receive a reduced benefit if they retire early. A decision would have to be made regarding whether and when retirees could gain access to their funds prior to the predetermined normal retirement age.

What Would Happen If an Individual's Self-Determined Periodic Payments or Withdrawals Failed to Cover His or Her Full Lifetime?

Individuals might calculate their monthly withdrawals on the basis of the number of years they expect to live. It is possible, though, that an individual who selected a timed withdrawal could live longer than expected and run out of money. In addition, a worker who selects a lump sum could spend it quickly or invest it badly, leaving none for retirement.

Would the Government Provide a Minimum Pension If Funds Were Outlived or Exhausted?

A decision would have to be made about a government guarantee in the event that retirement funds were outlived or depleted. In Chile, for example, for those who select a timed withdrawal option, the government guarantees a minimum pension if one's funds are depleted before his or her death. This again raises the possibility that some people would take greater risk with their investments if they knew that the government would provide a guarantee, thus creating a contingent liability for the government.

Start-Up Issues: Need for Payout Structure Before Implementation of Individual Accounts

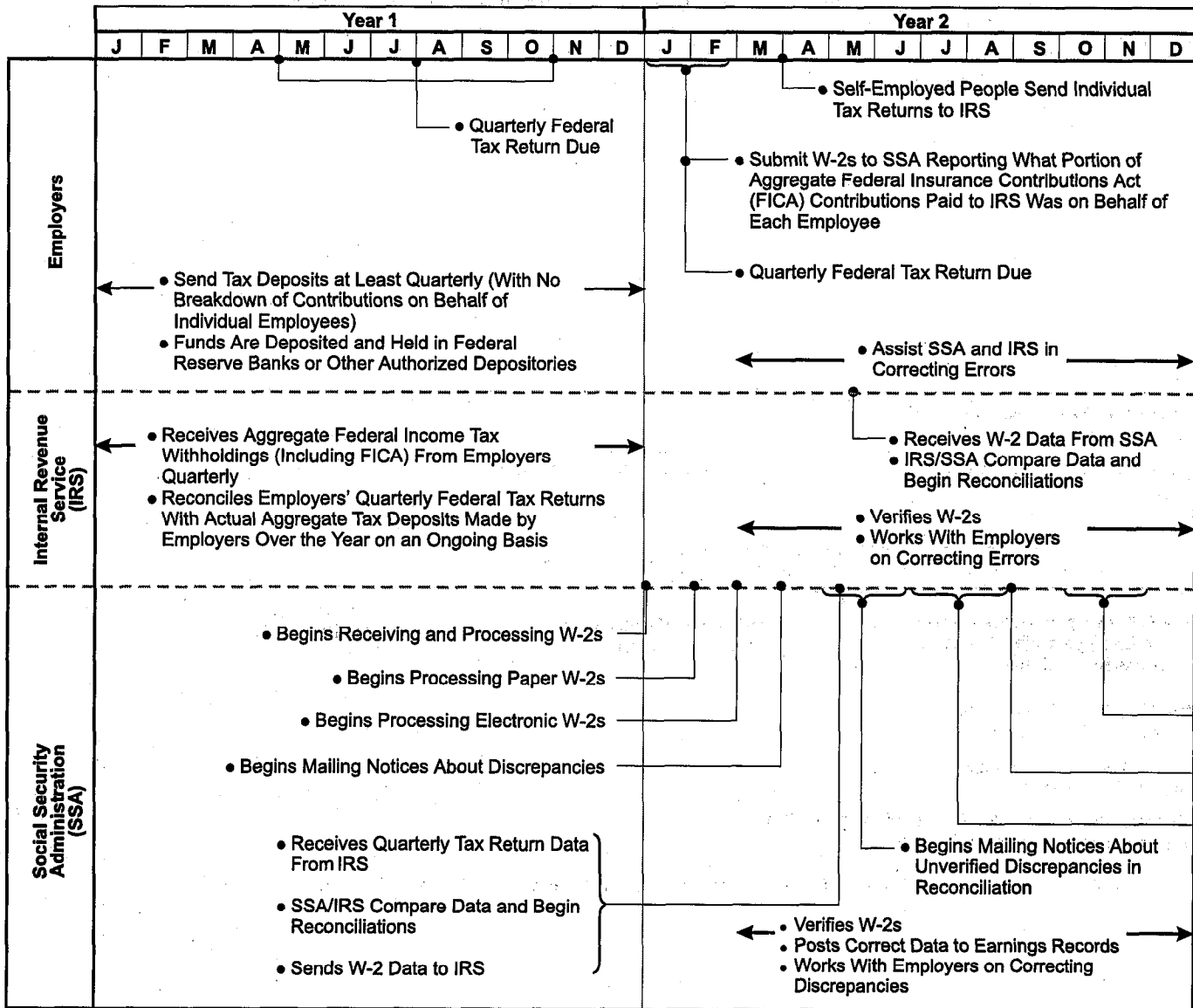
It would be important to look at how all the parts of a system of individual accounts would interact with each other and determine whether, as a whole, the system was structured to meet its preestablished goals—such as enhancing individual choice and paying retirement benefits. Therefore, the start-up time for creating a payout system should be considered within the broader context of the entire system. Whether annuities were mandatory or voluntary, the government's role would need to be redefined. If mandatory annuities were selected as the payout option, an oversight agency's responsibilities could include creating a system for processing annuities, developing a process for contracting out annuity services, or creating a system that regulated at least some of the activities of private insurance companies that offer annuities. Furthermore, the various types of annuities being offered would need to be considered, since the specific option selected could make a difference in retirement provisions.

