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A Legal and Operational Framework for the Privatization of Social Security

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EXECUTIVE SUMMARY

Gradually, we are coalescing around an understanding that the nation's retirement system needs an overhaul. Social Security, as it is currently structured, creates no property rights and builds no pool of national wealth. It is a combined taxation scheme and welfare scheme, with the taxation and welfare elements of the system largely unrelated to each other. In this paper we frame the broad outlines of a investment-based social security program that in our opinion best addresses, balances, and harmonizes the desire of the libertarian that there be reduced state regulation and the desire of the statist that government have a role in mitigating risks associated with market forces and human behavior.

One objective of a new investment-based system should be to minimize the potential for legal challenges. It should be grounded in some combination of the Tax and General Welfare powers of Congress. We propose a system with 6 key players: **PRA Owners, Employers, Private Financial Service Providers (PFSPs), PRA Administrators, a National Clearinghouse (NC), and a Final Regulatory Authority (FRA).** The National Clearinghouse is a quasi-self-regulating body similar to the NASD or DTCC. The objective of a government regulatory structure is to ensure the safety and integrity of the national retirement system. Accountants and attorneys develop systems that rely on monitoring. Economists prefer systems that minimize compliance costs and are self-regulating. "Self-regulation" is not a code phrase for "no regulation". Self-regulating systems achieve their objectives with lower economic and social costs. The National Clearinghouse regulates the system and provides a pooled-fund "default" investment vehicle for small accounts that minimizes employer involvement. PFSPs should be free to develop alternative operational models that meet the regulatory requirements of the National Clearninghouse. A competitive market system will evolve the most efficient models.

Taxation: There are three "levels" in the system that are subject to taxation: (1) Contributions, (2) Investment accumulations, and (3) Distributions. Notating each level as L1, L2, and L3, and either taxed (T) or exempt (E), we can choose any combination of system

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from TTT to EEE. We argue for an EEE system based on: administrative and transactions cost efficiency, marginal costs/ benefits, tax equity considerations, avoidance of perverse incentives, and transition cost minimization.

Retirement Age: Rather than think of a "Social Security" system in terms of preparing for "retirement" from the workforce, we need to shift our thinking to view the system as a means of lifting individuals to a""hold harmless" level of personal wealth that eliminates moral hazard. Allow individuals who have reached""hold harmless" status to access their "retirement" accounts according to certain rules that protect basic fund balances.

Spendthrift and Assignability Issues: One element of law that will evolve around PRA accounts will be provisions to protect account assets from irrational behavior and predation. Spendthrift and assignability-limitation provisions do that. The law must include an air-tight PRA anti-alienation requirement. Equally crucial is protection against account owners assigning their property rights to others.

Marriage and Divorce Provisions: One of the thorniest issues for a new system is how it handles marriage and divorce. We propose that individuals in any relationship legally defined as "marriage" by any state be required to form a "marriage" PRA account. The requirement is important to avoid a non-earning spouse being left without assets and to minimize litigation. Married couples would not be permitted separate accounts during their marriage. When a marriage dissolves, both members of the marriage partnership revert to "individual rules" for asset accumulation. The community assets of the marriage account are equally divided and added to the partner's individual PRA accounts. We propose a number of detailed rules for such accounts to minimize administrative and litigation expenses.

INTRODUCTION

Gradually, we are coalescing around an understanding that the nation's retirement system needs an overhaul. Social Security, as it is currently structured, creates no property rights and builds no pool of national wealth. It is, rather, a combined taxation scheme and welfare scheme, with the taxation and welfare elements of the system largely unrelated to each other. Given the Ponzi-like nature of the system, it is probable that sooner or later Social Security will be transformed into an investment-based system, citizens will enjoy property rights to their own accounts, and real wealth will accumulate to the benefit of all levels of our society. But what form will a privatized social security system take? Will the legal and regulatory structure that sustains a system of individual accounts look, for instance, more like the one that supports 401(k) Plans, or more like that which supports IRA's?

These questions, and others like them, are beginning to be asked. The focus of the debate, in fact, is very likely about to shift: away from questions of whether and when to discussions of how and how much. What is to be the legal, regulatory, and operational framework of a national investment-based Social Security system? Just how will funds flow from individuals into the system, who will run it, which government entities and private-sector institutions will be involved and how will they interact, to what extent will funds be taxed, who will write and enforce regulations, and what will be the legal and operational details of the system?

Getting from here to there will mean treading a perilous path through armies of accountants and attorneys who are

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going to try to regulate the new system into oblivion. What is more, the manner in which the basic law is framed constitutionally and the fundamental structure of the system that is created will be critical to its success or failure. It is time, we believe, to start paying attention to some of the details of the plan that is likely to emerge from the political process ahead of us.

In this paper we frame the broad outlines of an investment-based Social Security program that in our opinion best addresses, balances, and harmonizes the desire of the libertarian that there be reduced state regulation and the desire of the statist that government have a role in mitigating risks associated with market forces and human behavior. We start with a fundamental question: What is the constitutional basis for an investment-based Social Security system? The core of our proposal is something we call the Private Retirement Account or PRA. The reader will see that the PRA is closer to the IRA model than the 401(k) model. We then propose a fundamental regulatory structure that is designed to protect the system, minimize costs and maximize flexibility and innovation. Finally, we address several specific system elements that are critical to operational success: start-up funds-flow procedures, limits on investment discretion, marriage-and-divorce provisions, "hold harmless" status and the age of "retirement", taxation of contributions and disbursements, and assignability and spendthrift provisions.

I. CONSTITUTIONALITY

Congress may not institute a national forced savings program without the authority to do so, and that authority must come from the U.S. Constitution. If Congress has such authority, it is likely to be found in its power to tax (Art. 1, §8), its power to provide for the general welfare (Art. 1, §8), or its power to regulate commerce among the several states (Art. 1, §8). Of these three options, the least palatable choice is probably the third (Commerce). Opponents of a national forced savings program are most likely to argue that the Commerce clause is not sufficiently elastic to accommodate such a scheme, i.e., that such a scheme is the province of the states (Amend. X). They might also argue that it violates the Takings clause (Amend. V) in that the PRA owner's equitable or beneficial property interest in the principal, i.e. the use of that principal, has been taken by the state without just compensation during the period of employment. What is more, grounding a new system in the Commerce clause could lose the philosophical support of some of its strongest potential advocates. Libertarians and conservatives would not want to be put in the position of having to advocate a further expansion of the reach of the Commerce clause.[1]

Grounding any new law in some combination of the Tax and General Welfare powers of Congress makes good sense for several reasons. It is settled law that the Social Security program as it currently exists, for instance, is constitutional, because it is actually two legally unrelated regimes: one involving taxation and the other involving welfare appropriations.[2] They are so autonomous, that it is likely that Congress would have the authority to abolish the welfare appropriations provisions of the Social Security Act while leaving intact the taxation provisions.[3]

If a new investment-based retirement system utilizing Personal Retirement Accounts is to be constitutionally bullet proof, it should be established as an incident of Congress' power to tax and stay within current practice and precedent. Accordingly, we suggest that it "borrow" from the traditional IRA model and incorporate that model by amendment into the existing taxation provisions of the Social Security Act. The worker would be given a choice: he and his employer could

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The system must assure that all employers and participants have access to the program, regardless of the size or value.

pay the Social Security income and excise tax, or he and his employer could transfer to a PRA an amount of pre-tax income equivalent in value to what otherwise would go to the Treasury as Social Security tax payments. In theory, Congress would have the authority to terminate altogether the welfare appropriations provisions of the Social Security Act. Presumably, however, it would begin the process of cutting back or eliminating the PRA owner's right to Social Security welfare payments.[4]

II. A PROPOSED OPERATIONAL SYSTEM

An investment-based Social Security system is in many ways inevitably going to occupy a unique middle ground in the range of government-sponsored and private pension and retirement programs that form the panoply of current systems available to American workers. On the one hand, the new system will primarily be designed as a "Defined Contribution" (DC) system that both mandates and limits contributions, but leaves to market forces the exact accumulations and benefits available to individual participants. On the other hand, it is politically probable that the system that emerges will include some minimum level of support that will be guaranteed by the government (thus taxpayers). That guarantee produces something like a minimum Defined Benefit (DB), and creates a number of interesting and complex economic and legal issues.[5]

Operational systems for a national retirement program will be critical to its success, as there will be literally millions of accounts to be created and administered, with hundreds of millions of individual contributions flowing into the system each year. Employees will generate, sometimes, single paychecks from a short-term employment contract that produce contributions measured in cents that must find their way into cumulative balances credited to that individual's account. Unlike Social Security, which merely taxes employers and employees in the aggregate and waits until year-end to sort out who paid how much, the new system must somehow credit individual accounts and allow participants to start earning a return on their contributions virtually immediately. And, the system must assure that all employers and participants have access to the program, regardless of the size or value (to the administrator) of the management contract.

