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**SOCIAL SECURITY  
REFORM**

**Considerations for  
Individual Account Design**

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Highlights of [GAO-05-847T](#), a testimony before the Subcommittee on Social Security, Committee on Ways and Means, House of Representatives

## Why GAO Did This Study

Social Security forms the foundation for our retirement income system, providing critical benefits to millions of Americans. However, the Social Security program is facing significant future financial challenges as a result of profound demographic changes. A wide variety of proposals to reform the program are currently being discussed, including restructuring the program to incorporate individual accounts. When designing a system with individual accounts, there are many options and issues to consider. The choices that have to be made will affect not only participation in the accounts, but also the amount of savings accumulated in the accounts, and the benefit received from the individual accounts.

The Subcommittee asked GAO to discuss options for the administration of individual accounts, including the major design issues that are raised within the contribution, accumulation, and distribution phases of a retirement savings vehicle.

[www.gao.gov/cgi-bin/getrpt?GAO-05-847T](http://www.gao.gov/cgi-bin/getrpt?GAO-05-847T).

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or [bovbjergb@gao.gov](mailto:bovbjergb@gao.gov).

# SOCIAL SECURITY REFORM

## Considerations for Individual Account Design

### What GAO Found

Because Social Security is so deeply woven into the fabric of our nation, any proposed reform should be considered as a package and with respect to all of the major elements of the Social security program (e.g., retirement, disability, and survivors). Individual accounts can be a part of that reform, and in fact, many proposals include individual accounts. However, any proposed reform must consider the program in its entirety, rather than one aspect alone. Likewise, an individual account system must address key design issues associated with the phases of a retirement savings vehicle.

*Contribution phase:* Designing the contributions for individual accounts requires making choices about the role that contributions play with respect to the current Social Security system. These choices include determining the size of the contribution rate, how the contributions are collected, whether the funds come from existing revenue sources, and whether participation is voluntary or not.

*Accumulation phase:* Once contributions have been made, the accumulation phase requires making decisions about what to do with the funds to make them grow. These decisions include how much choice 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.

*Distribution phase:* Distributing the accumulated earnings in individual accounts needs to focus on how these funds would be preserved for retirement. This includes making choices about when individuals can gain access to their funds, how much money they receive, and in what form they receive the funds. Other considerations that arise include the tax treatment of distributions and whether there will be a guarantee of a specified level of benefits.

Overall, when designing individual accounts, it is important to keep in mind that more features tend to increase costs. For example, more investment choices can result in more administrative fees. Administering the accounts and educating the public about a system of individual accounts requires choices and trade-offs. However, any related administrative, management, and data systems must be developed and tested before the accounts become available to workers in order to maintain confidence in the system. Individual accounts could also be designed to include some progressive features, which would mirror the redistributive effects of the current Social Security program. However, it is important to distinguish between progressivity and benefit adequacy. Greater progressivity is not the same thing as greater adequacy and may result in less equity.

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Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss options for designing a system of individual accounts within the Social Security program. Social Security forms the foundation for our retirement income system and, in so doing, provides critical benefits to millions of Americans. However, the Social Security program is facing significant future financial challenges as a result of profound demographic changes. A wide variety of proposals to reform the program are currently being discussed, including restructuring the program to incorporate individual accounts. When designing a system with individual accounts, there are many options and issues to consider, such as whether the accounts should be voluntary or mandatory, the amount of choice individuals have over their investments, and how and when the funds are withdrawn from the accounts. The choices that have to be made will affect not only participation in the accounts, but also the amount of savings accumulated in the accounts and the benefit received from the account.

