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Structuring and Regulating Individual Social Security Accounts

David C. John

The decision to create a Social Security system that includes personal retirement accounts, which would allow workers to invest a portion of their existing Social Security taxes in a personally owned account, is only the first step toward improving Americans' retirement security. Congress will have to determine how these accounts should be structured and regulated. More than anything else, such decisions will determine whether personal retirement accounts reach their full potential of increasing retirement income without unreasonable levels of investment risk.

Where would the money come from? There are only two realistic sources for the funds that would go into a personal retirement account that is part of Social Security: the existing Social Security taxes that an individual already pays or new taxes.

Some lawmakers propose introducing new taxes or earmarking revenue from the expected budget surpluses to fund the new accounts. These are usually called "add-on" accounts because the money that goes into them is in addition to the taxes an individual already pays to Social Security. This method would mean higher taxes and would do nothing to improve an individual's rate of return on Social Security taxes.

The alternative is to fund the account with money that has been "carved out" or diverted from the taxes that now pay for Social Security retirement benefits. This method would make Social Security a much better deal for most Americans. In addition, diverting part of the existing Social Security tax would provide a much more stable source of funding that does not depend on the accuracy of economic forecasts or the ability of Congress to restrain its spending habits.

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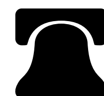

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How would accounts be structured? A simple system of personal retirement accounts would give workers the ability to choose from a limited number of investment choices while also allowing them to choose a qualified firm to manage those investments. Initially, in order to reduce administrative

costs and potential investor confusion, it should offer only three low-cost investment options: a broad-based stock index fund, a corporate bond index fund, and some sort of government bond fund, perhaps using the new inflation-indexed Series I U.S. Savings Bonds.

Because the hundreds of billions of dollars in personal retirement accounts would almost certainly become too large an amount to be managed by any single investment manager, individuals should be allowed to purchase their stock or bond index funds from an approved list of investment managers. If the manager is unsatisfactory for any reason, account owners should be allowed to change to another firm at least annually.

How would accounts be regulated? The long-term success or failure of personal retirement accounts would depend in large part on how they are regulated. Only established investment managers who can meet four strict, but objective, standards should be allowed to accept retirement savings. These standards are:

- **Capital adequacy**. The investment manager should have sufficient capital invested in the firm to ensure stability and the ability to survive market fluctuations.
- **Professional expertise**. Only qualified and experienced professionals should be allowed to manage these retirement savings accounts.
- **Disclosure of fees.** All fees and costs must be clearly disclosed in writing before any money is accepted.
- **Regular statements.** All account owners must receive regular statements in clear and simple language that discloses the status of their accounts, including the amount of contributions, the investment options chosen, the rate of return for each investment option, and the exact amount of any fees that were paid.

Because regulatory agencies tend to lack the technical knowledge needed to fully understand types of financial institutions beyond those that they regulate, the primary regulator of the financial institution owning the investment manager should handle the regulation of personal retirement accounts. To ensure that all types of financial institutions have an equal chance to compete for these accounts, and to ensure equal levels of consumer protection, a federal coordinating council should be established for personal retirement account regulators. Its primary responsibility would be to determine the basic structure of the regulations and issue them for public comment.

The Social Security Administration should have no role in regulating financial institutions that manage personal retirement accounts. A massive bureaucracy that can take years to determine eligibility for disability claims simply does not have the expertise or ability to understand the innovative and rapidly changing financial world. In addition, allowing the agency that administers the existing system to control its competition would be a conflict of interest.

Personal retirement accounts could allow every worker to participate fully in the growth of the American economy. However, in order to take full advantage of this opportunity, the accounts must be funded from a portion of the existing taxes that go to pay for Social Security retirement benefits. In addition, the structure and regulation of these accounts will make the difference between improved retirement income and unmet expectations.

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STRUCTURING AND REGULATING INDIVIDUAL SOCIAL SECURITY ACCOUNTS

DAVID C. JOHN

Social Security reform must ensure that every American worker can retire with more to show after a lifetime of work than just memories and a small monthly check from the government. The best way to do this is to enable all workers, at every income level, to invest a portion of their existing Social Security taxes in an account they personally own. That way, they could benefit from America's dynamic economic growth while building a retirement nest egg.