The operational plan we envision includes the following key players, each with an essential role to play:

1). **PRA Owner:** The PRA Owner is the essential, and central, legal player in the system. This is an important concept: that the PRA Owner maintains at all times property rights to his or her account balances, is responsible for certain elements of investment direction, and makes personal decisions regarding when to access account balances once threshold values have been achieved. In this sense, the PRA is much more like an IRA than a 401(k) or 403(b) plan. In the PRA world, in fact, there is no *plan* in the ERISA sense.[6] There are simply millions of individual accounts under the direction of individual account owners, restricted in their choices only in order to optimize the achievement of system-wide objectives.[7]

2). **Employer:** Employers continue to play an important role in the new, investment-based Social Security system. They are the middlemen in the cash flow process, just as they are now. In fact, that role will probably need to be somewhat enhanced by the increased data-transmission requirements necessary for an investment-based system.[8] But, the employer is *not* in any sense a "Plan Administrator (as ERISA uses the term), and has no fiduciary responsibility for account balances or account management.

3). **The Private Financial Services Provider** (PFSP) is an institution that offers PRA investment account services. Every employee must either choose a PFSP or (see below) participate in a National Clearinghouse “pooled fund”, and any employee is free to move to another PFSP at any time. The PFSP provides a series of investment vehicles that are designed to meet system requirements (see below) and that provide a range of investment choices to PRA owners. The PFSP is not a trustee of the mutual fund participations, and has no contractual rights in the bank accounts, the insurance contracts or mutual fund balances that are being managed on behalf of the PRA owner. The PFSP is acting, through its agent, much as an IRA-type custodian.

4). **PRA Administrator:** The PRA Administrator is an agent of and works for the PFSP. The PFSP itself may serve as PRA Administrator, i.e. it need not contract with and act through agents. “Administration” in this context should be clearly distinguished from the ERISA role of “plan administrator”. The term as used here merely connotes a provider of financial administrative services for PRA owners through their employers. The PRA Administrator handles asset custody and transfer; record-keeping and accounting; customer contact; and documentation storage, all according to procedures and regulations promulgated and enforced by a National Clearinghouse. The PRA Administrator is an agent of the PFSP, and as such the choice of PRA Administrator is made by the PFSP, which must be able to work efficiently with the Administrator for a smooth cash flow process. The PRA Administrator issues an order to an employer to pay withheld funds to that Administrator when an employee has chosen a PFSP that handles funds transfers through that Administrator.

5). **National Clearinghouse (NC):** All PFSPs, PRA Administrators, and individual account representatives must belong to a National Clearinghouse. A National Clearinghouse is a private corporation or trust, licensed by the Final Regulatory Authority (FRA) to oversee PRA services and provide common operational functions that are necessary to an integral system. Specifically, the NC:

a) Sets standards for and licensure of PFSPs, PRA Administrators, and their agents and representatives. This could include setting minimum capital requirements for PFSPs and PRA Administrators.
b) Sets asset allocation and portfolio diversification standards for approved PFSP funds.
c) Approves PFSP-sponsored funds as meeting NC asset allocation and portfolio diversification requirements.
d) Approves life annuity products for PRA owners who have reached “hold harmless” threshold values.
e) Defines administrative and marketing expenses and sets maximum expense ratio standards for PFSPs.[9]
f) Approves cash flow and participant contribution systems offered by PRA Administrators.
g) Provides a low-cost forum for dispute resolution.
h) Provides a mechanism for the easy electronic transfer, rollover, and/or aggregation of small accounts as employees move from employer to employer.
i) Maintains a pooled-asset fund into which PRA Administrators may pay PRA contributions until balances reach a threshold level making them economically attractive as customer accounts. This pooled-asset fund is

essential to the smooth operation of the entire system, as it is the "default" investment for most small accounts and the primary means by which employers are relieved of the burden and the responsibility of ERISA-type""plan administration".

6). **Final Regulatory Authority (FRA):** Some agency of the Federal government with final regulatory authority. This agency licenses a National Clearinghouse, sets broad policy objectives and standards for the system, is a court of final appeal for NC dispute resolution, and has final authority over and responsibility for the fiscal integrity of the system. On behalf of the taxpayers, this agency also reviews National Clearinghouse asset allocation and portfolio diversification standards for investment vehicles such that the system both avoids asset substitution problems and minimizes poor-portfolio-performance problems (this by determining maximum allowable statistical limits for the expected number of system participants falling into the system "safety net.)[10]

The Role of the National Clearinghouses (NC)

The National Clearinghouses (NCs) are arguably the most unique element of the proposed PRA operational system design. These bodies, licensed by the Final Regulatory Authority, share regulatory responsibility with that Authority, and exercise that authority under the guidance of, and with the final approval of, that Authority.

The argument in support of such a quasi-self-regulatory system is made below, and we believe it is compelling. But because the role of the NC is central to the operational plan we envision, it is appropriate to first detail more fully why this institution is operationally necessary to the system.

First, we must appreciate the magnitude of the task that will confront the new Social Security program, and the problems inherent in the mandate of universal employee participation. As Shipman has detailed, the current cash flow system utilized by Social Security takes up to 18 months to allow individual employee contribution data to catch up to the aggregate cash flows submitted periodically by employers.[11] This process works sufficiently for a system that maintains no property rights to individual accounts and for which individual returns on investment are irrelevant. But a PRA system depends on intricate record-keeping and crediting of returns, and it becomes essential not to impose lost-opportunity costs on PRA owners by delaying either accounting recognition of their contributions or, more importantly, actual investment of their balances in wealth-producing vehicles.

Couple this task with the reality of millions of small employers with just a few employees. Initial account balances will for some start with just a few cents to be contributed, invested and administered. All employees will be mandated to find a PFSP, but which PFSP is likely to offer its services to an employee with small account balances that generate little fee income? Eventually, most people's individual balances will reach a level where it is a profitable activity to administer them, and it is tempting to say simply that market forces will provide some PFSP who will invest the carrying costs now to benefit from profitable account administration later. But that answer ignores that 1) Individual employees would often be unmotivated to seek out PFSPs, or to make choices among competing PFSPs when a choice is offered, 2) They often do not have the information to make such decisions intelligently, even when they are motivated and 3) Employers will be mandated to send the withheld funds' *somewhere* and must have a default recipient for the funds if they (the employers) are not to make investment-direction decisions for their employees.[12] In order for our new national system to be successful, there must be an assurance that no one will be left out.

In the final analysis, there are only two ways to pay for the carrying costs of small-account maintenance. Either there must be some form of "cross subsidy" from larger accounts to smaller accounts, or the taxpayers, through the Federal government, must pay the costs of small-account administration. The latter solution is, we believe, appropriate only as a last-choice default should no private system emerge from the structure we propose (see below). But before resorting to a Federal system, we believe it is preferable to allow private organizations to come into existence with their own solution to the problem. These are what we have termed the National Clearinghouses.[13]

A National Clearinghouse must in some manner provide a mechanism whereby all contributions are moved into interest-bearing or other investment vehicles with a minimum of delay. Shipman's suggestion of a three-level system, for instance, is a logical one: The first level would move capital into a pooled money-market fund that "holds" the contributions and bears interest until such time as individual contribution information""catches up" with the aggregate contribution. Once the individual contribution data catches up, the contribution (plus accumulated proportional interest) is moved from the pooled money market fund into either a (level 2) pooled balanced fund vehicle (for PRA owners whose account balances haven't yet reached profitable-administration-threshold values), or into (level 3) individual account balances of the PFSPs (for those who have). PFSPs are free to "mine" the pooled-fund accounts and offer services to pooled-fund balance holders at any time, each PFSP determining for itself the lower-threshold limits of profitability.[14]

Since all PFSPs and PRA Administrators must be a member of a National Clearinghouse, fees paid for membership would support the work of the NC and the administrative costs of pooled-fund maintenance. In that sense, since the PFSPs are in the business of profiting from PRA investment and administration, the larger-account holders are effectively cross-subsidizing the costs of small-account maintenance. Each PFSP would be required to accept any employee who wants to utilize its services, even if that means giving that employee access to the NC's pooled fund system.

But is this the only solution to the problem of moving contributions into productive investment vehicles with a minimum of delay? Perhaps – or perhaps not. Fredrich Hayek observed that–"for some problems, there is only one best solution." But he also observed that it is a "fatal conceit" to believe that we can *design* that solution in advance. We must allow that best solution to *emerge* from a competitive process. Maybe someone has a better idea; maybe technology will provide other solutions. This need to provide for the possibility of alternative designs forms one of the fundamental justifications for allowing the emergence of competitive National Clearinghouses.[15]

III. A QUASI-SELF-REGULATORY STRUCTURE

That an investment-based social security system will be regulated by some arm of the Federal government is a certainty, and few would argue that some form of governmental oversight is not desirable. But there is regulation light and there is regulation heavy, and all the good intentions of those who have worked for the past two decades to make an investment-based system a reality could be

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What we propose is a quasi-self-regulatory system; one that balances both the role of the Federal government to safeguard and oversee the system and the role of competitive forces to minimize compliance and monitoring costs.

destroyed by a Rube Goldberg regulatory structure that imposes huge transactions and compliance costs on the system.

What we propose is a *quasi-self-regulatory system;* one that balances both the role of the Federal government to safeguard and oversee the system and the role of competitive forces to minimizes compliance and monitoring costs.

