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# Challenges the Four Truths of Personal Social Security Accounts: Evidence from the World of 401(K) Plans

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# CHALLENGING THE FOUR “TRUTHS” OF PERSONAL SOCIAL SECURITY ACCOUNTS: EVIDENCE FROM THE WORLD OF 401(K) PLANS

COLLEEN E. MEDILL\*

*This Article discusses the final recommendations of the President's Commission to Strengthen Social Security concerning the proposed creation of a system of personal Social Security accounts. The Article critically evaluates the Commission's findings (the four “Truths”) in light of numerous research studies concerning participant-directed 401(k) plans. The Article claims that Truth #1, the assertion that all workers will be better off in terms of total benefits from the combination of traditional Social Security and personal account benefits, is based on unrealistic assumptions concerning how workers choose to diversify their investments. The 401(k) plan research evidence suggests that, due to their choice of investments, many workers are unlikely to earn the Commission's assumed rate of investment return on personal Social Security accounts. Truth #2, the assertion that a government-sponsored program of investment education will change worker investment behavior and lead to improved investment performance, is contradicted by recent research showing that an investment education program for 401(k) plan participants generally is ineffective in changing investment behavior. The Article claims that Truth #3, the assertion that personal accounts will provide the opportunity for low-income and minority workers to “build wealth,” is misleading for two reasons. First, low-income workers who survive to retirement will be forced to annuitize all of their personal account assets to satisfy the Commission's minimum retirement income standard. Second, the Commission's proposed structure gives rise to adverse selection, the costs of which will fall most heavily on low-income workers. Finally, the Article addresses Truth #4, that personal accounts will be structured so that large sums of money (and its*

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*related power) will not be concentrated in the hands of a few government bureaucrats and money managers. The Article argues that to attain the high rates of worker participation necessary to achieve sustained popular and political support for a personal account system, the system must adopt an enrollment approach patterned after automatic enrollment 401(k) plans. Recent research studies of automatic enrollment 401(k) plans show that automatically enrolled participants have a strong tendency to remain “stuck” in the plan’s default investment fund. The Article claims that workers in a personal account system will do the same, thereby resulting in: (1) political pressure for an investment strategy for the default fund that furthers social policy goals, rather than maximizing investment returns; and (2) a potentially troublesome concentration of assets in the system’s default investment fund.*

INTRODUCTION .....	903
I. THE COMMISSION’S PROPOSALS FOR REFORM .....	910
II. 401(K) PLANS AS A “TEST CASE” FOR PERSONAL SOCIAL SECURITY ACCOUNTS .....	917
A. <i>Perspective: The Traditional Social Security System and 401(k) Plans</i> .....	917
B. <i>Similarities Between Personal Social Security Accounts and 401(k) Plans</i> .....	920
C. <i>Changes from the 401(k) Plan Norm</i> .....	922
1. Permissible Investment Options.....	922
2. Pre-Retirement Access to Account Funds.....	924
3. Forms of Distributions at Retirement .....	925
4. Investment Criteria for Default Fund .....	926
5. Changing Investment Allocations and Options .....	928
III. A CLOSER LOOK AT THE FOUR “TRUTHS” .....	928
A. <i>Truth #1: Workers Will Be Better Off, in Terms of Total Benefits, with Personal Social Security Accounts</i> ....	929
1. The Commission’s Investment Assumptions.....	930
2. The EBRI Study.....	933
3. Government Studies of Mutual Fund Fees.....	937
B. <i>Truth #2: Investment Education Will Significantly Change Investment Behavior and Thereby Improve Investment Returns</i> .....	946
C. <i>Truth #3: Personal Accounts Will Build Wealth Among Low-Income and Minority Workers</i> .....	953
D. <i>Truth #4: Giving Workers Investment Control Will Avoid Large Concentrations of Money (and Related</i>	

*Power) in the Hands of a Few Government Bureaucrats  
and Money Managers .....962*  
1. Political Influence and the Personal Social Security  
Account System .....962  
2. “Voluntary” Personal Social Security Accounts  
and Automatic Enrollment Investment Behavior .....965  
CONCLUSION: WINNERS AND LOSERS.....974

INTRODUCTION

On December 21, 2001, the President’s Commission to Strengthen Social Security released its final report on proposed reforms to the Social Security system (“Commission Report”).<sup>1</sup> The Commission Report proposes three models for reforming the traditional Social Security program through the creation of personal

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1. See PRESIDENT’S COMM’N TO STRENGTHEN SOC. SEC., STRENGTHENING SOCIAL SECURITY AND CREATING PERSONAL WEALTH FOR ALL AMERICANS (Dec. 21, 2001) (Sup. Doc. No. PR43.8:SO1/ST8/FINAL), *available at* <http://purl.access.gpo.gov/GPO/LPS16829> (on file with the North Carolina Law Review) [hereinafter COMMISSION REPORT]. The future financial woes facing America’s Social Security program have been well documented. See *id.* at 64; BD. OF TRUSTEES, FED. OLD AGE AND SURVIVORS INS. AND DISABILITY INS. TRUST FUNDS, THE 2001 ANNUAL REPORT OF THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS INSURANCE AND DISABILITY INSURANCE TRUST FUNDS, H.R. DOC. NO. 107-55, at 8–14 (2001) (Sup. Doc. No. Y1.1/7: 107-55). According to “best estimates” by the board of trustees for the Social Security program, benefit expenditures are expected to exceed payroll tax revenues starting in 2016. See H.R. DOC. NO. 107-55, at 14. Full program benefits would continue to be paid by drawing down assets held in the Social Security trust funds until 2038. See *id.* At that point, the trust funds would be depleted, and tax revenues would provide only seventy-three percent of program benefits. See *id.*

Of these two dates (2016 and 2038), it is the 2016 date that is significant for purposes of the federal budget. Writing separately, the two independent trustees of the Social Security and Medicare programs described the significance as follows:

[R]ather than providing net revenue to the Treasury, after 2016 the combined trust funds will require rapidly growing infusions of revenues from the Treasury to pay benefits projected under current law. It is at this point—and not at the later dates when trust fund assets (i.e., the securities being redeemed) are technically exhausted—that Social Security and Medicare will begin to be in direct competition with other Federal programs for the resources of the Treasury, requiring either growing tax increases or debt financing (or some combination of the two) to pay the benefits promised under current law and provide for the continuation of other Federal expenditures.

SOC. SEC. & MEDICARE BDS. OF TRUSTEES, STATUS OF THE SOCIAL SECURITY AND MEDICARE PROGRAMS, A SUMMARY OF THE 2001 ANNUAL REPORTS 13–14; see also COMMISSION REPORT, *supra*, at 68 (describing positive annual system cash flow as a “useful metric”). For a straightforward explanation of the nature of the Social Security trust fund, see MICHAEL TANNER, NO SECOND BEST, THE UNAPPETIZING ALTERNATIVES TO SOCIAL SECURITY PRIVATIZATION 6 (CATO Project on Social Security Privatization, No. 24, 2002), *at* <http://www.cato.org/pubs/ssps/ssp24.pdf> (on file with the North Carolina Law Review).

Social Security accounts.<sup>2</sup> Under each model, workers would deposit a portion of their Social Security payroll tax contributions in personal accounts and have the ability to direct the investment of assets held in their personal accounts.<sup>3</sup> A portion of the workers' traditional Social Security benefit, paid in the future at retirement, would be reduced. This "offset amount" is calculated based on an assumed rate of investment earnings for the account.<sup>4</sup> The Commission Report describes this offset method common to each of the three reform models as follows:

[E]very dollar invested in a personal account reduces the cost of future Social Security payments by one dollar, plus the offset rate of interest that is proposed for each plan (ranging from 2 percent to 3.5 percent after inflation). Total expected benefits to the worker are increased by the compounded difference between the offset rate of interest for the Reform Model and the expected rate of return earned by the personal account. So long as the personal account earns a return higher than the offset rate, both Social Security and the individual come out ahead.<sup>5</sup>

The Commission Report also suggests a complex administrative structure for regulating personal Social Security accounts.<sup>6</sup> This proposed administrative structure, which the Commission recommends for all three proposed reform models, essentially is paternalistic in nature. It is designed primarily to ensure that the balance in the worker's personal account will be sufficient to replace the dollar reduction in the worker's traditional Social Security benefits paid at retirement.<sup>7</sup>

The literature to date on proposals to "privatize" Social Security through the creation of personal accounts has emphasized either the normative implications of structural change<sup>8</sup> or the impact of reform

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2. See discussion *infra* Part I.

3. See discussion *infra* Part I.

4. See discussion *infra* Part I.

5. COMMISSION REPORT, *supra* note 1, at 74.

6. See discussion *infra* Part I.

7. See discussion *infra* Part I.

8. See generally Dorothy A. Brown et al., *Social Security Reform: Risks, Returns, and Race*, 9 CORNELL J.L. & PUB. POL'Y 633 (2000) (arguing that racial equity should be given serious consideration when debating Social Security reform); Karen C. Burke & Grayson M.P. McCouch, *The Impact of Social Security Reform on Women's Economic Security*, 16 N.Y.L. SCH. J. HUM. RTS. 375 (1999) (discussing the impact an incremental reform of Social Security would have on women in their roles as workers, wives and widows); Patricia E. Dilley, *Taking Public Rights Private: The Rhetoric and Reality of Social Security Privatization*, 41 B.C. L. REV. 975, 983 (2000) (arguing that Social Security privatization is a political and ideological debate about "public versus private rights and

on the long-term finances of the Social Security program.<sup>9</sup> This Article focuses on the four “truths”<sup>10</sup> of personal Social Security

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income rights versus wealth accumulation”); Jonathan Barry Forman, *Making Social Security Work for Women and Men*, 16 N.Y.L. SCH. J. HUM. RTS. 359 (1999) (proposing that Social Security reform must focus on improving the distribution of benefits among women and men equally); Jonathan Barry Forman, *Whose Pension Is It Anyway? Protecting Spousal Rights in a Privatized Social Security System*, 76 N.C. L. REV. 1653 (1998) (proposing that under a privatized Social Security system, spousal protections should be required benefits); Maria O’Brien Hylton, *Evaluating the Case for Social Security Reform: Elderly Poverty, Paternalism and Private Pensions*, 64 BROOK. L. REV. 749 (1998) (evaluating different proposals for privatization as they relate to reducing poverty in the elderly, distributing income for low-income workers, and avoiding elderly dependency and destitution); Kathryn L. Moore, *Partial Privatization of Social Security: Assessing Its Effects On Women, Minorities, and Lower-Income Workers*, 65 MO. L. REV. 341 (2000) [hereinafter Moore, *Partial Privatization*] (explaining why partial privatization of Social Security would have an adverse effect on women, minorities and low-income workers because of their increased potential poverty in old age); Kathryn L. Moore, *Privatization of Social Security: Misguided Reform*, 71 TEMP. L. REV. 131 (1998) (arguing against privatization because of the investment risks, problems in conversion from the old system to the new, the paternalistic nature of the proposed system, and its misconception of the role of national social security) [hereinafter Moore, *Misguided Reform*]; Sen. Don Nickles, *Retiring In America: Why the United States Needs a New Kind of Social Security for the New Millennium*, 36 HARV. J. ON LEGIS. 77 (1999) (supporting total reform of Social Security in order to implement a new system through the use of private markets); Lorraine A. Schmall, *Transnational Issues of Women and Pension Security and Reform*, 14 N.Y. INT’L L. REV. 87 (2001) (discussing the effects of pension reform efforts in several nations on elderly women); Alvin Williams, *Reforming Our Ailing Social Security System: The State of the Current System and Its Impact on African Americans*, 8 ELDER L.J. 221 (2000) (proposing that Social Security reform would correct the current system’s adverse effects on African-Americans in particular and Americans in general).

9. Prior to the release of the final Commission Report, critics objected that proponents of privatization had not clearly explained to the general public how reforms would improve the long-term financial status of the Social Security program. See Jonathan Chait, *Bold Over*, NEW REPUBLIC, May 29, 2000, at 22; Jonathan Cohn, *Dr. Feelgood*, NEW REPUBLIC, June 19, 2000, at 25–27; Henry Aaron et al., *Social Security Reform: The Questions Raised by the Plans Endorsed by President Bush’s Social Security Commission* (Dec. 3, 2001), at <http://www.cbpp.org/11-30-01socsec.htm> (on file with the North Carolina Law Review). The Commission Report addresses this criticism by acknowledging that certain “investments” (i.e., transition costs) would accompany a move to a personal account system. See COMMISSION REPORT, *supra* note 1, at 72. These transition costs are additional costs to workers during the decades when the plan was being phased in. These costs would be incurred because workers would have to pay for two retirement systems at the same time, both the system that is making payments to current beneficiaries, and the new individual account system that would pay for some or all of their own retirement.

SOC. SEC. ADVISORY BD., SOCIAL SECURITY: WHY ACTION SHOULD BE TAKEN SOON 19 (rev. ed. July 2001) (Sup. Doc. No. Y3/2:AD9/S0 1/2001). Although the Commission Report does address these financing issues in more detail, none of the three proposed reform models is projected to return the Social Security system to positive annual cash flow surpluses before the year 2059. See COMMISSION REPORT, *supra* note 1, at 113–14 (Model 1), 124–25 (Model 2), and 135–37 (Model 3). Positive cash flow surpluses are an important political criterion because it is at this fiscal point that the Social Security

accounts. These “truths” consist of the following findings made by the Commission in support of personal Social Security accounts:

1. Workers will be better off, in terms of total benefits, with personal Social Security accounts.<sup>11</sup>
2. Investment education will change investment behavior and improve investment performance. As a macroeconomic bonus, it will encourage more savings and investment among the public generally.<sup>12</sup>
3. Personal accounts will allow low income and minority workers to “build wealth.”<sup>13</sup>
4. Giving workers investment control will avoid large concentrations of money (and its related power) in the hands of a few government bureaucrats and money managers.<sup>14</sup>

Before relying on these assertions as the basis for fundamental change in the traditional Social Security program, it seems only prudent that lawmakers should consider the substantial body of contradictory evidence from another analogous system—the system of employer-sponsored 401(k) retirement plans.<sup>15</sup>

This Article examines in detail the emerging body of research concerning 401(k) plans.<sup>16</sup> The Article claims that this research

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program finances, rather than competes with, other federal programs for budgetary resources. *See* discussion *supra* note 1.

10. I have chosen to refer to the subject of this Article, the Commission’s “findings” in support of personal Social Security accounts as “truths” because in writing its report the Commission appears to have accepted what amount to mere assertions as indisputable and uncontroverted statements of fact.

11. *See* COMMISSION REPORT, *supra* note 1, at 30–35.

12. *See id.* at 49.

13. *See id.* at 32–33.

14. *See id.* at 38–39.

15. Indeed, the Commission Report itself recommends that at least a one-year period of public debate occur before any type of reform is enacted by Congress. *See id.* at 65.

16. The 401(k) plan was made possible by the Revenue Act of 1978. *See* Colleen E. Medill, *The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality*, 49 EMORY L.J. 1, 7 & nn.25–26 (2000) [hereinafter Medill, *Individual Responsibility Model*]. During the 1990s, the 401(k) plan emerged as a highly popular form of employer-sponsored retirement plans, in large part because participants are able to direct the investment of their 401(k) plan accounts. *See id.* at 7–11 & n.24. The national experience with 401(k) plans today is widespread and significant. *See* Medill, *Individual Responsibility Model*, *supra*, at 7–9; Colleen E. Medill, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J.L. REFORM 469, 475–79 (2001) [hereinafter Medill, *Stock Market Volatility*]. Experts estimate that 401(k) plans held approximately \$1,766 billion in assets as of the end of 2000. *See* EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 239, 401(K) PLAN ASSET ALLOCATION, ACCOUNT BALANCES, AND LOAN ACTIVITY IN 2000 6 & n.12 (2001) [hereinafter 2000 ASSET ALLOCATION STUDY]. Over 42 million

contradicts each of the four “truths” commonly cited by proponents of personal Social Security accounts, suggesting that these “truths” may, in fact, be mere political myths.

The Article begins with a detailed description of the Commission’s three proposed models for personal Social Security accounts and the general administrative structure common to all three models. Part II of the Article compares the Commission’s proposed administrative structure for personal accounts with the structure of 401(k) plans and notes those areas where the Commission’s proposed structure differs from the norm in 401(k) plans. These structural changes from the 401(k) plan norm are designed to address the perceived weaknesses of 401(k) plans in providing for retirement income security. As the discussion in Part II makes clear, however, the characteristics of personal Social Security accounts are fundamentally unchanged from the norm in 401(k) plans.<sup>17</sup> Participation in the personal account system is voluntary. Workers may direct the investment of the assets held in their personal accounts. At retirement, the balance in the worker’s personal account will determine the level of retirement benefits. These fundamental similarities, and research evidence from the 401(k) plan experience, are explored in Part III, the main body of the Article.

Part III is arranged according to the four “truths” propounded by the Commission in support of personal Social Security accounts. The first section of Part III examines the Commission’s assumptions concerning investment allocation decisions by workers in their personal accounts. These assumptions underlie Truth #1, the assertion that workers will be better off in terms of total benefits from the combination of traditional Social Security and personal benefits. This first section of Part III contrasts the Commission’s assumptions with the evidence from studies of investment behavior by participants in 401(k) plans. These studies strongly indicate that the Commission’s assumptions concerning how workers will allocate the investment of their personal accounts, and consequently how well these investments will perform, are unrealistic. The problem of poor

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workers today participate in 401(k) plans. *See id.* at 6. Importantly, for a growing number of workers, a 401(k) plan is their *only* employer-sponsored retirement plan. *See* PENSION & WELFARE BENEFITS ADMIN., U.S. DEP’T OF LABOR, PRIVATE PENSION PLAN BULLETIN, ABSTRACT OF 1998 FORM 5500 ANNUAL REPORTS, tbls.D4–D5 (2002) [hereinafter PRIVATE PENSION PLAN BULLETIN]. For these workers in particular, a privatized Social Security program could mean that they will be exposing a greater portion of their retirement nest egg to the potential volatility of the stock market.

17. *See* discussion *infra* Part II.B.



investment allocation decisions leading to poor earnings performance is magnified by the potential for mutual fund fees to further reduce the worker's account balance at retirement. The first section of Part III concludes by examining several recent studies of mutual fund fees by the Department of Labor, the General Accounting Office, and the Securities and Exchange Commission. These studies call into question the Commission's proposed approach to regulation of the mutual fund fees that will be deducted from workers' personal accounts. The Commission's approach appears to rely naively on the current system of fee disclosure under federal securities law, despite the growing body of evidence that such disclosure has failed adequately to inform unsophisticated investors of the adverse impact of fees on long term investment returns.

The second section of Part III examines recent studies of the impact of investment education on the investment behavior of 401(k) plan participants. These studies predict that a program of investment education aimed at workers who invest in personal accounts will have little influence on their investment behavior. As an alternative to investment education, workers who invest in personal accounts could receive investment advice instead. The recent trend in the 401(k) plan setting is to deliver personalized investment advice to large numbers of 401(k) participants through computerized investment advice programs. This second section of Part III concludes by noting that the Commission's proposed structure for personal accounts appears to ignore this recent trend and prohibits the use of such computerized models. This oversight is unfortunate, because the computerized investment advice program is an efficient vehicle for delivering personalized investment advice to the 401(k) plan masses. It is well-suited to do the same for workers who invest in personal Social Security accounts.

The third section of Part III examines the assertion that personal Social Security accounts will allow low-income and minority workers to "build wealth." This section argues that the wealth-building argument in support of personal accounts is overstated for two reasons. First, the Commission's proposed rules for the form of distributions from personal accounts will require low-income workers who survive to retirement to annuitize most, if not all, of the balance in their personal accounts. Second, the Commission's proposed distribution rules create an adverse selection problem, thereby raising the costs for workers who choose the traditional annuity distribution option. This section argues that the increased costs of adverse selection will fall most heavily on low-income workers, because this is

the group who, due to a lack of other financial resources, can least afford to bear the risks of longevity themselves by electing to “self-annuitize” their personal account benefits. In short, it is only by dying prior to retirement that the estates of low-income workers are likely to realize any “wealth building” effect from personal accounts. Many of those who survive to retirement may very well be worse off.

Finally, the fourth section of Part III examines the assertion that worker-controlled personal accounts will avoid the potential mischief associated with concentrating large sums of money, and its related power, in the hands of a few government bureaucrats and money managers. This section begins with a discussion of the Commission’s attempt to insulate its proposed regulatory structure for personal accounts from political influence. Two areas of political risk are identified. First, there is the risk that the political influence of elected government officials may taint the decision of government regulators and result in pressure for government-selected investment managers to engage in social investing. Second, there is the risk that political pressure from constituents may persuade Congress to override the protective features of the Commission’s recommendations and allow workers greater access to and control over their personal account funds, both prior to and during retirement. Next, the Article examines the Commission’s underlying premise that personal Social Security accounts will be “voluntary.” There are two distinct types of “voluntary” 401(k) plans today: the traditional 401(k) plan, where the participant must affirmatively elect to enroll in the plan; and the “automatic enrollment” 401(k) plan, where each eligible employee is automatically enrolled in the 401(k) plan, but may affirmatively elect not to participate. Significantly, the Commission does not describe which type of “voluntary” enrollment system will be utilized for personal Social Security accounts. The last section of Part III argues that to obtain the high levels of participation necessary to sustain popular and political support for a personal account system over the long term, personal accounts must use an automatic enrollment system. Recent studies of participant behavior in automatic enrollment 401(k) plans predict that, contrary to Truth #4, under an automatic enrollment structure many workers will remain invested in the “default” investment option for personal Social Security accounts. Under the Commission’s proposed administrative structure, a few money managers for this default investment option will be selected by a few governmental officials charged with overseeing the administration of a personal account system. Although the Commission stresses the need to insulate these governmental officials

from political influence, the selected money managers for the default investment option are likely to wield control over vast sums and are likely to face significant political pressure to invest these sums to achieve political and social objectives, rather than to maximize earnings performance. The likely result is a rate of investment return that underperforms the market, and thereby fails to meet worker expectations.

### I. THE COMMISSION'S PROPOSALS FOR REFORM

The Commission Report offers three models for reform of Social Security through the use of personal accounts.<sup>18</sup> The Commission Report also suggests a single administrative structure common to all three reform models.<sup>19</sup>

Under Model 1, workers may elect to have 2% of their payroll taxes paid to their personal accounts.<sup>20</sup> Model 2 assumes that workers may elect to contribute 4% of their payroll taxes to personal accounts, up to a maximum contribution of \$1,000 annually.<sup>21</sup> Neither Model 1 nor Model 2 would involve an increase in the level of Social Security payroll taxes paid by the worker, but would merely reallocate the placement of those dollars from the U.S. Treasury to the worker's personal Social Security account.<sup>22</sup> Model 3 differs in this respect from Models 1 and 2. Under Model 3, workers would choose to contribute an additional 1% of their Social Security payroll base to their private accounts.<sup>23</sup> The federal government would provide a matching contribution to the workers' personal accounts of 2.5%, up to a maximum matching contribution of \$1,000 annually.<sup>24</sup>

Each model makes different assumptions concerning the rate of investment return that will be used to calculate future reductions in the amount of the worker's traditional Social Security benefits.<sup>25</sup>

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18. See COMMISSION REPORT, *supra* note 1, 79–89.

19. See *id.* at 44–45.

20. *Id.* at 82.

21. *Id.* at 83. This \$1,000 contribution cap would be indexed annually for wage growth. *Id.*

22. See *id.* at 82–83.

23. *Id.* at 84. The Commission Report suggests that this additional one percent contribution be subsidized through a refundable tax credit. See *id.* at 131.

24. *Id.* at 84.