Today I will discuss options for the design of individual accounts specifically corresponding to the phases of a pension or similar retirement savings vehicle: the contribution phase, the accumulation phase, and the distribution phase. GAO has conducted several studies related to the design, implementation, and administration of individual accounts. My statement is largely based on that work.<sup>1</sup>

In summary, the creation of an individual account system faces key design decisions in each of the phases that comprise the dynamics of a retirement savings vehicle. For example, regarding contributions, the size of the contribution and whether the accounts will be mandatory or voluntary must be decided. This decision will be shaped to some degree by the implicit relationship of the accounts to the current Social Security program. In the accumulation phase, individual account design must negotiate a number of trade-offs in setting, for example, the amount of choice in investment options and the level of customer service provided. Finally, individual accounts, like current defined contribution (DC) plans and individual retirement accounts (IRAs), must distribute accumulated account balances to individuals. A system of individual accounts covering over 156 million workers would constitute a fundamental change to Social Security and would be significantly larger than any existing retirement

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<sup>1</sup> See the list of related GAO products at the end of this statement.

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investment program. Affected individuals need to know about and understand the features of such a new system to make informed life decisions about work, savings, and retirement.

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## Background

According to the Social Security Trustees' 2005 intermediate, or best-estimate, assumptions, Social Security's cash surplus begins to decline in 2009, and in 2017 cash flow is expected to turn negative. In addition, all of the accumulated Treasury obligations held by the trust funds are expected to be exhausted by 2041. Social Security's long-term financing shortfall stems primarily from the fact that people are living longer and having fewer children. As a result, the number of workers paying into the system for each beneficiary has been falling and is projected to decline from 3.3 today to about 2 by 2040.

A common feature of many Social Security reform proposals is the creation of a system of individual accounts. Individual accounts would generally not by themselves achieve solvency for the Social Security system. Achieving solvency requires more revenue, lower benefits, or both. Many proposals that incorporate a system of individual accounts into the current program would reduce benefits under the current system and make up for those reductions to some degree with income from the individual accounts. Individual accounts also try to increase revenues, in effect, by providing the potential for higher rates of return on account investments than the trust funds would earn under the current system, but this exposes workers to a greater degree of risk.

Three key distinctions help to identify the differences between Social Security's current structure and one that would create individual accounts.

**Insurance versus savings.** Social Security is a form of insurance, while individual accounts would be a form of savings. As social insurance, Social Security protects workers and their dependents against a variety of risks such as the inability to earn income due to death, disability, or old age. In contrast, a savings account provides income only from individuals' contributions and any interest on them; in effect, individuals insure themselves under a savings approach.

**Defined benefit versus defined contribution.** Social Security provides a defined benefit (DB) pension while individual accounts would provide a defined contribution (DC) pension. Defined benefit pensions typically determine benefit amounts using a formula that takes into account individuals' earnings and years of earnings. The provider assumes the

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financial and insurance risk associated with funding those promised benefit levels. Defined contribution pensions, such as 401(k) plans, determine benefit amounts based on the contributions made to the accounts and any earnings on those contributions. As a result, the individual bears the financial and insurance risks under a defined contribution plan until retirement.<sup>2</sup>

**Pay-as-you-go versus full funding.** Social Security is financed largely on a pay-as-you-go basis, while individual accounts would be fully funded. In a pay-as-you-go system, contributions that workers make in a given year fund the payments to beneficiaries in that same year, and the system's trust funds are kept to a relatively small contingency reserve.<sup>3</sup> In contrast, in a fully funded system, contributions for a given year are put aside to pay for future benefits. The investment earnings on these funds contribute considerable revenues and reduce the size of contributions that would otherwise be required to pay for the benefits. Defined contribution pensions and individual retirement savings accounts are fully funded by definition. Both mandatory and voluntary individual account plans would reflect all of these distinctions.

In addition to these key distinctions, options for the design of individual accounts can be grouped in three categories corresponding to the different phases of a retirement savings vehicle:

- contribution phase: who should contribute, how much, and with what funds;
- accumulation phase: how are funds invested to make them grow; and
- distribution phase: how much of a benefit is received, when is it received, and in what form is it received.

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<sup>2</sup>At retirement, individuals have the option of purchasing an annuity with their defined contribution accounts, which then transfers the financial and insurance risk to the annuity provider. Before retirement, individuals may also have the option of purchasing deferred annuities.