Objective of Regulation

The objective of a government regulatory structure should be to ensure the fundamental safety and integrity of the national retirement system. To the extent that regulation minimizes dishonesty, optimizes risk-taking, and minimizes the costs of compliance, it is successful. Unfortunately, the history of government regulation is generally otherwise. As Nobel-laureate James Buchanan has shown with his *Public Choice* theory, the incentives and rewards for representatives of the government are largely structured to encourage over-regulation and to reduce risk beyond optimal levels, increasing costs to both taxpayers and system participants.

And there is particular cause to be concerned about the regulatory structure that will be imposed on an investment-based retirement system, for the following reasons: (1) There will be tremendous pressure on politicians to regulate away "excessive risk taking" on the part of system participants; and (2) There are numerous private-account retirement plans already regulated by the Federal government, many of which have regulatory structures that are ill suited to this purpose.

The Wrong Model

Some have proposed adopting the 401(k) and 403(b) regulatory structure, codified in ERISA, for PRA accounts.[16] To understand why the ERISA regulatory structure is inappropriate to the task, it is necessary understand the legal context within which it has developed.

ERISA came about because of the perception that retirement plan sponsors were breaching their fiduciary duties to employees. As such, the entire focus of ERISA and its accompanying regulatory structure is to protect plan participants from either predation or incompetence on the part of plan sponsors. In the ERISA world, plan sponsors are fiduciaries for plan participants. But because plan sponsors are frequently in a position to unfairly benefit themselves at the expense of other plan participants, and because those plan sponsors make plan-wide decisions that affect all of the plan participants, it is necessary to provide some oversight mechanism that assures that those decisions are made fairly and responsibly.

But PRAs are entirely different world. There *is no plan* and neither the employer nor the PFSP are in any meaningful sense a fiduciary of the PRA owner.[17] At most, the employer and the PFSP are agents of the employee for the limited purpose of carrying out the employee's lawful directions regarding the administration of the PRA.

ERISA is an inappropriate regulatory model simply because the entire focus of ERISA's regulatory effort is unnecessary in a PRA world of individually-owned-and-managed accounts. It is of some concern to us that the ERISA model, however, may be seen as a"simple" solution to the regulatory question. The argument will go something like this: "The IRS and the Department of Labor have decades of experience regulating this sort of thing.[18] Let's just weave the PRA into the ERISA regulatory framework...Let's not re-invent the wheel." When someone objects to the unnecessary complexity of the ERISA system, the response is equally likely to be "But ERISA has simplified forms, like the 5500EZ, that can be used for PRAs".[19] But this misses the essential point. The PRA structure does not require even information returns to the IRS. Records will be kept by the PRA Administrator. The contributions are set by law and will be what they will be. The market values of investment accounts managed by the PFSPs will be what they will be based on the asset allocation and diversification standards set by the NC.[20] The employer handles the W-2s. Where is there a role for another level of reporting or oversight for which the 5500EZ was designed?

Regardless of how complex or simple one makes the ERISA structure, it is fundamentally inappropriate for a PRA which is *not a plan* and which has *no fiduciaries.* One cannot be a fiduciary for oneself. If we were to impose the ERISA regulatory structure on PRAs we would actually have to *create* plan sponsors and asset trustee analogues, a totally artificial exercise with no social utility whatsoever. It is no coincidence that IRAs are not subject to ERISA regulation.

A Quasi-Self-Regulatory Structure

Accountants and attorneys are trained in law and regulation, and tend to develop oversight systems that rely extensively on monitoring, audit and enforcement procedures for their effectiveness. Economists, on the other hand, prefer to create systems that attempt to minimize compliance costs by creating a set of internal incentives that are self-regulating. The uninitiated often assume that "self-regulation" is a code phrase for "no regulation," but that is not true. "Self-regulatory" systems are distinguished from "monitoring" systems by their objective function. Monitoring and audit systems have as their primary objective the elimination of all non-compliance, with little or no regard for the cost of securing marginal compliance. Self-regulatory systems recognize that imperfect compliance is inevitability regardless of the approach, and thus seek to minimize costs to achieve an optimal level of compliance. Neither approach in fact eliminates non-compliance, but self-regulating systems tend to achieve their objectives with lower economic and social costs.

Such self-regulatory systems are relatively rare in practice (most regulatory systems are created, after all, by attorneys and accountants, not economists). But where they have been tried, they have been extremely effective. Happily, several such systems are already in place in the securities industry and have been models of low-cost, effective self-regulation for the past seven decades; creating, implementing and enforcing a complex set of industry-wide regulations and professional licensures as well as providing secure mechanisms for securities and capital holding and transfer.

Example One: National Association of Securities Dealers (NASD): The National Association of Securities Dealers is the largest securities-industry self-regulatory organization in the United States. Through its subsidiaries, NASD develops rules and regulations; conducts regulatory reviews of members' business activities; disciplines violators; and designs, operates, and regulates securities markets and services all for the ultimate benefit and protection of the investor.

In 1938, Congress passed the Maloney Act as an extension of the Securities Act of 1934. The Securities Act of 1934 had created the Securities and Exchange Commission (SEC) as a Federal agency, and charged it with the responsibility for regulating securities markets. The

Self-regulatory systems recognize that imperfect compliance is inevitability regardless of the approach, and thus seek to minimize costs to achieve an optimal level of compliance.

Maloney Act "encouraged" the over-the-counter securities market to establish""private trade associations for self-regulation." The SEC is given authority to oversee and to change the rules of these "private associations," and such associations must be registered with and approved by the SEC. Effectively, all decisions and enforcement actions by such associations are appealable to the SEC.

The Maloney Act specifically stipulates that one *or more* associations of brokers and dealers may apply for registration with the SEC, that these groups may regulate themselves within the guidelines laid down by the SEC, and that the groups may grant discounts on securities traded among their members. To date, only one such association of dealers has registered with the SEC under the provisions of the act: The National Association of Securities Dealers (NASD). The NASD has approximately 7,000 member firms that operate over 20,000 branch offices and employ approximately 500,000 registered representatives who sell securities. The NASD has established a series of tests that must be passed by any individual wishing to join, and those tests have for all practical purposes become the admission ticket to a career in the financial services industry. The NASD has established and enforces a set of rules prohibiting fraud, manipulation, and excessive profit-taking; a uniform-practices code standardizing and expediting routine transactions, such as payments and deliveries; and a procedure for disciplining members who engage in illegal or unethical conduct.

Two elements of the NASD's status are of particular significance to our discussion here: (1) Although the NASD is the only association ever to have applied to the SEC for registration, nothing prevents another such competitive association from coming into existence. Any time the NASD fails to operate efficiently, or becomes too onerous in its regulatory structure, another such competitive organization may be formed. (2) This natural brake on regulatory zeal is counterbalanced by the oversight function of the SEC, which is there as a court of appeal and as the ultimate determinant of whether the NASD, as a registered association, is doing the regulatory job that was intended under the act and that the SEC itself considers appropriate. This constant tension between the standards and levels of enforcement that the SEC expects on the one hand, and the potential of a competitive entry into their market on the other, maintains an appropriate equilibrium level of enforcement and efficiency.

Example Two: Depository Trust and Clearing Corporation (DTCC): In September, 1999, the SEC established a new holding company, the DTCC, to combine the functions of the former Depository Trust Company (DTC) and the National Securities Clearing Corporation (NSCC). These two firms between them provide the primary infrastructure for the clearance, settlement and custody of the vast majority of equity, corporate debt and municipal bond transactions in the U.S. The DTC subsidiary, for instance, provides for the custody and safekeeping of traded securities, proxy distribution services, principal and income distribution, corporate action processing, withholding tax services, collateral loan services, delivery and payment services, sets and enforces settlement risk controls, and provides clearing and settlement links.

The DTCC, through its two subsidiaries, is the world's largest securities depository and the world's largest provider of centralized clearing services, with over 20 trillion dollars in assets. In a single year, the organization processes hundreds of millions of individual transaction entries and handles securities deliveries totaling over 70 *trillion* dollars.

Firms may choose to be "members" of the NSCC, and "membership" is open to any institution that meets DTCC standards. The DTCC itself is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code, and a "clearing agency" registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934, as amended. "Direct Participants" in the system include securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTCC is owned by a number of its Direct Participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc., and the National Association of Securities Dealers, Inc. But access to the DTCC system is also available to others such as securities brokers and dealers, banks and trust companies that clear through or maintain custodial relationship with a Direct Participant, either directly or indirectly ("Indirect Participants").

The SEC's recognition of the DTCC is an example of a quasi-self-regulating system, in that nothing in the law prevents a second organization being formed to compete with the DTCC to provide either depository or clearance services. On the other hand, the DTCC is recognized and approved for its activities by the SEC (the "Final Regulatory Authority"), which provides some assurance that the corporation acts in the best interests of the nation and securities customers at large. Once again, the natural tension between competition (or potential competition) on the one hand and Federal-agency oversight on the other produces an equilibrium level of efficiency and security that balances the concerns of both the libertarian and the statist.