25. Each reform model also makes different assumptions concerning whether changes to the formulas that determine the level of traditional Social Security benefits will be made. Model 1 makes no changes to the traditional benefit formula. See *id.* at 14. Model 2 slows the rate of future increases in traditional Social Security benefits by tying these increases to the lower price inflation index instead of the higher wage growth index used today. See *id.* at 120. This proposed index change has been criticized as a significant

Notably, these assumed rates of investment return used to determine the reduction in future traditional benefits ("offset rates") are expressed in real terms, i.e., they already have been adjusted (reduced) for inflation.<sup>26</sup> The offset rates for Models 1, 2 and 3 are 3.5%,<sup>27</sup> 2%,<sup>28</sup> and 2.5%,<sup>29</sup> respectively.

The Commission's proposed administrative structure for personal Social Security accounts is complex.<sup>30</sup> An independent governing board (the "Board"), modeled after the boards of directors of the Thrift Savings Plan for federal employees and the Federal Reserve Board, would be established to oversee the administration and regulation of personal Social Security accounts.<sup>31</sup> Personal Social Security accounts would be administered under two systems known as tiers.<sup>32</sup> Initially, personal Social Security accounts would operate

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reduction in benefits. *See* discussion *infra* note 297. Model 2 also increases the minimum traditional benefit and spousal benefit. *See* COMMISSION REPORT, *supra* note 1, at 120. Model 3 would reduce future increases in traditional benefits by using an index that is midway between the wage growth and price inflation indices. *See id.* at 132. As in Model 2, the minimum traditional benefit and spousal benefits would be increased. *See id.* In addition, the early retirement traditional benefit would be reduced, and the late retirement traditional benefit would be increased. *See id.*

26. *See* COMMISSION REPORT, *supra* note 1, at 74.

27. *Id.* at 82.

28. *Id.* at 83.

29. *Id.* at 84.

30. *See id.* at 44-45.

31. *See id.* at 60. Although the selection methods for board members of the Thrift Savings Plan and the Federal Reserve differ, each method is designed to insulate the board members from outside political pressures. *See id.*

The governing board for the Thrift Savings Plan consists of five part-time members. The chairman of the Thrift Savings Plan board is appointed by the President to serve a four year term. The remaining four board members are chosen in consultation with the House of Representatives and the Senate. Two of these members are appointed to three-year terms. The remaining two board members are appointed to two-year terms. The five members of the board select a full-time executive director, who serves as the chief executive officer for the Thrift Savings Plan. Funding for the Thrift Savings Plan board is independent of the President and Congress. *See id.*

The governing board for the Federal Reserve consists of seven members. The board members are appointed by the President and confirmed by the Senate. Federal Reserve board members are appointed to fourteen-year terms. These terms are staggered so that the opportunity for the President to appoint a new board members arises only once every two years. Like the Thrift Savings Plan, the funding for the board of the Federal Reserve is independent of Congress. *See id.*

32. *See id.* at 46. The Commission selected this two-tiered approach because in the Commission's view it offered the best balance between the short-term need to keep administrative costs low, particularly for small account balances, and the longer-term benefits of marketplace competition, which operates to provide workers with a variety of investment choices and higher quality service. *See id.* at 44-46.

under a centralized federal government administrator ("Tier I").<sup>33</sup> Employers would continue to report and forward worker contributions for personal accounts to the federal government in the same manner that employers report and forward Social Security payroll taxes today under the traditional Social Security system.<sup>34</sup> Until a worker's account balance reached a minimum threshold amount (the Commission suggests setting this "threshold amount" at \$5,000),<sup>35</sup> the account would be subject to Tier I central administration.<sup>36</sup> The Commission recommends a total of nine mutual funds as investment options for Tier I accounts.<sup>37</sup> The proposed mutual funds are three balanced funds,<sup>38</sup> five index funds patterned

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33. *See id.* at 46. The Tier I structure is modeled after the Thrift Savings Plan for federal employees. *See id.*

34. *See id.* at 47. The Commission Report did not propose to change the current system of payroll tax reporting and payment by employers in order to avoid increasing employer compliance costs for personal Social Security accounts. *See id.* Under the current system, the Commission estimated that it would take approximately fifteen months, on the average, before worker contributions would be credited to their personal accounts. *See id.* This delay occurs because although employers forward payroll taxes for their employees to the federal government throughout the year, albeit on varying schedules, they are not required to identify the individual employees until the end of the year. *Id.* at 47 nn.21 & 24. In addition, many smaller employers file payroll tax returns on paper (which are then processed by the federal government by hand) rather than electronically. *Id.* at 47. To avoid lost investment earnings during this period when payroll tax contributions are reconciled with and credited to individual employees, the Commission recommended that worker contributions be pooled and invested in government bonds, with earnings credited to each personal account once the contributions are credited and distributed to each worker's personal account. *See id.* The Commission Report does not address the issue of employer theft of worker contributions to personal accounts, which has proven problematic in the context of 401(k) plans. *See, e.g.,* Press Release, Pension & Welfare Benefits Admin., U.S. Dep't of Labor, Labor Department Sues Minnesota Printing Company to Recover Employee Contributions for 401(k) Plan (July 29, 2002), at <http://www.dol.gov/ebsa/newsroom/pr072902.html> (on file with the North Carolina Law Review) (announcing the filing of a lawsuit against Advanced Duplicating & Printing, Inc. for \$50,098.69 in employee contributions not forwarded to their 401(k) plan); Press Release, Pension & Welfare Benefits Admin., U.S. Dep't of Labor, Labor Department Sues Computer American Training Centers' 401(k) Trustee (June 7, 2002), at <http://www.dol.gov/ebsa/newsroom/pr060702.html> (on file with the North Carolina Law Review) (announcing the filing of a lawsuit against the trustee of the 401(k) plan for Computer American Training Centers, Inc. for failing to forward \$24,011.69 in employee contributions to the plan); *see also* Press Release, Pension & Welfare Benefits Admin., U.S. Dep't of Labor, Labor Department Recovers \$22 Million for 401(k) Plans and Begins Hotline for Workers (Mar. 31, 1997), at <http://www.dol.gov/opa/media/press/ebsa/archive/pwb97113.htm> (on file with the North Carolina Law Review) (noting the success of a Clinton Administration program designed to reduce misuse of 401(k) contributions).

35. COMMISSION REPORT, *supra* note 1, at 46.

36. *Id.*

37. *See id.* at 51.

after the five funds offered in the Thrift Savings Plan,<sup>39</sup> and one inflation-protected bond fund.<sup>40</sup> To reduce the fees associated with these mutual funds to a minimum,<sup>41</sup> the Commission proposes that the management services for each fund be auctioned off to competing private sector mutual fund companies.<sup>42</sup> Finally, the Commission recommends that a “standard” default fund be designated for those workers who elect to contribute to a personal Social Security account, but who fail to direct how their account assets should be invested.<sup>43</sup> The Commission does not offer a specific recommendation for this standard fund, but rather suggests broad guidelines.<sup>44</sup>

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38. These three indexed balanced funds would each consist of different proportions of corporate stocks, corporate bonds, and government bonds to reflect three distinct points (conservative, medium, and growth) along the investment risk-reward continuum. *See id.* at 51.

39. The five index funds offered by Thrift Savings Plan for federal employees are: the G fund, which specializes in short-term U.S. Treasury securities; the F fund, which is a bond index fund; the C fund, which holds large company stocks and tracks the Standard & Poor’s 500 Index; the S fund, which holds medium and small company stocks and tracks the performance of the Wilshire 4500 stock index; and the I Fund, which is invested in the stock of major corporations located in Australia, Europe and the Far East. *See id.* at 51 & n.28.

40. *See id.* at 51.

41. The significance of mutual fund fees for personal Social Security accounts is discussed in detail in Part III.A.3 of this Article.

42. COMMISSION REPORT, *supra* note 1, at 51.

43. *Id.* at 52. Because the worker must affirmatively act to move an account out of Tier I and into Tier II, accounts where no fund has been affirmatively selected by the worker will remain in Tier I, irrespective of the size of the account balance. *Id.*

44. The Commission Report states:

For those individuals who fail to choose a Tier-I fund, their contributions must be invested into a standard fund on their behalf. Empirical evidence suggests that many participants in private-sector 401(k) plans also base their investment decisions on the design of the standard fund. It is likely, therefore, that many participants will look to the standard fund as a benchmark for their own investment decisions in a Social Security system augmented with personal accounts. The standard fund, therefore, must be chosen appropriately. If the standard fund, for example, is too conservative by holding mostly bonds, then some participants will not be able to enjoy the higher expected returns from a fund with more stocks. At the same time, the standard fund must be appropriate for the participant’s age, as younger people should invest relatively more in stocks. The growth balanced fund discussed earlier, therefore, would be an appropriate standard fund for young workers; the medium fund for middle-age workers; the conservative fund for older workers. *However, the standard fund must also be consistent with any promises that are made with respect to personal accounts. If the government, for example, promises that the personal accounts will produce a minimum return or benefit, provided that the personal account is invested in a particular balanced fund, then that fund should be the standard.*

*Id.* at 52 (footnote omitted) (emphasis added).

Once the worker's account balance meets the designated threshold amount, the worker may elect to invest her account in mutual funds operated by the private sector ("Tier II").<sup>45</sup> These private sector mutual funds must "satisfy stringent rules as determined by the Governing Board."<sup>46</sup> The Commission suggests as criteria that "[t]he funds must be very diversified and reflect the performance of many companies spanning all major commercial sectors. Moreover, the share of the fund invested in each corporation cannot exceed strict limits as established by the Governing Board."<sup>47</sup> These criteria indicate that direct investments by workers in the stocks of individual companies, or investments in relatively narrow industrial sector funds, such as the high tech or health care industries, would not be permitted. For both Tier I and Tier II accounts, the Commission recommends that workers be allowed to change the allocation of their investments only once a year, but that account balance information be immediately accessible.<sup>48</sup>

The Commission Report also addresses the difficult issue of mutual fund fees and expenses.<sup>49</sup> The funds used as investment options for Tier I and approved by the Board as investment options for Tier II accounts must be "no-load" mutual funds.<sup>50</sup> Each fund will be allowed to charge a single annual fee that must be clearly stated as a percentage of assets.<sup>51</sup> The Board will not regulate the maximum amount of this annual fee, but apparently will consider fees when selecting fund vendors.<sup>52</sup> Consistent with this policy of avoiding direct Board regulation of mutual fund fees, the Commission recommends that the threshold amount for an account to be invested in private sector Tier II funds should be high enough that "it would be feasible

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45. *Id.* at 46. For a discussion of the Commission's reasons for proposing a two-tiered system, see *supra* note 32.

46. COMMISSION REPORT, *supra* note 1, at 46; see also *id.* at 53 (explaining that participants can invest threshold balances and subsequent contributions in the private sector).

47. *Id.* at 46.

48. *Id.* at 48.

49. See discussion *infra* Part III.A.3.

50. See COMMISSION REPORT, *supra* note 1, at 46.

51. See *id.* Under current federal securities laws, mutual fund fees are disclosed as a percentage of fund assets ("expense ratios") in the fund's prospectus, but are broken out into separate categories. See U.S. SEC. & EXCH. COMM'N, REPORT ON MUTUAL FUND FEES AND EXPENSES §§ II.A.2, III.B.2 (Dec. 2000), at <http://www.sec.gov/news/studies/feestudy.htm> (on file with the North Carolina Law Review) [hereinafter SEC FEE STUDY].

52. See COMMISSION REPORT, *supra* note 1, at 46.

for such accounts to be charged low transaction costs without the need for price caps.”<sup>53</sup>

The Commission recommends a hybrid set of distribution rules upon retirement. First, the worker must have a minimum level of income generated by the combination of traditional Social Security benefits and benefits from the worker’s personal account sufficient to keep the worker (and, if the worker is married, the worker’s spouse) “safely above the poverty line during retirement.”<sup>54</sup> The worker has two methods for satisfying this requirement. The worker may purchase a traditional annuity from a Board-approved vendor using the funds in her personal account. The traditional annuity must generate the level of annual income necessary to supplement her traditional Social Security benefits and bring the worker’s total benefits up to the Board’s minimum retirement income standard.<sup>55</sup> Alternatively, the worker may effectively “self-annuitize” her personal account by leaving a Board-determined amount in the account and gradually withdrawing these funds during retirement pursuant to a schedule determined by the Board.<sup>56</sup> Any funds remaining in the worker’s account after this minimum retirement income standard is satisfied may be withdrawn as a lump sum, or left in the account and bequeathed at the worker’s death.<sup>57</sup> If the worker is married, she must use the funds held in her account to purchase a two-thirds joint and survivor annuity for the benefit of herself and her spouse.<sup>58</sup> The annual income generated by this joint and survivor annuity must be sufficient to keep both spouses safely above the poverty line during retirement.<sup>59</sup> Workers are not allowed to access the funds held in their accounts prior to retirement, even in instances of hardship such as disability.<sup>60</sup> If the worker dies before attaining

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53. *Id.*

54. *Id.* at 56. This requirement applies regardless of the worker’s other financial resources. *See id.*

55. *Id.* The Board would be responsible for making different types of annuities available for purchase, presumably through contracts with outside vendors. *See id.*

56. *See id.* Retired workers would not be required, however, to make withdrawals from their personal accounts. *See id.*

57. *Id.*

58. *Id.* at 59. This two-thirds joint and survivor annuity distribution requirement mimics the current standard for traditional Social Security benefits paid to a surviving spouse who does not independently qualify for Social Security benefits. *See id.* The Commission Report indicates that spouses may agree to waive the two-thirds annuity distribution rule if they both independently qualify for Social Security benefits and can each purchase a qualifying single life annuity. *See id.*

59. *Id.* at 56.

60. *Id.* at 55. Disabled workers will, however, still qualify for traditional Social Security disability benefits. *See infra* notes 296–307, 326 and accompanying text.



Social Security retirement age, the balance in the worker's account can be bequeathed to the worker's heirs.<sup>61</sup>

Under a system of personal Social Security accounts, many workers will need financial information and education.<sup>62</sup> The Commission proposes that at the Tier I level, the Board will be primarily responsible for providing "informative" advice to workers.<sup>63</sup> The Commission's choice of the term "informative" advice appears to be an attempt to avoid the fiduciary connotations traditionally associated under federal retirement laws with a party who offers investment advice.<sup>64</sup> Other government agencies, such as the Securities and Exchange Commission, or non-profit organizations may assist the Board in this task.<sup>65</sup> At the Tier I level, with its limited universe of investment options, this approach ensures uniformity in the quality of informative advice provided to workers.<sup>66</sup> Although the Commission Report does not address expressly who will provide investment information once a worker transitions to Tier II,<sup>67</sup> this information would have to come (at least in part) from the private sector mutual funds themselves.

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61. COMMISSION REPORT, *supra* note 1, at 55.

62. See, e.g., EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 236, INDIVIDUAL SOCIAL SECURITY ACCOUNTS: ADMINISTRATIVE ISSUES 34-36 (2001) (describing the general lack of understanding exhibited by many Americans and asserting that the more freedom participants are given in managing their personal accounts, the more ongoing education they will need) [hereinafter ADMINISTRATIVE ISSUES STUDY]; David I. Laibson et al., *Self-Control and Saving for Retirement*, BROOKINGS PAPERS ON ECON. ACTIVITY, 1998, at 91, 92 nn.3-4 (using a hyperbolic model to examine under-saving in the United States); Medill, *Individual Responsibility Model*, *supra* note 16, at 14-17 (reviewing studies of retirement investment knowledge among the public); Carolyn Hirschman, *Growing Pains*, HR MAGAZINE, June 2002, at 31 (discussing human resource departments' roles in informing employees about 401(k)s); Mike McCarthy & Liz McWhirter, *Are Employees Missing the Picture?*, BENEFITS Q., First Quarter 2000, at 25-31, 2001 WL 1593640 (noting that despite efforts to educate employees, as many as fifty-seven percent choose to take cash payments from their 401(k)s when changing jobs, rather than rolling their balance into their new employer's plan); see also K.C. Swanson, *Nebraska Sees Red Over Its 401(k) Plan* (May 7, 2002), at [http://www.thestreet.com/\\_tscs/funds/belowradar/10021041.html](http://www.thestreet.com/_tscs/funds/belowradar/10021041.html) (on file with the North Carolina Law Review) (reporting on the abandonment of Nebraska's retirement plan due to employee lack of knowledge and interest).

63. COMMISSION REPORT, *supra* note 1, at 46; see also *id.* at 49 (noting that having investor information provided by the Board will reduce compliance costs for employers, improve investor confidence in the objectivity of the information, and ensure the same quality of investment information across employers).

64. See generally Medill, *Individual Responsibility Model*, *supra* note 16, at 27-30 (reviewing fiduciary duties in the context of ERISA).

65. See COMMISSION REPORT, *supra* note 1, at 49.

66. See *id.*

67. See *id.* at 46, 49.

## II. 401(K) PLANS AS A “TEST CASE” FOR PERSONAL SOCIAL SECURITY ACCOUNTS

### A. *Perspective: The Traditional Social Security System and 401(k) Plans*

Federal retirement policy historically has been based on what is commonly known as the “three-legged stool”: (1) the traditional Social Security system; (2) retirement plans voluntarily sponsored by private employers; and (3) personal savings.<sup>68</sup> Within the private retirement plan system, the 401(k) plan now dominates.<sup>69</sup> These three tranches of federal retirement policy historically have been viewed as distinct, each with its own attributes. Before examining the similarities and differences between personal Social Security accounts and 401(k) plans, it is useful to pause and consider how reform through personal accounts will fundamentally change the nature and purposes of the first tranche—the traditional Social Security system.

At its core, the traditional Social Security system represents a policy of paternalism by the federal government.<sup>70</sup> Contributions by employers and employees to the traditional Social Security system are mandatory, and coverage under the system is nearly universal.<sup>71</sup> The Social Security payroll deduction contribution system essentially assumes that workers will not adequately save for retirement and instead compels them to do so.<sup>72</sup> This paternalistic policy approach is also reflected in the nature of traditional Social Security benefits. A fixed benefit amount is determined by a complex formula based on earnings.<sup>73</sup> These monthly benefit payments are made until death.<sup>74</sup> Thus, the worker bears no stock market investment or longevity risk.

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68. See Michael J. Graetz, *The Troubled Marriage of Retirement Security and Tax Policies*, 135 U. PA. L. REV. 851, 852–53 (1987).

69. See PRIVATE PENSION PLAN BULLETIN, *supra* note 16, at *Highlights From the 1998 Form 5500 Reports* (“Since the early and mid-1980s, the number of 401(k) plans has grown at a rate that in 15 years has led them to dominate the private pension plan system by providing primary or supplemental plan coverage to about 70 percent of all pension plan covered workers.”).

70. See generally MICHAEL A. GRAETZ & JERRY L. MASHAW, *TRUE SECURITY: RETHINKING AMERICAN SOCIAL INSURANCE* 92–99 (1999) (describing reasons why persons fail to provide for their own retirement income security).

71. SOC. SEC. ADMIN., *FAST FACTS AND FIGURES ABOUT SOCIAL SECURITY* 5, 9 (2002) (Sup. Doc. No. SSA1.26:), available at [http://www.ssa.gov/statistics/fast\\_facts/2002/ff2002.pdf](http://www.ssa.gov/statistics/fast_facts/2002/ff2002.pdf) (on file with the North Carolina Law Review).

72. See *supra* note 34 and accompanying text.

73. See Kathryn L. Moore, *Redistribution Under the Current Social Security System*, 61 U. PITT. L. REV. 955, 961 (2000).

74. See *id.* at 962.

In contrast, 401(k) plans represent a federal government policy that the individual should be encouraged to bear some of the responsibility for ensuring his or her own financial security in retirement.<sup>75</sup> The federal government's role essentially is reduced to encouraging employers to offer 401(k) plans and workers to voluntarily save for their own retirement by providing an income tax incentive for them to do so.<sup>76</sup> This individual responsibility policy approach permeates the nature of contributions to and benefits from 401(k) plans.<sup>77</sup> Participation in 401(k) plans is voluntary, and the participant assumes both stock market investment risk and the risk of longevity.<sup>78</sup>

Benefits under the traditional Social Security system and 401(k) plans also tend to favor different income classes of workers. Traditional Social Security benefits replace a higher percentage of wages for low-income workers than for high-income workers.<sup>79</sup> In contrast, the 401(k) plan system favors higher income workers over lower income workers in several respects. In a 401(k) plan, the participant voluntarily elects to have the employer deduct a portion of the worker's present compensation and instead contribute this amount to the participant's 401(k) plan account.<sup>80</sup> Until 2002, as a practical matter, salary deferral contributions to 401(k) plans were

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75. See, e.g., JOHN H. LANGBEIN & BRUCE A. WOLK, *PENSION AND EMPLOYEE BENEFIT LAW* 43–45, 50–54 (3d ed. 2000) (describing the increased personal responsibility evident in 401(k) plans as both a positive feature and a drawback of the system); Medill, *Individual Responsibility Model*, *supra* note 16, at 9–13 (describing the shift to participant-directed 401(k) plans as the government shifting financial responsibility for retirement to the individual); Susan J. Stabile, *Freedom to Choose Unwisely: Congress' Misguided Decision to Leave 401(k) Plan Participants to Their Own Devices*, 11 CORNELL J.L. & PUB. POL'Y 361, 361–65 (2002) (demonstrating the dangers of participant-directed 401(k) plans due to the failure of ERISA to adapt to their use).

76. See LANGBEIN & WOLK, *supra* note 75, at 222–23.

77. See *id.* at 50–54.

78. See *id.*

79. See GEN. ACCT. OFFICE, *SOCIAL SECURITY REFORM: IMPLICATIONS FOR PRIVATE PENSIONS* 11–12 (2000) (Sup. Doc. No. GA1.13:HEHS-00-187). Viewed from the perspective of tax equity, it should be noted that although traditional Social Security benefits are progressive, the Social Security payroll tax system is highly regressive. See Graetz, *supra* note 68, at 865–68.

80. For 2002, the maximum salary deferral contribution amount was \$11,000. See I.R.C. § 402(g)(1)(B) (West 2002). Workers over age fifty can make an additional catch-up contribution in 2002. See *id.* § 414(v). Federal tax law does impose potential restraints on the contributions of “highly compensated employees” (as adjusted for inflation, those earning more than \$90,000 annually in 2002), *id.* § 414(q)(1)(B), in the form of the actual deferral percentage (“ADP”) test. See *id.* § 401(k)(3). Plans that satisfy the safe harbor requirements for 401(k) plans and simple 401(k) plans for small employers are exempt from ADP testing. See *id.* §§ 401(k)(11)–(12).

limited to the lesser of a fixed dollar amount or a percentage of the participant's compensation, which enabled many higher income workers to contribute larger amounts to their 401(k) plan accounts.<sup>81</sup> Although this percentage of compensation limit was removed in 2002, in general, higher income workers with greater amounts of discretionary income are better positioned financially to defer the receipt of some current income than lower income workers, who are more likely to need all of their compensation for immediate consumption needs.<sup>82</sup> In addition, the federal government's income tax incentive for making contributions to a 401(k) is significantly more valuable for higher income workers because they are in a higher marginal income tax bracket than lower income workers.<sup>83</sup>

Finally, the traditional Social Security system and 401(k) plans can differ in purpose for lower and higher income workers. The sole purpose of the traditional Social Security system is to provide a

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81. Prior to the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001) (codified in scattered sections of 26 U.S.C.) ("EGTRRA"), employee elective salary deferrals to a 401(k) plan were treated as "employer contributions" and therefore subject to the employer deduction limit under Code section 404(a) of fifteen percent of employee compensation. See I.R.C. § 404(a)(3)(A)(i)(I) (2000), amended by Pub. L. No. 107-16, § 616, 115 Stat. at 103; H.R. CONF. REP. NO. 107-84, at 220-21 (2001), reprinted in 2001 U.S.C.C.A.N. 46, 145-46. Elective salary deferral contributions also were subject to a maximum dollar amount limit. See I.R.C. § 402(g)(1) (West 2002). After adjustments for inflation, this maximum dollar amount limit was \$10,500 in 2001. H.R. CONF. REP. NO. 107-84, at 211, reprinted in 2001 U.S.C.C.A.N. at 135-36. As a practical matter, in order to comply with both of these restrictions, employers who sponsored 401(k) plans limited employee salary elective deferral contributions to the lesser of the maximum dollar amount limit of Code section 402(g) or the percentage of compensation limit for employer deductions of Code section 404. EGTRRA added Code section 404(n), which exempts employee elective deferrals to a 401(k) plan from the employer deduction limit based on a percentage of the employee's compensation imposed by Code section 404(a)(3). See Pub. L. No. 107-16, § 614(a), 115 Stat. at 102; H.R. CONF. REP. NO. 107-84, at 221, reprinted in 2001 U.S.C.C.A.N. at 146. New Code section 404(n) is effective for years after December 31, 2001. H.R. CONF. REP. NO. 107-84, at 221, reprinted in 2001 U.S.C.C.A.N. at 146. Post-EGTRRA, employee elective salary deferral contributions are still subject to a maximum dollar amount limit. This limit was \$12,000 in 2003. I.R.C. § 402(g)(1)(B). Participants who qualify as "highly compensated employees" are subject to additional limitations. See discussion *supra* note 80.