<sup>3</sup>Social Security is now temporarily deviating from pure pay-as-you-go financing by building up substantial trust fund reserves. Social Security is collecting more in revenues than it pays in benefits each year partly because the baby boom generation makes the size of the workforce larger relative to the beneficiary population. In 2017, shortly after the baby boomers start to retire, the benefit payments are expected to exceed revenues, and the trust fund reserves and the interest they earn will help pay the baby boomers' retirement benefits. For more detail about this temporary trust fund buildup and how it interacts with the federal budget, see GAO, *Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage*, [GAO/T-HEHS-98-43](#) (Washington, D.C.: Nov. 20, 1997).

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As we have reported previously with respect to Social Security reform as a whole, as policy makers decide whether and how to create a system of individual accounts, they must balance 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, administered, and explained to the public. An essential challenge would be to help people understand the relationship between their individual accounts and traditional Social Security benefits, thereby avoiding any gap in expectations about current or future benefits. Individuals would also need to be informed enough to make prudent investment decisions, which would require investor education, especially if individual accounts were mandatory. This would be especially important for individuals who are unfamiliar with making investment choices.

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## Design Considerations In the Contribution Phase

Determining how contributions to an individual account will be made requires choices about the role these contributions play vis-à-vis the current Social Security system. These choices include determining the size and role of contributions, management of contributions, whether the account is a substitute or a supplement, and whether participation in the accounts should be voluntary or mandatory.

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## Size and Role of Contributions

An individual account plan can provide for contributions in a variety of ways. For example, a plan might set contributions at a fixed rate, such as 2 percent of pay, or allow a range of rates with, possibly, a certain dollar limit. Some proposals provide for greater average contribution rates for lower earners than for higher earners. Individual accounts could be designed to include some progressive features, which could mirror the redistributive effects of the current Social Security program. For example, contribution rates may go down gradually as earnings rise, or alternatively, all workers might pay a fixed percentage but have a dollar cap on contribution amounts.

Ultimately the size of the individual account contribution rate determines the relative role of the DC aspect of the account versus the DB portion of the Social Security program. As a result, depending on their design,

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individual accounts will have a varying effect on the adequacy of benefits for certain subgroups of beneficiaries. For instance, disabled beneficiaries leave the workforce sooner than retired workers. With fewer years to make contributions (and accrue interest), disabled beneficiaries will likely have smaller account balances. At the same time, reform provisions that disfavor subgroups of earners can be offset by other provisions that favor them. As a result, any evaluations of reform proposals should not focus solely on individual account proposals but should consider both the DC and DB aspect of a proposal's provisions as a whole.

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## Management of Contributions

In managing individual accounts, contributions might be collected and deposited by the government in a centralized process or by employers or account providers in a decentralized process. Under a centralized process, which would build on the current payroll reporting and tax collection system, a federal agency, such as the Social Security Administration, 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. A decentralized structure could build on the system that has grown up around employer-sponsored 401(k) plans or individually managed IRAs. 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.

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## Substitute versus Supplementary Contributions

Individual accounts can either supplement current Social Security contributions or substitute for all or part of them. With supplemental accounts, sometimes referred to as add-ons, the individual account and contributions to it have no effect on existing Social Security benefits. The supplemental account approach effectively leaves the entire current 12.4 percent payroll tax contribution available to finance the program while dedicating additional revenues for individual accounts. With substitute accounts, or carve-outs, the existing Social Security benefit is reduced (or offset) in some way to account for contributions that have been diverted

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from the program.<sup>4</sup> The obvious effect is that less revenue is available to finance the current benefit structure, which creates a problem of transition costs. Absent any other reforms, these transition costs increase in proportion to the individual account contribution rate. This means that either benefits must be reduced or additional resources must be devoted to the defined benefit portion of the Social Security program in the near term. The trade-off to incurring transition costs is that the expected higher rate of return on the individual accounts may permit somewhat higher benefits to be paid, although with increased risk.

