MEMO# 7624

February 9, 1996

DRAFT SOCIAL SECURITY ADVISORY COUNCIL REPORT

1 Advisory Councils on Social Security have been appointed every four years by the Secretary of Health and Human Services, with the Chairman and 12 other members representing business, labor, self-employed persons and the public. February 9, 1996 TO: BOARD OF GOVERNORS No. 6-96 RE: DRAFT SOCIAL SECURITY ADVISORY COUNCIL REPORT ____ The Advisory Council on Social Security1 is expected to issue its final report on the financing of social security within the next few weeks. Attached is a draft currently circulating among Council members for their approval. The draft report does not reflect a single consensus recommendation. Rather, three different approaches are presented, none of which is supported by a majority of the Council. All three approaches would reduce social security benefits in the future to some extent. 1. Maintenance of Benefits Reform Plan This approach maintains the structure of the social security program essentially as it is now. The long-range deficit in the social security program would be eliminated principally by (1) assuming that annual cost-of-living increases in the future will be ½ percentage point below the increase in the present Consumer Price Index (the current basis for annual increases); (2) taxing social security benefits on a different basis which will increase revenues, with the revenues collected being deposited in the Trust Funds; (3) investing a portion (eventually reaching 37%) of the Trust Funds in the equity market; and (4) increasing payroll taxes from 12.4% to 14.4% in 2050 (the equivalent of a $60 billion annual tax increase in 1996 terms). 2. Individual Accounts Reform Plan This approach would eliminate the long-range deficit by lowering benefit costs to the level of expected revenues, and then creating a new government-run mandatory individual investment program funded by raising payroll taxes 1.6 percentage points (from 12.4% to 14%, approximately a $50 billion annual tax increase in 1996 terms). The revenues related to this increase would be held by the Trust Funds as individual accounts. According to the draft report, "Individuals would have constrained investment choices. . . ranging from a portfolio consisting entirely of safe bonds to common stock index funds that replicate the -2- behavior of the entire stock market." Upon retirement, individual accounts would be converted to minimum guarantee indexed annuities. Contributions to individual accounts would not be tax-deductible, but all withdrawals would be exempt from federal income taxes. 3. Personal Security Account Plan This approach would substantially change the nature of the social security program, create mandatory individually invested accounts in the private sector equal to 5 percentage points of the payroll tax, and raise taxes the equivalent of $50 billion a year (in 1996 terms) for the next 70 years. Five percentage points of the 12.4% payroll tax would be required to be invested in Personal Security Accounts with regulated private firms, and be "subject to necessary regulatory restrictions to make sure they were invested in reputable financial

instruments." Individuals would not be required to receive distributions in the form of indexed annuities (though these would be made available). All withdrawals would be exempt from federal income taxes. The Personal Security Account Plan would be funded by an additional tax of about $50 billion annually (1996 terms) over a 70-year period, and by additional government borrowing for perhaps the next two decades (with this additional debt repaid from the new tax by the end of four decades). Evaluation of the Draft Report It is significant that (1) two of the three alternative approaches incorporate an element of individual investment; (2) both of these alternatives recommend that individual investment funds not be taxed upon withdrawal; and (3) the draft report also advocates expansion of retirement plan coverage, particularly for small businesses. On the other hand, (1) both approaches which incorporate an element of individual investment also include tax increases of $50 billion annually (in 1996 terms); (2) the Individual Accounts Reform Plan would limit investment choices to a few government-run funds; and (3) the Maintenance of Benefits Reform Plan recommends that Social Security Trust Funds be directly invested in the equity market. We will keep you informed as this matter develops. Matthew P. Fink President Attachment

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