82. See EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 238, CONTRIBUTION BEHAVIOR OF 401(K) PLAN PARTICIPANTS 8-9 (2001); 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 18-19. Federal tax law does impose potential restraints on the contribution levels of highly compensated employees, see discussion *supra* note 80, which is reflected in the study's resultant higher income levels, see EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 238, *supra*, at 8-9; 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 18-19.

83. For a numerical illustration comparing the economic benefits of income tax deferral for taxpayers in the fifteen percent and forty percent marginal income tax brackets, see LANGBEIN & WOLK, *supra* note 75, at 229.

source of income during retirement. This purpose applies universally to all workers, irrespective of income. For lower income workers, generally speaking, the purpose of participating in a 401(k) plan is the same, because persons of modest financial means are likely to consume the balance of their 401(k) plan accounts during their retirement years. For higher income workers, however, 401(k) plans can serve the secondary purpose of facilitating the transfer of wealth to the next generation.<sup>84</sup> Rather than viewing their 401(k) plan savings as a source of future retirement income, higher income workers may view the income tax deferral opportunity offered by their 401(k) plan accounts as a mechanism to accumulate wealth for future generations.

Taken together, the distinct purposes and societal attributes of the traditional Social Security system and 401(k) plans can be viewed as offsetting from the perspective of federal retirement policy. Until now, Social Security and 401(k) plans have allocated responsibility for retirement income security between the federal government and the individual worker. Benefits under the traditional Social Security program and 401(k) plans also represent a policy determination of how tax revenues and expenditures should be allocated between the less affluent and the more affluent workers in American society.<sup>85</sup> Viewed in its broadest perspective then, to reform part of the traditional Social Security system so that it more resembles 401(k) plans means altering the current policy balance. Who wins and who loses if the status quo is altered? The answer to this question—the ultimate policy question—lies in a close examination of the assertions made by the Commission in support of personal Social Security accounts. This examination is the subject of Part III of the Article.

#### *B. Similarities Between Personal Social Security Accounts and 401(k) Plans*

The fundamental characteristics of 401(k) plans are similar to those of the administrative structure proposed by the Commission for

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84. See *The Fall of Enron, How Could it have Happened? Hearing Before the Senate Comm. on Governmental Affairs*, 107th Cong. 96 (2002) (statement of Professor John H. Langbein, Yale Law School) (Sup. Doc. No. Y4.G74/9:S.HRG.107-376) (noting that the fact that 401(k) account balances are transferable on death encourages employees to generously contribute).

85. See generally Graetz, *supra* note 68 (arguing that the current system of federal tax policy that finances the traditional Social Security system and the private employer pension system is inequitable).

personal Social Security accounts.<sup>86</sup> In a typical 401(k) plan, the worker voluntarily elects to have her employer contribute a portion of her compensation to the worker's plan account.<sup>87</sup> Like personal Social Security accounts, typically in a 401(k) plan the participant directs the investment of the assets in her plan account by choosing among a set of investment options.<sup>88</sup> In the 401(k) plan context, these investment options are selected by the employer who sponsors the plan.<sup>89</sup> Federal law safeguards the interests of 401(k) plan participants by imposing general fiduciary duties of prudence and loyalty upon the employer when it selects the menu of investment options for the plan.<sup>90</sup> Under the Commission's proposal, the governmental Board will assume the role of the employer in this important task.<sup>91</sup>

Department of Labor regulations governing participant-directed 401(k) plans (the "404(c) Regulations")<sup>92</sup> require the plan to offer a broadly diversified range of investment options.<sup>93</sup> For almost all 401(k) plans, this diversification requirement is satisfied by offering workers a variety of mutual funds as investment options.<sup>94</sup> The

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86. There are, however, key differences between how 401(k) plans are administered and how personal Social Security accounts are likely to be administered. See ADMINISTRATIVE ISSUES STUDY, *supra* note 62, at 2. Most notably, employers who sponsor 401(k) plans are subject to rules for depositing participant salary deferral contributions to their individual 401(k) plan accounts that effectively require the employer to deposit funds in the account no later than the fifteenth business day of the month following the month in which the participant's contribution was withheld from her compensation by the employer. See Definition of "plan assets"—participant contributions, 29 C.F.R. § 2510.3-102(b) (2002). In contrast, under the Commission's proposed structure, contributions will not be deposited into personal accounts for up to fifteen months. See COMMISSION REPORT, *supra* note 1, at 47. This potential delay obviously makes the possibility of employer theft problematic.

87. See I.R.C. § 401(k) (West 2002).

88. See 29 U.S.C.A. § 1104(c) (2002); ERISA section 404(c) plans, 29 C.F.R. § 2550.404c-1(b)(1)(ii) (2002); Medill, *Individual Responsibility Model*, *supra* note 16, at 11 & n.51. The Bureau of Labor Statistics estimates that as of 1997, eighty-six percent of 401(k) plans sponsored by medium and large private establishments allowed participants to direct the investment of their contributions. BUREAU OF LABOR STATISTICS, EMPLOYEE BENEFITS IN MEDIUM AND LARGE PRIVATE ESTABLISHMENTS, 1997, at 135, tbl.177 (1999) (Sup. Doc. No. L 2.3/10:) [hereinafter BUREAU OF LABOR STATISTICS].

89. See Medill, *Stock Market Volatility*, *supra* note 16, at 485–86.

90. See *id.* at 482–513 (illustrating application of the duties of prudence and loyalty to the employer's selection of 401(k) plan investment options).

91. COMMISSION REPORT, *supra* note 1, at 51, 53.

92. See 29 C.F.R. § 2550.404c-1(b)(1).

93. See *id.*; see also Medill, *Stock Market Volatility*, *supra* note 16, at 522–24 (explaining that 404(c) Regulations require an employer to "offer a broad and diversified range of at least three investment options").

94. See Medill, *Stock Market Volatility*, *supra* note 16, at 523–24.

Commission endorses a similar approach to investment diversification.

The 401(k) plan participant assumes the risk of investment performance concerning her account.<sup>95</sup> This assumption of investment risk is significant, because the worker's benefit at retirement is usually paid in the form of a lump sum representing the balance of the account.<sup>96</sup> Under the three reform models proposed by the Commission, the worker also assumes the risk of investment performance. The worker's future traditional Social Security benefits will be reduced based on the assumption that the account earned a specified annual average real rate of investment return, ranging from 2.0% to 3.5% for the three models.<sup>97</sup>

### C. *Changes from the 401(k) Plan Norm*

Several of the Commission's proposed structural features for personal Social Security accounts differ from the norm in employer-sponsored 401(k) plans. Specifically, these features concern: (1) the types of permissible investment options; (2) pre-retirement access to account funds; (3) the form of distributions from the account at retirement; (4) the investment criteria for a default investment fund for workers who do not direct the investment of their account; and (5) how frequently workers may change investment allocations and options. Studies of these features in the 401(k) plan context indicate that the Commission's proposed changes from the 401(k) plan norm may promote greater investment success for these workers who choose to contribute to personal Social Security accounts.

#### 1. Permissible Investment Options

The Commission's range of permissible investment options for both Tier I and Tier II personal accounts differs in two key aspects from the investment options offered by many 401(k) plans today. First, many 401(k) plans offer company stock as an investment option.<sup>98</sup> Research of investment behavior by participants in 401(k)

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95. See Medill, *Individual Responsibility Model*, *supra* note 16, at 11.

96. See BUREAU OF LABOR STATISTICS, *supra* note 88, at 137 tbl.182 (reporting that ninety-one percent of 401(k) plans sponsored by medium and large private establishments allow for lump sum distributions).

97. See *supra* text accompanying notes 25–29.

98. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 4; PATRICK J. PURCELL, THE ENRON BANKRUPTCY AND EMPLOYER STOCK IN RETIREMENT PLANS, at CRS-4 tbl.1 (Jan. 22, 2002), at [www.house.gov/boozman/issues/crsrsenron.pdf](http://www.house.gov/boozman/issues/crsrsenron.pdf) (on file with the North Carolina Law Review); JACK L. VANDERHEI, EBRI SPECIAL REPORT: COMPANY STOCK IN 401(K) PLANS 4 (Jan. 31, 2002), at <http://www.ebri.org/pdfs/iscebs.pdf> (on file

plans shows that when company stock is offered as an investment option, participants invest heavily in company stock at the expense of broadly diversified equity mutual funds.<sup>99</sup> The Commission recommends that personal Social Security accounts should not be invested in the stock of individual companies (including the employer's company) to ensure investment diversification.<sup>100</sup> One need look only to the well-publicized example of participants in the Enron 401(k) plan to see the wisdom of this recommendation as a matter of federal retirement policy.<sup>101</sup>

Second, a growing number of employers today are adding a self-brokerage feature to their 401(k) plans in addition to the "core" lineup of mutual funds required by the Department of Labor's 404(c) Regulations.<sup>102</sup> The Commission recommends a much more restrictive form of this self-brokerage approach to permissible investment options for Tier II accounts. Under the Commission's approach, only mutual funds are allowed as investment options, thereby excluding the wide variety of investments offered in self-brokerage 401(k) plans. Before a private sector mutual fund is permitted as an investment option for a Tier II account, the fund must be approved by the Board.<sup>103</sup> The criteria recommended by the Commission for approval of these Tier II mutual funds indicate that

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with the North Carolina Law Review); Daniel Altman, *Experts Say Diversify, but Many Plans Rely Heavily on Company Stock*, N.Y. TIMES, Jan. 20, 2002, at 26; Scott Burns, *Employer Stocks Hurt 401(k) Odds*, DALLAS MORNING NEWS, Jan. 27, 2002, at 1H.

99. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 8 (stating that participants in 401(k) plans that offer company stock, but not guaranteed investment contracts, have "dramatically lower" allocations to equity funds and balanced funds than plans which do not offer company stock as an investment option); Shlomo Benartzi, *Excessive Extrapolation and the Allocation of 401(k) Accounts to Company Stock*, 56 J. FIN. 1747, 1747-49 (2001).

100. See COMMISSION REPORT, *supra* note 1, at 51.

101. See, e.g., Richard A. Oppel, Jr., *Employees' Retirement Plan Is a Victim as Enron Tumbles*, N.Y. TIMES, Nov. 22, 2001, at A1 (describing the 401(k) losses of Enron employees); Jane Bryant Quinn, *401(k)s and the Enron Mess*, NEWSWEEK, Jan. 21, 2002, at 25 (describing the problems caused by heavy 401(k) investment in employer stock).

102. See Press Release, Hewitt Associates, *Hewitt Research Shows U.S. Employers Enhancing 401(k) Plans to Cure Common Employee Mistakes* (Nov. 5, 2001), at [http://www.401khelpcenter.com/press/pr\\_hewitt\\_110501.html](http://www.401khelpcenter.com/press/pr_hewitt_110501.html) (on file with the North Carolina Law Review) (describing a 2001 survey of employers finding that twelve percent offer a self-directed brokerage account feature, an increase from seven percent in 1999); Clifton Linton, *Self-Directed 401(k)s Expand Investment Choices*, (Oct. 17, 2000), at [http://www.mpowercafe.com/retirement/features/features.1.3.1\\_05082000.html](http://www.mpowercafe.com/retirement/features/features.1.3.1_05082000.html) (on file with the North Carolina Law Review) (stating that self-directed 401(k)s offer more investment options but also require more responsibility and more investment homework and cost more than traditional investment options).

103. See COMMISSION REPORT, *supra* note 1, at 53.



many private sector funds today simply would not qualify, either because they would not satisfy the Board's broad diversification requirements,<sup>104</sup> or because of their commission and fee structure.<sup>105</sup> Although to date no published studies exist concerning how 401(k) plan investments in self-brokerage accounts perform, the Commission's recommendations are consistent with the basic investment principle of using portfolio diversification to maximize investment gains and minimize investment losses.

## 2. Pre-Retirement Access to Account Funds

The Commission's proposed prohibition on pre-retirement access to account funds differs from the norm in 401(k) plans.<sup>106</sup> In the typical 401(k) plan, a participant may elect to take a distribution of her account upon termination of employment prior to retirement.<sup>107</sup> If the terminated participant's account balance is under \$5,000, the employer may "cash out" the account and distribute the funds to the participant,<sup>108</sup> unless the participant elects to do a direct rollover of the account.<sup>109</sup> Recent studies of the effect of the "cash out" rule have shown that many workers with account balances under \$5,000 fail to elect a direct rollover.<sup>110</sup> Instead, these small account holders are passive and allow the employer to "cash-out" their retirement savings.<sup>111</sup> The employer also may design its 401(k) plan

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104. *See id.* at 46, 53.

105. *Id.* at 46 ("Funds in both Tiers cannot charge sales 'loads' or other marketing fees on entry or exit.").

106. Under the Commission's proposal, workers would not be able to access the funds held in their personal Social Security accounts prior to retirement. This restriction on pre-retirement access to account funds would apply even in instances where the worker has become disabled prior to retirement. *See id.* at 55.

107. *See* JAMES A. CHOI ET AL., DEFINED CONTRIBUTION PENSIONS: PLAN RULES, PARTICIPANT DECISIONS, AND THE PATH OF LEAST RESISTANCE 13-14, (Nat'l Bureau of Econ. Research Working Paper No. 8655, 2001), at <http://www.nber.org/papers/w8655> (on file with the North Carolina Law Review) [hereinafter PATH OF LEAST RESISTANCE]; EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 188, LARGE PLAN LUMP-SUMS: ROLLOVERS AND CASHOUTS 3 (1997); EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 178, LUMP-SUM DISTRIBUTIONS: FULFILLING THE PORTABILITY PROMISE OR ERODING RETIREMENT SECURITY? 3 (1996); James M. Poterba et al., *Lump-Sum Distributions from Retirement Savings Plans: Receipt and Utilization*, in INQUIRIES IN THE ECONOMICS OF AGING 85, 87 (David A. Wise ed., 1998) (stating that defined contribution plans typically make lump sum distributions when participants terminate employment prior to retirement).

108. *See* I.R.C. § 411(a)(11) (West 2002).

109. *See id.* § 401(a)(31).

110. *See* PATH OF LEAST RESISTANCE, *supra* note 107, at 15; Craig Copeland, *Lump Sum Distributions: An Update*, EBRI NOTES, July 2002, at 6.

111. *See* PATH OF LEAST RESISTANCE, *supra* note 107, at 15.

to allow participants to access account funds in instances other than termination of employment. The 401(k) plan may allow a participant to borrow from her plan account,<sup>112</sup> or the plan may allow for pre-retirement withdrawals.<sup>113</sup>

Allowing 401(k) plan participants to access their account funds prior to retirement is inconsistent with the objective of saving for retirement. By withdrawing their account funds, participants forego the opportunity for compounding pretax investment earnings.<sup>114</sup> Nevertheless, participants are accustomed to being able to access their plan retirement savings prior to retirement. A similar trend is evident for IRAs. In recent years, Congress has created several exceptions that allow the owner of the IRA to withdraw the funds prior to retirement, without tax penalty, for certain specified purposes.<sup>115</sup> As personal Social Security accounts grow in size, the Commission's proposed prohibition on pre-retirement withdrawals, even in cases of disability, is likely to prove unpopular with workers who view their personal account contributions as "their" money.

### 3. Forms of Distributions at Retirement

The form of distribution in 401(k) plans typically is a lump sum payment of the participant's vested account balance.<sup>116</sup> In contrast, the Commission recommends that the worker first must annuitize at least a portion of her account.<sup>117</sup> The amount of the portion to be annuitized must, when combined with the worker's traditional Social

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112. See BUREAU OF LABOR STATISTICS, *supra* note 88, at 137 tbl.181 (noting that fifty-one percent of 401(k) plans sponsored by medium and large private establishments allow loans for full-time employees).

113. See *id.* at 136 tbl.180 (fifty percent of 401(k) plans sponsored by medium and large private establishments allow withdrawals).

114. See Poterba et al., *supra* note 107, at 85-86. The Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, § 641, 115 Stat. 38, 118 (2001) (codified in scattered sections of 26 U.S.C.) ("EGTRRA"), modifies these cash out rules effective in 2004. Under EGTRRA, employers will be required to rollover account balances between \$1,000 and \$5,000 to an IRA established by the employer on behalf of the participant. *Id.*

115. See EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 195, HOW DO INDIVIDUAL SOCIAL SECURITY ACCOUNTS STACK UP? AN EVALUATION USING THE EBRI-SSASIM2 POLICY SIMULATION MODEL 8 n.18 (1998).

116. See BUREAU OF LABOR STATISTICS, *supra* note 88, at 137 tbl.182 (showing that ninety-one percent of 401(k) plans sponsored by medium and large private establishments permit lump sum distributions). In theory, 401(k) plan participants could annuitize their plan benefits at retirement by using the lump sum payment to purchase an annuity. In practice, however, 401(k) participants rarely do this because purchasing a private annuity is costly. See discussion *infra* Part III.C.

117. See COMMISSION REPORT, *supra* note 1, at 56.

Security benefits, be sufficient to leave the worker “safely” above the poverty income level.<sup>118</sup> This minimum annuity requirement applies regardless of the worker’s other financial resources.<sup>119</sup>

The Commission’s purpose behind the minimum annuity requirement is essentially paternalistic. The requirement ensures that the worker will not have the ability immediately to consume the assets held in her personal account at the commencement of retirement. The Commission Report emphasizes that applying this minimum annuity requirement evenhandedly to all workers, irrespective of their other financial resources, ensures that workers of all income levels perceive the personal account system as fair.<sup>120</sup>

#### 4. Investment Criteria for Default Fund

The need for the employer to designate a default investment fund for a participant’s 401(k) plan contributions is a recent phenomenon that coincides with the emergence of the “automatic enrollment” plan design.<sup>121</sup> In automatic enrollment 401(k) plans, employers generally select a money market or stable value fund as the plan’s default investment option for participants who fail to affirmatively designate one.<sup>122</sup> This tendency of employers to select a safe but low-earning default investment option has been criticized.<sup>123</sup> Over time, the lower earnings produce an account balance at

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118. *Id.*

119. *See id.*

120. *Id.* (“[A]llowing wealthier people greater access to their personal retirement savings account seems like a regressive policy.”). I argue in Part III.C of the Article that, ironically, the Commission’s proposed administrative structure for implementing the minimum annuity requirement is likely to operate to the detriment of many lower income workers who cannot afford to bear the risk of longevity and therefore must select the traditional annuity option.

121. *See infra* discussion Part III.D.

122. *See* JAMES J. CHOI ET AL., FOR BETTER OR FOR WORSE: DEFAULT EFFECTS AND 401(K) SAVINGS BEHAVIOR 4 (Nat’l Bureau of Econ. Research Working Paper No. 8651, 2001), at <http://www.nber.org/papers/w8651> (on file with the North Carolina Law Review) [hereinafter DEFAULT EFFECTS]. Employers select a low earning money market mutual fund as the default investment option for both legal liability and psychological reasons. An account invested solely in a money market mutual fund is unlikely to ever experience a loss in terms of actual dollars. As a result, under current federal law it is less likely that the employer will incur fiduciary liability for its investment decision. *See* Medill, *Stock Market Volatility*, *supra* note 16, at 539–41 (arguing for recognition of “opportunity losses” by the federal courts in ERISA cases). In addition, the employer avoids the prospect of disgruntled participants, who might be unhappy if their hard-earned salary deferral contributions had lost money. In terms of real dollars (i.e., adjusted for the effects of inflation), of course, the participant’s account is losing future purchasing power.

123. *See* DEFAULT EFFECTS, *supra* note 122, at 28–29; Medill, *Stock Market Volatility*, *supra* note 16, at 539–41.

retirement that is much less than what the participant would have had if her contributions were invested in a more volatile, but higher earning, diversified equity mutual fund.<sup>124</sup>

The Commission Report suggests that the default investment option for personal Social Security accounts (the Commission calls this the “standard” fund)<sup>125</sup> should not follow the 401(k) plan norm.<sup>126</sup> Instead, the standard fund, as envisioned by the Commission, would be like Goldilocks’s porridge—not too conservative, not too aggressive, but just right for each particular worker’s age.<sup>127</sup> Although the Commission never attaches the label, it appears that what the Commission has in mind is equivalent to the so-called “lifecycle” mutual fund.<sup>128</sup>

Because personal Social Security accounts must replace a portion of the worker’s traditional benefits to be paid in the future, the Commission’s choice of an appropriately balanced default investment option is sound policy in theory. In practice, however, the investment managers selected by the Board to manage the assets held in the default investment option will be critical to its success.<sup>129</sup> Their task, to produce investment returns that satisfy the workers’ expectations, will be a challenging one. The Commission clearly recognizes this potential problem of satisfying worker expectations. Although rejecting the concept of a guaranteed rate of investment return guaranteed by the federal government,<sup>130</sup> the Commission explicitly states that “the standard fund must also be consistent with any

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124. See DEFAULT EFFECTS, *supra* note 122, at 28–29 (arguing that overly conservative default fund investment options undermine the long-term accumulation of wealth); Medill, *Stock Market Volatility*, *supra* note 16, at 539–41 (arguing that overly conservative default investment options in automatic enrollment 401(k) plans result in investment opportunity losses).

125. See COMMISSION REPORT, *supra* note 1, at 52.

126. See *id.*; see also *supra* note 44 (quoting the Commission’s description of the standard fund).

127. COMMISSION REPORT, *supra* note 1, at 52.

128. See Christopher Walker, *Should You Choose a Lifestyle Fund?* (Jan. 29, 2002), at [http://www.mpowercafe.com/retirement/features/features.1.3.1\\_11272000.html](http://www.mpowercafe.com/retirement/features/features.1.3.1_11272000.html) (on file with the North Carolina Law Review). In a lifecycle mutual fund, all of the investors have the same target date for retirement. *Id.* The fund’s investment manager selects and periodically adjusts the investments held by the fund with this target date in mind, gradually shifting from a more aggressive mix to a more conservative one as the retirement target date approaches. *Id.*

129. More importantly, these investment managers will, by virtue of the large sums of money under their control, wield significant power in the marketplace. For a discussion of how this situation is an inevitable product of the Commission’s “voluntary” structure, see Part III.D of this Article.

130. See COMMISSION REPORT, *supra* note 1, at 143 (“The Commission has chosen not to include guarantees in any of the three plans presented here.”).

promises [of a minimum return or benefit] that are made with respect to personal accounts.”<sup>131</sup>

### 5. Changing Investment Allocations and Options

The norm in 401(k) plans today is to allow participants to change their investment allocations and fund options frequently.<sup>132</sup> In contrast, the Commission proposes that workers be allowed to change their investment allocations and fund options only one time per year.<sup>133</sup> The purpose of this restriction is to eliminate “day trading” in personal accounts, and to encourage workers to select their investment options carefully for the longer term.<sup>134</sup> The ultimate goal, of course, is to improve worker investment performance in personal accounts.