Regardless of the payout structure, the public would need to be educated to understand the payout options available to them. If annuities were mandatory, for example, individuals would need to be educated about the annuity options available to them, because differing features could make a difference in the amount of retirement income. In addition, the public

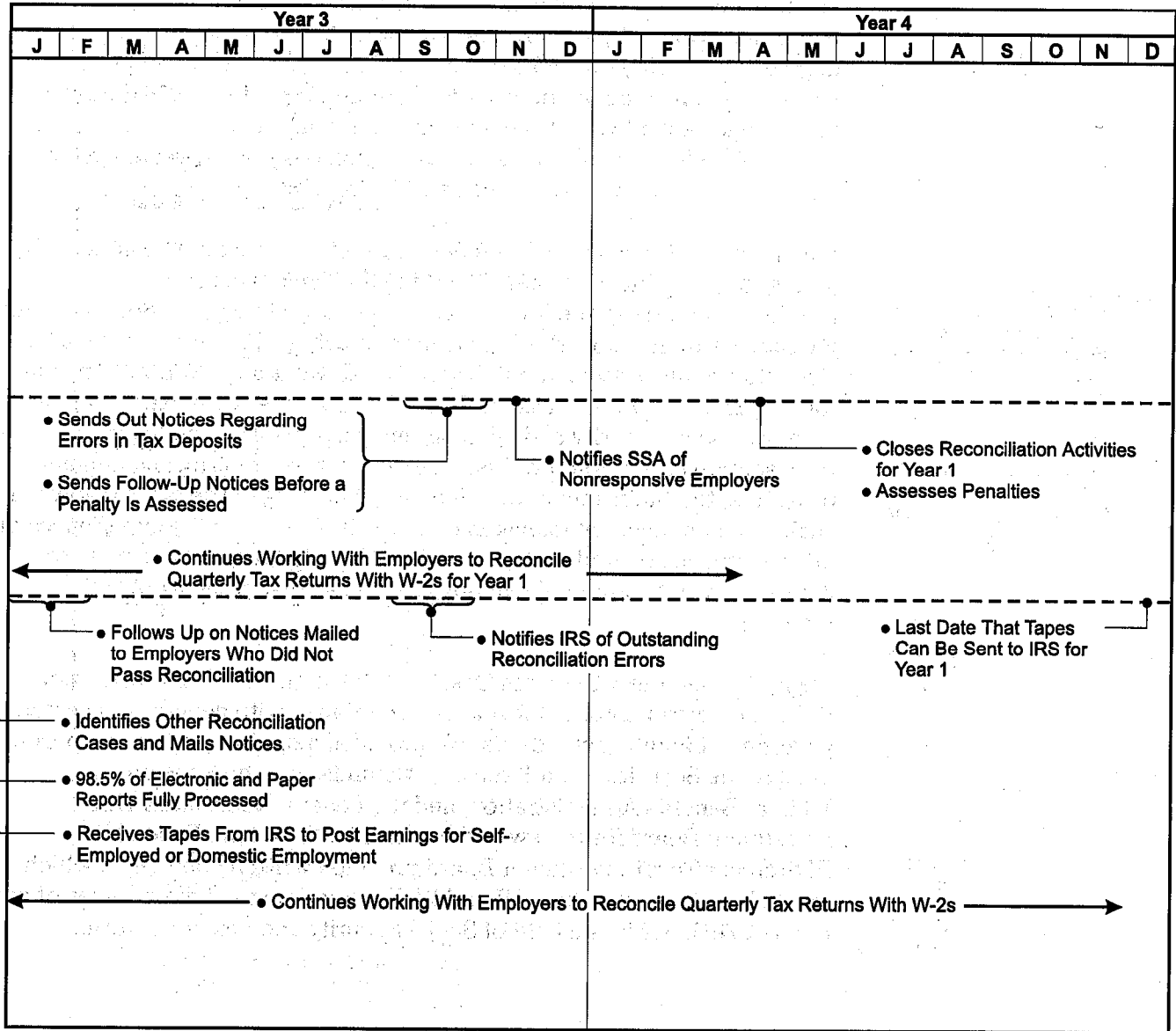
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would need to be educated about how the payout would occur, which agency would be responsible for processing the payout, and what the effects of each option available to them would be.