Final Regulatory Authority (FRA): The SEC

One key to the effectiveness of both the NASD and the DTCC has been the ability of the SEC to set regulatory mandates and standards, but to allow both the NASD and the DTCC to develop their own processes and procedures to implement them. Elaborate attempts to develop "one size fits all" funds collection and investment systems are unlikely to be flexible enough to meet the needs of tens of thousands of employers and millions of participants with differing circumstances. Nor would such a mandated system be nimble enough to take advantage of advances in technology or systems design that cannot be foreseen.

The roles of the DTCC and of the NASD are not unique within the SEC administrative structure. The SEC is itself comprised of four Divisions.[21] The Division of Market Regulation already serves as the Final Regulatory Authority over a panoply of SROs (Self-Regulatory Organizations), including the DTCC, NASD, MSRB and others.[22] The SEC defines a SRO as "a member organization that creates and enforces rules for its members based on the federal securities laws" and is the Federal agency with the most experience in overseeing self-regulatory structures.

Combined with this SRO experience is a role in the securities markets that is already analogous to that which will be necessary to oversee a PRA operational system. The SEC's Division of Investment Management already reviews investment company and investment advisor filings, mutual funds, and "works to improve disclosure and minimize risk for investors without imposing undue costs on regulated entities."

The SEC has a long history of working with quasi-independent SROs, understands the securities markets that they already are responsible for regulating, and is we believe the appropriate Federal oversight agency to exercise Final Regulatory Authority over a new investment-based Social Security system.

IV. TAXATION OF PRA ACCOUNTS

Government, of course, rarely passes up any opportunity to assess a new tax or extend the reach of an old one, and removing any economic activity from taxation is more often viewed as taking resources from government than allowing them to be retained by their owners. We can be certain that there will be politics aplenty surrounding the question of whether, which, and to what extent PRA account balances should be taxed.

We are interested in an investment-based system that minimizes government intervention, minimizes social engineering effects, and minimizes costs both during and after transition.

For our discussion here, however, let us adhere to the fundamental principles we laid out at the beginning of the paper. We are interested in an investment-based system that, in this context, (1) Minimizes government intervention, (2) Minimizes social engineering effects, and (3) Minimizes costs both during and after transition.

Broadly speaking, there are three fundamental "levels" in the investment-based retirement system process, and PRA balances are subject to taxation at each of those three levels. We can broadly classify PRA taxation schemes according to the level at which the taxation occurs: (1) Taxation of contributions, (2) Taxation of investment accumulations, and (3) Taxation of distributions. We can further notate the total taxation approach by designating a level that is taxed "T" and a level that is not taxed that is exempt from taxation, as "E". Thus, if only one level of the system is taxed, we have the following possible system notations: TEE, ETE, EET. If all three levels are taxed, we have a TTT system.[23]

Various of the current private-account retirement options available to Americans are taxed according to different schemes. Depending on one's income level and the availability of an employer-provided qualified retirement plan, a traditional IRA is either a TET or EET. A Roth IRA is TEE. SEPs, Keoghs, 403(b)s, 401(k)s, variable annuities – each is subject to taxation at one or more levels. Ultimately, *we believe that the entire system should be exempt from taxation*. In other words, we argue for an EEE system.

Administrative Efficiency

We start with the presumption that an EEE system is the most administratively efficient alternative available. The cost of doing nothing is … nothing.[24] Any form of taxation, by whatever system, at any level will incur transactions costs to the national economy that are avoided by simply exempting the entire retirement system from taxes. Furthermore, any amount of taxation, according to any scheme, will ultimately incur economic costs by skewing capital allocation decisions and negatively affecting productive incentives.

What is more, the marginal cost of even a very little taxation of the system is very, very high; and marginal revenue, particularly from taxation of low-wage-earner accounts, is likely to be low. Additional modeling is necessary to prove this contention, but if true then marginal cost/benefit considerations are likely to weigh against taxation at any level. Regardless of whether we look at Level One (L1), Level Two (L2), or Level Three (L3), the EEE approach, that is the totally "hands off" policy, is the most economically efficient choice. The EEE approach totally eliminates the vast machinery necessary for the accounting, collections, monitoring, audit, compliance, enforcement, and regulatory processes required to impose any taxation system on

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PRAs. It also avoids overlapping authority from a tax-enforcement agency that is likely to impose rules either beyond or in conflict with those imposed by the self-regulatory agencies overseen by the SEC (see above). In fact, allowing the""camel's nose in the tent" by inviting oversight by any taxing authority at any level will almost inevitably lead to the development and imposition of onerous and complex accounting and reporting rules that violate the entire spirit and purpose of the privatization effort.

Taxing the Poor: L1 & L2

If the purpose of imposing a mandated national retirement system is to avoid the moral hazard implicit in either personal financial irresponsibility or the effects of individual destitution in old age, then it makes little sense to tax the contributions of those who are in the first place least capable to accumulating the resources necessary for their own maintenance in their senior years. No economic transaction is costless, and it is clearly less economically efficient to tax away either contributions or accumulations to the point that low-wage-earning individuals will be unable or barely able to generate the funds necessary to reach "hold harmless" status. Anyone who fails to reach that status ultimately must fall back on the governmental "safety net", which means returning their own tax dollars to them (less transactions costs) in the form of an old-age subsidy.[25]

Taxing the Not-Poor: L1 & L2

It will be argued, of course, that taxation at either L1 or L2 will only affect the non-poor, as current exclusions and graduated tax rates will eliminate lower-income workers from the effects of taxation. Such reasoning, however, violates the financial principle of marginal analysis. At some point, some marginal group of earners will begin to be marginally taxed on their earnings. Those marginal earnings would have been available as personal savings in order to provide for their own retirement. If we tax those savings either before or after we place them within a PRA (at L1 or L2), then we are effectively voiding the benefits of the PRA system itself and retarding these individuals' ability to remove the moral hazard they potentially pose to the rest of society. Any retardation of that process ultimately increases the potential liability to other taxpayers. In other words, there is *no net benefit* to the larger taxpayer base associated with taxing PRA contributions (L1) or accumulations (L2). We either pay for their retirement by lowering taxes on their contributions and accumulations in order to allow them to build up to "hold harmless" status, or retard their ability to do so and wind up with greater marginal costs to the taxpayers who must subsidize the safety net. To do either results in an equal and offsetting potential liability to the rest of the taxpayer base.

Consider the retardive effects on asset accumulation of even a small tax on either contributions (L1) or accumulations (L2). Start with a young worker earning, say, twenty dollars/hour (approximately $41,600/year). Let's further assume that in order to reach "hold harmless" status, this worker must accumulate sufficient funds to be able to purchase a life annuity of some reasonable value relative to the poverty level. If we allow this worker to contribute, say, 4% of his earnings to his PRA ($1,664/year), he will build over 40 years an investment portfolio with a real-dollar value of $257,523.91.[26] If our worker then wants to retire and we project a life expectancy of another 40 years, he will be able to withdraw a pension of approximately $17,000 per year from his account.[27]

Now perform the same calculation, but subject our worker's contributions to 15% taxation at L1, reducing initial contributions to ($1,664 * .85) = $1414/year. The result is an accumulation of only $218,895, and an annual benefit reduced to $14,548. Even more devastating would be to subject the PRA to taxation at L2, reducing our annual growth rate to (.06 * .85) = 5.1%. The result (without L1 taxation) reduces our final balance to $205,984 and our annual benefit to $12,169. The combined effects of a 15% tax on L1 and L2 would reduce the total accumulation to just $175,037 and the annual benefit to $10,341.

Nor does it make good sense to tax the "not poor", the "not marginal", or even the wealthy at either L1 or L2. The PRA system should not be designed to facilitate the accumulation of great wealth. To the contrary, it should be purposely designed to limit the extent of either mandated or voluntary contributions to the system (see section on 'How Much Is Enough" and the negative implications of over-accumulations in PRA accounts). To the extent that we as a nation want to effect social policy and wealth redistribution through our taxation system, PRA accounts are a singularly inappropriate mechanism to effect such objectives.

Note, finally, that taxation at either L1 or L2 effectively turns the entire investment-based retirement system into little more than an enforced savings plan with lots of government rules. There is really no benefit associated with saving "inside" a PRA as opposed to saving "outside" a PRA. For many savers (particularly those with greater assets), the forced participation in the PRA will be a wealth-reducing exercise, as a portion of their income that would have been saved outside the PRA is shifted to forced savings within it, but subjected as a result to rules and restrictions and transaction costs that could have been avoided. Without the tax advantages of being able to (1) contribute untaxed dollars and (2) defer or avoid taxation on accumulations, these individuals will possibly be net losers in a mandated system.[28]

Avoiding Perverse Incentives

But what about L3? Surely there are good reasons to tax distributions, either to the PRA owner or, at death, as part of the PRA owner's estate. A strong moral argument will almost certainly be heard that these funds must not "escape taxation", and that to allow them to do so would be "unfair".

