

**MEMO# 7563**

January 18, 1996

# BOARD OF GOVERNORS -- SECOND DAY DISCUSSION

January 18, 1996 TO: BOARD OF GOVERNORS No. 2-96 RE: BOARD OF GOVERNORS -- SECOND DAY DISCUSSION

The second day of the Winter Board Meeting traditionally is devoted to a discussion of key issues facing the investment company industry. The Board this year will have two discussion sessions on Wednesday morning, January 31. The first session will commence with small-group breakfast discussions of the question "What do you see in the mutual fund environment that concerns you, and what should be done about it?" (This is a repeat of an interesting and useful session on the same topic two years ago.) Each table discussion will be moderated by a Board member who will then report in plenary session. No briefing materials are included for this session, since it is intended to be open-ended and informal. The second discussion session will be on the possible inclusion of an element of individual investment within the social security system ("privatization of social security"). Attached is a background paper to assist the Board in preparing for discussion of this topic, as well as some news clips you may find useful as background. I look forward to seeing you in Palm Beach. Matthew P. Fink President Attachments ATTACHMENT INCLUDING AN ELEMENT OF INDIVIDUAL INVESTMENT WITHIN THE SOCIAL SECURITY SYSTEM ("PRIVATIZATION OF SOCIAL SECURITY") EXECUTIVE INDEX I. The Social Security System Today A. Social security cash benefit programs. . . . . 2 B. Financing . . . . . 2 C. Long-range funding problem. . . . . 2 D. Proposals to deal with the funding problem . . . . . 3 II. Background Information A. Privatization at the governmental level . . . . . 4 B. Privatization at the individual level: complete or partial . . . . . 5 C. Transitional funding problem . . . . . 6 III. Topics for Board Discussion A. Should there be limitations on individual investment? . . . . . 6 B. What impact would Personal Investment Plans have on existing tax-favored retirement plans? . . . . . 7 C. What has the fund industry learned from existing tax-favored retirement plans that would be applicable to Personal Investment Plans? . . . . . 7 D. Should individual investment be voluntary or mandatory? . . . . . 8 21 Wages are only taxable up to an indexed maximum "taxable wage base," \$62,700 in 1996. I. THE SOCIAL SECURITY SYSTEM TODAY A. SOCIAL SECURITY CASH BENEFIT PROGRAMS. -- The social security cash benefit programs (Old-Age, Survivors, and Disability Insurance) provide monthly benefits to retired and disabled workers and their dependents, and to the survivors of deceased workers. The amount of a persons monthly retirement benefit is based on average taxable wages<sup>1</sup> over the persons working lifetime, under a formula which is relatively more

favorable to lower-income workers -- that is, the programs redistribute income from higher income workers to lower-income retirees. In 1994, \$317 billion was paid out in social security benefits; slightly more than two-thirds of the total (\$215 billion) represented retirement benefits, paid to about 30 million beneficiaries. (The remaining amounts were paid to survivors of deceased workers, and to disabled workers and their dependents.)

**B. FINANCING.** -- The social security cash benefit programs are principally financed by a 12.4% payroll tax (6.2% each on the employer and the employee; 2.4% on the self-employed) on earnings up to the maximum taxable wage base. Most payroll tax receipts are used to make current benefit payments. Funds collected in excess of the amount needed to make current benefit payments are credited to the social security trust funds as reserves, and by law must be invested in special Treasury securities. The cash benefit trust funds had a balance of \$436 billion at the beginning of 1995. Although social security retirement benefits have the characteristics of a defined benefit plan, the program has never been fully funded -- that is, current payroll taxes have never been sufficient to pay for anticipated future benefits of current employees. Instead, current payroll taxes are largely used to make payments to current beneficiaries, and the program has in effect relied on the government's future taxing power to pay for future benefits. In 1972, the Congress modified the program to provide for annual cost of living increases, accompanied by major changes in the nature of the assumptions on which actuarial projections were based. As a result, the program's future benefits became extremely sensitive to economic conditions, and social security has suffered a degree of projected financial instability ever since. Future financing crises were projected in the 1970s and again in the early 1980s, and in 1977 and in 1983 Congress enacted legislation designed to solve the financing problem, only to be faced with another projected financing crisis a few years later.