However, making the decision to create a Social Security system that includes personal retirement accounts is only the first step toward improving Americans' retirement security. Congress, of course, will have to determine how these accounts should be structured and regulated. More than anything else, such decisions will determine whether personal retirement accounts reach their full potential.

Personal retirement accounts already have an impressive track record. In a number of countries across the globe, they are helping people to increase their retirement incomes while at the same time greatly reducing the cost of the government-funded system.

The Practical Advantages of Personal Retirement Accounts. In addition to restoring fiscal stability to Social Security, personal retirement accounts would permit workers of all income levels to participate fully in the growth of the U.S. economy. Over the 12 months ending on September 2, 1999, Standard & Poor's S&P 500 stock index went up 34.3 percent.[1] The NASDAQ composite stock index went up 74 percent.[2] Corporate bonds, as measured by the Merrill Lynch Corporate Bond index, yield 7.5 percent a year,[3] and the government's Series I United States Savings Bonds yield 5.05 percent.[4]

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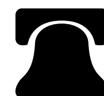

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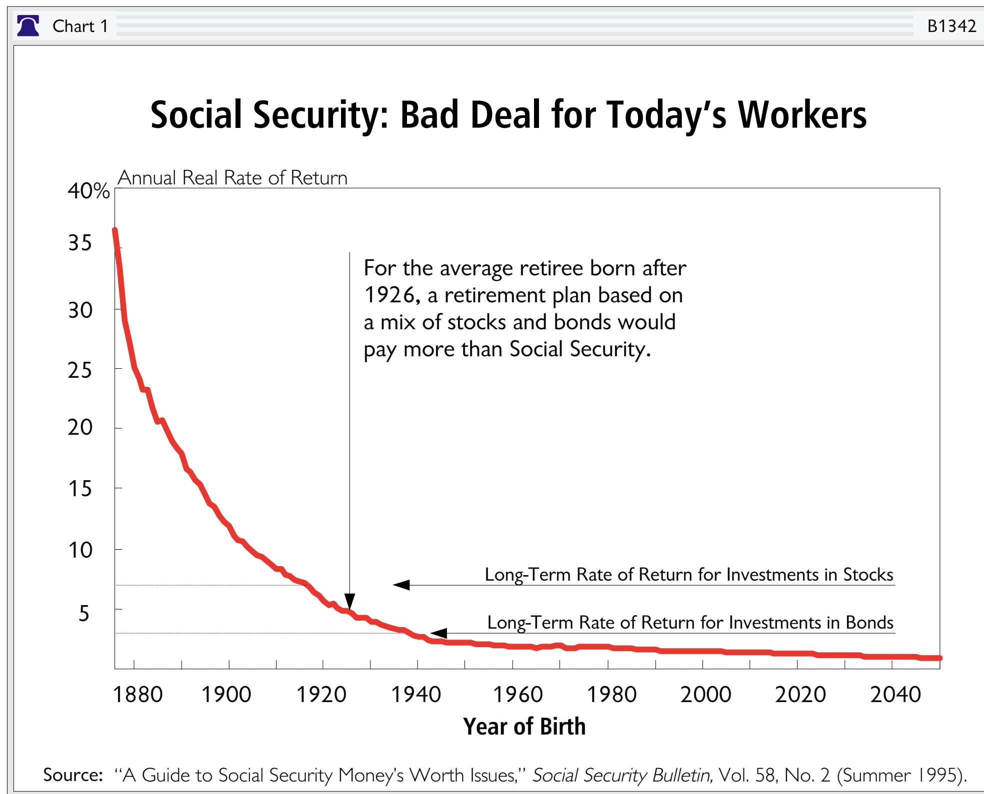
1. "Markets Diary," *The Wall Street Journal*, September 3, 1999, p. C1.
2. *Ibid*.



Source: "A Guide to Social Security Money's Worth Issues," *Social Security Bulletin*, Vol. 58, No. 2 (Summer 1995).

