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Report to the Ranking Minority Member, Special Committee on Aging, U.S. Senate

March 2003

SOCIAL SECURITY REFORM

Information on Using a Voluntary Approach to Individual Accounts

GAO Accountability * Integrity * Reliability

GAO-03-309

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Highlights

Highlights of GAO-03-309, a report to the Ranking Minority Member of the Senate Special Committee on Aging

Why GAO Did This Study

Many proposals have been offered to restructure the U.S. Social Security system to include individual retirement savings accounts. However, some key proposals would make participation in the accounts voluntary rather than mandatory. While any individual account plan can offer a variety of choices regarding contributions, investments, and withdrawals, the choice of whether or not to participate is fundamental to a voluntary approach. That choice could have significant effects on individual retirement incomes and on the costs to the government as well.

GAO was asked to report on the implications of using a voluntary approach to individual accounts. Accordingly, GAO's reporting on (1) how voluntary plans can affect individuals, (2) how they could affect the total costs of the retirement system, and (3) the role of educational efforts relating to the participation decision. Throughout this report, GAO focuses on the issues that pertain specifically to a voluntary approach as distinct from a mandatory approach.

GAO studied three countries that have enacted voluntary individual account plans—the Czech Republic, Germany, and the United Kingdom.

www.gao.gov/cgi-bin/getrpt?GAO-03-309.

To view the full report, 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.

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SOCIAL SECURITY REFORM

Information on Using a Voluntary Approach to Individual Accounts

What GAO Found

If policymakers decide to restructure Social Security to include individual accounts, making participation voluntary has significant implications for designing and administering the plan. While offering the choice to participate may be desirable, doing so substantially increases the complexity of an individual account plan and potentially its total costs. A variety of voluntary plan design features have potentially significant effects on individuals and total system costs.

The design features of voluntary individual account plans can affect whether individuals participate in the accounts and what retirement incomes they will receive. For example, some voluntary plans, such as those in the three countries we studied—the United Kingdom, the Czech Republic, and Germany, offer people the ability to opt in and opt out of the account periodically. Individuals may consider the extent of such flexibility in deciding whether to participate in the accounts. Also, voluntary plans generally offer incentives to participate, while mandatory plans do not need them. In addition to increasing participation, incentives generally add to the value of the accounts and, therefore, ultimately to the retirement income the accounts will provide. The three countries we studied offered incentives such as government contributions and tax advantages.

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 related to individuals' participation decisions. In particular, tracking individuals' participation decisions would require administrative processes that do not arise in mandatory plans. All three countries we studied used a centralized government authority to track participation and handle account contributions. Moreover, the uncertainty of participation rates in turn creates uncertainty for a variety of costs associated with individual account plans. For example, in the United Kingdom, participation in the individual accounts was much greater than expected, which resulted in unexpectedly high incentive costs. In addition, costs would arise from the need to educate individuals to help them make informed decisions about participating in voluntary accounts.

Significant education efforts may help individuals make informed participation decisions. Individuals face complex participation decisions in addition to the contribution, investment, and withdrawal decisions they might face in a mandatory plan. To make informed participation decisions, individuals need to understand the effects on their government retirement, disability, and survivor benefits and on their retirement income as a whole.

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Abbreviations

CSSS	Commission to Strengthen Social Security
DWP	Department for Work and Pensions
IRA	Individual Retirement Account
MIG	Minimum Income Guarantee
NIC	National Insurance Contributions
SERPS	State Earnings-Related Pension Scheme
S2P	State Second Pension
SSA	Social Security Administration
TSP	Thrift Savings Plan

G A O
Accountability * Integrity * Reliability

United States General Accounting Office
Washington, DC 20548

March 10, 2003

The Honorable John Breaux
Ranking Minority Member
Special Committee on Aging
United States Senate

Dear Senator Breaux:

Many proposals have been offered to restructure the U.S. Social Security program to include individual retirement savings accounts. However, some key proposals would make participation in the accounts voluntary rather than mandatory. Under a mandatory approach, all covered workers would typically have individual retirement savings accounts, and some portion of their Social Security contributions would automatically be deposited in the accounts. Under a voluntary approach, all covered workers would have a choice whether or not to have such an account as part of their Social Security package. While any individual account plan can offer a variety of choices regarding contributions, investments, and withdrawals, the choice of whether or not to participate is fundamental to a voluntary approach. That choice could have significant effects on individual retirement incomes and on the costs to the government as well.

You asked us to report on the implications of using a voluntary approach to individual accounts. Accordingly, we are reporting on (1) how voluntary plans can affect individuals, (2) how they could affect the total costs of the retirement system, and (3) the role of educational efforts relating to the participation decision. Throughout this report, we focus on the issues that pertain specifically to a voluntary approach as distinct from a mandatory approach.

To provide this information, we studied the experiences of selected nations, experiences with U.S. retirement savings accounts, and proposals to add individual accounts to the U.S. Social Security program. We conducted an extensive review of the relevant literature and interviewed researchers in the field and officials at multinational organizations, such as the World Bank, and at U.S. government agencies. On the basis of this preliminary research, we identified 3 countries with voluntary individual account plans that illustrate a variety of circumstances and key design features—the Czech Republic, Germany, and the United Kingdom. For example, the individual account plans of these countries have been in operation for different lengths of time, have used different incentives, and interact with the national social security systems in different ways. In addition, we studied 401(k) plans and other voluntary accounts in the United States. For both the foreign and domestic cases, we interviewed officials and analysts in a variety of organizations, including government agencies, unions, advocacy groups, employer organizations, research and academic institutions, and financial service companies. We did not conduct a legal analysis of the relevant laws of the foreign countries. We conducted our review from January 2002 through March 2003 in accordance with generally accepted government auditing standards.

Results in Brief

The design features of voluntary individual account plans can affect whether individuals participate in the accounts and what retirement incomes they will receive. For example, some voluntary plans, such as those in all three countries we studied, offer people the ability to opt in and opt out of the account periodically; most U.S. proposals have not explicitly considered whether people would face a one-time 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. Also, voluntary plans generally offer incentives to participate, while mandatory plans do not need them. In addition to increasing participation, incentives generally add to the value of the accounts and, therefore, ultimately to retirement income. Each of the three countries we studied offered incentives such as government contributions and tax advantages.

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. All 3 countries we studied used a centralized government authority to track participation and handle account contributions. In addition, incentive costs can be substantial. For example, Germany has dedicated roughly $10.6 billion over the next 6 years to pay for matching contributions and tax incentives. Moreover, the uncertainty of participation rates in turn creates uncertainty for a variety of costs associated with individual account plans. For example, in the United Kingdom, participation in the individual accounts was much greater than expected, which resulted in unexpectedly high incentive costs. In addition, in response to what has been called the "mis-selling scandal," British companies that provide accounts have spent billions of dollars to compensate participants who signed up for accounts that were clearly not to their advantage, given their particular circumstances.

Significant education efforts may help individuals make informed participation decisions. Individuals face complex participation decisions in addition to the contribution, investment, and withdrawal decisions they might face in a mandatory plan. To make informed participation decisions, individuals need to understand the effects on their government retirement, disability, and survivor benefits and on their retirement income as a whole. For example, in the United Kingdom, workers who left their employer plan to participate in the voluntary accounts often reduced their future retirement income because they lost employer contributions.

Background

According to the Social Security Trustees' 2002 intermediate, or best-estimate, assumptions, Social Security's cash flow is expected to turn negative in 2017. 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 while 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 2030.

Reductions in promised benefits and/or increases in program revenues will be needed to restore the long-term solvency and sustainability of the program. Within the program's current structure, possible benefit changes might include changes to the benefit formula or reductions in cost-of-living increases, among other options; revenue increases might include increases in payroll taxes or transfers from the Treasury's general fund. Also, some proposals would change the structure of the program to incorporate a system of individual retirement savings accounts. Many such proposals would reduce benefits under the current system and make up for those reductions to some degree with income from the individual accounts. Individual account proposals 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.

Three key distinctions help to identify the differences between Social Security's current structure and one that would use 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" pension while individual accounts would provide a "defined-contribution" 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 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.[1]

- **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.[2] 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 are fully funded by definition. Both mandatory and voluntary individual account plans would reflect all

[1]At retirement, individuals do 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.

[2]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 U.S. General Accounting Office, *Social Security Reform: Demographic Trends Underlie Long-Term Financing Shortage*, GAO/T-HEHS-98-43 (Washington, D.C.: Nov. 20, 1997).

of these distinctions. Both types of plans also have a variety of other features and design issues in common, which can be organized in four groups.

- **Supplement versus substitute**. Individual accounts can either supplement an existing national pension benefit[3] or substitute for all or part of it.[4] With supplemental accounts, the account and contributions to it have no effect on the national pension benefit. With substitute accounts, the national pension benefit is reduced (or "offset") in some way to account for contributions that have been diverted from the national program.[5]

- **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 up to a certain dollar amount. Also, contributions might be collected and deposited by the government in a centralized process or by employers or account providers in a decentralized process.

- **Accumulation**. An individual account plan can address the accumulation of interest and other investment earnings in a variety of ways. A plan might give participants a wide range of investment options through virtually any qualified investment manager or may limit them to a few mutual funds

[3]In other countries, "social security" refers to a wide range of social insurance programs, including health care, long-term care, workers' compensation, unemployment insurance, etc. To generalize across countries, we use "national pension benefit" to refer to defined-benefit old-age pensions provided by the social security system. We use "Social Security" to refer to the U.S. Old-Age, Survivors, and Disability Insurance Program since that is how the program is commonly known.

[4]In the United States, the terms "add-ons" and "carve-outs" have also been used. However, using these terms to describe foreign programs could be misleading because of the different contexts in which accounts exist. Moreover, in the case of mandatory accounts, "carve-out" plans may reduce benefits while adding the accounts; however, since the accounts are mandatory, the benefit reductions need not be construed as being linked to the accounts. To avoid this ambiguity, we use "substitute" accounts for cases in which participation in the accounts is linked to compensating benefit offsets and "supplemental accounts" for cases in which participation is not so linked.

[5]In the United States, for example, the Clinton Administration's Universal Savings Account proposal would have created supplemental accounts, while Model 2 of the Commission to Strengthen Social Security would create substitute accounts. See U.S. General Accounting Office, *Social Security: The President's Proposal*, GAO/T-HEHS/AIMD-00-43 (Washington, D.C.: Nov. 9, 1999) and *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).

through a single administrator or specifically authorized managers. Such design features determine in part how much investment risk individuals are allowed to take and how much choice they have in managing their money. Moreover, plans might offer some degree of investor education, depending on the complexity of the choices they face.

- **Withdrawal**. An individual account plan can offer a variety of ways to withdraw money. A plan may require individuals to purchase an annuity when they retire.[6] Alternatively, an individual account plan may also allow individuals to withdraw their funds according to a specified schedule. Such a "phased withdrawal" leaves ownership of the funds with the individual as well as much of the financial and insurance risk. Some individual account plans, such as most 401(k) plans, also allow individuals to take their entire account at retirement as a lump sum and spend it as they wish. The question of withdrawal options ultimately reflects a decision concerning how much choice to give individuals versus how far to go to ensure that assets are preserved for retirement income.

Several countries around the world have implemented national individual account plans as part of their retirement income policies. Many countries with individual account plans have made them mandatory. Some, such as Chile, have given current workers a choice but made the accounts mandatory for new workers. Still others have made the accounts voluntary for all workers.

All three of the countries we studied—the Czech Republic, Germany, and the United Kingdom—have reduced the growth of benefits in their public pay-as-you-go retirement systems in the face of demographic challenges. In all three cases, the decision to make the accounts voluntary related to either historical precedents, political realities, or both, rather than to a specific policy objective that a mandatory approach would not accomplish. Since 1961 employers in the United Kingdom have had the ability to opt their employees out of part of the national system to participate in employer-provided defined-benefit pension plans. The introduction of individual accounts in 1988 allowed workers, instead of employers, to make decisions about whether or not to opt out of part of

[6] Annuities pay benefits on a fixed schedule for life or sometimes for a fixed period. Some annuities, called joint-and-survivor annuities, pay benefits to the annuity holders while they live and to their survivors after they have died. Annuities provide a way of managing a lump sum of money and transferring financial and insurance risk to the providers to ensure a steady stream of income for the annuitant.

the national pension system. Further, individual accounts enabled workers without access to employer-provided pensions to opt out of part of the national pension system. In the Czech Republic, the accounts were intended to help workers make up for reductions in the national pension benefit while also helping spur growth in the capital market of the previously communist economy. In Germany, the accounts were also intended in part to make up for reductions in the national pension benefit. (See apps. I, II, and III for details on each country.)

In the United States, many employers offer defined-contribution pension plans, which take the form of voluntary retirement savings accounts, such as 401(k) plans for private sector employees and the Thrift Savings Plan (TSP) for federal employees. In recent years, the number of defined-contribution plans has been growing and becoming a relatively more common way for employers to offer pension plans than defined-benefit plans. In fact, some employers who had only defined-benefit plans now offer plans that include defined-contribution accounts, including the federal government and the state of Florida, to cite two examples.

While defined-contribution pensions and Individual Retirement Accounts (IRAs) are not directly comparable to individual accounts that are part of a national social security system, they do have similar features and raise similar issues. For example, many defined-contribution pension plans include incentives in the form of employer matching contributions. They also require administrative processes for collecting and distributing account contributions. They enjoy tax advantages and provide a range of investment and withdrawal options, as IRAs also do. Employer-sponsored plans typically provide some form of participant education. Moreover, in the Social Security reform debate, TSP has often been raised as an example of how a Social Security account plan might work, especially in terms of its centralized administration, relatively low administrative costs, independent oversight board, and passively managed investment options. Still, some have noted its limitations as an example, pointing especially to the fact that all its participants work for a single employer.

Design of Voluntary Plans Can Affect Individuals' Participation and Retirement Incomes

Through a variety of design features, voluntary individual account plans can affect whether individuals participate in the accounts and what retirement incomes they will receive. Using a voluntary approach to individual accounts adds considerable complexity due to the way choice and participation interact with the plan's design features. In particular, design features relating to the participation decision include the ability to opt in and out of the plan and the use of incentives. Also, under some designs, accounts supplement national pension benefits while, under other designs, the accounts substitute for such benefits to some degree. Other design features relate to the accumulation and withdrawal phases of the accounts. (See table 1 for a summary of design features that can affect individuals' participation and retirement incomes.) Finally, the effects of voluntary accounts on individuals will vary by market and demographic factors. Some groups of individuals may be more likely to participate in voluntary accounts than others.