**C. LONG-RANGE FUNDING PROBLEM.**-- The adequacy of social security's long-range actuarial status traditionally has been measured by comparing income and outgo over a 75-year period -- a period long enough to cover the anticipated retirement years of almost all current workers. By that test, the social security cash benefit programs have a long-range actuarial deficit of 2.17% of payroll -- equivalent to a deficit of roughly \$60 billion each year for the next 75 years (in 1996 dollars). Under current actuarial projections, the social security trust fund will receive more in payroll tax revenues than it pays out in benefits each year until the year 2013; after that time, outgo will exceed tax revenues, to the extent that by 2030 there will be insufficient funds to pay all social security benefits.

**D. PROPOSALS TO DEAL WITH THE FUNDING PROBLEM.**--It is widely recognized that the social security funding problem is a critical issue that must be addressed. Various components of a solution have been proposed: Provide annual cost-of-living increases that are less than the increase in the consumer price index (the basis for these increases under present law). Over time, increase to age 70 the "normal retirement age" at which full benefits are payable (it is now 65, and already scheduled to increase gradually to age 67 by the year 2027); also, increase gradually from 62 to 65 the age at which actuarially reduced benefits are first payable. Decrease a spouse's benefits from one-half of a worker's benefit to one-third of a worker's benefit. Make other changes in the benefit formula which would decrease payments to future beneficiaries compared with present law. Increase social security payroll taxes. Include an element of privatization -- that is, replace at least part of the present wholly governmental social security system with some form of investment in the private markets. The Board's discussion will focus on the last of these components, the privatization of at least a portion of the social security program. The current Advisory Council on Social Security<sup>2</sup> is devoting its attention to finding alternative solutions to the problem. For the first time ever, a majority of the Social

Security Advisory Council favors proposals that go beyond the structure of the present social security system (i.e. beyond benefit and payroll tax modifications). Notably, in its December meeting, a majority of the Advisory Council supported social security reform proposals which included an element of privatization of part of the social security system. II. BACKGROUND INFORMATION

Revising the social security system to incorporate an element of privatization can provide a great opportunity for the investment company industry to attract new investments from persons who are not now shareholders, as well as from existing shareholders. Marketing IRA or 401(k) investments today means convincing individuals to invest funds they would otherwise consume. But if individual investment becomes a part of the social security system, the employee's choice will be between paying money into the social security trust fund or investing the same money in a personal account -- in either case, the money cannot be used for immediate consumption. Though the amounts invested annually may be small, such amounts must remain invested until retirement, death, or disability, and thus will accumulate over time. (For example, if employees had been able to invest 2 percent of their social security wages in individual accounts beginning in 1981, and half of them had chosen to do so in ways similar to IRA investment patterns, the assets of these accounts would have totaled an estimated \$700 billion by the end of 1994.) In addition to the opportunity offered the investment management industry, privatization can offer employees the possibility of significantly increased retirement income compared with what they might expect from a purely governmental program. It also offers the likelihood of an increase in personal savings which will have beneficial effects throughout the economy. Because any modification in the social security program will affect so many people, when legislation is considered many different interests will be represented, and privatization can expect to face strong political opposition. The legislative process will reflect a conflict between those who want the social security program to remain a completely governmental program and those who see a need for private sector involvement in any solution. Achieving the requisite degree of consensus on restoring the fiscal soundness of the social security program and incorporating an element of privatization will take time, perhaps several Congresses. The purpose of the Institute's current efforts is to position the investment management industry to play an important role, from the beginning, in the design of the revised social security system which will emerge. 4The following items are not suggested as issues for Board discussion at this time for one of two reasons: first, our position on some is clear; second, other items require more information. They are described below for the Board's information because they will be subsequent issues in the debate that will take place as social security modifications advance.

A. Privatization at the Governmental Level One significant threshold issue associated with privatization is whether private investment should be done at the governmental or individual level. Some Members of Congress and some members of the Social Security Advisory Council have already proposed direct government investment of social security trust funds. These proponents contend that if the government were to invest at least a portion of the social security trust funds in the private sector, the higher returns (compared with the present mandatory investment in Treasury securities) would solve a portion of the long-term financing problem. The Institute would argue that such direct government investment in the private markets should not be undertaken. Social security trust fund assets total about a half a trillion dollars now; these funds under present law are all invested in special issue Treasury debt. If this amount were instead invested in the private markets, then the Federal government would have to borrow half a trillion dollars more from the public than it would otherwise borrow. This could have a significant impact on interest rates and the private equity and bond markets. If the government invested in the private markets, how would the managers of the trust funds decide what investments to make? Even a passive investment strategy involving indexed funds would make