A look at the historical data, including data for years in which investments performed very poorly as well as those in which they performed well, shows that stocks average a real return (after inflation) of 7 percent annually. But Social Security, on which many low-to-moderate-income workers will rely for much of their retirement benefits, has average annual real returns of only about 1.2 percent.[5]

Translated into dollars, this means that a typical family of four, with two working parents, will have $525,000 less saved up for retirement under the current system than if they had been able to invest their Social Security retirement taxes in a personal retirement account.

Criteria for Success or Failure. A growing number of legislators from both parties have introduced plans that would allow workers to divert some or all of their Social Security retirement taxes into some form of personal retirement account. In recognizing the importance of allowing Americans to increase the rate of return on the portion of Social Security taxes that funds their retirement benefits, these plans take a major step toward increasing retirement security for working Americans and their families.

However, the success or failure of any plan that would establish personal retirement accounts will depend largely on three key decisions:

- What the **source of funds** going into the individual accounts will be;
- How the accounts will be **structured and administered**; and
- How the accounts will be **regulated**.

WHERE WOULD THE MONEY COME FROM?

There are only two realistic sources for the funds that would go into a Social Security personal retirement account that is part of Social Security. Essentially, the money could come from the existing Social Security taxes that an individual already pays or from new taxes.

3. *Ibid.*
4. U.S. Treasury Web site at *http://www.publicdebt.treas.gov/sav/sbiinvst.htm*.
5. William W. Beach and Gareth G. Davis, "Social Security's Rate of Return," Heritage Foundation *Center for Data Analysis Report* No. 98–01, January 15, 1998.

Some lawmakers propose introducing new taxes or earmarking revenue from the expected budget surpluses to fund the new accounts.[6] These are usually called "add-on" accounts because the money that goes into them is in addition to the taxes an individual already pays to Social Security. Although this method would improve a worker's retirement income, it means higher taxes and would do nothing to improve an individual's rate of return on Social Security taxes.

The alternative is to fund the account with money that has been "carved out" or diverted from the taxes that now pay for Social Security retirement benefits.[7] This method would reduce the income to the Social Security trust fund and take a significant step toward tackling insolvency even sooner; it also would make Social Security a much better deal for most Americans. In addition, diverting part of the existing Social Security tax would provide a much more stable source of funding that does not depend on the accuracy of economic forecasts or the ability of Congress to restrain its spending habits.

Some legislators have proposed that another alternative might be a system of voluntary personal retirement accounts that would be a part of Social Security.[8] In effect, workers would be allowed to save additional money in these accounts, but the full amount of their Social Security taxes would still go to the existing system.

This approach is very unlikely to be successful. Social Security taxes are so high that they eliminate the possibility of additional savings for millions of workers. Faced with the need to pay this month's mortgage or the children's medical bills, these workers understandably would choose to meet immediate needs rather than to save for an event far in the future. Thus, while some Americans might be able to benefit somewhat from voluntary accounts if they increased their total savings, most of them either are already saving this money through an existing investment plan or do not have the after-tax income to open a retirement account.

How Would Accounts Be Funded?

Add-on Accounts. A personal retirement account that would be funded by new taxes or revenues from the budget surplus is called an "add-on" account. These accounts are not funded by diverting a portion of the existing tax that pays for Social Security retirement benefits. Both President Bill Clinton's Universal Savings Account (USA) proposal, which the White House says will be financed from the budget surplus,[9] and the Social Security Guarantee Account plan proposed by House Ways and Means Committee Chairman Bill Archer (R–TX) and Social Security Subcommittee Chairman Clay Shaw (R–FL), are types of add-on accounts.[10]

Although the White House often mentions the USA plan in discussions of Social Security reform, there actually is no connection between these accounts and Social Security. Any amounts accumulated in them would be in addition to Social Security benefits. On the other hand, the accounts