Table 1: Design FeaturesThat Can Influence Voluntary Account Participation and Individual Retirement Incomes

Design feature categories	Examples
Supplemental versus substitute accounts	• Additional versus diverted contributions • Benefit offsets, especially potential for "adverse selection"[a]
Participation decision and contribution phase	Participation decision features • Flexibility, such as opt-in/opt-out • Automatic enrollment • Administrative costs Incentives • Government or employer contributions • Tax advantages
Accumulation phase	• Investment options (and how they are regulated) • Guarantees • Tax advantages
Withdrawal phase	• Pre-retirement loans • Withdrawal options: annuities, installment payments, and lump-sum distributions • Tax advantages
Other design considerations	• Plan complexity • Public education

Source: GAO.

[a]Adverse selection occurs when certain groups of individuals (e.g., 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. (See section below on substitute versus supplemental accounts for further discussion.)

Participation Decision Features and Contribution Features Can Affect Incomes as Well as Participation

Design features related to the participation decision include the flexibility of the decision, automatic enrollment provisions, and administrative costs borne by the participants. Additionally, participation incentives generally include government contributions and tax advantages. These features can affect not only individuals' participation but also their eventual retirement incomes. Many of these features arise only under a voluntary approach and, therefore, result in added complexity of voluntary plans.

Participation Decisions

Some voluntary plans, such as those in all three countries we studied, offer people the ability to opt in and opt out of the account periodically; most U.S. proposals have not explicitly considered whether people would face a one-time or a periodic decision to participate. The need to track individuals' participation decisions requires additional administrative tasks and complexity, especially in the case of substitute account plans with benefit offsets that reflect those decisions. Individuals may consider the extent of flexibility in opting in and out when deciding whether to participate in the accounts. In the United Kingdom, workers can opt out of or opt back into part of the national pension at any time. Ultimately, the national pension benefit calculation adjusts by reflecting any periods of time that a person has opted out. In the case of supplemental accounts, it is less complicated to opt in and out. In the Czech Republic, individuals can stop making contributions to their accounts after 3 years and resume them when they wish. Government contributions to the accounts reflect any such changes in participation because they are based on reports from the pension funds about the individuals' contributions. In Germany, individuals can participate in accounts through their employer or approved financial service companies. The ability to opt-in and opt-out of would depend on the plan in which they participate.

In contrast to opting in and out, plans can also give participants the ability, to varying degrees, to cancel their accounts and get a refund of their past contributions. Generally, penalties are associated with canceling accounts, and government contributions are taken back from the participants' accounts. The ability to cancel accounts may encourage participation by giving individuals the ability to reverse their decision. At the same time, individuals who cancel their accounts may be diminishing their eventual retirement incomes, especially because of any penalties and forfeited government contributions.

The flexibility of participation also varies according to how much latitude participants have with the size of their contributions. Some individual account plans allow participants to contribute at various rates while other plans specify one contribution rate for everyone. Also, some plans set a dollar limit on account contributions per year. In some cases, minimum and maximum contributions primarily relate to eligibility for government contributions or tax advantages. (See discussion of government contributions and tax advantages below.) U.S. proposals have ranged widely in the size of the contributions they would allow. Some proposals set contribution rates at 2 percent of taxable earnings, while another varies contribution rates by income level. Still another allows a range of contributions up to $1,500. In the United Kingdom, one type of pension account permits contributions of as little as $32[7] at various intervals and limits contributions depending upon an individual's circumstances. In the Czech Republic, participants can contribute as little as $3 per month. In Germany, participants will be able to contribute from 1 to 4 percent of their annual salaries that is subject to social security tax. The flexibility of contribution rates may encourage participation. Individual retirement incomes will clearly depend on the contributions individuals actually make.

In contrast to providing flexibility of participation, some plans use an administrative process to facilitate participation. In both the United Kingdom and the United States, employers can use automatic enrollment to place employees in voluntary company pension plans as a default option, while still allowing employees the choice not to enroll. According to one U.K. provider association, companies with automatic enrollment have employee participation rates around 90 percent compared with 70 to 80 percent for companies without it. Similarly, a U.S. study found that after automatic enrollment provisions were enacted in 3 companies, employee participation rates in 401(k) plans increased dramatically to more than 85 percent.[8]

In addition, the size of administrative costs and who bears them could influence participation decisions and retirement incomes. The costs of administering individual accounts can be substantial, especially for small accounts. If individuals directly bear such costs, the costs could substantially diminish the account balances and the retirement incomes

[7]All currency values have been converted to U.S. dollars, using the following average exchange rates for the month of January 2003: U.S.$1=£0.61882; U.S.$1=29.88 Czech koruna (CZK); U.S.$1=€0.94203.

[8]Participation rates were initially 57 to 69 percent for employees that had over 3 years of tenure. Participation rates were initially 26 to 43 percent for employees that had over 6 months of tenure but less than 3 years.

received from them. In the United Kingdom, for example, administrative costs for one type of individual pension account are deducted from the accounts up front. According to one study, such costs have diminished the account balances by 40 to 45 percent on average.[9] However, under another type of account, administrative charges are limited to 1 percent of the account balance per year. In the United States, estimates of the administrative costs for individual accounts have ranged from one-tenth of a percent to 3 percent per year, depending on how the accounts are administered.[10] In addition to basic costs for administering the accounts, individuals may also pay fees or penalties for a variety of activities, including early withdrawal or termination, investment changes, and purchasing annuities.

Government and Employer Contributions

Government and/or employer contributions can provide a major financial incentive for individuals to participate in accounts and are one of the most powerful, according to some U.S. pension providers. To encourage participation, many U.S. employers provide matching contributions, including the federal government in its TSP for workers under the Federal Employees Retirement System. Germany and the Czech Republic also provide matching contributions to encourage participation. Such contributions clearly increase account balances, which will generally increase retirement incomes in turn. Such contributions can also be designed to help redistribute income.[11]

In Germany, workers contributing a specified percent of their pay into an individually arranged pension plan may receive a government

[9]Mamta Murthi, J. Michael Orszag, and Peter R. Orszag. "Administrative Costs under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Hollzman and Joseph E. Stiglitz, *New Ideas About Old Age Security: Toward Sustainable Pension Systems in the 21st Century*. The World Bank (Washington, D.C.: 2001).

[10]U.S. General Accounting Office, *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design*, GAO/HEHS-99-131 (Washington, D.C.: June 18, 1999).

[11]Such account contributions are generally related to annual income rather than lifetime income. As a result, they could go to people who turn out to have relatively high lifetime incomes, such as students and people with irregular but not necessarily low annual earnings. Under national defined benefit pension plans, redistribution is generally based on lifetime incomes.

contribution.[12] This approach encourages participation in a way that rewards lower earners proportionally more than higher earners. The government also provides contributions to reflect marital status and the number of children. Some individuals may participate in individual account plans through their employers. Such plans do not receive direct government contributions but do qualify for tax advantages. Employer contributions to such accounts depend on the specific arrangements for those plans.

The Czech Republic makes matching contributions to encourage participation. For the lowest worker contribution allowed, participants receive a 50-percent matching contribution. As contributions rise, the matching rate gradually declines to 0.[13] The Czech Republic also allows employers to contribute to their workers' accounts, although such contributions do not receive government matches.

In the United States, some individual account proposals would provide for government contributions, and some would redistribute income in the process. The Clinton Administration's Universal Savings Account proposal would have provided account contributions only for those with incomes below certain levels. Also, under one of the proposals of the Commission to Strengthen Social Security (CSSS), account participants would contribute 1 percent of taxable earnings to their accounts (in addition to the 2.5 percent diverted from their payroll taxes), which the government would subsidize with a refundable tax credit that phases out as participant incomes rise.[14]

Tax Advantages

Favorable tax policies also provide incentives for individuals to participate in voluntary accounts. In the United States, such tax advantages encourage

[12]In 2008 and thereafter, Germans contributing a recommended 4 percent of their salary to an individual account will receive a direct payment of $163. Those contributing less will receive a smaller direct payment. Individual accounts are being implemented between 2002 and 2008. Individuals investing 1 percent of their annual salary as of 2002, 2 percent as of 2004, 3 percent as of 2006, and finally 4 percent as of 2008 will receive the respective maximum government subsidy.

[13]Note that in contrast to the German approach, the Czech matching schedule is not progressive with respect to income, only with respect to contributions. In effect, the Czech matches decline relative to contribution levels while the German matches decline relative to income, which is not the same. See appendix II for more details on the Czech Republic's matching levels.

[14]GAO-03-310.

participation in employer-sponsored defined-contribution plans and IRAs. Proposals to add individual accounts to Social Security would extend such tax advantages to those accounts to varying degrees.

All three countries we studied also make some portion of the individual account contributions tax exempt. In Germany, individuals are allowed to deduct government subsidies along with personal contributions from their income taxes.[15] In the Czech Republic, contributions exceeding the government matching level are tax-deductible up to a limit. Czech analysts we interviewed explained that tax advantages are more attractive to higher earners for whom the government contributions are relatively small. For lower earners, who pay little or no tax, tax advantages offer little benefit. They believe that offering both tax advantages and government contributions provides a balanced approach that gives effective incentives across a range of income levels.

Also, in contrast to government contributions, which actually increase account balances, tax advantages generally have the effect of making participant contributions cost less out-of-pocket. For example, individuals making deductible IRA contributions will pay less income tax than if they did not, and they do not have to deposit those income tax savings into the IRAs.

Initially, to encourage workers to join individual account plans, the United Kingdom offered additional tax incentives in the form of reduced social security taxes. The government offered an “incentive bonus” which was an additional rebate of 2 percent of payroll taxes from 1988 to 1993. A smaller incentive bonus of 1 percent was offered from 1993 to 1996 to individuals over age 30. The government also encouraged people to join individual account plans by making a special, one-time offer when the law became effective in July 1988. The government credited individuals’ accounts with rebates, tax incentives, and incentive bonuses in a single lump sum for both the years 1987 (retroactively) and 1988.

[15]Tax deductions may only be claimed up to a specified amount. In the assessment periods 2002 and 2003, individuals can deduct up to $557. In the assessment periods 2004 and 2005, individuals can deduct up to $1,115. In the assessment period 2006 and 2007, individuals can deduct up to $1,672. Finally, in the assessment period 2008 and thereafter annually, individuals can deduct up to $2,229.

Substitute and Supplemental Accounts Have Different Effects on Participation and Retirement Incomes

Individual accounts that supplement national pension benefits affect participation and retirement incomes differently than accounts that substitute for some portion of them. Participation in supplemental accounts does not affect national pension benefits, and such accounts do not draw on revenues of that national system. As a result, supplemental accounts normally require additional out-of-pocket contributions from the individual and thus a higher total contribution rate. The higher contribution rate offers the prospect of higher retirement incomes than participants would receive from the national pension alone. Both Germany and the Czech Republic employ supplemental accounts.

In contrast, substitute accounts do draw on revenues of the national pension system and have benefit offsets to adjust for contributions diverted from that system. Typically, a substitute plan does not affect the total contribution rate. Any potential for higher retirement incomes thus results primarily from the opportunity to earn potentially higher returns on plan contributions through investment in the private market. The United Kingdom employs substitute accounts, though some of its accounts can also be used as supplemental accounts.[16] Some U.S. account proposals employ substitute accounts, some employ supplemental accounts, and some use a combination approach.

In deciding whether to participate in voluntary accounts, individuals may be sensitive to whether the accounts supplement or substitute for the national pension benefit and also to the amount of that benefit individuals expect to receive. In the case of supplemental plans, their willingness to make additional out-of-pocket contributions may depend on how adequate they expect their retirement income to be without the account. In the case of substitute accounts, their decision might depend more on the investment returns on the accounts they expect to receive. In either case, any reductions in the national pension benefit that are enacted (or expected to be enacted) to maintain program solvency could also affect their participation decision.

[16] In the United Kingdom, for any or all years they work, workers can contract out of the State Second Pension (S2P), which provides a defined-benefit retirement pension that is related to earnings and years of service. When workers contract out to an individual account, they receive a rebate to deposit into the account, which represents the value of the benefits they give up, as calculated actuarially. In turn, any S2P benefit they ultimately receive is calculated to reflect any periods in which they have opted out. Still, other national benefits they receive, such as the Basic State Pension and disability benefits, are not affected. The Basic State Pension is a flat-rate benefit paid to all retirees worth roughly $122 per month in 2002.

Benefit offsets under substitute accounts may have built-in incentive effects that favor some individuals over others, and these effects and the offsets generally may be confusing and poorly understood by the public. In a substitute plan, retirement benefits would generally come partly from the national pension benefit and partly from the account assets. Offsets could be applied to the retirement benefits from either the national pension or the accounts, and the incentive effects could depend on which of the two is subject to the offset.

For example, if the offset reduced monthly Social Security benefits for life, it might be calculated using life-expectancy assumptions for the population at large. Individuals who do not live as long as assumed would be subject to this benefit reduction for fewer years, so the offset could cost them less, in effect, than those who live longer. In such a situation, individuals who do not expect to live long in retirement, perhaps due to known health issues or family histories, could have more to gain by participating in the accounts than individuals who expect to live longer.

In contrast, hypothetically, if the benefit offset took a lump-sum at retirement from the individuals' account balances, all participants would be subject to the full offset no matter how long they lived. For participants purchasing an annuity, it would reduce the monthly annuity income they could receive from their accounts. For everyone else, it would reduce the account balances they could either spend during their remaining lifetimes or leave to their heirs. Under this approach, monthly national pension benefits would be unaffected. In this case, the lump-sum offset might also be calculated using life-expectancy assumptions for the population at large. Those individuals who live shorter than the assumed life expectancy would be subject to the same total benefit offset as those who live longer even though they would collect benefits over fewer years. In effect, this lump-sum offset approach would transfer income from people who live shorter lives to those who live longer lives, just as life annuities do.

If individuals accurately perceive any built-in incentives in the benefit offsets, given their personal circumstances, and make their participation decisions accordingly, then "adverse selection" could result, which 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. (See section on total cost effects below.)

Other Design Features Could Also Affect Participation

A range of other design features have the potential to affect whether individuals participate in a voluntary account plan. Design features relating to the accumulation and withdrawal phases could affect the appeal of participation. In addition, complexity of individual account plans might discourage participation while educational efforts might encourage participation by helping participants understand and be more comfortable with their decisions.

Investment Choices

Under both voluntary and mandatory approaches, individual account plans have provisions regarding the range of investment choices participants have. Such choices affect earnings on account balances during the accumulation phase, and retirement incomes will depend on how participants exercise those choices. However, under a voluntary approach, the appeal of participating will depend on whether individuals are satisfied with those options. Individuals might consider how high expected returns are, how much risk is associated with those returns, and how much flexibility they have to adjust their investment choices. Regulation of the investment choices, as well as their design, affects the rates of return individuals might receive and the risks they face. In the Czech Republic, pension fund investments are strictly regulated in order to minimize risk; accordingly, returns on those funds have been relatively modest. One analyst we spoke with does not participate because the returns are too low from his perspective, even after accounting for the government match and tax advantages.