In fact, however, the exact opposite is true. That the wealthy among us do, and will continue to, bear the primary burden of income taxation is a simple fact under our current progressive tax rate structure. Exempting from taxation distributions from PRAs is unlikely to have a significant effect on that already-skewed distribution of the tax burden. For the very wealthy, in fact, PRA balances are likely to be extremely small relative to other assets and income. Allowing PRA balances to "escape" taxation is easily compensated for with minor adjustments to the progressive tax rate structure to which the remainder of their income will continue to be subject.

For low- and middle-income PRA owners, that is those workers on whose behalf the "equity" argument is likely to be made, the situation is quite the opposite. There is the very real potential of creating an "ordinary tax machine" that converts income from a status in which it would have been either lightly taxed or untaxed into a status in which it is subject to substantial taxation.

Tax planners are already aware of this effect as a result of the taxation of IRA distributions to savers. IRAs built with after-tax dollars can actually be a tax-inefficient investment vehicle for many savers. Had they invested those same after-tax dollars in an equity portfolio composed of "growth" stocks (non-dividend paying securities that experience capital gains over time), account accumulations would be untaxed until the securities were sold, and then they would be taxed at a lower capital gains rate. But when contributing those same funds to an IRA, all income within the IRA (whether from dividends, interest or capital gains) is taxed at the "ordinary" rate when it is distributed. What is more, for many middle-income individuals accumulated IRA fund balances combined with other sources of pension and retirement income mean that they are actually shifted into a *higher* marginal tax bracket on retirement than they were in during their early or middle-age income years.

The same will be true for many PRA contributors who in their early years many be subject to no or low marginal tax rates, but who build substantial account balances before retirement (remembering, too, that income quintiles are not static. Many, many people who start their earning years in the lowest earning quintiles end them in the upper income ranges). For these individuals, a perverse effect of the PRA system that taxes at L3 would be to reduce their retirement wealth.

A further complication arises if we choose a TET, ETT, TEE, or ETE system. If either contributions or accumulations are taxed on a differential basis than distributions, a dual-balance phenomenon arises that immensely complicates distribution planning and again invites armies of accounts and regulators into the system to play. That problem exists now, for instance, when calculating distribution benefits for variable annuities. Since investments to the variable accounts are made with after-tax dollars, but investment income accrues tax-deferred, all account balances must be disaggregated into their "taxed" and "untaxed" components. Complex distribution rules govern how much of each distribution is composed of pretax vs. post-tax dollars so that some level of taxation can be applied to the portion of the distribution that has not yet been taxed. Similarly, basis calculations for bequests are immensely complicated by the mixed-tax structure of the account balances.

Finally, should distributions be taxed at death?[29] (Should we call this L4?) The national debate over a "death tax" is currently underway, and many of the same arguments being brought to bear in that debate will apply here as well. "Death taxes" create perverse incentives to irrationally consume, create very large transactions and administrative costs of avoidance, and particularly punish the very poor who have few means now of accumulating wealth and transferring it to future generations.[30] This last observation is a particularly poignant one. The very poor, by definition, are those most likely to pose a moral hazard in old age, and PRA balances are likely to be their major asset at the end of their lives. Taxing away those assets denies the least among us the opportunity to build intergenerational wealth that has the potential to lift their progeny out of poverty and into a higher standard of living, removing in turn a next generation's moral hazard.

Taxes and Transition Cost Minimization[31]

Although it would require detailed scoring to determine the exact economic effects to be anticipated, we suspect that the low-cost projection for EEE tax treatment of an investment-based system may extend beyond the (somewhat obvious) implications for individuals and tax preparation and monitoring costs to include costs to the national economy for overall retirement liability as well. This observation is far from intuitive, however, and will necessitate some more sophisticated economic analysis to test.

What we are suggesting is that there is a trade-off between the amount of "bridge" financing needed during a transition to an investment-based system, and the timing associated with various individuals reaching a requisite "replacement rate" for their Social Security benefits. However the new system is structured, and however the transition process is devised, it is most likely that millions of individuals will find themselves "on the cusp" between a clear benefit associated with moving to the new system and a clear preference for retaining their rights to Social Security benefits. In general, the sooner an individual accumulates enough wealth to reach the predetermined "replacement rate" for what would have been his or her Social Security benefits, the sooner the government's obligation to that individual ends.

Assuming that the government finances the transition with debt, then debt service as an explicit cost is reduced.[32] It is a legitimate economic issue whether if, in present value terms, the debt service saving is greater or lesser than the loss of tax revenue caused by the contribution being pre-tax versus after tax. This is an empirical question that deserves study and further thoughtful inquiry. Assume for the moment, however, that they are offsetting effects; that is, that the bridge financing gain equals precisely the pre-tax contribution loss. In such a case, it is probable that the result is still a net gain to the system as more people make the decision to move to the market-based structure as a result of the ability to contribute pre-tax dollars to it.[33]

Surely we already have enough complexity in our tax system and don't need to add more? We vote for EEE.

V. QUESTIONS AND SUBSIDIARY ISSUES

Q: What if no one forms a National Clearinghouse (NC)?

A: The question, while well meaning, is really a naive one in terms of how the SEC works in relation to the securities industry. If the SEC is charged as the Final Regulatory Authority, the Commissioner will take a leadership role in organizing elements of the securities industry to form an initial National Clearinghouse. The important element of the system is that which allows additional, competitive Clearinghouses to come into existence. It is the existence, or the potential, of such competitive systems that creates the balance between government's tendency towards regulatory overreach vs. appropriate oversight.

Q: Are PFSPs required to accept all employees who want to join their system?

No. PFSPs may "mine" the National Clearinghouse "pooled fund" for any customers to whom they want to offer services, and it is anticipated that a variety of alternative investment vehicles (within the regulatory limits) will be developed to appeal to employees. But PFSPs are free to se their own criteria for accepting PRA account management.

Q: When could PRA owners access their accounts and take distributions?

It is curious that one consistent feature of almost every investment-based retirement system that has yet been introduced in Congress or proposed by reformers is an assumption that the government should decide when it is appropriate for an individual to remove him or herself from the workforce. Most commonly, the age 59.5 has become the touchstone. The provenance of that age is unknown to these authors, but there can in any case be no rational economic justification for choosing it or any other fixed point in time.

Let us remember that the only economic purpose of a national retirement system is to limit the social liability associated with people not saving sufficient resources for their own old-age maintenance, thereby imposing a moral hazard on the rest of the population. Once a person has accumulated sufficient resources to indemnify others against this hazard, why not let an individual choose the timing of his exit from the workforce? For that matter, *why do we assume that the decision to begin drawing on one's accumulated assets is the same decision as that to exit the workforce?* It is time to retire the word "retire" from our

The only economic purpose of a national retirement system is to limit the social liability associated with people not saving sufficient resources for their own old-age maintenance, thereby imposing a moral hazard on the rest of the population.

vocabulary as we refer to an investment-based Social Security system. We suggest referring to meeting "threshold requirements" for "hold harmless" status thereby affording individuals the luxury of making life style choices independent of the need to assure a minimum standard of living.[34] This converts the Social Security system into a "wealth-specific" rather than an "age specific" system, where the trigger for account access is the amount of wealth accumulated rather than any specific chronological age.[35]

The object of the system should be to raise everyone in it at some point to a level of personal wealth that is capable of providing a lifetime income sufficient to meet minimum living standards, thus removing from others the implied obligation to care for them. The "Hold Harmless" threshold should be the test that determines whether an individual may have access to his or her account balances. Borden has suggested, for instance, that PRA fund distribution options could be available under three options:

1) A 100 percent payout to purchase a minimum-wage life annuity from the private insurance industry. Annuitization requirements and regulations would be set by the SEC-licensed self-regulatory associations governing the PRA industry (the National Clearinghouse).

2) Withdrawals as desired with only one constraint: the amount remaining in the account after withdrawal must always be at least 110 percent of the amount necessary to purchase a life annuity guaranteeing a minimum-wage income.

3) A combination of 1 and 2 with the purchase of a partial annuity and voluntary withdrawals up to 110 percent of the amount necessary to purchase the remaining minimum-wage annuity.[36]

For obvious reasons, the amount necessary to purchase such an annuity in the open market would vary by age and other mortality characteristics. The provision of options 2 and 3 allow, also, for higher-asset individuals to gain access to their accounts at any time without sacrificing their assets to annuitization if they prefer otherwise.

One objection that has been raised to allowing individuals to effectively choose their own access to the Social Security system is that many individuals would exit the workforce as a result, reducing economic production and lowering national wealth. This argument fails on two counts:

1) There is no way to predict whether the average person will exit the workforce earlier or later when the "retirement" and "account access" decisions are delinked. Some would doubtless exit early, but others might find the fact of financial independence to be professionally liberating, moving into a series of employment contracts by choice. And, the disincentives produced by the high marginal tax rates imposed by the retirement mandate would disappear.

2) There is no loss of economic wealth when an individual chooses to exercise a personal values choice and experience leisure. Our national economic accounting system does not record the benefit, but it is just as personally satisfying for person A to receive his utils by laying on a beach in Florida as it is for person B to continue working, receive income that is recorded in the national accounts, and in turn exchange that income for something he values.