6. For instance, the Social Security Guarantee Account Plan proposed by Representatives Bill Archer (R–TX) and Clay Shaw (R–FL) would use money from the expected budget surplus to fund the accounts, while the plan proposed by Senator Phil Gramm (R–TX) would divert money from taxes on business income to pay for some of the transition costs.
7. Examples of this type of account include H.R. 1793, introduced by Representatives Jim Kolbe (R–AZ) and Charles Stenholm (D–TX), and S. 1383, introduced by Senators Judd Gregg (R–NH) and John Breaux (D–LA). See following discussion.
8. S. 21 introduced by Senators Daniel Patrick Moynihan (D–NY) and Robert Kerrey (D–NE) takes this approach. Senator Kerrey later decided to become a cosponsor of S. 1383, the Gregg–Breaux plan.
9. Details of the plan are contained in background material for the 1999 State of the Union speech, which can be found at *http://www.whitehouse.gov/WH/SOTU99/sss.html.*
10. The Social Security Guarantee Account Plan was announced on April 28, 1999. As of December 20, 1999, it had not been introduced as legislation.

contained in the Archer–Shaw proposal would, in almost every case, end up financing a major part of the Social Security benefits that a worker would have received anyway.

Problem #1: Lower Rate of Return. The major objection to add-on accounts is that they do nothing to improve Social Security's poor rate of return and could make the system an even worse deal.[11] In addition to paying his or her share of the existing 10.6 percent Social Security retirement tax, a worker would have to pay enough federal tax to fund the add-on account. A personal retirement account funded with an amount equal to 2 percent of a worker's income, such as that contained in the Archer–Shaw plan, would result in a total tax burden equal to about 12.6 percent of income.

In the President's plan at least, the account that is funded by this extra tax could be expected to raise the worker's retirement income. But under the Archer–Shaw plan there is almost no way for an individual to change his or her retirement income unless the investments in the account do spectacularly well. This is because Archer–Shaw guarantees that workers will receive their full Social Security benefits under all circumstances. At the same time, the individual accounts that are established by this plan are structured so that it would be very difficult for them to accumulate enough to increase the worker's retirement benefit without a high-risk investment strategy. If workers' investments did not pan out, the government would pay the same retirement benefit that it would have paid if the accounts had not existed in the first place,[12] even though workers would have to pay higher taxes—reducing their rate of return even more.

Problem #2: Unstable Source of Funding. Another major question about add-on accounts is whether there is a stable source of funding if the money that goes into them comes out of the expected surplus. Former Congressional Budget Office (CBO) Director June O'Neill has warned that the era of budget surpluses could be fairly short,[13] and any long-term economic forecast is volatile. In August 1998, the CBO projected the aggregate surplus for fiscal years 1999 through 2008 to be $1.54 trillion.[14] Just a few months later, in January 1999, the aggregate projections for the same period were increased 72 percent to $2.65 trillion.[15] Over the next few years, these forecasts could just as easily drop—a not unreasonable prediction in light of Congress's propensity to spend.

When the inevitable economic slowdown hits, deficits are very likely to return. At that point, Congress will have only two options. It can either end federal contributions to these add-on accounts or convert them into another expensive entitlement program.

The retirement security of American workers is far too important to base on hopes for a future surplus. While it might make sense to start funding USA accounts with the surplus, Congress should then shift to funding them with a proportion of the existing taxes that workers already pay to Social Security. That way, once the surpluses end, these

11. This does not apply to President Clinton's USA account plan, which is completely separate from Social Security and does not affect either the system's rate of return or its impending financial problems. However, it does apply to plans such as the Archer–Shaw proposal.
12. Under Archer–Shaw, workers are guaranteed that they will receive 100 percent of the Social Security benefits they would have received under current law. However, unless the worker's Archer–Shaw account earns enough to pay for an annuity that is higher than the expected Social Security benefit would be, all of that account just goes to pay for that benefit. Because the Social Security benefit is guaranteed in any event, the worker has nothing to lose by making high-risk investments—especially since that is the only way that he or she will get any benefit from the Archer–Shaw account.
13. June E. O'Neill (then Director of the Congressional Budget Office), "The Economic and Budget Outlook: Fiscal Years 2000–2009," testimony before the Committee on the Budget, U.S. Senate, January 29, 1999.
14. Congressional Budget Office, "The Economic and Budget Outlook: An Update," August 1998.
15. Congressional Budget Office, "Economic and Budget Outlook: Fiscal Years 2000–2009," January 1999.

accounts could continue to grow and, with them, the retirement incomes of American workers.

