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Some lessons from Sweden on the pros and cons of privatizing Social Security.

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"YOUNGER workers," President Bush said in his State of the Union address, "should have the opportunity to build a nest egg by saving part of their Social Security taxes in a personal retirement account."

According to former Treasury Secretary Paul H. O'Neill, the president believes that the reason he was elected was his bold -- some would say risky -- stance on replacing part of Social Security with personal accounts. If the president holds onto office in November and his party continues to hold Congress, the creation of some sort of personal retirement accounts as part of Social Security seems likely.

Although it is impossible to know what form such accounts might take, in 2000 Sweden instituted a system of personal accounts that holds many lessons for any country seeking to reform its retirement system.

Sweden now has a blended system, an approach Mr. Bush apparently favors. Employers and employees contribute a combined 16 percent of payroll toward a "pay as you go" retirement system like Social Security, and an additional 2.5 percent toward individual retirement accounts. Those born after 1954 are fully in the new system, while older workers are phased in.

The reform process began in 1991, when a center-right coalition came to power. At the time, Sweden's generous retirement system was expected to exhaust its "buffer" funds in about 20 years, a more dire situation than what now confronts the United States; Social Security will not exhaust its trust fund until 2042, according to the latest projections.

To address its problems, Sweden set up a committee with representatives from all parties in Parliament. Because the reforms were expected to last for decades, there was pressure to devise a plan with broad support, said Annika Sunden, an expert on pensions at Stockholm University. There was agreement back in 1994 that reform would include individual accounts, so beginning in 1995 the government began tucking away 2.5 percent of payroll for employees to invest once the system was set up.

Personal investment accounts were not established until 2000, with a bewildering array of funds to choose from. Some 456 funds participated initially, and the number has since grown to around 600. Most funds invested in stocks, with a quarter primarily in Swedish stocks. Workers could choose up to five funds.

Anyone who did not choose a fund was automatically assigned to the default fund, which was set up by the government. The default fund must invest 80 to 90 percent of its assets in stocks.

A central pension agency records all the accounts and fund values. The agency also ran an ad campaign to discourage people from going into the default fund.

Nonetheless, a new study by Henrik Cronqvist and Richard Thaler of the University of Chicago finds that a third of Swedish workers did not make an active choice when the system started in 2000, and were therefore assigned to the default fund. Since 2000, fully 92 percent of new enrollees have not made a choice and have been added to the default fund.

Apparently, the large number of funds to chose from paralyzed many individuals from making a choice. This has also been the experience of many 401(k) plans that have a default option in the United States: the default option, whatever it may be, is chosen by a high proportion of investors. People are also reluctant to switch once they are in a fund, a tendency that the economists William Samuelson and Richard Zeckhauser have called status quo bias.

Another bias that Mr. Cronqvist and Mr. Thaler documented is home bias, a tendency to pick funds composed of Swedish companies, as opposed to a diversified portfolio of companies from around the world. Nearly half the money actively invested was in Swedish stocks. The default fund, by contrast, was better diversified: only 17 percent was in Swedish stocks.

They also found that people tended to pick funds in sectors that had done well recently, and to pick funds with low fees. The average fee for active choosers was 77 basis points, or 0.77 percent of the funds invested. For the default fund it was just 16 basis points. Chile's mandatory savings plan provides another point of comparison. Fund management fees were much lower in Sweden than administrative costs in Chile's plan, probably because the central pension agency orchestrated rebates and advertised the fee rates.

How did the funds do?

Sweden had bad timing. The stock market tumbled just after the program started.

It turns out, however, that the default fund lost less money than the aggregate portfolio of selected funds. The average selected fund fell by 40 percent in the first three years of the program, while the default fell 30 percent.

Although three years is a short period, there is no evidence that the active choosers made better choices than those assigned to the default fund.

For the United States, the main lesson from the Swedish experience, Ms. Sunden said, is that the default fund should be constructed very carefully, because it will attract many investors. (Ditto for 401(k) plans.) She also highlighted that more use should be made of generation funds, which move money into less risky assets as workers approach retirement, and that converting funds into annuities should be mandatory for retired workers.

The consequences of making a bad investment decision in Sweden are much less severe than they would be in the United States if Mr. Bush gets his way and allows workers to divert part of the 12.4 percent of their paycheck that goes to Social Security -- half from the employee, half from the employer -- into personal accounts.

Sweden devotes 16 percent of payroll to an earnings-linked pension system, creating a strong safety net beneath individual accounts. Sweden also established a "guaranteed pension" that provides a minimum pension amount, in excess of the poverty line, to anyone with little or no pension income.

All this leads one to wonder if it is possible to design a system that diverts some Social Security contributions into personal accounts yet still provides adequate insurance against bad luck and bad investment decisions. Moreover, the current American system is not beyond repair. In their new book, "Saving Social Security: A Balanced Approach" (Brookings Institution Press), for example, Peter A. Diamond of M.I.T. and Peter R. Orszag of the Brookings Institution outline a plan to preserve the best elements of Social Security by making politically difficult but sensible reforms, like indexing benefits to rising life expectancy and collecting some payroll taxes above the earnings cap.

Sometimes, a little status quo bias is not such a bad thing.