Flowchart of Current Earnings Process



**Appendix I
Flowchart of Current Earnings Process**



Objectives, Scope, and Methodology

At your request, the objectives of this review were to explore the options under a system of individual accounts for (1) placement of new administrative responsibilities, (2) managing investment funds and determining the extent of investment choices, and (3) determining the degree of flexibility offered to individuals at payout. To accomplish this, we agreed to include in our analysis the federal role in administering or regulating both individual accounts and personal savings accounts as well as the role of large and small employers, including the self-employed and businesses that typically have no retirement plans.

We met with officials from the federal agencies that would be affected by a system of individual accounts, including the Social Security Administration (SSA), the Internal Revenue Service (IRS), the Securities and Exchange Commission, the Department of Labor's Pension and Welfare Benefits Administration, the Pension Benefit Guaranty Corporation, and the Department of the Treasury. In addition, we met with experts in the areas of Social Security and pension reform, as well as employer representatives, payroll processors, investment managers, and annuity providers, to obtain a more detailed understanding of the tasks involved in each aspect of account management. We also reviewed the experiences of other countries related to the administration of individual accounts to determine what additional manpower or other resources would be required.

We performed our work from October 1998 to May 1999 in Washington, D.C., and Sacramento, California, in accordance with generally accepted government auditing standards. We provided a draft copy of our report to SSA, IRS, the Securities and Exchange Commission, the Pension and Welfare Benefits Administration, and the Federal Retirement Thrift Investment Board for review and comment. SSA and the Federal Retirement Thrift Investment Board provided written comments, which are included in appendixes III and IV. We also provided draft copies of our report to experts in the field of Social Security and pension reform.

Comments From the Social Security Administration



SOCIAL SECURITY

Office of the Commissioner

June 01, 1999

Cynthia M. Fagnoni
Director, Education, Workforce, and
Income Security Issues
United States General Accounting Office
Washington, DC 20548

Dear Ms. Fagnoni:

Enclosed are our comments on the Government Accounting Office's (GAO) proposed report, Social Security Reform: Implementation Issues for Individual Accounts (GAO/HEHS-99-122). We appreciate the opportunity to review the report and hope that these comments will prove useful.

We are pleased that the report explains that certain critical questions must be addressed when discussing implementing any proposal that includes individual accounts, and that various trade-offs must be considered before any plan can be implemented. We are concerned, however, that the plan does not fully address the issues associated with ensuring compliance by all of the parties involved in implementation. In addition, we believe that the report could more clearly discuss how, under any individual accounts model, different entities could be involved in various aspects of administering such accounts. Our comments focus on the two major issues cited above. We are also providing several technical comments.

If you should have any questions concerning our comments, your staff may contact Jane Ross, the Social Security Administration's Deputy Commissioner for Policy, at (202) 358-6082 in Washington or (410) 966-6756 in Baltimore. Again, we appreciate the opportunity to review the report and look forward to the GAO's continued involvement in this vital debate.

Sincerely,

A handwritten signature in black ink that reads "Kenneth S. Apfel".

Kenneth S. Apfel
Commissioner
of Social Security

Enclosure

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

**COMMENTS OF THE SOCIAL SECURITY ADMINISTRATION ON
THE GENERAL ACCOUNTING OFFICE'S DRAFT REPORT,
SOCIAL SECURITY REFORM: IMPLEMENTATION ISSUES FOR
INDIVIDUAL ACCOUNTS (GAO/HEHS-99-122)**

• **COMPLIANCE**

While the GAO draft report mentions some problems associated with compliance, it is our view that compliance would be a major cost driver in any system of individual accounts. Compliance is more than ensuring contributions and investments are made timely. It also involves preventing fraud and abuse. We believe that current regulations that cover voluntary systems may not be adequate for a mandatory system of individual accounts.