Carve-out Accounts. The other alternative is to fund an individual Social Security account by diverting, or "carving out," some portion of the 10.6 percent of income (including the part that an employer pays on behalf of the employee) that Americans now pay for Social Security retirement benefits. In the legislation introduced by Representatives Jim Kolbe (R–AZ) and Charles Stenholm (D–TX),[16] and that introduced by Senators Judd Gregg (R–NH) and John Breaux (D–LA),[17] 8.6 percent of income continues to go to Social Security, while an amount equal to 2 percent of income funds a personal retirement account.

In these and similar proposals, the individual worker would own and receive the full benefits from any money accumulated in the personal retirement account. The funding of a carve-out is stable since it uses existing payroll taxes. And because it uses taxes already being paid by workers, any person paying Social Security taxes could afford an account.

Challenge #1: Funding Benefits for Current Retirees. A carve-out proposal, however, must deal immediately with the fact that under a pay-as-you-go retirement system, today's Social Security retirement taxes pay mainly for benefits to current retirees. Thus, any money that goes into an individual Social Security account will not be available to fund today's benefits. This is not a critical problem when Social Security is running a surplus, as it is now, but a carve-out would cause the surpluses to end sooner and increase the program's deficit for a time once they began.

Challenge #2: Avoiding "Double-Dipping." As a result, Americans who choose to divert part of their payroll tax into a personal retirement account should not be permitted to "double-dip." In other words, they should trade part of their traditional Social Security benefits in return for the higher earnings of a personal account. One way to accomplish this would be to require these workers to give up the proportion that is equal to the amount of tax diverted. Thus, if 20 percent of a worker's Social Security retirement taxes (an amount equal to about 2.0 percent of income) was diverted into a personal retirement account, that worker's monthly Social Security check would be reduced by 20 percent.[18]

HOW WOULD ACCOUNTS BE STRUCTURED?

The most important decision that must be made about any Social Security reform plan that includes personal retirement accounts is how the investment choices are structured and regulated. A simple system would give workers the ability to choose from a limited number of investment choices while also allowing them to choose a qualified firm to manage those investments.

Limiting Investment Options

There is a good case to be made for initially offering only about three low-cost investment options in order to reduce administrative costs and potential investor confusion. This approach was used successfully in the early days of 401(k) account plans for much the same reason, and as time went on, additional investments and services were added. For reasons that will be seen below, these initial investment options should include a broad-based stock index fund, a corporate bond index fund, and some sort of government bond fund, perhaps using the new inflation-indexed Series I U.S. Savings Bonds.

Reducing Administrative Costs. Initially limiting the number of investment options would have two advantages. First, studies have shown that administrative costs are directly related to the complexity

16. H.R. 1793, the 21st Century Retirement Security Act was introduced on May 13, 1999.

17. S. 1383 was introduced on July 16, 1999.

18. Since the taxes diverted to a personal retirement account would earn much more than what Social Security would pay, a higher reduction would also be possible without reducing the worker's overall level of retirement income.

of the account and to the level of services offered.[19] Stock index funds, which are computer traded, have extremely low administrative costs. This is also true for corporate bond index funds. Overall, an account that offers only a few simple investment options, one of which is a stock index fund, will provide the best trade-off between potential returns and low administrative costs. A recent study by State Street Trust shows that personal retirement accounts could be offered for an annual administrative cost of 0.5 percent of assets or less.[20]

Reducing Risk. Second, limiting the number of investment options reduces risk. Your brother-in-law's hot stock tip is not usually the best road to retirement security. An index fund would give the returns associated with the equity markets without the hazard and expense of picking individual stocks. Regardless of which investment manager is offering a product, equity funds tied to a specific stock index are very similar. Studies show that while individual stocks tend to have wide swings in value, long-term investments that track the growth of the overall stock market have very little risk. Studies by Ibbotson Associates, a noted stock market research company, show that the overall stock market has increased in value over every possible 20-consecutive-year period since 1926.[21]

Learning to Invest. Limiting the number of investment choices would also allow people who are not currently managing their own money to learn gradually to invest. Since any of the three basic options would earn substantially more than the current Social Security system does, any choice would improve their retirement incomes. Those workers who fail to choose an investment option would go into a default portfolio made up of 50 percent stock index funds and 50 percent Series I U.S. Savings Bonds. This would provide Americans of all ages a mixture of higher investment returns and greater security.