### III. A CLOSER LOOK AT THE FOUR “TRUTHS”

Parts I and II of this Article examined the Commission’s proposed administrative structure for personal Social Security accounts and compared this structure to the norm for 401(k) plans today. Although Part II found that the Commission’s proposed structure for personal accounts differs in certain areas from the norm for 401(k) plans, Part II concluded that, fundamentally, personal Social Security accounts are designed to function like 401(k) plans.

Part III of the Article critically examines the Commission’s findings in support of personal Social Security accounts (the four “Truths”) in light of the research evidence concerning the investment behavior of participants in 401(k) plans. Where appropriate, Part III also suggests areas where the Commission’s proposed structure should be modified in light of the 401(k) plan research evidence.

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131. *Id.* at 52.

132. See BUREAU OF LABOR STATISTICS, *supra* note 88, at 126 tbl.157. According to the Bureau of Labor Statistics, forty-seven percent of savings and thrift plans sponsored by medium and large private establishments place no restrictions whatsoever on a participant’s ability to change investments. *Id.*

133. COMMISSION REPORT, *supra* note 1, at 48. According to the Bureau of Labor Statistics, a “one change per year” rule exists in only two percent of savings and thrift plans sponsored by medium and large private establishments. BUREAU OF LABOR STATISTICS, *supra* note 88, at 126 tbl.157.

134. See COMMISSION REPORT, *supra* note 1, at 48.

A. *Truth #1: Workers Will Be Better Off, in Terms of Total Benefits, with Personal Social Security Accounts*

One of the most appealing aspects of personal Social Security accounts is their potential to generate greater investment returns through the stock market.<sup>135</sup> Advocates for personal Social Security accounts often point to theoretical market indices, such as the Standard and Poor's 500 ("S&P 500"), as evidence of what workers could earn through private Social Security accounts.<sup>136</sup> The implication, of course, is that the investment returns from private Social Security accounts will generate comparable investment returns. Viewed against the rather spectacular investment returns of the S&P 500 in recent years,<sup>137</sup> by contrast, workers who have "invested" in Social Security's traditional benefits will not receive their "money's worth."<sup>138</sup> Putting these two arguments together, the Commission

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135. A USA Today/CNN/Gallup poll conducted November 26–27, 2001, found that popular support for individual Social Security accounts was not affected by the downturn in the stock market in 2001 or by the tragedy of September 11th. Sixty-four percent of those surveyed favored individual Social Security accounts, the same general level of public support as before the 2000 presidential election. Susan Page, *Why Social Security Reform Is Dead, For Now*, USA TODAY, Dec. 4, 2001, at 1A. In contrast, a more recent poll, taken in August of 2002 by the Alliance for Retired Americans, found that nearly seventy percent of Americans over age sixty strongly oppose personal Social Security accounts that would permit individuals to invest in stocks and bonds. Fred Brock, *Social Security and the Ballot Box*, N.Y. TIMES, Oct. 6, 2002, § 3, at 8.

136. The co-chairs of the Commission use a similar approach, citing as an example the annual compound rates of return for three funds used as investment options for the Thrift Savings Plan for federal employees. See COMMISSION REPORT, *supra* note 1, at 6.

137. E.g., Chelsea Emery, *Stock Boom is Likely to Keep Rolling Along*, CHI. SUN-TIMES, Jan. 2, 2000, at 61, 2000 WL 6662814 ("U.S. stocks as measured by the Standard & Poor's 500 index have returned an average of 18 percent annually since the end of 1981; in the second half of the 1990s, that growth accelerated to 28 percent annually, well over twice the long-term average.").

138. See COMMISSION REPORT, *supra* note 1, at 5 (Under the traditional system, a single male worker born in 2000 with average earnings will have a real annual return of 0.86% on his scheduled contributions to Social Security). It was the 1994–1996 Social Security Advisory Council's report that first broke new political ground by highlighting this "money's worth" issue. This report concluded:

One of the concerns that most members of the Council had in considering various policy options was that for many . . . future . . . retirees these projected rates of return are quite low relative to the rates of return that these workers could achieve if they invested in financial assets widely available in the national economy. . . . In other words, all but the lowest-wage workers . . . could expect higher real rates of return, on average, by investing their payroll tax contributions in widely available financial instruments than they could expect from Social Security under current law.

1 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY, REPORT OF THE 1994–1996 ADVISORY COUNCIL ON SOCIAL SECURITY 41 (1997) (Sup. Doc. No. SSA1.2:AD9/v.1/994-96). Professor Patricia E. Dilley has criticized this money's worth argument for

arrives at Truth #1: Workers will be better off, in terms of total benefits, with personal Social Security accounts.<sup>139</sup>

### 1. The Commission's Investment Assumptions

In support of Truth #1, the Commission provides several illustrations comparing how low-, medium-, and high-income workers would fare under the traditional Social Security benefit system and a reformed system of personal accounts.<sup>140</sup> Significantly, these illustrations, which show that workers of *all* income groups would receive greater total benefits under a personal account system, assume that the worker's account would earn an average annual real rate of return of 4.6%,<sup>141</sup> a rate considerably more than the offset rates for the three models.<sup>142</sup> To support this assumed 4.6% real rate of return, the Commission makes several investment assumptions.

First, the Commission assumes that the worker will invest in a portfolio that consists of 50% equity mutual funds, 30% corporate bond mutual funds, and 20% government bond mutual funds.<sup>143</sup> This prescribed investment allocation is central to the Commission's projections, all of which are based on a 4.6% average annual real rate of investment return.<sup>144</sup> The Commission justifies using a 4.6% annual average rate of investment return by assuming that the equity mutual fund portion of the worker's account will earn an average annual real rate of return of 6.5%.<sup>145</sup> The corporate bond mutual fund and

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privatization as flawed because it ignores the social and institutional policy goals served by the program. See Dilley, *supra* note 8, at 1050–53; Patricia E. Dilley, *The Evolution of Entitlement: Retirement Income and the Problem of Integrating Private Pensions and Social Security*, 30 LOY. L. REV. 1063, 1185 (1997).

139. See COMMISSION REPORT, *supra* note 1, at 35.

140. See *id.* at 87–89. These comparative illustrations have been criticized because for workers retiring in 2052 they use as a basis for comparison the benefit amount the Social Security system is projected to be able to pay if no fiscal reforms are enacted, rather than using the currently scheduled benefit amounts. See *id.*; see also PETER A. DIAMOND & PETER R. ORSZAG, REDUCING BENEFITS AND SUBSIDIZING INDIVIDUAL ACCOUNTS: AN ANALYSIS OF THE PLANS PROPOSED BY THE PRESIDENT'S COMMISSION TO STRENGTHEN SOCIAL SECURITY 14 (2002), at <http://www.cbpp.org/6-18-02socsec.pdf> (on file with the North Carolina Law Review) (noting Alan Greenspan's recent assertion that “a pattern of no action for nearly four decades followed by a closing of the imbalance that emerges when the Social Security Trust Fund is exhausted entirely through sharp benefit cuts—which is what the ‘payable benefits’ baseline assumes—simply will not be allowed to occur”).

141. COMMISSION REPORT, *supra* note 1, at 98.

142. See *supra* notes 27–29 and accompanying text.

143. COMMISSION REPORT, *supra* note 1, at 97.

144. *Id.*

145. See *id.* To evaluate whether the Commission's assumed 6.5% rate of return is realistic, it is important to recall that the Commission's investment assumptions are based

government mutual fund portions of the account are assumed to earn average annual real rates of return of 3.5% and 3.0% respectively.<sup>146</sup> Second, the Commission assumes that the worker will rebalance her account portfolio annually to maintain the perceived 50/50 ratio of equity and bond funds.<sup>147</sup> Third, in its primary results the Commission assumes that at retirement the worker will use the entire balance of her account to purchase a variable annuity that will continue to earn a 4.6% annual rate of real return during the worker's retirement years until death.<sup>148</sup>

This section of the Article examines two important aspects of the Commission's underlying assumptions concerning the investment performance of workers under a personal Social Security account system. Under the Commission's investment assumptions, the investment allocation decisions of workers are central to the financial success of personal Social Security accounts. Each worker's investment mix will determine the investment returns generated by her Social Security account. This section of the Article begins by examining the results of the Employee Benefit Research Institute ("EBRI") study of the investment allocation choices made by individual participants in 401(k) plans.<sup>149</sup> Examining individual level data, rather than averages for a group as a whole, is particularly important from a policy perspective. Under a personal account system, an individual worker will not receive the "average" investment returns from all private Social Security accounts. Rather, she will receive what her individual Social Security account actually

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on a *real* rate of return, i.e., one that has already been adjusted (reduced) for inflation. For example, during the period 1984 through 2000, inflation averaged 3.23% annually. DALBAR INC., QUANTITATIVE ANALYSIS OF INVESTOR BEHAVIOR STUDY, 2001 UPDATE 16 (2001). For an "apples-to-apples" comparison of the Commission's assumed rate of return with the rates of return reported by the media (which are typically *not* reduced for inflation), it is necessary to adjust (increase) the Commission's 6.5% figure for inflation. Using, for purposes of illustration, the 3.23% inflation figure for the period 1984 through 2000, this would result in a historical rate of return of 9.73%. It is this higher figure that provides the appropriate "apples-to-apples" comparison for the typical worker to make with reports of the stock market performance on the nightly news. Experts have criticized the Commission's 6.5% assumed average annual real rate of investment return for equity mutual funds as unrealistically optimistic. See Elizabeth Harris, *Gearing Up for Lower Expectations*, N.Y. TIMES, June 16, 2002, § 3, at 7; Letter from Dean Baker, Co-Director of the Social Security Information Project, to Steve Gross, Chief Actuary of the Social Security Administration (June 14, 2002) (on file with the North Carolina Law Review).

146. COMMISSION REPORT, *supra* note 1, at 97.

147. See *id.*

148. See *id.* at 98.

149. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 3-4.



earns.<sup>150</sup> The EBRI study found that although the investment portfolio of the average 401(k) plan participant was invested predominately in equities,<sup>151</sup> there were wide variances in the investment allocation decisions of individual 401(k) plan participants.<sup>152</sup> This research shows that significant numbers of 401(k) plan participants are not diversified, resulting in investment portfolios that are either exposed to excessive levels of investment risk, or are likely to generate very low investment returns.<sup>153</sup>

The second (but easily overlooked) factor in determining the investment performance of personal Social Security accounts is the fees charged by the mutual funds who provide the investment options for worker accounts. These mutual fund fees reduce the fund's overall rate of investment return.<sup>154</sup> Since 1998, the fees being charged by mutual fund companies to their investors have come under increasing scrutiny, first by the Department of Labor in the context of 401(k) plans,<sup>155</sup> and more recently by the General Accounting Office<sup>156</sup> and the Securities and Exchange Commission.<sup>157</sup> These studies strongly suggest that lawmakers should reconsider the Commission's determination that direct regulation by the Board of the level of mutual fund fees charged is unnecessary, and that mere disclosure of fees to workers will provide sufficient protection.<sup>158</sup>

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150. Feldstein and Rangelova have suggested that individuals could purchase pension collars to protect against the risk of investment loss in personal accounts. The pension collar would guarantee a minimum annuity payment in exchange for foregoing some portion of the account's investment returns above a specified level. See MARTIN FELDSTEIN & ELENA RANGUELOVA, ACCUMULATED PENSION COLLARS: A MARKET APPROACH TO REDUCING THE RISK OF INVESTMENT-BASED SOCIAL SECURITY REFORM 4 (Nat'l Bureau of Econ. Research Working Paper No. W7861, 2000), at <http://www.nber.org/papers/w7861> (on file with the North Carolina Law Review).

151. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 6.

152. See *id.* at 12 tbl.7.

153. See *infra* notes 171–75 and accompanying text.

154. See *infra* notes 193–94 and accompanying text.

155. PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, A LOOK AT 401(K) PLAN FEES . . . FOR EMPLOYEES (1998) [hereinafter 401(K) FEES].

156. GEN. ACCOUNTING OFFICE, MUTUAL FUND FEES, ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION (2000) (Sup. Doc. No. GA1.13:GGD-00-126) [hereinafter GAO FEE STUDY]; GEN. ACCOUNTING OFFICE, SEC'S REPORT PROVIDES USEFUL INFORMATION ON MUTUAL FUND FEES AND RECOMMENDS IMPROVED FEE DISCLOSURE (2001) (Sup. Doc. No. GA1.13:GAO-01-655R) [hereinafter GAO FEE STUDY REPLY].

157. See *supra* note 51.

158. See COMMISSION REPORT, *supra* note 1, at 46.

## 2. The EBRI Study

The EBRI Study is a joint project of the Employee Benefit Research Institute and the Investment Company Institute (“ICI”).<sup>159</sup> EBRI and ICI have developed a database of 35,367 401(k) plans, with 11.8 million active participants and \$579.8 billion in assets.<sup>160</sup> The database covers about 33% of all 401(k) plan assets and 28% of all 401(k) plan participants in the United States.<sup>161</sup> The database is designed to be representative of the universe of 401(k) plans and covers a wide range of plan sizes.<sup>162</sup> Findings of the study have been reported previously for 1996, 1997, 1998, and 1999.<sup>163</sup> The discussion below addresses the results of the study reported for 2000. The findings for prior years are similar to the 2000 study results.<sup>164</sup> The EBRI Study found that, on the average, approximately 51% of the average 401(k) plan account balance was invested in equity mutual funds and 19% was invested in company stock.<sup>165</sup> The remaining average plan account balance was invested 10% in guaranteed investment contracts, 7% in “balanced mutual funds,” 5% in bond mutual funds, 4% in money market mutual funds, and 1% in other “stable value” mutual funds.<sup>166</sup> If investments in employer stock are included in the equity securities category, approximately 70% of all 401(k) plan balances are invested, either directly or indirectly, in equity securities.<sup>167</sup>

The Commission refers to this average 70% figure from the 1999 edition of the EBRI Study favorably in support of the assumption that the hypothetical worker will maintain 50% of her personal account invested in equity mutual funds, 30% in corporate bond

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159. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 3. The Employee Benefit Research Institute (“EBRI”) is a non-profit public policy research organization. *Id.* at 24 n.2. The Investment Company Institute (“ICI”) is the national trade association for the mutual fund industry in the United States. *Id.* at 25 n.3.

160. *Id.* at 3.

161. *Id.*

162. See *id.* at 3, 6.

163. See EMPLOYEE BENEFIT RESEARCH INST., ISSUE BRIEF NO. 230, 401(K) PLAN ASSET ALLOCATION, ACCOUNT BALANCES, AND LOAN ACTIVITY IN 1999 4 n.4 (2001) [hereinafter 1999 ASSET ALLOCATION STUDY].

164. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 4.

165. *Id.* at 8 chart 3.

166. *Id.*

167. See *id.* at 6. When the equity portion of balanced funds also are included, on average the 401(k) plan participants in the EBRI Study had seventy-five percent of their account balances invested in equity securities. See *id.*

mutual funds, and 20% in government bond mutual funds.<sup>168</sup> The Commission's reliance on these average asset allocation figures from the EBRI Study, however, is potentially misleading in two respects. First, the Commission ignores the clear caveat contained in both the 1999 and 2000 editions of the EBRI Study: "Among individual participants, the allocation of account balances to equity funds varies widely around the average of 51% for all participants."<sup>169</sup> Second, under the Commission's proposed administrative structure for personal accounts, for obvious (post-Enron) reasons the stock of any individual company, including employer stock, is prohibited as an investment option.<sup>170</sup> It is the inclusion of employer stock in the "equity" investment category that results in the 70% figure cited by the Commission.<sup>171</sup>

Examining the investment allocation decisions of individual plan participants, and excluding employer stock as an investment option, reveals a much different picture. This individual level data from the EBRI Study is summarized in Table 1 below.

**TABLE 1. Percentage of Account Allocated  
to Equity Funds by Age<sup>172</sup>**

Age	(0%)	(< 20%)	(20%–80%)	(> 80%)
20s	28.3%	4.3%	35.1%	32.4%
30s	23.5%	5.4%	37.4%	33.7%
40s	26.0%	6.6%	37.9%	29.5%
50s	29.9%	7.5%	36.5%	26.1%
60s	41.9%	8.0%	30.8%	19.2%

The data presented in Table 1 indicate that the Commission's hypothetical worker investment portfolio is truly hypothetical.<sup>173</sup> In

168. See COMMISSION REPORT, *supra* note 1, at 97; 1999 ASSET ALLOCATION STUDY, *supra* note 163, at 10.

169. 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 11 (finding that fifty-one percent of average 401(k) plan account balance invested in equity funds); 1999 ASSET ALLOCATION STUDY, *supra* note 163, at 14 (reporting that fifty-one percent of average 401(k) plan account balance invested in equity funds).

170. See *supra* notes 47–48 and accompanying text.

171. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 4; 1999 ASSET ALLOCATION STUDY, *supra* note 163, at 10.

172. The data presented in Table 1 are taken from the 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 12 tbl.7.

173. The EBRI Study data is consistent with what financial advisors have long known—investors do not consistently rebalance their portfolios. See Karen Damato, *Time For A Portfolio Trick: Rebalancing*, WALL ST. J., Feb. 8, 2002, at C1.

particular, the investment allocation decisions of some younger workers in the EBRI study are quite revealing. Although approximately one-third of workers in their twenties were more than 80% invested in equity funds, more than one-fourth of workers in this age group were not invested in equity funds at all.<sup>174</sup> This general pattern was similar for workers in their thirties.<sup>175</sup> Table 1 also reveals the potential for some workers who are nearing retirement to suffer significant losses. Almost one-fifth of workers in their sixties (19.2%) remained more than 80% invested in equity funds and, consequently, exposed to the short term volatility of the stock market.<sup>176</sup> Interestingly, this percentage of workers in their sixties whose 401(k) accounts were invested more than 80% in equity funds declined only slightly from 1999,<sup>177</sup> despite the single largest annual decline in 2000 by the S&P 500 and the Russell 3000 market indices in nearly twenty years.<sup>178</sup> This investment allocation pattern may reflect an intent by older higher income workers to use their 401(k) plan as a mechanism for intergenerational wealth transfer rather than to provide a source of income during retirement. Alternatively, it may simply reflect a high degree of confidence that, given the market's strong showing throughout the late 1990's, the stock market would quickly recover.

Table 2 below, which reflects investment allocation decisions by the salary of the participant, reveals more patterns indicating how workers might fare under a personal Social Security account system.

**TABLE 2. Percentage of Account Allocated to Equity Funds by Salary<sup>179</sup>**

Salary	0%	< 20%	20%–80%	> 80%
\$20,000–\$40,000	29.6%	8.8%	40.1%	21.5%
\$40,000–\$60,000	26.6%	8.6%	40.8%	24.0%
\$60,000–\$80,000	17.8%	9.0%	45.8%	27.3%
\$80,000–\$100,000	14.5%	8.3%	45.9%	31.3%
> \$100,000	14.8%	8.4%	44.1%	32.7%

174. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 12 tbl.7.

175. See *id.*

176. See *id.*

177. See *id.* (showing that 20.6% of workers in their sixties had 401(k) plan account balances that were more than 80% invested in equity funds).

178. See *id.* at 3, 25 n.5. During 2000, the S&P 500 was down 10%, and the Russell 3000 fell about 9%. See *id.* at 25 n.5.

179. The data presented in Table 2 are taken from the 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 12 tbl.7.

Because salary level tends to correlate with age, it is not possible to use the data presented in Table 2 to draw definitive conclusions concerning how lower income workers (represented here by the lowest range reported in the EBRI Study, the \$20,000 to \$40,000 salary range group) might invest their personal Social Security accounts. Table 2 does show, however, that over one-fourth of participants in this lowest salary range were not invested in equity funds at all.<sup>180</sup>

These data illustrate a crucial policy question. Do lower-income workers, as a group, invest more conservatively than the population of workers as a whole? Some preliminary evidence to date indicates that they might.<sup>181</sup> Generally speaking, investment performance correlates strongly with education, and education correlates strongly with income levels.<sup>182</sup> Social Security's traditional benefit structure is designed to favor lower income workers by replacing a higher portion of their wages than for higher income workers.<sup>183</sup> If lower-income workers have lower investment returns from their personal accounts than higher-income workers, this redistributive function of the traditional Social Security system, and the social safety net it provides, will be undermined.

The possibility also exists that the EBRI Study provides an overly optimistic indicator of how very low-income workers would invest their personal Social Security account assets. Participants in traditional 401(k) plans are a self-selected group who earn wages and salaries at levels sufficient to provide a measure of discretionary income. The lowest-earning category of 401(k) plan participants measured in the 2000 EBRI Study earned between \$20,000 and \$40,000 annually.<sup>184</sup> In contrast, the Commission estimates that, under the nearly universal coverage of the Social Security system, twenty-eight million American workers had annual wages and salaries below \$5,000 in 2000.<sup>185</sup> How workers in this lowest-income group would choose to invest their personal accounts is simply unknown. It is not far-fetched, however, to predict that workers who earn little

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180. *See id.*

181. *See* Brown et al., *supra* note 8, at 650 (collecting various studies); Schmall, *supra* note 8, at 125-27; Jayne Elizabeth Zanglein, *Investment Without Education: The Disparate Impact on Women and Minorities in Self-Directed Defined Contribution Plans*, 5 EMPLOYEE RTS. & EMP. POL'Y J. 223, 238-44 (2001).

182. *See* Moore, *Partial Privatization*, *supra* note 8, at 354-66; Schmall, *supra* note 8, at 125-27.

183. *See* SOC. SEC. ADVISORY BD., *supra* note 9, at 3; Moore, *supra* note 73, at 965.

184. *See* 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 12 tbl.7.

185. COMMISSION REPORT, *supra* note 1, at 45.

and save little will prefer the perceived security of low-earning United States government bond funds over the volatility and short-term investment losses of equity funding. This is particularly true for workers who do not appreciate the perceived effects of inflation.

In summary, the EBRI Study indicates that, unlike the Commission's hypothetical worker, the investment behavior of individual workers is likely to vary widely from the "ideal" 50% equity fund, 30% corporate bond fund, and 20% government fund personal account portfolio. The EBRI Study sharply contradicts the underlying assumptions about worker investment behavior that lead to the Commission's projections that all workers will be better off, in terms of total Social Security benefits, with personal Social Security accounts.

Can the investment behavior evidenced in the EBRI Study be modified through a Board-provided program of "informative" advice?<sup>186</sup> Advocates for personal accounts argue that under a personal account system workers will become more educated about investing, and that as a consequence they will modify their investment and savings decisions accordingly. This argument, which is Truth #2, is addressed in the next section of Part III of the Article.

### 3. Government Studies of Mutual Fund Fees

Investment allocation and the resulting investment performance will not be the sole determinate of the balance in a worker's personal Social Security account available to pay benefits at retirement. Another important factor will be the fees deducted from the account for investment management and administrative services. In 1998, the Department of Labor issued the results of a study of the mutual fund fees and expenses being charged to participants in 401(k) plans.<sup>187</sup> As a direct result of this study, the Department of Labor initiated a public education program for both 401(k) plan participants and sponsoring employers concerning the adverse impact of fees on the accumulation of retirement assets in 401(k) plans.<sup>188</sup> More recently, the issue of mutual fund fees has been studied by both the General Accounting Office ("GAO")<sup>189</sup> and the Securities and Exchange

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186. *See id.* at 46, 49.