To address concerns individuals may have about risk, several individual account plans offer guarantees that benefits will reach a certain level. Under a voluntary approach, such guarantees are intended to encourage participation by reducing risk to the individuals. However, even some mandatory plans have offered guarantees. Guarantees can take a variety of forms. For example, some proposals would guarantee that Social Security beneficiaries would receive total benefits at least as high as those promised under current law. Germany requires that account providers return to participants on withdrawal an amount at least equal to the contributions participants made to their accounts.

Tax Advantages

Under many individual account plans, investment earnings on account balances are not taxed during the accumulation phase. Both the United Kingdom and Germany allow most or all investment earnings to accrue to the accounts tax-free. In the Czech Republic, investment earnings also accrue tax-free for individuals; however, pension funds are required to pay taxes on the investment earnings. In the United States, investment earnings on retirement savings also generally accrue tax-free during the accumulation phase.

Individual account plans also have provisions for tax treatment during the withdrawal phase. In Germany and the United States,[17] withdrawals from individual accounts are fully taxable, but marginal tax rates are often lower for individuals during retirement when their incomes are lower. In the United Kingdom, part of an individual's benefit can be paid as a tax-free lump sum upon retirement or death.

Loans

Some individual account plans allow participants to take out loans from their accounts before retirement, often for specified purposes such as buying a home or educational or medical expenses. Such provisions encourage participation by assuring participants that they can still use their money if they really need it. However, loans can reduce retirement incomes if they are not repaid, incur penalties, or miss out on periods of high investment returns. According to our 1997 study, in 401(k) plans that allow borrowing, participants contribute 35 percent more than those in plans that do not.[18] Also, the effects of account borrowing provisions on retirement income may affect certain participants more than others. Borrowers from 401(k) plans, on average, have less family income, lower net worth, and more nonhousing debt than nonborrowers.

None of the countries we studied allow loans on accounts. The Czech Republic allows participants to withdraw their own contributions after 1 year, though they cannot collect any government matches or subsidies. In the United Kingdom, officials explained that doing so would not be consistent with the purpose of government expenditures on the accounts, which is to provide for retirement income. Additionally, one expert said that the United Kingdom prohibits loans from individual accounts as a way to preserve retirement income and keep individuals from claiming means-tested benefits.

Withdrawal Options

Individual account plans can provide for withdrawals during retirement through lump-sum distributions, annuities, and installment payments.

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[17]For one type of individual retirement account in the United States—the Roth IRA—withdrawals are not taxed though contributions are not tax-deductible.

[18]U.S. General Accounting Office, *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).

Individual accounts that offer only one type of withdrawal option may discourage participation among those interested in other withdrawal options. In addition, plans typically set an age at which participants can withdraw all their funds and apply penalties for any withdrawals before that age. Such age provisions help ensure that the assets are preserved for retirement. Neither the Czech Republic nor Germany allows full withdrawal before age 60. In the United Kingdom, individuals may retire early at age 50 (due to be raised to age 55) or due to ill health and start to draw on their accounts at that time.

Lump-sum withdrawals give participants flexibility in using their accounts' funds.[19] However, lump-sum withdrawals also pose the risk that participants might outlive those funds. Only the Czech Republic allows participants the option to withdraw the entire voluntary account as a lump sum. Still, lump-sum withdrawal can help avoid prohibitively high administrative or annuity costs for relatively small accounts.

Lifetime annuities provide a guaranteed income for life and protect individuals from the financial and longevity risks of outliving their assets. However, annuity providers charge to assume that risk and cover their administrative and other costs. In addition, "adverse selection" can occur when consumers who expect to live a long time are more likely to purchase an annuity than those who do not. As a result, annuity prices can be as much as 14 percent higher than they would be if every retiree purchased an annuity, according to one study.[20]

Making annuities mandatory could mitigate the effect of adverse selection. It could also help ensure that account assets provide life-long income. However, making annuities mandatory transfers income from those who do not live very long to those who do. It could also discourage participation in voluntary accounts, especially for those who do not expect to live long, perhaps due to known health problems or family history. Moreover, depending on the annuity provisions, prospective participants may be concerned that they would be forced to annuitize at a time when

[19]In the case of U.S. employer-provided accounts, individuals can typically take their funds if they leave a plan prior to retirement. While this provides pension portability, it also creates the possibility that individuals will not preserve those lump sums for retirement.

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

market conditions are unfavorable, either with respect to the value of the account balance or prevailing annuity prices, which depend significantly on interest rates.

Whether mandatory or not, annuities can have a variety of features that may make them either more or less attractive and, as a result, influence individual participation in the accounts. For example, a cash refund feature such as death benefits might be incorporated to accommodate those with an especially short life expectancy at retirement. Annuities could also account for family risk by incorporating a survivor feature.

Some individual account plans, such as IRAs and some 401(k) plans, also offer a phased withdrawal option, under which individuals receive installment payments on a schedule that attempts to ensure that the funds last until death. Such a phased withdrawal is not an annuity and does not provide insurance because it leaves the financial and longevity risk with the individual. Still, it would avoid the issue of adverse selection and some of the costs and other issues associated with annuities, though phased withdrawals also involve some administrative costs. Providing a phased withdrawal option may encourage participation by those who would object to mandatory annuitization.

Germany allows for different account draw-down options. One option is a lifelong annuity. Another allows a draw down of assets until age 85 when the participant would have to purchase a life annuity. The United Kingdom requires annuitization of 75 percent of the voluntary account balance by age 75. The other 25 percent may be taken in a lump-sum payment. Some U.S. account proposals would require annuitization while others offer more withdrawal options.

Complexity and Public Education

Under both voluntary and mandatory approaches, individual account plans can be very confusing to participants given the wide range of design features and other considerations they face. However, under a voluntary approach, such confusion may have the effect of reducing participation. Moreover, voluntary plans may have additional sources of confusion and complexity that do not arise in mandatory plans, such as how the incentives work and, in the case of substitute accounts, how national pension benefits are affected. Public education efforts can play a major role in helping participants understand both voluntary and mandatory individual account plans. However, their effectiveness can also influence participation in voluntary plans. In all three countries we visited, officials reported that individuals experienced substantial confusion over the complexity of the individual account plans. Some experts in Germany believe participation is lower than expected because the tax subsidies are too complicated for the general public to understand. In all three countries, officials underscored the importance of educational efforts.

Market and Demographic Factors Can Also Affect Participation

Market factors can affect the investment returns individual accounts earn in both voluntary and mandatory plans. In voluntary plans, consumer confidence in the market can also affect participation. For example, in Florida, which recently added individual accounts to the state retirement system, participation has been lower than expected with just 5 percent of employees opting in.[21] Officials cite the accounting scandals at a number of major corporations, a slowing economy, and the generally weak condition of the financial markets as possible reasons for the low participation.

Moreover, if the market offers attractive, alternative investment opportunities, individuals may choose those instead of participating in the accounts. For example, advanced financial markets, like that in the United States, offer workers the ability to participate in employer-sponsored pensions and IRAs. In the case of supplemental accounts, such alternatives could compete for the workers' contributions. In Germany, for example, improvements in employer-sponsored pension plans may be responsible for lower than expected participation in government-sponsored voluntary accounts, according to government officials. In the Czech Republic, "building savings" accounts that help individuals save for purchasing a house may compete with the voluntary retirement accounts, especially since they receive a more generous government subsidy. According to one U.S. pension provider, it is difficult to predict whether new Social Security accounts would diminish participation in employer-provided pension accounts, even in the case of substitute accounts. The ability of individuals to alter their savings and even consumption behavior in other areas when they have Social Security accounts makes it especially difficult to predict how such accounts will ultimately affect retirement incomes.

Demographic factors could play a role in investment choices for either voluntary or mandatory accounts. Some groups such as lower income

[21]Since June 1, 2002, approximately 160,000 Florida State employees were given the option of participating in a new individual account plan. The first choice period was open from July 1, 2002, to September 3, 2002. There will be three more choice periods when the remaining employees can decide whether or not to participate in the plan. The government initially predicted approximately 35 to 40 percent of state workers would participate in the new accounts. However, later the government revised its estimates and predicted approximately 17 to 24 percent would participate.

groups and women appear to be more conservative in their investment choices on average; over the long term, on average, such choices can result in lower retirement incomes. At the same time, a lower tolerance for risk may be quite understandable under their circumstances. Under a voluntary approach, such characteristics could also correlate to participation patterns. Participation patterns appear to vary by demographic factors in other countries as well as in the U.S. private pension market. In the United Kingdom, for example, individual accounts were initially popular with younger workers and workers with higher earnings. In the Czech Republic participation in individual accounts steadily increases with age until age 60, and the average age of participants is about 48 years, 10 years higher than the population average.

The design of individual account plans can attempt to compensate for the effect of both market and demographic factors. In the case of market factors, the investment choices and the companies who manage them can be selected to promote consumer confidence. In the case of demographic factors, government subsidies and other incentives and withdrawal options can be designed with particular groups in mind. For example, the German government developed individual accounts with subsidies designed to benefit those with low or average income as well as families with children. In the United Kingdom, older workers are given higher payroll tax rebates than younger workers to encourage their participation in the individual accounts.

Giving Choice of Participation Could Affect Total Costs and Increase Uncertainty

Under a voluntary approach to individual accounts, a variety of design features can have implications for the total costs to the government, providers, employers, or participants. In some cases, giving choice can involve additional administrative, incentive, regulatory, and educational costs. In many cases, the uncertainty of participation rates in turn creates uncertainty for total costs.[22] Such costs include those associated with the participation decision and contribution phase. In addition, plans using substitute accounts pose transition costs and costs related to benefit adjustments that do not arise with supplemental accounts. Also, costs

[22]A mandatory approach to individual accounts can also involve a variety of costs that depend on the plan's design, even though participation rates are not at issue. See U.S. General Accounting Office, *Social Security Reform: Administrative Costs for Individual Accounts Depend on System Design*, GAO/HEHS-99-131 (Washington, D.C.: June 18, 1999) and *Social Security Reform: Implementation Issues for Individual Accounts*, GAO/HEHS-99-122 (Washington, D.C.: June 18, 1999).

associated with the accumulation and withdrawal phases of the account and interaction effects with other government programs might also depend on participation rates.

Participation Decisions Create Unique Costs and Add Uncertainty

The participation decision available to individuals in voluntary plans increases complexity and creates costs that do not arise in mandatory plans. Such costs include tracking the participation decisions themselves, some startup costs, incentive costs, and education costs. The extent of such costs is uncertain because they depend partly on participation rates.

Costs Related to Participation Decisions

In voluntary individual account plans, tracking individuals' participation decisions requires administrative processes that do not arise in mandatory plans. Under a substitute plan, such tracking might also be needed for computing benefit offsets. The tracking process depends partly on how account contributions are collected and deposited into the accounts. If individuals have a one-time choice to participate, the tracking process could become even more critical. Using a centralized administrative structure could help address tracking and related issues. Moreover, centralized administration offers the opportunity for economies of scale. However, in a voluntary plan, low participation rates could diminish opportunities to take advantage of economies of scale that centralized administration could offer.

All three countries we studied used a central government authority to handle account contributions. In the United Kingdom, voluntary account providers present the government revenue authority with a request for the account rebates. However, it takes about a year for rebated contributions to arrive to providers to allow for reconciliation. Officials described the delay as a price individuals pay for having the ability to opt out. In Germany, the tax authority largely manages government administration of the individual accounts via tax returns. In the Czech Republic, pension funds administer the accounts and reconcile funds with the Ministry of Finance to obtain the government matching contribution.

Also, administrative costs are generally relatively higher for smaller accounts because of the fixed costs associated with maintaining accounts. As a result, account providers may have an incentive to focus marketing efforts on individuals who are likely to have higher account balances. On the other hand, one U.S. provider speculated that many low earning individuals would chose to not participate under a voluntary account approach, which would reduce the number of smaller accounts.

In addition to costs for administering the accounts on an ongoing basis, startup costs would be incurred for creating new systems for a variety of administrative functions, including recording individual investment decisions, collecting account contributions, transmitting contributions to investment managers, recording account value changes, and sending periodic statements. Under a voluntary approach, such functions would also include recording participation decisions. Some of these administrative functions would need to be developed before actual participation rates were known. Such costs would need to be paid for by the government, account providers, program participants, or some combination thereof, and the cost per participant would depend on participation rates.

Incentive Costs

Many voluntary individual account plans include participation incentives, as noted earlier. Incentive costs can be significant, depending on their design and on participation rates. For example, Germany offers tax incentives and government subsidies to participants. Germany has allocated $10.6 billion for incentives through 2008, but actual costs will depend on participation.

In the United Kingdom, soon after accounts were introduced in 1988, participation was much higher than predicted, and as a result so were incentive costs. An expert on the UK's pension system asserts that the reasons for the high rates included overly generous rebates and tax incentives. In fact, in 1997, the UK Department of Social Security estimated that the net present value of savings resulting from opted-out voluntary individual accounts was $11.6 billion for the period from 1987-88 to 1994-95. During the same period, contribution rebates and incentives paid to voluntary account participants totaled $35.1 billion at net present value. Thus, the total government revenue foregone as a result of opted-out voluntary individual accounts was about three times the expenditure savings.[23] However, since 1997 the government has moved to a rebate that is estimated to equal the actuarial value of the forgone benefits.

Education Costs Related to the Participation Decision

Under a voluntary approach, individuals would face the decision of whether to participate, which they would not face under a mandatory

[23]The ratio of expenditures to savings would be slightly higher if tax relief were included. For the years 1988-89 to 1995-96, the net present cost of income tax relief for contribution rebates to voluntary individual accounts amounted to $3.2 billion. For more information see Lillian Liu, "Retirement Income Security in the United Kingdom," Social Security Bulletin, vol. 62, no. 1, 1999.

approach. Helping them make an informed decision would entail costs for education, financial advice, and marketing efforts that would go beyond what mandatory plans would require. Such efforts and their costs could be the responsibility of the government, employers, account providers, or individuals, depending on the plan's design. If employers or account providers were given the responsibility, the government might still incur costs for regulating those efforts. All of the countries we studied emphasized the need for significant educational efforts to explain the voluntary system, but none identified any concrete expenditures.

Substitute Accounts Can Have Special Consequences for Total Costs

A voluntary plan using substitute accounts raises potential costs that do not arise with supplemental accounts and which depend on participation rates. Such costs include costs associated with moving from pay-as-you-go to advanced funding. Also, substitute accounts adjust benefits to reflect the diversion of social security contributions to individual accounts. Such benefit adjustments can affect system costs, depending both on their design and participation patterns.