While the small number of investment choices available at the program's start may be frustrating to more sophisticated investors, as the personal retirement account system matures, additional investment options and services could be made available without a substantial increase in administrative costs. This was the case with 401(k) retirement accounts. As the system developed, investment managers increased both the level of service and the number of investment options that were available to plan members. More recently, the law that established the Thrift Savings Plan for federal workers was amended to increase the number of investment options from three to five. In the case of personal retirement accounts, additional investment options should be made available as soon as cost factors warrant.

Allowing a Choice of Investment Managers

Over time, these retirement savings accounts no doubt would attract hundreds of billions of dollars worth of savings and retained earnings. This pool of money would almost certainly be too large to be managed by any one investment manager. For that reason, rather than having everyone invest in one big stock index fund, as is currently the practice in the federal Thrift Savings Plan, it would be better to allow individuals to purchase their stock or bond index funds from an approved list of investment managers. In the event that the manager is unsatisfactory for any reason, account owners should also be allowed to change managers at least annually.

The competition among investment managers—the large companies that handle the investment of large pools of money such as mutual funds and pension assets—would do more than any other factor to keep the administrative costs of these accounts low. It would also encourage the development of new products and services that could

19. Olivia S. Mitchell, "Administrative Costs in Public and Private Retirement Systems," in Martin Feldstein, ed., *Privatizing Social Security* (Chicago: University of Chicago Press, 1998).

20. State Street Corporation, *Administrative Challenges Confronting Social Security Reform*, Boston, March 22, 1999.

21. *Stocks, Bonds, Bills and Inflation 1999 Yearbook* (Chicago: Ibbotson Associates, 1999), p. 50.

make personal retirement accounts even more valuable to their owners.

Reducing Political Interference. In addition, allowing investors to make an individual choice of investment managers would significantly reduce the probability of political interference in investment decisions. Allowing a government agency, no matter how it is structured, to invest Social Security funds in equity markets sets up a situation in which the long-term needs of future retirees are likely to be subordinated to short-term political goals.[22]

However, political influence is possible even if stock investments were to be limited to index funds containing 500 or more stocks. Index funds can be developed using any criteria, and it would be extremely easy to develop, for example, an index fund of 1,000 stocks that left out tobacco companies, gun manufacturers, and other companies that had aroused the ire of organized labor or were deemed to have a poor record on the environment.

First Steps. When the system is first launched, it might not be feasible to allow each person to select his or her own investment manager. Depending on how a Social Security system with personal retirement accounts is structured, it could be necessary to allow smaller accounts to build to a certain amount before they could be transferred to a private investment manager. It might also take some time to develop the actual mechanism to transfer both the existing account and future contributions while still allowing both to be tracked properly for regulatory purposes. However, these delays should be temporary and should be overcome within a few years.

Other countries have adopted such approaches. In the United Kingdom, for instance, retirement taxes are collected by the government and kept for a year in a government bond fund while income data are being collected. Once it is clear how much is due to each person, both the taxes and the accumulated interest they have earned while they are in the bond fund are sent to that individual's investment manager and credited to his or her specific account.

A method similar to this could be also used for personal retirement accounts that are part of Social Security. This would have the advantage of utilizing Social Security's existing method of collecting individual income data while still allowing the greatest number of private investment managers to be involved in the investment process. The accounts of workers who fail to choose a private investment manager could be apportioned among managers in much the same way that many states assign high-risk motorists to automobile insurance companies.