distinctions; for example, securities of smaller companies would likely not be included. Most importantly, in a political environment, there would be the possibility of requirements that investments be made at least in part to meet social or political objectives, which could increase risk or lower returns. The proponents of direct government investment assume it will result in a greater rate of return than trust fund investment in Treasury securities. But if the investments did not yield the anticipated returns, the social security system would have less income than needed, and either taxpayers would be required to make up the losses with higher taxes, or social security beneficiaries would receive lower benefits. The Institute is commissioning a study critiquing the proposal that social security trust funds be directly invested in the private markets.

### B. Privatization at the Individual Level: Complete or Partial

The alternative to direct government investment of social security trust funds is privatization in the form of individual investment. If individuals rather than the government were to be the investors, the question arises whether privatization should be complete or partial -- that is, whether there would continue to be a wholly federal part of the social security program. The CATO Institute and others have proposed the complete replacement of the present social security program (after a transition period) by a system of individual accounts whose investment would be directed by individual workers. On the other hand, Senators Simpson and Kerrey have introduced legislation which would preserve a government social security benefit program, but include an element of individual investment; under this proposal, Personal Investment Plans (PIPs) would be established for the individual investment of 2 percentage points (about one-sixth) of the 12.4% payroll tax. The remaining 10.4% of the payroll tax would support a modified version of the present social security system. The Institute testified in support of the Simpson-Kerrey proposal; it was the only financial services trade association to do so. Complete privatization seems unlikely to be enacted. It is far more controversial than partial privatization, both because of the uncertainties involved in total repeal of the present social security system at some point in the future, and because of specific issues total privatization raises. For example, if the present social security system were to be completely replaced by a system of individual investment, how would the continued social security benefits be financed for present and near-term future beneficiaries? (Retirement benefits paid in 1994 totaled \$215 billion.) The present social security system is redistributive -- taxes on the wages of higher income workers pay for the disproportionately larger benefits of lower income workers. A completely privatized system would lack that feature, which could lead to proposals to supplement the benefits for lower income workers. In a purely privatized system, the present totally defined benefit program would be replaced by a system in which no particular level of retirement income would be certain. If all workers were dependent on individual investing to provide for their retirement income, concern for their protection might result in some form of government-guaranteed minimum retirement income level. For example in Chile, where the social security system was completely replaced by an individual investment system, the government guarantees (and bears the cost of) both a minimum rate of return and a minimum benefit. Total privatization would also affect all other aspects of the social security system (as partial privatization would not). For example, about one-third of cash benefits last year went to disabled workers and their dependents, and to survivors of deceased workers. Since the death or disability of a worker can occur at a relatively young age, individually invested funds might not be sufficient to replace the social security benefits, and complete privatization would be an inadequate replacement for the social security disability and survivor benefit programs.

### C. Transitional Funding Problem

Getting from the present kind of social security to an actuarially sound system with an element of privatized investment will involve a significant transitional funding problem. Under individual privatization proposals, whether complete or partial, participating employees would immediately pay less into the social security trust fund; in return, they

would ultimately receive lower social security benefits. Thus the trust fund would immediately have less income from employee payroll taxes, yet it would be some years before those employees received lower payments from the trust fund. Even if the proposal were actuarially sound in the long run, with lower tax receipts eventually balanced by lower benefit payments, there would be a transitional cash flow problem over the next three decades while continued social security benefit payments were made to present and near-term future beneficiaries. This transitional funding problem is the largest single fiscal problem associated with privatization proposals, and the magnitude of the problem increases as the percentage of social security benefits allowed for individual investment increases. The Institute has engaged the services of an actuary to assist in finding solutions to the transitional funding issues associated with a two percentage point Personal Investment Plan (PIP).

III. TOPICS FOR BOARD DISCUSSION ASSUMPTION: For discussion purposes, assume that the proposal involves the individual investment of two percentage points of the social security payroll tax.