Transition Costs

Under a substitute individual account plan, some Social Security contributions would be diverted to the accounts. However, under Social Security's pay-as-you-go financing, some of those contributions would also be needed to pay for current benefits. Making account deposits while also meeting current benefit costs requires additional revenue, which we refer to as "transition costs."[24]

For example, according to one study, contribution rates to the national pension system in the United Kingdom were an estimated 2.5 percent to 3.0 percent higher in 1999 to 2000 than they would need to be without opted-out voluntary accounts.[25]

[24]In the United States, the amount necessary to pay the benefits already accrued by current workers and current beneficiaries is roughly $9 trillion, according to the Social Security Administration. Under the CSSS proposals, transition costs would be funded through general revenue transfers, which would be repaid in future years when decreasing benefit costs fall below payroll tax revenues.

[25]See Richard Disney, Carl Emmerson and Sarah Smith, "Pension Reform and Economic Performance in Britain in the 1980s and 1990s." Discussion paper available at: http://www.nottingham.ac.uk/economics/staff/details/papers/PensionReformEconomicPerformance.doc.

While such transition costs would also arise under a mandatory approach, they would vary with participation rates under a voluntary approach and, therefore, would be smaller with less than 100 percent participation. Under a supplemental account plan, transition costs would not be an issue because no resources are diverted away from paying current benefits, though such plans do require additional contributions.

Adjustment Costs

Substitute account plans adjust participants' contributions or benefits in some manner to reflect that they are replacing some portion of their national pension benefit with an individual account. Under some U.S. proposals, a specified percentage of Social Security contributions would be deposited in the accounts, and a benefit offset would be calculated to reflect those diverted contributions. In contrast, in the United Kingdom, the account contributions, or "rebates," are calculated to reflect the value of the national pension benefit that participants forego. In either case, the adjustment calculations can implicitly provide an incentive to participate, as they did initially in the United Kingdom, as previously discussed. In addition, the calculations depend on assumptions that, if incorrect, could either cost the government or participants money, on average. Under either situation, the costs arising from such adjustments depend on participation. Moreover, under any benefit offset, the potential for adverse selection exists, resulting in costs to the government. In short, the total actuarial value of the benefit offsets could differ from the total value of the diverted contributions, depending on the interaction of the benefit offset design and participation patterns. In that case, a subsidy either from or to the government could occur.

In the United States, some proposals would calculate the benefit offset as the annuitized value of the diverted contributions, assuming they earned a rate of interest specified by the proposal; in effect, the specified interest rate is applied to a "hypothetical account." For example, under the three alternative options offered in 2001 by the President's Commission on Strengthening Social Security (CSSS), three distinct interest rates are specified for the offsets, but only one rate would yield an offset with an actuarial value equal to the diverted contributions, even assuming that participation patterns are predicted with perfect accuracy. Implicitly, any other rate would represent either a subsidy or cost to the government. Under a voluntary approach, the total cost of (or revenue from) any such subsidies depends on the level of participation.

The benefit offsets under the CSSS and similar proposals would also make a variety of actuarial assumptions in converting the hypothetical account balances into an annuitized monthly amount. Such assumptions include mortality rates and the interest rates that insurers would use to set annuity prices (in contrast to the interest the accounts earn during the accumulation phase). To the extent that actual experience differs from these assumptions, the offsets will be either higher or lower than they would have been with perfect foresight, and there will be either a net loss or gain to the government fund; such effects will depend on the level of participation.

Still, even with perfect foresight of actuarial assumptions, the potential for adverse selection exists. The characteristics of those who participate in the accounts may not reflect the actuarial assumptions used in calculating the offsets. For example, offset calculations might assume that men and women participate at the same rate. If they do not, the rebates could pose a net loss or gain to the government fund because women live longer than men on average and therefore would collect benefits longer. Varying participation patterns by earnings level and household type could also result in adverse selection because U.S. Social Security benefits also depend on these factors. In fact, according to a recent report by the American Academy of Actuaries, adverse selection is inherent in any system involving voluntary participation.[26]

Participation also Makes Other Costs Uncertain

Under either a voluntary or a mandatory approach, the total costs of an individual account plan include costs associated with the accumulation and withdrawal phases of the accounts. During the accumulation phase, they may include administration, investment management, investor education, and tax deferrals. During the withdrawal phase, they may include administration of account withdrawals or annuitization costs. However, under a voluntary approach, participation rates can affect all these costs. In particular, participation rates can affect economies of scale, account size, the total cost of tax deferrals, and the contingent costs of benefit guarantees.

Under either a voluntary or a mandatory approach, individual accounts could also affect the costs of other government programs. For example, if income from substitute accounts leaves particular individuals with less retirement income than if they had not participated, some may qualify for other government programs such as Supplemental Security Income in the

[26]American Academy of Actuaries, "Social Security Reform: Voluntary or Mandatory Individual Accounts." September 2002 Issue Brief.

case of the United States, which provides income supplements to aged, blind, and disabled individuals with low incomes. On the other hand, to the extent that the accounts increase retirement incomes, costs for such programs may fall. Under a voluntary approach, such effects could depend partly on the rate of participation.

Significant Education Efforts May Help Individuals Make Informed Participation Decisions

Under a voluntary approach to individual accounts, individuals face a complex participation decision in addition to the contribution, investment, and withdrawal decisions they might face in a mandatory plan. Individuals could benefit from both education and financial advice in making informed decisions, but the liability associated with providing advice can be an obstacle to providing education. Still, public education campaigns can offer a variety of tools to help with their decisions.

Individuals Face Complex Choices

To make informed decisions about participating in voluntary accounts, individuals need to understand the social security system, the role of the accounts, and how much income they will need in retirement. For example, a German study shows that one of the reasons participation in individual accounts has been lower than expected is because the public believes they will have adequate income in retirement without the new accounts.

Furthermore, to make informed participation decisions, individuals need to understand who should participate in the accounts. Voluntary accounts can be designed to provide benefits to a broad range of people or select groups of people. In the United Kingdom, for example, voluntary accounts were initially designed to allow individuals without access to employer-sponsored pension plans the ability to opt out of part of the national pension system. However, strong incentives encouraged workers who had employer-sponsored pensions to leave their pension plan for an individual account. As a result, workers often reduced their future retirement income because they lost employer contributions in their employer plans.

Individuals should also understand the implications of individual accounts that interact with national pension benefits. For example, in the United Kingdom, individuals can opt out of part of the national social security system to participate in an employer-sponsored pension plan or an individual account. One government survey showed a quarter of public and private sector workers did not know whether they were participating in the national system or whether they were participating in an opted-out plan. Furthermore, government research conducted in 1997 with a small group of people showed that although the principle of opting out was fairly well-known, they had difficulty understanding the implications. Recently, the government in the United Kingdom announced a number of initiatives designed to improve financial education and awareness.[27] In the United States, some proposals would reduce (or offset) an individual's Social Security benefit to reflect the diversion of program contributions into an individual account. According to one expert, it could be difficult to explain these Social Security benefit reductions to the public because the offset calculations can be complex.

Individuals could also make more informed choices if they received education about the effects of individual accounts on their family if they become disabled or die. Under some U.S. proposals, benefit offsets would reduce disability and/or survivors' benefits as well as retirement benefits. On the other hand, individual account balances could provide income in cases of disability and death, though the balances may not be very large for younger workers.

Individuals have varying levels of financial interest, which can further complicate the educational efforts associated with a voluntary approach to individual accounts. In particular, one survey in the United Kingdom highlighted individuals' lack of interest in financial matters, including pensions. Overall, it found that 60 percent of respondents thought about financial matters when it was absolutely necessary and that 10 percent didn't think about financial matters at all. The same survey also found that older individuals have a more pronounced interest in financial matters than younger individuals.

The Social Security program includes workers from all levels of income, those who currently invest in equity and bond markets and those who do not. It is unlikely that a "one size fits all" educational effort would be appropriate for an individual account program. Investor education is especially important for individuals who are unfamiliar with making investment choices, including low-income and less well-educated individuals who may have limited investing experience. Specifically, one

[27] In December 2002, the government announced a number of proposals to help individuals access information about their retirement. These proposals include telephone and Web site information services, interactive financial planning tools, interactive digital television, retirement planning around life events, and an online retirement planner.

provider said that different communication strategies should be developed for low-income workers and high-income workers. Additionally, the provider noted that a simple plan design with few investment choices would make it easier to educate low-income workers, in particular. According to another pension provider, the workers who have not participated in employer-sponsored defined contribution pension plans will need more education about individual accounts than those who have. One pension professional said that inequality would exist in a voluntary system if workers were unable to develop financial planning skills.

Financial Education versus Advice

A critical tension exists between financial education and financial advice. Government agencies, employers, account providers and others who might provide financial education may be reluctant to do so because those educational efforts might be construed as advice. Providers of advice can be held responsible for the outcomes of decisions based on that advice. Although this tension would arise under any approach to individual accounts regarding individual investment decisions, it would arise under a voluntary approach also regarding participation decisions. This distinction becomes even more relevant in a substitute system where individuals give up a portion of their Social Security benefit to participate in an individual account. In this instance, a provider of advice could be held liable for wrongly advising people to participate in an individual account when they would have been better off by not doing so.

For example, in the United Kingdom, financial service industry salespeople advised people to participate in individual accounts instead of the social security system or employer-sponsored pensions, where many of them would have been better off, given their particular circumstances. As a result, the government ordered the financial service industry to reimburse the individuals who were mis-sold individual accounts.

Governments often try to define the roles and responsibilities of those who would educate and advise the public in individual account plans. In the U.S. private pension market, the tension between investment education and investment advice led the Department of Labor to issue guidance to investment advisers and employers. In particular, the guidance shows how advisers and employers can provide educational investment information and analysis to participants without becoming a fiduciary under the Employee Retirement Income Security Act.[28] In the United Kingdom, employers are allowed to provide individuals with education, but not advice. However, employers are wary of providing education, fearing it will be misinterpreted as advice. Additionally, many workers do not seek financial advice because advisors are expensive. Similarly, in Germany, employers are allowed to inform employees about individual accounts; however, employers could be held liable if they provided employees with bad information.

Public Education Campaigns Involve Variety of Educational Tools

Pension systems in the United States and other countries have used a variety of educational tools to inform the public about pension options, including electronic tools. For example, Florida recently gave state and local employees the option of participating in the state's defined benefit pension plan or in an individual account. To educate employees about participation decisions, Florida used a variety of communication mediums that included printed materials, Web sites, workshops, and a toll-free telephone line. Focus groups revealed that individuals had a strong preference for printed materials. To accommodate that preference, information kits were mailed directly to individuals' homes.

Educating the public about a voluntary approach to individual accounts would have associated costs. For example, in 2000, approximately 153 million people worked in employment or self-employment covered by the Social Security program. The majority of these individuals paid Social Security payroll taxes on their earnings. According to SSA staff, information on changes to the program would most likely be sent to every working individual through the mail. As we reported previously, SSA estimated the minimum mailing cost would be $0.50 per letter, which totals more than $70 million per mailing.[29]

Florida also experienced associated costs to educate workers about their pension choices. For example, the state budgeted roughly $42 million over 2 fiscal years to educate 617,000 employees that worked for 800 separate employers. The budget was designed to provide comprehensive education

[28]The interpretive bulletin (29 C.F.R. 2509.96-1) by the Department of Labor provides examples of educational investment information and analysis, including: plan information, general financial and investment information, asset allocation models, and interactive investment materials.

[29]GAO/HEHS-99-131.

through a variety of communication mediums. Additionally, the state expects that a number of the education assets provided by the budget will be in place for the long-term. Furthermore, the state points out that the $23 million budgeted for education costs in the first fiscal year represents 0.10 percent of the annual payroll of Florida Retirement System employers and 0.03 percent of the amount of assets invested in the system's trust fund.

A variety of tools can be used to inform individuals about participation decisions. Other governments have used a number of tools, such as customized statements, decisions trees, and financial education classes and workshops to inform the public.

Customized Statements

Customized statements provide information on a personalized basis. In the United States, an example of a customized statement is the Social Security Statement. This statement is mailed annually to workers and provides estimates of Social Security benefits based on their own earnings histories. Florida also provides state and local employees with a customized statement, known as a personalized Benefit Comparison Statement. The statement compares projected benefits in the defined benefit plan with benefits from the individual account, using one set of assumptions. The statement is directly mailed to the employee's home as part of a Retirement Choice Kit. Furthermore, workers can use an Internet-based service to forecast their future benefits under both plans, using a variety of different assumptions. According to state experts, approximately 20 to 25 percent of employees used the Internet-based service to forecast future benefits.[30]

The United Kingdom is also using customized statements to educate the public about social security issues. For a number of years, the United Kingdom has offered national pension forecasts upon request. These forecasts show individuals what they can expect to receive in retirement from their national pension. Recently, the government announced that it plans to automatically provide national pension forecasts to the working-age population. Additionally, the government is providing individuals with a combined pension forecast that shows what they can expect to receive in retirement from both their national pension and their employer-

[30]Florida introduced individual accounts to state employees in different groups. In the first group eligible to participate in individual accounts, 20 to 25 percent of employees used the Internet-based service. At the time of our interview, the state did not yet have statistics on the remaining groups.

sponsored or private pension plan. Dissemination of the combined pension forecasts will rely on the voluntary participation of employers and pension providers.

Decision Trees

In the United Kingdom, individuals must decide whether they should participate in the national social security system, their employer-sponsored pension plan, or an individual account. The Financial Services Agency publishes decision trees on its Web site.[31] Decision trees in the United Kingdom ask basic questions about pension arrangements to help individuals make their own choices.

Government officials said that usually individuals need more individualized attention than the decision trees can provide. Additionally, the decision trees are not very helpful for individuals with little financial planning skill. Some individuals may find the decision trees too complicated to understand, especially given the United Kingdom's complicated pension system. While decision trees are designed to help individuals make informed choices, they are not intended to provide financial or professional advice. Further, the trees recommend that individuals in need of additional assistance consult with their financial advisor or pension provider.

Classes and Workshops

Classes and workshops provide ways to educate adults on financial matters. In Florida, the state conducted 3,000 workshops to educate state and local employees about their pension choices. A number of local governments have required their employees to attend the workshops. The workshops lasted approximately 2 hours and provided employees with the opportunity to ask questions. The workshops were conducted by a nationally known financial services firm and were well received by the employees, according to state officials.

Some educational efforts have explored trying to promote financial education in the schools and prepare students for future choices concerning their retirement. For example, the United Kingdom introduced personal financial education as a nonstatutory part of the national curriculum in England. Additionally, Scotland, Wales, and Northern Ireland are also developing ways to improve personal financial education.

[31] www.fsa.gov.uk/pubs/public/stakeholder.pdf.

Concluding Observations

If policymakers decide to restructure Social Security to include individual accounts, making participation voluntary has significant implications for designing the plan. Giving individuals the ability to participate or not is the most fundamental type of choice an individual account plan can offer.

