

S. 824 - the Personal Investment Plan Act of 1995

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Senate Finance Committee Subcommittee on Social Security and Family Policy

Testimony of

Matthew P. Fink

President

Investment Company Institute

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I am Matthew P. Fink, President of the Investment Company Institute, the national association of America's mutual fund industry. The Institute's membership consists of over 5,000 mutual funds with assets of approximately \$2.3 trillion. Increasingly, mutual funds serve as the investment medium of choice for retirement programs, including employer-sponsored retirement plans and IRAs. As of December 1994, approximately \$760 billion, representing 35 percent of total fund assets, were held in such retirement vehicles. Of this amount, \$147 billion is held in 401(k) plans, and over \$285 billion are IRA assets. Mutual funds account for 28 percent of total 401(k) plan assets and 31 percent of total IRA assets.

I appreciate this opportunity to testify today on S. 824, the Personal Investment Plan Act of 1995. This legislation represents a major step in addressing the impending retirement saving crisis, an issue of vital importance to our nation's future. It is a thoughtful and timely proposal to combine a social insurance system with a system of voluntary private saving, and it offers individuals the possibility of substantially higher retirement income than they are likely to achieve under the current Social Security program. Indeed, Institute calculations indicate that, had the PIP proposal been in place 40 years ago, an individual earning the maximum wage base and investing 2 percentage points of his contributions into a PIP tracking the S&P 500 would receive a benefit that is 57 percent greater than the benefit offered under our current system.

Introduction

My testimony today will address:

Our industry's primary focus is on saving and long-term investment. Accordingly, the Institute has long supported legislative efforts designed to enhance both individual and employment-based retirement programs. For example, the Institute was a vigorous proponent of the 1981 universal IRA legislation and has more recently urged enactment of pending legislative proposals to enhance the IRA. The Institute also strongly supports legislation designed to simplify the complex and burdensome operational requirements applicable to employee retirement plans and to increase retirement plan coverage among small employers.. In July of this year, the Institute joined the Department of Labor to promote greater public awareness of these issues in a campaign with the theme "Save! Your Retirement Clock is Ticking." This nationwide effort is designed to help educate the public about the importance of retirement planning and to increase levels of personal retirement saving.

The Need for Enhancing Social Security Through Individual Saving

The Institute strongly supports [S. 824](#), the Personal Investment Plan Act of 1995, as an essential and well-conceived element of a national program, building on our existing Social Security system, to assist all Americans to save for their own retirement. Our current pay-as-you-go system is dependent upon an ever-increasing workforce to finance benefits for retirees. Yet, in light of national

birthrate trends, the workforce of the future will actually be smaller than the current workforce. When the so-called "baby boom" generation reaches retirement, the ratio of workers to retirees will be smaller than ever before. Today, for each person aged 65 and over, there are almost five persons between ages 20 and 64; when today's younger workers reach retirement age in 2040, there will be only an estimated 2.7 persons between 20 and 64 for each person 65 and older. Furthermore, demographic projections reveal that future U.S. retirees will have a longer life expectancy and, therefore, a longer retirement, than prior generations. The Social Security Trustees report that the system is insufficiently funded in the long run and is conservatively projected to have a negative cash flow by approximately the year 2013.

In light of these well-documented and widely reported projections concerning the upcoming crisis in the Social Security system, Americans understandably are losing confidence in the system. A survey released in December 1994 by the Employee Benefit Research Institute reports that roughly two-thirds of Americans age 26 and over are not confident that Social Security will continue to provide benefits of a value equal to those received by retirees today. A similar survey conducted for the public policy research organization Public Agenda revealed that 72 percent of Americans think that their Social Security benefits will decline relative to those paid to current retirees or that they will receive no benefits at all. This skepticism is most intense for those age 18-34; only 28 percent of this group believes that Social Security will still exist by the time they retire.

Yet, even this widespread sense of "no confidence" in the current Social Security system has not led most Americans to increase or even begin saving for retirement on their own. Government statistics show that personal saving as a percent of disposable personal income has tumbled over the last decade -- from a high of 8.0 percent in 1984, to a low of 4.0 percent in 1993.