Today, SSA and the Internal Revenue Service (IRS) employ administrative tolerances in annual wage reporting that limit the work we need to do to ensure that employers and the self-employed comply with reporting requirements (which your report explains). The report should also indicate that if these tolerances were eliminated, as they likely would be for an individual account system, the reconciliation workload, which ensures compliance, would at least double. There is also the question as to whether, in the absence of tolerances, IRS or some other agency would have to more aggressively pursue the collection of FICA, SECA or other taxes.

Any agency that administers individual accounts would have to be concerned not only with participant fraud, but also with employee fraud. Currently, SSA expends significant resources to prevent both. A system of individual accounts could increase the incidence of such fraud. The report alludes to fraud on the part of investment entities, but there could also be an increase in fraud and abuse targeted against participants at payout, particularly if lump sum payments are allowed.

There are also privacy concerns—in a centralized plan, one agency could have in its possession substantially more personal information on individuals than is available today. The implementing agency may need to make more resources available to ensure individual privacy rights. Also, under the Privacy Act, individuals have the right to access their own records—the workload related to this requirement could be substantial.

We recommend that the report devote a section to discussing measures to ensure compliance with the new program.

• **ROLE OF VARIOUS ENTITIES**

The report discusses how the role of entities changes in different scenarios, but we believe it is important to explain how roles could shift under all models under consideration. For example, under a TSP-type model, employers could still have a substantial role if, for example, employers were required to forward contributions directly

**Appendix III
Comments From the Social Security
Administration**

to a central authority. Likewise, in an IRA-type model the government could have a large role if the system were funded by tax rebates or credits—IRS's workload could therefore increase substantially. Also, how initial enrollments are received is important (through employers, directly by individuals)—this question is important regardless of the model. Finally, how the system is funded will affect implementation—tax credit, employer rebate, etc.

Comments From the Federal Retirement Thrift Investment Board



FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

May 26, 1999

Ms. Cynthia M. Fagnoni
Director, Education, Workforce, and
Income Security Issues
Health, Education, and
Human Services Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Ms. Fagnoni:

Executive Director Mehle has asked that I respond to your request for comments on the proposed General Accounting Office (GAO) Report No. GAO/HEHS-99-122, Social Security Reform: Implementation Issues for Individual Accounts. I am returning the copy of the report you provided along with suggested clarifying edits.

Additionally, as discussed with your staff today, the paragraph on page 30 regarding the administrative costs of TSP loans would require substantial expansion in order to portray accurately the effects of statutory changes enacted in 1996 that made TSP loans comparable to 401(k) loan programs.

As indicated in written response #11 which we provided to GAO at our March 2, 1999, meeting, it cannot be stated that TSP administrative costs increased as a result of general purpose loans. Although the volume of loan activity increased, this was offset by the shift from the labor-intensive processing required for limited purpose (documented) loans to the simple administration of the general purpose (undocumented) loans.

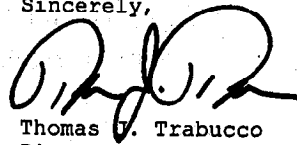
Your staff indicated that, for purposes of this report, more general references to the costs associated with various administrative activities would suffice, and that references to the TSP as an example in this paragraph would be deleted. We concurred with this approach.

This discussion was deleted.

**Appendix IV
Comments From the Federal Retirement
Thrift Investment Board**

I hope this and other information regarding the TSP that we have provided has been helpful.

Sincerely,



Thomas J. Trabucco
Director, External Affairs

Enclosure

GAO Contacts and Staff Acknowledgments

GAO Contacts

Barbara D. Bovbjerg, (202) 512-7215
Kay E. Brown, (202) 512-3674

Staff Acknowledgments

In addition to those named above, the following team members made important contributions to this report: Valerie Rogers, Abbey Frank, Gerard Grant, Deborah Moberly, Elizabeth O'Toole, Roger Thomas, and Rodina Tungol.

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Related GAO Products

Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design (GAO/HEHS-99-131, June 18, 1999).

Social Security: Criteria for Evaluating Social Security Reform Proposals (GAO/T-HEHS-99-94, Mar. 25, 1999).

Social Security: Individual Accounts as an Element of Long-Term Financing Reform (GAO/T-HEHS-99-86, Mar. 16, 1999).

Social Security Reform: Experiences of the Alternative Plans in Texas (GAO/HEHS-99-31, Feb. 26, 1999).

Social Security and Surpluses: GAO's Perspective on the President's Proposals (GAO/T-AIMD/HEHS-99-96, Feb. 23, 1999).

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