While offering the choice to participate may be desirable to some policymakers, doing so creates additional administrative tasks, substantially increases the complexity of an individual account plan, and potentially increases its total costs. The full range of design features found in individual account plans can influence whether people participate or not. In turn, design and participation can interact to have significant effects on both the individual retirement incomes people enjoy and the plan's total costs, whether borne by the government, employers, providers, or participants. In particular, in any substitute voluntary account plan, care should be taken to anticipate and minimize the potential for adverse selection. As a result, policymakers would be wise to consider the design of a voluntary plan with careful attention to the effects on participation and its consequences. Moreover, as we have said in the past, reform proposals should be evaluated as packages that strike a balance among various objectives, including achieving sustainable solvency, balancing benefit adequacy and equity, and ensuring the feasibility of implementing and administering the reforms. While using a voluntary approach has the potential to cost more than a mandatory approach, such costs should be weighed as part of a total package that could contain offsetting savings.

The role of incentives deserves particular attention in a voluntary plan. Early on, policymakers should make a deliberate decision about whether they intend to actively promote participation or simply to offer another retirement planning choice. Actively promoting participation generally requires offering costly incentives that should be weighed against the costs of other approaches to restoring Social Security's long-term solvency. If incentives are offered, they will have the desired effect only if the public understands them.

In addition, individuals will need education and advice to help them make their participation decisions as well as the many other decisions associated with their accounts. Otherwise, confusion about their decisions may discourage participation or lead them to choices that could make them worse off than if they did not participate. In particular, any plan should offer a variety of educational tools that allow individuals to examine their specific circumstances given their own level of financial knowledge and experience. Achieving a high degree of transparency in how the account plan works would help ensure that people make choices that are in their best interest. Also, clearly articulating the reason for reform would promote system understanding and encourage participation.

If policymakers decide to create individual accounts as part of Social Security, using a voluntary approach is a fundamental decision with implications that flow through to many other design features. While the decision is ultimately a policy choice, successful plans would require clear objectives as well as design features that are consistent with those objectives.

Agency Comments and Our Evaluation

We provided SSA an opportunity to comment on a draft report of this report. The agency provided us with written comments, which appear in appendix IV. SSA also provided technical comments, which we have incorporated where appropriate.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will send copies of this report to appropriate congressional committees and other interested parties. Copies will also be made available to others upon request. In addition, the report will be available at no charge on GAO's Web site at http://www.gao.gov. Please contact me at (202) 512-7215, Charles Jeszeck at (202) 512-7036, or Ken Stockbridge at (202) 512-7264, if you have any questions about this report. Other major contributors include Charles Ford and Ali Bonebrake.

Sincerely yours,

Barbara D. Bovbjerg

Barbara D. Bovbjerg
Director, Education, Workforce
and Income Security Issues

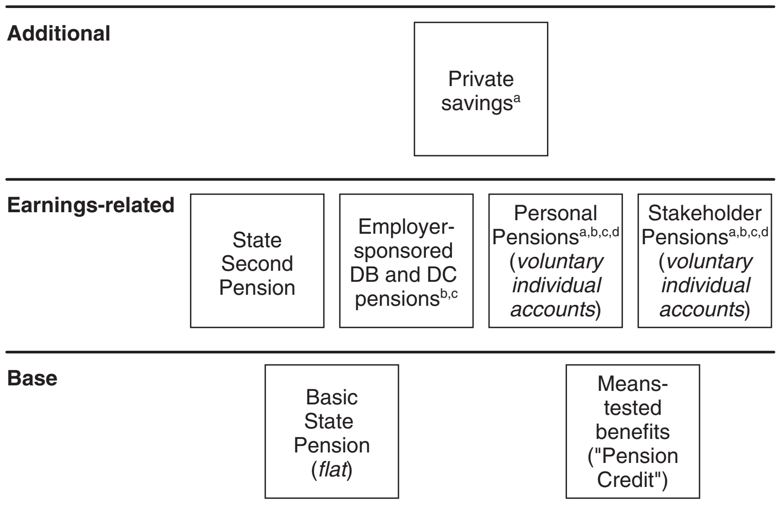
Appendix I: Summary of the United Kingdom's Retirement System

Description of Current System

In the United Kingdom, retirement income comes from a variety of sources, which can be organized in three levels—base, earnings-related, and additional. (See fig. 1.) The country's social security system provides both base level and earnings-related benefits.[1] The base level consists of the Basic State Pension (BSP) and means-tested benefits for pensioners with low income. The earnings-related level consists of the government-run State Second Pension (S2P) and opted-out arrangements. Workers can choose to participate in S2P, employer pension plans, or individual pension accounts. Individuals can also set aside additional private savings for retirement on a voluntary basis. A variety of voluntary savings instruments enjoy tax-relief to encourage workers to save for their retirement.

[1]In the United Kingdom, the term "social security" refers to a dual social insurance and social assistance system that includes benefits for old-age, disability, survivors, sickness and maternity, work injury, unemployment, and family allowances. In this appendix, the term "social security" refers specifically to the government-run retirement income security programs: the Basic State Pension and the State Second Pension.

Figure 1: Overview of the United Kingdom's Retirement Income Sources



Source: GAO.

Notes: "Base" income sources include flat-rate or means-tested government benefits. "Earnings-related" income sources relate to earnings levels either through DB benefit formulas or DC contribution levels. "Additional" income sources consist of voluntary individual savings that are not directly related to earnings.

[a]Some individuals may use personal or stakeholder pensions as additional rather than earnings-related sources of retirement income.

[b]Can either substitute for (when "contracted-out," or opted-out, of) or supplement (when "contracted-in," or opted into) S2P benefits.

[c]Individuals may also make additional contributions to these accounts.

[d]Can either be arranged individually or through employer.

The Base Level: The Basic State Pension and Means-Tested Benefits

The Basic State Pension

The U.K. social security system began in 1908 with the enactment of the Old-Age Pensions Act. At that time, the system provided flat-rate, means-tested benefits for individuals over age 70. In the 1940s, economist Sir William Beveridge advocated major changes to the country's social security system. In a report, he proposed a universal social security system that would provide a minimum benefit to all individuals funded by worker contributions. Eventually, the Beveridge report led to the passage of the National Insurance Act of 1946, which created the basis for the current social security program.

BSP is the foundation of the country's social security system. BSP benefits are paid to over 10 million people, which is nearly 100 percent of the country's pensioners. BSP provides a flat benefit based on the number of "qualifying years" that individuals contribute to the system. Individuals make contributions to the BSP and a variety of other benefits through payroll taxes known as National Insurance Contributions (NICs).[2] To receive full benefits, men are required to have 44 qualifying years; whereas, the number of qualifying years for women will gradually increase from 39 to 44 between 2010 and 2020. Individuals with fewer qualifying years will receive less than the full benefit amount; however, they may be able to earn credits towards the full BSP for periods of unemployment due to caregiving, disability, and certain other circumstances.

Workers are eligible for BSP benefits at the normal retirement age, which is 65 for men and will gradually increase from age 60 to age 65 for women between 2010 and 2020. Currently, full BSP provides a benefit of $122[3] per week for a single person.[4] Relative to average wages, the benefit provided from BSP has declined since the 1980s. This decline in benefit levels, relative to average wages, reflects a 1980 change to benefit indexing. Prior to 1980, annual increases to BSP were linked to inflation or real wage growth, whichever was higher, but after 1980 annual increases were linked only to inflation. In December 2002, the government announced that it would increase BSP benefits in future years by at least 2.5 percent per year, even if this amount were larger than the increase in inflation.

Means-Tested Benefits

The Minimum Income Guarantee

The Minimum Income Guarantee (MIG) was introduced April 1999. It is a means-tested entitlement that provides extra financial support to poor pensioners. MIG is available to pensioners who are aged 60 and older,

[2]Individuals earning more than $7,458 a year (in 2002/03) are required to pay NICs towards the BSP. However, individuals earning between $6,302 and $7,458 a year (in 2002/03) can still build entitlement to the BSP even though they do not pay NICs.

[3]In this appendix, all British pounds are converted into U.S. dollars using a conversion of 0.61882 British pounds per U.S. dollar. This figure represents the monthly conversion average in January 2003.

[4]Beginning in April 2003, the full BSP will increase to $125 a week for a single pensioner.

have savings under $19,392, and work less than 16 hours per week (or less than 24 hours per week if they have a partner).

MIG provides poor pensioners with a minimum income that is higher than BSP. Currently, poor pensioners can receive weekly MIG entitlements that top up their income to $159 for a single person or $242 for a couple.[5] Individuals receive different MIG entitlement amounts, based on whether they have a full- or reduced-rate BSP, their amount of savings, and their income. Additionally, individuals can receive higher weekly MIG entitlements for certain circumstances, including disability and caregiving.

Some experts were concerned that MIG provides poor pensioners with a disincentive to work and save money for retirement. This is because MIG entitlement amount is reduced £1 per £1 based on income an individual receives from an occupational, personal, or stakeholder pension. Under MIG, some pensioners with modest savings would be no better off than pensioners without any savings. This concern, among others, led the government to reform MIG with the Pension Credit, which will be introduced in 2003.

The Pension Credit

In response to concerns regarding MIG, in October 2003 the Pension Credit will become the major form of means-tested social assistance to individuals with modest incomes over the national pension age. The Department for Work and Pensions (DWP) believes that the Pension Credit will reward pensioners for their retirement savings efforts. DWP estimates that over 5.3 million pensioners (about half of all pensioner households) will be better off from the introduction of the Pension Credit. The government expects that the Pension Credit will entitle nearly half of all pensioner households to gain an average of $646 a year.

The Pension Credit consists of two elements: (1) a guarantee credit and (2) a savings credit. The guarantee credit tops up the income for a single pensioner to $165 a week and for a pensioner couple to $252 a week.[6] The

[5]In April 2003, the MIG will increase so that poor pensioners can receive weekly entitlements that top up their income to $165 for a single person or $252 for a couple.

[6]The guarantee credit links benefit increases to changes in wages; whereas, BSP links benefit increases to changes in prices. As a result of the differences in benefit indexation, it is likely that in the future more pensioners will be entitled to means-tested benefits.

savings credit provides a "reward" element, so that those with savings, second pensions, or earnings that fall between the amount of BSP and $218 a week ($323 for couples) will receive a credit.[7] The savings credit is designed to taper away as an individual's income rises. For example, income between BSP and the guarantee credit is entitled to a 60-percent savings credit, whereas, additional income (up to $218 a week) is entitled to a 40-percent savings credit.

The Earnings-Related Level: The State Second Pension and Contracted-Out Arrangements

To provide more adequate retirement income, the U.K. government created the second tier to the national pension system in 1959. This tier was a supplemental earnings-related plan called the graduated pension. The government allowed employers to "contract out" their employees, that is, opt them out, of the national graduated pension plan if they offered comparable benefits in occupational pensions. The U.K. history with contracting-out continued with the Social Security Pensions Act of 1975. This act created the State Earnings-Related Pension Scheme (SERPS) to provide more substantial benefits and to further help those without employer pensions. In 1986, SERPS was further reformed to provide workers themselves with the option of contracting out of SERPS for participation in an employer-sponsored, defined contribution plan or a personal pension.

In July 2000, the U.K. government enacted reforms that called for replacing SERPS with S2P. In April 2002, the government implemented S2P to provide a more generous national pension plan than SERPS would have provided to individuals with low and moderate incomes. In addition, S2P provides more generous benefits to individuals caring for young children or a disabled person and individuals with long-term disabilities who have intermittent work records.

Although workers are required to participate in the second tier of the U.K. social security system, they have a range of participation choices. For example, workers can either participate in S2P, their employer's pension plan, a personal pension, or a stakeholder pension. Additionally, workers can choose to participate in S2P while simultaneously participating in their employer's pension plan and a personal pension or stakeholder pension plan.

[7] In 2003, the maximum credit payable is $22 a week for single pensioners and $30 a week for pensioner couples.

State Second Pension

On April 6, 2002, the government introduced S2P to replace SERPS, the second tier national social security system that existed from 1978 to 2002. While SERPS provided individuals with earnings related benefits, S2P provides more generous redistributive benefits targeted to low earners, disabled individuals, and caregivers. The government intends to convert S2P into a flat rate benefit once stakeholder pensions have become established. It is the belief of the government that stakeholder pensions will provide an incentive for moderate earners to opt out of the national system.

S2P provides individuals earning up to $39,753 annually (in 2002/03 terms) a larger pension than they would have received under SERPS. Individuals build entitlements to S2P by earning at least $6,302 in income per year.[8] In 2002/03, individuals earning more than $6,302 but less than $17,453 annually will be treated for S2P purposes as if they had earned $17,453. Low and low-to-middle income individuals are also better off in S2P because the accrual rate (the rate at which the pension builds up) is more generous than it was in SERPS.[9]

Similar to BSP, contributions are made to S2P through payroll taxes (NICs). Currently, employees who remain in S2P pay NICs on 10 percent of weekly earnings between the primary threshold ($144) and the upper earnings limit ($945). Employers are also required to pay NICs on 11.8 percent of earnings above $144 per week.[10] Also, like BSP, individuals can build entitlements to S2P during periods when they cannot work due to long-term illness or disability or when they are providing certain types of care. These individuals will be able to build up about a $1.62 per week in S2P for each year they are eligible.

When S2P was introduced in 2002, the government estimated that approximately 18 million people would begin accruing entitlements from the program. Individuals accruing entitlements from S2P include 4.5 million low earners (less than $15,352 a year), 9.5 million moderate

[8]In 2002/03, the lower earnings limit was $6,302.

[9]SERPS had a 20-percent accrual rate; whereas, S2P has three different accrual rates related to annual earnings.

[10]From April 2003, NIC rates will increase by 1 percent for employers and employees on earnings above a threshold. Employees will also pay 1 percent of earnings above the earnings limit, and the earnings limit will be raised in line with inflation.

earners (between $15,352 and $34,905), 2 million caregivers, and 2 million individuals with long-term disabilities.

Contracted-Out Arrangements

Individuals may choose to contract out of S2P to participate in employer pensions, personal pensions or stakeholder pensions. However, individuals may also choose to participate in these arrangements while remaining in the national system. Those choosing to contract out of the national system will either pay reduced NICs or will receive government rebates. In particular, individuals choosing to participate in an employer-sponsored pension plans pay reduced NICs on a portion of their weekly earnings.[11] Whereas, those participating in personal pensions and stakeholder pensions pay full-rate NICs but receive a rebate from the government paid directly into their private pension account. Individuals participating in an employer-sponsored defined contribution pension plan will receive a rebate from the government in addition to paying reduced NICs. The amount of rebate an individual receives depends on their age and the amount of their earnings. The age-related rebate allows individuals to receive a larger rebate amount as they grow older. For personal pensions and stakeholder pensions, there is currently a 1-year delay between when NICs are paid and when the rebates are paid to the pension provider. However, rebates may be paid more quickly to individuals participating in an employer-sponsored defined contribution plan.

Employer Pension Plans

There is no statutory obligation for employers to establish, or for employees to join, employer-sponsored pension plans. Rather, it is up to the employer (or group of employers) to establish the pension plan and decide upon the rules and benefits of the plan. Approximately 50 percent of the working population is covered by an employer-sponsored pension.