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## Voluntary Contributions Require Additional Considerations

Another important design feature to consider with respect to the contribution phase is whether the individual account is voluntary or mandatory. As we have previously reported, voluntary individual accounts require additional design considerations that mandatory accounts do not.<sup>5</sup> For instance a voluntary account could offer participants the ability to opt in and opt out of the account periodically; most U.S. proposals for voluntary accounts have not explicitly considered whether people would face a onetime or a periodic decision to participate. Individuals may consider the extent of such flexibility in deciding whether to participate in the accounts. Moreover, the need to track individuals' participation decisions requires additional administrative tasks and complexity. Educational efforts would be needed to inform individuals if their participation in an individual account would be advantageous or not, especially if the account substitutes for existing Social Security benefits.

Voluntary individual account plans may also require incentives to induce participation, while mandatory plans do not. In addition to increasing participation, incentives generally add to the value of the accounts and,

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<sup>4</sup>In GAO's work to date, we have used the term "add-on" accounts to refer to accounts that would have no effect on Social Security benefits, would supplement those benefits, and would draw contributions from new revenue streams. In contrast, we have used the term "carve-out" accounts to refer to accounts that would result in some reduction or offset to Social Security benefits because contributions to those accounts would draw on existing Social Security revenues. Others have used these terms in different manners. For example, some have used "add-ons" in connection with new individual accounts funded from new revenue sources that result in a reduction or offset to some or all Social Security benefits. In the final analysis, there are two key dimensions: first, whether individual accounts are funded from existing or new revenue sources; second, whether individual accounts result in some reduction or offset to Social Security benefits.

<sup>5</sup> See GAO, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts*, [GAO-03-309](#), (Washington, D.C.: March 10, 2003).

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therefore, ultimately to retirement income. Government contributions and tax advantages are just a few of the potential incentives for voluntary individual accounts. The costs of incentives can be difficult to estimate and can be substantial. Further, in certain circumstances, the net effect of voluntary individual account incentives may not result in improving overall retirement income. For example, if the voluntary account was also supplementary, then it might be difficult to determine whether a voluntary account adds to total retirement income, as it might merely substitute for other forms of saving. On the other hand, if the individual accounts truly add to total retirement income, they allow workers the opportunity and choice to build up additional savings to meet both income and health care cost needs in retirement.

Voluntary individual account plans can also affect the total system costs to the government, providers, employers, or participants, depending on design. In some cases, offering choice involves additional administrative, incentive, and educational costs. In particular, tracking individuals' participation decisions would require administrative processes that do not arise in mandatory plans. Moreover, the uncertainty of participation rates in turn creates uncertainty for a variety of costs associated with voluntary individual account plans. For instance if individuals accurately perceive any built-in incentive in the benefit offsets, given their personal circumstances, and make their participation decision accordingly, then adverse selection could result. This occurs when certain groups of individuals (for example, those with longer life expectancies) are more (or less) likely to participate than others and when such participation patterns result in a net cost to the government.

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## Design Considerations in the Accumulation Phase

A system of individual accounts would provide workers with opportunities to assert greater control over their retirement savings. Therefore, when designing a system, critical decisions would need to be made about who will manage and invest funds and what investment choices will be offered. 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.

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## Options for Investment Management

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 Thrift Savings Plan

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(TSP), to offering a broad array of private market choices, such as those available through IRAs. Options for managing these investment choices could vary from a centralized, government-managed system to a decentralized, privately managed system. A centralized system would take advantage of economies of scale, which is to say that the more accounts managed by a single entity, the lower the cost for each; thus such an approach could have lower administrative costs than a decentralized system. This is especially important when considering that a number of individuals may initially have small account balances. Depending on how administrative costs are assessed, administrative costs may eat into the accumulated savings of all accounts but could have a greater impact on the smaller accounts.