187. PENSION & WELFARE BENEFITS ADMIN., U.S. DEP'T OF LABOR, STUDY OF 401(K) PLAN FEES AND EXPENSES (1998), at <http://www.dol.gov/ebsa/pdf/401kRept.pdf> (on file with the North Carolina Law Review) [hereinafter DOL FEE STUDY].

188. 401(K) FEES, *supra* note 155.

189. GAO FEE STUDY, *supra* note 156; GAO FEE STUDY REPLY, *supra* note 156.

Commission ("SEC").<sup>190</sup> Both the GAO and SEC studies conclude that the requirements for disclosure of mutual fund fees need to be changed so that investors can understand and compare mutual fund fees when making investment decisions.<sup>191</sup> The GAO and SEC studies disagree, however, on how to change the format for disclosure of mutual fund fees to remedy this problem.<sup>192</sup>

The potential adverse impact of mutual fund fees on the growth of assets held in personal Social Security accounts is illustrated by the following example, published by the Department of Labor's public education booklet, *A Look At 401(k) Plan Fees*:

Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of \$25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to \$227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent, however, your account balance will grow to only \$163,000. *The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.*<sup>193</sup>

The example illustrates the potential adverse effect of mutual fund fees over time on personal Social Security accounts. Higher expenses represent lost investment opportunity costs, the cumulative effect of which is greatly magnified over time.<sup>194</sup>

In the 401(k) plan context, fees generally fall into three categories: plan administration fees; investment management fees; and fees for individualized services.<sup>195</sup> Two of these categories, administrative fees and investment management fees, will apply to personal Social Security accounts.<sup>196</sup>

Administrative fees cover the costs of the daily operation of the account, such as record keeping, reporting, accounting, and trustee services.<sup>197</sup> For 401(k) plans, administrative fees are relatively small;

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190. SEC FEE STUDY, *supra* note 51.

191. See *infra* notes 218-45 and accompanying text.

192. See *infra* notes 218-45 and accompanying text.

193. 401(K) FEES, *supra* note 155, at 2 (emphasis added).

194. See DOL FEE STUDY, *supra* note 187, § 1.

195. See 401(K) FEES, *supra* note 155, at 4-5.

196. Individual service fees are charged to participants who use optional 401(k) plan features, such as plan loans or pre-retirement withdrawal, that will not be allowed under the Commission's proposed administrative structure for personal Social Security accounts. See 401(K) FEES, *supra* note 155, at 5; *supra* note 60 and accompanying text.

197. See 401(K) FEES, *supra* note 155, at 4.

investment management fees represent the largest component of fees and expenses.<sup>198</sup> Under the Commission's proposed administrative structure for personal Social Security accounts, the same is likely to be true. At the Tier I level, administrative fees (the Commission Report uses the term "transaction costs") will be minimized through the use of a central administrator.<sup>199</sup> At the Tier II level, however, the Commission's recommended fee structure for Tier II private sector mutual funds merges the issue of administrative fees with the far more significant issue of investment management fees.

In the 401(k) plan context, investment management fees are estimated to represent between 75% to 90% of the total fees and expenses charged to 401(k) plans.<sup>200</sup> Investment management fees are paid to the investment manager of the mutual fund for managing and investing the assets of the mutual fund.<sup>201</sup> These fees are charged as a percentage of the assets held in the mutual fund (the "expense ratio" in the above example),<sup>202</sup> and are deducted directly from mutual fund assets.<sup>203</sup> Although investment management fees are not deducted directly from each participant's account, these fees represent an indirect "charge" in the sense that the investment management fees reduce the level of investment returns generated by the mutual fund.<sup>204</sup>

Under the Commission's proposed administrative structure for personal accounts, mutual fees will not be regulated directly by the Board. Both Tier I and Tier II mutual funds will be allowed to charge only a single annual fee, expressed as an expense ratio.<sup>205</sup> At the Tier I level, the Board's competitive selection process for qualifying mutual funds and their investment managers should operate to reduce fees to a minimum.<sup>206</sup> It is primarily at the Tier II level, where

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198. DOL FEE STUDY, *supra* note 187, § 3.6.

199. The Commission assumes administrative costs of thirty basis points (0.3 percent of the account balance) in its projections of low-, medium-, and high-income worker benefits under a personal account system. See COMMISSION REPORT, *supra* note 1, at 97.

200. GAO FEE STUDY, *supra* note 156, at 26–27 ("The largest component of a fund's total expense ratio usually is the management fee, which is the ongoing charge paid to the investment adviser for managing the fund's assets and selecting its portfolio of securities.").

201. See DOL FEE STUDY, *supra* note 187, § 3.3.4.

202. See SEC FEE STUDY, *supra* note 51, § III.B.1.

203. See DOL FEE STUDY, *supra* note 187, § 3.4.3.

204. See 401(K) FEES, *supra* note 155, at 4–5.

205. See COMMISSION REPORT, *supra* note 1, at 46.

206. See *id.* at 51 ("Fund management services would be auctioned off to several private-sector providers in order to provide low fees and to avoid any single fund manager holding too much money.").



workers are offered the opportunity to invest their accounts in private sector mutual funds approved by the Board, that several recent government studies strongly suggest that the Commission's reluctance to directly regulate mutual fund fees or significantly change the current system of disclosure is problematic.

In 1998, the Department of Labor publicly called attention to the significance of mutual fund fees in its commissioned report, *Study of 401(k) Plan Fees and Expenses* ("DOL Fee Study").<sup>207</sup> The DOL Fee Study found that the amounts being charged as fees and expenses for 401(k) plans varied greatly.<sup>208</sup> Several possible reasons for these wide discrepancies in fees and expenses among 401(k) plans were discussed. First, fees and expenses were not clearly disclosed to plan sponsors.<sup>209</sup> Indeed, the DOL Fee Study noted that there were at least eighty different ways in which fees and expenses were being charged to 401(k) plans.<sup>210</sup> Second, the general market for 401(k) plan services was not efficient in the sense that it was "difficult to impossible" for employers to obtain information about the universe of potential plan service providers and compare the fees and expenses charged.<sup>211</sup> This was in part a function of the lack of standardization and disclosure of fees.<sup>212</sup> Finally, a third reason given for variations in fees was that larger 401(k) plans enjoyed a competitive advantage in negotiating lower prices.<sup>213</sup>

The Commission's requirement that Tier II mutual funds may charge only one standardized fee, expressed as an expense ratio,

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207. See DOL FEE STUDY, *supra* note 187, § 1.

208. See *id.* § 4.2.

209. See *id.* § 3.7. Although some of these criticisms in the DOL Fee Study were directed at investment products other than mutual funds, see *id.* § 2.4.2 (stable value accounts); § 2.4.3 (company stock); § 2.5.1 (insurance products), the DOL Fee Study noted that even among mutual funds investment management fees varied greatly. See *id.* § 4.2.1. This occurred despite the fact that the Securities and Exchange Commission ("SEC") mandates and regulates disclosure of fees charged by mutual fund investment managers. See *id.* § 3.4.3; Medill, *Individual Responsibility Model*, *supra* note 16, at 38–46 (discussing mutual fund fees in the context of federal regulation of employer-sponsored retirement plans). Despite SEC regulation of the amounts and mandated disclosure, only eight percent of mutual fund investors understand the fees they are charged. See SEC Commissioner Paul R. Carey, Social Security Privatization (Jan. 31, 2001), at <http://www.sec.gov/news/speech/spch459.htm> (on file with the North Carolina Law Review); Press Release, Invesmart, Invesmart Estimates That Three-Quarters of Retirement Plan Sponsors Are Unaware of "Hidden Fees" (Nov. 2, 2001), at [http://www.invesmart.com/press\\_room/press/releases/release\\_110201.htm](http://www.invesmart.com/press_room/press/releases/release_110201.htm) (on file with the North Carolina Law Review) [hereinafter Invesmart Press Release].

210. See DOL FEE STUDY, *supra* note 187, § 3.7.

211. See *id.* § 2.7.4.

212. See *id.* § 3.7.

213. See *id.* § 4.4.

addresses many of the problems originally identified in the DOL Fee Study. In mandating a standard fee disclosure format rather than proposing to regulate the fees chargeable by Tier II mutual funds directly, the Commission has chosen to rely on the market itself to regulate the level of Tier II mutual fund fees. Recently, however, the popular press,<sup>214</sup> industry insiders,<sup>215</sup> the General Accounting Office,<sup>216</sup> and the Securities and Exchange Commission itself<sup>217</sup> have questioned the effectiveness of marketplace regulation of mutual fund fees.

In June of 2000, the General Accounting Office released a study of trends in mutual fund fees ("GAO Fee Study").<sup>218</sup> This study was conducted at the request of several committees of Congress.<sup>219</sup> The GAO Fee Study found that marketplace competition in the mutual fund industry does not focus directly on fees, but rather on fund investment returns.<sup>220</sup> Fund investment returns only indirectly reflect the cost of mutual fund fees, which are deducted from the fund's assets before investment returns are calculated.<sup>221</sup> Although federal securities laws require that the fees be disclosed in the fund's prospectus and annual and semi-annual reports,<sup>222</sup> the GAO noted that prior research studies conducted by the SEC itself had found that mutual fund investors do not pay attention to, or understand, the impact of mutual fund fees on fund investment performance.<sup>223</sup> The GAO noted that the SEC's own research showed that "fewer than one in six fund investors understood that higher expenses can lead to lower returns," and "about 40 percent of fund investors surveyed

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214. See Scott Burns, *From Your Pocket, Into Managers'*, DALLAS MORNING NEWS, Nov. 25, 2001, at H1; Scott Burns, *Fund Companies Often Outshine Their Products*, DALLAS MORNING NEWS, Sept. 29, 1998, at D1, 1998 WL 13106450; Scott Burns, *Managers' Fees Can Add up to Big Losses*, DALLAS MORNING NEWS, Nov. 27, 2001, at D1; Tom Kalbrener, *Opinion: 401(k) Plan Fees Are Unfair*, PLAN SPONSOR, Dec.-Jan. 1998, at 60-61.

215. John C. Bogle, *After the Fall: What's Next for the Stock Market and the Mutual Fund Industry?* (Mar. 21, 2001), at [http://www.vanguard.com/bogle\\_site/march212001.html](http://www.vanguard.com/bogle_site/march212001.html) (on file with the North Carolina Law Review); John C. Bogle, *Mutual Fund Directors: The Dog That Didn't Bark* (Jan. 28, 2001), at [http://www.vanguard.com/bogle\\_site/january282001.html](http://www.vanguard.com/bogle_site/january282001.html) (on file with the North Carolina Law Review). John C. Bogle is the founder of the Vanguard Group. *Id.*

216. See GAO FEE STUDY, *supra* note 156, at 7; GAO FEE STUDY REPLY, *supra* note 156, at 3-4.

217. See SEC FEE STUDY, *supra* note 51, § IV; Carey, *supra* note 209.

218. GAO FEE STUDY, *supra* note 156.

219. See *id.* at 4.

220. See *id.* at 62-64.

221. See *id.* at 63-64.

222. See *id.* at 66-70.

223. See *id.* at 72-74.

believed incorrectly that a fund's annual operating expenses have no effect on its gains."<sup>224</sup> The GAO Fee Study identified as a potential source of investor ignorance the fact that mutual fund fees are deducted automatically by the fund and not reported as a separate "expense" to the investor.<sup>225</sup> As one industry expert quoted in the GAO Fee Study stated, "[n]o one sends the investor a bill, and the fund simply quietly and continually deducts its fees. The result is that the information [fee disclosures in the prospectus and annual and semi-annual reports] is ignored."<sup>226</sup>

The GAO Fee Study found that market conditions in the mutual fund industry may not be sufficiently competitive to reduce mutual fund fees.<sup>227</sup> The GAO Fee Study described the mutual fund industry as exhibiting the characteristics of a monopolistically competitive market, where "products" (mutual funds) are differentiated by quality or services.<sup>228</sup> In a monopolistically competitive market, firms can charge different "prices" (the investment manager fee) for their products because each product is promoted to consumers as unique.<sup>229</sup> In the mutual fund industry, fund marketing strategy promotes each mutual fund as unique due to the fund's particular investment strategy, a strategy designed and implemented by the fund's investment manager(s).<sup>230</sup> The GAO Fee Study found that the potential for fund differentiation, with its accompanying reduction in fee competition, was greatest among actively traded equity mutual funds.<sup>231</sup> In essence, the wider range of investment returns among equity mutual funds (before the deduction of investment manager

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224. *Id.* at 73. It is unclear whether anyone at the GAO or the SEC, in reviewing the results of this research, considered whether very small investors were being rationally ignorant in foregoing the time it would take to understand, investigate, and compare the fees charged by mutual fund companies.

225. *See id.* at 13, 75-78.

226. *Id.* at 76.

227. *See id.* at 64-65.

228. *See id.* at 56-65. There is some indirect evidence, however, that competition on the basis of fees may exist in the market for no-load mutual funds. For example, the Vanguard Group, the mutual fund industry's second largest company in terms of assets under management and the industry's leader in offering low-cost mutual funds, may soon surpass the industry leader, Fidelity Investments. *See* Aaron Lucchetti, *Can Vanguard Group Outgrow No. 1 Fidelity?*, WALL ST. J., May 14, 2002, at C1.

229. *See* GAO FEE STUDY, *supra* note 156, at 56-57.

230. *See id.* at 62.

231. *See id.* at 63 ("The chairman of one mutual fund firm stated that although price competition exists among money market and bond funds, for which the impact of operating expense fees [on fund investment returns] was much more obvious, stock funds were not subject to nearly as much price competition.").

fees) served to mask variances in the levels of investment manager fees.<sup>232</sup>

To increase investor awareness of mutual fund fees and to promote greater fee competition, the GAO Fee Study recommended that mutual fund investors receive “personalized” mutual fund fee statements along with their quarterly investment returns.<sup>233</sup> These personalized fee statements would show the actual dollar amount that was deducted from the investor’s returns due to mutual fund fees.<sup>234</sup> In short, mutual fund investors would receive a “bill” for the services of the fund’s investment manager.

Not surprisingly, the SEC responded with its own study of trends in mutual fund fees in December of 2000 (“SEC Fee Study”).<sup>235</sup> The SEC’s results were inconclusive as to whether the overall cost of investing for mutual fund shareholders had been increasing or decreasing over the period 1979–1999.<sup>236</sup> The SEC Fee Study was not inconclusive, however, in its response to the GAO’s call for quarterly personalized fee bills. Although the SEC agreed that mutual fund investors needed to be better educated and informed concerning mutual fund fees,<sup>237</sup> the SEC objected to personalized fee bills on the grounds that it would be difficult and costly to change the structural methods by which mutual funds are marketed and administered in the ways that would be necessary to produce personalized fee statements.<sup>238</sup> The SEC instead proposed that mutual fund fees should continue to be disclosed using a table showing the costs in

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232. *See id.* at 63. The GAO Fee Study notes that mutual fund industry officials offered two potential explanations for the wider range of fees charged by equity mutual funds. First, the wider range of investment returns from equity funds made fees less relevant to investors, who are concerned with investment performance. Second, a talented investment manager can justify a higher fee by producing higher than average investment returns. *See id.*

233. *See id.* at 97–98. Lower cost alternative disclosure methods were also suggested. *See id.*

234. *See id.*

235. SEC FEE STUDY, *supra* note 51.

236. The SEC found that although mutual fund operating expense ratios had increased since 1979, the sales commissions (“loads”) charged to investors had declined over time with the growth of “no-load” mutual funds. Because sales commissions are not included in operating expense ratios, this shift made it difficult to compare operating expense ratios from earlier and later periods. *See id.* § I.B.1.

237. *See id.* § I.B.2.a. (“We agree with the General Accounting Office that the fund industry and the Commission should encourage fund shareholders to pay greater attention to fees and expenses.”).

238. *See id.* § IV.A.1.; *see also* GAO FEE STUDY REPLY, *supra* note 156, at 5 (considering the SEC’s recommendations, but concluding that investors’ interests would be best served by disclosure of the fees paid on their shares).

dollars incurred by a shareholder who invested a standardized amount, such as \$10,000.<sup>239</sup> This table would be contained in the investor's annual and semi-annual reports, but not in the investor's one-page quarterly statements.<sup>240</sup> The SEC argued that a standardized table, expressing fees using the common denominator of a percentage of fund assets, would be sufficient to allow investors easily to compare fees among different mutual funds.<sup>241</sup>

At the request of members of Congress, the GAO reviewed and commented on the SEC Report.<sup>242</sup> The GAO had two main comments. First, the GAO found that the SEC's survey of mutual fund fees charged by the 100 largest mutual funds provided additional support for its conclusion that monopolistic competition existed in the industry.<sup>243</sup> Second, the GAO objected to the SEC's proposed table disclosure method for two reasons. The proposed system would not disclose mutual fund fees in a manner that was specific and personal to each investor, and it would not be contained in the most meaningful and relevant source relied upon by investors—the quarterly statement showing the dollar amount in the investor's mutual fund account.<sup>244</sup> The GAO also noted that the SEC's proposed fee table also could be incorporated into quarterly statements, and thereby allow investors to make comparisons across mutual funds.<sup>245</sup>

It is against the backdrop of this very public debate that the Commission made its recommendations concerning the disclosure of fees charged by mutual fund companies who manage funds used as

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239. See SEC FEE STUDY, *supra* note 51, § IV.A.1.

240. See *id.* The SEC's rationale for including the table in the fund's annual and semi-annual reports, rather than in the quarterly statement, was that investors should evaluate the fee in light of the management analysis of the fund's performance, an analysis that is contained in the annual and semi-annual reports. See *id.*

241. See *id.*

242. GAO FEE STUDY REPLY, *supra* note 156, at 1.

243. See *id.* at 3–4. The GAO found that the assets held by many large funds were beyond the “breakpoints” in the fee structure that called for automatic reductions in the percentage amount of the fee charged as the funds' assets grew, thereby passing on to the funds' investors the cost savings realized through economies of scale. See *id.* The GAO stated:

This lack of breakpoints may result because the funds have already achieved whatever economies of scale exist so that fees may remain stable as assets grow. Alternatively, if economies of scale do exist, the lack of breakpoints could be a symptom that competitive forces are not sufficient to force funds to pass on savings to investors.

*Id.* at 4.

244. See *id.* at 5–7.

245. See *id.* at 7.

investment options for personal Social Security accounts. Given that under the Commission's proposals the Board will not directly regulate the level of mutual fund fees and expenses,<sup>246</sup> the issue of effective disclosure becomes paramount. With respect to disclosure, the Commission's recommendation of a single fee, expressed as a percentage of fund assets, takes the SEC's side of this debate.<sup>247</sup> Although the GAO's more rigorous approach to fee disclosure may be cost prohibitive if required for the entire mutual fund industry, there are compelling policy reasons to require a higher standard for fee disclosure in the much more limited context of personal Social Security accounts. Under the current fee disclosure system, many mutual fund investors, including many 401(k) plan participants, do not realize the long-term impact of mutual fund fees on investment performance.<sup>248</sup> If experienced mutual fund investors are unable to understand and evaluate the adverse financial impact of fees, it seems foolhardy to expect that literally millions of workers (many of whom are woefully ignorant in financial matters) who become first-time investors under a personal account system would be able to do so. The issue of fee disclosure should be addressed from the perspective of the unique social policy purpose of the Social Security system—to promote income security in old age—rather than evaluated in terms of cost effectiveness for the mutual fund industry.<sup>249</sup> The significant reduction in the balance of a worker's personal account at retirement that can result from even a small difference in fees, compounded over a worker's lifetime, justifies a rigorous system of regulatory disclosure that aspires to the ideal in terms of effective communication to

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246. See COMMISSION REPORT, *supra* note 1, at 46. ("The Governing Board chooses the threshold amount that is required for people to move their balances into Tier II so that it would be feasible for such accounts to be charged low transaction costs without the need for price caps.").

247. See *id.*

248. See Carey, *supra* note 209; Invesmart Press Release, *supra* note 209.

249. Indeed, the cost concerns that prompted the SEC to reject the GAO's disclosure recommendations can be mitigated in the context of a personal account system. The SEC's objection to personalized quarterly fee bills was based primarily on the costs of modifying the preexisting structure for how all mutual funds are marketed and distributed. See SEC FEE STUDY, *supra* note 51, § IV.A.1. This concern is not nearly so strong in the context of personal Social Security accounts, the legal structure of which has yet to be created by Congress. Initially, the Board will select the mutual fund investment managers for the nine funds allowed as investment options for Tier I accounts using a competitive process. See COMMISSION REPORT, *supra* note 1, at 51. A personalized fee bill reporting system simply could be built into the requirements governing this competitive selection process. Similarly, when the Board certifies Tier II private sector mutual funds, one of the requirements for certification could be that the mutual fund will provide quarterly fee bill statements as proposed by the GAO.

workers. In short, the fee disclosure system for personal accounts should not simply conform to market standards—it should create new standards that become an example of “best practices” for the mutual fund industry.

*B. Truth #2: Investment Education Will Significantly Change Investment Behavior and Thereby Improve Investment Returns*

If personal Social Security accounts are implemented, it is undisputed that many workers will need investment education.<sup>250</sup> Indeed, one of the advantages of personal Social Security accounts cited by the Commission is that such accounts will promote greater investment knowledge and expertise among the United States workforce and might even improve the rate of national savings.<sup>251</sup> The Commission proposes that at the Tier I level, where all workers initially must begin, the Board will undertake the task of providing investment education to these workers by providing information about investing for retirement generally and specific information concerning their Tier I investment options.<sup>252</sup> The underlying implication, Truth #2, is that after spending several years becoming educated at the Tier I level, workers will significantly change their investment behavior, make sound investment decisions, and thereby improve the investment returns from their personal Social Security accounts.

This section of the Article argues that Truth #2 is flawed in two respects. First, recent research concerning the impact of providing investment education to 401(k) plan participants indicates that investment education of the type proposed by the Commission will be

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250. See, e.g., ADMINISTRATIVE ISSUES STUDY, *supra* note 62, at 34–36 (describing the general lack of understanding exhibited by many Americans and asserting that the more freedom participants are given in managing their personal accounts, the more ongoing education they will need); Laibson et al., *supra* note 62, at 91, 92 nn.3–4 (using a hyperbolic model to examine under-saving in the United States); Medill, *Individual Responsibility Model*, *supra* note 16, at 14–17 (reviewing studies of retirement investment knowledge among the public); Hirschman, *supra* note 62, at 33–36 (discussing human resource departments' roles in informing employees about 401(k)s); McCarthy & McWhirter, *supra* note 62, at 25–31 (noting that despite efforts to educate employees, as many as fifty-seven percent choose to take cash payments from their 401(k)s when changing jobs, rather than rolling their balance into their new employer's plan); see also K.C. Swanson, *Nebraska Sees Red Over Its 401(k) Plan* (May 7, 2002), at [http://www.thestreet.com/\\_tscs/funds/belowradar/10021041.html](http://www.thestreet.com/_tscs/funds/belowradar/10021041.html) (on file with the North Carolina Law Review) (reporting on the abandonment of Nebraska's retirement plan due to employee lack of knowledge and interest).

251. See COMMISSION REPORT, *supra* note 1, at 34, 39.

252. See *id.* at 46.

ineffectual in influencing the investment behavior of workers under a personal account system. Second, the Commission's proposed structure for personal accounts appears to preclude the very type of information that *could* influence worker investment behavior, namely, providing workers with investment *advice*.<sup>253</sup>

The effect of providing investment education on the investment decisions of participants in 401(k) plans has been the subject of numerous studies.<sup>254</sup> Early studies consistently reported that investment education had a significant positive effect on the investment decisions of 401(k) plan participants.<sup>255</sup> A recent study by the National Bureau of Economic Research ("NBER")<sup>256</sup> calls into question the results of these early studies due to serious

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253. Investment "education" is a term of art in the ERISA field and is often used as a contrast with another related term of art, investment "advice." The distinction between investment education and investment advice is a critical one in the ERISA field because one who provides investment advice for a fee or other compensation is a fiduciary, subject to ERISA's rules governing fiduciary conduct and liability. See Medill, *Individual Responsibility Model*, *supra* note 16, at 27–28. In theory, as interpreted by the Department of Labor, the difference between these two legal concepts is that education involves general information concerning investment theory and plan investment options, whereas advice consists of specific investment recommendations tailored to the unique circumstances of the individual participant. See *id.* at 28–29, 51–54. In practice, the difference between education and advice oftentimes is unclear, particularly from the perspective of the plan participants. See *id.* at 54–62.