Many employers offer defined benefit or defined contribution pension plans. A defined benefit plan promises to provide a benefit that is generally based on an employee's salary and years of service. Whereas, a defined contribution plan provides a benefit based on the contributions to and investment returns (gains and losses) on individual accounts. Similar to

[11]Currently, employees that contract out of S2P to participate in an employer-sponsored pension receive a flat rate reduction of NICs at a rate of 1.6 percent. Similarly, employers also receive a flat rate reduction of NICs ranging from 1 percent to 3.5 percent.

the United States, a number of employers in the United Kingdom have begun offering defined contribution plans instead of defined benefit plans.

Personal Pensions

Personal pensions are tax-deferred, defined-contribution individual pension accounts that were created by the 1986 Social Security Act and implemented in 1988. The original purpose of personal pensions was to allow individuals without access to employer-sponsored pensions the ability to contract out of the second tier government-run social security system. A variety of financial service providers, such as, banks, mortgage companies, investment trusts, and other financial institutions offer personal pensions. Individuals are subject to contribution limits depending upon certain circumstances. For example, those participating in an employer-sponsored plan or those with nontaxable or minimal earnings can contribute up to $5,818 in a personal pension each year. Otherwise, individuals can contribute up to a certain percentage of their taxable earnings. The maximum percentage individuals can contribute increases with age. These contributions can be made by the individual, the employer, and from tax relief received from Inland Revenue.

Administrative charges vary based on the type of personal pension an individual chooses. Additionally, the government provides few regulations concerning the administrative costs and fees that personal pension providers can charge. In personal pension plans, providers can front-load the administrative charges, thereby charging a high amount of fees in the beginning stage of an individual account. These charges can consume a substantial amount of an account balance, particularly for individuals that may not have the means to make sizeable contributions or cannot make contributions for a prolonged period of time. For example, one study found that on average, various administrative costs in the United Kingdom have historically consumed between 40 and 45 percent of an individual account's value.[12]

When personal pensions were first introduced, hundreds of thousands of individuals were convinced to opt out of their employer-sponsored

[12]Mamta Murthi, J. Michael Orszag, and Peter R. Orszag. "Administrative Costs under a Decentralized Approach to Individual Accounts: Lessons from the United Kingdom," in Robert Hollzman and Joseph E. Stiglitz, *New Ideas About Old Age Security: Toward Sustainable Pension Systems in the 21st Century*. The World Bank (Washington, D.C.: 2001).

pension into a personal pension when it was disadvantageous to them. These individuals found themselves with lower benefits than they would have had if they remained in their employer-sponsored pensions. This became known as the "mis-selling scandal." The insurance industry was held responsible and required to compensate individuals that were mis-sold pension products. It is expected that payments in compensation to those mis-sold pension products will reach $19.4 billion.

Stakeholder Pensions

According to U.K. experts, stakeholder pensions were created to address the tarnished image of personal pensions after the mis-selling scandal. Stakeholder pensions were introduced in April 2001 and provide additional pension coverage to the self-employed and to employees with low to moderate incomes.[13] Like personal pensions, stakeholder pensions provide individuals with the option of contracting out of the national second tier social security system to participate in the tax-relieved defined contribution individual pension accounts.

Stakeholder pensions were designed to meet a number of standards concerning administrative costs, flexibility, and security. Specifically, stakeholder pensions differ from personal pensions in the following ways:

- Administrative charges are capped at 1 percent of the account's total value.
- Individuals are not penalized for breaks in contributions or for transferring to another pension plan.
- Individuals can contribute as little as $32, which can be paid weekly, monthly, or at less regular intervals.
- Trustees and stakeholder managers are required to make investment decisions for individuals that do not want to make such decisions.

Employers that do not provide an employee pension plan and have five or more employees are required to provide their employees with access to a stakeholder pension. However, employers are not required to make any

[13]Stakeholder pensions are targeted to approximately 3.1 million employees who do not have pension coverage and earn between $16,160 and $32,320 per year. Stakeholder pensions are also targeted to about 1.5 million self-employed individuals.

contributions to the stakeholder pension. Stakeholder pensions are subject to the same contribution limits as personal pensions. These contributions can be made by the individual, the employer, and from tax relief received from Inland Revenue.

The Additional Level: Individual Voluntary Savings

The additional level to the U.K. pension system consists of individual forms of voluntary savings. For example, individuals can make additional voluntary contributions into their employer-sponsored pension plan. Individuals can also save money for retirement by participating in a personal or stakeholder pension while they are simultaneously participating in S2P or an employer-sponsored pension. Individuals can receive tax relief for these additional contributions, up to a ceiling. Furthermore, individuals can also choose to make contributions to a variety of other tax-relieved instruments, such as, annuities and life insurance.

Key Design Features of Voluntary Individual Accounts in the United Kingdom

Voluntary individual accounts represent an integral part of the retirement system in the Untied Kingdom. Table 2 describes the key design features of voluntary individual accounts in four areas: (1) the interaction with national pension benefits, (2) the contribution phase, (3) the accumulation phase, and (4) the withdrawal phase.

Table 2: Key Design Features of Voluntary Individual Accounts in the United Kingdom

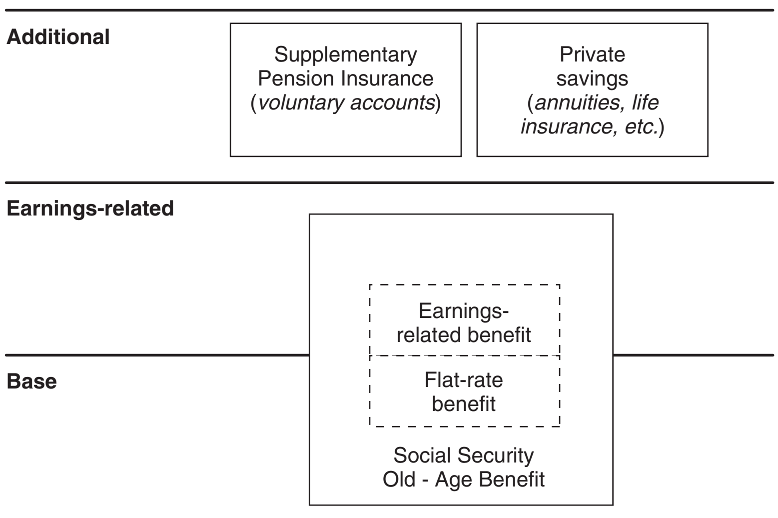
Interaction with national pension benefits (social security)	
Substitute or supplement	The United Kingdom has a system of substitute accounts. This is because individuals give up their benefits from S2P when they are participating in a voluntary individual account that qualifies for either a reduction payroll taxes or a government rebate.
Contribution phase	
Who can participate	Anyone who is eligible to participate in S2P can choose to opt out of S2P to participate in an individual account. (Individuals earning at least $6,302 a year—the lower earnings limit in 2002/03—are eligible to participate in S2P.)
Opt-in/opt-out ability	Individuals can decide to opt in and opt out of accounts at any time.
How much individuals can contribute	Individuals are subject to contribution limits depending upon certain circumstances. For example, those participating in an employer-sponsored plan or those with nontaxable or minimal earnings can contribute up to $5,818 in a personal pension each year. Otherwise, individuals can contribute up to a certain percentage of their taxable earnings. The maximum percentage individuals can contribute increases with age.
Government or employer contributions	Once a year, the government contributes a rebate into individual account plans known as personal pensions and stakeholder pensions. The amount of the rebate an individual receive depends on their age and the amount of their earnings. Employers are not required to make contributions to their employees' individual accounts.
Automatic enrollment	Employers can automatically enroll their employees into an employer-sponsored pension plan. However, employees have the right not to participate in such a plan.
Tax advantages	Individuals and employers receive tax relief for the contributions they make to individual accounts. Additionally, individuals are not taxed on any contributions that employers may make to their account.
Accumulation phase	
Regulation of investment options	Financial service companies offer individual account investment options that provide varying degrees of risk.
Regulation of administrative charges	One type of individual account, the stakeholder pension, limits the administrative charges to 1 percent of the value of the account each year. Whereas, another type of individual account, provides few regulations regarding administrative charges.
Tax advantages	Individual accounts are exempt from the tax on capital gains and most of the investment returns accruing to the account are also tax exempt.
Withdrawal phase	
Preretirement loans	Individuals cannot take preretirement loans from their individual accounts.
Withdrawal options—annuity, installment payments, and lump-sum distributions	Between the ages of 60 and 75, individuals must annuitize the portion of their account that was funded by tax rebates. Individuals have more flexibility with the portion of the account funded by their additional contributions. They are still required to purchase an annuity between the ages of 50 and 75. However, they can choose to take up to 25 percent of the account balance as a lump sum provided that they purchase an annuity or take income withdrawals at the same time.
Rate of return or minimum benefit guarantees	Individual accounts are not required to provide specified rates of return or minimum benefit guarantees.
Tax advantages	Individuals can receive some benefits from an individual account free of income tax. Specifically, the benefits an individual receives as a lump sum are not subject to income tax.

Source: GAO.

Appendix II: Summary of the Czech Republic's Retirement System

The Czech Republic has a pay-as-you-go social security system with old-age benefits that provide individuals with base-level and earnings-related benefits in retirement. (See fig. 2.) The base benefit consists of a basic, flat-rate amount and an earnings related pension. Additional retirement income comes from voluntary accounts. These voluntary accounts are fully funded and encourage participation through government matching, tax-deferred interest accruals, and tax preferred participant and employer contributions.

Figure 2: Overview of Czech Retirement Income Sources



Source: GAO.

Notes: "Base" income sources include flat-rate or means-tested government benefits. "Earnings-related" income sources relate to earnings levels either through DB benefit formulas or DC contribution levels. "Additional" income sources consist of voluntary individual savings that are not directly related to earnings.

Description of Current System

The National Old-Age Pension

The Czech Republic first introduced laws relating to old-age, disability and death benefits in 1906. The current system described below was enacted in 1995. The national pension system covers all employees, members of assimilated groups, including certain groups of students, farmers, artists, the unemployed, caregivers, military personnel, and the self-employed. Employees, employers, and the government all contribute to the system's funding. Employees pay taxes of 6.5 percent of earnings, employers pay 19.5 percent of payroll, and the government pays for any cash flow deficits incurred by the system.[1] To qualify for old-age benefits, one must have 25 years of insurance coverage[2] and be within 3 years of retirement age. The current retirement age is 61 years and 4 months for men. For women the retirement age is between age 55 and 8 months or age 59 and 8 months.[3] The retirement age will continue to increase by 2 months per year for men and 4 months per year for women until they reach their target level in 2007 of age 62 for men and age 57 to 61 for women. The expected old-age replacement rate is on average 53 percent. However the replacement rate varies across earnings levels as it falls from 81 percent for those with the lowest wage to less than 30 percent for those with double the average wage.

The old-age benefit is composed of a basic benefit and an earnings-related benefit. The basic benefit is a flat-rate benefit that is currently $43.84 per month.[4] The second part of a participant's national pension consists of an earnings-related pension. The earnings included are indexed earnings, that is, earnings are adjusted to reflect the average wage.[5] Monthly earnings of up to $247.62 receive 100 percent inclusion into the earnings calculation. Monthly earnings amounts between $247.62 and $598.98 receive 30 percent inclusion. Monthly earnings amounts over $598.98 receive 10 percent inclusion into the earnings calculation. The earnings-related benefit is derived from a calculation base that varies by type of pension. For old-age (and full disability) pensions, 1.5 percent of the calculation base is

[1]Currently the income rate is 26 percent of payroll and the cost rate is about 28 percent of payroll with the government contributing the difference.

[2]One qualifies with 15 years of insurance if aged 65.

[3]The reason for this variation is that women are given allowances for the number of children they raise. The current retirement ages are up from the retirement ages in 1995 of 60 for men and 53 or 57 for women.

[4]Under law, the government is authorized to increase this basic benefit. All Czech koruna (CZK) are converted into U.S. dollars using a conversion of 29.88 CZK per U.S. dollar. This figure represents the monthly conversion average in January 2003. The $43.84 amount per month, converted to a yearly amount, equals only about 1.5 percent of 2001 per capita gross domestic product (GDP) in the United States ($35,000 in 2001). However, the same benefit amount equals about 9.6 percent of 2001 per capita GDP ($5,500 in 2001) in the Czech Republic. In part, this comparison reflects that about $120 worth of goods in the United States would be roughly equivalent to $43.84 worth of goods (or 2.7 times as much) in the Czech Republic (on a purchasing power parity basis).

[5]The annual coefficients determined by the Czech Statistical Office.

multiplied by the number of insured years. The minimum earnings-related pension is $25.77 per month, which combines with the base pension for a total minimum of $69.60 per month. The average old-age benefit in 2002 was $228.92 per month. Old-age benefits at or above $4,015.49 a year are subject to income taxation.

In addition to old-age benefits the Czech system provides for full disability, partial disability, survivors, widows or widowers, and orphans. Partial disability benefits are paid using the same flat benefit of $43.84 per month and using half of the accrual rate (0.75 percent of the base multiplied by the number of insured years). Widows and widowers receive that flat benefit of $43.84 plus half of the deceased spouses earnings related pension. This benefit is paid at any age for one year immediately following the loss of the spouse, and thereafter paid to widows age 55 or older and widowers age 58 or older. Benefits are payable at any age if the widow or widowers is disabled, caring for dependent or disabled child or for disabled parent.

Additional Retirement Sources: Voluntary Supplementary Pension Insurance

In 1994 the Czech Republic introduced supplementary pension insurance.[6] The supplementary pension insurance system is not integrated with the government-provided base or earnings related old-age benefits. The system is characterized by voluntary participation and is largely administered by private pension funds with government supervision performed by the Czech Ministry of Finance and the Czech Securities Commission. Participants may contribute as little as $3.34 per month. For participant contributions in the $3.34 to $16.73 per month range, the government contributes a match related to the amount contributed by the participant. (See table 3.) Contributions between $200.77 and $602.32 per year are tax deductible. Participants may contribute more than $602.32 per year, but they do not receive any additional government contributions or tax advantages.

[6]To review the act enabling the creation of supplementary pension insurance in English visit http://www.mpsv.cz/files/clanky/1140/No_42_1994.pdf.