Q: Would there be limits on contributions to PRA accounts, and if so what should those limits be?

Bearing in mind that in no case should contributions exceed the level of the social security payroll tax for the current system, the question of whether and to what extent lower limits on contributions should be placed on PRA accounts is a surprisingly complex one, and bears on issues of system and individual-account risk minimization as well as broader social policy and personal choice issues. Fundamentally, there are three broad areas of concern: 1). How much contribution is necessary in order to reasonably assure that account balances will grow to the level necessary to achieve the hold harmless threshold? 2). What are the implications of allowing contributions in excess of that level, and if such contributions are to be allowed how will they be treated? And 3). How does the system avoid "asset substitution" problems resulting from the interaction of privatized returns (ownership of PRA assets) coupled with socialized risks (DB elements of the plan that provide a "benefit floor", or "safety net" for low-income earners)?[37]

1). How Much is Enough? In order for an investment-based Social Security system to accomplish its primary objective of indemnifying the taxpaying public against financial irresponsibility on the part of others, it is necessary that a mandated level of system contributions be set sufficiently high that all wage earners, even those on the lower end of the continuum, are able to accumulate sufficient assets to sustain themselves into their non-earning years. The exact level of accumulation that will do that varies, of course, with one's assumptions about what constitutes a minimally-acceptable lifestyle. A reasonable starting point for a new Social Security system, however, is to assume that the new system must at least replace the benefits that the old one provides.[38] One way to view that level is to look at the extent to which Social Security "replaces" end-of-earning-years income in its initial benefit payment.[39] The amount itself differs by income category and age cohort, but varies from a low of 24.1% for a maximum wage earner retiring in 2030 to a high of 52.8% for a low-wage earner retiring in 2000.[40] For our purposes, we will assume a replacement rate of 42% as the target rate for an investment-based system.[41]

The level of contribution required to reach that replacement rate also depends on the rate of return one assumes for an investment portfolio, which in turn depends on the level of risk and portfolio-return assumptions one employs. It will, in our system, be up to the National Clearinghouse (overseen by the SEC) to set asset allocation and portfolio diversification standards. But for our purposes here, let us assume the following portfolio allocation: 40% Large-Cap Stocks, 20% Small-Cap Stocks, 30% Investment-Grade Corporate Bonds, 10% Government Bonds.[42] Ibbotson Associates provides the following data for nominal rates of return and annual CPI inflation between the period 1926 and 2000:

Large-Cap Stocks	11.3%
Small-Cap Stocks	12.6%
Investment-Grade Corporate Bonds	5.6%
Government Bonds	5.1%
CPI	3.1%[43]

Adjusting for inflation, then, and allocating our assets as above, an assumption that the next 75 years are going to produce economic rates of return similar to the last 75 years produces a balanced-portfolio return of $[(0.40)(.113) + (0.20)(.126) + (0.30)(.056) + (0.10)(.051)] - .031 = 6.23\%$. But – let's be conservative, and assume that the next 75 years produces a real rate of return 10% *below* that of the past 75 years, = 6.23 * 0.9 = **5.6%.**

The next projection necessary to make is that concerning the expected growth in real wages over the coming, say, 75 years or so. For our purposes, we will use a projection of 2%/year.

Our final variable necessary to calculate a mandated contribution level is an assumption about longevity. The Social Security system itself projects high, low and moderate assumptions for expected human longevity for a child born 75 years from now. The range for males is (years in retirement after leaving the workforce following reaching Social Security's minimum retirement age for benefits) from 16 – 23 years (moderate = 19.7), and for females is 19 – 25.9 years (moderate = 22.6).[44] We will use the moderate assumptions and average them for a post-distribution life expectancy of 21 years..

Using these assumptions, a simple calculation indicates that a replacement rate of 42% can be achieved with annual contributions of **4.65%** of annual earnings

2). Can an individual make "Excess" Contributions? "Excess" contributions can arise in any one of four ways, all of which should be legitimate within the system: 1). A PRA owner reaches his or her threshold for hold harmless status, but continues contributing to the account above that level. 2). A PRA owner who has reached the threshold and stopped contributing experiences higher-than-expected growth in account assets. 3). A PRA owner is allowed to make contributions in excess of those needed throughout his contribution history. 4). A PRA owner who is independently wealthy is allowed to contribute to the PRA system in spite of already having sufficient wealth to purchase hold harmless status.

We see no point in restricting PRA owners from contributing above the legally-mandated minimum contribution during the period of building assets toward "hold harmless" status. Beyond the accumulation of sufficient assets (of perhaps 110% of sufficient assets) to purchase a life "hold harmless" annuity, however, excess contributions arising from the third mechanism above should be restricted in order to avoid the utilization of the system as a means of escaping income taxation.

Q: Should it be possible for someone of sufficient wealth to "Opt Out" of the entire PRA system?

Yes. As long as an individual has purchased an approved life annuity assuring the availability of a life income stream of sufficient magnitude, they should be allowed to not pay into a PRA and retain as post-tax income what he would have contributed.

Q: Would there be spendthrift and assignability provisions for PRAs that limit the possibility of PRA owners losing their accumulated assets?

Yes. One critical element of the body of regulation and law that will evolve around PRA accounts will be those provisions that maintain a firewall protecting account assets both from irrational behavior and from predation. Irrational behavior in this context can take many forms and any regulations minimizing such behavior are necessarily an infringement of personal liberty. But it is probably true that those citizens who pose the greatest moral hazard to their fellows are highly correlated with those citizens who are both easy financial prey and who are most likely to abuse the trust of maintaining their own accounts.[45]

Spendthrift and assignability-limitation provisions are designed to prevent people from voiding through their own behavior the moral hazard protections inherent in the PRA concept. In the U.S., it has been a matter of public policy that one cannot place one's property in a trust or an agency account for one's own benefit and keep it beyond the reach of one's creditors.[46] [47] While that may be good public policy in general, its application to PRAs would void the public protections inherent in the mandated-retirement concept in the first place.

A partial precedent for removing PRAs from the usual ability of creditors and others to access trust accounts is provided by ERISA. An employee benefit plan may well include an associated trust or custodial account that serves as a receptacle for employer and employee contributions. Under ERISA, contributions and the income generated by their investment are entitled to favorable tax treatment, *provided the plan meets certain requirements*. One such requirement is that the documentation governing the trust or custodial receptacle must contain a "spendthrift" (anti-alienation) provision prohibiting the employee from anticipating, assigning, or alienating his beneficial interest. The subject property also may not be subject to attachment, garnishment, levy, execution or other legal or equitable process."[48]

In most cases, an ERISA-mandated anti-alienation provision will prevent creditors, including the trustee in bankruptcy, from reaching the debtor's interest in a tax-qualified plan, even though the associated trust would not have enjoyed protection under state law. This is because ERISA pre-empts state law.[49] In any case, ERISA affords trusts and custodial accounts associated with IRAs no spendthrift protection. Thus, federal bankruptcy law, state statutes and the common law determines whether property held by an IRA trustee or custodian is reachable by the taxpayer's creditors, including the trustee in bankruptcy.[50]

The lesson for a new investment-based PRA system is that the law must include *an air-tight PRA anti-alienation requirement*. To put it another way, the law should avoid merely incorporating by reference the ERISA precedent. Rather, it should explicitly pre-empt all state laws affording creditors access to assets held in self-settled trusts and custodial accounts, as well as require explicit language in the documentation providing for spendthrift protection. PRA assets should also be off limits to the trustee in bankruptcy.

Equally crucial is protection against an account owner knowingly or unknowingly assigning his or her property rights to others. Assets in a PRA should be *per se* unassignable. Only lawful distributions out of a PRA should become the subject of an assignment, and only then after the property has left the PRA. Consideration might even be given to subjecting a purported assignor and a purported assignee to criminal liability and criminal sanctions for directly *or indirectly* entering into an assignment of the equitable or beneficial interest in assets that are held in a PRA. Without such provisions, it is a virtual certainty that a market would develop in PRA anticipations and participations (similar to that which has developed around lottery payouts), thus negating the social benefits of the entire system.

All of this, however, can be done simply, with little actual regulatory oversight, as long as the original legislation is carefully crafted and any self-regulatory body that comes into existence to oversee plan administration is charged with the responsibility to assure compliance. If the originating legislation is itself well crafted, then the body of case law that develops around it will itself serve as a shield against abuse.

In the same vein, the trustee, custodian, and/or PRA administrator should not be saddled with any enforcement responsibilities as far as assignments are concerned. All that should be required of the trustee or custodian is that it have on file an affidavit of the PRA owner that there has been no direct or indirect assignments of the equitable or beneficial interest. A fraudulent affidavit should subject the PRA owner to severe criminal penalties, and predators seeking to fraudulently entice PRA owners into assigning their accounts should likewise be subject to severe criminal sanctions. The former, however, should be a matter between the self-regulating PRA oversight agencies, and the latter a matter for the criminal justice system. Neither should be of concern to the private PRA administrator and the private financial services provider.

Q: How will the complexities of marriage and divorce be handled by the PRA system, and how will it provide for non-earning spouses?