Researchers have explored the impact of providing investment "education" to 401(k) plan participants on investment behavior. Recent research in this area has concluded that providing investment education is not effective in influencing investment behavior. See discussion *infra* text accompanying notes 254–71. This research is consistent with earlier studies of investment behavior finding a strong bias in favor of maintaining the investment status quo. See Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia In 401(k) Participation and Savings Behavior*, 116 Q.J. ECON., 1149, 1176–79 (2001) (401(k) plans); William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision-Making*, 1 J. RISK & UNCERTAINTY 7, 31–33 (1988) (403(b) plans sponsored by TIAA-CREF). Researchers attribute this status quo bias in part to the high indirect transaction cost of gathering and analyzing the information necessary to make a complex investment decision relative to the short-term benefit of making an investment change. See Madrian & Shea, *supra*, at 1177–79. Investment education plays into this status quo bias effect because of the general nature of the investment information provided to the plan participant. In contrast, the individualized and specific nature of investment advice serves to eliminate the indirect transaction cost associated with making an investment change, thereby eliminating a root cause of status quo bias. Another root cause of the status quo bias effect identified by researchers is the lack of self-control by plan participants. See Madrian & Shea, *supra*, at 1179–80. Investment advice also potentially mitigates this problem of self-control because rather than relying on self-discipline, the participant can merely follow the "orders" of the investment advisor.

254. See PATH OF LEAST RESISTANCE, *supra* note 107, at 28–29 (collecting and describing prior studies).

255. See *id.*

256. *Id.*



methodological flaws.<sup>257</sup> The NBER researchers found that, contrary to the findings of these earlier studies, investment education does not significantly change investment behavior among 401(k) plan participants.<sup>258</sup>

The NBER researchers classified earlier studies of the effects of investment education as falling into two categories.<sup>259</sup> The first category involved case studies of companies or organizations where the employer provided financial education to its workers.<sup>260</sup> The NBER researchers found that the results of these case studies were methodologically flawed because the reported findings were based on the investment changes the participants *said* they intended to make, rather than on the investment changes the participants *actually made*.<sup>261</sup> The NBER researchers concluded:

Unfortunately, a growing body of both theoretical and empirical evidence, including the survey results reported in . . . this paper, suggests that despite the best intentions of employees, retirement saving is one area in which individuals excel at delay. Thus, measures of intended behavior are *likely to dramatically overstate the actual effects of financial education*.<sup>262</sup>

The second category of investment education studies criticized by the NBER researchers were described as “cross-sectional surveys of individuals from across the population, not just from a single company or organization.”<sup>263</sup> The NBER researchers characterized these cross-sectional data surveys as presenting “numerous” problems, such as (1) the inability to control for other significant factors, such as 401(k) plan design, (2) the lack of a uniform definition of “financial education,” (3) possible recall bias that would overstate the impact of financial education, and (4) “quite low” response rates by survey participants.<sup>264</sup>

To correct these methodological errors, the NBER researchers compiled a new data set.<sup>265</sup> One of the companies in the study,

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257. *See id.* at 28–29.

258. *See id.* at 31.

259. *See id.* at 28–29.

260. *See id.* at 28.

261. *See id.* at 28–29.

262. *Id.* (citations omitted) (emphasis added). This “gap” between intention and action is a well-recognized problem in economic studies of consumer behavior. *See* Laibson et al., *supra* note 62, at 92–93; Madrian & Shea, *supra* note 253, at 1177–80.

263. PATH OF LEAST RESISTANCE, *supra* note 107, at 29.

264. *Id.* at 29–30.

265. *See id.* at 44 tbl.1.

Company C, was an insurance company with 30,000 workers.<sup>266</sup> Company C hired a financial education provider to provide one-hour seminars to its employees. The provider's seminar covered basic topics such as how to set retirement savings goals to meet retirement income targets and the fundamental principles of investing, such as asset classes, investment risk, and investment diversification.<sup>267</sup> The data set collected from Company C was unique in that it enabled the researchers to track the pre-seminar and post-seminar investment behavior of the seminar attendees.<sup>268</sup> The NBER researchers found that of those seminar attendees who were already participating in the plan, 28% reported they planned to increase their 401(k) contribution rate, 41% reported they planned to change their investment choices, and 36% reported they would change their percentage allocations among the various plan investment choices.<sup>269</sup> In reality, however, only 8% of the 401(k) plan participants attending the seminars increased their contribution rate, 15% changed their investment choices, and 10% changed their allocation percentages.<sup>270</sup> The NBER researchers concluded: "[w]hile the fraction of seminar attendees making such changes is slightly higher than the fraction of non-seminar attendees, *it is substantially below what the attendees reported they planned on doing.*"<sup>271</sup>

The NBER study could be criticized on the ground that Company C's financial education seminars provided information that was too general to be useful to the participants. In other words, the seminars provided general investment *education*, when what 401(k) participants really needed was individualized investment *advice*.<sup>272</sup> Proponents of Truth #2 are likely to minimize the policy implications of the NBER study by arguing that, in contrast to the Company C employees, workers who invest in personal Social Security accounts will receive more than just general investment education; they will receive "informative" (investment) advice.<sup>273</sup>

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266. *Id.* at 30, 44 tbl.1.

267. *See id.* at 30.

268. *Id.*

269. *Id.* at 31.

270. *Id.*

271. *Id.* (emphasis added).

272. For a detailed discussion of the fine legal distinctions between general investment education and individualized investment advice under the federal laws governing 401(k) plans, see generally Medill, *Individual Responsibility Model*, *supra* note 16, at 27–48.

273. COMMISSION REPORT, *supra* note 1, at 46.

In the 401(k) plan context, the line between investment education and investment advice has been a murky one.<sup>274</sup> Employers and plan service providers generally have faced two significant legal obstacles to providing 401(k) plan participants with personalized investment advice. The first legal obstacle to providing 401(k) participants with investment advice is the potential co-fiduciary liability of the employer for “bad” advice<sup>275</sup> under the Employee Retirement Income Security Act<sup>276</sup> (“ERISA”), the federal law that governs the duties of employers who sponsor 401(k) plans and the service providers who assist employers in administering their plans.<sup>277</sup> This obstacle presumably would not exist in the context of personal Social Security accounts, where the governmental Board would effectively substitute for the employer. The other legal obstacle to providing workers with investment advice has been the prohibited transaction rules of ERISA.<sup>278</sup> To avoid violating ERISA’s

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274. See *supra* note 253.

275. See Medill, *Individual Responsibility Model*, *supra* note 16, at 48. A recent survey of employers by the Profit Sharing Council of America found that the overwhelming reason why employers did not provide investment advice to their workers was the potential legal liability. See Profit Sharing/401(k) Council of America, *Investment Advice Survey 2001*, at <http://www.psc.org/data/advice2001printer.html> (last visited Feb. 16, 2003) (on file with the North Carolina Law Review).

276. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified as amended in scattered sections of 26 & 29 U.S.C.) (“ERISA”).

277. This potential employer liability arises under ERISA’s fiduciary and co-fiduciary duty provisions. See 29 U.S.C.A. § 1104(a) (Supp. 2002); 29 U.S.C. § 1105(a) (1999); Medill, *Individual Responsibility Model*, *supra* note 16, at 30–32, 48.

278. See 29 U.S.C. § 1106; Medill, *Individual Responsibility Model*, *supra* note 16, at 38–48. ERISA’s prohibited transaction rules generally bar a plan fiduciary from self-dealing with plan assets, engaging in a transaction using plan assets where the fiduciary has a conflict of interest, or receiving kickbacks from other persons who are engaged in a transaction involving plan assets. See § 1106(b)(1)–(3). ERISA defines a plan fiduciary to include any person who renders investment advice for compensation with respect to any moneys or property of the plan (whether the compensation is direct or indirect). *Id.* § 1002(21)(A)(ii); see also Medill, *Individual Responsibility Model*, *supra* note 16, at 28–30 (discussing the Department of Labor’s regulatory interpretations of the definition of an investment advisor). Generally, service providers receive at least a portion of the mutual fund fees that are deducted from the plan’s assets, i.e., the plan’s mutual fund investment options. The service provider’s receipt of mutual fund fees satisfies the “compensation” element required for fiduciary status under the statutory definition of an investment advisor. See Medill, *Individual Responsibility Model*, *supra* note 16, at 30, 41–46 (explaining mutual fund fee arrangements with service providers in the 401(k) plan context). Consequently, if the service provider also renders investment advice, it then becomes a fiduciary under ERISA, and as a consequence of the prohibited transaction rules, the service provider is prohibited from retaining its share of mutual fund fees. See *id.* at 30. Faced with the choice of retaining their portion of mutual fund fees or providing investment advice, service providers have chosen to keep the mutual fund fees and not render investment advice. See *id.*

prohibited transaction rules, service providers have used independent investment experts to develop computer models programmed to generate model asset allocation portfolios based upon the participant's individualized investment goals and risk tolerance characteristics.<sup>279</sup> When the computerized investment advice model was first developed, the industry practice was for the service provider to submit its program to the Department of Labor and obtain an administrative exemption from the prohibited transaction rules<sup>280</sup> prior to using the model to offer investment advice to its "customers," the 401(k) participants. In December of 2001, however, the Department of Labor issued an advisory opinion ("SunAmerica letter")<sup>281</sup> concerning a computerized investment advice program that effectively relieves service providers from going through the cumbersome and costly administrative exemption procedure.<sup>282</sup> The anticipated result of the SunAmerica letter will be the proliferation of computerized investment advice models as a means of providing personalized investment advice to 401(k) participants.<sup>283</sup>

The computerized investment advice models developed by the financial services industry for 401(k) plan participants represent a cost-effective mechanism for delivering "personalized" investment advice to the millions of workers who would invest in personal Social Security accounts. At the Tier I level, the Board's program of "informative" advice could be developed to incorporate such computer models. At the Tier II level, however, it is unclear whether the Commission's emphasis on broad market diversification as a

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279. See Medill, *Individual Responsibility Model*, *supra* note 16, at 57–62 (commenting on the mechanics of such computer models).

280. See 29 U.S.C.A. § 1108(a) (Supp. 2002); Medill, *Individual Responsibility Model*, *supra* note 16, at 57–62, 77–78.

281. Advisory Opinion Letter 2001-09A from Louis Campagna, Chief, Division of Fiduciary Interpretations, Pension & Welfare Benefits Admin., to William A. Schmidt & Eric Berger, Kirkpatrick & Lockhart, L.L.P., Counsel for SunAmerica, (Dec. 14, 2001), at <http://www.dol.gov/ebsa/programs/ori/advisory2001/2001-09A.htm> (on file with the North Carolina Law Review).

282. See Press Release, Pension & Welfare Benefits Admin., Statement of Assistant Secretary Ann L. Combs Regarding SunAmerica Advisory Opinion (Dec. 19, 2001), at <http://www.dol.gov/ebsa/media/press/pr121911.htm> (on file with the North Carolina Law Review); Employee Benefits Inst. of Am., *DOL Permits Investment Company to Hire Financial Advisors for Participants* (Dec. 27, 2001), at <http://www.ebia.com/weekly/articles/2001/401k011227DOL2001-09A.html> (on file with the North Carolina Law Review); Groom Law Group, *DOL Advisory Opinion Clarifies Application of Prohibited Transaction Rules to Asset Allocation Programs* (Feb. 7, 2002), at [http://www.groom.com/articles\\_display.asp?display=157](http://www.groom.com/articles_display.asp?display=157) (on file with the North Carolina Law Review).

283. See Press Release, Pension & Welfare Benefits Admin., *supra* note 282; Employee Benefits Inst. of Am., *supra* note 282; Groom Law Group, *supra* note 282.

prerequisite to certification of private sector mutual funds as Tier II investments<sup>284</sup> would accommodate these computerized investment advice models.

The Commission's proposed diversification standard for Board certification of Tier II private sector mutual funds is reminiscent of the historical "prudent person" standard imposed on trustees of a trust when selecting trust investments.<sup>285</sup> Under the prudent person standard, the trustee had to evaluate the prudence of each investment held by the trust individually.<sup>286</sup> Similarly, the Commission proposes that the Board may only certify Tier II private sector mutual funds if they "meet very strict diversification requirements as established by the Governing Board . . . . Stock funds must be very diversified and reflect the performance of many companies spanning all major commercial sectors."<sup>287</sup>

Today's approach to the trustee's duty of care in selecting trust investments, known as the "prudent investor" standard, relies instead upon the modern portfolio theory of investments.<sup>288</sup> Under the prudent investor standard, each individual trust investment, in and of itself, does not have to satisfy the historical prudent person standard of diversification.<sup>289</sup> Rather, under the prudent investor standard the diversification and risk of the investments held by the trust are evaluated as a whole in accordance with modern portfolio theory.<sup>290</sup> The more recent computerized investment advice programs developed in the context of 401(k) plans are programmed by independent investment experts using modern portfolio theory.<sup>291</sup> To function properly, a computer model programmed using modern portfolio theory could not use investment options (Tier II private sector mutual funds) that individually and independently are broadly diversified. Rather, the program is designed to use a set of investment options that independently are not diversified, but which result in an overall investment portfolio that is diversified, and which is designed to produce an overall higher rate of total return. Admittedly, there have been no studies of whether computerized

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284. See COMMISSION REPORT, *supra* note 1, at 53.

285. Compare *id.*, with AMY MORRIS HESS ET AL., THE LAW OF TRUSTS AND TRUSTEES § 612, at 16 (3d rev. ed. 2000) ("The prudent person standard required a trustee to determine the prudence of each investment individually.").

286. HESS ET AL., *supra* note 285, § 612, at 16.

287. COMMISSION REPORT, *supra* note 1, at 53.

288. See HESS ET AL., *supra* note 285, § 611, at 6.

289. See *id.* § 612, at 31-32.

290. See *id.* § 612, at 27, 31-32.

291. See Medill, *Individual Responsibility Model*, *supra* note 16, at 59-60.

investment advice models are effective in changing the investment behavior of 401(k) participants. Clearly, however, workers could benefit from something more constructive than “informative” advice when selecting investments for their personal Social Security accounts. Unfortunately, the Commission’s proposed administrative structure appears to prevent the possible use of something more constructive—computerized investment advice programs—in the context of personal accounts.

*C. Truth #3: Personal Accounts Will “Build Wealth” Among Low-Income and Minority Workers*

The Commission (and others) assert that the traditional Social Security system is unfair to low-income or minority workers who die prior to ever receiving benefits, or who have a shorter life expectancy as a group and therefore do not receive their “money’s worth” in traditional benefit payments.<sup>292</sup> Under the Commission’s proposed structure for personal Social Security accounts, if a worker dies prior to becoming eligible for traditional benefits, the worker’s account balance will become part of her estate.<sup>293</sup> Similarly, if a retired worker does not consume the balance of her Social Security account during life, any remaining account balance may be bequeathed at death.<sup>294</sup>

For low-income or minority workers who die prior to retirement, personal Social Security accounts would provide an opportunity for intergenerational wealth transfer that is not available under the traditional benefit system.<sup>295</sup> Critics of personal Social Security accounts have responded to this point by arguing that low-income and minority workers benefit disproportionately from the disability benefits and benefits paid to their minor children under the current traditional Social Security system and from the progressive structure of traditional Social Security benefits.<sup>296</sup> Reductions in these benefits

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292. See COMMISSION REPORT, *supra* note 1, at 6; MICHAEL TANNER, DISPARATE IMPACT: SOCIAL SECURITY AND AFRICAN AMERICANS 2 (CATO Inst. Briefing Papers No. 61, Feb. 5, 2001), at <http://www.socialsecurity.org/pubs/articles/bp61.pdf> (on file with the North Carolina Law Review).

293. COMMISSION REPORT, *supra* note 1, at 56. The Commission Report explicitly addresses only bequests (the technical term for a gift made by a will). Presumably this is an oversight, and any remaining balance of a worker who died intestate would pass to the deceased worker’s heirs under the applicable state laws of intestate succession if the worker dies without a will. See *id.* at 55.

294. See *id.* at 56.

295. See *id.* at 32.

296. One report critical of the Commission’s plan noted that:

under the Commission's proposals,<sup>297</sup> critics argue, will more than offset the benefits of intergenerational wealth transfers for low-income and minority workers as a group.<sup>298</sup>

To date, the public debate concerning the "wealth building" potential of personal accounts has focused on workers who die prior to retirement, and has overlooked the implications for low-income workers of how benefits from personal Social Security accounts will be paid to workers who survive to retirement. The Commission's proposal structure for benefit payments undermines Truth #3 in two respects. First, under the Commission's proposed structure for controlling distributions from personal accounts, a low-income worker who survives to retirement must annuitize most (if not all) of the balance in her personal account.<sup>299</sup> Second, the Commission's distribution structure creates an adverse selection problem, which will increase the costs of annuitization.<sup>300</sup> The discussion below illustrates

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[M]inorities have higher rates of disability, on average, than the rest of the population and thus disproportionately benefit from the disability benefits that Social Security provides. Social Security data show, for example, that the percentage of black workers aged 50–59 who became disabled in 1997 was nearly double the percentage of all workers in that age group who became disabled. Blacks account for 13 percent of working-age Americans, but 17 percent of disabled workers' beneficiaries. . . . The reductions in survivor benefits also would disproportionately harm minorities: African-American children currently constitute 15 percent of Americans under age 18 but more than 22 percent of the children who receive Social Security survivor benefits.

DIAMOND & ORSZAG, *supra* note 140, at 19–20; see also BERNARD WASOW, SETTING THE RECORD STRAIGHT: TWO FALSE CLAIMS ABOUT AFRICAN AMERICANS AND SOCIAL SECURITY 1–3 (The Century Foundation, Mar. 2002), at [http://www.socsec.org/facts/Record\\_Straight/African\\_Americans.pdf](http://www.socsec.org/facts/Record_Straight/African_Americans.pdf) (on file with the North Carolina Law Review) (asserting that African-Americans are not short-changed by the current Social Security system).

297. These reductions are the result of the Commission's proposal to change the index method for all types of traditional Social Security benefits, including disability and young survivors benefits, from the wage index to the price (inflation) index. See DIAMOND & ORSZAG, *supra* note 140, at 13–20. Measuring the effect of this indexing change against the benchmark of benefits scheduled to be paid under the current Social Security benefit formula, Diamond and Orszag conclude that under Model 2, "[t]hese benefit reductions are so substantial that they are sufficient, by themselves, to *more than* eliminate the long-term deficit in Social Security." *Id.* at 17. Under Model 3, this indexing change by itself would eliminate two-thirds of Social Security's projected long-term deficit. *Id.* Diamond and Orszag also conclude that, although Model 2 provides modest increases in the minimum traditional benefit paid to workers with low wages throughout a long career and for persons with below-average Social Security benefits, eventually the overall benefit reductions caused by the indexing change will outweigh Model 2's increase in the traditional minimum benefit for this sub-group of beneficiaries. See *id.*

298. See *id.* at 19–20; Karen C. Burke & Grayson M.P. McCouch, *Privatizing Social Security: Eight Myths*, 74 TAX NOTES 1167, 1173 (1997).

299. See *infra* notes 304–10 and accompanying text.

300. See *infra* notes 311–22 and accompanying text.

why the costs of adverse selection are likely to fall most heavily, and unfairly, on low-income workers.<sup>301</sup>

In support of Truth #3, the co-chairmen of the Commission provide the following example of the potential that personal accounts hold for “wealth building”:

To illustrate what a participant might anticipate from setting aside one percent of his or her pay, matched with the government’s one percent, we can forecast the situation of a “scaled medium earner” [one who earns \$35,277 in annual income in today’s dollars<sup>302</sup>] entering the workforce at age 21 and retiring at age 65 in the year 2052. Assume a portfolio choice—there should be choices—roughly that of the current Thrift Savings Plan: 50 percent corporate equity, 30 percent corporate bonds, and 20 percent U.S. Treasury bonds. Real yields are assumed to be 6.5 percent for equities, 3.5 percent for corporate bonds, and 3 percent for Treasury bonds.<sup>303</sup> Also assume that this worker pays 0.3 percent of his account assets for annual administrative costs. At retirement she or he will have an expected portfolio worth \$523,000 (\$101,000 in constant 2001 dollars). A two-earner family could easily have an expected net “cash” worth of \$1 million.<sup>304</sup>

This example ignores, of course, the Commission’s own proposal for the form of distributions from personal accounts. Under the Commission’s proposed requirements, a worker’s combined total annual income from her traditional Social Security benefits and the benefits attributable to the worker’s personal account must be sufficient to maintain the worker (and if married, the worker’s

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301. See *infra* note 322 and accompanying text.

302. COMMISSION REPORT, *supra* note 1, at 8 n.4.

303. These are the same assumptions concerning average annual real rates of investment return that produce the Commission’s overall assumed rate of 4.6%. See *id.* at 97.

304. *Id.* at 9. This paragraph, found in the introduction to the Commission’s Report, is misleading because the \$523,000 figure cited by the Commission has not been adjusted (reduced) for inflation, despite the fact that this figure purports to be derived from “real yields.” Using the assumptions made by the Commission in this paragraph, it is possible to “reverse engineer” how the Commission arrived at its 2001 constant dollars figure of \$101,000. This reverse engineering process is most easily explained as a math story problem. If a worker contributes two percent of \$35,277 at the end of each year annually for a period of forty-five years, and the worker’s account contributions earn an annual compounded real rate of return of 4.6, how much money will be in the worker’s account at the end of the period? The answer is \$100,724.10, or approximately \$101,000, the figure in 2001 constant dollars cited by the Commission. A copy of the computer program incorporating the mathematical translation of the above-described math story problem is available from the author upon request.



spouse) “safely above the poverty line” during retirement.<sup>305</sup> Therefore, the single worker who survives to retirement in the example above will not be able to access the “wealth” built up in her account. She must annuitize at least a portion of it to satisfy the minimum standard.

Truth #3, the wealth building argument in favor of personal accounts, is designed to appeal primarily to low-income workers. Therefore, to evaluate the validity of this assertion, it is important to ask how much of a low-income worker’s account must be annuitized to satisfy the suggested minimum income standard. Because the Commission provides the value of the single worker’s account in the example above in constant 2001 dollars (i.e., adjusted for the effect of inflation), it is possible to answer this hypothetical question.

In the Commission’s illustrations of the total benefits that would be provided by the combination of traditional Social Security benefits and personal accounts, the Commission estimates that a low-income worker retiring in 2052 would receive \$8,568 annually in traditional Social Security benefits (again, this estimate is in constant 2001 dollars).<sup>306</sup> Applying the Commission’s recommended minimum “safely above the poverty line” standard for total benefits, assume that total benefits of \$18,000 annually (again, in constant 2001 dollars) are required.<sup>307</sup> Using Internal Revenue Service tables,<sup>308</sup> it is possible to compute the economic value as of December 2001 of an annuity for a worker, age sixty-five, that will pay \$1,500 per month for life.

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305. *Id.* at 56.