Table 3: Schedule of Government Matching Contributions for Czech Voluntary Supplementary Insurance

Amounts shown in U.S. dollars

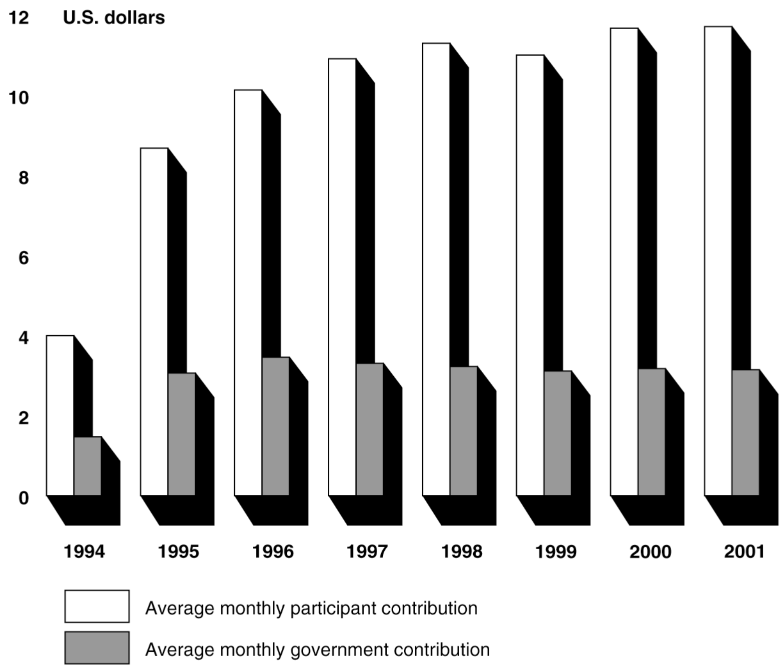
Planholder's monthly contribution	Government contribution
$3.34 to $6.66	$1.67 + 40% of the amount over $3.34
$6.69 – $10.01	$3.01 + 30% of the amount over $6.69
$10.04 – $13.35	$4.02 + 20% of the amount over $10.04
$13.38 – $16.70	$4.68 + 10% of the amount over $13.38
$16.73 and more	$5.02

Source: State-Contributory Supplementary Pension Insurance Act (http://www.mpsv.cz/files/clanky/1140/No_42_1994.pdf).

Note: Contribution amounts are not continuous as they reflect whole Czech koruna amounts (approximately $0.03). Amounts converted by GAO using a conversion rate of 29.88 CZK per U.S. dollar.

The supplementary system has 2.5 million participants that account for roughly 25 percent of the population and 50 percent of the labor force. In 2001 the average contribution was $11.54 per month and the average government contribution was $3.11 per month. (See fig. 3.) In 2000 a provision was introduced to allow participants to receive employer contributions to their supplementary pension. The employer contributions are not matched by government contributions, but employers and employees receive tax advantages for employer contributions up to a limit. (See table 5 for more detail on tax advantages.) About 25 percent of participants receive employer contributions.

Figure 3: Average Monthly Participant Contribution and Average Government Contribution to Czech Voluntary Supplementary Pension Insurance, 1994-2001



Source: Czech Ministry of Finance, Office of the State Supervision In Insurance and Pension Funds.

Note: "*State Supervision in Pension Funds: Annual Report 2000*." Data for 1994 reflects only one fiscal quarter and data for 2001 reflects only the first two fiscal quarters of data.

Plan holders are eligible to receive both their own contributions and the government contributions after they have contributed for at least 5 years and have attained age 60. The current eligibility thresholds are higher than 3 contribution years and attainment of the age 50 that applied to supplementary pensions from 1994 to 1999. The age was raised, as it appeared that accounts were used as short-term savings vehicles just prior to retirement rather than long-term retirement savings. However, since the increase in contribution years and eligibility age, the average age of plan holders has remained around age 48, about 10 years higher than the population average age of 38.

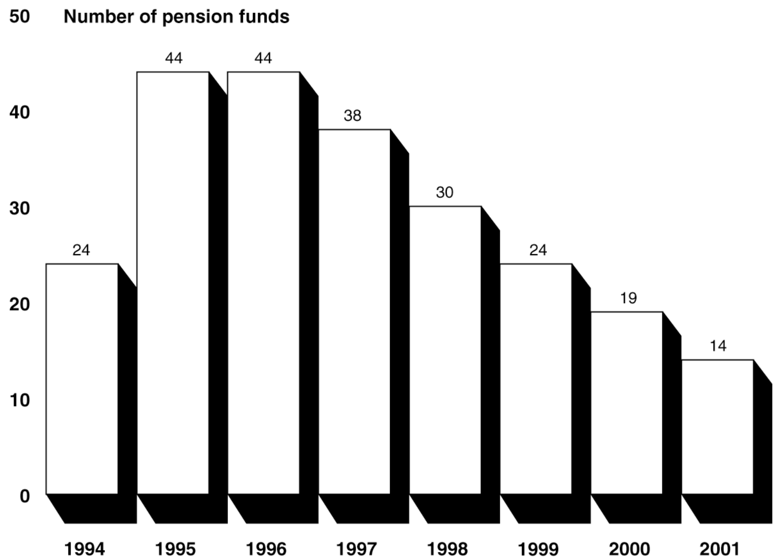
Some flexibility exists regarding plan holders access to account funds prior to retirement. Plan holders may also adjust the amount of monthly contributions, though they may be required to wait up to 3 months by the fund to change their contribution amount. Contributions to the accounts may be suspended without penalty after a period of 3 years. In addition, plan holders may terminate their accounts after 1 year and receive both their own contributions as well as accrued interest. In the event of termination, the matching contribution is returned to the government. If the plan holders terminate their accounts but transfer the accounts to a new pension fund provider, the plan holders maintain both their own contributions and government matching contributions.

Plan holders may choose the form of payout (annuity or lump sum) and there are provisions for payout in the event of death (i.e., survivors) or disability. At the present, it appears that lump sum payouts are a popular form of payout. A representative of the pension funds estimated that only 5 percent of plan holders take benefit payouts in the form of an annuity.

Just a year after the Czech voluntary supplementary pension insurance system began, there were 44 pension funds, yet by 2001 the number of pension funds declined to 14. (See fig. 4.) The drop in funds is mainly due to the consolidation of funds and the imposition of capitalization requirements after early failures of some of the smaller funds. Some of these failures resulted in liquidation and various degrees of accounts losses for about 46,000 plan holders.[7]

[7] Less than 2 percent of all current plan holders.

Figure 4: Number of Pension Funds Providing Czech Voluntary Supplementary Pension Insurance, 1994-2001



Source: Jiří Král, Director of Social Insurance Department, Czech Ministry of Labor and Social Affairs.

Note: June 12, 2002 Presentation, "The Czech Pension Reform."

The Czech Republic's Ministry of Finance regulates the funds, which must have at least $1.7 million in registered capital. Funds are joint stockholding companies. This means that funds are independent legal entities formed by solely for capital financing as a pension fund. Both national and foreign legal entities or individuals may establish a pension fund and be a shareholder in it. One criticism of this arrangement is that operating costs and distribution of profits between plan holders and shareholders are not very transparent. Funds are allowed to make no more than 10 percent profit or return distributions, with the remainder put in reserve (at least 5 percent) or to the benefit of the participant. Average rates of return accruing to accounts have been fairly low. (See table 4.) In 1998 and 2001, the average inflation-adjusted rate of return was negative. The portfolio of the funds is fairly conservative. Most investments are in low risk vehicles as laws regulate both the type of investment vehicle as well as the portfolio composition of pension funds.[8] As of December 31, 2001, about 83 percent of the total funds were invested in bonds or treasury bills.

Table 4: Average Inflation-Adjusted Rate of Return for Czech Pension Funds, 1995-2001

Amounts shown in percent

Year	1995	1996	1997	1998	1999	2000	2001
Average nominal rate of return	11.0	9.9	9.2	8.2	5.6	4.0	3.9
Annual inflation rate	9.1	8.8	8.5	10.7	2.1	3.9	4.7
Average inflation-adjusted rate of return	1.7	1.0	0.6	-2.3	3.4	0.1	-0.7

Source: Czech Ministry of Finance, Office of the State Supervision In Insurance and Pension Funds and Czech Ministry of Labor and Social Affairs.

Note: "*State Supervision in Pension Funds: Annual Report 2000.*"

Key Design Features of Voluntary Individual Accounts in the Czech Republic

Voluntary individual accounts are a part of the retirement system in the Czech Republic. Table 5 describes the key design features of voluntary individual accounts in four areas: (1) the interaction with national pension benefits, (2) the contribution phase, (3) the accumulation phase, and (4) the withdrawal phase.

[8]This includes not allowing more than 10 percent of a fund's portfolio to be composed of one security traded on the stock exchange, and no more than 25 percent of the total portfolio can be composed of shares traded on the stock exchange. Additionally the pension fund cannot own more than a 20 percent share of any one issuers stock.

Table 5: Key Design Features of Voluntary Individual Accounts in the Czech Republic

Interaction with national pension benefits (social security)	
Substitute or supplement	The Czech Republic has a system of supplemental accounts.
Contribution phase	
Who can participate	Any permanent resident of the Czech Republic over 18 years of age that signs a contract for supplementary pension insurance with a pension fund.
Opt-in/Opt-out ability	Can opt in at any time. Cancellation is also possible at any time though government contributions must be returned to the government and penalties may be due.
How much can individuals contribute	To qualify for government contributions, individuals must contribute at least $3.35 per month.
Government or employer contributions	Plan holder contributions between $3.35 and $16.73 per month are eligible for government contributions between $1.67 and $5.02 per month. (See table 3 for complete schedule of government contributions.) Employers may make contributions of any amount, but tax advantages to the employer and employee are limited. (See below).
Automatic enrollment	There is no automatic enrollment.
Tax advantages	Employer contributions and individual plan holder contributions enjoy tax advantages up to a limit. Plan holder contributions between $200.77 per year up to $602.32 per year are tax deductible. An employer may receive tax deductions for contributions up to 3 percent of an employee's earnings subject to social security tax. Further the employee is exempt from income tax on employer contributions up to 5 percent of the employee's earnings subject to social security tax.
Accumulation phase	
Regulation of investment options	To qualify as a pension fund, fund must adhere to certain investment choices including approved financial vehicles. Account holders may change pension fund provider at no penalty at any time.
Regulation of administrative charges	The pension fund may keep no more than 10 percent of distributed profits.
Tax advantages	Investment returns accruing to the account is tax exempt.
Withdrawal phase	
Pre-retirement loans	No. However, account may be terminated after 1 year. Termination returns all individual contributions and accruals.
Withdrawal options – annuity, installment payments, and lump sum distributions	Individuals may take full distributions in the form of an annuity or lump-sum after contributing for 5 years and attaining age 60.
Rate of return or minimum benefit guarantees	None.
Tax advantages	Non-interest income is subject to a preferential tax rate.

Source: GAO.

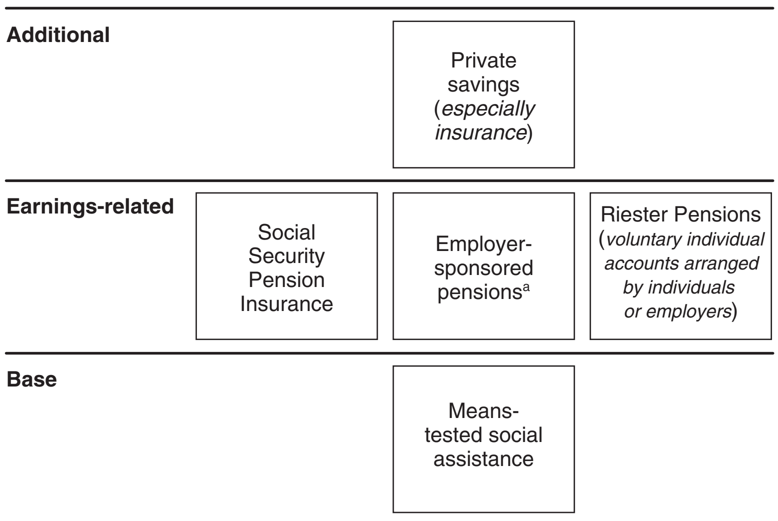
Appendix III: Summary of Germany's Retirement System

Description of Current System

In Germany, retirement income comes from a variety of sources, which can be organized in three levels—base, earnings-related, and additional. (See fig. 5.) At the base level, Germany provides means-tested social assistance benefits, which are not formally part of the social security system.[1] The country's social security system provides pension insurance benefits that are primarily earnings-related. Also, employer-sponsored pensions offer earnings-related benefits but only to a small portion of retirees. A system of voluntary individual accounts, known as "Riester Pensions," has recently been introduced, which will provide earnings-related retirement income and which can be arranged either individually or through employers. Finally, individuals can also set aside additional private savings for retirement on a voluntary basis through a variety of savings vehicles, such as, bank accounts, stocks and bonds, and particularly life insurance contracts.

[1]In Germany, the term "social security" refers to a social insurance program that includes benefits for old-age, disability, survivors, sickness and maternity, work injury, and unemployment. In this appendix, the term "social security" refers specifically to the old-age pension system.

Figure 5: Overview of German Retirement Income Sources



Source: GAO.

Notes: "Base" income sources include flat-rate or means-tested government benefits. "Earnings-related" income sources relate to earnings levels either through DB benefit formulas or DC contribution levels. "Additional" income sources consist of voluntary individual savings that are not directly related to earnings.

[a]Employer-sponsored pensions account for less than 5 percent of total retirement income.

The Base Level: Means-Tested Social Assistance for the Elderly

Germany has a means-tested, social assistance program that provides benefits for those needing assistance towards living expenses. Germany also provides assistance for special circumstances, such as, illness, disability, or old age. Social assistance can come in the form of personal assistance, cash benefit payments, or payments in kind. However, before individuals are eligible to receive social assistance, they must draw upon any personal assets.[2] The amount an individual receives from social assistance is dependent on their need.

In 2003, the government reformed social assistance for the elderly (those over age 65) and the disabled. The reform is designed to encourage elderly individuals to claim the social assistance that they are entitled to. In the past, elderly individuals have not claimed social assistance because

[2]There are some exceptions in drawing upon personal assets to be eligible for social assistance. For example, individuals do not have to draw upon assets consisting of smaller savings deposits or the house in which they are living.

German family law holds relatives liable for social assistance payments.[3] The new reform encourages elderly individuals to claim social assistance by removing the obligation that their relatives pay for it. Specifically, relatives with an annual income of less than $106,154[4] will not be required to pay social assistance. The government believes that this reform will make it easier for elderly individuals to enforce their rightful claims to social assistance, thereby improve their living conditions.

The Earnings-Related Level: National Pension Insurance, Employer-Sponsored Pensions, and Riester Pensions

The earnings-related level of the German retirement system consists of national pension insurance, employer-sponsored pension plans and Riester pensions. Individuals are compelled to participate in the national pension insurance system; however, they can choose whether or not to participate in employer-sponsored pension plans and Riester pensions.

National Pension Insurance

Chancellor Bismarck introduced Germany's first social security system in 1889. Initially, the system was designed to provide disability insurance to a limited segment of the workforce. However, over time the social security system began to provide pension insurance and to increasingly larger segments of the workforce. The current system of pension insurance has been in place since 1957. The objective of the German system is to provide a comfortable retirement income to workers based on the standard of living they achieved during their working years. As a result of this objective, the German pension insurance system, unlike the Social Security system in the United States, incorporates only a few redistributive properties.