An Institute study released three years ago confirmed that, compared to other generations, the Baby Boom generation seems much less prepared financially for their retirement years. Despite a higher number of two-income families and a considerably higher per capita income than previous generations, their saving rates are lower than the two generations that preceded them. The study found that more than 6 out of every 10 Baby Boomers stated that they either were not or could not save for retirement, even though more than half expressed worry about meeting their financial needs during retirement. Subsequent research confirms these alarming trends.

The Reforms Proposed by the Personal Investment Plan Act of 1995 Are Sound and Urgently Needed

In short, legislation addressing our retirement saving crisis is imperative. The Institute commends the Subcommittee for undertaking this effort. Sensible reforms that increase retirement saving must be among our highest national priorities. In this regard, the Personal Investment Plan Act of 1995 is an excellent place for starting this process of reform. The bill would allow workers the option of choosing to invest 2.0 percentage points of their OASDI payroll taxes in their own personal investment plans (PIPs). The funds in such PIPs would be invested in the private sector through either a program similar to the government employees thrift plan or an IRA type account.

For a number of reasons, a legislative proposal such as the PIP, which provides for partial funding of Social Security benefits, will enhance retirement security.

First, a program such as the PIP would allow workers to realize the power of positive compounding on the portion of their payroll tax contributions contributed to the PIP. Those contributions otherwise would be added to the Social Security Trust Fund, which, under the current pay-as-you-go system, would soon be paid out in the form of benefits.

Second, contributions to the PIP could be invested in assets other than Treasury securities, such as equities. While the actual investment experience for PIPs cannot be projected, equities have traditionally produced a greater return than Treasury obligations. For example, over the past 40 years, the Standard & Poor's 500-stock index has risen an average of 11% a year (with dividends reinvested), while long-term government bonds have risen an average of 5.6% a year. Over this 40-year period, a \$1,000 investment in common stocks would have grown to \$65,000 (as measured by the S&P 500 index). By comparison, a \$1,000 investment in long-term government bonds would have grown to only \$8,894.

Third, in addition to increasing potential investment return to PIP investors, the shifting of these funds from Treasuries into stocks, bonds and mutual funds would provide much needed capital for private industry. Indeed, the privatization of the Chilean system has been credited with helping to capitalize its stock market at a rate of 100 percent of gross domestic product.

Fourth, the PIP program would increase the personal saving rate of Americans above their current inadequate levels. Moreover, the use of PIPs may help Americans to develop a "saving and investment" "habit" that would carry over into their non-Social Security assets. This factor is especially important for younger Americans who often do not recognize the need to save until they are too close to retirement to build up significant accumulations.

Fifth, in addition to their direct impact upon saving, PIPs would serve to promote American workers' sense of personal responsibility for their own financial future and provide a sense of empowerment for those who take individual control of their retirement investments. The habits ingrained in American workers through their the PIP investment program could result in less overall reliance on "big government." As such, the PIP proposal responds directly to the message sent last November by middle-class voters who want to reduce the role of government in their lives.

Finally, and perhaps most importantly, the PIP program would help to restore confidence in the Social Security system. The public policy organization Public Agenda surveyed the general public and asked them to rank the strength of various arguments for getting rid of Social Security. The survey respondents reacted most strongly to the following two arguments: 1) government is mismanaging the program so badly that money is going to waste; and 2) people can get a much better return if they invest retirement money on their own. In addition, the Third Millennium survey of those age 18-34 reported that 82 percent would support a system that would "[a]llow Americans to direct part of their social security taxes to a personal retirement account, like an IRA, which could be kept at any financial institution you could choose."

Funding of Social Security Would Be Best Achieved Through a Self-Directed Individual Account Similar to the IRA

As detailed above, the potential benefits of funding at least a portion of the Social Security obligations are both numerous and significant. Thus, the PIP program should be designed so as to maximize these benefits. For a number of reasons, the Institute believes that the use of a self-directed individual account similar to the IRA, such as that proposed for PIP investments under S. 824, would enhance the chances for this program's success.