A. SHOULD THERE BE LIMITATIONS ON INDIVIDUAL INVESTMENT? The legislation introduced by Senators Simpson and Kerrey would allow investment either in a PIP similar to an IRA, or in a program like the Federal employee thrift plan -- a government-run program which offers a government bond fund, a single indexed bond fund, and a single indexed equity fund. As the Simpson-Kerrey legislation receives greater scrutiny, there are likely to be efforts to limit the kinds of investments individuals may make. The Institute has commissioned a study to rebut the argument that individual investment should be limited to a government-run program similar to the thrift plan for Federal employees. If substantially broader personal investment choices are allowed, policy makers will ask the following questions:

C Should all kinds of IRA-type investment be allowed? C If not, who would determine the appropriate investment restrictions? C Should individuals be permitted to invest in individual stocks and bonds? In employer stock? In GICs? In tax-exempt securities? In mutual funds investing in foreign securities, emerging market funds, sector funds, or "junk bonds" funds? C Are load funds or funds with 12b-1 fees appropriate PIP investments? C Should individuals below a certain age be required to invest in equities and equity funds and those above a certain age restricted to more conservative investment options? C Should the array of mutual fund investment options be limited to indexed funds? C Are retail funds appropriate vehicles for these assets, or should PIP assets be invested only in funds with lower expense ratios, or only in dedicated PIP funds (vehicles solely invested for PIPs)? C If the only permissible investment vehicles are dedicated PIP funds, what investment criteria should govern the funds? C Should sponsorship of dedicated PIP funds be limited to entities selected by the government? What criteria should the government use to choose the funds?

B. WHAT IMPACT WOULD PERSONAL INVESTMENT PLANS HAVE ON EXISTING TAX-FAVORED RETIREMENT PLANS ? The value of pension assets held by U.S. households is equal to more than 70 percent of Gross Domestic Product. While participation in defined benefit plans has been growing slowly, participation in defined contribution plans has shown substantial growth, increasing from 11.2 million participants in 1975 to 38.5 million in 1990, and projected to have 52.3 million participants by 2000. Individual Retirement Account assets have grown from \$200 billion in 1985 to about a trillion dollars today. Mutual funds have been particularly successful in providing retirement investment vehicles where investment decisions are made by the individual (such as defined contribution plans or IRAs). The retirement market has been a significant factor in the mutual fund industry's growth; retirement plan assets (even exclusive of nonqualified variable annuities) account for about one-third of industry assets. About two-fifths of total IRA assets and one-third of 401(k) assets are invested in mutual funds.

C What impact would the enactment of the PIP proposal have on the existing retirement plan market? C Employees participating in PIPs would see the extent to which their investments grew over time. What would be the consequences? C Would employee

participation in PIPs result in employers establishing fewer or less generous pension plans for employees? C Would employees participating in PIPs be likely to make smaller salary reduction contributions to employer plans and fewer IRA contributions? C Would aggressive marketing of PIPs introduce a large number of persons to investing and result in their saving more than they do now -- as participants in employer pension plans and IRAs and even as individual investors? C. WHAT HAS THE FUND INDUSTRY LEARNED FROM EXISTING TAX-FAVORED RETIREMENT PLANS THAT WOULD BE APPLICABLE TO PERSONAL INVESTMENT PLANS? C Do investors in the retirement income market respond to investment education efforts? C In general, do they invest wisely for their retirement? C Would broad participation in PIPs introduce new investors to the benefits of mutual fund investments and lead former non-savers to develop a savings habit? C Would it be worthwhile for a fund from a business perspective to set up many relatively small (and perhaps initially unprofitable) accounts for PIPs for the opportunity to market to a substantially expanded customer base? C Should there be SEC or IRS regulatory modifications or rules changes that would reduce the administrative costs associated with PIPs or of funds dedicated exclusively for investment of PIPs? C Should dedicated Personal Investment Funds be exempt from SEC regulation? C What other lessons from the retirement income market are applicable in designing legislation for PIPs? D. SHOULD INDIVIDUAL INVESTMENT BE VOLUNTARY OR MANDATORY? C Should participation in personal investment plans be required of all workers? C Or should workers be allowed the choice of either remaining wholly within the social security system or participating in a personal investment plan? C If all workers were required to participate in an individual investment program, who would be responsible (and to what extent) for providing information or advising workers on possible investments? 6C What would be the default investment for workers not indicating their investment selection? C Would mandatory participation necessitate the imposition of limitations on investment choices or regulatory burdens on employers and financial services companies far more severe than under a voluntary program? C Would workers need to be protected from the full consequences of their investment choices (for example by a government-guaranteed minimum benefit, or through a private or governmental program to insure the principal invested)?

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