Protecting Consumers Against Fraud

Existing consumer protection laws should be more than adequate to prevent the type of misselling problems that hit the British Social Security system several years ago. The United States has a long tradition of carefully regulating the way that investments can be sold to consumers, something the British lacked at the time. If it is required that all financial managers be licensed and regulated, and if the types of investments that can be offered to consumers are limited, this problem should not arise. However, these existing laws should be strictly enforced, and regulators should be ready to respond to any reports of fraud with immediate prosecution and recommendations for ways to tighten consumer protection laws.

HOW WOULD ACCOUNTS BE REGULATED?

The long-term success or failure of personal retirement accounts would depend in large part on how they are regulated. Regulation that is too strict would prevent account owners from earning enough on their investments for a better retirement income. It could also discourage private

22. For more information, see Daniel J. Mitchell, "Why Government-Controlled Investment Would Undermine Retirement Security," Heritage Foundation *Backgrounder* No. 1248, February 5, 1999.

management firms from participating in the program.

On the other hand, regulation that is too loose could result in investment choices that are either too risky or otherwise questionable for a retirement account. It could also result in participation by under-capitalized or inexperienced investment managers. Either overregulation or underregulation could cause the program to fail.

At the same time, all types of financial institutions should be encouraged to set up offices or subsidiaries to manage personal retirement accounts. This type of business should not be limited to investment banks or any single group of financial intermediaries. The American financial markets have become extremely efficient and cost-effective because they constantly compete with each other, and this rivalry should also work to the benefit of those who own these retirement accounts.

Perhaps the most dangerous move would be to create an entirely new regulator or to give the job to an existing agency that has no real experience in regulating this type of investment. In either case, the learning curve would be steep, and either the program would be unnecessarily delayed or potentially dangerous gaps in regulatory control could develop. Additional problems would be created if the agency has a conflict of interest. For instance, the Social Security Administration not only has no experience in financial regulation, but also could be tempted to hinder the development of a system that is in competition with the existing system.

Criteria for Licensing Investment Managers. Only established investment managers who can meet several strict, but objective, standards should be allowed to accept retirement savings. This requirement would serve both to protect investors and to reduce the possibility of political influence in the licensing of those who could hold and invest personal retirement accounts. Existing financial regulators have wide experience in determining whether companies and individuals have the ability and financial strength to compete successfully. This knowledge can readily be adapted to the licensing of investment managers.

In order to protect both the individual account owner and the Social Security system, potential investment managers should meet four major standards:

- **Capital adequacy.** The investment manager should have sufficient capital invested in the firm to ensure stability and the ability to survive market fluctuations.
- **Professional expertise.** Only qualified and experienced professionals should be allowed to manage these retirement savings accounts.
- **Disclosure of fees.** All fees and costs must be clearly disclosed in writing before any money is accepted.
- **Regular statements.** All account owners must receive regular statements in clear and simple language that discloses the status of their accounts, including the amount of contributions, the investment options chosen, the rate of return for each investment option, and the exact amount of any fees that were paid.

Investment managers should be examined regularly to ensure that they continue to meet these qualifications and any other rules that the individual regulator finds to be necessary. In addition, there could be a requirement that the principal (but not investment gains) would be covered against loss by a private insurance policy to provide an additional level of security and reduce the possibility that individuals will become anxious because of temporary market dislocations. However, this insurance would be payable only at retirement, and not triggered because of market fluctuations.

Avoiding New Levels of Regulation. Financial regulation is extremely technical, and regulatory agencies tend to lack the knowledge needed to fully understand types of financial institutions beyond those that they regulate. The daily activities of a bank, for instance, differ greatly from those of an insurance company or a credit union. To date, no single regulator has the type of detailed information necessary to regulate every other type of financial entity.

As a result, the wisest course could be for the primary regulator of the financial institution owning the investment manager to handle the regulation of personal retirement accounts. The imposition of yet another regulator will only serve to increase the cost to the account owner without adding any substantial benefit.

Thus, an investment managing service owned by a securities firm would be regulated by the Securities and Exchange Commission, while that owned by a national bank would be regulated by the Office of the Comptroller of the Currency. This would allow the regulator with the best knowledge of the day-to-day activities of the investment manager to oversee personal retirement accounts.