First, our experience with the IRA demonstrates that the active support and participation of the private sector, with respect to both marketing and investment education, is critical to the success of any initiatives. When private sector financial institutions such as mutual funds, banks and insurance companies promote saving vehicles, they typically launch marketing campaigns that assure public awareness of the availability of these vehicles and the advantages of saving. Economic studies on IRAs have confirmed that such marketing efforts play an important role in IRA purchases. Economist Jonathan Skinner cited the sharp decline after 1986 in both IRA advertising and IRA contributions among those still eligible as evidence of the role of marketing in the growth of IRAs.

The private sector also has taken the lead in efforts to educate the public on investment issues. For several years, economists have expressed concern that Americans invest their retirement assets too conservatively by focusing on guaranteed investment contracts, certificates of deposit and money market funds to the exclusion of equities. Financial institutions have responded to the need for public education by providing to the public numerous resources designed to demonstrate the amount of money that an individual would need for a comfortable retirement and the level of saving and investment returns necessary to achieve that goal.

These public education efforts have produced positive results in the allocation of retirement assets among different categories of investments. IRA investments in equity mutual funds increased from 46.6 percent of all mutual fund IRA investments in 1989 to 53.9 percent in 1994, while the investments in money market mutual funds decreased from 22.9 percent to 18 percent over the same period. (See Attachment A)

Americans also are investing their 401(k) plan assets with a more long-term perspective. 401(k) plan investments in stable value vehicles dropped from 38.2 percent of all 401(k) assets in 1990 to 29.8 percent in 1993, while 401(k) plan investments in equities, other than company stock, increased from 19.8 percent to 27.7 percent over the same period. (See Attachment B)

As our experience with these other forms of retirement saving demonstrates, a private sector role in the PIP program would virtually guarantee that financial institutions will make American workers aware of the advantages of PIPs and will assist them in making prudent decisions about how best to invest their PIPs in order to meet their retirement needs. Such experience further indicates that Americans are eminently capable of directing the investment of their retirement assets, particularly when provided with appropriate private sector assistance.

Second, the current familiarity of Americans with the IRA would be very important in encouraging the use of PIPs. Regardless of the type of vehicle that is eventually used for the PIP, widespread public education will be necessary, and, as noted above, the private sector has the marketing and investment education expertise to launch a successful PIP program. The education effort would be simplified if the PIP used an IRA-type vehicle, because there is widespread public familiarity with the IRA. Americans have known about IRAs for over 20 years. They are available at virtually every financial institution and have been the subject of substantial marketing efforts.

Third, a PIP structured like an IRA can offer a wide variety of investment options. This flexibility would allow each worker to structure his PIP investments in the way that best suits his particular needs. For example, a younger worker might choose to invest more

aggressively than an older worker close to retirement.

The success of the proposed PIP program depends upon its use by large numbers of American workers. We believe that the chances of success would be greatly enhanced through an IRA-type investment vehicle, which offers significant private sector marketing and education efforts, public familiarity and investment flexibility.

Conclusion

The Institute appreciates this opportunity to comment on the PIP proposal and looks forward to continuing to work with the Committee as it considers Social Security reform proposals. We believe that our industry's extensive experience with IRAs and other retirement saving vehicles will help us to identify and resolve potential problems in various legislative proposals. We look forward to continuing to work with the Subcommittee and its staff. Efforts to convert our current pay-as-you-go system to a wholly or partially funded system raise a number of difficult but significant transition issues. These issues will be important to older workers who may rely primarily on our existing system, because they will not have had sufficient time to accumulate substantial amounts in a funded account. Transition issues will also be important to younger workers who could, under some circumstances, be subject to a double tax burden.

Although the resolution of these issues will be controversial, we have no choice but to deal with these problems. We commend Senators Simpson and Kerrey for being willing to confront the issues. The PIP proposal recognizes the need to squarely address our saving problem--it is a major step toward enhanced retirement security.

As this Subcommittee continues to work on legislative proposals to secure adequate retirement saving for all workers, we believe that our industry's extensive experience with IRAs and other funded retirement saving vehicles will help us to identify and resolve potential problems. We look forward to continuing to work with the Subcommittee and its staff.

I would like to conclude by once again congratulating the subcommittee for its timely consideration of the PIP proposal. Adoption of this proposal would improve not only our Social Security system but our entire economy and thus the confidence of the American people in both.

Thank you again for permitting me to testify.