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## Tradeoffs Between Investment Choices

There are trade-offs associated with the range of investment choices offered. 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. As the range and variety of investment choices grow, so does the range of possible outcomes for individual account returns. This means that a number of individual accounts could perform very well, while others will not perform well at all. This results in increased risk to the government that individuals with inadequate income will turn to the government for support through other programs. In addition, a wider range of investment choices can also lead to higher administrative costs, which, if not offset by significantly higher returns, could undermine 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.

Investment decisions become more complicated as the number of choices increase. If individuals do not make an investment choice, managers would need to decide how to invest the contributions for those individuals. Some have proposed placing these contributions in the lowest risk accounts. One such option would be to place these contributions in a limited number of funds and then weight individual portfolios differently

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depending on the age of the worker, similar to a life-cycle fund, so that workers increasingly assume less risk as they neared retirement.

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 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. However, as the number of choices increases, the public would need a greater level of education to learn about the wider variety of investment options to understand and use the information disclosed to them, and to fully appreciate the consequences of investment choices.

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## Customer Service Considerations

Frequent statements indicating the actual account value, daily or periodic valuation of account balances, and the ability to transfer funds between investment options are some of the different services that could be available with individual accounts. When more services and more flexibility are offered, the costs and administrative complexity of managing the investments increase. Moreover, if individuals consider the individual accounts as their personal property, they may expect options and service consistent with those often provided by private sector fund managers, such as frequent detailed account statements and allowing frequent interfund transfers.

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## Design Considerations in the Distribution Phase

The final design element centers on how the accumulated earnings in individual accounts would be preserved for retirement. Ensuring that retirement income is available for the life of the retiree is a fundamental goal of Social Security. With respect to the distribution phase, individual account systems could use three basic ways to pay retirement benefits: annuitization, timed withdrawals, and lump sum payments. The appropriateness of additional distribution features such as loans or early withdrawals, which are common in 401(k) plans, would also need to be considered. While such features would enhance the account holder's sense of ownership and control, loans or early withdrawals create a risk for leakage of account income that could diminish adequacy in retirement. Further, administrative aspects of the distribution must be considered. These include any guarantees that may be offered as well as the tax treatment of the distributions.

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## Annuities

Under a system of annuities, retirees would receive monthly payments for an agreed-upon length of time, and the size of those payments would depend on the total value of the individual accounts. Under individual account proposals, annuities would be obtained either through government agencies or the private market. Further, such annuitization could be mandatory, voluntary, or some hybrid of both. For example, some individual account proposals have suggested mandatory annuitization up to an amount necessary to avoid poverty, and then any remaining account monies could be distributed at the account holder's discretion.

Mandatory annuitization could help ensure that the accounts provided retirement income for the entire remaining lifetimes of participants. Mandatory annuitization of accounts could also minimize adverse selection. Adverse selection occurs, for example, when only healthy people buy annuities and on average live longer than nonbuyers, driving up the cost of annuities. According to one study, annuity prices in a voluntary environment can be as much as 14 percent higher than they would be if every retiree were required to purchase an annuity. However, mandatory annuitization also effectively transfers income from the shorter-lived to those that are longer-lived.

Additional design considerations for annuities include the type of annuities that could be offered. For example, monthly income can be a fixed amount per month (fixed annuity); a steadily increasing amount based on an index, such as the Consumer Price Index (indexed annuity); or a variable amount based on returns from investing the premium (variable annuity). Under a single-life annuity, the annuitant receives a guaranteed stream of payments that end with the annuitant's death. Under a joint and survivor annuity, the payments continue to be made, sometimes at a reduced rate, to a second annuitant, such as a spouse, on the death of the primary annuitant. For a term-certain annuity, payments are not contingent on the annuitant's life; instead, they are guaranteed for a specified period of time, such as 5 or 10 years. With a variable annuity, the annuitant assumes some of the risk from the investment returns on the annuity.