306. *Id.* at 111 (Model 1), 122 (Model 2), 133 (Model 3). This amount is the Commission’s estimate of the benefit affordable under current law, given that the traditional Social Security system is projected to be 27.6% under-funded in 2052. *Id.* at 111, 122, 133. The projected benefit in 2001 dollars for a low-income worker retiring in 2052, not taking into account funding deficits, is \$11,832. *Id.*

307. The Commission does not define a dollar amount for its suggested minimum income standard. I selected \$18,000 as an example because it provides for a monthly income of \$1,500, which seemed adequate, but certainly not extravagant. For 2001, the federal poverty level for a single individual residing in the forty-eight contiguous United States or the District of Columbia was \$8,590. U.S. Dep’t of Health and Human Serv., The 2001 HHS Poverty Guidelines, at <http://www.aspe.hhs.gov/poverty/01poverty.htm> (last modified Mar. 4, 2002) (on file with the North Carolina Law Review).

308. The above calculation uses Table S, promulgated by the Internal Revenue Service under section 7520 of the Internal Revenue Code, I.R.C. § 7520 (West 2002). Table S is a gender-neutral table used to calculate the economic value of a single-life annuity. Table S is generally regarded by estate planners as containing mortality assumptions that are conservative in comparison with the mortality assumptions used by the vendors of individual annuities. By 2052, the Internal Revenue Service (or private annuity vendors) could adjust mortality assumptions upward to reflect longer life expectancies. The effect of such an adjustment would be to require a *larger* lump sum payment up front to generate the same amount of monthly income payments to the annuitant for life.

The economic value of this annuity is \$109,642,<sup>309</sup> or more than the Commission's hypothetical medium-income worker holds in her personal account.

What does this \$109,642 figure mean for low-income workers? It means that low-income workers who live to retirement will not be able to access the "wealth" built up in their personal accounts. They will be forced to annuitize all of their account balance to satisfy the Commission's minimum income standard.<sup>310</sup>

The second flaw in Truth #3 concerns the adverse selection problem<sup>311</sup> created by the Commission's proposed benefit payment options for personal Social Security accounts. Recall that the Commission proposes that at retirement a worker will have two options for satisfying the minimum retirement income requirement. The worker may use the account balance to purchase a single premium immediate annuity that will generate the requisite amount of income ("traditional annuity").<sup>312</sup> Alternatively, the worker may choose to leave a Board-determined amount in the account and make

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309. This calculation uses the December 2001 applicable federal rate of 4.8% and makes an adjustment for the monthly payment feature. A copy of the printout from the Tiger Table computer software used to run the calculation is on file with the author.

310. Note that the above comparison, using the Commission's example of the account balance of a medium-income worker, overestimates the balance in a low-income worker's account. The low-income worker will have even less in her account at retirement because account contributions are based on a percentage of the worker's income under all three of the Commission reform models. In addition, note too that the economic value of the monthly annuity, \$109,642, underestimates the amount it would cost a low-income worker to purchase such an annuity because it does not include a profit margin for the insurance company or other vendor who provides the annuity. Although proponents of personal accounts may argue that the cost of a variable annuity (recall that the Commission assumes a variable annuity earning an average annual real rate of return of 4.6%, or that the account will continue to earn 4.6% during the worker's retirement years) would be less, I view this argument as unresponsive to my fundamental point—Truth #3 is disingenuous for low-income workers who survive to retirement.

311. The problem of adverse selection occurs when a large group of potential insureds are treated alike irrespective of some factor that differentiates them as insurance risks. In these circumstances, a disproportionately high percentage of applications for such insurance tends to come from the less desirable applicants because they receive the better bargain. ROBERT E. KEETON, *BASIC TEXT ON INSURANCE LAW* 8 (1971). Adverse selection occurs in the private market for single premium immediate annuities because insurers assume that persons who voluntarily purchase such annuities tend to live longer than average. The price for the annuity is set at a higher level to compensate the insurer for the longer life expectancy of the purchaser. See Olivia S. Mitchell et al., *New Evidence on the Money's Worth of Individual Annuities*, in *THE ROLE OF ANNUITY MARKETS IN FINANCING RETIREMENT* 71, 71–72 (Jeffrey R. Brown et al. eds., 2001) [hereinafter *ANNUITY MARKETS*].

312. The Commission Report describes the Board as being "required to make available different types of annuities," presumably by outsourcing to outside annuity providers, e.g., insurance companies. COMMISSION REPORT, *supra* note 1, at 56.

withdrawals as needed. This second option effectively allows the worker to “self-annuitize” her account, thereby avoiding the costs associated with the risk of longevity that are charged by the provider of a traditional annuity (“self-annuity option”).<sup>313</sup>

This distribution structure is functionally analogous to the distribution options for 401(k) plan accounts.<sup>314</sup> In theory, a 401(k) plan participant may take a lump sum distribution and use the money to purchase a traditional annuity from an insurance company or other vendor. Alternatively, the worker may leave the money invested in the 401(k) plan account, withdrawing amounts as needed. Despite the apparent usefulness of traditional annuities for converting lump sum retirement benefits into a guaranteed stream of retirement income, the market for traditional annuities in the United States is quite small.<sup>315</sup> The traditional explanation given by economists for the low demand for traditional annuities is the problem of adverse selection.<sup>316</sup> Professor Kathryn L. Moore has argued that 401(k) participants rarely purchase annuities because annuities purchased on the private market provide a less than actuarial fair rate of return.<sup>317</sup> To account for adverse selection and other transaction costs,<sup>318</sup> the price charged for an annuity purchased by an individual 401(k) plan participant on the private market exceeds its expected economic value in projected lifetime payments.<sup>319</sup> Consequently, most 401(k)

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313. See *id.* at 56 (describing the “gradual withdrawal” alternative to a purchased annuity). For recent research analyzing the risk of longevity under a self-annuitization strategy, see generally PETER ALBRECHT & RAIMOND MAUER, SELF-ANNUITIZATION CONSUMPTION SHORTFALL IN RETIREMENT AND ASSET ALLOCATION: THE ANNUITY BENCHMARK, (Pension Research Council Working Paper No. 2002-6, 2002), at <http://prc.wharton.upenn.edu/prc/PRC/WP/WP2002-6.pdf> (on file with the North Carolina Law Review); John Ameriks et al., *Making Retirement Income Last a Lifetime*, J. FIN. PLAN., Dec. 2001, at 60.

314. See discussion *supra* Part II.C.3.

315. See *Introduction and Overview*, in ANNUITY MARKETS, *supra* note 311, at 7–8.

316. See *id.* at 8–9; A.M. Milevsky, *Optional Asset Allocation Towards the End of the Life Cycle: To Annuitize or Not to Annuitize?*, 65 J. RISK & INS. 401, 402 (1998); Mitchell et al., *supra* note 311, at 71.

317. See Moore, *Partial Privatization*, *supra* note 8, at 378–81 & n.179.

318. These other transaction costs include such items as marketing and a profit margin for the issuer of the annuity. See Mitchell et al., *supra* note 311, at 72.

319. Economists recently have begun to study the effects of adverse selection on the price of single premium immediate annuities in the United States annuity market. Professor Jeffrey R. Brown estimated the cost of adverse selection in annuity pricing at ten percent of the purchase price. See JEFFREY R. BROWN, HOW SHOULD WE INSURE AGAINST LONGEVITY RISK IN PENSIONS AND SOCIAL SECURITY? 10 (Ctr. for Ret. Research, Issue Brief No. 4, Aug. 2000), at [http://www.bc.edu/centers/crr/issues/ib\\_4.pdf](http://www.bc.edu/centers/crr/issues/ib_4.pdf) (on file with the North Carolina Law Review). Professors Mitchell and McCarthy estimated that adverse selection and transaction costs were slightly less than ten percent of

participants apparently choose to self-annuitize their retirement savings and assume the risk of longevity themselves.<sup>320</sup>

A similar adverse selection problem exists in the Commission's proposed distribution structure for personal Social Security accounts. Workers who know (or suspect, based on their personal health history) that they are unlikely to meet or exceed their actuarial life expectancies will tend to choose the self-annuity option. Workers who know (or suspect, again based on their personal health history) that they will outlive their actuarial life expectancy will tend to choose the traditional annuity option and shift the risk of longevity to the provider of the annuity. Annuity providers will price the traditional annuity at a higher cost to account for this systemic increased risk of longevity among purchasers of traditional annuities.

Analyzed in terms of income classes, and controlling for health status, it seems apparent which group of workers will be the most likely to select the traditional annuity option, and which group of workers will be the most likely to select the self-annuity option. Higher income workers are more likely to have accumulated other personal and retirement savings during their lifetime. In addition, higher income workers are more likely to view their personal accounts as a mechanism for intergenerational wealth transfer and consequently are likely to favor the self-annuity option for this reason.<sup>321</sup>

Low-income workers are much less likely to have accumulated a significant amount of other personal and retirement savings during their lifetimes to draw upon during their retirement years. Thus, low-income workers are less well-positioned to assume the risks of longevity themselves and self-annuitize their personal accounts to

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the purchase price of the annuity: See OLIVIA S. MITCHELL & DAVID MCCARTHY, ANNUITIES FOR AN AGEING WORLD 14 (Pension Research Council Working Paper No. 2002-12, June 2002), at <http://rider.wharton.upenn.edu/~prc/PRC/WP/WP2002-12.pdf> (on file with the North Carolina Law Review). Although adverse selection and transaction costs for traditional annuities have declined since 1985, economists are uncertain as to why this decline occurred. See Mitchell et al., *supra* note 311, at 91-92; James M. Poterba & Mark J. Warshawsky, *The Costs of Annuitizing Retirement Payouts from Individual Accounts*, in ANNUITY MARKETS, *supra* note 311, at 153, 182-83.

320. See Moore, *Partial Privatization*, *supra* note 8, at 378-80 n.179. Other possible reasons why individuals choose not to purchase a traditional annuity with their 401(k) plan savings include a desire to preserve liquidity in case of an unanticipated financial emergency, the advice of financial planning experts to avoid annuitizing, underestimating one's own risk of longevity, or a desire to pass on accumulated wealth to future generations. See BROWN, *supra* note 319, at 10-13; MITCHELL & MCCARTHY, *supra* note 319, at 16-18.

321. See *supra* note 84 and accompanying text.

satisfy the Board's minimum income retirement standard. Controlling for health status factors, this means that low-income workers will be more likely to select the traditional annuity option than higher income workers. The adverse selection problem created by giving workers the option of satisfying the Board's minimum retirement income requirement by choosing between a traditional annuity and a self-annuity will raise the cost of the annuity for everyone who selects the traditional annuity. But unfortunately, the group of workers upon whom the costs of adverse selection is likely to fall most heavily will be low-income workers—the very workers who are supposed to be “building wealth” through personal Social Security accounts.<sup>322</sup>

This result can be easily avoided. In defined benefit plans sponsored by private employers, the problem of adverse selection is resolved by requiring that the normal form of distribution for plan benefits must be in the form of a traditional annuity, payable for the life of the participant, or, if the participant is married, the joint lives of the participant and spouse.<sup>323</sup> A system requiring all workers who survive to retirement to purchase a traditional annuity to satisfy the Board's minimum income requirement would eliminate this adverse

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322. Proponents of personal accounts may respond to this argument by noting that the Board can mitigate the potential for adverse selection by making available annuities with a sum-certain payment provision, thereby encouraging more workers to select the traditional annuity option. See COMMISSION REPORT, *supra* note 1, at 56. The economic trade-off for a sum-certain annuity, however, will be either lower guaranteed lifetime monthly payments, or a higher cost annuity, both detriments to lower-income workers. Proponents of personal accounts also could argue that the Board could reduce the costs of adverse selection by requiring annuity providers to build lower life expectancy assumptions into the price of annuities for low-income and minority workers. There are several potential problems with this approach. First, annuity vendors may be unwilling to provide annuities on these terms. Second, disparate treatment of minority workers in annuity pricing is likely to prove politically controversial. Third, such an approach is philosophically inconsistent with the gender-neutral standards required under federal law for traditional annuities offered by defined benefit plans. See discussion *infra* note 323.

323. This requirement is known as the “qualified joint and survivor annuity requirement.” See I.R.C. §§ 401(a)(11), 417 (West 2002). To protect spouses of workers who die prior to retirement, the normal form of distribution of benefits from a defined benefit plan to the deceased worker's spouse also is in the form of a traditional annuity. This is known as the “qualified pre-retirement survivor annuity requirement.” See *id.* Federal law also requires unisex pricing of traditional annuities purchased by defined benefit plans so that the monthly benefits for a male and a female worker with the same work and compensation history are equal, despite the fact that women in general enjoy longer life expectancies. See SHEILA CAMPBELL & ALICIA H. MUNNELL, SEX AND 401(K) PLANS 1–2 (Ctr. for Ret. Research, May 2002), at [http://www.bc.edu/centers/crr/facts/jtf\\_4.pdf](http://www.bc.edu/centers/crr/facts/jtf_4.pdf) (on file with the North Carolina Law Review). State laws regulating the sale of annuities to individuals do not require unisex pricing. *Id.* at 2. The Commission Report does not address this potential issue of gender equity.

selection problem and increase the payouts from traditional annuities.<sup>324</sup>

In summary, a close examination of the potential “wealth building” effect of personal Social Security accounts is much more limited than proponents of Truth #3 would have the general public, and low-income workers in particular, believe. This wealth building effect will be limited to those workers who die prior to becoming eligible for Social Security benefits, or those who know they are likely to die prior to their actuarial life expectancy, and therefore select the self-annuity option.<sup>325</sup> The increased potential benefits of intergenerational wealth transfer for this sub-group are offset, however, by the reductions in disability and young survivor benefits under the Commission’s proposals which disproportionately benefit minority and low-income workers.<sup>326</sup> For low-income workers who survive to their retirement years, Truth #3 is simply a canard. Low-income retirees will need to annuitize most, if not all, of their personal accounts to satisfy the Board’s minimum retirement income requirement. Low-income retirees are more likely to choose the traditional annuity option because they form the income category that is least well positioned, in terms of other financial resources, to bear the risks of longevity. It is this group of low-income retirees who will bear the brunt of the costs of adverse selection, potentially resulting in a lower level of benefits from their personal accounts.<sup>327</sup>

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324. Professor Brown suggests that if adverse selection is eliminated by a mandatory annuity requirement, annuity payouts might increase by as much as ten percent. See BROWN, *supra* note 319, at 10. A mandatory annuity requirement also would eliminate the possibility, for all workers, that personal accounts could serve the dual function of promoting intergenerational wealth transfer. This secondary benefit, however, primarily would be lost by higher-income workers who do not need to consume their account balance to provide for income during retirement.

325. Even for this limited group, the wealth created and transferred at death will be limited to the balance of the personal account, a limited amount for low-income workers.

326. See *supra* note 296 and accompanying text.

327. Two countervailing costs associated with requiring workers to purchase traditional annuities are: (1) the possibility of over-annuitization by some individuals; and (2) the potential redistribution effects due to different group characteristics of mortality risk. See BROWN, *supra* note 319, at 16. The risk of over-annuitization is minimized because workers are required to annuitize only that portion of their personal Social Security account necessary to satisfy the Board’s minimum retirement income standard. See *supra* notes 54–56 and accompanying text. The potential redistribution effects of a mandatory traditional annuity requirement are a more serious concern because redistribution would offset the benefits of eliminating adverse selection for low-income and minority workers. The author is unaware of any study that measures how the potential redistribution effects of a traditional annuity requirement for personal accounts compare to the costs of adverse selection.

*D. Truth #4: Giving Workers Investment Control Will Avoid Large Concentrations of Money (and Related Power) in the Hands of a Few Government Bureaucrats and Money Managers*

1. Political Influence and the Personal Social Security Account System

Considering the high political priority given to Social Security, the risk that elected officials and partisan politics may influence the Commission's proposed regulatory structure should be considered. There are at least two areas of potential concern. First, there is the risk of political influence tainting the decisions of the Board as it oversees the operation and administration of the personal account system. Second, there is the risk that Congress will yield to the demands of constituents who desire greater access to and control over the funds in their personal accounts.

The Commission expressly recognizes the first risk, finding that "[t]o isolate the Governing Board from political risk, Congress should follow the models of the Thrift Savings Plan and the Federal Reserve Board when designing the Board structure."<sup>328</sup> The Commission Report suggests that by giving the Board a funding source for its budget that is independent of both Congress and the President, and by giving Board members lengthy and staggered terms, the risk of political influence will be minimized.<sup>329</sup>

Administrative law scholars and political scientists have long studied how politics influences the conduct of administrative agencies, including "independent" regulatory agencies.<sup>330</sup> Although a discussion of this issue is beyond the scope of this Article, two observations concerning the unique context of personal Social Security accounts are appropriate. First, the Commission's comparison with the structure and funding of the Thrift Savings Plan and Federal Reserve Board seems oddly oblivious to the political intensity that surrounds any proposed change to the traditional Social

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328. COMMISSION REPORT, *supra* note 1, at 60.

329. *See id.*

330. *See* MARVER H. BERNSTEIN, REGULATING BUSINESSES BY INDEPENDENT COMMISSION 164-87 (1955); PETER L. STRAUSS, AN INTRODUCTION TO ADMINISTRATIVE JUSTICE IN THE UNITED STATES 61-63, 86-97 (1989); PETER WOLL, AMERICAN BUREAUCRACY 6-18 (2d ed. 1977). For a classic case study of the relationship between one independent regulatory agency, the Securities and Exchange Commission, and the White House, see generally WILLIAM L. CARY, POLITICS AND THE REGULATORY AGENCIES (1967).

Security system.<sup>331</sup> The debate over Social Security reform, and personal accounts in particular, has been a defining and divisive issue for Republican and Democratic candidates in the 2000 and 2002 national election cycles.<sup>332</sup> To assert that, once a personal account system is enacted, the governing Board will be relegated to the public anonymity and private autonomy of the directors of the Thrift Savings Plan and the Federal Reserve Board (Alan Greenspan being one notable exception) simply strains credibility.<sup>333</sup>

Second, the Commission itself acknowledges the risk that the Board will be subject to political pressure to favor investment policies that further social policy goals rather than maximize investment returns ("social investing").<sup>334</sup> This risk cannot be underestimated, due to the sheer magnitude of the dollars at stake. A recent study of the Commission's proposals estimates that if, for example, Model 2 is enacted, approximately \$2 trillion dollars will be transferred to the personal account system, and the Board's control, over the next seventy-five years.<sup>335</sup>

Social investing has been most prevalent in public sector pension plans.<sup>336</sup> The Commission concludes that, because personal accounts are structured differently from these public sector pension plans, the risk that Board members will be politically pressured to favor an investment strategy (and investment managers) amenable to social investing is "significantly reduced."<sup>337</sup> Rather than address the

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331. See GRAETZ & MASHAW, *supra* note 70, at 306 ("[O]ur own observations of national politics suggest that most proposed changes are immediately characterized by certain policy and political communities as either impossible or inevitable. The middle ground between these polar positions is seldom glimpsed.").

332. See Erin P. Billings, *GOP Drops Social Security Legislation for the Year, Fearing It's Too Divisive*, ROLL CALL DAILY, Apr. 15, 2002; David Espo, *GOP Book Advises House Candidates*, ASSOCIATED PRESS, Aug. 8, 2002, 2002 WL 25137362; Don Lambro, *Social Security Changes to be Theme of Fall Race*, WASH. TIMES, Apr. 29, 2002, at A1, 2002 WL 2909491; Jim VandeHei & Juliet Eilperin, *Bush's Plan for Social Security Loses Favor*, WASH. POST, Aug. 13, 2002, at A1.

333. Perhaps a more realistic assessment of the Board's potential political risk is evidenced by the controversy surrounding the appointment of the Commission members themselves. From the beginning, the Commission has been dogged by charges that its findings and conclusions were politically predetermined. See Nicholas Confessore, *Commission Impossible: Why Bush is Abandoning Social Security Reform*, AM. PROSPECT, Dec. 17, 2001, at 10, 2001 WL 7681336.

334. See COMMISSION REPORT, *supra* note 1, at 60-61.

335. DIAMOND & ORSZAG, *supra* note 140, at 3. This estimate is in present dollars.

336. See COMMISSION REPORT, *supra* note 1, at 60-61.

337. *Id.* at 61. Political pressure to promote social investing is not the only way that politics and politicians may influence the Board's investment policies. For example, if the default investment fund experiences a loss in actual dollars for several years due to conditions in the equity markets, disgruntled workers may demand that the federal



Board's position in detail here, I take up this social investing risk later in this Part of the Article, where I discuss the potentially powerful role of the Board and its selected money managers in overseeing the default investment fund for personal accounts.<sup>338</sup>

A different type of political risk—that Congress may yield to the demands of constituents and reject some of the Commission's more paternalistic features for personal accounts—cannot be addressed by regulatory structure. Several of the Commission's proposed features are likely to prove unpopular, such as the prohibition on pre-retirement withdrawals,<sup>339</sup> mandatory annuitization,<sup>340</sup> and limiting changes in investment options to once per year.<sup>341</sup> All of these constraints, although well-intentioned, are contrary to what the public, through its extensive involvement with 401(k) plans, has come to expect from a retirement system based on personal accounts. Workers may view their personal Social Security accounts as just another version of their 401(k) plan accounts.<sup>342</sup> This potential public perception of personal Social Security accounts as merely close cousins of 401(k) plan accounts is likely to be reinforced by efforts to promote personal accounts to the public by emphasizing that the money in the account belongs to the worker, not the United States government.<sup>343</sup> Workers may resent the Commission's proposed constraints on personal Social Security accounts (and become vocal in making these feelings known to Congressional lawmakers) as an unjustified attempt by the federal government to control "their" money.

Would a future Congress yield to this second type of political pressure? Some experts have argued that access to personal account

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government guarantee a minimum rate of investment return for the default fund. Politicians in both the legislative and executive branches who are opposed to such a government guarantee may instead send a clear message to the Board and its selected money managers to adopt a more conservative investment strategy instead, thereby avoiding short-term losses, but also foregoing potentially greater long-term investment gains.

338. See discussion *infra* text accompanying notes 383–92.

339. See *supra* note 60 and accompanying text.

340. See *supra* notes 54–59 and accompanying text.

341. See *supra* note 48 and accompanying text.

342. Some workers may believe that a personal account is more secure, in terms of investment volatility and benefits payments, than a 401(k) plan account because the personal account is designed to partially replace a "secure" traditional Social Security benefit. The Commission's position on providing federally guaranteed minimum benefits from personal accounts and an explanation of why workers might be misled into believing that personal account benefits are more secure than 401(k) plan account benefits are discussed *infra* notes 388–92 and accompanying text.

343. See COMMISSION REPORT, *supra* note 1, at 30.

funds for non-retirement purposes is inevitable.<sup>344</sup> Unlike 401(k) plans, however, Social Security traditionally has attracted interest groups who advocate for low-income workers to protect their interests in the system. These advocacy groups to date have focused their lobbying efforts on opposing the idea of personal Social Security accounts.<sup>345</sup> If personal accounts become a political reality, these advocacy groups may represent a successful counterweight to political pressure for changes to the regulatory structure for personal accounts that provide for greater worker control, and pose greater financial risk, for low-income workers in a personal account system.

## 2. "Voluntary" Personal Social Security Accounts and Automatic Enrollment Investment Behavior

The Commission Report identifies numerous potential problems associated with direct government investment of personal Social Security accounts.<sup>346</sup> Essentially the Commission views a direct government investment approach as dangerous to both capitalism and democracy because it would place control over large amounts of money (and its related power) in the hands of a few government bureaucrats and money managers.<sup>347</sup> The Commission proposes to avoid these dangers by instead allowing each worker to direct the investment of her own personal Social Security account.<sup>348</sup> The advantage of this decentralized approach to investing is Truth #4, that, by giving workers investment control over their personal Social Security accounts, the system will avoid large concentrations of money (and its related power) in the hands of a few government bureaucrats and money managers.<sup>349</sup>

Recent studies of the investment behavior of participants in 401(k) plans strongly indicate that, contrary to the assertions of Truth #4, many workers simply will invest their Social Security contributions in the Board's default investment option,<sup>350</sup> the "standard fund."<sup>351</sup>

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344. See Peter Diamond, *Macroeconomic Aspects of Social Security Reform*, BROOKINGS PAPERS ON ECON. ACTIVITY, 1997, at 1, 44.