One of the thorniest issues for an investment-based system, and one where there exists huge potential for excessive litigation, for onerous regulation writing, for political mischief, and for palpable inequity, is in the area of how the system handles marriage and divorce. There is little need to belabor here both the inequities and the complexities of the current Social Security system in this regard. Divorce law is generally the province of the states, and is a legal quagmire everywhere. Add to this the difficulty of even defining "marriage" any more and the political repercussions of trying to do so, and the field is set for political battles unending.

Perhaps nowhere in the entire process of bring a new system into being is it more important to pay attention to the need for and benefits of simplicity and clarity in the plan's legal and regulatory structure. Attempting to regulate perfect equity and fairness into the system will almost certainly result in a cascade of further inequities and an avalanche of litigation and expense.

Whatever specific emerges from the process, it must address to some extent these fundamental issues:

1) What manner of domestic partnerships will be recognized by the system?

2) What body of law adjudicated at what level of government will apply to the system?

3) What rights do non-contributing partners have to a contributing partner's account balances in the case of death or separation.

4) How will partnership ownership of account balances affect determinations of "hold harmless" status regarding moral hazards and distribution options available to account owners?

We might start by recognizing that there are *no* simple answers to these questions. Keeping that in mind, however, we offer the following approach.

Recognizing that our objectives are simplicity and clarity, not the making of social policy; and further recognizing the importance of maximizing personal choice, we propose that individuals in any relationship that is legally defined by and recognized under state law as a "marriage" be required to make contributions to a "marriage" PRA while in that relationship. Such contributions shall be deemed to be community property. Each partner's 50% interest in a marriage PRA (including any increase in market value of the property and any income thrown off by the property) may not be disclaimed, renounced, assigned or made the subject of antenuptial agreements and/or equitable division incident to divorce. These state-imposed

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protections are important in order to avoid the moral hazard associated with a non-earning spouse being left in the cold as a ward of the state, and also to minimize litigation resulting from separation. Married couples would each contribute to the joint marriage account and would not be permitted to maintain separate accounts during their marriage.

We further propose that all matters pertaining to the ownership, disposition, and bequethal of PRA assets be federalized and removed from the state courts and all divorce or partnership case law or proceedings.[51] We then further recommend that:

(1) A person while unmarried shall make his or her contribution to an individual PRA. Property held in an individual PRA also may not be disclaimed, renounced, assigned or made the subject of antenuptial agreements and/or equitable division. Each married partner, before, during, and after a marriage, shall at all times have sole discretion over and property rights to his or her individual PRA.

(2) At the time a PRA account is established, the participant, whether or not married, will be required to file with the PRA administrator an "Affidavit of Marital Status." The participant has the responsibility of filing an amended affidavit each time there is a change of marital status, and failure to file within the time period prescribed causes the affidavit to be deemed fraudulent. The PRA administrator may rely on the marital status information contained in an Affidavit of Marital Status whether or not it has actual notice that the affidavit is fraudulent. Finally, the law should provide a""grace period" commencing at the time a participant marries during which continuing contributions to his or her pre-existing individual PRA account are permitted and will not be deemed community property. Failure to file an amended Affidavit of Marital Status and to establish a marriage PRA before the grace period expires subjects the participant to criminal penalties.

It bears explaining that the Affidavit is essential to the marriage provisions of the PRA system because it is the mechanism that allows the system to be "self-regulating". Without the Affidavit requirement, some oversight, monitoring or audit mechanism will have to be in place. With it, the fraud statutes and criminal law system serve as a *post hoc* self-regulatory mechanism.

(3) Only one spouse need file an amended Affidavit of Marital Status, provided a duly authenticated copy of the marriage certificate or divorce decree is affixed to the amending document. In the case of marriage, receipt by the PRA administrator will automatically trigger the creation of a marriage PRA. In the case of divorce, receipt will automatically trigger a termination and 50% division of the assets in the marriage PRA.

(4) With respect to a marriage PRA, investment discretion should reside jointly in the marriage partners and all investment directions should be in writing and signed by both partners. The administrator of a marriage PRA who does not have in its files an investment direction that is duly signed by both partners should park the assets of the PRA in a default commingled investment vehicle that is operated by the private financial services provider and that meets the specifications of our self-regulating agency.

(5) For PRA purposes, a marriage may only be terminated by death or by a final and legally binding divorce decree issued by a state court as evidenced by appropriate documentation.

(6) Upon the termination of a marriage by the death of a spouse, the balance of the assets in the marriage PRA account shall be distributed as follows: 50% into the surviving spouse's individual PRA and the other 50% in accordance with the terms of a duly executed beneficiary designation form that shall be effective notwithstanding the laws of wills and agency of the various states. [52]

(7) Determination of eligibility for "hold harmless" status (see "Retirement Age" above) should be made for each individual within a marriage separately. For such determination, half the value of the marriage IRA is at all times available as a "virtual balance" in a marriage partner's individual IRA. For PRA purposes, a marriage will only be recognized if it is sanctioned by state law and evidenced by documentation issued by a state or its instrumentalities. No implied marriage or other partnerships will be recognized, regardless of living circumstances or verbal commitments. Finally, except as otherwise provided, federal law shall pre-empt state law in matters pertaining to the establishment, administration, and termination of PRA accounts.

VI. CONCLUSION

The Social Security system was designed almost 70 years ago, when our understanding of financial economic principles was still in its infancy. In those 70 years, we have learned much about how financial markets work, the nature and management of risk, and the intergenerational economic effects of public retirement financing. The social and economic landscape of America in the twenty-first century bears little relationship to that of the America of the 1930's. We are a nation of great wealth, with broad public participation in our financial markets, and with extreme social and economic fluidity. The last 70 years have seen a huge increase in the scope and power of the Federal government, and at the same time have educated us about the limits of government and the essential wealth-creating role of private markets. And we have experimented with a variety of voluntary personal-retirement vehicles [401(k)s, 403(b)s, SEPs, IRAs, Roths, Keoghs] that have been proving grounds for the legal and regulatory structures that are most efficient. It is time now to learn from those years, and to reengineer our nation's retirement system to be consistent with a more mature view of how private financial markets work.

ENDNOTES

[1] It is not entirely clear that the Rehnquist court would allow it to moor there. *See United States v. Lopez*, 514 U.S. 549 (1995).

[2] See *Helvering v. Davis*, 301 U.S. 619 (1937); *Flemming v. Nestor*, 363 U.S. 603 (1960).

[3] *See* Oral Arguments in *Helvering v. Davis*.

[4] The provision of a "claw back" in current parlance: the proportional reduction in expected Social Security benefits in response to the redirection of some portion of current FICA tax payments.

[5] Among them, the question of "Who speaks for taxpayers?" in the system. If individuals largely direct their own investments, and if PRA owners are allowed to invest in any manner of portfolio, there will be a strong tendency toward" "asset substitution": The preference for high-risk, high-potential-return assets for individuals whose account balances are at or near the minimum levels necessary to merely replace the "benefit floor" that a national safety net implies (the DB portion of the system). Unlike an IRA, therefore, there must be some role for some entity at some level to protect the interests of taxpayers and their potential liability.

[6] Employee Retirement Income Security Act.

[7] Minimization of the moral hazard associated with individuals reaching retirement age with no source of long-term support.

[8] Consider, for instance, the simple fact that employers do not now transfer FICA funds to the government with individual account balance data. Rather, employers simply pay their required FICA tax in a lump sum. The government has no idea whose tax, that is which employee's tax, is actually being paid until after the end of the calendar year, when W-2 forms are submitted with employee detail that must be reconciled with the FICA cash transfers for the previous year. An investment-based system must provide more detail if individual account balances are to be updated and invested according to the owners ' directions. But – the choice of PFSP and the direction of the account must remain firmly in the hands of the PRA owner. The employer's role, while critical, is limited to simply paying withheld funds to the appropriate agency.

[9] Defining the terms is probably more important than setting limits, as competitive forces should probably suffice for most circumstances. However, it is probably necessary to set outside boundaries on these amounts in order to avoid the worst cases of PRA participant fraud and abuse.

[10] "Asset Substitution" refers to the tendency of organizations and individuals facing financial distress to substitute more risky assets for less risky assets. If a "safety net" provides a minimum level of support, and an individual's investment portfolio is at a level that provides less, or only barely more, than that minimum level of support, then as an individual approaches retirement he will be more likely to take extreme risks with his remaining assets. Any losses consequent to the risky portfolio mix will be effectively borne by the taxpayers, as the safety net provides a minimum level of support. Any gains, however, potentially benefit the PRA owner by providing a larger-than-minimum level of support. Projections of expected portfolio value variances (based on historical returns for asset categories) can identify probabilities associated with numbers of individuals expected to achieve portfolio values at the extremes of the distribution. The FRA can then set maximum allowable probabilities for expected "safety net utilization," approve NC portfolio asset allocation on that basis, and avoid the worst cases of asset substitution.

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[11] See "Administrative Challenges Confronting Social Security Reform," a working paper published by State Street Corporation, March 22. This otherwise excellent paper is directed primarily toward proposing a cash-flow model for system participants ' contributions, but by referring generically to 401(k) plans as a "model" it may inadvertently be blessing a regulatory structure that is ill-suited to this purpose.