In Germany, national pension insurance benefits provide the major source of income for workers in retirement. Most workers, with the exception of self-employed workers, are required to contribute to the social security

[3]The social service office decides whether or not direct relatives will be required to pay social assistance. The office also decides the amount of such payments. Only first-degree relatives (parents and children) or spouses can be held liable for social assistance payments.

[4]In this appendix, all Eurodollars are converted into U.S. dollars using a conversion of .94203 Eurodollars per U.S. dollar. This figure represents the monthly conversion average in January 2003.

system.[5] The German system provides generous benefits that currently replace approximately 69 percent of pre-retirement income for an illustrative worker with average earnings.[6] In the future, the system will replace a slightly lower proportion of a worker's pre-retirement income. By 2030, the government expects social security to replace between 67 and 68 percent of pre-retirement income.[7] Furthermore, workers receive annual increases in their social security benefits based on changes in net wages.

The system is financed from equal contributions paid by employees and employers plus a subsidy from tax funds to cover the gap between the system's income and payments. It is difficult to estimate the exact amount of contributions that finance old age pensions because the German system simultaneously collects contributions to finance disability benefits and some health prevention plans. One expert estimates that approximately two-thirds of the entire contributions collected finance old-age pensions. Due to recent reforms, the government has specified total contribution rates from 2002 to 2030 ranging from 18.3 percent in 2010 to 21.8 percent in 2030.[8]

Within the social security system, workers can choose among several types of old-age pensions: (1) standard old-age pension; (2) long service pensions; (3) old-age pension after unemployment or partial retirement; (4) old-age pension for women; (5) severe disability pension; and (6) miner's long service pension. Benefit eligibility and years of contributions varies among the different types of pensions. However, most workers are eligible for social security benefits at standard retirement age, which is 65 for men and is gradually increasing for women in monthly steps from age

[5]In addition to the self-employed, workers with low earnings and workers in some professions that have their own mandatory retirement system (such as civil servants) are not covered by social security.

[6]These replacement rates apply to an illustrative worker with 45 years of contributions who always earned exactly the average income per worker. Since workers work less than 45 years on average actual replacement rates tend to be lower than those cited here. Thus, these pension benefits are less generous than the replacement rate might suggest.

[7]Assuming participation in voluntary individual accounts, the government expects social security to replace 76 percent of preretirement income in 2030.

[8]Prior to reform, the contribution rate was 19.3 percent in 2000.

60 to age 65 between 2000 and 2004.[9] Workers can choose to delay their retirement beyond the age of 65 and, in return, receive a bonus that increases their pension by 0.5 percent. Conversely, workers can choose to retire before age 65 and receive pensions that are reduced by 0.3 percent for each month of early retirement. The average age of retirement in Germany is about 60.

Employer-Sponsored Pensions

Employer-sponsored pensions account for less than 5 percent of total retirement income among elderly households. While overall employer-sponsored pension coverage is low, it varies significantly from industry to industry. For example, many more employees in the manufacturing industry are covered by employer-sponsored pension plans than employees in the wholesale and retail industries. Approximately 66 percent of employees in the manufacturing industry are covered by an employer-sponsored pension; whereas, only 25 percent of employees are covered in the wholesale and retail industry.

A number of reasons explain the slow development of employer-sponsored pensions in Germany. For example, the ability of the national pension insurance system to provide generous benefits has reduced the need for individuals to have employer-sponsored pensions. Additionally, employers have been offering pension plans at declining rates due to the rise in unemployment, the establishment of specific indexation rules, unfavorable changes in taxation, and complicated legal rules.

Germany has five different types of employer-sponsored pension plans: "direct promises," "support funds," "pension assurance associations," "direct insurances," and "pension funds." Various supervisory authorities and taxation rules regulates each type of plan. Direct promises and support funds have traditionally been organized as defined benefit pension plans. Increasingly, companies in Germany are moving away from these types of plans because of the financial risks, administrative costs, inflated balance sheets, and the lack of comparability of financial ratios between German and foreign companies. The government recently introduced pension funds as a way to promote occupational pensions while helping companies improve both their balance sheets and their standing in international capital markets. This new type of employer-sponsored

[9] For workers with a severe disability pension, the retirement age is increasing from age 60 to age 63 between January 2001 and December 2003. Workers with a miner's long service pension can retire at age 60.

pension provides minimum benefit guarantees and allows for more flexibility of investment.

Recently, a number of reforms to the German social security system were designed to strengthen employer-sponsored pension plans. One such reform legally entitles employees to an employer-sponsored pension by waiving certain parts of their income, such as, holiday pay or overtime to be directly deposited into their employer-sponsored plan. Another reform reduced the general statutory time limits for becoming vested in an employer-sponsored pension from 10 years to 5 years.

Riester Pensions: Voluntary Individual Accounts

In May 2001, the German parliament passed reforms that were designed to make the social security system more financially sustainable and better able to handle demographic challenges. One major part of the reform created special incentives for workers to participate in voluntary individual accounts, known as Riester pensions. [10] Individuals have been able to participate in a Riester pension since January 1, 2002. Individuals can receive the special incentives associated with Riester pensions by participating in either employer-sponsored pension plans or individual pension plans. However, only certain types of employer-sponsored pension plans are eligible to receive the special incentives.[11] Due to recent reforms, collective agreements will play a larger role in establishing employer-sponsored pension plans and such agreements could take advantage of the Riester incentives. Agreements have already been created in the construction industry, the metal industry, the chemical industry, and the civil service. Those participating in Riester pensions on an individual basis may also receive special incentives for a variety of approved individual pension plans, including: private pension insurances, investment funds, and bank deposit plans.

Riester pensions are composed of personal contributions, government subsidies, and tax-free allowances. The government subsidies provide direct payments to individual accounts and are designed to benefit individuals with lower income and families with children.[12] To obtain the

[10]Named for Walter Riester, the Minister of Labor at the time of their adoption.

[11]Employer-sponsored pension plans consisting of pension assurance associations, direct insurances, and pension funds are eligible for the Riester incentives; whereas, the book reserve funds and support funds are not eligible.

[12]The maximum subsidy per child that can be claimed annually is $49 in 2002, $98 in 2004, $146 in 2006, and $196 in 2008.

full government subsidy, individuals must pay a certain proportion of their annual salary that is subject to social security contributions into the Riester pension. Individuals contributing 1 percent as of 2002, 2 percent as of 2004, 3 percent as of 2006, and finally 4 percent as of 2008 of their salaries will receive the respective maximum subsidy. Individuals contributing less than the recommended amount receive correspondingly lower payments from the government. As the contribution rate grows between 2002 and 2008, the government subsidy also becomes larger. For example, the subsidy for single individuals grows from $40 annually in 2002 to $163 in 2008 and the subsidy for married couples grows from $81 in 2002 to $327 in 2008. Instead of receiving the direct payments from the government, individuals can choose to deduct their personal contributions along with the amount of the government subsidy from their income taxes. Tax deductions may only be claimed up to a specified amount that increases between 2002 and 2008.[13] The tax office will automatically check whether individuals will benefit from the tax deduction.

To receive the subsidies and tax relief associated with Riester pensions, individual account plans have to be certified by the Federal Insurance Supervisory Office.[14] This certification verifies that Riester pensions meet certain legal requirements. For example, to receive certification the individual account plan must not allow individuals to withdrawal benefits until they reach age 60 or until they begin to receive pension insurance benefits. Individuals withdrawing money before age 60 must repay the government subsidies and tax relief they received. Furthermore, Riester pensions must provide permanent and guaranteed benefits. Individuals can have benefits paid in the form of a life annuity that provides payments of equal or rising amounts. Additionally, individuals can take a portion of their account as a lump sum or installment payment, provided that the account balance meets certain criteria and provided that account will revert to a life annuity at age 85. Riester pensions must also provide a nominal capital guarantee; that is, individuals are guaranteed total payments that are at least equal to the actual amount they paid into the account, without an adjustment for inflation. In addition to these requirements, Riester pensions are also subject to administrative,

[13]The maximum tax relief that can be claimed annually is $557 in 2002, $1,115 in 2004, $1,672 in 2006, and $2,229 in 2008.

[14]Individual account plans require certification; whereas, certification is not required for employer-sponsored plans receiving the Riester subsidies and tax relief.

documentary, and transparency requirements. For instance, contracting fees must be spread equally over a period of 10 years or more.

The Additional Level: Private Savings

The additional level of the German retirement system consists of various forms of private saving. Many Germans save in bequeathable vehicles, such as, bank accounts, stocks and bonds, and life insurance contracts. Life insurance is particularly popular among Germans with approximately 50 percent of individuals in West Germany and 64 percent of individuals in East Germany covered by life insurance contracts.

Key Design Features of Voluntary Individual Accounts in Germany

Voluntary individual accounts, known as Riester pensions, have been part of the German retirement system since January 2002. Table 6 below describes the key design features of voluntary individual accounts in four areas: (1) the interaction with national pension benefits, (2) the contribution phase, (3) the accumulation phase, and (4) the withdrawal phase.

Table 6: Key Design Features of Voluntary Individual Accounts in Germany

Interaction with national pension benefits (social security)	
Substitute or supplement	Germany has a supplemental system of voluntary individual accounts. Participation in voluntary individual accounts does not affect the benefit an individual receives from the national pension insurance system.
Contribution phase	
Who can participate	Individuals can participate in the voluntary individual accounts if they are covered by the national pension insurance system. Those not covered by the national pension insurance system can participate in a voluntary individual account if they are disabled and working in workshops, insured during creditable child-raising periods, providing care, or are in military or civilian replacement duty.
Opt-in/opt-out ability	Individuals can terminate their voluntary individual account at any time and immediately receive the money they paid into the account. However, the government subsidies must be paid back and individuals will be taxed on the appreciation and returns to the account.
How much individuals can contribute	Currently, individuals can contribute 1 percent of their annual salary that is subject to social security contributions into an individual account. This amount gradually increases to 4 percent in 2008.
Government or employer contributions	The government provides direct payments to individual accounts. These payments are designed to benefit individuals with lower income and families with children The amount of direct payments from the government increases between 2002 and 2008. Instead of receiving the direct payments, individuals can choose to receive tax relief.
Tax advantages	Instead of receiving the direct payments from the government, individuals can choose to deduct their personal contributions along with the amount of the government subsidy from their income taxes. Tax deductions may only be claimed up to a specified amount that increases between 2002 and 2008.
Accumulation phase	
Regulation of investment options	Individuals can choose among various types of individual accounts based on their willingness to take risks. For example, bank savings plans and private pension insurance represent low-risk individual accounts; whereas, investment funds have more risk but may yield higher returns. Although each of these individual account plans must undergo government certification, there is no guarantee as to how much profit an account will make.
Regulation of administrative charges	Individual accounts are subject to administrative requirements. For instance, contracting fees must be spread equally over a period of 10 years or more.
Tax advantages	Individual accounts can accrue capital gains and investment returns tax-free.
Withdrawal phase	
Preretirement loans	Individuals withdrawing money from their individual account before age 60 must repay the government subsidies and tax relief they received.
Withdrawal options—annuity, installment payments, and lump sum distributions	Individuals can have benefits paid in the form of a life annuity that provides payments of equal or rising amounts. Additionally, individuals can take a portion of their account as a lump sum or installment payment, provided that the account balance meets certain criteria and provided that account will revert to a life annuity at age 85.
Rate of return or minimum benefit guarantees	Individual accounts must provide a nominal capital guarantee; that is, individuals are guaranteed total payments that are at least equal to the nominal amount they paid into the account.
Tax advantages	Individual accounts are fully taxable upon withdrawal.

Source: GAO.

Appendix IV: Comments from the Social Security Administration

SOCIAL SECURITY

The Commissioner

March 5, 2003

The Honorable David M. Walker
Comptroller General of the United States
U.S. General Accounting Office
Washington, D.C. 20548

Dear Comptroller General:

Thank you for the opportunity to review and comment on the preliminary draft report "Social Security Reform: Information on Using a Voluntary Approach to Individual Accounts" (GAO-03-309). Social Security is one of the most important and successful government programs. The Trustees of Social Security and many others have said projected benefits as presently financed, are unsustainable over the long term. Potential solutions many observers have suggested include voluntary personal savings accounts. Therefore, your report is very timely.

GAO has done an excellent job covering many of the issues surrounding the creation of voluntary accounts. The report identifies a series of important design issues, some of which have not yet been the subject of much public debate. This delineation of the issues, their interaction, and the foreign experience will provide policy makers and analysts with important information as they consider individual account plans.

If your staff has questions about our comments, they may contact Patricia Vinkenes, Acting Deputy Associate Commissioner for Retirement Policy. Ms. Vinkenes can be reached by phone at (202) 358-6110 or by E-mail at pat.vinkenes@ssa.gov.

Sincerely,

Jo Anne B. Barnhart

Jo Anne B. Barnhart

Enclosure

SOCIAL SECURITY ADMINISTRATION BALTIMORE MD 21235-0001

COMMENTS ON THE GENERAL ACCOUNTING OFFICE (GAO) REPORT "SOCIAL SECURITY REFORM: INFORMATION ON USING A VOLUNTARY APPROACH TO INDIVIDUAL ACCOUNTS" (GAO-03-309)

Administrative Issues. The draft report cites the Federal Thrift Savings Plan and private 401(k) and IRA plans as models for a national voluntary account system, but gives little information on how the TSP has achieved very low costs. Combining the contributions of much of the U.S. workforce into a single, limited-option system of individual accounts could achieve significant economies of scale. For example, the cost of developing a computer system to support individual accounts does not increase in proportion to the number of participants. Limiting the number of account features (such as the availability of loans) would also hold down costs. The use of index funds would keep investment fees to minimal levels.

Benchmarks. Although the draft states at one point that "reductions in benefits and/or increases in revenue will be needed to restore solvency" to Social Security, it generally seems to presume that the baseline benefit is that promised under current law. GAO has previously made clear that proposals that achieve sustainable solvency for Social Security should not be compared to benchmarks that are unsustainable at present tax rates. This report should emphasize that the projected level, at present tax rates, of defined Social Security benefits (including coverage in the event of death or disability) is likely to affect the rate of participation in voluntary individual accounts.

Benefit Offsets. The discussion of substitute accounts should include a more thorough discussion of benefit offsets, including specific examples. The way in which participation in a voluntary individual account could affect a person's total Social Security benefit, and the extent to which people understand the affect, will influence the rate of participation.

Participation Decision. The draft states that most proposals for voluntary individual accounts in the U.S. would not provide for an annual participation decision. In fact, most proposals have not explicitly considered whether participation would be an annual or a one-time decision. More public debate on this topic is needed.

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