345. Examples of these advocacy groups include the Center on Budget and Policy Priorities, the Century Foundation, the Economic Policy Institute, the National Committee to Preserve Social Security and Medicare, the Social Security Information Project, and the Urban League.

346. See COMMISSION REPORT, *supra* note 1, at 38–39.

347. See *id.*

348. See *id.* at 44–45, 48–52.

349. See *id.* at 38, 60–61.

350. See DEFAULT EFFECTS, *supra* note 122, at 5, 23–24; PATH OF LEAST RESISTANCE, *supra* note 107, at 11–13; Madrian & Shea, *supra* note 253, at 1171–76. This

The investment managers for the default fund will be selected by the Board.<sup>352</sup> Under the Commission's proposals, these money managers for the default fund will decide how to invest worker contributions to the default fund and will vote the corporate stock of the companies in which they choose to invest the default fund assets.<sup>353</sup> The result is likely to be the very scenario of concentrated investment power and control that Truth #4 purports to avoid.

To understand why this scenario is likely to emerge, the place to begin is with the concept of a "voluntary" system of personal Social Security accounts, a concept left undefined by the Commission. There are two distinct types of "voluntary" 401(k) plans today.<sup>354</sup> Under the traditional 401(k) plan system, an employee must affirmatively elect to participate in the plan.<sup>355</sup> As part of this plan enrollment process, the employee completes the necessary paperwork, which typically includes the selection of investment options for her 401(k) plan contributions.<sup>356</sup> Thus, under the traditional 401(k) plan, generally there is no need for a designated "default" investment option.

Since 1998, a second type of "voluntary" 401(k) plan has emerged—the automatic enrollment 401(k) plan.<sup>357</sup> Under an

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is particularly true for low-income workers, who make up large numbers of the workforce covered by Social Security. See COMMISSION REPORT, *supra* note 1, at 45.

351. See COMMISSION REPORT, *supra* note 1, at 52.

352. The Commission Report is vague concerning how investment managers for the default fund actually will be selected. For example, it is unclear what, if any, minimum qualifications investment managers would have to meet to bid to be the default fund manager. Additionally, there is an obvious danger in an auction-based system where a low bid may translate into low-quality investment management, with corresponding poor investment returns for this segment of the default fund. Alternatively, if the qualifying criteria to become a competing bidder for managing a portion of the default fund are set too high, then the pool of bidders may become so small that achieving the underlying objective of the auction process, to have competition drive the costs of investment management down, may be an exercise in futility. Compare COMMISSION REPORT, *supra* note 1, at 51 (stating that fund management services for Tier I index funds will be "auctioned off"), with *id.* at 52 (failing to discuss how investment managers are to be selected for the standard default fund).

353. See *id.* at 62.

354. Medill, *Stock Market Volatility*, *supra* note 16, at 515–16.

355. *Id.* at 515.

356. See Medill, *Individual Responsibility Model*, *supra* note 16, at 37 n.220.

357. See Medill, *Stock Market Volatility*, *supra* note 16, at 515. A recent survey by the Profit Sharing/401(k) Council of America found that 8.1% of the 401(k) plans surveyed used automatic enrollment. Patty Alman, *A Look at Current Profit Sharing/401(k) Trends and Practices*, PROFIT SHARING, Nov.-Dec. 2001, at 15. The survey found that automatic enrollment was most common among 401(k) plans sponsored by large employers. Among 401(k) plans surveyed with 5,000 or more participants, 19.8% used automatic enrollment. *Id.*

automatic enrollment 401(k) plan, the employer automatically enrolls all eligible employees in the plan and then selects the amount of the employee's salary deferral contributions (typically one to three percent of the employee's compensation) to the plan.<sup>358</sup> Participation in an automatic enrollment 401(k) plan is still voluntary in the sense that the employee may opt out of the plan.<sup>359</sup> To do so, however, requires an affirmative election by the employee not to participate.<sup>360</sup> Unless and until the participant acts, the employer deducts the preset amount from the participant's compensation and invests this amount in the default investment option selected by the employer.<sup>361</sup>

Participant investment behavior in automatic enrollment 401(k) plans has been the subject of several recent studies.<sup>362</sup> What researchers have found is that automatic enrollment 401(k) plans dramatically increase the percentage of employees who participate in the plan.<sup>363</sup> Significantly, this increase in participation is greatest among the groups of workers who are least likely to enroll and participate in a traditional 401(k) plan: younger workers, lower income workers, and minority workers.<sup>364</sup>

Although the Commission does not say which type of "voluntary" system will be adopted for personal Social Security accounts, the primary financial solvency projections contained in the Commission Report for each of the three models assume a sixty-seven percent participation rate.<sup>365</sup> Ironically, the reasons supporting a relatively high participation rate in a voluntary personal Social Security account system appear to be much less compelling from a fiscal perspective than they are from a political perspective. From the perspective of system financial solvency, the more workers who contribute to personal accounts, the less money will be available for

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358. Profit Sharing/401(k) Council of America, Automatic Enrollment 2001, at <http://www.psc.org/data/autoenroll2001.asp> (last visited Feb. 16, 2003) (on file with the North Carolina Law Review).

359. *See id.*

360. *See id.*

361. *See id.*

362. *See* DEFAULT EFFECTS, *supra* note 122, at 3, 5; PATH OF LEAST RESISTANCE, *supra* note 107, at 8–13; Profit Sharing/401(k) Council of America, Automatic Enrollment 2001, *supra* note 358.

363. *See* DEFAULT EFFECTS, *supra* note 122, at 5, 9–12; PATH OF LEAST RESISTANCE, *supra* note 107, at 9–11.

364. *See* DEFAULT EFFECTS, *supra* note 122, at 3; PATH OF LEAST RESISTANCE, *supra* note 107, at 10–11; Madrian & Shea, *supra* note 253, at 1161.

365. *See* COMMISSION REPORT, *supra* note 1, at 93–94, 101. The Commission acknowledges that actual participation rates are likely to vary according to the model adopted. *See id.* at 101.

the U.S. Treasury to pay traditional Social Security benefits. This worsens the program's solvency in the "short-term" (seventy-five year actuarial projection period)<sup>366</sup> by accelerating the time the system will begin operating on a negative cash flow basis.<sup>367</sup> In contrast, the political reasons supporting a high participation rate are much more compelling. The hallmark of the traditional Social Security system has been its nearly universal participation and coverage of American workers. It is this attribute that has made the system so popular, and enduring, in American democratic society. The research concerning automatic enrollment 401(k) plans predicts that an automatic enrollment approach to personal accounts is likely to prove effective in increasing participation rates, particularly among the low-income workers who make up a large percentage of the workforce covered under the Social Security system. Moreover, an automatic enrollment system that boosts participation rates for low-income workers will blunt the criticism that personal Social Security accounts are designed to benefit primarily higher income workers.<sup>368</sup> For these political reasons, an automatic enrollment approach to personal accounts seems inevitable.<sup>369</sup>

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366. "Short-term" obviously has a unique meaning when used in the context of Social Security reforms. Only Model 2 projects to return the Social Security system to a positive cash flow within the seventy-five year actuarial projection period. See discussion *supra* note 9.

367. See COMMISSION REPORT, *supra* note 1, app. at i-vii; DIAMOND & ORSZAG, *supra* note 140, at 2-4.

368. See Burke & McCouch, *supra* note 298, at 1173.

369. This conflict between the fiscal and political incentives for personal accounts highlights the inherent conflict of interest created by the Board's role as the primary provider of "informative" advice to workers concerning the investment of their personal Social Security accounts. Even under a "voluntary" automatic enrollment approach, workers may affirmatively elect not to participate in personal accounts. High rates of worker participation in personal accounts, however, are necessary to achieve sustained political support for reform. On the one hand the Board's program of "informative" advice must be objective and forthright about the risks of investing in personal accounts, particularly in terms of the offsetting decrease in traditional benefits at retirement. The need for such honesty is particularly compelling in light of wide-spread public ignorance concerning the traditional benefits provided by the current Social Security system. The 2001 Retirement Confidence Survey found that "[m]any workers greatly underestimate the amount they will receive from Social Security when they retire." EMPLOYEE BENEFIT RESEARCH INST., THE 2001 RETIREMENT CONFIDENCE SURVEY SUMMARY OF FINDINGS 3, at <http://www.ebri.org/rcs/2001/01rcses.pdf> (last visited Feb. 16, 2003) (on file with the North Carolina Law Review). On the other hand, the Board's educational program cannot deter large numbers of workers from voluntarily participating in a reformed Social Security system of personal accounts, or else political support for reform will be undermined. This is indeed a delicate balancing act. Cynics may contend it is an impossible one.

How are workers in an automatic enrollment system likely to invest the assets held in personal Social Security accounts? The research concerning automatic enrollment 401(k) plans indicates that a high percentage of participants are invested exclusively in the plan's designated default investment fund.<sup>370</sup> Although this percentage appears to decline somewhat over time, nevertheless substantial numbers of automatically enrolled participants remain invested in the plan's default investment option.<sup>371</sup> There is no reason to believe that workers who are automatically enrolled in a personal Social Security account will change this investment pattern. It seems more likely that this pattern of remaining invested in the designated default investment option will prove even stronger in a personal account system where large numbers of low-income workers are covered.<sup>372</sup> Indeed, the Commission recognizes that workers who are inexperienced investors are likely to view the Board's standard fund as a safe place to invest.<sup>373</sup> The result is likely to be a ballooning of the assets invested in the Board's default standard fund.

This tendency of automatically enrolled workers to remain invested in the Board's default mutual fund is likely to be strengthened and reinforced by the Board's criteria for, and representation of, the investment return objectives for the default fund. In the 401(k) plan setting, employers have tended to select a low-earning stable value (U.S. government bond) fund as the plan's default investment option.<sup>374</sup> In contrast, the Commission recommends that the default fund for personal Social Security accounts must be diversified and must use an equity investment strategy (aggressive, moderate, or conservative) that is appropriate for the worker's age.<sup>375</sup> This Commission recommendation is followed by the following cautionary statement:

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370. See DEFAULT EFFECTS, *supra* note 122, at 5, 12–19; PATH OF LEAST RESISTANCE, *supra* note 107, at 11–13; Madrian & Shea, *supra* note 253, at 1171–76.

371. See DEFAULT EFFECTS, *supra* note 122, at 5, 12–19; PATH OF LEAST RESISTANCE, *supra* note 107, at 11–13; Madrian & Shea, *supra* note 253, at 1171–76.

372. See DEFAULT EFFECTS, *supra* note 122, at 19 (concluding that “[l]ower paid participants are much more likely to be at the default than are higher paid participants, and the fraction of participants at the default is more persistent for the lower paid”); Madrian & Shea, *supra* note 253, at 1171–76.

373. See COMMISSION REPORT, *supra* note 1, at 52.

374. See *id.*

375. See *id.* Curiously, the Commission Report cites the *Path of Least Resistance* study in support of the assertion that workers will look to the asset allocation of the standard default fund when independently making their own investment allocation decisions. See *id.* Although it is true that some workers will do this, the Commission seems to ignore the principal conclusion of the *Path of Least Resistance* study, namely that automatically

If the government, for example, *promises that the personal accounts will produce a minimum return or benefit*, provided that the personal account is invested in a particular balanced fund, then that fund should be the standard [default] fund.<sup>376</sup>

This statement by the Commission is curious indeed. Contrary to the common disclaimer given by investment managers (“past investment returns are not necessarily indicative of future investment performance”), any such promises by the Board will be perceived by workers, particularly workers who are inexperienced or risk-averse investors, as an implied warranty that the default fund will achieve a minimum level of investment returns.<sup>377</sup> (The Commission Report, however, does not recommend a minimum federal government guarantee of investment returns from the default fund.<sup>378</sup>) In this sense, the Board’s default fund appears to mimic another common investment option in 401(k) plans—the guaranteed investment contract (“GIC”). In the 401(k) plan setting, the empirical evidence shows that when the plan offers a GIC (but not employer stock) as an investment option, participants lower their allocations to equity mutual funds.<sup>379</sup> Similarly, large numbers of workers are likely to respond to implied government promises of minimum investment returns by investing in the Board’s default fund rather than in other equity fund options.

Why is the accumulation of significant sums in the default fund for personal accounts so troublesome? The Commission Report identifies three risks associated with direct government investment of the funds held in personal Social Security accounts. First, there is the risk that government officials will be pressured into making investment decisions to promote social policy rather than on financial criteria (“social investing”), resulting in below-market investment returns.<sup>380</sup> Second, the role of government as a large institutional

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enrolled workers have a strong tendency to remain invested in the default investment option. Compare PATH OF LEAST RESISTANCE, *supra* note 107, § III.1, with *id.* § III.6.

376. COMMISSION REPORT, *supra* note 1, at 52 (emphasis added).

377. The Commission Report later recognizes and discusses the problems associated with explicit investment guarantees. See *id.* at 143–45.

378. See *id.*

379. See 2000 ASSET ALLOCATION STUDY, *supra* note 16, at 8 & tbl.4.

380. See COMMISSION REPORT, *supra* note 1, at 38, 60. The Commission Report describes examples of social investing, primarily in the context of pension funds operated by state governments. See *id.* For theoretical discussions of the legalities and economic merits of social investing in private pension plans and private trusts, see generally John H. Langbein & Richard A. Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 72 (1980). For the Department of Labor’s position on social investing and fiduciary responsibilities under ERISA, see 29 C.F.R. § 2509.94-1 (2002).

investor could interfere with corporate decision-making.<sup>381</sup> Finally, having the federal government as a corporate shareholder could lead to conflicts of interest between the government's dual roles of maximizing investment value for workers and regulating public corporations and public markets.<sup>382</sup>

The Commission Report addresses the first risk, that political pressure will lead to social investing and reduced investment returns, by arguing that under a personal account structure "the temptation for political interference is significantly reduced."<sup>383</sup> The logic of the Commission's argument is that the temptation to engage in social investing is unique to the context of defined benefit pension plans sponsored by state governments. There are two aspects to this argument. First, in a defined benefit plan structure there is not a visible and direct link between current inferior investment returns and the future pension benefits promised to the worker.<sup>384</sup> This lack of a direct connection masks the fiscal consequences of social investing and reduces the accountability of the plan's investment managers. Second, state government pension plans are exempt from the minimum funding requirements that federal law imposes on defined benefit pension plans sponsored by private employers.<sup>385</sup> If a private employer-sponsored pension plan suffers poor investment results, there is an immediate financial consequence to the employer, who must make additional contributions to the plan if it falls below the minimum funding standards of federal law.<sup>386</sup> This immediate financial accountability serves as a deterrent to social investing in the context of defined benefit plans sponsored by private employers. In a defined benefit pension plan sponsored by a state government, however, there is no immediate financial consequence. The liabilities represented by the plan's promised benefits are simply shifted to future generations of taxpayers, whose taxes ultimately will pay for the plan's benefits when they become due.<sup>387</sup>

The Commission argues that these conditions, which make state officials and plan investment managers susceptible to political pressure to engage in social investing, are mitigated by a personal

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381. See COMMISSION REPORT, *supra* note 1, at 38, 60.

382. See *id.* Imagine the conflict of interest if, for example, the federal government on behalf of the Social Security system had invested in Enron or Worldcom prior to revelations of improper accounting practices and fraud.

383. *Id.* at 61.

384. See *id.* at 60–61.

385. See 29 U.S.C.A. § 1003(b)(1) (2002).

386. See *id.* §§ 1081–82.

387. See COMMISSION REPORT, *supra* note 1, at 60–61.



account structure.<sup>388</sup> A closer examination of this argument reveals several reasons for skepticism. As structured by the Commission, personal Social Security accounts also have features that may tend to blur the connection, in the minds of workers who invest in the default fund, between the default fund's investment returns and their future retirement income security. In a 401(k) plan, the connection is clear—the worker's account balance represents the amount he or she has to spend in retirement. The balance in the worker's personal account, however, is not the worker's sole benefit from Social Security. Workers know that they also will receive traditional Social Security benefits. Workers will be told, of course, through the Board's "informative" advice program, that their future traditional benefits will be reduced by a formula that assumes their personal accounts earned a specified rate of investment return. But this offset will not be computed and translated into a dollar amount per month until years later when the worker retires.

The Board's message concerning the future offset of traditional benefits also is likely to become lost due to the Board's larger role, and message, in providing investment education to workers. The Board certainly will encourage workers to follow the basic principles of prudent long-term investing, i.e., be diversified and stay invested during market downturns. Simultaneously with this message, the Board will offer a designated default fund, which purports to be managed to achieve the offset rate. If the default fund underperforms (either the market benchmarks or the specified offset rate, or both) due to social investing, will workers respond? Or will they simply shrug and tell themselves that they are invested for the long term—in other words, follow the Board's advice?

The tangential link between present investment returns from the default fund and the future offset of the worker's traditional Social Security benefits also creates the potential for shifting the hidden costs of social investing, in terms of lower investment earnings, to future taxpayers. Some experts already are anticipating a situation where, due to demographic and economic conditions, the equity markets do not produce a rate of investment return sufficient to attain the Commission's offset amount.<sup>389</sup> In discussing how to finance a possible "guarantee" of a minimum investment return for personal accounts, the Commission itself identifies the concern that

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388. *See id.*

389. *See Harris, supra* note 145; Letter from Dean Baker to Steve Gross, *supra* note 145.

the federal government as “guarantor may be asked to pay out precisely when economic conditions . . . are bleak,”<sup>390</sup> and that “taxpayers might be unwilling or unable to raise taxes on themselves to cover the guarantees.”<sup>391</sup> Suppose that, thirty years hence, the Commission’s default fund has underperformed the offset rate for personal accounts. Faced with a generation of newly retired personal account holders who now realize that they are worse off financially for having participated in a personal account, what will be the likely political response? Given the historical politics of Social Security reform, it seems unlikely that Congressional lawmakers will ignore the complaints of a generation of newly retired voters. Instead, it seems more plausible that Congress will instead simply reduce the offset rate, thereby shifting the costs of social investing by the default fund to future generations of taxpayers, but without incurring the immediate pain of a payroll tax increase.<sup>392</sup>

The accumulation of significant assets in the Board’s designated default fund also would present risks similar to the second and third dangers associated by the Commission with direct government investment of the funds held in personal Social Security accounts. The Commission asserts that under a system of direct government investment, as a large institutional investor, the federal government could interfere with corporate decision-making.<sup>393</sup> The Commission’s

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390. COMMISSION REPORT, *supra* note 1, at 145.

391. *Id.*

392. *See id.* at 143 (“While the [traditional Social Security] benefit formula does not subject individuals to financial market uncertainty, the formula itself can be changed and has been changed in the U.S. numerous times in the past.”); DIAMOND & ORSZAG, *supra* note 140, at 25–26 (concluding that the Commission’s proposed Model 2 would require a general revenue transfer of more than \$2.2 trillion, with a similar result for Model 3); *id.* at 37 (“A claim of long-term balance that is heavily dependent on substantial, unspecified general revenue transfers, however, raises questions of credibility, especially when the Commission makes no recommendations regarding where the money to be transferred should be found.”). *Cf.* GEORGE M. CONSTANTINIDES ET AL., JUNIOR MUST PAY: PRICING THE IMPLICIT PUT IN PRIVATIZING SOCIAL SECURITY 30 (Nat’l Bureau of Econ. Research Working Paper No. 8906, 2002), at <http://www.nber.org/papers/w8906> (on file with the North Carolina Law Review) (assuming that the government adopts a centralized approach to privatization and invests part of the Social Security Trust Funds in the equity markets, the study concludes that “there is a distinct possibility that Social Security funds [will] decline in value” and that “the government may be compelled to remedy a shortfall by raising taxes on the younger working generations”); PETER R. ORSZAG & ROBERT GREENSTEIN, CTR. ON BUDGET & POLICY PRIORITIES, FINANCING PRIVATE ACCOUNTS IN THE AFTERMATH OF THE TAX BILL: THE CHALLENGE FACING THE SOCIAL SECURITY COMMISSION AND THE ADMINISTRATION 15 (2001) (concluding that a future tax increase to avert budget deficits is among the alternatives facing policymakers for financing private Social Security accounts).

393. *See* COMMISSION REPORT, *supra* note 1, at 38, 60.

proposed structure does not eliminate this risk. Instead, it merely shifts this risk from the federal government to the select group of investment managers chosen by the Board to manage the assets of the default fund.<sup>394</sup> In other words, the potential for corporate interference is shifted from publicly accountable government officials to a few private entities and individuals operating under a contract with the Board, a situation that arguably is less desirable and less protective of the public's interest.

Finally, the Commission asserts that under a system of personal accounts, the federal government will avoid a potential conflict of interest because it will not be serving in a dual role as the asset manager for Social Security funds and the regulator of public corporations and markets.<sup>395</sup> This potential conflict of interest is lessened, but not eliminated, under a personal account system. It will still exist due to the Board's oversight of the default fund for personal accounts.

#### CONCLUSION: WINNERS AND LOSERS

This Article evaluated personal Social Security accounts in light of the substantial body of research concerning participant-directed 401(k) plans. This research suggests that each of the four "truths" cited by the Commission in support of personal accounts may, in fact, merely be political myths.

Viewing the research evidence from 401(k) plans as a whole, what can be said about the likely winners and losers under the Commission's proposed personal Social Security account system? Workers who are knowledgeable and experienced investors will adopt a diversified investment strategy that, over the long run, is most likely to result in real investment returns that will exceed the amount offset from their traditional Social Security benefits paid at retirement. These are the potential "winners" under a personal account system. But for many workers, particularly low-income workers, a personal account system will be their first significant investment experience. Fearful of any type of investment loss with their Social Security funds, and not sophisticated enough to appreciate the loss in purchasing power inflicted by inflation over time, workers who make an affirmative investment election are most

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394. The Commission recommends that the fund managers vote the equity shares held by the fund, rather than passing voting rights through to the Board or the workers themselves. *See id.* at 62.

395. *See id.* at 38, 60.

likely to choose a “safe” investment strategy and avoid investing in equity mutual funds so that their Social Security account funds will not be exposed to the short-term volatility of the stock market. A Board-provided program of “informative” advice is unlikely to change the investment behavior of many of these workers. Over the long term, the real investment returns for non-equity investors are likely to be less than the Commission’s projected 4.6% average annual real rate of return. Many may not even attain the much lower (2.0%–3.5%) proposed offset rates for traditional benefits.

Alternatively, many inexperienced investors are likely to invest in the Board’s designated default mutual fund. The investment performance of this fund will be the true measure of whether the Commission’s projected total Social Security benefits, based on an assumed 4.6% real rate of return, are realistic. One telling indication that these projected total benefits may not be realistic is that the Commission refused to recommend a federal government guarantee that the default fund returns would even match the much lower proposed offset rates for traditional benefits.

Low-income and minority workers will be the group most adversely affected by the Commission’s proposed indexing changes, which will substantially reduce the future value of scheduled traditional, disability, and survivor benefits. The personal account benefits paid to low-income workers who survive to retirement will be further reduced by the costs of adverse selection associated with the traditional annuity payment option. Adverse selection costs will fall disproportionately on low-income workers because they are the ones least able to bear the risks of longevity associated with the Commission’s alternative payment option, self-annuitization. In contrast, high-income workers will benefit from the self-annuity option as a mechanism for intergenerational wealth transfer. Promoting the intergenerational transmission of wealth, however, has never been a policy objective of the traditional Social Security system. Rather, the primary policy goal of the traditional Social Security program has been to provide a social safety net for the segment of the American population that is most vulnerable to poverty in old age. The cumulative effect of the Commission’s proposals is likely to be lesser total benefits for low-income and minority workers than under today’s traditional Social Security system. They will be the group most likely to “lose” under a reformed personal Social Security account system.