The current Social Security retirement benefit provides a fixed lifetime annuity that increases with inflation. In addition, Social Security provides auxiliary benefits to workers' eligible spouses, children, and survivors without reducing the size of the worker's own annuity. While annuity providers could potentially replicate some of the features of Social Security benefits, some important features would not likely be replicated.

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Adding components such as inflation indexing or a joint and survivor annuity will require the primary annuitant to accept less monthly income than under a single-life annuity. Furthermore, individuals with small account balances at retirement could have difficulty purchasing annuities in the private sector insurance market. Insurers may find provision of annuities to be inefficient and costly for individuals with small accounts because of the relatively high cost of issuing monthly checks and other administrative costs.

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### Timed Withdrawals and Lump Sums

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. Both timed withdrawals and lump sums give the individual the most immediate control of their account. Such options also underscore that increased personal choice comes with increased personal responsibility if the retirement income is to be preserved for the long term.

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### Guarantees

A unique distribution phase design feature of some proposals involves a guarantee of a certain benefit level at retirement. This guarantee could be provided in tandem with other benefit structure changes such that the worker would be guaranteed a minimum benefit. One such approach would guarantee the current Social Security defined benefit. If the individual account provided less than the current benefit, then the system would ensure that benefits were provided to fill the gap. Such an arrangement might be desirable from a benefit adequacy perspective but would require safeguards against the government becoming an insurer of excessive risk taking by individuals. This risk taking could occur if individuals assumed unwarranted investment risk knowing that the government would still guarantee a minimum benefit or rate of return.

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### Preretirement Access

While the above design features consider design options in the distribution phase at retirement, individual account design may also consider whether to allow preretirement access. For example, most 401(k) pension plans allow participants to borrow against their pension accounts at relatively low interest rates. In past work we have shown that preretirement access

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improves participation in 401(k) pension plans and might also be an incentive for participation in a system of voluntary individual accounts.<sup>6</sup> However, those plan participants who borrow from their accounts risk having substantially lower pension balances at retirement and, on average, may be less economically secure than nonborrowers. While some may argue that individuals should be allowed the freedom to access income through borrowing from their accounts before retirement, the added complexity and potential diminution of retirement income need to be given serious consideration.

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## Tax Treatment

Any payout option, whether pre- or postretirement, would need to consider the tax treatment of the individual account distribution. Benefits from individual accounts could be taxed in a variety of ways. For example, individual account benefits could be taxed like current Social Security benefits. Persons who currently receive Social Security benefits and have income over a certain amount may have to pay taxes on their benefits.<sup>7</sup> Generally, the higher one's total income, the greater the taxable part of one's benefits. Typically, up to 50 percent of one's benefits will be taxable. However, up to 85 percent can be taxable if, for example, a person filed a federal tax return and one-half of his or her benefit and all other income exceeds \$34,000. Alternatively, individual accounts could be taxed similarly to ordinary income. Individual accounts could also be treated like pension payments (such as DC pensions like 401k plans) or annuity payments from a qualified employer retirement plan, which may either be fully or partially taxable, depending on the type of retirement plan.

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## Conclusions

Clearly, the wide range of possible options complicates the design of an individual account system. In general, our work shows that the features that provide additional flexibility and choice may increase system costs. Such features would include making participation voluntary, rather than

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<sup>6</sup> Participants in plans that allow borrowing contribute, on average, 35 percent more to their pension accounts than participants in plans that do not allow borrowing. See GAO, *401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some*, GAO/HEHS-98-5, (Washington, D.C.: Oct. 1, 1997).

<sup>7</sup> Individual income tax filers pay this tax if their adjusted gross income plus tax-exempt interest income plus one-half their Social Security benefits exceeds \$25,000. A married couple filing jointly will pay the tax if this income exceeds \$32,000. These levels are not adjusted for inflation, so the percentage of beneficiaries paying tax on Social security benefits is expected to rise in the future.