As Congress shifts to a system of functional regulation, instead of the existing system of regulating by type of firm regardless of what types of activities the firm engages in, the regulation of investment managers should be given to the SEC. However, until that system is completely in place, consumers would benefit most by using the existing regulators.

Avoiding Additional Layers of Complexity. Current financial law divides the responsibility for regulating financial institutions according to type. However, the complex network of financial regulators often overlaps, and in some situations, any one of several different regulatory agencies could regulate similar activities.

It would make little sense to make this often confusing system even more complex by adding another set of regulators. At the same time, it will be important to ensure that all financial managers adhere to the same set of regulations. Requiring a commercial bank that manages personal retirement accounts to meet stricter standards than an investment bank or brokerage house would place the commercial bank at a competitive disadvantage.

Coordinating Regulatory Efforts. In order to ensure that all types of financial institutions have an equal opportunity to compete for these accounts, and to ensure equal levels of consumer protection, regulators should coordinate their activities. Back in the early 1980s, Congress established the Depository Institutions Deregulation Council, consisting of the major depository regulators, to ensure that the different regulators followed the same set of basic rules. Rather than create an entire new bureaucracy, each regulator assigned staff to the council, and each regulator had an equal voice.

A similar coordinating council should be established for personal retirement account regulators. Its primary responsibility would be to determine the basic structure of the regulations and to issue them for public comment. Once a decision had been reached on key regulatory issues, it would be up to the individual agencies to issue the specific regulations that would affect the institutions under their jurisdiction. However, these regulations would have to meet the standards contained in the council's drafts. The specific agencies would also be required to administer them in the same manner.

Under normal circumstances, this council would meet quarterly, but its staff could meet as often as necessary. Its purpose would be to ensure that all types of investment managing services, no matter which type of financial institution owned them, would meet the same level of regulation. While each agency would have the ability to adapt the regulations to meet the specific circumstances of the entities under its jurisdiction, none of them could adopt a looser standard than that agreed upon by a supermajority of the overall council.

Even if Congress changes the financial regulatory system, the need for a coordinating council will remain. Although some financial regulators could be combined at some point, there is little chance that a single financial regulator will be created, and it is even less certain that such a super-regulator would be desirable.

WHY THE SOCIAL SECURITY ADMINISTRATION SHOULD NOT REGULATE PERSONAL RETIREMENT ACCOUNTS

While the Social Security Administration (SSA) does an admirable job of calculating and delivering benefits to millions of Americans, it has no experience whatever in investing. The Department of the Treasury collects taxes for the SSA, and the Bureau of the Public Debt turns any taxes that are not immediately spent into special issue Treasury bonds. But at no point does the SSA have substantive dealings with financial markets or private-sector financial institutions.

Avoiding a Conflict of Interest. In fact, allowing the SSA to regulate personal retirement accounts could create a conflict of interest. Allowing workers to choose whether they wish to divert a portion of their Social Security taxes into such an account or remain in the existing SSA-administered version would place the two systems in competition with each other. If the SSA had the ability to regulate personal retirement accounts, it could be tempted to use its authority to obstruct the development of these accounts with unnecessarily heavy regulatory burdens.

As a result, the SSA should have no role in regulating financial institutions that manage personal retirement accounts. A massive bureaucracy that can take years to determine eligibility for disability claims simply does not have the expertise or ability to understand the innovative and rapidly changing financial world. The SSA could add nothing positive either to funds management or to consumer protection, and it could do a great deal of damage by misunderstanding the nature of the business.

There may be a good argument for requiring investment managers to coordinate with the SSA when determining benefits or recording contributions to personal retirement accounts, but not for any other activity concerning them.

CONCLUSION

Personal retirement accounts could allow every worker to participate fully in the growth of the American economy. However, in order to take full advantage of this opportunity, the accounts must be funded from a portion of the existing taxes that go to pay for Social Security retirement benefits. In addition, the structure and regulation of these accounts will make the difference between improved retirement income and unmet expectations.

The importance of these decisions to the success or failure of Social Security reform cannot be overstated. While reformers must also concentrate on macroeconomic concerns such as the effect of reform on economic growth, the seemingly mundane decisions about regulators and investment choices will be crucial.

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