[12]And it is critical that employers *not* make such decisions if the new system is to avoid ERISA-style regulatory oversight and the monitoring costs such oversight entails.

[13] As we explain in a later section, there may be one or more "National Clearinghouses" that come into being. All would be licensed by the Final Regulatory Agency. The opportunity for multiple clearinghouses is essential to the quasi-self-regulatory structure we envision.

[14] In other words, they would have access to the pooled-fund participant database, and could at any time market their services to pooled-fund participants.

[15]In practice, where similar self-regulatory agencies have been created, competitive institutions have not emerged. But the *potential* of such a competitive organization is an important check on the activities of the single agency that is formed.

[16] See, "Administrative Challenges Confronting Social Security Reform," Op. Cit.

[17] A "fiduciary" is a person (e.g., an investment manager or the executor of an estate) or an organization (e.g., a bank) that is entrusted with the property of another party, and *in whose best interests the fiduciary is expected to act* when holding, investing, or otherwise utilizing that party 's property. The employer may temporarily "hold" the employer's funds for a short time between when they are earned and when they are forwarded to the PRA administrator, the PRA Administrator may likewise "hold" funds in the process of aggregating them and forwarding them either to the PFSP or to the NC pooled fund, and the PFSP of course invests the funds according to the PRA owner direction. But none of these parties is expected to make investment decisions for the PRA owner and "act in the PRA owner's best interests". Discretion over account balances, within limits, is always in the hands of the PRA owner.

[18] No thought being given to what "this sort of thing" is.

[19] The 5500EZ was designed for HR10 plan sponsors with no employees to be able to report in a simpler fashion.

[20] It is unlikely that a lot of active portfolio management will be taking place for PRA accounts. Competition is likely to take place primarily on the basis of client service and administrative costs.

[21] Division of Corporation Finance, Division of Market Regulation, Division of Investment Management, Division of Enforcement.

[22] Municipal Securities Rulemaking Board.

[23] We are aware of only two countries with a TTT system: Belgium and Australia.

[24] Economists will object that there is often a very real opportunity cost of doing nothing. The rhetorical point being made here, however, is that it costs less to administer no system than it costs to administer some system.

[25] Additional modeling here is appropriate. It is possible that a market-based system that is taxed could be more efficient than a PAYG system that is not taxed.

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[26] This is a simplistic assumption. In fact, there will be a probability distribution surrounding both accumulations and withdrawals and a range of probable outcomes.

[27] The same simplifying assumptions create even more uncertainty around this number, but the principle being addressed in the argument is unaffected by this uncertainty.

[28] Depending on the tax rules on savings outside the system.

[29] We should keep in mind that at one time IRC §2039 provided an unlimited federal estate tax exclusion for most kinds of retirement benefits. *See* Natalie B. Choate, Life and Death Plannng for Retirement Benefits 386 (3d ed.-1999). *"Then the exclusion was limited to $100,000 by TEFRA '82 and repealed by TRA '84. However a grandfather clause was included in TRA '84 for both laws; and then the Tax Reform Act of 1986 made major substantive retroactive amendments to these grandfather clauses. The retroactive '86 changes made it substantially easier to qualify for the exclusion that it was under the "original" grandfather provision in TRA '84. However, the TRA '86 amendments are so obscure that they are not even mentioned in widely used estate tax reporting services. The casual researcher may find only the strict TRA '84 grandfather rules (as embodied in IRS Temp.Reg. §20.2039-1T, 1/29/86) under which only participants who were "in pay status" and had "irrevocably elected a form of benefit by 1982 or 1984 still qualified for the exclusion. But TRA '86 simply repealed those two requirements and substituted others. Thus Temp. Reg. § 20.2039-1T is nugatory. The best explanation of this incredible tangle appears in PLR 9221030 (2/21/92)…"* Id. at 386.

[30] Raising the lower limit on inheritance and estate taxes eliminates some of this problem. Removing estate and inheritance taxes totally eliminates it.

[31] The authors are indebted to William Shipman for his contributions to this section of the article. Most of the insights presented here are his.

[32] Though it should be noted that it probably doesn't matter to the analysis how the government technically "finances" the transition, that is what specific paper instrument the government uses to make explicit its implicit liabilities. Markets have already discounted the government 's liability for future retirement benefits and the cash must be raised from somewhere either in the present or in the future.

[33] And further assuming that the new plan is structured such that, at least for some people on the cusp, such a move is an option and not a mandate.

[34] We use the term "hold harmless" in an economic, not a legal, sense. It refers to attaining a sufficient level of wealth such that one is capable of sustaining a minimally-acceptable lifestyle, thereby relieving society of any responsibility for one's care and maintenance.

[35] Moving to a wealth-specific system also eliminates system (taxpayer) liability for large, unanticipated increases in life expectancy. As life expectancies rise, the market will automatically reprice life annuity products to reflect the change.

[36] Borden, Karl, "Dismantling The Pyramid: The Why and How of Privatizing Social Security. CATO Institute, SSP # 1. August 14, 1995, pp 42.

[37] See footnote #10.

[38] If for no other reason than needing to provide a rational basis for individual system participants to choose to "switch" from paying FICA taxes for current benefits. If they are not reasonably assured of achieving at least comparable levels of support with their contributions, the rational choice will be to stay with the old system. It is probable that, at least for some marginal earners within some age range, a choice will be available.

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[39] PIA or Primary Insurance Assessment.

[40] 2001 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors and Disability Insurance Trust Funds. (Washington: Government Printing Office, March 2001), p. 185. Replacement rates at age 65 for low, average, high, and maximum earners in the year 2000 were 52.8, 39.2, 31.7, and 23.7 percent respectively. For those retiring in 2030 at age 65, the replacement rate drops across the board (except for the maximum earner) to: 49.3, 36.6, 30.2, and 24.1 percent, respectively. The replacement rate itself is a “moving target” as the current Social Security system alters mandated retirement ages, thus reducing tive rate for a comparable age. Also, low-income workers tend to have shorter life expectancies than high income workers. Since the current Social Security system provides no property rights to future expected benefits, low-income workers receive a smaller total income stream than high-income workers. This produces many bizarre results. For example, the RAND Corporation concludes that the net effect of this phenomenon is to produce a cross subsidy transferring wealth from the poor to the rich and from African-Americans to whites. Constantijn Panis and Lee Lillard, “Socioeconomic Differentials in the Return to Social Security,” RAND Corporation Working Paper No. 96-05, 1996.

[41] The 42% figure is, of course, arbitrary, but it is on the upper end of the range and can be used to illustrate the calculation necessary to determine the required contribution level. We recommend choosing a single contribution level and not trying to fine-tune an exact equivalence to prior Social Security benefits for all system participants.

[42] We will also assume that the portfolio is adequately diversified to eliminate all non-systematic risk.

[43] Stocks, Bonds, Bills, and Inflation, (Chicago: Ibbotson Associates, various years).

[44] Trustees Report, Table V.A3, p. 77.

[45]It is likely, in other words, that the same lack of financial sophistication that leads people to plan inadequately for their retirement results also in an inability to distinguish between legitimate investment advice and huckstering.

[46]Charles E. Rounds, Jr., Loring A Trustee’s Handbook (Frederick, MD: Panel, 2002). It should be noted only as a point of information that recently Alaska, Delaware, Rhode Island, and Nevada, by legislation have afforded certain self-settled trusts spendthrift protection that they would not otherwise have been afforded under common law.

[47] It should be noted only as a point of information that recently Alaska, Delaware, Rhode Island, and Nevada, by legislation have afforded certain self-settled trusts spendthrift protection that they would not otherwise have been afforded under the common law.) Ibid. 120.

[48] Ibid., 131.

[49] There is some legal confusion, however, as to whether a “self-settled” employee benefit plan established by a sole proprietor, a sole practitioner or sole shareholder” who has no employees is “ERISA-qualified ” and thus entitled to federal spendthrift protection in the bankruptcy context. ”Ibid. 134.

[50] Ibid. 135-135.

[51] What we recommend here is effectively Federal preemption of state statutes to exempt all PRAs from equitable division incident to divorce. Congress can go a long way towards making PRAs off-limits when it comes to equitable division incident to divorce. Admittedly, it can’t

prevent a state probate judge from taking the value of a PRA into account for computation purposes; but it should be possible to keep the court's hands off of the account itself.

[52] If no such form is on file, then distribution shall be in accordance with the terms of the decedent's own estate planning documents. If no such documentation is in place and/or operative then distribution shall be directly to those who would be entitled to take under the laws of intestacy if the decedent had died intestate in his last domicile, by-passing to the extent possible the decedent's estate. The PRA administrator shall determine who the deemed intestate takers are and its determination shall be final and binding on all parties. Distributions to minors may be to those who have custody of such minors. The PRA administrator shall be held legally harmless for any negligent mistakes of law with respect to the identity of deemed intestate takers and minor custodians. The PRA administrator shall be entitled to deduct its reasonable compensation from the PRA account for effecting distribut ion of PRA assets.

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