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mandatory, and expanding the number of investment options.<sup>8</sup> Other key decisions also have cost implications. For example, the contribution phase, the accumulation phase, and the distribution phase could each be administered in a centralized or decentralized manner, and at various levels by the government or by private contractors. In general, costs of individual accounts will rise with increasing decentralization.

No matter what sort of features individual accounts include, any related administrative, management, and data systems must be developed and tested before the individual accounts are made available to American workers. If reforms are implemented with haste and key administrative functions are neglected, the ensuing problems have the potential to undermine an otherwise well-designed accounts system. The federal Thrift Savings Plan has been suggested as a model for providing a limited amount of options that reduce risk and administrative costs while still providing some degree of choice. While using this existing model could mitigate administrative issues, a system of accounts that spans the entire national workforce and millions of employers would be significantly larger and more complex than the TSP.

The choice to include individual accounts as part of broader reform could fundamentally alter the defined benefit aspect of current Social Security benefits. Under its current structure, Social Security redistributes benefits to lower-income workers. Mirroring the redistributive effects of the current Social Security program, individual accounts could be designed to include some progressive features. However, it is important to distinguish between progressivity and benefit adequacy. Greater progressivity is not the same thing as greater adequacy and may result in less equity. As a result, any evaluation of a Social Security reform proposal that includes individual accounts should consider not only the overall costs to the system but also, very importantly, the impact on individuals and families. Administering the accounts and educating the public about a system of individual accounts requires difficult choices and trade-offs; and these choices will determine the degree and speed of public acceptance. Ultimately, what matters most is that we maintain a strong retirement security system for the millions of American workers and their families.

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<sup>8</sup> See GAO, *Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts*, [GAO-03-309](#) (Washington, D.C.: Mar. 10, 2003), and GAO, *Social Security Reform: Implementation Issues for Individual Accounts*, [GAO/HEHS-99-122](#) (Washington, D.C.: June 18, 1999).

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Mr. Chairman and Members of the Subcommittee, this concludes my prepared statement. I would be happy to respond to any questions you or the other Members of the Subcommittee may have.

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**GAO Contacts and  
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Acknowledgments**

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215. Blake Ainsworth, Alicia Cackley, Charlie Jeszeck, Michael Collins, and Charles Ford also contributed to this statement.

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# Related Products

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*Social Security Reform: Answers to Key Questions.* [GAO-05-193SP](#). Washington, D.C.: May 2005.

*Options for Social Security Reform.* [GAO-05-649R](#). Washington, D.C.: May 6, 2005.

*Social Security Reform: Early Action Would Be Prudent.* [GAO-05-397T](#). Washington, D.C.: Mar. 9, 2005.

*Social Security: Distribution of Benefits and Taxes Relative to Earnings Level.* [GAO-04-747](#). Washington, D.C.: June 15, 2004.

*Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario.* [GAO-03-907](#). Washington, D.C.: July 29, 2003.

*Social Security and Minorities: Earnings, Disability Incidence, and Mortality Are Key Factors That Influence Taxes Paid and Benefits Received.* [GAO-03-387](#). Washington, D.C.: Apr. 23, 2003.

*Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security.* [GAO-03-310](#). Washington, D.C.: Jan. 15, 2003.

*Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts.* [GAO-03-309](#). Washington, D.C.: Mar. 10, 2003.

*Social Security: Program's Role in Helping Ensure Income Adequacy.* [GAO-02-62](#). Washington, D.C.: Nov. 30, 2001.

*Social Security Reform: Potential Effects on SSA's Disability Programs and Beneficiaries.* [GAO-01-35](#). Washington, D.C.: Jan. 24, 2001.

*Social Security Reform: Information on the Archer-Shaw Proposal.* [GAO/AIMD/HEHS-00-56](#). Washington, D.C.: Jan. 18, 2000.

*Social Security: Evaluating Reform Proposals.* [GAO/AIMD/HEHS-00-29](#). Washington, D.C.: Nov. 4, 1999.

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